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Tax Advantages of Retirement Plans

Sheldon M. Young* and Martin Silverman**

I. Background

IN 1930, THERE WERE APPROXIMATELY 110 RETIREMENT plans in the United States which could be classified as pension, profit-sharing or stock bonus programs. This mere ripple on the sea of American business has, in less than a generation, grown to a wave of respectable proportions, for there are now approximately 43,000 such plans which have qualified before the Treasury Department as programs to which tax-deductible contributions may be made and upon which contributions tax-free interest may be accumulated.¹

A great many factors have been responsible for this phenomenal growth—not the least of them being the impetus given to the establishment of pension plans as a result of labor negotiations initiated by unions after the *Inland Steel* decision of 1949,² wherein the National Labor Relations Board ruled that pensions were a proper subject of collective bargaining. Most authorities, however, recognize that high corporate and personal income tax rates, and broad beneficial tax privileges accorded to recipients of benefits under such programs are largely responsible for the adoption of these programs.

It must first be recognized that the tax rules respecting a pension plan present an anomaly in American income tax law. Normally, when one person is able to claim a deduction for a payment made to benefit another, the latter must include that payment in reporting his income for tax purposes. However, a payment into a pension plan by an employer for the benefit of an

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¹ Statistics as to number of qualified programs are from Prentice-Hall Pension and Profit-Sharing Report, May 9, 1958, Vol. XVIII, Number 1.

² *Inland Steel Co. v. N. L. R. B.*, 170 F. 2d 247 (7th Cir., 1948).

employee will *not* be taxable to the employee if the pension plan meets certain criteria set forth in the Internal Revenue Code. Immediate accrual of benefits with tax treatment thereof deferred to a later date when tax rates may be lower and/or when total income subjected to our graduated system of income tax may be less, presents a pattern which the key personnel of the corporation usually find to be highly advantageous to them. If such key personnel are sufficiently influential in the counsels of the corporation, either because of stock control or intrinsic ability, they can and will cause the corporation to adopt the program. Since 1942, they have done so in increasing numbers.

The rule for deferred tax treatment has been in effect since 1921.³ The statutory rules for qualification as they exist today have been in effect since 1942. Prior to 1942, the Treasury Department was disposed to look upon retirement programs for small organizations as surreptitious schemes for the deferment of income for a few highly placed officers and shareholders⁴—a system hardly palatable to the social philosophy of the times. In an attempt to minimize the adoption of programs for such purposes, Regulations 101 under the 1938 Internal Revenue Act provided that a pension plan was a program “solely designed and applied to enable all or a large percentage of the total number of the employer’s clerks and workmen (as distinguished from persons in positions of authority) to . . . provide for the livelihood of such employees upon their retirement from employment.”⁵ The Internal Revenue Code of 1938, however, provided that “a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of his employees” would qualify for favorable tax treatment; and in the *Harris* case,⁶ the Board of Tax Appeals recognized that an employees’ trust maintained solely for certain executives was within the scope of the statute. To combat the trend, the Treasury Department in 1942 presented proposals to the House Ways and Means Committee for revisions in the qualification requirements. Ultimately, the Revenue Act of 1942 provided that at least 56 per cent of all employees (excluding those employed temporarily or part time

³ Winslow and Clark, “Profit-Sharing and Pension Plans” (Commerce Clearing House, 1939), p. 108.

⁴ *Ibid.*, pp. 95-96; 105.

⁵ Art. 165-1 of the 1938 Regulations.

⁶ Albert W. Harris; BTA Memo Op. (1939).

or having less than five years of service) of an employer must be covered, or that the plan cover employees under a classification found by the Commissioner not to be discriminatory in favor of officers, stockholders, supervisory employees, or highly compensated employees.⁷ The Code further stated that a program limited to salaried and clerical personnel would not be discriminatory and that programs would not be discriminatory when the contributions or benefits bore a uniform relation to the basic or total compensation of the covered employees.⁸

Paralleling this clarifying development of the Government's position was the rise in corporate and excess profits taxes during World War II. Many employers found it relatively inexpensive to adopt plans and include large numbers of employees thereunder when the amount to be contributed would, if there were no plan, be taxed as income by as much as 85 per cent. Moreover, salary "freezes" in effect during the war increased the propensity for management to explore new routes to compensate the executive. The pension plan presented one avenue without too many barriers, and the corporate executive, faced with personal tax rates that he was prone to call "confiscatory," was responsive to any approach that would make it possible for him to be benefited, but not taxed. While excess profits taxes fell after the war, high corporate rates and high individual rates continued, and as we shall show subsequently, continued to be persuasive inducements to maintaining and adopting retirement programs.

As conducive to the adoption of the program as the low after-tax cost to the employer and non-immediate-tax benefits to the employee were favorable provisions in the tax law minimizing the amount of tax to be paid on benefits when ultimately received. For example, benefits payable in a lump sum in one year as a result of termination of employment are taxed at the capital gain rate—currently 25 per cent. If payable in installments, it must be recognized that the installments may be payable when the recipient's income has dropped substantially below the amount of his income during the years of accumulation of the funds required for the installment payments, and that one is entitled to two exemptions if he is age 65 or over, and four ex-

⁷ Section 165(a) (3) (B), Internal Revenue Code of 1939, as amended; now Section 401(a) (3) (B), Internal Revenue Code of 1954.

⁸ Section 165(a) (5) of the Internal Revenue Code of 1939, as amended; Section 401(a) (5) of the Internal Revenue Code of 1954.

emptions if both he and his wife are age 65 or over. In addition, collateral death benefits are payable virtually income tax free to the employee's beneficiary and, since 1954, under recently published estate tax rules, are free of estate taxes.

In 1940, there were, according to the National Planning Association, approximately 1,965 plans in operation covering some 3.7 million employees; in 1945, 7,425 plans covering 5.6 million employees; and in 1950, 12,330 plans covering 8.6 million employees.⁹ Assuming that an insignificant number of plans adopted were later discontinued and that an insignificant number of those adopted duplicate the coverage of those already adopted,¹⁰ these statistics would lead us to the conclusion that there are fewer persons covered per plan today than previously, while the number of plans is constantly increasing. To the personal knowledge of the writers, this has been a trend which has gone on for at least the last ten years. The balance of this paper will attempt to show the tax incentives which have induced the small employer to cover a limited classification of his employees under such a program.

II. Application of Tax Advantages to a Closed Corporation

All of the foregoing tax advantages are dramatically accentuated in the case of a qualified retirement plan established by a small, closely held corporation, where 100 per cent of the stock of the company is owned by the president of the company and his family. The introduction of more modern means of funding retirement plans, such as specially designed insurance contracts, and pooled investment funds for pension plan purposes,¹¹ now enable the smaller companies to maintain flexible low-cost plans heretofore available only to larger firms.

As a case in point, consider the financial effect of the establishment of a qualified retirement plan by a small corporation under typical, though hypothetical, facts. For the purposes of the illustration, it will be assumed that all payments to fund the

⁹ National Planning Association, *Pensions in the United States*, a study prepared for the Joint Committee on the Economic Report, 82nd Congress, 2d Sess. (Washington: Government Printing Office, 1952), p. 11.

¹⁰ Many employers do cover employees under more than one program, such as a basic pension plan and pension plan whose benefits are based solely on earnings over \$4,200; or under a pension plan and a profit sharing plan.

¹¹ Cf. Regulation F, Trust Powers of National Banks, Board of Governors, Federal Reserve System.

pension plan considered will be made from that part of annual corporate income in excess of \$25,000. Significantly, corporate income in excess of \$25,000 is currently taxable at the rate of 52 per cent.

A. Type of Retirement Plan.

The retirement plan under consideration is a typical retirement plan for salaried and clerical employees of the Company, which we shall call The X Corporation, founded ten years ago by Mr. Executive, president and sole owner. Benefits of the plan are funded on a "combination basis"—that is, by means of a combination of deposits to an Insurance Company and deposits to an Auxiliary Conversion Fund held by a Trustee as part of a larger pooled investment fund. The deposits to the Insurance Company provide for insurance protection during the employee's working years and also serve to build up values to buy part of the retirement income. Because of the size of the group which will be insured, the insurance carrier will normally issue most, if not all, of the insurance required under the program without requiring individual evidence of insurability through medical examination or otherwise. Therefore, everyone will be insured. The excess of the cost of the employee's scheduled annuity over the cash value of his insurance at the time the annuity is to begin is provided by funds accumulated and invested for this purpose in an Auxiliary Conversion Fund. At retirement, an amount is withdrawn from this Conversion Fund and turned over to the Insurance Company to be combined with the cash value of the insurance to provide the required pension benefits. The entire cost of the Plan is paid by the Company and no contributions are required of employees.

B. Eligibility for Participation in the Plan.

All salaried and clerical employees of The X Corporation are eligible to participate in the plan when they have reached age 30 but are not yet age 60, and have completed 5 years of employment with the Company. At the inception of the plan, out of a total of 25 salaried and clerical employees, 13 are initially eligible to participate. The classification is reasonable within the scope of Section 401 of the Internal Revenue Code, even though the 13 will be less than 56 per cent of all the employees.

C. Benefits Provided by Plan.

Seven distinct classes of benefits are provided by the plan considered by The X Corporation. The tax effect of each upon the recipient thereof will be discussed later. The types of benefits and the requirements for entitlement are as follows:

1. *Normal Retirement Pension*—A pension payable at age 65 to employees who remain with the Company and elect to retire at that time. The amount of pension is determined by a formula set forth in the plan, usually expressed as a function of the annual salary and the years of service with the Company. The formula under consideration provides for a monthly pension of \$50.00 plus 25 per cent of the monthly salary in excess of \$350.00, subject to a maximum monthly pension of \$600.00. Pensions are proportionately reduced for less than 20 years of service at age 65.

2. *Late Retirement Pension*—A pension payable at any time after age 65 to employees who do not elect to retire at such age, but are permitted to remain in active employment beyond age 65.

3. *Early Retirement Pension*—A pension payable in the event of retirement before age 65, usually on or after age 60. The Early Retirement Pension is usually expressed as a reduced actuarial equivalent of the Normal Retirement Pension. The reduction is attributable to the longer life expectancy of the employee retired at the earlier age, with the annuity starting at such earlier age, and the lesser period of contributions by the Company.

4. *Disability Retirement Pension*—A pension payable in the event of retirement because of mental or physical disability, usually on or after age 50. The Disability Retirement Pension under a program for a small number of salaried and clerical employees is usually expressed as a reduced actuarial equivalent of Normal Retirement Pension, based on age and service of retired employee at time of disability.

5. *Termination of Service Benefit*—At termination of service for any reason other than retirement or death, the terminating employee is entitled to a portion of the cash value of the insurance coverage held for his benefit, usually expressed as a percentage, e.g., 5 per cent, of the cash value for each year of employment (not to exceed 100 per cent of such cash value).

6. *Death Benefit Before Retirement*—If the death of a participant occurs prior to retirement, his designated beneficiary will receive \$1,000 for each \$10.00 of monthly pension. For example, if the anticipated monthly pension is \$100.00 per month, the death benefit is \$10,000; if the anticipated monthly pension is \$150.00 per month, the death benefit is \$15,000, etc. Again, note that the bulk, if not all, of the insurance to provide the death benefit will be issued without the insured having to prove his insurability.

7. *Death Benefit After Retirement*—If death occurs before the retired employee has received his pension for 120 months, his designated beneficiary will continue to receive the pension for the remainder of such 120 month period. For example, if a retired employee lives only 1 year after retirement and receive only 12 pension payments, his designated beneficiary will continue to receive the same payments for 9 more years (108 payments). However, if a retired employee lives for 10 full years or longer after retirement, the pension payments are guaranteed to continue for as long as he lives, but no survivorship benefits are paid after such 10 year period.

D. Analysis of Individual Benefits and Costs.

The following Table I sets forth a summary of the individual benefits and costs applicable to The X Corporation:

TABLE 1

1	2	3	4	5	6	7
Employee	Age	Annual Salary	Monthly Pension*	Insurance Protection	Value of Benefit At Normal Retirement**	Annual Cost***
A	54	\$45,000	\$600.00	\$60,000	\$97,380	\$8,612
B	44	12,000	210.00	21,000	34,083	1,400
C	36	10,020	170.00	17,000	27,591	725
D	37	10,020	170.00	17,000	27,591	765
E	34	9,600	160.00	16,000	25,968	618
F	35	7,200	110.00	11,000	17,853	450
G	31	6,300	90.00	9,000	14,607	305
H	44	6,000	90.00	9,000	14,607	606
I	35	5,700	80.00	8,000	12,984	330
J	48	5,400	80.00	8,000	12,984	703
K	32	4,500	60.00	6,000	9,738	217
L(f)	43	4,800	70.00	7,000	12,775	481
M(f)	53	3,400	50.00	5,000	9,125	723
TOTAL COST						\$15,935

(f) Female.

(Continued on next page, footnote)

III. Tax Advantages of Adoption of Retirement Plan to Mr. Executive Personally

Let us first examine and analyze the value of the retirement plan to Mr. Executive (Employee A) personally, from the standpoint of the tax advantages to be gained merely by the adoption of the retirement plan.

A. Cost of Mr. Executive's Benefits in Relation to Total Cost of Plan.

As can be seen from Column 7 of Table 1 the cost of sustaining the retirement plan in the first year of its operation is \$15,935. Of such amount, \$8,612, or approximately 54 per cent, is the cost of the benefits for Mr. Executive. (See Tables 2 and 3 below.) As the total cost is tax deductible from corporate net income at the 52 per cent rate, it is manifest that the entire cost of providing benefits for all participants other than Mr. Executive is being paid for in dollars that would otherwise be paid in income taxes. The following illustrates the point:

Total Cost of Plan—	\$15,935	48%
		—
Net Remaining After Taxes—	\$ 7,649	
Less: Cost for Mr. Executive—	8,612	
		—
Cost for All Other Participants	—0—	

In lieu of adopting the retirement plan, an amount equivalent to the first year cost of the Plan of \$15,395 could be used to raise Mr. Executive's salary. It is assumed that the Treasury Department would not challenge such an increase as making Mr. Executive's compensation "unreasonable" and that the total new salary would be deductible at the 52 per cent tax rate. The net increase to Mr. Executive after taxes on this basis would be approximately \$9,591, or approximately 11 per cent more than the cost of providing him with his benefits under the retirement plan. This would, as shown below, buy about the same benefits

(Continued from preceding page)

- * Normal age pension payable at age 65, in addition to Social Security.
- ** Lump sum actuarial value of pension at Normal Retirement Age of 65.
- *** Computed on the basis of level funding from entry into the program to normal retirement age, to be deducted under Sec. 404(a) (1) (B). If computed on a basis to be deducted under Sec. 404(a) (1) (C), precise individual cost allocations would not be possible because of aggregate method of cost computations.

for Mr. Executive outside the Plan as under it, while under it, 12 more people benefit.

Will the government approve such a retirement program? In the 1940's the Treasury Department had ruled that a program would not qualify under Section 165 of the Internal Revenue Code of 1939, as amended, if contributions required to provide benefits for employees, each of whom owned, directly or indirectly, more than 10 per cent of the voting stock of the corporation, exceeded, in the aggregate, 30 per cent of the contributions for all participants under the plan.¹² The issue was taken to the courts, inasmuch as such ruling flagrantly conflicted with the express words of the statute that a program would not be discriminatory where the contributions or benefits bore a uniform relation to the compensation of officers, shareholders, supervisory or highly compensated employees. The statute contains no words indicating that stricter criteria are to be applied in determining whether discrimination exists in favor of shareholders than in determining whether discrimination exists in favor of the other three classes. In *Volckening, Inc.*¹³ the Tax Court sustained the taxpayer in holding that a pension plan was not discriminatory even though more than 50 per cent of the employer contributions were for the benefit of the husband-and-wife sole stockholders. As a consequence, the so-called "30 per cent rule" was revoked.¹⁴

Positions die harder than rules, however, and the agents in the Treasury Department who fought against Section 165 of the pre-1942 Acts becoming a device for benefiting shareholders have in many cases fought tenaciously against programs which are called "top-heavy." Confusing the issue is Part 5(c) of Revenue Ruling 57-163 which talks of top-heaviness, states that ceilings are not needed when benefits bear a uniform relation to compensation, and then concludes that ceilings may satisfy "other essential requirements." All too often, agents have referred to the Section as their authority for clamping down on a "top-heavy" plan. In a case of the type discussed in this example, it is unlikely that the agent would refuse approval but possible that he would be more discriminating in his review. Nevertheless, it is the experience of the writers that programs of this type have been repeatedly approved where a determined

¹² IT 3674 (1944).

¹³ 13 T. C. 723 (1949).

¹⁴ IT 4020 (1950).

position has been taken and where there has been insistence that the statute be followed—and rightly so.

It must be remembered that at least one measure of the value of money is what it will buy for Mr. Executive as contrasted with his proportionate interest in the payment. Even if the total payment to the program were smaller so that Mr. Executive's interest in it rose in proportion, the value of the program would be as great to him. Conversely, if his interest in the total payment were 10 per cent rather than 50-plus per cent, the payment on his behalf would do the same work for him. It is therefore necessary to determine what the value of the payment is to Mr. Executive in terms of what it would cost his corporation to provide him with a salary increase which, after taxes, would leave him with his present net income plus an amount sufficient to buy benefits equivalent to the benefits under the program.

B. Cost of Providing Mr. Executive With Equivalent Benefits Outside the Plan.

The retirement plan contemplates that Mr. Executive will have a pension of \$600.00 per month upon retirement at or after age 65. Until then, he will be insured for \$60,000.

To obtain equivalent benefits outside the retirement plan, it would be necessary for Mr. Executive to purchase insurance, prove his insurability, and accumulate cash with his net income after taxes. At least two alternative personal programs could be employed.

One such program involves buying insurance now and accumulating savings or investments to purchase an annuity at age 65. However, an annuity that will be bought eleven years from now will be at insurance company purchase rates then in effect. Based on the history of such rates which have over the past fifteen years increased by at least 15 per cent, it is anticipated that there will be further increases in future annuity purchase rates. The insurance company issuing insurance under the retirement plan *guarantees* that it will, eleven years hence, make the conversion of the \$60,000 of insurance to a \$600.00 per month annuity at *today's annuity purchase rates*.

As an alternative to the foregoing program, to guarantee the cost of the annuity and obtain the insurance, Mr. Executive could personally purchase from an insurance company a combination insurance and annuity contract. Such a contract is com-

monly known as a "Retirement Income Contract." If such a contract were bought by him from a leading first-line insurance company at his present age, the annual gross cost to him for the next eleven years would be \$9,154 per year. His salary would have to be increased by \$15,170 in order to obtain an increase in net income after taxes of \$9,154. (See Table 4 following.)

TABLE 2

*Mr. Executive's Present Net Income After Taxes*¹⁵

Present Gross Income	\$45,000
Tax on Gross Income	10,152
	<hr/>
Net Income After Taxes	\$34,848

TABLE 3

*Mr. Executive's Net Increase in Income After Taxes If His Salary Is Increased by \$15,935*¹⁵

Increased Gross Income	\$60,935
Tax on Increased Gross Income	16,496
	<hr/>
Net Increased Income	\$44,439
Present Net Income After Taxes	34,848
	<hr/>
Net Increase in Income	\$ 9,591

TABLE 4

*Increase in Gross Income Necessary to Meet Premium Payment of \$9,154 on Retirement Income Contract*¹⁵

Increased Gross Income	\$60,170
Tax on Increased Gross Income	16,168
	<hr/>
Net Increased Income	\$44,002
Present Net Income After Taxes	34,848
	<hr/>
Total Increase After Taxes	\$ 9,154
	<hr/>
Increased Gross Income	\$60,170
Present Gross Income	45,000
	<hr/>
Total Gross Increase in Income	\$15,170

¹⁵ Derivation of Taxes and Net Income as set forth in Tables 2, 3 and 4 are based on following assumptions:

- (1) Total income of Mr. Executive is his salary alone;
- (2) Joint return is filed by Mr. Executive;
- (3) Exemptions total \$1,200, composed of \$600 each for Mr. Executive and his wife;
- (4) Deductions from gross income aggregate \$5,000;
- (5) 1957 Tax rates.

C. *Conclusions.*

It is evident from the foregoing that greater retirement benefits can be bought for Mr. Executive with money spent before taxes than afterward. A salary increase, equivalent to the cost of the retirement plan, would not provide him with the extent of benefits, annuity cost and tax advantages being provided under the Plan. It should be borne in mind that the cost to the Company for benefits under the plan is, after taxes, less than the cost of Mr. Executive's benefits alone, so that any "fringe benefits" going to all other employees can be said to be paid with tax dollars.

IV. Tax Advantages to Mr. Executive and His Beneficiaries of Benefits Provided by Plan

This section sets forth in greater detail the specific tax advantages available to Mr. Executive and his beneficiaries when he becomes eligible for and receives the benefits of the plan which were described in Item C of the preceding Section II. The underlying principle to be borne in mind is that until retirement age is reached, the cost of the benefits being accumulated for Mr. Executive will not be taxable to him. The one exception to this general principle is that the annual term cost of the \$60,000 insurance protection is considered to be income and will constitute taxable income to him.¹⁶ Such annual term cost amounts to approximately \$650.00.

A. *Tax Aspects of Normal Retirement Pension.*

1. *Situation*—Mr. Executive elects to retire at his Normal Retirement Age of 65 years.

2. *Result*—At retirement, the plan contemplates converting Mr. Executive's insurance to an annuity. Monthly payments do not begin until actual retirement and then will be taxed at ordinary income tax rates.¹⁷ Mr. Executive may exclude from gross income during the first three years annuity payments aggregating the amount he has included in his income in previous years as the term cost of insurance protection.¹⁸ (See Item IV preceding.) However, if a lump sum payment is made at actual

¹⁶ Treasury Decision No. 6203 (1956) on Section 402(a) of the Internal Revenue Code of 1954.

¹⁷ Section 403(a) and Section 72 of Internal Revenue Code of 1954.

¹⁸ Section 72(d) of Internal Revenue Code of 1954.

retirement, in lieu of monthly pension payments, the lump sum will be taxable at the capital gains rate.¹⁹ Such rate is currently 25 per cent. It is anticipated that accumulated lump sum value of Mr. Executive's pension at age 65 will be \$97,380 (See Column 6 of Table 1). If this sum were paid to Mr. Executive upon his retirement at age 65, his maximum net after taxes would be \$73,035.

B. Tax Aspects of Late Retirement Pension.

1. *Situation*—Mr. Executive elects not to retire at his Normal Retirement Age of 65 years, but rather to continue in the employ of the Company.

2. *Result*—At age 65 the insurance of \$60,000 is converted to the lump sum required to provide the pension. Such amount of \$97,380 is held by the insurance company at interest. When Mr. Executive does finally retire, the tax results will be the same as outlined in Item A preceding. However, should Mr. Executive die after age 65 but before he has actually retired, the lump sum value of \$97,380 being held for him will be payable to his beneficiary as a death benefit. Such amount will be taxable to the beneficiary at capital gains income tax rates,²⁰ and will not be included in the estate for determination of the federal estate tax.²¹

C. Tax Aspects of Early Retirement Pension.

1. *Situation*—Upon attaining age 60, Mr. Executive decides to sell a controlling interest in the Company and to retire from active service with the Company, at a reduced monthly pension of \$315.00,²² the lump sum value of which is \$57,488.

2. *Result*—Monthly payments will be taxed at ordinary income tax rates.²³ If a lump sum payment is made, capital gain rates apply.²⁴ Based on the current rate of 25 per cent, the net after taxes to Mr. Executive would be \$43,116.

¹⁹ Section 403(a)(2) of Internal Revenue Code of 1954.

²⁰ Section 402(a) of Internal Revenue Code of 1954.

²¹ Section 2039(c) of Internal Revenue Code of 1954.

²² Reduced actuarial equivalent of normal monthly benefit based on years of service to date of Early Retirement and 1937 Standard Annuity Mortality Table—3% Interest.

²³ Section 403(a) and Section 72 of Internal Revenue Code of 1954.

²⁴ Section 403(a)(2) of Internal Revenue Code of 1954.

D. Tax Aspects of Disability Retirement Pension.

1. *Situation*—Mr. Executive becomes physically disabled at age 57 so that he is forced to retire from active service with the Company, at a reduced monthly pension of \$325.00.²⁵

2. *Result*—While monthly payments would be taxed at ordinary income tax rates,²⁶ Mr. Executive can exclude from his income up to \$100.00 per week of disability payments he receives from the plan because of personal injuries or sickness.²⁷ Such exclusion applies from the date disability payments begin until Mr. Executive reaches age 65, his normal retirement age. Since the disability pension of Mr. Executive on a weekly basis is \$75.00 (\$325.00 times 12 divided by 52), being less than \$100.00 per week, all of the payments are excludable from income for the eight year period from age 57 to age 65.

E. Tax Aspects of Termination of Service Benefit.

1. *Situation*—Five years after the establishment of the retirement plan, The X Corporation is bought out by one of the "giants" in the field at a price too good for Mr. Executive to pass up. He decides to take his profit from the sale and terminates his services with the successor company. The successor company, as part of the purchase agreement, assumes the obligations of, and agrees to, continue the retirement plan.

2. *Result*—One of the principal purposes of any employee retirement plan is to encourage employees to remain with the Company. Consequently, termination of service benefits are usually the least liberal of all benefits in a retirement plan, and in many instances, can almost be considered a penalty imposed on the employee for leaving the Company. At the time he leaves the Company, Mr. Executive will have had fifteen years of service, which entitles him to 75 per cent of the then cash value of the insurance coverage held for his benefit,²⁸ or approximately

²⁵ Reduced actuarial equivalent of normal monthly benefit based on 1937 Standard Annuity Mortality Table—3% Interest. No service reduction is made in view of shorter life expectancy of disabled persons.

²⁶ Section 403(a) and Section 72 of Internal Revenue Code of 1954.

²⁷ Section 105(d) of Internal Revenue Code of 1954; Reg. Secs. 1.105-4(a) (2) and 1.105-5. It is possible that semantics may result in determining whether Mr. Executive is or is not entitled to exclude the first \$100 of his pension from income. The benefit must qualify as a disability benefit under the statute.

²⁸ Vesting on termination of service is at the rate of 5% of the cash value of the insurance coverage for each year of employment. No termination

(Continued on next page)

\$6,000. Such amount is taxable to Mr. Executive at capital gains rates.²⁹ Mr. Executive also has the option of either converting the insurance to a paid-up policy of approximately \$7,000, or if he buys his non-vested portion of the cash value from the trust, continuing the entire \$60,000 on a personal basis at a premium based on his original age at issue, which would cost Mr. Executive approximately \$3,200 per year, less any dividends declared by the insurance company.

F. Tax Aspects of Death Benefit Before Retirement.

1. *Situation*—Mr. Executive dies while he is in active employment and before he has reached age 65. His designated beneficiary is his wife.

2. *Result*—The entire \$60,000 of insurance, less the cash value of such insurance at the time of death, is payable to the beneficiary *exempt from any income tax*.³⁰ If the cash value at the time of death exceeds \$5,000, only the excess cash value is taxable to the beneficiary, and at capital gains rates; if the cash value is less than \$5,000, such cash value is excluded entirely from the income of the beneficiary.³¹ The entire proceeds of \$60,000 are *excluded* from Mr. Executive's estate for determination of the federal estate tax.³²

G. Tax Aspect of Death Benefit After Retirement.

1. *Situation*—Mr. Executive has retired at age 65 and is receiving a monthly pension of \$600.00. After receiving 48 monthly payments (four years), Mr. Executive dies. His named beneficiary is entitled to receive the balance of 72 monthly payments (6 years), so that an aggregate of 120 monthly payments will have been made to Mr. Executive and his wife.

2. *Result*—If the beneficiary of Mr. Executive elects to receive payment in the form of a monthly annuity, such annuity

(Continued from preceding page)

benefit is payable from the Auxiliary Conversion Fund since costs for such fund have been discounted on a conservative basis for anticipated labor turnover.

²⁹ Section 403(a) (2) of Internal Revenue Code of 1954.

³⁰ Section 101(a) and (b) of Internal Revenue Code of 1954; Reg. Sec. 1.402(a)-1(a) (4) (iii).

³¹ Section 402(a) of Internal Revenue Code; Reg. Sec. 1.402(a)-1(a) (4).

³² Section 2039(c) of Internal Revenue Code; Regulations published in Treasury Decision 6296 (1958).

payments are taxable at ordinary income tax rates.³³ If the beneficiary should elect to take the commuted lump sum value of the unpaid installments, such value is taxable at capital gains rates.³⁴ In either event, the entire amount received is excluded from Mr. Executive's estate for federal estate tax purposes.³⁵

V. Summary

Senate Resolution 215 of the 75th Congress, proposed by Senator Vandenberg of Michigan, authorized a study of the then (1938) pension and profit-sharing plans in the country. The study attempted to determine the propriety of what encouragement the Federal Government could give to the adoption of pension and profit-sharing plans, including "the grant of compensatory tax exemptions and tax awards when profit-sharing is voluntarily established."³⁶ The Committee concluded that it was not practical to apply incentive taxation to the profit-sharing motive.³⁷ Yet it cannot be denied that the tax rates of today and the temporary exemption from taxation of benefits accrued provide Mr. Executive with strong incentives to adopt his program and cover his employees so that he may minimize his taxes while increasing his wealth through deferment of income. The foregoing example shows concretely, we think, that in terms of measuring a salary increase sufficient to buy benefits outside the program equivalent to the benefits obtainable under the program, the adoption of the program presents Mr. Executive with the better alternative.

Multiply Mr. Executive by the many Messrs. Executive there are in this country and we begin to see why there has been such a great increase in the number of programs adopted in the last fifteen years. Multiply the number of Mr. Executive's employees by the number of employees of the many Messrs. Executive in the country and we begin to visualize how broad has become the coverage of pension plans in the country today.

To determine whether the programs are carrying out a legitimate social purpose recognized as such by Congress, we

³³ Reg. Sec. 1.402(a)-1(a)(5).

³⁴ Section 402(a) of Internal Revenue Code of 1954.

³⁵ Section 2039(c) of Internal Revenue Code of 1954; Regulations published in Treasury Decision 6296 (1958).

³⁶ "Study of Experiences in Profit Sharing and Possibilities of Inactive Taxation," Senate, 76th Congress, 1st Session, Report No. 610. June 19, 1939—Ordered to be printed. P. 1.

³⁷ *Ibid.*, p. 6.

must distinguish between Mr. Executive's motives for adoption of the program and the results to Mr. Executive, on the one hand, and the results to the other employees. Referring back to Table 1, we note that the bulk of the employees of Mr. Executive fall below the concept of being highly compensated as we understand that term today. Inflation and taxes make it difficult for these people to save for old age, and yet we must face the fact that we are dealing with a work force which is about to swell in the near future as the children of our baby boom of the 1940's and 1950's become working men and women of the 1960's and 1970's. Increased pressures will be brought to bear to cause the aged to absent themselves from the labor force. From what resources are they to draw on, to live in a non-working period of life, other than public and private pensions, asset income and dissaving? We do not suggest that a pension plan will solve all the problems for these people or that it should lull them into a false sense of old-age security, but we do suggest that the tax reasons for the adoption of the program will result in income being paid to them at a time when they may not be able to earn income. Whether or not as many programs would have been installed without the tax reasons is answered by comparing the number of programs in effect in 1930—110—with the number in effect in 1958—43,000.