Pensions (1948)

Executives need *Pensions* too!

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DEC 6 1950

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If you would like to have suggestions for a sample pension plan and a general idea of its cost, we will be glad to furnish this information without obligation on your part.

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Executives need Pensions too!

THERE ARE AT LEAST FIVE REASONS why it is difficult for a salaried executive to build up an adequate retirement income:

First: Current income tax rates take a large proportion of earnings.

Second: Today's high cost of living makes it almost impossible to save money.

Third: The return on investments is at a low level, so that invested savings accumulate far less rapidly.

Fourth: This small investment yield is further reduced by income tax.

Fifth: The high cost of living after retirement requires a larger accumulation of funds than was formerly needed to maintain standards of living.

Because of these obstacles, many an executive who plans to retire in later years may find it impossible to do so without suffering a drastic reduction in income.

No executive wishes to retire on an income which covers only the bare necessities. A person who is retired finds it necessary to develop new interests to replace his business activities. He wants to develop new hobbies, to travel, and to do the many things that he has previously been too busy to enjoy. If his retirement income is too low to allow new pursuits, retirement from work will become retirement from active living.

Help Where Help Is Needed

What is the answer? If current economic conditions make it extremely difficult for a salaried man to accumulate capital by ordinary means, is there any arrangement that will make it easier for him to do so?

There is:

(1) An employer contributes to a retirement fund for his employee throughout the term of employment (and is entitled to income tax deductions on these contributions);

(2) the employee may not draw on the fund while he is still employed (and is not taxed for any of it until the fund becomes available to him);

(3) interest, dividends, and other income earned by the fund are exempt from tax.

This is a pension plan, established by the employer and approved by the Bureau of Internal Revenue.

Let's see just how much of a difference a pension plan of this nature can make in enabling an executive to retire in comfort.

Where There Is No Pension Plan

John Smith receives a salary of $20,000 a year. His employer raises it to $22,000. Smith decides to save the $2,000 increase for his retirement days.

First he has to pay about half of it to the tax collector as income tax. That leaves him with $1,000 per year. He invests this at 3% but has to pay about half the interest earned to the tax collector; so it is really invested at only 1½%.

Smith keeps this up for 20 years, then retires. How much will he have? *Answer:* $23,000 which, if invested in an annuity, would give him about $1,800 per year.

Where There Is a Pension Plan

William Jones likewise has a $20,000 salary. His employer doesn't give him a salary increase but does start putting $2,000 a year into a pension trust for him.

The trustee of the pension trust receives the $2,000 intact and invests it at the same rate, 3%. This 3%, however, is not reduced by income tax because the trust is not required to pay a tax.

Jones retires after 20 years. By that time the funds standing to his credit in the trust amount to $54,000, giving him an annuity of about $4,400 per year.

After-Retirement Taxes

It is true that Smith's $1,800-per-year annuity will be partly exempt from income tax, while Jones's $4,400 annuity will be fully taxed as he receives it. But, after retirement, Jones is likely to be in a relatively low surtax bracket. Should his annuity under the pension plan be his only taxable income, his annual Federal tax would be only $483, even if he were unmarried, had no dependents, and had no large deductions.

Lump-Sum Payments from Pension Plans

So, if Jones stays with the company until retirement, he is considerably "ahead of the game," thanks to the pension plan.

What happens if he dies or leaves before retirement? Suppose he dies ten years after the pension plan is started and, under the terms of this particular plan, the funds accumulated for his benefit are paid in a lump sum to his beneficiary. Or, suppose he resigns or is discharged after ten years and some or all of the funds accumulated for him are paid to him in a single sum.

In either of these cases will his or his beneficiary's

taxable income be pushed high into the upper brackets of the tax scale by the sudden and large payment?

The answer is "No." A special provision of the Federal tax law allows the lump-sum payment to be treated as "long-term capital gain," just as though it were gain from the sale of securities held more than six months. Thus, only half the payment would be taxed and, in any event, the tax on the full payment could not exceed 25%.

Pensions Are Not Just for the Little Fellow

Will the Bureau of Internal Revenue approve a pension plan that includes *executives and key personnel*, as well as the hourly workers and the salaried force?

With respect to this question, the Federal tax law is the basic guide. It says the tax privileges shall be granted only if —

> ". . . the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

That is far from saying that officers and other highly paid employees may not participate in a plan.

They certainly may participate and, in the great majority of existing pension plans, they do participate.

That which is prohibited—if the tax privileges are to be had—is the granting of special favors to the executive group.

Participation Without Discrimination

Generally speaking, the rule is liberal enough. Under it, the executive is not considered to be receiving any special favors merely because his pension is larger. His pension is arrived at by the same method of computation as is used in computing the pensions of all the other employees. The fact that it is larger is solely because his salary is larger.

For example, a plan may provide that each employee's pension is to be 1¼% of salary for each year of employment. Obviously, under this formula, the pension of the $16,000-per-year executive will be four times as great as that of the $4,000-per-year bookkeeper, assuming equal periods of employment. Such a plan may be perfectly acceptable to the Bureau.

Of course, if a pension plan were *only* for the executives—with no pensions available to the other employees—the plan clearly would be "discriminatory" and would not be approved by the Bureau of Internal Revenue. If it included all the highly paid personnel and barred some of the employees in the lower salary brackets, it might not be approved by the Bureau.

Discrimination or the absence of discrimination cannot be determined merely by taking into consideration which employees are included or excluded. Officers and executives *can* be included in a properly planned pension system and can receive generous retirement benefits from it.

Shareholders Can Get Pensions

In a small or closely held company the executives are likely to be stockholders. In many companies the active head of the business owns 100% of the stock.

The tax law itself—the Internal Revenue Code—has nothing to say about the participation of shareholders in a pension plan except to stipulate that they shall receive no special favors. The Bureau of Internal Revenue, however, has laid down this general rule:

> "A pension or profit-sharing plan shall not generally be considered to be for the benefit of shareholders if contributions which are required to provide benefits for employees, each of whom owns, directly or indirectly, more than 10% of the voting stock of the corporation, do not exceed, in the aggregate, 30% of the contributions for all participants under the plan. For the purpose of determining stock ownership an individual shall be considered as owning the stock owned by the spouse and minor lineal descendants of such individual."

In short, contributions for shareholders shouldn't be more than 30% of *all* contributions; but a person isn't considered a "shareholder" unless he owns or controls more than 10% of the voting stock.

This rule sometimes serves to cut down the pension benefits that normally could be paid to executives. Usually, however, substantial retirement incomes can be provided within the limits laid down by the Bureau.

The Executives Are Helped — And So Is the Business

If a pension system solves the retirement problem of the executives of a business, it is advantageous to the business itself.

It serves to attract "long-term" executives—those who are willing to tie their whole careers to the success or failure of the business. It assures retirement of the top executives at the proper age, thus opening up opportunities for promotion to those who are "just below the top." It puts the business on a current basis so far as obligations to its management are concerned.

Just as surely as executives need pensions, a business needs executives. A properly designed pension system helps it get and keep the best executives.

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