PENSION AND PROFIT-SHARING PLANS - FACT AND FRICTION†

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A business owner, be he sole proprietor, partner or major or sole stockholder, will not create an estate large enough to require attention of the estate planning team — accountant, attorney, life underwriter and trust officer — unless he makes and keeps his business successful. Like the giant corporation, the small or medium business has a basic problem — getting, training, motivating and keeping capable supervisory personnel. Fringe benefits are important in this operation — death benefits, vacations, leave of absence, hospital and surgical care, pleasant and safe working conditions. And, of major importance in this fringe area is deferred compensation in the form of ultimate retirement income.

A good pension or profit-sharing plan always does double duty. It benefits both the giver and the receiver. The employer in the smaller business is often a major stockholder as well as an employee. He benefits from deferred compensation as do his employees. At the same time, as an employer, he gains the advantages which come from a happy and stable working force.

Man's suppressed and often expressed desire through the years has been that payday be perpetual. Concern envelops him when he thinks of the day he will no longer be able to work. It is work which provides periodic paydays. No work; no payday — unless; unless he directly or indirectly has saved part of each of his working paydays for his non-working tomorrows.

Recognition of the need for such forced savings by employer and employees has resulted in the creation of scores of thousands of pension and profit-sharing plans by employers from coast to coast. Payments from such plans are making payday perpetual for millions of American workers. Many more millions want that same assurance.

A commonly accepted method of saving some of today's earnings for tomorrow's use is the qualified pension and the qualified profit-sharing plan. Such plans, in addition to providing benefits for employees and their beneficiaries, also benefit the employer. Employers like such plans because they:

1. Decrease the salary load by facilitating the retirement of older employees who have slowed down;

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† Address at the Southern Arizona Estate Planning Council, 1960 Estate Planners Day, at the University of Arizona, in Tucson, Arizona, on November 25, 1960.

* See Contributors' Section, p. 87, for biographical data.

2. Improve morale both generally and as a result of bringing about promotions through retirement;
3. Reduce employment turnover;
4. Help meet employment competition;
5. Minimize labor difficulty;
6. Create good will and favorable public opinion; and
7. Provide income tax deductions if acceptable to the Internal Revenue Service.

Employees like pension plans because, in addition to assuring them perpetual paydays, they give them additional compensation which will be taxed at a lower rate because of deferment to a time when their income will be less than today. Also, such a plan usually provides death benefits which will increase the employee's estate and aid his family. Of major interest, too, are the opportunities for promotion which are created by a formal retirement plan.

You are probably wondering this morning whether this subject is big enough to spend an hour on. Is it a grain of sand on Camelback Mountain — or is it one of the humps? We better get the facts before we make a decision on that point. Is it a grain or sand or one of the humps?

Let's look at the size of the subject. This should be of interest to you who will be faced with the job of working out and handling the details and mechanics of pension and profit-sharing plans which will be created in the State of Arizona during the coming decade.

Statistics are often boring. In addition, they can be misleading. I'll never forget the story about the statistician who drowned while wading a river with an average depth of three feet.

Currently, in the United States there are more than 4,000,000 business entities. There are, however, only 59,000 qualified pension and profit-sharing plans according to the Internal Revenue Service. Of specific interest is the fact that of the more than 4,000,000 business entities — or employers — only 200,000 of them employ 20 or more people. That means that there are millions of employers of small groups who have the same problem as large employers. They must attract and retain talented personnel in order to be successful.

Not one of us here this morning is so old that he does not recall Jack's mythical beanstalk. To some degree a modern counterpart of that fast growing agricultural wonder is the private employee pension and profit-sharing plan. In the past fifteen years such plans have experienced a phenomenal growth. Reasons for that growth are many. However, the amazing expansion has been largely due to three basic factors: (1) the imposition at the start of World War II of high corporation taxes linked with allowable deductions for contributions to these programs; (2) court rulings which made such plans proper subjects of collective bargaining; and (3) the continuing growth of Social Security.

Today, millions of persons are depending in some manner upon the benefits which these plans promise. Reserves for private pension plans alone now exceed 44 billion dollars. Funds accumulated behind the nation's system of pension and retirement programs, public and private combined, increased by more than 150% in the last decade to enter the 1960's with an aggregate that is rapidly approaching 100 billion dollars. Of particular interest is the fact that the growth of assets and reserves of private plans (insured and noninsured together) was double their government sponsored counterparts. This is a reversal of the trend in the previous decade when government plans set the growth pace. At the beginning of the 1950's, private plan funds represented 31% of all retirement funds. As we entered the 60's that percentage had moved up to 47%.

In view of the interest of lawyers and other self-employed persons in Keogh-type legislation, we should be aware of the potentialities which could develop if such legislation is ultimately a law. There would probably be a great increase in the number of persons interested in pension and profit-sharing plans. It is possible that if we do finally get Keogh legislation, it will involve qualified pension plans. It is not unlikely that final legislation will require self-employed people who want to "Keogh" themselves to establish qualified pension plans for their employees. It is also possible that final legislation in this area would make sole proprietors and partners "employees" for purposes of qualified plans in order that they might participate in such plans which they do create for their organizations. In the Kintner area it is conceivable, too, that if groups of doctors, lawyers, architects, etc., are finally able under the law of many states to establish associations which will have substantial corporate characteristics, such groups will dissolve their partnerships and organize associations taxable as corporations for federal income tax purposes. After such action many associations will consider establishing qualified pension or profit-sharing plans for their employees. Under our understanding of the law and final regulations, the associates themselves could participate in such plans because they would be considered employees.

My aim this morning is to discuss fact and friction in each of four areas: pension plans; profit-sharing plans; tax aspects pertaining to both; and the Federal Welfare and Pension Plan Disclosure Act.

PENSION PLANS

According to reliable reports, a fellow by the name of Weaver, who employed a small group of men, installed the first formal pension plan in America in 1888. He went broke in 1889. This reference to Mr. Weaver is neither symbolic nor prophetic. Other employers, without pension programs, also went broke in 1889 and others with and without pension programs have done so in practically every year since then.

Some people still think of pensions as something relatively new in the economic life of our nation. For example, life insurance, which they understand to some degree, is considered by them to be an old, mature and stable business with deep roots, a sturdy trunk and outreaching limbs. The idea of pension plans, some think, is a mere seedling whose roots have hardly penetrated the subsoil. It is easy to uproot that fallacy. Here is proof positive.

This year the company I work for was 103 years old. The business of life insurance is 261 years old and pension plans are 572 years old. The first pension plan was set up in Germany in 1388.

A qualified pension plan, to paraphrase the regulations, is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer — to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to profits.

Components of Pension Plan

In determining the makeup of a pension plan an employer must make decisions in four basic areas. Who gets? Gets what? Gets when? Who pays?

In the "who gets" area he must decide upon rules of eligibility. A natural goal is to include employees who are presumably permanent and to exclude those who are not in that category. If a sole proprietor or partner creates a plan for his employees, he may not participate because he is the employer. However, under a corporate arrangement, stockholder employees may participate. Customary rules of eligibility include a minimum age, a minimum period of service and sometimes a maximum age.

In the "gets what" area it is necessary to determine the amount of pension. There are many ways of doing that. For example, the pension could be equal to a stated percentage of salary; there could be a specific benefit for each year of past and future service; or the amount of pension could be determined by spending a specific percentage of compensation.

It must, too, be determined when the participants get the benefits being accumulated in the plan. Shall there be benefits in event of prior employment termination? In event of disability? In event of death? Should early retirement be permitted? Should the pension begin if retirement is deferred or should payment of pension also be deferred?

It is important also to determine who will pay for the pension plan. Shall the employer carry the full cost or shall employees make a contribution? If the latter, should the contribution be substantial or token? It is the usual procedure, these days, in the type of plans we have seen to have the employer pay the entire cost.

Funding Media

Here comes the friction. It is believed by many that a pension plan, which is a promise to pay, should be funded. However, there are several schools of thought on the question of *how* a pension plan should be funded. The employer when making such a promise has assumed an ultimate liability. It is good business to fund that liability — to accumulate funds which will enable the employer to fulfill his promise at the paying out time to his employees.

Most advocates of pension plan funding, regardless of their inclination, will agree that the long term cost of any pension plan must be the sum total of benefits paid, plus administrative expenses, less investment earnings. Whether the plan is insured or uninsured the long term cost must be the result of that computation. It is possible, however, to reduce or vary the current outlay of a pension plan by choosing one or the other of various funding mediums. Let us take a look at the chief systems of funding pension plans.

Uninsured

First there is the uninsured category. Under this arrangement the employer enters into a trust agreement, usually with a corporate trustee. A consulting actuary is hired to make calculations to determine required annual contributions to the trust so established. The employer then makes the required payments to the trust and the trustee invests the money. This system, which permits substantial advance discounting, can produce a lower current outlay than insured funding methods. However, the long term cost will not be substantially affected by this system. It should be remembered that under the self-administered arrangement the employer is in effect the insurer. No guarantees accompany this system.

Insured

In the insured area there are a number of mediums available. Let us go over them quickly just to bring them in focus. First there is the granddaddy of the pension system, the group annuity. It involves a master contract between employer and insurance carrier. In effect, each year a single premium deferred annuity is purchased for each employee by applying the pension formula to his earnings for that year. At retirement, the various single premium deferred annuities purchased through his years of participation become his monthly pension.

Next, the deposit administration system. The employer deposits money with the insurance carrier under a master contract. The insurance carrier invests that money or administers the deposits. None of the money is allocated to the specific accounts of any employees. When the first employee in the plan reaches normal retirement age, the insurance company reaches into the account it has been administering for that employer and takes out enough money to buy, at that point, a single premium immediate annuity to provide the required pension under the plan. This system has some guarantees — for example, the insurance carrier guarantees a minimum interest return and guarantees annuity rates for at least five years. Also, it should be understood that the money thus invested by the insurance company will be more in fixed dollar investment than in equities. Under this system, too, it is possible to discount in advance for certain events which will occur in the future. Thus, the current outlay can be kept lower than under some other insured methods.

Group permanent is a system involving permanent insurance on a group basis purchased under a master contract beween the employer and the insurance carrier. Coverage is actually purchased for each employee as he enters the plan and is maintained on a premium paying basis during his participation. When he retires, the insurance company pays him a life annuity. If he terminates employment before retirement, it is possible for him to carry on his policy on a personal basis. Life insurance is furnished under this system generally on a non-medical basis. A substantial death benefit is a part of this system as distinguished from the deposit administration and group annuity methods.

Now we come to the individual policy system. It is used mostly by smaller employers and is an effective system for providing pensions on an all-insured or fully insured basis. There are, however, variables in this system which permit some advance discounting and a reduction of current outlay below the amount necessary for an all-insured plan.

For example, under the Combination method, offered by many carriers, the employer establishes his plan in the form of a trust and contributes money to the trustee of that trust. The trustee then purchases individual Life policies on the lives of participants. Some of the money, however, is left in a policy change fund for investment. It may be left with the insurance company or the trustee may invest it at its discretion. Under the normal arrangement the Life policies are maintained on a premium paying basis until the employee reaches retirement age. At that time the trustee withdraws money from the policy change fund and uses it to change the life policy to an annuity policy in an amount necessary to pay the prescribed pension benefit. As you can see, under this system it is possible insofar as the policy change fund is concerned to do some discounting in advance. In fact, the regulations require a discount for mortality and interest earnings and permit a discount for employment termination.

Under the individual policy all-insured system a trust is also involved. The employer contributes dollars to the trust; the trustee uses all of those dollars to buy individual retirement endowment policies on the lives of participating employees; and the trustee as owner of the policies administers them in accordance with the terms of the trust. There is no policy change fund — no other investment duties.

Profit-Sharing Plans

Now, the second item on our list. A qualified profit-sharing plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer — to enable employees or their beneficiaries to participate in the profits of the employer's trade or business pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan.

This system of deferred compensation also requires decisions on basic points before it can be inaugurated. First the employer must decide who gets the benefits. Rules of eligibility for profit-sharing plans are usually more liberal than they are for pension plans. The goal seems to be to bring employees in as soon as possible, whether or not they are presumably permanent. There are, of course, differences of opinion on this point too. The employer must determine how much of his profits he wishes to contribute to the profit-sharing plan. He can either operate under a definite predetermined formula for contributions or he may provide that the amount to be contributed from profits shall be determined each year. Contributions must be "recurring and substantial." One shot propositions are barred by the regulations.

Also to be determined is the time the participants will receive distributions from the profit-sharing plan. Admittedly, a true profit-sharing plan is an incentive program. On that basis it would be expected to see periodic distributions of cash from the plan to the employees in order to have it serve as an incentive. However, most profit-sharing plans are pension plans in effect. They provide for no distribution until death, retirement or employment termination.

In the profit-sharing area, too, we also encounter friction in connection with the investment philosophy. Should the money be substantially in equities; substantially in fixed dollars; or split on some reasonable basis? The following comments may sound like a commercial. However, if they do it is purely coincidental because they are intended as a factual, logical discourse.

A profit-sharing plan investment portfolio filled primarily with securities is an amber light. It contains possible defects for both employer and employee. It could soon change to red, particularly if substantial shares of stock are among the securities. Life insurance intelligently used can change the amber to green.

A major advantage of a profit-sharing plan is that contributions are made in good years when profits are high — contributions are not called for in poor years when profits are low. In good years, however, when profits are high and contributions are made it is likely, on the average, that common stock prices are also high. In poor profit years, on the average, it is likely that common stock prices will be lower.

Profit-sharing trusts which invest in stocks heavily each year when contributions are made may compel the trustee, or at least tempt it, to buy at the high point and thus make funds unavailable for stock purchases at low tide. Because of the logic of the foregoing, it seems that a thinking employer will agree that a policy of making guaranteed or fixed-dollar investments in boom times — when stocks are high and dollars are cheap — with the opportunity of shifting more heavily into equities in years of lower equity prices, could produce better long-term results.

An investment counselor would certainly suggest a combination of fixed and equity dollars in a profit-sharing investment fund, rather than equities alone, because safety of the fund is important. Typically, people think of a combination of common stocks and bonds in such cases. Why not recognize the life insurance cash value as the "bond account" and the protection element as a comparatively modest cost in the typical case? After all, is not the combination of investment and protection in a life insurance policy a better hedge against the needs at death than merely another bond account?

In the long run, the major payoff from a typical profit-sharing plan will come from the employer's contributions of profits — not from capital gains or interest earned on the fund. Is it not better to conserve the principal with a reasonable rate of interest — as in a life insurance investment — than to risk some of the value of the principal at a time when profit-sharing contributions may also be lacking?

Profit-sharing plans also offer another chance for friction. Friction could develop if employees or their representatives show concern over profit-sharing contributions and want to see the employer's books — or demand the right to participate in functions traditionally in the realm of management. However, Prentice-Hall, in a recent publication, stated that the history of profit-sharing has shown this fear of friction to be groundless. In the experience of all the members of the Council of Profit-Sharing Industries, for example, not one single case has been reported where labor tried to usurp the functions of management because of the existence of a profit-sharing plan. Apparently to date in most cases employers have given unions or union members only non-confidential information; nothing beyond the balance sheets or operating statements normally given to stockholders or the public. Nevertheless, some employers do and will contend that permitting employees to share in profits must necessarily permit them to share in management.

Tax Aspects

Income Tax

Employer contributions to a qualified pension or profit-sharing plan are deductible for federal income tax purposes. The amount necessary to fund the pension on a current service basis is always deductible if, when added to other compensation paid the employee, it is considered reasonable. It is also possible to take special deductions for contributions to cover past service. In profit-sharing trusts the allowable deductible contribution in one year is an amount equal to 15% of the covered compensation of the employees participating in the plan. Section 404 of the Internal Revenue Code and applicable regulations cover this in detail.

An acknowledged advantage of a pension or profit-sharing plan is that the employee in effect receives compensation which is not taxable currently. The law provides that employer contributions to a qualified plan are not taxable to the employee until they are distributed or made available to him. Under present law, even when it is distributed and does become taxable, favorable treatment is available. For example, if all that is due an employee from a qualified plan is paid to him in one taxable year because of his separation from the service of the employer, capital gain treatment is available. Also, when the pension is paid there are friendly methods of reporting the income — see sections 72 and 402 of the 1954 Internal Revenue Code.

If a trust is used as the vehicle for administering a qualified plan, it becomes a non-taxable entity for income tax purposes. That means, of course, that investment earnings accumulate in the trust free of income tax in the year of accrual. Section 401 of the 1954 Internal Revenue Code is the reference here.

Estate Tax

Distributions from a qualified plan which are attributable to employer contributions are excludable from estate taxes if such distribution is payable to a beneficiary other than the estate of the decedent. Section 2039(c) of the 1954 Internal Revenue Code and applicable regulations are worth reading on this point.

Qualifications of Plan or Trust

There are two ways of handling this matter. First, the employer can do what he wants to do and then seek qualification. On the other hand, he may seek qualification first and then do it.

Specific information is required by the Internal Revenue Service before it will consider issuing determination letters. Such letters are issued on plans in force. However, he can find out whether what he intends to do will meet with approval before he does it. It is also possible, under a recent ruling, to establish a pension plan or trust on a conditional basis. That is, provide that if the plan does not receive Internal Revenue Service approval it will be considered ineffective and the contribution made by the employer will be returned to it.

FEDERAL DISCLOSURE ACT

The fourth and last subject this morning is the Federal Welfare and Pension Plans Disclosure Act. Most people believe, and investigations have supported that belief, that while the great majority of plans (pension, profit-sharing and welfare) are responsibly and honestly administered there have been some cases of willful abuse and mismanagement due to incompetence and negligence. Recognition of that fact at a national level spurred Congress into action. The result — the Federal Welfare and Pension Plans Disclosure Act which was passed in 1958. It became effective January 1, 1959. It is primarily a disclosure measure. Its basic objective is the publication and making available to participants and beneficiaries of information describing the plan and explaining how it is being administered.

Prime responsibility for carrying out the provisions of the act is placed upon the plan administrator. It is he who must see to it that the necessary filing with the Labor Department is accomplished and that a description of the plan is given to all those covered by the plan who ask for it. In addition, he must see that the Annual Report is prepared and that in each case the information required by the statute is contained in the reports. Also, when requested, he must furnish employees a summary of the latest Annual Report.

This law is also basically a self-policing measure. The policing of these disclosure or report publication requirements rests with the employees covered by the plan. It is they who must ask for a copy of the administrators' reports. If they feel that the reports are defective or dishonest they can then seek court action.

Technically, the philosophy of this law calls for a minimum of government interference or surveillance. It is important to note that the Secretary of Labor has no investigative or enforcement functions. He may draft reporting forms but their use is optional with each administrator. The Secretary of Labor has no authority to interpret the statute nor to issue rulings designed to help clarify the law. He must, however, make copies of the filings available for examination in the Public Document Room of the Department of Labor.

For just a few minutes let's jet past the high points of this Federal Disclosure Act:

1. It does not apply to an employee welfare or pension plan if such plan covers less than 26 employees.
2. Key definitions to check and understand are "employee welfare benefit plan"; "employee pension benefit plan"; "Plan Administrator"; "Description of the plan"; and "Annual Report".

The description of the plan (D-1) must be filed with the Department of Labor within 90 days after a plan has been established. The Annual Report (D-2) must be filed within 120 days after the end of the calendar or fiscal year as the case may be.

Copies of the plan description and the latest Annual Report must be available for examination by employees in the principal office of the plan. Upon written request of the employee, the Plan Administrator must deliver to him a copy of the plan description and a summary of the latest Annual Report.

How is the Act working out? It's hard to tell because one cannot be sure just what Congress expected it to do. Here, however, is one opinion — that of the man who has charge of administering the Act — Secretary of Labor Mitchell.

In a letter dated last August 9, 1960, to the President of the Senate and to the Speaker of the House, Secretary Mitchell said among other things, and I quote:

> I am submitting to you a report covering the administration and operation of the Welfare and Pension Plans Disclosure Act during the first 18 months of its existence.
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> As the law is now written, neither its reporting nor its disclosure purposes are being effectively achieved. Nor is it likely these important objectives can be accomplished unless the law is substantially strengthened. The inability of administrators of employee benefit plans to obtain authoritative interpretations of the Act's provisions has caused confusion and contributed to the substantial degree of non-compliance and inadequate reporting which has occurred. The lack of either investigatory or enforcement powers by the Secretary of Labor has seriously handicapped the Department and affords no persuasive deterrent to those who wish to ignore its provisions, or to manipulate or embezzle funds.

He then cited some examples and concluded:

> The only recourse, therefore, is the prompt amendment of the Act to require, among other considerations, that reports should be complete and meaningful and timely filed; that plan administrators should be entitled to receive authoritative interpretations of the Act's provisions; and that the Department of Labor should have the appropriate investigatory and enforcement powers customarily granted by the Congress for the proper enforcement of legislation it has adopted.

Perhaps the 87th Congress will get around to thinking about Secretary Mitchell's suggestions. Many feel however that the Act should not be amended until it has had some more time to operate. Given another year unmolested the bugs might disappear.

PENSIONS AND PRIVATE ENTERPRISE

The millions of Americans who reach 65 in the next few decades will have a two fold desire — to *stop* working and *go* on living in about the manner to which they have become accustomed. Fulfillment of that twofold desire will require retirement income. Without an assist from private pension plans and personal savings, Social Security will not — and should not be expected to — do the complete job.

In spite of the fast growth in private pension plans in the past two decades, less than 50% of our labor force is covered currently by pension plans. The rate of growth from here on will be slower than it has been. Most employers of large groups have retirement plans. Employers of small groups have moved more slowly. By number of employees, a great multitude is without pension plans. It is that multitude which must be motivated. Scores of thousands of employers must be convinced, one by one, that unless private enterprise moves in voluntarily to better fill the retirement income need of American workers, the federal government will, through continuing expansion of Social Security, try to do the job.

In a paper submitted last year to the House Committee on Ways and Means, San Francisco Attorney Joseph L. Seligman, Jr., succinctly stated an opinion to which many concerned citizens can subscribe. Said he, "I believe that compulsory Social Security is necessary and desirable only to the extent that private and group arrangements cannot and do not provide adequately for the security of our people;" and "While I do not question our need for Social Security, I emphasize that it is desirable to our way of life only to provide protection against want — a reasonable minimum retirement security — for those who would otherwise be destitute. Nothing more should be attempted or permitted."

In a similar vein, is the statement of Lord Beveridge in his famous report "Social Insurance and Allied Services":

> To give by compulsory insurance more than is needed for subsistence is an unnecessary interference with individual responsibilities. More can be given only by taking more in contributions or taxation. That means departing from the principle of a national minimum above which citizens shall spend their money freely, and adopting instead the principle of regulating the lives of individuals by law.

All of us are a part of that task force which must carry the pension story to the millions of employers without such plans. They are in need of education, motivation and assistance. If they, the mountains, will not come to us, we the consolidated Mohammed, are in a good position to go to them.