Development of Limitations on Deductions under Pension and Profit-Sharing Plans

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How much of an employer's contribution under a tax-qualified plan is deductible in a taxable year? The answer depends on several factors, namely: reasonableness of compensation; the type of plan involved; the time payment is made; the methods, factors, and assumptions used in determining the deduction limitation; the existence of contribution carry-overs; and the availability of credit carry-overs in the case of a profit-sharing or stock bonus plan.

Depending upon the applicability of such factors, the full amount of a contribution may be deductible, or only a small portion may be applied in a particular year. For example, a contribution under a profit-sharing plan, not exceeding fifteen per cent of covered compensation and satisfying the requirement as to reasonableness of compensation would be fully deductible in the year paid.\(^2\) On the other hand, a contribution under a pension plan discharging in full the entire past service liability would be deductible to the extent of ten per cent of the cost which would be required to completely fund the past service credits as of the date included in the plan.\(^3\) The excess, however, would be available as a carry-over to be absorbed in succeeding taxable years in the order of time.\(^4\) The applicable treatment under appropriate situations will here be discussed.

I. Reasonableness of Compensation

An employer's contribution under a pension or profit-sharing plan is deductible within prescribed limits, provided that it constitutes either an ordinary and necessary trade or business expense or an expense for the production of income and is compensation for personal services actually rendered.\(^5\) Total compensation, inclusive of the contribution must be reasonable for such services.

A determination as to reasonableness of compensation is made on the basis of the facts in a particular case. In making such a determination, consideration is given to the personal services actually rendered in prior years as well as in the current year. All compensation and contributions paid to or for the employee for all years involved are compared with the value of the services for such years.

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1 See, Int. Rev. Code of 1954, § 401(a) for plans generally; Int. Rev. Code of 1954, §§ 403(a) and 404(a)(2) for nontrusteed annuity plans; Int. Rev. Code of 1954 § 501(a) for employees' trusts.


3 Id. § 404(a)(1)(C).

4 Id. § 404(a)(1)(D).

5 Id. § 162.

6 Id. § 212.

7 Treas. Reg. § 1.404(b) (1956).
LIMITATIONS OF DEDUCTIONS

A. Past Service

A contribution which is in the nature of additional compensation for services performed in prior years may be deductible even if the total of the contribution and other compensation for the current year is in excess of reasonable compensation for services performed in the current year, provided that such total together with all compensation and contributions paid to or for the employee in prior years represents a reasonable allowance for all services rendered through the end of the current year.

Payment in one year of a reasonable amount of additional compensation for services performed in previous years, during which there was no legal obligation to pay for such services, gives rise to a question as to the deductibility for such payment. The issue arose in an outstanding case in 1920 and was finally settled by the Supreme Court of the United States in 1930 with the holding that the amount is deductible in the year of payment to the extent that the compensation for past services is reasonable in view of the benefits that the employer had received as the fruits of such services. This concept has been included in the Income Tax Regulations and made applicable to plan contributions.

B. Proration

If reasonableness of compensation is challenged and an adjustment required, questions arise as to whether the disallowance applies to the direct compensation, or to the contribution, or both. If, for example, $100,000 was paid to an employee as direct compensation for a year when the employer had no plan, and compensation was held to be excessive to the extent of $25,000, and in the following year with all facts the same except that a profit-sharing plan had been established and a contribution of $25,000 made for the same employee, under a formula weighting compensation by years of service, there is excessive compensation of $50,000. Against which items is this amount to be charged, and to what extent? If it is entirely charged against salary, the employee will derive the benefits of qualification on the full amount contributed for him. On the other hand, since his compensation was excessive even before the contribution was made, should the deduction for the contribution be disallowed in full, and the balance of the excess charged against salary? If so, the employee will in effect be denied the benefit of participating in a qualified plan.

The equitable treatment is to allocate the allowable compensation and contribution in the proportion that the reasonable compensation bears to the total claimed. Total reasonable compensation of $75,000 is 60 per cent of the total claimed in the amount of $125,000. Therefore, 60 per cent of the contribution of $25,000, or $15,000, is allocated to contributions, and 60 per cent of the $100,000, or $60,000, is allowable as direct compensation, making a total allowance for reasonable compensation of $75,000. This treatment permits the em-
ployee to participate in the same proportion as originally contemplated, giving effect to weighting for years of service.

Since the disallowed contribution does not constitute an ordinary and necessary business expense, or an expense for the production of income, in the year paid or any subsequent year, no carry-over of the excessive contribution that is disallowed would be available as a deduction in a subsequent year.\textsuperscript{10}

II. Deduction Limitations

While the issue as to the deductibility of compensation in the year paid for services rendered in prior years was proceeding through the courts,\textsuperscript{11} huge reserves that had accrued for past service credits under pay-as-you-go pension plans, and for which no deductions were allowable until paid, were paid into pension trusts and deducted in full in the year of payment. Under such procedure, not only were large deductions claimed in one year but the employer could choose the year of deduction.

This, however, was stopped in 1928 with a statutory change limiting deductions under pension trusts which provided benefits based on past service credits, so that a deduction for contributions to provide such benefits had to be spread over a period of ten years.\textsuperscript{12} Contributions during a taxable year to cover the pension liability accruing during such year, however, continued to be deductible in full to the extent that they constituted ordinary and necessary business expenses. Thus, for example, a payment of $1,000,000, for past services, and $100,000 on account of the liability accruing during the current year, was deductible in the year of payment to the extent of $200,000, consisting of $100,000 for the current cost and $100,000 (ten per cent of $1,000,000) for past service funding. The balance of $900,000 was deductible in equal parts over the remaining nine years.

Such limitations, however, did not apply to contributions under non-trusteed annuity plans,\textsuperscript{13} nor to profit-sharing and stock bonus plans.\textsuperscript{14} Those contributions were deductible to the extent that they constituted ordinary and necessary business expenses.

A. Changes in 1942

This treatment was changed under the Revenue Act of 1942. The method of limiting deductions for past service pension trust contributions was modified and extended to contributions under non-trusteed annuity plans. Limitations were also imposed on deductions for contributions under profit-sharing and stock bonus plans. In addition, restrictions were provided for deductions on account of contributions under non-qualified plans and compensation under a plan deferring the receipt thereof.

\textsuperscript{11} Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930).
\textsuperscript{12} Rev. Act of 1928 § 23(q); continued under Rev. Act of 1932 and Rev. Act of 1934; succeeded by Rev. Act of 1936 § 23(p) which was continued under Rev. Act of 1938 and the Internal Revenue Code of 1939; replaced by new § 23(p) under Rev. Act of 1942 § 162(b).
\textsuperscript{14} Gisholt Machine Co., 4 T.C. 699 (1945).
B. Pension and Annuity Limitations

It was recognized that limiting deductions to ten per cent of the amount contributed to fund past service credits could, and in many cases did, extend such deductions far beyond ten years. If, for example, the employer contributed ten per cent of the original past service liability in each of ten years, deductions would continue for nineteen years, in addition to which there would be interest on the unfunded liability. The last payment, made in the taxable year, would be deductible only to the extent of ten per cent thereof in that year, and the balance would be deductible in equal parts during each of the next nine years.

The change in 1942 provided for a deduction to the extent of ten per cent of the liability,\(^{15}\) instead of the amount contributed. Thus, in the above example, the contributions made in each of ten years would have been deductible in full in ten years, again apart from the interest. Of course, unless the past service liability is paid in full at the inception of the plan, it increases daily through accretions for interest. The deduction, however, is limited to ten per cent of the original liability. Thus, for example, with interest at 3½ per cent, funding at a straight ten per cent rate would take more than twelve years to discharge the liability.

Payment on account of the liability accruing during the taxable year, denominated "normal cost," continued to be deductible without percentage limitation.

A five per cent of compensation limitation,\(^{16}\) and on a level-percentage of compensation basis,\(^ {17}\) were also provided.

C. Profit-sharing and Stock Bonus Limitations

While the Tax Revision Bill of 1942 was under consideration, a uniform limitation of five per cent of compensation of covered employees was sought to be imposed on deductions for contributions under all types of plans: profit-sharing and stock bonus, as well as pension and annuity.\(^ {18}\) It was recognized, however, that the basis for contributions under profit-sharing plans is entirely different from that under pension plans. One is a budget item which is not geared to profits, while the other is completely dependent on profits. Profits fluctuate and an annual rate of five per cent could deprive participating employees of the benefits of contributions during years of little or no profits while large profits may be derived in other years from which they would not benefit, except to the limited extent of five per cent.

Changes were accordingly made whereby first, the rate for profit-sharing and stock bonus plans was increased to fifteen per cent and second, provision was made for contribution and credit carry-overs.\(^ {19}\) If more than fifteen per


\(^{17}\) Id. § 404(a)(1)(B).


cent of compensation of participating employees is contributed in a taxable year, the excess is carried forward to, and is deductible in, succeeding taxable years, in the order of time, to the extent that such carry-over, plus the amount then contributed, does not exceed fifteen per cent of compensation. In a taxable year in which nothing, or less than fifteen per cent of compensation, is contributed, the full fifteen per cent, or the difference, is available as a credit carry-over, and may be absorbed in succeeding taxable years, in the order of time. In a year in which a credit carry-over is available, unlike the situation applicable to contribution carry-overs, the deduction may be as high as thirty per cent of compensation, consisting of fifteen per cent for such year, and as much as fifteen per cent for the available carry-over. These limitations and carry-overs are currently in effect.

D. Alternative Pension Limitations

The five per cent recommended limitation, however, was retained for pension and annuity plans, as an alternative where the total for both current and past service funding does not exceed such rate. Where it does, and such excess is necessary to provide for covered employees the remaining unfunded cost of their past and current service credits on a level funding basis over the remaining future service of each such employee, such level annual cost may be deductible in lieu of a deduction for the normal cost plus ten per cent of past service liability. Where, however, the remaining unfunded cost with respect to any three individuals is more than fifty per cent of such cost, the deduction for such cost must be spread over at least five years.

E. Overall Limitation

An overall limitation was also imposed on deductions for contributions under (1) pension or annuity plans and (2) profit-sharing or stock bonus plans, covering one or more of the same employees. In such case, the maximum amount deductible for a contribution in a taxable year is 25 per cent of compensation of covered employees. If the contribution exceeds such limitation, the excess is deductible in succeeding taxable years, in the order of time, but the total, consisting of the carry-over and the then-current contributions, cannot exceed thirty per cent of compensation of employees under the plan. First, the separate limitations applicable to deductions under pension and annuity plans, on the one hand, and profit-sharing and stock bonus plans, on the other, are imposed, and then the overall limitation is applied.

F. Nonqualified Plans

Percentage limitations, however, do not apply to nonqualified plans. Under the 1942 change,\(^22\) which continued in effect to August 1, 1969,\(^24\) contributions under nonqualified plans were deductible to the extent that they constituted ordinary and necessary business expenses, or expenses for the production of income, only in the taxable year paid, and only if the employee's rights thereto, or derived therefrom, were nonforfeitable at the time of payment. Each employee was taxable on his share of such contributions, to the extent of his nonforfeitable interest, in the taxable year when made.\(^25\)

Such treatment, however, was changed under the Tax Reform Act of 1969, which extended the new rules applicable to restricted property to deductions for contributions under nonqualified plans.\(^26\) As in the case of restricted stock, the employer is allowed a deduction in the taxable year in which an amount attributable to the contribution is includible in the gross income of the employee. Separate accounts are required for participants where there are more than one.\(^27\) The employee is taxable on the contribution at the time of receipt, or when it is freely transferable, or not subject to substantial risk of forfeiture, as elected by the employee within 30 days.\(^28\)

If the employee is required to perform substantial future service, there is a substantial risk of forfeiture. Should he, however, elect to be taxed at the time the contribution is made, but later forfeits, no refund or deduction is available. An election to be taxed may be made where there is a good likelihood for subsequent appreciation which may be taxable as a capital gain on sale. The employer is allowed a deduction when the amount is included in the gross income of the employee.\(^29\) The employees in nonexempt trusts,\(^30\) or nonqualified annuity plans,\(^31\) have the same election as in the case of restricted property for inclusion in gross income of the employer's contribution, regardless of nonforfeitability.

Hence, if the employee stands to forfeit his interest in the event that he does not remain in the service of the employer until he attains a specified age, or completes a prescribed period of employment, or for other substantial reasons he need not include such interest in his gross income until the conditions are fulfilled, but the employer is not allowed a deduction until such time. On the other hand, if the employee is willing to risk forfeiture and establish a current basis against a subsequent distribution, he may elect within 30 days from the time the contribution is made to include his share in gross income and the employer is allowed a deduction in the same year.

The election to report currently is likely to be made where the employee is reasonably sure that he will meet the required conditions. A stockholder-employer

\(^{22}\) INT. REV. CODE of 1939, § 23(p)(1)(D).
\(^{24}\) INT. REV. CODE of 1954, § 404(a)(5).
\(^{25}\) INT. REV. CODE of 1939, §§ 165(c) and 22(b)(2)(B); INT. REV. CODE of 1954, §§ 402(b), 403(c).
\(^{26}\) TAX REFORM ACT OF DEC. 30, 1969, PUB. L. 91-172, § 321(d).
\(^{27}\) Id. § 321(b)(3), amend'g. INT. REV. CODE of 1954, § 404(a)(5).
\(^{28}\) INT. REV. CODE of 1954, § 83(b) (as amended 1969).
\(^{29}\) INT. REV. CODE of 1954, § 402(b) (as amended 1969).
\(^{30}\) INT. REV. CODE of 1954, § 403(c) (as amended 1969).
in a closely held corporation may find it advantageous to elect the current tax
treatment where payment is contingent, for example, on employment until retire-
ment, or prior disability or death. He reports the income, but the employer is
allowed a current deduction.

III. Effect of Exemption of Trust on Carry-overs

As heretofore pointed out, limitations were first imposed under the Revenue
Act of 1928 on deductions for employer contributions to pension trusts funding
past service benefits. Provision was made in subsequent Acts to absorb carry-
overs for contributions in excess of the allowable limitation. As set forth in the
1939 Code, prior to amendment in 1942, section 23(p) provided in part:

(3) EXEMPTION OF TRUSTS UNDER SECTION 165.—The
provisions of paragraphs (1) and (2) of this subsection shall be subject to
the qualification that the deduction under either paragraph shall be allow-
able only with respect to a taxable year (whether the year of the transfer or
payment or a subsequent year) of the employer ending within or with a
taxable year of the trust with respect to which the trust is exempt from tax
under section 165.

Hence, in order to obtain a deduction for a carry-over resulting from an
excess contribution in a prior year, it was necessary that the trust be exempt in
the year in which the carry-over was applied. The purpose was to prevent the
employer from obtaining a deduction for an excess contribution through carry-
overs and then recovering the funds contributed. Prior to 1938, there was no
requirement for qualification of a plan that the trust instrument must make it
impossible, at any time prior to the satisfaction of all liabilities with respect to
employees and their beneficiaries under the trust, for any part of the corpus or
income to be diverted to purposes other than for the exclusive benefit of the em-
ployees or their beneficiaries. Such requirement, however, was added under the
Revenue Act of 1938, effective for taxable years after 1939.

When the Tax Revision Bill of 1942 came up for consideration, the bill as
passed in the House contained the old requirement that the trust had to be
exempt in the year the carry-over was applied. This requirement, however, was
eliminated by the Senate, and agreed to in conference. Since the qualification
requirement provided against prohibited diversion, the requirement for exemption of
the trust in the year the carry-over was applied was not retained in the deduc-
tion section.

The regulations, however, continued the requirement but the provision was
held invalid after litigation. The present regulations allow a deduction for a

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32 See section on "Deduction Limitations" infra, and note 12.
34 H.R. REP. No. 7378, 77th Cong., 2d Sess. 116-17 (1942).
37 Royers, Inc. v. U.S., 265 F.2d 615 (3rd Cir. 1959).
carry-over arising from an excess contribution to or under a pension or annuity plan that is no longer qualified, or has been terminated, within the limits applicable to past service funding under the ten per cent rule. In the case of a profit-sharing plan, a deduction for a carry-over in the case of a trust that is no longer exempt, or has been terminated, is allowable to the same extent as under an exempt trust.

IV. Special Problems

A. Make-up Contributions

In the usual profit-sharing case, an employer makes a contribution out of profits for the benefits of its own employees. A payment for employees of another would not be an ordinary and necessary business expense of the paying company. Problems, however, arose in cases where plans were maintained by a group of employers. A single plan and trust could be maintained by any number of employers, regardless of their degree of affiliation, but each employer separately must meet all applicable requirements as though he were the only one maintaining the plan.

Where single plans were maintained by affiliated companies, hardships were usually experienced by employees of companies with little or no profits. All companies constituted an economic unit and, in certain cases, employees of loss companies contributed to earning the overall profits to the same extent as the employees of the profit-making companies. Nevertheless, they were not permitted to share in the profits.

This situation was changed in 1954. It has since been permissible for the profit-making companies in a group of affiliated corporations to make up a contribution under a profit-sharing plan, or a stock bonus plan in which contributions are determined with reference to profits, on behalf of a loss member so that its employees could share in the profits as though such loss member had made the contribution.

Deductions are allowable to the contributing companies for the make-up contributions, but credit carry-overs are available only to the loss member on whose behalf the contributions are made. If the group files a consolidated return, the contribution on behalf of the loss member may be made up in any proportion the contributing companies agree upon. If, however, a consolidated return is not filed, each of the profit-making companies is limited to a portion of the make-up contribution determined by a prescribed formula. Under the formula the profits for the taxable year of each company are added to its accumulated earnings and profits at the beginning of the year and its own contribution is deducted from the total, leaving a balance of accumulated earnings and profits;

38 Treas. Reg. § 1.404(a)-7 (1956).
39 Id. § 1.409(a)-3(e).
43 Id. § 401(a), permitting contributions by an employer who is entitled to deduct his contributions under section 404(a)(3)(B).
the portion of each company's accumulated earnings and profits in relation to
the total for all companies results in a rate that is used in determining the share
that each is to make up on behalf of the loss member.

B. Foreign Situs Trusts

One of the requirements for qualification of an employees' trust is that it
be created or organized in the United States. There is no effective way of col-
clecting a tax on distributions from a foreign situs trust to nonresident aliens.
Hence, by denying exemption to the trust a tax on income earned in the United
States could be collected at the source by withholding.

There are situations, however, where the trust would have qualified except
for the fact of its foreign situs. Questions were then presented as to the allowance
of deductions for employer contributions and the tax treatment of employees.
These were answered by changes in the 1954 Code by (1) permitting deductions
within the applicable limits for employer contributions to a foreign situs trust
which would have qualified except for its foreign situs, and (2) providing the
same tax treatment to participants in such a trust to the same extent as under
an exempt trust.

C. Negotiated Plans

The deduction limitations apply to amounts contributed by an employer
under a pension, annuity, stock bonus, profit-sharing plan, or any plan of deferred
compensation. Such limitations, however, do not apply to a plan which does
not defer the receipt of compensation, nor to a plan which is solely a dismissal
wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical
expense, recreation, welfare, or similar benefit plan, or a combination there-
of.

However, cases arose under union negotiated contracts providing for both
pension and welfare benefits which caused some concern. Contributions to pro-
vide pensions were subject to the deduction limitations, but those to provide wel-
fare benefits were not. Under the changes effected in 1954, provision was made
to treat the total contribution as an ordinary and necessary business expense,
not subject to the deduction limitations, if two conditions are met.

The contributions are to be paid into a trust for the purpose of paying at
least medical or hospital care for employees or their families, and pensions on
retirement or death of employees. The plan also must have been established
prior to January 1, 1954, as a result of an agreement between the employee
representatives and the Government of the United States during a period of Gov-
ernment operation, under seizure powers, of a major part of the production facil-
ities of the industry in which the employer is engaged. This involves the coal

44 INT. REV. CODE of 1954, § 404(a) (3) (B); TREAS. REG. § 1.404(a)-10(b) (1956).
45 Id. § 402(c).
46 Id. § 1.404(a)-1(a)(2) (1956).
47 Id. § 404.
48 Id. § 402(c).
49 INT. REV. CODE of 1954, § 162.
50 Id. § 404(a) (1).
industry, and includes employers who were in competition with those whose facilities were seized, being applicable to employers in the bituminous as well as in the anthracite coal industry.\textsuperscript{51}

The trust providing such benefits, not being part of a qualified plan, is not exempt. Should such trust, however, qualify for exemption, this special treatment of contributions as trade or business expenses would no longer apply, even though the trust may later lose its exemption.

D. Plans Benefiting Self-Employed Individuals

The Self-Employed Individuals Tax Retirement Act of 1962 provided for the participation of self-employed individuals in qualified plans to a limited extent. As originally enacted, provision was made for the allowance of deductions on account of contributions for self-employed individuals to the extent of one-half of the amount which otherwise would have been deductible under the applicable limits, limited however to the lesser of $1,250 or ten per cent of the individual's earned income for the taxable year.\textsuperscript{52}

Also, where both personal services and capital were material income producing factors, provision was made limiting earned income to an amount not in excess of thirty per cent of the individual's share of the net profits of the trade or business from which the income was derived.\textsuperscript{53}

Changes, however, were effected for taxable years beginning after December 31, 1967, removing the 50 per cent reduction and the limitation on earned income where both personal services and capital are income producing factors.\textsuperscript{54}

These changes permit substantial increases in deductions for contributions on behalf of the individuals concerned. For example, an individual with business net income in 1967 of $25,000, where both personal services and capital are material income producing factors, would have been allowed a deduction of only $375, i.e., \( \frac{1}{2} \) of 10\% of $7,500 (30\% of $25,000). Under identical facts, for taxable years, beginning after 1967, the allowable deduction increases to $2,500, i.e., 10\% of $25,000.

Thus, the amount the individual may provide for his retirement is more than tripled (from $750 to $2,500), and his deduction would be more than six times as much (from $375 to $2,500).

V. Conclusion

A bird's-eye view of the development of the deduction limitations under pension and profit-sharing plans has here been presented. An understanding as to how these came about, and how they changed over the years, may be helpful in making a judicious choice in the selection of a plan and in providing the benefits thereunder.

\textsuperscript{51} Id. § 404(c); Treas. Reg. § 1.404(c)-1 (1956).
\textsuperscript{53} Id. § 401(c)(2), prior to amendment, subjecting the term "earned income" to the "30 percent rule" contained in Int. Rev. Code of 1954, § 911(b).
\textsuperscript{54} Pub. L. No. 89-809, §§ 204(a), 204(c), effective for taxable years beginning after Dec. 31, 1967.