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INCOME TAXES ON BENEFICIARIES OF PENSION AND PROFIT-SHARING PLANS

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DOCTORS who have any substantial number of lawyers among their patients must realize by this time that the Revenue Act of 1942 is responsible for much of the pathological preoccupation afflicting members of the tax bar. For although that Act simplified some fields of the law of Taxation, in other fields it created more problems (and more perplexing problems) than it eliminated. This is especially true of its provisions for the taxation of employees' pension and profit-sharing plans.[1] In place of the comparatively simple principles of the pre-1942 law, the new provisions present a highly technical system for screening industrial pension and profit-sharing plans with favorable tax consequences for plans which qualify.[2] Moreover, the actuarial computations required in applying the new law, when determining whether a plan is properly integrated with Social Security insurance benefits,[3] in fixing the amount and method of an employer's tax deductions,[4] and in several other matters connected with the establishment of a qualified plan, have permanently furrowed the brow of many a lawyer. Nevertheless, with its usual determination, the profession has educated itself anew, and

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1. Revenue Act of 1942, § 162.

2. Section 162 of the Revenue Act of 1942 amended § 165 (a) of the Internal Revenue Code. Plans qualifying under § 165 (a) of the Internal Revenue Code, as so amended, receive favorable tax treatment in that participants are not taxable on benefits until received or made available to them. INT. REV. CODE § 165 (b). Under plans which do not qualify under § 165 (a) participants must include in taxable income, each year, the amounts contributed to the plan by their employers for their benefits, if their beneficial interest in the contributions is non-forfeitable at the time the contribution is made. INT. REV. CODE § 165 (c).

3. The rules for integration of pension benefits with Social Security benefits are found in Commissioner's Mimeograph No. 5539, INT. REV. BULL. (1943) at 499. If classification of employees under a pension plan results in proportionately greater benefits for employees earning above any specified salary rate than for those earning below such rate, the plan will be considered discriminatory by the Commissioner of Internal Revenue, unless the differences in benefits under the plan are offset by the benefits provided by the Social Security Act. If a plan discriminates against lower paid employees it will not qualify under § 165 (a).

The statute does not require integration with Social Security benefits and it is questionable whether Congress intended it to be required.

4. Tax deductions for pension, stock-bonus and profit-sharing plans are now taken under § 23 (p) of the Internal Revenue Code. A special booklet of forty pages has been issued by the Commissioner to explain the application of two subdivisions of § 23 (p). See, Bulletin on I. R. C. § 23 (p) (1) (A) and (B), June 1, 1945.

has participated to a great extent in the establishment, between January 1942 and the present time, of more than six thousand plans.[5]

Many articles[6] and symposia[7] by lawyers, actuaries and insurance men have helped to guide the bar down the labyrinthine ways of the new rules respecting the qualification of employee plans under Section 165 (a) of the Internal Revenue Code as amended by the Revenue Act of 1942. Some useful papers are available on the question of the amount and time of the employer's tax deduction.[8] However, published materials on the income taxes assessable against employees and their beneficiaries in connection wtih such plans are rare. Probably, this aspect of the subject of industrial pension and profit-sharing plans is, on the whole, less intricate than others. Yet the statute and regulations involved have their puzzling features and there are no interpretations in the decided cases to help. Hence the following effort to state some of the problems connected with such taxes, to suggest solutions occasionally, and to indicate some particulars in which the applicable rules need clarification, may serve a useful purpose.

Employee pension and profit-sharing plans usually fall into two classes. In the first category may be placed those involving the creation of a trust, with the trustee investing the contributions of the employer and of the employees also, where employees contribute to the fund. The fund from which employees' pensions and other benefits are later paid is built up from such investments and their earnings. In the second class are plans insured with a life insurance company, without the intervention of a trustee, usually under a group annuity policy.[9] Where a pension plan involves a trust, the agreement often provides for purchase by the trustee of individual policies providing a pension annuity for each employee, with pension payments to commence at his retirement date. Such individual policies may also provide life insurance pro-

5. Cann, *Administration of the Internal Revenue Code Relating to Pension, Stock Bonus and Profit-Sharing Plans* (1945) 26 N. A. C. A. BULLETIN 1027. More than $500,000,000 is contributed annually by employers to plans now in existence.

6. For a collection of papers on the subject of the establishment and qualification of pension plans, see special issues, Journal of Commerce, July 15, 1943, May 15, 1944, May 15, 1945.

7. Pension plans were the subject of a three-day forum held under the auspices of the New York University School of Law. It published its proceedings in the booklet *New York University School of Law, Conference on Pension and Profit Sharing Trusts* (1944). Representatives of many life insurance companies held conferences from time to time in 1943 with officers of the Bureau of Internal Revenue. The Association of Life Insurance Presidents has published the memoranda of these conferences in a booklet.

8. See papers in the collection cited in note 6, *supra*.

9. The usual group annuity plan is designed to provide pensions only. However, plans combining group life insurance with group annuities are available.

tection payable, if the employee dies before reaching retirement age, to his designated beneficiary. Of course, life insurance protection is not added to the annuity feature, if the employee is not an acceptable medical or occupational risk. Profit-sharing trusts usually provide for periodic contributions of a share of the employer's profits to a trustee who invests in income producing securities. A fund is thus accumulated and allocated among the employees. It is disbursed to them later in lump sum payments or installments, the disbursements sometimes being delayed until the employees retire from employment.

While most pension and profit-sharing plans are classified quite simply from the point of view of their character as trusteed or non-trusteed arrangements, great diversity exists with respect to the types of benefits available to participants and the manner of payment of such benefits. One practice contributing to this diversity is the practice of life insurance companies of offering the "optional modes of settlement" (familiar to every holder of an ordinary life insurance policy) in connection with policies issued under pension plans. The full number of options is usually offered where individual policies provide life insurance protection. Somewhat similar options are extended under the simple pension-annuity policies.

Although pension and profit-sharing plans reveal so much variety in the ways in which their benefits are payable, the Internal Revenue Code and the promulgated regulations[10] propose but one or two rules for taxing such benefits, assuming that those few rules are adequate to provide a clear and equitable scheme of assessment. As far as they relate to the income tax exacted in connection with plans, which have qualified under Section 165 (a), those rules may, for purposes of this discussion, be summarized as follows:

(1) No tax is imposed until benefits are distributed or made available to recipients,[11] except that the cost paid for life insurance on individual policies is taxed to an insured employee each year.[12]

(2) When benefits are distributed or made available to recipi-

10. INT. REV. CODE §§ 22 (b) (2), 165 (b), 165 (c); U. S. TREAS. REG. 111, §§ 29.22 (b) (2)-5, 29.165-6, 29.165-7.

11. INT. REV. CODE § 165 (b).

12. The cost of life insurance is taxed to the insured each year where individual policies are issued. U. S. TREAS. REG. 111, § 29.165-6. Raymond J. Moore, 45 B. T. A. 1073 (1941). However, premiums paid by an employer for group life insurance, apart from pension plans are not taxable to employees, U. S. TREAS. REG. 111, § 29.22 (a)-3. Whether tax exemption is also extended to employees where group life insurance is purchased for participants in a group annuity pension plan is a problem now being studied by the Bureau of Internal Revenue.

ents, periodic payments are taxed as annuity payments;[13] lump sum payments are taxed as long-term capital gains.[14]

The Tax on Life Insurance

From the above principles, it is evident that unless a qualified plan provides life insurance protection the tax collector has no special interest in its participants until distributions become available to them, *i.e.*, until they retire or terminate participation by death, disability, resignation or by being discharged. Until such an event occurs, under plans involving no life insurance features, the contributions of the employer are not taxable to the employee, even though such contributions are deductible business expenses.[15] However if the employee does obtain life insurance protection under the plan, then the employer's contribution (paid to the trustee or directly to an insurance company) is used not only to provide for funding the employee's pension but also to cover the cost of his insurance, and the tax collector has a function to perform. If the policy is an individual policy, he must see that the employee includes in his gross income that part of the employer contribution which is applied during the employee's taxable year to the cost of his life insurance. In determining that cost the regulations provide certain beacons for the collector and the employee:[16]

"If the trust purchases under the plan retirement income insurance with life insurance protection payable upon the death of the employee participants, so much of the premiums as was paid from the contributions of the employer or earnings thereon for such life insurance protection will constitute income

13. Under § 22 (b) (2)-2 of the Internal Revenue Code annuity payments are includible *in toto* in the annuitant's income, as received, unless the annuitant contributed some part of the consideration for which the annuity is being paid. If the employee-annuitant has contributed toward the establishment of the fund from which his payments are derived, he should exclude from his taxable income each year an amount equal to 3% of the consideration paid by him. When finally the amounts so excluded equal the consideration paid by him for the annuity, he will be deemed to have recovered the entire capital outlay made by him. Payments received thereafter will be fully taxable to him.

14. Gains from the sale or exchange of a capital asset held for more than six months cannot be taxed at more than 25% of the gain. INT. REV. CODE § 117. If an employee contributed to the plan, he should subtract the amount of his contribution from the lump sum payment received by him and treat the difference as a long-term capital gain includible in gross income as such. If his plan was non-contributory the entire amount of the distribution is long-term capital gain.

15. U. S. TREAS. REG. 111, § 29.23 (p)-1, provides that the deduction for payment of premiums for life insurance is to be taken by the employer as a business expense under § 23 (a) of the Internal Revenue Code. The form of information return now required of employers under § 147 of the Code (Form 1099) calls for a statement of the amounts contributed for an employee's life insurance.

16. U. S. TREAS. REG. 111, § 29.165-6.

to the employee for the year or years in which the contributions or earnings are applied to the purchase of such life insurance. If the amount payable upon death at any time during the year exceeds the cash value (or if no cash value, then the reserve) of the insurance policy at the end of the year, the entire amount of such excess will be considered current life insurance protection. The cost of such insurance will be considered to be the one-year term premium for such amount based upon the rates of the company issuing the annuity contract (or if no one-year term policy is issued, the cost of such one-year term computed by using the same mortality table and rate of interest and rate of loading as was used in determining the rates for the annuity contract)."

As will be seen, only fitful illumination gleams from the beacons so set up, when the following problems are presented:

(1) In what year are employer contributions for insurance taxable to the employee? In other words, when are contributions "applied" to the purchase of insurance, when the contribution is transferred to the trustee by the employer or when the funds are finally accepted by the insurer?

(2) What part of the total premium paid an insurer is considered "applied" to life insurance and what part is deemed to be used for funding the employee's pension benefits?

(3) With respect to an employee, who is required to pay an "excess premium" because he is a poor medical risk, how is the amount taxable to him affected by the fact that he contributes to the cost himself?

The first problem, respecting the year in which life insurance costs are taxable looms large at the present time because many plans were instituted toward the closing days of 1943 and 1944 and tax returns for those years will soon be audited. When the plans were instituted, substantial payments were made to the trustees, which payments were intended to be used, in part, for paying life insurance premiums. However, medical examinations were not completed, in many cases, until after the close of the year in which the plans were instituted. Hence premiums were not paid by the trustees or received by the insurers until the early months of the year following the year in which payments were made by the employers to the trustees. In determining when employees should include employer contributions in income it is necessary to determine whether such contributions are deemed to have been applied to the employee's life insurance in the year of institution of the plan or in the following year.

The regulations seem to suggest that an employer's contributions will not be considered to have been "applied" to the employee's insurance until the year in which they were finally accepted by the insurer, *i.e.*, in the year following the institution of the plan. No insurance was in force in the year of institution of the plan. Until an insurer accepts the premium and assumes the risk (usually by delivering a policy or binder) a participant is not insured, and his death will not give him any right to insurance payments against the insurer. Unless at least $1.00 of insurance was in force on the life of an employee in the year of the institution of the plan, no cost of insurance can be established for that year in accordance with the method described in the last two sentences of the excerpt from the regulations quoted above. Since the employee is taxable only on the cost of insurance, he is not taxable until acceptance by the insurer puts some insurance in force and makes computation of its cost possible. Not payment to the trustee in the year of institution, but acceptance by the insurer is the taxable event.

However, a different conclusion may be indicated if the first sentence in the quoted excerpt is emphasized. That sentence indicates that the employee is to be taxed in the year or years in which the contributions or earnings are "applied" to the purchase of his life insurance. It may be argued that employer contributions are so "applied" as soon as they are delivered to the trustee. The trustee is under a duty placed upon him by the trust agreement to purchase life insurance and his action of forwarding the moneys to the insurer is merely administrative. Normally, the duty is carried out promptly. Payment to the trustee should therefore be treated as payment to the insurer and an application of funds within the meaning of the regulations.[17] The fact that the regulations use the word "applied" rather than the word "paid," strengthens the argument. *Application* of funds to life insurance costs may be a different act from *payment* of a premium and may occur as soon as the employer is advised of the amount necessary to pay the life insurance costs and transfers that amount to the trustee. Hence, the view that the transfer of the funds to the trustee is enough to fix the time when they are taxable to the employee is not without support.[18] Neverthe-

17. This argument would seem quite forceful where the payment is made in connection with a so-called "auxiliary fund" pension plan. There an insurable participant is insured under a policy providing only insurance protection without annuity features. The trustee receives separate contributions from the employer for an "auxiliary fund" to be held in trust until the normal retirement date of the employee. At that time, the insurance policy is converted and an annuity purchased. Any amount over the proceeds of the conversion required to purchase the annuity is withdrawn from the auxiliary fund. In this arrangement the amounts contributed by the employer for insurance are clearly marked by the employer and set aside by the trustee for insurance protection. It may be claimed that they were "applied" as soon as paid by the employer, since all that remains is the administrative detail of forwarding the check through the mails to the insurer.

18. This view is consistent with the rule covering plans not qualifying under § 165 (a). Under that rule the employee's contributions are taxed to the employee for the year in

less, the first answer seems the more satisfactory interpretation of the regulations as a whole. But the problem certainly calls for clarification of the regulations.

The second problem concerns the calculation of the amount applied for insurance. It becomes pertinent in a situation like the following. A plan, established by a trust agreement is made effective as of November 1, 1944. *A*, an employee becomes eligible for participation on March 1, 1945. A life insurance policy is bought for *A* in 1945. Administrative convenience requires that *A*'s insurance mature on an anniversary of the effective date of the trust. Hence, the policy must be placed on a yearly basis running from November 1, of one year to October 31, of the next year. Therefore, the trust procures a policy for the term from March 1, 1945 to November 1, 1945 and this policy is placed on a yearly basis as of November 1, 1945. The premium paid is divisible into two separate parts, the first part representing the term cost of *A*'s life insurance from March 1, 1945 to October 31, 1945. The second part represents the term cost of his insurance from November 1, 1945 to October 31, 1946.

In the situation described it has been suggested by some insurance counsellors that the amount includible in *A*'s income for 1945 is the total paid during 1945 for his life insurance. The supporting argument is that the law contemplates a tax on a cash basis taxpayer for the total amounts actually paid for his benefit by the employer during the taxable year. It is pointed out that under the general theory of taxing employees on amounts paid for their insurance, such amounts are taxed to them as part of their compensation and in calculating an employee's compensation for tax purposes, all amounts paid him or for his benefit during his taxable year represent compensation. Consequently, it is claimed that the regulations should not be interpreted to reduce the amounts taxable to the employee below the full amount paid during the year. However, despite the merit of the argument, presented, there is ground for believing that the regulations do effect a reduction. They

which they are contributed to the trustee regardless of whether the trustee is required to apply them to the purchase of policies at some later date. Section 165 (c) provides: "Contributions to a trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under § 165 (a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made." No reason is seen why employees of a qualified plan should be treated differently with respect to contributions for life insurance. Such contributions are considered to fall outside the purposes of a qualified pension plan, as is shown by treating such contributions as compensation.

seem to provide, in the situation given, for the taxation of less than the full amount applied during the taxable year to the employee's insurance. A reading of the last sentence of the excerpt quoted above shows that they require the employee to pay tax each year only on the one-year term cost of his life insurance. Even though, through prepayment of premium the insurer actually receives, during the employee's taxable year, more than the one year term cost of the insurance, the employee is taxable only on such one-year term cost. Thus, in *A*'s case, where the insurer received in 1945 the term cost for the period from March 1, 1945 to October 1, 1946, the employee is taxable for no more than the one-year term premium of the net amount[19] of insurance at risk during 1945. If this view of the regulations properly interprets them as now drawn, reconsideration of the present position of some insurance counsellors, that the total paid the insurer during the year is taxable, seems to be in order.[20] Moreover, the regulations may need revision to protect the revenues. Danger to the revenues may now exist where premiums, for several years, are prepaid in one year (some insurance companies being willing to accept prepayment for several years). Nothing will be taxable to employees for the later years of the period covered by such a prepayment, because no moneys will be "applied" in those years to purchase insurance. And, only the one-year term cost is taxable to the employees in the year of prepayment. Thus, although all costs for an

19. The regulations state that in computing the net amount of insurance at risk, the cash surrender value of the policy is to be deducted from the highest amount of insurance protection in force during the year. If the policy has no cash surrender value then the reserve is to be used instead of the cash value. Apparently the Bureau of Internal Revenue now permits use of either the reserve or the cash value at the option of the insured. If the reserve is higher than the cash surrender value and it is used in computing the net amount of insurance, the amount of such insurance will be lower than would be the case if the cash surrender value were used. As a consequence the tax burden of the employee is lighter.

20. Some who have advanced this argument have suggested that the "year" in § 29.165-6 of the regulations refers to the policy year and not the taxable year of the employee assuming that, on the basis of such an interpretation, the employee should be charged with the full amount paid to the insurer during his taxable year. Even if this interpretation is accepted, it is difficult to see why it changes the conclusion that the employee is taxable only on the one-year term cost. If the term "year" in the regulations refers to the policy year, it would be necessary to determine the reserve on the policy in the example given in the text as at October 31, 1946, the end of the policy year. However, insurance actuaries consider that the reserve does not change during the policy year after the payment of a premium. Hence the reserve at any time between November 1, 1945 and October 31, 1946 would be the same figure and the net amount of insurance at risk calculated either at December 31, 1945 or October 31, 1946, would be the same amount. The regulations seem clear that no more than the one-year term cost of the net amount of insurance is taxable to the employee.

employee's insurance for several years have been paid, during the period covered by the prepayment, he will pay tax only on the one-year term cost.[21]

Here it is appropriate to draw attention to what may be an inequitable result of the regulations as far as they establish principles for computing the amount includible in an employee's income. The first situation involves an employee who became eligible for entry into a plan on November 1, 1945 and was then insured for $10,000. His insurance is determined by deducting from the highest amount of insurance at risk during 1945, the cash value or reserve at the end of 1945. This amount of insurance is to be paid for as if it had been in force during the whole of 1945. No provision for reducing the charge in proportion to the time that the employee enjoyed the full insurance protection appears in the regulations. Although without insurance protection for ten months of 1945, he must pay tax for 1945 on the one-year term cost of his insurance, if the regulations are followed. The second situation is similar to the first. The case concerns an employee who became eligible for a pension plan in 1944. His salary was increased during 1945 and he thereby became entitled on November 1, 1945 to an increase in insurance, of $4,000 over his prior insurance of $10,000.[22] Assume that, on that date, the trustee made payment of the premium for the policy year from November 1, 1945 to October 31, 1946 for the increased insurance. The charge to the employee is determined by deducting the cash value of the policies or their reserves at the end of 1945 from the fixed amount of insurance, the net insurance so determined is again paid for as if it had been in force for the full year 1945. In fact the employee has had insurance for ten months of 1945 in the lower amount and only for the last two months of 1945 in the increased amount. The equity of the rule in the two situations described is questionable. It seems that the employee should pay only for the benefit which he received. It is suggested that the one-year term cost of the insurance should not be charged to the employee if the term cost of the insurance, prorated for the particular periods enjoyed, is lower. If it be said that the charge to the employee should be governed by the

21. The employer's deduction for each year of the period covered by the prepayment will probably be allowed only for the cost attributable to each particular year. Draper & Co., Inc. v. Commissioner, 5 T. C. § 100 (1945).

22. Most plans provide that life insurance shall be in proportion to salary. Hence as an employee's salary is increased it is necessary to purchase additional policies. If it is decreased, the policy must be surrendered and a new policy in a lower amount issued. It is usually provided that increases or decreases in insurance are to be effective on an "entry date" *i.e.,* an anniversary of the effective date of the plan.

amount actually paid for his taxable year, it may be retorted that, as already indicated, the regulations do not follow that theory.

When an employee is not insurable at ordinary rates, because of some physical weakness but is insurable at extra rating insurance companies charge extra premiums, and the plan usually provides that the employee must himself pay any excess premium required for his insurance. In connection with such payments by the employee the third problem, mentioned above, is raised—how is the determination of the amount includible in the employee's income affected by his own payments? This question arises because although the extra premium is charged insurance companies are advising employers that the term cost of insurance for substandard risks is the same as that for standard risks.[23] In seeking for the answer, we may first refer to the fact that the Bureau has ruled, in a situation where all employees were required to contribute a percentage of salary toward purchase of individual contracts that employee contributions may be applied first to the cost of their life insurance and the balance of the cost of their annuities.[24] The ruling did not suggest any distinction between those insured in the plan at ordinary rates and those substandard risks who were required to pay extra premium. The facts stated did not indicate whether there were any such substandard risks. However, many insurance men are now relying on this ruling to support the view that an employee may consider his own contribution as applied in partial payment of the term cost of his insurance. If this view is correct, the balance of the term cost, payable out of employer contributions is all that is taxable to the employee. Again, addition of a statement to the regulations would be helpful.

The Tax on Benefits

Upon retirement pension payments or profit-sharing distributions may begin. The applicable tax rules are stated briefly in the statute and regulations. Periodic payments are taxable to the participant as he receives them or as they are made available for him.[25] If he should take the entire amount due him in one payment, during one taxable year, he may include the payment in income as a long-term capital gain, pro-

23. Many insurance companies do not have term cost tables for substandard risks requiring extra payments from them. They are reporting the one-year term cost of insurance of a substandard risk or the same as the one-year term cost of similar insurance for a standard risk.

24. P. S. No. 32, 443 C. C. H. 1945 Fed. Tax Serv. § 6568. The suggestion has been made that the amount of an employee's contribution to his pension plan should be allowed the employee as a deduction from gross income. Griswold, *Tax Treatment of Employees Contributions to Pension Plans* (1943) 57 HARV. L. REV. 247.

25. INT. REV. CODE § 165 (b); U. S. TREAS. REG. 111, § 29.165-6.

vided the payment was made on account of his "separation from the service."[26] Of course, if he may treat his benefits as such a gain he will have the advantage of the rule limiting tax to 25% of the amount received.[27] However, when applying these rules we may have difficulty with plans which issue individual life insurance policies because, as indicated above, they often provide that the employee may choose, from various optional methods of receiving his benefits, the one best suited to his needs. One of these optional methods of settlement permits the participant to elect to have the sums payable to him on normal retirement date held by the insurance company, under an agreement that interest on such sums will be paid to him periodically. The principal held by the insurance company is subject to withdrawal at any time by the participant and if not withdrawn prior to his death is then payable to his beneficiary.

No doubt the interest paid under the foregoing arrangement is includible in gross income as it is received,[28] but doubt does exist as to the tax status of the principal in the year when the employee makes his election of options and also as to its status in the year when it is finally received. In the year of the employee's election to take the particular mode of settlement selected, the principal was available to him and could have been taken by him in one lump sum even though he elected to leave it at investment with the insurance company. Do the regulations stating that benefits are taxable when "available" to the participant require inclusion of the principal in the income of the employee in the year of election? One's first reaction is to answer in the affirmative. Nevertheless, an opposite approach is indicated by a provision inserted in the regulations to cover a somewhat similar situation Thus, where an employee receives a policy from the trust on his retirement the regulations provide:[29]

> "If a trust exempt under section 165 (a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered."

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26. *Ibid.*

27. INT. REV. CODE § 117 (1945).

28. U. S. TREAS. REG. 111, § 29.22 (b) (1)-1. If the beneficiary of a decreased participant had made such contract with the insurer the interest would be taxable. Edith M. Kinnear, 20 B. T. A. 718 (1930); United States v. Heilbronner, 100 F. (2d) 379 (C. C. A. 2d, 1938).

29. U. S. TREAS. REG. 111, § 29.165-6.

Although the employee might surrender the policy for cash as soon as he receives it, he is nevertheless not taxable until he actually surrenders the policy and takes the cash. This seems to indicate that only on the final liquidation of a contract for its cash value will an employee be taxed. Hence, it might be argued that merely turning over the principal, due on an insurance policy, for investment does not attract tax. On the other hand, when an employee decides to leave the principal at interest with the insurance company he is usually required to surrender his policy and accept a certificate of deposit evidencing the debt owed to him. The fact that the policy is surrendered technically differentiates his case from the one contemplated in the regulations just quoted, but the cases seem to be similar as far as availability of cash is concerned. Hence, the employee ought not be taxed in the year of election. However, the apparent conflict with the rule that "available" proceeds are taxable makes one wish for more detailed regulations.

Assuming that the principal is not taxable until finally withdrawn, the question is raised as to how it is taxable at that time. If the participant withdraws the fund several years after retirement, is the amount withdrawn includible as ordinary income or as long-term capital gain? In this connection, the statute permits a participant to include funds as long-term capital gain if receipt of them fits the following requirements: (1) the funds represent the "total distributions" payable with respect to him under the trust (2) they are paid to him within one taxable year (3) they are paid on account of his separation from service (4) they are paid in a year when the trust is exempt under Section 165 (a).

When applying the first of these four requirements we must remember that, in the instance under consideration, interest has been received by the employee for several years. Hence the principal is not all that the employee has taken as a benefit, derived from his employer's trust. It seems, however, that in treating of "distributions" the regulations are referring to amounts payable to the employee at the time that his right to receive such funds matures, *i.e.*, at normal retirement date. If so, the term "total distributions" as applied to our example should refer to principal left at investment with the insurer. The withdrawal of principal was therefore a "total distribution" of benefits and the first requirement is satisfied. The distribution also satisfies the second and fourth requirements because the "total distributions" (as we interpret that term) are all received in one taxable year of the recipient and the trust is a qualified one *ex hypothesi.*

However, the question of the third requirement, *i.e.*, whether the sums are paid on account of the employee's "separation" from service is more difficult. They are withdrawn some years *after* the date of his separation from service. Does the lapse of time prevent the payment from being one *on account of* the employee's separation from service? Do the regulations intend that a payment shall only be deemed to be a payment on account of the employee's separation from service, where it has the characteristics of severance pay? The answers will not be found in the documents—no hint is given in the typical insurance policy or in the typical trust agreement as to whether such payments are *on account of* separation from service. The fact that severance pay is usually taken by an employee when he leaves the employ of a company seems to prevent the payment in question from having the characteristics of severance pay. Moreover, many employers have contracts with groups of employees guaranteeing severance pay to them. In addition they have pension plans providing lump sum payments of the type in question. These employers would no doubt be surprised to find their pension plan benefits classified as severance pay.

It is submitted that, if the regulations continue as presently drawn, any payment to which the employee becomes entitled on his separation from service should be deemed to be a distribution on account of separation from service even though not taken by him until some time after separation from service. Moreover it is submitted that the regulations should not stand as presently drawn but should be revised in order to eliminate the inequitable treatment accorded under them to employees who continue in employment. Sometimes, an employee reaches normal retirement date at a time when illness or misfortune in his family makes it financially impossible for him to retire on pension and live on reduced income. He may then determine to continue in employment. His insurance contract will nevertheless, be turned over to him. The employee may find it necessary to surrender the contract and use the proceeds for medical bills or other expenses. Because he has continued in employment the amounts received by him are not received *on account of* separation from service and he is denied the advantage of treating them as long-term capital gain. However, no reason for treating him differently from the employee who actually leaves employment is perceived and the law seems to need revision to place both employees on an equal basis.

A word in connection with the taxation of benefits to a person designated by an employee to receive such benefits on his death may be said here. Such a designee finds his situation complicated by the present uncertainty respecting *Pierce v. Commissioner*.[30] The options provided

30. 146 F. (2d) 388 (C. C. A. 2d, 1944).

by life insurance contracts are often exercisable by such a designee. One option available is the option of taking the amounts due in a fixed number of installment payments. The total of such payments (due to the earnings of the policy) will exceed the amount that would have been payable in a lump sum on the death of the insured. When such an option is exercised by such a beneficiary the Commissioner's present regulations[31] permit the amount which would have been paid immediately upon the death of the insured to be taken tax free. It is considered that that amount is a life insurance payment received by reason of the death of the insured. But those regulations provide in effect that if the installments received are greater than the amount which would have been payable immediately on the death of the insured the excess is includible in the taxable income of the recipient. One theory supporting this view that the excess is not tax free insurance, is that advanced by Judge Frank in *Pierce v. Commissioner*. He stated:[32]

"The statute exempts 'amounts received under a life insurance contract paid by reason of the death of the insured.' Are the amounts here paid 'by reason of' such death? Yes, in part; for the contract made by the insured provided that the beneficiary upon the death of the insured should have an option, so that the option came into being 'by reason of' his death. But the death alone did not bring about such payment; it required both (a) the death of the insured and (b) the election, after that death, of the beneficiary to exercise the option . . . the money is paid by the insurance company not 'by reason of the death,' but because the beneficiary exercised a deliberate choice to avail herself of the privilege of making such an investment."

However, the majority of the court held the Commissioner's regulations invalid. The entire amount paid the recipient in installments was deemed received because of the death of the insured, within the intendment of Congress, even though it included some amounts earned after the death of the insured. This view was stated as follows:[33]

"We are to assume that Congress wished to favor the class of dependents in whose behalf life insurance is ordinarily secured—the wife and children of the insured. Although that involves an exemption from taxation and exemptions are viewed with jealousy, when the purpose is evident enough, we should not defeat or mutilate its realization. . . . If the Commissioner is right, an insured who has taken out such a policy, and who wishes to give the beneficiary —ordinarily his wife—the power to decide how she will use the proceeds, must consult her in advance, and act while he lives, unless he is willing to forego the exemption. As he cannot tell when he will die, he must make sure that

31. U. S. TREAS. REG. 111, § 29.22 (b) (1)-1.

32. 146 F. (2d) 388, 391 (C. C. A. 2d, 1944).

33. *Id.* at 390.

he keeps abreast of all changes in their financial position, and provides for them; he will be unable to give her the power after his death to adapt her means to her needs."

Until the Commissioner indicates his acquiescence and revises his regulations or the Supreme Court settles the matter the obscurity will not be removed. It is submitted that the rule of the *Pierce* case is sound. Judge Frank's criticisms are hypertechnical and unrealistic. Congress never intended to draw a distinction between the situation of a person who receives the proceeds of a life insurance policy under an option exercised by the decedent and the situation of a person who receives the same amounts under an option exercised by the beneficiary.

The foregoing suggestions as to clarifying the regulations are not made to detract from the prestige acquired by the Pension Trust Group in the Bureau of Internal Revenue. In administering the statute and regulations adopted in respect of pension and profit-sharing plans the group did an excellent job. Sympathetic and fair treatment was accorded employers and employees. However, the tools it worked with, a statute and regulations which are not quite adequate, increased its difficulties as well as the burden of industry. Perhaps clarification along the lines suggested in the foregoing paragraphs may ameliorate those difficulties somewhat. If, however, those suggestions are not acceptable there may still be some consolation to be found in the knowledge that the author and many others interested in the field are resting no more easily upon their pillows than those who are struggling with the problems in Washington.[34]

34. Treatment of amounts received or made available under pension or profit-sharing trusts for purposes of the income tax under state laws is complicated by the fact that many states have not yet conformed their rules to the federal rules. For example, in New York it is provided only that the distributee shall be taxed in the year in which distributions are "distributed or made available", and no further guidance is given in the regulations. N. Y. TAX LAW § 365 (5).