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THE TAX EFFECT OF CORPORATE REORGANIZATIONS ON PENSION PLANS

Robert S. Taft*

A pension plan is a program established by an employer for the accumulation of funds for the benefit of its employees. These funds are usually paid out to the individual employee upon or subsequent to his retirement. The employer generally funds the program through periodic contributions, although the employees may also make some contributions. The plan or program constitutes a separate financial entity receiving the contributed funds, investing this money and accumulating it at interest and with investment gains for the benefit of the employees.

In effect, the pension plan is a form of compensation to employees with special tax advantages if the plan meets certain requirements prescribed in the Internal Revenue Code. Assuming qualification of the plan under the code, the employer's contributions to the plan are treated as an expense by the employer. Such contributions cost the employer neither more nor less than the same amount of money paid in cash compensation. Payments to the plan by the employer, however, are not currently taxable as income to the employees who are members of the plan. The individual employee's tax liability is deferred and to some degree reduced since he is taxed only on the receipt of benefits from the plan, presumably at a time when his income has been reduced. Gain realized from the sale of investments as well as interest and dividends accruing to the fund are tax-free to a qualified fund. Nor are such earnings taxable to the employee members until they receive benefits from the fund. These are just a few of the tax advantages inherent in a pension plan.

The Treasury has estimated that by December 31, 1964, there were 113,438 qualified plans in operation. According to the annual survey made by the Securities and Exchange Commission, the assets of private pension funds, other than insured plans, amounted to 51.9 billion dollars at the end of 1964. It is apparent that pension obligations represent a substantial dollar liability to employers. Nevertheless, it seems that in many instances of corporate reorganizations the last item to be considered is the acquired corporation's pension plan. In some instances, the entire plan of reorganization is negotiated, adopted and perhaps even consummated before an analysis is made of the status of the pension plan, its assets and liabilities and the effects of the reorganization on the pension plan. This article concerns the tax effects of corporate acquisitions and divisive reorganizations on qualified pension plans.


I. Acquisitions of Assets and Mergers

If permitted under the language of the existing pension plan of a company being acquired or merged, the plan may be terminated, curtailed, modified in various respects or merged with other plans—or new plans may be established. Any of these actions may have a bearing on the tax consequences to the employer, the employee and the fund itself. The applicable tax treatment depends upon the provisions for the plans involved that are made in connection with the acquisition. In a merger or acquisition of assets situation, the surviving corporation may not maintain a plan for any of its employees or, if it has one, it may wish to cover the employees of the acquired corporation under the existing plan. In either case, the predecessor’s plan may be terminated and total distributions made to the employees concerned. The effects of a proposed termination of one company’s plan may affect the method of acquisition. In any event, a reorganization usually requires some amendment to either one or both companies’ pension plans, often in advance of the reorganization. For example, when vested rights are involved, the revisions require the consent of the participating employees or their unions.

Whenever an acquisition results in a material change in the operation of a qualified pension plan, the complete termination of such a plan, the discontinuance of contributions or a consolidation of two plans, questions arise concerning the continued qualification of the plans. These include whether income is to be taxed to the employee, the deductibility of employer contributions and other tax matters. The first aspect of the effect of a corporate acquisition on an acquired or merged company’s pension plan to be considered is the termination of the pension plan.

A. Termination of the Acquired Company’s Plan

The acquiring corporation may desire to terminate the plan of the acquired corporation for several reasons. If the acquiring corporation has no plan of its own, it may not want to carry on the plan for only part of its employees. Or if its own plan is basically different, it may not desire to have two different plans in existence. Other reasons for discontinuing an acquired corporation’s plan include the possibility of the existence of a substantial, unfunded past service liability from the acquired corporation which the acquiring corporation would not want to take over, or merely the fact that the acquiring corporation may wish to terminate the employment of the employees of the acquired corporation.

If the qualified plan is terminated, all amounts held under the plan for payment of benefits to the plan’s participants (with certain exceptions for the twenty-five highest paid employees) must become nonforfeitable, that is, vest in the participants.5 Commonly the plan will require distribution at this point. Distributees will be accorded long-term capital gain treatment with respect to total distributions or total amounts payable from such plans, where such distributions or amounts represent the balance to the credit of the employee, and

where they become payable on account of his death or other separation from service of the employer or on account of his death after separation from service, if payment is made within one of the distributee’s taxable years. The key clause or requirement is “separation from service” when considering the termination of a pension plan as the result of a reorganization.

A reorganization of the type described in section 368(a)(1)(C) of the Internal Revenue Code, i.e., the acquisition of assets in exchange for stock, effects the required change of employment so as to constitute a separation from service. Where pursuant to such a reorganization all the assets and liabilities of a company are turned over to a corporation in exchange for its voting stock, and where such corporation in turn makes a transfer thereof to its wholly owned subsidiary and receives the common stock of the subsidiary so that the business of the original company is then owned and operated by such subsidiary which also takes over the employees, there is a separation from service within the contemplation of sections 402(a)(2) and 403(a)(2) of the code. Therefore, distributions within one taxable year of the total amount standing to the credit of participants under the predecessor company’s qualified plan, which is terminated by reason of the reorganization, are accorded long-term capital gain treatment.

Proper care must be taken in terminating a plan in order to obtain such capital gain treatment for employees. In *Glinske v. Commissioner*, a company established a pension trust which was held to be exempt as forming part of a qualified plan. The employer subsequently sold all of its assets, including the use of its name, and discontinued its business. About three weeks later the purchaser exercised its right to discontinue the plan and trust, effective one month later, and distributions were accordingly made. Glinske, one of the employees who went to the new management, reported his distribution as a long-term capital gain. The Tax Court held that the distribution was made under the termination provision of the trust agreement and therefore constituted ordinary income. The court reasoned that, although the employee severed employment with his former employer, distribution was not made on account of such severance. He went to work for the purchasing corporation which continued the plan, and it was not until some time subsequent to its acquisition of the predecessor’s assets that the acquiring corporation exercised its right to terminate the plan. The ensuing distribution, therefore, did not relate back to the prior severance of employment.

Within the purview of the long-term capital gain requirements, a severance of employment must be complete and final. The termination of the employment relationship with respect to the acquired corporation is not affected by services rendered to the acquiring corporation, whatever the degree or extent.

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8 17 T.C. 562 (1951).
9 Clarence F. Buckley, 29 T.C. 455 (1957); Estate of Frank B. Fry, 19 T.C. 461 (1952), aff'd per curiam, 205 F.2d 517 (3d Cir. 1953).
Another leading case in this area, *Mary Miller*, 10 concerned a 368(a)(1) (C) reorganization pursuant to which the May Company acquired the assets and business of the Strouss-Hirshberg Company in exchange solely for 147,983 shares of its voting stock. These shares were distributed to the shareholders of the Strouss-Hirshberg Company in cancellation of their 185,000 outstanding shares. The May Company assumed all liabilities of Strouss-Hirshberg Company, whose stores were then operated by May under the name of the predecessor company and whose employees continued in their jobs. Pursuant to this reorganization, the Strouss-Hirshberg Company Employees’ Retirement Fund, an exempt trust under a qualified profit-sharing plan, was terminated and distribution was made to participants. Lump sum payments to employees who continued in their former jobs, but as employees of the May Company, were held to be on account of separation from service and qualified for the long-term capital gain treatment.

The fact that the employees continued in their jobs in stores which were operated without change of name did not alter the result that there was a separation from the service of their former employer. Prior to the reorganization, the employees concerned were employees of Strouss-Hirshberg; thereafter, they were employed by the May Company, a separate and different entity. Hence, the transfer constituted a separation from the service of the Strouss-Hirshberg Company, the employer whose plan was terminated with the total distribution made thereunder.

A separation from service may also be effected where a corporation takes over the assets, business and employees of another previously unrelated corporation in accordance with a merger agreement involving a tax-free exchange of stock for stock under section 354(a) of the code, in pursuance of a plan of reorganization under section 368(a)(1)(B) and a subsequent statutory merger within section 368(a)(1)(A), pursuant to the same plan. Thus, where there exists a merger agreement under which a corporation acquires more than eighty percent of the stock of an unrelated company in exchange for its own single class of outstanding voting stock in a stated per share ratio, and where, immediately following the acquisition of such stock in accordance with the plan of reorganization, the acquiring corporation takes the necessary steps to effect a statutory merger under the applicable state law and continues the business of the acquired corporation, the employees who are transferred to the acquiring corporation are separated from the service of the acquired corporation. They, therefore, qualify for long-term capital gain treatment with respect to total distributions made from the exempt employees’ trust of the acquired corporation.11

The acquisition of the assets of the former employer involved a statutory merger, and for some purposes the surviving corporation in a statutory merger is deemed to be a continuation of the corporation which goes out of existence. Nevertheless, this does not alter the result under the facts considered.12

If the acquired corporation's plan is to be terminated, it is advisable to secure a termination ruling from the Internal Revenue Service to be certain that the plan will not be retroactively disqualified. Disqualification may rest on the ground that the termination did not have a business purpose or on the ground that the termination benefits would discriminate in favor of the more highly paid employees. The fact of reorganization furnishes a valid business reason for this purpose.¹³

Meeting the nondiscrimination requirement, however, is usually a more difficult matter. A variance in benefits in favor of employees who are officers, stockholders, etc., may be due to funding at a greater rate for such employees than for others. Benefits for employees at or near retirement are usually funded sooner than for younger employees. If those whose benefits are funded at a greater rate are officers, stockholders, etc., and the plan is terminated before benefits for lower paid employees are similarly funded, prohibited discrimination may become an issue. A reallocation of benefits may solve the problem in some cases.¹⁴ In other situations, the continuance of benefits in the successor's plan may make up for any shortcomings under the plan being terminated.

Compliance with the requirements as to the restriction of benefits with respect to the twenty-five highest paid employees in the event of early termination¹⁵ also creates additional problems in acquisition situations. The fact that the plan is being curtailed means that the applicable limitation on benefits for employees in the top twenty-five group must be invoked. Deletion of the limitation provision, prior to the expected termination of a pension plan, will not adversely affect the qualification of the plan, when such termination is by reason of the liquidation of the employer, provided that the ratio of benefits to current compensation, per year of service, is not discriminatory within the purview of section 401(a) of the code, and all past service credits are fully funded.¹⁶ The limitation period is the ten-year period commencing with the date of the inception of the plan or the date of the last amendment increasing benefits.

It is clear that in an acquisition situation, if the acquired company's pension plan is to be terminated, it should be terminated at such a time and in such a manner as to realize long-term capital gain for the employees receiving benefits thereunder. It may be necessary to amend the plan prior to the acquisition to facilitate such a termination. Finally, a ruling should be received from the IRS with regard to the termination.

B. Continuation of the Acquired Company's Plan

As an alternative to terminating the acquired company's plan, the acquiring corporation may take over and continue such a plan. If the acquiring corporation does not have a plan of its own or has a plan basically different from the autonomous unit. It may be necessary to amend the acquired company's plan in operation, particularly if the acquired company is to become a fairly

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¹⁵ Mim. 5717, 1944 CUM. BULL. 321.
autonomous unit. It may be necessary to amend the acquired company plan if it is to be retained. For example, many plans do not provide for the substitution of a successor employer in the event of the dissolution or merger of the employer. A second possible amendment would bring the benefits of the acquired company’s plan more nearly in line with the benefits under the plan of the acquiring corporation. If this adjustment involves the reduction of plan benefits, it may constitute a curtailment of the plan. As in the case of a termination discussed above, it is necessary to justify a curtailment as a business necessity and to make certain that it does not result in discrimination in favor of highly paid employees. Again, the business necessity requirement is satisfied by the fact that a merger or other change of ownership is involved.

If the acquiring corporation intends to continue the acquired corporation’s plan for the latter’s employees, such a plan may continue to be qualified. Plans may qualify even though they limit coverage to employees in certain designated departments, provided that the effect of covering only such employees does not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees. Thus, if employees of the acquired corporation coming over to the acquiring corporation constitute a nondiscriminatory classification, a plan covering only such employees may continue to qualify.

Where, however, a particular group consists of officers, shareholders, etc., and does not constitute a nondiscriminatory classification, it may also be possible to maintain a separate plan for such employees. An employer may designate several trusts—or a trust or trusts and an annuity plan or plans—as constituting one plan which is intended to qualify, in which case all of such trusts and plans taken as a whole may meet the coverage requirements.

If all of the plans so designated cover a sufficient number of employees, there is no requirement that a definite proportion of the employees be included in any one plan. The plan, or plans, must benefit employees in general, and, towards this end, must either cover a number which is at least equal to that determined under the percentage provisions of section 401(a)(3)(A) of the Code, or such employees as qualify under a nondiscriminatory classification within the purview of section 401(a)(3)(B) of the Code.

Thus, even if any one or more plans standing alone would fail of qualification as not meeting the coverage requirements, if all plans considered as a unit meet such requirements, all of the plans are deemed qualified.

C. Consolidation of the Plans

If the plans of the acquired and acquiring corporations are uninsured trusted plans, the acquiring corporation may wish to consolidate the trusts even though separate plans are to be maintained. There are advantages in doing so,

19 Treas. Reg. §1.401-3(d) (1956).
including reduced administrative costs and greater diversification of investments. However, there are also disadvantages in combining the trust funds which should be taken into consideration.

A consolidation of the trusts involves a "transfer" of the assets of either one or both of the former trusts, which in the case of a pension trust may result in the recognition of gains and losses. Such gains or losses must be taken into account under the cost method of valuation in determining (1) the extent to which benefits under the plans are then funded and (2) the limitation on currently deductible employer contributions to the trust. The IRS applies this rule in a situation where an employee's pension trust transfers its assets to a collective investment fund maintained for qualified pension trusts. Consolidation of trusts involves complications in record keeping and in allocating assets between the separate plans. A better solution, therefore, might be to keep the trusts separate for administrative purposes but combine the funds for investment purposes.

If only one consolidated plan is to be continued, there are problems in combining the two plans. This is especially true if they are basically different in structure. For example, if a group annuity plan of the acquired corporation is to be discontinued and the employees brought into the uninsured plan of the acquiring corporation, the problem is to dispose of the annuity contract and avoid full vesting with resultant taxation of vested amounts and loss of carryover deductions. The proper approach is to consolidate both plans into one by amending both plans and contracts. The annuity contract of the acquired company's plan which is ultimately to be cancelled should be transferred to the trust for the consolidated plan. The proceeds received upon cancellation of the annuity contract are applied against the pension the acquired employees are to receive under the consolidated plan. The IRS does not require full vesting of these annuity rights if substantially all of the acquired company's employees become participants in the consolidated plan. But full vesting may be required if the services of a large number of employees are terminated as a result of the acquisition. Consent of the acquired employees is needed to transfer their interests to the consolidated trust if their original plan provides for full vesting in the event of the discontinuance of contributions.

In the situation mentioned above, the group annuity plan is terminated without adverse affect on its prior qualification. The deductions by the acquired corporation for contributions under its group contract prior to the acquisition are not affected as a result of such acquisition. Likewise, the transfer of the funds from the insurer to the trustee upon cancellation of the annuity contract does not result in taxable income to the acquiring corporation.

The most important point to remember in consolidating pension plans is that the consolidation must not result in the application of the termination sections of the plans or bring about any premature vesting. It should be noted that the IRS may view pension and profit-sharing plans as two different types of plans and consider any attempt to combine the two as a termination.

D. Problems Where the Acquired Company Has No Plan

The situation may also arise where the acquiring company has a plan and the acquired company has none. As a general rule there is no problem in bringing the employees of the acquired company into the acquiring company's plan, although the eligibility provisions of the plan may have to be amended. Amendments may also be necessary to assure past service credit for acquired employees and equitable allocation of contributions and assets between the old and newly acquired employees.

In computing the cost of past service credits, service with the acquired company may be included under appropriate circumstances, provided that the requirement as to reasonableness of compensation for services to the new employer is met. Without such a requirement, one company may be paying and claiming deductions for the pension cost of another.25

It should be noted that under certain circumstances the IRS permits a parent company to take deductions for contributions to fund all past service benefits, including benefits for services previously rendered by employees to a subsidiary corporation which was liquidated. This ruling applies where the plan of the subsidiary does not provide for vesting on termination of service prior to the death or retirement of the employee, and where the plan of the parent company covers all employees who were in its employ on the effective date thereof and were then eligible to become participants thereunder. Furthermore, where the subsidiary corporation is liquidated and its assets, liabilities and employees are transferred to the parent corporation, the parent, as the successor corporation, is allowed deductions (within the applicable limits) for contributions under a pension plan to fund the benefits for all the transferred employees on account of services rendered by such employees to either the parent corporation or the subsidiary corporation or both, whether such services were rendered on, after or prior to the effective date of the plan and trust.26 The key to the granting of prior service credits with the predecessor is that it must not entail a duplication of benefits. Where an employee has been included in a predecessor's plan and subsequently becomes covered under the plan of the successor, he may be granted past service credit in the successor's plan, but only to the extent of putting him on a par with other participants and not to provide him with benefits from two sources for the same service. This view is expressed by the IRS where there is renewed participation in a plan by a retired employee who had accumulated prior service credits before his previous separation from service.27

Prior to the enactment of section 381(c)(16) in 1954, it was doubtful whether a deduction could be taken for payments or contributions by the acquiring corporation with respect to unfunded past service liability for retired employees of the acquired corporation. The rule was that only the taxpayer's own carryovers were available to him. The section now permits such a deduction provided the liability is assumed in connection with a tax-free transaction.

and the consideration paid for the acquired corporation's assets does not reflect an offset for the liability assumed.

If the acquired company's employees are not to be brought into the plan, an amendment may be necessary to keep them out. Otherwise, they may automatically qualify when they fulfill the minimum eligibility requirements. The exclusion of acquired employees does not disqualify the plan as long as there is no discrimination.

E. Problems Where the Acquiring Company Has No Plan

Another situation to consider is that where the acquired company has a plan but the acquiring company has no plan. Many of the considerations relating to the continuation of the plan for the acquired company's employees only, or extension of the plan to include employees of the acquiring company, or the termination of the plan will be the same as discussed above. There are, however, several differences where the employer whose plan is involved is the company going out of existence.

Upon a merger of the acquired company into the acquiring company as the result of a 368(a)(1)(A) or 368(a)(1)(C) reorganization, the acquiring corporation will succeed to the acquired corporation's rights with respect to carryover deductions from prior years if the plan of the acquired corporation is adopted by the acquiring corporation. The acquiring corporation is considered to be the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining allowable deductions under section 404 of the code.28 Where the applicable requirements are met, the successor takes over the predecessor's carryover and is allowed deductions with respect to it to the same extent that the predecessor would have obtained had it continued in business. However, if the terms of the plan and the makeup of the participating employees are so changed as a result of the merger that the plan as continued by the successor corporation is considered as a new plan rather than as a continuation of the predecessor's old plan, then, as in the case of any plan termination, the carryover deductions may be lost.

Most plans contain provisions permitting a successor to the business of the employer company to adopt and continue the operation of the plan, in which case the termination provisions will not become operative. Thus, when the employer company is merged into another company which adopts the plan and becomes the successor employer thereunder as permitted by the plan, the rights of the employees are usually not affected by the merger. By "rights," it is meant the legal rights of the employees as determined under local laws of contract and trusts.

In the absence of special circumstances where discrimination in favor of the officers, shareholders, etc., may result, the IRS apparently recognizes that a plan may be assigned from one employer to a successor, whether by merger or otherwise, without being regarded as terminated. Thus, whereas the regulations have long provided that employees' interests must fully vest on termination of a plan, such vesting is not ordinarily required where a successor employer

adopts and continues to operate a predecessor’s plan. However, if the prede-
cessor’s plan is adopted by the successor corporation and there is a substantial
change in the makeup of the covered employees by reason of severance of a
large number of employees of the predecessor and an admission to the plan of a
large number of employees of the successor, the IRS may consider the plan
as adopted by the successor to be a new plan and the plan of the predecessor
to have been terminated. In this case, the IRS may require, before ruling on a
continued qualification of the plan, that (1) the beneficial interests of the
employees of the predecessor be fully vested, and (2) that the plan be amended
to impose restrictions as to the maximum amount of benefits which may be
made available to the twenty-five highest paid employees in the event of ter-
mination of the plan or failure to meet current costs within the period of ten
years from the adoption of the plan by the successor.29

II. Divisive Reorganizations

In a divisive reorganization (where one company transfers part of its
business to another company, either through a stock spin-off from the transference
or by making the transferencee a subsidiary) the employees of the transferencee
usually accompany their part of the business to the transferencee and become employees
of the transferencee.

Amendments to the transferor’s plan are needed to make the transferencee
a participating employer and to provide for the transferencee’s contributions,
allocation of cost between companies, intercompany employee transfers and
other details. The plan must continue to qualify with respect to each company,
even if one is a one hundred percent subsidiary of the other.30 For example, if
most of the working force is put into the subsidiary and the parent is left with
only the executives and a few office workers, the plan may be found to be discrimi-
natory as to the employees of the parent even though it qualified before the
reorganization. A new determination letter should be obtained to establish the
continued qualification of the plan.

Section 381(c) of the code does not apply to divisive reorganizations.
Therefore, the parent company retains its right to deduct the excess contribu-
tion carryovers even though many of the employees for whom the contributions
have been made are transferred to the subsidiary. Either company can deduct
past service pension costs for an employee’s transfer to the subsidiary, as long
as the contribution is properly charged to the company that makes it.31

If the transferencee does not adopt the transferor’s plan, amendment to the
plan may be necessary to dispose of the plan assets representing the interests of
the transferred employees. For example, if the transferor has a noncontributory
pension plan, the interests of the transferred employees may be considered as
forfeited. To avoid this, it may be necessary to amend the plan to provide for
full vesting. The transferred employees may lose the advantage of capital gain

treatment of their distribution, however, unless ownership is changed so that the separation from service requirement is met.\textsuperscript{32} In some cases where there is a divisive reorganization, the transference corporation may choose to adopt and continue the plan for the employees transferred to its payroll, and the transferor corporation may choose to discontinue the plan as to the employees remaining on its payroll. In this case, distributions to the transferor's employees of their interests under the plan will not qualify for long-term capital gain treatment because there is no separation from service.\textsuperscript{33} To avoid lumping large amounts of ordinary income in one year, it may be advisable to provide for deferred distributions to the transferor corporation's employees until they terminate employment or to make distributions of their interests in the form of an annuity contract, in which case tax impact can be deferred until the contract matures or is surrendered.\textsuperscript{34} Long-term capital gain benefit will be available only if the employee receives and realizes upon the contract in one year on account of separation from service.\textsuperscript{35}

When on account of termination of service the entire interest of an employee in a qualified plan is distributed partly in cash and partly in the form of an annuity contract which the distributee does not surrender in the taxable year in which distributed by the trust, the IRS rules that capital gains treatment is accorded such distribution to the extent that the distributee realizes income subject to tax in his taxable year in which the distribution is made. Therefore, says the IRS, the distributee is entitled to the benefits of capital gains treatment on the cash distributed by the trust regardless of when, if ever, the annuity contract is surrendered.\textsuperscript{36}

If the transferor corporation has excess contribution carryovers from prior years and the plan is assumed by the transferee and discontinued by the transferor, it would seem that the transferor could deduct such amounts in succeeding years to the same extent that such deductions would have been allowable under section 404 if the plan had been continued by the transferor instead of the transferee. An employer is entitled to deduct past service contributions at the maximum rate of ten percent per year for former employees, and where the full cost is paid in one year, such deductions may be claimed until the full amount has been deducted, whether or not the employee is still on the payroll in the years when the deductions are claimed.\textsuperscript{37} But, in view of the holdings that deduction rights with respect to prior years' contributions expire on termination of the plan,\textsuperscript{38} the IRS may take the position that such rights expire when the transferor has discontinued making contributions to the plan for its continuing employees after the transfer. The solution to this problem may

\begin{itemize}
\item \textsuperscript{34} The purchase of annuities is an effective method of winding up a plan and trust since the employee is not taxed on the cash value of an annuity contract delivered to him from a qualified trust. Treas. Reg. \$1.402(a)-1(a)(2) (1956), as amended, T.D. 6676, 1963-2 Cum. Bull. 41.
\item \textsuperscript{36} Rev. Rul. 65-267, 1965 Int. Rev. Bull. No. 47.
\item \textsuperscript{38} Rose Packing Co., 28 T.C. 1028 (1957); Rev. Rul. 54-270, 1954-2 Cum. Bull. 97.
\end{itemize}
depend on whether the availability of deduction rights for prior years' contributions is dependent on the continuation of the plan by the employer who is claiming the deductions, or whether the continued availability of the deductions is dependent only on the continuation of the plan, as a qualified plan, in the year the deduction is claimed, whether by the original employer under the plan or a successor employer.

The transferor corporation may continue its plan but the transferee may adopt a different plan. In this instance, it may be appropriate to transfer a portion of the assets attributable to the pension reserves for the transferred employees from the transferor's pension trust to the transferee's pension trust. In such a case, it may be necessary for the transferred assets to be held and accounted for as a separate fund to insure that there will be no diversion of these assets for the benefit of other employees of the transferee.

The problems of consolidating plans and aligning benefits with respect to the transferred employees and the transferee's own employees are mostly the same as previously discussed in the case of mergers of two companies with different plans. There is an exception where the transferor's plan is to be continued by the transferor for those of its employees who are retained. Then there is the further complication of dividing the transferor's trust or group annuity contract into two parts as a preliminary step to the consolidation of the transferred part with the transferee's plan. This, however, is primarily a mechanical problem, and the qualification and tax effect are essentially the same as in the case of mergers.

III. Other Problems

There are several other aspects of the tax treatment of pensions in a reorganization which should be considered. The section 381 carryover has been briefly mentioned above. Section 381(c)(11) of the code provides that in certain tax-free acquisitions where one corporation acquires the assets of another corporation, it succeeds to and can use the transferor corporation's unused deductions or excess contribution carryovers which, "in the absence of the transaction causing section 381 to apply, would have been available to the distributor or transferor corporation under section 404." The acquiring corporation thus steps into the transferor's shoes as to these unused deductions or excess contribution carryovers. Section 381(c)(11) also provides that the acquiring corporation is to be considered as the transferor corporation

... for the purpose of satisfying any conditions which would have been required of the distributor or transferor corporation in the absence of the distribution or transfer, so that it may be determined whether the distributor or transferor corporation, or the acquiring corporation, is entitled to take a deduction under section 404 in respect of a trust or plan established by the distributor or transferor corporation.40

If the acquiring corporation is to be allowed such a deduction, this rule states

that it must fulfill the requirements which section 404 imposes upon the transferor corporation.

It should be noted that section 381 of the code provides that "the taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer." The effect of this provision on section 381(c)(11) is illustrated by an example set forth in the regulations as follows:

Thus, for example, in a case when the taxable year of the transferor corporation ends on the date of transfer pursuant to section 381(b)(1), that corporation is entitled, pursuant to the provisions of section 404(a)(6) and paragraph (c) of §1.404(a)-1, to a deduction in such taxable year for a payment to a qualified trust of that corporation made by the acquiring corporation after the close of such taxable year but within the time specified in section 404(a)(6). The time specified in section 404(a)(6) of the code applies only where the transferor corporation is on the accrual basis. Section 404(a)(6) provides that a payment to a pension plan will be deemed to have been made on the last day of the taxpayer's taxable year if it is made in the next taxable year but not later than the time prescribed for filing such taxpayer's return (including extensions). In view of the foregoing, the time at which the acquiring corporation makes a contribution can be decisive as to whether the transferor corporation gets the deduction or the acquiring corporation gets the deduction. If the latter result is desired, payment of the contribution should be delayed beyond the period prescribed in section 404(a)(6).

It is also possible for the acquiring corporation to deduct contributions made for the benefit of former employees of the transferor corporation. A further example in the regulations states:

In further illustration, if the transferor corporation were to establish a qualified plan, and if the plan were maintained as a qualified plan by the acquiring corporation, then any contributions paid under the plan by the acquiring corporation (other than those which are deductible by the transferor corporation by reason of section 404(a)(6)) would be deductible under section 404 by the acquiring corporation even though the plan were exclusively for the benefit of former employees of the transferor corporation.

It is clear from this example that even though the beneficiaries under the plan never become employees of the acquiring corporation, the acquiring corporation would be entitled to the deduction. The determinative event is therefore whether the acquiring corporation acquires the assets of the transferor in the section 381(a) transaction and not whether it employs any of the beneficiaries of the transferor corporation's plan. The results of the second example would pertain, for instance, to a situation where the transferor corporation had established a pension plan providing benefits based on past service as well as current service but only for the benefit of a closed group of employees of the

43 Ibid.
transferor, all of whom had retired prior to the transfer of its assets in the section 381(a) transaction. If there were any unfunded past service credits as of the time of the transfer of assets and if the plan were maintained as a qualified plan by the acquiring corporation, it would be permitted to deduct, (in a year or years subsequent to the acquisition) the contributions which it had made to fund these past service credits.\(^4\)

It must be remembered that contributions under pension plans must first qualify as ordinary and necessary business expenses, or expenses relating to the production of income, before they are deductible within the special limits applicable to such plans.\(^5\) In this respect, they must represent compensation for personal services actually rendered.\(^6\) Services rendered in prior years, as well as in the current year, are considered for the purpose of determining reasonableness of compensation.\(^7\)

Finally, there is the problem of constructive receipt. Various acquisitions entail transfers from one funding medium to another. The funds under a plan of an acquired company may be paid over and included under the plan of the acquiring corporation. In other situations, funds under insured plans may be transferred to trusts, or vice versa. In any situation, if it is possible for employees to obtain any of the funds, they are deemed to be in constructive receipt of them and subject to tax since such funds are made available to them.\(^8\) An employee's interest under a pension plan is deemed to have been made available to him at the earliest date upon which he can unqualifiedly receive a distribution, regardless of whether such a distribution is actually made.\(^9\) Such interest, however, is not made available to him where there are substantial conditions or restrictions on his right of withdrawal.\(^10\) For example, where a substantial penalty is imposed on a withdrawal, such as discontinuance of further participation in the plan,\(^11\) or a forfeiture of part of the credits,\(^12\) the employee's interest is not deemed to have been made available to him.

The transfer of funds from one retirement plan to another, where employees do not have the right to direct the disposition of such funds, does not result in availability of the funds. Where employees have an election to authorize the transfer of their individual accounts to the new plan with full credit for all years of prior service or to require a return of their own contributions with interest and to forfeit all credits for prior service upon becoming participants in the new plan, those who elect to transfer their full interest do not realize taxable income by reason of such election.\(^13\)

Where employees come into possession of funds which are being transferred from one exempt employee's trust to another, but have previously executed,

\(^{46}\) Treas. Reg. §1.404(a)-1(b) (1956).
\(^{48}\) Int. Rev. Code of 1954, §402(a) (1).
\(^{51}\) Estate of A. N. Berry, 44 B.T.A. 1254 (1941); Dillis C. Knapp, 41 B.T.A. 23 (1940).
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and thereafter carried out, a legally enforceable agreement to pay over their distributive shares to the transferee trust, the distribution is considered a transfer of funds from one trust to the other through the agency of the employees. Hence, such employees realize no taxable income from the transaction.54

The transfer of funds in an insured contributory plan directly by the insurer to the trustee under a newly established plan does not give rise to taxable income to the participants. Thus, where upon cancellation of all insurance contracts, the insurer transfers the accumulated funds under such contracts directly to a trust for the funding of benefits under the plan, the participants under the nontrusted plan do not receive income as a result of the transfer of funds from the insurer to the trust.55

In some cases, a contributory plan may be modified so as not to require employee contributions and refunds may be made of amounts previously contributed by employees. Where a contributory insured plan is amended to eliminate the requirement for employee contributions, and the insurer returns all amounts previously contributed by employees, the IRS considers the refunds to be return of premiums and not taxable income to the employees.56

A very recent Revenue Ruling in this area provides that the former officer-stockholders and other employees of a merged corporation who continue employment with the surviving corporation are, under the circumstances, "separated from service" of the merged corporation for the purpose of capital gain treatment of lump-sum distributions under the following factual situation:

The officers of X corporation, a shirt manufacturer, owned its outstanding shares of stock and participated in the employees' pension plan and trust. The trust has been held to meet the requirements of section 401(a) of the Internal Revenue Code of 1954 and to be exempt from tax under section 501(a) of the Code. X sold substantially all of its assets to an unrelated corporation which took over the shirt business and certain employees of X. The assets of X, including the sales proceeds, were transferred to Y, an operating real estate company, in accordance with the statutory merger under section 368(a)(1)(A) of the Code. Prior to the merger, the officer-stockholders of X were also officer-stockholders of Y. These officer-stockholders will continue their relationship with Y and some of the clerical personnel formerly employed by X will be employed by Y, but their duties will now be related solely to the real estate business. A lump sum distribution was made of the total amount standing to the credit of the participants in the pension plan, including the officer-stockholders and the clerical personnel.57

Under these circumstances the IRS considers the ownership of both X and Y by the same officer-stockholders not to be such a relationship as to prevent the officers and clerical personnel employed by Y from being "separated from the service" of X within the meaning of section 402(a)(2) of the code and Revenue Ruling 58-383.58 Therefore, a distribution to any of the employees,

within one taxable year, of the total amount due them under the trust is con-
considered to be a long-term capital gain, to the extent that it exceeds the amount 
contributed by the employees.

IV. Conclusion

From the preceding discussion it should be quite evident that when an 
acquisition, merger or divisive reorganization is contemplated, the corporations 
involved should carefully weigh the financial and tax implications concerning 
their pension plans. The status of a pension plan can have a bearing on the 
price of the acquisition depending on the program to be maintained in the 
future. Some of the items which might influence the price set for an acquisition 
include: the medium of funding, benefits, costs, unfunded liability, termination 
provisions, deductions for contributions and union contracts involving pensions.

In considering the effect of reorganizations on qualified pension plans, the 
basic considerations are whether the reorganization will result in the termina-
tion of employment, the termination of the plan, the expansion of coverage of 
the existing plan, the consolidation of plans or the adoption of new plans. That 
the transaction is taxable or tax-free or that the buyer acquires assets or stock 
or other property should not be a controlling factor with respect to the fore-
going discussion.

Termination of employment often means realization of taxable income 
by the employee. However, termination of employment can be avoided, under 
certain circumstances, where the plan of the acquired corporation, in effect, 
is continued by the acquiring corporation. Necessary amendments to such plans 
in order to accomplish this objective should be made prior to the consumma-
tion of the acquisition. Rulings from the IRS on the continued qualification 
or on any terminations of such pension plans should also be obtained prior to 
consummation if possible.