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Permissible and Impermissible Discrimination in Deferred Compensation & Pension Plans

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PERMISSIBLE AND IMPERMISSIBLE DISCRIMINATION IN DEFERRED COMPENSATION & PENSION PLANS

I. INTRODUCTION

The purpose of deferred compensation and pension plans is to provide employees and self-employed individuals with future funds for retirement income. Internal Revenue Code (IRC) section 401 establishes the requirements for the qualification of those trusts or plans which create a reserve fund to make future payments to employees and self-employed individuals.[1] If the trust or plan qualifies under section 401, the employer can deduct current cash contributions to the trust from gross income,[2] and the income subsequently earned by the trust will be exempt from taxation.[3] Alternatively, the employer may purchase annuities for its employees under a plan which meets the section 401 requirements and deduct the annuity premiums.[4]

Congress enacted the requirements of section 401 to preclude employers from creating plans which impermissibly discriminate in favor of executives or highly compensated employees and to prevent the use of the trust corpus or income for purposes other than the exclusive benefit of the employees.[5] This legislation has produced mixed results. Some areas of impermissible discrimination have been alleviated by the amendment of existing statutes or the creation of new statutes,[6] by judicial interpretation,[7] or by Internal Revenue Service (IRS) regula-

1. I.R.C. § 401.

2. I.R.C. § 404(a) provides in part:

> GENERAL RULE—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject . . . to . . . limitations.

3. I.R.C. § 501(a).

4. I.R.C. § 404(a). A discussion of the advantages and disadvantages of utilizing annuities in deferred compensation and pension plans is beyond the scope of this comment.

5. H.R. REP. No. 779, 93d Cong., 2d Sess. 1, 8 (1974), *reprinted in* 1974-3 C.B. 244, 251.

6. *E.g.*, I.R.C. § 414(b) (treating all employees of those corporations considered to be members of a controlled group of corporations as employed by a single employer).

7. *E.g.*, Forsythe Emergency Serv. v. Commissioner, 68 T.C. 881, 890 (1977) (plan is discriminatory unless it "operates for a fair cross section of all employees in general").

tions.[8] However, discrimination still exists in deferred compensation and pension plans. It is inherent in many of the statutes;[9] it is intentionally planned by many employers;[10] and it is cause for plan disqualification by the IRS, whether it occurs intentionally or inadvertently.[11] Only that discrimination deemed by the IRS to be "impermissible" disqualifies a plan from tax exemption. The purpose of this comment is to examine past and present permissible and impermissible discrimination in deferred compensation and pension plans, to examine the criteria used by the IRS to disqualify plans on the grounds of discrimination, and to apply the criteria to future planning techniques.

II. INCENTIVES

Formal pension plans have been in existence in the United States since 1875.[12] With the advent of the Social Security System in the 1920's, private pension plans as a retirement planning technique experienced their first widespread popularity.[13] However, the striking growth in their use has only occurred during the last few decades. Since the early 1950's, deferred compensation plans for employees have been one of the primary focuses of business planning because of their extremely favorable tax consequences.[14] More recently, the increasing cost of financing pension plans, strict reporting requirements,[15] and the

8. *E.g.*, Treas. Reg. § 1.401-4 (1978) (concerning discrimination as to contributions or benefits).

9. For example, a problem inherent in the integration of pension plans with Social Security benefits is the allocation among employers of reductions for Social Security benefits when using the offset method of integration. This method allows the employer to deduct his required Social Security contribution from his contribution to each employee's plan. However, when a worker has more than one employer, it is possible for one of the employers to use portions of the contributions made by other employers to provide himself with a larger Social Security offset against the worker's pension than he is entitled to. Pension reductions can thus exceed the amount of the Social Security benefit. This occurs because there is no adequate method of attributing the Social Security benefit received by an employee to a single employer. Testimony of Richard A. Kuzmack, President's Comm'n on Pension Policy (Oct. 10, 1979), *reprinted in* [1980] 5 PENS. PLAN. GUIDE (CCH) ¶ 25,308.

10. *See* text accompanying notes 54-75 *infra*.

11. *See* text accompanying notes 126-36 *infra*.

12. Historians generally agree that the first formal pension plan in the United States was established in 1875 by the American Express Company. *See* W. GREENOUGH & F. KING, PENSION PLANS AND PUBLIC POLICY 26 (1976).

13. Rachlin, *Effects of Social Security Changes and Carter's Proposed Integration Changes*, 4 J. PENS. PLAN. & COMPLIANCE 225 (1978).

14. *E.g.*, I.R.C. § 404 (contributions deductible by employer); I.R.C. §§ 402-403 (taxation on compensation deferred until receipt by beneficiary).

15. The burdensome filing requirements have even been extended to the state. Under I.R.C. § 6058(a), state agencies which are pension plan sponsors are required to file information returns. California v. Blumenthal, 457 F. Supp. 1309 (E.D. Cal. 1978).

ever present threat of plan disqualification by the IRS[16] have detracted from their desirability.

The tax incentives for funding a pension plan begin when a contribution is made by the employer to a qualified plan, and the employer receives a current deduction for the amount contributed.[17] The employee does not report the contribution as income until the funds are actually distributed to him.[18] Thus, for a highly compensated employee, a pension plan can lower his current effective tax rate.[19] Additionally, income earned through the investment of this fund is accumulated tax-free resulting in the fund accumulating much more rapidly.[20] In effect, the federal government has given the employee an interest-free loan by permitting the use of the "non-collected tax" to generate additional revenue. Finally, when the employee does retire, he will be taxed only on those disbursements actually made and usually at a lower rate.[21]

III. PRE-ERISA[22]

Discrimination by employers under deferred compensation and pension plans is not a new problem. Over the years, Congress has become increasingly aware of this problem and has attempted to abate it. In a message to Congress on June 1, 1937, President Roosevelt specifically addressed the need for legislative reform when he stated that the tax exemption allowed to employers "ha[d] been twisted into a means of tax avoidance by the creation of pension trust[s] which include[d] as

16. A pension plan will be disqualified by the IRS if it fails to meet *any* of the requirements for qualified plans. I.R.C. §§ 401-415. *See* text accompanying notes 126-36 *infra*.

17. I.R.C. § 404(a).

18. I.R.C. § 402 (taxability of beneficiary of employee's trust); I.R.C. § 403 (taxation of employee annuities).

19. Since 1976, a highly compensated employee has had less of an advantage when deferring compensation because I.R.C. § 1348 now limits a taxpayer's non-deferred compensation to a maximum marginal tax rate of 50% rather than the previous 70%. Effective for taxable years beginning after December 31, 1976, I.R.C. § 1348 applies to employee deductions from deferred compensation plans. H.R. REP. No. 1515, 94th Cong., 2d Sess. 428 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 1554.

20. I.R.C. § 501(a) provides an exemption from income taxation for organizations described in § 501(c) or (d) and § 401(a).

21. After retirement, an individual's income generally will be reduced to a fraction of his previous earnings. The tax rate on the distributions from the plan will, therefore, be substantially less than the tax the employee would have paid on that income in the year it was contributed or earned.

22. In 1974, the Employee Retirement Income Security Act was passed (hereinafter ERISA). "Pre-ERISA" denotes the period prior to 1974. *See* notes 47-50 *infra* and accompanying text.

beneficiaries only small groups of officers and directors or employees in the high income tax brackets."[23] In response, Congress adopted a two-fold approach to close the loopholes. Under former IRC section 401(a)(3), plans "qualified,"[24] and thus received tax advantages, if a specified percentage of the firm's employees were eligible and participated,[25] or if the Secretary of the Treasury or his delegate found that the eligibility requirements did not discriminate in favor of officers, shareholders, supervisors, or "highly compensated employees."[26]

In response to section 401, many different mechanisms were developed by employers to discriminate in favor of certain employees and against others. Some of the mechanisms used factors like salary,[27] age,[28] employee turnover,[29] or years of service[30] to discriminate in

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23. 81 CONG. REC. 5125 (1937) (President's Message to Congress).

24. A plan is deemed "qualified" if it meets the requirements of I.R.C. § 401. The fund, trust, or plan is then treated as an exempt organization; employer's contributions to it are deductible and its income is accumulated tax-free.

25. I.R.C. § 401(a) (1954) (current version at I.R.C. § 410(b) (1974)) provided:

> A trust . . . forming part of a . . . pension, or profit-sharing plan of an employer . . . shall constitute a qualified trust under this section—
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> . . . .
>
> (3) if the trust . . . benefits either—
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> (A) 70 percent or more of all employees or 80 percent or more of all employees who are eligible to benefit under the plan . . . .

26. I.R.C. § 401(a)(3)(B) (1954) (current version at I.R.C. § 410(b) (1974)) provided that a trust qualified if it benefited employees who "qualif[ied] under a classification set up by the employer and found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees or highly compensated employees."

The terms "highly compensated" and "lower compensated" are relative, and the distinction between them must be based upon the circumstances of each case. Rev. Rul. 56-497, 1956-2 C.B. 284, 286. "Highly compensated" is defined under ERISA in I.R.C. § 401(k)(4) to mean "any employee who is more highly compensated than two-thirds of all eligible employees."

27. Plans which compute benefits on the basis of wages are not discriminatory if they "bear a uniform relationship to the total compensation" of each employee. I.R.C. § 401(a)(5).

28. I.R.C. §§ 410(a)(1)(A),(3)(A) provide that a qualified plan cannot exclude an otherwise eligible employee who has attained a minimum age of twenty-five or completed a twelve-month period of not less than 1,000 hours of service, whichever occurs later. However, this one year of service requirement can be extended to three years, provided the employee is 100% vested upon entry into the plan. I.R.C. § 410(a)(1) (B)(i). Thus, an employer can fix its plan's eligibility requirements and vesting schedule on the basis of its workers' (youthful v. non-youthful) ages and rate of turnover, in order to minimize the number of employees covered or the amount of benefits that each eligible employee will receive.

I.R.C. § 410(a)(2) prohibits the exclusion of employees on the basis of age. However, it permits a plan with a normal retirement age of sixty-five to *exclude* employees who join the company within five years or less of retirement. Although this appears to be age discrimination, in Opinion Letters No. 304.1 and 404 of the Wage-Hour Administration (Feb. 9, 1970), the Administration specifically held that the exclusion of older employees from a bona fide favor of highly compensated employees.

Section 401(a)(5) states that a plan shall not be considered discriminatory "merely because it is limited to salaried or clerical employees," yet, some plans covering only salaried employees may be considered discriminatory.[31] In *Commissioner v. Pepsi-Cola Niagara Bottling Corp.*,[32] the plan covered only the salaried employees, and excluded the hourly employees. The Commissioner held that the plan impermissibly discriminated because the "more highly" compensated employees were being favored over other employees. On appeal, the Tax Court held that because the pay differential between the lowest paid individual in the covered group (salaried) and the highest paid individual in the non-covered group (hourly) was only $1,000 per year, the covered group could not rationally be regarded as " 'highly paid.' "[33] On subsequent appeal, the United States Court of Appeals, Second Circuit, reversed, stating that the plan impermissibly discriminated in favor of salaried employees and against hourly paid employees.[34] The court agreed with the Commissioner's interpretation of "highly compensated" as meaning "more highly compensated" and held that his interpretation was not an abuse of his powers.[35]

In another pre-ERISA case, *Ryan School Retirement Trust v. Commissioner*,[36] the Tax Court held that a pension plan which utilized the employee turn-over rate to provide the executives with proportionately more benefits was not impermissibly discriminatory.[37] Originally, only 8.4% of the corpus of the trust was credited to the five officers and

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benefit plan cannot violate the Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (1976), because the policy of that Act was to prohibit discrimination in *hiring*. Therefore, under I.R.C. § 410(a)(2), an employer may permissibly structure its workpool to include more elderly employees without having its plan disqualified for not including them.

29. *E.g.*, Ryan School Retirement Trust v. Commissioner, 24 T.C. 127 (1955) (disproportionate benefits favoring officers held nondiscriminatory when the result of unforeseen employee turnover).

30. *E.g.*, McMenamy v. Commissioner, 54 T.C. 1057 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971) (plan formula based on each employee's number of years of service to corporation was discriminatory where the formula was adopted to favor only sole shareholder-officer).

31. For a review of the basic problems of qualifying a salaried only plan, see Rev. Rul. 79-337, 1979-2 C.B. 189; Rev. Rul. 66-15, 1966-1 C.B. 83; Rev. Rul. 66-14, 1966-1 C.B. 75; Rev. Rul. 66-13, 1966-1 C.B. 73; Rev. Rul. 66-12, 1966-1 C.B. 72.

32. 399 F.2d 390 (2d Cir. 1968).

33. *Id.* at 392. The Second Circuit Court's opinion looks particularly suspect in light of the IRS's definition of "highly compensated" as a comparison of the covered versus the uncovered employees in Larsons, Inc. v. Commissioner, 69 T.C. 773, 782 (1978).

34. 399 F.2d at 393-94.

35. *Id.*

36. 24 T.C. 127 (1955).

37. *Id.* at 134.

91.6% was credited to the remaining 110 lower level employees. However, within seven years, the five officers' interest in the trust fund increased to 58%, while the remaining employees' interest decreased to 42%; the change in percentages was directly attributable to forfeitures.[38] The court held that the prohibited group, composed of management and key employees, had legitimately derived substantial benefits under the plan through forfeitures because the number of forfeitures was unforeseeable.[39] The court found that the plan operated to give permanent employees a preferred position over nonpermanent employees and that this was not the type of discrimination prohibited by the statute.[40] Therefore, as a general rule, when the purpose and effect of a plan's eligibility requirements are to avoid the immediate coverage of nonpermanent employees, the classification will not technically, according to the courts, be discriminatory.

In *McMenamy v. Commissioner*,[41] the Tax Court considered the validity of a pension profit-sharing plan in which employer contributions were allocated among the participants on a combined basis of compensation and years of service. By giving credit for all past service, the sole shareholder-officer was assured of receiving a much more favorable allocation than any other participant because he had accumulated the most years of service. However, the court held that the adoption of a contribution allocation formula known to favor a sole shareholder was discriminatory under section 401(a)(4).[42]

The most controversial scheme under the pre-ERISA code sections involved the use of affiliated corporations.[43] Under this scheme, the corporate head was dissected from the corporate body. Management and key employees were employed by one corporation which provided a very generous deferred compensation or pension plan. Rank and file members were employed by a separate service corporation, which provided little or no such plans. Business was then conducted pursuant to

38. A forfeiture is a loss of pension rights that occurs upon a voluntary or involuntary termination when the employee has failed to meet the minimum vesting requirements of the plan.

39. 24 T.C. at 134.

40. *Id. Accord*, Lansons, Inc. v. Commissioner, 69 T.C. 773, 784 (1978). *See also*, Scudere, *Tax Court's "Latest" Nondiscriminatory Classification Test—Balancing the Equities*, 4 J. PENS. PLAN. & COMPLIANCE 150, 153 (1978).

41. 54 T.C. 1057 (1970), *aff'd*, 442 F.2d 359 (8th Cir. 1971).

42. *Id.* at 1064. The taxpayer-sole shareholder should have known better than to be so greedy. Revenue Ruling 68-303 states that the IRS will assume that a self-employed individual is "highly compensated," thus making the taxpayer's plan inherently suspect. Rev. Rul. 68-303, 1968-1 C.B. 165.

43. *See, e.g.*, Kiddie v. Commissioner, 69 T.C. 1055, 1056 (1978).

a contract where the management corporation hired the service corporation. Although not all attempts to use multiple corporations managed to avoid being deemed discriminatory and therefore disqualified under the statute,[44] the IRS was deeply concerned with those that did. This concern caused the IRS to render opinions that unfairly combined or "attributed" employees of one business entity to another entity to determine whether a pension plan qualified.[45] More often than not, the dissimilarities in the attributed businesses would cause the plan to be disqualified.[46]

IV. Discrimination Under ERISA

In order to stop taxpayer evasion of the anti-discrimination provisions and to provide the taxpayer with an objective test for determining whether entities were affiliated, the Employee Retirement Income Security Act of 1974 (ERISA) was enacted.[47]

Congress trumpeted the introduction of ERISA as the mechanism that would eradicate the prior abuses of the anti-discrimination provisions in the pre-ERISA Internal Revenue Code sections:

> This legislation is concerned with improving the fairness and effectiveness of qualified retirement plans in their vital role of providing retirement income. In broad outline, the objective is to increase the number of individuals participating in employer-financed plans; to make sure to the greatest extent possible that those who do participate in such plans actually receive benefits and do not lose their benefits as a result of unduly restrictive forfeiture provisions or failure of the pension plan to accumulate and retain sufficient funds to meet its

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44. *See, e.g.*, Burnetta v. Commissioner, 68 T.C. 387 (1977). *Burnetta* involved a professional medical corporation that hired its shareholder-incorporators. Its office staff was obtained through a wholly independent corporation called Staff, Inc., to whom the professional corporation paid an amount equal to the aggregate salary of the office staff. The professional corporation also handled the daily supervision, bookkeeping and taxes relating to the staff, and instructed Staff, Inc. on all personnel changes. The Tax Court held that the pension plan established by the professional corporation discriminated against the office staff, whom the court found were the professional corporation's common law employees. *Id.* at 398.

45. *See, e.g.*, Rev. Rul. 68-370, 1968-2 C.B. 174 (employees were attributed by IRS for determining plan's qualified status to each partner of the joint venture even though employees never performed services for the individual partners).

46. *Id.*

47. 29 U.S.C. §§ 1001-1381 (1976). Unfortunately for the taxpayer, the loophole that Congress sought to close may not have really been a loophole. *See* text accompanying notes 130-36 *infra*; Lynch, *How the Festering Problems of Section 414 are Frustrating Reasonable Business Needs*, 4 J. PENS. PLAN. & COMPLIANCE 369 (1978).

> obligations; and to make the tax laws relating to qualified retirement plans fairer by providing greater equality of treatment under such plans for the different taxpayer groups concerned.[48]

The changes brought about by ERISA were many[49] and the effects immediate.[50] One major impact of the new changes was on affiliated and controlled entities, which were now required to comply with the "objective" discrimination test of section 410.[51] Section 410(b)'s objective test set forth the following minimum participation standards:

> ELIGIBILITY:
>
> (1) In general.—A trust shall not constitute a qualified trust under section 401(a) unless the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under section 401(a) which benefits either—
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> (A) 70 percent or more of all employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have not satisfied the minimum age and service requirements, if any, prescribed by the plan as a condition of participation, or
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> (B) such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated.[52]

While ERISA eliminated many of the abuses that had previously

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48. H.R. Rep. No. 779, 93d Cong., 2d Sess. 1, 48, *reprinted in* 1974-3 C.B. 244, 251.

49. One such change was that members of a collective bargaining unit (e.g. unions) were not to be considered by the IRS in calculating the statutory formula for determining discrimination in an employer's plan. I.R.C. § 410(b)(2)(A). Thus, if an employer had union and non-union employees, only the non-union employees would have to be covered under the corporation's plan.

50. During the first three years after the enactment of ERISA, over 470,000 pension plans covering 35 million employees and 1.1 million welfare plans covering an estimated 75 million employees were revised to meet ERISA requirements. Dunigan, *ERISA Misfire-The Small Employer*, 4 J. Pens. Plan. & Compliance 252, 252 (1978). Yet, many plans failed to meet these new requirements. "IRS Commissioner Jerome Kurtz recently testified before a congressional subcommittee that as many as 30% of the nation's 500,000 private pension plans may have gone out of business since ERISA was enacted." 124 Cong. Rec. S461-63 (daily ed. Jan. 25, 1978) (*Study of the Effects of ERISA on Private Pension Plans in Indiana* by Sen. Lugar of Indiana).

51. I.R.C. § 414(c); Treas. Reg. § 11.414(c)-2 (1975).

52. I.R.C. § 410(b)(1)'s objective test was previously codified in § 401(c)(3) (1954).

gone unchecked, it also allowed other abuses. While most employers amended their plans to comply with ERISA,[53] others quickly took advantage of the weaknesses in the new "objective" discrimination test.

In *Garland v. Commissioner*,[54] Doctors Garland and Dunn, as individuals, dissolved their partnership. Thereafter, Dr. Garland formed a professional corporation, in which he was the sole employee. A second partnership was then formed with 50 percent of the interest held by Dr. Dunn and 50 percent of the interest held by Dr. Garland's professional corporation. For a flat fee, the partnership maintained the office and equipment and provided the office staff. Initially, the pension plan adopted by the professional association included Dr. Garland and the employees of the partnership.[55] However, after the enactment of ERISA in 1974, the plan was amended to eliminate the partnership's employees.[56]

Garland requested a ruling on the plan's qualified status from the IRS. Although the plan was initially approved, the IRS subsequently disqualified it[57] for failure to include the partnership's employees as required by Revenue Ruling 68-370.[58] Revenue Ruling 68-370 basically sets forth the aggregation tests used by the IRS in determining when employees of a joint venture or partnership are to be included under a corporate-partner's pension plan. Garland appealed the IRS

53. *See* note 50 *supra*.

54. 73 T.C. 5 (1979).

55. The contributions made on behalf of the employees were based on the association's share of the total compensation paid to those employees. *Id.* at 7 n.2.

56. *Id.* at 7. The plan was amended to eliminate the partnership's employees in order to funnel all of the contributions and benefits to Dr. Garland.

57. *Id.* The Tax Court stated:

> [T]he National Office issued a ruling which stated that the association and the partnership were not under common control as defined in section 414(c) and the regulations thereunder. Consequently, the partnership employees were not to be considered the employees of the association in determining whether the association's plan met the coverage requirements of sections 401(a)(4) and 410(b)(1). However, on September 30, 1976, the National Office limited the scope of the ruling by stating that it was directed only at the specific issue of whether the plan ran afoul of sections 401(a)(4) and 410(b)(1) by virtue of section 414(c), and that it did not consider the effect of Revenue Ruling 68-370, 1968-2 C.B. 174.

Id. (footnote omitted).

58. 73 T.C. at 6-7. Rev. Rul. 68-370, 1968-2 C.B. 174, provides in part:

> The joint venture of the two corporations is a partnership within the meaning of sections 761(a) and 7707(a)(2) of the Code. A partnership is not itself a taxable entity for Federal income tax purposes but rather is merely the aggregate of the constituent partners. . . . Once the requisite employment relationship is established between the partnership and the individuals who are rendering services to the partnership, such relationship is also established between each corporate partner and the employees for purposes of sections 401 through 404 of the Code. . . . The sole effect of such conclusion is to attribute to each partner the employment relationship that exists between the partnership and the individuals.

ruling, contending that subsections 414(b) and (c), which were enacted after Revenue Ruling 68-370, provided the proper and *exclusive* aggregation tests.[59] Subsections 414(b) and (c) provide that employees of trades or businesses which are under "common control" shall be treated as employed by a single employer.[60]

The Tax Court held that Revenue Ruling 68-370 was inapplicable.[61] On the basis of a committee report showing clear legislative intent,[62] the court held that subsections 414(b) and (c) were the exclusive means for determining whether employees of related trades or businesses should be aggregated for purposes of applying the antidiscrimination provisions."[63] However, the court concluded that the plan at issue in *Garland* was not prohibited by those sections or their respective regulations[64] because: 1) there was no parent-subsidiary relationship because the association did not own 80% of the partnership;[65] 2) there was no brother-sister relationship because the association had only 50% ownership and therefore lacked "effective control;"[66] and 3) there was no "combined group" relationship because there were only two organizations involved rather than the statutorily required three or more.[67] As a result, Garland's borderline legitimate plan had run the IRS gauntlet and survived.

Garland and its pre-ERISA predecessor, *Kiddie v. Commissioner*,[68] exposed the different approaches taken by the IRS and the Tax Court concerning affiliated employers in pension planning. The IRS's position under the pre-ERISA statutes emphasized substance over form using the "fishy smell" test.[69] This test meant that regardless of the form,

59. 73 T.C. at 11.

60. The temporary regulations which define "common control" are modeled after the controlled group provisions in I.R.C. § 1563(a). *See* I.R.C. § 414(b); Treas. Reg. § 11.414(c)-2 (1975).

61. Garland v. Commissioner, 73 T.C. 5, 13 (1979). The Tax Court followed the same reasoning previously used in Thomas Kiddie, M.D., Inc. v. Commissioner, 69 T.C. 1055 (1978) (partnership employees not attributable to the two partners, which were professional corporations).

62. Garland, 73 T.C. at 12, (referring to H.R. REP. No. 807, 93d Cong., 2d Sess. 1 (1974), *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 4670).

63. Garland, 73 T.C. at 13.

64. Treas. Reg. § 11.414(c)-2 (1975).

65. 73 T.C. at 10-11; *see* Treas. Reg. § 11.414(c)-2(b) (1975).

66. *Id.*; *see* Treas. Reg. § 11.414(c)-2(c) (1975).

67. *Id.*; *see* Treas. Reg. § 11.414(c)-2(d) (1975).

68. 69 T.C. 1055 (1978) (under identical factual circumstances, court upheld use of multiple professional corporations, where each had a pension plan that covered only the incorporator and not the employees).

69. The substance over form doctrine provides that, for tax purposes, the substance or

plans were disqualified if something in them looked suspicious to the IRS.

In a break from tradition,[70] the Tax Court's position in this area was directly contrary to that of the IRS. The Tax Court, in *Garland*, strictly interpreted the statutes based on legislative intent, resulting in decisions favoring the taxpayers.[71]

To stop taxpayer avoidance of the qualified pension plan requirements through multiple entities, Congress responded with ERISA to close what it considered to be loopholes.[72] ERISA was also enacted to eliminate the vagueness and subjectivity of the IRS's "fishy smell" test by providing an objective test.[73] Despite this test, the IRS has continued to use the "fishy smell" test and to emphasize substance over

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reality of a transaction shall control over the form in which the transaction is cast by the taxpayer. *See* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

70. It is an unstated fact that the Tax Court typically follows the IRS's position.

71. 73 T.C. at 12-13.

> It is apparent from the committee report [H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 1] that Congress was aware that prior to the enactment of ERISA it was possible to circumvent the antidiscrimination provisions through the use of related business entities. To safeguard against this possibility, Congress enacted legislation which establishes a straightforward, objective test for determining whether the employees of affiliated entities should be treated as employed by a single employer. Under this test, the employees will be so treated if the business entities are found to be under common control as defined in regulations based on controlled group principles. In light of this direct congressional response to the employee attribution problem and the express statement of intent to clarify this matter for the future . . . we see no reason to [add the more stringent tests proposed by the Commissioner to the already existing provisions of § 414(c)].

Id. at 13. *See* Scudere, *Will the IRS Acquiesce to* Kiddie *and* Garland, 6 J. Pens. Plan. & Compliance 66, 66 (1980).

72. Before ERISA, though one corporation was related via ownership to another corporation, neither corporation was prohibited from adopting a separate pension or profit-sharing plan for its own employees. Congress viewed this as a "loophole" because one plan could be highly favorable to key employees and the other only marginally favorable to rank and file employees. Unfortunately, this "loophole" was not totally a loophole. The bi-plan system was needed when the ownership of two entities was similar, but the businesses dissimilar. For example, a doctor who has professionally incorporated himself and who also owns a fast-food franchise would not normally be expected to include the fast-food employees, who have a plan, in his professional corporation's plan. However, under section 414 and its regulations, that same fast-food franchise's plan would be combined with the professional corporation's plan by the IRS for determining overall plan qualification. Because the plans would obviously be different, by aggregating them, they would both be disqualified as discriminatory. Thus, by closing the "loophole," Congress has succeeded in aggregating and disqualifying the pension plans of businesses which deal in unrelated areas. *See* Lynch, *How the Festering Problems of Section 414 are Frustrating Reasonable Business Needs*, 4 J. PENS. PLAN. & COMPLIANCE 369, 370-71 (1978).

73. The objective test is contained in I.R.C. § 410(b) which states that a plan must cover 70% or more of all employees or 80% or more of the eligible employees if at least 70% are eligible. *See* text accompanying note 52 *supra*.

form.[74]

A. Impermissible Discrimination Under ERISA

Under ERISA and other related tax sections, qualified pension plans will still be disqualified if found to be discriminatory in contributions or benefits.

Although not argued by the Commission in *Garland*, the IRS certainly could argue that if an individual is considered an employee under the relevant sections of the Employment Tax Regulations,[75] then that individual should be considered an employee under pension plans. The Employment Tax Regulations provide that an employment relationship exists when the person for whom the services are performed has a right to control and direct the manner, efforts, and results of the individual performing the services.[76] Although this would not have changed the result in *Garland*, due to the presumably exclusive test for affiliated corporations under section 414(b) and (c), the Employment Tax Regulations do lend credibility to the Commissioner's substance over form argument, which the Tax Court may someday accept.

Another form of discrimination that has been deemed impermissible in pension plans consists of formulas which determine contributions on the combined basis of compensation and years of service, where it is blatantly obvious that the key employees, shareholders, or highly paid individuals will benefit unfairly.[77]

Some stock bonus plans have also been held to be impermissibly discriminatory. In *Friedman and Jobusch, Architects & Engineers v. Commissioner*,[78] the Tax Court[79] and the Ninth Circuit Court of Appeals[80] found that the corporation's stock bonus plan was discriminatory in form under IRS sections 401(a)(4)(A),(B) and (C), because of the independent restrictions on stock transfers which favored the principal shareholder-officers. The articles of incorporation and the stock

74. *E.g.*, Garland v. Commissioner, 73 T.C. 5 (1979).

75. Treas. Reg. §§ 31.3121, 31.3306, 31.3401 (1975).

76. For purposes of federal employment taxes, the usual common law rules ordinarily apply in determining whether the employer-employee relationship exists, and if so, who the employer is. The regulations identify employers as persons who employ employees, Treas. Reg. §§ 31.3121(d)-2, 31.3306(a)-1 (1975), and as any person for whom services are performed as an employee, Treas. Reg. § 31.3401(d)-1 (1975). Rev. Rul. 75-41, 1975-1 C.B. 323.

77. Bernard McMenamy Contractor, Inc. v. Commissioner, 442 F.2d 359 (8th Cir. 1971) (plan disqualified where combined years of service and compensation formula resulted in officers and shareholders receiving benefits in excess of pay differential).

78. 627 F.2d 175 (9th Cir. 1980).

79. 68 T.C. 929, 940 (1977).

80. 627 F.2d at 177.

certificates gave the corporation the option of purchasing at "book value" the stock of any employee transferring shares or terminating employment. However, under a separate stock purchase agreement, the corporation was required to repurchase the shares of the *principal shareholders-officers* upon their death at an "adjusted book value." "Adjusted book value, unlike book value, included goodwill in the computation of the corporation's assets."[81] This difference in the repurchase provisions, according to the Ninth Circuit Court of Appeals, was sufficient to cause the entire plan to be considered impermissibly discriminatory, resulting in disqualification.[82]

Probably the strangest case in which impermissible discrimination was found was *Olmo v. Commissioner*.[83] In *Olmo*, the corporation's principal business was dentistry. Dr. Rubach was the president and Dr. Olmo was the vice-president. Both were 50% shareholders and employees of the corporation. The corporation maintained two plans, a money purchase pension plan and a profit sharing plan. The plans required that an employee, in order to participate, be both twenty-two and one-half years old and have at least nine months of service. One of the company's four employees failed to qualify due to the age requirement. The other three were fully eligible to participate, but one voluntarily waived participation. This resulted in only two members, Dr. Olmo and Dr. Rubach, being covered by the plan.

The Tax Court agreed with the IRS that the plans were discriminatory, stating:

> The unexplained failure to include anyone except members of the prohibited group as participants in the plans when there are two other full-time employees who could have been covered is inconsistent with the Congressional purpose underlying the qualification of deferred compensation plans of providing for the general welfare of employees.[84]

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81. *Id.*

82. *Id.* The reason for the difference in the two provisions is obvious. The two principal incorporator-members probably owned sufficient stock to control their respective firms and desired their families to receive the premium which market investors would be willing to pay over book value for "control." Additionally, because the "goodwill" or inherent value of the ongoing enterprise was directly due to their efforts and the risks taken to create the enterprise, they probably felt that being paid for the goodwill in the corporation was just. Because the employees did not take the risks, put forth the effort, nor have the "control" that would merit a premium, their stock was only worth book value. In spite of the realities, the Ninth Circuit Court of Appeals and the Tax Court held that these differences in the repurchase provisions were discriminatory and disqualified the whole plan.

83. 38 T.C.M. (CCH) 1112 (1979).

84. *Id.* at 1117.

Thus, the plans were found to be discriminatory not because the two principal shareholder-employees had intentionally favored themselves, but because the only truly eligible employee voluntarily opted not to participate.[85] The court noted that while the dentists did not control the individual's act of waiving participation, they did "control the forms of the plans," and could foresee that they would be the only ones covered.[86] To be non-discriminatory, the plans would have had to have required mandatory participation. The irony of this case is that the Tax Court was aware that even if the employee had not waived her right to participate, she would *not* have received any benefits under the plan as a participant because when she finally terminated she was zero-vested.[87]

Olmo involved a taxable year subject to the pre-ERISA rules. ERISA introduced the concept of Individual Retirement Arrangements (IRAs)[88] which allows the employee to establish his or her own private retirement plan. Commenting on the possible use of IRAs, the Tax Court in *Olmo* stated:

> Under ERISA, . . . an employee who is an "active participant" in a qualified plan may not contribute to an individual retirement arrangement. Sec[tion] 219(b)(2). Waivers of participation by potential participants who prefer individual retirement arrangements to plan coverage may under ERISA be more convincingly tied to the interests of the employee rather than was [the employee's] waiver here. We do not intend to suggest that a waiver of participation for such bona fide purposes will, under ERISA, tend to make an otherwise qualifying plan discriminatory.[89]

However, in a recent case subject to ERISA,[90] the Tax Court and the IRS held that a corporation's plan was impermissibly discriminatory when two of the three eligible employees voluntarily waived participation in the plan to establish their own IRAs.

B. Permissible Discrimination Under ERISA

The Social Security System has always been highly discriminatory

85. *Id.* at 1118.
86. *Id.*
87. *Id.* at 1117. Zero-vested refers to the fact that at termination, the employee is not entitled to any benefits due to the employee's failure to meet the plan's eligibility requirements.
88. I.R.C. § 219(b)(2).
89. 38 T.C.M. at 1117 n.7.
90. Calcedo Construction Corp. v. Commissioner, No. 80-2250 (T.C., filed June 5, 1980).

in favor of the lower-paid employees.[91] However, Social Security benefits have never been sufficient even for the rank and file, thus necessitating the need for a tax-subsidized private pension system. To encourage the private business sector to adopt pension plans, certain methods of permissible discrimination have been devised by Congress, which allow an employer to disproportionately favor key employees and executives. One such method is integration.

Integration is a concept whereby the present Social Security System allocation is combined with the individual employer's plan. The concept was introduced in 1942 by Congress and has evolved through regulations and rulings by the Treasury Department for the express purpose of discriminating *in favor* of key employees, to offset the disproportionately small rewards received by them under the Social Security System.[92] Under integration, a plan is not discriminatory if: (1) it excludes employees earning less than the Social Security *wage base*; (2) it is limited to salaried or clerical employees; (3) it relates benefits or contributions strictly to compensation levels; or (4) it provides for different levels of benefits or contributions above and below the wage base.[93] Thus, the net effect of integration is to allow a larger percentage of contributions or benefits to be received by highly compensated employees than would otherwise be possible under a qualified retirement plan.

A simple example can be used to illustrate the basic theory of integration and its value in tax planning.[94] Assume that a profit-sharing

91. The reason why the Social Security percentages are so skewed in favor of the lower income earners is that the system is aimed at providing only one basic level of retirement income for all strata of workers. This results in lower income workers receiving a higher percentage of their annual compensation in retirement benefits, and higher income workers receiving a smaller percentage.

92. Rachlin, *Effects of Social Security Changes and Carter's Proposed Integration Changes*, 4 J. PENS. PLAN. & COMPLIANCE 225, 226 (1978).

93. Boynton & Mahoney, *Statement of American Academy of Actuaries*, 4 J. PENS. PLAN. & COMPLIANCE 298, 300 (1978).

94. Definitions for the terms used in the example are:

Taxable Wage Base: the maximum amount of earnings during a year which may be considered wages for that year under I.R.C. § 3121(a)(1). For example, the taxable wage base for 1980 was $25,900.

Covered Compensation: that portion of an individual's annual compensation to which old age and survivor's insurance benefits will be provided under the Social Security Act when an individual's total annual compensation is at least equal to the taxable wage base for that year.

Integration Level: an employer-designated level of compensation, above which additional benefits or contributions are made by the employer. Each employee's compensation in excess of the level is used in the computation, with each employee receiving benefits or contributions in proportion to their excess. Below the integration level, the only benefits and plan has an integration level of $9,000 and employer contributions allocated to the plan are credited first to the accounts of those employees who earn over $9,000, up to a maximum of 7% of that portion of their compensation over this amount. The plan has three employees—A, B and C—who annually earn $50,000, $10,000 and $6,000, respectively. Their total annual compensation is $66,000.[95] Using a 10% contribution factor, $6,600 is the total sum contributed by the employer each year. This amount will be allocated to the participants' accounts in two steps:

(1) the amount of each employee's compensation over the integration level of $9,000 is determined. Only A and B earn more than $9,000. After subtracting $9,000 from each of their salaries and combining the differences the total excess amount of compensation A and B earn is $42,000.[96] Seven percent of $42,000 is $2,940 of which $2,870 will be allocated to A's account and $70 will be allocated to B's account.[97]

(2) the total amount allocated under Step 1, $2,940, is subtracted from the total employer contribution, $6,600, in order to determine the amount to be allocated to all participants. The difference, $3,660, will then be allocated among all the participants in proportion to the total compensation earned.

Amount of Individual Employees' Compensation	Each Employee's Percentage of All Compensation Earned	Step 1 Allocation	Step 2 Allocation[98]	Total Allocation to Each Employee	Percent Allocated
A. $50,000	75.75%	$2,870	$2,773	$5,643	85.50%
B. $10,000	15.16%	$ 70	$ 554	$ 624	9.45%
C. $ 6,000	9.09%	$ 0	$ 333	$ 333	5.05%
$66,000	100.00%	$2,940	$3,660	$6,600	100.00%

Had the plan not been integrated, the "Percent Allocated" would have equalled "Each Employee's Percentage of All Compensation Earned,"

contributions that employees receive are determined by Social Security. For example, a defined contribution plan is integrated at the $9,000 level when it provides additional employer contributions for employees only as to that part of their compensation in excess of $9,000 annually. Similarly, a defined benefit plan is integrated at the $5,000 level when it provides a certain benefit level for all employees, but reduces that benefit level by a certain percentage for "covered compensation" which is less than $5,000.

95. $50,000 + $10,000 + $6,000 = $66,000.

96. $50,000 - $9,000 = $41,000 and $10,000 - $9,000 = $1,000; $41,000 + $1,000 = $42,000.

97. The figures for A and B reflect their proportionate excess amounts: 41/42 for A and 1/42 for B.

98. The Step 2 figures reflect the employer's contribution to each employee based on each employee's total earned compensation.

and A, B and C would each have received benefits in proportion to their compensation. When the corresponding Social Security benefits are added in (39% for A, 75% for B, and 86% for C), the need to use integration as an offset mechanism is demonstrated.[99] Thus, if there is no integration and independent distributions are made from the private pension plan and Social Security, the more highly compensated employees will receive substantially less than if the plan is integrated.

Integration thus provides the employer with a legitimate means of discriminating in favor of highly compensated employees as long as the required Social Security contributions for all employees are made. As a general rule of planning to achieve maximum discrimination in favor of those employees with higher compensation, the integration level should just exceed the compensation of the employees against whom discrimination is desired.[100]

Beyond integration, there are other subtle forms of discrimination. For example, the courts have held that discrimination against non-permanent employees is permissible.[101] Thus, the allocation of forfeiture, which are losses in pension rights which occur when employees terminate their employment prior to meeting the minimum vesting requirements of the plan, is a permissible discriminatory source. Forfeitures allocated in proportion to the pension plan account balance of only the *vested* employees tend to discriminate in favor of officers, shareholder-employees and other key employees. These employees tend to have a lower rate of job turnover which naturally results in their having much larger accumulated pension plan account balances than rank and file employees.

Vesting provisions[102] provide another means of permissible discrimination. ERISA requires a pension plan sponsor to select one of three vesting provisions to satisfy the minimum vesting requirements.[103] The first provides for full vesting after ten years of service.[104] The second, involving gradual vesting, provides for twenty-five percent vesting after five years of service, increasing five percent per year for

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99. Boynton & Mahoney, *Statement of American Academy of Actuaries*, 4 J. PENS. PLAN. & COMPLIANCE 299, 317 (1978).

100. M. CANAN, QUALIFIED RETIREMENT PLANS, § 10.3 at 270 (1977).

101. Ryan School Retirement Trust v. Commissioner, 24 T.C. 127 (1955). *See* text accompanying notes 36-40, *supra*.

102. "Vested" refers to an employee's fixed right to enjoy specific property after satisfying the eligibility requirements of a plan, *e.g.*, retirement benefits, upon that person's termination from employment.

103. I.R.C. §§ 411(a)(2)(A)-411(a)(2)(C).

104. I.R.C. § 411(a)(2)(A).

the next five years and ten percent per year for the following five years.[105] The third ERISA vesting standard is known as the "rule of 45."[106] This rule provides for fifty percent vesting after either ten years of service or when the combination of years of service (minimum of five years) and the employee's age totals forty-five, whichever occurs first. Thereafter, the employee's vested interest increases ten percent per year for the next five years.

Depending upon a business' rate of employee termination, the real differences inherent in each of the three standards become an important vehicle for permissible discrimination.[107] For instance, if the support staff tends to be less than forty-five years old and tends to leave within five years or less, then they will be less likely to vest because their totals do not each equal or exceed 45. Thus, the rule of 45 can be an important planning device for the employer.

A method which is not primarily used for discrimination, but which is increasingly being utilized to provide highly compensated employees with increased benefits, is the combined use of defined contribution plans,[108] such as money purchase or profit sharing plans, with defined benefit plans.[109] Under the IRC, if a corporation has both a profit sharing plan and a money purchase or defined benefit pension plan, the maximum deduction for corporate income taxes is 25% of the aggregate compensation of all plan participants.[110] However, this limitation does *not* apply if the corporation maintains a defined contribution plan and a defined benefit pension plan, without including the profit sharing plan. The tax incentive gained by removing the 25% deduction limit is obvious. By combining a defined contribution plan with a defined benefit plan, the only limit that the employer is subject to is the "1.4 Rule."[111]

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105. I.R.C. § 411(a)(2)(B).

106. I.R.C. § 411(a)(2)(C).

107. For a discussion of the differences, *see* Sahin & Balcer, *ERISA Vesting Standards—Is There a Choice?*, 6 J. PENS. PLAN. & COMPLIANCE 309 (1980).

108. Defined contribution plans have the common characteristic of predetermined (or discretionary) formulas geared to contributions, rather than to retirement benefits. The money purchase pension plan and the profit sharing plan are the most common types of defined contribution plans. Money purchase pension plans contain fixed contribution formulas (e.g., 10% of the participant's compensation) and obligate the corporation to make annual contributions regardless of profits. On the other hand, corporate contributions to profit sharing plans do not obligate the corporation to make contributions each year; contributions need only be made when there are current or accumulated profits.

109. Defined benefit plans are geared to provide the beneficiary with a fixed retirement benefit, regardless of the amount of contributions that are needed to achieve that benefit.

110. I.R.C. § 404(a)(7).

111. I.R.C. § 415(e)(1) provides:

For example, suppose that a doctor incorporates himself in 1975 and receives $150,000 annual compensation. By 1977, his business is well established, so he begins a money purchase pension plan to shelter some of his income. In that first year of the corporation's money purchase pension plan, the maximum annual addition for 1977, $28,175, was made. In 1978, the maximum annual addition for that year, $30,050, is also made. For purposes of utilizing the "1.4 Rule," the defined contribution fraction would be computed as follows:

Year	Actual Contribution	Maximum Contribution
1975........	$ 0	$ 25,000
1976........	0	26,825
1977........	28,175	28,175
1978........	30,050	30,050
Total	$ 58,225	$ 110,050

The defined contribution plan fraction of .529 is calculated by dividing $58,225 by $110,050. Although it appears that the fraction should be 1.0, because the corporation did make the maximum contributions for the doctor to the money purchase plan for the two years that it was in existence, the fraction is actually .529 because *all years of service* to the corporation are counted, regardless of when the plan started.

Because the defined contribution plan fraction is only .529, the maximum defined benefit plan fraction will be .871 (1.4–.529). Therefore, in 1978, the corporation could institute a defined benefit plan and provide Dr. Smith with a projected annual retirement benefit of $78,520 (.871 x $90,150), using the highest limits allowed in 1978.[112] This defined benefit of $78,520 is, of course, in *addition* to the defined contribution plan's projected benefits. The combination of these two

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> In any case in which an individual is a participant in both a defined benefit plan and a defined contribution plan maintained by the same employer, the sum of the defined benefit plan fraction and the defined contribution plan fraction for any year may not exceed 1.4.

Id. See also Krass & Keschner, *How to Get the Most Effective Use Out of the "1.4 Rule"*, 4 J. PENS. PLAN. & COMPLIANCE 473 (1978).

112. This result would be reached as follows: In 1978, the maximum limitation on the annual retirement benefit that a participant could derive from a defined benefit plan was the lesser of 100% of earned compensation or $90,150. The cost to fund this benefit would vary from participant to participant because contributions under a defined benefit pension plan depend upon a person's age and the reasonable actuarial assumptions, such as interest and mortality rates, utilized by an actuary to calculate the cost. Whatever the amount of the contribution, it will be deductible by the corporation, as will the amount contributed on behalf of any participant's money purchase plan.

types of plans and their respective benefits vividly demonstrates the higher total benefits that can be obtained through the use of the "1.4 Rule." Obviously then, this method can be used to permissibly discriminate in favor of incorporators, key employees and others whose years of service prior to the defined contribution plan's installation will allow them to have a lower defined contribution plan fraction and a correspondingly higher level of defined plan benefits.

Combining a non-qualified plan[113] with a qualified plan provides another method for permissible discrimination.[114] Under ERISA, benefits from a qualified defined benefit plan may not exceed 100% of a participant's average highest compensation over a continuous three year period or $110,625, whichever is lower.[115] A non-qualified deferred compensation plan can provide the desired additional retirement income in excess of the limitations on qualified plans in order to make up for the inadequacies of a broad-based qualified retirement plan.

Under a non-qualified plan, the employee-beneficiary will normally incur current tax liability[116] under the tax doctrines of constructive receipt[117] or economic benefit.[118] However, in Revenue Ruling 60-31, the IRS stated that deferred compensation is *not* taxable to the employee-beneficiary before actual receipt occurs, whether it is forfeitable or non-forfeitable, provided: (1) the deferral is agreed to between the employer and employee before the compensation is earned, (2) the deferred amount is not unconditionally placed in trust or escrow for the benefit of the employee, and (3) the promise to pay the deferred compensation is merely a contractual obligation not evidenced by notes or secured in any other manner.[119] Thus, if the employee is the contractual beneficiary, he/she is considered to have received a current "eco-

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113. A non-qualified plan is a plan which does not receive the benefits of I.R.C. §§ 401-415. As such, the employer cannot take advantage of current tax deductions for its advance funding of the obligations and those contributions made to the employee's account will be immediately taxed to the employee under the doctrines of constructive receipt or economic benefit. *See* text accompanying notes 117-18 *infra*.

114. *See* Emering, *"Top Hat" Pension Plans*, 6 J. PENS. PLAN. & COMPLIANCE 165 (1980).

115. $110,625 was the maximum limit for defined benefit plans in 1980. I.R.C. § 415(b)(1).

116. Treas. Regs. §§ 1.451-1(a) (1978), 1.446-1(c)(1)(i) (1973).

117. The doctrine of constructive receipt states that if a taxpayer could receive the income at any time but elects to receive it later, he will still be taxed currently because he has a non-forfeitable right to the income. Rev. Rul. 60-31, 1960-1 C.B. 174.

118. The doctrine of economic benefit states that if a taxpayer is receiving a current benefit he should be currently taxed on the value of that benefit. This concept embodies the principles of "payment in kind" or "cash equivalent," where the benefit taxed is a non-cash benefit. Rev. Rul. 60-31 1960-1 C.B. 174.

119. Rev. Rul. 60-31, 1960-1 C.B. 174.

nomic benefit" and will incur current tax liability on the amount expended or placed in trust. If, however, the employer is both the policyholder and the beneficiary, the income is not currently taxable to the employee. Deferred compensation occurs because there is no guarantee that the proceeds from these contracts will indeed be used to pay the deferred compensation as it becomes due.

The combination of the progressive income tax system and a rising inflation rate have posed a serious problem in providing executives with an adequate income during their working years. Due to the highly competitive job market and an extremely mobile employee work force, the task of attracting and retaining competent executives has become a cumbersome one. A non-qualified deferred compensation plan[120] can provide the desired additional retirement income in excess of the limitations on qualified plans in order to make up for the inadequacies of a broad based qualified retirement plan. Thus, an Executive Pension Plan (EPP) can provide an attractive part of an executive's total benefit package, giving employers who offer such a plan a competitive edge over those who do not.

The existence of EPP programs has been given explicit recognition under ERISA;[121] however, EPPs are not qualified tax programs.[122] Thus, advance funding of EPP obligations will not result in current tax deductions and may subject the plan to a number of ERISA's reporting and disclosure requirements which would not otherwise apply.[123] The major advantage is that because EPPs do not qualify for any special income tax considerations, coverage can be on a fully discriminatory basis. Thus, EPP programs can be used to: 1) provide retirement benefits in excess of current ERISA limits, 2) overcome the deficiencies of the new corporation's broad based qualified plan, and 3) provide for uniform treatment of the special retirement needs of senior executives, including early retirement problems.

For example, a company president receiving $60,000 annual income wishes to retire at 60. Under the corporation's defined benefit

120. In a non-qualified deferred compensation plan, the funds for the payment of benefits must be set aside and invested prior to the retirement of the employee, and the employer must be unable to use them in the ordinary course of its business. The trust instrument must make it impossible for any such funds to be diverted for the employer's use at any time prior to the satisfaction of all liabilities to the employees and their beneficiaries. I.R.C. § 401(a)(2); Treas. Reg. § 1.401-2 (1964).

121. I.R.C. § 402(b).

122. Because EPPs are highly discriminatory, they do not meet the requirements of I.R.C. §§ 401-415, which define qualified plans.

123. I.R.C. § 6058(a).

plan, he is entitled to an annual accrued pension of $30,000 at age 65. The plan's actuarial reduction feature, triggered by early retirement, produces an actual benefit of only $20,000 per year at age 60. Without EPP, the president would be limited to $20,000. With EPP, he may receive supplemental benefits totaling the desired level of retirement income equal, for example, to 75% of his final compensation or $45,000.[124] Thus, EPPs are aimed at providing higher retirement income to key executives of an employer.

V. Abuse of Discretion in Administration of ERISA

While some plans are rightfully disqualified as being too discriminatory, the IRS, in its oversight function as the regulator of pension plans, abuses its discretion by indiscriminantly disqualifying plans which at any time fail to meet the legislative requirements of IRC sections 401 through 415. Employers who make innocent mistakes are as subject to harsh treatment by the IRS as are the most blatant offenders.[125] Effect is the only criteria and intent is never considered.[126]

This problem occurs because a "legislature seeking to catch a particular abuse may find it necessary to cast a wider net,"[127] thus causing overbroad legislation. When this sweeping legislation is combined with the IRS's frustration in attempting to catch employers who intentionally create discriminatory plans, as in *Garland*,[128] there is an adminis-

124. 75% x $60,000 = $45,000. The executive will not qualify for Social Security benefits until age 62, at which time he will be entitled to 80% of the $6,000 benefit payable at age 65 or $4,800. The EPP will provide an income of $25,000 for the first two years which will then be reduced to $20,200 per year thereafter.

Source	Amount
Defined Benefit Plan	$20,000
100% of Social Security Payable at age 62	4,800
EPP Benefit	20,200
Total	$45,000

125. Scudere, *Small Plans: No Place to Make an Innocent Mistake*, 4 J. Pens. Plan. & Compliance 231 (1978).

126. *E.g.*, Ludden v. Commissioner, 68 T.C. 826 (1977), *aff'd*, 620 F.2d 700 (9th Cir. 1980). The Tax Court held that:

> There is no provision in the Internal Revenue Code governing the retroactive correction of errors in the administration of employee plans. We therefore have no statutory criteria for determining under what circumstances, if any, respondent [Commissioner] might be considered to have abused his discretion in refusing to deem a plan qualified if a retroactive correction of an inadvertent error in its operation were made.

Id. at 834 (footnote omitted).

127. Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d 390, 392 (2d Cir. 1968).

128. *See* text accompanying notes 59-66 *supra*.

trative backlash which tends to be severe and often unfair.

In an effort to control the use of multiple corporations to avoid the anti-discrimination provisions, IRC section 414 was passed.[129] Unfortunately this legislation is overbroad. As a result, privately owned, unrelated businesses are attributed to one controlling group of owners which causes the aggregation of all pension plans and triggers the requirement that all employees of all the businesses be treated equally under the plans.[130] Consider, for example, a doctor, who is the sole shareholder of a professional corporation which has a pension and profit sharing plan for all of his corporate employees. He then buys a fast-food franchise but does not institute a pension plan for that business. Undoubtedly these are two different types of business; yet, section 414(b) utilizes the definition of a brother-sister control group contained in IRC section 1563(a)(2), causing the two corporations to be linked for pension plan purposes. The professional corporation's pension plan would then be considered discriminatory because the lowest paid medical employee covered by the plan would probably be more highly paid than the highest paid franchise employee not covered by the plan. Therefore, the professional corporation's plan would not operate for a "fair cross section"[131] of all employees of both corporations because the franchise employees would not be covered, and thus the plan would be deemed discriminatory and disqualified. Accordingly, section 414 which was enacted by Congress to stem the ongoing intentional abuses of the anti-discrimination provisions by employers is now its own source for the abuse of others.

Considering the complexity of pension plans, innocent mistakes by employers, as in the example above, are unavoidable. Yet, when Congress authorized employers to make retroactive corrections for defects under section 401(b), these corrections were limited to defects which appear "on the face of the plan."[132] Unintentional operational mistakes which make a plan discriminatory were not covered. Thus, where a plan is "facially" correct, but an employer has unintentionally

129. H.R. REP. No. 779, 93d Cong., 2d Sess. 1, 8 (1974), *reprinted in* 1974-3 C.B. 244, 251.

130. Treas. Reg. § 11.414(c)-2 (1975).

131. *E.g.*, Forsyth Emergency Serv. v. Commissioner, 68 T.C. 881, 890 (1977) (retroactive amendment to include more employees and escape disqualification held to be untimely and not permissible even though amended prior to final IRS determination of plan's status); Orthopaedic Assocs. v. United States, 487 F. Supp. 868 (E.D. Tenn. 1980) (improper operation of pension plan cannot be cured retroactively by funding contributions to eligible employees previously excluded).

132. I.R.C. § 401(b).

omitted an employee, the IRS disqualifies the plan.[133] Even when the employer has offered to correct the mistake retroactively, the IRS has rejected the offer.[134] The result has been equally as harsh for employers who have voluntarily amended their plans before the mistake was discovered by the IRS.[135] Considering the effect that disqualification of a pension plan has on all members of that plan, *i.e.*, immediate taxation, this steadfast rejection of all substantive retroactive corrections truly does not fulfill the "humanitarian" needs and goals espoused by Congress in creating pension plans. To alleviate this abuse, operational mistakes should be treated in the same manner as mistakes which appear "on the face" of the plan, unless an intent to discriminate is found.

VI. NEW ERISA LEGISLATION

On December 28, 1980, Congress passed a bill[136] which undoubtedly will have a profound impact in the area of pension plan planning. The House Ways and Means Committee Report expressly stated that the bill was aimed at stopping the use of multiple entities which avoided the anti-discrimination requirements.[137] These requirements were designed to benefit rank-and-file employees. *Garland* was cited by the committee as epitomizing this type of abuse.[138]

Simply stated, this new provision requires that all employees who are members of an affiliated service group be treated as employed by a single employer when determining whether the employer's plan is discriminatory. More specifically, an adjunct service (staff) corporation[139] will be treated as related[140] to a specified service (executive) organiza-

133. Ludden v. Commissioner, 68 T.C. 826 (1977), *aff'd*, 620 F.2d 700 (9th Cir. 1980); Myron v. United States, 550 F.2d 1145 (9th Cir. 1977).

134. Ludden v. Commissioner, 68 T.C. at 829.

135. Orthopaedic Assocs. v. United States, 487 F. Supp. 868 (E.D. Tenn. 1980) (plan retroactively amended by corporation prior to IRS disqualification).

136. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 201, 94 Stat. 3526-27 (1980) (to be codified in I.R.C. § 414(m)).

137. H.R. REP. No. 1278, 96th Cong., 2d Sess. 35 (1980); S. REP. No. 1036, 96th Cong., 2d Sess. 32 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 11,609.

138. *Id.*

139. *Id.* An employer is an adjunct service or staff organization if a significant portion of its business consists of performing services for a specified service or executive organization and if the services provided by the staff organization are historically the kind performed by employees of that type of executive organization.

140. *Id.* For purposes of determining whether the employee benefit requirements (I.R.C. §§ 401(a)(3),(4),(7),(16), 410, 411, 415) are being satisfied in a non-discriminatory manner, all employees of employers who are members of an affiliated service group are treated as if they are employed by a single employer.

tion[141] if (1) the executive organization regularly uses the services of the staff organization or is regularly associated with it in performing services for third persons, and (2) ten percent or more of the interests in the staff organization is owned by persons who are officers, highly compensated employees or owners of the executive organization.[142]

This new provision effectively ends all types of *Garland* plans. No longer will a partnership owned by two professionally incorporated doctors, each owning 50%, qualify. The new test mandates that the staff organization's employees be attributed to any corporation which uses its services and has a 10% ownership interest in it either by direct ownership or through indirect stockholder or key employee ownership. Under the *Garland* type scheme, each executive corporation's 50% interest in the staff corporation will cause the entities to be attributed, which will cause each of the executive corporations' plans to be found discriminatory and disqualified.

The above result is exactly what the IRS and Congress desired in enacting IRC section 414(m).[143] Unfortunately, this provision does more than remedy abuses. Now, any organization which performs a "significant"[144] amount of services for another organization will be attributed if the second organization directly or indirectly owns 10% or more of the first. For example, consider the situation where a small incorporated secretarial service provides a fair amount of its total services to a moderately sized law firm. Initially the two businesses are totally unrelated; therefore, the law firm's pension plan would not be expected to cover the secretarial service. However, suppose that subsequently, an associate of the law firm decides to buy a 10% interest in the secretarial service as an investment. Because the associate is a highly compensated employee owning 10% or more of the secretarial service, the service's employees will now be attributed to the law firm for deter-

141. *Id.* An employer is a "specified service organization" (or executive organization) if its principal business consists of the performance of specified services, that is, services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or any other field designated in the Treasury Department's regulations as a field in which separate organizations are being used to avoid the employee benefit requirements. Thus, a "specified" service organization is really not very specified. It can basically be defined as any service organization which attempts to use multiple entities to avoid the antidiscrimination provisions.

142. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 201, 94 Stat. 3526-27 (1980) (to be codified in I.R.C. § 414(m)).

143. H.R. REP. No. 1278, 96th Cong., 2d Sess. 35 (1980); S. REP. No. 1036, 96th Cong., 2d Sess. 32 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 11,609.

144. The term "significant" provides no direction to a planner since it is currently undefined. The IRS will undoubtedly define it, as it desires, in revenue rulings and/or regulations in the years to come.

mining the firm's pension plan's qualified status. Even if the firm's original plan qualified under the IRC's anti-discrimination provisions, the attribution of the lower paid secretarial service's employees, for purposes of determining the firm's plan's qualified status, will cause the plan to be disqualified as discriminatory.[145] This result will occur even though the two organizations are separate and independent, had no common ownership for a period of years, became affiliated through a highly compensated employee's inadvertent buy-in, and were not created as separate entities for the purpose of pension plan discrimination.

The inability of the new provision to account for organizations which are in "form" affiliated, under the provision's test, but which are in "substance" or reality unrelated is a major pitfall in the legislation. However, Congress was aware of this pitfall. The proposed statute submitted to Congress by the Tax Section of the American Bar Association (ABA), prior to the passage of the provision, specifically addressed this shortcoming:

> [T]he [above] provisions . . . shall not apply to any organization which otherwise would be aggregated with one or more other organizations, if such organization was *not formed* or *availed* of and is *not maintained primarily* for the purpose of *excluding* employees . . . from participation in its qualified . . . plans. (emphasis added).[146]

However, Congress failed to see the logic of the ABA's subjective test. The ABA provision would have given the employer a right to defend and preserve the qualified status of its plan upon an affirmative showing that the primary purpose of the multiple corporate structure was not to exclude the staff employees from the employer's plan. Instead, Congress enacted a statute which will effectively disqualify numerous plans which inadvertently become affiliated under the provision's low 10% ownership test. Apparently, Congress felt it was better to purge the pension area of all employers, even innocent ones, who violate this new provision.

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145. The example assumes that the secretarial service does not have a pension plan. If the secretarial service did have a plan, the two organizations would still be aggregated and the firm's pension plan, standing alone, would be checked to see if it satisfied the coverage requirements of § 410(b)(1). If the coverage for the employees of both organizations was not sufficient, the plans of the two organizations would be compared to determine whether the benefits or contributions under the respective plans were discriminatory. For determining the comparability of two qualified plans, *see* Rev. Rul. 74-165, 1974-1 C.B. 96 and Rev. Rul. 74-166, 1974-1 C.B. 97.

146. ABA COMM. ON EMPLOYEE BENEFITS, LEGISLATIVE RECOMMENDATION NO. 1 (Nov. 21, 1980) (draft).

A second shortcoming of this new provision is the subjective "significant portion" test. Under the provision, for a staff organization to be attributed to an executive organization, the IRS must find that a "significant portion" of the business of the staff organization is for the performance of services for the executive organization. Nowhere, however, is the phrase "significant portion" defined. The Tax Section of the ABA, in its proposed statute, concluded that an objective affiliation test should be used, rather than a subjective one. The ABA recommended that two entities be deemed affiliated, which would cause the employees of the staff organization to be attributed to the executive organization, if "more than 50% of the aggregate goods and services" of the staff organization were sold to the executive organization *or* more than 50% of the aggregate goods and services acquired by the staff organization were from the executive organization.[147] However, Congress rejected this suggestion, possibly because of the *Garland*-type schemes which easily evaded the anti-discriminatory provisions by manipulating an objective test.[148] Unfortunately though, by selecting a subjective test like "significant portion," Congress gave tax planners little guidance concerning the meaning of "significant." Thus, Congress, through its own action, has basically invited litigation over this term.

Given the parameters of section 414(m), there appear to be few methods for avoiding it. One method is to structure the ownership of the staff organization so that no shareholder or highly compensated employee of the executive organization owns 10% or more of the staff organization. The result would be that those owners similar to Dr. Garland would now have to join forces with ten other doctors in owning a staff organization to avoid being deemed affiliated.

A second method of avoidance would require the alteration of the existing contractual relationships between the executive organization and the staff organization. Under the new provision, a staff organization is only attributed if a "significant portion of (its) business . . . is the performance of services" for an executive organization. Under this second method, the staff organization would perform *no* contractual services for the executive organization. Rather, the executive organization, which is usually a professional corporation, would be contracted to work for the staff corporation. The office suite and all equipment

147. *Id.*

148. I.R.C. § 414(b) requires that an adjunct organization be attributed to a service organization if *more than 50%* of the adjunct is owned by the service organization or one of its shareholders. Dr. Garland evaded this objective test by owning *exactly 50%*.

would be purchased by each professional corporation and then leased to the staff organization. Technically, the professional corporations would still be the executive organizations because they own the means of doing business (leased equipment, etc.), and the employee organization would still be the staff organization. However, because this contractual alteration is in fact a scheme which merely disguises the same transaction that the statute was designed to stop, undoubtedly the Secretary of the Treasury will issue a regulation to stop this scheme.[149]

In conclusion, this new provision appears to provide none of the obvious loopholes for intentionally discriminating employers as did I.R.C. section 414(b).[150] Unfortunately, this provision also provides no leeway for employers who innocently and inadvertently violate it. In this regard, it suffers from the same defect as the old legislation. Additionally, it does not provide the planner with any objective tests or guidance on how to interpret the vague key phrases of its subjective tests. From a practitioner's standpoint, this provision provides little guidance for planning and is only a cause for concern.

VII. PLANNING

Integration of Social Security with qualified plans is still the most viable means for achieving permissible discrimination. Structured correctly, integration will provide the prohibited group (key employees and other highly compensated employees) with a disproportionate amount of benefits over the Social Security base.[151] Especially where employees have multiple employers using the "offset" method of integration, the pension reductions to the employee's account can exceed the amount of Social Security payments, allowing the prohibited group an even larger share of the benefits.[152]

Vesting standards combined with forfeitures also provide a planning method for permissible discrimination.[153] The vesting standard for a plan can still be chosen on the basis of employee turnover. Proposed regulation section 1.411(d)-1[154] only disqualifies a plan if the difference between the benefits accrued to the prohibited group and to the

149. Under § 414(m)(6), the Secretary is given the power to prescribe regulations as necessary to prevent the avoidance of this section.

150. *E.g.*, Garland v. Commissioner, 73 T.C. 5 (1979). *See* note 149 *supra*.

151. *See* text accompanying notes 92-101 *supra*.

152. *See* note 9 *supra*.

153. *See* text accompanying notes 103-07 *supra*.

154. 45 Fed. Reg. 39869 (1980); 45 Fed. Reg. 24201 (1980).

lower employees is "unreasonable." In short, the key to planning is not to be greedy.

Structuring an employer's workpool so that lower positions are filled with employees who are within five years of the plan's retirement age provides another means of permissible discrimination. Employees who are within five years of retirement need not be included in pension plans.[155] The result is that pension benefits will be more heavily concentrated in the prohibited group because fewer lower employees will be eligible.

Combining defined benefit plans with defined contribution plans and utilizing the "1.4 Rule" provides another mode for permissible discrimination in planning.[156] This method is particularly effective when the executives and other highly compensated employees were members of the organization near the time of its incorporation, when no defined contribution plan existed. Because the defined contribution fraction takes into account *all years of service*, the executives will have a lower defined contribution to years of service ratio. This results in executives receiving higher defined *benefits*, since their "defined benefit" percentage will be reduced by the lower "defined contribution" percentage.[157]

Non-qualified Executive Pension Plans, when combined with qualified plans and integrated with Social Security, also provide the planner with a source of permissible discrimination.[158] EPPs, when not placed in the employee's constructive or actual possession, avoid current taxation. Because these plans are *not* subject to ERISA's discrimination provisions, they can be as discriminatory as the planner desires. Eligibility should be based on position or title rather than on income, because inflation will push incomes upward and other employees, not intended for EPP coverage, may qualify.

Lastly, and most importantly, the *Garland*-type scheme is no longer a *permissible* source of discrimination. Section 414(m) has effectively put an end to the impermissible discrimination that was being practiced by such arrangements under section 414(b).

Therefore, the best permissible means of discrimination is still integration. It can be coupled with other permissible mechanisms, such as long vesting schedules, to provide the executives with additional discriminatory benefits.

155. *See* text accompanying notes 108-12 *supra*.

156. *Id.*

157. *See* text accompanying notes 113-25 *supra*.

158. *See* text accompanying notes 54-67 *supra*.

VIII. CONCLUSION

In pension planning, there are permissible and impermissible means by which discrimination in favor of executives, officers, and other highly compensated employees can be achieved. Although the intent of this comment was not to suggest that all employers should amend their plans to be more discriminatory, the realities of the business world demand that methods be found. For the small businessman who risked his capital, health, sanity and hairline in creating his business, it seems rather unjust that under the Social Security system and ERISA he should receive a proportionately smaller amount than his hired help. For the businessman struggling to compete for new management personnel, it also seems odd that under present law he cannot offer higher retirement benefits without being required to spend additional sums for the retirement funds of the rank and file. Congress' purpose in providing for private pension plans was to increase the benefits received by employees. Disqualification for the disproportionate allocation of benefits made after the Social Security base is covered seems ludicrous. The cost-benefit analysis of ERISA is tilting towards cost, which will result in fewer plans being instituted. Incentives for the creation of pension plans are needed, and permissible discrimination in planning provides such a source.

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