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PENSION AND PROFIT SHARING PLANS: COVERAGE AND OPERATION FOR CLOSELY HELD CORPORATIONS AND PROFESSIONAL ASSOCIATIONS.

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THE GREAT GROWTH of pension and profit sharing plans during the last quarter century may be overshadowed by their expansion in the next few years as a result of new laws and increased public awareness of the benefits such plans offer.¹ Two of man's fondest dreams are reducing his taxes and providing financial security for his retirement. These advantages are attainable through pension and profit sharing plans which offer him a pot of gold at the end of the rainbow filled with tax savings and other money the federal government compels him to set aside in order to qualify for the tax advantages. Developments of the last few months make it possible for professional men in some states to become beneficiaries of pension and profit sharing plans and changes in laws of the past few years make it easier for small businessmen to adopt such programs.² At the same time the self-employed individual and partner cannot qualify.

After considering the expanded coverage of pension and profit sharing plans, this Article will consider the use of these plans by closely held corporations, partnerships, limited partnerships, and professional associations. The owner-employee of the closely held corporation or professional association is initially concerned with the question of how he will personally realize tax advantages from the institution of a pension and profit sharing plan. The major limitation on tax savings for the owner-employee is the principle that a qualified plan may not discriminate in favor of shareholders, supervisors, officers or highly

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1. The growth of employee benefit plans is traced in Note, *Protection of Beneficiaries Under Employee Benefit Plans*, 58 COLUM. L. REV. 78, 79-80 (1958). Since 1930 the number of operating plans has multiplied approximately 500 times. P-H PENSIONS & PROFIT SHARING SERV. ¶ 1012. The suggestion has been made that the growth would have been even greater were it not for the rigid contribution requirements by a qualified plan. Lurie, *Plastic Contributions for Pensions And Profit-Sharing*, 67 YALE L.J. 1003 (1958).

2. In 1958 the enactment of Subchapter S made it possible for certain small businesses to incorporate so that the shareholder-employees could become beneficiaries of pension and profit sharing plans while the business continued to be taxed as a partnership for most purposes. BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 403-04 (1959).

compensated employees.³ Notwithstanding that principle, the courts and the Commissioner have recognized avenues of advantage for the preferred employee over other workers. A distillation of cases and rulings considered herein show that special advantages are available to preferred employees through limitations on coverage, forfeiture by temporary employees, larger contributions for certain employees, termination of the plan and accepted investments of the trust funds. While the tax adviser is interested in such recipes where his client may have his cake and eat it too, public policy requires a re-examination of many facets of the law on pension and profit sharing plans. Special advantages for some should be eliminated, and coverage for others, such as the self-employed, should be extended.

HISTORICAL GROWTH SPURRED BY FEDERAL TAX POLICY

The historical trend of pension and profit sharing plans indicates society's conclusion that they should cover as many people as possible. Pensions were originally granted to court favorites by kings to express appreciation for literary, artistic or military achievements.⁴ The seeds for modern industrial pension plans were sown in 1794 in Geneva, Pennsylvania, when the employee's trust was inaugurated⁵ and by the turn of the twentieth century pension plans were well established on the American scene, although it was not until the 1930's that pension and profit sharing programs flourished.⁶

The rising popularity of pension and profit sharing plans is attributable to a number of factors. Impetus was given to pension programs during World War II when they were used to make employment more attractive since wage stabilization prevented pay boosts.⁷ Employers have initiated these programs to promote industrial harmony and stimulate employee loyalty and efficiency.⁸ The requirement that

3. If the employer wishes to discriminate in favor of such employees, he may set up a non-qualified plan under which the employee is not taxed until he actually receives the funds. Durkin, *Non-Qualified Deferred Compensation Plans*, 29 U. CINC. L. REV. 68 (1960). And the employer takes the deduction for contributions to the trust fund in the year when distribution is made to the beneficiaries. Russell Manufacturing Company v. United States, 175 F. Supp. 159 (Ct. Cl. 1959) noted in Note, *Employer Contributions to Non-Qualified Profit-Sharing Plan*, 28 GEO. WASH. L. REV. 803 (1960) and Note, *Deductible Contributions to Non-Qualified Profit-Sharing Plans*, 58 MICH. L. REV. 799 (1960).

4. PRITCHETT, *THE SOCIAL PHILOSOPHY OF PENSIONS* 4 (1930); Hickey v. Pension Board, 378 Pa. 300, 106 A.2d 233 (1954).

5. DRYE, *PENSION, STOCK BONUS & PROFIT SHARING PLANS UNDER THE FEDERAL TAX LAWS* 1 (1945).

6. HANDY, *PRIVATE PENSION PLANS AND THE FEDERAL REVENUE ACT* 1 (1939).

7. BUREAU OF NATIONAL AFFAIRS, *NEGOTIATED PENSION PLANS* 1 (1949).

8. WINSLOW, *PROFIT SHARING & PENSION PLANS* 17 (1946). A survey of 86 companies with pension programs disclosed that 25.6% reported decreased employee turnover, 27.9% said employee efficiency had increased and 50% felt employee loyalty had improved. *Id.* at 13. A more recent poll of 139 companies using profit

employers bargain collectively on the subject of pension plans has contributed to their growth.⁹ However, the greatest stimulus has been provided by tax advantages awarded to qualified pension and profit sharing plans.¹⁰ By establishing a qualified plan, the employer may deduct contributions to pension and profit sharing funds in the year when made, and beneficiaries may defer reporting the income until the year it is actually received.¹¹ When the beneficiary of a pension or profit sharing fund receives his entire share in a single year, he is generally taxed at capital gains rates.¹² In addition, the income earned by the accumulated fund is not taxed until distributed to the beneficiaries.¹³

The popularity of pension and profit sharing plans increased as tax rates rose and the pattern of tax advantages obtainable through their use became well established. As early as 1919 the Department of Internal Revenue ruled that contributions by a corporation to a pension fund for its employees and officers were deductible from gross income.¹⁴ But it was not until the Revenue Act of 1928 that legislation

sharing plans showed 110 rated their programs a success, 28 replied that it had not been in operation long enough to tell and 1 said the program was unsuccessful. KNOWLTON, *PROFIT SHARING PATTERS* (1954) reported in P-H, *PENSIONS & PROFIT SHARING SERV.* ¶ 1023.

9. Note, *Legal Problems of Private Pension Plans*, 70 HARV. L. REV. 490 (1957).

10. INT. REV. CODE OF 1954, § 401 enumerates the requirements for a qualified plan. Section 404 provides for deductions for employers' contributions to employees' trusts. Sections 402 and 403 provide for taxation of employees' trusts and annuities. Up to 25% of an employee's compensation may be contributed to pension and profit sharing plans. In addition, a plan may qualify even though employees contribute up to 10% of their compensation providing employer contributions and benefits are not geared to employee contributions. Rev. Rul. 59-185, 1959-1 CUM. BULL. 86.

11. A participant was taxed on an insurance policy distributed from a pension trust fund when he borrowed on the policy even though he endorsed the check over to the employing corporation. *Lauinger v. Commissioner*, 281 F.2d 419 (2d Cir. 1960).

12. INT. REV. CODE OF 1954, §§ 402, 403. *Commissioner v. Miller*, 226 F.2d 618 (6th Cir. 1955). The participant will be taxed at capital gain rates if the distribution takes longer than a year providing the delay is due to administrative problems. Rev. Rul. 60-292, 1960-2 CUM. BULL. 153. However, a participant was taxed at ordinary rates where he received a lump sum payment of profit sharing benefits rather than allow his credits to be transferred to a successor corporation in a reorganization. *McGowan v. United States*, 277 F.2d 613 (7th Cir. 1960). Taxation of single distribution at capital gains rates was criticized by Eckerman, *The Unrationalized Capital Gains Treatment of Lump-Sum Termination Distributions from Qualified Pension, Profit-Sharing and Annuity Plans*, 7 SYRACUSE L. REV. 1 (1955).

13. INT. REV. CODE OF 1954, §§ 402, 403. A pension plan will not qualify if a participant can obtain any funds prior to severance of employment or discontinuance of the plan; however, a profit sharing plan would not be disqualified if participants were allowed to withdraw part of the funds in times of financial need. Rev. Rul. 56-693, 1956-2 CUM. BULL. 282. Under the provisions of Treas. Reg. § 1.401-4(a)(1)-(ii) (1956), a profit sharing plan may provide for distribution for reasons such as illness or lay off. See also Rev. Rul. 57-163, 1957-1 CUM. BULL. 128 part 5(k). If the withdrawals result in discriminatory benefits for preferred employees, the plan can be disqualified. Rev. Rul. 57-587, 1957-2 CUM. BULL. 260. However, a participant may withdraw his own contributions. Rev. Rul. 60-281, 1960-2 CUM. BULL. 146; Rev. Rul. 60-338, 1960-2 CUM. BULL. 148.

14. O.D. 110, 2-19-165, 1 CUM. BULL. 224 (1919).

was enacted to guarantee the deductibility of amounts paid into a trust to pay reasonable pensions for employees.¹⁵ This congressional assurance inspired widespread growth of actuarially sound pension plans.

The underlying philosophy behind this grant of tax advantage was to encourage private programs to provide income for retired individuals. Society's obligation to care for the aged is thus shifted, at least in part, to the employer. In addition, society is benefited by the industrial harmony and higher productivity engendered by pension and profit sharing plans. A beneficial by-product of more recent vintage is the deflationary postponement of consumer purchasing power. To make certain that the average employee would be benefited, Congress provided that tax advantages could not be enjoyed unless pension and profit sharing plans operated for the exclusive benefit of the employees and did not discriminate in favor of officers, shareholders, supervisors or highly compensated employees.¹⁶

AVAILABILITY OF PLANS FOR PARTNERSHIPS, LIMITED PARTNERSHIPS, CLOSELY HELD CORPORATIONS AND PROFESSIONAL ASSOCIATIONS

A. *The Exclusion of Partners.*

The businessman who wants the benefits of pension and profit sharing plans has been compelled to incorporate because the sole proprietor and partners cannot be beneficiaries of such plans.¹⁷ This conclusion has resulted from the statutory language that a plan should be for the exclusive benefit of employees. Thus, the partner is eliminated as a possible participant since he is regarded as the employer.¹⁸

The construction prohibiting participation by partners has been rigidly enforced where corporations were dissolved. When a corporation was transferred into a partnership, stockholders lost their eligibility for pensions or profit sharing because they were changed from employees into partners.¹⁹ Efforts by stockholders to maintain the guise of employees after dissolving their corporation have been unsuccessful.

15. HANDY, *op. cit. supra* note 6, at 8.

16. INT. REV. CODE OF 1954, § 401(a)(4).

17. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, part 2(i)(1); Rev. Rul. 33, 1953-1 CUM. BULL. 287, part 2(b)(1); I.T. 3350, 1940-1 CUM. BULL. 64; I.T. 3268, 1939-1 CUM. BULL. 196. Any employee of the partnership, including a partner's relative, is eligible to be a participant in a pension and profit sharing plan. PS No. 23, 9-2-44, 3 CCH 1944 STAND. FED. TAX SERV. ¶ 6553.

18. Similarly a program is no longer for the exclusive benefit of the employees if the corporate employer gains an interest in the fund. In *Estate of Aldis*, 46 B.T.A. 1171 (1942), a plan was disqualified because the Chrysler Corporation purchased a deceased employee's interest and thereby became a beneficiary of the profit sharing fund.

19. *Meldrum & Fewsmith, Inc. v. Commissioner*, 20 T.C. 790, 794 (1953).

In *Bently v. Commissioner*²⁰ the two shareholders dissolved their corporation, transferred their business to their wives and assumed the status of employees. The Tax Court held the men were really the partners in the business and were therefore not qualified to be participants in a profit sharing plan.

B. The Limited Partner May Be Eligible.

It is possible that partners who are not general partners may qualify as employees for pension and profit sharing purposes. An Insurance Industry Memorandum issued in 1944 suggested that some partners could qualify as beneficiaries under pension and profit sharing programs.²¹ This memorandum apparently relied on a negative inference from a release by the Bureau of Internal Revenue that "a general partner, as such, is not an employee of the partnership. . . ."²² Assuming the Bureau release did not use an unnecessary word, it may be inferred that partners who are not general partners may qualify as employees for pension and profit sharing purposes.

C. Coverage For Those Who Could and Would Incorporate.

While the general partner and individual proprietor have been excluded, the businessman could become a beneficiary of a pension and profit sharing plan by incorporating and becoming an employee of the new fictional entity. The complete availability of pension and profit sharing programs to any businessman who could and would incorporate is illustrated by the ruling that a plan may be set up for a single employee of a closely held corporation if the program qualifies on other grounds.²³

The consequence of allowing only "employees" to be covered under pension and profit sharing plans created harsh consequences for taxpayers who could not incorporate or who did not want to be treated as a corporation for all purposes. The door was virtually closed on the professional man who could not incorporate because of state law, ethics or tradition. With enactment of Subchapter S in 1958, some taxpayers, who did not want to be taxed as corporations generally, have been able to achieve the status of a corporate employee so that they

20. 14 T.C. 228 (1950), *aff'd without opinion* 184 F.2d 668 (2d Cir. 1950).

21. Item VI-25, Insurance Industry Memorandum, 3 CCH 1944 STAND. FED. TAX SERV. ¶ 6269. Some are of the opinion that limited and special partners are in the same category as general partners. Mackay, *Pension Plans and Associations Taxable as Corporations for Professional Persons*, 10 Sw. L.J. 281 (1956).

22. I.T. 3350, 1940-1 CUM. BULL. 64.

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

become pension and profit sharing plan beneficiaries and still elect to be taxed as partners. This is not a complete answer for the individual proprietor or partner, however, since not all are eligible for a Subchapter S election and many would not choose that form of business organization in any event because of being treated like a corporation for state and many federal tax purposes.²⁴

D. *The Professional Man's Battle To Be A Beneficiary.*

The past decade has witnessed the struggle of the professional man to obtain coverage as a beneficiary of pension and profit sharing plans. The rule requiring a beneficiary to have the status of an employee virtually ruled out the professional man who could not incorporate because of state law, ethics or tradition. But, the desire to save taxes (like necessity) being the mother of invention, led a group of eight doctors to circumvent the problem by forming an association under the laws of Montana. The articles of association provided that the organization was to be treated like a corporation for tax purposes. Federal corporate income tax and state corporation license taxes were paid by the association. Moreover, the articles of association provided for continuity of existence beyond the lives of the current members, centralized control and limited liability. Instead of receiving shares of assets of the association, each member received pension benefits. The association set up a pension plan to cover all employees who had worked for three years and had attained the age of 30.

The Commissioner of Internal Revenue contended that the practice of medicine was purely personal and the doctors were really the employers in a partnership. The Commissioner ruled that the association's contributions to the pension fund were income to the taxpayer and assessed a deficiency. The taxpayer paid the assessment and sued for a refund. The Ninth Circuit, in *United States v. Kinter*,²⁵ held the pension plan was valid, stating that the doctors were employees of the association and were therefore eligible to be beneficiaries of a pension plan.²⁶

The same conclusion was reached in *Galt v. United States*,²⁷ when a number of Texas doctors entered into articles of association covering

24. While a Subchapter S election is in effect, corporate redemptions, liquidations, reorganizations and many other transactions are governed by the tax law applicable to corporations rather than partnerships. BIRTKER, *op. cit. supra* note 2, at 405-06.

25. 216 F.2d 418 (9th Cir. 1954).

26. While the Commissioner initially rejected the Kinter holding in Rev. Rul. 56-23, 1956-1 CUM. BULL. 598, he later ruled that an organization could qualify as an association for federal tax purposes even if formed for that purpose providing it had the requisite characteristics. Rev. Rul. 57-546, 1957-2 CUM. BULL. 886.

27. 175 F. Supp. 360 (N.D. Tex. 1959).

substantially all matters which would ordinarily be covered in corporation although Texas law prohibited incorporation by a group of doctors. The Commissioner determined that the association should be treated as a partnership for tax purposes and not as a corporation. Reasoning that Texas law did not prohibit such an association of doctors, the Court held that the association was entitled to be treated as a corporation for federal income tax purposes.

The *Kinter* and *Galt* decisions placed pressure on the Internal Revenue Service to define the type of association, if any, which would qualify as the employer of the professional man. Responding to the need for a definition of "association" the Internal Revenue Service issued a regulation, applicable to taxable years subsequent to December 31, 1960, setting forth the "characteristics [which] require it [an association] to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust."²⁸ The Kinter Regulation,²⁹ as it has been called, classifies the major characteristics of an association as: (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests. Since characteristics (1) and (2) are common to partnerships and corporations, the Regulation provides that the determination of the status of a business organization as an association will be based on whether it has more corporate attributes than non-corporate characteristics with respect to the four latter items.³⁰

The Regulation defines each characteristic and provides that an entity shall not be deemed to have a characteristic, whether or not its instrument of creation provides for it, if it is ineffective under state law. For example, an agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization.³¹ At the same time the Regulation provides that, for purposes of the

28. Treas. Reg. § 301.7701-2 (1960).

29. In an illuminating article, Wolfman and Price point out that the Internal Revenue Service's definitions on associations ought to be called the Anti-Kinter Regulation since the Kinter association could not qualify under the Regulation because it lacks the requisite continuity of life and centralized management by virtue of being regulated by the Uniform Partnership Act of Montana. Wolfman & Price, *Qualifying Under Final Kinter Rules Will Be Difficult in Most States*, 14 J. TAXATION 105, 108, 110 (1961).

30. Treas. Reg. § 301.7701-2(a) (2) (1960).

31. Treas. Reg. § 301.7701-2(b) (1) (1960).

Internal Revenue Code, organizations will be uniformly classified as a corporation, partnership or trust regardless of the classification by the state.³² While the application of those principles will doubtless create confusion, the generalization may be drawn that state law will govern the interpretation of a given characteristic and federal law will govern the interpretation of what composite of characteristics classifies an organization as a partnership or corporation for tax purposes.³³ Sound reasoning has led some to conclude that the Kinter Regulation will bar professional groups in states which have the Uniform Partnership Act from qualifying for pension and profit sharing plans because local law precludes the business organization from having the requisite characteristics.³⁴

Reacting to the problems posed for professional men attempting to form associations under existing state law which would qualify under the Kinter Regulation, many states have revised their partnership laws or enacted new professional corporation or association laws.³⁵ Connecticut amended its version of the Uniform Partnership Act to allow three or more professional men to form associations providing they had three of the four characteristics of continuity of life, centralized management, limited liability and free transferability.³⁶ Other jurisdictions enacted professional corporation laws authorizing one or more professional men to set up corporations.³⁷ A third approach, adopted by Pennsylvania and some other states, has been the enactment of Professional Association Acts which enable professional men to associate in a manner consistent with the characteristics required by the Kinter Regulation.³⁸

The new state laws are tailor-made to satisfy the requirements established by the Internal Revenue Code and Regulations. The Professional Corporation Acts should enable the shareholder-employee to obtain the benefits of pension and profit sharing plans like his counterpart in any business corporation. Laws like the Pennsylvania Professional Association Act authorize professional groups to obtain the

32. Treas. Reg. § 301.7701-1(c) (1960).

33. In testing certain attributes, the Regulation deviates from the generalization that local law alone governs. For example, on the question of limited liability, the Regulation superimposes its own rules. Wolfman & Price, *supra* note 29, at 109.

34. *Id.*

35. By the end of 1961, fourteen states had enacted such laws. As of February 1962, seven other states were considering such legislation. P-H, Pension & Profit Sharing Service 2-23-62, p. 6.

36. 7 CCH 1961 STAND. FED. TAX REP. ¶ 6444.

37. The State legislation in the first few months after the promulgation of the Kinter Regulation was summarized in Maier, *Don't Confuse Kinter-Type Associations With New Professional Associations*, 15 J. TAXATION 248 (1961).

38. *Id.* Act of August 7, 1961, No. 416, 7 CCH 1961 STAND. FED. TAX REP. ¶ 6492.

characteristics deemed necessary under the Kinter Regulation. The framework is established so that the association may obtain the requisite continuity of life, centralized management and transferability of interests. While the Pennsylvania Act does not limit the associate's liability to the association's property,³⁹ the association has a sufficient preponderance of corporate attributes to qualify under the Kinter Regulation.⁴⁰

While it is beyond the scope of this article to consider the private law consequence of these new acts, it should be noted that there are many ramifications in addition to qualifying for the benefits of pension and profit sharing plans.⁴¹ One area of concern is the ethical problem.⁴² By retaining the same civil liability to the client or patient as before the formation of the new business unit, the principal ethical doubt should be removed since there is no interposition of a business organization between the professional man and his responsibility to the client-patient.⁴³

By forming a professional association, the group may be subjecting itself to tax and filing problems under state law. Many problems are presented as a result of the internal regulation of the professional

39. Similarly, section 12 of Oklahoma's Professional Corporation Act provides that the new law makes no modification on the liability arising out of the performance of professional services. 7 CCH 1961 STAND. FED. TAX REP. ¶ 6476. Similarly, Section 44 of Connecticut's Modified Uniform Partnership Law precludes limitation of liability for professional misconduct or torts. 7 CCH 1961 STAND. FED. TAX REP. ¶ 6444.

40. The first example under Treas. Reg. § 301.7701 (1960) classified as an association the business unit which has three characteristics but does not have limited liability.

41. Some of the problems for the professional men who seek the benefits of pension and profit sharing plans are examined in Jones, *The Professional Corporation*, 27 FORDHAM L. REV. 353 (1958) and Note, *Qualified Pension Plans for Unincorporated Professional Associations*, 12 STAN. L. REV. 746 (1960).

42. The ethical problems are treated in Jones, *Should Lawyers Incorporate*, 11 HASTINGS L.J. 150, 153 (1959).

43. While setting forth many caveats, opinions of the American Bar Association and the Philadelphia Bar Association have concluded that the practice of law by a professional corporation or association is not a violation of any canon of ethics in and of itself. American Bar Association Opinion No. 303, is printed in the Philadelphia Legal Intelligencer, December 18, 1961, p. 1, col. 1. The Philadelphia Bar Association Opinion No. 61-7 is printed in the Philadelphia Legal Intelligencer, December 29, 1961, p. 1, col. 1. The Florida and Oklahoma Supreme Courts have approved of lawyers practicing under the new professional corporation laws of those states. In the Matter of the Florida Bar, Case No. 31,073 reported P-H, Pension & Profit Sharing Service, 12-1-61, p. 6; Oklahoma S.C.B.D. 1378, P-H Pension & Profit Sharing Service, 2-23-62, p. 6. The Ohio Supreme Court ruled that the Secretary of State of Ohio was under no clear duty to accept for filing articles of incorporation which set forth that the corporate purposes is the practice of law until the Ohio Supreme Court, through its rules for admission to the practice of law, recognizes the right of a corporate entity to practice law. *Green v. Brown*, p. 2-14-62, 30 LW 2415. An opinion from the Attorney General of Pennsylvania holds that a group of doctors may ethically form an association under the Pennsylvania Professional Association Act. Philadelphia Legal Intelligencer, October 9, 1961.

group by the new acts. The requirement that interests be freely assignable would become problematic if a shareholder transferred his interest to one disliked by the remaining associates. However, the problem may be solved by giving the remaining associates the first right to purchase the interest of the departing interest holder. What rights to income will an associate have who decides not to contribute his services? If the association wants to take in a new associate, must all the old shares be surrendered and all new shares issued in the new proportion? How can an existing shareholder be compelled to surrender his existing shares for reduction? These and many other problems must be resolved by the individual group before the tax advantages will justify the formation of a new business organization.

THE POSSIBILITY OF FEDERAL LEGISLATION

The rash of state legislation may be the catalyst necessary to spur enactment of federal legislation, such as Keogh Bill, so that professional men and other self-employed individuals may obtain tax relief while providing for their retirement income. Ten years of congressional debate have failed to produce passage of such legislation; however, the Keogh Bill passed in the House of Representatives and has been approved by the Senate Finance Committee.⁴⁴ According to Representative Keogh, the chances of passage of his bill are good.⁴⁵

However, passage of the Keogh Bill will not necessarily eliminate the interest of professional men in forming associations or corporations because of the restrictions imposed by the proposed legislation. Compared to the benefits available under the Internal Revenue Code at the present time, the proposed bill imposes many more limitations with respect to contributions, trust investments, vesting, waiting period and the age at which benefits may be paid.⁴⁶ If the new legislation imposes the same limitations on "owner-employees" of closely held corporations, then the professional man will have no incentive to associate or incorporate if the tax treatment under those circumstances is to be identical with that available to the self-employed. But if new legisla-

44. Keogh, *Pensions for the Self-Employed*, 100 TRUSTS & ESTATES, 175, 176 (1961). A brief summary of the history of the Keogh Bill and the attempted legislation which preceded it are set forth in Rapp, *The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keogh Bill*, 14 TAX L. REV. 55 (1958) and Polisher, *The Self-Employed Individuals' Retirement Bill of 1959*, 37 TAXES 321 (1959).

45. Keogh, *supra* note 44.

46. *Id.* Rapp, *Pensions for the Self-Employed: The Treasury Department-Finance Committee Plan*, 16 TAX. L. REV. 227 (1961). Rapp discusses the Treasury Department's recommendations for dealing with the "owner-employee" of closely held corporations at 238 *et seq.*

tion leaves the self-employed in a less advantageous position than the "owner-employee" in closely held corporations, then the professional corporation or association under state law may still be useful to obtain tax advantages.

If the professional man must fit his business organization into an uncomfortable mold to qualify under professional association or corporation acts, then prudence dictates awaiting Congressional action since he may realize similar benefits as a partner or self-employed individual. However, regardless of whether the taxpayer seeks the benefits of pension and profit sharing plans as an individual, partner, associate or corporate employee, he will be vitally concerned with the procedure for obtaining a favorable ruling on his plan and the advantageous avenues of operation.

A PLAN MAY BE QUALIFIED ALTHOUGH IT ULTIMATELY COVERS ONLY PREFERRED EMPLOYEES

While Section 401(a)(4) of the Internal Revenue Code explicitly provides that a qualified plan may not discriminate in favor of shareholders, supervisors, officers or highly compensated employees, the case law indicates that pension and profit sharing programs can attain qualified status even though they inure to the benefit of preferred employees. Sound tax planning, however, dictates that the taxpayer should not press for the last ounce of advantage in order to be certain that his plans will be qualified. And considerations of public policy suggest that the areas of preferential treatment should be curtailed.

A plan is considered non-discriminatory if it covers salaried employees although it excludes all wage earners.⁴⁷ Moreover, a qualified pension or profit sharing plan may require an employee to work for ten or fifteen years and remain with a firm until the age of 55 or 65 before being fully covered. It is not necessary for a qualified plan to grant an employee a vested right to any of the contributions made by the employer for his account until he possesses the requisite age and tenure.⁴⁸

The decisions show that plans have been upheld where officers and shareholders have become disproportionate beneficiaries due to the sporadic nature of the business resulting in large turnover of employees. In *Ryan School Retirement Fund*,⁴⁹ an employee had to serve the corporation until the age of 55 with 15 years of service or until he was

47. Marjorie F. Birnie, 12 CCH Tax Ct. Mem. 867 (1953).

48. Rev. Rul. 33 part 5(a)(1), 1953-1 CUM. BULL. 267; PS No. 22, 9-2-44, P-H PENSIONS & PROFIT SHARING SERV. ¶ 9520.

49. 24 T.C. 127 (1955).

65 in order to qualify under the pension program. At the plan's inception in 1944, there were 5 officers and 110 other employees. When the plan was terminated in 1951, the same 5 officers remained while only 3 of the rank and file employees were still employed. Reasoning that the statute was not designed to prevent discrimination in favor of permanent employees, the Tax Court held that ultimate benefits to all of the officers and a small percentage of the employees did not disqualify the plan.⁵⁰

Similarly, the Court of Appeals for the Sixth Circuit was unperturbed about discrimination although the number of participants in two pension and profit sharing plans dropped from 27 in 1943 to 3 in 1945.⁵¹ Two of the employees who finally qualified were the corporation's sole shareholders when the plan was adopted. And the Eighth Circuit has declared that a plan is not disqualified because an employees' contributions would be forfeited when he terminates his employment without just cause where the employer would be the judge of what constituted good cause.⁵²

In *Marjorie F. Birnie*,⁵³ notwithstanding a decrease in the number of participating employees in pension and profit sharing programs from seven to one within a three year period, the Tax Court held that the plans were organized for the benefit of the firm's employees in general. The Court categorized the reduction of covered employees as merely "fortuitous."⁵⁴

The Commissioner of Internal Revenue ruled that a pension plan was not discriminatory even though shareholders and highly paid employees derived substantially larger benefits than other employees due, in part, to the fact that the preferred employees had longer periods of service than other workers who were employed when the plan was terminated.⁵⁵ These decisions illustrate the limits of how plans may qualify even though ultimately they principally benefit preferred employees.

50. *Id.* at 134.

51. The facts of this plan are set forth in *H.S.D. Co. v. Kavanagh*, 191 F.2d 831 (6th Cir. 1951) and *Estate of Harold S. Davis*, 22 T.C. 807 (1954).

52. *Mississippi River Fuel Corp. v. Koehler*, 266 F.2d 190 (8th Cir. 1959).

53. 12 CCH Tax Ct. Mem. 867 (1953).

54. 12 CCH Tax Ct. Mem. 867, 871 (1953).

55. Rev. Rul. 55-60, 1955-1 CUM. BULL. 37.

PREFERRED EMPLOYEES ARE BENEFITED BY FORFEITURE,
CONTRIBUTION DIFFERENTIALS AND TERMINATION
OF OTHER EMPLOYEES

A) *Forfeiture by Temporary Employees.*

Credits forfeited by temporary workers may benefit permanent employees. Funds which have been credited to a worker's pension or profit sharing account are forfeited to the trust fund when his employment is terminated prior to fulfilling the tenure or age requirements for participation.⁵⁶ If the plan gives the employee no vested right to any of the money credited to him, it is all forfeited. Some programs provide that the employee receives a vested right to a part, such as 10 percent, of the fund credited to his account for each year he is employed. Under such a plan, short term employees would forfeit a substantial part of their credits when they leave the firm. Forfeited pension funds are ordinarily used to reduce future employer contributions;⁵⁷ however, the results of termination of a plan, discussed below, show that forfeiture may provide extra benefits for preferred employees. Forfeiture of profit sharing contributions need not be applied toward amounts the employer will owe in the future, but discriminatory benefits in favor of preferred employees are not supposed to result from such forfeitures.⁵⁸ The *Ryan* and *Birnie* cases show that restriction is only theoretical.

The *Ryan* case demonstrates how some employees can benefit from amounts forfeited by short-term workers. About \$6,000 was initially contributed to the pension fund for 5 officers and over \$64,000 for 110 rank and file employees. In the next seven years the firm contributed less than \$ 2000 and the trust earned about \$18,000. One hundred seven departing employees were paid \$19,000 as their share which had vested prior to their departure. When the plan was terminated, the 3 remaining employees were credited with \$19,000 and the 5 officers, still with the firm, had \$52,000 in their accounts. Thus, even assuming that the entire \$18,000 of earnings and the \$2,000 subsequently contributed were credited to the officers, at least \$26,000 originally designated to benefit rank and file employees was shifted to the

56. *Irvin B. Schwabe Co.*, 17 T.C. 1215 (1952). The employer has substantial discretion in deciding how much, if any, of the contributions should vest in an employee. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 5(b).

57. Treas. Reg. § 1.401-1(b)(1)(i) (1956), as amended T.D. 6301, 1958-2 CUM. BULL. 197; Rev. Rul. 109, 1953-1 CUM. BULL. 288. Some forfeitures may be reallocated in pension plans while retaining the requisite definiteness providing the reallocations are anticipated in the plan. Rev. Rul. 60-73, 1960-1 CUM. BULL. 155.

58. *Ryan School Retirement Fund*, 24 T.C. 127 (1955).

officers' accounts. The small contributions by the employer after the plan's inception and the shift into the accounts of the officers were not due to having forfeited funds applied against subsequent contributions due by the employer. The firm conducted very little business and employed few people after the first anniversary of the adoption of the pension plan. The funds were shifted under the plan's provisions to allocate forfeited funds.

Marjorie F. Birnie further indicates how forfeited funds may benefit preferred employees.⁵⁹ There, a \$3,300 a year secretary with slightly more than three years of service was the only employee of 7 to qualify under a firm's pension plan, and she also received most of the profit sharing fund. She was paid almost \$8,000 of the \$11,000 contributed to the pension and profit sharing funds by her employer due to forfeitures by departing employees. The Tax Court held that the pension and profit sharing plans operated for the benefit of the employees in general despite the fact that the secretary was the primary beneficiary. The Court said that the secretary was not an officer, shareholder, supervisor or a highly paid employee, but commented in language strong enough to be construed as an alternative holding that even if she were classified as a supervisor, the plan would not be disqualified because it was non-discriminatory when formulated.

B) *Larger Contributions May Be Made For Preferred Employees.*

The employer may make larger contributions for officers, shareholders, supervisors or highly paid employees than for rank and file workers. Section 401(a)(5) provides that a plan shall not be considered discriminatory because the benefits bear a uniform relationship to the employee's total compensation. In *Volckening, Inc.*,⁶⁰ approximately 55 per cent of the corporation's contributions to a pension plan were credited to two stockholders who owned 97 per cent of the firm's stock while the other 6 employees received credit for the remaining 45 per cent. The Tax Court held that the plan was non-discriminatory because the contributions bore a proper relationship to the total compensation of the employees. Similarly, *Betty C. Stockvis*⁶¹ held a pension plan non-discriminatory even though some employees received larger benefits than others. In that case the employer contributed 20 per cent of each employee's yearly earnings to his pension account.

In addition, a firm may contribute larger sums to the accounts of older employees in order to provide a sound actuarial basis for their

59. 12 CCH Tax Ct. Mem. 867 (1953).

60. 13 T.C. 723 (1949).

61. 10 CCH Tax Ct. Mem. 74 (1951).

retirement. Since all employees are entitled to retire at the same age⁶² and since executive employees are likely to be nearer that age at the plan's inception, larger contributions may be made so that in a few years there will be sufficient funds to provide for their retirement. Larger contributions for older shareholders and other highly compensated employees to put their retirement credits on a sound actuarial basis allowed those individuals to gain substantial advantages over average workers on the premature termination of a pension plan approved by the Commissioner.⁶³

C) *Preferred Employees Benefit By Premature Termination.*

Premature termination or discontinuance of pension and profit sharing programs may result in discriminatory benefits for executive and other preferred employees due to forfeiture by temporary employees and disproportionately large contributions made to their accounts.⁶⁴ Theoretically, the large contributions for older executive employees are necessary to put them on an actuarial par with younger workers. However, at termination of the pension or profit sharing plan, amounts credited to employees become vested.⁶⁵ Under the Internal Revenue Code highly paid employees are entitled to a credit of more funds than average employees on a ratio relative to their normal compensation. But extra contributions to provide actuarially sound plans for older executive employees will give those individuals a preferred position when termination of the plan vests all existing credits.⁶⁶ In addition, forfeitures and reallocations to the accounts of remaining employees in profit sharing plans are likely to have swelled accounts even beyond what an accelerated schedule requires. Thus, premature termination presents a broad avenue for the employer to award executive employees discriminatory benefits.⁶⁷

Employers have considerable latitude to manipulate the termination of pension and profit sharing programs which may result in discriminatory benefits for shareholders, officers, supervisors or highly paid em-

62. It is permissible for an employee to retire at an earlier age than that specified in the plan providing the benefits do not exceed those already vested. Rev. Rul. 58-151, 1958-1 CUM. BULL. 192.

63. Rev. Rul. 60, 1955-1 CUM. BULL. 37.

64. The differences between a suspension and discontinuance are considered in Rev. Rul. 60-2, 1960-1 CUM. BULL. 164.

65. Rev. Rul. 186, 1955-1 CUM. BULL. 39.

66. Employers can contribute larger sums for employees who are older at the start of the plan. Mim. 6136, 1947-1 CUM. BULL. 48, 50. But employers are not permitted to make disproportionate contributions without some apparent justification. I.T. 3678, 1944-1 CUM. BULL. 321.

67. Ryan School Retirement Fund, 24 T.C. 127 (1955); Rev. Rul. 60, 1955-1 CUM. BULL. 37.

ployees. The regulations provide that the term "plan" implies a permanent program.⁶⁸ Regulation 1.401-1(b)(2) specifies that abandonment of the plan within a few years after its adoption for any reason, except business necessity, will be taken as evidence that the plan was not bona fide from its inception. Elaborating the meaning of the identical regulation requiring permanency under the 1939 Code, the Commissioner of Internal Revenue said that a plan may be terminated only for a valid reason such as bankruptcy, change of ownership in an arm's length transaction, a bona fide and substantial change in stockholding and management or financial inability to continue meeting the cost of the plan.⁶⁹

In practice, less dramatic reasons have been held sufficient to warrant abandonment of pension and profit sharing plans. Adverse business conditions, without a showing of real inability to meet the cost of the plan, have been held to be ample justification to terminate a program.⁷⁰ Moreover, the Sixth Circuit undermined the entire requirement of permanency when it said if the Commissioner accurately interpreted that regulation, it was invalid.⁷¹ More recently the Sixth Circuit has held that an employer may take a deduction and the trust is exempt where the employer is under no obligation to make the contribution to a pension trust fund.⁷² Abandonment and curtailment of pension and profit sharing plans has been allowed where new employers needed funds to meet salary increases and for plant expansion.⁷³ Language from some releases from the Bureau of Internal Revenue state that pension plans "may be terminated at the will of the employer" or may be ended if the "board of directors deems it inadvisable" to continue the plan.⁷⁴

The Commissioner has warned that pension and profit sharing plans will be retroactively disqualified if they discriminatorily benefit preferred employees by termination.⁷⁵ In Mimeograph 5717 issued in 1944, the Commissioner attempted to restrict termination by providing

68. Treas. Reg. § 1.401-1(b)(2) (1956), as amended T.D. 6301, 1958-2 CUM. BULL. 197 is identical with Reg. § 118, 39.165-1 under the 1939 Code. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, Part 2(g) specifies that a plan must be permanent and continuing to qualify and prohibits funding at a higher rate for beneficiaries of pension plans where the plans are later discontinued.

69. Mim. 6136, 1947-1 CUM. BULL. 58. Liquidation of the employer justifies termination. Rev. Rul. 59-241, 1959-2 CUM. BULL. 118.

70. Ryan School Retirement Fund, 24 T.C. 127 (1955); *Birnie v. Commissioner*, 12 CCH Tax Ct. Mem. 867 (1953); Rev. Rul. 60, 1955-1 CUM. BULL. 37.

71. The Commissioner had interpreted permanency to require periodic contributions and a definite formula. *Lincoln Electric Co. v. Commissioner*, 190 F.2d 326 (6th Cir. 1951).

72. *United States v. General Shoe Corp.* 282 F.2d 9 (6th Cir. 1960).

73. Mim. 6136, 1947-1 CUM. BULL. 58 (A) (F).

74. Mim. 5717, 1944-1 CUM. BULL. 321; Rev. Rul. 186, 1955-1 CUM. BULL. 39.

75. Rev. Rul. 33, 1953-1 CUM. BULL. 267(e); Mim. 6136, 1947-1 CUM. BULL. 58.

that if a pension plan was terminated or not fully funded any time within the first ten years, employer contributions for the benefit of the highest paid 25 employees were limited.⁷⁶ This restriction was not severe since at least \$20,000 could be set aside for each employee without incurring this limitation. Moreover, a patient taxpayer could circumvent Mimeograph 5717 by waiting more than ten years before terminating his pension program.⁷⁷ The ineffectiveness of the requirement of permanency is illustrated by *Blume Knitwear v. Commissioner*⁷⁸ where a profit sharing plan in operation for one year until disapproved by the Office of Salary Stabilization was held to have the requisite permanency.

BUSINESS PROFITS MAY BE SIPHONED OFF THROUGH LARGE CONTRIBUTIONS IN A SINGLE YEAR

Tax advantages may be realized by making sizable contributions to a profit sharing fund during prosperous years and later curtailing or abandoning the program.⁷⁹ While the Commissioner has said such a scheme will result in disqualification because of the temporary nature of the program,⁸⁰ the case law suggests it can be done. This practice is impractical for pension programs since fixed contributions are required, but contributions to profit sharing plans are more flexible. In *Ryan* the profit sharing plan was held to be qualified although over \$70,000 was contributed by the employer during the program's first year when profits were high and less than \$2,000 was set aside during the next six low-profit years until the plan was ended.⁸¹ In 1956 the Treasury Department abandoned its rule that profit sharing plans needed a definite formula for profit contributions.⁸²

76. *Mim.* 5717, 1944-1 CUM. BULL. 321. A participant was allowed to receive a lump sum distribution even though he was one of the 25 highest paid employees and the plan had been in existence less than 10 years where he promised to make certain repayments if the plan terminated before 10 years which promise was secured. *Rev. Rul.* 61-10, 1961 INT. REV. BULL. No. 3, at 12.

77. *Ibid.* The demise of a similar restriction illustrates the Commissioner's difficulty in imposing effective limitations on pension and profit sharing plans. *I.T.* 3674, issued in 1944, provided that a plan would be considered to benefit discriminatorily shareholders if 30% or more of contributions for all employees was credited to a stockholder who owned more than 10% of voting stock. 1944-1 CUM. BULL. 315. After the Tax Court weakened this provision by holding it was not an absolute rule, but only could be considered with all the facts, the 30% rule was revoked. *Volckening Inc.*, 13 T.C. 723 (1949). *I.T.* 4020, 1950-2 CUM. BULL. 61. Efforts to enact the 30% rule into the 1954 Code failed. P-H PENSION & PROFIT SHARING SERV. ¶ 4091.

78. 9 T.C. 1179 (1947).

79. But to qualify as a profit sharing plan, the contributions must depend on and be geared to profits. *Mississippi River Fuel Corp. v. Koehler*, 266 F.2d 190 (8th Cir. 1959).

80. PS No. 7, 7-29-44, 3 CCH 1944 STAND. FED. TAX SERV. ¶ 6498.

81. *Ryan School Retirement Fund*, 24 T.C. 127 (1955).

82. *Lurie, Plastic Contributions for Pension and Profit Sharing*, 67 YALE L.J. 1003 (1958).

The Court of Appeals for the Sixth Circuit held that the Lincoln Electric Company's profit sharing plan was qualified even though the employer made only a single million dollar contribution.⁸³ However, deductible contributions cannot exceed 10 per cent of the employee's compensation for the pension fund and 15 per cent of the worker's pay for the profit sharing plan.⁸⁴ Preferred employees or shareholder employees may thus receive these large contributions from high profit periods staggered through later years or in a lump sum at capital gains rates.

THE EMPLOYER MAY CONTROL THE TRUST FUND'S INVESTMENTS

The employing corporation or partnership may retain indirect control over the funds contributed to pension or profit sharing trusts.⁸⁵ It was noted that 86 per cent of all pension programs are administered unilaterally by the employers.⁸⁶ This is possible so long as the investment policy of the trust is for the exclusive benefit of the employees.⁸⁷ By setting up a trust and designating trustees who are interested in or confident of the firm's future prospects, the employer can use the contributed funds by inducing the trustee to invest in his business. In *Forcum-James Co.*,⁸⁸ seven of eight trustees of a qualified pension fund, who had the complete power to make all trust investments, were officers of the corporation and owned 73 per cent of its stock. The Tax Court held a plan qualified when two of three pension fund trustees were corporate officers, and one was a 90 per cent shareholder.⁸⁹ There is authority for the proposition that a corporation may act as the trustee of a qualified plan without having a formal trust arrangement set up. The Second Circuit reached that result, but commented that the

83. *Lincoln Electric v. Commissioner*, 190 F.2d 326 (6th Cir. 1951).

84. INT. REV. CODE OF 1954, § 404(a)(1)(A) and 404(a)(3)(A). When pension and profit sharing plans are combined, 25% of the employees compensation may be contributed. § 404(a)(7). However, the contributions when added to other pay cannot exceed reasonable compensation. Treas. Reg. § 1.404(a)-1 (4)(b) (1956). It has been suggested that reasonableness of compensation should be judged on the value of the overall plan to the employer compared to the cost rather than the compensation paid to an individual employee. Note, *Legal Problems of Private Pension Plans*, 70 HARV. L. REV. 490, 491-92 (1957). The shareholders' derivative suit is another check to guarantee that the executive is not overpaid. Note, *Corporations-Pension Plan-Stock*, 33 TUL. L. REV. 677 (1959). The observation has been made that contributions to profit sharing plans are less subject to attack as unreasonable than in pension plans since the former are geared to profits. Rothman, *Variability of Annual Contributions*, 100 TRUSTS & ESTATES 302 (1961).

85. For a detailed analysis of the limitations imposed by the regulations on trust investments, see Goodman, *Strict Rule's Limit Investments of Qualified Pension and Profit Plans*, 14 J. TAXATION 153 (1961).

86. Note, *Protection of Beneficiaries Under Employee Benefit Plans*, 58 COLUM. L. REV. 78, 82 (1958).

87. Treas. Reg. § 1.401-1(b)(3) (1956) as amended T.D. 6301, 1958-2 CUM. BULL. 197.

88. 7 T.C. 1195 (1946).

89. *Irvin B. Schwabe Co. v. Commissioner*, 17 T.C. 1215 (1952).

arrangement qualified as a trust because the corporation did not invest in its own stock.⁹⁰ If an employer desires that pension and profit sharing funds be invested in his business, caution dictates that the trustee should make the investment under an independent trust arrangement.

THE TRUST FUND MAY BE INVESTED IN THE EMPLOYER'S BUSINESS

The Internal Revenue Code, regulations and revenue rulings seek to impose no limitations on what the trust fund may be invested in as long as it is for the exclusive benefit of the employees.⁹¹ However, if the plan is a subterfuge for the distribution of profits to stockholders, it will not qualify as a program for the exclusive benefit of employees.⁹² A statutory limitation on trust fund ventures, section 503(c)(1) of the Internal Revenue Code, provides that a trust will lose its tax exempt status if it engages in certain prohibited transactions such as loaning any part of its income or corpus without adequate security. The regulations permit trust funds to be used for any investments permitted by the trust instrument and local law.⁹³ Therefore, investments in the employer's business, loans to the employer and leases of real or personal property are permitted if full disclosure is made so that the transaction is for the exclusive benefit of the employees.⁹⁴ The security of the investment and the reasonableness of the rate of return are important factors in evaluating whether the investment was made in the sole interest of the employees.⁹⁵ It has been recognized that the trust funds may be used to acquire all of the employer's stock.⁹⁶

Investments must be made with a view to providing sufficient liquidity for distributions in accordance with the terms of the plan and

90. *Tavanes Watch Co. v. Commissioner*, 176 F.2d 211. (2d Cir. 1949).

91. There are other regulations about which the administrator must be concerned. The application to pension and profit sharing plans of the Federal Welfare And Pension Plan Act, effective January 1, 1959, is considered by Arends, *Pension and Profit Sharing Plans — Fact and Friction*, 3 ARIZ. L. REV. 61, 70-72 (1961). It has also been suggested that such plans may be subject to federal and state securities acts. Note, *The Profit-Sharing Method of Providing for Employee Retirement Income*, 41 IOWA L. REV. 277, 283 (1956).

92. Treas. Reg. § 1.401-1(b)(3) (1956), as amended, T.D. 6301, 1958-2 CUM. BULL. 197 is identical with Treas. Reg. 118, § 39.165-1(a)(4) under the 1939 Code; Rev. Rul. 33, 1953-1 CUM. BULL. 267, 271(g); I.T. 4020, 1950-2 CUM. BULL. 61.

93. Treas. Reg. § 1.401-1(b)(5)(i) (1956), as amended, T.D. 6301, 1958-2 CUM. BULL. 197.

94. Treas. Reg. § 1.401-1(b)(5)(ii) (1956), as amended, T.D. 6301, 1958-2 CUM. BULL. 197. A detailed analysis of permissible investments is set forth in Note, *Investment of Pension and Profit-Sharing Trust Funds in the Employer's Business under the Internal Revenue Code of 1954*, 45 MINN. L. REV. 575 (1961).

95. Rev. Rul. 33, 1953-1 CUM. BULL. 267, part 2(i). Treas. Reg. § 1.503(c)-1(b) (1956), as amended, T.D. 6301, 1958-2 CUM. BULL. 197, requires that there be adequate security for any loan by the trust fund.

96. Goodman, *Strict Rules Limit Investments of Qualified Pension and Profit Plans*, 14 J. TAXATION 153 (1961).

a fair return to the trust, and the cost must not exceed the fair market value.⁹⁷ When a ruling is sought to determine whether an investment in the employer's business qualifies as being for the exclusive benefit of the employees, the following factors are considered: nature and amount of the investment, annual yield, restrictions on marketability, collateral, total trust assets, total trust investments in stock or securities of the employer, percentage of total assets invested in stock or securities of the employer, nature of the employer's business, and the liquidity and diversification of the trust investments.⁹⁸

*H.S.D. Company v. Kavanagh*⁹⁹ illustrates the extensive manner in which pension and profit sharing funds may be invested in an employer's business. The H.S.D. Corporation had an authorized capital of \$66,500. On April 30, 1945, the executive employee's trust owned \$48,800 of H.S.D. stock and the other employee's trust owned \$11,200 of that corporation's stock.¹⁰⁰ The initial stock investments were made by the trustees the day after the trusts were formed and immediately after the employer made the original contributions.¹⁰¹ Upon these facts, the H.S.D. Corporation received a ruling from the Commissioner of Internal Revenue that the plans met the requirement that such a program must be for the exclusive benefit of the employees.¹⁰² A new Commissioner later disagreed with that ruling and litigation ensued. The Sixth Circuit said that at the very least the taxpayer was entitled to a jury trial, on its timely demand, since a question of fact was presented because different inferences might be drawn from the stipulated facts. However, the H.S.D. Corporation was held to be entitled to a directed verdict that their pension and profit sharing plan was qualified because the government did not uphold its burden of proof by sustaining its affirmative defense that the deduction was improperly taken. The Commissioner made no deficiency assessment and did not benefit by the presumption of having established a prima facie case. When the taxpayer filed a complaint asking for a refund, the Court said the Commissioner assumed the burden of proof in raising the affirmative defense that the deduction was improperly taken.

97. Rev. Rul. 57-163, part 2-k, 1957-1 CUM. BULL. 128, 135.

98. Goodman, *Pension and Profit-Sharing Trust Investments under the Income Tax Law*, 32 TAXES 183, 185 (1954).

99. 88 F. Supp. 64 (E.D. Mich. 1949) *rev'd* 191 F.2d 831 (6th Cir. 1951). Control over some employer-corporation has been acquired by a pension trust fund. Lurie, *Plastic Contributions for Pensions and Profit Sharing*, 67 YALE L.J. 1003, 1020 (1958).

100. 88 F. Supp. 64, 68 (E.D. Mich. 1949). This same program created more litigation when the widow of one of the shareholders sought to pay only a capital gain tax on her deceased husband's share. S. Davis, 22 T.C. 807 (1954).

101. 191 F.2d 831, 838 (6th Cir. 1951).

102. *Id.* at 835.

Advance Rulings.

It is helpful, although not indispensable, to obtain an advance ruling from Internal Revenue Service that the contemplated plan is qualified.¹⁰³ Upon a request for a ruling accompanied by written instruments setting up a plan and the trust thereunder, the Internal Revenue Service will issue an advance determination letter advising the requesting party as to the qualification of the plan and the exempt status of the trust.¹⁰⁴ A conference about a plan in the District Director's Office is possible only after the plan has been formally submitted.¹⁰⁵ The plan may be set up prior to the initial determination as to qualification with a provision that contributions will be returned to the employer if the plan is deemed not to be qualified.¹⁰⁶ Approval is especially beneficial since there is authority for the proposition that subsequent commissioners are bound by the Acts of prior commissioners in approving pension plans.¹⁰⁷

EVALUATION AND RECOMMENDATIONS

Pension and profit sharing plans should be permitted to include partners and still receive tax advantages. There is no reason to withhold from members of a partnership the tax benefits that are available to shareholders in a closely held corporation. Economically, these two business organizations play very similar roles. In general, their employment policies are likely to be highly analogous. There is no justification for placing shareholders in a preferred position merely because incorporation endows them with a fictional employer whose employees they may be in order to qualify as beneficiaries of pension and profit sharing plans.

The *Kinter* case has provided the rationale to support classifying partners as employees for purposes of pensions and profit sharing. In that case the Ninth Circuit not only said the partners were employees of the association, but also that they would be considered employees of the partnership preceding formation of the association in order to give

103. The procedure for advance rulings, amendments and appeals within the Internal Revenue Service is set forth in Goodman, *Pension and Profit Sharing Rulings and Procedure*, 17 N.Y.U. INSTITUTE ON FED. TAX. 993 (1959).

104. Rev. Proc. 56-12, 1956-1 CUM. BULL. 1029.

105. Rev. Proc. 60-1, 1960-1 CUM. BULL. 874.

106. Rev. Rul. 60-276, 1960-2 CUM. BULL. 150.

107. *Time Oil Co. v. Commissioner*, 258 F.2d 237 (9th Cir. 1958). There, the plan was upheld even though significant variations were made after initial approval. While a later Commissioner challenged a plan approved by a former Commissioner in *H.S.D. Co. v. Cavanagh*, discussed in text at footnotes 99-102 *supra*, it is probable that the prior approval was very helpful to the taxpayer in the Court's judgment.

them the requisite three years of employment to enable them to qualify for the pension plan immediately on formation of the association. The Court said the partners were "employed about the business of the partnership."¹⁰⁸ The "business of the partnership" lends itself well to being fictionalized as the employer of the partner. It does not possess the precedent of calling a sole shareholder the employee of the corporation, but it is equally as logical.

It is similarly logical, and fair, to extend coverage to self-employed individuals. The rational that the partner is employed on the business of the partnership could be extended to holding that the individual is employed and occupied on the operations of the business, which he happens to own. A "business" could be fictionalized as being the employer of the individual owner as well the partner. Since the sole-shareholder, sole-employee of a corporation may qualify as the sole beneficiary of a pension and profit sharing plan, the individual proprietor should be entitled to the same treatment.

It is unfortunate that the Congress, the courts or the Commissioner did not extend the benefits of pension and profit sharing plans to partners and self-employed individuals before the rash of state legislation on professional associations and corporations. Experience may show that professional men will become embroiled in an unwieldy business unit in order to derive benefits that should be available to them as partners or self-employed individuals. This situation is analogous to the flood of state legislation in the 1940s instituting community property law in order to allow husbands and wives to split their income until federal law was amended to give married couples in non-community property states the same benefits enjoyed by spouses in states which had community property laws. Professional men should have the same rights to be beneficiaries of pension and profit sharing plans without regard to whether their state legislature has passed a professional association or corporation law. Fairness and equality dictate that all taxpayers should have the same rights to enjoy the tax shelter of pension and profit sharing plans without regard to where they live or whether they are corporate shareholder-employees, partners or self-employed individuals.

A requirement that part of the contribution for the employee must vest in him immediately upon allocation to his account would be a substantial aid in the elimination of discrimination due to forfeitures of benefits by workers who terminate their employment before becoming fully covered. To accomplish this purpose, it should be required that

108. *United States v. Kintner*, 216 F.2d 418, 427 (9th Cir. 1954).

ten per cent of the money allocated to each worker's account would vest in him for each year of his employment. It is true that such a provision would place a pot of gold of some size at every bend of the rainbow to replace the requirement that an employee must stay with a firm until retirement before qualifying for pension benefits. This basic premise of pension programs must be changed in order to eliminate discrimination due to forfeitures. The only alternative is to transfer credits of terminating employees back to the taxable income of the business. This is undesirable, because the net result would still be that a pension or profit sharing program would have been established only for long-term employees.

Eliminating liberal forfeiture provisions would probably not encourage workers to leave their employment prior to retirement age or discourage employers from instituting pension or profit sharing plans. Employees would still have incentive to remain with the firm, for only by continuing to be employed until the age specified in the plan would an employee receive all his benefits or accrue sufficient credits to receive the benefits calculated to support him at retirement.

More rigid standards should be applied in determining whether a pension or profit sharing plan should be retroactively disqualified because of discrimination resulting from premature termination. Termination should not be permitted at the whim of the employer, but only for real inability to meet the cost of the plan or a real change in the status of the employer's business such as dissolution or a substantial change in stock ownership. The courts should adopt a more realistic attitude in evaluating the original motive behind plans which are terminated a short time after they are adopted. While it is not desirable to make termination so difficult that employers will not be willing to start a pension or profit sharing plan, the current ease of termination only invites temporary plans.

Special vigilance should be employed to disqualify plans whose termination allows older employees to gain vested interests in large accounts amassed to provide an actuarially sound retirement program within a relatively short time. If such plans are not disqualified, at an absolute minimum the part of the funds credited to such employees because of accelerated contributions due to their advanced age should be returned to the taxable income of the employer in the year when contributed. The administrative difficulty of such recalculation would be much less than total retroactive disqualification of the plan.

The Commissioner and courts should adopt a strict position on profit sharing plans which are marked by extraordinary contributions

for a short period of time and then decline to small sums or nothing. Such situations indicate that the plans are not permanent and that the taxpayer is merely instituting the program to divert high profits in a single year. The keystone should be whether it is likely that the plan will be continued in the same vein judged against the history of the corporation. Of course, a corporation should not run the risk of having its plan disqualified because its business goes bad and subsequent contributions to a profit sharing plan dwindle. However, an evaluation must be made whether it was intended at the outset that the plan would be permanent or whether the motive was merely temporary diversion of corporate profits.

While certain loops in the law should be closed, the problems of the taxpayer must be kept in mind in formulating tax policy. Since the taxpayer cannot control or completely predict the profits picture, his profit sharing plan should not be disqualified because of some variations in contributions. And the corporate taxpayer should not have his plan subjected to disqualification because there is a significant turnover in his employees. Substantial turnover of employees is inevitable for certain types of business. The requirement of partial vesting should solve that problem.

CONCLUSION

Public policy has been well served by federal tax laws which have encouraged the enormous expansion of pension and profit sharing plans in this century. The tax shelters and opportunity for retirement income should be extended to partners and the self-employed who are, realistically viewed, in the same economic position as their corporate counterparts. The technical rules applicable to the operation of pension and profit sharing plans for small business units, considered herein, indicate that certain avenues of advantage for preferred employees should be closed. But time will probably tell that the long range benefits derived from pension and profit sharing plans justify liberal tax treatment.