Despres

May 3, 1941

Chairman Eccles

Emile Despres

Attached is a memorandum prepared by Mr. Solomon, at my request, on the tax aspects of pension trusts and annuities. Although some improvement in the section of the Internal Revenue Code dealing with pension trusts might be in order, it would appear that the decisions of the Bureau of Internal Revenue have tended to keep abuses within reasonably narrow limit. In the case of annuities, the problem is under active consideration by the Bureau and it is likely that, here also, the Bureau's powers to prevent abuses will be reasonably effective.

Attachment

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May 3, 1941.

Mr. Despres — Tax aspects of Pension Trusts and Annuities.

Mr. Solomon

As you requested, certain tax aspects of pension trusts and annuity plans are discussed below.

Pension Trusts Under Section 165

In the typical pension trust both the employer and employee contribute to the trust. If the trust complies with section 165 of the Internal Revenue Code, it is not taxed on its income.

The employee is taxed on his own contribution in the same manner as if he received the amount as salary and then invested it. In turn, when he receives payments from the trust he does not pay tax on the sum that represents the mere return of his own funds.

The employer gets credit, as a business expense, for his contribution -- but he gets it only if the contribution, when added to the regular salary paid the employee, can qualify under section 23(a) of the Code as "a reasonable allowance for salaries or other compensation for personal services actually rendered". Special provision is made in section 23(p) of the Code for lump sum contributions by the employer to cover past services, but the employer's tax credit for these has to be spread over a period of ten years.

The contributions by the employer are not taxed to the employee until he receives them from the trust after he has retired.

Tax Advantages Under Section 165. - The pension trust provisions of section 165 do offer the advantages of a postponement and a reduction in taxes. Presumably this was deliberately intended by Congress in order to encourage corporations and other employers to make provision for the old age security of their employees. It may be noted further that the benefits increase as the employee's salary moves into the higher income brackets.

In a sense the benefit flows only to the employee, since it really is only his tax which is reduced. However, if the employing corporation is interested in providing a certain net retirement income for the employee, such a retirement income can be acquired at considerably less expense to the corporation by using the concessions of 165 instead of merely increasing the employee's salary to a point where, after he pays the tax on the salary, he can purchase

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sufficient investments to give him the desired retirement income. It is only in this sense that the employing corporation can get a tax advantage -- but in some cases such an advantage can be very real.

The Bureau of Internal Revenue has taken the position that in order for a pension trust to qualify under section 165, it must provide reasonably representative benefits and cannot be limited to a few top men. The Board of Tax Appeals has shown a tendency to permit greater latitude in setting up plans which are limited to a comparatively few men, but the Bureau usually is in a position to prevent flagrant abuse. The advantage, so far as key men are concerned, may induce the corporation to set up the plan -- and if it has to be reasonably inclusive and representative, as the Bureau attempts to require, the advantage for the key men may thus help to bring the retirement benefits to the lower income workers in the way that Congress presumably intended.

Possible legislation. - Consideration might nevertheless be given to writing into the statute a limit on the contribution that could be made for any one employee, and providing either that contributions beyond that limit would be taxed to the employee or would be denied as a credit to the corporation. Such a limit could be stated either in terms of the size of a contribution which would bring the employee specified payments after he retires, or in terms of the dollar amount of the contribution by the corporation. For example, Mr. Randolph Paul, in one of his confidential memoranda, has suggested that the corporations' contribution be limited to $5,000 for any one employee.

Consideration might also be given to clarifications in the statute which would strengthen the hand of the Bureau in its efforts to require that the plans be reasonably representative and inclusive.

These general problems, together with the further problem of the corporation being able to recapture earnings which it had placed in the trust, were placed before the Joint Committee on Tax Evasion and Avoidance in 1937. However, only the latter point has since been the subject of legislation. In presenting these problems, Deputy Commissioner of Internal Revenue Charles T. Russell stated:

> "It will require very careful study to correct the pension provision of the revenue act in such a way as to prevent abuse by the guilty without doing injury to the innocent."

Annuity Plans

In view of the savings which result when the corporation can deduct a sum as a business expense while the employee's tax on the sum

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is postponed and reduced, efforts have been made to achieve similar results without having to meet the safeguards which the Bureau has set up under 165.

Such efforts can take the form of trusts which fail to comply with 165, or in the simplest case the corporation can merely purchase an annuity directly for the employee without setting it up as a trust. The principles involved in both such plans are similar, however, and for convenience we will discuss only the annuity plan.

The deduction for the corporation in such a case depends upon the same considerations as in the case of the 165 trust. But the question of when the employee is taxable depends on when he is held to "realize" the income.

Question of when Employee "Realizes" Income. - As a general proposition, income is not taxed to a person until he realizes it, but there often can be great difficulty in the particular case in determining the exact time when he does. This problem of the time of realization is one of the fundamentals of tax law -- and like many of the other fundamentals in the field, is of uncertain status.

A series of rulings of the Bureau of Internal Revenue seem to hold that income is not realized until the employee receives payments under the annuity. One of the more important rulings involved a case in 1935 in which a university purchased some annuities for certain professors. The Bureau ruled that the professors realized income when they received payments under the annuities, and not when the annuities were purchased for them.

These rulings may seem to imply that the sky is the limit, and that any large salary or similar income could be spread out into smaller future payments in order to reduce taxes. It must be recalled, however, that each ruling is limited to the facts of the particular case. It seems very doubtful that the Bureau, the Board of Tax Appeals, or the courts, would permit the principle to be applied in flagrant cases.

As a matter of fact, it is understood that the general subject is at present under active consideration by the Bureau.

Possible Rulings on Question. - There are three broad alternatives, with perhaps subdivisions of each, which the Bureau, the Board of Tax Appeals and the courts might follow on the subject. FIRST, they can permit unlimited use of annuities, holding that the employee always realizes income when he receives payments under the annuity rather than when the annuity is purchased for him. SECONDLY, they can take the opposite view,

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reverse the rulings mentioned above, and hold that the employee always receives income when the annuity is purchased for him. THIRDLY, they can consider each case on its merits holding in some that the employee realizes income when the annuity is purchased for him and in others that he does not realize income until he receives payments under the annuity.

If the third view were adopted, much would depend on the extent to which the employee really had, or could have had, access to the funds. This would involve such questions as the following: To what extent did the employee actually, or potentially, control the decision of the employer to use the annuity device? Was the annuity device used chiefly in order to help the employer -- in discharging the moral responsibility for providing old age security for its employees - or chiefly to reduce the taxes of the employee? Would the employer have given the employee the cash instead of purchasing the annuity if the employee had preferred cash?

It would not be surprising if either the second or the third alternative was adopted. The possibility of the first alternative prevailing would, however, seem to be quite remote.

Possible legislation. - In the circumstances, therefore, it seems unlikely that the device will be available to any substantial degree as a loophole. However, if legislation were under consideration for strengthening section 165, consideration might be given to some clarification of the status of non-conforming pension trusts and annuities.

One possibility might be to state certain limits on the use of such devices, somewhat as mentioned in connection with section 165. However, this still would leave such devices free from the other safeguards of that section. Therefore, if any legislation at all were considered on the subject it might be better to outlaw the use of such devices, i.e., to write the second alternative above into the statute. This would mean that any such plans would then have to meet the safeguards set up by the Bureau under section 165.

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