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The "Original Intent" of the Federal Tax Treatment of Private Pension Plans

James A. Wooten
University at Buffalo School of Law

SPECIAL REPORT

TAX ANALYSTS

THE 'ORIGINAL INTENT' OF THE FEDERAL TAX TREATMENT OF PRIVATE PENSION PLANS

by James A. Wooten

James A. Wooten is Associate Professor at the State University of New York at Buffalo School of Law.

The Internal Revenue Code has long granted distinctive tax treatment to retirement plans sponsored by private employers. Wooten thinks that most present-day commentators view the provisions for qualified plans as a subsidy to encourage employers to provide deferred compensation. As this report explains, the policymakers who devised these rules in the 1920s had a very different purpose in mind. In its early years, the income tax discriminated against deferred compensation by taxing it more heavily than wage and salary income. Wooten believes that policymakers developed special rules for retirement plans to eliminate this bias, rather than to create a subsidy.

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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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[1]*See* Nancy J. Altman, "Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security," 42 *Tax L. Rev.* 433, 444-45 (1987).

[2]Section 404(a)(1).

[3]Section 501(a).

[4]Section 402(a).

[5]*See* Altman, *supra* note 1, at 445-46; *see also* Richard A. Ippolito, *Pensions, Economics, and Public Policy* 16-26 (1986); Norman P. Stein, "Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky," 9 *Am. J. Tax Pol'y* 225, 229-30 (1991).

[6]*See Public Policy and Private Pension Programs: A Report to the President on Private Employee Retirement Plans* 15-19 (1965). *See also* Altman, *supra* note 1, at 436; Bruce Wolk, "Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality," 70 *Va. L. Rev.* 419, 421-25 (1984); Dan M. McGill, Kyle N. Brown, John J. Haley, and Sylvester J. Schieber, *Fundamentals of Private Pensions* 115 (7th ed. 1997). For contrary views, see Raymond Goetz, "The Myth of Special Tax Concessions for Qualified Pension Plans," 51 *Iowa L. Rev.* 561 (1966); Ray M. Peterson, "Surrey's 'Subsidy,'" 6 *Pension and Welfare News* 34 (1970); and Edward A. Zelinsky, "The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo," 66 *N.C. L. Rev.* 315 (1988).

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.[7] Contributions that fund nonforfeitable accruals, on the other hand, would be taxed to the employee because they provide a current economic benefit to the employee.[8] 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.[9] 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."[10] Congress grants the subsidy to induce employers to provide retirement income to employees.[11]

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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."[12] 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."[13] More recently, Christopher Howard contends that "[t]he *preferential* tax treatment of employer pensions evolved incrementally, first in administrative rulings and later in congressional statutes, between 1914 and 1926."[14] 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.[15]

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 meant 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."[16] 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.[17] 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.[18]

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

[7] *See* Wolk, *supra* note 6, at 422.

[8] *See id.* at 422-24. *See also* section 83(a).

[9] *See* Wolk, *supra* note 6, at 424-25.

[10] McGill et al., *supra* note 6, at 115.

[11] *See id. See also* Altman, *supra* note 1, at 436; Wolk, *supra* note 6, at 419.

[12] Beth Stevens, "Blurring the Boundaries: How the Federal Government Has Influenced Welfare Benefits in the Private Sector," in *The Politics of Social Policy in the United States* 123, 128 (Margaret Weir, et al. eds., 1988) (italics added).

[13] Jill Quadagno and Melissa Hardy, "Private Pensions, State Regulation and Income Security for Older Workers: The U.S. Auto Industry," in *The Privatization of Social Policy? Occupational Welfare and the Welfare State in America, Scandinavia and Japan* 136, 138 (Michael Shalev, ed., 1996) (italics added).

[14] Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* 55 (1997) (italics added).

[15] *See* Altman, *supra* note 1, at 450.

[16] Alicia H. Munnell, *The Economics of Private Pensions* 30 (1982). *See also* Ippolito, *supra* note 5, at 16.

[17] Thus, 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).

[18] American Law Institute, *Basic Law of Pensions, Welfare Plans, and Deferred Compensation* (1995) (ALI/ABA course of study materials); *see also* John H. Langbein and Bruce A. Wolk, *Pensions and Employee Benefit Law* 120-321 (1990).

"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.[19] Only five pages of Murray Latimer's huge study, *Industrial Pension Systems,* discuss federal income tax laws.[20] 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."[21]

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.[22] 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."[23]

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.[24] 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."[25] These new circumstances led managers to conceive and manage the employment relationship in new ways.[26] 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."[27]

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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."[28] 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.[29] Yet these "inefficient" workers often had contributed many years of service and needed their wages to survive.[30]

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 workmen, — each case being dealt with on its merits."[31] 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

[19] *See* Luther Conant, Jr., *A Critical Analysis of Industrial Pension Systems* (1922); National Industrial Conference Board, *Industrial Pensions in the United States* (1925).

[20] Murray Webb Latimer, 2 *Industrial Pension Systems in the United States and Canada* 660-64 (1932).

[21] Rainard B. Robbins, *Impact of Taxes on Industrial Pension Plans* 6 (1949); Robbins also notes that there is no discussion of tax issues in the National Industrial Conference Board report. *See id.* at 4.

[22] *See* Steven A. Sass, *The Promise of Private Pensions* 13-14, 18-37 (1997); *see also* Carol Haber and Brian Gratton, *Old Age and the Search for Security* 106-09 (1994); Roger L. Ransom, Richard Sutch, and Samuel H. Williamson, "Inventing Pensions: The Origins of the Company-Provided Pension in the United States 1900-1940" in *Societal Impact on Aging: Historical Perspectives 1*, 11-16 (K. Warner Schaie and W. Andrew Achenbaum, eds., 1993).

[23] Abraham Epstein, "Industrial and Commercial Pensions in the United States" in *Selected Articles on Old Age Pensions* 47, 56 (Lamar T. Beman, ed., 1927).

[24] *See* Sass, *supra* note 22, at 28-30; *see also* Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* 240-83 (1977); Ransom et al., *supra* note 22, at 11.

[25] Sass, *supra* note 22, at 29.

[26] *See generally* Sanford M. Jacoby, *Employing Bureaucracy: Managers, Unions, and the Transformation of Work in American Industry, 1900-1945* 40-49 (1985).

[27] *See* Ransom, et al., *supra* note 22, at 12-13; Haber and Gratton, *supra* note 22, at 107-08. *See also* Brian Gratton, "'A Triumph in Modern Philanthropy': Age Criteria in Labor Management at the Pennsylvania Railroad, 1875-1930," 64 *Bus. Hist. Rev.* 630, 634 (1990).

[28] Sass, *supra* note 22, at 29.

[29] *See* Haber and Gratton, *supra* note 22, at 109; *see also* Ransom et al., *supra* note 22, at 13-14.

[30] "To keep worn-out, incapacitated men on the pay roll," Lee Squier wrote, "is an economic waste. To turn such adrift is not humane and exercises a depressing influence upon workers still in the prime of life." Lee Squier, *Old Age Dependency in the United States* 105 (1912).

[31] *Id.*

because there was literally no "plan" to tell them about.[32]

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.[33] As Lee Squier observed, these "systems of pensions" were "almost without exception inspired by economic motives," rather than altruism.[34] 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.[35]

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.[36] 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.[37]

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."[38] 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.[39] 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.[40]

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.[41] 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.[42] 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."[43] In other words, firms adopted the same financial practices they used for wages and salaries. Pension payments were "dealt with as supplementary pay roll."[44]

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.[45] In the 1910s, a number of public employers encountered cash

[32]*Id. See also* 1 Latimer, *supra* note 20, at 19; NICB, *supra* note 19, at 42-7; Conant, *supra* note 19, at 131-42; Sass, *supra* note 22, at 23-7.

[33]*See* Sass, *supra* note 22, at 28-37, 46-55; Gratton, *supra* note 27, at 639-45.

[34]Squier, *supra* note 30, at 106.

[35]*See* Sass, *supra* note 22, at 28-37, 38-40; *see also* Gratton, *supra* note 27, at 631 and n.2.

[36]This paragraph is based on Sass, *supra* note 22, at 33-35 and Gratton, *supra* note 27, at 644-645.

[37]For a perceptive contemporary analysis of the control issue, see Henry S. Pritchett, "Contributory and Non-Contributory Pension Systems," in *Carnegie Foundation for the Advancement of Teaching, Seventh Annual Report of the President and of the Treasurer*, 59-63 (1912).

[38]Gratton, *supra* note 27, at 640.

[39]*See id.* at 640-42; Sass, *supra* note 22, at 34-5.

[40]*See* Sass, *supra* note 22, at 35.

[41]*See* 2 Latimer, *supra* note 20, at 580.

[42]Charles L. Trowbridge, "ABC's of Pension Funding," 44 *Harv. Bus. Rev.* 115, 116 (1966). For a justification, see Sass, *supra* note 22, at 34.

[43]Trowbridge, *supra* note 42, at 116; *see also* Dan M. McGill and Donald S. Grubbs, Jr., *Fundamentals of Private Pensions* 371-373 (6th ed. 1989).

[44]M.B. Folsom, "Old Age in the Balance Sheet," 143 *Atlantic Monthly* 399, 401 (1929).

[45]*See generally* Sass, *supra* note 22, at 56-87.

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 of the first generation of American pension specialists that pensions would be secure only if employers funded these obligations in advance.[50]

According to critics, pay-as-you-go financing misapprehended the nature of pension costs. As one put it, an employer with a pay-as-you-go plan thought "on a 'cash disbursement' rather than an 'accrual' basis."[51] Building on studies by British actuaries, self-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]

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 pensions 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." "[F]rom the practical viewpoint," the author counseled, pension costs were "generally too important an item to be omitted from operating expenses and costs."[55]

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.[56] 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."[57] 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 Pritchett, the President of the Carnegie Foundation for the Advancement of Teaching and an early

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[46]Mary Conyngton, "Industrial Pensions for Old Age and Disability," 22 *Monthly Lab. Rev.* 21, 50-1 (1926).

[47]Teachers' pension systems that experienced financial difficulties by the mid 1910s included Puerto Rico, New Jersey, Maryland, Virginia, New York City, Boston, Indianapolis, Philadelphia, and Cincinnati. *See* Clyde Furst, "Pensions for Public-School Teachers," in *Addresses and Proceedings of the Fifty-Fourth Annual Meeting of the National Education Association* 140 (1916); *see also* Rainard Robbins, *Pension Planning in the United States* 25-39 (1952); *Carnegie Foundation for the Advancement of Teaching, Thirteenth Annual Report of the President and of the Treasurer,* 109-15 (1918).

[48]*See* "Steel Corporation Pensions," 95 *The Iron Age* 902 (1915).

[49]*See Foundation for the Advancement of Teaching, Seventeenth Annual Report of the President and of the Treasurer,* 157 (1922); *see also* Ellen Condliffe Lagemann, *Private Power for the Public Good: A History of the Carnegie Foundation for the Advancement of Teaching* 160-61, 168-73 (1983).

[50]*See* Sass, *supra* note 22, at 57-58. *See also Carnegie Foundation for the Advancement of Teaching, Thirteenth Annual Report of the President and of the Treasurer,* 109-115 (1918); Gurden Edwards, "Industrial Pension Plans Collapsing," 26 *The Annalist* 637 (1925).

[51]Ingalls Kimball, *Discussion in* Edward S. Cowdrick, *Pensions: A Problem of Management 27* (American Management Ass'n, Annual Convention Series No. 75, 1928).

[52]*See* Sass, *supra* note 22, at 62-76.

[53]*See* Kimball, *supra* note 51, at 27.

[54]Bryce M. Stewart, *Financial Aspects of Industrial Pensions* 16 (American Management Ass'n, Gen. Management Series No. 87, 1928).

[55]James H. Bliss, *Management Through Accounts* 705 (1924).

[56]Gurden Edwards refers to "reassuringly insignificant" costs in "The Way Out of the Industrial Pension Crisis," 26 *The Annalist* 667 (1925).

[57]Quoted in Sass, *supra* note 22, at 40.

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."[58]

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."[59] 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."[60] Having begun with the lowest out-of-pocket costs, pay-as-you-go plans end up with the highest.[61]

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.[62] 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.[63] 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."[64] One widely cited author claimed that "compound interest" allowed an employer to substitute manageable levels of contributions for the "parasitic burden" of a pay-as-you-go plan.[65]

By the mid 1920s, informed commentators recognized this critique of pay-as-you-go pensioning to "furnish as accurate an appraisal of the future pension situation as can be reached by the use of the data available."[66] Some rejected pay-as-you-go financing out of hand. In 1928 Henry Pritchett wrote that "experience has shown the cash disbursement plan to be the most costly, the most unscientific, the most prejudicial to the interests of stockholders, the most lacking in economic justification, the most speculative for both employer and employee, and altogether the most dangerous as regards the improvement of the retirement situation in industry and elsewhere."[67] Even sanguine observers conceded that the critics' arguments and prescriptions had to be given serious attention. Edward Cowdrick, a prominent writer on personnel issues, observed in 1924 that "no mistake is likely to be made by appropriating for pensions an annual amount sufficient to build up gradually a reserve in excess of immediate needs."[68]

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.[69] Only the first two are relevant for understanding the origins of the federal tax treatment of private pensions.[70]

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."[71] The fund was an

[58]*Carnegie Foundation for the Advancement of Teaching, Thirteenth Annual Report of the President and of the Treasurer,* 114 (1918).

[59]Charles L. Trowbridge, "Fundamentals of Pension Funding," 4 *Transactions of the Soc'y of Actuaries* 17, 17 (1952).

[60]McGill and Grubbs, *supra* note 43, at 372.

[61]*See* Sass, *supra* note 22, at 80-83 and fig. 4.1; Trowbridge, *supra* note 59, at 17.

[62]*See* Edwards, *supra* note 56. As Trowbridge observes, "the choice of funding method" affects the out-of-pocket expense of a pension plan and the distribution of this expense over time, but it "in no way affects true over-all costs, which are a function of the benefits to be provided and certain other factors such as mortality, interest, and employee withdrawal." Trowbridge, *supra* note 59, at 17.

[63]*See* Trowbridge, *supra* note 59, at 18-19.

[64]Furst, *supra* note 47, at 140.

[65]Edwards, *supra* note 56, at 668.

[66]Edward S. Cowdrick, "Will the Pension Break the Business?" 13 *Am. Mgmt. Rev.,* Aug. 1924, at 4. *See also* Sass, *supra* note 22, at 62.

[67]*Carnegie Foundation for the Advancement of Teaching, Twenty-Third Annual Report of the President and of the Treasurer* 96-97 (1928).

[68]Cowdrick, *supra* note 66, at 4.

[69]Sass, *supra* note 22, at 85-87; 2 Latimer, *supra* note 20, at 570.

[70]Although the most fervent supporters of advance funding favored group annuities, annuity contracts became an important medium for funding pension obligations of private plans only in the mid to late 1920s. Sass, *supra* note 22, at 67-76. Group annuities are not directly relevant to the early development of the tax treatment of private pensions because employers did not deduct amounts used to purchase group annuities under the provision of the code that governed pension trusts. Annuity payments fell under the section of the code that allowed employers to deduct reasonable business expenses. Congress consolidated the tax treatment of deductions for pension contributions and purchase of annuities in the Revenue Act of 1942. *See* Robbins, *supra* note 21, at 77-78.

[71]Bliss, *supra* note 55, at 269.

accounting reserve that registered the employer's prospective liability as employees accrued pension benefits.[72] 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 trusteed 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 trust 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 "gratuities 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 rule in personnel administration, the Bureau's decision drew protests from corporate executives and accounting experts.[81] Treasury quickly

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[72]*See* E. L. Hicks and C. L. Trowbridge, *Employer Accounting for Pensions: An Analysis of the Financial Accounting Standards Board's Preliminary Views and Exposure Draft* 16-17 (1985).

[73]Bliss, *supra* note 55, at 270.

[74]Roy B. Kester, *Advanced Accounting* 595 (3rd rev. ed. 1930). *See also* Bliss, *supra* note 55, at 270.

[75]"Revenue Act of 1928: Hearings Before the Senate Comm. on Finance," 70th Cong. 209 (1928)[hereinafter 1928 Senate Hearings] (testimony of William S. Elliott).

[76]Bliss, *supra* note 55, at 269.

[77]*Id.*

[78]Sass, *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.

[79]Tariff of 1909, ch. 6, section 38, 36 Stat. 11, 112.

[80]T.D. 1606, 13 *Treas. Dec. Int. Rev.* 43 [para. 59] (1910).

[81]*See* "Tax Law Pamphlet Arouses Protest," *N.Y. Times,* Dec. 29, 1910, at 8. Recall Squier's observation in 1912 that firms adopted pension plans "almost without exception" on the basis of "economic motives." Squier, *supra* note 30, at 106. Christopher Howard argues that granting corporations a deduction for pension payments was a tax expenditure because few firms had pension plans. "All things considered," he says, "business expenses for retirement pensions were anything but ordinary and necessary for the vast majority of employers." Howard, *supra* note 14, at 57. Howard's conclusion is not warranted for several reasons. First, a tax expenditure generally is conceived to be a provision of law that causes a taxpayer's "taxable income" to appear to be lower than its "economic income." A rule that causes a taxpayer's "taxable income" to be higher than its "economic income" is a tax penalty. The 1910 Treasury ruling that denied deduc-

(Footnote 81 continued on next page.)

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' . . . ."[82] 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.[83]

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.[84] 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.[85] And employers commonly reserved the right to terminate the plan or refuse to pay any employee's pension.[86] At least until 1926, when Congress directly addressed pension trusts, these complexities left firms that funded much more in the dark about how to comply with the tax laws than firms that maintained pay-as-you-go plans.

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.[87] 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."[88] 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.[89] 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."[90]

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tions for pension payments was a tax penalty. It made a corporation's "taxable income" appear to be higher than its "economic income by denying deductions . . . for the cost of producing income." *See* Boris I. Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," 22 *Nat'l Tax J.* 244, 245 and n. 4 (1969). In other words, Treasury's and Howard's narrow readings of "ordinary and necessary expenses" depart from a true tax on net income. Setting aside this objection, it should also be noted that many business practices are "anything but ordinary and necessary for the *vast majority* of employers." For example, few firms buy flour. Does that make granting a deduction to bakeries for purchasing flour a tax expenditure? Obviously not, because it is ordinary and necessary for bakeries to buy flour. But many railroad companies had pension plans by 1909. It was thus "ordinary" for railroad companies to have pension plans, and managers had concluded it was "necessary." So it would appear that railroads ought to have been allowed to deduct pension payments. But railroads were not the only firms that offered pension plans. Would it be fair to allow railroads to deduct pension payments but not to allow other firms to do so? Would this be a tax expenditure? As the author of an early treatise observed, "What may be comprehended in the general description of 'ordinary and necessary expenses' will depend greatly upon the nature of the business, trade, or pursuit carried on." Henry Campbell Black, *A Treatise on the Law of Income Taxation Under Federal and State Laws* section 89 at 179 (1st ed. 1913).

[82]T.D. 1675, 14 *Treas. Dec. Int. Rev.* 20 [para. 57] (1911). *See also* "Corporation Tax Decisions," *Wall St. J.*, Feb. 16, 1911, at 7.

[83]*Compare* T.D. 1675, *supra* note 82, at 20 and T.D. 1944, 16 *Treas. Dec. Int. Rev.* 68 [Art. 120] (1914). The 1914 ruling does add a comma and correct a typographical error.

[84]*See, e.g.*, T.D. 2690, 20 *Treas. Dec. Int. Rev.* 134 [Art. 4, para. 49] and 195 [Art. 136, para. 438] (1918).

[85]Conyngton reported in 1926 that pension plans commonly required 20 to 25 years of service to qualify for benefits. Conyngton, *supra* note 46, at 47.

[86]2 Latimer, *supra* note 20, at 719-721; Robbins, *supra* note 21, at 3-4.

[87]Bliss, *supra* note 55, at 705.

[88]T.D. 2690, *supra* note 84, at 195 [Art. 136, para. 439].

[89]The questions whether and what reserve accounts a firm ought to be able to deduct were a continuing source of conflict between tax authorities and accountants. *See* Comment, "Accounting Principle v. Tax Practice: Treatment of Deferred Credits and Reserves," 64 *Harv. L. Rev.* 1010 (1948). Tax accounting generally does not allow deductions for reserves for future liabilities: "taxpayers might try to deduct excessive reserves under the financial accounting principle of conservatism, with resulting excessive revenue losses." Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* 189 (1985).

[90]Robert H. Montgomery, *Income Tax Procedure 1919* 420-21 (1919).

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 firm "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.

[91]Henry Rand Hatfield, *Accounting: Its Principles and Problems* 238 (1927).

[92]Bliss, *supra* note 55, at 270.

[93]2 Latimer, *supra* note 20, at 665, 671-72. For discussion of the tax consequences of revocability, see note 147 below.

[94]S. 965, 1 C.B. 224 (1919).

[95]O. D. 110, 1 C.B. 224 (1919).

[96]T.D. 2090, 16 *Treas. Dec. Int. Rev.* 278 (1914).

[97]O. D. 110, *supra* note 95. See Montgomery, *supra* note 90, at 427-430. *See also* Robbins, *supra* note 21, at 73-74; Altman, *supra* note 1, at 447 and n. 52.

B. Taxation of Employee/Beneficiary

The correlative 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

[98]*See* O. D. 763, 4 C. B. 76 (1921); O. D. 791, 4 C. B. 76-77 (1921). *See also* Robert H. Montgomery, *Income Tax Procedure 1923* 428-430 (1923).

[99]*See* Jacob Mertens, Jr., 1939 *Cumulative Supplement to Randolph E. Paul and Jacob Mertens, Jr., The Law of Federal Income Taxation* 1090 and n. 97g (1934). *See also* E.E. Rossmoore, *Federal Income Taxes: Principles and Practice* 397-398 (1924); I.T. 1891, 3-1 C.B. 132-138 (1924); and 1 Randolph E. Paul and Jacob Mertens, Jr., *The Law of Federal Income Taxation,* section 11.36 at 519-520 (1934).

[100]O. D. 791, *supra* note 98, at 77.

[101]Revenue Act of 1921, ch. 136, section 219(f), 42 Stat. 227, 247.

[102]This 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.

[103]Conyngton, *supra* note 46, at 47.

[104]*Id.* at 44.

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."[105] 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 plans.[106]

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.[107] 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.[108] As Daniel Halperin has shown, the relative rates of taxation that employers, retirement plans, and employees face are very important in such a transaction.[109] 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.[110] 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 $850, 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 $(1.08-0.012)^{15}$] 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.[111]

Table 1
Investment of $1,000 Payment for 15 Years at 8% Interest[112]

Example 1: Employer/Trust Tax Rate = 0%; Employee Tax Rate = 15%

	Regular Account	401(k) Plan
Contribution	$1,000	$1,000
Tax on Contribution	150	0
Deposit	850	1,000
Value at Withdrawal	2,280	3,172
Tax on Withdrawal	0	476
Net Withdrawal	2,280	2,696
Gain Over Regular Account	—	416

Example 2: Employer Tax Rate = 15%; Employee Not Taxed[113]

	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 Employee[114]	2,682	3,172
Additional Cost to Employer	490	—
After-Tax Cost to Employer	417	—

[105]Robbins, *supra* note 21, at 31.

[106]Revenue Act of 1926, ch. 26, section 219(f), 44 Stat. 9, 33-34.

[107]For general discussions of these issues, see Daniel I. Halperin, "Interest in Disguise: Taxing the 'Time Value of Money,'" 95 *Yale L. J.* 506, 515-524 (1986); Ippolito, *supra* note 5, at 20-24.

[108]The interchangeability of wages and pension contributions is stated very clearly in 1928 Senate Hearings, *supra* note 75, at 210, 213. *See also Report of Illinois Pension Laws Commission, 1916,* quoted in Conyngton, *supra* note 46, at 22; and Hatfield, *supra* note 91, at 238.

[109]Halperin, *supra* note 107, at 519-524.

[110]The figures I use are drawn from Congressional Budget Office, *Tax Policy for Pensions and Other Retirement Saving* 3-6 (1987).

[111]*See* Halperin, *supra* note 107, at 519-524; Stein, *supra* note 5, at 230.

[112]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.

[113]Consistent 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.

[114]The employer's payment is "grossed up" to reflect the tax deduction the firm receives as a result of the payment. The after-tax cost of the $2,682 payment is $2,280 ($2,682 - $402 [$2,682 x 15% tax rate]).

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 1, 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 payment 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, "touches directly perhaps only 5 or 6 percent of the population . . . ."[117] 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 . . . ."[121] 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."[123] 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.

[116]W. Elliot Brownlee, *Federal Taxation in America: A Short History* 47-48 (1996).

[117]Thomas S. Adams, "How Federal Taxes Are Made," *1923 Proceedings of the 15th Ann. Conf. on Tax'n, Nat'l Tax Ass'n* 331, 337 (1923).

[118]John Witte, *The Politics and Development of the Federal Income Tax* 125-127 figs. 6.2 and 6.3 (1985).

[119]*Id.* at 125.

[120]See Sass, *supra* note 22, at 38-55.

[121]Anice L. Whitney, "Establishment Disability Funds, Pension Funds, and Group Insurance for Employees," 6 *Monthly Lab. Rev.* 444, 452 (1918). *See also* Conyngton, *supra* note 46, at 44-45.

[122]1 Latimer, *supra* note 20, at 63 Tbl.10.

[123]Bureau of Internal Revenue, U.S. Treasury Department, *Bulletin "I" Income Tax: Comparison of Titles and Sections of the Revenue Acts of 1918 and 1921 Applicable to Income and Profits Taxes* 16 (1922).

[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.[126] 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.[127] 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.[128] 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.[129] 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.[130]

> ***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 1918 act, income of a trust was taxed to a beneficiary only if distributed or distributable to the beneficiary. Income accumulated in trust for the benefit of "persons with contingent interests . . ." was "taxed to the fiduciary as to any single individual . . . ."[131] For calendar year 1918, the 1918 act taxed single individuals at normal tax rates of 6 percent on their first $4,000 of net income in excess of the $1,000 exemption and at 12 percent thereafter.[132] In addition, income in excess of $5,000 was subject to a surtax that started at a modest 1 percent but eventually climbed to 65 percent for incomes in excess of $1 million.[133] In years after 1919, normal tax rates of 4 percent and 8 percent applied.[134] 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.[135] 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.[136] The company contributed 5 percent of its net earnings, which were allocated to individual employee accounts in proportion to employee contributions.[137] 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."[138]

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.[139] 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."[140] 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."[141] 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."[142] These contingencies required "that the income in question . . . be taxed to the Fund."[143]

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[126]*Id.* at 708. *See also* Robert H. Montgomery, *Excess Profits Tax Procedure 1921* 41-45 (1921).

[127]Elliot 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.

[128]Revenue Act of 1918, *supra* note 124, sections 210(a) and 216(c).

[129]*Id.* sections 210(a) and 216(c). *See also* Montgomery, *supra* note 90, at 46-47, 111-112.

[130]*Id.* sections 210(b), 211(a), and 230(a)(2). *See also* Montgomery, *supra* note 90, at 112 n.3.

[131]T.D. 2831, 21 *Treas. Dec. Int. Rev.* 257 [Art. 342] (1919). *See also* Robert H. Montgomery, *Income Tax Procedure 1921* 1029 (1921).

[132]Revenue Act of 1918, *supra* note 124, section 210(a).

[133]*Id.* section 211(a). *See* Montgomery, *supra* note 90, at 112-114.

[134]Revenue Act of 1918, *supra* note 124, section 210(b).

[135]*Sears, Roebuck & Co. Employees' Sav. and Profit Sharing Pension Fund v. Commissioner,* 17 B.T.A. 22, 27-28 (1929), *rev'd* 45 F.2d 506 (7th Cir. 1930).

[136]*Id.* at 23 (Art. III, section 1).

[137]*Id.* at 22-23 (Art. I and Art. III, section 1).

[138]*Id.* at 24 (Art. VI, section 2).

[139]*Id.* at 22.

[140]*Id.* at 27.

[141]*Id.*

[142]*Id.* at 28.

[143]*Id.* 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, Bartlett & 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.[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.[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.[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.[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.[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.[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 Garrard 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.[150]

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and a separate taxable entity"); *Scarborough v. Commissioner,* 17 B.T.A. 317, 320 (1929) (In the case of a benefit trust for sick employees, "[n]o fiduciary or income-tax returns have ever been made of the income from the fund, because in each year the income has not been sufficient to require it.").

[144] *Sears, Roebuck & Co. Employees' Sav. & Profit-Sharing Pension Fund v. Commissioner,* 45 F.2d 506 (7th Cir. 1930). The Court of Appeals held that the Sears Plan was an "association" and thus taxable as a corporation. The Board of Tax Appeals notes that "the only income of the Fund was dividends received upon . . . shares of [Sears] stock." 17 B.T.A. at 25. Under the 1918 Revenue Act, corporations did not pay tax "on dividends received from other corporations which are themselves taxable under the federal income tax law." Montgomery, *supra* note 131, at 559.

[145] *See generally* Robert Charles Clark, "The Federal Income Taxation of Financial Intermediaries," 84 *Yale L. J.* 1603, 1615-1616 (1975).

[146] Revenue Act of 1921, ch. 136, section 219(f), 42 Stat. 227, 247 (1921).

[147] *Internal Revenue: Hearings before the Senate Comm. on Fin. on H.R. 8245,* 67th Cong. 312 (1921). The provision requiring the trust to be irrevocable was stricken from the bill before enactment. *See Internal Revenue: Hearings before the Senate Comm. on Fin. on H.R. 8245,* pt. 2, 67th Cong. 387 (1921). This action should be seen in its 1920s context. The Bureau of Internal Revenue took conflicting positions on the taxation of revocable trusts until Congress specifically addressed the issue in the Revenue Act of 1924. The '24 act generally made revocable trusts taxable to the settlor. *See* Roswell Magill, *Taxable Income* 274-276 (1936). Although this rule did not apply to pension trusts, the Bureau issued regulations in 1929 that stated that an employer's "right to a deduction . . . will be recognized in cases where the pension trust may not be perpetual, provided the trust is of such a character as to

(Footnote 147 continued in next column.)

evidence good faith on the part of the employer actually to pay the amounts trusteed for employees' pension purposes." Reg. 74, Art. 271 (1929), *reprinted in* 138 *U.S. Rev. Acts, 1909-1950: The Law, Legislative Histories & Administrative Documents* (Bernard D. Reims ed. 1979). In 1938 Congress amended the code to require the trust instrument to include language that prevented trust assets from being "used for, or diverted to, purposes other than for the exclusive benefit of [the sponsor's] employees" until "all liabilities with respect to employees under the trust" were satisfied. Revenue Act of 1938, ch. 289, section 165, 52 Stat. 447, 518 (1938).

[148] A 1923 Bureau of Internal Revenue publication noted that "some fiduciaries have reported income on Form 1041 [used to report income distributed to beneficiaries], when instead they should have filed Form 1040 [used to report income taxable to the trust] . . . ." This mistake, the author observed, "in the majority of instances . . . is done intentionally in order that the high rates of surtax will not fall on the fiduciary, but instead the superficial beneficiaries will escape with a much lower rate of surtax, assuming that each one's total net income is normal." Bureau of Internal Revenue, U.S. Treasury Department, *Federal Income Tax on Estates and Trusts* 2-3 (1923).

[149] Mertens, *supra* note 99, section 23.119 at 1090; Robbins, *supra* note 21, at 71. The Bureau of Internal Revenue's notice of deficiency against the Sears Fund did not include years after 1920, but the Sears plan was denominated a profit-sharing plan.

[150] Krebs to Winston, January 12, 1926, General Records of the Department of the Treasury, National Archives, Record Group 56, Correspondence of the Office of the Secretary of the Treasury, Central Files of the Office of the Secretary of the Treasury, 1917-32, Box No. 211, Entry 191, Tax — Pension Fund Contributions.

Lower yields would have made tax-exempt securities poor investments for all or virtually all of the individual employees in the Armour plan.[151] 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 taxables after payment of income tax."[152]

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. . . ."[153] Senator George McLean, R-Conn., offered and the Senate approved such an amendment during consideration of the Revenue Act of 1926.[154] "I think we [Treasury] will have no difficulty in keeping the same in conference," Walker predicted.[155] 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). . . ."[156]

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.[157] 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 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.[158]

Many analysts have noted that it is "extremely difficult, and perhaps impossible," to integrate income taxation of a defined-benefit plan and its participants.[159] 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

[151]For a comparison of yields on tax-exempt and taxable securities in the 1920s, see Gene Smiley and Richard H. Keehn, "Federal Personal Income Tax Policy in the 1920s," 55 *J. Econ. Hist.* 285, 293 fig.1 (1995).

[152]Krebs to Winston, *supra* note 150.

[153]Walker to Winston, February 16, 1926, General Records of the Department of the Treasury, National Archives, Record Group 56, Correspondence of the Office of the Secretary of the Treasury, Central Files of the Office of the Secretary of the Treasury, 1917-32, Box No. 211, Entry 191, Tax — Pension Fund Contributions.

[154]67 *Cong. Rec.* 3,853 (1926).

[155]Walker to Winston, *supra* note 153.

[156]H.R. Rep. No. 69-356, at 35 (1926).

[157]Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke L.J.* 1021, 1028 (1997).

[158]*See* Folsom, *supra* note 44, at 403.

[159]Altman, *supra* note 1, at 449. *See also* Robbins, *supra* note 21, at 30-31; Peterson, *supra* note 6, at 35; Zelinsky, *supra* note 6, at 335-360; Robert L. Clark and Elisa Wolper, "Pension Tax Expenditures: Magnitude, Distribution, and Economic Effects," in *Public Policy Toward Pensions* 43, 55-59 (Sylvester J. Schieber and John B. Shoven, eds. 1997).

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.[160] 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.[161] The result was a shift in the focus of retirement plans toward the needs of high-compensation employees who paid income taxes.[162] Second, beginning in 1935, FDR proposed and Congress passed tax increases for individuals along with reforms to prevent the use of corporations to avoid taxes.[163] Pension plans quickly emerged as a way for owner-employees to take income out of a small corporation and defer tax for a lengthy period of time.[164] Third, the Revenue Act of 1942 introduced "mass" taxation and, with it, mass incentives for tax avoidance.[165] Under the "class" tax of 1926, most employees paid tax at the same rate — zero — as the pension trust an employer used to fund a retirement plan. Under the '42 act, even rank-and-file employees paid tax at higher rates than a pension trust.

Officials in the Treasury Department developed the tax-subsidy theory of deferred compensation to explain and counteract the undertaxation and tax avoidance that resulted when the taxation of retirement plans and participants "disintegrated" in the late 1930s and early '40s.[166] The genesis of the subsidy theory illustrates what political scientist Deborah Stone calls "causal politics."[167] Policymaking necessarily involves analysis and argument about the causes of social problems. As Stone puts it, "policy politics involves strategically portraying issues" in an effort to establish "the possibility of control and the assignment of responsibility" for a social problem.[168] "Complex causal explanations," she observes, "are not very useful in politics, precisely because they do not offer a single locus of control, a plausible candidate to take responsibility for a problem, or a point of leverage to fix a problem."[169] For this reason, causal politics invites simplification. Where experts see complex causal processes, "real-world politics" "searches for immediate and simple causes."[170]

The appeal of the subsidy theory was that it explained the tax treatment of deferred compensation in "immediate and simple" terms that had clear policy implications. The theory detached undertaxation from the complex problem of accommodating the income tax to the business practices of private-sector employers.[171] 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 the proposed rules was "to prevent the subsidy from being used only in behalf of the higher salaried, key employees."[172] Likewise, Adrian DeWind, a lawyer in the Office of the Tax Legislative Counsel, explained in 1944 that "[t]he 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."[173]

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."[174] 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 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.

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[160]On the substitutability of social security and private pensions, see Munnell, *supra* note 16, at 13-16. *See also* Sass, *supra* note 22, at 98-99.

[161]*See* Murray W. Latimer and Karl Tufel, *Trends in Industrial Pensions* 10-14 (1940); National Industrial Conference Board, *Company Pension Plans and the Social Security Act* 24-26 (Studies in Personnel Policy No. 16, 1939).

[162]Sass, *supra* note 22, at 98-101, 114-119.

[163]Brownlee, *supra* note 116, at 74-75, 77-79.

[164]Although it was short-lived, I suspect the undistributed profits tax in the Revenue Act of 1936 played an important role in sensitizing taxpayers to the tax avoidance potential of retirement plans. I discuss this issue in James A. Wooten, "Regulating the 'Unseen Revolution': A Political History of the Employee Retirement Income Security Act of 1974," draft Ph.D. Thesis, Yale University, Program in American Studies (on file with author). On the excess profits tax, see also Witte, *supra* note 118, at 102-103. The tax was dramatically reduced in 1938, and finally repealed in 1939. *Id.* at 106-107.

[165]Brownlee, *supra* note 116, at 89-100.

[166]*See* Revenue Revision of 1942: Hearings before the House Ways and Means Committee, 77th Cong. 2405, 2407 (1942) (statement of Randolph Paul). *See also* Adrian W. DeWind, "Federal Regulation of Pension Plans," in *Designing a Company Pension Plan* 10 (National Industrial Conference Board, Studies in Personnel Policy No. 67, 1944); Adrian W. DeWind, "Special Wartime and Other Problems With Respect to Pension and Profit-Sharing Plans Under the Federal Income Tax," 3 *N.Y.U. Inst. on Fed. Tax'n* 87, 90 (1945).

[167]Deborah A. Stone, "Causal Stories and the Formation of Policy Agendas," 104 *Pol. Sci. Q.* 281, 284 (1989).

[168]*Id.* at 283.

[169]*Id.* at 289.

[170]*Id. See also* R. Douglas Arnold, *The Logic of Congressional Action* 18-25 (1990).

[171]The "marriage penalty" involves a similar logic. *See* Michael J. Graetz, *The Decline [and Fall?] of the Income Tax* 29-41, 294 n. 6 (1997); Gene Steuerle, "How Marriage Penalties Arise," *Tax Notes,* Mar. 23, 1998, p. 1559.

[172]*Revenue Revision of 1942, supra* note 166, at 2407.

[173]DeWind, "Special Wartime and Other Problems," *supra* note 166, at 90.

[174]*See* Stone, *supra* note 167, at 290.