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A NEW APPROACH TO THE PROFIT-SHARING TRUST

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PENSION OR PROFIT-SHARING plans are sufficiently well known to lawyers and business men to make extended comment thereon unnecessary. If such plans qualify under the Internal Revenue Code,[1] they permit of tax advantages not otherwise possible in that employers obtain the benefit of current deductions from income which would, but for the deduction, be taxable[2] while employees gain a form of future protection without adding to their current tax burdens, being obliged to pay taxes only when they actually receive distributions under such plans.[3] These exceptions from general tax doctrines exist because of a firm public policy to encourage incentive while also providing for the ultimate retirement of employees from gainful occupation. Much has been written on the subject of pension plans, but the profit-sharing arrangement is a relative newcomer to the field. Some treatment of the legal aspects thereof might, then, be of service, especially

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1 26 U. S. C. § 165(a).

2 Ibid., § 23, provides: "In computing net income there shall be allowed as deductions: . . . (p) Contributions of an employer to an employee's trust or annuity plan and compensation under a deferred-payment plan. . . ."

3 The tax burden is then, frequently, a lighter one as distribution usually occurs on or after the date when higher exemptions favor the taxpayer, or comes at a time when other taxable income, in the form of salary or wages, ceases to accrue.

if particular attention is given to one approved plan now in operation which involved the marking out of at least two developments not previously utilized.

I. The Controlling Law

Any investigation of the legal elements involved in the profit-sharing plan must start with the section of the Internal Revenue Code which lays down the requirements for qualification of the plan. In that connection, Section 165(a) thereof is the important one for it, through six sub-paragraphs, specifies the tests to be met.[4] These tests may be summarized generally as requiring that the plan (1) be for the exclusive benefit of the employees or their beneficiaries; (2) be permanent in character; (3) be based on a definite written program; (4) be designed to benefit the employees generally, not some limited class thereof; and (5) be non-discriminatory in character. In addition to compliance therewith, in the manner hereinafter specified, it would seem desirable to secure the advance approval of the plan from the Internal Revenue Department, before putting the same into operation, in order that no question be left open concerning the right of both employer and employee to the benefit of the potential tax advantages in a profit-sharing plan.[5]

Concerning the first requirement, one which directs that the plan must be for the exclusive benefit of the "employees," or their beneficiaries, it should be noted that partners in a partnership would not be eligible to participate in the profit-sharing plan,[6] they not being considered to be "employees" of the employer.

[4] 26 U. S. C. §§ 165(a) (1) to 165(a) (6), inclusive. For the purpose of this paper, the non-trusteed annuity plan is left out of discussion. It should be noted, however, that plans of this character must meet similar tests: I.R.B. 1953-6, Rev. Rul. 33, p. 48.

[5] While advance approval is not required as a condition precedent to tax benefits, it is desirable to secure the same. Heretofore, applications for approval were made to the Bureau in Washington. Since April 1, 1953, requests for advance rulings should be made to the director of internal revenue in the appropriate district, as defined in I.R.B. 1953-6, Rev. Rul. 32, pp. 44-5. Approval of a plan by one official does not prevent a subsequent disapproval by another: H. S. D. Co. v. Kavanagh, 191 F. (2d) 831 (1951).

[6] I. T. 3350 (C.B. 1940-1, 64); P.S. No. 23. See also Bentley v. Commissioner, 14 T. C. 228 (1950), affirmed in 184 F. (2d) 668 (1950).

On the other hand, professional workers, such as attorneys serving on the employer's staff[7] or life-insurance salesmen on a full-time program[8] may be, within certain restrictions,[9] classed as such. Wage-earners, whether on a salary basis or paid at hourly rates, including executives, are eligible to be included within the plan, if it is otherwise fair, but it is not necessary to extend the coverage of the plan to all employees on the payroll so long as the plan, or plans,[10] do cover enough employees to meet the percentage provisions of the statute[11] or those eligible to participate are selected according to some scheme of classification set up by the employer which does not discriminate in favor of officers, shareholders, supervisors, or other highly-compensated workers.[12] It might also be possible to fix different eligibility standards with respect to present employees, on the one hand, and those who might become employees in the future, on the other, so long as the standard for new employees is not so weighted against them as to disqualify present executive-type workers if they were to be measured against such a standard.[13]

The principal difficulty likely to be experienced with respect to eligibility for benefits is apt to come when stockholders in the

7 I.R.B. 1953-6, Rev. Rul. 33, p. 49, notes that the mere fact the practitioner also has an independent income from the practice of his profession would not necessarily preclude him from participating in the plan. He must, however, to be eligible, be regarded as an employee for all other purposes, including social security and income tax withholding measures.

8 26 U. S. C. § 3797(20), added in 1951, provides that such salesmen are "employees" for this purpose if they are considered as "employees" for the purposes of 26 U. S. C. § 1400 et seq., as well as for old-age and survivor insurance tax under 26 U. S. C. § 1426(d)(3)(B). This inclusion does not extend to insurance brokers or those who are not employed on a full-time basis.

9 I.R.B. 1953-6, pp. 49-50.

10 26 U. S. C. § 165(a)(3) permits an employer to designate several pension, stock bonus, profit-sharing, and annuity plans as parts of an overall scheme. If these plans, taken together, cover a sufficient portion of all employees, there is no requirement that a definite portion of the employees should be included in any one plan: I.R.B. 1953-6, p. 54.

11 See 26 U. S. C. § 165(a)(3)(A) and (B). The percentages there mentioned are to be applied after excluding certain short service, seasonal, and part-time employees. Illustrations in this respect may be found in I.R.B. 1953-6, p. 55.

12 A plan may qualify even though limited to employees within a prescribed age group, who have been employed for a stated number of years, or who have been employed in certain designated departments of the employer's operations, provided the effect of such selectivity does not discriminatorily favor those who fall within the class mentioned: Commissioner v. Produce Reporter Co., 207 F. (2d) 586 (1953).

13 See I.R.B. 1953-6, pp. 55-6.

employing corporation, although bona-fide employees in all other respects, seek to participate in the profit-sharing plan or wish to have the same extended for their benefit. The mere fact that one is a shareholder should not serve to disqualify for the profit-sharing plan would then work at cross-purpose with the highly desirable modern attitude which encourages workers to become part-owners of the businesses in which they are employed. The presence of a number of small shareholder-employees in the covered group would probably create no problems.

Quite frequently, however, especially among the smaller corporations, the shares of stock, or a majority thereof, will be closely held by the founder, by the members of his family, or by these persons and a few key employees. It is also frequently the case that these persons serve the corporation, as its employees, while occupying varied executive positions. Their presence in the plan would not necessarily condemn the arrangement but, if it is designed primarily for their benefit or as a subterfuge for the distribution of corporate profits to them otherwise than as dividends, the plan would probably fail to receive approval even though it included all the other employees.[14] Care must be taken, therefore, to see to it that the terms of eligibility are not so weighted, with respect both to participation and contribution, in favor of stockholder-employees of this last-mentioned type, for rejection of the plan would then follow.[15]

Since the profit-sharing plan is intended for the benefit of employees or their beneficiaries,[16] the plan should be so drafted as to permit the covered employees to select their own beneficiaries as a matter of right and without dictation from the employer.[17] Any provision which would tend to eliminate this right, or hamper the employee in its exercise, would probably be con-

14 I. T. 4020 (C.B. 1950-2, 61). See also Parker v. Commissioner, 38 B. T. A. 989 (1938).

15 Volckening, Inc. v. Commissioner, 13 T. C. 723 (1949).

16 26 U. S. C. § 165(a).

17 For this purpose, Reg. 111, § 29.165-1(a), defines "beneficiaries" as ". . . *any persons* designated *by the employee* to share in the benefits of the plan after the death of the employee." Italics added.

strued to turn the plan into one other than a scheme for the *exclusive* benefit of employees or their beneficiaries. Provisions in a plan under which an advisory committee, or other administrative body, would be charged with the function of selecting or designating the beneficiary, with or without consulting the employee, or calling for the compilation of lists restricted to specified groups of beneficiaries from among which the employee was to make a choice, would serve as illustrations of hampering restrictions.[18] It would, however, appear to be proper to insert a provision to the effect that, upon the failure of the employee to make a designation, the distributions could be made to close relatives of the employee, in a stated order of priority, or to the estate of the deceased employee.[19] Certainly, in the last-mentioned instance, the right of designation would be preserved for the employee could, by exercising his right to make a will, channel the distributions in any manner he saw fit.

The second requirement which will have to be observed, if the profit-sharing plan is to receive approval, contemplates that the plan must be one of permanent character and intended to serve as a continuing program.[20] Certainly, the employer may not, for this reason, reserve the right to terminate the trust as to the past.[21] For that matter, the plan could not, for example, be set up during periods of high corporate taxes and then be abandoned, without valid business reasons, when profits fell off or tax burdens declined, particularly not if there was any thought of reinstating the plan when, and if, the tax burden again increased.[22] Business men, above all, know that no arrangement is permanent within the full meaning of that term but what is here contemplated is that the proposed plan should not be one intended to

18 Consider, in this respect, the pension trust plan concerned in the case of Lichter v. Commissioner, 201 F. (2d) 49 (1952), cert. den. 345 U. S. 942, 73 S. Ct. 833, 97 L. Ed. 1368 (1953).

19 I.R.B. 1953-6, p. 50.

20 But see Lincoln Electric Co. v. Commissioner, 190 F. (2d) 326 (1951).

21 As to the employer's ability to provide for a contingent right to terminate in the event approval cannot be secured, see Service Combustion Corp. v. Commissioner, 9 T. C. 631 (1947).

22 I.R.B. 1953-6, p. 50.

serve merely as a temporary expedient but should be intended to continue indefinitely unless, or until, supervening circumstances made further continuance impracticable or forced the making of some sort of amendment to the original plan.

Obviously, the varied facts likely to develop in assorted cases prevent the laying down of any prescribed rule intended to determine whether any given plan would be a "permanent" one, on the termination of which no unexpected tax repercussions would be likely to occur,[23] or would be considered to be no more than a subterfuge, leading to a reopening of tax liability. To this point, satisfactory reasons for termination have been found to exist where bankruptcy or insolvency has intervened,[24] where the proposal failed to receive the approval of the Salary Stabilization Board,[25] or where there has been a financial inability to continue to meet the cost of the plan.[26] It can be seen, therefore, that this requirement calls for serious attention on the part of the corporation before it sets up a profit-sharing plan.

Plans of this character must, by the third requirement, be in written form, with the program being drafted so as to include therein all provisions essential to qualification. As the normal plan would call for the use of a trust,[27] the trust instrument should not only be fully executed but should be drawn in such form as to be valid according to the law of the appropriate jurisdiction.[28] Although an oral trust might be effective in law for other purposes, this one must be in writing and nothing less will suffice.[29] There is no requirement, however, that only the services of a cor-

23 P.S. No. 60 and P.S. No. 56 have bearing on this point.

24 Mimeo. 6136 C.B. 1947-1, 58.

25 Blume Knitwear, Inc. v. Commissioner, 9 T. C. 1179 (1947).

26 T. D. 5278, C.B. 1943, 478 and 481.

27 Non-trusteed plans have been omitted from this discussion. With respect thereto, see Mimeo. 6020, C.B. 1946-1, 74, and Merrill Trust Co. v. Commissioner, 21 B. T. A. 1409 (1931).

28 Mimeo. 5985, C.B. 1946-1, 72. See also Wooster Rubber Co. v. Commissioner, 189 F. (2d) 878 (1951).

29 26 U. S. C. § 165(a)(2). See also Mimeo. 5985, C.B. 1946-1, 72, and Mimeo. 6394, C.B. 1949-1, 118.

porate trustee be retained[30] so, to the extent permitted by law, a human being may serve in the capacity of trustee, or several such persons may be called upon to act as trustees.[31] Naturally, if humans do serve, the agreement should provide, to preserve continuity in the arrangement, against such contingencies as disability, resignation or death. If a corporate trustee is used, attention should be given to such matters as corporate consolidation and succession. No standard form of trust agreement for use in conjunction with profit-sharing plans can be said to exist, but it goes without saying that, as this instrument will be the back-bone of the whole arrangement, it should be skilfully and carefully drawn.

Some aspects of the fourth condition, one dealing with employee coverage generally, have already been considered. It has been noted that it is not necessary that all employees be included but, the purpose being to provide for employees generally, the plan should not be so restrictive as to confine the operations and advantages thereof to a favored few. In that connection, the plan should be so drawn as to cover either a number at least equal to the one prescribed by statute[32] or else be drafted so as to benefit those who qualify under some form of non-discriminatory classification such as is permitted by law.[33] Classification schemes do sometimes, on paper, appear to be non-discriminatory but more than that will be needed, for they must be non-discriminatory in actual operation if they are to pass muster.

For example, a plan which ostensibly covers an entire class would appear to be satisfactory on the surface but it might contain a stipulation that non-forfeitable rights accrue only to those employees who have completed a substantial term of service and

30 A corporation could be organized for the specific purpose of operating the profit-sharing plan, if permitted to do so by local law: Tavannes Watch Co. v. Commissioner, 176 F. (2d) 211 (1949).

31 If several serve, unanimous action on their part would normally be necessary unless the trust instrument provided for majority determination.

32 26 U. S. C. § 165(a)(3)(A) specifies, as alternatives, that the benefits must extend (1) to 70% or more of all employees, or (2) to 70% of those eligible for benefits provided at least 80% thereof are actually covered into the profit-sharing system.

33 See 26 U. S. C. § 165(a)(3)(B) and I.R.B. 1953-6, pp. 54-6.

who remain in employment until the normal retirement age. If the staff of the employer, except for a handful of persons in executive positions, should consist principally of transient workers, being those who remain on the job a relatively short period of time and then move on, the benefits of the plan would accrue to no more than a few top employees, hence the scheme would probably be denied approval.[34] The same thing might also be said to be true with respect to rules providing for re-entrance into the plan after a period of discontinuance, to rules governing the continuation of participation in the event a leave of absence is granted, or to various forms of limitation which may attach because of a failure to enter the plan upon, or within a reasonable time after, becoming eligible, unless such rules are so drafted as to be completely uniform in operation.[35]

Probably the most important of the five requirements is the one which demands that there must be no discrimination with respect to contributions or benefits. The statute does not intend that an absolute equality should be preserved among the participating employees, that each should receive precisely the same credits in the fund, or be given exactly the same benefits on retirement or death, any more than it contemplates treating each covered employee according to his needs without giving consideration to the degree of contribution he has made to the success of the employer. It being well within the American tradition to reward each according to his ability or industry, a profit-sharing plan which paid benefits according to units of compensation, units of service, or on the basis of some factor produced by a multiplication of these elements, would not necessarily be objectionable

[34] Solution of this issue depends, to some extent, on whether the benefits provided by the plan are to be considered as vested in the employees at the time contribution is made or whether vesting is postponed until some later date. See I.R.B. 1953-6, pp. 60-1.

[35] These matters are of considerable moment in connection with plans calling for employee contributions to the fund, or in relation to certain insurance plans, for an employee may refuse to sign an authorization for the deduction of participation payments from his salary or may refuse to take the necessary medical examination. They are less likely to be involved in profit-sharing plans. The matter of regulating the effect of leave of absence, however, whether because of sickness, disability, or service in the armed forces, should not be overlooked in plans of this character.

so long as it was not top-heavy and did not result in a showing of favoritism toward the higher paid employees.[36]

It would, for that matter, be possible to set up a scheme which varied benefits under a distribution formula based on years of service,[37] again provided the formula did not operate to allocate a disproportionate share of the benefits to that group in whose interest no discrimination is permitted.[38] It can only be said, however, that there is no sure-fire system which would inevitably receive approval any more than there is one clear formula which would always be disapproved. Any formula adopted must stand or fall on the basis of the result it produces in the given case so if, in operation, it proves to be non-discriminatory, no matter what form it takes, this crucial test will have been met. It might be added, by way of a word of caution, that forfeiture provisions included within a plan might also be considered as being capable of producing a degree of discrimination, even though the initial plan for contribution and benefits might otherwise be satisfactory.[39] If so, disapproval would follow.

Discrimination may also come about in connection with the terms used to define the vesting of employees' rights under the plan. It is not essential, to secure qualification, that the employee be granted vested rights in the employer's contributions upon adoption of the plan or upon becoming eligible to participate therein. There must, however, be some fixed and determinable period at which the employee is to receive vested rights and the postponement thereof beyond that point would invoke criticism. With respect to pension plans, a variety of provisions are now in use, ranging from those providing for complete and immediate vesting down through different gradations to others making benefits contingent until the attainment of a stated retirement age, usually at 65. By analogy thereto, and provided the deferment

36 I. T. 3686, C.B. 1944, 326.

37 I. T. 3685, C.B. 1944, 324.

38 For example, a profit-sharing plan which allocated benefits at the rate of 20% to officers, shareholders and executive employees but gave only 10% to all other employees would fail to meet statutory requirements: I. T. 3678, C. B. 1944, 321.

39 See I.R.B. 1953-6, pp. 59-60.

rests on reasonable grounds,[40] the use of uniform provisions in a profit-sharing trust, deferring the vesting of the employee's rights not later than the normal retirement age, would probably not be open to objection.[41] Again, the question is one as to whether or not the provisions will, in fact, operate without discrimination in favor of those in whose interest no discrimination is permitted.

The law in general recognizes the possibility that a vested interest may be divested upon the happening of designated contingencies, provided those contingencies are clearly and distinctly specified.[42] There would seem to be room, in a profit-sharing plan, for utilization of this idea, especially where the benefited employee is one who, by reason of the nature of his service, might have come into possession of secret and valuable information of vital concern to the employer. Independently of any express contract on the point, such an employee might be prevented, on leaving his employment, from making this information available to a competing employer[43] and, if a valid contract existed on the point, from even taking employment with a competitor, at least for a reasonable period of time.[44] In the light thereof, it would seem not improper to condition the employee's right to benefits under the profit-sharing plan for the period of his continued loyalty to the employer or, conversely, to provide for a discontinuance, or some lessening, of benefits if a breach thereof occurred. Naturally, since equity abhors forfeitures, provisions of this character should rest in reason and be sharply defined but, in addition thereto, for tax purposes, the effect of a forfeiture must not be such as to increase disproportionately the shares due to top-flight officers and employees.

Pension plans are often criticized because, under the con-

40 P.S. No. 22.

41 I.R.B. 1953-6, p. 64, makes provision for the treatment to be accorded to employees who remain in employment beyond the stated age.

42 Simes, Handbook on the Law of Future Interests (West Publishing Co., St. Paul, 1953), pp. 44-7.

43 McClintock, Handbook of Equity (West Publishing Co., St. Paul, 1936), pp. 265-6.

44 Ibid., pp. 267-8.

trolling formula and by reason of age or magnitude of salary earned, they too frequently favor the top-bracket employees. Tax limitations have, therefore, been imposed with regard thereto.[45] While similar rules are not applicable to profit-sharing plans, for acceptable formulae are intended to preclude discrimination under comparable circumstances, other problems are likely to develop from provisions regarding termination. In that connection, the Internal Revenue Code declares that a plan will not be discriminatory "merely because the contributions or benefits . . . bear a uniform relationship to the total compensation."[46] Total compensation, of course, could very easily include overtime pay, commissions, bonuses, etc., in addition to basic compensation or regular hourly rates,[47] so a sudden increase in any one of these factors shortly before retirement would be likely to affect the amount of benefits payable and might produce imbalance.

In that connection, any proposed formula should be given careful study. In one instance, for example, provision was made for two groups of employees, the first consisting of shareholders, officers, and other supervisory personnel, the other being made up of ordinary workers. It was deemed to be discriminatory in that, as there was no reason for differentiating between them, both groups should have been treated alike.[48] In another, where a years-of-service factor produced a lowest salary group credit equal to 3.33 per cent. of salary but produced one of fifty per cent. for the highest salary group, discrimination was found to be present.[49] A third case also used a years-of-service factor which resulted in the lowest group receiving a six per cent. salary credit, the highest group one of 8.88 per cent., but gave the intermediate group the equivalent of twenty per cent. It was also treated as being discriminatory.[50] To offset this possibility and to prevent

[45] See Mimeo. 5717, C.B. 1944, 321.

[46] 26 U. S. C. § 165(a)(5). See also Reg. 111, § 29.165-1(a).

[47] Compensation paid must be reasonable in the light of the service rendered: Charles E. Smith & Sons Co. v. Commissioner, 184 F. (2d) 1011 (1950).

[48] I. T. 3678, C.B. 1944, 321.

[49] I. T. 3686, C.B. 1944, 326.

[50] P.S. No. 28, Sept. 2, 1944.

any "loading" of the formula by large increases in compensation shortly before retirement, the plan should be so drafted as to require the spreading of the total compensation received over a sufficient number of years of service to furnish a reasonable base for the allocation of benefits.[51]

In addition to the foregoing requirements, it should also be noted that, as the trust created under the profit-sharing plan is to be one for the exclusive benefit of the covered employees, or their beneficiaries, no diversion from the terms of the trust can be permitted. To insure against this, the trust agreement should specify that it is not possible, prior to the satisfaction of all liabilities to the covered employees, or their beneficiaries, to divert any part of the corpus or the income arising therefrom,[52] and should also specify against the possibility of a reversion in favor of the employer. The mere fact that some incidental benefit may inure to others, even to the employer, will not produce criticism in this connection, so long as the primary purpose of benefiting the employees is maintained.[53]

Funds supplied to the trustee under a profit-sharing plan would, normally, be kept invested until needed, would produce income, and might even result in the production of a profit.[54] If so, the income and profits ought to be allocated among the covered employees in accordance with some uniform formula without discrimination. To insure faithful operation according to the plan in these and other respects, the trustee should, therefore, be required to maintain an inventory and complete records and to make annual reports. The plan should require that a valuation of all securities held be taken on a specified inventory date, in

51 Under this same general classification, attention must be given to provisions intended to deal with disability and hardship cases. If these provisions are loaded in favor of the higher-paid employees, they will probably produce disqualification of the plan.

52 I.R.B. 1953-6, pp. 52-3. See also Alldis Estate v. Commissioner, 46 B.T.A. 1171 (1942), affirmed in 140 F. (2d) 885 (1942).

53 A purchase of securities by the trustee may, to some extent, benefit the vendor, but would be treated as an incidental benefit if the purchase was made in the best interests of the trust: I.R.B. 1953-6, p. 51.

54 The making of a profit does not, of itself, show there was an improper diversion of corporate assets to the trust: H. S. D. Co. v. Kavanagh, 191 F. (2d) 831 (1951).

accordance with a method consistently followed and uniformly applied, but the use of a fair market value on the inventory date would probably prove to be acceptable. On the basis thereof, the accounts of the respective participants should, at least annually, be adjusted accordingly and, as reserves would not be needed in a profit-sharing plan as contrasted with a pension plan, full allotment should be made to each account. If suspense accounts are used to accumulate cash until an investment thereof can be made, the respective shares of the several beneficiaries in these funds should also be determined periodically.

A question might well arise as to the right of the trustee to invest the funds of the profit-sharing trust in securities of various types, possibly even in stock or other securities issued by the employer. The question is primarily one to be resolved by local law.[55] If investments of that character are appropriate trust investments, the plan would not be denied approval merely because it authorized the trustee to so invest and might, by providing a market, thereby produce an incidental benefit to the employer. There is, however, in that situation, the basis for an inference that a trust including an authority of this nature might have been created for purposes other than those intended exclusively to benefit the employees, so the Commissioner of Internal Revenue has promulgated a ruling requiring that the local director be furnished with certain specified information in the event any of the employer's securities are to be acquired by the trustee.[56] It would, then, be necessary to provide this information along with all other required materials.[57] To prevent delay in securing approval, all documents necessarily involved in the proposed plan should be submitted at one time.

55 In that connection, note Ill. Rev. Stat. 1953, Vol. 2, Ch. 148, § 32 et seq., adopting the "prudent man" rule for this state except where the trust instrument provides otherwise.

56 I.R.B. 1953-6, Rev. Rul. 32, and see also pp. 51-2 thereof.

57 See Reg. 111, § 29.23(p)-2 and § 29.165-1(c). I.R.B. 1953-6, Rev. Rul. 33, Part 2(g), also requires that the employees be given notice not only with respect to the establishment of the plan but also as to its salient provisions. While the most effective way to give notice would be to furnish each employee with a complete copy of the plan, substitute methods may be utilized. In the event a substitute is to be used, it would be desirable to submit a copy of the proposed substitute along with all other documents.

II. A New Application

The preceding analysis of the legal aspects involved in a profit-sharing trust can be made more definite when considered in the light of an actual application which received approval. A small manufacturing corporation, best here described as X Company, had earned profits of approximately $50,000 per year. A majority of the outstanding stock was held by one family, consisting of the founder and his two sons, who served the corporation as its officers. The president, with a salary of $20,000 a year, had been an employee for twenty-five years. The secretary, earning $15,000 a year, had served for twenty years. The treasurer, paid $10,000 a year, had worked for ten years. In addition, the corporation carried thirty-two other employees on the payroll, two of whom served in supervisory capacities and the balance in performing subordinate functions.[58] All employees, except for the three officers, were paid at hourly rates, and punched time in and out on a clock. To this point, the employees were not unionized, although talk of a union had become prevalent.

Production at the plant had begun to fall off, evidently because of increasing absenteeism or tardiness on the part of the employees. There was need for a stimulus of some sort if the corporation was to continue as a success, yet any stimulus which would be provided by a general increase in the level of salaries, or in the dividends paid to the stockholder officers, would merely increase tax burdens and prevent the setting aside of reserves for the future. In the light thereof, the corporation caused an investigation to be made of the possibility of adopting some form of profit-sharing plan with the belief in mind that it might, thereby, (1) reduce absenteeism and tardiness, (2) prevent, or at least reduce, the possibility of unionization, (3) defer distribution of some of the corporate profits, (4) prevent an increase in personal

[58] The two supervisors, with thirty-four years of service between them, each earned $10,000 a year. Six other employees, in the $8,000-$10,000 salary range, had accumulated 88 years of service credit; ten, earning from $6,000 to $8,000, had totalled 93 years of service; eleven others, in a $4,000-$6,000 bracket, aggregated 75 years; the remaining three, earning between $2,000 and $4,000, had only 12 years of service credit.

income taxes while establishing reserves for the future and against retirement, (5) create or enhance employee interest in the business, while (6) retaining control over the plan on the part of the corporation. The general idea appeared to be a simple one to fulfill, but the working out of the detailed steps called for careful study and the development of some innovations not present in ordinary profit-sharing plans.

In the first place, adoption of the normal method of distributing profits on the basis of a formula composed from years of service and salary range would not provide any solution for the problem arising from absenteeism and tardiness. In addition, such a formula could well have made the arrangement top-heavy. Instead, it was decided to set up a formula based on "security points," with distribution of profits to be made on the basis of the total number of points so earned. Calculation was made by granting one security point for each year of service, two points for each month of perfect attendance, and two points for each month in which the employee was punctual. Further emphasis on attendance and punctuality was provided by authorizing a deduction from these security points, where proper, scaled at the rate of two points to be deducted for each day of absence during the month and two points for each day late, but with a maximum limitation that not more than six points were to be deducted in any one month.

Determination as to the number of security points which could be earned was but part of the job for, except as to years of service, it would have been theoretically possible for each employee to earn as many points as the next man, hence be entitled to share equally in all distributions, even though his contribution to the earning of profits might have been inferior to that of the others. It became necessary, therefore, to blend into the formula the element of compensation paid, thereby granting recognition to such matters as overtime pay, higher salary for relatively higher service, and the like. This was done by taking the total compensation earned and multiplying it by the earned total of security points and thereafter reducing the product by three decimal points.[59] This factor then determined the relative share of the profits to be allocated to each employee, with the dollar and cent value credited to each being fixed by dividing the total number of points earned by all employees during the period into the amount of profits available for distribution and then multiplying the unit value so ascertained by the appropriate factor for the particular employee.

Once this formula had been decided upon, other problems began to arise. It was noted that there was nothing in the proposal to prevent an employee from coming regularly and punctually to work but thereafter leaving without giving full service. To prevent such an employee from earning security points, it was necessary to provide a definition for the working day. The matter of vesting the shares of the several employees in the fund called for attention, but it was solved, to head off any tendency to quit employment too rapidly, by permitting the annual vesting of ten per cent. of the amount allocated for ten consecutive years and then vesting the entire amount together with all amounts paid thereafter. Other issues were resolved as fairly as possible in favor of the employees.[60]

Realizing that certain inequities might develop in the actual operation of the plan, both with respect to the formula and the vesting provisions, and also in the application of certain features relating to forfeiture, which the trustees might not wish to be obliged to resolve or even be faced with, the trust agreement embodying the plan provided for the creation of a "welfare" board composed of two employees chosen by the workers, two of the three trustees, and one representative selected by the corporate management. This board was to act, in the main, in an advisory capacity to the trustees but was given the power to determine whether a different scale of forfeiture should be applied in well-defined hardship cases, to settle disputes between the

59 This reduction was made to bring all figures into line in terms of units for each $1,000 earned. If the base for calculating shares had been $100, only two decimal points would have been marked off.

60 Naturally, among other things, the plan had to make it clear that the employees were possessed of an unqualified right to designate their own beneficiaries.

employees and the trustees, and to determine amounts earned under the plan if any question arose with respect thereto.[61] Inasmuch as two of the three trustees were to be officers of, and stockholders in, the corporation and the trustees collectively had full discretionary power over the operation of the trust, with full advisory control resting in a majority of the welfare board, the net result was to place the corporation in a position of dominance, able to control both the operations of the plant and the profit-sharing trust.

It appeared, up to this point, that no profit-sharing trust containing features of the type mentioned, particularly with respect to the security-point formula and the grant of discretionary powers to a welfare board, had been treated as qualified for tax purposes by the Internal Revenue Department. The decision was made, nevertheless, to submit the plan so drafted for approval and, if necessary, to amend the trust later. The required documents were, accordingly, prepared and the plan was submitted together with a chart[62] designed to reveal the working operation of the security point formula. Objection came at the points anticipated. Those relating to the powers of the welfare board were easily handled by amendments designed to make it clear that the board was to handle all cases possessing similar facts which came before it in a similar manner, so as to obliterate any possible semblance of power to discriminate. Actually, however, these amendments possessed little of significance for few cases could arise with sufficiently similar facts to call for identical board action.

The prime disagreement came with respect to the security point formula. The original chart, involving a division of the employees into six classes determined according to salary range,[63]

61 The grant of more extended powers to an advisory board is likely to cause difficulty; Lichter v. Commissioner, 201 F. (2d) 49 (1952), cert. den. 345 U. S. 942, 73 S. Ct. 833, 97 L. Ed. 1368 (1953).

62 The chart was submitted pursuant to I. T. 3685 and I. T. 3686, C.B. 1944, 324 and 326.

63 Class 1 included only the president and the secretary, ranging from $15,000 to $20,000. Class 2 included the treasurer and the two supervisory employees, in the $10,000-$15,000 bracket. Class 3 was formed by the six who earned between $8,000 and $10,000. Class 4 was made up by the ten workers in the $6,000-$8,000

showed a distribution of trust benefits ranging from slightly more than six per cent. for the top executives to a maximum percentage of 8.845 for the lowest class, with some variation in between. It had been compiled on the basis of actual conditions and plant records covering the period immediately prior to the submission of the proposal.

While no criticism was expressed as to the use of classes of beneficiaries and none could be made with regard to coverage requirements, for all employees were included, an objection was advanced that the original chart did not take into consideration the possibility that every employee covered by the plan might, in some ensuing period, have a perfect record, hence it was not clear that discrimination could not occur. A new chart, using the same classifications, was then compiled to illustrate that theory. Although the other statistical data remained the same, the revised chart, which included the maximum possible number of points which could be earned for service, attendance, and punctuality, revealed that the percentages of allotment would then vary from a high of 8.344 to a low of 6.649, with the upper brackets being favored over the less well-paid employees. Naturally, the agent in charge refused to approve a plan which, while not likely to operate in that precise fashion, appeared to discriminate in favor of those in whose behalf discrimination is not permitted.

Since no amount of juggling of figures would produce an acceptable formula, it was then decided to make one amendment in the security point idea so as to confine the calculation of benefits to the first $10,000 of compensation earned. By reducing this one of the several basic factors used in fixing benefits under the plan, it was possible then to prepare still a third chart which, while allowing for the assumption of perfect attendance and punctuality, nevertheless brought the individual percentages more nearly into line with one another. This combination of the first and second charts, after making allowance for the basic earning

category. Class 5 included the eleven workers who were paid from $4,000 to $6,000. The last class contained the three who earned less than $4,000. Particulars with respect to years of service are set forth in note 58, ante.

factor, then revealed that the officer-stockholder employees would probably receive a percentage of benefits equivalent to less than six per cent. on their total compensation, while the less well-paid employees would probably be credited with amounts ranging from 6.918% to 8.648%. As the Internal Revenue Department does not insist upon absolute equality of treatment for all beneficiaries in a profit-sharing plan, being concerned more nearly with whether or not the arrangement is one weighted in favor of stockholder or top-flight employees, this proposal received approval. While some major amendments to the trust agreement thereby became necessary, these changes related to matters of form rather than substance. With the principal objectives left untouched, the X Company instituted the profit-sharing plan so approved and began to work under it.

There should be little need to comment on the effectiveness of the arrangement. Within two months, absenteeism was cut drastically, punctuality became the rule rather than the exception, production increased steadily and profits began to mount. Not only did the company enjoy a decrease in labor turnover but the presence of the plan furnished an inducement for the ready hiring of new, and better qualified, employees. Talk of organizing a union soon vanished and worker morale improved. Without any special action on the part of the management, employees searched for methods to prevent waste as they came to realize that the more profits there were available for distribution the larger their credits would be. In much the same way, the employee-stockholders prospered, not only by the strengthening of their investment in the corporation but also by being able to channel some of the funds which would otherwise have been paid out in the form of taxable dividends into a reserve against the future.

These end products are not particularly or peculiarly the result of a profit-sharing plan embodying a security point formula, for other employers, with varied welfare and benefit plans, have enjoyed similar experiences. It is believed, however, that formulae of this type make much more flexible arrangements possible and, now that one approval has been secured, the security point formula will likely become a more widely used device in the future.[64] It should not be assumed that the precise composition of the formula used in the X Company situation must be slavishly followed, for units of production, units based on saving, or measured by safety record, or a variety of other factors could be substituted for units based on attendance and punctuality. The important thing is to see to it (1) that the elements of the formula are based in reason and are not unduly weighted in relation to each other, (2) that the statement of the formula is carefully set forth by an attorney familiar with statutory requirements, and (3) that the overall operation thereof in a given case can be demonstrated to be just without evidencing a tendency to discriminate in favor of top-level executives. The giving of due observance to these points should facilitate the obtaining of approval for the profit-sharing plan.

64 It is understood that the House Ways and Means Committee has made recommendations with respect to certain statutory revisions which could affect the overall picture, but congressional action will be needed to put these recommendations into effect.