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THE ‘ORIGINAL INTENT’ OF THE FEDERAL TAX TREATMENT OF PRIVATE PENSION PLANS

by James A. Wooten

Since the 1920s, private pension plans financed through employer contributions to a trust have received distinctive treatment under the Internal Revenue Code.1 Employer contributions that fund a qualified retirement plan are deductible when the employer makes them.2 Investment income of a qualified plan accrues tax-free.3 Employees do not pay tax on employer contributions or trust income until they receive benefits.4 In the context of the contemporary Internal Revenue Code, the effect of these provisions is to tax deferred compensation provided through a qualified plan less heavily than wage and salary income. Consequently, an individual may reduce her lifetime tax burden (and federal revenues) by substituting deferred compensation for wage and salary income.5

Commentators have argued for several decades about how to characterize this bias toward deferred compensation, but the orthodox view is that qualified plans receive a subsidy or “tax expenditure.”6 Proponents of the tax-subsidy theory hold that the revenue-reducing features of the tax treatment of qualified plans are a departure from the prevailing conception of a normative income tax. For example, Bruce

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2 Section 404(a)(1).
3 Section 501(a).
4 Section 402(a).
Wolk argues that general tax principles would not allow an employer to deduct contributions that fund forfeitable pension accruals because such contributions may benefit the employer by reducing contributions for future liabilities. Contributions that fund forfeitable accruals, on the other hand, would be taxed to the employee because they provide a current economic benefit to the employee. General principles would treat trust income in parallel fashion, taxing income allocated to forfeitable accruals to the employer and income allocated to vested obligations to the employee. These deviations from general tax principles create a subsidy, it is argued, because “[i]n effect, the private sector is being permitted to allocate for business and personal goals money that would otherwise have flowed into the federal treasury to be spent in ways determined by Congress.” Congress grants the subsidy to induce employers to provide retirement income to employees.

Comments have argued for several decades about how to characterize this bias toward deferred compensation, but the orthodox view is that qualified plans receive a subsidy or ‘tax expenditure.’

Most work on the history of private pension plans assumes that plans have benefited from a subsidy since policymakers adopted this tax treatment and that the purpose of the subsidy is (and was) to induce firms to create retirement plans. Beth Stevens writes, for example, that “[t]he premise [of the tax exemption of pension trusts under the Revenue Act of 1926] was that such a tax exemption would lead employers to regard pensions as a mechanism for lowering their tax bills, as well as for ensuring the welfare of their older workers.” Likewise, Jill Quadagno and Melissa Hardy state that “[t]he tax code encouraged firms to initiate pension plans by allowing them to accumulate deferred contributions tax free but forcing them to pay corporate taxes on accumulations outside the plan.” More recently, Christopher Howard contends that “[t]he preferential tax treatment of employer pensions evolved incremen-

tally, first in administrative rulings and later in congressional statutes, between 1914 and 1926.” Even Nancy Altman, who argues that policy-makers did not intend to create an incentive when they developed the tax treatment of pension trusts, concedes that the tax treatment did, as a matter of fact, constitute a subsidy. She argues, however, that policy-makers may have considered the subsidy an ex post reward to firms that already maintained pension plans rather than an ex ante inducement to create plans.

A closer examination of the historical record suggests a very different story. The policy-makers who developed the distinctive tax treatment of private pension plans were not concerned with encouraging employers to create retirement plans or with rewarding firms that did so. Rather than providing a benefit, policymakers wanted to eliminate a bias. In the early years of the income tax, the Internal Revenue Code taxed deferred compensation more heavily than wage and salary income. The discriminatory effect was particularly clear in cases in which an employer financed its pension obligations through a trust. Congress adopted a new tax treatment of pension trusts after tax experts concluded that the code’s bias against deferred compensation impeded efforts by employers to finance retirement plans in a responsible fashion. The adoption of today’s rules, then, was not perceived to be a preferential departure from neutral taxation. On the contrary, it was and was perceived to be a step toward more neutral taxation of deferred compensation.

I. The Era of Pay-As-You-Go Pensioning

Tax law is central to contemporary thinking about private pension plans. According to economist Alicia Munnell, “The federal income tax laws have been instrumental in both encouraging the growth of private pension plans and influencing the way they developed.” Of course, tax law is central to the management and administration of pension plans. Most law practice in the field of pensions is tax practice. Programs offered by professional groups focus on tax law, and the first casebook on ERISA, Langbein and Wolk’s Pension and Employee Benefit Law, devotes about 200 of its 660 pages to tax issues.

The ubiquity of tax issues in today’s private pension system is in marked contrast to the early literature on

7See Wolk, supra note 6, at 422.
8See id. at 422-24. See also section 83(a).
9See Wolk, supra note 6, at 424-25.
10McGill et al., supra note 6, at 115.
11See id. See also Altman, supra note 1, at 436; Wolk, supra note 6, at 419.
15See Altman, supra note 1, at 450.
17Thus, comprehensive looseleaf publications on pension plans devote a large share of their pages to tax issues. See Research Institute of America, Pension and Profit Sharing (1999); see also Commerce Clearing House, Pension Plan Guide (1999).
“industrial pensions.” Early accounts make only passing reference to tax law if they address it at all. Luther Conant’s A Critical Analysis of Industrial Pension Systems, published in 1922, and the National Industrial Conference Board’s 1925 study of Industrial Pensions in the United States are silent. Only five pages of Murray Latimer’s huge study, Industrial Pension Systems, discuss federal income tax laws. And as a later commentator observed, Latimer gave “no indication . . . that [the provisions of the 1928 Revenue Act and related regulations] were having any noticeable influence on” the development of retirement plans. There is little discussion of tax law in early studies because employers did not adopt the first pension plans in response to financial incentives of the tax laws. Businesses created the earliest pension arrangements to address personnel problems that arose in the operation of large, complex business enterprises. Managers in the late-nineteenth and early-twentieth centuries saw the practice of pensioning aged employees as an apparently simple and effective response to a difficult and increasingly common dilemma — “the question of what to do with the worn-out worker.”

This dilemma was a consequence of fundamental changes in the post-Civil War economy. In the last decades of the nineteenth century, the development of high-throughput production methods contributed to the creation of long-lived, large-scale enterprises in which stages of the production process were tightly interdependent. As Steven Sass writes of railroading, “The services provided by all these employees were essentially complementary, with the output of any one worker tied closely to the output of co-workers, and with limited ability to substitute the labor of one for another.” These new circumstances led managers to conceive and manage the employment relationship in new ways. High-speed, closely coordinated production processes made stability of employment a critical factor in production. Firms responded by adopting new strategies of personnel administration that rewarded workers for long service. Seniority emerged as the source of internal hierarchy as businesses “replaced short-term [employment] contracts with implicit long-term ones.”

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But seniority systems created their own personnel problems. As a firm’s workforce aged, managers found themselves with older workers whose capacities were declining as a result of superannuation. The same factors that made stable employment important increased the harm that might be done by superannuated employees. As Sass puts it, “One inefficient man . . . degraded an entire group’s performance.” Furthermore, the steadily increasing earnings that a seniority system provided to long-service employees eventually made even able workers expensive for a firm to maintain. Yet these “inefficient” workers often had contributed many years of service and needed their wages to survive.

Confronted with this uncomfortable situation, some businesses granted allowances to prevent “worthy” employees from falling into destitution. Lee Squier, who investigated pension practices around 1910, found that “[m]any corporations report that individual provision has been made for worn-out or incapacitated workers, — each case being dealt with on its merits.” The practices of firms that made “individual provision” generally were very informal. Most did not develop rules to govern the pension arrangement or documents to describe it to employees. Indeed, it was not unusual for employees to be told nothing at all.
because there was literally no “plan” to tell them about.  

After the turn of the twentieth century, more and more firms and, in particular, the large enterprises that introduced the “visible hand” to American industrial management abandoned informal pensioning in favor of more formal, less reactive retirement arrangements. These firms made pensioning a part of a larger system of personnel management. As Lee Squier observed, these “systems of pensions” were “almost without exception inspired by economic motives,” rather than altruism. The plan initiated in January 1900 by the Pennsylvania Railroad Company, “perhaps the most advanced business organization in the world,” served as an inducement and model for many firms. The development of pensioning at the Pennsylvania illustrates the concerns that led firms to adopt plans in the early decades of the century. Pennsylvania executives believed this plan would rationalize personnel administration in a manner that economized on labor costs while producing a smooth flow of employees through the firm. Managers had become concerned in the 1890s that the company’s seniority system compromised efficiency. “The average pay received by [men 65 and older],” one executive explained, “is $55 per month, and their places could probably be filled by two-thirds of younger men at an average of $40.00 per month.” The introduction of a mandatory retirement provision promised to harness expenses under the railroad’s existing informal pension arrangement by allowing the firm to replace older, high-wage workers with smaller numbers of younger, lower-paid employees. Managers believed these savings would substantially offset the additional cost of paying pensions to retiring employees. In addition, the regular pattern of mandatory retirements promised to enhance organizational efficiency by giving managers more flexibility in staffing and by reinforcing younger workers’ commitment to the firm with the prospect of future promotions.

Yet as different as the sophisticated, formal plans created by large firms were from informal pension arrangements, the modes of financing were similar. In most early plans, the employer paid pensions out of its current revenues. In pension argot, the plans were “pay-as-you-go.” Although there were some sophisticated rationales for pay-as-you-go financing, most employers likely adopted this method because it was “the simplest and most straightforward way” to provide retirement income. No financial arrangements were made before employees retired. After an employee retired, the employer made the payments called for by its plan and took “a charge against net earnings or operating income for any period equal to the amount of benefits paid in that period.” In other words, firms adopted the same financial practices they used for wages and salaries. Pension payments were “dealt with as supplementary pay roll.”

II. The Advent of Advance Funding

In the second and third decades of the twentieth century, it became clear that the pay-as-you-go approach was no way to manage pension costs. The Pennsylvania’s retirement plan was part of a comprehensive system of personnel administration based on age and length of service. Under this system, the firm did not consider applicants who were over 35 years of age. Once hired, an employee’s compensation was governed by a detailed seniority system. An employee age 65 or older with 30 years of service who became disabled, whether management or wage worker, was eligible to receive a pension equal to 1 percent of his average salary over his last 10 years of employment multiplied by his total years of service with the firm. All employees were forcibly retired at age 70. If an employee had 30 years of service, he would receive a pension based on salary and length of service. Employees played no role in financing their benefits. The company retained complete responsibility for paying for pensions to ensure that the plan was “absolutely subject to company direction and control.” This control was reflected clearly in one of the most important features of the plan: The pensions it provided were discretionary. The Pennsylvania reserved the right to terminate the plan as a whole or any individual employee’s pension at any time.

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shortages when the costs of their plans rapidly increased out of all proportion to expectations. The same problem hit many private firms in the 1920s. In 1926, a Department of Labor investigator described the experience of pay-as-you-go “industrial pension plans” in terms that applied equally to public plans:

At first the expense is usually not serious. When a plan is initiated there are apt to be but few employees who have reached the retiring age, and for some years pensioners may be few, but as new workers each year reach the age limit and are added to the roll, while those already on it are apt to remain there for some time, the cost mounts rapidly.46

By 1915 this pattern of escalating costs produced financial difficulties and reorganizations of teacher pension plans in a number of cities and states.47 In the same year, the U.S. Steel pension plan amended its age and service requirements in the face of rising costs. This plan’s troubles were a particularly ominous sign. Andrew Carnegie had contributed $4 million and the company $8 million, and the plan had only begun operation in 1911.48 Another plan based on Carnegie’s largesse, that of the Carnegie Foundation for the Advancement of Teaching, reorganized several years later for similar reasons.49 These events and others like the much publicized failure of the pension plan of Morris & Co. in the mid 1920s gave credence to the warnings many employers to underestimate the financial burden that the pay-as-you-go method misunderstood the incidence of an employer’s pension liabilities.52 –“If you should buy a ton of coal in December, and burn it in December,” an insurance company executive explained, it would be charged against December production, no matter whether you paid for it in January, February or March. Nobody pays any attention, in cost accounting, to the day on which the bill for material used is paid. Yet with pensions, you pension a man on December 31st, make no account of it at all, but on January 31st you pay the first payment of $50.00 and charge up $50.00 as a part of the January expense.53

These experts argued that an employer incurred its pension liabilities over an employee’s entire working career, not when the employee retired and received pension payments. As one explained, “Since pensions are given for service rendered by employees, and, more particularly, since the longer the service the greater the pension, it is apparent that a liability for future payments accrues concurrently with service rendered.”54 Likewise, a contemporary accounting text advised that “current contributions to pension funds based on the scientific computation of the liability accruing from year to year should be treated as operating expenses and taken into consideration in costs.”55 “[From the practical viewpoint,” the author counseled, pension costs were “generally too important an item to be omitted from operating expenses and costs.”56

The misguided “cash disbursement” method led many employers to underestimate the financial burden of a pension plan. Firms often made cost projections by comparing the amount of pension payments in a particular year with the payroll expenses for the same year. Managers usually made this comparison in the early years of a plan when there were few retirees and, thus, relatively low pension expenses. The “reassuringly insignificant” costs in these forecasts lulled employers into complacency.57 For example, a Western Electric official who interviewed railway officers in the early 1900s reported “an absolute unanimity” that the expense of a pension system was “not burdensome.”58 But as pension reformers emphasized again and again, comparing pension payments to payroll expense was meaningless. “[T]he cost of a pension system,” said Henry Fritchett, the President of the Carnegie Foundation for the Advancement of Teaching and an early educated pension reformers in the 1910s, joined by insurance industry representatives in the 1920s, argued that the pay-as-you-go method misunderstood the incidence of an employer’s pension liabilities.52 “If you should buy a ton of coal in December, and burn it in December,” an insurance company executive explained, it would be charged against December production, no matter whether you paid for it in January, February or March. Nobody pays any attention, in cost accounting, to the day on which the bill for material used is paid. Yet with pensions, you pension a man on December 31st, make no account of it at all, but on January 31st you pay the first payment of $50.00 and charge up $50.00 as a part of the January expense.53

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COMMENTARY / SPECIAL REPORT

proponent of pension funding, “can bear no stable relation to operating expenses, since the pension represents an accumulated debt for past services, for the payment of which no reserve has been set aside.”

Contrary to these misleadingly low estimates, pay-as-you-go financing eventually produces higher out-of-pocket contributions than any other method of pension finance. This is so because “[t]he funding method is . . . the controlling factor in determining how much of the eventual cost [of a pension plan] is to be paid at a particular point of time.” The more funds an employer puts aside to meet its pension liabilities in the early years of operation when there are few retirees, the lower its financial contributions will be later when employees retire in larger numbers. In other words, advance funding allows a firm to spread its pension expense over a longer period of time. Because pay-as-you-go financing does nothing to spread an employer’s expense, “the annual outlay under this arrangement, expressed as a percentage of payroll, ultimately reaches a level that is considerably higher than that of any other financial method.” Having begun with the lowest out-of-pocket costs, pay-as-you-go plans end up with the highest.

Furthermore, many early proponents of funding were struck by the fact that advance funding lowers the total out-of-pocket cost of a pension plan. This fact derives from a simple equation of pension finance: an employer’s out-of-pocket contributions equal the amount of pension payments reduced by the investment income earned by funds set aside to meet those payments. Under a pay-as-you-go plan, no funds are set aside to meet the firm’s liability, so the employer’s out-of-pocket contributions equal the amount of pension payments. In contrast, each dollar of investment income on funds set aside to meet pension obligations reduces by a dollar the contributions the employer must make in the future. If funds are set aside over an employee’s entire career, investment income can greatly reduce a firm’s out-of-pocket cost. As one funding advocate put it, a pay-as-you-go plan “plans to spend two or three times as much money . . . as would be required if sums were set aside each year to accumulate during the [employee’s] period of service.”

Some firms responded to the critique of pay-as-you-go pensioning by adopting a more responsible method of managing pension costs. In the 1910s and 1920s, the most common strategies were (1) to create a balance-sheet reserve, (2) to make contributions to a pension trust, or (3) to purchase annuities from a life insurance company. Only the first two are relevant for understanding the origins of the federal tax treatment of private pensions.

Under the balance-sheet reserve approach, an employer would “create a fund internally and within the control of the company, though perhaps handled by trustees acting for the company.” The fund was an

1310 TAX NOTES, December 6, 1999
accounting reserve that registered the employer’s prospective liability as employees accrued pension benefits. A reserve of this sort helped a firm plan its future pension payments but did little to protect employees. According to one accounting text, “The disadvantage of [an internal reserve] from the employees’ point of view is that it does not absolutely assure a pension according to the agreement, in that such internal pension fund is liable to claims of creditors of the company in the event of liquidation . . . .”73 In addition, a pension reserve, like the reserves an employer might create for other prospective liabilities, was “usually self-imposed and [might] therefore be changed at will . . . .”74 One proponent of trustee’d plans alluded to a “case where stock control of a corporation was bought up and the control taken out of the hands of the people who wanted to build up this fund for employees. In such a case there is nothing to prevent them from turning the pension reserve back into the surplus, or distributing it as dividends, or using it to increase the value of the stock.”75

Under a formal pension trust, the employer entered into a trust agreement, perhaps with a trustee company serving as trustee. The employer (and, in the case of a contributory plan, the employees as well) transferred funds to “trustees or a trust company . . . . entirely removed from the control of the organization.”76 The contributions and investment income of the trust would be used to pay pensions to retired employees. In theory, a pension trust protected employees by placing plan assets beyond the reach of the employer’s creditors.77 But many early pension trusts fell short of the niceties of a formal trust arrangement. In some, perhaps most cases, the “trust” was revocable and was little more than a bank account maintained in the name of the pension plan by “trustees” who were employees of the plan sponsor.78

III. Deferred Comp., Advance Funding & the Code

Very few employers had taken steps toward responsible pension financing practices when Congress established the income tax. The early income tax did nothing to encourage funding and probably impeded it. One reason was that funding of pension promises raised more vexing tax questions than pay-as-you-go pensioning. A second and more important reason was that the Internal Revenue Code was biased against deferred compensation. The bias existed because the vehicle an employer used to finance a pension plan — the firm itself or a pension trust — paid tax at higher rates than plan participants did. The bias existed whether a firm funded or not, but it was most apparent when an employer funded its retirement plan through a trust. In such a case, the trust paid tax on income of assets segregated to meet pension obligations to employees who, if they paid tax at all, faced much lower rates than did the trust. When legislators amended the code in 1926 to eliminate this discrepancy, their goal was to encourage employers to fund retirement plans, not to create retirement plans. The amendment encouraged funding because a funded plan escaped the code’s bias against deferred compensation.

From the perspective of an employer that wished to fund its pension obligations, the initial tax issue concerned the timing of deductions for amounts accrued to a pension reserve or contributed to a trust.

For all its actuarial shortcomings, pay-as-you-go pensioning was relatively easily accommodated to income taxation. The Bureau of Internal Revenue addressed the income tax treatment of pay-as-you-go plans by adopting the treatment under the corporation excise tax of 1909.79 In 1910, Treasury ruled that corporations could not deduct pension payments because pensions were “gratuties and not ‘ordinary and necessary expenses.’”80 The ruling was a triumph of legal form — the theory that pensions were gifts — over business function. Because retirement plans played an important role in personnel administration, the Bureau’s decision drew protests from corporate executives and accounting experts.81 Treasury quickly

74Bliss, supra note 55, at 270.
75Roy B. Kester, Advanced Accounting 595 (3rd rev. ed. 1930). See also Bliss, supra note 55, at 270.
77Bliss, supra note 55, at 269.
78Id.
79Sass, supra note 22, at 85. In the leading case of Hibbard, Spencer, Bartlett & Co. v. Commissioner, 5 B.T.A. 464 (1926), the Board of Tax Appeals recognized a “trust” in circumstances in which few of the formalities of a formal trust arrangement were present. For discussion of the tax consequences of revocability, see note 147 below.
80The ruling was a triumph of legal form — the theory that pensions were gifts — over business function. Because retirement plans played an important role in personnel administration, the Bureau’s decision drew protests from corporate executives and accounting experts. Treasury quickly
reversed itself, ruling that “[a]mounts paid for pensions to retired employees, or to their families or others dependent upon them . . . are proper deductions as ‘ordinary and necessary expenses’ . . .

When Treasury issued income tax regulations in January 1914, the text of Article 120 — which addressed the deductibility of pension expenses — was taken verbatim from the 1911 ruling under the corporation excise tax. Pay-as-you-go plans were easily accommodated to income taxation because they made timing issues very simple. The employer deducted its pension expense at the same time the employee received taxable income. By contrast, an employer that funded its pension obligations made contributions long before individual employees received payments based on those contributions. Furthermore, the contingent character of pension arrangements compounded the timing problem. In the late 1910s, virtually all pension plans required long service before an employee qualified to receive a pension. And employers commonly reserved the right to terminate the plan or refuse to pay any employee’s pension. At least until 1926, when Congress directly addressed pension trusts, these complexities

A. Employer Deduction

From the perspective of an employer that wished to fund its pension obligations, the initial tax issue concerned the timing of deductions for amounts accrued to a pension reserve or contributed to a trust. Allowing an employer to deduct these amounts coordinated the classification of its operations for tax-accounting purposes with its cost-accounting practices. Under the accrual methods favored by critics of pay-as-you-go pensioning, pension accruals and the amounts set aside to meet them were costs of doing business for the year the accruals occurred. The income of a business ought to be reduced to reflect these costs. Denying deductions would subject firms to taxation on amounts set aside to meet this expense and complicate corporate accounting procedures by introducing conflicting treatments of the same transaction for cost-accounting and tax-accounting purposes.

It is useful to view the tax treatment of pension plans through the lens of the treatment of stock-bonus and stock-purchase plans.

Notwithstanding these concerns, the Bureau of Internal Revenue denied deductions “for contributions to a pension fund the resources of which are held by the corporation, the amount deductible in such case being the amount actually paid to the employee.” The uncertainties of such an arrangement — discretionary reserves “held by the corporation” to meet discretionary obligations — apparently led the Bureau to refuse to recognize the practice. At least one prominent tax accountant objected to the Bureau’s action, however. “[I]f it can be shown that the contributions to a fund are not in excess of the reasonable requirements of the pension plan, applicable to the employees on the payrolls during the period in question,” argued Robert Montgomery, “the entire contribution is clearly a necessary expense of the business.” He criticized the regulation as “another case of failure to permit the deduction of amounts set aside during accounting periods as accruing expenses.”

B. Pension Plans

A law of 1912 that funds much more in the dark about how to comply with the tax laws than firms that maintained pay-as-you-go plans.

TAX NOTES, December 6, 1999

1312

1312
Use of a trust to fund pension obligations fared better. In contrast to a balance-sheet reserve, an employer that created a pension trust at least nominally parted with the assets contributed to the trust. Where “annual appropriations . . . are paid to trustees who hold them, and the accumulations thereon, in trust for the beneficiaries,” explained an accounting text, “the payment of wages consists of two parts, one paid currently to the workman, the other paid to his trustees.” 91 Another text designated trust contributions “an out and out expenditure so far as the company is concerned.” 92 The clear picture these texts present is clouded by the great discretion employers exercised over pension plans and pension trusts. Again, employers commonly reserved the right to terminate a plan or amend its terms as well as the right to decide to pay or refuse to pay pensions to particular employees. And few pension trusts contained provisions limiting the employer’s power to revoke the trust. If the terms of a trust allowed it, an employer apparently could abolish its plan, revoke the trust, and recover its contributions. 93

Notwithstanding these contingencies, in 1919 the Bureau placed its blessing on funding through a trust. The Bureau denied a deduction in a case in which a trust “reserve[d] absolute discretion as to the selection of the employees to be benefited.” 94 But it approved deductions for contributions to a trust that was “organized entirely separate and distinct from the corporation, having its own set of books, making its own investments, and paying its own expenses, legal title of which does not remain in the corporation . . . .” 95 The reasoning behind this holding again illustrates the equivocal character of pension plans under the tax laws. Although corporate gifts generally were not deductible, the Bureau did allow firms to deduct contributions such as, donations to a hospital upon consideration that employees of the corporation are to have a ward for their use in case of accident or illness.” Such donations “legitimately represent a consideration for a benefit flowing directly or indirectly to the corporation as an incident of its business . . . .” 96 The Bureau viewed a corporation’s “donations” to a pension trust the same way. They were “donations to a charitable institution conducted for the benefit of the corporation’s employees or their dependents representing a consideration for a benefit flowing directly to the corporation as an incident of its business . . . .” 97 The benefit to the corporation supported the deduction.

B. Taxation of Employee/Beneficiary

The cumulative of the question when employers should be allowed deductions was when employees should be taxed for pension accruals or contributions. It is useful to view the tax treatment of pension plans through the lens of the treatment of stock-bonus and stock-purchase plans. A common arrangement of the latter sort was for a corporation to transfer stock to a trust for the benefit of employees. An employee’s interest remained contingent until he fulfilled specified conditions, at which point title to the stock transferred from the corporation or trustees to the employee. 98 Although the subject was in considerable confusion, the Bureau ruled that employer contributions were taxable as immediate income to the employee “unless the contributions were under a plan under which their eventual receipt by the employees was too contingent to permit of the immediate treatment as income constructively.” 99 Thus, an employee whose interest was subject to a condition was not taxed immediately. His interest “constitute[d] taxable income . . . in the year in which the title vested in [him] . . . .” 100 In 1921, Congress amended the code by adding section 219(f), which provided that contributions to “stock bonus and profit-sharing” plans would not be taxed to the employee “until . . . distributed or made available to the extent that it exceeds the amounts paid in by him.” 101

Although section 219(f) mentioned only “stock bonus and profit-sharing” plans, the Bureau reportedly gave the same treatment to employees who participated in pension plans. 102 There appear to have been several reasons for this. First, the contingency of an employee’s interest in a pension plan weighed against taxing him when contributions were made to a pension trust. Lengthy service requirements meant that many employees who accrued credit never received a pension because they left the employer’s service before they met the service requirement. 103 In addition, employers usually reserved the right to amend or eliminate their plans. 104 Furthermore, even if an employee had a vested right to pension accruals, it was extremely difficult to allocate employer contributions to particular employees because most early pension plans were defined-benefit plans that did not maintain


94This paragraph follows Robbins, supra note 21, at 30-31 and Altman, supra note 1, at 449-450. See also Mertens, supra note 99, at section 23.119 at 1090 and n. 97g.

95Id. at 47.
individual accounts. Rather, firms made contributions on behalf of the entire population of covered employees. Under these circumstances, actuary Rainard Robbins observed in a perceptive 1949 study of pension taxation, an employee’s interest in his employer’s contributions was “not the kind of a credit that furnishes a strong defense for taxation despite the fact that new economic value is the basis of the contributions that give rise to it.”

Apparently on these grounds, the Bureau deferred taxation until an employee received benefits. Congress made this treatment statutory in 1926 when it amended section 219(f) to include pension benefits. C. Tax Treatment of a Pension Trust

The Bureau’s refusal to allow a deduction for pension accruals unless an employer contributed to a separate fund expressed a clear preference for businesses to use a trust to fund pension obligations. It became clear in the 1920s, however, that the general principles for taxing trusts were incompatible with the intermediary function pension trusts performed.

When an employer promises deferred compensation to its employees, the economic effect is for employees to make a loan to the firm that is repaid when the firm pays the promised compensation. The amount of the loan is equal to the present value of the obligation incurred by the employer. Importantly, the loaned funds might also be paid to employees as additional wages or salaries. As Daniel Halperin has shown, the relative rates of taxation that employers, retirement plans, and employees face are very important in such transactions. Today income earned by assets of a qualified plan is not taxed, while the income on amounts invested by individuals is subject to taxation. As proponents of tax expenditure analysis emphasize, this creates a bias in favor of deferred compensation over wage and salary income.

Assume, for example, that an employee is taxed at a 15 percent rate, that employers receive a deduction for contributions to a pension trust, that trust income is not taxed, and that the interest rate is 8 percent. Assume further that the employer promises that in year x+15 it will pay the employee a single lump-sum payment worth $1,000 (pre-tax year x). [See Table 1, Example 1] If the employer deposits $1,000 in a trust in year x, in year x+15 the principal and interest on this amount will total $3,172 [$1,000 x (1.08)^15]. The after-tax value of the lump sum payment to the employee in year x+15 is about $2,696 [$3,172-$476 (15 percent tax)]. On the other hand, if the employer paid the $1,000 as wages and the employee invested this amount, the income paid to the employee would be subject to tax, so the employee would invest $880, instead of $1,000. Furthermore, the income earned on this investment would be taxed at the employee’s 15 percent rate. As a result, the return on the investment will be 6.8 percent rather than 8 percent. At this rate of return, the $1,000 invested by the employee will increase to only about $2,280 [($1,000 x 0.85) x (1.08-0.012)] in 15 years. This tax structure tilts in favor of deferred compensation because the tax exemption of trust income allows the employee to receive $416 more in year x+15 by trading $1,000 of pre-tax wage or salary income for a $1,000 contribution to a retirement plan.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Investment of $1,000 Payment for 15 Years at 8% Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 1: Employer/Trust Tax Rate = 0%;Employee Tax Rate = 15%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Regular Account</td>
</tr>
<tr>
<td>Contribution</td>
<td>$1,000</td>
</tr>
<tr>
<td>Tax on Contribution</td>
<td>150</td>
</tr>
<tr>
<td>Deposit</td>
<td>850</td>
</tr>
<tr>
<td>Value at Withdrawal</td>
<td>2,280</td>
</tr>
<tr>
<td>Tax on Withdrawal</td>
<td>0</td>
</tr>
<tr>
<td>Net Withdrawal</td>
<td>2,280</td>
</tr>
<tr>
<td>Gain Over Regular Account</td>
<td>—</td>
</tr>
</tbody>
</table>

| Example 2: Employer Tax Rate = 15%;Employee Not Taxed | |
| | Employer Plan | Regular Account |
| Contribution | $1,000 | $1,000 |
| Tax on Contribution | 150 | 0 |
| Deposit | 850 | 1,000 |
| Value at Withdrawal | 2,280 | 3,172 |
| Payment to Employer | 2,682 | 3,172 |
| Additional Cost to Employer | 490 | — |
| After-Tax Cost to Employer | 417 | — |

See Halperin, supra note 107, at 519-524; Stein, supra note 5, at 230.

The figures assume that the contribution is deposited for 15 years at 8 percent interest. Example 1 and most of the figures in Example 2 are taken from Tax Policy for Pensions and Other Retirement Saving, supra note 110, at 4 Tbl.1.

3Consistent with the Bureau of Internal Revenue’s 1919 ruling, I assume that the employer receives no deduction for pension liabilities set aside in a reserve. I assume that the employee is subject to tax, but in fact has no tax liability.

15The figures I use are drawn from Congressional Budget Office, Tax Policy for Pensions and Other Retirement Saving 3-6 (1987).
The same principles that incline the tax system toward deferred compensation when employers face lower tax rates than employees tilt it against deferred compensation when employers face higher rates.\(^{115}\) When an employer faces higher rates of tax on the investment income of the employee’s “loan” than the employee would face if he invested the funds himself, the cost to the employer of providing deferred compensation worth $1,000 in year x will be higher than paying $1,000 of current compensation in year x. [See Table I, Example 2.] If the tax rates in the preceding example are reversed — the employer facing a 15 percent tax rate on investment income while the employee pays no tax — an employee who was paid and invested $1,000 in year x would have $3,172 in year x+15. A firm that set aside a reserve of $1,000 would accumulate only $2,280 over the same period. Taking into account the reduction in taxes the firm would receive as a result of its investment to the employee, the $1,000 investment would allow the firm to pay the employee $2,682 in year x+15. The firm would have to come up with another $490. Although this additional payment would reduce the firm’s taxes by $73, the deferred compensation arrangement would still cost the firm $417 more in year x+15 than had it paid the employee $1,000 in year x. And as the difference between a firm’s and its employees’ rates of taxation increases, the additional cost of paying deferred compensation increases. All other things being equal, under these circumstances, employers are better off paying wages or salary instead of deferred compensation.

In fact, the rate structure of the early income tax and prevailing patterns of coverage under private pension plans created precisely this problem. As Elliot Brownlee observes, the tax regime that financed WWI relied on “steeply progressive tax rates and [a] tax base consisting of the incomes of corporations and wealthy individuals.”\(^{116}\) Even after Republican politicians scaled back tax rates in the 1920s, Yale economist and Treasury advisor T.S. Adams characterized the income tax as “a class tax of the most extreme form.” The income tax, Adams observed in 1923, “touched directly perhaps only 5 or 6 percent of the population . . . .”\(^{120}\) This was so because although all “individuals” were subject to income taxation, the relatively large personal exemptions meant that the great majority of people who received wage or salary income were not taxed.\(^{118}\) According to John Witte, even when Congress broadened the tax base to meet the revenue needs of World War I, “at most 13 percent of the labor force [paid] income taxes.”\(^{119}\)

And while the scope of the tax base was narrow, the practice of pensioning was concentrated among large employers whose pension plans were very broad in coverage.\(^{120}\) In the 1910s and 1920s, researchers at the Department of Labor found that the plans they reviewed “[i]n general . . . apply to all grades of employees . . . .”\(^{112}\) Murray Latimer reported similar findings. Indeed, Latimer found only a handful of plans that excluded all but “higher employees.”\(^{122}\) In other words, most pension plans covered all or most of the employees in the sponsoring firm’s workforce. In contrast to their corporate employers, the income of most employees would not have been taxed.

The same principles that incline the tax system toward deferred compensation when employers face lower tax rates than employees tilt it against deferred compensation when employers face higher rates.

The code’s bias against deferred compensation was clearest when pensions or other compensation were funded through a trust because the trust segregated and aggregated assets held for the benefit of a work-force that might number in the thousands. “Under the 1918 Act the income of such trusts was taxable either to the trust or the corporation, dependent upon the measure of control exercised by the corporation over the trust.”\(^{113}\) Whether taxed to the employer or to the trust, trust income would be taxed at levels well in excess of the rates faced by all but very affluent employees.

Under the 1918 act, for example, corporate income in excess of $2,000 was subject to normal tax at a 12 percent rate for calendar year 1918 and a 10 percent rate for subsequent years.\(^{124}\) In addition, the 1918 act subjected corporations to excess profits and war profits taxes in 1918 and to an excess profits tax in 1919 and thereafter. For 1918 the rates in the top brackets were 65 percent for the excess profits tax and 80 percent for the war profits tax.\(^{125}\) In 1919 and subsequent years,

\(^{115}\)See Stein, supra note 5, at 243.  
\(^{119}\)Id. at 125.

\(^{112}\)See Sass, supra note 22, at 36-55.  
\(^{114}\)Latimer, supra note 20, at 63 Tbl.10.  
\(^{124}\)Revenue Act of 1918, ch. 18, section 230(a) and (b), 40 Stat. 1057, 1071 (1919).  
\(^{125}\)Under the war profits tax, an 80 percent tax rate was applied to a firm’s net income in excess of certain credits. If the result of this calculation exceeded a firm’s tax liability under the excess profits tax, the firm paid the higher amount calculated under the war profits tax formula. Montgomery, supra note 90, at 703-706.
the tax on a firm’s excess profits could reach 40 percent. If the investment income of a pension trust was taxed as additional net income of the sponsoring firm, the large employers that were most likely to sponsor pension trusts were virtually certain to pay tax on these amounts. Furthermore, the additional increment of net income that resulted from crediting trust income to the firm would be taxed at the firm’s highest marginal rate. The great majority of employees, again, paid no tax at all. In 1918, an individual was taxed at a rate of 6 percent on his first $4,000 of net income in excess of the $1,000 personal exemption. An individual taxpayer with no dependents did not face a marginal tax rate as high as the corporate normal tax rate unless his net income exceeded $5,000. A married taxpayer with no dependents had to make at least $6,000. In 1919 and thereafter, individuals would have to have even higher net income to be taxed at a rate as high as the corporate normal tax rate.

Section 219(f) solved the aggregation problem by relieving stock-bonus and profit-sharing trusts of taxation on their investment income and deferring taxation of employees until they actually received stock or cash.

Taxing investment income to the trust was equally problematic. And because trust assets were segregated to meet a plan’s obligations to employees, the tax treatment of pension trusts brought the bias against deferred compensation clearly into focus. Under the operation of pension trusts brought the bias against trust assets was segregated income accumulated in trust for the benefit of only if distributed or distributable to the beneficiary. Under these rules, a trust that funded a retirement plan might be taxed like an individual even though it had thousands of beneficiaries.

A notice of deficiency issued in 1926 to the Sears, Roebuck & Co. Employees’ Savings and Profit Sharing Pension Fund (the Sears Fund) illustrates the operation of these provisions. Indeed, this case underscores the bias in the code because the Sears Fund was a contributory defined-contribution plan. The plan required each participating employee to contribute 5 percent of his or her salary. The company contributed 5 percent of its net earnings, which were allocated to individual employee accounts in proportion to employee contributions. The plan provided that its assets would be invested “so far as practicable and advisable . . . in shares of stock of Sears, Roebuck and Co. to the end that the depositors may, in the largest measure possible, share in the earnings of the Company.”

The IRS contended that the Sears Fund was a trust and that it had failed to pay taxes of about $190,000 for the years 1917 to 1920. When the fund petitioned for redetermination of its liability, the Board of Tax Appeals agreed with the IRS and denied the petition. The fund drew the board’s attention to the aggregation problem described above by arguing that the fund was not a single trust but “a collection of separate trusts for each employee.” The board rejected this contention, however, and held that the fund was “a single trust established for the benefit of many beneficiaries” and “a separate taxable entity.” Although the income of the fund was divided among the participants, the participants did not have unconditional rights to the funds allocated to them: “The pro rata shares of earnings did not become the property of the respective beneficiaries until and unless they remained in the service of the company for 10 years, and were at the time participants in the Fund.” These contingencies required “that the income in question . . . be taxed to the Fund.”

120Id. at 708. See also Robert H. Montgomery, Excess Profits Tax Procedure 1921 41-45 (1921).
121Elliot Brownlee writes that “[e]xcess-profits taxation turned out to be responsible for most of the tax revenues raised by the federal government during the war.” Brownlee, supra note 116, at 51.
122Revenue Act of 1918, supra note 124, sections 210(a) and 216(c).
123Id. sections 210(a) and 216(c). See also Montgomery, supra note 90, at 46-47, 111-112.
124Id. sections 210(b), 211(a), and 230(a)(2). See also Montgomery, supra note 90, at 112 n.3.
126Revenue Act of 1918, supra note 124, section 210(a).
127Supra note 124, section 210(a).
128Revenue Act of 1918, supra note 124, section 210(b).
130Id. at 23 (Art. III, section 1).
131Id. at 22-23 (Art. I and Art. III, section 1).
132Id. at 24 (Art. VI, section 2).
133Id. at 22.
134Id. at 27.
135Id.
136Id. at 28.
137Id. at 28. Prior Board of Tax Appeals decisions either recognized pension and other forms of employee benefit trusts as taxable entities or suggested that they were. See Hibbard, Spencer, Barlett & Co. v. Commissioner, 5 B.T.A. 464, 470 (1926) (although no fiduciary returns were submitted on behalf of fund, petitioner argued that it was a separate taxable entity and the court held for petitioner); Sears, 17 B.T.A. at 27 (stating that in Hibbard the fund was “held to be a trust (Footnote 143 continued on next page.)
Although the Court of Appeals for the Seventh Circuit reversed the Board of Tax Appeals, it did so on grounds that were applicable to few pension trusts.\textsuperscript{144} Thus, the Sears case illustrates that the code and regulations appeared to tax a benefit trust on terms that were incompatible with its function as a financial intermediary for employees who, if they paid any tax at all, faced much lower marginal rates than the trust.\textsuperscript{145} In 1921 Congress added section 219(f) to the code to remedy this aggregation problem as it applied to trusts created in connection with stock-bonus and profit-sharing plans.\textsuperscript{146} Treasury advisor T.S. Adams explained the amendment in confidential testimony to the Senate Finance Committee:

The point is this: At the present time many corporations are creating trusts and making arrangements by which, if their employees contribute a certain amount of money, they will contribute a certain amount of money, too, for a certain length of time. Stock may be taken by the employees. There is some doubt as to whether those trusts, so created, would not be taxable in their entirety at the time they accumulated any income, and subject to surtax. It is proposed here to make it clear that these trusts shall not be subject to such tax if they are irrevocably trusts, so that the employer can not take the money back or base it on a contingency.\textsuperscript{147}

Section 219(f) solved the aggregation problem by relieving stock-bonus and profit-sharing trusts of taxation on their investment income and deferring taxation of employees until they received stock or cash.\textsuperscript{148} The treatment of pension trusts under this provision is less clear. Some sources indicate that the Bureau applied section 219(f) to pension trusts even though they were not included in the language of the 1921 statute.\textsuperscript{149} But at least one plan conducted its operations as if it were subject to taxation. In January 1926, David Krebs, an attorney with Armour & Company, contacted the Treasury Department about the firm’s pension plan. “Without entering upon any lengthy discussion of the subject,” he told Treasury Undersecretary Gar- rard Winston,

it seems to us that the taxation of a pension fund narrows the field of investment of the fund and reduces the rate of income which it might otherwise earn, either by compelling it to invest in tax exempt securities or to pay tax which reduces its rate of yield on taxable securities below that which could be realized upon tax exempts, and that such limitation of its choice of investments is a hardship upon the trustees and the fund which the government could well afford to relieve in view of the economic benefits of such plans.\textsuperscript{150}

\textsuperscript{144}\textsuperscript{145}\textsuperscript{146}\textsuperscript{147}\textsuperscript{148}\textsuperscript{149}\textsuperscript{150}
Lower yields would have made tax-exempt securities poor investments for all or virtually all of the individual employees in the Armour plan. But the code appeared to view a pension trust in terms of its legal form rather than its intermediary function. As an independent taxable entity, it made sense for the Armour trust to invest in tax-exempt bonds.

Noting that he had discussed this problem with T.S. Adams, Krebs said he and Adams agreed that Treasury would lose nothing by exempting pension plans from taxation while the plans would gain much. “From the standpoint of the Treasury,” he wrote, “the taxation of such funds merely involves an extremely difficult administrative problem without any corresponding revenue because the tax can be escaped through investment in tax exempt securities, which will provide in case of any large fund a net yield in excess from that of taxable employees after payment of income tax.”

The ‘framers’ of the special tax treatment of pension plans did not mean to create a bias in favor of deferred compensation. They meant to eliminate a bias against it.

At about the same time, Treasury officials took steps to have section 219(f) amended to include pension plans. In February 1926, John Walker, a Treasury official, told Undersecretary Winston that he did not “acknowledge [Krebs’s] letter as Dr. Adams and Mr. Krebs . . . were familiar with the steps that were being taken to amend section 219 to cover pension funds. . . .” Senator George McLean, R-Conn., offered and the Senate approved such an amendment during consideration of the Revenue Act of 1926. “I think we [Treasury] will have no difficulty in keeping the same in conference,” Walker predicted. He was right. The amendment became law because, as the conference report put it, pension plans “are similar to the stock bonus and profit-sharing plans covered by subdivision (f). . . .”

IV. Conclusion

In their recent study of U.S. international taxation, Graetz and O’Hear note that the “original intent” of particular tax policies may furnish “important counterpoints to the consensus views” of today. Their observation is as true for the taxation of deferred compensation as it is for international taxation. Today the conceptual framework of tax-expenditure analysis dominates discussion of the taxation of deferred compensation. Most contemporary debate either presupposes or contests the idea that the tax treatment of qualified plans is a subsidy to induce employers to provide retirement benefits. The story I’ve recounted highlights very different concerns.

The “framers” of the special tax treatment of pension plans did not mean to create a bias in favor of deferred compensation. They meant to eliminate a bias against it. Policymakers were concerned about this bias because they recognized that many employers had compelling business reasons for establishing a defined-benefit pension plan. The experience of the railroad industry, which was repeated many times in the course of the 20th century, illustrates the point. Until the second half of this century, managers of large firms seldom established a retirement plan until a firm had been in existence for some time. Businesses and, where employees were organized, unions got around to creating a pension plan when there were older employees that managers and union officials wished to retire. Under these circumstances, employers adopted defined-benefit plans because a DB plan, unlike a defined-contribution plan, could immediately pay relatively generous pensions to aged employees. DBs did this by giving older employees past-service credit, that is, by calculating an employee’s pension on the basis of years of service before the plan came into being.

Many analysts have noted that it is “extremely difficult, and perhaps impossible,” to integrate income taxation of a defined-benefit plan and its participants. The impediments to integration have two important consequences. First, the absence of integration means that the general principles of an income tax often overtax deferred compensation. A second consequence is that special rules that abrogate overtaxation often produce undertaxation. The first consequence was particularly obvious in the 1910s and ’20s because the second was not a problem.

The basic structure of the early income tax and the characteristics of “industrial pension plans” allowed policymakers to mitigate overtaxation without producing much undertaxation. Since most retirement plans covered a broad range of employees and most employees paid little or no income tax, tax-exemption of pension trusts effected a rough-and-ready integration of the taxation of pension plans and employees.

Later developments undid the de facto integration of the 1920s so that the special rules for pension trusts...
undertaxed deferred compensation. First came the Social Security Act. For many firms, the Old Age Insurance [OAI] program in the Social Security Act duplicated the functions of a retirement plan with respect to most employees. Consequently, many businesses coordinated their retirement plans with OAI by reducing benefits or eliminating coverage for workers who made less than the $3,000 taxable wage base. The result was a shift in the focus of retirement plans toward the needs of high-compensation employees who paid income taxes. Second, beginning in 1935, toward the needs of high-compensation employees resulted in a shift in the focus of retirement plans. I discuss this issue in James A. Wooten, and argument about the causes of social problems. As political scientist Deborah Stone calls the political process, "tax-subsidy theory of deferred compensation to explain the complex problem of accommodating the income tax to the business practices of private-sector employers. Instead, the theory depicted undertaxation as the product of an intentional decision by lawmakers to give something to private-sector actors. The implications were that employers with a retirement plan were spending government funds and that government had a claim on those funds. For example, when Treasury proposed coverage rules for pension plans in 1942, Randolph Paul explained that "the purpose of these rules was "to prevent the subsidy from being used only in behalf of the higher salaried, key employees. Likewise, Adrian DeWind, a lawyer in the Office of the Tax Legislative Counsel, explained in 1944 that "[i]t is the propriety of setting up a tax provision which makes the Government so large a partner in the pursuit of private corporate interests and the personal interests of covered employees must depend to a great extent upon the degree to which the serving of the special interests coincides with the general national interest." These origins suggest the deficiencies of the subsidy theory as an account of the reasons lawmakers created the basic tax treatment of deferred compensation. As Deborah Stone observes, "Purpose must always be demonstrated with evidence of the actor's wishes or motives, apart from the effects of his actions." The Treasury officials who developed the tax-subsidy theory were not concerned with the "wishes or motives" that led lawmakers to develop special rules for pension trusts. Instead, they wished to justify policy changes to regulate the undertaxation of these rules produced. In light of this political and rhetorical goal, it is understandable that the tax-subsidy theory neglected the broader problem — nonintegration — that led lawmakers to adopt and to maintain special tax rules for defined-benefit pension plans.