Pensions - Financing
(1950)

Advantages *of* FUNDING *a* PENSION PLAN

ONCE you have decided that your company should install a funded pension plan, the question remains of *how* to fund it. "Frozen Liability?" Pay off past service in ten years? Twenty years? Thirty years?

We can help you answer these questions. Our practical experience in the pension field is available to you without obligation. Write to or call on our Pension Trust Section, One Federal Street, Boston. Or let us know if you would like us to come and see you.

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Advantages of
Funding a Pension Plan

WHAT IS "funding" a pension plan? It is the extent to which an employer (and employees in a contributory plan) sets aside funds for pensions over and above the amount actually paid out each year to retired employees.

Sometimes plans are funded—sometimes they are not. In an unfunded plan, there are no reserves. In a funded plan, the reserves can be set aside on the company's own books, or with a trustee, or with an insurance company. In the first two instances, and sometimes in the third, there are several different ways of setting aside these reserves—of "funding" a pension plan.

Unfunded Plan

When an employer sets up no reserves at all either prior to or after retirement of his employees, and simply pays pensions "out-of-pocket" as the need arises each year, he has an unfunded plan. Such a plan does not have the immediate tax advantages of a plan approved by the Internal Revenue Bureau.

Terminal Funding

A terminal funded plan is one in which the employer sets aside no reserves prior to the actual retirement of an employee. At retirement, however, he sets aside in a single sum (sometimes spread over five or ten years) an amount which, at a given rate of interest, will pay the employee his pension for life.

Current Funding

As the name implies, in a currently funded plan, the employer starts to set funds aside for all participating employees from the time they become eligible for the plan, thus creating reserves not only for those who have retired, but also for those who eventually will retire.

Current funding has several forms. Basically they all involve two types of cost calculations. First there is figured a single sum representing the liability for all eligible employees for benefits earned prior to the start of the plan (i.e., past service). Secondly, there is calculated an annual cost for all benefits to be earned after the plan starts (i.e., current service).

The minimum payment required to keep a plan qualified by the Internal Revenue Bureau is the current service cost plus the interest factor on the past service liability. This is known as the "Frozen Liability" method and under it the past service liability never gets paid off.

More common practice is to pay the current service annually and to amortize the past service liability over periods ranging from ten to thirty years.

How a Tax Deduction May Be Lost

"*If I want to fund my plan,*" asks an employer, "*why not set aside reserves on my books? Why use a trust company or an insurance company?*"

Some companies follow this practice, but it has several troubles. The employer does not get a tax deduction for any money set aside, and income earned on that reserve is subject to tax. In a plan approved by the Internal Revenue Bureau, where a trustee is used, both the payment to the reserve and any income earned on it are tax free.

Why Fund At All?

"*All right,*" says the employer, "*but why not pay pensions 'out-of-pocket'? Why set aside any reserves at*

all in a trust or with an insurance company?"

Thousands of employers, including the three largest automobile manufacturers, have committed themselves to make regular payments into reserves *for men and women who are still working.* They must have had some good reasons. What are they?

True Statement of Earnings . . . First of all, there is the important point of charging the earnings of a year with the expenses of that year.

If a company coasts along, making no provision for pensions while the employees are performing their services, it is ignoring a substantial current expense. This expense, the cost of pensions attributable to employees' services, is allowed to pile up, and must eventually be taken out of earnings for a later period.

This is poor bookkeeping. The effect is much as though the company forgot about depreciation. With respect to pensions, as well as depreciation, the management should not give its stockholders and creditors an overstatement of earnings by disregarding costs when they actually are incurred.

Flexibility . . . In a funded plan, through its very definition, reserves exist over and above the annual outlay for pensions. If, during a bad business period, the company finds it difficult to make contributions into its plan, it can postpone them, in a properly funded plan, for a long period without danger of disqualifying its plan and without stopping pension payments to retired employees. In an unfunded plan this is not possible.

Costs Misleading . . . One of the characteristics of costs in an unfunded plan, and usually in a terminal funded plan, is that in the early years pension payments are much lower than they will eventually be. The employer can very easily be misled into agreeing to a pension plan which, on an unfunded basis, seems to be within his ability to pay, only to find later that his costs have gone completely out of hand.

Employees Favor Funding . . . Entirely apart from the dollars and cents advantages of funding, there is the very practical consideration that employees are demanding that their pensions be backed up by definite commitments of property.

These demands may at times appear unreasonable. The largest and richest corporations can be expected to meet—twenty or thirty years in the future—the pension obligations they undertake today. A reserve in the form of trust funds that they will do so could be regarded as superfluous.

"No," say the employees. They point out that some of the railroads, back in the 1930's, found it impossible to continue pension payments at promised levels. Furthermore, what about the smaller companies, and the ones that are not so firmly established as the industry giants? Could not a business recession endanger the employees' pensions, no matter how well-intentioned the management might be in the matter?

At the least the employer, by funding his plan, will effect a greater improvement in employee morale than if he operates his plan on a "pay-as-you-go" basis.

Does Funding Add To Pension Costs?

Usually funding will not add to pension costs and in some cases it may reduce them. A formal funded plan, for example, would probably be much cheaper because of its tax advantages than an informal plan where a company set aside reserves on its own books and invested them in securities. The higher taxes go, the cheaper it is to fund a plan. The excess profits tax of the 1940's permitted corporations to pass on to the Government a very substantial part of their pension costs.

Most Plans Funded

There are many advantages to be obtained through funding a pension plan as indicated above. The value of these advantages is amply evidenced by the fact that most pension plans today are funded in whole or in part, while the employees are still working.

We shall be glad to discuss this matter with you and to consider which of the various funding methods is most applicable to your company. Our practical experience in the pension field is available to you without obligation.

THIS BOOKLET is number 9 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?

No. 8—CAN YOU POSTPONE PENSION CONTRIBUTIONS?

We will gladly send you copies of any of these publications on request.

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