The Taxation of Qualified Annuity Plans and Deferred Compensation Agreements to the Employee and His Beneficiary

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3. The Agreement

The third limitation on scope is perhaps the easiest to deal with. The agreement itself may limit the arbitral scope depending upon the intention of the parties as evidenced by the type of agreement employed. A problem of interpretation of the clause, be it general or specific, arises here. The courts seem to have formulated a workable rule for this problem: arbitrators may interpret and select any meaning which a reasonably intelligent person would accept, but a meaning which no intelligent person would accept is void.95

Conclusion

As has been indicated the scope of a “future disputes” arbitration agreement may be broad or restricted, but in either case problems abound. Since questions of law under most of the American arbitration statutes are determined in the arbitration itself, the lawyer's significance is felt in the period when the contract is made. Therefore, the best method of removing barriers and of gaining effective arbitration is through expert draftsmanship in drawing the agreement. The penalty for failure in this respect is severe because the benefits of the arbitration process are otherwise lost in the milieu of arbitration, coupled with litigation.

95 Marceau, Are All Interpretations “Admissible”? 12 Arb. J. (n.s.) 151 (1957).

1 For leading cases involving deferred compensation plans, see Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957); Commissioner v. Oates, 207 F.2d 711 (7th Cir. 1953); Howard Veit, 18 P-H Tax Ct. Mem. 811 (1949).
ments available under this Ruling. As a background, however, it will be well to consider the sections of the Code relating to qualified deferred compensation plans.

In order to prevent qualified plans from being used exclusively for high-salaried employees, Congress in 1939 adopted section 165 establishing the requirements for these plans in order to qualify for tax benefits. Because of the complexity of provisions in many pension plans, each one is sui generis, and it is difficult to determine in advance whether a particular plan will qualify under the Code. The Internal Revenue Service has promulgated guides and adopted procedures whereby the employer seeks advice from the Service in establishing his plan to insure that it is a qualified one.

The general requirement for qualification is that there be a plan, which means a definite written program with a view to permanence. This general requirement insures that the plan in operation meets the conditions of the written plan as qualified; that the employee benefits under the plan may be definitely determinable; and that the plan is not merely established during years when profits are good.

The basic requirement for qualification is that the plan be maintained for the exclusive benefit of the employees or their beneficiaries. As specifically provided in the Code, this means first

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2 H.R. 2333, 77th Cong., 2d Sess. (1942). "The coverage and discrimination requirements would operate to safeguard the public against the use of the pension plan as a tax avoidance device by management groups seeking to compensate themselves without paying their appropriate taxes." Id. at 50.


4 There is a belief that these provisions discriminate in favor of salaried employees and against self-employed individuals. See Note, 66 HARV. L. REV. 1105 (1953).

5 See, e.g., Rev. Proc. 56-12, 1956-1 CUM. BULL. 1029. A current revised pamphlet has also been made available as a guide for qualification. Announcement 59-64, 1959 INT. REV. BULL. No. 27, at 28. Determination applications are processed by specially trained reviewers assigned to the audit divisions of the District Directors' offices. The work of the district offices is supervised and coordinated by the Pension Trust Section of the Tax Rulings Division under the Assistant Commissioner, Technical, in the national office in Washington.


7 Disqualification may result if the plan in operation varies from the written plan as previously approved. See Time Oil Co. v. Commissioner, 258 F.2d 237 (9th Cir. 1958).

8 Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 133.


10 Employees may include attorneys or other practitioners but not partners. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 134.

11 INT. REV. CODE OF 1954, § 401(a). It is well to note, however, that a
that the trust instrument makes it impossible for the employer to divert any of the income or corpus of the trust to his own business. If termination becomes necessary, the employer must satisfy all of the fixed and contingent rights of the employees covered under the plan.\textsuperscript{12}

The next requirement is that of coverage. The Code makes two specific provisions as to coverage; the plan must cover either a stated percentage of employees\textsuperscript{13} or a classification of employees which in the opinion of the Commissioner does not discriminate in favor of officers, executives, shareholders, or highly compensated personnel.\textsuperscript{14} The percentage requirement, in essence, provides a minimum necessary coverage of fifty-six per cent\textsuperscript{15} of all employees. In lieu of meeting these percentage requirements, an employer may set up a classification of employees to be covered if found by the Commissioner not to be discriminatory. Generally, plans may qualify which are limited to employees within a prescribed age group, with a stated number of years of service, or who work in designated departments provided of course that these are not discriminatory.\textsuperscript{16}

There is an element of discrimination built into the operation of a qualified pension plan. This occurs in the area of the amount of benefits derived under the plan. Employer contributions are based on a fixed percentage of the total compensation paid or accrued to the employees covered by the plan.\textsuperscript{17} A participant's pension benefits under the plan may be computed with relation to the employer's contributions which was based on his total compensation.\textsuperscript{18} Since officers and executives generally are paid more than ordinary employees, their benefits will be proportionately greater.\textsuperscript{19} This element of discrimination will not cause disqualification, however.\textsuperscript{20}


\textsuperscript{12} No reversion at all is permitted to the employer for profit-sharing or stock-bonus plans. In the case of pension trusts the employer may take any surplus existing because of an actuarial error. Rev. Rul. 57-163, 1957-1 Cum. Bull. 128, 138.

\textsuperscript{13} Int. Rev. Code of 1954, § 401(a) (3) (A). Short-term, seasonal, or part-time employees are not included for the purposes of coverage. Ibid. Hereinafter all Code sections will be from the 1954 Code unless otherwise indicated.

\textsuperscript{14} Code § 401(a) (3) (B).

\textsuperscript{15} 80% of all eligible employees must be covered if 70% or more of the employees are eligible for coverage. Specifically excluded from such computation are seasonal, part-time and recently hired employees. § 401(a) (3) (A).


\textsuperscript{17} Ibid. There is at present no requirement that a specific formula be adopted prior to qualification fixing the percentage contributions under a profit-sharing or stock-bonus plan. Rev. Rul. 56-366, 1956-2 Cum. Bull. 976. See also Commissioner v. Produce Reporter Co., 207 F.2d 586 (7th Cir. 1953); Lincoln Elec. Co. v. Commissioner, 190 F.2d 326 (6th Cir. 1951).


\textsuperscript{19} Ibid.

\textsuperscript{20} Ibid. The previous ruling that contributions for the benefit of employee-
A plan may be disqualified if it requires burdensome contributions to be made by the employees themselves. A qualified plan may allow an employee to contribute to the plan from his own compensation where such a feature is to encourage savings. Formerly, it was held that where such contributions would exceed six per cent of the employee's compensation, this would discriminate in favor of high-salaried personnel. This six per cent rule has been amplified and now an employee may be allowed to contribute up to ten per cent of his compensation provided employer contributions are not geared to these contributions.

There is no specific requirement for qualification that an employee be granted an immediate vested right in his employer's contributions. A reasonable minimum number of years of service may be required before the employee's rights become fully vested. There is a stipulation, however, that the rights of the employee become fully vested upon reaching normal retirement age. The granting of vested rights again cannot discriminate in favor of high-salaried personnel. With relation to the amount of the contributions in which the employee has a vested right, provision may be made for the granting of loans to the employee up to the extent of his vested interest.

**Distinctions Between the Plans**

There are three types of plans provided for in the Code, pension, profit-sharing and stock-bonus plans. A pension plan is a fixed debt of the employer in that his contributions are determined actuarially on the basis of providing definitely determinable benefits to the employee on retirement. Pension plans are established specifically for the employee's retirement, and thus such benefits as accident or hospitalization insurance may not be included since they are not shareholders could not exceed 30% of total contributions (I.T. 3674, 1944 Cum. Bull. 315, 316) has been revoked in light of the Commissioner's acquiescence in the case of Volkening, Inc. v. Commissioner, 13 T.C. 723 (1949). I.T. 4020, 1950-2 Cum. Bull. 61, 62.

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24 Rev. Rul. 57-163, supra note 21, at 147.
25 Ibid.
26 Rev. Rul. 57-163, 1957-1 Cum. Bull. 128, 152. There must be specific provision made, however, for the giving of security to repay the loan; otherwise the loan may be regarded as a distribution. Ibid.
27 Code § 401(a).
considered within the purview of a retirement plan. Under a profit-sharing plan, on the other hand, employer's contributions must be geared to profits and must be entirely dependent upon profits. A profit-sharing plan is not a retirement plan in that the only provision is that there be an accumulation of funds for a fixed number of years. Since a profit-sharing plan is not a retirement fund, there is no restriction against accident or health provisions being incorporated in the plan. A stock-bonus plan is similar to the profit-sharing arrangement in that it is not primarily a retirement program. The only provision is again that there be an accumulation for a fixed number of years. However, employer's contributions to a stock-bonus plan are not based on profits or dependent upon them. Any distributions from the stock-bonus plan must be exclusively in the stock of the employer company.

The distinguishing feature of the three types of plans is the amount of deductions the employer is allowed for his contributions. Under the pension plan, contributions and deductions are based on actuarial cost, but the Code provides a maximum limitation of five per cent of the total compensation paid or accrued to the employees covered by the plan. Contributions to a profit-sharing or stock-bonus arrangement are limited to fifteen per cent of the total compensation paid or accrued to the employees covered. In the case of a plan having both pension and profit-sharing features, the maximum limitation is twenty-five per cent. Carryovers to subsequent years are allowed for contributions in excess of the allowable maximums in any year.

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28 Treas. Reg. § 1.401-1(b) (1) (i) (1954).
30 What is a fixed number of years has not been answered. Ibid. There is a ruling that a fixed number of years is at least two years. Rev. Rul. 54-231, 1954-1 Cum. Bull. 150.
31 See note 28 supra.
32 Treas. Reg. § 1.401-1(b) (1) (iii) (1954). The distributions cannot be of stock of another corporation, affiliated or not. It would appear that a stock-bonus plan is limited to a corporation. But see § 7701 (3), wherein the definition of corporations under the 1954 Code includes associations.
33 All contributions are deductible only in the year when paid. § 404(a). Accrual basis taxpayers may take a deduction in the prior year if made before filing their return. § 404(a) (6). Also, the availability of a deduction is limited to section 404 and cannot be taken under sections 162 or 212.
34 CODE § 404(a) (1) (A). The Commissioner may lower the maximum if he finds that the amounts are unreasonable. Also any dividends earned from the fund will lower the contribution limitation. Rev. Rul. 60-33, 1960 Int. Rev. Bull. No. 5, at 15.
35 It is sometimes difficult to compute the deduction under a stock-bonus plan because of the difficulty in placing a value on the stock especially in small corporations.
36 CODE § 404(a) (3) (A).
37 CODE § 404(a) (7).
38 CODE § 404(d). In the case of a plan having both pension and profit-
The primary benefit of these plans to the employer is their use in fostering good employee relations. The pension plan is especially adaptable in encouraging the retirement of superannuated employees. On the other hand, profit-sharing and stock-bonus programs are basic methods of providing incentives in the form of a share in the profits and in the business. Even in the executive ranks plans such as these provide incentives.39

While the employer is benefitting from good employee relations, there are definite tax advantages available to him. His contributions to the fund are deductible currently when made, and he need not wait for the actual distribution of the benefits to the employee as in a non-qualified plan.40 Further, any income earned by a trust administering the plan from the contributions is exempt from tax.41

**Taxation of Qualified Plans to the Employee**

As originally put, the main purpose of the qualified plan is to allow the employee to defer his compensation to the future along with the incidence of taxation when his earning power has declined and he is in a lower tax bracket. This is accomplished by postponing the employee's tax on the employer's contributions until the benefits are actually distributed or made available to him.42 Premiums on any life insurance protection purchased by the plan which is payable to the beneficiary of the employee is included currently in the gross income of the employee in the year such premiums are paid. However, premiums paid on group term life insurance would not be includible.43

Distributions of benefits from the plan are taxed as an annuity under section 72 of the Code.44 Total distributions are not entitled to the three-year tax spread provided under that section, because, as will be seen, long-term capital gains treatment is available for lump sum distributions. Any contributions made by the employee from compensation which was taxable to him at the time are excluded from gross income when distributed. This is done by means of an

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40 Code § 404.
41 Code § 501(a). The employer need not set up a trust in establishing his plan. In such a case, however, the income of the fund would be taxable to him. See, e.g., Code § 502 (feeder organizations). In practice, therefore, it is customary to establish a trust to administer the plan.
42 Code § 402(a).
exclusion ratio.⁴⁵ The exclusion ratio is the proportion the employee's contributions bear to the expected return under the contract as of the annuity starting date.⁴⁶ The expected return is figured on the life expectancy of the employee determined actuarially.⁴⁷ To simplify the computation of the tax,⁴⁸ the Code provides that if the employee's contributions are recoverable in three years from the annuity starting date, then there is no tax until the total amount of his contributions are recovered.⁴⁹ Thereafter all amounts received are taxable in full.

A seemingly unrationalized provision in the Code⁵⁰ authorizes long-term capital gains treatment for total distributions which become payable in one taxable year on account of the employee's death or other separation from service.⁵¹ The gain on such a distribution is the excess of the payment over the employee's contributions less his contributions previously distributed which were excluded from gross income. The total distributions need not actually be paid out in one year, as long as they become payable and are made available in one year.⁵²

The Code provides further preferential treatment by allowing any unrealized appreciation in securities of the employer corporation to escape tax on distribution to the employee if the securities are part of a total distribution or if the securities are purchased with an amount considered to have been contributed by the employee for the purchase of such securities.⁵³ The reason for this latter provision is to provide the distributee (employee or his beneficiary) with the

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⁴⁵ Code § 72(b).
⁴⁶ If the employee retires at age 60 with benefits under the contract of $2,000 a year until death, and his life expectancy is 10 years (as determined by the Regulations) the total expected return is $20,000. If he had made contributions totalling $4,000, there would be an exclusion ratio of 4,000/20,000 - or 1/5. Thus out of every yearly payment $400 is excluded from gross income. This introduces an element of wager since the exclusion continues even after his life expectancy has been exceeded, so he may exclude more than his actual contribution if he outlives his life expectancy, or less if he should die before reaching his life expectancy.
⁴⁷ Code § 72(c) (2) (C).
⁴⁸ This also eliminates the element of wager.
⁴⁹ Code § 72(d).
⁵¹ Code § 402(a) (2).
⁵² It is this availability of shifting ordinary income into capital gain that has met with disapproval. See Sporn, Some Proposed Revisions of the Provisions of the Internal Revenue Code Governing the Taxation of Deferred Compensation Arrangements, 14 Tax L. Rev. 289, 303 (1959). It can be justified, however, on the grounds that it eliminates the unfortunate effects of bunching.
⁵³ Employer corporation includes parent or subsidiary corporation. Code § 402(a) (3) (B).
⁵⁴ Code § 402(a) (2).
same basis as if the employee himself had bought the securities. Any
gain realized by the distributee in a subsequent taxable transaction
is taxed as a long-term capital gain.

The taxation of the employee on annuities purchased for him
under a qualified plan is the same. The annuity is taxed only when
distributed or made available to him. Long-term capital gains treat-
ment is also available on lump sum distributions payable by reason
of the employee's death.

Taxation of Non-Qualified Deferred Compensation Plans

Non-qualified plans are plans which have not met the require-
ments of section 401 and thus are not available for the tax advan-
tages provided. However, the new Service Ruling 60-31 has re-
moved most of the tax disadvantages from non-qualified plans. They
are now substantially equal to qualified plans. Discrimination no
longer must be safeguarded against, so the non-qualified plan will
operate specifically as deferred compensation arrangements for
executives, officers and key-employees. Deferred compensation ar-
rangements provide a form of additional compensation but are de-
signed to soften the impact of the high progressive surtax rates.

The 1954 Code makes no mention of these deferred compensa-
tion plans. Their income tax effects are not determined specifically
with relation to the Code sections dealing with pension plans. The
tax liabilities of these plans are determined under the Code sections
relating to accounting methods and the taxable year in which items
of gross income are included.

In discussing the tax liability of the executive for whose benefit
the plan is inaugurated, he is considered to be operating on the cash
receipts and disbursements method, which would be the common
practice for an individual taxpayer. Although under the cash re-
ceipts and disbursements method a person is not taxed on income
until he receives it, there is the doctrine of constructive receipt.

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55 Code § 403(a).
56 Code § 403(a) (2).
57 The general purpose of such an arrangement is as follows: Suppose a
key-employee is currently paid a salary of $30,000 a year. A $10,000 salary
increase is contemplated. If taxpayer is married, he will keep about $4,700
out of the increase. Instead of paying the employee presently, the employer
agrees to pay him $10,000 a year commencing at age 65 if the executive re-
mains with the company until that time, agrees to render consulting services,
and agrees not to compete after retirement. On retirement at age 65, assuming
the executive has $6,000 of retirement income of his own, the $10,000 paid
now will result in his keeping over $7,000. Also after age 65 there is the
additional old age exemption of $600 and a retirement income credit. There
is a possible tax-saving of $2,300.
58 Code §§ 401-04, 501.
59 Code §§ 446(c), 451(a).
60 See, e.g., Commissioner v. Oates, 207 F.2d 711 (7th Cir. 1953); Howard
Under this doctrine a taxpayer is deemed to have income though not actually reduced to his possession if the income has been set apart for him or credited to him and he can demand payment or draw on the account without restriction.\textsuperscript{61} The doctrine of economic benefit also upsets many deferred payment arrangements.\textsuperscript{62} Under this doctrine an employee may have current taxable income if the employer’s grant of benefits in the future has a present value.\textsuperscript{63}

\textit{Revenue Ruling 60-31}

Formerly, the tax effects of a deferred compensation plan depended entirely upon circumventing these two doctrines. If the court found an arm’s length transaction with sufficient contingencies provided to keep the executive’s rights forfeitable, he would not be taxed currently on the income.\textsuperscript{64} If constructive receipt were found because his rights were considered nonforfeitable, the executive was taxed currently.\textsuperscript{65} This would be especially prejudicial since he does not have the funds currently with which to pay the tax. This confusion is no longer the situation. A new Ruling by the Internal Revenue Service has authorized these deferred compensation plans and does not apply the doctrine of constructive receipt to plans that meet the requirements of the Ruling.\textsuperscript{66} To a great extent, also, the ruling does not require the executive’s right to be forfeitable.

The Ruling is adapted around an acquiescence in the case of \textit{Commissioner v. Oates},\textsuperscript{67} a leading case involving the deferment of compensation. There are five fact patterns discussed in the ruling, each involving an attempt to postpone the receipt of income.\textsuperscript{68} Two examples involve an employer and a key-employee and both are successful in deferring the tax to the year the income is actually received. Both plans are formal contractual arrangements whereby the employer

\textsuperscript{61} Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957); Drysdale v. Commissioner, 32 T.C. No. 37 (May 22, 1959); Deupree v. Commissioner, 1 T.C. 113 (1942).

\textsuperscript{62} Sproull v. Commissioner, 16 T.C. 244 (1951), aff’d, 194 F.2d 541 (6th Cir. 1952).

\textsuperscript{63} Many of these cases arise where the employer purchases a commercial annuity to provide the funds in the future. See, e.g., Morse v. Commissioner, 202 F.2d 69 (2d Cir. 1953); Hackett v. Commissioner, 159 F.2d 121 (1st Cir. 1946); Brodie v. Commissioner, 1 T.C. 275 (1942).

\textsuperscript{64} Note 60 supra.

\textsuperscript{65} Note 61 supra.

\textsuperscript{66} Rev. Rul. 60-31, 1960 INT. REV. BULL. No. 5, at 17.

\textsuperscript{67} 207 F.2d 711 (7th Cir. 1953).

\textsuperscript{68} The first three examples are successful in deferring the tax. The remaining two are not successful. Note 66 supra.
promises to pay additional compensation in the present, receipt by the employee to be postponed to the future.

The first is an example of a retirement plan under which fixed amounts are credited to a bookkeeping reserve account. Distributions are to be made to the taxpayer-employee "upon (a) termination of the taxpayer's employment by the corporation; (b) the taxpayer's becoming a part-time employee of the corporation; or (c) the taxpayer's becoming partially or totally incapacitated." 69 The contract need not provide for the forfeiture by the taxpayer of his right to distributions and even if the taxpayer refuses or fails to perform his duties, the corporation may be relieved of any obligation to make further credits, "but not of the obligation to distribute amounts previously contributed." Death benefits are provided if the taxpayer should die before receiving all his benefits in the account.

Under this plan it is not necessary at all to make the executive's rights contingent or forfeitable. He does not lose the credits once made to the account even if he subsequently fails or refuses to perform his services. Constructive receipt is guarded against by providing that distributions are to be made only on the happening of the enumerated events and not before. There is no indication whether the bookkeeping reserve account is to be funded or unfunded. 70 Probably, this will not affect the tax liability of the executive, but it might well affect the availability of a deduction to the corporation. 71

The second example set forth in the Ruling is a profit-sharing plan which provides additional compensation based on a percentage of the employer's profits in excess of a stated minimum. This plan is even more liberal in that it allows the amounts to be credited to the separate account of each individual participant in the plan, and any investment income from the fund created is also credited to the participant's account. Distributions are to begin when the employee "(1) reaches age 60, (2) is no longer employed by the company, including cessation of the employment due to death, or (3) becomes totally disabled to perform his duties, whichever occurs first." 72 Certain contingencies are provided which may relieve the corporation from making any distributions from the accounts. These contingencies are the same formal ones that have been recognized in the past, 73 namely, that (1) the employee refrain from entering into

69 Note 66 supra.
70 In strict accounting terminology a reserve would not be funded as in a reserve for depreciation or a reserve for bad debts.
71 See Diamond, Tax Aspects of Nonqualified Pension and Deferred Payment Plans, 32 Taxes 615, 617. See also Pomeroy, Real Contingencies Important in Unqualified Pension Plans—And Beware of Funding, J. Taxation 110 (Feb. 1959). The deductibility of the contributions will be discussed infra note 87.
73 Note 71 supra.
a competing business on retirement, (2) the employee be available to render consulting services after retirement, and (3) he make no attempt to borrow on his beneficial interest in the plan. If the employee dies before exhausting all the funds in his account, his beneficiary will receive the amount remaining.

While this profit-sharing plan does provide some contingencies and does contain an element of forfeitability, the contingencies called for are more formal than real: an incapacitated person will not readily enter into a competing business or be able to make himself available to render consulting services. Again, constructive receipt is guarded against by providing for distribution only on the happening of certain events.

This ruling represents a major change in policy for the Internal Revenue Service. It is more than a surrender in an area where the courts have not always favored the Commissioner's contentions. The Service has outlined well-reasoned plans which allow formal contractual arrangements to bind the employer whereby funds are actually set aside to the separate account of the individual executive without constructive receipt, economic benefit, or nonforfeitable rights frustrating the purpose. The reasoning of the Service stresses the fact that a mere promise to pay does not give rise to constructive receipt or economic benefit. A second reason which was expressly mentioned as distinguishing a successful plan from an unsuccessful one is that no trusts were created and there was no intent that the employer should hold the funds in trust for the employee.

There is no provision in these plans for long-term capital gains treatment for lump sum distributions as in a qualified plan. However, there is a provision in the Code allowing a three-year tax spread for lump sum distributions under an annuity or retirement contract. This provision is expressly disallowed for qualified plans, but there is no similar restriction for non-qualified plans. This three-year averaging provision may be available for any lump sum distributions from these deferred compensation agreements if these arrangements are considered an annuity under section 72.

It is submitted that the plans suggested in the ruling be closely followed in adopting a deferred compensation arrangement. No ad-

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75 Rev. Rul. 60-31, 1960 Int. Rev. Bull. No. 5, at 17, 20. This is similar to the non-commercial annuity under which the tax is postponed to the year of receipt because the value of the promise depends on the continued solvency of the promisor. See Estate of Bertha Kann, 16 P-H Tax Ct. Mem. 787 (1947), aff'd, 174 F.2d 357 (3d Cir. 1949).
77 Id. at 21-22.
78 Code § 72(e) (3).
79 Code § 402(a).
vance determinations will be issued to decide the tax consequences of a specific plan.\textsuperscript{80} It is submitted further that the plan in operation meet the requirements of the contractual arrangement as written to avoid a finding that the transaction was a sham.

There are two important questions left open by the ruling. The first is: will the income of the fund created be taxed presently to the corporation? The retirement plan makes no mention of a fund or any income from it. The profit-sharing plan does make provision for a fund and states that "each account is also credited with the net amount, if any, [of income] realized from investing any portion of the amount in the account."\textsuperscript{81} It would seem that without express provision not to tax such income, it cannot be implied that the Service desired to exempt it. The ruling expressly states that the amounts are not being held by the corporation in trust for the employee. The fund, therefore, still belongs to the corporation subject to a liability. The corporation as the owner of the funds should be taxed with the income from it in the absence of an express exemption.\textsuperscript{82}

The second question deals with the deductibility of the contributions by the employer. There is no problem with unfunded plans since the ruling expressly allows a deduction when the contributions are paid to the employee. The ruling refers to section 404(a)(5) of the 1954 Code which allows the employer a current deduction for his contributions only if the employee’s rights in the contributions are nonforfeitable at the time.\textsuperscript{83} Where his rights are forfeitable, there is no current deduction for the employer. Moreover, if the plan is a funded one the employer may not be allowed a deduction for any taxable year, even when paid to the employee.\textsuperscript{84}

This general rule as to deductibility may result in different treatment for the retirement plan and the profit-sharing plan. The differences arise on the basis of the contingencies in the contracts to which the employee’s rights are subject. Under the retirement plan, the employee’s rights are not subject to any contingencies; his rights vest immediately upon the credit being made to the account. His rights, therefore, are nonforfeitable and the corporation is expressly allowed a deduction under section 404(a)(5).\textsuperscript{85} Under the profit-

\textsuperscript{81} Id. at 17, 18.
\textsuperscript{82} Helvering v. Horst, 311 U.S. 112 (1940).
\textsuperscript{83} Code § 404(a)(5).
\textsuperscript{84} Treas. Reg. § 1.404(a)-12 (1956). “If an amount is paid during the taxable year to a trust or under a plan and the employee’s rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for any taxable year.” Ibid.
\textsuperscript{85} “Contributions made . . . shall be deductible . . . by the employer making such contribution . . . in the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), [referring to qualified plans] if the employees’ rights to or derived from such employer’s contribution or such
sharing arrangement, however, the ruling makes the employee's rights to distributions contingent upon certain conditions the employee must meet. An employee's right is forfeitable when there is a contingency under the plan which may cause the employee to lose his right in the contribution. If this regulation as to forfeitability be followed strictly, it will result in the deduction for contributions being disallowed to the employer. However, a valid argument can be made to prove that the employee's rights under the profit-sharing plan are nonforfeitable also. The contingencies provided in this plan are conditions subsequent. The employee does have a present right in the contributions and he will receive distributions from the separate account maintained for him unless he breaches the agreement by performing certain prohibited acts. Moreover, these contingencies are illusory in the sense that the plan allows distributions to commence, in any case, upon the death of the employee, or upon his becoming totally incapacitated. Under such conditions, it is apparent that his availability to render consulting services or his refraining from competing businesses are not the elements upon which his rights depend.

This discussion is more than academic when there are recent Service rulings to the effect that the employer's contributions to a funded plan are not deductible for any taxable year if the employee's rights under the plan are forfeitable. This means that there are no deductions even when distributions are made to the employees. This position of the Service is found also in the ruling dealing with deferred compensation plans where it is said:

In the application of those sections [referring to section 404(a)(5) of the Code and section 1.404(a)-12 of the Regulations] to unfunded plans, no deduction is allowable for any compensation paid or accrued by an employer on account of any employee . . . except in the year when paid . . .”

The express restriction of this deduction to unfunded plans may be considered a reaffirmance of its position not to allow a deduction for contributions to funded plans in any taxable year even when distributions are made, if the employee's rights in the plan were forfeitable.

compensation are nonforfeitable at the time the contribution or compensation is paid.” (Emphasis added.) Code § 404(a)(5).

The conditions are that the employee (1) refrain from engaging in a competing business after retirement, (2) make himself available to render consulting services after retirement, (3) refrain from borrowing on his beneficial interest. Rev. Rul. 60-31, 1960 Int. Rev. Bull. No. 5, at 17, 18.

The position of the Service is that "if an amount is paid during the taxable year [by the employer to a non-qualified plan] but the rights of the employee therein are forfeitable at the time the amount is paid, no deduction is allowable for any taxable year." Rev. Rul. 59-383, 1959 Int. Rev. Bull. No. 49, at 30, 31, reaffirming T.D. 5666, 1948-2 Cum. Bull. 34, 46.

A recent case refused to follow the position of the Service. The court allowed the employer a deduction for contributions to a funded plan in the form of employee trusts when the benefits were actually paid although the employee's rights were forfeitable at the time the amounts were paid into the fund. The court reasoned that, in denying certain tax advantages to non-qualified plans, Congress did not intend to disallow completely a deduction for the ordinary and necessary expenses of a business. A fortiori, if a deduction is allowed by the courts where the plan is funded through a trust, a deduction will certainly be allowed where no trust is created but funds are merely set aside in an account or through the purchase of government obligations. The Service has refused to acquiesce in this decision relying on the old Ruling that contributions to such a plan are not deductible in any year. It is submitted that this position can be carried ad absurdum when it leads to the conclusion that if the employee's rights are forfeitable under a non-qualified plan, no deduction is ever allowed if the plan is funded, but a deduction is allowed in the year of payment when the plan is unfunded. The present situation is at least confused, and care should be taken in adopting a deferred compensation plan.

Estate Tax on Qualified Plans, Section 2039(c)

A moving consideration in the tax liability of both qualified and non-qualified plans are the effects of the estate tax provisions of the Code. Annuities are included in the gross estate of the decedent. However, special treatment is granted to annuities paid under a qualified plan. This preferential treatment is an express exclusion of death benefits (annuities or other payments) paid under a qualified plan if the beneficiary is other than the estate of the decedent. This exclusion does not apply to amounts contributed by the employee but applies only to amounts contributed by the employer. The exclusion extends to "other payments" made under a qualified plan and thus extends to the proceeds from life insurance provided by the plan.

The value of this special treatment for qualified plans can be seen by a comparison with the recent case of Garber's Estate v.

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89 Russell Mfg. Co. v. United States, 175 F. Supp. 159 (Ct. Cl. 1959). This case also involved profit-sharing plans.
90 Id. at 162.
91 It is no longer unusual for an employee to have an estate valued at over the $60,000 statutory exemption. § 2052.
92 CODE § 2039(a), (b).
93 CODE § 2039(c).
94 For example, if the employer contributed % of the cost and the employee contributed % thereof, % of the benefits under the qualified plan are absolutely exempt from estate tax. CODE § 2039(b).
Commissioner decided under the 1939 Code. Although the decedent was covered by a qualified plan, the value of the annuity at his death was included in his estate for estate tax purposes. The decision of the court was based on section 811(a) of the 1939 Code, which included in the decedent’s gross estate all property in which the decedent had an indefeasible right at the time of his death. This result would be different under section 2039(c) of the 1954 Code. The fact that an employee’s rights are vested will not affect this exclusion since an employee’s rights must ultimately vest under a qualified plan in order for it to qualify.

It is important, in order to take advantage of this exclusion, that the plan provide for payment to a beneficiary of the employee in case of the employee’s death to avoid payment to the employee’s estate which would cause the annuity to be included.

Estate Tax on Non-Qualified Plans

The 1939 Code contained no provision specifically dealing with the estate tax liability of annuities or other payments under pension, profit-sharing, or retirement plans of employees. The inclusion of such benefits rested on the court’s finding of a property interest possessed by the employee at death. There was some confusion as to when a sufficient property interest existed. Under the 1954 Code, the inclusion of annuities is specifically provided. Annuities under a non-qualified or deferred compensation plan are included in the gross estate if they are made “under any form of contract or agreement” under which “an annuity or other

96 271 F.2d 97 (3d Cir. 1959).
97 Int. Rev. Code of 1939, ch. 1, § 811(a), (c), (d), (f), 53 Stat. 120-22.
98 Supra note 96, at 99. Although the court considered the plan a qualified one, it may not have enjoyed a qualified status in light of present requirements. The plan gave Garber, the employee, the right to elect not to receive any payments himself but to have all payments made to his beneficiary. Id. at 100. But see Rev. Rul. 56-656, 1956–2 Cum. Bull. 280 which denies qualified status to a plan which allows the employee to make such an election.
99 The inclusion resulted in an estate tax of $26,516.55. Id. at 99.
100 Code § 2039(c).
101 See generally Garber’s Estate v. Commissioner, 271 F.2d 97 (3d Cir. 1959); Goodman v. Granger, 243 F.2d 264 (3d Cir. 1957).
102 Int. Rev. Code of 1939, ch. 1, § 811(a), (c), (d), (f), 53 Stat. 120-22.
105 Code § 2039(a).
payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment” at the time of his death.106 Includibility under this provision is determined exclusively on the right of the decedent to receive the payment. Decedent is considered to possess this right “so long as he had complied with his obligations under the contract . . . up to the time of his death.”107 This includes employer’s obligations to make payments which arise by reason of the employee’s death. Thus, the value of all the payments under a deferred compensation agreement would be includible.108 The amount includible in the gross estate consists of all of the employer’s contributions made pursuant to the contract or agreement.109

**Taxation of Employee’s Beneficiary Under a Qualified Plan**

The beneficiary is taxed on the payments under the plan in the same way the employee would have been had he lived.110 The beneficiary does not receive a basis for the payments equal to the fair market value at the date of the decedent’s death.111 The payments are taxed as an annuity under section 72 of the Code.

**Section 101(b)(2)(B)**

In the area of lump sum distributions, qualified plans are given further preferential treatment by allowing the beneficiary to exclude $5,000 of the taxable amount received.112 As distinguished from payments under a non-qualified plan, this exclusion applies even where the employee’s rights were nonforfeitable at death.113 Where there are a number of beneficiaries, the $5,000 exclusion is allocated among them in the same proportion as their share bears to the total amounts payable.114 The exclusion is limited to a total of $5,000 for any one decedent, and does not depend on the number of employers the decedent had.115 The provision in the 1954 Code allowing the $5,000

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106 Ibid.
108 See Rev. Rul. 60-31, 1960 INT. REV. BULL. No. 5, at 17. Even if the employee’s rights were entirely forfeitable and do not become fixed at death, payments may be includible in his gross estate if it can be proved that the employer had nevertheless consistently made payments under such circumstances.
109 Code § 2039(b).
111 Code § 1014(c).
112 Code § 101(b) (2) (A), (B).
113 Ibid.
115 Code § 101(b) (2) (A), (B).
exclusion for employee death benefits broadens somewhat the scope
of the exclusion under the 1939 Code. The $5,000 exclusion for lump sum distributions to the bene-
ciciary plus the preferential capital gains treatment if paid on the
death of the employee are attractive provisions for qualified plans. However, the distribution in the lump sum may result in a higher tax than if the beneficiary elected to receive the payments as an annuity over the years. Even if a higher tax does not result, there is still the danger of unwise investment and speculation by the bene-
ciciary, who is likely to be a widow or a child. It may be suggested, therefore, that the employee create trusts to receive any lump sum distributions. The payment of the benefits into more than one trust will avoid the bunching of income into the hands of the beneficiary alone. The $5,000 exclusion is not lost since the trust qualifies as a distributee and the total exclusion will be allocated among the trusts. Long-term capital gains treatment is also available to the trusts.

**Taxation of the Beneficiary Under Deferred Compensation Plans**

With the promulgation of the new Service ruling authorizing certain tax savings plans, it is well to consider the tax effects on death benefits under the plans. The death benefits are taxed as an annuity under section 72. Under the deferred compensation plans given favorable treatment under the ruling, the agreement may provide for the employer's obligation to make payments to arise on the

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116 Int. Rev. Code of 1939, ch. 1, § 22(b) (1) (B), 53 Stat. 9, 10, allowed the $5,000 exclusion if the amounts were paid pursuant to a contract with the employer. See Code § 101(b) (2) (B). See also Hess v. Commissioner, 271 F.2d 104 (3d Cir. 1959). This case shows the distinction in treatment of qualified plans under the 1939 Code and under the 1954 Code. This case is a companion to the case of Garber's Estate v. Commissioner, 271 F.2d 97 (3d Cir. 1959), where a qualified plan was included in the employee's gross estate on his death. In the Hess case the beneficiaries were disallowed the $5,000 exclusion but they were allowed a deduction on their income tax for the estate tax paid by reason of the inclusion. The result would be different under the 1954 Code. Section 2039(c) excludes from the decedent-employee's estate the value of any qualified plan. Thus there would be no estate tax. Also if the payments were made in one lump sum, there would be a $5,000 exclusion under section 101(b) (2) (B).

117 The maximum rate of tax on long-term capital gains is 25%. Code § 1201(b) (2).

118 See Code § 662. The benefits in the hands of the trust would be considered corpus. Thus the trustee would have to be given the power in the instrument to draw on corpus to make distributions to the beneficiary.

119 See Code §§ 402(a) (2), 403(a) (2).


121 If the contributions are recoverable within three years then all of the payments received are nontaxable until the total contributions are recovered. Thereafter all amounts received are taxable in full. Code § 72(d).
Such payments would be on behalf of the employer and "paid by reason of the death of the employee" and should therefore be available for the $5,000 exclusion provided in section 101(b). Where contingencies are provided in the contract, it could not be said that the employee possessed an immediate right to receive payments while living since the obligation to pay arose only by reason of his death. The $5,000 exclusion should therefore become effective. This exclusion applies whether or not there is a lump sum distribution, unlike the qualified plan. The exclusion is treated the same as an investment in the contract and a proportionate amount would be excluded from the gross income of the beneficiary in each year when distributions are made.

The foregoing discussion assumed that the right to receive distributions arose solely by reason of the death of the employee. However, under either of the plans whether contingencies were provided for or not, if the distributions became payable during the life of the employee as provided by the contract, the $5,000 exclusion would not be available to the beneficiary. Thus if the employee had the right to receive payments or was receiving payments because he became disabled, or reached age 60, he would be considered to have had a nonforfeitable right to receive the payments while living and the exclusion would not apply. Under the Regulations, however, the nonforfeitable right applies only to the present value of the death benefits immediately before the employee's death. Where the amounts to be paid at the employee's death are fixed, then the present value will be the total amount. But, where the amounts to be paid to the beneficiary are greater than the present value to which the employee had a nonforfeitable right immediately prior to his death, then the $5,000 exclusion applies to the amounts above the employee's present value.

There is no long-term capital gains treatment available for lump sum distributions as in the qualified plans. However, there is a Code provision allowing the lump sum distributions of annuities to be taxed over a three-year spread. This provision allowing for the three-year tax spread is not available for the employees or bene-

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122 Supra note 120, at 18.
123 Code § 101(b) (2) (B).
124 Ibid.
125 Code § 72(b).
126 Code § 101(b) (2) (B). See also Treas. Reg. § 1.101-2(d) (2), example 1 (1954).
128 Treas. Reg. § 1.101-2(d) (2), examples 3, 4, 5. The simplest example of this is where the payments are to be a certain amount per year for the life of the beneficiary and the life expectancy of the surviving widow exceeds what the normal life expectancy of the employee was.
129 Code §§ 402(a) (2), 403(a) (2).
130 Code § 72(e) (3).
ficiaries under qualified plans. There is no similar restriction for non-qualified plans. Thus the three-year tax spread may be available to deferred compensation plans if they are considered an annuity within the purview of section 72.

On the death of the employee, the value of these annuity payments is included in his gross estate for estate tax purposes. In order to avoid a double tax on these payments when received by the beneficiary, he is entitled to an income tax deduction for the estate tax paid by reason of the inclusion.

Conclusion

A comparison of qualified and non-qualified plans will serve as a capsule review of this article. The variety of benefits to the employee and his beneficiary under a qualified plan are as follows: (1) The employee is not taxed presently on the contributions to the plan; (2) the employee is taxed in the year of receipt when his productive capacity has declined; (3) long-term capital gains treatment is available to the employee and his beneficiary on lump sum distributions; (4) any unrealized appreciation in the value of any employer's securities distributed are not taxable to the employee on distribution; (5) the value of the benefits is excluded from the decedent-employee's gross estate; (6) a $5,000 exclusion is available to the beneficiary if the benefits become payable in one lump sum. For the employer, besides fostering good employee relations, the tax advantages provided are (1) a current deduction for contributions to the plan, and (2) the income of the trust established to administer the plan is exempt from tax.

Advantages are now sanctioned for deferred compensation plans that are not qualified under the Code. This is perhaps a recognition that the executive has a difficult time providing for his old age. The benefits to the executive under a deferred compensation agreement are as follows: (1) He is not currently taxed on any credits or contributions; (2) he is taxed in the year of receipt when his income has declined; (3) a three-year tax spread may be available for lump sum distributions; (4) the value of the benefits is included in his gross estate on death but an income tax deduction is provided for his beneficiary for the estate tax paid by reason of the inclusion; (5) a $5,000 exclusion may be available to the beneficiary if the executive died before the distributions became payable; (6) a $5,000 exclusion is available if the amounts which the beneficiary may receive are in excess of the present value of the amounts to which the employee had a nonforfeitable right at death.

131 Code § 402(a).
132 Code § 2039(a).
133 Code § 691(c).
The ruling authorizing deferred compensation plans will be appreciated by business. It is hoped that the plans adopted will be bona fide arrangements to provide benefits on retirement, death, or disability.

The Problem of Substantial Evidence in Administrative Hearings and Departmental Trials

Both the federal and New York jurisdictions agree that the findings of fact made by a quasi-judicial administrative board are subject to judicial scrutiny in that the reviewing court must determine whether the facts found are supported in the record by "substantial evidence." The concept of substantial evidence, referred to by Mr. Justice Frankfurter as an "undefined defining" term, is of necessity and of legislative design an elastic one. After a preliminary consideration of the general scope of the substantial evidence rule, this note will concern itself with the extent to which this elastic concept of review encompasses an examination of the credibility of the witnesses before the board.

The Federal Concept

The federal statute generally determinative of the scope of judicial review of administrative findings of fact is Section 10(e) of the Administrative Procedure Act. This section reads in pertinent part:

Except so far as as (1) statutes preclude judicial review or (2) agency action is by law committed to agency discretion—

(e) Scope of Review. . . . [T]he reviewing court shall . . . (B) hold unlawful and set aside agency action, findings, and conclusions found to be . . . (5) unsupported by substantial evidence in any case subject to the requirements

2 60 Stat. 243 (1946), 5 U.S.C. § 1009(e) 1958). In rare instances, judicial review of an administrative finding of fact includes a determination de novo of the disputed fact. For cases involving a "jurisdictional" fact, where the Supreme Court held that protection of a constitutional right necessitated court determination of the facts, see Crowell v. Benson, 285 U.S. 22 (1932) (whether, in a claim under the Longshoremen's and Harbor Workers' Compensation Act, the injury occurred upon the navigable waters of the United States and whether the relationship of master and servant existed in the maritime employment); Ng Fung Ho v. White, 259 U.S. 276 (1922) (whether a person under order of deportation is a citizen).