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DEVELOPING PENSION AND PROFIT-SHARING REQUISITES

Isidore Goodman*

The Tax Revision Act of 1942 introduced a new concept into the pension and profit-sharing area: prohibited discrimination. A tax qualified plan must not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated.

After provision was made in 1921 for exemption of a trust forming part of a stock bonus or profit-sharing plan of an employer for the exclusive benefit of some or all of his employees,¹ and for over two decades thereafter, the requirements were fairly simple and few interpretative rules were established. However, World War II brought a dramatic rise in tax rates and deductions were sought for plan contributions. Efforts were also exerted to curb inflation by way of deferment through pension and profit-sharing plans which were to provide for substantial coverage on a non-discriminatory basis.

A new law was enacted and new rules were promulgated. Some rules proved to be temporary,² but others are still in full force and effect. This article will examine some of the particularly important rules in current practice.

WEIGHTED_ALLOCATIONS

A qualified profit-sharing plan must provide a definite, predetermined formula for allocating the contributions made to the plan among the participants, and for distributing the accumulated

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* Chief, Pension Trust Branch, Internal Revenue Service. The opinions expressed are the author's and do not necessarily reflect the views of the Internal Revenue Service.

The purpose is to designate the shares of the respective participants and to preclude discrimination in favor of the upper echelon employees. Variations in contributions or benefits, however, may be provided so long as the plan, viewed as a whole for the benefit of employees in general with all its attendant circumstances, does not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated.

Accordingly, various methods are used for allocating contributions among participants. Some take into account a years-of-service factor; others gear contributions to predetermined retirement benefits, which may or may not affect the qualification of the plan.

Units of Retirement Benefits

The profit-sharing deduction limits do not apply to any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially. A plan designed to provide benefits for employees or their beneficiaries, to be paid upon retirement, or over a period of years after retirement, will be considered a pension plan if the employer contributions can be determined actuarially on the basis of definitely determinable benefits. Distributions under a profit-sharing plan, on the other hand, consist of accumulated contributions and the increments thereon, without regard to definitely determinable benefits. Where the benefits are so determinable, a pension plan, rather than a profit-sharing plan, may be involved. Nevertheless, some profit-sharing plans contain pension features. The most common shared feature is a years-of-service factor. The objective is to reward long-service employees with additional credits. The service feature is permissible where it is not used to predetermine, but merely to increase benefits and does not result in prohibited discrimination.

In one type of profit-sharing plan, the employer's contributions are used to provide benefits allocated in proportion to the cost of providing units of retirement annuities in proportion to annual compensation, where the cost of such units is dependent upon the sex and age of the respective participants in the year of allocation. The plan is funded under a deposit administration account.

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group annuity contract. The allocation formula provides a two step formula for calculating priorities to be used in each year of the plan. The first step is the allocation to each participant’s account of that proportion of the contribution which the cost of providing him with a monthly retirement benefit of one percent of the first $350 of his average monthly earnings, plus two percent of his average monthly earnings in excess of $350, bears to the total cost of furnishing such benefits. However, if the annual contribution is more than sufficient to furnish all participants with such benefits, only that part of the annual contribution necessary to furnish such benefits shall be allocated as provided in this part of the calculation. The second step allocates the remainder of the annual contribution in the same proportion as the cost of providing such participant with a monthly retirement benefit of one percent of his average monthly earnings bears to the total cost of furnishing such benefits for all participants. The result of such an allocation formula is that larger portions are used for older employees of the same sex, as measured by current compensation.

In a pension plan, contributions are allocated in accordance with the cost of proportionate benefits. The employer undertakes to provide definite retirement benefits in proportion to compensation and/or service for each participant. If contributions to the plan are continued as intended, each employee who fulfills the requirements will receive his contemplated benefits. If the plan or contribution thereunder should terminate prematurely, resulting in discrimination in favor of the original older group, the restrictions on contributions to provide benefits for the top twenty-five employees may necessitate a reallocation of credits to limit such discrimination.8

In a profit-sharing plan, however, since the employer contributions are geared to profits, there is no assurance that contributions will be continued and, accordingly, there is no way of determining what the ultimate retirement benefits will be. Neither is there a limitation on benefits for the top twenty-five employees, as there is under a pension plan. Although each participant is furnished with a retirement annuity in proportion to his monthly compensation for each year that a contribution is made, the value of the annuities purchased for the older participants is greatly in

7. A deposit administration group annuity contract is a funding device that operates like a trust, except that the funds are held by an insurance company for the purpose of purchasing single premium annuities as employees retire. The rate of interest and the single premium immediate annuity rates applicable at retirement are usually guaranteed by the insurance company as to contributions during the first five years.
excess of the value for the younger participants. If the older participants are upper echelon employees, the prohibited discrimination is bound to occur. Only where the same relative contributions are continued fairly evenly each year is there any assurance that the ultimate benefits will take account of changes in compensation.

The purpose of a profit-sharing plan is to provide for participation in the employer's profits by his employees or their beneficiaries. Accordingly, the measure for determining discrimination is the allocation of the employer's contributions from profits, even though such allocated contributions may be accumulated from varying periods for employees of different ages. A "units of retirement" plan may qualify for tax benefits in one year but, in its operation, may fail to qualify in future years. Accordingly, favorable advance determination letters are not issued on such plans.

Compensation and Service Units

Service factors are included in the allocation formula by weighting compensation in several ways. One way is to add units for compensation to units for service. The total contribution is then allocated in the proportion the total units of each participant bears to the total for all. Another approach is to multiply compensation units by service units and then divide by the aggregate units for all participants. The resulting fraction is then applied to the total contribution to determine the amount to be allocated to each participant. Still another method is to segregate participants by categories which are based on service over a period of years, and then weight each category by a factor which will provide a greater share for longer service.

Some plans with weighted allocations pay compensation at a specified amount in order to limit the allocation that may be made for highly paid participants. However, the result, not the method, controls.

11. E.g., one unit for each full $100.
12. E.g., one unit for each full year of service.
15. E.g., class 1, one to five years, in proportion to compensation only; class 2, over five but not over 10 years, in proportion to twice compensation; and so forth.
Weighted Employee Contributions

Where employer contributions are allocated in proportion to employee contributions weighted by years of service, and the highly paid employees also have longer service, prohibited discrimination will result. In a recent case, employer contributions were allocated to the accounts of participants in the proportion that each participant’s weighted contribution bore to the total weighted contributions of all participants. The weighted contribution of each participant was determined by multiplying his contribution by a percentage which varied with his years of service, ranging from 100 percent for service of less than two years to 200 percent for service of fifteen years or more.

The president of the employer-corporation had the longest service and participated in allocations to a greater extent than did other employees. The employer contended that the formula for allocating contributions was chosen in order to encourage employees to remain with the business. The argument was advanced that this objective is a legitimate business purpose and, therefore, even though it resulted in the president receiving more favorable treatment, this is not the kind of discrimination that is prohibited by statute.

The Tax Court countered by reasoning that the Income Tax Regulations recognize that years of service may be taken into consideration in allocating contributions under a qualified profit-sharing plan, provided that the allocation on such basis does not result in discrimination in favor of employees in the upper categories. The history of the regulation prohibiting discrimination furnishes strong support for accepting the validity of the regulations as interpreted.

The Court continued with the observation that an employer may have a number of reasons for establishing a profit-sharing plan, and has considerable latitude in choosing the type of plan which will accomplish the desired objectives. In McMenamy, if the employer contributions had been allocated in proportion to compensation, the plan would not have been challenged. Furthermore, credits for years of service could have been given with-

18. The regulations and rulings in point were adopted in 1944, shortly after enactment of the Tax Revision Act of 1942, which added to the tax structure the concept of prohibited discrimination. Twice, once in 1954 and again in 1962, Congress considered the requirements for qualification of a plan, but did nothing to indicate any disapproval of that provision of the regulations or administrative interpretations.
out favoring the upper level employees. If, for example, service credits had been limited to service performed after the adoption of the plan, such credits might have been nondiscriminatory.

Since the president was the sole stockholder, there was no need to grant him credit for past service in order to encourage him to remain with the corporation. By granting such credit, however, he was assured of a more favorable allocation than any other participant. Even if, in time, other employees might also qualify for the higher rates, in the meantime proportionately larger allocations would be made for the president.

Moreover, the employer was under no obligation to continue comparable contributions in later years when other employees might qualify for more favorable weighting. Under a profit-sharing plan, no contribution would be required in later years if there were no profits. Further, even if there were profits, the plan required only a nominal or prescribed contribution. The board of directors, therefore, might decide not to continue contributions to the same extent as before. If, in some future year, an examination established that the plan had been operated in a discriminatory manner, the statute of limitations would prevent retroactive action.

Since there is no obligation to continue contributions in later years to the extent applied when the president derived benefits, the plan must be judged on the basis of the facts existing in the years involved. For such years, the weighted allocation used in McMenamy discriminated in favor of the president of the employer-corporation.

**Rewarding Employees' Status**

Another case which involved weighting factors, Philip M. Auner, received novel treatment. A medical clinic established a profit-sharing plan and provided an allocation formula that took into consideration not only years of service but also training and experience. A participant's service points were multiplied by the number of points allotted for training and experience, resulting in a percentage that was applied to compensation. During the three years of the plan's operation, less than 5 percent of employer contributions was allocated to the lower paid supporting

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21. The service points ranged from one to five, based on service and training, and experience points were awarded in accordance with the extent of the individual's experience in previous similar employment and time spent in specific types of training.
personnel, whose compensation was equal to about 13 percent of the total compensation of all participants. On the other hand, 95 percent of such contributions was allocated to the doctors whose compensation equalled about 87 percent of the total.

It was contended on behalf of the clinic that the point formula was designed for the purpose of forming a strongly knit organization, attracting competent and well-trained men and women, retaining competent employees, and encouraging additional training and education for all employees at all levels. The appellate court, however, pointed out that the issue is whether the plan discriminated in favor of the officers or highly compensated employees; if it did, whether the formula was thought to achieve employment objectives is irrelevant. The officers and highly paid employees received disproportionately greater allocations of employer contributions than the lower paid participants. This resulted in prohibited discrimination.

**Application of Forfeitures**

A qualified plan must provide that upon its termination or complete discontinuance of contributions thereunder, the rights of all employees to benefits accrued to the time of such termination or discontinuance are to be nonforfeitable to the extent funded or credited.\(^2\) The plan must additionally provide for full vesting of an employee's interest upon attaining normal retirement age or a stated retirement age, and completion of the service and other reasonable requirements set forth in the plan.\(^3\) Other provisions are also used, ranging from full and immediate vesting through different forms of graduated vesting to no vesting until normal or stated retirement age.\(^4\)

Forfeitures arise in cases where there is anything less than full and immediate vesting. In the case of a pension plan, forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan.\(^5\) The amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan.\(^6\) In the case of a profit-sharing or stock bonus plan, provision may be made for the use

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\(^{22}\) Int. Rev. Code of 1954, § 401(a)(7); Treas. Reg. § 1.401-6 (1971)
of forfeitures to reduce employer contributions that otherwise would be made. Such treatment is not required, but whatever provision is made must not result in prohibited discrimination.\(^{27}\)

If the formula for allocating employer contributions is not weighted, an allocation of forfeitures among remaining participants in accordance with such formula is usually satisfactory. Problems arise, however, where other methods of allocating forfeitures are used.

**Account Balances**

In some cases, forfeitures are allocated in accordance with the account balances of the remaining participants. Whether this results in prohibited discrimination will depend on whether the upper-echelon employees are favored by the method of allocation. If account balances consist only of employer contributions that had been allocated in accordance with current compensation, without weighting, a uniform treatment would result and an allocation of forfeitures by the same method would quite likely be nondiscriminatory. Where weighting is used or other elements, such as employee contributions, are included in the account balances, longer service employees may have proportionately greater shares. If these employees are in the upper-echelon group, an allocation in accordance with account balances will result in prohibited discrimination.

If the allocation formula takes into account factors other than current compensation, it will have to be established on a year-to-year basis that their use has not resulted in prohibited discrimination. Account balances are merely one of several factors that may be considered in allocating forfeitures if discrimination does not thereby result.\(^{28}\)

**Suspense Accounts**

Problems arise at times when forfeited funds have been placed in a suspense account pending reallocation, and the trust is terminated before reallocation can be effectuated. The question is, “May such funds revert to the employer?”

All funds in an exempt profit-sharing or stock bonus trust must be allocated to participants in accordance with a predeetermined formula.\(^{29}\) No reserves are to be established by with-

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holding allocations from participants. If, however, suspense accounts are temporarily maintained for subsequent credits pending allocation, provision is to be made for ascertaining the respective interests of the participants in such accounts and these interests are to be included in the distribution.\textsuperscript{30}

Further, allocations to participants under profit-sharing and stock bonus plans are not predicated upon amounts actuarially necessary to provide stipulated retirement benefits.\textsuperscript{31} Consequently, there can be no reversion of any kind under such plans.\textsuperscript{32}

\textit{Affiliated Groups}

A single plan and trust may be maintained by a group of employers, regardless of whether or not affiliated, but each employer separately must satisfy all applicable requirements as though he were the only employer maintaining the plan.\textsuperscript{33} Problems commonly arise over the application of forfeitures in such plans. Their solution requires a determination of whose employees forfeited, and whose employees are to benefit from the forfeitures.

A plan will not qualify unless under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their benefits under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries.\textsuperscript{34} Since, in a multi-employer plan, each employer separately must satisfy all applicable requirements,\textsuperscript{35} the employees for whose exclusive benefit the funds are to be used are the employees of the contributing employer. The amounts contributed for, and allocated to, employees of one employer may not be used for the benefit of employees of another employer.\textsuperscript{36}

\textsuperscript{31} Int. Rev. Code of 1954, § 404(a)(3)(A); Treas. Reg. 1.401-1(b)(1)(i) (1971), to the effect that a plan designed to provide benefits to be paid upon retirement or over a period of years after retirement will be considered a pension plan.
\textsuperscript{34} Int. Rev. Code of 1954, § 401(a)(2).
\textsuperscript{36} Rev. Rul. 69-570, 1969-2 Cum. Bull. 91. E.g., Amounts forfeited by employees of employer A may not be used for the benefit of employees of employer B, but only for employees of employer A.
Deductions are also frequently at issue. For a contribution to be deductible, it must first constitute an ordinary and necessary business expense, or an expense for the production of income, before being subjected to the deductions limitations. A payment by one for services rendered to another is not an ordinary and necessary business expense of the payor. No deduction is allowed for such payment, except in the case of a profit-sharing plan (or stock bonus plan geared to profits) of an affiliated group, where the profit-sharing companies may make up a contribution for a loss member and obtain a deduction therefor within prescribed limits. In other cases, the only method of allocating contributions among employers that is acceptable for deduction purposes is a method that will actually reflect the contributions by each employer for the benefit of his employees.

Forfeitures stem from employer contributions and the increments thereon. An employer contribution which had originally been allocated to employee A, is reallocated because of forfeitures, inuring to the benefit of employee B. In the case of a plan of a single employer there is no problem in determining whose employees are involved; both A and B are employees of the contributing employer. Similarly, in the case of a multi-employer plan where the accounting method permits direct tracing, the employees of each employer are identifiable and forfeitures are allocated directly to the remaining employees of the contributing employer.

There are cases, however, where it is not feasible to determine whose employee an individual may be at any given time. For example, in one case, a chain of restaurant corporations with common ownership found it necessary to shift employees between stores as the volume of business varied at the different locations. Those in the business section were usually busiest during the luncheon period, while those in outlying areas did the most business in the late afternoon and in the evening. When the manager of a store found that he needed more help, he called the management office and asked for the required number of additional people. Management then contacted one or more of the other restaurants and arranged for the necessary transfer. Thus, an employee might be working in restaurant A during the lunch period, in B during the cocktail hour, and in C at dinner time,

37. INT. REV. CODE OF 1954, § 162.
38. Id. at § 212.
39. Id. at § 404(a).
40. Id. at § 1504.
41. Id at § 404(a)(3)(B).
with varying hours at each place each day. He was paid by the management corporation, however, for total service at all locations, without a breakdown as to time actually put in at each place.

Management, in turn, billed each corporation on a pro rata basis in accordance with the percentage of the gross receipts of each to the total gross receipts of all. If Company A had 10 percent of the aggregate receipts, it was charged with 10 percent of the aggregate payroll. The employees who were moved about rendered services to the employers participating in the plan. Since it was not feasible to ascertain the origin of forfeited amounts and since a reasonable allocation of total payroll was made among the respective corporations, the same method could be used in allocating forfeitures. However, the method must be followed consistently without resulting in prohibited discrimination.  

**FEEDER PLANS**

A qualified plan must be maintained for the exclusive benefit of employees or their beneficiaries. A stock bonus or profit-sharing plan is not a plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. It is a prohibited feeder plan when its funds can be siphoned off and used to pay for pensions which otherwise would be provided by employer contributions. The fact that the same employees are beneficiaries under both plans is immaterial to its qualification if the employer also benefits by being relieved of a commitment. A commitment is not necessarily synonymous with a legal liability. The employer may provide that the employees can look only to the funds under the plan and thus prevent a liability for future contributions. While the plan is in existence, however, the employer benefits by realizing an economic gain through the services of the participants.

This does not mean that an employer cannot, under any circumstances, have both a pension and a profit-sharing plan which covers the same employees. Where employees' pension benefits are not reduced by an accumulation in a profit-sharing plan, there is no problem. Problems do, however, arise where the employees' beneficia...
pension benefits are affected by their interests in a profit-sharing plan.

Offsetting Pension Benefits

A provision for offsetting benefits under a pension plan by amounts received under a profit-sharing plan, operating concurrently and covering the same employees, disqualifies both plans. For example, in one case,\(^{48}\) an employer established a profit-sharing plan which he intended to meet the applicable requirements for qualification. He also established a pension plan, covering the same employees and providing a monthly retirement benefit after age sixty-five equal to 50 percent of each employee's average annual compensation, offset by the actuarial value of any amounts to which the employee might be entitled under the profit-sharing plan. Since the funds held in an employee's account under the profit-sharing plan were to be used to reduce the employee's pension benefits, the employer would have been relieved from contributing to that extent under the pension plan. Hence, the profit-sharing plan was not for the exclusive benefit of employees in general and failed to be qualified.

Further, in order for the pension plan to qualify, it had to provide for definitely determinable benefits.\(^{49}\) The determination of the amount of retirement benefits and the contributions to provide such benefits may not be dependent on profits. In this case, however, the amount of pension benefits was contingent upon the amount available under the profit-sharing plan. This, in turn, depended upon the amount of the employer's profits and his willingness to make contributions from them. Under these circumstances, the benefits the employee would receive from the pension plan were not definitely determinable. Accordingly, the pension plan also failed of qualification.\(^{50}\)

\(^{50}\) Some such combination pension and profit-sharing plans had been acted on favorably prior to the issuance of Rev. Rul. 69-502, 1969-2 Cum. Bull. 89. Accordingly, under the authority contained in Int. Rev. Code of 1954, § 7805(b), such plans are not treated as unqualified solely by reason of the offsetting provision if such provision had been eliminated by appropriate amendment before the end of the first taxable year beginning after October 6, 1969, the date of publication of the Revenue Ruling. Furthermore, union-negotiated plans previously held qualified are not disqualified solely because of the offsetting provision if such provision had been eliminated by appropriate amendment by the later of (1) the end of the first taxable year beginning after October 6, 1969, or, (2) six months after the expiration of the applicable collective bargaining agreement in effect on October 6, 1969. In non-negotiated plans, the amendments must be effective for all purposes not later than the first day of the employer's taxable year beginning after October 6, 1969, and,
Determinable Offset Provision

Although when pension benefits are contingent upon profits and contributions by the employer both plans will fail, where the amount of offset pension benefits is definitely determinable when the plan is established and is not affected by future contributions to the profit-sharing plan, the status for qualification of each of the two plans is not adversely affected by having two plans. For example, in one case an employer had maintained a qualified profit-sharing plan for several years and then established a pension plan covering the same employees. The pension plan provided for a monthly retirement benefit, commencing at age sixty-five, equal to 50 percent of a participant's monthly career average compensation, which was reduced by an amount of deferred monthly retirement benefit actuarially equivalent to the amount standing to the participant’s credit in the profit-sharing plan at the time the pension plan was established.

The profit-sharing plan continued in effect after the pension plan was established and the employer expected to make annual contributions thereto out of profits. Contributions to the profit-sharing plan and trust earnings credited after that time would not reduce or otherwise affect the benefits to be received under the pension plan. The effect, accordingly, was the same as being provided a smaller pension benefit. Provision could properly be made for a 40 percent pension benefit; if, for example, the actuarial value of the prior profit-sharing accumulation had been ten percent, then a pension benefit of 50 percent less that actuarial value would be equivalent. Hence, the pension benefits were definitely determinable.

Contributions to the profit-sharing plan and to trust earnings during the period that both plans are maintained, would not reduce or otherwise affect the employer's commitment to make contributions to the pension plan. Furthermore, the employer could never be required to make contributions to the pension plan for the amount by which benefits were reduced, and this reduction in benefits was known at the time the pension plan was put into effect. Thus, the employer's commitment to provide pension benefits was definitely determinable.

The pension benefits were definitely determinable and profit-sharing funds were not used to relieve the employer of a com-

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for union-negotiated plans, the amendments must be made effective not later than the first day of the first taxable year beginning after October 6, 1969, or the date of expiration of applicable collective bargaining agreement.

mitment under the pension plan. Neither plan, therefore, was adversely affected because of the method used in providing pension benefits.

**Offsetting Profit-Sharing Contributions**

Unlike a method which offsets pension benefits by profit-sharing accumulations, a provision by which an amount which otherwise would have been contributed under a profit-sharing plan is reduced by the amount of contributions to a pension plan does not prevent either plan from qualifying.

For example, in one case an employer maintained both a 10 percent money-purchase pension plan and a profit-sharing plan calling for employer contributions equal to the lesser of 12 percent of net income or twenty percent of compensation, minus the amount of contributions under the pension plan.\(^{52}\) The reduction was in the profit-sharing plan, not in the pension plan. Contributions under the pension plan were fixed, without being geared to profits, in conformance with the Regulations applicable to money-purchase pension plans.\(^{53}\) Further, contributions under the profit-sharing plan would not reduce the employer's contributions under the pension plan.

The principle is not confined to money-purchase plans; the important factor is that the amount that otherwise would be contributed to the profit-sharing plan is reduced by the amount contributed to the pension plan, rather than the converse.

**Terminations and Curtailments**

A qualified plan must be a permanent program.\(^{54}\) The employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, if there is a valid business reason for so acting. The plan must comply with the requirements for qualification in all respects, both at the time the plan is adopted, and throughout its entire operation, including its termination.\(^{55}\)

**Valid Business Reason**

Plans are terminated for various reasons. The most common is a discontinuance of the employer's business brought about

\(^{54}\) Treas. Reg. § 1.401-1(b)(2) (1971).
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by bankruptcy, death, retirement, sale or liquidation. In some cases, the business is merged with a company that has no plan of its own and does not wish to continue the plan of the previous employer for the employees taken over; in other cases the acquiring company may have a plan which extends to all eligible employees. In either situation the plan of the previous employer is terminated. Financial considerations also give rise to terminations. Bankruptcy and insolvency are extreme examples; additionally, sound and valid business demands may require the use of the funds for such other purposes as plant expansion, inventory increase, or business extension. Other reasons for termination are substitution of another plan, union demands for different benefits, changes in location, change in product or type of business, and failure to realize the objectives of the plan caused by lack of employee interest or a scarcity of eligible employees.

The circumstances surrounding termination must be sufficient to establish that the plan was not adopted in anticipation of a short existence after providing for employees in whose favor discrimination is prohibited. Each case must be determined on its facts, and a reason found satisfactory in one case may not be controlling in another. For example, in one case, a company took on a new force to work on a five-year project. A plan was established providing for deferred vesting, but on completion of the project, the new force was discharged leaving only three stockholder-employees and a bookkeeper to benefit from the plan. Accordingly, it was held that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general, but was merely an arrangement to siphon off profits for subsequent distribution primarily to stockholders.

Another common situation in plan terminations involves a frequently used method of funding pension benefits on the basis of "oldest first." The cost of benefits for older employees is fully paid in a relatively short time, while the cost for younger employees, spread over their remaining years to retirement, will not be met for a much longer time. This is satisfactory in a continuing plan where every participant receives his contemplated benefit in accordance with the formula set forth in the plan. If, however, the older participants are upper-echelon employees and the plan is terminated soon after their benefits have


been fully funded while those for junior employees either have not been funded at all, or are not funded to the same extent as the higher-paid, prohibited discrimination arises.\textsuperscript{58}

For example, under a fifty percent fixed-benefit plan, the single lump-sum cost of funding a straight life annuity of $25,000 for a sixty-four year old man earning $50,000 a year, commencing at normal retirement age sixty-five, on the basis of actuarial factors submitted, is approximately $295,000, or 590 percent of his compensation. The level annual cost of a $2,500 annuity for a twenty-five year old man earning $5,000 a year, commencing at age sixty-five, and using the same factors, is approximately $345, or 6.9 percent of his compensation. There is no discrimination in stated benefits while the plan is in operation, since a uniform rate of 50 percent is provided for all participants, but discrimination arises on termination because of the variance in funding. Participants then receive only what is available for them. The older employees may receive full, or almost full, benefits, while the younger employees may receive little or nothing. If the older people are upper-echelon employees, as is usually the case, the termination is discriminatory.

\textit{Termination Rule}

The prescribed method of limiting prohibited discrimination on termination of a pension or annuity plan is to restrict the contributions that may be used to provide benefits for the upper-echelon employees. For this purpose, upper echelon employees are those who are the twenty-five highest paid\textsuperscript{59} at the time the plan is established and whose anticipated annual pension exceeds $1,500. The restrictions become applicable if:\textsuperscript{60}

(a) The plan is terminated within ten years after it is established, or

(b) The benefits of an employee among the top twenty-five become payable within ten years after the plan is established, or

(c) The benefits of an employee among the top twenty-five become payable after the plan has been in effect for ten years, but its current costs for the first ten years have not been fully funded.

In the case of an employee who is among the top twenty-five and whose benefits become payable within ten years after the

\textsuperscript{58} Treas. Reg. \S 1.401-1(b)(2) (1971).

\textsuperscript{59} All employees if total employment is lower.

\textsuperscript{60} Treas. Reg. \S 1.401-4(c)(2) (1971).
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plan is established, the restrictions are to remain applicable until the plan has been in effect for ten years; however, if the current costs have then been fully funded the restrictions no longer apply to such employee. Restrictions are not required in the case of a money-purchase pension plan under which all participants are treated alike with respect to the employer contributions and the increments thereon. The contributions, however, must bear a uniform relationship to each employee's total compensation and no employee may obtain a disproportionate benefit because of his age or the method of funding.

The requirement for restrictions is referred to as the "Termination Rule." The plan must restrict employer contributions used to provide benefits for any of the twenty-five highest paid employees so that such contributions will not exceed, over the ten year period, the greater of:

(a) $20,000, or
(b) The product resulting by multiplying 20 percent of the employee's annual compensation, not in excess of $50,000, by the number of years between the date of establishment of the plan and its termination.

To illustrate the applicability of the rule, let us assume that a plan has been in effect for eight years, the annual compensation of the employee involved is $30,000, and that $85,000 had been contributed on his behalf in accordance with the funding method under the plan. The restricted portion would then be $37,000.

The unrestricted balance of $48,000 may be used for the payment of benefits, but the remainder of $37,000 continues to be restricted for the remaining two years. The restricted portion is released as the current costs are fully met.

The restricted portion, however, may be exceeded for the purpose of making current retirement income benefit payments to retired employees under the following circumstances:

(a) Employer contributions on behalf of an employee subject to the restrictions must be applied either (i) to pro-

62. If the benefits of an employee become payable within 10 years from the date the plan is established, 20 percent of compensation is to be multiplied by the number of years from the establishment of the plan to the date the benefits become payable. Also, where the current costs have not been fully funded for the first 10 years, 20 percent of compensation is to be multiplied by the number of years from the date the plan was established to the date of the failure to meet the full current costs.
63. $85,000 less 20% of $30,000 for 8 years.
64. Treas. Reg. § 1.401-4(c)(4) (1971).
vide level amounts of annuity in the basic form of benefit under the plan at retirement (or, if he has already retired, beginning immediately), or (ii) to provide level amounts of annuity in an optional form of benefit under the plan if the level amount of annuity under such optional form is not greater than the level amount of annuity under the basic form of benefit under the plan;

(b) The annuity provided must be supplemented to the extent necessary to provide the full retirement income benefits in the basic form called for under the plan by current payments to such employees as the benefits become due; and

(c) Such supplemental payments can be made at any time only if the full current costs of the plan have been met, or the aggregate of such supplemental payments does not exceed the aggregate employer contributions already made under the plan in the year then current.

If disability income benefits are provided under the plan, similar provisions may be made for the current payment of such benefits.

The restrictions required for the first ten years of a plan's existence are similarly applicable to amendments which increase substantially the extent of possible discrimination in benefits actually payable in the event of subsequent termination of the plan or the subsequent discontinuance of contributions thereunder. The restrictions apply as though a new plan were established on the date of amendment. The provision that the unrestricted amount of employer contribution be at least $20,000, however, is applicable to the aggregate amount contributed by the employer for the particular employee from the date of establishment of the original plan. Furthermore, for the purpose of determining whether the employee's anticipated annual pension exceeds $1,500, both the employer's contributions prior to amendment and those expected to be made subsequently for that employee are to be taken into account.

Curtailments

A curtailment is a modification of a plan that reduces benefits or employer contributions, or narrows coverage, or makes the vesting provisions less liberal. An amendment converting a noncontributory plan to one requiring employee contributions,

but providing the same benefits, is a curtailment. Similarly, a plan is curtailed when it is amended to increase the waiting period for acquiring vested rights. Because curtailment is a partial termination of the plan, criteria applicable to terminations, i.e., valid business reason and absence of prohibited discrimination, are similarly applicable to curtailments.

As was true of terminations, the mere fact that a plan is curtailed does not necessarily result in adverse tax consequences. For example, the amendment of a plan integrated at the maximum compensation level for old-age and survivor insurance benefits under the Social Security Act into an all-coverage plan, but reducing vesting or benefits, may be acceptable. Although substantial changes may have been effected, the employer's overall cost may be the same or more than before the amendment. The requirement of a valid business reason would therefore be met and, since prohibited discrimination would not result because of the larger coverage, the amendment would be satisfactory.

If both coverage and the waiting period for vesting are extended, however, prohibited discrimination may result. For example, in a plan ostensibly covering all employees, but providing vested rights only for those who have completed fifteen years of service and stay on to normal retirement age sixty-five, only the stockholder-employees will benefit where the others are migratory workers and rarely return after one season.67

A curtailment limiting contributions or benefits for upper-echelon employees does not result in prohibited discrimination. Thus, where a ceiling on compensation is applied, only the benefits for those compensated above the applicable portion will be affected, and since they are the highly compensated employees, no adverse tax consequences result.68

Discontinuances and Suspensions

Plans may be terminated via the slow death process of discontinuing contributions. Although the formal steps for termination have not been taken, the result is the same unless the process is reversed and contributions are resumed. Employees who become eligible to enter the plan subsequent to the discontinuance receive no benefits, and no additional benefits attributable to employer contributions accrue to participants. The same requisites that apply to terminations are therefore equally applicable to dis-

continuances. Vesting of employee rights is required in both cases.69

A suspension is a temporary cessation of contributions, rather than a permanent discontinuance. If contributions are resumed within a reasonable period and deficiencies are made up, the employees probably will not be hurt by the suspension. If the period is prolonged, however, or if contributions are made in insufficient amounts, a suspension may ripen into a discontinuance.

Benefits under a pension or annuity plan must not be affected at any time by a suspension. Additionally, the unfunded cost at any time must not exceed the sum of the unfunded past service cost at the inception of the plan and any additional past service or supplemental costs that may have been added by amendment. The unfunded past service cost at any time will include any unfunded prior normal cost and unfunded interest on any unfunded cost.70 If the benefits are not affected and if the cost has not increased, the requirement for vesting is not applicable and the status of a prior determination as to the qualification of the plan is not adversely affected by the suspension.71

Where, however, the benefits are affected or the unfunded cost has increased, the case is treated as a termination or curtailment of the plan. The trustee must notify the District Director of Internal Revenue of the situation. A determination will then be made as to the tax effects and the trustee will be advised.72 If a valid reason is found to exist and prohibited discrimination does not result, the qualification of the plan will not be adversely affected.

Contributions to a profit-sharing plan must be recurring and substantial.73 This does not mean that employer contributions must be made every year, or in the same amount, or at the same rate. A single or occasional contribution out of profits, however, does not satisfy the requirement that the plan be permanent. Where contributions are made while the upper-echelon employees are practically the only participants, but are discontinued when others become eligible, prohibited discrimination arises.74 A de-

74. Rev. Rul. 66-251, 1966-2 CUM. BULL. 121, announcing that the Internal Revenue Service will not follow the decision in Sherwood Swan and Co.,
termination as to whether a suspension of contributions under a profit-sharing plan constitutes a discontinuance is made upon consideration of the facts and circumstances of the particular case.

If, under the terms of a profit-sharing plan, authority is specifically reserved to discontinue contributions without terminating the trust, the plan must also contain an appropriate provision granting participants fully vested rights upon discontinuance of contributions by the employer. The rule is similar to the rule for actual termination. 76

Order of Distribution

A qualified plan must provide that upon its termination, or upon complete discontinuance of contributions thereunder, the rights of each employee to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the rights to the amounts credited, are nonforfeitable. 76 The plan must also provide for the allocation of any previously unallocated funds to participants upon termination or complete discontinuance of contributions. 77 Any provision for the allocation of unallocated funds is acceptable if it specifies the method to be used and does not result in prohibited discrimination. The allocation may be in cash or in the form of other benefits provided under the plan.

As long as the prohibited discrimination does not result, the allocation need not necessarily benefit all participants. Thus, the funds may be used to provide benefits in accordance with some order of priority. 78 For example, benefits might be provided first, for retirees, second, for those eligible to retire and receive benefits, third, for those over age sixty, and so on for those in progressively younger age groups until the funds are fully exhausted.

A qualified trusteed pension plan may contain a provision permitting the employer to recover at termination of the trust any

Ltd. v. Commissioner, 352 F.2d 306 (9th Cir. 1965) aff'g 42 T.C. 299 (1964), holding that if, when adopted, a profit-sharing plan and trust meet all the requirements of the statute and the regulations, then the trust continues to be exempt from tax even though contributions to the trust cease altogether and, because of the employee dropouts, the group in whose favor discrimination is prohibited is likely to receive the most of the benefits upon termination of the trust.

balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust.\textsuperscript{79} In the case of a qualified nontrusteed annuity plan, a definite written arrangement between the employer and the insurer must provide that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received, or within the next succeeding taxable year, toward the purchase of retirement annuities under the plan.\textsuperscript{80} Any dividends, or experience credits similar to dividends, or surrender or cancellation credits, made after permanent discontinuance of contributions and after all retirement annuities with respect to service prior to discontinuance of the plan have been purchased, may be paid to the employer. However, they must be paid as soon as they are determined to the degree that is practicable, so that no substantial accumulation results.\textsuperscript{81} This treatment is similar to that provided for in the case of a termination of an exempt pension trust permitting return to the employer of any surplus funds arising from erroneous actuarial computations.

\textbf{CONCLUSION}

There has been considerable activity recently elucidating and applying established pension and profit-sharing requisites, especially as they apply to specific factual situations in the areas here considered. An analysis of the principles involved has been presented so that it will serve as a guide to establishing and maintaining plans in qualified status.

\textsuperscript{79} Treas. Reg. \S 1.401-2(b)(1) (1971).
\textsuperscript{80} Treas. Reg. \S 1.404(a)-8(a)(3) (1971).