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Pension Plans: The Discrimination Concept of Section 401(a)--Its Workings and Effects

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I. INTRODUCTION

An employee pension plan qualifying under section 401(a) of the Internal Revenue Code of 1954[1] provides employee remuneration with substantial tax advantages to both the employee and employer. The employee is not taxed at the time of the employer's contribution, but at subsequent distribution when he retires.[2] Under some conditions the subsequent distribution will receive capital gain treatment.[3] The employer's contribution[4] is deductible at the time of contribution, and the income from the pension trust is tax-exempt.[5] The policy underlying these provisions is the encouragement of employee retirement benefits[6] to help alleviate society's burden of supporting its senior citizens while reducing labor turnover, maintaining labor efficiency, and providing employees with a framework for a lifetime career.[7]

The Code currently provides that four requirements must be met before a plan can qualify: (1) the plan must be for the exclusive benefit of the employees;[8] (2) under the trust instrument it must be impossible, at any time before the satisfaction of all liabilities to the employees, to divert any part of the corpus or income to purposes other than the exclusive benefit of the employees;[9] (3) upon termination of the plan, the employees' rights to accrued benefits must be nonforfeitable;[10] and (4) the plan must not discriminate in favor of upper level employees.[11]

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1. The concept of a qualified pension plan was first introduced in the Revenue Act of 1921, § 219(f), 42 Stat. 227 (1921).
2. INT. REV. CODE of 1954, § 402(a)(1) [hereinafter cited by section number only].
3. To qualify as capital gain, the entire amount must be paid within one year from the employee's separation. Section 402(a)(2).
4. Section 404(a).
5. Section 501(a).
6. *See* H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942); Goldworn, *Pension Plans: Their Background, Current Trends, and an Agenda for Inquiry*, 25 OHIO ST. L.J. 234, 235-36 (1964); Goodfellow, *Tax Consequences of Pension Trusts and Employer Purchased Annuities to Employee or Beneficiary*, 39 CALIF. L. REV. 204, 204-06 (1951).
7. *See* Hoffman, *Tax Planning in Qualified Pension and Profit-Sharing Plans*, 5 TAX COUNSELOR'S Q. 189, 192, 206-07 (1961).
8. Section 401(a).
9. Section 401(a)(2).
10. Section 401(a)(7).
11. Sections 401(a)(4), (5).

Failure to comply with these requirements results in taxation of the pension trust,[12] taxation of the employee at the time of the employer's contribution,[13] and loss of the employer's deduction unless it was nonforfeitable when made.[14] This Note will explore the nondiscrimination requirement necessary for qualification as a section 401(a) pension plan.

The original legislation provided that a pension plan would qualify if it benefited "some or all of [the] employees."[15] The Treasury soon realized that this language allowed employers to put into pension trusts what actually amounted to compensation for the sole benefit of highly paid personnel, thereby deferring such compensation until their retirement, at which time individual tax brackets are lower.[16] The Revenue Act of 1942 introduced the concept of discrimination into the pension plan qualification requirements, disqualifying any plan which discriminated in favor of employees who were officers, shareholders, supervisors, or highly compensated employees.

The discrimination concept of sections 139(a)(3), (4), and (5) of the 1939 Internal Revenue Code is incorporated verbatim into sections 401(a)(3), (4), and (5) of the 1954 Code. These provisions deny qualification to any plan which favors upper level employees in eligibility or coverage requirements[17] or in the scale of benefits or contributions.[18]

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12. Section 401(a).
13. Section 402(a).
14. Section 404.
15. Revenue Act of 1921, § 219(f), 42 Stat. 227 (1921).
16. *See* JOINT COMM. ON TAX EVASION AND AVOIDANCE HEARINGS, 75th Cong., 1st Sess. 290 (1937).
17. Section 401(a)(3).
18. Section 401(a)(4). Because of the tax consequences of nonqualification, advance determination letters are available through the District Director, advising employers as to whether or not the plan initially qualifies and whether or not subsequent modifications will result in disqualification, *see* Rev. Proc. 67-4, 1967 INT. REV. BULL. No. 1, at 27; Goodman, *Pension and Profit-Sharing Rulings and Procedures*, N.Y.U. 17th INST. ON FED. TAX. 993 (1959). While the letters are not binding upon the courts, *see* Rev. Proc. 67-4, 1967 INT. REV. BULL. No. 1, at 31, favorable letters are apparently binding upon the Treasury and cannot be revoked without a change in the law or facts. *See* Time Oil Co. v. Commissioner, 258 F.2d 237 (9th Cir. 1958); Dejoy Stores, Inc. v. Ryan, 229 F.2d 867 (2d Cir. 1956); H.S.D. Co. v. Kavanagh, 191 F.2d 831 (6th Cir. 1951); *but see* Rev. Proc. 67-1, 1967 INT. REV. BULL. No. 1, at 14, 16. In spite of such a letter, the Commissioner may contend that, although the plan qualified as proposed, it failed to qualify in operation, *see* Treas. Reg. § 1.401-1(b)(3) (1956); Greenwald v. Commissioner, 366 F.2d 538, 540 (2d Cir. 1966).

II. COVERAGE REQUIREMENTS

A. The Percentage Test

To comply with the coverage requirements, the plan must meet either the mechanical percentage test[19] or the nondiscriminatory classification test.[20] Under the former, if seventy per cent of all employees actually receive benefits, or if seventy per cent of all employees are eligible and eighty per cent of those eligible *actually receive* benefits, the plan's coverage qualifies. The term "all employees" does not include those working less than twenty hours in any week or five months in any year; nor does it include those not working the specified number of years required by the plan, not to exceed five.[21]

B. The Nondiscriminatory Classification Test

Because the required percentage in the mechanical test is often too difficult to meet,[22] most plans attempt to qualify their coverage under the nondiscriminatory classification test[23] which allows qualification if the classification of benefiting employees is found, by the Treasury, not to be discriminatory in favor of officers, shareholders, supervisors, or highly compensated personnel.[24]

1. *Discretion of the Service*

Coverage under the classification test will be met if the classification is ". . . found by the Secretary or his delegate not to be discriminatory. . . ."[25] Because the majority of plans qualify for coverage under this rule, the scope of the Service's discretionary power in this determination is significant. The Commissioner has acquiesced that a determination can be overruled by showing an "abuse of discretion, unreasonableness, or arbitrariness."[26] This limitation has been noted in a district court;[27] it appears, however, that the Tax Court imposes greater

19. Section 401(a)(3)(A).
20. Section 401(a)(3)(B).
21. Section 401(a)(3)(A).
22. *See* Goldstein, *Integrating Pension and Profit-Sharing Plans with Social Security*, N.Y.U. 15th Inst. on Fed. Tax. 1165, 1167 (1957).
23. *See* Bomar, *Requirements for Qualification of Plans (Compensation Problems, Pensions and Profit Sharing)*, N.Y.U. 13th Inst. on Fed. Tax. 395, 404-05 (1955).
24. Section 401(a)(3)(B).
25. *Id.*
26. Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75, 82 (1967).
27. Duguid & Sons, Inc. v. United States, 278 F. Supp. 101, 105-06 (N.D.N.Y. 1967).

restraints. A recent holding set aside the Commissioner's determination of discrimination because it was not ". . . reasonable, rational, and supportable."[28]

2. *The Prohibited Group*

The Commissioner's determination on whether or not a classification discriminates in favor of the prohibited group is to a large extent dependent upon the definition of the various employee categories making up such group. The term "stockholders" does not include employees owning an insignificant number of shares and exercising no control over the corporation,[29] but includes stockholders of the parent corporation which owns the employer corporation.[30] Since the statute does not expressly mention relatives of stockholders, it has been contended that they are not among the prohibited group.[31] However, to allow a stockholder-employee to meet the nondiscriminatory requirements by merely transferring stock of the employer corporation to his wife or children seems entirely inconsistent with the intent of the Congress in enacting the stockholder discrimination provision.[32] Such a result would allow qualification of a plan where the economic benefits went exclusively to stockholders to the exclusion of the general employees. Therefore, it is not surprising that the Service has ruled an employee a constructive stockholder if either his spouse or minor lineal

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28. Ray Cleaners, Inc., 27 CCH Tax Ct. Mem. 23, 28 (1968). The Commissioner determined that a plan benefiting three of twenty-two employees, the three benefiting being the president and controlling stockholder and two workers receiving salaries in excess of all but one of the other employees, was discriminatory. In ruling that such a determination can be overturned by the courts, the court significantly weakened the authority delegated to the Commissioner since the statute would have virtually the same effect had the words "by the Secretary" been omitted, leaving the discretion in the hands of the courts. The Service should not be given free rein; its determinations should be subject to judicial reversal if clearly arbitrary or unreasonable. However, delegation of authority by Congress should be given effect by interpreting § 401(a)(3) to mean that the employer, if he cannot qualify under the mechanical test of § 401(a)(3)(A), must subject himself to the reasonable determination of the Service with respect to discriminatory coverage.

29. *See* Gordon, *Discrimination Problems in the Drafting and in the Operation of Pension and Profit-Sharing Plans*, N.Y.U. 14TH INST. ON FED. TAX. 1153, 1155 (1956).

30. I.T.: P.S. No. 20 (1944).

31. Gordon, *supra* note 29, at 1156. The author reasons that where the statute intended to include stockholders' relatives, it did so expressly, as in § 267 of the Code; therefore, *a fortiori*, such relatives were not intended to be within the prohibited group of § 401(a).

32. Notes 6 & 16 *supra*.

descendants are stockholders,[33] although this position has not yet been tested in court.

Officers can usually be identified by examining the corporate bylaws.[34] It has been held, however, that those employees given a nominal title so as to have the authority to sign checks, affix the corporate seal, and perform other ministerial duties are not "officers" within the meaning of the statute.[35] The prohibition regarding supervisors refers to "persons whose principal duties consist in supervising the work of other employees. . . ."[36] It has been held that an employee devoting twenty-five per cent of her time to supervising was not a member of the statute's prohibited group,[37] and one author contends that an employee is not a "supervisor" unless more than half his time is devoted to supervisory duties.[38]

The most troublesome problem under the nondiscriminatory classification test is identification of the highly compensated employees. It has been suggested that the standard be absolute, such that employees earning over, for example, $5000, would be within the prohibited group.[39] This contention is based on the assertion that the statutory nondiscrimination requirement is aimed at preventing the use of qualified plans to aid high bracket taxpayers in reducing their taxes. If so, the significant factor should be the employee's absolute tax bracket and not his relative compensation as compared to other employees.[40] This view is supported by a holding of the Tax Court that ". . . the term [highly compensated] may be relative but we believe . . . it should be more related to compensation standards which might produce some rather substantial tax

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33. *See* I.T. 3661, 1944 CUM. BULL. 315. *But see* I.T. 4020, 1950-2 CUM. BULL. 61. The issue is often inconsequential as most shareholder employees are likely to be "officers" or "highly compensated" and thus be members of the prohibited group regardless.

34. Gordon, *supra* note 29, at 1156.

35. I.T.: P.S. No. 4 (1944).

36. Sections 401(a)(3)(B), (a)(4).

37. Marjorie Birnie, 12 CCH Tax Ct. Mem. 867, 871 (1953). Therein the employee spent 75% of her time performing clerical duties and 25% supervising one employee in the preparation of reports.

38. Gordon, *supra* note 29, at 1157. *But see* Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75, 84 (1967), where the court said there was considerable doubt that an employee spending only 50% of his time supervising was within the prohibited group.

39. Gordon, *supra* note 29, at 1157. *See* Ets-Hokin & Galvan Inc., 21 CCH Tax Ct. Mem. 717, 720 (1962), where all employees receiving over $10,000 were considered within the prohibited group.

40. Gordon, *supra* note 29, at 1158.

avoidance. . . ."[41]

Although it is true that Congress sought to deprive high bracket taxpayers of a tax reduction via a qualified plan, it is clear that this was not its primary motive. The Committee Report states that the requirements of nondiscrimination are to guarantee ". . . that the pension plan would be operated for the welfare of the employees *generally* . . . . High salaried employees should not be favored at the expense of the low-paid employees."[42] One congressman stated that the plans must not ". . . discriminate in favor of high-salaried . . . employees *as against low-salaried employees*."[43] These comments seem to reflect a congressional intent to deny qualification to plans which include higher paid employees while excluding the lower paid, regardless of the absolute compensation of the various participants. The relative standard, therefore, appears to be preferable in fostering plans for the welfare of employees generally and the cases[44] ruling against the Commissioner on this point seem incorrectly decided.

3. *Classifications*

The prohibited employees are often prime beneficiaries of plans having both discriminatory and nondiscriminatory classifications. Plans have been limited to employees who are salaried or clerical, employed in a specified department or geographical location, employed for a designated length of time, having reached a specified age, or having made a required contribution to the plan. Such classifications are not on their face discriminatory and each must be analyzed seriatim to determine which classifications will be disallowed because of their discriminatory effects.

The Code provides that a classification limited to salaried or clerical employees[45] will not, by itself, disqualify a plan.[46]

41. Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75, 84 (1967), *appeal docketed*, 2d Cir., Sept. 11, 1967.

42. H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942) (emphasis added).

43. 88 CONG. REC. 6378 (1942) (emphasis added).

44. In Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75 (1967), those receiving benefits had salaries in excess of $9,000 while those excluded were paid less than $7,500. Similarly, in Ray Cleaners, Inc., 27 CCH Tax Ct. Mem. 23 (1968), the three participating employees earned in excess of $5,200 while those excluded received compensation from $20.35 to $4640.10.

45. Section 401(a)(5).

46. Rev. Rul. 66-13, 1966-1 CUM. BULL. 73.

If, however, the classification as designed or operated limits participation to employees in whose favor discrimination is prohibited, the plan's coverage will not qualify.[47] While the position of the Commissioner is not entirely clear, revenue rulings indicate what the Commissioner will consider discriminatory. For example, the adoption of a salaried-only plan by an employer having twenty employees, of which seventeen were not salaried, left only officer-stockholders participating and, therefore, constituted prohibited discrimination.[48] Similarly, where there were fifty hourly employees and six salaried, of which five were officers or stockholders, the salaried-only plan failed to qualify.[49] On the other hand, a salaried-only plan was not found to be discriminatory where twenty-six of 109 employees were salaried and of these twenty-six, eleven were officers, shareholders, or highly compensated.[50] It thus appears that the Treasury will approve salaried-only plans if a substantial portion of those covered are not members of the prohibited group.

One court has held that a salaried-only classification will fail to win approval if the members covered under such a category are all within the prohibited group.[51] However, other cases indicate that the classification is not discriminatory even if half of the salaried employees covered are members of the prohibited group.[52] It may be concluded, therefore, that the discretion of the Service to disqualify under section 401(a)(3)(B) is limited to classifications where at least more than half of those participating are supervisors, shareholders, officers, or highly compensated.[53]

47. Rev. Rul. 55-81, 1955-1 CUM. BULL. 392.

48. *Id.*

49. Rev. Rul. 66-13, 1966-1 CUM. BULL. 73.

50. Rev. Rul. 66-12, 1966-1 CUM. BULL. 72. The remaining fifteen participants had substantially the same income as the excluded hourly workers.

51. *See* Greenwald v. Commissioner, 366 F.2d 538, 540 (2d Cir. 1966). In *Greenwald* the coverage was satisfactory at inception, but the employer discontinued one line of business, thereby terminating the employment of all his personnel. When only the employer benefited from the plan, it failed to qualify. However, a plan will not fail if it covers all employees, even though they are all highly compensated stockholders of a close corporation, because both tests of § 401(a)(3) are met. One hundred per cent coverage meets the mechanical test while the classification test is met because there is no discrimination.

52. *See, e.g.*, Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75 (1967); Ryan School Retirement Trust, 24 T.C. 127 (1955).

53. Clearly these plans were unable to meet the 70% coverage test, as is most often the case in salaried-only plans.

The reasons for the employer's discrimination are apparently irrelevant; the fact of discrimination is determinative. Thus, although an

Plans which cover only those employees with a specified number of years service have qualified under section 401(a)(3)(B).[54] Although the classification is latently discriminatory, since it favors employees who are more likely to be members of some prohibited group as compared to less senior workers, allowance has been made because of the salutary effect of such classifications on employee turnover. A length of service classification will not be deemed discriminatory if the period is reasonable considering the turnover[55] situation of the employer.[56] Likewise, plans which cover only those employees who have reached a stated age will qualify if the age requirement is reasonable to secure the continued employment of personnel and not designed or operated to benefit primarily members of prohibited groups.[57] If higher-ups participate under such plans, however, it is imperative that they meet all requirements requisite to a new employee's participation. For example, if the plan provides that new employees will be eligible only after five years service, any member of a prohibited group who participates must have five years service or the coverage requirements are discriminatory and the plan will fail.[58] It can be assumed that classifications of this type, which produce coverage primarily for prohibited employees, will fail to qualify under similar tests imposed on salaried-only classifications.[59]

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employer is precluded from granting benefits to rank and file salaried personnel because of a union agreement, discrimination is not justified. *See* Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75 (1967); Rev. Rul. 66-14, 1966-1 CUM. BULL. 75.

54. *See* Sherwood Swan & Co., 42 T.C. 299 (1964); Ets-Hokin & Galvan, Inc., 21 CCH Tax Ct. Mem. 717 (1962). A length of service requirement is not the same as a vesting requirement. In the former, the employee must work a specified number of years before any contributions are credited to his account. In the latter, the employee is being credited with contributions during the waiting period but has no property interest in the contributions. If he leaves his job prior to the expiration of the waiting period, he forfeits the contributions credited to his account.

55. In Ets-Hokin & Galvan, Inc., 21 CCH Tax Ct. Mem. 717 (1962), a five-year length of service requirement was allowed. The court recognized that because the employees were largely wives of naval personnel at a nearby naval base the employer was justified in excluding short-term employees, *id.* at 724. A five-year length of service requirement is allowed to employers who qualify their coverage under § 401(a)(3)(A).

56. 21 CCH Tax Ct. Mem. at 724.

57. I.T.: P.S. No. 22 (1944). *See, e.g.*, Ray Cleaners, Inc., 27 CCH Tax Ct. Mem. 23 (1968) (25 years old); Ets-Hokin & Galvan, Inc., 21 CCH Tax Ct. Mem. 717 (1962) (25 years old).

58. Rev. Rul. 65-178, 1965-2 CUM. BULL. 94, 113.

59. *See* text accompanying note 53 *supra*.

A plan may be made available only to those employees who contribute with the employer.[60] In such plans, the coverage is discriminatory if the required contribution is burdensome. It is obvious that a required contribution of fifty per cent of salary would result in participation by the highly paid personnel to the exclusion of the rank and file workers.[61] The Treasury, therefore, has ruled that employee contribution requirements exceeding six per cent of salary will disqualify the plan as discriminatory.[62]

The above discussion represents the various criteria for qualification of coverage. Any single classification could be nondiscriminatory while in combination with others it becomes discriminatory. On the other hand, an employer may provide for more than one plan, in which case the coverage requirements might be met by the combination of plans where an individual plan might fail.[63] In addition to meeting the coverage requirements, however, a plan must not manipulate the scale of benefits or contributions in such a way as to result in discriminatory treatment favoring members of the prohibited group.[64]

III. CONTRIBUTIONS OR BENEFITS

A. Alternative Requirements

To qualify under section 401(a)(4), the contributions or benefits must not discriminate in favor of stockholders, officers, supervisors, or highly paid personnel. It is not necessary that both the contributions and the benefits be free from discrimination. The requirement is stated in the alternative to give effect to both nondiscriminatory contributions in profit sharing and money purchase plans, and nondiscriminatory benefits in pension plans generally.[65] In the profit sharing plans, a certain amount,

60. Treas. Reg. § 1.401-3(d) (1956). *See also* Rev. Rul. 65-178, 65 Cum. Bull. 94, 113-14.

61. R. Samuelson, Principles of Economics 217-20 (3d ed. 1958).

62. Rev. Rul. 65-178, 1965-2 Cum. Bull. 94, 114. In Ray Cleaners, Inc., 27 CCH Tax Ct. Mem. 23 (1968), only two of seven employees asked to participate accepted a plan calling for a 2% contribution. Employees declining to participate under such requirements can be forever barred from the plan, but it is imperative that the employee is given adequate notice, and the consequences of his failure to comply must be clearly presented to him. *See* Rev. Rul. 59-185, 1959-1 Cum. Bull. 86.

63. Treas. Reg. § 1.401-3(f) (1956).

64. Section 401(a)(4).

65. *See* Dederick, *What Constitutes Discrimination in Pension and Profit-Sharing Plans?*, 22 J. Taxation 272, 273 (1965).

based on profits, is contributed and used to fund benefits which are actuarially determined. If these contributions do not discriminate in favor of higher-ups, the plan qualifies even though employees near retirement at the commencement of the plan will benefit the least, since few contributions will have been made to them. In pension plans, the employee is given specified benefits at retirement and, if these benefits are uniformly granted to employees, the plan will qualify even though a larger contribution will be required to fund the benefits of employees near retirement at the commencement of the plan.

B. Geared to Compensation

The statute provides that contributions and benefits may be commensurate with the employee's compensation without being discriminatory.[66] A requirement that the plan give absolutely equal benefits or contributions to each worker would make the plan insignificant to highly paid personnel, or so costly as to be prohibitory. Bonuses may be included in compensation for the purpose of determining benefits or contributions, if the bonuses are a basic component and are regularly paid.[67] Contributions or benefits based partly on bonuses which are paid at the discretion of the employer could result in disqualification of the plan because of the ability to manipulate them in favor of prohibited groups.[68] To justify the use of bonuses given primarily to higher-ups, tax counsel should be prepared to show that these bonuses had been given in prior years.[69] Similarly, overtime pay and commissions actually earned and a part of the basic compensation may be included. In fact, failure to include overtime which is a basic and regular part of the compensation of the rank and file workers could result in prohibited discrimination.

In plans calling for benefits related to the pensioner's salary at his retirement, discrimination can result when the employer makes substantial increases in the compensation of higher-ups during their final year of employment.[70] Such a plan would probably not be questioned if the benefits were based on the pensioner's average salary over the last five years of his employment.[71]

66. Section 401(a)(5).
67. *Id.*
68. Dederick, *supra* note 65, at 273.
69. *Id.*
70. Rev. Rul. 65-178, 1965-2 Cum. Bull. 94, 123.
71. *Id.*

C. CONTRIBUTIONS—PROFIT SHARING PLANS

Profit sharing plans are funded via a percentage of profits allocated to each employee on the basis of some specified formula. The percentage of profits contributed need not be provided by a fixed and definite formula,[72] but the employer is allowed to vary his contributions as his needs and resources demand.[73] However, the formula on which he allocates this contribution among the individual participants must be definite.[74] Neither the formula for the percentage of profits put into the plan as a whole, nor the formula for the allocation of that percentage to each individual worker, may discriminate in favor of stockholders, officers, supervisors, or highly paid personnel.[75] For example, if a group comprised primarily of prohibited employees received eight per cent of the profits, while the other group of employees received five per cent of the profits, the contribution would be discriminatory and the plan would not qualify.[76] Likewise, if all employees, as a group, received eight per cent of the employer's profits and members of the prohibited group were allocated a larger individual contribution out of this eight per cent, the contribution would be discriminatory and again the plan would fail to qualify.[77] Such a differential is not discriminatory, of course, when it results merely from the differences in the individual employee's compensation.[78]

The Tax Court has ruled that where more than fifty per cent of the contribution went to stockholders, there was no discrimination when the contributions bore a uniform relationship to compensation.[79] Thus, it appears that any contribution based on a uniformly applied ratio to compensation will

72. *See* Lincoln Elec. Co. v. Commissioner, 190 F.2d 326 (6th Cir. 1951). However, if there is no definite formula an accrual taxpayer will not receive a deduction unless, prior to the end of the taxable year, he has decided upon the amount of the contribution and incurred a liability to pay it. *See* Treas. Reg. § 1.404(a)-1(c) (1956).

73. Gordon, *supra* note 29, at 1172.

74. Treas. Reg. § 1.401-1(b) (1) (ii) (1956).

75. Treas. Reg. § 1.401-4(a) (2) (iii) (1956).

76. I.T. 3678, 1944 CUM. BULL. 321.

77. I.T. 3685, 1944 CUM. BULL. 324.

78. Section 401(a) (5).

79. *See* Volckening, 13 T.C. 733 (1949). The Service had once ruled that a plan would not be discriminatory in favor of stockholders if the contributions required for employees with more than 10% of the voting stock did not exceed 30% of the total contribution for all participants. I.T. 3674, 1944 CUM. BULL. 315. *Volckening* overruled this ruling and the Treasury has acquiesced by revoking it. *See* I.T. 4020, 1950-2 CUM. BULL. 61.

qualify regardless of variances in benefits. This is in keeping with the alternative language of section 401(a)(4) and the allowances of section 401(a)(5).

D. Benefits—Pension Plans

A plan might provide an annuity of x dollars per year for y years for each employee at retirement. If these benefits are not favorable to the prohibited group the plan qualifies, even though the yearly contributions needed to fund such benefits for employees who are near retirement at the commencement of the plan, who may very well be primarily higher-ups, will be greater than for the younger workers.

Benefits, like contributions, may be based upon compensation without being discriminatory.[80] Such benefits, however, have a built-in potential for discrimination if based upon the employee's compensation at the commencement of the plan. The benefits of the personnel near retirement would often be based upon their highest or nearly highest salary level, while the benefits to the workers with short service would often be based upon their lowest or nearly lowest salary level. To eliminate these discriminatory results a provision must be made for uniform increases in benefits with increased compensation.[81]

E. Other Problems in Benefits or Contributions

1. *Years Service Credits*

Although the statute expressly allows contributions based on the employee's compensation,[82] there is no such allowance for the employee's years of service. Because employers often wish to provide larger contributions to or benefits for employees with longer service, the circumstances under which credit given for years service will not result in prohibited discrimination[83] must be examined.

The Treasury has indicated that the use of years service credits will not result in discrimination if prohibited employees do not receive a contribution or benefit which, as a percentage of salary, is larger than that received by the rank and file workers.[84] In other words, years service credits cannot be used

80. Section 401(a)(5).
81. Rev. Rul. 65-178, 1965-2 Cum. Bull. 94, 123; Mim. 5677, 1944 Cum. Bull. 320.
82. Section 401(a)(5).
83. Treas. Reg. § 1.401-4(a)(2)(iii) (1956).
84. I.T. 3685, 1944 Cum. Bull. 324; I.T. 3686, 1944 Cum. Bull. 326.

to create any greater differential in contributions or benefits between the rank and file and the higher-ups than is possible by the use of a uniform relationship between contributions or benefits and level of compensation. Because the level of the employee's compensation is customarily related to his years service, separate use of years service credits is often redundant in rewarding long-standing personnel and, therefore, because of the potential discrimination, should be avoided. Even if the years service criteria does not result in prohibited discrimination at the inception of the plan, higher-ups as a group often continue in service longer than rank and file employees, thereby receiving greater contributions or benefits each year. Because of certain difficulties in amending contribution or benefit schedules of plans, the prevention of this discrimination subsequent to the plan's inception might be impossible.

2. *Vesting*

Vesting is the employee's acquisition of a property interest in the contributions made to his account which is not contingent upon his continuation of employment. Vesting is not a requirement for qualification under section 401(a) and, therefore, deferred vesting, like the length of service requirement,[85] is used by employers to discourage employee turnover. Many employees cannot be considered participants in these plans because it is probable that they will separate prior to the vesting of their interest due to the lengthy waiting period imposed by the plan.[86] Stockholders, officers, supervisors, and highly compensated employees customarily remain employed for a longer duration than rank and file workers and, therefore, potential discrimination looms over all deferred vesting requirements.

Although the Treasury has ruled that discrimination will depend upon the facts of each case and that an employer with a large turnover will not receive a favorable advance determination if vesting periods are excessively long,[87] the courts have not disqualified a single plan because of excessive waiting requirements. In *Sherwood Swan & Company*,[88] a plan with a ten-year waiting period was approved. In that case a substantial number of employees did not remain long enough to qualify, and only a few, including the sole stockholder and president, ac-

85. See note 54 *supra*.
86. *See* Dederick, *supra* note 65, at 273.
87. Rev. Rul. 65-178, 1965-2 CUM. BULL. 94, 120.
88. 42 T.C. 299 (1964).

quired vested interests. The court said: "The plan is to benefit permanent as distinguished from transient employees. It is to be expected that the company's chief stockholder and managing officer will be the most permanent of the employees covered by the plan."[89] In *Ryan School Retirement Trust*,[90] a ten-year requirement resulted in a plan under which 110 rank and file employees failed to qualify, leaving only ten participants with vested interests, half of whom were members of the prohibited group. The court, in sustaining the plan, held that discrimination favoring the permanent as against the impermanent employees is not the type of discrimination contemplated by the statute.[91]

However, it is to be expected that the Service will continue to challenge such plans. When the permanent personnel are primarily higher-ups, the discrimination is precisely the type which the statute sought to prevent. Furthermore, under these cases, the management of a declining business could initiate a profit sharing plan with a vesting requirement that no employee currently meets, begin contributing to the plan and taking the accompanying deduction, and then systematically terminate each employee before his interest vests, applying the forfeited interests to the remaining participants who will probably be select upper level employees. Thus, holding that plans which merely favor permanent employees are not discriminatory not only defeats the purpose of the statute, but opens the door to undesirable abuse.[92]

3. *Forfeitures*

Where there is deferred vesting, there are forfeited contributions from separated employees. The disposal of such forfeitures will depend upon the type of plan involved. In pension plans, the statute provides that forfeitures from such plans "must not be applied to increase the benefits any employee would otherwise receive."[93] The regulations command that these forfeitures "be used as soon as possible to reduce the employer's contribution under the plan."[94] The reason advanced for

89. *Id.* at 307.
90. 24 T.C. 127 (1955).
91. *Id.* at 134.
92. The holding could be justified on other grounds, however. The plan was salaried-only and only one-half were members of the prohibited group. *See* text accompanying note 53 *supra*.
93. Section 401(a)(8).
94. Treas. Reg. § 1.401-7(a) (1963).

this requirement is that benefits of a qualified pension plan must be definitely determinable,[95] and this is impossible if forfeitures could accrue to the benefit of the remaining employees.[96]

Profit sharing plans are not subject to the requirement of determinable benefits,[97] since the benefits bear a direct relationship to a specific percentage of profits, which are not predictable. Forfeitures under profit sharing plans may, therefore, benefit the remaining employees if discrimination does not result thereby. How the forfeiture should be distributed to the remaining participants has not been expressly decided. However, since forfeitures are no different from other contributions to the plan, it might be assumed that the rule governing the allocation of contributions should apply, and the relationship of each employee's allocation to his salary must be uniform among all the remaining participants.

4. *Integration*

The Code provides that a plan will not be considered discriminatory merely because it excludes those employees whose remuneration is wholly wages, or because contributions or benefits based on compensation exclusive of wages differs from those based on total compensation.[98] Wages, as defined under section 3121 of the Code, constitute remuneration up to the Social Security base, *i.e.*, up to the upper limit of compensation on which employers must contribute a certain percentage thereof for the funding of benefits under the Social Security Act. This allowance permits employers who are contributing to Social Security on each employee's income up to the Social Security base, say $6600, to make comparable contributions on income in excess of $6600 to supplement Social Security contributions for more highly paid employees.

A plan excluding employees whose remuneration is wholly wages will qualify if properly integrated so that the relative differences in benefits resulting from such a classification are offset by the Social Security benefits attributable to the em-

95. Treas. Reg. § 1.401-1(b)(1)(i) (1964); Rev. Rul. 65-178, 1965-2 CUM. BULL. 94, 105.

96. Treas. Reg. § 1.401-7(b) (1963). This requirement could result in greater discrimination in closed corporations. Although the remaining participants in the plan would not share the forfeitures, stockholders would benefit from the requirement because it relieves the corporation of a liability to the plan to the extent of the forfeiture.

97. Treas. Reg. § 1.401-4(a)(1)(iii) (1963).

98. Section 401(a)(5).

ployer's contribution.[99] Similarly, a plan which bases benefits on that part of the employee's compensation in excess of the Social Security base will not be discriminatory if those benefits are equivalent to the Social Security benefits provided by the employer's contribution with respect to the first $6600 of compensation.[100]

IV. CONCLUSION

To make consideration of the above material meaningful it is necessary to ask (1) whether the pension plan provisions of the Code are intended to encourage social action; (2) if so, what social action is sought to be encouraged by these provisions in general and the discrimination concept in particular; and (3) in light of the desired objectives, whether the discrimination provisions are effective in achieving them.

The legislative history[101] and comments in the area[102] indicate that the provisions were meant to encourage private retirement plans to aid society in its burden of caring for retired persons. The discrimination concept was intended to guarantee that qualification and the accompanying tax advantages would be available only to the employers who offered benefits to their employees generally rather than to upper level employees exclusively.[103]

To contend that the prime purpose of the discrimination concept was to prevent tax avoidance by high bracket taxpayers[104] is to compromise logic. Tax avoidance could have easily been prevented by repealing the pension plan provisions and their accompanying tax advantages altogether. Congress, of course, chose not to do so. Considering the individuals in the prohibited group, it seems clear that the concept was aimed at encouraging plans for the benefit of employees generally. If concerned only with preventing income deferment by high bracket taxpayers, Congress might have put only highly compensated employees in the prohibited category. Instead, supervisors, officers, and stockholders were similarly included.[105]

It is unclear that a salaried-only plan meets the nondiscriminatory requirement merely because most of the salaried

99. Treas. Reg. § 1.401-3(e)(1) (1956).
100. *Id.*
101. *See* note 6 *supra.*
102. *Id.*
103. *See* text accompanying notes 40 & 41 *supra.*
104. Gordon, *supra* note 29, at 1158.
105. Sections 401(a)(3)(B), (a)(4).

participants are not higher-ups. If these plans can qualify without any reference to the benefits of the nonsalaried employees, incongruities arise. If an employer can exclude employees whose compensation is *wholly wages* only upon equating the benefits of the participants with the benefits provided for the wage earners under Social Security,[106] it is difficult to rationalize the qualification of *salaried-only* plans which avoid these integration requirements without giving undue emphasis to mere form.

Furthermore, a plan providing benefits for wage-earners as well as salaried personnel is discriminatory if the benefits favor the higher-ups,[107] whereas a plan which provides no benefits whatsoever for the wage-earners is likely to qualify, since it can avoid the discrimination provision merely by insuring that the salaried participants are not primarily members of the prohibited group.[108] Thus, the merits of continuing to allow salaried-only classifications can be seriously questioned. Although there was a recent recommendation to eliminate the salaried-only option from the Code,[109] it was not acted upon on the ground that mandatory coverage of all employees would often be unrealistic where a particular group of employees indicate a preference for a different type of benefit, such as a cash wage increase or some type of fringe benefit.[110] But this argument can be advanced in support of almost all discriminatory plans, as it is not uncommon for upper level employees to want a retirement plan while the rank and file prefer immediate wage increases or their equivalent.[111] The argument seems to be valid only in those cases where the wage-earners collectively bargain, being able to reject a retirement plan in favor of other benefits. It seems desirable to allow salaried-only plans only in cases where the employer shows that pension benefits were genuinely offered to the bargaining unit, but rejected in favor of other benefits.

Currently, one-half of the nonfarm labor force is covered by private pension plans.[112] However, because of deferred

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106. *See* text accompanying note 99 *supra*.
107. Section 401(a)(4).
108. *See* text accompanying note 53 *supra*.
109. Address by S. Surrey, Assistant Secretary of the Treasury, American Pension Conference, May 11, 1967. *See* 7 CCH 1968 STAND. FED. TAX REP. 71,089.
110. *Id.*
111. This would be especially so if the employee had to contribute himself or remain for many years before acquiring a vesting interest in the benefits.
112. A REPORT TO THE PRESIDENT, PUBLIC POLICY AND PRIVATE PEN-

vesting, these figures are very misleading. Two-thirds of employees covered must remain with the same employer for at least fifteen years to qualify for a vested interest.[113] It has been estimated that less than twenty per cent of the employees now covered will actually receive cash benefits from the plans,[114] average length of continuous service being approximately four years.[115]

In light of the above, as well as the litigation discussed earlier,[116] it is clear that deferred vesting is working against the rank and file employees to the detriment of society. Fewer retired employees are able adequately to provide for themselves, evidenced by the fact that currently over forty per cent of those classified as "poverty stricken" are over the age of sixty-five.[117] Labor mobility, considered essential to an economy characterized by rapid technological change, is significantly retarded.[118] Finally, deferred vesting fosters age discrimination in employment in that older workers without any vested pension credits from past employment will probably not be hired when employers find the annual cost of funding a pension plan including such workers prohibitive.[119]

Employers object to early vesting because of its high cost and the lessening of their economic hold over employees,[120] but these contentions lose their persuasiveness when the issue is considered from a broader viewpoint. With respect to the employer's economic hold on the employee, many argue that this interest must at some point give way to the interest of society in a fluid labor supply. The employers' contention that, without deferred vesting, the high cost will eliminate their plans altogether is similarly nonpersuasive. To prevail, employers must show that the value of pension plans with a long vesting period is

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SION PROGRAMS vi (Jan. 1965). *See also* Goldworn, *Pension Plans: Their Background, Current Trends, and an Agenda for Inquiry*, 25 OHIO ST. L.J. 234, 240 (1964).

113. BUREAU OF LABOR STATISTICS, LABOR MOBILITY AND PRIVATE PENSION PLANS, BULL. No. 1407, at 12, 44 (June, 1964).

114. *Pension Fund Regulations Being Studied by Congress*, AD. MANAGEMENT, June, 1967, at 31.

115. Hamel, *Job Tenure of Workers*, MONTHLY LABOR REV., Jan., 1967, at 37.

116. See text accompanying notes 88 & 90 *supra*.

117. *See* Goldworn, *supra* note 112, at 234.

118. *See* Hoffman, *supra* note 7, at 218.

119. R. Bagley, An Analysis of Portability and Vesting Rights in Pension Plans 9, Jan. 20, 1968 (unpublished thesis at Graduate School of Business Administration, University of Minnesota).

120. Hoffman, *supra* note 7, at 211.

such that it outweighs the tax loss to the Treasury resulting from their qualification. Writers recognize[121] and the cases show[122] that plans with substantial waiting periods benefit primarily the executive and shareholder personnel. Such a benefit is of minimal social value in terms of combating post-retirement poverty. On the other hand, the favored tax treatment allowed these plans has been estimated to exceed one billion dollars each year.[123] It is clear, therefore, that the Treasury is subsidizing plans which are of primary benefit to upper level employees, contrary to the objectives of the pension statute.

Both the salaried-only allowance of section 401(a)(5) and the absence of any standards for vesting seem inconsistent with the social goals of the pension plan provisions and, to the extent that these attributes of the statute fail to encourage pension benefits for the general employees, they are objectionable. Salaried-only classifications which are not integrated with benefits for the remaining employees should be disqualified unless the employer can show that the remaining employees collectively rejected a comparable plan which was genuinely offered.

Vesting requirements should become imperative by statute. Immediate vesting is probably not necessary, since employee mobility would not be unduly hampered by a deferred vesting requirement of relatively short length. Under a ten year requirement, one-tenth of the covered labor supply, on the average, would be mobile each year and such mobility would seem to satisfy the requirements for employee reallocation within the economy. The required period should not be allowed to exceed ten years, however, because this period represents about one-fourth the typical working life of an employee and loss of benefits after such a period would result in a substantial reduction of his retirement security.[124]

It should be reiterated that other problem areas, previously discussed, need reexamination. It is submitted that the relative standard should prevail in defining highly compensated employees. Also, the allowance of required contributions up to six per cent is objectionable. To low salaried employees, those in greatest need of pension benefits, a required contribution of

121. *See* Goldworn, *supra* note 112, at 258.

122. *See, e.g.*, Sherwood Swan & Co., 42 T.C. 299 (1964); Ryan School Retirement Trust, 24 T.C. 127 (1955).

123. REPORT TO PRESIDENT, *supra* note 112, at vii.

124. *See* Surrey, *supra* note 109, at 71,090.

six per cent might very well result in their declining such a plan.[125]

To the extent that plans providing for a substantial segment of the rank and file employees are not encouraged, the pension provisions fail in their societal task of mitigating post-retirement poverty and perform the sole function of allowing upper-level employees to defer income at a cost of over one billion dollars per annum to the public.

125. *See* Ray Cleaners, Inc., 27 CCH Tax Ct. Mem. 23 (1968).