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AN INTRODUCTION TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Pension and profit-sharing plans have become a major factor in today's economy—both as they relate to the individual employee and to the employer. The author describes the ground rules necessary for such plans to qualify as tax-deductible expenses.

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Nearly every person has some contact with pension and profit-sharing plans—either as a participant in one or as a financial adviser to clients who have them. This discussion is limited to qualified plans because most plans fall into this category.

Definition of "Qualified"

"Qualified" applied to a plan means that the plan has complied with Section 401 of the Internal Revenue Code. Once qualified, the contribution by the employer is a deductible expense in determining his taxable income, within the limitations of the Internal Revenue Code. Equally important, the employee has no tax liability for the contributions by the employer and the earnings on those contributions until he actually receives them or until such contributions and earnings or the benefits derived therefrom are made available to him.

Funding Requirements

Years ago, many employers who even considered paying pensions would pay them on a "pay-as-you-go" basis; that is, when an employee retired, his employer would look for the funds to pay a pension. Today, employers who provide a pension system for their employees set aside money for this purpose during all or part of the employee's working years. This spreads the costs over a greater period of time and tends to match the pension cost with the employee's productivity. Further, the company can be reasonably sure of having enough money to pay the contemplated pension by the time the employee retires. These contributions are paid to a trust, to a custodial account, to an insurance company, or to any two or more when a combination of methods is used or United States Retirement Bonds are purchased. Setting aside money beyond the employer's control in a *separate* fund makes the plan a funded one—the first requirement of any qualified pension or profit-sharing plan. "Beyond the employer's control" is the second major requirement. The employer must not be able to recoup the funds contributed to the plan. It is acceptable, however, for a plan to provide that an employee, who is in debt to his employer at the time he leaves, will have his receipts from the plan reduced by the amount of the debt. This provision, to be applicable, must be written into the plan.

Knowledge of Plan

All plans must be written and communicated to the employees, either in full or in summary form. A complete copy of the plan must be available for inspection. It is important for the participants to be aware of their rights under the plan and to know when their rights have been violated or infringed.

Deferred Compensation

A basic characteristic of any qualified plan is that it must be one of deferred compensation. In other words, the benefit payments

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must be a reasonable payment for services rendered by an employee. Further, payments to the employee from the plan must be deferred until the employee leaves the company or, in a profit-sharing plan, until a stated number of years have elapsed.

Employee Contributions

Contributions to a plan may be made by the employees as well as by the employer. Employees may even be required to contribute a certain percentage of their pay in order to participate in the plan or they may have the option of contributing. In either case, their funds accumulate together with the employer's funds without taxation on earnings until the time of distribution. Any required contribution must not operate so that the plan discriminates in favor of officers, shareholders, supervisors, or other highly paid employees.

Employees Covered

All bona fide employees may be included in the employer's qualified plan. Partners, however, cannot be included with common law employees in a plan, except in special plans for self-employed individuals. Neither can a partner or proprietor be given credit for service for eligibility or benefits prior to the time he qualified as a common law employee. Shareholders who are bona fide employees may participate to the same extent as other employees as long as the plan is not geared in favor of shareholder-employees in meeting eligibility requirements or in obtaining benefits. An attorney, accountant, or other professional person may be a common law employee and also be self-employed from a part-time practice. He may still participate in a plan as a common law employee.

Eligibility Requirements

Plans may qualify which limit participation to employees who are in a specific age group, have been employed a certain number of years, work in a designated department, or meet other requirements provided the effect is not to discriminate in favor of officers, shareholders, supervisors, or other highly paid employees. A plan may have eligibility requirements for future employees that differ from those for present employees. For example, the requirements for participation by future employees may be five years of service and attainment of age 25, but for present employees only one year of service and no minimum age. Such a dual eligibility provision is acceptable as long as the officers, shareholders, supervisors, and highly paid employees are able to meet the more stringent requirements of five years of service and age 25. Plans may have other eligibility provisions such as a minimum wage. A plan may exclude employees who earn less than a certain amount, or it may provide reduced benefits for these employees and still qualify if the benefits under the plan integrate with those provided under social security or similar programs. To integrate, a plan builds its benefits on top of those provided by social security instead of in addition to those benefits. Minimum compensation may be at any level not in excess of the maximum compensation recognized for social security, i.e., $7,800 at present, unless the benefit rate is appropriately reduced for higher amounts.

Differences Between Pension and Profit-sharing Plans

Comments up to now have applied equally to pension and to profit-sharing plans. The names "retirement plan," "savings plan," and "thrift plan" can denote either type. A look at the plan's requirement for employer contributions will quickly reveal the type it is. A contribution formula in any way dependent on profits is part of a profit-sharing plan. The reference to profits may be the requirement that either a certain percentage of profits as defined by the plan (such as 10%) or a stated dollar amount ($10,000 out of profits or 5% of compensation paid out of profits) be contributed. The plan may provide for contributions out of profits to be determined annually by the board of directors. No contribution is required in any year the employer has no profits as defined by the plan.

A pension plan in order to provide a definite benefit requires a contribution without regard to profits. Benefits in a pension plan are frequently stated either as a percentage of compensation (30%) or a percentage of compensation for each year the employee is with the company (1% per year of service). Another alternative is for the employer, for each year the employee is in the plan, to put a certain percentage of pay (5%) to accumulate towards retirement.

A profit-sharing plan has no stated benefits, since contributions fluctuate with profits. Instead, it provides a definite formula for allocating contributions among the plan participants. An allocation formula may provide varying benefits by taking into consideration years of service (1 point per $100 of compensation plus 1 point per year of service). Variations in contributions or benefits are acceptable as long as the plan does not discriminate in favor of officers, shareholders, supervisors, or highly paid employees.

Benefits Other than Retirement Benefits

A qualified pension plan may provide for payment of incidental death benefits through insurance or otherwise and for medical benefits for retired employees and their spouses. It may not, however, provide for benefits which are not customarily included in a pension plan, such as benefits on layoff, sickness, accident, hospitalization, or medical benefits for active employees. It may also provide for the payment of benefits upon an employee separation or on his death. On the other hand, a profit-sharing plan may provide life, accident, and health insurance and call for commencement of distributions in the event of layoff.

Benefits Before Retirement

A qualified pension plan may, under certain circumstances, permit an employee to withdraw his own voluntary contributions while still employed. Withdrawal of employer contributions before termination of employment is not permitted in a pension plan. It is acceptable for a profit-sharing plan to provide for distributions to employees in the event of hardship or financial distress. This type of distribution may include not only employee contributions but also employer contributions plus increments. The amount an employee is entitled to receive on termination of employment depends on the various vesting provisions contained in the plan. The amount vested in an employee is the portion of his account that he would be entitled to receive if he quit at any particular time, based on his years of employment or years of participation. The provisions range from complete and immediate vesting on entering the plan, through graduated vesting based on years of service or years of participation (such as 10% for each year of participation), to no vesting until normal retirement. The latter is a characteristic of pension plans rather than profit-sharing plans. Plans may provide that vesting be ignored in the event an employee is discharged for cause (such as dishonesty) or, after he has terminated employment, enters into competition with the employer. Full vesting is required when employer contributions are completely discontinued and when the plan is terminated. Many plans provide an optional retirement age prior to normal retirement either with or without the employer's consent, but usually with reduced benefits. A plan may also provide for participation of employees who remain in service after normal retirement age, as long as such provisions apply in a nondiscriminatory manner.

Forfeitures

What happens to amounts to which an employee is not entitled when he quits? These amounts, called forfeitures, will be used to reduce subsequent employer contributions if the plan is a pension plan. If it is a profit-sharing plan, forfeitures may either reduce employer contributions or be allocated to the remaining participants in a nondiscriminatory manner.

Conclusion

The above discussion has considered various characteristics of qualified pension and profit sharing plans: some characteristics which *must be* found in a plan and others which *may be* included. Whatever provisions *are* included in a plan govern that plan's operation. Other features which are important to employers in establishing a plan, and to their employees as participants of those plans, go beyond the scope of this introduction. Readers interested in these provisions, or in more technical explanations of the terms discussed, may wish to obtain a copy of **Pension Trust Procedures and Guides for Qualification,** IRS Publication No. 377, available from the Superintendent of Documents, Washington, D. C., for a nominal charge.

ANNUAL MEETING
AMERICAN SOCIETY OF WOMEN ACCOUNTANTS

In accordance with Article XI, Section 1, of the National Bylaws of the American Society of Women Accountants, notice is hereby provided that the 30th Annual Meeting of the Society will be held in conjunction with that of the American Woman's Society of Certified Public Accountants at the New York Hilton Hotel, New York, New York, September 16-19, 1970. The Annual Business Meeting of the American Society of Women Accountants has been called for 9:00 AM, Friday, September 18, 1970.

Elenore M. Kuberske
National Secretary, 1969-1970