Pensions (1952)

HOW TO SET UP A PENSION PLAN

under the

NEW W.S.B. RULES

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c1952

PENSION

and

PROFIT-SHARING

FUNDAMENTALS

FOREWORD

It is indisputable that pension and profit-sharing plans are a definite part of the American industrial scene. The tremendous increase in the number of programs installed over the past 10 years is proof of this. Pension arrangements negotiated through collective bargaining made headline news.

Today, with substantial wage increases denied because of wage and salary stabilization, unions may be expected to seek vigorously additional compensation in other ways. Pension and profit-sharing plans are the obvious and logical objectives.

You, as an employer, cannot afford not to know something about pensions and profit-sharing, any more than you can ignore other accepted means of achieving good management-labor relations.

> Keep this in mind, too: Where stockholders are also officers or employees of a corporation, self-interest may be a factor in the decision to install a plan. As "employees", these stockholders may participate in the plan's benefits. It can easily be shown that a dollar contributed for them to the plan is worth much more net after taxes than the same dollar if paid to them as salary or dividends. The ratio may run as high as 10 to 1 if the corporation is subject to excess profits taxes.

Recent action of the Wage Stabilization Board has lifted the temporary freeze on the installation of new programs. Employers are free to go ahead. It is an appropriate time for a general review to see just what pensions and profit-sharing actually mean today. This little booklet will provide that review.

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WAGE STABILIZATION RULES

Here, in a nutshell, are the wage stabilization requirements for new plans:

Qualification Under the Tax Law.—New pension and profit-sharing plans will not meet wage stabilization requirements unless they "qualify" under the tax law (see pp. 13, 14). *Advance* approval of this qualification (by the Bureau of Internal Revenue) is required for a profit-sharing plan but not for a pension plan.

New Pension Plans.—A pension plan will meet wage stabilization requirements if it:

1. Provides for a normal retirement age of at least 65.
2. Makes appropriate reductions in benefits in the case of early retirement. (This does not apply to disability retirement.)
3. Provides that the benefit (except death benefit) shall be paid at least over the employee's lifetime, i.e., an annuity.
4. Provides no lump-sum cash or loan values except in the event of the employee's death.
5. Provides that benefits to employees whose employment ends before retirement other than by death (i.e., severance benefits) must be deferred to normal retirement age and must not carry a cash surrender or loan value.

New Profit-Sharing Plans.—A profit-sharing plan will meet wage stabilization requirements if benefits are payable only at retirement (age 65 or later), or disability, or severance (including death). These rules cover the payments themselves:

1. Death benefits may be paid in a lump sum.
2. Retirement benefits may start immediately on retirement, but must be spread over at least a 10-year period.
3. Severance benefits (other than death) may not start earlier than 10 years after the employee's admission to the plan, and then must be spread over at least a 10-year period.

If a plan meets the above wage stabilization requirements, it may be put into effect without formal approval of the Wage Stabilization Board. It must, however, be reported to the Board in Washington on a special form (not available when this booklet was prepared). The Board will acknowledge this report. If nothing is heard from the Board within 30 days, the plan may be put into effect as of its effective date.

NOTE: At the time this booklet was prepared, the regulations for employees within the jurisdiction of the Salary Stabilization Board had not been released. When released, they are expected to be at least as liberal as the rules given above. Very roughly, the Salary Stabilization Board has jurisdiction over the executive, administrative, professional and outside-sales type of employee.

WHY A PLAN?

Pension and profit-sharing plans are essentially different, yet the basic reasons why you, as an employer, should consider a plan are the same for both. There are two broad categories: employee morale and taxes.

Employee Morale.—A primary concern of any employer is to get and retain competent personnel. He must do so to retain his competitive position. And in a defense-minded economy, where labor shortages are prone to develop, the retention of good employees is even more important. A pension or profit-sharing plan is an important factor; further, it lets the entire community know that the particular company is a good one to work for.

Today, also, these plans are more or less taken for granted; an employer without one may find himself out of the running for good employees. Since the Inland Steel case, unions have made pensions one of their chief demands; profit-sharing plans are also well received by them if the regular pay rate is considered right.

Pension plans remove superannuated employees from the working force, thereby making way for the younger workers and giving them something to aim at. Then, too, the retirement of employees who may have lost their former efficiency is a measure of economy, cutting down the so-called "hidden payroll" that must result when pay and production are disproportionate. If the plan is contributory, employee economy will be promoted and the worker or his beneficiary will have the security that results from the return of his contributions, with or without interest, at death or severance. Of course, retirement income is the most significant benefit for the employee.

The sharing of profits makes employees partners in the business, in a sense. They therefore strive for greater efficiency and production, which is clearly beneficial to the employer. (In some cases the results have been amazing.) Under a deferred plan, where the employee's share is used to provide retirement income, his security is provided for. This latter type of profit-sharing program is similar to a pension plan in this respect.

The Tax Factor.—It is a platitude that the higher taxes go, the lower the cost of approved pension and profit-sharing plans becomes. This is because employers with such programs can deduct from gross income within liberal limits the amount of their plan contributions. They therefore pay for the benefits with after-tax dollars which become smaller as taxes rise. In this era of high taxation it is clear that benefit plans are particularly desirable since, in effect, they are cheaper to the employer than ever before. Although this saving is not the only factor to be considered in deciding whether or not a plan is to be installed, it definitely is there today.

> **Example:** The X Corporation has a taxable net income of $100,000 in 1952, and its excess profits credit is $40,000. The tax rate on the income above $40,000 is 82%. Thus, the tax on the top $60,000 will be $49,200. Assume that the corporation sets up a tax-exempt pension plan and contributes $10,000 to the plan in 1952. This contribution is deductible by the corporation, leaving only $50,000 to be taxed in the top tax bracket. The tax on this top $50,000 will be $41,000, in contrast to a top-bracket tax of $49,200 if the contribution to the plan had not been made. Making the $10,000 contribution reduces the tax by $8,200. Consequently, the actual cost of the $10,000 contribution is only $1,800, or 18% of the actual contribution. (The actual cost would be less if state income taxes were taken into account.)

It will readily be seen that when the X Corporation pays $1 into the plan, it really parts with only 18¢. Yet the $1 provides $1 of benefits since the government, in effect, makes up the other 82¢ by foregoing the tax. Moreover, each $1 and the earnings on it remain untouched by taxes while in the plan. And the employees themselves have no taxes to pay until they receive their benefits under the plan.

PENSION PLANS

After you've decided you want a pension plan, you've only just begun. There are quite a few things you'll have to get settled before you're through. Who will be eligible? How much will they receive? When will they retire? Will there be vesting, death or disability benefits? Should the plan be funded and if so, should it be insured or trusteed? Should the employees contribute toward the cost? These are but a few of the questions you'll have to answer. Some of your decisions will involve business considerations, others will concern labor relations, and still others will be matters of law. Many questions will be complex. There will be some that only you can answer. There will be others that should be answered only by one of these:

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Eligibility.—It's a good idea to cover all of your permanent employees if you can. In this way there should be no jealousy or suspicion that you favor one group over another. Of course, the greater the coverage, the greater the cost. Yet it may very well be that practically all your workers are in need of pension security which you could provide.

Of course, plans are sometimes restricted to certain groups, such as those in certain departments or those making over a stated salary. Even for the covered groups there invariably are eligibility requirements of service and/or age. The aim and design of these eligibility clauses is to bring into the plan only those employees who are likely to stay until retirement. Remember, it's expensive to register a person under the plan, and uselessly so when he doesn't stay to get a benefit.

Amount of Benefits.—Cost more than anything else will decide this point for you. You'll undoubtedly want to provide as much as you can afford. If the employee contributes, that will help you in attaining whatever benefit amount seems right. Perhaps it will be a benefit of from 1% to 3% of salary for each year of service. Possibly a higher benefit will be allowed on salary over $3,600 than under this amount. If you do this, however, you must comply with the Commissioner of Internal Revenue's "integration rules". You may favor a formula providing a benefit of a fixed percentage of final or average earnings, such as 70%, inclusive of Social Security. There is much room here for selection, depending on the circumstances.

Retirement Dates.—The normal retirement date under most plans is age 65. The use of this date stems from the fact that 65 is retirement time under Social Security. Another reason today for using 65 as the normal retirement age is that you must get wage stabilization approval of any lower age. Most plans permit retirement before normal retirement on an actuarially reduced pension. Some permit work beyond 65, and postpone payment of benefits. When the pension becomes payable at the deferred retirement date, it is sometimes more than what it would have been at the normal retirement date. The terms of the plan determine whether or not this is so.

Vesting.—The word "vesting" refers to the right of the employee to take, at severance of employment before retirement, the benefit provided by the employer. For example, an employee terminating service after 15 years of employment and 5 years of plan membership might be entitled to receive at his normal retirement date all or part of the benefits provided by the employer up to the time of the termination of service. The percentage of benefits vested might vary with the service, membership, or age if this were stipulated in the plan. Vesting is said to be conditional when it is dependent on the employee's not withdrawing his own contributions from the plan. Otherwise it is unconditional.

Death and Disability Benefits.—These benefits follow no common pattern. Some plans provide no death benefit. At the other extreme, especially in plans funded with individual life insurance policies, a very generous death benefit is given. In contributory plans the minimum death benefit is the return of the employee's contributions, with or without interest.

Then, there are options available to the employee in many plans as to the form his pension benefits take; these provide a measure of protection against death. For example:

Under the *modified cash refund option*, the benefit in the event of death after retirement is equal to the difference between the employee's contributions, with or without interest, and the total pension payments he had received.

Under the *contingent-annuitant option*, a second annuitant receives, after the employee's death, lifetime installment payments equal to, or less than, the employee's monthly pension.

Under the *years certain option,* payments are made for the employee's life, and the payments continue to the employee's beneficiary for the remainder of this certain period if the employee should die before its end.

Disability benefits are usually not provided under an insured plan. Trusteed plans often contain such a feature. ("Insured plan" and "trusteed plan" are explained below.) For instance, a trusteed arrangement might provide a disability benefit after 15 years of service and the attainment of age 50.

Funding.—It is possible to provide pensions on the so-called "pay-as-you-go" method by which retirement income is paid to pensioners from current income without any advance setting aside of funds. The chief difficulty with this method is that the aggregate amount of the payments increases as the pensioners become more numerous. Sometimes a bookkeeping reserve is set aside. This method, in effect, makes advance provision for payment of subsequent liabilities but does not take advantage of the tax benefits accorded approved funded plans. Moreover, a pay-as-you-go plan requires affirmative approval under wage stabilization.

Insured and Trusteed Plans.—Funded plans are commonly classified as either "trusteed" or "insured". These terms are not mutually exclusive in all cases, however. In all funded plans some provision is made in advance for the accumulation of a fund from which to pay pensions when they become due.

In the trusteed type, the employer contributes actuarially determined amounts to an independent trustee, to be invested at interest with a resulting increase in the fund.

Insured plans (which are sometimes administered through a trust) are underwritten by insurance companies, which provide stated benefits in return for definite premiums. The more common types of insured plans are:

The *group annuity*, which is probably the most well known.

The *deposit administration plan*, which is in a sense a combination insured-trusteed method: The insurance company accumulates the funds until retirement, much as a trustee would, at which time immediate annuities are paid for out of the fund.

The *individual policy plan*, which is an insured arrangement under which a separate pension contract, with or without insurance features, is purchased for each employee.

The *group permanent plan*, which is essentiall endowment insurance, the endowment being used at retirement to provide a pension.

> **NOTE:** In the case of both individual policies and group permanent, a supplemental fund is also accumulated to purchase additional retirement income if the insurance is of the ordinary-life type.

Any pension program may be composed of a combination of trusteed, deposit administration, or insured elements. For example, past service benefits (see below) could be provided by the trusteed or deposit administration method, with group annuities or individual policies for future service.

Some definitions.—You can't deal with pensions very long without meeting up with the nomenclature. Here are some common terms not yet explained.

A *past service benefit* is that part of the pension which is based on service performed by the employee before the plan went into effect.

Similarly, a *future service benefit* is that part for service after the effective date.

Actuarial equivalent means that, to the actuary, the value of one benefit is no greater or less than another. (A simple parallel is the equivalence of 4 x 5 and 2 x 10.)

A *unit-annuity plan* is one where each year a separate benefit is provided as a stated percentage of that year's pay, the pension to be the sum of the units. Under a *money-purchase* method, the employer's (and employee's, if any) contributions buy just what they will, and that's the pension.

Discount for mortality means that employer contributions are made with the realization that not all employees presently covered will *live* until retirement. If you change the word "live" in the previous sentence to "work", you have an idea of what "*discounting for severance*" is. In either case the contributions are less than what they would be if it were assumed all employees would retire.

PROFIT SHARING

A big advantage of profit sharing is that the employer has no fixed commitment. In good years he makes a big contribution, and in poorer years, a smaller one – and without violating the terms of the plan.

A profit-sharing plan is principally built around two formulae: the contribution formula and the allocation formula.

The *contribution formula* tells what percentage of the employer's profits are to be shared among the employees. It might call for a contribution, for example, of 20% of profits before taxes, but not more than 15% of payroll of the participating employees.

The *allocation formula* tells what each employee's share will be. It might be based on salary alone or on salary and service. In this case it may be possible to "weight" for prior service, that is, give the long-service employees greater credit. For example, one unit might be given for each $100 of yearly salary, with one more unit for each year of employment. The value of one unit would be the total contribution divided by all units allowed.

Either formula, particularly the allocation, can become quite complicated.

Some profit-sharing plans use the employee's share to provide retirement income at retirement age. Vesting, death and disability benefits can be provided in a profit-sharing program. Employees may contribute, too, in which case you have a thrift or savings plan. Usually the idea in these arrangements is that the employer's allocation will be dependent on the individual worker's contribution.

> **NOTE:** For plans established while stabilization restrictions are in effect, care must be taken to observe the limitations imposed by the stabilization rules; otherwise the plan will need approval.

TAXATION

Employer.—It is decidedly advantageous for you to set up a plan that meets the requirements set by law and the Commissioner of Internal Revenue. This would be so even though such compliance were not required under stabilization. The Commissioner's qualification requirements, though detailed and often quite complicated, in large part merely interpret Section 165(a) of the Internal Revenue Code which prohibits discrimination in favor of the more highly paid personnel, supervisors and executives. In other words the nondiscrimination requirement is the keystone of qualified status.

Each contribution the employer makes to a "qualified" pension or profit-sharing plan is deductible for purposes of income tax within liberal limits. In addition, the income earned by the funds of the plan accumulates tax-free.

Section 23(p) of the Code prescribes the employer's deduction limits. Very much simplified, the annual deduction limit for a qualified pension plan is either: (1) future service cost, plus 10% of the past service liability; or (2) the cost of the plan (both for past and future service) spread evenly over the remaining future service of the employees.

The profit-sharing limit is, in general, 15% of participating payroll.

Employee.—If the pension or profit-sharing plan is approved, the employee is not taxed immediately on the employer's contribution in his behalf, whether his rights are vested or not. (Special rules apply to life insurance protection.) If the plan is not approved, then a vested contribution is employee income for the year contributed and consequently is considered part of the employee's cost for the benefit.

When a pension benefit becomes payable at retirement, the so-called "3% rule" comes into play: Each year the employee is to report as income only 3% of his cost for the pension, excluding the rest. When the amounts excluded equal his cost, further benefit payments are taxable. Pensions provided through profit-sharing plans are treated no differently.

Lump-sum distributions made by an exempt pension or profit-sharing trust on account of the employee's separation from service are long-term capital gain to the extent they exceed any employee contributions. This means that only half the gain is taxable at all, and that the tax on the whole gain cannot be more than 26% for 1952-1953, and 25% for other years. This privilege is not allowed when the distribution is made on account of termination of the plan, nor is it allowed unless the distribution is the final one, made within one taxable year of the employee.

The stabilization rules permit lump-sum distributions from new pension and profit-sharing plans only in the event of the employee's death. This restricts the utility of the capital gain rule as to new plans. (When stabilization is no longer with us, these plans may be amended to provide for lump-sum distributions in other events.) However, it still applies to plans installed prior to the wage freeze of January 25, 1951.

CONCLUSION

There you have a bird's-eye view of pension and profit-sharing plans. Of course, only the most significant points could be touched on. Yet we hope we have succeeded in giving a general picture of a subject that is becoming more and more important.

Our final thought: The broad concepts of pension and profit-sharing are simple; it is their application to the particular circumstances of the individual employer that entails a high degree of technical skill. Experience has shown that each plan must be tailor-made for the employer. Don't attempt to do it alone. The good plan is the product of the combined efforts of the employer, his lawyer, tax advisor, pension consultant, and trust company or insurance company.