

Taxation of Distributions from Qualified Pension, Profit Sharing and Stock Bonus

Joseph I. Swietlik

Follow this and additional works at: <http://scholarship.law.marquette.edu/mulr>



Part of the [Law Commons](#)

Repository Citation

Joseph I. Swietlik, *Taxation of Distributions from Qualified Pension, Profit Sharing and Stock Bonus*, 47 Marq. L. Rev. 15 (1963).
Available at: <http://scholarship.law.marquette.edu/mulr/vol47/iss1/2>

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

TAXATION OF DISTRIBUTIONS FROM QUALIFIED PENSION, PROFIT SHARING AND STOCK BONUS PLANS

JOSEPH I. SWIETLIK*

Pension plans, profit sharing plans, stock bonus plans and other deferred compensation arrangements have become as essential in the event of disability, retirement, or death as Social Security.¹ Such plans constitute a private sponsorship and financing of individual Social Security plans as distinguished from the general public Social Security system. This is evidenced by the fact that Internal Revenue Service permits integration of benefits paid under qualified pension, profit sharing and stock bonus plans with the benefits paid under the Social Security program.

Confusion often arises, however, concerning the tax benefits and tax treatment relating to the distributions received from qualified pension, profit sharing and stock bonus plans. The universal acceptance and use of such plans inevitably leads one to the conclusion that they are beneficial economically, particularly from a tax standpoint. It is the purpose of this paper to set forth the tax treatment of distributions received from qualified pension, profit sharing and stock bonus plans.²

I. WHAT IS A "QUALIFIED" PLAN?

A "qualified" plan as distinguished from an unqualified plan is one which meets the requirements of Section 401 of the Internal Revenue

* A.B., Marquette University, 1931; LL.B., Marquette University, 1956; LL.M., Harvard University; member of the American Bar Association; member of the firm of Laikin, Jacobson & Swietlik, Milwaukee, Wisconsin.

¹ A pension plan is defined as "a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise." Treas. Reg. §1.401(b)(1)(i). A profit sharing plan is defined as "a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries." Treas. Reg. §1.401(b)(1)(ii). A stock bonus plan is "a plan established and maintained by an employer to provide benefits similar to those of a profit sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company." Treas. Reg. §1.401(b)(1)(iii).

² In addition to pension, profit sharing and stock bonus plans, certain annuity plans may also constitute qualified plans within the meaning of Section 402 and 403 of the INTERNAL REVENUE CODE of 1954. Such an annuity contract is one which provides primarily for periodic installment payments to the annuitant and under which death benefits at any time cannot exceed the larger of the reserve or the total premiums paid for the annuity proceeds. REV. RUL. 55-639, 1955-2 CUM. BULL. 230. This paper will only consider trustee plans and will not deal with non-trusteed annuity plans established pursuant to section 403 and which meet the requirements of section 404(a)(2). Annuity contracts will be considered only in so far as they may be purchased to fund a trustee plan.

Code. Basically, such plan must be organized for the exclusive benefit of the employees or their beneficiaries and may not discriminate in favor of officers, shareholders, supervisors or highly compensated employees. The plan itself, together with detailed schedules of all employees covered by the plan indicating their status as officers, shareholders, supervisors or highly compensated employees, and other relevant data, must be submitted to the Pension Trust Division of the Internal Revenue Service for review.³ Should the Internal Revenue Service determine that the plan is in accord with the requirements of the Internal Revenue Code, it will issue a determination letter to that effect.

With regard to the employer, any contributions made by him to the plan pursuant to the regulations under Sections 401 through 404 will constitute deductions for federal income tax purposes.

With regard to the plan itself, the securing of a favorable determination letter means that any income earned by assets held in the plan will not be subject to tax.⁴

With regard to the employee participants, any amount contributed by employer is not income to the employees at time of the contribution except to the extent that the contribution represents the cost of current life insurance protection.⁵ In addition, tax benefits will be secured by the employees who are beneficiaries of the plan when distributions are made to them.

II. WHEN ARE PROCEEDS FROM QUALIFIED PLANS TAXABLE TO THE EMPLOYEE?

A. *Actual Receipt of Proceeds from Qualified Plans*

The Internal Revenue Code provides with regard to distributions from qualified plans that "the amount actually distributed or made available to any distributee by an employee's trust . . . shall be taxable to him, in the year in which so distributed or made available. . . ."⁶ Thus, any amount actually received by an employee is taxable to him in the year of receipt.

B. *Constructive Receipt of Proceeds from Qualified Plans*

If an employee has an unrestricted right to receive the amount standing to his credit in a qualified plan, such amount is considered as being available to him and will be taxable to him in the year in which it is so made available. An employee may not avoid taxation by neglecting or

³ See: REV. RUL. 61-157, 1961-2 CUM. BULL. 67, for guides applicable to the qualification of stock bonus, pension, profit sharing and annuity plans under §401(a) of the INT. REV. CODE OF 1954.

⁴ INT. REV. CODE OF 1954, §501.

⁵ Treas. Reg. §1.402(a)-1(a)(3). The cost of current insurance is stated in REV. RUL. 55-747, 1955-2 CUM. BULL. 228.

⁶ INT. REV. CODE OF 1954, §402(a)(1).

⁷ REV. RUL. 54-265, 1954-2 CUM. BULL. 239.

refusing to receive his distribution since it is made available to him.⁷ If, however, the withdrawal of an amount from a qualified plan is "substantially restricted" then the employee will not bear the tax burdens of the amount standing to his credit because such amount is not considered as having been made available to him.⁸ For example, where a substantial penalty is imposed upon withdrawal, such as discontinuance of further participation in the plan, the employee's interest is not deemed available to him for tax purposes.⁹ If by withdrawing the amount standing to his credit the employee will forfeit part of such amount, the amount is not "made available" to him and is not taxable to him.¹⁰

In some instances the employee may take affirmative action so as to avoid the amount standing to his credit from being "made available" to him and thus taxable to him. Thus, if an employee continues to work beyond normal retirement age, and if prior to normal retirement age, he makes an irrevocable election not to receive any amount standing to his credit prior to actual retirement, then the amount standing to his credit is not made available to him until actual retirement.¹¹ However, a recent case has held that if an employee may elect to place a portion of what would otherwise be paid to him directly into a profit sharing trust, such portion is taxable to the employee even if the election must be made prior to the end of the employer's fiscal year.¹²

When an employee may elect at any time prior to the completion of a stated number of years, e.g. 14 years, of continuous service to receive distribution of his interest upon completion of 15 years of continuous service and where he may otherwise receive a distribution of his interest only upon retirement, the trust funds are not "made available by reason of the right to make such an election."¹³ Where the determination of whether the employee may receive the amount standing to his credit is vested in the trustees who may pay out such amount pursuant to standards established by the plan, the amount standing to the employee's credit is not made available to him and is not taxable to him until the trustees exercise such discretion.¹⁴

⁸ REV. RUL. 55-423, 1955-1 CUM. BULL. 41.

⁹ Dillis C. Knapp, 41 B.T.A. 23 (1940); Estate of A. M. Berry, 44 B.T.A. 1254 (1941).

¹⁰ REV. RUL. 55-423, 1955-1 CUM. BULL. 41.

¹¹ REV. RUL. 57-260, 1957-1 CUM. BULL. 164.

¹² Hicks v. U.S., 205 F.Supp. 343 (1962), —F.2d— (4th Cir. 1963).

The Hicks case appears to be contrary to REV. RUL. 57-260, 1957-1 CUM. BULL. 164. In each case the employee affirmatively made an election not to receive an amount which he would have received had he not made the election. Both elections were made prior to the time the employee had a right to the money. The fact that the Hicks case deals with annual payments and the ruling deals with postponement of payment to the employee beyond retirement age appears inconsequential. The Hicks case suggests that no distribution should be at the election of or in the discretion of the employee.

¹³ REV. RUL. 55-425, 1955-1 CUM. BULL. 43.

¹⁴ REV. RUL. 55-424, 1955-1 CUM. BULL. 42.

In those instances where there is a substantial restriction imposed upon withdrawal from a qualified plan, it would appear that the employee may not withdraw part of the amount standing to his credit without having the entire amount deemed to be made available to him and taxable to him. This result obtains because the employee would suffer no additional penalties by taking out the entire amount standing to his credit. Thus, there would be no further restriction or penalty on the amount left in the plan and such amount would consequently be made available to him upon withdrawal of part of this amount.

In the event the funds of one plan are transferred over to or merged with the funds of a second plan due to changes of corporate structure, the employee is not taxed on the amount standing to his credit where he does not have a right to direct the disposition of those funds. Also, if upon transfer of the funds of one plan to a second plan the employee is given election either (1) to leave his funds with the second plan and receive credit for all prior years of service or (2) to withdraw the amount standing to his credit and lose all credit for prior service so that he will be treated as a new employee in the second plan, those employees who elect not to withdraw their amounts are not taxable on such amounts because of the penalty imposed upon withdrawal. The loss of prior service credits prevents the amounts from being made available to the employee at the time of the transfer of funds.¹⁵ Whether or not the employee who elects to withdraw the amount standing to his credit would be entitled to capital gain treatment depends upon whether there has been a "separation from service" of the employer.¹⁶

If the employees are under a contractual obligation to repay amounts received from one plan into a second plan, then such amounts are not made available to them because they are merely acting as agents for the transfer of the funds.¹⁷ Furthermore, the transfer of funds in an insured contributory plan to a trustee under a non-insured plan does not cause the amounts to be taxable to the employees. Thus, a change of funding from insurance to a trustee method does not result in tax to the participants.¹⁸

III. PAYMENTS RECEIVED DURING LIFETIME—ON RETIREMENT OR OTHER TERMINATION OF SERVICE

Most qualified plans provide for distributions to the employee upon his termination of employment because of retirement or termination of service. There is a distinct difference in the tax treatment afforded to the distribution depending upon whether the payment is made in one lump sum or whether the payments are made over a period of years.

¹⁵ REV. RUL. 55-317, 1955-1 CUM. BULL. 329.

¹⁶ See discussion following footnote 59 *infra*, *re*: separation from service.

¹⁷ REV. RUL. 55-368, 1955-1 CUM. BULL. 40.

¹⁸ REV. RUL. 55-427, 1955-2 CUM. BULL. 27.

A. *Lump Sum Payments Received During Lifetime*

When an employee receives a lump sum payment as his distributive share from a qualified plan, it must first be determined who made the contributions to the plan. That is, if the employee made contributions to the plan, then he is merely receiving back his own capital, whereas, if only the employer made contributions to the plan, then the employee is receiving upon retirement something which he did not have prior to that time. Special consideration must be given to the proceeds of insurance in the event the plan has been funded through an insurance program. In addition, distributions of stock of the employer and distributions of annuity contracts from trustee plans are subject to separate tax rules.¹⁹

1. Amount Contributed by Employee.

If the employee made contributions to the qualified plan, then upon receipt of a lump sum distribution, he is entitled to receive back on a tax-free basis the amount which he, himself, originally put into the plan.²⁰ It should be noted that any income earned by the amount which the employee placed in the plan is not treated in the same manner and is not received on a tax-free basis by the employee.

2. Amount Contributed by Employer.

If distribution is made in a lump sum within one taxable year of the employee on the account of his separation from service of the employer, then the amount of the distribution constituting contributions made by the employer, together with all income earned by both employer and employee contributions, will be entitled to capital gain treatment.²¹

3. If the Plan is Funded by Insurance.

In the event of a lump sum distribution during lifetime to an employee from a plan which is funded by insurance, the employee is entitled to receive on a tax-free basis not only his own actual contributions to the plan, if any, but, in addition thereto, the amount of constructive

¹⁹ As indicated in footnote 2 *supra*, this paper will only deal with trustee plans.

Annuity contracts will be discussed only to the extent that they are used to fund part or all of a trustee plan.

²⁰ INT. REV. CODE OF 1954, §§402(a)(2) and 101(b). An employee participant is clearly entitled to receive back any amount paid into a qualified plan at the time of normal distribution under such plan. He is also entitled to withdraw his own contributions with interest if he ceases to participate in a qualified plan but stays with the company. REV. RUL. 60-281, 1960-2 CUM. BULL. 146. Furthermore, an employee may withdraw his own voluntary contributions to a qualified plan where the withdrawal doesn't affect (1) the employee's participation, (2) the employer's past or future contributions on his behalf, or (3) the basic benefits provided by both his and the employer's compulsory, non-withdrawable contributions, and *where no interest is allowed* on the withdrawn contributions either at the time of withdrawal or in computing benefits at retirement. REV. RUL. 60-323, 1960-2 CUM. BULL. 148.

²¹ INT. REV. CODE OF 1954, §402(a)(2).

contributions made by him.²² That is, while he was a member of the plan, the cost of current insurance protection was taxable to him. Thus, it follows that the cost of current insurance protection which he paid while he was a member of the plan, or in other words his constructive contributions, should be received on a tax-free basis because the employee has already paid ordinary income tax on those amounts.²³ Thus, any amount received as a lump sum distribution from a plan funded by insurance is tax-free to the extent of actual employee contributions and to the extent of constructive employee contributions. The excess, if any, consists of contributions made by the employer and income of the trust, both of which items will be taxed at capital gain rates to the employee.

4. Special Problems with Regard to Capital Gain Treatment of Lump Sum Payments During Lifetime.

Although the rules governing the taxability of lump sum distributions from qualified plans have been set forth in the Code and in the regulations, the application of those rules is often troublesome. The payment must be made within one taxable year of the employee, and it must be made on account of his separation from service of the employer. In the usual case of retirement or total disability no problems are presented. However, in the event of corporate sales, corporate reorganizations, mergers of two or more companies, liquidation of the corporation or simple termination of the plan, questions arise as to whether or not any part of the payment made at that time is entitled to capital gain treatment.

a. Payments Must Be Made Within One Taxable Year of the Employee to Obtain Capital Gain Treatment.

The lump sum payment must be received within one taxable year of the employee.²⁴ It should be noted, however, that the lump sum payment need not be paid in the taxable year in which the employee terminates his service.²⁵ Whether an employee will be taxed during the year of his termination of service will depend upon whether or not the amount standing to his credit in the qualified plan is either "paid to or made available" to him during such year.²⁶ An employee cannot arbitrarily elect to leave his distributable amount in the plan and avoid pay-

²² INT. REV. CODE OF 1954, §§402(a)(2) and 72(f).

²³ Treas. Reg. §1.402(a)-1(2)(3); REV. RUL. 55-747, 1955-2 CUM. BULL. 228.

²⁴ If the entire amount standing to a participant's credit is distributed in one taxable year of the participant and a later payment is made upon adjustment of the year-end contribution, the first distribution is entitled to capital gain treatment and the later adjusted amount is ordinary income. Treas. Reg. §1.402(a)-1(2)(6)(ii); REV. RUL. 56-558, 1956-2 CUM. BULL. 290.

²⁵ REV. RUL. 60-292, 1960-2 CUM. BULL. 153.

²⁶ INT. REV. CODE OF 1954, §402(a).

ing the tax thereon.²⁷ However, if sufficient restrictions are placed upon the exercise of the employee's rights to receive a lump sum distribution so that his electing to receive payment will become burdensome to him, then the employee will be taxed on his distributable lump sum on the date he elects to receive actual payment or on the date said restrictions are lifted, whichever first occurs.²⁸

b. Payments Must Be Made Upon "Separation from Service" to Obtain Capital Gain Treatment.

For purposes of the Internal Revenue Code, the term "separation from service" means "separation from service of the employer."²⁹ Thus, the question of whether a separation from service has occurred depends upon the termination of the employer-employee relationship. Separation from service may occur even though an employee continues at the same job without interruption of any kind if actual ownership and management of the company is transferred to a new employer.

(1) Separation from service and capital gain treatment upon resignation or retirement.

Ordinarily a separation from service will occur upon resignation or retirement. However, there must be actual retirement and not merely termination of participation in a qualified plan. Thus, if the plan provides that employees are to retire from the plan upon reaching the age of 60 and at such time are to receive their benefits in a lump sum, the employee may not continue to be an employee if he wishes to obtain capital gain treatment on the lump sum distribution. This is true even though the employee may continue his employment under a new employment agreement.³⁰

In order to qualify for capital gain treatment upon a lump sum distribution, the separation from service must be complete and final. In *Estate of Frank B. Fry v. Commissioner*³¹ the qualified pension plan provided for retirement upon reaching age 70. Upon attaining that age, Mr. Fry received a lump sum distribution from the plan and thereafter spent less time and effort in working for the employer corporation. Although he continued to receive the same compensation for the services that he had previously rendered, he spent an increasing amount of his time at his winter home in Florida and at his farm and hunting lodge in Canada. Because he continued to render some services to the corporation, a lump sum distribution did not qualify for capital gain treatment.

²⁷ REV. RUL. 55-423, 1955-1 CUM. BULL. 41; REV. RUL. 55-460, 1955-2 CUM. BULL. 591.

²⁸ See discussion at footnote 8 *supra*.

²⁹ Edward J. Glinske, Jr., 17 T.C. 562 (1951).

³⁰ REV. RUL. 46-215, 1956-1 CUM. BULL. 196.

³¹ *Estate of Frank B. Fry v. Commissioner*, 19 T.C. 461, 205 F.2d 517 (3rd Cir. 1952); see also: William S. Bolden, 39 T.C. No. 85 (Feb. 20, 1963).

The fact that the employee's compensation is terminated is not determinative of whether there has been a separation from service of the employer. Thus, where an employer corporation liquidated all of its assets, invested its funds in securities, and terminated the services of all its employees except one individual who continued to act as an uncompensated officer and director, capital gain treatment was not available to such individual upon a lump sum distribution from the employer's profit sharing plan at the time the services of all other employees were terminated.³² However, if an officer-employee is discharged, there is "separation from service," and he is entitled to capital gain treatment even though the shareholders may later elect him to serve as liquidator of the corporation under applicable state law.³³ Although the question of whether compensation is paid may have some bearing in determining whether there has been a separation from service, the deciding factor is whether there has been an actual termination of physical services.

A director is not normally classified as an employee and consequently if an individual terminates all services and remains a director of the corporation, he will probably be entitled to capital gain treatment upon a lump sum distribution at the time of his termination of services as an employee even though he remains as a director.³⁴ However, if such director performs any services other than those required as a director, he will be classified as an employee.³⁵

In *Estate of E. I. Rieben*,³⁶ the employer corporation discontinued its sales operations, liquidated its assets, and terminated its qualified plan. The corporation was not dissolved, but, rather, was continued as an investment company by the stockholders. The employee in question continued as an officer of the corporation. The Tax Court held that an officer is an employee, and that a lump sum payment made to him at the time of termination of the plan was not entitled to capital gain treatment because termination of business activity does not constitute separation from service of the employer if the employer corporation is not dissolved and the employee remains an officer of such corporation.

(2) Separation from service and its relationship to deferred compensation contracts.

Because capital gain treatment of a lump sum payment from a qualified plan requires separation from service, a problem arises with respect to drafting deferred compensation contracts.

³²REV. RUL. 57-115, 1957-1 CUM. BULL. 160.

³³REV. RUL. 62-22, INT. REV. BULL. No. 1963-8, at 14.

³⁴I.T. 4077, 1952-1 CUM. BULL. 149; REV. RUL. 57-246, 1957-1 CUM. BULL. 338.

³⁵*Oliphint v. Commissioner*, 24 T.C. 744, 234 F.2d 699 (5th Cir. 1956).

³⁶*Estate of E. I. Rieben*, 32 T.C. 1205 (1959).

In most cases, a deferred compensation contract should not be funded.³⁷ That is, the contract should not provide for the current payment of premiums on an annuity contract nor should it require the employer to set aside or establish any particular fund. If the deferred compensation contract is funded and the employee's rights are non-forfeitable, then the employee must include in taxable income currently the amount set aside or used to fund the contract.³⁸ Thus, a non-forfeitable funded contract destroys the primary objective of deferment of paying income taxes. On the other hand, if the employee's rights are forfeitable, the employer gets no deduction for current payments to fund the contract.³⁹ According to the regulations, this deduction is lost forever to the corporation.⁴⁰

From the foregoing, it can be seen that in most cases a funded contract is not feasible. The question then arises as to whether a contract which is not funded should be forfeitable or non-forfeitable. That is, should the employee's rights to receive deferred payments after retirement be contingent on his being available for consulting services or on his agreeing not to compete with the employer after his retirement. With respect to the corporation, it may deduct payments under an unfunded contract at the time such payments are actually made regardless of whether the employee's rights are forfeitable or non-forfeitable.⁴¹ With respect to the employee, however, there is some danger that if the unfunded contract is non-forfeitable, the employee may have to report the income currently on the basis of constructive receipt.⁴² Therefore, the

³⁷ For purposes of this paper, a "funded" contract is one which provides for the purchase of an annuity or other insurance contract, or for the establishment of a specified fund. If the contract is silent with respect to funding, and the employer purchases an annuity or other insurance contract, such contract is not "funded" so long as the employer is the owner and beneficiary of the annuity or insurance. Nor is a contract funded if the employer voluntarily sets funds aside without being required to do so by the deferred compensation contract.

³⁸ INT. REV. CODE OF 1954, §402(b) or §403(c) if the plan is an annuity plan.

³⁹ INT. REV. CODE OF 1954, §404.

⁴⁰ Treas. Reg. §1.404(a)-12. The Court of Claims in *Russell*, 175 F.Supp. 159 (1959), has held that the employer is entitled to a deduction when a payment is subsequently made from a funded forfeitable contract to the employee. The Internal Revenue Service has announced that it will not follow this decision. REV. RUL. 59-383, 1959-2 CUM. BULL. 456.

⁴¹ INT. REV. CODE OF 1954, §404.

⁴² At first glance, REV. RUL. 60-31, 1960-1 CUM. BULL. 174, appears to take the position that contingencies are no longer necessary in deferred compensation contracts in order to avoid the employee's being taxed currently on the basis of constructive receipt. However, a danger still arises if contingencies are not used because (1) the ruling states that each case must be decided on its own facts; (2) if the deferred payments are made at the request of the employee, then he may be taxed currently on the basis of constructive receipt; and (3) there is uncertainty whether an existing employment contract may be changed to provide for deferred payments without incurring taxability on the grounds of constructive receipt. The first two points involve questions of fact, and it is impossible to say how a revenue agent will interpret the facts in any given case. With respect to the third point, see: *James Oates*, 18 T.C. 570 (1932), *aff'd*, 207 F.2d 711 (7th Cir. 1953); *Howard*

safest type of deferred compensation contract is an unfunded forfeitable contract. Under such an arrangement, the corporation would be entitled to a deduction when the deferred compensation is paid, and the employee would not have to report the payments as income until he receives them.

There are two common contingencies used in deferred compensation contracts to make the employee's right forfeitable and thus to avoid the application of any theory of constructive receipt of current income. First, the deferred compensation contract could provide that the employee be available for consulting services after his retirement. Under such an arrangement, he may also be retained as an officer and/or director of the employer. If this contingency is used, there is a serious question of whether the employee has "separated from service" of the employer so as to qualify for capital gain treatment with respect to a lump sum payment from a qualified plan.⁴³ In addition, any payments for consulting services as an officer or director may also prevent the employee from receiving Social Security benefits to which he would otherwise be entitled.⁴⁴

The second contingency commonly used to make an employee's rights forfeitable under a deferred compensation contract is that the employee refrain from entering into any competitive business after his retirement. The use of this contingency would make the employee's rights forfeitable under the deferred compensation contract and, at the same time, would not require any services of the employee and thus permit him to accomplish a complete separation from service which

Veit, 8 T.C. 809 (1947); and George W. Drysdale, 32 T.C. 378 (1959), *rev'd*, Drysdale v. Commissioner, 277 F.2d 413 (6th Cir. 1960).

⁴³ See discussion at footnotes 35 and 36 *supra*.

⁴⁴ See 42 U.S.C. §§402(b) and 403(f). An individual under 72 years of age may lose part or all of his Social Security benefits if his wages or self-employment income exceeds \$1,200 per year. The Soc. Sec. Regs., §404.1004(b), provide, in part, as follows:

"Corporation Officers—Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation . . ."

Thus, if the employee remains as an officer after his retirement, there is a strong possibility that any payments to him under a deferred compensation contract will prevent him from receiving his Social Security benefits. The danger of losing these benefits increases as the "retired" employee performs more services. Because a director is generally considered an independent contractor, a "retired" employee may be a director and receive payments under a deferred compensation contract without losing his Social Security benefits so long as his services as a director are limited (e.g., attendance at two directors' meetings per year). If his services to the corporation increase, then the danger of his losing his Social Security benefits increases proportionately.

would entitle him to capital gain treatment on any lump sum payment from a qualified plan.⁴⁵

- (3) Separation from service and capital gain treatment upon termination of both the employer's business and the qualified plan.

In addition to receiving capital gain treatment upon complete and final resignation or retirement, a participant will be entitled to capital gain treatment on a lump sum amount distributed to him in the event the employer corporation is liquidated and the qualified plan is terminated. There is clearly separation from service of the employer in this instance.

- (4) Separation from service and capital gain treatment upon a change of ownership of the employer and termination of the qualified plan.

An employee may be entitled to capital gain treatment upon a lump sum distribution of the amount standing to his credit when ownership of the business changes hands even though the employee may have no interruption in his work schedule because of such change of ownership. However, a mere technical change of ownership or reorganization will not give rise to capital gain treatment.⁴⁶ Different tax rules are applied depending upon whether the change of ownership is brought about by a sale of assets, a sale of stock, or a corporate reorganization.

- (a) Change of ownership of employer by reason of sale of assets.

Where all the assets of a corporation are sold, incident to a plan of complete liquidation, with resulting recognition of gain or loss under Section 1002 of the Code, and the qualified plan is terminated, distribution may be considered to be made on account of the employee's separation from service as to all separated employees including those employees who, incident to the sale of assets, go over to the purchaser. If the distributions represent the total distributions payable and are made in one taxable year of the distributee, the amount of such distribution to the extent exceeding the amounts contributed by the employee shall be entitled to capital gain treatment.⁴⁷ Also, where, incident to a plan of complete liquidation, the assets used in carrying on the business of one of two divisions of a corporation are sold to another corporation and the employee's qualified plan is continued by the seller, a total distribution of the amount standing to the credit of those employees who go over to the purchasing corporation may be considered as a long term

⁴⁵ Although there is a possibility that payment for a covenant not to compete may be considered a payment for "services," such an interpretation would appear to be unreasonable.

⁴⁶ REV. RUL. 58-94, 1958-1 CUM. BULL. 194.

⁴⁷ REV. RUL. 58-96, 1958-1 CUM. BULL. 200.

capital gain to the extent that it exceeds the amount contributed by the employee.⁴⁸

(b) Change of ownership of employer by sale of stock and subsequent dissolution pursuant to Section 332(b).

In determining whether a sale of assets has occurred, the Internal Revenue Service has announced that it will look to the substance rather than the form of the transaction. A sale of stock followed by a complete liquidation of the sold corporation pursuant to Section 332(b) of the Code will be treated as an integrated transaction involving in substance the purchase of assets rather than the purchase of stock. Thus, a separation from service of a corporate employer occurs when the termination of its qualified plan is incident to the acquisition of all its stock by another corporation for cash in a transaction amounting in substance to a purchase of assets for cash, even though shortly thereafter its employees are taken over by the controlling corporation upon the transfer of assets of the subsidiary to the controlling corporation under a plan of complete liquidation within the meaning of Section 332(b) of the Code. Therefore, a distribution made in one taxable year of each distributee of the total amount due such distributee upon termination of the trust may be considered a gain from the sale or exchange of a capital asset, and thus be entitled to capital gain treatment.⁴⁹ In *Lester B. Martin*⁵⁰ the stock of the employer corporation, Dellinger, was purchased by another corporation, Sperry. Sperry held the stock of Dellinger from September, 1948, through March, 1949, at which time Dellinger was liquidated and its assets together with its employees were transferred to Sperry. The qualified plan of Dellinger was terminated and the lump sum distributions were entitled to capital gain treatment. The *Martin* case seems to hold that a separation from service occurs upon the liquidation of a subsidiary corporation. However, the Internal Revenue Service has taken the position that the *Martin* case must be interpreted as integrating the original sale of stock with the subsequent dissolution so that there was in substance a sale of assets. The Revenue Service has stated, "... that the liquidation of a wholly-owned subsidiary corporation does not, in and of itself, effect a 'separation from service' of an employer within the meaning of Section 402(a)(2) of the 1954 Code."⁵¹ There appears to be a difference of interpretation, therefore, between the *Martin* case and the Internal Revenue Service as to whether the liquidation of the subsidiary corporation constitutes separation from service of the employer.

⁴⁸ REV. RUL. 58-97, 1958-1 CUM. BULL. 201.

⁴⁹ REV. RUL. 58-95, 1958-1 CUM. BULL. 197.

⁵⁰ *Lester B. Martin*, 26 T.C. 100 (1956), *acq.*, 1958-1 CUM. BULL. 5.

⁵¹ REV. RUL. 58-95, 1958-1 CUM. BULL. 197.

If there is a sale of stock followed by a liquidation of the purchased corporation, and if the purchasing corporation continues to operate the qualified plan of the liquidated corporation after such liquidation, then upon a subsequent termination of that plan the participants who receive lump sum distributions are not entitled to capital gain treatment because there has been no separation from service of the employer (the employer at that time being the purchasing corporation).⁵² Where, however, an employee's services were discontinued prior to the termination of his former employer's qualified plan by the purchaser of such employer's capital stock, and a total distribution had been made to the employee, it was held that such distribution was on account of his separation from service of his employer and was taxable as a long term capital gain.⁵³ In the latter instance the employee was actually separated from his employer's service prior to termination of the pension plan.

- (c) Change of ownership of employer upon sale of stock and no subsequent dissolution of the employer corporation.

The term "separation from service" means separation from service of the employer. The sale of stock of an employer corporation to a new independent third party does not constitute separation from service of the employer, because for purposes of Section 402(a) the corporation, itself, and not the stockholders thereof, is considered the employer. Thus, where the employees of a subsidiary corporation are participants in the qualified employee's pension plan and trust established by the parent corporation and such subsidiary, and the subsidiary is separated from the parent corporation and continues as a separate taxable entity, a distribution from the employee's trust of the total amount standing to the credit of the employees of the subsidiary corporation cannot be considered as having been made on account of the employee's separation from service and is therefore not entitled to capital gain treatment.⁵⁴ In *McGowan v. U.S.*⁵⁵ the taxpayer as an employee of Universal, a wholly-owned subsidiary of Sears, was eligible to participate in the Sears qualified pension fund. When Sears sold part (less than 50%) of its shares in Universal, although Sears remained the major stockholder of Universal, the latter ceased to be a wholly-owned subsidiary and the taxpayer was no longer eligible to participate in the fund. The taxpayer elected to withdraw his share rather than transfer to the Universal retirement trust. The Court held that Universal, a corporate entity, employed the taxpayer both before and after termination of the taxpayer's eligibility to participate in the Sears fund and was

⁵² Clarence F. Buckley, 29 T.C. 455 (1957).

⁵³ Thomas E. Judkins, 31 T.C. 1022 (1959), *acq.*, 1959-2 CUM. BULL. 5

⁵⁴ REV. RUL. 58-99, 1958-1 CUM. BULL. 202.

⁵⁵ *McGowan v. U.S.*, 175 F.Supp. 364, 277 F.2d 613 (7th Cir. 1959).

still employing him at the time of the trial. The Court further held that no change in the taxpayer's employment had occurred. The distribution was made to the taxpayer not because of his separation from the service of Sears as its employee but because Universal's employees ceased to be eligible to participate in the Sears fund. The *McGowan* case thus appears to support the Internal Revenue Service to the effect that separation from service of the employer refers to separation from service of the employer corporation regardless of whom the stockholder of that corporation may be.

It is difficult to discern whether the Internal Revenue Service is, in fact, holding to the principal that it looks to the substance rather than to the form of the transaction. Where stock of a corporation changes hands there appears to be in substance a change of ownership and a change of employers even though the corporate form may remain the same. In substance the ultimate decision of how the business is to be run is placed in the hands of a new stockholder and thus a new employer. The Internal Revenue Service has recognized the sale of stock followed by a corporate liquidation of the sold corporation as constituting a separation of service from the employer. The Internal Revenue Service therefore, by its position, forces the purchasing taxpayer corporation to dissolve the purchased corporation, and if it wishes to operate the business of the purchased corporation as a separate entity, to do so by treating it as a separate branch or perhaps at some later date by reincorporating. Whether stock or assets have been sold, if the basic control of the corporation changes hands so that the decision as to how the company will be run, who will be its directors, and ultimately who will be its officers, is in the hands of a new party, it would appear that in substance there has been a separation from service of the employer. Thus, there seems to be no sound distinction in the position taken by the Revenue Service in that it will recognize capital gain treatment upon the sale of stock if the purchased corporation is dissolved but that it will deny capital gain treatment if the purchased corporation is not dissolved. The dissolution, itself, does not in substance bring about a new employer and the Internal Revenue Service has recognized this. It is rather the change of stock ownership which in substance brings about a change in the employer relationship.

(5) Separation from service and capital gain treatment upon change of ownership in corporate reorganization.

The Internal Revenue Service has stated that there must be more than a mere technical change of corporate structure before there has been a separation from service of the employer.⁵⁶ However, a change of organization from a corporation to a partnership is such a substantial

⁵⁶ REV. RUL. 58-94, 1958-1 CUM. BULL. 194.

change as to bring about a separation from service of the former corporate employer.⁵⁷

In determining whether a tax-free reorganization will constitute a separation from service for purposes of Section 402(a) of the Internal Revenue Code, the same rules as discussed above with regard to corporate sales are applied. Thus, if there is merely a stock for stock reorganization pursuant to Section 368(a)(1)(B) no separation from service will be recognized by the Internal Revenue Service. However, if a stock for stock tax-free reorganization is integrated with a statutory merger of the two corporations so that in effect there is an acquisition of assets rather than stock, then the Internal Revenue Service has stated that it will recognize the transaction as involving a separation from service of the employer.⁵⁸

In accord with the same rule, the Internal Revenue Service has stated that a reorganization involving an exchange of assets for stock pursuant to Section 368(a)(1)(C) will involve a separation from service of the employer. This is true, if following the acquisition of stock, the acquired corporation is subsequently dissolved. In *Commissioner v. Miller*⁵⁹ all the assets and the business of the company were acquired by another corporation in exchange for common stock of the latter which was distributed to the shareholders of the former in cancellation of their previous stock. Thereafter the new company operated the business under the same name taking over employees who continued in the same job. The Court held that a total distribution from the profit sharing plan of the predecessor corporation to transferring employees qualified for long term capital gain treatment.

- (6) Separation from service and capital gain treatment upon a change of ownership of the employer, continuation of the plan by the employer and an option to withdraw from the plan by the employee participant.

It is clear that if a new corporation purchases the assets of an old corporation and terminates the qualified plan of the old corporation, the recipients of lump sum payments under the old plan will be entitled to capital gain treatment. However, a question arises as to the tax treatment of distributions if the new corporation continues to operate the qualified plan of the old company but grants the employees an option to withdraw their vested amounts in the old company's plan at the time the assets of the old company are acquired. It is assumed that immediately prior to the sale of assets the interests of all participants in the old plan would be vested 100%. It is further assumed that if the

⁵⁷ REV. RUL. 58-98, 1958-1 CUM. BULL. 202.

⁵⁸ REV. RUL. 58-383, 1958-2 CUM. BULL. 149.

⁵⁹ *Commissioner v. Miller*, 22 T.C. 293, 226 F.2d 618 (6th Cir. 1954).

option is exercised the employees so exercising their option would lose credit for all prior service, whereas those who did not exercise the option would retain such credit for prior service in computing the allocation of the new company's contribution to the plan. This would prevent taxability to all employees of their vested interest so long as they did not exercise their option.

A lump sum paid to an employee upon the exercise of such an option could clearly be paid within one taxable year of such employee. However, a question arises as to whether in substance there has been a separation from service. It could be argued that Section 402(a) is a relief provision and, as such, is not meant to apply where the employee has an option to receive the amount standing in his credit; but rather that such relief provision should only apply where the employee is forced to take the amount standing to his credit. There is no wording in the statutes which warrants such an interpretation. On the contrary, the Internal Revenue Service has held that where the employee is given an option to take a lump sum distribution of the amount standing to his credit for a period of up to five years, and where such employee in fact exercised the option in the fourth year, he is entitled to capital gain treatment upon such distribution.⁶⁰ Thus, where there has been a sale of assets, a continuation of the qualified plans, and the participating employees are granted an option to withdraw the amount vested to their credit, those employees who elect to exercise such option should be entitled to capital gain treatment upon receipt of the amount in their credit in one lump sum.

B. *Periodic Payments Received During Lifetime*

The capital gain treatment available to employees upon receipt of a lump sum distribution is not available in the event payments are made from a qualified plan on a periodic basis over a number of years.⁶¹

1. Amount Contributed by Employee.

The employee is entitled to receive back on a tax-free basis any amount which he himself contributed to the qualified plan.⁶²

2. Amount Contributed by Employer.

Generally, the amount contributed by the employer and any income earned by the amounts contributed both by the employee and the employer will be taxed to the employee as ordinary income.⁶³

⁶⁰ REV. RUL. 60-292, 1960-2 CUM. BULL. 153.

⁶¹ INT. REV. CODE OF 1954, §402(a)(2), which grants capital gain treatment applies only to lump sum distributions or distributions made within one taxable year of the employee.

⁶² INT. REV. CODE OF 1954, §402(a) and 72.

⁶³ INT. REV. CODE OF 1954, §402(a) and 72.

3. If the Plan is Funded with Insurance.

If the plan is funded with insurance, then the employee is entitled to receive on a tax-free basis not only the amount put into the plan by the employee, but also any constructive contributions made by him.⁶⁴ A constructive contribution consists of the amount paid for insurance risk which was previously taxed to the employee.

4. Allocation of Periodic Payments Made to the Retired Employee.

Because amounts contributed by the employee, both actual and constructive, are received on a tax-free basis and because amounts contributed by the employer will be taxed as ordinary income, a problem of allocation arises when payments are made over a period of years. Thus, if the employee is to receive payments over a period of ten years, what part of each payment constitutes a contribution by the employer and taxable as ordinary income, and what part of each payment constitutes a contribution by the employee, whether actual or constructive, and, thus, receivable on a tax-free basis?

If the actual and constructive employee contributions consist of an amount less than the total payments which will be made within three years of the beginning of payment of periodic distributions, then no tax is paid until such contributions are recouped. Thereafter, the entire amount received will be taxed as ordinary income.⁶⁵ On the other hand, if the employee contributions both actual and constructive, consist of an amount which is greater than the periodic payments during the first three years of payment, then a portion of each installment distribution will be received on a tax-free basis and a portion of each installment distribution will be taxed as ordinary income. The following formula may be used to determine the amount of any one distribution to be excluded from income:⁶⁶

$$\begin{array}{l} \text{Amount to be} \\ \text{Excluded from} \\ \text{Gross Income} \end{array} = \frac{\text{Total Employee Contributions}}{\text{Total Expected Return}} \times \begin{array}{l} \text{Amount of} \\ \text{Installment} \\ \text{Distribution} \end{array}$$

For Example:

Total employee contribution:	\$ 4,000
Total expected return:	16,000
Amount of Installment Distribution:	1,600

Then:

$$\begin{array}{l} \text{Amount to be Excluded from} \\ \text{Income} = 4,000 \times \frac{1,600}{16,000} = \$400 \end{array}$$

Where periodic payments are to be made for life, expectancy tables are used to compute the total expected return.⁶⁷

⁶⁴ INT. REV. CODE OF 1954, §§72(b), (c) and (f) (1) and 402(a) (2).

⁶⁵ INT. REV. CODE OF 1954, §72(d).

⁶⁶ INT. REV. CODE OF 1954, §72(b).

⁶⁷ Treas. Reg. §1.72-9.

IV. PAYMENTS RECEIVED AT DEATH BY THE EMPLOYEE'S ESTATE OR BENEFICIARY

Nearly every qualified plan provides that upon the death of an employee, his named beneficiary (or his estate if there is no named beneficiary) will receive the entire amount standing to the credit of the deceased employee as of the date of his death. In addition many plans permit the employee to elect to receive benefits under a joint and survivor annuity program with a named third party beneficiary.

A. *Lump Sum Payment Received at Death*

Generally, the same rules apply with regard to a lump sum payment at death as are applied to a lump sum payment during lifetime with the added tax benefit that an additional \$5,000 may be received tax-free upon death.⁶⁸

1. Amount Contributed by Employee.

Upon the death of an employee and a lump sum payment to his named beneficiary, the amount received by such beneficiary is not taxable to the extent of the contributions made by the decedent to the plan.⁶⁹ This is in addition to the \$5,000 amount which may be received on a tax-free basis.

2. Amount Contributed by Employer.

Upon a lump sum payment to a named beneficiary the initial \$5,000 of the amount contributed by the employer may be received upon a tax-free basis. Any excess is taxed at capital gain rates.

A problem arises as to the applicability of the \$5,000 exclusion when more than one type of payment is received by the widow on the employee's death. For example, assume that the employee's widow received \$12,000 from a qualified profit sharing plan and \$5,000 from the company, itself, pursuant to a director's resolution reciting her husband's valuable services apart from the usual duties and responsibilities of his position. In one Tax Court case the government conceded that under these circumstances, the \$5,000 employee death benefit exclusion could be applied entirely against the payment received directly from the company.⁷⁰ This would prove advantageous to the taxpayer particularly

⁶⁸ INT. REV. CODE OF 1954, §101(b).

⁶⁹ INT. REV. CODE OF 1954, §§402(a)(2) and 72(f).

⁷⁰ In *Estate of Olsen*, T.C. Memo 1961-191 (5/31/61), *rev'd*, 302 F.2d 671 (8th Cir. 1962), the government conceded that the \$5,000 employee death benefit exclusion could be applied in its entirety against a payment received directly from the deceased's employer and that none of such exclusion need be applied against a lump sum benefit received from the employer's qualified profit sharing trust. Where, however, the aggregate payments of one type of death benefit payable to several beneficiaries exceeds \$5,000, the \$5,000 exclusion shall be apportioned among said beneficiaries in the same portion as the amount received by each bears to the total death benefit paid. Treas. Reg. §1.101-2(c)(1).

if the taxpayer were not able to show that the \$5,000 company payment was a gift, because it would then be taxed at ordinary income rates, whereas, the \$12,000 profit sharing payment would be taxed at capital gain rates.

3. Distribution of Insurance Proceeds Upon Death.

Where insurance proceeds are distributed upon death, the amount of pure insurance (the face amount of the policy less the cash reserve immediately prior to death) is not subject to income tax.⁷¹ The amount of the cash reserve is subjected to tax and is given capital gain treatment subject, however, to the deduction of up to \$5,000 plus the amount of actual and constructive contributions made by the employee.

B. *Periodic Payments Received After Death of the Employee*

Periodic payments made from a qualified plan to the beneficiary of an employee after his death are taxed similarly to periodic payments made during the lifetime of the employee, except that the \$5,000 exclusion available under Section 101(b) will be applicable if the employee possessed immediately before his death a forfeitable right to receive the distribution while living.⁷² With respect to periodic distributions, if the right to the distributions was non-forfeitable before death, then the exclusionary provisions of Code Section 101(b) do not apply.

1. Amount Contributed by Deceased Employee.

The beneficiary of the employee is entitled to receive on a tax-free basis the amount which the employee contributed to the plan.

2. Amount Contributed by Employer.

Periodic distributions received by the beneficiary of an employee which consist of employer contributions are taxable at ordinary income rates except that \$5,000 thereof will be received on a tax-free basis if the employee possessed immediately before his death a forfeitable right to receive the distribution while living.⁷³

3. If the Plan is Funded with Insurance.

Where periodic distributions to an employee's beneficiary begin upon the death of an employee, the amount of each distribution attributable to pure insurance proceeds is not taxed.⁷⁴ Of the remaining taxable

⁷¹ INT. REV. CODE OF 1954, §101(a).

⁷² A non-forfeitable interest is one in which the employee has an unrestricted vested right immediately prior to his death. Thus, if an employee's interest in a qualified plan is vested but the plan provides that should any employee be discharged because of "conduct constituting a misdemeanor or felony" such employee shall forfeit his right to receive any distribution, the employee's interest in the profit sharing plan is forfeitable and the \$5,000 death benefit exclusion will apply to periodic payments made to the employee's beneficiary. Hazel W. Pollnow, 35 T.C. 715 (1961), *acq.*, 1961-2 CUM. BULL. 5.

⁷³ INT. REV. CODE OF 1954, §101(b).

⁷⁴ INT. REV. CODE OF 1954, §101(a).

amount, such portion attributable to employee contributions, both actual and constructive, is received tax free. In addition, if the employee had a forfeitable right immediately prior to his death, to distribution, then up to \$5,000 of the taxable amount may be exempt from tax.

4. Allocation of Periodic Payments Made to the Employee's Beneficiary.

If the amount to be received by the employee's beneficiary on a tax-free basis because of employee contributions, actual or constructive, and because of the application of the \$5,000 exemption (if available) is less than the periodic payments to be received during the first three years after payments begin, then no part of the periodic payments will be taxed until the employee's beneficiary has recouped the entire amount he is entitled to receive on a tax-free basis. Thereafter, the entire amount of each periodic distribution will be taxed as ordinary income.⁷⁵ On the other hand, if the amount which the employee's beneficiary is entitled to receive on a tax-free basis is greater than the periodic payments to be made during the first three years after payments begin, then each periodic payment must be allocated between a taxable amount and a tax-free amount upon the following formula:⁷⁶

$$\frac{\text{Amount to be Excluded from Gross Income}}{\text{Total Expected Return}} = \frac{\text{Total Employee Contributions}}{\text{Total Expected Return}} \times \frac{\text{Amount of Installment Distribution}}{\text{Total Expected Return}}$$

In this instance the "total employee's contributions" may include \$5,000 under Section 101(b) of the Internal Revenue Code if the employee possessed immediately before his death a forfeitable right to receive the distribution while living.

V. DISTRIBUTIONS IN KIND

Distributions in kind other than securities of the employer corporation are afforded the same tax treatment as cash distributions. Different tax treatment is applied to the distribution of the employer's securities depending upon whether the distribution is made in one lump sum payment or in periodic payments. If the distribution of the employer's securities is made in one lump sum within one taxable year of the distributee on account of his separation from service, then upon such distribution there is no tax on the entire net unrealized appreciation in value of such securities. If, however, distribution of the employer's securities is not made within one taxable year of the employee, then all of the net unrealized appreciation in such securities which is attributable to the amount contributed by the employer will be taxable upon

⁷⁵ INT. REV. CODE OF 1954, §72(d).

⁷⁶ INT. REV. CODE OF 1954, §72(b).

receipt thereof and only such portion as is attributable to contributions made by the employee will be received on a tax-free basis. Regardless of which method of distribution is followed, any excluded appreciation at the time of distribution will be taxed upon a subsequent sale of the securities by the distributee. Ordinarily such gain will be long term capital gain. Any appreciation of such securities in the hands of the distributee, subsequent to distribution from the qualified plan will be taxed as long or short term capital gain on a later sale of such securities depending upon the length of time during which the distributee held the securities.⁷⁷

VI. DISTRIBUTION OF ANNUITY AND LIFE INSURANCE CONTRACTS

Qualified trustee plans are frequently funded in part or fully by insurance.⁷⁸ If the trustees purchase annuity contracts, such contracts are often distributed to the retiring employee. The employee is not taxed on the distribution of an annuity contract. Rather, the amounts paid pursuant to such contracts are taxed according to the rules applied to periodic distributions from qualified plans.⁷⁹

If, however, the trustees of a qualified plan distribute to a retiring employee an insurance contract which is a retirement income, endowment, or other life insurance contract, the entire cash value of such contract must be included in the distributee's income at the time of distribution unless within 60 days after the distribution of such contract it is converted into an annuity contract.⁸⁰

VII. DISABILITY PAYMENTS PRIOR TO RETIREMENT

Where an employee received disability benefits prior to retirement from a qualified plan, the normal rules governing the taxation of payments made during lifetime apply, with the added benefit that the \$100 per week sick pay exclusion is applicable to such payments.⁸¹ However, the sick pay exclusion only applies to payments received before the employee reaches retirement age. The Internal Revenue Service has ruled that for this purpose "retirement age" is the earliest date at which the employee is able to retire without actuarial or similar reduction.⁸² That definition was recently modified in *Commissioner v. Winter*.⁸³ In that case the pension plan of the employer company provided that an employee became eligible for his pension when: (1) he was required to retire upon reaching the age 65 and had at least 15 years service; (2)

⁷⁷ INT. REV. CODE OF 1954, §402(a)(2).

⁷⁸ See REV. RUL. 61-157, 1961-2 CUM. BULL. 67, at part 2(d) for limitations on the purchase of life insurance under a qualified trust.

⁷⁹ INT. REV. CODE OF 1954, §72.

⁸⁰ Treas. Reg. §1.402(a)-1(a)(2).

⁸¹ INT. REV. CODE OF 1954, §105(d); Treas. Reg. §1.105-4(a)(3)(i).

⁸² REV. RUL. 57-76, 1957-1 CUM. BULL. 66.

⁸³ *Commissioner v. Winter*, 303 F.2d 150 (3d Cir. 1962).

he became permanently disabled after working 15 years for the company; or (3) he voluntarily retired at age 60 after 30 years service. In 1954, at age 58 after 33 years service, Winter stopped work because of a lung condition and received payments under "2" of the plan. The Revenue Service argued that the payments received until age 60 were subject to the sick pay exclusion. The Court disagreed and held that the sick pay exclusion applied to all payments until age 65 because that was the retirement age under the normal practice of the employer company.

The sick pay exclusion applies only to periodic payments and does not apply to lump sum distributions from qualified plans. This suggests that in drafting a qualified plan a choice should be made available as to whether payments will be made periodically or in a lump sum.

If the plan is contributory the disability benefits are presumed to have been provided by company contributions and the entire sick pay exclusion may be applied against such part of each periodic distribution as is attributable to the company contribution. Thus, the payment of disability benefits will not reduce an employee's investment in the contract for the purpose of computing his exclusion ratio under Section 72(d) of the Internal Revenue Code.

VIII. GIFT TAX CONSIDERATIONS

An employee participant of a bona fide plan who has a vested right to part or all of the amount standing to his credit in the plan, may, if the plan so provides, irrevocably elect to take a smaller portion upon retirement on the condition that a named beneficiary, usually his wife, will receive a payment or series of payments. The value of the payment or payments to be made to the survivor is exempt from gift tax to the extent it is attributable to the employer's contribution.⁸⁴ Thus, if at the time the employee makes such election he has a vested right in \$15,000 which has been contributed by the employer and \$5,000 which has been contributed by himself, and if the value of the wife's annuity is \$8,000, the exempt portion of the value of his gift to her is \$6,000 (\$15,000 over \$20,000 times \$8,000 equals \$6,000).⁸⁵

IX. ESTATE TAX CONSIDERATIONS

Qualified plans often provide for death benefits in the event the employee should die prior to retirement. In addition many plans permit the employee to elect to receive payments under a joint and survivor annuity program. Any payment made from a qualified plan which is attributable to the company's contribution and which is payable to a beneficiary other than the decedent's estate is excludable from the

⁸⁴ INT. REV. CODE OF 1954, §2517.

⁸⁵ Treas. Reg. §25.2517-1(c)(1).

decedent's estate for Federal estate tax purposes.⁸⁶ Thus, if at the time of the employee's death or the date upon which he irrevocably elected to have payments made to a beneficiary, the employer had contributed three fourths of the amount standing to the employee's credit, then three fourths of the value of the death benefit would be excludable from the employee's gross estate for federal estate tax purposes. This suggests that a beneficiary other than the estate of the employee should be named in order to take advantage of the aforesaid exclusion. In addition, one or more contingent beneficiaries should be designated in order to avoid the possibility of the estate becoming the beneficiary.

X. CONCLUSION

Careful drafting of qualified plans will minimize many of the problems discussed above. However, in some areas more than careful drafting is required. In administering such plans, the trustees should be made cognizant of the importance of keeping detailed records, particularly those relating to the cost basis of the employer's securities contributed to the plan and those relating to employee contributions, both actual and constructive. In addition, further clarification by the Internal Revenue Service is required with regard to its position on many of the problems presented.

⁸⁶ INT. REV. CODE OF 1954, §2039(c).