COMMENT

QUALIFICATION OF PENSION AND PROFIT SHARING PLANS UNDER SECTION 165(a) I.R.C.: THE LINCOLN ELECTRIC CASE

Pension and profit-sharing plans, while not actually new programs, have reached a position of key importance in the field of labor relations within a relatively few years. Up-to-date statistics are difficult to obtain; however, it has been estimated that current corporation outlay for deferred compensation plans is approximately one and one-half billions annually.[1] Prior to the institution of wage-salary stabilization, new plans were being established at the rate of 100 per month. From 1942 to June 20, 1950, the Bureau of Internal Revenue had ruled on 13,899 pension, profit-sharing, and stock bonus plans as to the requirements for tax exemption under Section 165(a) and 23(p) of the Internal Revenue Code.[2]

While not solely responsible for the great increase in deferred compensation systems, doubtless an important factor in their popularity is the fact that payments to qualified plans are income tax deductions for the employer.[3] However, any tax saving incentive on the part of the employer becomes valid only when there are other sound business reasons for instituting a plan.

A pension plan is established primarily to provide systematically for the payment of definitely determinable benefits over a period of years or life after retirement, while a profit-sharing plan, on the other hand, provides for participation in profits by means of a definite predetermined formula for both sharing the profits and distributing the funds so accumulated to the participants.[4]

The contributions made by the employer are deductible in the year made,[5] regardless of whether the participant's interests are non-forfeitable,[6] providing the plan is qualified by meeting the requirements set

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1. THE HOWARD E. NYHART CO. PENSION AND PROFIT-SHARING BULLETIN (November, 1950).
2. P-H PENS. & PROF. SHAR. SERV. ¶ 2011 (1951).
3. The employer with high profits, for example, one who is in the 77% tax bracket, pays for the plan with dollars having a value of twenty-three cents.
4. U.S. Treas. Reg. 111, § 29.165-1, as amended, T.D. 5422 (Dec. 13, 1944), P-H PENS. & PROF. SHAR. SERV. ¶ 9176 (1949); ¶ 4021 (1951).
5. However, only within the prescribed limits of INT. REV. CODE § 23(p).
6. BUREAU OF NATIONAL AFFAIRS, HANDBOOK FOR PENSION PLANNING 69 (1949).

out in Section 165(a),[7] as interpreted by the Commissioner.[8] The funds accruing to the benefit of the employee under a *qualified* plan are taxable to the employee when the amount is distributed or made available rather than at the time of the employer's contribution and deduction.[9] This means that the benefits will generally be paid to the participant on

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7. INT. REV. CODE § 165, EMPLOYEES' TRUSTS.

(a) *Exemption from Tax.*—A trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall not be taxable under this supplement and no other provision of this supplement shall apply with respect to such trust or to its beneficiary—

(1) if contributions are made to the trust by such employer, or employees or both, for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

(3) if the trust or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 per centum or more of all the employees, or 80 per centum or more of all the employees who are eligible to benefit under the plan if 70 per centum or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years, employees whose customary employment is for not more than twenty hours in any one week, and employees whose customary employment is for not more than five months in any calendar year, or

(B) such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees;

and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(5) A classification shall not be considered discriminatory within the meaning of paragraphs (3) (B) or (4) of this subsection merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 1426 (a) (1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 1426 (a) (1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law.

(6) A plan shall be considered as meeting the requirements of paragraph (3) of this subsection during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

8. If a trust is involved, the income from the trust is also exempt. Over a period of years, the tax savings on the trust income may be substantial, thus reflecting increased benefits to the employees or a lower cost to the employer. P-H PENS. & PROF. SHAR. SERV. ¶ 4012 (1951).

9. INT. REV. CODE § 165(b); § 22(b)(2).

retirement, or severance of service, a time when his tax rate is much lower. Should the employee receive the employer contributions in a lump sum from a trust[10] in a single year, rather than periodic payments because of termination of service with the employer, the benefit is taxed at a reduced rate as a capital gain.[11]

Although the employer would be allowed a deduction for his contributions to a *non-qualified* plan if they were immediately non-forfeitable, such contributions are taxable to the employee in the year made.[12] Where a large lump sum contribution is placed in the *non-qualified* fund in a single year, the high immediate tax load on the highly paid employee would largely subvert the basic purpose of the plan.[13] In this area the tax-saving features of a qualified pension or profit-sharing plan are particularly significant.

The public policy favoring industrial pension and profit-sharing plans has long been recognized, and was expressed through favorable congressional legislation as early as 1921.[14] As the tax legislation has evolved during the intervening years, the trend has been to encourage the institution of plans through tax concessions, and at the same time require these plans to meet standards which benefit the community and the employees generally. In attaining this objective, a retirement plan need not cover all employees of a particular employer—but merely be designed to aid in solving the problems of superannuation among its particular group of employees. By a wide adoption of plans accomplishing this objective, the cost to the federal, state, and local govern-

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10. The long term capital gain treatment is not applicable to non-trusteed plans (*e.g.*, group annuity types). P-H PENS. & PROF. SHAR. SERV. ¶ 5305 (1951).

11. P-H PENS. & PROF. SHAR. SERV. ¶ 2031 *et seq.* (1951).

12. The terms non-forfeitable and fully vested are often used interchangeably. By the use of the terms, it is meant that the accumulations made by the employer, and standing to the credit of the employee, are fully and immediately vested in interest in that employee. Most plans are not fully vested, but such employer contributions credited to the employee are forfeited under certain circumstances, *e.g.*, if the employee leaves the employ of the company before reaching a certain age. In this case, since the plan is of a forfeitable nature, it must qualify under § 165(a), for the contributions to be deductible.

13. For a thorough treatment of this subject, see HALL, EFFECTS OF TAXATION—EXECUTIVE COMPENSATION PLANS (1951); Goodfellow, *Tax Consequences of Pension Trusts and Employer Purchased Annuities to Employee or Beneficiary*, 39 CALIF. L. REV. 204 (1951). Where an organization is exempt from taxation under § 101 (6) I.R.C., employees do not have to include employer contributions when made to an annuity plan which does not use a trust, whether or not the rights under the plan are non-forfeitable. Such employees are subject to tax when the income is actually received. U.S. Treas. Reg. 111, § 29.22(b)(2)-5 (1951); P-H PENS. & PROF. SHAR. SERV. ¶ 7021 (1951).

14. The 1921 Act made no mention of pension plans or trusts, but only of stock-bonus and profit-sharing plans. It was not until 1926 that the legislation was extended to pension plans.

ments in caring for the constantly increasing portion of aged and dependent population would be reduced and a stabilizing factor in the nation's purchasing power created.[15]

The early enactments favoring deferred compensation systems were found in Section 219(f) until the Revenue Act of 1928. To qualify as a tax-exempt trust, four qualifications had to be met: (1) the plan had to be for the exclusive benefit of some or all of the employees; (2) contributions were required by the employer, employees, or both; (3) the earnings and principal of the trust fund were to be distributed to such employees; (4) the fund was to be accumulated in accordance with a plan of which the trust was a part.

Prior to 1928, the deductions were taken under Section 23(a) as ordinary and necessary business expense, and were allowed only for current commitments accruing during the taxable year. Thus, no deductions were permitted for contributions to fund past service credits nor for amounts necessary to make the pension plan actuarially sound but in excess of pension requirements actually accruing during the year.

In 1928, two important changes were made. Section 219(f) became Section 165, and Section 23(q) was adopted. Section 23(q), which was later to become Section 23(p), made possible a deduction, to be spread in equal amounts over ten years, for a reasonable contribution in excess of the liability accruing during the current year. Thus, it was possible to fund past service liability, create an actuarially sound plan, and take a deduction for the amount so contributed. However, to have deducted the excess above current commitments under 23(q), the requirements of Section 165 must have been satisfied.

The Revenue Act of 1938 added a new requirement to Section 165 to the effect that the trust must be irrevocable in the sense that there should be no diversion of the funds prior to satisfaction of all liabilities to employees under the trust. To Section 23(p) (formerly 23(q)) was added the qualification that the prorated deduction should be allowed only in taxable years during which the trust was exempt under Section 165. Contributions to discharge the current pension liability, and all contributions to stock bonus and profit-sharing plans were not deducted under 23(p) but continued until 1942 to be deducted under 23(a) and thus were not subjected to the requirements set out in Section 165.[16]

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15. Freyburger, *Pension Plans—The Philosophy of 165(a)*, 22 TAXES 60 (1944).

16. For a discussion of the earlier legislation affecting the tax status of pension, profit-sharing and stock bonus plans, see CLARK, PROFIT SHARING AND PENSION PLANS—LAW AND TAXES §§ 13, 62 (1946); P-H PENS. & PROF. SHAR. SERV. ¶ 5001 (1951).

The Revenue Act of 1942 entirely rewrote Section 165 and Section 23(p), with the dual objectives of preserving the fundamental tax advantages provided under earlier enactments and at the same time blocking tax avoidance loopholes. Sweeping changes as to the number of employees which must be covered and as to requirements for non-discrimination were adopted.[17] Only plans which benefited large numbers of employees were to be given favorable tax treatment and those covering only a few, favored, high-salaried employees or executives should not qualify.[18] Thus, minimum coverage requirements were inserted into the law, with the added proviso that plans which do not meet the minimum requirements may nevertheless be qualified if the classification is found to be non-discriminatory by the Commissioner. It was recognized, however, that such extended coverage alone would be no guarantee that the trust was designed for the welfare of the employees generally, in view of the possibility of manipulating the benefits under the trust.[19] Consequently, the statute requires the extension of the benefits and contributions to be administered in a non-discriminatory manner, to prevent the favoring of high-salaried employees. Section 23(p) was greatly changed in that all contributions to all types of plans must be deductible under this section in addition to being required to meet the test of reasonable compensation under 23(a).[20] For the first time, all deferred compensation systems, to be deductible, had to comply with the newly rigorous requirements of 165(a) for qualification.[21]

For a plan to qualify under Section 165(a), the Commissioner requires generally that it be a plan: (1) established for the exclusive benefit of the employees or their beneficiaries,[22] (2) permanent and definite,[23] (3) written and communicated,[24] (4) by which it is

17. Considering the necessity for raising revenue, it might not have been surprising if the Treasury had proposed and Congress had enacted more stringent legislation. But Congress, realizing the ever increasing importance of pension and profit-sharing plans, continued to look upon them with favor. The Treasury, represented by Mr. Randolph Paul, tax advisor to the Secretary of the Treasury, proposed more rigid standards in two respects than were later adopted. The first of these was that the plans should be fully vested, and the second was that contributions for pensions over $7,500 should not receive the favorable tax treatment. See *Hearings before Committee on Ways and Means on Revenue Revision of 1942,* 77th Cong., 2d Sess. 2405 (1942).

18. *Id.* at 2406.

19. *Ibid.*

20. P-H PENS. & PROF. SHAR. SERV. ¶ 5001 (1951).

21. An exception to this will be found in non-qualified plans in which the interest of the employee is non-forfeitable.

22. U.S. Treas. Reg. 111, § 29.165-1, as amended, T.D. 5422 (Dec. 13, 1944), P-H PENS. & PROF. SHAR. SERV. ¶ 9176 (1949).

23. *Ibid.*

24. *Ibid.*

impossible to divert the funds to any other purpose than for the benefit of the participants or their beneficiaries,[25] and (5) that the plan shall not discriminate in favor of officers, stockholders, highly paid, or supervisory employees, either in coverage or contributions and benefits.[26]

The 6th Circuit, in *Lincoln Electric Company Employee's Profit-Sharing Trust, Cleveland Trust Company, Trustee v. Commissioner of Internal Revenue,*[27] has held the requirements invalid to the extent that they deny tax-exempt status to a profit-sharing plan when there is but one contribution. The Court, in overruling the Tax Court,[28] said in effect that "permanency" and "definite profit-sharing formula" were not required by Section 165(a).[29]

In December, 1941, the Lincoln Electric Company established a trust for the benefit of 890 of its employees, most of the company's personnel, and paid $1,000,000 to the trustee for purposes of the trust. There was no provision for future contributions to the trust, nor were any made. The trust was to continue for a term of ten years, unless distribution of all the benefits under its terms had been fully completed prior to that time.[30]

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25. U.S. Treas. Reg. 111, § 29.165-2 (1943), P-H PENS. & PROF. SHAR. SERV. ¶ 9177 (1945).

26. U.S. Treas. Reg. 111, § 29.165-3 (1943), P-H PENS & PROF. SHAR. SERV. ¶ 9178 (1943); U.S. Treas. Reg. 111, § 29.165-4, as amended, T.D. 5422 (Dec. 13, 1944), P-H PENS. & PROF. SHAR. SERV. ¶ 9179 (1945).

27. 190 F.2d 326 (6th Cir. 1951).

28. 14 T.C. 598 (1950).

29. In so finding, the circuit court sided with three dissenting Tax Court judges "with whose views [they] are in complete accord."

30. The right of Lincoln Electric to claim full tax deduction for the $1,000,000 contribution made in 1941 has not yet been settled after 10 years of bitter litigation.

The company claimed the deductions under Sec. 23(a) I.R.C. as an ordinary and necessary expense or as compensation paid for personal service; or under Sec. 22(a) I.R.C. as a part of the cost of goods sold.

The commissioner disallowed the deductions and his ruling was upheld by the Tax Court. 6 T.C. 37 (1946).

The Company appealed to the circuit court of appeals, 162 F.2d 379 (6th Cir. 1947), which reversed the Tax Court and held that the contributions were ordinary and necessary business expense.

Back in the Tax Court, the Commissioner argued that the court should decide the question of reasonableness of the deduction, but the Tax Court held that it was without power to decide that issue, because the circuit court had held that the contributions were ordinary and necessary. T.C. Memo and Order (Oct. 27, 1947).

The Commissioner appealed this ruling, and was this time upheld by the circuit court which held that it was the function of the Tax Court to determine whether or not the amounts were reasonable; the element of reasonableness being inherent in the phrase "ordinary and necessary." 176 F.2d 815 (6th Cir. 1949).

At this writing, the Tax Court has yet to determine the amount of deduction which would be reasonable. The Supreme Court denied the Company's application for certiorari. 338 U.S. 949 (1951). See P-H PENS. & PROF. SHAR. SERV. ¶ 1013 (1947); ¶ 1019 (1947); ¶ 5016 (1951); Peters, *Lincoln Electric Co. Case,* 4 MIAMI L.Q. 12 (1942); Comment, 49 MICH. L. REV. 395 (1951); Note, 45 ILL. L. REV. 295 (1950).

The Commissioner determined a deficiency in income tax with respect to the earnings of the trust for 1944. The question was whether the employees' profit-sharing trust was tax-exempt within the meaning of Section 165(a). The case is extremely significant. It involves the tax-exempt status of a trust in 1944, after the important amendments of 1942. Not only could it affect the necessity for "permanency" and "definite profit-sharing formula" to qualify for tax exemption of earnings on similar trusts already in existence, but, likewise it could affect the requirements for original qualification of a plan under Section 165(a), so that the employer may deduct his contribution under Section 23(p).[31]

Permanency of a Plan

Treasury regulations insist that a plan must be permanent "as distinguished from a temporary program".[32] Although subject to disqualification at any time, the Commissioner usually passes on the question either when the plan is submitted for initial approval, or at the time it is terminated. In the latter instance, disqualification would have a retroactive effect in disallowing exempt status for all years in which the plan did not qualify and upon which the statute of limitations had not run.[33]

Little basis for the requirement of permanency can be found in the Code. As pointed out in the opinion in the *Lincoln* case, and by the dissenting judges in the Tax Court, the statute requires only that there be a "plan".[34] The Commissioner's insistence on permanency is based on the desire to restrict the creation of plans during years of high profits, principally to secure tax advantage, only to be abandoned as profits decrease and when it no longer appears desirable from a tax standpoint to continue payments.[35] Doubtless, the Commissioner considers that the provisions of the statute prescribing non-discrimination and non-diversion of the funds furnish sufficient statutory basis for requiring permanency.[36] It is suggested, however, that the require-

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31. Lincoln is seeking its original deduction under § 23(a) I.R.C. Prior to the Revenue Act of 1942, deductions for profit-sharing trusts, stock-bonus plans and current pension liability (as distinguished from past service pension liability) were made under § 23(a). Thus, it was not necessary, under this section, to meet the requirements of § 165(a) I.R.C. to claim deduction. With the 1942 amendments, deductions for all profit-sharing, stock-bonus, and pension plans are deducted under § 23(p) I.R.C.

32. U.S. Treas. Reg. 111, § 29.165-1(a), as amended, T.D. 5422 (Dec. 13, 1944).

33. P-H PENS. & PROF. SHAR. SERV. ¶ 4214 (1951).

34. INT. REV. CODE § 165(a).

35. PS 7, dated July 29, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9505 (1946).

36. CLARK, PROFIT SHARING AND PENSION PLANS—LAW AND TAXES § 35 (1946).

ments of non-diversion and non-discrimination may be fully effectuated, regardless of the permanency of the plan.[37]

The Commissioner will act on the presumption that the plan is being created as a permanent program, unless there is clear evidence to the contrary.[38] While the employer may reserve the right to alter or terminate the plan, its abandonment within a few years[39] for any cause other than business necessity, will create a presumption that the plan at its inception was not intended to be permanent.[40] This presumption may be rebutted by such facts as adverse business conditions not within the control of the employer,[41] bankruptcy or insolvency,[42] or unanticipated sale or transfer of the business. These conditions must not have been reasonably foreseen.[43] There is little differentiation between profit-sharing, pension, or stock bonus plans in this respect in the rulings promulgated by the Commissioner, since the requirement of permanency applies to all types of deferred compensation plans.[44]

If permanency no longer be necessary, as suggested by the Circuit Court, early termination would not in any way affect the non-diversion subsection of the Code.[45] The plan could be terminated at will, but the proceeds previously contributed by the employer would be distributed among the employee participants or their beneficiaries.

Similarly, the Commissioner could greatly strengthen the anti-discrimination requirements to prevent possible discrimination in favor of officers, supervisory or highly compensated employees in the event that

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37. "The probable intention of Congress in the use of the term [plan] was . . . merely to describe the general character of the arrangement in respect to which a trust forming part thereof may qualify as tax exempt." CLARK, *op. cit. supra* note 36, at 118. In contrast to the term "plan," Section 165(a) sets out in some detail the requirements of non-discrimination and non-diversion of the funds.

38. PS 52, dated Aug. 9, 1945, P-H PENS. & PROF. SHAR. SERV. ¶ 9551 (1945).

39. It is not certain what is meant by a "few years." Since MIM. 5717, discussed below, uses a 10 year period, the term might well be considered to mean 10 years or less.

40. See notes 32 and 38 *supra*.

41. See note 38 *supra*.

42. *Ibid.*

43. In one instance, the Tax Court held in favor of an employer who discontinued his profit-sharing plan after it had been in operation only one year because the main purpose of the plan as originally envisaged was found to be impossible of fulfillment. Blume Knitwear, 9 T.C. 1179 (1947).

44. In order for the Commissioner not to disqualify a plan retroactively should it be terminated, the plan must: (1) be spelled out in the written documents furnished the Commissioner at its inception; (2) meet qualification requirements in other respects during its operation; (3) have been intended to be permanent; and, (4) valid reasons for termination must exist. MIM. 6136, dated Apr. 3, 1947, P-H PENS. & PROF. SHAR. SERV. ¶ 9271 (1947); ¶ 4213 (1951).

45. It is required in § 165(a)(2) I.R.C. that "at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust . . . [it shall be impossible] for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of . . . employees or their beneficiaries."

the plan does not prove to be a permanent one. The possibility of discrimination on early termination is more acute in a pension than in a profit-sharing plan because pensions for the highly paid employees or others, in favor of whom discrimination is prohibited under Section 165 (a), could be fully funded and then the plan abandoned.[46] To prevent this possibility, the Commissioner has limited the amount of deductible employer contributions for the 25 highest-paid employees scheduled to receive pensions in excess of $1,500 a year when the plan goes into effect, in the event that the plan is terminated or current costs are not met during the first ten years following its establishment.[47] Any excess funds which have been contributed by the employer would be distributed among other employees, but so as not to discriminate in favor of the more highly compensated employees.[48] This limitation has never been applied to profit-sharing trusts, but there is no apparent reason why a similar rule should not be promulgated.

While the safeguards provided by statute in Section 165(a) may be effectuated by proper exercise of the authority expressly found in the statute, without the added requirement of permanency, the removal of such a requirement is likely to give added momentum to the institution of pension and profit-sharing plans. Thus, employers who have desired to install plans in past years, but have refused because of a hesitancy to commit themselves to a permanent program, will be more inclined to establish them. They would not face the possibility of having their deductions retroactively denied, after having initially and year by year seemingly met the qualification requirements. The burden of proving "business necessity", as applied by the Commissioner, as a condition to terminate or even amend has proved a deterrent to many employers. The problem has been especially critical in the area of profit-sharing. Since profit-sharing contributions are tied to earnings, the abandonment of the plan is more difficult to justify.[49]

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46. U.S. Treas. Reg. 111, § 29.165-1, as amended, T.D. 5422 (Dec. 13, 1944).

47. P-H PENS. & PROF. SHAR. SERV. ¶ 4211 (1951). The restrictions are contingent and do not affect the plan so long as it is kept in operation and current costs are met. Nor do the requirements have any bearing on deductions of contributions under § 23(p) I.R.C. However, should the plan be terminated within the prescribed period, the maximum employer contributions which may be used for any employee within the restricted group is limited to the greater of: (1) $20,000, or (2) an amount computed by multiplying 20% of his annual compensation or $10,000, whichever less, by the number of years since the establishment of the plan. There may be a possibility that a new 10 year period will begin to run if there is a change in the plan which might substantially increase the possibility of discrimination. MIM. 5717, dated July 13, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9548 (1950); ¶ 4224 (1951).

48. PS 8, dated Aug. 4, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9506 (1946).

49. CLARK, *op. cit. supra* note 36, at 123.

The advantage gained by making pension and profit-sharing plans more attractive to employers, thus assisting employees to solve their economic problems, would seem to greatly outweigh the possibility that not requiring permanency would induce the use of a plan as a tax avoidance device. The maximum amounts which may be deducted each year under Section 23(p) are rigidly fixed and generally are not affected by the duration of the plan.[50]

Moreover, pension plans are unavoidably bound to union collective bargaining agreements. Pension benefits are now wages in the sense that there is a legal duty to bargain concerning them.[51] Insistence on permanence is not consistent with this concept since there is likelihood of a change in the plan whenever a new collective bargaining agreement is negotiated. The Commissioner has recognized the problem, and, while not discarding the permanency requirement, has indicated that he will not prevent initial qualification under 165(a) of the ordinary union negotiated pension plan.[52] In his first ruling it was stated that the plan would be considered permanent, even though the union contract did not require the employer to continue the plan beyond the contract term.[53] A subsequent ruling indicates the permanency requirement is met if there is no provision in the union agreement or any collateral document which requires that the plan be discontinued, or which shows an intent to discontinue the plan at a definitely determinable time; and if there is some showing (to the employees) of an intention to continue the plan on a permanent basis.[54]

If the union agreement or other document specifically provides that the plan is to terminate at a definite date, the plan must cover only those employees who could retire within that time.[55] Only in this situation could the permanency requirement not be invoked to bring about a retro-

50. If a pension plan is involved, it is assumed that the actuarial determination of the yearly liability would be made on the basis that the plan would be permanent.

51. Inland Steel Co. v. NLRB., 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949).

52. The problem is not likely to arise in case of a profit-sharing trust, but it would seem that there should be no difficulty in applying the principle to that area as well.

53. PS 64, dated Nov. 9, 1950, P-H PENS. & PROF. SHAR. SERV. ¶ 9563 (1950); ¶ 5021 (1951).

54. The employer still must obtain the approval of the Commissioner to terminate or amend. Deductions might be retroactively disallowed, should the employer desire to terminate the plan perhaps at the end of the collective bargaining contract, when the union may no longer press for continuance of the plan. It is this possibility that is likely to work the most serious hardship on the unwilling employer forced to install a pension plan solely through union pressure.

55. PS 67, dated Apr. 26, 1951, P-H PENS. & PROF. SHAR. SERV. ¶ 9566 (1951). Any funds in excess of those required for liabilities to pensioners or those eligible to retire at the time of termination may revert to the employer.

active disallowance of deductions. Therefore, an employer desiring to avoid difficulty in securing approval for termination of a union negotiated plan may seek to require that there be a definite termination date. However, consideration should be given to the possibility that the advantages of a plan with a definite termination date would not outweigh the disadvantage of limiting the funding of pensions to only those who could retire within the specified period.

This possible incentive to definiteness of termination frequently could bring about a result opposite to the permanency which the Commission is endeavoring to achieve. This inconsistency could possibly be rationalized on the basis that permanency for its own sake is not what is being sought by the Commissioner, and a plan with a short but definite life could be justified under some circumstances.

Definiteness

Section 165(a) provides for deduction of contributions to bonus, pension, or profit-sharing plans which provide for the distribution of the fund accumulated only to employees or their beneficiaries. In the case of a profit-sharing plan, the Commissioner has interpreted the word "plan" to mean that there must be definite formulae for determining the profits to be shared and for the distribution of the funds thus accumulated.[56] The Circuit Court in the *Lincoln* case held the definite contribution formula requirement was not supported by the statute.[57]

There are two principal rules governing profit-sharing formulae which will adhere to the Commissioner's interpretation.

First, a profit-sharing formula must involve no discretion on the part of the employer;[58] and secondly, the amount contributed under the formula should fluctuate with profits, but may be limited to a maximum per cent of the compensation of participants.[59] There is no limitation on the amount of profits which a formula might share. However, deductions for contributions would be limited by Section 23(p)(1)(C) to

56. See note 32 *supra*. I.T. 3661, dated May 25, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9226 (1950).

57. Lincoln Electric's profit-sharing plan provides for a definite destribution formula. It would appear doubtful that the necessity for a distribution formula will ever seriously be questioned.

58. PS 33, dated Sept. 20, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9531 (1945). An example of an invalid formula would be one providing for a contribution of 50% of net profits, less dividends on common stock as voted by the Board of Directors, or less a contingency reserve as voted by the Board. PS 21, dated Aug. 29, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9519 (1945).

59. A formula which provided for a percentage of net profits, but limited contributions to a maximum of 15% of compensation of participants would be allowable. How-

15% of compensation paid participating employees, plus possible carry-over deductions in subsequent years. Nor will a formula be disallowed because the percentage of profits to be contributed to the fund might increase or decrease as profits vary. This flexible factor may be introduced into the formula provided the percentage is definitely determined by actual conditions, and does not depend on discretion.[60]

In this regard, it is essential that the basic differences between profit-sharing and a pension plan should be understood and maintained, because of the difference in deductions allowable under 23(p). A profit-sharing plan is one established by an employer to provide for participation by his employees in his profits, and the funds thus accumulated are distributed after a fixed number of years, an attainment of a stated age, or upon the occurrence of some event such as illness, death, retirement, disability, or severance of employment. A pension plan provides systematically for the payment of definitely determinable benefits over a period of years, usually for life, after retirement. Retirement benefits are generally measured by such factors as years of service and the wages or salaries received by the employees. Neither the amount of benefits nor the contributions to the pension fund is dependent on the employer's profits. If either the benefits payable to the employee, or the required contributions to provide the benefits can be determined actuarially, the plan is a pension plan.[61]

Generally, larger tax exempt contributions may be made for a profit-sharing plan than a pension plan.[62] Should the requirement of a definite profit-sharing formula be removed, there would undoubtedly be a trend toward a greater use of a profit-sharing plan to provide income at retirement. However, in most organizations, the security provided the employee by a fixed pension benefit should not be entirely lacking. It is suggested that this measure of security plus the advantages of the profit-sharing principle might well be achieved by designing a pension plan with the benefits low enough that the fixed commitment would not be unreasonable for the employer. In addition there would be a profit-

ever, if the plan provided that the maximum would be contributed regardless of profits, the plan would not be a profit-sharing plan, but a pension plan. PS 24, dated Sept. 2, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9522 (1947). Examples of formulae provided by the Commissioner are: (a) a specified percentage of annual profits, or (b) a specified percentage of annual profits in excess of the sum of dividend commitments plus a fixed amount. I.T. 3661, *supra* note 56.

60. PS 33, dated Sept. 20, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9531 (1945).

61. See note 32 *supra*. Benefits are not actuarially determinable if the funds arising out of forfeitures are used to increase the sums standing to the credit of remaining participants, instead of being used to reduce the amount of contributions to be made by the employer.

62. INT. REV. CODE § 23(p).

sharing trust into which the employer could, at his own discretion, place funds to be used for retirement benefits.[63] By the use of this principle, many firms unwilling to install a pension plan with its high fixed obligations could help provide for the retirement needs of their employees. Employers could decide yearly what profits, if any, would be included. In exceptionally good years, more willingness would be shown to make large contributions to profit-sharing because of the knowledge that such a liberal policy could be curtailed in years that the profits should be directed into other channels. As in the case of the *Lincoln Electric* trust, it would be logical to assume that some employers might be willing to make a single large contribution with no intent of making any subsequent contributions.

In addition to the greatly increased flexibility, there would be other significant inducements to the institution of profit-sharing plans. While ways have been devised to avoid its full effects, many employers, even though they might desire to share profits, have been reluctant to expose the amount of profits to their employees and the public to the extent necessary in establishing a definite formula plan.

If such requirement should be no longer necessary, the fundamental principle underlying profit-sharing would be completely reversed. Under present regulations, profits must be shared in a mechanistic, automatic manner which involves absolutely no management discretion. Should the rule of the 6th Circuit be adopted, this insistence on non-discretion would be replaced by complete discretion on the part of management as to what profits are to be shared. Instantly, profit-sharing would become more palatable to the employer. The protections afforded the employee in the sole-benefit, non-discrimination, and non-diversion rules, discussed below, would be unaffected by granting the employer this prerogative.

The stand of the Commissioner could be justified on the basis that in this area the possibility of the use of a profit-sharing plan as a tax avoidance device is very acute. But, as was pointed out in the decision of the 6th Circuit, this argument is of little avail where the trust is irrevocable, as is necessary under the non-diversion requirement.[64]

It has been suggested also that definite agreement to contribute a certain percentage of profits will produce greater employee acceptance

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63. A profit-sharing plan, however, may not be actually used to meet the costs of a pension plan. PS 37, dated Oct. 7, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9535 (1945).

64. It becomes of even greater insignificance in the case of the "one-contribution type" established by Lincoln Electric where the opportunity of deductions for contributions in other years of perhaps larger profits was surrendered. See note 27 *supra*.

of a profit-sharing plan.[65] However, it would seem that a discretionary type plan will, if adequately explained, receive as high a percentage of acceptance as one based on a definite contribution formula. If the employee is confident that the employer is acting in good faith, the presence or absence of a definite formula would have little significance so far as the employee is concerned.

It would seem that the requirement of definiteness which the Commissioner applies to pension plans, *i.e.* that they be established and maintained on an actuarially sound basis, should meet with very little criticism.[66] However, many union negotiated plans cannot meet this requirement. Contributions based on some factor other than the amount of pensions to be provided, such as a fixed amount per employee or a flat percentage of the payroll, will not insure an actuarially sound plan if the amount of pensions to be paid is also fixed.[67]

Thus, the desire to qualify union negotiated pension plans conflicts with the regulations governing qualification. The regulations were adopted at a time when union negotiated plans were rare, and when the principal need was to ferret out unsound plans established for a limited group. This conflict was partially resolved by the Commissioner's ruling that both the contributions and the benefits may be fixed in a union negotiated plan, if the employer certifies that he has used reasonable actuarial calculations.[68]

Written and Communicated Plan

The regulations have defined the term "plan" to mean "a definite written program and arrangement communicated to the employees."[69] The requirement that the plan be written is to insure strict compliance with the non-discrimination provisions.[70] If a trust is involved, it must be a valid existing trust under the laws of the jurisdiction to which the trust is subject.[71] Communication is not made necessary by the statute and was not required by the regulations before 1938.[72] The Commissioner has not specified the nature of the communication required, or

65. SEN. REP. No. 610, 76th Cong., 1st Sess. 127 (1939).

66. See note 32 *supra.*

67. An example would be where the employer was required to contribute 25 cents per ton to a pension fund, and at the same time the employees would be guaranteed $100.00 a month pensions. It should be evident that there is no correlation necessarily between the benefits promised and the contributions.

68. PS 64, dated Nov. 9, 1950, P-H PENS. & PROF. SHAR. SERV. ¶ 9563 (1950).

69. See note 32 *supra.*

70. CLARK, *op. cit. supra* note 36, § 15.

71. MIM. 5985, dated Feb. 21, 1946, P-H PENS. & PROF. SHAR. SERV. ¶ 9267 (1946).

72. Nor would a trust be invalid without it. However, communication *may* be necessary in a group annuity plan where no trust is used. CLARK, *op. cit. supra* note 36, § 17.

when it must be made. As a practical matter, the employer should realize the importance of communicating the plan to his employees, whether or not this requirement of the regulation be valid. Contributions made to a pension or profit-sharing plan will prove to be a good investment only to the extent they are understood and appreciated by the employees. Failure to disclose the plan to employees would be indicative of lack of good faith on the part of the employer.

Exclusive Benefit Rule

Section 165(a) provides for exemption of contributions to a trust forming part of a plan of an employer "for the exclusive benefit of his employee or their beneficiaries."[73]

The implementing regulations promulgated by the Commissioner would seem to have the full support of the statute. A plan will not qualify if designed as a subterfuge for the distribution of profits to shareholders, even if other non-shareholding employees are included.[74] Former employees may be included, or those in the armed forces or on temporary leave.[75] Beneficiaries may include the employee's estate, dependents, natural objects of the employee's bounty, or persons designated by him to share in the benefits of the plan after his death.[76] In no event may the plan name the employer as beneficiary.[77] When a stock bonus or profit-sharing plan is used to support a pension plan, the former is not for the employee's sole benefit.[78]

The Commissioner has rather broadly construed the term "employee" to include officers, employed shareholders,[79] and even board chairmen.[80] However, partners and individual entrepreneurs may not participate, although they may create plans for their employees.[81] An attorney who derives the major portion of his income from private prac-

73. See note 34 *supra.* The phrase "or their beneficiaries" was added by the 1942 amendments.

74. See note 32 *supra.*

75. *Ibid.*

76. *Ibid.*

77. See P-H PENS. & PROF. SHAR. SERV. ¶4161 (1950). An employee must be given the right to name his own beneficiary. However, in the absence of any designation, the plan may provide that the beneficiary will be designated in a certain order of priority, such as wife, children, parents, etc.; but any such designation must be subject to change by the employee. Any actual designation of a beneficiary by an advisory committee, even after consultation with the employee would not meet the requirements of § 165 (a)I.R.C. PS 19, dated Aug. 29, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9517 (1945).

78. U.S. Treas. Reg. 111, § 29.165-1, as amended, T.D. 5422 (Dec. 13, 1944); P-H PENS. & PROF. SHAR. SERV. ¶4035 (1951).

79. Holmes v. Republic Steel Corp., 84 Ohio App. 442, 84 N.E.2d 508 (1948).

80. PS 23, dated Sept. 2, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9521 (1947); ¶4035 (1951).

81. U.S. Treas. Reg. 111, § 29.165-1, as amended, T.D. 5422 (Dec. 13, 1944).

tice, over which the client who pays him the largest fee has no control, is not an employee of that client.[82]

The employer who faces the prospect of contributing to a union welfare plan should realize that his contribution may not qualify if the plan is designed to benefit all of the union members, wherever employed, and thus could not be considered a plan for the exclusive benefit of the employees of the particular employer.

Non-diversion Rule

As a corollary to the concept that a plan must be for the exclusive benefit of employees or their beneficiaries, Section 165(a) provides that it must be "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or beneficiaries."[83] The primary purpose of this provision is to prevent employers from making tax exempt contributions in profitable years, only to retrieve them in less remunerative years.[84]

The regulations require that the trust instrument make impossible any such diversion by operation or termination of the trust, revocation or amendment, the happening of a contingency, or by any other means.[85] Excluded are all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.[86] In actual practice, this means that the employer may not retrieve any funds paid to the trustee.[87] There are two exceptions to this rule: (1) an employer may reserve the right to recover any balance due to "erroneous actuarial calculation;" however, this may be recovered only at the termination of the trust, and only after all fixed and contingent liabilities to employees are met;[88] (2) an employer may

82. This does not necessarily mean that an attorney, to qualify as an employee, must devote full time to the employer's business. As an attorney, however, the major portion of his working time and services must be devoted to the interests of the employer who controls and directs his activities in this respect. PS 15, dated Aug. 24, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9514 (1945).

83. INT. REV. CODE § 165(a)(2).

84. I.T. 6394, dated May 31, 1949, P-H PENS. & PROF. SHAR. SERV. ¶ 9274 (1950); CLARK, *op. cit. supra* note 36, § 47.

85. U.S. Treas. Reg. 111, § 29.165-2 (1943).

86. *Ibid.*

87. BUREAU OF NATIONAL AFFAIRS, HANDBOOK FOR PENSION PLANNING 54 (1949).

88. For example, if 1,000 employees are covered by a plan, and only 300 have satisfied the eligibility requirements to receive a pension, a contingent obligation has arisen toward the remaining 700. Until this is met, no excess resulting from actuarial error could be recovered.

insert a provision in the plan that will permit recovery of the contribution in the event that such payment is not approved by the wage stabilization authority.[89]

No specific limitations are provided in Section 165(a) with respect to investments of the trust fund. However, care must be taken to assure that the funds are not improperly diverted by the borrowing of trust funds by the employer, or investment in the employer's securities. Where the trust funds are invested in stock or securities of the employer, full disclosure must be made to the Commissioner of the reasons for such investments and the conditions under which they are made.[90] The lending of money by the trust to the employer would logically fall in the same category.[91]

It would appear that the interpretations of the Commissioner in this general area follow the mandates of the statute with one exception. Apparently, the non-diversion rule prevents the employer from recovering sums paid into the trust resulting from mathematical miscalculations, errors in the calculation of profits under a profit-sharing plan, or erroneous inclusion of individuals. It is suggested that this requirement is not demanded by the statute, and is very likely to work hardship on the employer. Sums paid in error do not fairly constitute a part of the corpus or income of the trust, and, therefore, a trust provision allowing for their recovery should not prevent a plan from qualifying under Section 165(a).[92]

Non-discrimination Rule

A second corollary to the "exclusive benefit rule," and probably the heart of the qualification requirements, is that there must be no discrimination "in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."[93] The Commissioner is not only interested in whether the plan is discriminatory on its face, but also whether it could possibly be discriminatory in its operation. The non-discrimination requirement may have major importance in two phases of the pension designing problem; in eligibility or coverage and in benefits and contributions.

To insure adequacy in eligibility or coverage, Section 165(a)

89. PS 68, dated July 3, 1951, P-H PENS. & PROF. SHAR. SERV. ¶ 9567 (1951). Such a provision was also in effect during World War II, but was later revoked.

90. See note 81 *supra*; PS 49, dated June 16, 1945, P-H PENS. & PROF. SHAR. SERV. ¶ 9547 (1945).

91. P-H PENS. & PROF. SHAR. SERV. ¶ 4203 (1951).

92. CLARK, *op. cit. supra* note 36, § 47.

93. INT. REV. CODE § 165(a)(3)(B); § 165(a)(4).

requires the satisfaction of either the "arbitrary requirement," or the "non-discrimination requirement."

The arbitrary requirement, specifically provided for in the statute,[94] is complied with if, after short-term and part-time employees have been excluded, the plan actually covers at least 56% of the remaining employees.[95] This requirement refers to a percentage of all active employees, including employees temporarily on leave or in the armed forces, if such employees are eligible under the plan.[96]

Should a plan not satisfy the arbitrary requirement for coverage, it may still qualify as a non-discriminatory plan.[97] To do so, a plan must cover those employees within a classification established by the employer and found by the Commissioner to be non-discriminatory in favor of officers and shareholders. Most plans fulfill the non-discrimination requirement in this manner, rather than by the arbitrary coverage requirement,[98] since no specific percentage of employees need be covered.

There is little concrete information as to what types of coverage requirements will be found discriminatory. The statute itself specifies several classifications that, in themselves, will not discriminate; *i. e.*, exclusion of employees whose entire wages are covered by Social Security (those earning under $3,600), or limitation of the plan to salaried or clerical employees.[99] Other plans have been approved which were limited to male employees, employees above a stated age (especially if there is high turnover among the lower age group), employees not covered in the collective bargaining agreement, or employees at a particular plant or division.[100] In most plans, a combination of eligibility requirements are found, such as minimum and maximum age limitations and a specified number of years of service with the company.[101] In profit-sharing plans, there is a possibility that the eligibility requirements may be discriminatory if a large group, among whom there is a high rate of turn-

94. INT. REV. CODE § 165(a)(3)(A).

95. Specifically, the statute provides that 70% of all employees actually participate; or 80% of all eligible employees participate providing that 70% of all employees are eligible. To determine whether the plan meets this requirement, the term "all employees" may exclude employees who have not been employed for a minimum period of time specified in the plan (not exceeding five years), and part-time employees, whose customary employment is for not more than 20 hours in any one week, or whose customary employment is for not more than 5 months in any one calendar year.

96. U.S. Treas. Reg. 111, 29.165-3 (1943).

97. INT. REV. CODE § 165(a)(3)(B).

98. BUREAU OF NATIONAL AFFAIRS, HANDBOOK FOR PENSION PLANNING 55 (1949).

99. INT. REV. CODE § 165(a)(5).

100. BUREAU OF NATIONAL AFFAIRS, HANDBOOK FOR PENSION PLANNING 55 (1949).

101. For an analysis of the eligibility requirements of a number of pension plans, see BANKERS TRUST COMPANY, A STUDY OF INDUSTRIAL RETIREMENT PLANS (1950).

over, are permitted to participate, since forfeitures from this turnover might then be reallocated to a select group.[102]

For a plan to satisfy the requirements as to coverage, it must qualify at least one day in each quarter of the taxable year.[103] If the employer has more than one plan in operation, *e.g.*, one for salaried and another for wage-earning employees, these plans may be considered as a unit for the purpose of testing coverage.[104] If they fail to qualify when considered together, individual plans may qualify separately.[105]

As a practical matter, compliance with the coverage requirements of the statute as interpreted by the Commissioner should not be overly difficult. However, one serious problem has arisen in union negotiated plans. Many employers find it difficult to meet the requirements as to non-discrimination in coverage when dealing with specific unions within a plant. Even more difficult is the establishment of a coverage that will qualify if employers wish to exclude employees with whom they may have to bargain collectively. The Commissioner's interpretation and application of the non-discrimination requirement to coverage was developed before the prevalence of union negotiated plans. The statute itself would seem to be sufficiently flexible in this regard to permit a modification in the Commissioner's concepts of discrimination so as to ease the situation. In such instances, the Commissioner might promulgate special rulings, freeing both the employer and union from being hampered by the possibility that a plan covering only a particular group, singled out through the realities of the collective bargaining process, may not meet the coverage requirements.

Not only must a plan comply with the coverage requirements, but in addition, there must be no discrimination as to contributions or benefits.[106] This statutory requirement would seem to grant the Commissioner the greatest control over the tax exempt status of contributions. If any of the provisions of the plan could possibly operate in a discriminatory manner in favor of officer, shareholder, or supervisory employees as against other employees, either within or without the coverage of the plan, then the plan does not adhere to Section 165(a).[107]

The non-discrimination rule applies to all considerations of pension designing and profit-sharing. These generally may be categorized into considerations of the time of payment of the benefits, the amount of

102. CLARK, *op. cit. supra* note 36, § 19.
103. INT. REV. CODE § 165(a)(6).
104. See note 96 *supra*.
105. PS 27, dated Sept. 2, 1944, P-H PENS. & PROF. SHAR. SERV. ¶ 9525 (1945).
106. INT. REV. CODE § 165(a)(4).
107. U.S. Treas. Reg. 111, § 29.165-4, as amended, T.D. 5422 (Dec. 13, 1944).

benefits to be paid, and the mode of funding the plan. Improper designing in any of these general areas may render the plan discriminatory. No attempt will be made to discuss all of the many rulings promulgated by the Commissioner on non-discrimination, but it seems proper to consider some of the more important.

The plan will not be discriminatory merely because the higher paid employees receive larger benefits than lower paid ones, if the benefits have a uniform relationship to the employee's regular income.[108] Benefits in a profit-sharing plan may vary according to a distribution formula which takes into account years of service or similar factors.[109] Plans may be contributory, but if the required contributions are so burdensome as to make the plan acceptable to only the higher paid employees, the plan will be discriminatory.[110]

At one time, a Commissioner's ruling[111] limited contributions on behalf of stock-owning employees (those who owned or controlled more than 10% of the stock of a corporation) to not more than 30% of the total contributions made on behalf of all participating employees.[112] The rule acted as a deterrent to establishing pension and profit-sharing plans in small closely held corporations, which would likely have a large percentage of stockholding employees. In the *Volckening* case,[113] the Tax Court overturned the 30% rule, holding it to be merely a general factor to be considered with all of the circumstances. The Commissioner did not appeal the decision, but instead acquiesced; thus, in effect, revoking the rule.[114] The removal of this rule should greatly increase the interest in profit-sharing and pensions among smaller corporations.

The statute provides that a plan shall not be discriminatory merely because employees are excluded whose income is less than what constitutes wages for purposes of Social Security.[115] Likewise, the plan will not be discriminatory merely because the contributions or benefits are larger for the income above what constitutes wages for Social

108. See note 99 *supra*. This permits higher paid employees to receive larger benefits than lower paid ones. In a sense, this could be considered discriminatory, but it is not the type of discrimination in which the commissioner has interested himself.

109. See note 107 *supra*.

110. See note 96 *supra*.

111. I.T. 3674; I.T. 3675; I.T. 3676; P-H PENS. & PROF. SHAR. SERV. ¶ 9227, ¶ 9228, ¶ 9229 (1950).

112. P-H PENS. & PROF. SHAR. SERV. ¶ 4071 (1951).

113. Volckening v. Commissioner, 13 T.C. 723, (1949).

114. I.T. 4020, P-H PENS. & PROF. SHAR. SERV. ¶ 9241 (1950).

115. INT. REV. CODE § 165(a)(5). This amount is now $3600, compared to the former $3000.

Security than for wages below that amount.[116] These provisions were included in the 1942 amendments to permit a plan, designed in good faith to supplement Social Security benefits, to qualify as not being discriminatory in favor of highly compensated employees.[117] However, the Commissioner has ruled that a plan which excludes employees on the basis of this low compensation, or which provides for higher benefits on one part of the compensation than on the other, will not qualify unless it "integrates" with Social Security benefits.

A plan is said to be integrated with Social Security when the ratio of federal payments and the pension plan benefit (if any) added together, is to compensation no greater for highly paid than for the lower paid employees.[118] Not only is the comparison made with those employees who are covered by the private plan, but with those employees excluded as well.[119] Because the federal benefit is fixed by law, limitation, if any, must be made in the private pension plan.[120]

Where Social Security coverage is available, generally most plans are designed as supplementary plans to take advantage of the already provided federal benefits.[121] The advantage to the employer is obvious; the cost of a plan is greatly reduced. However, the requirement that plans must integrate with Social Security has met with some criticism. The requirement tends to enforce limitations on plans which would be non-discriminatory under the general non-discrimination requirements, for where employees making an income of less than a specified amount are excluded, the necessity for integration is likely to become a limitation on the benefits of those employees who are included in a

116. INT. REV. CODE § 165(a)(5).

117. H.R. REP. No. 2333, 77th Cong., 2d Sess. 104 (1942); SEN. REP. No. 1631, 77th Cong., 2d Sess. 137 (1942).

118. P-H PENS. & PROF. SHAR. SERV. ¶ 4062 (1951).

119. *Ibid.*

120. *Ibid.* The Commissioner has promulgated two rulings, the latter of which applies to plans to be integrated under the recently amended Social Security laws. No attempt will be made in this brief space to analyze the technical requirements set forth in these two mimeographs. It should be said, however, that plans that integrate under the earlier ruling are not required to fulfill the new tests. MIM. 5539, dated Nov. 15, 1943, P-H PENS. & PROF. SHAR. SERV. ¶ 9256 (1947); MIM. 6641, dated May 3, 1951, P-H PENS. & PROF. SHAR. SERV. ¶ 9277; ¶ 4081 (1951).

121. Generally this is accomplished by one of two means: (1) deductive or offset method, where the amount received from Social Security is subtracted from the benefit received from the company plan; or (2) the additive method, by which the Social Security benefit is estimated and the plan designed so that the employee will receive an adequate retirement income when the company benefit and Social Security are added together. In other words, when the integration takes place on the "input side" of the plan, the additive method is being used, and when it takes place on the "output side"—the deductive method is in operation. See STRONG, EMPLOYEE BENEFIT PLANS IN OPERATION 51 (1950).

non-discriminatory manner, rather than a method of preventing discrimination.

There are no requirements that a ceiling be placed on benefits under a plan, although this was suggested by the Treasury during the hearings on the 1942 amendments to the Revenue Code. However, maximum benefits are often imposed in pension plans to reduce the cost. Where small companies are concerned and a majority of the persons to be covered are highly paid personnel, a maximum pension benefit may be necessary to prevent discrimination in favor of such employees.[122]

Neither the statute nor the rulings of the Commissioner require that the benefits under the plan be fully vested to the credit of the participants. Such a requirement of full vesting was suggested by the Treasury[123] but not included in the 1942 amendments. Obviously, the greater the vesting and the fewer the years of service required for vesting, the greater will be the cost of the plan. Despite this, the majority of plans do provide for some benefits on termination of employment before retirement age. In contributory plans, almost without exception, there is a return of the employees' contributions, often with interest.[124] A plan will be discriminatory if the forfeitures, which result because of a lack of vesting, inure principally to the benefit of the employees who are shareholders, officers, or highly paid employees, or if the forfeitures revert to the employer on termination of the plan.[125]

It is suggested that reservation of discretion in the administration of the plan be avoided wherever possible. The Commissioner will generally fail to qualify a plan under the non-discrimination provision when there is a reservation of discretion which can be used in a discriminatory manner, *i.e.* to favor one employee over another in a similar situation.[126] However, it is entirely possible for a discretionary power to be permitted in one plan and not in another because of the differences in the plans and the factual situations involved.

Summary

It is difficult to forecast in advance the effect which the latest *Lincoln Electric* decision will have on the field of pensions and profit-sharing. It is possible that the Commissioner will petition the Supreme

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122. P-H PENS. & PROF. SHAR. SERV. ¶4131 (1951).
123. *Hearings Before Committee on Ways and Means on Revenue Revision of 1942,* 77th Cong., 2d. Sess. 2405 (1942).
124. BOYCE, HOW TO PLAN PENSIONS 62 (1950).
125. PS 22, dated Sept. 2, 1944, P-H PENS. & PROF. SHAR. SERV. ¶9520 (1947).
126. P-H PENS. & PROF. SHAR. SERV. ¶4181 (1951).

Court for a review of the lower court's decision. Unless the Supreme Court adopts the view of the 6th Circuit, the Commissioner will not be bound by the decision, even in the 6th Circuit.[127]

It is suggested, however, that the Commissioner might well acquiesce in the decision. The removal of the requirements of permanency and definite profit-sharing formula would be within the spirit and letter of Section 165(a). Once the possibility of discrimination has been eliminated, there would seem to be no statutory authority for applying more stringent requirements for the purposes of qualifying a plan. More limiting requirements could be an attempt by the Commissioner to do administratively that which he was denied by Congress in the Revenue Act of 1942. While, by the very nature of the subject with its countless individual problems, it is necessary that the Commissioner be specifically given great discretionary power, it becomes of the utmost importance that the courts should critically review the requirements of the Commissioner in light of the basic purpose of the statute.

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127. P-H PENS. & PROF. SHAR. SERV. ¶ 4212 (1951).