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Employee Pensions

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Miss Susie Sudderth, as tax accountant for the Retail Credit Company, is well qualified to present so important and timely a subject as Employee Pensions. She has a B.S.C. degree from the Evening College of the University System of Georgia and is a member of Delta Mu Delta, national honorary commerce fraternity.

A comparatively newcomer to the ranks of ASWA, Miss Sudderth is serving as the first president of the recently organized Atlanta Chapter ASWA and with this further evidence of ability and a genuine interest in the work of the Society, gives promise of becoming one of its outstanding members.

Employee Pensions

SUSIE SUDDERTH, *Tax Accountant, Retail Credit Co.,* Atlanta, Ga.

The time, talent, brains, and downright ingenuity spent on the subject of employee pensions during the past two years probably exceeds that spent on any business problem since the first enactment of an income tax law. But this subject has not been confined to the worries of *big business.* The man on the street has talked about and the comedian has joked about it. That part of Section 23 (p) "Such contributions shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection . . ." was even quoted in the New Yorker for the humor of its ambiguity. Most, however, missed its humor in the maze of complications which it brought down on their heads.

Employee pensions today is a many-sided question: a prism. It is governed by a law enacted and regulations formulated to close the loophole that was inevitable with the sudden increase in the scale of individual tax rates, and the confiscatory excess profits taxes assessed against corporations. But it was soon discovered that perhaps there was more to the law and regulations than met the eye. The light that came so clearly through the simple piece of glass might be broken up into a variety of interesting color patterns, some of them quite pretty, by a slight turn of the wrist. It was all in the knowing how.

While the whole idea of employee pensions has grown with the development of our industrial society, it has usually been approached from the sociological standpoint. It was looked upon with scorn by some who felt that business was not its brother's keeper. A pension was a nice reward for long and faithful service, something like a pat on the head and a bone for an old sheep dog; but such humanitarian measures had no place in a practical world. Surprisingly enough, this attitude was encouraged by the labor unions. They did not favor a paternalistic role for business, but reserved this right to themselves. In their way of thinking, a pension was simply deferred compensation and they said let the employee receive his full wage now and we will collect dues from it and take care of him when he has passed his period of productivity. It was another selling point for membership in a union; and it has only been in the last year or so that a union has taken the opposite view and used employee pensions in collective bargaining.

In 1935 came our first general social legislation with the enactment of the Federal Social Security Act. This provided among other benefits, a form of old age pension which was to

be paid for in part by a fifty-fifty contribution by the employer and the employee. There were many who feared that employee pensions would now become a political football. Fortunately, however, this has not been true. Though there has been one general change in the basis for computing benefits, changes are to be expected to keep provisions in conformity with changing economic conditions.

After the passing of the Social Security Act, however, employers everywhere seemed to give more thought to private plans for pensions. Employer-employee relations had been gaining attention for some time, and this question of retirement was a definite consideration. After all, a pension can be the solution for removing dead wood from an organization. To get rid of such employees raises the standard of efficiency and improves the morale. For the older employees it gives a feeling of financial security and leaves them free to concentrate on their work. For the younger ones it stimulates their efforts to know that promotions and advancement will be open to them through the retirement of the older employees. From an economic standpoint it is sound. Personnel depreciates just as much as machinery, and current operations should reflect the cost of this depreciation through a reserve that will take care of the worn-out employees.

The Federal Government has always recognized pensions to employees as an expense and provision was made for it just as there has always been a reasonable allowance for salary or other compensation for personal services actually rendered. So the employer could take as an allowable deduction the expense of almost any kind of pension plan which he might provide for his employees. There were some regulations, but these were of a general nature, such as the requirement that the pension cover "*some* or all of the employees." The Government was protected from excessive deductions by business itself through the efforts of management to show efficient operation and a good profit for its stockholders.

Several years ago all of this was suddenly changed. In the first place, the corporate income tax rate, and particularly the excess profits tax rate, was stepped up so high that the stockholder was getting only about 10c on the dollar of the top bracket of income. Where was there any incentive to curb costs? Coinciding with this increase in taxes were the increasing personnel problems that were particularly the outgrowth of the war. Turn-over alone had become so heavy that it was almost destructive. Certainly something must be done. Management was willing to pay anything to obtain and keep employees. It was not even hard to sell the stockholders since Uncle Sam was paying 90% of the bill. But at this same time individual rates were also stepped up so that increased salaries seemed hardly the answer. These increased rates were not limited to what was thought of as the high-salaried group for it took only $14,000 net income to reach the 50% tax bracket. Those with incomes over $50,000 were paying about 75% in their top bracket. And even the lowest income group found themselves paying taxes they had never dreamed of. It even reached the point with them where overtime and additional work were not desirable because taxes reduced the net return so much. Then in October 1942 there came the Salary Stabilization Act. This did not literally freeze the salaries of all employees, but it put a definite control on them and the rate of increase was slowed down.

In view of all of these factors the pension looked like the solution. The expense of the pension could be taken by the employer as a deduction during the period of high taxes; and at the same time, benefits to employees would be deferred and taxable to them in their years of low income. It was a morale builder that offered the employee something that nothing else had, and this made it doubly welcome to the employer right at this time.

The Administration, too, wanted the pension; but some of its leaders recognized the gapping pitfalls. They forsaw one thing in particular and that was discrimination in favor of stockholder-employees, officers, and the high-salaried key management group. Immediately they set about preparing to meet this situation; and the Revenue Act of 1942 and subsequent Regulations 111 set up a tight control on employee pensions.

No longer can a corporation operate on a flexible policy of pensions molded to fit the needs of individual employees. Section 23 (p) says that contributions paid under a *plan* which meets the requirements of certain parts of Section 165 regulating employees' trusts may be deductible to a certain limited extent. The word *plan* is usually thought of as a general word for a proposed method of action or procedure; but from the provisions of Section 165 and the Treasury Regulations and Mimeographs that have already been issued, the *plan* in Section 23 (p) seems to mean a complete

blueprint. No specification may be omitted. The Regulations claim that the law is concerned not so much with the form of the plan as with its effect in operation. A trust set up for an employer's pension plan must meet the requirement of Section 165, but the Regulations for this section state that a trust may meet all of the provisions of these Regulations and still be discriminatory in actual operation. The plan must not leave anything to the administrators that will create even a possibility of discrimination.

The term *plan* also implies something of a permanent nature. This has led to much speculation as to what will happen when that possible post-war depression hits business and the weaker companies are forced to abandon their expensive plans. If, as is threatened, past years are opened and taxes collected retroactively, it will upset our whole economic structure and set us back many years in the stabilization we are striving to maintain.

In order to be sure that pension plans meet the requirements of Section 165, the Treasury Department requires approval of each plan, such approval to be obtained through the filing of an affidavit as given in Section 10.23 (p) (1)-2 of the Treasury Regulations. This approval was first required by December 31, 1943, but the time has been extended to December 31, 1944. This reviewing of plan for approval placed a tremendous burden on the Treasury Department. Early this year there were 4,000 plans stacked up to be reviewed. By July this number had reached 6,000, and it is estimated that by the end of the year there will be 10,000.

The Commissioner has recently announced that Internal Revenue Agents in Charge in the field have been given authority to determine whether a plan adopted by an employer satisfies the requirements of the 1942 Act and thereby entitles the employer to a deduction on his income tax for his contribution to the plan. Rulings by field agents are of course subject to review in Washington, but the Commissioner has promised that any reversals or revisions will not be retroactive. This procedure in administration of the pension regulations will be advantageous to corporations as well as the Treasury Department as it will give an opportunity for personal conferences between employers and agents to iron out misunderstandings.

A plan in its simplest form should cover requirements for membership before retirement, requirements for pension upon retirement, and the method of computing the pension. In addition, it should cover whether or not employees shall contribute and to what extent, the vesting provision upon termination of employment, and insurance benefits, if any that are to be included in the plan. The question of vesting provisions is especially important from the standpoint of discrimination. Any set-up that would allow an employee to work until just before time to receive his pension and then be dismissed and benefits accumulated for him revert to others under the plan would certainly leave open a possibility for discrimination.

To go back to Section 23 (p), that example of double-talk where punction seems more important than words, it is clarified in Regulations 111 which say, "A contribution to be deductible under Section 23 (p) must be an ordinary and necessary expense which would be deductible under Section 23 (a) if it were not for the fact that the statute specifically provides that it shall be deductible under Section 23 (p) . . ." In other words, it has to meet the requirements of Section 23 (a) first and then be deducted under Section 23 (p) if it meets the requirements of that section also. Section 23 (p) continues further to say that if contributions are paid into a pension trust, the trust must meet certain requirements of Section 165; or if paid toward the purchase of retirement annuities, such purchase must be a part of a plan, which plan meets the requirements of Section 165. Therefore Sections 23 (p) and 165 must be considered hand in hand in formulating a plan for employee pensions.

Section 165 deals actually with the taxability of Employees' Trusts, but the provisions that make the trust itself not taxable under this section also make the employer's contributions to it deductible under Section 23 (p). Section 165 (a) (3) says that if the plan benefits either—"(A) 70 per centum or more of all the employees, or 80 per centum or more of all the employees who are eligible to benefit under the plan if 70 per centum or more of all the employees are eligible to benefit under the plan . . ." exclusive of certain minimums, or "(B) such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."; and Section 165 (a) (5) states that "A classification shall not be considered discriminatory within

the meaning of paragraph (3) (B) or (4) of this subsection merely because it excludes employees the whole of whose remuneration constitutes *wages* under Section 1426 (a) (1) relating to the Federal Insurance Contributions Act) . . ."

The percentage provision of Section 165 (a) (3) (A) is reasonable since a plan might otherwise require employee contributions of 25% or some amount which only a few could afford; and in such case only that few would benefit by the employer's contribution to meet what the employee was paying. But Section 165 (a) (3) (B) with its injection of the angle of old-age benefits under the Social Security Act, opens up an entirely new angle. Many authorities are frankly at a loss to understand how this section and its corresponding regulations operate.

Mimeograph 5539, issued by the Bureau of Internal Revenue on July 8, 1943, provides schedules by which a plan may be correlated and integrated with retirement benefits so that no employee under the plan shall receive a substantially larger total pension in proportion to his compensation than any employee excluded from the plan. These provisions are admittedly almost beyond comprehension.

The Federal Social Security Tax applies to only the first $3,000 income per annum, and benefits are figured on only this part of the income. Primary insurance benefits are figured by taking (a) 40% of the first $50 average monthly earnings over the entire period from about age 22 to age 65, plus (b) 10% of the balance of the average monthly earnings (limited to $200 as only the first $3,000, or $250 a month, is considered), with 1% of the total of (a) and (b) for each year in which earnings were as much as $200. In addition to primary insurance benefits, payable to a covered individual when he reaches age 65, there is an additional 50% of the primary benefits added if the recipient has a wife over age 65. Mimeograph 5539 therefore, in setting up the benefits which the employer might provide to supplement the Federal benefits for income over $3,000 a year, figured the Federal pension at 150% of the primary benefits.

This puts an entirely different light on any plan which serves only to supplement the Federal benefits. According to the law, if the plan meets the regulations it is not discriminatory; but there are so many contingencies to Federal benefits that it is difficult to see how a plan can be actually correlated with it.

First and foremost, what percentage of the employees today will be paid Federal benefits on the basis now in force? The law has been in effect since January 1, 1937, and there has been one major change already in the computation of benefits. There will certainly be other changes if for no other resaon than to meet changing economic conditions.

In the second place, since old-age benefits are figured on *average* earnings, a long period of unemployment for sickness or any other reason, or retirement at an earlier age, reduces the average and cuts down benefits correspondingly. Employer's plans must, of course, provide for a minimum period of service and such, but it seems that there is a possibility that the old-age benefits will fluctuate far more than is provided for in Mim. 5539. And while the percentage of benefits is higher on the lower average earnings, at the same time an individual might be earning $200 a month now but would average only $100 over the entire lifetime.

Third, there is the relationship of employee contributions. While it is recognized that there is no actuarial connection between the Federal old-age benefits and the tax that is collected presumably, though not specifically, to pay for these benefits, still, however unsound the basis and however much the subsidy from general taxes, the fact remains that the employer is paying only half the bill and the employee is paying the other half. According to Mim. 5539 the *employer* is allowed to provide all the benefits for compensation not covered by the Federal pension as long as he keeps these benefits in line with 150% of the benefits for less than $3,000; and if the employee is to contribute also, slightly higher benefits may be provided.

Many businesses sincerely want a fair plan, a plan that they can put squarely before all of their employees and their stockholders. There are many advantages to a qualified plan.

1. The fund that may be set up is exempt from income tax on its investments;

2. The employee is not taxed on the employer's contribution;

3. Payments are not considered salaries to employees under the rules of the Salary Stabilization Act; and

4. The employer's contribution is an allowable expense.

If the plan under which the employer's contributions are made does not qualify under Section 165, the employer may deduct such con-

tributions only if the employees' rights are non-forfeitable. When contributions are made for benefits that are immediately and irrevocably vested in the employee but the plan under which the contributions are made does not meet the requirements of the Regulations, then the employee is liable for tax on this income just as for any other remuneration for services. If, however, contributions are made under a plan that does not qualify and the benefits are forfeitable by the employee, then the contribution can not be taxed to the employee and therefore the employer loses his right to take it as an expense.

For plans that do qualify, contributions allowable as expenses for the employer are fairly liberal for provision is made to take care of past service credits as well as current credits. A corporation is allowed to build up past service credits for its employees and take a maximum of 10% of the cost per year over a period of years. The employer can use this to his advantage now during the period of high taxes as he can start building up past service credits now and as his employees leave due to turnover in subsequent years the amounts to their credit will apply to reduce current cost to the employer. Current contributions are limited to percentages of total salary, but the limitation here is not as stringent as in Canada. There the limit is not only 5% of the total but it is $300 for any one individual, so that a low salaried employee can not absorb the income from a high salaried employee.

In all discussions of Employee Pensions, regardless of the angle that is being spotlighted, however, there is always the Commissioner and his final approval to be met. No matter how far in the background he may be pushed, he is never out of the picture for the plan must finally receive his OK. To date there have been comparatively few plans that have been through the Commissioner's hands. Other employers however have these plans that have been approved for study and have standard plans prepared by authorities that will probably be approved. Finally they have the Field Agents themselves with whom they may discuss the various features which they wish to include in their individual plan. In view of this, it seems reasonable to say that if an employer sincerely wants a pension plan *for his employees* he can formulate such a plan that will meet the approval of the Commissioner. If he wants to get something for nothing out of Sections 23 (p) and 165, he has plenty to work with. As for his results, it will remain for time to tell.

Robert Browning is accused of being obscure, but he probably never uttered words that hold more uncertainty now than that beautiful line, "*Grow old along with me, the best is yet to be . . .*"

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