COMPENSATING KEY PERSONNEL — III

Pension and Profit-Sharing Plans—Tax Advantages: Stiff corporate and individual income tax rates make it hard for most executives and salaried men to save up for the future security of themselves and their families. The favored tax treatment of pension and profit-sharing plans offers a possible solution to this problem. Hence the great popularity of such plans. The boom in pension and profit-sharing plans is definitely on. There are about 19,000 Treasury-approved plans in existence. New applications are being received at the rate of 250 per month. Removal of wage controls is a further impetus for their adoption.

This article describes the tax benefits. Next week we will outline the main requirements to qualify for these benefits under Section 165 of the Code and the Bureau rules.

The main tax advantages of pension and profit-sharing plans are these:

(1) Contributions by the employer to the plan are currently deductible.

(2) The income of the fund is exempt from Federal income taxation.

(3) Each beneficiary is taxed upon distributions only when he gets them.

(4) Under some circumstances the employee can get his share at capital gain rates.

Here's a comparision of the salient features of these plans:

Profit-Sharing Plans	Pension Plans
(1) Provides a share of company profits payable in whole or in part at retirement.	Provides income after retirement not based on profits.
(2) Cash disbursements may be made at any pre-determined time.	Cash disbursements before retirement are made for specific reasons: such as death, accident, sickness or disability.
(3) Employer's contributions are made from profits. The contributions vary in amount depending upon amount of profit and the contribution formula of the plan.	Employer's contribution is a fixed expense. The contributions are not in proportion to profits, but may be a fixed amount, or such amount as is necessary to provide certain benefits.
(4) When distribution is made at retirement, the amount to the employee's credit in the fund determines how much will be paid.	The size of the pension is usually fixed in advance and contributions are made accordingly.
(5) Employees generally do not contribute.	Employees contribute under approximately 50% of the plans.
(6) Where distribution is made on severance of employment, the payment acts as a "cushion" until the employee secures another job.	While distributions on severance of employment may be made, this is not a main purpose of a pension plan. It is only an incidental function.

Profit-Sharing

The particular advantages of profit-sharing plan are these: It puts no financial strain on the employer because there are no fixed dollar commitments. Contributions are based on profits alone and are deductible expenses of the employer. When business is good and profits are up, contributions go up too. When profits drop, so do the contributions. Your share and other employees' shares aren't taxed until withdrawn, and then possibly at capital gain rates. Best of all, the income of the profit-sharing trust is tax-free. Out of every dollar put into a profit-sharing plan, the government, through the tax deduction puts in 52 to 82 cents and the employer puts in the balance. (If the excess profits tax expires as scheduled the government will put up 52 to 67 cents this year.)

Example: Suppose your corporation sets up a profit sharing plan under which it will contribute the lesser of 25% of profits or 15% of payroll. If profits for 1952 were $60,000 before taxes and the payroll was $85,000, the corporation's contribution to the plan would be $12,750 (15% of payroll).

The following table shows how little it would actually cost the corporation to make the $12,750 contribution, assuming that it had a $40,000 excess profits tax credit:

	No Plan	Plan
Profits before taxes	**$60,000**	**$60,000**
Contribution to plan	......	**12,750**
Income subject to tax	**$60,000**	**$47,250**
Normal tax and surtax	**25,700**	**19,070**
Income after normal tax and surtax	**34,300**	**28,180**
Excess profits tax	**6,000**	**2,175**
Income after taxes without contribution	**$28,300**	**$......**
Income after taxes and contribution	......	**26,005**

Thus the actual cost of the $12,750 contribution is $2,295.

To set up the example below we distribute the income between surplus and dividends as follows:

To funded reserve and surplus	$14,000	$14,005
Balance to dividends	14,300	12,000

Now let's see how you, a stockholder-executive in this corporation, would fare under the plan. Assume you own 50% of the stock, draw an annual salary of $12,000, have other income of $3,200, are married and have two children. Assume also that the corporations contribution to the plan is allocated among employees in proportion to their salaries.

Without the plan your dividends would be $7,150; with the plan $6,000—a difference of $1,150. Your apparent loss of $1,150 in dividends shrinks to $713 after taxes.

What can you buy for $713? You might invest it at 5%. If earnings, taxes, etc. remained constant and if you invested like amounts each year, you could accumulate about $20,000 in 20 years or about $27,000 in 25 years.

With the plan you not only have a $1,800 per year interest in a tax exempt trust ($12,000 salary x 15% contributions) but also your employees have a $10,950 interest in this same trust. Assuming again that all factors remain constant and trust investments yield 5%, your interest in the trust will be about $62,000 at the end of 20 years; $90,000 at the end of 25 years. (The accumulation in your trust is larger than your private accumulation because more goes in each year and there is no current tax depletion.) Furthermore, you can reasonably expect that forfeitures due to employees leaving before retirement will at least increase your interest by an amount equal to the 26% capital gains tax you would pay if you withdraw your share in a lump sum at retirement. Thus you get three times as much money from the profit-sharing plan as you would get from the investment of salary or dividends. Remember too that there are comparable amounts under the trust for each of the other employees.

The following table illustrates in another way the tremendous advantage flowing to employees in various income brackets as the result of receiving $1,000 extra compensation through a profit-sharing trust rather than as a salary increase.

TAX IMPACT ON INVESTMENTS

Investor	Balance of $1,000 After Tax	After Tax Return on 5% Yield	20-Year Result	25-Year Result	30-Year Result
Profit-Sharing Trust	**$1,000**	**5.0%**	**$34,719**	**$50,114**	**$69,761**
$5,000 Man	**780**	**3.9**	**23,891**	**33,315**	**44,732**
$10,000 Man	**710**	**3.5**	**20,781**	**28,622**	**37,935**
$20,000 Man	**620**	**3.1**	**17,357**	**23,625**	**31,427**
$50,000 Man	**340**	**1.7**	**8,152**	**10,662**	**12,393**

Pensions

The profit-sharing plan enables corporate officers and employees to share in corporate profits and to save some portion of their earnings under favorable tax conditions. But it is not the primary purpose of profit-sharing plans to provide the individual with a steady income after retirement. This is done through the pension plan. The entire cost of a pension plan can be borne by the employer or it may be financed through contributions by both employer and employees. The benefits desired and the financial position of the company will generally determine the method of financing.

Pension plans may be divided into two general classes: (1) "Pay-as-you-go" plans in which retirement income is paid to the pensioners from current income without any advance setting aside of funds. (2) Funded plans which may be either insured or trusteed. Insured plans are underwritten by insurance companies which provide stated benefits for definite premiums. In trusteed plans the employer contributes actuarially determined amounts to an independent trustee, to be invested at interest with a resulting increase in the fund.

Funded plans assume fixed contributions on the part of the corporation. This presents no serious problem if the plan is based on normal business conditions. Contributions to the pension fund receive the same favorable tax treatment as contributions to a profit-sharing fund.

We repeat what we said above as to the cost of a profit-sharing plan: Out of every dollar put into a pension plan by the employer, the government through the tax deduction puts in 52¢ to 82¢ and the employer puts in the balance.

(Next week we will present the main legal requirements that a plan must meet in order to qualify for these benefits.)

Conference on Charitable Foundations: The New York University Institute on Federal Taxation will conduct an afternoon and evening conference on problems of the charitable foundation. Date, April 29. Time, 2:30 P.M. Place, the N.Y.U. Law Center. The price, including dinner, is $15. To register and for more information write Mr. Henry Sellin, Institute on Federal Taxation, New York University, New York 3.

Stock Dividend And Trust Income: Trustees received a *non-taxable* stock dividends on certain stock held in trust. State law forbade distribution of the dividend stock, so the trustees paid the life income beneficiary in cash out of the principal. "No taxable income is realized by the beneficiary by this cash payment" [Rev. Rul. 24, IRB 1953-5].

Suppose the trustees had sold the dividend stock and distributed the proceeds of the sale. The Bureau says: "If capital gain income resulted from the sale . . . by the trustee and . . . [if distributed] . . . it is taxable to the beneficiary at capital gain rates . . ." [Rev. Rul. 24, supra.]

● *Absent the State prohibition, if the trustees had distributed the stock dividend, the character of the payment would be the same to the beneficiary as it was to the trustee [IT 1622, CB II-1, 1923]. Its basis to the beneficiary is that part of the original basis allocable to the old stock [Case, 26 BTA 1044].*

In its Ruling, the Bureau said, in effect, that it would not follow *McCullough* [153 F.2d 345, *rev'g* 4 TC 109]. There the Second Circuit held that although dividend shares were not taxable income when received by executors, they were taxable when received by a life beneficiary in satisfaction of a right to receive income.

If the stock dividend had been *taxable,* the general rule holds the *value* taxable to the beneficiary upon distribution. Upon later sale, its basis would be the value as taxed. If the trustees sold the taxable dividend, and distributed the entire proceeds to the life tenant, he would be taxable on the entire amount so distributed.

COMPENSATING KEY PERSONNEL — IV

Pension and Profit-Sharing Plans—Legal Requirements: To yield the benefits described last week, a pension or profit-sharing plan must meet the requirements of Sec. 165, IRC and the Bureau rules. The fundamental principle underlying the various requirements is that the plan must be set up by the employer for the exclusive benefit of his employees. And it must cover a substantial proportion of the employees: It can't be limited to officers, stockholders, supervisors, or highly paid employees; nor can it discriminate in their favor as to eligibility, coverage, or benefits. So to obtain the tax benefits of a Treasury-approved profit-sharing or pension plan for key personnel, other employees too must be included.

In Rev. Rul. 33 [IRB 1953-6] the Bureau recently brought together and summarized the main rules for qualifying a plan and any trust used to administer a plan. Here are the highlights:

1. The plan must be established by the employer for the exclusive benefit of his employees or their beneficiaries.

Partners are employers and as such are not eligible to participate in the plan. Professional men (doctors, lawyers, etc.) working for a corporation are eligible to participate provided they are employees for all purposes, including social security and income tax withholding. Stockholders who are bona fide employees of a corporation may participate to the same extent as other employees.

Employees must be given the power to designate their own beneficiaries. The plan, however, may provide that in the absence of designation by an employee payments in the event of death will be made to certain stated beneficiaries.

2. Plan must be in writing: There must be a definite written program setting forth all provisions essential to qualification. In trusteed plans, the trust must be evidenced by an executed written document setting forth the terms. In insured plans the writing will be incorporated in the contract with the insurance company.

The plan must be communicated to the employees. Furnishing the employees with a booklet summarizing the plan or posting the salient provisions of the plan on a bulletin board in conspicuous view will qualify as communication.

3. Plan must be "permanent:" The Bureau says that "a plan which is set up during years of high tax rates and is abandoned without a valid business reason when profits fall off is not within the intent of" Sec. 165.

A plan which is abandoned or substantially reduced as to benefits or contributions after a short time is in danger of being considered void from its inception.

However the Bureau recognizes that for valid reasons a plan may have to be discontinued. If you prove that the plan was qualified on paper and in operation, was intended to be permanent, and was discontinued only because of current business conditions unforeseeable when the plan was established, you won't lose the benefits you or your employees derived from the plan. In *Blume* [9 TC 1179] a plan which was terminated for good business reasons at the end of one year's operation was upheld.

4. Trust fund must not be diverted: The trust instrument must be valid under local law, must prohibit diversion and must assure the use of the funds for the exclusive benefit of employees or their beneficiaries. However, incidental benefits may inure to others provided the primary benefit is maintained. For example—the sale of securities to the trust may benefit the vendor to the extent of his profit on the sale. This is of no consequence provided the purchase is at a fair price and is one that would be made by a prudent investor. If stock or securities *of the employer* are purchased by the trust the Bureau (District Director) should be notified.

Once an employer makes a contribution to a plan he loses all rights to recovery. A minor exception under pension plans is that any surplus existing because of actuarial error may sometimes be recovered. Under profit-sharing plans it seems that there can be no reversion of any kind because they are not predicated on actuarial computations.

5. Who must be covered? This is one of the first problems facing the employer after he has decided to adopt a plan. He must follow either the percentage rule or the classification rule.

Percentage rule: If the plan covers 70% of all employees, the coverage requirement is met. Also, if 70% of the employees are *eligible,* and 80% of those eligible are *covered,* the requirement is met.

Example: There are 1,000 employees, and 700 are eligible to join a pension plan requiring employee contributions. If at least 560 employees (80% of 700) join the plan and make contributions, the coverage is sufficient.

Who are included in *all* employees? The following, although employed in fact, may be excluded when determining minimum requirements:

(1) Employees who have been employed less than the minimum length of time specified in the plan. (The period normally may not exceed five years.)

(2) Employees who work 20 hours a week or less.

(3) Seasonal employees who work 5 months a year or less.

The employer is not limited to one plan. If there's more than one, no definite proportion of all employees need be covered by any one plan. But the plans together must cover enough employees to meet the percentage requirement.

Classification rule: If the employer does not wish to cover the greater portion of his employees he may set up a plan under Section 165 (a) (3) (B) and limit coverage to employees in a certain department, over a prescribed age, employed for a stated number of years, etc. The plan must not discriminate in favor of officers, shareholders, supervisors or highly compensated employees. Further, the classification must have the approval of the Bureau. A plan including only employees in a specified age group was held to qualify [Bureau letter, 6-23-48].

A plan may completely exclude employees all of whose earnings are taxed for Social Security, that is, up to $3,600. But plans that exclude employees who earn less than a specified amount, or provide proportionately less benefits for such employees, qualify only if the benefits under the plan integrate with those provided under Social Security or similar programs such as Railroad Retirement. To be non-discriminatory the total benefits (including Social Security or similar program) must be proportionately no greater for employees earning above the specified amount than for those earning below that amount.

Burdensome contributions: If a contributory plan is offered to all employees but the requirements for employee contributions are so burdensome that it is acceptable only to the highly paid employees, it will be considered discriminatory in favor of such employees. Contributions of 6% or less are not considered burdensome.

*6. **Contributions and Benefits:*** The plan cannot be discriminatory as to contributions or benefits in favor of officers, etc. Likewise there can be no such discrimination in the allocation of funds arising from forfeitures. In profit-sharing plans the contribution formula may provide that forfeitures are to be used to reduce employer contributions. Normally under pension plans the forfeitures must be used to reduce subsequent employer contributions.

The Code does not require that the employee be given immediate vested rights. But a plan will not qualify unless an employee who has reached the normal retirement age in a pension plan or the stated age in a profit-sharing plan, and has satisfied the other requirements, can get his benefits under the plan without the consent of the employer.

Benefits under a profit-sharing or pension plan may be fixed in direct relation to the compensation of the employee. Compensation on which benefits are computed may be total compensation (including bonuses, commission and overtime pay), basic compensation, or regular rate of compensation. But it must be uniformally applicable to all participants and must not result in prohibited discrimination.

Adjustments of benefits based on increases or decreases of compensation may be provided for in the plan, but substantial raises to officers, etc., just before retirement, which result in greatly increased pension benefits will be considered discriminatory.

*7. **Formula for employers' profit-sharing contribution:*** While Rev. Rul. 33 doesn't state a formula requirement the Regulations [Sec. 29.165-1] call for a definite formula based on (a) a percentage of annual profits, (b) a percentage of annual profits in excess of certain limits, or (c) a percentage of annual profits not to exceed a percentage of payroll.

Some courts have refused to enforce this requirement.

In *Lincoln Electric Trust* [190 F.2d 326, 40 AFTR 1018; *rev'g* 14 TC 598] an irrevocable lump sum contribution to be distributed in 10 years, with no provision for future contributions was held to qualify. The Sixth Circuit said that if the failure of the plan to meet the definite formula requirement of Sec. 29.165-1 meant that the trust was not exempt, then that part of the Regulation was invalid.

In *Produce Reporter* [18 TC 69] the Court upheld a plan that provided for an original contribution and for later contributions based on profits whenever the company saw fit to make them. In *Wagner* [18 TC 657] the Court upheld a plan that originally called for contributions of 35% of profits and was reduced to 10% for valid business reasons. The Commissioner has acquiesced in *Wagner*.

So it would seem that as long as the contribution is irrevocable and made for the exclusive benefit of the employees it will be upheld by the courts.

Getting advance rulings: Even though the Bureau doesn't require an advance ruling on a plan, it's good business to get one. Where there has been no change of law or the facts the Commissioner cannot repudiate a favorable ruling [H.S.D. Co., 191 F.2d 831].

Rev. Rul. 32 requires that all requests for advance rulings as to qualification of pension and profit-sharing plans must be submitted to the District Director of Internal Revenue. It also tells what information should accompany such request.

***Non-qualified plans:* A corporation will not necessarily lose the deduction for contributions to a plan that does not qualify under Sec. 165(a). If employees' rights were nonforfeitable at the time the contribution was made, the deduction can be claimed under Sec. 23(p)(1)(D), IRC. The employees' tax benefits are lost, however, and the amount allocated to them is taxable income immediately.**

We have hit the highpoints of pension and profit sharing plans in this article. The broad concepts of these plans are simple; but their application requires technical skill. Each plan must be tailor-made. A good plan can result only through the combined efforts of the employer, his lawyer, tax advisor, pension consultant and trust or insurance company.

Mississippi Conference on Estate Planning: On May 1 and 2 the University of Mississippi—in cooperation with the State associations of CPA's, lawyers, bankers and life underwriters—will conduct a conference on estate planning. Several nationally known estate planning specialists will take part in the sessions which will deal with the problems of a typical estate by the case-study method. Fee, $10. To register and for more information, write Mr. D. C. Trexler, University of Mississippi, University, Miss.

Cost Accountants Conference: The 34th annual cost conference of the National Association of Cost Accountants will be held June 15-19 at the Biltmore and Statler Hotels, Los Angeles, Calif. The general theme will be "Looking Ahead in the Industrial Accounting Field." Seminars will deal with different segments of industry. For more information write the N.A.C.A. at 505 Park Avenue, New York 22, N. Y.