Pensions - Financing
(1950)

Can You *Postpone* Pension Contributions?

SOMETIMES pension systems are inflexible—not because of any rules of the Bureau of Internal Revenue—but because of the way they were planned. More thoughtful preparation might have given the employer greater leeway in meeting future conditions.

Careful, unhurried consideration of a pension system is essential. Perhaps we can help you choose the right kind of a plan—a flexible plan—for your company. Write or telephone to our Pension Section; or, if more convenient, drop in to see us.

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Can You *Postpone* Your Pension Contributions?

A PENSION PLAN, it is often supposed, calls for more or less inflexible contributions by the employer each year. Many employers have been led to believe that whether business is good or bad, whether the employer operates at a profit or a loss, whether he "needs" another tax deduction or does not, the annual contributions into the pension trust must be made.

How much truth is there in this belief?

A Funded Plan

It is true, of course, that if an employer wants *at all times* to have funds in his pension trust sufficient to pay completely all the pensions earned by his employees, he will have to contribute regularly.

But what happens if for some reason he finds it difficult to keep "up to snuff"? What if he has a loss in operations, or finds it difficult for some other reason to make his regular contribution?

Original Liability

The fundamental rule of the Bureau of Internal Revenue is that the original unfunded liability of a plan cannot be exceeded without danger of the plan's being disqualified.

To explain this, let us assume that when the ABC Company started its plan, it was found actuarially that it needed to have $100,000 in the trust to pay for "past-service" benefits—i.e., the benefits earned by its employees up to the time the plan began. Let us further assume that for each year after the plan started the employer needed to put up $10,000 to pay for "current-service" benefits—the benefits earned by services of employees in that year.

When the plan started, therefore, the original liability of the employer was $100,000. This liability would increase at the rate of $10,000 a year (omitting interest factors) if no contributions whatever were made by the company. In fact, however, the ABC Company decides to pay its past-service liability of $100,000 at the rate of $10,000 a year and, in addition, to pay $10,000 a year for its current-service liabilities.

In three years the company would thus pay in $60,000, reducing its total liability to $70,000. In the fourth year, let us assume the company finds that it has not only lost money in operations, but does not have enough cash on hand to pay any part of the $20,000 that it has been contributing annually. So it puts nothing into the plan. This means that the unfunded liability increases, because of the current-service benefits, by $10,000 that year; so that at the end of the year there is $80,000 of unfunded liability as against $70,000. Assume that another year passes with exactly the same situation. The unfunded liability would then increase to $90,000.

This plan still remains a qualified plan because the unfunded liability has not reached the original amount of $100,000. It is obvious, therefore, that considerable leeway exists in a completely funded plan, and that the employer can, in many instances, omit payments without danger of disqualification.

Exceeding the Unfunded Liability

While the Bureau of Internal Revenue has set up a danger signal at the point where the original unfunded liability is exceeded, a plan will not necessarily be disqualified even if this figure is exceeded. Under those circumstances, the employer has a chance to prove that his failure to contribute has resulted from reasons of business necessity, and if his position is justified, the

Bureau of Internal Revenue may still consider the plan as qualified.

Termination

Finally, there is an additional "safety feature" in every pension plan. An employer can change his plan to reduce the benefits, or he can terminate the plan entirely, thus either reducing his contributions or even eliminating them. In general, the employer must show that the curtailment or termination of the pension plan is a matter of business necessity. If a pension plan were to be cancelled after a few years, for no valid reasons, all tax privileges connected with the plan might be withdrawn retroactively.

While it is clear that pension plans can be curtailed or terminated under certain conditions, this step should be regarded as a last resort. It is unwise to inaugurate a pension system if it appears likely that the contributions cannot be maintained indefinitely.

Loss of Tax Deduction?

While it is clear that contributions can be omitted under certain circumstances, there are one or two questions which arise from such procedure.

What happens if a company has an operating loss in a given year, but because of a strong cash position is able to maintain its contributions? Does it lose the tax deduction on this contribution?

Not at all. There are "carry-back" and "carry-forward" provisions in the law which give the corporation the right to use the deductible feature of the contribution in other years—years in which there were profits and in which a tax would be payable. The loss is available as a carry-back for two years and a carry-forward for two years, so that unless there are no profits during that whole period, the tax deduction for a contribution made during a loss year is not wasted.

> *Example:* A company just about broke even in 1950, not taking into account its $20,000 contribution to its pension plan. The contribution leaves it with a $20,000 net loss. The company made no money in 1949 or 1948 either, after paying its contributions into the pension plan. But in 1951 it has a $50,000 profit, even after taking into account a contribution that year to the pension plan. On its 1951 tax return the company can reduce the $50,000 profit by a $20,000 carry-over from 1950, paying a tax on a net income of only $30,000.

Recently, President Truman and Secretary Snyder have recommended a change in this provision. The loss, they say, should be available as a carry-back for one year and as a carry-forward for five years. If their proposal is enacted into law, the period during which the loss can be taken will be increased from five to seven years.

Paying Up the Postponed Deposits

If a contribution for any year is omitted, when must it be made up? It must be paid at some time; otherwise there would not be enough in the pension trust to pay the employees' pensions.

In effect, an omitted contribution is added to the unfunded liability and can eventually be made up in installments extending over many years.

Overpayments

Now assume the opposite situation. An employer has set out to make annual contributions into the pension plan. But in one year let us say that he happens to pay *more* into the pension trust than he is allowed to deduct on that year's tax return. Can he ever take an income tax deduction for the overpayment?

The Federal income tax law provides that the excess over the amount deducted may be carried over to following years. In a following year, if less is deposited than could ordinarily be taken as a tax deduction, the "carry-over" can be used as a tax deduction.

It should be noted, however, that "overpayments" into a pension fund are looked upon with disfavor by the Bureau of Internal Revenue. Deliberate overpayment could result in disqualification of a plan.

Planning for Flexibility

While a pension plan should not be established unless the employer intends to contribute regularly, he can, under certain conditions, postpone payments without penalty. A properly drawn and financed pension plan is more flexible than many employers believe.

THIS BOOKLET is number 8 in a series published by Old Colony Trust Company on various aspects of Pensions and Profit-Sharing Plans. The other titles are:

No. 1—PRIMER ON PENSION AND PROFIT-SHARING PLANS

No. 2—EXECUTIVES NEED PENSIONS TOO

No. 3—WHY A TRUSTEE FOR PENSIONS

No. 4—WHY WORKERS WANT PENSIONS

No. 5—SIMPLICITY IN PENSIONS

No. 6—A PENSION PLAN OR A PROFIT-SHARING PLAN

No. 7—SHOULD COMMON STOCKS BE USED IN A PENSION FUND?

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One Federal Street • Boston 6, Mass.