Pensions (1950)

EMPLOYEE PENSION PLANS

The Big Question:

"How Much Does A Pension Plan Cost?"

City Bank Farmers
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The Big Question:

"How much does a Pension Plan Cost?"

VERY often an employer says, "Sooner or later we'll have to face this problem of a pension system for our employees. But I'm not so sure we can afford one now. What would it cost us per year?"

The answer depends upon the type of system the employer selects. The cost of any particular plan is determined by the provisions it contains.

COST DEPENDS ON PROVISIONS OF PLAN

In the case of a plan for your company, you would determine the cost by selecting the type of plan best suited to your company and pocketbook. We can help you make the selection by showing you how cost is affected by the various provisions that might be included in your plan.

To illustrate, let's start with what might be regarded as an average plan and then show you how the cost would be decreased or increased by changing certain of its provisions or adding new ones.

THE OUTLINE OF A PENSION PLAN

AN AVERAGE PLAN

The XYZ Company, we'll say, is considering the installation of a pension system for all of its employees. It is a pension system without any frills. However, an employee will get an adequate pension if he starts working for the company not too late in life and stays until he is 65. But the plan makes no provision for an employee who becomes disabled before he is 65, and it gives nothing to an employee who resigns or is discharged. Nothing is paid to an employee's estate if he dies before 65.

The Gross Cost

If the XYZ Company pays for everything, without calling on the employee to share the burden, how much will it cost per year?

COST OF FUTURE SERVICE BENEFITS

If we were to estimate the cost of the pension plan described, we would ordinarily break it down into two parts:

(a) the cost of providing benefits based on future service—service performed by employees after the installation of the plan.

For this kind of plan many companies have found that the gross initial cost for benefits based on future service would not exceed, annually, 6% to 7% of the total payroll.

PAST SERVICE BENEFITS

(b) the cost of providing benefits based on past service—service performed before the installation of the plan.

For medium sized and large companies with a great deal of past service, the lump-sum, single-payment cost of providing benefits based on past service will rarely exceed a total of one-half to three-quarters of one years' payroll. For newer companies with less past service, this lump sum will be considerably smaller, perhaps no more than one-third of one years' payroll.

SPREADING THE COST OF PAST SERVICE BENEFITS

LUMP SUM LIABILITY CAN BE LIQUIDATED OVER MANY YEARS

There can be no minimizing of the problem involved in providing benefits based on past services. In many instances it is the main problem. However, the liquidation of this liability can be made less burdensome by spreading its payment over a period of years. In fact, the Treasury Department does not allow a company to take more than 10% of the past-service cost as a tax deduction in any one year. Many companies are now funding the past-service liability over a period of ten, twenty, or even forty years.

ANNUAL PAYMENT A TAX DEDUCTION

If, therefore, in considering a plan, you found that your liability for past-service benefits amounted to 50% of your payroll, you could pay it off in twenty years for as little as 3.2% of total payroll annually, or 2.4% if you elect to fund over a 30-year period. (These figures reflect gross payments before the tax deduction.)

TOTAL ANNUAL GROSS COST OF PLAN

CONSEQUENTLY, for the described plan, taking into account past and future service, your total cost normally would amount roughly to 10% of your total payroll for 20 years. After discharging the past-service liability, the cost would drop to around 6% gross.

Factors Reducing Gross Cost

It should be understood that the employer's contributions to a pension plan are not just so much added expense. There are a number of offsetting factors that reduce the gross cost substantially:

(1) TAXES

An employer's contributions to a pension plan can be deducted in computing his Federal income tax, assuming that the plan has been approved by the Bureau of Internal Revenue and the contributions are within the limits set by the tax law.

THE GOVERNMENT NOW PAYS 38% OF THE COST OF A QUALIFIED PLAN

This brings the net cost of a pension plan down still further. If an employer's tax rate is the normal 38%, he gets 38% of his contribution back in the form of a reduction of tax. Putting it in other words, the employer pays 62% of the cost of pensions, the Government 38%.

For example, if the cost of your selected plan were to be approximately 10% for 20 years and thereafter 6% of total payroll, the tax credit alone would reduce your net cost to about 6% and 3.6% of total payroll.

(2) ELIGIBILITY

REDUCTION BY ELIGIBILITY REQUIREMENTS

The initial company contribution can be controlled and reduced by establishing eligibility requirements for participation, such as age 25 or age 30, and from one to five years of service. Certain other restrictions are permissible.

(3) TURNOVER

TURNOVER WILL REDUCE THE COST OF BOTH PAST AND FUTURE SERVICES

Another factor that will reduce the cost of a pension plan is the turnover of employees. This reduction will depend upon your own turnover experience. Normally, this would amount to a substantial sum since few employees spend their whole working lives with one company. Contributions paid for the benefit of employees who leave are usually used to reduce the total contributions for succeeding years.

(4) CONTRIBUTIONS BY EMPLOYEES

CONTRIBUTIONS BY EMPLOYEES LOWER COST

Another means of lowering the cost of a pension plan is to have the employees contribute a part of the cost. About half the pension systems now in existence require employees to contribute. Payroll deductions are never popular. Yet if it is necessary to offer the employees a choice between a contributory plan and no plan, most employees will favor the former. They know they need pensions.

(5) SAVING OF OTHER OLD AGE COSTS

YOU ARE NOW PAYING HIDDEN COSTS

Practically all companies without formal plans are now paying hidden pension costs, such as retention on the payroll of superannuated employees or informal retirement arrangements with certain employees. A formal pension plan takes the place of these informal methods that a company may have used to take care of older workers. If an employer adds up all the costs of these other methods, the tangible as well as intangible costs, he may find them to be almost as much as the cost of a systematic pension plan.

GREATER EFFICIENCY

BETTER MORALE

In addition, when a pension plan is installed, there is apt to be a stepping up of efficiency and morale. Older workers will be retired with adequate pensions at a normal retirement age, making way for younger, more efficient employees. Junior executives, working towards the top, can be more certain to achieve desired management objectives within a definite time limit through the retirement of their older superiors. This could result in a competitive advantage in attracting and retaining desirable personnel.

There is likely to be, too, a more stable, more satisfied, and more willing group of employees, simply because the company for which they work has done much to relieve the uncertainty about their future economic security.

COST-REDUCING FACTORS SUBSTANTIAL

The cumulative effect of the five foregoing cost-reducing factors has been found to be quite substantial by many companies.

More liberal benefits add to cost

LARGER RETIREMENT INCOME

We have discussed those factors which tend to reduce the gross cost of a plan. On the other hand, your idea of an "adequate" pension for employees might be on the generous side. The XYZ plan, like many others, allows a long-time employee to retire at "half pay," meaning that his pension, plus Social Security benefits, will total about half of what his average annual salary or wages had been during his years of work with the company. You might prefer to provide employees with a larger retirement income, for example one based on final pay rather than average pay.

Similarly you might wish a plan that pays income to a disabled employee, or allows long-service employees to take with them a share of the money set aside for their pensions in the form of a deferred pension if they leave the company before retirement age.

DISABILITY PROVISIONS

These added features all tend to increase the cost of a plan, although in most cases not substantially.

THE COST DETERMINES DECISIONS ON PENSIONS

Whether or not to install a pension plan has become a primary problem to every employer. Obviously he cannot attack this problem intelligently without the facts as to cost. Too often companies have postponed considering pensions because of preconceived notions, based on hearsay, that a plan would cost too much.

DON'T GUESS AT THE COST

Costs can be controlled. More often than not we have found it possible for an employer to install a plan that fits his company's underlying policies and philosophy, that meets all the problems of a given personnel situation, and provides adequate pensions for the employees at a percentage of payroll cost within prescribed ceilings.

COST CAN BE CONTROLLED

WE'LL ESTIMATE THE COST FOR YOU

City Bank Farmers Trust Company has an experienced group in its Pension Trust Division. If you will communicate with us—either directly or through our affiliate, The National City Bank of New York—we will tell you what information we will require to make a preliminary analysis for you. With this cost analysis as a start, we can, in discussions with you based on our knowledge of employee benefit plans and your knowledge of your company, assist you to select the plan best suited to your own particular requirements.

GET THE FACTS FROM OUR PENSION TRUST DIVISION

If you already have a pension plan and it should seem desirable to revise it, we would welcome the opportunity to offer any suggestions we feel are appropriate after careful study with you.

CONSULTATION WITHOUT OBLIGATION

We should like to emphasize that our assistance, either in the preparation of a plan or in the revision of an existing one, would give rise to no obligation whatever on your part. We serve as trustee under many pension plans and should be glad to have you consider appointing us as trustee under any plan your company may establish. But we do not expect every employer who considers a plan will establish a plan. Even though you may regard a pension plan as something to be undertaken in the remote future, if at all, we shall welcome the opportunity to help you in any way we can.