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Distributions from Disqualified Plans—Should They Be Apportioned?

I. INTRODUCTION

Employee retirement plans are intended to accumulate earnings for consumption in the future while minimizing the participant's tax liability. Many plans are designed to qualify for the tax advantages described in sections 401(a) and 401(e) of the Internal Revenue Code (the "Code"). Despite careful design, some plans eventually lose tax qualified status due to improper plan administration or changes in the employer's circumstances. Presently, the courts disagree on the question of how distributions from disqualified plans should be taxed.

According to the Internal Revenue Service (the "IRS"), distributions from disqualified plans should be taxed under section 402(b), which offers none of the tax benefits available in sections 402(a) or 402(e). To the extent that the employee's interest in the funds is substantially vested, section 402(b) requires taxation of the entire distribution as ordinary income in the year of distribution.

1. "Retirement plan" is a generic term that refers to stock bonus plans, annuity contracts, profit sharing plans, KEOGH's, individual retirement accounts, and pension plans. For purposes of this article, "retirement plan" will refer specifically to employee pension and profit-sharing plans.

An employee pension plan is generally established to give determinable benefits to participating employees (ordinarily for postretirement use). See FED. TAXES (P-H) ¶ 19,026 (1985). The extent of benefits any particular employee will realize depends on variables such as years of service to the employer and compensation level. Id.

A profit-sharing plan allows the employees to participate in the employer's profits. A predetermined formula allocates employer contributions among the participants and the allocated funds are distributed to the beneficiaries at retirement or some other event. Id.


3. Id. In addition to the income tax incentives, other types of tax advantages can be found in the Code. See I.R.C. § 2039(c) (West 1985) (exemption from estate taxes available for retirement plan participants); I.R.C. § 2517(a) (West 1985) (exclusion from gift tax available for distributions from qualified retirement plans).


5. See infra notes 81-82 and accompanying text.


The Fifth, Sixth and Seventh Circuits have upheld the IRS's method of taxation.\(^8\) The Second Circuit, the Tax Court and several district courts, however, have opposed the IRS's position.\(^9\) These courts favor an apportionment method of taxation in which contributions and earnings accumulated prior to the plan's disqualification receive favorable tax treatment under sections 402(a) and (e)\(^10\) while contributions made after the disqualification, plus the earnings accrued after the disqualification, receive ordinary income treatment under section 402(b).\(^11\)

This comment will discuss various income tax incentives which evidence Congress' desire to promote retirement plan participation. First, the comment will examine the relevant Code provisions and their purposes. Next, the comment will discuss disqualification and the two divergent methods of taxation after disqualification. After offering an example of a typical postdisqualification distribution, the comment will compare the apportionment method of taxing retirement plan distributions to the non-apportionment method. The comment will then conclude that the nonapportionment method is unacceptable and that the apportionment method warrants clarification and modification. Finally, congressional action will be urged in order to ensure the equitable taxation of future distributions from disqualified plans.

II. BACKGROUND

A. Relevant Code Provisions: Content and Purpose

Sections 401, 402 and 501 of the Code address taxation of employee retirement plans.\(^12\) Generally, section 401(a) provides that a trust which forms part of an employee's stock bonus, pension or profit-sharing plan, and which operates for the exclusive benefit of the employees, is eligible for qualification.\(^13\) An eligible trust will be qualified if it meets a series of specific requirements, most of

\(^8\) See Baetens v. Commissioner, 777 F.2d 1160 (6th Cir. 1985); Benbow v. Commissioner, 774 F.2d 740 (7th Cir. 1985); Woodson v. Commissioner, 651 F.2d 1094 (5th Cir. 1981).


\(^10\) See infra notes 19-36 and accompanying text.

\(^11\) See infra notes 37-43 and accompanying text.

\(^12\) I.R.C. §§ 401, 402, 501 (West 1985).

\(^13\) I.R.C. § 401(a) (West 1985).
which can be found in section 401. These provisions ensure against misuse of the trust and discrimination among plan participants. For example, section 401 dictates that the retirement plan agreement must be written, permanent and communicated to potential participants, and that benefits from the plan may not be alienated or assigned.

Section 402(a)(1) sets forth the general rule for taxation of benefits from a qualified retirement plan. This provision states that distributions from qualified trusts are taxable in the same manner as annuities in the year of distribution. The effect of annuity

14. Id.; see also I.R.C. §§ 401(d) (special requirements for owner-employee plans), 410 (minimum participation standards), 411 (minimum vesting standards), 415 (limitations on benefits and contributions), 416 (special rules for top-heavy plans) (West 1985). Requirements for other types of retirement plans can be found in other Code sections. See I.R.C. §§ 409 (stock option plans), 403 (annuity contracts), 408 (individual retirement accounts) (West 1985). Discussion of these types of retirement plans is outside the scope of this comment.

15. See I.R.C. § 401(a) (West 1985). Utilization of the trust funds for the exclusive benefit of the employees is a threshold requirement for all qualified retirement plans. This requirement is stated in I.R.C. § 401(a) (West 1985), which provides that "[a] trust . . . forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section — [if] . . . ." The requirement is reiterated in I.R.C. § 401(a)(2) (West 1985), which provides that under the trust agreement, it must be impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries.

16. See I.R.C. § 401(a)(4) (West 1985). Discrimination in the giving of benefits or contributions to officers, shareholders or highly compensated employees is prohibited under this provision. Id.


18. I.R.C. § 401(a)(13) (West 1985). A voluntary, revocable assignment of 10 percent or less of a benefit payment, however, will not cause the plan to be unqualified unless the assignment is used to pay for administrative expenses of the plan. Id. A loan to a participating employee or his beneficiary which is secured by the recipient's right to a benefit payment is not considered an alienation or assignment for purposes of § 401(a)(13) unless it is subject to an excise tax on prohibited transactions imposed under I.R.C. § 4975 and not exempt therefrom by I.R.C. § 4975(d)(1)). I.R.C. § 401(a)(13) (West 1985).

19. See I.R.C. § 402(a)(1) (West 1985). This provision provides in pertinent part:

General rule.—Except as provided in paragraphs (2) and (4), the amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to him, in the year in which so distributed under section 72 (relating to annuities). The amount actually distributed to any distributee shall not include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee (other than deductible employee contributions within the meaning of section 72(o)(5)). . . .

Id.

20. Id.
treatment is to tax the distribution, less any employee contributions, as ordinary income at the time that it is received by the beneficiary.\textsuperscript{21} The advantage of taxation under section 402(a)(1) is tax deferral on employer contributions until the taxpayer actually realizes income from the contributions.\textsuperscript{22} The tax system's progressive nature results in the application of a higher marginal rate to large incomes than to smaller incomes; thus, the employee benefits from deferring taxation until he retires. During retirement, the participant's income typically will be lower than it was during the employment years. Accordingly, distribution income will be taxed at a lower marginal rate.\textsuperscript{23}

Section 402(a)(2) provides an additional benefit to participants in a qualified plan who elect a lump sum distribution.\textsuperscript{24} Under this provision, the employee may apply long term capital gain treatment to the portion of his distribution that reflects employer contributions and trust income earned before 1974.\textsuperscript{25} Thus, only forty percent of the amount credited to the employee on December 31, 1973 will be included in gross income.\textsuperscript{26}

\textsuperscript{21} See I.R.C. § 72 (West 1985); Treas. Reg. § 1.72-1 et seq.
\textsuperscript{22} M. CANAN, supra note 2, at 5.
\textsuperscript{23} Although it is common for a plan to distribute funds upon retirement, other events may trigger a distribution. See 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25B.06, at 25B-16, 17 (1985).
\textsuperscript{24} I.R.C. § 402(e)(4)(A) (West 1985) defines a “lump sum distribution” as:

the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient—

(i) on account of the employee’s death,
(ii) after the employee attains age 59 1/2,
(iii) on account of the employee’s separation from the service, or
(iv) after the employee has become disabled...

from a trust which forms a part of a plan described in section 401(a) and which is exempt from tax under section 501 or from a plan described in section 403 (a) ....

\textsuperscript{25} I.R.C. § 402(a)(2) (West 1985). This provision states in pertinent part:

In the case of an employee trust described in section 401(a), which is exempt from tax under section 501(a), so much of the total taxable amount ... of a lump sum distribution as is equal to the product of such total taxable amount multiplied by a fraction—

(A) the numerator of which is the number of calendar years of active participation by the employee in such plan before January 1, 1974, and
(B) the denominator of which is the number of calendar years of active participation by the employee in such plan,

shall be treated as a gain from the sale or exchange of a capital asset held for more than 6 months ....

Id.

\textsuperscript{26} See I.R.C. § 1202 (West 1985). The 40% taxable income figure assumes that the taxpayer has a net capital gain for the year at least as large as the pre-1974 portion of the distribution.
Congress structured section 402(a)(2) to permit capital gains treatment for lump sum distributions out of a concern that those distributions had the effect of bunching income.\footnote{27} Before the enactment of this provision, earnings from years prior to retirement would aggregate, thereby increasing the employee's gross income and the corresponding marginal tax rate. Hence, a retirement plan participant paid more tax per distribution dollar than he would have paid had he received the compensation in salary form.

Capital gains treatment ameliorates bunched income because sixty percent of the income is deducted from the employee's artificially high distribution-year gross income.\footnote{28} Although capital gains treatment was available for the entire lump sum distribution under the taxation scheme that was in effect before the enactment of the Tax Reform Act of 1969, that arrangement favored taxpayers earning more than $50,000 annually, and thus Congress phased it out.\footnote{29} In its place, Congress provided for ten-year income averaging.\footnote{30} Ten-year income averaging is available for the portion of a lump sum distribution that reflects post-1973 contributions and


\footnote{28} See I.R.C. § 1202 (West 1985); \textit{supra} note 26.


\footnote{30} See I.R.C. § 402(e) (West 1985). Ten-year forward income averaging is the practical effect of the separate tax on lump sum distributions. \textit{Id.} I.R.C. § 402(e)(1)(A)-(D) (West 1985) provides:

\text{Tax on Lump Sum Distributions.—}

(1) Imposition of separate tax on lump sum distributions.—

(A) Separate tax.—There is hereby imposed a tax (in the amount determined under subparagraph (B)) on the ordinary income portion of a lump sum distribution.

(B) Amount of tax.—The amount of tax imposed by subparagraph (A) for any taxable year shall be an amount equal to the amount of the initial separate tax for such taxable year multiplied by a fraction, the numerator of which is the ordinary income portion of the lump sum distribution for the taxable year and the denominator of which is the total taxable amount of such distribution for such year.

(C) Initial separate tax.—The initial separate tax for any taxable year is an amount equal to 10 times the tax which would be imposed by subsection (c) of section 1 if the recipient were an individual referred to in such subsection and the taxable income were an amount equal to the zero bracket amount
earnings and is therefore ineligible for capital gains treatment. This post-1973 portion, called the “ordinary income portion,” is taxed separately under a ten-year income averaging method which simulates the tax consequences that would have occurred if the taxpayer had received yearly distributions over a ten-year period. According to the taxpayer’s gross income and corresponding marginal tax rate do not increase upon receipt of the post-1973 portion of a retirement plan distribution.

Under section 402(a)(5), participants have the option of rolling over part or all of a lump sum distribution into an eligible retirement plan without subjecting the distribution to taxation.

Applicable to such an individual for the taxable year plus one-tenth of the excess of—

(i) the total taxable amount of the lump sum distribution for the taxable year, over
(ii) the minimum distribution allowance.

(D) Minimum distribution allowance.—For purposes of this paragraph, the minimum distribution allowance for the taxable year is an amount equal to—

(i) the lesser of $10,000 or one-half of the total taxable amount of the lump sum distribution for the taxable year, reduced (but not below zero) by
(ii) 20 percent of the amount (if any) by which such total taxable amount exceeds $20,000.

If the taxpayer elects, the pre-1973 portion of the distribution may be treated as if it were attributable to post-1974 participation in the plan, thereby receiving 10-year income averaging treatment instead of capital gains treatment. I.R.C. § 402(e)(4)(L) (West 1985). I.R.C. § 402(e) (West 1985) establishes a minimum distribution allowance which is subtracted from the total taxable amount before the initial separate tax is calculated. I.R.C. § 402(e)(1)(C), (D) (West 1985). If the total taxable amount is less than $20,000, then $10,000 may be subtracted as the minimum distribution allowance. Id. No taxes are due on ordinary income portions of less than $10,000. Id. The amount of the minimum distribution allowance decreases as the total taxable amount increases. Id. When total taxable income reaches $70,000, no minimum distribution allowance is received. Id.

31. See supra note 30.
32. See H.R. REP. No. 807, 93d Cong., 2d Sess. 148 (1974), reprinted in 1974-3 C.B. 236, 383 (Supp. 1974) (“The 10-year averaging is provided in order to give roughly the equivalent of what the tax would be were the individual to live 10 years after retirement and receive his interest in the plan over that period.”).
33. See I.R.C. § 402(e) (West 1985).
34. I.R.C. § 402(a)(5)(A) (West 1985). This provision provides in pertinent part: Rollover amounts.—

(A) General rule.—If—

(i) any portion of the balance to the credit of an employee in a qualified trust is paid to him,
(ii) the employee transfers any portion of the property he receives in such distribution to an eligible retirement plan, . . .

then such distribution (to the extent so transferred) shall not be included in gross income for the taxable year in which paid.

Id. I.R.C. § 402(a)(5)(E)(iv) (West 1985) lists four types of “eligible retirement plans”: an individual retirement account as described in § 408(a); an individual retirement annu-
to the enactment of this provision, any distribution from an employees' trust was taxed in the distribution year, regardless of whether the taxpayer redeposited the funds into another retirement plan. The tax-free rollover provision facilitates the transfer of funds from one retirement plan to another when an employee changes jobs. Employees naturally benefit from tax-free rollovers since the distribution will be taxed upon retirement, when gross income usually will be lower, instead of upon a change in employment. In the absence of tax-free rollovers the employee might be compelled to remain in an undesirable job in order to avoid the tax consequences of a distribution from his retirement plan.

In contrast to section 402(a), section 402(b) governs taxation of benefits from unqualified plans. Section 402(b) does not provide for capital gains treatment, ten-year income averaging or tax-free rollovers. In addition, section 402(b) does not allow tax deferral for employer contributions made during a year when the plan was not qualified. Instead, to the extent that the employee's interest in the contributions is substantially vested, section 402(b) requires immediate taxation of employer contributions made during unqualified years. The amount of tax paid on employer contributions under section 402(b), however, creates a basis in the ultimate distribution. Upon retirement, this basis offsets the amount reality as described in § 408(b); a qualified trust; and an annuity plan as described in § 403(a).


37. I.R.C. § 402(b) (West 1985). This provision states:


38. Id.

39. Id.

40. Id.

41. Baetens v. Commissioner, 82 T.C. 152, 169 (1984), rev'd, 777 F.2d 1160 (6th Cir. 1985). Discussing taxation under § 402(b), the Tax Court in Baetens stated that "the
ized from the distribution and the employee's realized gain is taxed as ordinary income. Of course, the employee has no basis in the trust earnings or in the employer contributions made during years when the plan is qualified.

By granting tax exempt status to trusts forming part of a qualified retirement plan, section 501(a) affects retirement plan participants less directly than sections 401 and 402. A trust generally is a taxable entity and therefore the income generated by the trust corpus usually will be taxed to the trust. A tax exempt trust, however, does not incur income tax and thus the trust has more money to reinvest or to disburse to the beneficiaries pursuant to the retirement plan agreement. Therefore, a tax exempt trust under section 501(a) indirectly benefits retirement plan participants since tax-free trust earnings result in larger investment returns.

Compared to the employee who does not participate in the retirement plan, the employee who participates may be in a less favorable tax position if the trust loses its tax exempt status. This result occurs because the contributions, in substance, constitute deferred compensation. If the employee had received the compensation currently in salary form and invested it in tax exempt securities or in high yield investments, he could be in a more favorable financial situation than he would be in had his employer contributed part of his salary to an employee trust that was not tax exempt.

B. Compliance: Requirements and Sanctions

Congress enacted sections 401, 402 and 501 to promote imple-
mentation of qualified employee retirement plans. A retirement plan participant will reap the tax benefits of sections 402(a) and 501(a) if the plan complies with the requirements set forth in section 401. At the same time, the operation of sections 401, 402 and 501 discourages the creation of unqualified retirement plans since noncompliance with section 401 results in the unavailability of tax advantages. Participation in qualified plans is discouraged, however, when the IRS revokes the qualified status of an operating plan due to the violation of a section 401 requirement. Notwithstanding the failure to apply section 402(b) while the plan was qualified, the IRS requires taxation of retirement plan distributions under section 402(b) after disqualification.

By taxing disqualified plans under section 402(b), the IRS uses plan disqualification as punishment for noncompliance with section 401. If the person who caused the violation has participated in the plan, then section 402(b) prevents him from obtaining favorable tax treatment because the wrongdoer's own distribution is taxed as ordinary income. Unfortunately, plan disqualification also penalizes innocent participants who did not participate in the disqualifying act. Under the current status of the law, the IRS cannot differentiate between the culpable party and the innocent participants. Once the IRS revokes the plan's qualified status, the plan is deemed unqualified, and consequently the innocent participants cannot claim the tax advantages of sections 402(a) and 402(e).

49. See H.R. REP. NO. 807, 93d Cong., 2d Sess. 2 (1974), reprinted in 1974-3 C.B. 236-37 (Supp. 1974). The House Ways and Means Committee reported on a bill that addressed the tax aspects of ERISA. In that report, the committee stated that "[increasing] the number of individuals participating in retirement plans" was one of the bill's main objectives. Id.

50. See I.R.C. §§ 402(a), 501(a) (West 1985).

51. See I.R.C. § 402(b) (West 1985).


53. See, e.g., Greenwald v. Commissioner, 366 F.2d 538 (2d Cir. 1966).

54. See I.R.C. § 402(b) (West 1985).

55. Comment, Pension and Profit-Sharing Plans: The Tax Effects of Disqualification on Lump Sum Distributions, 6 DEL. J. CORP. L. 279, 290 (1981); see also Pittman Const. Co. v. United States, 463 F. Supp. 1215, 1219-20 (E.D. La. 1977) ("[T]he interests of employees who were not responsible for the taxpayer's error but who will nonetheless suffer from disqualification ought to be considered.").


57. Satterfield, supra note 27, at 421.
C. Section 402 in Greater Detail

Courts have divided on how sections 402(a) and 402(b) should apply to disqualified retirement plans. Their disagreement centers on the language of these two sections. Section 402(a) states that amounts received in distribution from an employees' trust that "is exempt" from tax are taxable in the distribution year. Under section 402(a), a lump sum distribution from a trust that "is exempt" from tax will also be eligible for capital gain, ten-year income averaging and tax-free rollover treatment.

Section 402(b) governs a distribution from an employees' trust that "is not exempt" from tax and requires that the distribution be subject to ordinary income taxation without the benefit of capital gain, ten-year income averaging or tax-free rollover treatment. Thus, when a disqualified plan is taxed as an unqualified plan, those tax advantages are not available to plan participants.

Sections 402(a) and 402(b) do not explicitly govern the taxation of a trust that loses its qualified status (the "disqualified trust"). Courts, however, have devised two methods of taxing the disqualified trust. Under the nonapportionment method, distributions from disqualified trusts are taxed as if they were from an unqualified trust; therefore, the participant cannot claim the tax advantages that might have been relied upon when investing in the retirement plan. Moreover, the participant's distribution will be taxed as ordinary income even though the participant was not made aware of the trust's disqualification.

Under the apportionment method, however, the predisqualification portion of the distribution is taxed under section 402(a). Although the apportionment method results in equitable treatment of innocent plan participants, the penal purpose of plan disqualification is undermined since the culpable participant can also claim

58. Compare Woodson v. Commissioner, 651 F.2d 1094 (5th Cir. 1981) (section 402(b) applicable to distributions from disqualified trusts) with Greenwald v. Commissioner, 366 F.2d 538 (2d Cir. 1966) (section 402(b) inapplicable to the portion of a distribution from a disqualified trust attributable to employer contributions and trust earnings accumulated prior to disqualification).
59. See supra note 19.
60. See supra notes 25-37 and accompanying text.
62. Rands, supra note 52, at 68.
63. See I.R.C. § 402(a), (b) (West 1985); see also Hesse v. United States, 47 A.F.T.R.2d (P-H) 81-1024, 1026 (E.D. Mo. 1980); Stogel & Ervin, supra note 56, at 584.
64. See Stogel & Ervin, supra note 56, at 584.
65. See Rands, supra note 52, at 80; supra notes 20-21 and accompanying text.
the tax advantages concomitant with the predisqualification portion of his distribution.67

III. APPORTIONMENT VS. NONAPPORTIONMENT

A. An Example

The consequences of these different methods of taxation can be best illustrated by an example which is typical of cases in which a retirement plan has been disqualified. Assume that in 1964 an employer decides to implement a retirement plan. The employer sends the details of the proposed plan to the IRS and receives a favorable determination letter stating that the plan qualifies for beneficial tax treatment.68 The employer then makes contributions to the employees' trust from 1965 through 1980. These contributions are allocated to the accounts of the participating employees.69

In 1981, a disqualifying event occurs.70 The employer or some other control group member71 may have intentionally committed a disqualifying act or the act might have been inadvertent.72 Nevertheless, the employee is unaware of the disqualifying act and continues to participate in the plan. The employer, also unaware of the disqualifying act, or its tax consequences, continues to contribute to the trust until 1985.

Assume that in 1985 the employee retires and receives a lump sum distribution of $75,000. The employee computes his 1985 in-

67. See infra note 121 and accompanying text. If the gain from misusing the trust funds is large and the postdisqualification portion of his distribution would be small, then the threat of plan disqualification probably would not dissuade a party from violating the requirements set forth in I.R.C. § 401 (West 1985). Woodson v. Commissioner, 651 F.2d 1094, 1095 n.4 (5th Cir. 1981).

68. Although advance rulings regarding plan qualification are usually sought, they are not required by the Code or treasury regulations. 4A J. MERTENS, supra note 23, § 25B.146, at 25B-322.

69. The hypothetical retirement plan is a "defined benefit plan" and provides a separate account for each participant. See M. CANAN, supra note 2, at 74.


71. "Control group member" means any person having access to or control over the trust or its operation, e.g., a trustee, fiduciary, employer or employer owner.

come tax based on the assumption that the retirement plan is qualified. Accordingly, the employee treats $40,000 (representing his pre-1974 participation) as a capital gain. Therefore, only $16,000 of the $40,000 is included in gross income. Assuming that the employee is unmarried and that he has no other taxable income or deductions, he will pay income tax of $2,201 on this amount. The employee then uses the ten-year income averaging method to determine the tax on the remaining $35,000. The result is a separate tax of $5,737. Thus, the $75,000 distribution results in a total tax liability of $7,938.

73. See supra notes 24-26 and accompanying text. I.R.C. § 402(e)(4)(L) (West 1985) allows for the election of ten-year income averaging on the pre-1974 portion instead of the capital gains treatment allowed under § 402(a)(2). The assumption in this hypothetical, however, is that the taxpayer decided to use capital gains treatment for the pre-1974 portion under § 402(a)(2).

74. Pursuant to I.R.C. § 1202 (West 1985), 60% of the net capital gain is deducted from gross income. Assuming that the employee had a net capital gain in 1985, and that he received no other income, he is allowed to deduct 60% of $40,000 or $24,000 from the capital gains portion of the distribution ($40,000 - $24,000 = $16,000).

75. See I.R.C. § 1(c)(3) (West 1985). ($2,001 + [20% ($16,000-$15,000)] = $2,201).


77. Pursuant to I.R.C. § 402(e) (West 1985) the employee’s separate tax is computed as follows:

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Total taxable amount
Amount distributed - (employee contributions + net unrealized appreciation on employer securities) = $75,000 - (0 + 0) = $75,000
Minimum distribution allowance
Lesser of ($10,000 or 1/2 of total taxable amount) - [20% (total taxable amount - $20,000)] = $10,000 - [20% ($75,000-$20,000)] = $10,000 - $11,000 = 0
Initial Separate Tax
STEP 1
(total taxable amt. - min. dist. allow.) + zero bracket amt. = $7,500 + $2,300 = $9,800
STEP 2
Tax on $9,800 per I.R.C. § 1(c)(3) (West 1985) is $1,043.
STEP 3
$1,043 x 10 = $10,430
STEP 4
$10,430 x # of post-1973 participation yrs. = total # of participation yrs.
$10,430 x 11/20 = $5,737 separate tax
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78. The $5,737 separate tax is added to the employee’s 1985 tax liability ($2,201 +
Also assume that in 1987 the IRS reexamines the retirement plan and discovers the 1981 disqualifying event. The IRS retroactively revokes the plan's qualified status as of 1981.\textsuperscript{79} A deficiency letter is sent to the employee demanding the difference between the ordinary income tax on $75,000 and the amount of taxes actually paid by the employee in 1985—an additional $17,633.\textsuperscript{80} The IRS bases its deficiency letter on the proposition that the distribution should be taxed according to the status of the trust on the distribution date. Since the trust lost its exempt status in 1981 and the distribution was made in 1985, the IRS considers the entire distribution to be ordinary income in 1985.

The Fifth, Sixth and Seventh Circuits have approved the IRS's method of taxation.\textsuperscript{81} In contrast, the Tax Court and Second Circuit have held that the distribution must be apportioned and taxed according to the trust's status when the contributions were made.\textsuperscript{82} Under the apportionment method, the employee owes an additional $1,906 plus interest\textsuperscript{83} since any contributions and trust earn-

\hspace{1cm}

\textsuperscript{79} See I.R.C. § 7805(b) (West 1985) (Secretary of the Treasury is given authority to prescribe the retroactive effect of any ruling or regulation).

\textsuperscript{80} Ordinary income tax on $75,000 less amount paid in 1985 = $25,571 − $7,938 = $17,633.

\textsuperscript{81} See Baetens v. Commissioner, 777 F.2d 1160 (6th Cir. 1985); Benbow v. Commissioner, 774 F.2d 740 (7th Cir. 1985); Woodson v. Commissioner, 651 F.2d 1094 (5th Cir. 1981).


\textsuperscript{83} The additional tax owed under apportionment is figured as follows: the entire capital gains portion (i.e., pre-1974 portion) receives capital gains treatment. See supra note 77. It was contributed during years when the plan was qualified, so under the apportionment method it deserves favorable tax treatment. The result is taxable income of $16,000. See supra note 74. The ordinary income portion (i.e., the post-1973 portion) is eligible for 10-year income averaging to the extent that the contributions and earnings are attributable to predisqualification years. The predisqualification balance in the employee's account of $60,000, see infra note 84, less the capital gains portion ($40,000), leaves $20,000 that is eligible for 10-year income averaging. The initial separate tax on this ordinary income portion is calculated as follows:

\textbf{STEP 1} \hspace{1cm} ($60,000 − $2,000) \times \frac{1}{10} + $2,300 = $8,100

\textbf{STEP 2} \hspace{1cm} Tax on $8,100 per I.R.C. § 1(c)(3) (West 1985) is $775.
ings made in the years after disqualification would be taxed as ordinary income. 84

The difference between the tax owed under the apportionment method and the nonapportionment method is approximately $15,700. 85 Of course, for the majority of taxpayers in their third year of retirement, this is a significant sum. Thus, it is reasonable to assume that the possibility of significant tax liability upon receipt of a distribution could discourage employees from participating in retirement plans.

B. Statutory Interpretation of Section 402

In determining how a disqualified plan should be taxed, the apportionment and nonapportionment courts have relied upon the language of section 402. 86 Courts rejecting apportionment contend that the language of sections 402(a) and 402(b) mandates that a trust be qualified on the date of distribution to gain favorable tax treatment. 87 These courts assert that the phrase "the amount . . .

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STEP 3

$775 \times 10 = $7,750

STEP 4

$7,750 \times \frac{7}{16} = 3,391

The remaining postdisqualification contributions and earnings ($15,000) are taxed as ordinary income along with the nondeductible part of the capital gains portion. Therefore, the employee must pay ordinary income tax on $16,000 + $15,000 (or $31,000). According to I.R.C. § 1(c)(3) (West 1985), this results in a tax liability of $6,453. The separate tax of $3,391 is added to the $6,453 for a total tax liability of $9,844. Since the employee paid $7,938 in 1985, he owes only an additional $1,906 plus interest in 1987.

84. Employer contributions and trust earnings in this hypothetical stood at $60,000 when the disqualifying event occurred. This figure was determined by dividing the $75,000 distribution among the 20 years of participation. In reality, the size of employer contributions may vary over the years. For instance, they may increase in accordance with years of service to the employer or according to the employer's profits if the plan is a profit-sharing plan. Also, trust earnings generally increase each year since the corpus which generates the earnings increases yearly. Although the court in Greenwald v. Commissioner, 366 F.2d 538 (2d Cir. 1966), did not include total earnings in the portion of the distribution on which the court allowed preferential tax treatment, the Tax Court has stated that predisqualification trust earnings deserve favorable tax treatment. See Boggs v. Commissioner, 83 T.C. 132, 151-52 (1984), vacated on other grounds, 57 A.F.T.R.2d (P-H) 86-844 (4th Cir. 1986).

85. $17,633 - $1,906 = $15,727.


87. See, e.g., Benbow v. Commissioner, 774 F.2d 740 (7th Cir. 1985). In Benbow, the court stated:

We do not agree with the Tax Court’s conclusion that the language “which is exempt from tax under section 501(a)” is ambiguous as to when exempt status must exist for a distribution to qualify for tax-free rollover treatment. Section
distributed . . . by an employees' trust . . . which is exempt from tax,” means “the amount distributed by an employees' trust which is exempt at the time of distribution.”

Conversely, apportionment advocates assert that the language of section 402 is ambiguous when applied to disqualified trusts. These courts note that subsections (a) and (b) of section 402 pertain exclusively to exempt and nonexempt trusts, respectively. The apportionment courts also have recognized that neither subsection contemplates a trust that loses its qualified status. Thus, the apportionment courts have held that subsections (a) and (b) must be concurrently applied. Hence, section 402(a), with all its tax advantages, governs the taxation of amounts contributed while the trust was exempt. Section 402(b), which requires that distributions be taxed as ordinary income, governs the taxation of amounts contributed during the period in which the trust was nonexempt.

The apportionment method is also predicated on the assumption that subsections (a) and (b) are counterparts. The similarity in 402(a)(5) explicitly limits tax-free rollover treatment to instances in which the distribution flows from an employee trust “which is exempt from tax under section 501(a).” As we read the relevant provisions, they grant beneficiaries of employee trusts exempt under section 501(a) deferral of income tax on employer contributions and trust income while the plan is “qualified.” . . . To realize the additional benefit of tax-free rollover treatment under section 402(a)(5) the trust must be exempt at the date of the distribution.

Id. at 744 (emphasis in original) (citation omitted).

88. See Baetens v. Commissioner, 777 F.2d 1160, 1166 (6th Cir. 1985); Woodson v. Commissioner, 651 F.2d 1094, 1095 (5th Cir. 1981).
91. See, e.g., Hesse v. United States, 47 A.F.T.R.2d (P-H) 81-1024, 1026 (E.D. Mo. 1980) (“There is no question that Congress did not provide for the situation at hand.”); see also Woodson v. Commissioner, 73 T.C. 779, 784 (1980), rev'd, 651 F.2d 1094 (6th Cir. 1985).
92. E.g., Benbow v. Commissioner, 82 T.C. 941 (1984), rev'd in part, 774 F.2d 740 (7th Cir. 1985), and rev'd in part sub nom. Baetens v. Commissioner, 777 F.2d 1160 (6th Cir. 1985). The Tax Court in Benbow explained:

The position of this Court is that, to the extent a distribution is attributable to the exempt life of the trust, that portion of the distribution is to be treated as one to which sections 402(a) and 402(c) apply, with the remainder being treated as a distribution to which section 402(b) applies.

82 T.C. at 947.
94. See Woodson v. Commissioner, 73 T.C. 779, 783 (1980), rev'd, 651 F.2d 1094 (5th Cir. 1981) (court refers to § 402(b) as the “natural corollary” to § 402(a)).
titles and language and the simultaneous enactment of these sections support the proposition that they are interdependent.\textsuperscript{95} Because subsections (a) and (b) are part of the same scheme of taxation, the Tax Court has suggested that the year-by-year status determination found in subsection (b) applies to all retirement plan contributions.\textsuperscript{96} Under subsection (b), employer contributions are not deferred.\textsuperscript{97} Instead, they are taxed currently to the employee if the trust is not exempt in that year.\textsuperscript{98} The decision to tax currently or to postpone taxation is therefore made on a yearly basis.\textsuperscript{99} The apportionment courts apply year-by-year status determinations to all contributions,\textsuperscript{100} and once the contributions are deemed to be tax favored, that status is permanent regardless of whether the retirement plan is later disqualified.\textsuperscript{101}

Annual determination of exemption results in a dual characterization of distributions whenever the trust loses its exempt status. Predisqualification contributions will be characterized as qualified contributions, and upon distribution these contributions will be eligible for the favorable tax treatment found in section 402(a).\textsuperscript{102} Postdisqualification contributions will be characterized as unqualified contributions and will be ineligible for capital gains treatment, ten-year income averaging or tax-free rollovers when they are distributed.\textsuperscript{103}

\textsuperscript{95} Compare I.R.C. § 402(a) (West 1985) with I.R.C. § 402(b) (West 1985).
\textsuperscript{96} See, e.g., Baetens v. Commissioner, 82 T.C. 152, 167 (1984), rev'd, 777 F.2d 1160 (6th Cir. 1985) ("Section 402(b) expressly requires a yearly determination of a plan's qualified status. We conclude that the benefits of qualification also attach on a year-by-year basis rather than just in the year of distribution.").
\textsuperscript{97} See supra note 37 for the text of I.R.C. § 402(b).
\textsuperscript{98} I.R.C. § 402(b) (West 1985). The amount of taxes owed on employer contributions made in a nonexempt year is based on the degree to which the employee's right to the funds is substantially vested. See generally 4A J. MERTSCH, supra note 23, § 25B.201, at 25B-467.
\textsuperscript{99} I.R.C. § 402(b) (West 1985).
\textsuperscript{100} See, e.g., Greenwald v. Commissioner, 366 F.2d 538, 541 (2d Cir. 1966); Boggs v. Commissioner, 83 T.C. 132 (1984), vacated on other grounds, 57 A.F.T.R.2d (P-H) 86-844 (4th Cir. 1986). The Tax Court extends the year-by-year determination of qualified status to the trust earnings and to employer contributions. Boggs, 83 T.C. at 152.
\textsuperscript{101} See Baetens v. Commissioner, 82 T.C. 152, 166 (1984) ("[T]he whole tenor of section 402(b) is that the distributions taxed by section 402(b) are based on contributions to a trust that is nonexempt at the time of contribution, and this is entirely without regard to the status of the trust at the time of distribution."), rev'd, 777 F.2d 1160 (6th Cir. 1985).
\textsuperscript{102} See supra notes 100-01 and accompanying text.
\textsuperscript{103} See supra notes 100-01 and accompanying text.
C. Treasury Regulations

Courts on both sides of the apportionment issue utilize treasury regulations to bolster their positions.\textsuperscript{104} Of the regulations cited by the courts, Treasury Regulation section 1.402(b)-1(c)(1) is most relevant to taxation of distributions from nonexempt trusts.\textsuperscript{105} This regulation unequivocally requires that a distribution from a trust that is nonexempt in the year of distribution be taxed as ordinary income.\textsuperscript{106} Although no proapportionment court has addressed this regulation, the Tax Court invalidated a different regulation that similarly required nonapportionment.\textsuperscript{107} The Tax Court found that this regulation did not reasonably implement the congressional purpose of section 402.\textsuperscript{108} The Tax Court noted that a regulation requiring that the trust still be exempt at distribution time was unreasonable since Congress intended to afford favorable tax treatment according to the trust's status when contributions were made.\textsuperscript{109} The Sixth and Seventh Circuits, however, have rejected the Tax Court's invalidation of the regulation.\textsuperscript{110} Nonetheless, the Tax Court has not retracted its position that the regulation is invalid.\textsuperscript{111}


The United States Supreme Court has held that Treasury Regulations should be followed if they reasonably implement congressional intent. United States v. Correll, 389 U.S. 299, 307 (1967). Regulations issued under a general grant of authority are entitled to less deference than regulations promulgated under a specific grant of authority. United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982). All of the treasury regulations which have been cited in the apportionment controversy have been issued under a general grant of authority. See I.R.C. § 7805(a) (West 1985) (Secretary of the Treasury has a general grant of authority to promulgate "all needful rules and regulations for the enforcement of this title").

\textsuperscript{105} Treas. Reg. § 1.402(b)-1(c)(1) (West 1985) provides in pertinent part:

(c) Taxation of distributions from trust not exempt under section 501(a)—

(1) In general. Any amount actually distributed or made available to any distributee by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be taxable under section 72 (relating to annuities) to the distributee in the taxable year in which it is so distributed or made available. . . .

\textsuperscript{106} Id.


\textsuperscript{109} Id.

\textsuperscript{110} See Baetens v. Commissioner, 777 F.2d 1160, 1166 (6th Cir. 1985); Benbow v. Commissioner, 774 F.2d 740, 745 (7th Cir. 1985).

\textsuperscript{111} See Baetens v. Commissioner, 82 T.C. 152, 163-64 (1984), rev'd, 777 F.2d 1160
D. Legislative History and the ERISA Amendments

In 1974, Congress enacted the Employee Retirement Income Security Act ("ERISA"), a comprehensive, proemployee act which increased federal supervision of employee benefit plans.ERISA was the source of several Code amendments which pertain to retirement plan qualification requirements. The congressional reports submitted during consideration of ERISA indicate that Congress was aware of the hardship caused by ordinary income treatment of distributions from disqualified retirement plans. These reports describe ordinary income treatment as being unfair to innocent plan participants and indicate that certain ERISA amendments to the Code were intended to partially eliminate plan disqualification. Sections 4971 and 4975, added to the Code by ERISA, describe excise taxes which replace plan disqualification as a deterrent against failing to meet minimum funding standards and engaging in prohibited transactions. Since the effective date of ERISA, innocent participants in underfunded retirement plans, or plans that extended loans to control group members, have been able to report their distributions under section 402(a) regardless of these qualification violations. Thus, the IRS can no longer disqualify the plan on minimum funding or prohibited transaction grounds. Instead, the IRS must assess excise taxes against the control group member responsible for underfunding or accepting

(6th Cir. 1985). Noting that the treasury regulations distinguish between contributions made during exempt years and those made during nonexempt years, the Tax Court in Baetens construed the regulations to require apportionment. 82 T.C. at 163-64. For example, the court pointed out that Treas. Reg. § 1.402(b)-1(b)(1) provides that when an exempt trust ceases to be exempt, the employee shall include only the amount contributed during nonexempt years in his gross income. Id.

113. See generally Stogel & Ervin, supra note 56, at 565-83.

It is grossly unfair to hold an employee accountable for acts which disqualify him from benefits if he had no knowledge of these acts . . . . There is a need, therefore, for more effective remedies [than plan disqualification] to prevent misuse of the pension funds to the detriment of the interests of participating employees.

Id.

117. Id.
118. Id.
Despite Congress' apparent disapproval of using plan disqualification punitively, the Sixth Circuit has claimed that ERISA is proof of congressional intent to retain plan disqualification. The court used the principle of *inclusio unius est exclusio alterius* to support its position that Congress tacitly endorsed the IRS's present system of disqualification as a punishment for disqualifying acts that are not mentioned in the ERISA amendments.

In contrast to the view that ERISA endorses punitive actions against rank and file retirement plan participants, several advocates of apportionment have taken a holistic view of ERISA's legislative history. Noting that Congress enacted ERISA to protect individual pension rights, apportionment proponents argue that utilizing ERISA to support an anti-employee action such as plan disqualification directly contravenes the underlying purpose of ERISA. Moreover, rather than depicting an intent to retain plan disqualification, congressional reports demonstrate that the ERISA amendments to the Code were primarily intended to reduce the effect of bunched income and facilitate the transfer of retirement funds when an employee changes jobs.

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119. See I.R.C. §§ 4971(a), (b), 4975(a), (b) (West 1985); see also I.R.C. § 4975(e)(2) (West 1985) (definition of "disqualified person").

120. Baetens v. Commissioner, 777 F.2d 1160, 1164-65 (6th Cir. 1985).

121. *Id.* The principle of *inclusio unius est exclusio alterius* means that "[t]he inclusion of one is the exclusion of another." *Black's Law Dictionary* 687 (5th ed. 1979). Thus, in light of the enactment of limited excise taxes which can be assessed against control group members, the Sixth Circuit in *Baetens v. Commissioner* submitted that Congress' intent to maintain nonapportionment is evidenced by its failure to supplant completely the disqualification remedy. *Baetens v. Commissioner*, 777 F.2d 1160, 1164-65 (6th Cir. 1985).


124. *Baetens v. Commissioner*, 82 T.C. 152, 169-70 (1984) ("punitive aspect" of taxing a distribution from a disqualified trust entirely as ordinary income is "contrary to Congress' overall purpose in passing ERISA"), *rev'd*, 777 F.2d 1160 (6th Cir. 1985); *Rands*, *supra* note 52, at 67 (disqualification "frustrates the legislative purpose of encouraging the establishment and maintenance of employee retirement plans").

125. *See* H.R. REP. No. 807, 93d Cong., 2d Sess. 150, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4670, 4815 (explanation of the effect and purpose of ten-year income averaging provision—to simulate a ten-year retirement pension and thereby alleviate bunching); H.R. REP. No. 779, 93d Cong., 2d Sess. 148-49 (1974) (also discussing the purpose of ten-year income averaging); H.R. CONF. REP. NO. 1280, 93d Cong., 2d Sess. 341, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 5038 ("To facilitate portability of pensions—or their transfer with the employee as he changes jobs—the conference substitute provides that money or property may be distributed from a tax-qualified plan . . . on a tax-free basis. . . ."); *see also* *supra* notes 27-28 and accompanying text.
E. Policy Considerations

Even the Sixth Circuit, an anti-apportionment court, has admitted that ordinary tax treatment is unfair to innocent retirement plan participants.\(^{126}\) This court, however, also has warned that a desire for equity should not lead to an unauthorized judicial expansion of the statute.\(^{127}\) Anti-apportionment courts point out that Congress, not the judiciary, is responsible for modifying the Code to achieve equity.\(^{128}\)

The pro-apportionment courts, on the other hand, find that apportionment can be granted absent resort to revisionism.\(^{129}\) If the present provisions are read with particular attention to the overall purpose of promoting retirement plan participation, then grounds for apportionment can be found in the language of section 402.\(^{130}\) The apportionment courts read section 402(a) as allowing tax advantages if the distribution is from a “trust ... which is exempt from tax [at the time of contribution].”\(^{131}\) This interpretation remains faithful to the congressional purpose underlying the retirement plan taxation scheme.\(^{132}\)

The anti-apportionment courts submit that apportionment reduces the deterrent effect of disqualification.\(^{133}\) With apportionment, a member of the control group who operates the plan in violation of the qualification requirements puts only the postdisqualification portion of his own distribution at risk.\(^{134}\) Without apportionment, the balance in the wrongdoer’s account will lose favorable tax treatment when the IRS disqualifies the plan.\(^{135}\) Thus, the threat of ordinary income treatment for the wrongdoer’s entire distribution is a more effective deterrent.\(^{136}\)

\(^{126}\) See Baetens v. Commissioner, 777 F.2d 1160, 1164 (6th Cir. 1985) (“We recognize, as the tax court and the Second Circuit have, that a fundamental unfairness has occurred ... ”).

\(^{127}\) Id. at 1162; Woodson v. Commissioner, 651 F.2d 1094, 1095-96 (5th Cir. 1981).

\(^{128}\) Baetens v. Commissioner, 777 F.2d 1160, 1164 (6th Cir. 1985); Woodson v. Commissioner, 651 F.2d 1094, 1095-96 (5th Cir. 1981).


\(^{130}\) Greenwald v. Commissioner, 366 F.2d 538, 541 (2d Cir. 1966); Baetens v. Commissioner, 82 T.C. 152, 160, 163 (1984), rev’d, 777 F.2d 1160 (6th Cir. 1985); Note, supra note 89, at 1200.

\(^{131}\) See supra notes 100-03 and accompanying text.

\(^{132}\) See supra notes 122-24 and accompanying text.

\(^{133}\) Woodson v. Commissioner, 651 F.2d 1094, 1095 n.4 (5th Cir. 1981).

\(^{134}\) See supra notes 69-70 and accompanying text.

\(^{135}\) See supra note 67 and accompanying text.

\(^{136}\) Woodson v. Commissioner, 73 T.C. 779, 787-89 (1980) (Chabot, J., dissenting); Comment, supra note 55, at 296.
At least one proponent of apportionment, however, has noted that the nonapportionment approach undermines Congress' policy of allowing favorable tax treatment to all retirement plan participants even if a plan does not qualify under section 401. Section 402(b) alleviates bunched income even when it governs taxation of distributions from plans which were never qualified. When the employee is taxed currently on employer contributions, the employee builds a tax basis which offsets the income he receives from a distribution. The employee is not entitled to capital gains treatment, ten-year income averaging or tax-free rollovers. The employee nevertheless acquires a basis in the retirement funds, and therefore he will not be burdened with a large increase in taxable income upon distribution.

Conversely, when the IRS treats an entire disqualified distribution as ordinary income, it recreates the bunched income effect that Congress sought to avoid. In effect, the IRS's procedure bunches together income that was earned during previous years and taxes that income in a single year. Because the plans are often disqualified after the employee has already received his distribution, and because the revocation of qualified status can operate retroactively, the employer contributions to the disqualified plan are not taxed currently as required under section 402(b). Thus, the employee has no basis to offset the distribution amount and his past income is bunched. Of course, this result is anomalous in light of Congress' objective of promoting private pension plans through tax incentives.

IV. ANALYSIS

The second sentence of section 402(b) allows the IRS to tax the amount actually distributed from an unqualified trust as ordinary income. See Baetens v. Commissioner, 82 T.C. 152, 169-70 (1984), rev'd, 777 F.2d 1160 (6th Cir. 1985); see supra note 125.

See supra notes 37-42 and accompanying text.

See supra notes 39-42 and accompanying text.

See supra note 38 and accompanying text.


Id.

Id.


See Woodson v. Commissioner, 73 T.C. 779, 783-84 (1980), rev'd, 651 F.2d 1094 (5th Cir. 1981); see supra note 123 and accompanying text.
The first sentence, however, requires that the employee initially be taxed each year that the plan fails to qualify. As a unified whole, section 402(b) is fair to the employee because it allows him to build a tax basis that will help offset the ultimate distribution. At the same time, it encourages the control group members to continue to meet section 401(a) requirements in order to avoid current taxes.

Taxation of trust funds under the second sentence of section 402(b) without application of the first sentence of section 402(b) undermines the scheme of taxation intended by Congress. Antiapportionment courts, however, have failed to address this problem. Congress has included both sentences in one subsection, the sentences are not separated into paragraphs or set apart in any fashion. Thus, trusts whose beneficiaries have not been subjected to current taxation under the first sentence of section 402(b) are not the legitimate targets of the second sentence of section 402(b).

If section 402(b) does not govern the taxation of distributions from disqualified plans, then distributions from those plans must be taxed under a different Code section. Section 61, the general provision for taxing income as ordinary income, provides a feasible alternative. A distribution taxed as ordinary income under section 61, however, would still subject the plan participant to all the inequities which are concomitant with taxation under section 402(b).

The simultaneous use of subsections 402(a) and 402(b) provides a more acceptable solution. The inherently ambiguous language of section 402 leaves open this possibility. Despite assertions to the contrary, there can be no doubt that the language of section 402 is ambiguous when applied to disqualified retirement plans. The four courts that have found that section 402 yields two interpretations have resolved the ambiguity in favor of apportionment.

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147. I.R.C. § 402(b) (West 1985).
148. Id.
149. See supra notes 138-41 and accompanying text.
150. See supra note 54 and accompanying text.
151. See I.R.C. § 402(b) (West 1985).
153. See supra notes 87-90 and accompanying text.
result conforms with the rule of statutory construction that ambiguities in tax statutes must be resolved in the taxpayer's favor.\footnote{155}

Still, the ambiguity in section 402 does not connote that apportionment is proper. The ambiguity must ultimately be resolved in the manner intended by Congress. The Tax Court has convincingly demonstrated that Congress' purpose in legislating tax incentives for retirement plan participants was to encourage plan participation and to ensure the safety of the participants' investments.\footnote{156} Nonapportionment accomplishes neither of these goals.

Favorable tax treatment is perhaps the greatest incentive for retirement plan participation.\footnote{157} This benefit, however, is emasculated when disqualified trust distributions are taxed as ordinary income. Moreover, as a protective device, plan disqualification followed by nonapportionment taxation has been a proven failure.\footnote{158} Despite the contentions that Congress enacted section 402(b) as a threat against control group members who misuse their power over the trust, it is far from clear that Congress had that deterrent purpose in mind.\footnote{159} Moreover, if Congress enacted section 402(b) as a punitive measure, it is anomalous that Congress did not expressly grant the IRS the power to disqualify a plan. It also is highly unlikely that Congress would have sponsored a scheme of taxation that is so grossly unfair to innocent taxpayers.

The inequities of nonapportionment arise from three sources. First, the rank and file employee has no power to prevent the disqualification.\footnote{160} Second, the IRS has the general authority to retroactively revoke any ruling, including one regarding the qualification of a plan.\footnote{161} Third, only plans making distributions associated with plan termination are likely to be reevaluated by the IRS with regard to their qualification status.\footnote{162} As a result of these
three factors, an innocent employee can claim favorable tax treat-
ment for his pre-termination lump sum distribution while the distri-
bution of a fellow employee who waits until the plan terminates
will be taxed as ordinary income. It was surely not the purpose
of Congress to tax so indiscriminately.

Concededly, due deference must be given to the Treasury Regu-
lations, which were promulgated by an agency with the expertise
and the authority to interpret reasonably and enforce tax legisla-
tion. The judiciary, however, should not be forced to accept an
agency interpretation that was not issued pursuant to the agency’s
legislative powers.

V. RECOMMENDATIONS

Presently, taxpayers who live in the Fifth, Sixth and Seventh
Circuits will incur harsher tax consequences than those in the Sec-
ond Circuit if they receive a distribution from a disqualified retire-
ment plan. Taxpayers residing in the remaining circuits who
participate in a disqualified trust await an uncertain fate. Congres-
sional amendment of the Code is the most certain and efficient
method of alleviating this problem. Congress should enact a new
 provision which addresses (1) under what circumstances, if any, a
plan may be disqualified; (2) the tax consequences of disqualifica-
tion; and (3) the kinds of participants to be affected by
disqualification.

In formulating the new Code provision, Congress could extend
the rationale of sections 4971 and 4975 and thus impose excise
taxes upon the control group person responsible for qualification
requirement violations while leaving the qualified status of the plan
intact. This alternative would have the advantage of retaining all
of the tax advantages that innocent rank and file employees be-
lieved they would receive when they elected to participate in the
plan. Although this provision would not result in sanctions being
imposed upon nonculpable parties, it would have the distinct dis-

Benbow v. Commissioner, 82 T.C. 941, 944 (1984), rev’d in part, 774 F.2d 740 (7th Cir.
1985), and rev’d in part sub nom. Baetens v. Commissioner, 777 F.2d 1160 (6th Cir.
1985); Boggs v. Commissioner, 83 T.C. 132 (1984), vacated on other grounds, 57
A.F.T.R.2d (P-H) 86-884 (4th Cir. 1986); Woodson v. Commissioner, 73 T.C. 779
(1980), rev’d, 651 F.2d 1094 (5th Cir. 1981); see also M. CANAN, supra note 2, at 458;
163. See, e.g., Greenwald v. Commissioner, 366 F.2d 538, 541 (2d Cir. 1966).
164. See supra notes 104-11 and accompanying text.
165. See supra note 104 and accompanying text.
advantage of requiring adjudications of guilt each time a plan is disqualified.

Another alternative is to use section 402(a)(2) as a model in fashioning the new Code provision. Section 402(a)(2) sets a date as of which all employer contributions and trust earnings then accumulated are taxed in one way, while all employer contributions and earnings accrued after that date are taxed in another. In the case of a disqualified trust, the determinative date would be the date when the revocation of qualification took effect. The balance to the employee's credit at that time would be granted favorable tax treatment while the amount accrued after that date through employer contributions and trust earnings would receive ordinary income tax treatment. This scheme of taxation, adopted by the Second Circuit and the Tax Court, has the advantage of relative simplicity but has the disadvantage of taxing earnings on the predisqualification balance as ordinary income. Since the funds generating those earnings are attributable to years when the plan was qualified, the earnings themselves also should receive favorable tax treatment.

Finally, the new Code provision could mandate apportionment while also granting favorable tax treatment to the trust earnings received by the trust after the disqualification date but attributable to funds accumulated before the disqualification. Although this plan of taxation would require more complex regulations to compute the postdisqualification earnings on the predisqualification balance, the calculations would not be prohibitively complicated. An average annual rate of earnings for the trust could be determined and applied to the employee's balance on the disqualification date. Earnings calculated in this manner would be continually added to the balance and the average annual earnings rate applied to that adjusted balance for each participation year in which the plan was disqualified. This model is preferable to the other alternatives because it avoids the guilt-finding adjudications which would be required by the excise tax model, but accords tax advantages on the earnings generated by the entire predisqualification amount.

VI. CONCLUSION

Each side in the apportionment controversy has presented forceful arguments, and the statutory language can be interpreted either as prohibiting apportionment or demanding it. Although the ap-

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Applicable Treasury Regulations require nonapportionment, the equities require apportionment. In this state of equiposition, the balance must be tipped by the need to achieve fidelity to Congress’ intention of protecting employee investments in retirement plans and encouraging participation in private retirement plans. Apportionment achieves these goals. Congressional action, however, is needed to clarify the specific method of apportioning the distribution.

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