Pensions
(1965 folder)

For a Better Tomorrow

PRIVATE PENSION PLANS

CHAMBER OF COMMERCE
OF THE UNITED STATES
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CONTENTS

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FOREWORD

The contribution which private pension plans make, and can make, to Americans, as individuals, and to our national economic life, is not as fully understood as it should be.

More than 25 million persons, employed by American business and industry, are now covered by such plans. And additional millions will likely come under private pension plan coverage in the next decade.

Recent developments have posed a broad and important question:

Will these programs continue to be inspired, operated and improved by private enterprise—or will their potential be inhibited by federal intervention, and regulatory attempts to broaden coverage by laws and guidelines?

In this booklet, the National Chamber sets down some of the principles and methods by which private pension benefits can be developed and maintained *through voluntary action* by American employers and employees.

The last few years, as you perhaps know, have seen important strides forward in the preparation of basic plans, special packages, to serve the needs of smaller businessmen and their working associates. These plans have a ready adaptability to most situations.

The suggestions in these pages come out of the knowledge and practical experience of skilled pension plan specialists—experts in the field.

And so this booklet will, we hope, be useful to small and large firms, and individual businessmen, considering the establishment or expansion of pension programs.

There are many recognized advantages—to both employers and employees — in pension programs. This booklet spells them out, and offers them for your consideration.

For a better tomorrow, we suggest . . . *Private Employee Retirement Programs.*

ARCH N. BOOTH
Executive Vice President

I. Introduction: Popularity Unlimited

Retirement programs are highly desired by many career employees. They are a major item in the fringe benefit package in labor negotiations. They can provide a measure of financial security to older and disabled employees, the cost of which can be spread over the working life of an employee in a manner that is considered a sound accounting practice.

Most large and medium-size employers have programs in existence. Thousands of small employers have established and are funding deferred benefit plans. However, there are many small employers (those with employee groups of under 100 to 200) that have, for various reasons postponed or not even explored the establishment of a plan. Some of these may feel, incorrectly, that the installation costs of hiring an actuary or other consultant and a lawyer are "too high." A reasonable examination of the facts will soon convince an employer of the fallacy of such views.

There is growing public interest in broadening the coverage of private employee retirement programs. Several million American workers, still not covered by plans, are in types of employment that lend themselves to such coverage. It is a fact that among this number are many who, through individual choice or through collective bargaining processes, have elected not to participate in proferred or suggested programs and, in lieu, have accepted other or more direct forms of remuneration.

Nevertheless, it would seem an eventuality for the great majority of the work force to be covered under private programs within the next decade.

In exploring its particular circumstances, each company which does not now have a plan will be helping to discourage federal and state intervention in what has been and should continue to be a matter to be decided upon by employers for the best interests of their business and their employees.

II. Basic Types of Deferred Benefit Programs

The two main methods of providing cash payments to employees at or after retirement are through *pension plans* and *deferred profit sharing* plans. Each has certain basic characteristics.

Pension Plans

A pension plan can be described as one which provides an orderly flow of payments, usually monthly, to a retired person. The benefit payments are determinable in advance by a formula contained in the plan itself and usually are payable for the life of the pensioner. Frequently, such plans also provide for further payments to the spouse or other dependent of the pensioner.

The above definition is an oversimplification, since there are many variations, but the main characteristic of a pension plan is that of definiteness—either the ultimate benefits or the pattern of contribution to the plan are determinable in advance in accord with its terms.

Pension plan formulas are usually based on an employee's compensation and/or service with an employer. Credit may be given only for service in the future, that is after the date of installation of the plan (called current or future service benefits), but frequently credit is also given for service rendered prior to that date (called past service benefits). Thus a pension plan can, and often does, provide benefits measured by the total service of an employee.

The compensation base for such plans, if one is used, may be the average annual earnings of each covered employee. This would be called a "career earnings" plan. Or the base for the application of the benefit formula might be some form of "final average earnings," such as the average of the five years immediately prior to retirement.

The benefit formula applied to a compensation base is usually expressed in percentages, such as:

a) 1% of the final average earnings base, multiplied by years of credit service (both past and future service) or;

b) 1½% of annual future service earnings, plus 1% of the compensation base in effect at the date of the plan installation, multiplied by credited past service.

Inasmuch as pension plans are often designed to supplement Social Security benefits, the benefit formulas can also integrate with, or take into consideration, expected Social Security payments in whole or in part. This is done by reducing the pension plan benefits by direct offset or by lowering the plan formula in its application to that portion of an employee's earnings subject to Social Security taxes.

Another form of pension benefit formula is called the "flat benefit" type and is frequently found in plans covering hourly or production employees. A typical example might be:

> $2.00 (or $3.00 or $4.00 etc.) per month per year of credited service; i.e., $60.00 (or $90.00 or $120.00 etc.) per month for 30 years of credited service.

Under the flat benefit type of plan, there is usually no offset for Social Security payments.

In most pension plans, the "normal retirement age" is usually age 65 at which time the plan benefit becomes payable. However, additional provisions may be included to provide similar or reduced benefits at earlier retirement or upon disability. Many plans also provide for the accrual of a benefit—to be payable at age 65—for employees who terminate their services prior to normal retirement, but after having completed a designated period of service (such as 10, 15 or 20 years) and perhaps a specified age (such as 40, 45 or 50). This is called a "vested benefit."

Deferred Profit Sharing Plans

A deferred profit sharing plan is a formal arrangement under which an employer agrees to contribute a portion of his annual business profits to a fund created as part of the plan. The amount of this employer contribution may be in accordance with the application of a specified formula such as:

a) 10% of net earnings (before taxes);

b) 10% of net earnings (before taxes) in excess of $100,000;

c) 10% of net earnings (before taxes) in excess of $100,000 provided that there shall remain after taxes net earnings at least equal to X dollars per share of common stock.

Under certain circumstances it is even possible to leave the amount to be contributed solely to the discretion of the employer; in other words, no specific formula is required under present Federal laws and Internal Revenue Service regulations. However, the application of such discretion must be made with care and free of what the Internal Revenue Service might consider discriminatory practices.

Under a profit sharing plan, the amounts contributed by the employer are allocated among the covered employees to bookkeeping accounts maintained in their names under the plan. This is usually done on a basis that is pro rata to their respective compensations during each year. However, under certain circumstances, it is possible to provide some other form of allocation such as an additional weighting for years of service.

The funds contributed are placed in the selected funding medium, usually a trust fund, and these are invested and administered as a unit. The scope of the permissible investment program is usually spelled out in the trust agreement accompanying the plan. The investment income and gains or losses from the sale of securities or other investments in the fund are allocated to the accounts of the employee participants.

Employer contributions are tax deductible by the employer, but the amounts set aside for the employees (together with any income and investment profits) are not taxable to the employees (or their beneficiaries) until actually distributable to them under the terms of the plan.

Distributions are made upon an employee's retirement (normal or early) and also in the event of death, disability or other termination of employment. To take care of the latter event, a vesting schedule is set forth in the plan which specifies the portion of an employee's account which is payable to him upon termination of employment—usually based on the length of his service or plan participation.

Distribution can take the form of 1) lump sum payments (under appropriate conditions these may be subject to Federal tax as capital gains); 2) installments over a period of years and 3) purchase of an annuity contract from a life insurance company.

III. Flexibility in Design

There are many variations of both types of plans available in designing a deferred benefit program to suit the needs of an employer and his employees as well as his capabilities to provide the funds.

For the employer of modest means, or whose short term profit projection is uncertain, pension plans can be developed to provide modest retirement benefits with little in the way of such additional benefits as early retirement, vesting, disability benefits, etc. As his circumstances permit, the employer can liberalize the plan by amendment to increase benefits and add these other provisions. Within the ranges permitted by the Internal Revenue Code and Regulations, the employer may limit the group covered by the plan to older and more senior employees (such as those over the age of 30 or 35) or to those who earn more than the wage level covered by Social Security.

Employee contributions may also be provided for as a means of defraying employer costs or of increasing benefits. Such contributions may be made a requirement of participation or may be permitted as employee options to increase benefits.

IV. Advantages of Formal Methods

There are many advantages to developing and maintaining a formal and funded method of providing for superannuated employees as compared with informal or "out-of-pocket" methods.

From the employer's standpoint, the advantages are:

1) It provides an orderly and dignified method of pensioning elderly employees from active service thereby making room for younger employees and maintaining open avenues of promotion.

2) If an employer accepts the philosophy that he has some responsibility to provide a form of retirement benefit to his employees, it is a sound accounting principle to recognize the accruing future financial requirements by formally setting aside funds from current earnings to meet these contingencies.

3) Within the limits prescribed by the Internal Revenue Code, the employer may take a current deduction for Federal Income Tax purposes of the amounts contributed to a formal program.

4) The creation of a formal funding arrangement relieves the employer of additional financial hardship in meeting pension needs of retired employees during times of poor business conditions.

5) The employer can, within certain Internal Revenue Code limitations, accelerate contributions during

good business years and reduce contributions during poorer years without affecting the steady flow of payments to current pensioners.

6) The funds set aside by the employer under a program approved by the Internal Revenue Service accumulate and grow through investment in earning assets. Income and investment profits are exempt from Federal Income Tax under present laws.

There are advantages to the employee also:

1) A formal funded program furnishes the employee's pension expectations with an additional measure of financial security beyond the continued existence of his employer.

2) The amounts set aside to fund the program are not currently taxable to the covered employees. Certain lump sum distributions may be accorded capital gains treatment. However, the usual pension plan provides for periodic payments, for the life of the pensioner and such payments are taxable as ordinary income. The probability that his taxable income will be lower than during his active working life, plus the additional exemptions accorded persons over age 65, will generally result in the average pensioned employee paying a relatively lower rate of income tax than when he was actively working.

3) The presence of a formal program assists an employee to plan his financial future, even requires him to do so, taking into consideration the certainty of his retirement date, his expected income from Social Security and other sources including his own savings and other supplemental programs which the employer may provide.

V. Methods of Funding

In order to fund a formal retirement program properly, and to be eligible for the tax treatment referred to above, the contributions of the employer (and of the employees, if any) must be physically set aside from the assets of the employer. The two main methods of doing this are through the use of a trust fund or through a contract arrangement with a life insurance company or through a combination of both.

Trust Fund

A trust is created by the employer, as part of the plan, to receive the contributions, usually determined by actuarial computations in the case of a pension plan, or which are based on company profits and the plan formula in the case of a profit sharing plan. The assets are invested and reinvested by the trustee and are used to provide the benefits as they become payable.

The trustee is usually a bank or trust company but individuals may also serve in this fiduciary capacity. Trustees are held to a strict code of conduct in discharging their fiduciary duties, must use prudence in investing and care in safeguarding the assets, and are held financially responsible for their actions.

A trustee must operate within the bounds of Federal and State laws and is guided by precedents established by judicial decisions and opinions. In addition, banks are supervised by regulatory agencies such as State Banking Superintendents, the Federal Reserve System, the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

Contracts of Life Insurance Companies

Various forms of contract arrangements are available through life insurance companies to provide for the funding of employee benefit plans. These range from arrangements utilizing individual policies—usually for smaller employee groups—to group annuity policies and deposit administration contracts for larger employee groups.

Contributions made to such contracts under an employee benefit plan are usually invested with all other assets of the life insurance company and represent a general claim against the life insurance company's assets. These assets are invested in accordance with applicable state laws. The contracts participate in the earnings on the basis set forth in the contracts. These contracts impose certain contractual obligations on the life insurance company to provide annuities payable for life.

Life insurance companies are regulated by the states where they are authorized to do business. They must conform to state insurance laws and regulations and, generally, to many of the same Federal and State laws affecting employee benefit programs as are applicable to trust funds.

In deciding on a funding method that is best suited to a particular situation it would be advisable for the employer to discuss the possible use of each of the broad methods with experienced representatives of a bank or trust company and of a life insurance company which specialize in providing the required services.

VI. Development of a Program

Although the basic provisions of a pension or profit sharing plan are a reflection of company policy, the actual development of a plan and the installation of the funding process are not a "do-it-yourself" program. There are a number of technical aspects to be considered and decided upon and these are most efficiently handled under the supervision and guidance of technicians experienced in their respective fields.

It is highly recommended that appropriate use be made of an employee benefit plan consultant or consulting actuary or other qualified experts to develop the broad concepts of a program designed to best serve the employer's needs as well as to determine the probable future costs of the program. The legal, tax and financial aspects of the proposed program should be reviewed by the employer's legal counsel and accountant.

The funding program is also subject to discussion and advice of all of these parties as well as with the representatives of the selected funding agency as mentioned previously. These latter organizations often can be helpful in initial discussion to determine the feasibility of installing a program and in identifying available consulting and advisory services.

This is not to imply that the formation of a program is too technical for laymen to understand. However, since a program will directly affect personnel policy and the employer's financial structure, as well as legal and tax considerations, it is important that the initiation of a program be made subject to sound advice. The costs of installation can be discussed with these various parties in advance of any work to be done.

VII. In General

A deferred employee benefit program should not be entered into lightly. It has many advantages and the problem of personnel policy in regard to older employees is an eventuality that all employers must face at some time. Ability to provide for the financing of the program should be carefully considered in order to protect to the greatest extent possible the reasonable benefit expectations of the covered employees.

Experience of successful programs is that the sound and careful approach to plan development and funding has its own rewards in good acceptance by employees. It is better to start off with a modest program, if there is going to be any doubt of financial ability to provide for a more extensive one. Improvements can be added from time to time—and will be well received—but cut-backs have a deleterious effect on employee relations.

Proper administration and effective communication with the employee participants are sound adjuncts of any program that may be installed. The costs of a program are such that the additional expenditure of a small amount of effort and money to fully acquaint the employees with coverage and benefit provisions of the plan is well worth while. It is also important that such communications make the employees fully aware that the ultimate success of the program depends upon the successful continuance of the company's business and its ability to meet its costs.

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