

In appraising "favorable tax treatment"; i.e., the effect on Federal revenues of the tax provisions relating to qualified plans, Mr. Surrey, it is submitted, makes the wrong comparison—the comparison should be made with the alternative of pay-as-you-go financing by the employer and not with a funded nonqualified plan. As will be indicated later in this paper, in the 1942 legislation, in stipulating the requirements for a qualified funded plan that were aimed, mainly, to prevent tax avoidance, it was necessary, in the very nature of things, to stipulate the tax treatment of nonqualified funded plans. Such tax treatment proved to be rather severe. But, an employer is under no compulsion to fund a plan; he is free to finance it on a pay-as-you-go basis and would be greatly impelled to do so if there were highly undesirable tax results on a funded basis. What would be revealed by a long-term comparison of the effect on Federal revenues of advance funding with pay-as-you-go financing?

The following analysis of pay-as-you-go financing versus advance funding is concerned only with the relative financial effects on Federal Government revenues and on the employer's cost of operation: i.e., without regard to other funding considerations such as the desirability of enhancing the security of benefits for employees or a purpose to invest pension funds outside of the employer's business.**

Consider a noncontributory plan now on a pay-as-you-go financing basis. All pension payments made are properly deductible by the employer as a reasonable and necessary business expense whether the plan structure meets "qualification" requirements or not provided the benefits are "reasonable." As a natural tax treatment, the retired employee includes pension payments in his taxable income as received¹. The employer may be maintaining balance sheet reserves and considers that the pension contributions, in effect, are invested in his business. (Under Opinion 8 of the American Institute of Certified Public Accountants, there must now be an appropriate recognition of currently accruing costs on some recognized actuarial cost method.) The retired employee has no concern with the employer's accounting practice—he pays an income tax as he receives his pension payments. If the employer goes beyond accounting and places funds in a qualified trust or insurance company contract, it still should be of no interest to the retired employee so far as his personal income tax is concerned.

In this process of advance accounting for pension costs by either internal balance sheet reserves or a qualified advance funding operation, the contributions, actual or assumed, and investment earnings, actual or assumed, must match the pension payments, dollar for dollar, over the duration of the pension operation. At first blush, assuming uniform corporate income tax rates throughout the pension operation, it would appear that the capitalized value of tax deductions on the pay-as-you-go basis should be equal to the capitalized value of the corresponding tax deductions for contributions and investment earnings under advance funding. The situation, however, is not that simple.

**Furthermore, no attempt has been made to explore the implications of situations where, in choosing between financing methods, the employer cannot use additional capital profitably or, if the employer can, such capital is available on good terms from sources other than foregone advance pension funding contributions.