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Attorney's Role in Pension and Profit-Sharing Plans: The Challenge to Learn, Innovate and Advise, The

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THE ATTORNEY'S ROLE IN PENSION AND PROFIT-SHARING PLANS: THE CHALLENGE TO LEARN, INNOVATE AND ADVISE

by

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ONE of the most remarkable social and economic developments in the past twenty-five years has been the emergence of private pension and profit-sharing plans. The legal problems encountered in this field are many and complex. Moreover, the attorney is challenged to keep abreast of many peripheral considerations in order to serve his client. The challenge to the profession is clear. The bar must equip itself with the ability to do a thorough, complete and competent job in planning pension and profit-sharing plans for corporate clients. This Article will focus mainly on the extra-legal questions.

Basic Advantages of Qualified Plans. While there are perhaps a dozen tax advantages inherent in a qualified pension and profit-sharing plan,[1] there are three fundamental advantages. First, contributions by the employer are deductible from gross income for federal income tax purposes.[2] Second, the contribution made by the employer is not income to the employee until it is actually distributed from the plan to him or otherwise made available to him.[3] Finally, earnings on funds set aside in a qualified plan are not currently taxed.[4]

Tax Savings. Assuming that the top corporate profit dollar is in the surtax bracket, there is currently a forty-eight per cent tax due, which means that the corporation will have fifty-two cents after taxes. This amount can be accumulated by the corporation, but the income on the accumulation is subject to tax and an excessive accumulations tax may be levied. With a reasonable investment yield on the accumulation, the corporation can accumulate approximately $2.80 from the top corporate dollar at the end of five years.[5] Thus, in effect, the corporation has a "profit-sharing plan" with the tax collector and at the end of five years will have accumulated about fifty-six per cent of the original profit earned. On the other hand, if a qualified plan is established and the entire dollar is contributed to the plan, the accumulation will be on a tax-free basis. At the end of the same five-year period, and based on the same investment yield, the corporation could have nearly $6.00 accumulated in the plan. The "profit-sharing plan" with the tax collector will result in an accumulation of approximately fifteen dollars over a twenty-year period;

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[1] 1 CCH PENSION PLAN GUIDE §§ 2225-31 (2d ed. 1968).

[2] INT. REV. CODE of 1954, § 404.

[3] *Id.* § 402(a)(1).

[4] *Id.* § 501(a).

[5] For convenience, a before-tax interest assumption of 8% was employed, and an after-tax rate of 4% utilized. Thus, 52¢ accumulated at 4% for five years amounts to about $2.80.

whereas the qualified plan will have had approximately forty-six dollars accumulated. Without considering the tax effect of any benefit distribution, the corporation's top profit dollar will accumulate in a qualified plan to a sum equal to about three times the amount which can be accumulated without the plan over twenty years.

Expense. The following illustrations, based on 1967 tax rates, show how "inexpensive" it is for the typical small and medium-sized corporation to establish a qualified pension or profit-sharing plan.

Illustration 1: The corporation has ten employees, including the owner, with an average annual profit of $15,000. Total annual payroll is $60,000, which includes the owner's annual salary of $12,000. The owner has three tax exemptions and personal deductions equal to $1,000. The company establishes either a qualified profit-sharing plan or pension plan with a benefit design requiring contributions of approximately $5,000 per annum.

The following table reveals that the owner in this case can share $5,000 with his employees, and that his after-tax cost is only $1,772, or approximately thirty-five per cent of the total cost of the program.

	Item	*Without Plan*	*With Plan*
1.	Contribution	$ —0—	$ 5,000
2.	Net Profit Before Taxes	15,000	10,000
3.	Federal Corporation Income Tax	3,300	2,200
4.	Company's Net Profit	$11,700	$ 7,800
5.	Dividend to Owner[6]	$11,700	$ 7,800
6.	Owner's Salary	12,000	12,000
		$23,700	$19,800
7.	Owner's Personal Federal Income Tax (Estimate)	4,668	3,540
8.	Owner's Take-Home Pay	$19,032	$16,260
9.	Owner's Retirement Fund	—0—	1,000
10.	Owner's Total After Income Taxes	$19,032	$17,260

Illustration 2: The company has twenty-five employees, including two equal owners. Profit has averaged $40,000 per annum. Payroll amounts to $100,000, which includes owners' salaries of $40,000 per annum. Each owner has three exemptions and personal deductions amounting to $1,000. The company establishes a plan and contributes $11,000 annually (eleven per cent of payroll).

The following table indicates how the owners can establish a plan for the benefit of all their employees, contribute $11,000 thereto, and show an after tax *profit* of $910. This foreshadows the dramatic effects that can be obtained for key employees.

[6] It is assumed that all the company's net profit is distributed each year.

	Item	*Without Plan*	*With Plan*
1.	Contribution	$ —0—	$11,000
2.	Net Profit Before Taxes	40,000	29,000
3.	Federal Corporation Income Tax	12,700	7,420
4.	Company's Net Profit	$27,300	$21,580
5.	Dividend to Owners[7] (divided between the two owners)	$27,300	$21,580
6.	Owners' Salaries	40,000	40,000
		67,300	61,580
7.	Owners' Personal Federal Income Tax (Estimate)	16,423	14,193
8.	Owners' Take-Home Pay	$50,877	$47,387
9.	Owners' Retirement Fund	—0—	4,400
10.	Owners' Total After Income Tax	$50,877	$51,787

Illustration 3: The ABC Corporation has a $200,000 earned surplus and is concerned about its unreasonable accumulation problems.[8] Its sole stockholder and president, John Doe, has been unable to accumulate any capital for investment purposes. Substantially all of his assets are represented in the ABC Corporation. In the event of his death there would be little cash available to his wife, and the estate tax problem in valuing the ABC Corporation stock would be difficult.[9] John and his wife have a son who is active in the corporation and would continue to manage the company on John's death.

The corporation has pre-tax earnings of $50,000 and an annual payroll of $102,000, which includes the president's salary of $52,000. The company has been advised that any direct increase to the salary of its president might be considered excessive compensation and disallowed.[10]

Acting on the advice of counsel, the corporation establishes a qualified profit-sharing plan integrated with Social Security[11] and makes the maximum deductible contribution to the plan which is an amount equal to fifteen per cent of the covered payroll.[12] Because of the "leverage" that can be obtained in allocating the company's contribution to specific individuals in an integrated plan, the allocation to John's account equals twenty per cent of his pay. The plan is submitted to the Internal Revenue Service by counsel and approved.[13]

The following table illustrates the effect of the establishment of this plan.

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[7] *Id.*

[8] *See* INT. REV. CODE of 1954, § 531.

[9] *See* Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.

[10] *See* INT. REV. CODE of 1954, § 162.

[11] *See* Mim. 6641, ¶ 19, 1951-1 CUM. BULL. 41.

[12] INT. REV. CODE of 1954, § 404(a)(3)(A).

[13] *See* Rev. Proc. 67-4, 1967 INT. REV. BULL. No. 1, at 27.

	Item	*Without Plan*	*With Plan*
1.	Tax on ABC Corp. Earnings of $50,000	$17,500	$10,156
2.	Tax on John's Salary of $52,000	16,660	16,660
3.	Total Tax	$34,160	$26,816
4.	Available to ABC Corp. After Taxes	$32,500	$24,544
5.	Available to John After Taxes	35,340	35,340
6.	Credited to John in Integrated Profit-Sharing Plan	—0—	10,400
7.	Total "Available" After Taxes	$67,840	$70,284
8.	Provision for Retirement of Other Employees	—0—	4,900

There are many benefits in this plan. The $10,400 credit to John's account may be invested and earn tax free income. Of equal importance, of course, is the fact that the corporation did not itself pay a tax on the amount credited to employee accounts, nor did John have to pay a tax on the amount credited to his account.

Other advantages are that John will pick up approximately fifty per cent of the "forfeitures" (that is, non-vested amounts previously allocated to employee-participants which are forfeited by such employees when their employment is terminated prior to full vesting).[14] The amount of forfeitures will, of course, depend on the rate of employee turnover, but a conservative estimate would be that John will average about $1,000 annually credited to his account from forfeitures. Further, when John does receive distribution of the amount set aside for him, including forfeitures and tax free earned income, the distribution will be taxed to him at capital gains rates if paid in one taxable year.[15] If John remains with the corporation until his death, which is quite likely in a family or closed corporation, his share in the fund can be paid to any beneficiary other than his estate and there will be no estate tax on the distribution.[16] In addition, the first $5,000 will be income tax free,[17] and the excess taxed at long-term capital gains rates if paid in one taxable year.[18]

Finally, about $8,000 less has been added to the corporation's earned surplus, and approximately $5,000 has been set aside to provide for the future security of the other employees of the corporation. And all of this has been done in a fashion which has generatd $2,444 more in after-tax income to John and the corporation than if no plan was established at all (amount credited to John under the plan less reduction in amount available to ABC Corporation). And as long as a "prohibited transaction"[19] is not entered into, the fund may be utilized to build the business.

Summary. In many situations involving medium-sized and smaller corporations, the establishment of a properly conceived and implemented pen-

[14] Forfeitures are usually reallocated in proportion to pay, and John's pay is 50% of the payroll.

[15] INT. REV. CODE of 1954, § 402(a)(2).

[16] *Id.* § 2039(c).

[17] *Id.* § 101(b).

[18] *Id.* § 402(a)(2).

[19] *Id.* § 503(a)(1)(C).

sion and profit-sharing plan is not only a sound business decision, but often results in a profit to the owner or owners. Since the corporation currently has a "profit-sharing plan" with the tax collector, the question really becomes whether or not the corporation can share its profits on a more favorable basis with its employees.

Actuarial Methods and Assumptions. The question of whether a pension plan is preferable over a profit-sharing plan in a given case, or vice versa, or whether both should perhaps be established, is beyond the scope of this Article. Likewise, the determination of the best funding agent, including the pros and cons of trusteed funding versus insured funding is left for others. But in the event that a self-administered pension plan utilizing a trust fund appears to be in the best interest of the company, or alternatively, if it is simply a program that management wishes to explore, the attorney must have an understanding of actuarial methods and assumptions to advise his clients intelligently. The basic objective of an actuary in valuing the benefits of a pension plan is to see that the trust fund will be adequate to pay for the benefits called for by the plan as they become due. This simply requires a determination of an annual contribution in a given year which will be adequate to maintain the fund on a sound actuarial basis. A secondary objective of the actuary is to see that contributions by the employer are made on a basis so that they will remain relatively constant as a percentage of payroll, or as an annual cost per annum per employee, or on some other yardstick.

A pension plan must provide a definitely determinable benefit.[20] In contrast, a profit-sharing plan does not provide a definitely determinable benefit. Since a pension plan must provide a fixed "output," it logically follows that there must be a fixed "input." Determining the level of the input and the frequency of the input in order to assure that the output can be made in accordance with the terms of the plan is the basic purpose of a periodic actuarial valuation.

To determine the amounts that should be contributed to a pension plan, it is necessary to determine what benefits might be expected to be paid under the plan. Participants in a pension plan may die in active service, may become totally and permanently disabled in active service, may retire under the plan and receive a benefit, may terminate employment for other reasons, may receive salary increases which will result in benefit increases, and so forth. The actuary has established reasonable assumptions for all of these probabilities. For illustration, mortality tables indicate that approximately one person out of a thousand will die at age thirty, two out of a thousand at age forty, six at age fifty, fifteen at age sixty, and so forth. Likewise, approximately one person out of a thousand will be disabled at age twenty-five, two out of a thousand at age forty-five, three at age fifty, and twelve at age sixty. Salary scales developed by actuaries are sometimes employed, and assuming that an employee's earnings level at retirement equals one hundred per cent, his earnings level at age twenty

[20] Treas. Reg. §§ 1.401-1(b)(1) (1964).

is approximately thirty per cent; at age thirty, approximately fifty-six per cent; at age forty, seventy-four per cent; at age fifty, eighty-seven per cent, and so forth. Finally turnover tables project that approximately one hundred employees out of a thousand will terminate at age twenty, seventy out of a thousand at age thirty, sixteen at age forty, and only three at age fifty.

Combining these various actuarial assumptions produces a somewhat surprising result. Assuming that a corporation had one hundred thousand employees aged twenty, the following "probabilities" would result before age sixty-five: approximately seventy-six per cent would terminate employment; five per cent would die; and four per cent would become disabled. Fifteen per cent would retire at age sixty-five.

Actuarial assumptions come from many different sources and every major actuarial firm has its own assumptions which it considers most appropriate for given circumstances. Sometimes where there is an agreement on actuarial assumptions, there is a disagreement on the actuarial method to be employed, or vice versa. Sometimes both assumptions and methods vary. The area in which contributions are actuarially sound is broad. For example, based on one set of actuarial assumptions and one actuarial method, an employer could contribute and deduct a specified amount to fund a particular benefit; while based on another set of assumptions and a different method, the employer could contribute, and deduct, twice that amount. Both contributions would be "actuarially sound."

The tax deductions for contributions to a qualified plan are limited under Internal Revenue Code section 404(a).[21] There are three basic Code sections. Section 404(a)(1)(A) provides a basic limitation equal to five per cent of the compensation of the covered employees. Section 404(a)-(1)(B) relates to the amount needed to fund the benefits for the participants in a pension plan on a "level method" funding basis to their normal retirement dates. Finally, section 404(a)(1)(C) is based on considering the pension cost as being the sum of two factors: (1) the "normal cost" for the year, and (2) the "past service cost" determined at the time the plan is established.[22] The normal cost is the level annual funding cost assuming that the plan had always been in effect. For example, a plan is established today for a company which employed its president forty years ago when he was twenty years old. If a pension plan is established and his benefits are funded on a "level method" basis to age sixty-five starting at age sixty, the cost over the next five years is going to be substantial. However, if the plan had always been in effect, the funding of his benefits would have been commenced forty years ago, when he was twenty years old, and the level annual cost at that time to fund his pension to age sixty-five would have been much less. When the normal cost method is utilized, the level annual cost for each individual is computed as if he came into the plan on the day that he was employed. The past service cost simply represents the sum which would have been accumulated had

[21] INT. REV. CODE of 1954, § 404(a).
[22] Treas. Reg. §§ 1.404(a)-6(a)(2) (1961).

the normal cost actually been contributed over all of the past years. In other words, in the above example, it represents the sum that would have accumulated for the president, now aged sixty, if the plan had in fact been established forty years ago. Under section 404(a)(1)(C) the maximum deductible contribution is a sum equal to the normal cost plus ten per cent of the past service cost.

Summary. Obviously, it is not the purpose of this Article to give a short course in actuarial methods, but rather to give a brief description of various actuarial methods and assumptions, and most important to stress that actuarial cost estimates are simply that—estimates. Assumptions or methods can be changed. They can be increased or decreased to meet the particular situation.

Pension Plan Benefits. In designing benefits in a pension plan, consideration must be given to the objectives of management and the funds available. Ideally, a pension plan should not be looked at in a vacuum, or as an entity complete unto itself, but rather as a part of an over-all compensation program, since, in most instances, benefits provided under a pension plan are in lieu of greater direct compensation to employees.

Normal Retirement Benefit. The basic benefit of a pension plan, of course, is the normal retirement income. There are certain basic concepts which should be followed in most cases. First, the retirement benefits should be a function of the employee's earnings and his length of service. Presumably an employee's compensation is a measure of his worth to the company at a particular time. It is generally accepted that retirement benefits also should be related to the worth of an individual to the company. Length of service is usually recognized because it is expensive to provide a short service employee with the same pension which is provided for the longer service employees, where the pensions are such that they would be considered adequate for the longer service employees. In addition, a person who has devoted his entire working lifetime to a company would expect a larger pension, and a psychological problem could develop if such service recognition was not granted. Some modification in the recognition of the period of service may be necessary in situations where some of the key employees were partners and proprietors for a period of time and thus have shorter credited periods of service,[23] or where key employees were hired at a greater than normal employment age in order to obtain their ability and past experience.

Normally, benefits should be based upon the employee's highest average compensation during the last few years of employment. An employee's compensation determines his standard of living, and it is important that the retirement benefits of a person reflect conditions of his situation near the time of retirement, rather than his position and compensation as of twenty or thirty years previously. A common procedure is to base the benefit on the average monthly compensation for the last five calendar years prior to retirement or for the five consecutive calendar years of

[23] *See* Rev. Rul. 65-178(2)(j)(1), 1965-2 CUM. BULL. 94.

compensation out of the last ten calendar years prior to retirement which produce the highest average. This type of formula is called a "final average" compensation formula. The "career average" compensation formula, on the other hand, bases the pension benefit on an employee's compensation averaged over his entire period of considered service.

There are two major differences between the effect of a "final average" type of formula and a "career average" type. First, in comparison to the "career average" type, a final pay plan gives proportionately larger benefits to the employee whose earnings have increased sharply over the years. For example, if an employee's salary starts out at a level of $5,000 a year and rises to $15,000 by the time of retirement, his "career average" earnings might be $7,000 to $8,000 a year, whereas his "final average" earnings would be near $15,000 a year. Thus, if the retirement benefits are twenty-five per cent of average pay, under the "career average" earnings definition, an executive's pension benefit would be only $1,750 to $2,000 a year, while a pension of $3,750 a year could be granted under a "final average" formula. On the other hand, if an employee's salary starts out at $5,000 per year and remains there, his pension would be the same under either type of formula. Since the earnings progression of the lower-paid employees tends to be relatively level, the earnings base used does not greatly affect their benefits.

The second difference is that the final pay formula will automatically offset the effect of inflation during the employee's period of active service to the extent that the general level of his salary keeps pace with the current inflationary trends. However, since the level of benefits rises with the general level of compensation, there may be substantial increases in the employer's total obligation toward the end of an employee's period of active service. While no exact method of providing for this contingency has been developed, if a substantial portion of the trust fund is invested in equities, the appreciation in value of this part of the portfolio should substantially offset the increase in obligation due to inflation. Thus, at least in terms of "creeping" inflation, large increases in cost can be avoided by following a liberal investment policy.

Advocates of the "career average" plan normally justify their choice on the claim that a "final average" plan commits the company to too large an unknown liability. However, the commitment of the company is not a binding one if it should be unable to meet the costs of the plan. The "career average" plan, on the other hand, suffers very greatly from the fact that the benefits do not keep pace with compensation and inflation. As a result, a "career average" plan must be adjusted periodically to provide a new earnings base at a higher level than in the past in order to produce the benefits which are required for an adequate retirement income. To be satisfactory, any pension plan has to produce an income which meets certain standards of adequacy. Where a "final pay" plan is used, some of this greater liability of future years may be prefunded by anticipating salary increases. This is not possible to the same extent under a "career average" plan. As a result, greater liabilities are presented at the

time the base must be increased. Therefore, the "career average" plan tends to be more costly in the long run than the "final pay" plan.

Disability Benefits. Next to the normal retirement benefit, the disability benefit is probably the most important provision of a pension plan. Disability is a contingency that is difficult for an employee to provide for since no adequate low-cost personal insurance protection is readily available. This is particularly true if disability is due to sickness, and the ratio of sickness to accident disability cases is approximately ten to one. Most disability income insurance policies do not provide an income beyond age sixty-five because of disability due to sickness.

The disability provision in the pension plan usually includes the same benefit formula as is used for retirement at age sixty-five. The benefit is calculated on the basis of the earnings up to the date of disability and length of service. However, in some instances, the disability benefit is calculated using full anticipated service to the normal retirement date. In some plans, the disability benefit is reduced by an actuarial equivalent factor to allow for the fact that payments begin at an earlier age than the normal retirement benefit. This reduction has the advantage of lowering the cost of the plan, but it has the major disadvantage that, in many cases, the disability benefit would be reduced to such a small amount that it would fail to fulfill its desired purpose.

Under present law, disability benefits received for absence from work after the first thirty days up to $5,200 a year are exempt from income tax.[24] This special income tax treatment extends only to payments made prior to the attainment of the normal retirement age. After the normal date, disability benefits are subject to the same income tax as other retirement benefits.[25]

Death Benefits. Another very valuable type of incidental benefit is a death benefit. Where pre-retirement death benefits are desired, the least expensive way of providing them is through a group-term life insurance policy. If a relatively modest post-retirement death benefit should be desired, consideration might be given to prefunding amounts up to $5,000 under the pension plan. Any post-retirement benefit should be on a more modest basis than for active lives since there is less need for large death benefits and since death after retirement is a certainty rather than a probability.

Where additional death benefits are desired under the pension plan, the general rule is that benefits may be provided up to eight and one-third times the anticipated annual pension.[26] The amounts could be provided as some multiple of salary or some other indicated amount. A more selective death benefit is to provide death benefits in the form of a life income payable only to a dependent spouse at the rate of fifty per cent of the employee's pension. These payments could be made only while the dependent spouse remained unmarried. In order to avoid excessive cost, the fifty per cent benefit is usually reduced on an actuarial equivalent basis

[24] INT. REV. CODE of 1954, § 105(d).
[25] Treas. Reg. §§ 1.105-4(a) (1964).
[26] Rev. Rul. 65-178(2)(n), 1965-2 CUM. BULL. 94.

if the spouse is ten years younger than the employee. This benefit is a rather costly one and adds about one-third to the cost of retirement benefits for married employees.

Settlement Options. A major concern of a married employee after retirement is to provide a lifetime income to a spouse should he predecease her. Through the use of a joint and survivorship option on an actuarial equivalent basis, a retiring employee may provide for this contingency by electing a smaller annuity which will be continued in whole or in part for the lifetime of the survivor.

To prevent the selection of this type of option on a deliberate basis by an individual who is in poor health at the time of retirement, normally a requirement is made that the option be chosen two or three years before retirement or be based on evidence of good health.

Another useful option is the lump sum distribution option whereby an employee may receive, in lieu of the annuity benefits otherwise payable, a lump-sum distribution which is the actuarial equivalent of the annuity benefits payable under the plan. The lump sum might be advantageous for higher paid executives who, by taking the long-term capital gain income tax treatment, could reduce their taxes as compared to the tax liability on annuity payments. Such lump-sum options are also desirable if the monthly annuity payable to the employee is less than twenty-five dollars. In this event, the lump-sum distribution would reduce the administrative costs of paying monthly benefits in such small amounts. It might also provide a more meaningful benefit to the employee.

Separation Benefits. Another type of benefit which could be provided in a pension plan is a vesting of benefits to employees who leave before their normal retirement date. Since one of the purposes of the pension plan is to encourage people to stay to normal retirement, vesting should typically be on a minimal basis and probably not available until the attainment of some age such as fifty, fifty-five or sixty. Also, to discourage people from terminating their service to receive a lump-sum payment, such benefits usually should be in the form of a deferred annuity to begin at the normal retirement age. Where the amounts involved are rather small, a lump-sum payment might be made to minimize administrative costs.

When restricting the availability of separation benefits to employees age fifty-five or sixty, such benefits are more commonly viewed as early retirement benefits. Although not many employees retire before age sixty-five, an early retirement provision is a valuable part of a pension plan since some employees lose their effectiveness before normal retirement, and such a provision gives the employer an effective means of terminating the services of such employees. Early retirement may be at the request of either the employee or the employer, but the employer may reserve the right to determine whether the retirement benefit may start immediately on an actuarially reduced basis or must be deferred until age sixty-five.

Designing the Pension Plan Formula—Integration with Social Security. During 1968 every employer pays a Social Security tax on the first $7,800

of an employee's annual pay.[27] The primary Social Security benefit payable upon retirement at age sixty-five, during 1968, is equivalent to approximately twenty-five per cent of pay for an employee earning between $500 and $600 a month, but only five per cent of pay for an employee earning $2,500 per month.[28] When the Social Security benefits payable to the retired employee's wife are added, the inequity is compounded.

Actual benefits, of course, depend upon the worker's average monthly wage and year of retirement, but they constitute a much more meaningful benefit to persons on the lower two-thirds of most payroll structures. Thus, in designing a pension plan benefit formula, it must be considered that a retirement plan (Social Security) already exists and that it provides reduced benefits as earnings increase.

There are two basic types of pension plan formulas. One type may be referred to as a "non-integrated" formula and the other as an "integrated" formula. A typical non-integrated formula provides a uniform percentage of pay for all employees, regardless of salary level, for a given period of service. An example is: one per cent times final average monthly pay for each year of service. Thus, a man retiring after fifteen years of service receives a pension of fifteen per cent of pay. After twenty years of service, he receives twenty per cent of pay, and so on. When this type of plan and Social Security are combined, the benefit pattern is the same as that of Social Security alone. That is, the higher the pay level of the employee, the smaller his benefit when expressed as a percentage of pay. Some employers feel that this is desirable since the employee at the higher compensated level is better able to accumulate savings for his retirement. Others feel that the higher paid employee suffers enough discrimination already from the graduated income tax, and that the combined benefits from Social Security and a qualified plan, as a percentage of pay, should as nearly as possible be equalized.

The Internal Revenue Code does permit a qualified pension plan to provide a "supplemental" benefit on compensation in excess of any given level per month in order to "integrate" the private plan with Social Security.[29] A plan may be integrated at any integration level, and many plans are still being integrated at $4,800 simply because a person retiring in 1968 would receive a Social Security benefit based on an average monthly wage which could not, mathematically, exceed $400 by much. In other words, while the tax base has been increased to $7,800, it will be the turn of the century before anyone has an average monthly wage equal to the current tax base. Using the lower figure is logical since the purpose of integration is to coordinate benefits.

Consider the following example of an integrated formula: three-fourths of one per cent times final average monthly pay for each year of service, plus a supplemental benefit equal to one-half of one per cent times

[27] The maximum tax is $343.20 on both employer and employee, or $686.40 total. INT. REV. CODE of 1954, § 3101.

[28] These approximations are based on amounts indicated in the Social Security Benefit Table. Social Security Act, 42 U.S.C.A. § 415 (1964).

[29] INT. REV. CODE of 1954, § 401(a)(5).

final monthly pay in excess of $550 for each year of service. This plan is an "integrated" plan because it is designed to offset the decrease in the Social Security benefit pattern. After forty years of service, an employee earning $400 per month would receive a plan benefit equal to thirty per cent of pay, while an employee earning $2,500 a month would receive a plan benefit equal to forty-six per cent of pay. Under the non-integrated formula set forth above, each would have received a plan benefit equal to forty per cent of pay, based on forty years of service. Thus, the effect of integration is to provide a reduced benefit to lower paid employees and increased benefit to higher paid employees. However, when Social Security benefits are added back, the integrated formula results in a more equitable package.

Under the integrated formula set forth above, each pension plan benefit payable after forty years of service would be exactly twice the benefit after twenty years of service. In other words, the benefits are in direct proportion to the number of years of service. For lower paid employees, it is desirable that benefits be in direct proportion to service since the value of such employees to the employer is relatively constant throughout their period of service as reflected in a relatively constant rate of pay. Further, if such an employee is hired at an older age, it is increasingly likely that he will have a vested pension with his former employer based on a comparable pay level. However, for employees at higher pay levels pensions which are in direct proportion to service may be objectionable since it is likely that such an employee worked at a much lower pay level during his earlier service. For example, compare two highly paid employees, age sixty-five, one with forty years of service and the other with twenty years of service, both having received the same compensation over the last twenty years. A benefit in direct proportion to service implies that the forty-year employee contributed twice as much to the success of the company as the twenty-year employee, even though in both cases their early years were spent in training and in advancing from a less skilled position to a position requiring higher skills. The twenty-year employee came to the company already qualified for the higher paid position requiring higher skills. If the pension paid the forty-year employee is exactly twice that paid to the other, it is not reflective of the relative values of the two employees.

The answer might be in an alternative formula designed to provide larger benefits to the higher paid employee during his later years. An example of such an alternative "integrated" plan is: three-fourths of one per cent times final average monthly pay for each year of service plus a supplemental benefit equal to twenty-five per cent of final average monthly pay in excess of $550, with the supplemental portion prorated for service less than twenty years. The basic part of the formula (three-fourths of one per cent) is directly proportionate to service. The supplemental part of the formula (twenty-five per cent) is the same for all employees with service greater than twenty years. It bears no relation to service unless service is less than twenty years. The formula is a compromise between

no weighting for service and a direct proportion to service. At the $2,500 per month level, the plan benefit for a twenty-year service employee will now be approximately seventy per cent of the benefit for a forty-year service employee rather than only one-half. The remaining difference allows for the possibility that the twenty-year employee may have a vested pension with his former employer which will give him additional retirement income.

Because of the fact that plans are being integrated at various levels, coupled with the fact that integration limits vary based on the type of plan, a discussion of the integration limits based on the level and type of plan is useful. Six basic types of plan will be used as examples: Plan A provides a life-only pension benefit. Plan B provides a pre-retirement death benefit. Plan C does not have a pre-retirement death benefit but the pension is guaranteed for five years certain and life thereafter. Plan D does not have a pre-retirement death benefit, but the pension is guaranteed for life but not less than ten years. Plan E has a pre-retirement death benefit, and the pension is guaranteed for five years certain and life thereafter. Plan F has a pre-retirement death benefit, and the pension is guaranteed for ten years certain and life thereafter. Assuming that these plans are integrated at $4,800, the maximum flat percentages that will be allowed on earnings in excess of $4,800 are: Plan A—37.5 per cent; Plan B—33.33 per cent; Plan C—36.37 per cent; Plan D—33.75 per cent; Plan E—32.33 per cent; and Plan F—30 per cent. If the plan is integrated at $6,600, the foregoing percentages are modified by multiplying each percentage by .727; and if the plan is being integrated at $7,800, the multiplier is .615. Thus, if Plan A is being integrated at $6,600, the maximum flat percentage is 27.2 per cent. If Plan A is integrated at $7,800, the maximum flat percentage is 23 per cent.

If instead of a flat percentage benefit, a benefit is based on years of service without service limit, the maximum credit per year of service can be obtained by dividing the appropriate percentage by forty-five. For example, if Plan D is being established and is integrated at $4,800 and the pension formula provides a benefit for each year of service, without service limit, the maximum credit per year of service would be .75 per cent. If the same plan were integrated at $7,800 per year of service, the maximum credit per year of service would be .46 per cent.

The problem can be approached from another direction by providing a percentage benefit for each year of service and limiting service. In this manner the plan formula can utilize more conventional percentage amounts so long as service is limited in order that the formula will integrate. To illustrate, if Plan A is established and integrated at $4,800 utilizing a formula which provides a percentage benefit for each year of service equal to one per cent, service must obviously be limited to thirty-seven and one-half years in order that the plan may integrate. If Plan F is integrated at $4,800 utilizing a formula which provides a percentage benefit for each year of service equal to one per cent, service must be limited to thirty years in order that the plan may integrate.

Summary. The design of a pension plan benefit formula is the most important aspect of a well-conceived pension program. Yet how often "pattern formulas" become an advisor's favorite and are recommended in one situation after another without any in-depth analysis of the particular circumstances at hand. Hopefully, this discussion will encourge the reader to innovate new formula designs so as to achieve more perfectly the objectives of management in establishing a qualified pension plan within the budget limitations.

Design of Profit-Sharing Plans—Allocating the Company Contribution. Perhaps the most misunderstood aspect of establishing a sound profit-sharing plan centers around crediting the company's contribution to the participants in the plan. A majority of profit-sharing plans are "non-integrated," and the company's contribution is simply credited to the participant's account in proportion to pay. Thus, it is a rather simple task to project these allocations to retirement for each employee at a reasonable rate of interest, convert the amount accumulated into lifetime income at reasonable annuity rates, and express this lifetime income as a percentage of present pay. In doing this, the reader will note that individuals with equal years of participation in the plan will retire on near equal percentages of pay, regardless of their salary level. When Social Security benefits are added the familiar distortion and inequity results.

A profit-sharing plan may be integrated with Social Security by simply allocating a portion of the company's contribution on earnings in excess of a certain pay level. Thus, a profit-sharing plan can be integrated at $4,800, $6,600, $7,800, or some other level. Except in very rare instances, a profit-sharing plan allocation formula should be integrated with Social Security.

There is one other type of allocation formula enjoying considerable usage. This is the "point plan" which usually takes the form of crediting each participant with one point for each $100 of compensation and one point for each year of service. The advocates of the point plan stress the fact that it is one of the only ways to "load" the allocation formula for valuable past service, which generally has been rendered by the key employees. The Internal Revenue Service has approved the point plan allocation formula.

The only justification or excuse for a point plan is that management simply wishes to establish another retirement program providing benefits in the same inverse proportion to pay as are provided by Social Security. The following table illustrates the typical point plan allocation for the first year for the ABC Company.

Name	*Age*	*Salary*	*Years of Service*	*"Points"*	*Allocation*	*Percent of Pay*	*Percent of Allocation*[30]
1	42	$25,000	6	256	$3,694.55	32.8%	32.3%
2	40	12,000	5	125	1,803.98	15.7%	15.7%
3	47	7,800	3	81	1,168.98	10.2%	10.2%

[30] A "+" sign indicates an allocation which is greater than proportionate to pay.

4	38	6,000	3	63	909.20	7.9%	8.0%+
5	39	6,000	1	61	880.34	7.9%	7.7%
6	51	4,200	2	44	635.00	5.5%	5.6%+
7	43	4,000	3	43	620.57	5.3%	5.4%+
8	28	4,000	4	44	635.00	5.3%	5.6%+
9	29	3,600	2	38	548.40	4.7%	4.8%+
10	31	3,600	1	37	533.98	4.7%	4.7%
		$76,200	30	792	$11,430.00	100%	100%

In this company, the president (number 1) had twice as many points as anyone else, and on the surface it would appear that the point plan would have merit. But as the table indicates, five employees receive an allocation which is greater than proportionate to their pay, and they are all in the lower two-thirds of the payroll. But this table does not really indicate the extent of the fallacy. Five years later the president will have eleven years of service, and assuming the payroll is "frozen," he will have 261 points. There will be a total of 842 points, and assuming an equal contribution the fifth year, the allocation to the president is now thirty-one per cent. In other words, at the end of five years, the allocation for the top three individuals has gone down, while the allocation for the remaining employees has increased. The following table brings the problem into perspective by indicating the accumulation at age sixty-five for the president under each of the three basic types of allocation formulas.

	Accumulation at 65[31]		
Item	*"Point" Plan*	*Non-Integrated Plan*	*Integrated Plan*
Accumulation	$228,523[32]	$246,618	$304,812
Annual Income[33]	17,613	19,000	23,483
Percentage of Pay	70%	76%	94%

The difference between a point plan and an integrated plan to the president of ABC Company will amount to over $76,000 at age sixty-five. Thus, the choice of allocation formulae in a profit-sharing plan design may result in added benefits to key employees equal to a five-figure amount in the average corporation at no increase in cost.

How disturbing it is to see one profit-sharing "model plan" after another furnished by various institutions set up two methods of allocating the company's contributions: the first being non-integrated and the second being the point plan system. While it may be assumed that the motivation inspiring this situation is to take the wrinkles out of the road for the attorney, the end result is that the road is made so slippery that all too often the attorney falls into error. It is hoped that this Article will sound the death knell for the point plan.

Summary. Qualified pension and profit-sharing plans are smart business. Any going concern making a profit should establish a plan, and the sooner

[31] A plan interest assumption of 8% is used.

[32] The president's allocation the first year ($3,694.55) was projected twenty-three years to retirement at the assumed interest rate; his allocation the second year ($3,662.73) was projected twenty-two years, and so forth.

[33] Based on typical annuity rates for life, but no less than ten years.

the better. No one will argue that a good pension and profit-sharing plan will replace current income, and that is not their intention, but in today's society and economy and under existing tax laws, they are the best way to accumulate money and to prepare for retirement.

Conclusion. Every employer has a retirement plan. Some plan simply to discharge old, loyal employees when they can no longer get the job done. Others plan to let old employees simply hang onto their jobs as long as they want them. Others plan to handle the problem on an individual case by case approach, making a "deal" with each employee as he reaches retirement age, paying the freight out of current operating income. Others plan to establish a qualified pension or profit-sharing program. Every plan has its cost, and there is no doubt that ignoring the problem costs most. Discharging old, loyal employees when they are too old to get the job done any more will result in business failure. Leaving employees on the payroll is a retirement plan at one hundred per cent of pay. Making individual deals with each person is degrading in most instances to both the employee and the employer, and it is just paying pensions out of retained income. The best plan is a qualified pension or profit-sharing program. It is the least expensive in the long run, and it does a much better job of accumulating funds for the higher paid employees.

A knowledge of the type of benefits that can be provided in a pension plan and a little sophistication in innovating the pension plan's formula gives the attorney the opportunity of *making* his client substantial sums of money as compared to the average plan the client might otherwise establish. Proper planning when determining the allocation method in a profit-sharing plan can mean a difference of hundreds of thousands of dollars to the president of a corporation if he is young and highly compensated.

The attorney's role in pension and profit-sharing plans is simply to learn, innovate and then give unselfish, unbiased expert advice and service to his client. The alternative to the attorney is to bear witness as his responsibility in this area becomes little more than "keeper of the rubber stamp."