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Deductibility of Employer Contributions to Employee-Benefit Plans

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NOTE

DEDUCTIBILITY OF EMPLOYER CONTRIBUTIONS TO EMPLOYEE-BENEFIT PLANS

Since 1921 employers have been allowed immediate deductions from gross income for contributions to qualified pension and profit-sharing trusts, while the employee-beneficiaries have not been taxed until distribution of the funds contributed.[1] Especially during years of high corporate taxation this permits the employer to shift much of the burden of funding employee-benefit plans to the federal government. Further, the employee pays no income tax on his interest in the contributions made for his benefit until the decrease in income normally accompanying retirement has placed him in a lower tax bracket. Until 1942 an employee-benefit plan was entitled to these tax advantages if it was "for the exclusive benefit of some or all of [the] employees,[2]" and deductible contributions were limited in amount only by the requirement that when added to the regular salary of the beneficiary, the total could not exceed reasonable

1. 4 Mertens, The Law of Federal Income Taxation § 25.69 (1942). Since 1918 regulations have recognized that pensions were deductible as ordinary and necessary expenses. *Ibid.*

2. *E.g.,* Revenue Act of 1938, § 165(a), 52 Stat. 518 (1938).

compensation for the services rendered.[3] As the burdens of corporate and individual income taxes became more onerous, the prospect of deferring payments of compensation by use of employee-benefit plans became more attractive, especially to the highly paid who were finding increasing difficulty in saving enough to maintain their standard of living after retirement.[4] Thus arose the practice of establishing generous tax exempt employee-benefit programs, the benefits of which were limited to the executive level personnel —often including those with heavy stock holdings in the employer corporation.[5]

To correct these abuses the Revenue Act of 1942[6] required that, to be exempt, employee-benefit plans must satisfy elaborate provisions the purpose of which is to prevent discrimination in eligibility requirements or benefits in favor of "officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."[7] At present, to receive the above described favorable tax treatment, a benefit plan must satisfy the anti-discrimination provisions of Internal Revenue Code Section 165(a), and the contributions must be within the maximums permitted by Section 23(p) and must qualify as ordinary and necessary expenses within the terms of Section 23(a).[8] The difficulty of measuring an employee-benefit plan by the standards prescribed by the statute, coupled with the necessity that the employer be sure of the tax status of the plan before he commits himself under it evidently has led to a provision for advance approval of proposed plans by the Commissioner of Internal Revenue.[9]

3. See Freyburger, *Pension Plans—the Philosophy of Section 165(a)*, 22 Taxes 60 (1944).

4. See Lourie and Cutler, *Income Tax Advantages of Deferred Compensation under Qualified and Unqualified Plans*, 9 Fed. B. J. 153, 157 (1948).

5. See *e.g.*, Phillips H. Lord, 1 T. C. 286 (1942) (⅔ of the employer contributions were for the benefit of the sole shareholder of the employer); The Princess Garmet Co., P-H 1942 TC Mem. Dec. ¶ 42,639 (1942) (of the taxpayer's 300 employees, the eight benefited were all shareholders or executives); Raymond J. Moore, 45 B. T. A. 1073 (1941) (plan was for the benefit of 10 selected employees, all of whom were shareholders); 4 Mertens, The Law of Federal Income Taxation § 25.71 (Supp. 1952).

6. 56 Stat. 862 (1942).

7. Int. Rev. Code § 165(a).

8. Section 23(p) permits deductions only for contributions which constitute ordinary and necessary expenses as defined in Section 23(a) and which are made to benefit plans exempt under Section 165(a). Thus, although the latter section refers only to exemption of the income of the employees' trust, its requirements also control the right of the employer to deductions for his contributions to the trust.

9. *See* H. S. D. Co. v. Kavanagh, 191 F. 2d 831, 846 (6th Cir. 1951); Philadelphia Suburban Transp. Co. v. Smith, 105 F. Supp. 650, 651 (E.D. Pa. 1952); see 4 Mertens, The Law of Federal Income Taxation § 25.70 (Supp. 1952).

Without attempting to catalog the myriad technical rulings of narrow application that have been made in this area, this Note will examine the general principles bearing on an employer's right to deductions for his contributions to an employee-benefit[10] plan.

REQUIRED SCOPE OF COVERAGE

The abuses that would have been permitted by a literal interpretation of the provisions that an exempt benefit plan need include only "some" of the taxpayer's employees[11] led the courts, at least when faced with flagrant cases, to deny deductions for contributions; the reasoning was that the unexpressed intent of Congress had been to permit tax advantages only to plans designed to provide for the security of a large percentage of the employees.[12] In 1942, Code Section 165(a) was amended[13] to express this intent by requiring that a qualified plan benefit at least either (1) seventy per cent of the taxpayer's employees, or (2) eighty per cent of the class eligible to benefit, from which class not more than thirty per cent of all employees may be excluded, or (3) a classification which in the judgment of the Commissioner does not discriminate in favor of officers, shareholders, supervisory employees, or the highly paid. The last alternative was included to permit exclusion of large classes of employees, such as those whose total wages are subject to social security taxes and whose position is such that there is good reason for denying them the benefits of the plan.[14]

ANTI-DISCRIMINATION PROVISIONS

Prior to 1942, though the Internal Revenue Code did not expressly prohibit employee-benefit plans from discriminating in favor of shareholders-employees, if an excessive proportion of the employer's contributions accrued to the benefit of a shareholder, a

10. "Employee-benefit" plan will be used as a generic term inclusive of pension, profit-sharing, stock bonus and annuity plans, since many of the requirements of the Internal Revenue Code apply to all of these types of plans.

11. *E.g.*, Revenue Act of 1938, § 165(a), 52 Stat. 518 (1938).

12. *E.g.*, Hubbell v. CIR, 150 F. 2d 516 (6th Cir. 1945) (alternative holding) (of 350 employees, the two benefited by the plan were substantial shareholders); Harold G. Perkins, 8 T. C. 1051 (1947) (short-lived plan for benefit of four key employees out of 41,000); W. F. Parker, 38 B. T. A. 989 (1938) (81% of contributions were for benefit of majority shareholder or taxpayer). In view of the fact that Congress had rejected suggestions that a minimum scope of coverage be prescribed, see Hubbell v. CIR, *supra* at 522 and authorities cited, these interpretations of the Congressional intent behind the "some" phrase seem questionable.

13. Revenue Act of 1942, § 162, 56 Stat. 862 (1942).

14. U. S. Treas. Reg. 111, § 29.165-3 (1943); Sen. Rep. No. 1631, 77th Cong., 2d Sess. 136 (1942).

plan was denied tax advantages on the ground that it did not satisfy the requirement that it be for the exclusive benefit of the taxpayer's *employees*.[15] The only other limitation was the requirement that the payments must not constitute disguised dividends;[16] the bona fides of such pension payments depended on whether the total benefits to the employee were within the limits of reasonable compensation for the services rendered and on the extent to which the distributions were influenced by proportions of stockholdings of the recipients.[17]

The 1942 Revenue Act amended Code Section 165(a) to expressly provide that employee-benefit plans must not discriminate in favor of shareholders through eligibility requirements or variations in benefits.[18] Since it is clear that shareholder-employees may still participate in benefit plans, the problem is the extent to which they may benefit before fatal discrimination will be found. To clarify this problem the Treasury Department announced that a plan would generally not be considered discriminatory if not more than thirty per cent of the employer contributions were for the benefit of employees each of whom held ten per cent or more of the stock of the employer.[19] Subsequently, however, the Tax Court permitted a plan to qualify under Section 165(a) although more than fifty per cent of the contributions were for the benefit of the only two stockholders of the employer.[20] The court reasoned that the large contributions were legitimate results of the high salaries and advanced age of these employees and did not reflect discrimination based on shareholdings. The Commissioner's acquiescence in this ruling led to the abandonment of the "thirty per cent rule."[21]

15. W. F. Parker, 38 B. T. A. 989 (1938) (alternative holding).
16. Astorian-Budget Publishing Co., 44 B. T. A. 969 (1941).
17. See Forcum-James Co., 7 T. C. 1195 (1946); Gisholt Machine Co., 4 T. C. 699 (1945); Princess Garmet Co., P-H 1942 TC Mem. Dec. ¶ 42,639 (1942); Raymond J. Moore, 45 B. T. A. 1073 (1941).
18. Int. Rev. Code § 165(a)(3) and (4); U. S. Treas. Reg. 111, § 29.165-1 (1944).
19. I. T. 3674, 1944 Cum. Bull. 315; I. T. 3675, 1944 Cum. Bull. 316; I. T 3676, 1944 Cum. Bull. 317. The "thirty per cent rule" would have arbitrarily limited shareholder-employees' benefits even though no difference in treatment based on the fact of shareholdings existed. Such limitation depends on the premise that provision for retirement income for shareholders need not be encouraged since their security will be assured by dividend payments. See W. F. Parker, 38 B. T. A. 989, 996-997 (1938), but this premise is valid only if the corporate income is derived largely from invested capital rather than the personal services rendered by the shareholder-employees. The "thirty per cent rule" unduly penalizes a corporation owned by a small group of shareholders. See 63 Harv. L. Rev. 1071 (1950). If the stock is more widely distributed, few employees are likely to hold the proscribed ten per cent.
20. Volckening Inc., 13 T. C. 723 (1949).
21. I. T. 4020, 1950-2 Cum. Bull. 61.

The reasoning of the Tax Court in refusing to follow the thirty per cent rule could ultimately permit shareholder-employees to receive any amount of benefits required by a benefit formula that applies uniformly to all employees. However, in light of the limits of "reasonable compensation" for services rendered,[22] there appears to be little danger that any extension of this reasoning would result in excessive benefit payments to shareholders.[23]

At present, benefits under an employee benefit plan may vary in proportion to the total compensation paid to the employee,[24] and disqualification based on discrimination in favor of the highly paid will result only if the ratio of benefits to total compensation is greater for any group of employees than for another less highly paid group.[25] Increased benefits may be awarded employees for length of service, provided the result does not discriminate in favor of the highly paid.[26] However, since long periods of service often lead to pay increases, the group benefiting from the use of years-of-service factor will usually contain a disproportionate number of the highly paid. Thus, the effect of such a factor could well be a distortion of the benefits-compensation ratio in favor of the highly paid. In fact, with the passage of time a qualified plan could well be disqualified if many of the employees covered remained to take advantage of the years-of-service factor while their total compensation was increasing. To avoid this anomaly it would seem better to redefine "discrimination" in this area so that it would not exist if all employees *having equal periods of service* receive plan benefits constituting equal proportions of their total compensation.

In determining the existence of discrimination in favor of the highly paid, benefits to which an employee will be entitled under government retirement programs and under the private plan are to be considered together to arrive at the ratio between benefits and total compensation for any wage group.[27] A comparison will be made

22. See note 86 *infra* and text thereto.
23. See 63 Harv. L. Rev. 1071 (1950).
24. Int. Rev. Code § 165(a)(5); U. S. Treas. Reg. 111, § 29.165-4 (1944); Betty C. Stockvis, P-H 1951 TC Mem. Dec. ¶ 51,023 (1951); Volckening Inc., 13 T. C. 723 (1949).
25. I. T. 3678, 1944 Cum. Bull. 321; P. S. 28, P-H Pension & Profit-Sharing Serv. ¶ 9526 (1944). For administrative convenience, changes in compensation may be disregarded until great enough to produce a certain minimum effect on benefits, even though such a policy would be less likely to work to the disadvantage of the highly paid. Mim. 5677, 1944 Cum. Bull. 320.
26. U. S. Treas. Reg. 111, § 29.165-4 (1944); I. T. 3685, 1944 Cum. Bull. 324 (no discrimination); I. T. 3686, 1944 Cum. Bull. 326 (discrimination found); P. S. 28, *supra* note 25 (discrimination found).
27. U. S. Treas. Reg. 111, § 29.165-3 (1943).

not only between the amounts of periodic pension payments, but also between the values of the total anticipated payments—periodic payments multiplied by the years of life expectancy of the employees. This comparison would reveal discrimination if a private plan entailed pension payments of greater total value arising from a longer period of retirement permitted by a minimum retirement age lower than that of the related government program.[28] Wages covered by federal or state retirement insurance programs may be excluded from the benefit formula of a properly integrated private plan, or benefits based on such wages may be calculated at a reduced rate.[29] To expedite integration between the federal social security program and private benefit plans, the Treasury Department has prescribed the maximum benefits that will be offset by social security payments to those excluded from plans having various minimum wage requirements.[30]

When an employee leaves his employer before he has worked for the minimum period required by the plan to entitle him to receive any of the contributions made for his benefit, forfeitures results. The funds forfeited similarly are subject to the limitation that they must not be used so as to discriminate in favor of officers, shareholders, supervisors, or highly paid employees.[31] Such funds may apparently be used to reduce the required employer contributions.[32]

The discrimination problem also may arise when an employee-benefit plan is terminated soon after its inception. At the institution of any plan some of the employees covered will be within a few years of the retirement age, and this group is likely to include a large number of officers, supervisors, and highly paid employees. In order to effectively solve the problem of superannuation, these employees should be permitted to retire with full benefits at the normal retirement age.[33] To provide these benefits large contributions will be required for these emplyees during the relatively short period they will remain employed. Should the plan be abandoned after a short period of operation, the employees whose benefits has been rapidly funded would receive much larger benefits in

28. I. T. 3615, 1943 Cum. Bull. 477.
29. Int. Rev. Code § 165(a)(5); U. S. Treas. 111, § 29.165-4 (1944).
30. Mim. 6641, 1951-1 Cum. Bull. 41.
31. U. S. Treas. Reg. 111, § 29.165-4 (1944); P. S. 22, P-H Pension & Profit-Sharing Serv. ¶ 9520 (1944).
32. *Cf.* U. S. Treas. Reg. 111, § 29.165-1 (1944).
33. See Goldstein, *How to Amend Existing Pension and Deferred Distribution Profit-Sharing Plans to Meet Your Current Conditions,* 7th Annual Inst. on Fed. Taxation 1253, 1258 (N.Y.U. 1949).

relation to their total compensation than those whose benefits would have been funded over a long period of employment.[34]

To aid in the solution of this problem the Treasury Department has prescribed certain limits for employer contributions that it will find "generally acceptable" to preclude the possibility of discrimination on termination, if at all times the full current costs[35] of the plan have been met.[36] These limits apply to the contributions of funds that would be received by any employee in the event of his withdrawal from the plan or its termination during the first ten years of its operation, if he is among the twenty-five highest paid whose anticipated annual benefits exceed fifteen hundred dollars. The contributions limits increase in proportion to the employee's total compensation and the number of years the plan has been in operation.[37] Subsequent rulings, however, have pointed out that compliance with these limits seldom precludes discrimination but merely limits it in some cases so that such compliance will be a guarantee against disqualification only to the extent it actually prevents discrimination[38] as judged by the usual standards.[39] Since plan amendments made at the time of termination which eliminate any resulting discrimination will apparently prevent retroactive disqualification,[40] the value of complying with the limits set out by the Department seems restricted solely to the fact that it will inform the affected employees that they will not receive full benefits in the event of early termination of the plan.

Bona Fide Intention to Benefit Employees

Even though no discrimination results, early termination of a plan for any reason other than "business necessity" will constitute at least evidence that it was not intended as a bona fide plan for the

34. See Mim. 6163, 1947-1 Cum. Bull. 58.

35. "Full current cost," which means "normal cost," Mim. 5717, 1944 Cum. Bull. 321, is the amount of employer contributions that would be required as a result of each year's operation of the plan had it been in effect since the beginning of service of each covered employee and had all actuarial assumptions concerning mortality, withdrawals, etc., been fulfilled. U. S. Treas. Reg. 111, § 29.23(p)-7 (1948).

36. Mim. 5717, *supra* note 35.

37. *Ibid.* These limits do not prevent the payment of full benefits to presently retired employees, but make the continuation of such payments contingent on the continuation of the plan. P. S. 25, P-H Pension & Profit-Sharing Serv. ¶ 9523 (1944).

38. P. S. 52, P.H. Pension & Profit-Sharing Serv. ¶ 9551 (1945); *cf.* P. S. 42, P-H Pension & Profit-Sharing Serv. ¶ 9540 (1944).

39. See note 25 *supra* and text thereto.

40. Mim. 6136, 1947-1 Cum. Bull. 58.

exclusive benefit of the employees,[41] as is required.[42] A qualifying profit-sharing or stock bonus plan must not only be intended as permanent, but the amounts of employer contributions must be controlled by a formula incorporated in the plan rather than by the discretion of the employer.[43] The Treasury Department has stated[44] that it will regard any departure from the contributions formula of a profit-sharing plan as a partial termination. A suspension of contributions to a pension plan will be so regarded only if past service costs[45] rise above the level at which they stood when the plan was instituted.[46] These rulings as to termination and control of contributions reflect the reluctance of the Treasury Department to permit an employer to channel funds into a tax exempt benefit plan during periods of high profits, only to abandon the plan or reduce contributions to it when lower profits make the tax advantages less attractive.[47]

"Business necessity" as an acceptable reason for the termination or modification of a benefit plan generally consists of such circumstances as unforeseeable business conditions[48] that preclude the expenditures to support the plan.[49] A bona fide sale[50] of the business of the employer to a buyer that has its own benefit plan or, being without one, does not wish to extend a plan to all its em-

41. U. S. Treas. Reg. 111, § 29.165-1 (1944); P. S. 7, P-H Pension & Profit-Sharing Serv. ¶ 9505 (1944). This situation has also been said to raise a presumption of mala fides. P. S. 52, P-H Pension & Profit-Sharing Serv. ¶ 8551 (1945). Should capricious termination be accompanied by discriminatory operation of the plan, the strength of the evidence of mala fides increases. U. S. Treas. Reg. 111, § 29.165-1 (1944). Such evidence of mala fides was refuted by a showing that the purpose of the plan of serving in lieu of a wage increase had been frustrated by an adverse ruling of the Salary Stabilization Unit. Blume Knitwear, Inc., 9 T. C. 1179 (1947).

42. Int. Rev. Code § 165(a).

43. U. S. Treas. Reg. 111, § 29.165-1 (1944).

44. P. S. 57, P-H Pension & Profit-Sharing Serv. ¶ 9556 (1946).

45. Past service, or supplementary, cost is the amount required at any time to provide the benefits guaranteed by the plan that will not be funded by payments of normal costs; *i.e.*, those arising as a result of employment prior to the adoption of the plan. U. S. Treas. Reg. 111, § 29.23(p)-7 (1948).

46. P. S. 57, P-H Pension & Profit-Sharing Serv. ¶ 9556 (1946). Curtailment of benefits also must be justified by "business necessity." Mim. 6136, 1947-1 Cum. Bull. 58.

47. See E. R. Wagner Mfg. Co., 18 T. C. No. 76 (June 25, 1952); P. S. 7, P-H Pension & Profit-Sharing Serv. ¶ 9505 (1944).

48. P. S. 52, P-H Pension & Profit-Sharing Serv. ¶ 9551 (1945) (foreseeable drop in post-war profits not acceptable).

49. E. R. Wagner Mfg. Co., 18 T. C. No. 76 (June 25, 1952) (modification because of adverse business conditions); P. S. 7, P-H Pension & Profit-Sharing Serv. ¶ 9505 (1944) (insolvency, bankruptcy or adverse conditions); Mim. 6136, 1947-1 Cum. Bull. 58 (employees' demand for wage increase about equal to cost of plan).

50. P. S. 52, P-H Pension & Profit-Sharing Serv. ¶ 9551 (1945) (transfer to former stockholders as partners not bona fide).

ployees justifies termination of the plan without reference to "business necessity."[51] Changes of circumstances that render a plan less advantageous to management are generally not acceptable.[52]

A Treasury Regulation has defined a profit-sharing "plan" within the terms of Section 165(a) as a program "based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan. . . ."[53] A series of rulings clearly interpreted this regulation as requiring that the amounts of employer contributions be controlled by application of a predetermined formula to factors whose values are independent of the discretion of the employer.[54] And in *Lincoln Electric Co. Employees' Profit Sharing Trust*,[55] the Tax Court that a profit-sharing trust created by a single contribution of corpus in an amount determined by the discretion of the employer, and which was to be distributed within a ten year period, did not satisfy the regulation. Consistent with this, contributions in excess of those required by a profit-sharing formula have been held not deductible because they were not in pursuance of the plan,[56] and because they were not ordinary and necessary business expenses.[57]

On appeal, however, the Tax Court decision in the *Lincoln Electric* case was reversed.[58] The court of appeals concluded that the single contribution itself served as the "definite predetermined formula for determining the profits to be shared" upon which the regulation requires a profit-sharing plan to be based. Moreover, the

51. Mim. 6136, 1947-1 Cum. Bull. 58; P. S. 52, *supra* note 50.
52. Mim. 6136, *supra* note 51 (termination after reduction of excess profits taxes or immediately after amending to comply with Treasury Department insistence on elimination of discrimination in favor of executive employees—not acceptable).
53. U. S. Treas. Reg. 111, § 29.165-1 (1944).
54. Though contributions must be determined by application of a definite formula, its application may be restricted to profits exceeding a certain level, I. T. 3661, 1944 Cum. Bull. 315, and variable factors such as a graduated scale of rates may be used, provided their value does not depend on discretion. P. S. 33, P-H Pension & Profit-Sharing Serv. ¶ 9531 (1944). Profits subject to profit-sharing may be defined as net profits less such reserves as those for federal income taxes, dividends on 6% preferred stock, or current liabilities, but may not be adjusted for a reserve whose level depends on discretion, such as for dividends to be voted on a class of stock. P. S. 21, P-H Pension & Profit-Sharing Serv. ¶ 9519 (1944); *accord*, P. S. 16, P-H Pension & Profit-Sharing Serv. ¶ 9514 (1944).
55. 14 T. C. 598 (1950).
56. Wooster Rubber Co., 14 T. C. 1192 (1950), *rev'd on other grounds*, 189 F. 2d 878 (6th Cir. 1951).
57. Gross-Given Mfg. Co. v. Kelm, 99 F. Supp. 144 (D. Minn. 1951).
58. Lincoln Electric Co. Employees' Trust v. CIR, 190 F. 2d 326 (6th Cir. 1951).

court observed that if the requirements incorporated in the regulation were not satisfied by the trust under consideration, the regulation was invalid as an unjustified interpolation of the statute.[59] The apparent significance of the *Lincoln Electric* decision lies in the fact that, within the limitation that payments must not exceed compensation for the employees benefited,[60] it permits the size and timing of the employer's contributions to depend on his discretion, rather than upon independent extrinsic conditions.[61] This in turn, makes possible the realization of tax advantages through large deductible contributions only in years when high profits would otherwise be subject to high corporate taxes. An acceptable profit-sharing formula could be devised so that its application would achieve substantially the same tax advantages.[62] This would, however, require an advance determination of the level of profits to be preserved for the stockholders. Also, should the employer be presented with the possibility of another deductible expenditure not allowed for in the definition of profits subject to the profit-sharing formula,[63] he could not choose it in lieu of the profit-sharing contribution because of his commitments under the plan. If contributions to profit-sharing plans are to be left entirely to the discretion of the employer, termination or reduction of contributions for any reason will logically no longer affect the status of the program as a bona fide plan.[64] It would seem that this liberalization of treatment of profit-sharing plans would tend to an increase in their use in place of pension plans, since substantially the same benefits can be assured for both employer and employee, and the employer

59. *See id.* at 330.

60. See note 86 *infra* and text thereto.

61. The court of appeals used language that could be construed as indicating that this liberality will be accorded only if the payment is to be the initial and sole contribution to finance the plan over a period of years, see Lincoln Electric Co. Employees' Trust v. CIR, 190 F. 2d 326, 329 (6th Cir. 1951), in which case the effect of the decision will be to permit the employer to readjust the amount of his contributions only at the beginning of each period. However, on the strength of the *Lincoln Electric* case, deductions have been permitted for repeated discretionary contributions to the same plan, though the Tax Court also did not choose to expressly over-rule the regulation. Produce Reporter Co., 18 T. C. No. 8 (Apr. 10, 1952). Similarly, while holding the reduction in percentage of profits to be contributed was justified by "business necessity," the Tax Court commented that Congress had not provided that a profit-sharing plan must be permanent or include a contributions formula, and that reasonable changes in such a formula were not inconsistent with any intent of Congress. See E. R. Wagner Mfg. Co., 18 T. C. No. 76 (June 25, 1952).

62. See note 54 *supra.*

63. *Ibid.*

64. See notes 41-52 *supra* and text thereto.

could avoid the restricting requirements of a "bona fide" plan.[65] This result would conflict with the policy of seeking to encourage provision for the future security of employees,[66] since profit-sharing plans do not provide a guaranteed level of future benefits.

Nevertheless, tax advantages are the inducement Congress has offered in an effort to encourage adoption of profit-sharing plans.[67] Therefore, attacking the exempt status of such a plan on the ground that it is being used for tax avoidance by means of taking advantage of the offered deductions seems illogical. While Congress has provided that an exempt benefit plan must be for the exclusive benefit of the employees or their beneficiaries,[68] the whole tenor of the provision, as evidenced by the fact that it is devoted almost completely to preventing discriminatory distribution of funds, indicates that this requirement must refer to benefits in the form of payments from the plan.[69] If the tax advantages realized by the employer constitute "benefits" within the terms of this restriction, obviously no plan qualifies for the exemption. A maximization of these tax advantages should not affect their nature as benefits to the employer. Consistent with this reasoning, Congress has made no provision respecting the permanence of a profit-sharing plan or the adherence to a contributions formula.[70] Though there is value in encouraging the use of permanent benefit programs, the Treasury Department requirements of permanency seem inconsistent with the intent of Congress.

Limitations on the Nature and Amounts of Deductions

Deductions from gross income are permitted for employer contributions to employee-benefit plans by virtue of Internal Revenue Section 23(p).[71] But unless the plan conforms to the requirements of Section 165(a) already discussed, the deductions will be per-

65. *Ibid.*
66. See Freyburger, *Pension Plans—the Philosophy of Section 165(a),* 22 Taxes 60 (1944).
67. *See* E. R. Wagner Mfg. Co., 18 T. C. No. 76 (June 25, 1952).
68. Int. Rev. Code § 165(a).
69. The major ill for which a remedy was sought in the adoption of the more stringent requirements of the 1942 Revenue Act appears to have been the practice of distorting benefit plan payments in favor of stockholders and executive level employees. See discussion of legislative history of § 162 of the 1942 Revenue Act in 4 Mertens, The Law of Federal Income Taxation § 2571 (Supp. 1952).
70. *See* E. R. Wagner Mfg. Co., 18 T. C. No. 76 (June 25, 1952).
71. This has become the exclusive section permitting such deductions which formerly were allowed also under section 23(a), relating to ordinary and necessary expenses. *See Tavannes Watch Co. v. CIR,* 176 F. 2d 211, 214 (2d Cir. 1949).

mitted only if the employees acquire immediate non-forfeitable interests,[72] and in such case the employees will be immediately taxed on the contributions;[73] thus, the valuable privilege of delayed taxation depends on conformance with Section 165(a). As a result, employer contributions must be made to a trust whose terms affirmatively make impossible any use of the funds other than for the exclusive benefit of the employees.[74] In the case of an annuity plan, this requirement is satisfied by a provision that any premium refunds[75] be redistributed to the employees in a manner not inconsistent with Section 165(a).[76]

Deductible contributions to pension plans may be as large as necessary to finance the benefits provided by the plan by means of uniform contributions over the period of employment remaining before the retirement of each included employee.[77] Either of two alternative limitations are applicable if a more liberal maximum will result from their use. The employer may contribute annually an amount equal to five per cent of the compensation otherwise paid or accrued to the employees covered,[78] or an amount equal to the normal cost[79] of the plan for the year plus ten per cent of the cost, as of the date they were included under the plan, of any past service or supplementary credits.[80] Should contributions in any year exceed the

72. Int. Rev. Code § 23(p).
73. Int. Rev. Code § 22(b) (2) (B).
74. U. S. Treas. Reg. 111, § 29.165-2 (1943) (however, upon termination the employer may recover any surplus resulting from erroneous actuarial calculations); Mim 6394, 1949-1 Cum Bull. 118. Conditional payments are deductible if recoverable by the employer only on the contingency of disapproval of the plan under wage stabilization requirements. P. S. 68, P-H Pension & Profit-Sharing Serv. ¶ 9567 (1951).
75. "Premium refunds" means "payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits." U. S. Treas. Reg. 111, § 29.23(p)-9(c) (1948).
76. U. S. Treas. Reg. 111, § 29.(p)-9 (1948); P. S. 45, P-H Pension & Profit-Sharing Serv. 9543 (1945).
77. Int. Rev. Code § 23(p) (1) (A) (ii). There is one exception, however. Should the unfunded cost of the plan for any three employees exceed 50% of the total unfunded cost, deductions for the cost of their benefits must be spread over at least a five year period. *Ibid.*
78. Int. Code § 23(p) (1) (A) (i). This percentage may be reduced if periodic examinations of the plan by the Commissioner reveal that it is higher than reasonably required to provide the benefits. *Ibid.*
79. See definition in note 35 *supra.*
80. Int. Rev. Code § 23(p) (1) (A) (iii). See definition of past service or supplementary costs in note 45 *supra.* Contrary to the position taken by the Treasury Department, P. S. 36, P-H Pension & Profit-Sharing Serv. ¶ 9534 (1944), it has been held that the requirement of this Code section that past service credits be funded over a period of at least ten years does not prevent more rapid funding under Int. Rev. Code § 23(p) (1) (A) (ii), *if necessary to finance the benefits offered.* Philadelphia Suburban Transp. Co. v. Smith, 105 F. Supp. 650 (E.D. Pa. 1952); Saalfield Publishing Co., 11 T. C. 756 (1948).

amount deductible for that period, the excess may be deducted in succeeding years in order of time to the extent that contributions in those years are less than the maximum permissible deductions.[81] Annual deductions equal to fifteen per cent of the compensation otherwise paid the employees covered may be taken for contribution to profit-sharing plans.[82] Not only may contributions in excess of this limit be deducted in succeeding years, but if contributions in any year are less than the permissible maximum, the difference may be carried forward to increase the maximums available for succeeding years; but in no event may the deduction for any year exceed thirty per cent of the compensation otherwise paid the covered employees during that year.[83] Irrespective of the statutory maximums, contributions in excess of the amount required by the profit-sharing formula are not deductible in either the current[84] or succeeding years.[85] Contributions to any benefit plan, when added to all other compensation paid the employee for whose benefit they are made, must not exceed the level of reasonable compensation for the services rendered.[86]

81. Int. Rev. Code § 23(p)(1)(A)(iv); U. S. Treas. Reg. 111, § 29.23(p)-8 (1948).

82. Int. Rev. Code § 23(p)(1)(C). A program will be considered a pension rather than a profit-sharing plan if either the benefits to be provided or the employer contributions required can be determined actuarially rather than by the level of profits of the employer. I. T. 3660, 1944 Cum. Bull. 136; P. S. 24, P-H Pension & Profit-Sharing Serv. ¶ 9521 (1944).

83. Int. Rev. Code § 23(p)(1)(C); U. S. Treas. Reg. 111, § 29.23(p)-10 (1948).

84. Gross-Given Mfg. Co. v. Kelm, 99 F. Supp. 144 (D. Minn. 1951); Wooster Rubber Co., 14 T. C. 1192 (1950), *rev'd on other grounds*, 189 F. 2d 878 (6th Cir. 1951). The relaxation of the requirement that a profit-sharing plan include a contributions formula has perhaps lessened the significance of these cases. See notes 58-61 *supra* and text thereto.

85. I. T. 4055, 1951-2 Cum. Bull. 30.

86. U. S. Treas. Reg. 111, § 29.23(p)-1 (1948); see Acme Pie Co., P-H 1951 TC Mem. Dec. ¶ 51,029 (1951); Charles E. Smith & Sons Co., P-H 1947 TC Mem. Dec. ¶ 47,128 (1947), *aff'd*, 184 F. 2d 1011 (6th Cir. 1950), *cert. denied*, 340 U. S. 953 (1951).