San Fernando Valley State College

TAX ASPECTS OF INDIRECT COMPENSATION
(Pension-Profit-Sharing and Stock Option Plans)

A thesis submitted in partial satisfaction of the requirements for the degree of Master of Science in Business
by
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ABSTRACT

TAX ASPECTS OF INDIRECT COMPENSATION
(Pension) Profit-Sharing and Stock Option Plans

by

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Although the development of Indirect Compensation Plans (Pension) Profit-Sharing and Stock Options has largely been the result of business and labor initiative, public policy in the form of favored tax treatment has encouraged the establishment and expansion of such plans. The prevailing tax provisions make it possible to provide such plans at a substantially lower cost than that which would result if no special tax provisions were available. The loss of revenue to the Federal Government as a result of this special tax treatment is estimated to be more than one billion annually.

In the past two decades tax considerations contributed strongly to the growth of indirect deferred compensation plans. This is due to a great extent to sharp increases in corporate tax rates which add financial incentive toward the establishment of such plans. Economic and social developments that have characterized the
past twenty years, combined with the individual employee's sophisticated attitude towards income tax and its resultant tax benefits, have greatly contributed to the expansion of such plans. In this thesis, an attempt is made to ascertain whether provisions of the Federal Internal Revenue Code have encouraged the creation and expansion of indirect compensation plans in the United States.
CHAPTER I

INTRODUCTION

The Problem

Scarcely a responsible job exists in the United States today which does not carry with it some kind of indirect compensation or benefit over and above the direct pay.¹

A few decades ago, a typical employee drew all of his pay in cash at the end of the pay period. Now an employee receives his compensation in a variety of forms—the money wage or earnings and fringe benefits, such as pension plans, profit sharing plans, stock options, group insurance, expense accounts and other work connected advantages.² The change in type or methods of compensation appears to be the consequence of modern industrialization.³ This is due primarily to the economic and social developments that have


²Ibid.

characterized the past several decades. Certain plans in particular, however, such as Pension, Profit-Sharing and Stock Options (with which this thesis will be mainly concerned) appear to be the result of the favorable treatment afforded by the Federal Internal Revenue Code under which the employee receives substantial tax advantages. The business firm (employer) also benefits from subject provisions of the code in several forms: such as 

1. higher morale of its key employees; 
2. added incentives to employees to be a "part" of the company by sharing in its profits; 
3. advancing the marketability and valuation of its capital stock (stock options), and 
4. availability of cash for immediate use instead of direct payments of compensation. 

Overall, an attempt will be made to test the premise that some of the basic motives for such indirect compensation or non-money wage in the United States today are the tax advantages afforded by the provisions of the 1954 Internal Revenue Code as amended.

Hypothesis

THE PROVISIONS OF THE FEDERAL INTERNAL REVENUE CODE PROVIDE INCENTIVES TO INDUSTRY FOR ESTABLISHMENT AND ENLARGEMENT OF FRINGE BENEFITS IN THE FORM OF NON-PAYCHECK COMPENSATION.
Definitions

Provisions.--Articles or clauses in any statute, contract et cetera . . . by which a condition is introduced.

Internal Revenue Code.--A systematic body of law, especially one given statutory force--in this case in connection with the collection, administration, enforcement of Revenue Laws in the United States and its areas of jurisdiction outside the continental limits of the United States.

Incentives.--Motivation Technique. Incites an individual to do a certain task.

Deferred Fringe Benefits.--Benefits bestowed upon employees in addition to the express or implied money or paycheck compensation which will accrue to employee after separation from employer.

Compensation for Time Not Worked.--Compensation or benefits furnished in any form such as sick leave, vacations, workmen's compensation and paid holidays.

Importance of the Study

The government's anti-inflation and corporate income taxation programs during World War II encouraged some redistribution of compensation so that more of labor's income was diverted to nonwage items. Needing to preserve the general income stabilization program, the government encouraged the development of company benefit
plans and discouraged increases in the money wage. Because much of the employer's cost of the benefit program was deductible for income taxation purposes as a necessary business expense, companies had an incentive to install the indirect income benefits. The continuation of high corporate income taxation in the postwar period has tended to perpetuate this development.

As long as the benefit expenditures constitute business expenses and, therefore, are deductible for tax purposes, there appears to be no material monetary difference to the employer whether workers are compensated in wage and non-wage items or whether labor costs are expended in some different way. This reasoning is based on the premise that establishment of a deferred compensation plan is costly in terms of additional personnel to administer such plan and such items as brokerage and trust fees. However, such expenses are usually offset by the savings of deductible payroll taxes on regular wage compensation.

The tax implications are also of considerable importance to the worker. Personal income taxes at the outset reduce the amount of earnings that can be spent for purchasing various kinds of individual insurance or saved to meet the various contingencies that arise. What protection employees purchase and what savings they

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make must be done with "after-tax" dollars. Moreover, the purchase of different kinds of protection on an individual basis not only costs more than group insurance but also generally provides fewer benefits than group plans. It appears that most companies today approach the complex subject of compensating their employees on a case-by-case basis with no apparent guiding principles or overall policies ever being formulated. The purpose of this thesis is to call attention to the importance of "Chronology" in the compensation of employees and to point out the advantages afforded both to the company and to its employees in proper and efficient tax planning as permitted by the Code, Regulations, Revenue Rulings and case law.

Essentially, there is no substitute for adequate current compensation under whatever guidelines are used by management. Any company which is considering a pension and/or profit sharing plan must examine its compensation policies and principles to determine whether or not a realignment of such policies is in order before it embarks on a pension, profit-sharing or other deferred compensation program. of the type discussed in this thesis. It is possible to have payments from a profit-sharing plan paid out on a current basis. This is accomplished by paying the prorata share of the net
profits on a monthly or quarterly basis in accordance with the provisions of the plan. However, such payments are mere extensions of the regular current cash wages or compensation. Further, such current payments would not meet the requirements of the Internal Revenue Code and consequently would not enjoy tax advantages similar to the qualified plans discussed in this thesis.

By analyzing and interpreting the technical tax aspects of such plans, this thesis will attempt to support the idea that improved use of pension, profit-sharing and deferred compensation plans can be made by management to further its financial goals and objectives in the vital area of compensation.

The use of such "fringe" benefits may give rise to greater employee productivity because of the peace of mind generated on the part of the employee. The cost to the company could provide more working capital and, with proper planning, reduce its total wage outlay by reducing employee turnover training costs. With adequate planning and tailoring to the facts and circumstances, the cost to the contributing company can be more than offset by the tax savings. Today's tax rates, competitive and economic business conditions, and the eroding effect of inflation have a direct bearing on any decisions that might be made in formulating adequate deferred
compensation plans.

Organization of the Study

As a basis for this study, an attempt will be made to analyze and interpret the various technical provisions of the Internal Revenue Code, Congressional Committee Reports (House and Senate) as they pertain to the tax relief offered to industry and individual employees who avail themselves of the advantages of the various qualified and unqualified pension and profit-sharing plans, stock-option and stock-purchase-option plans. As far as the committee reports are concerned, the main emphasis will be on the reasoning or rationale of the committee in its recommendations which have ultimately become law. Further, various technical and general publications dealing with the subject of indirect compensation, both governmental and private, will be closely scrutinized in order to check the hypothesis.

Source of Data

The main source of data for this thesis are the provisions of Sections 401 through 404 and 501 of the 1954 Internal Revenue Code as far as Pension and Profit-Sharing Plans are concerned; and Sections 421 through 424 of the Code in connection with Stock Options. The code
sections are supported by U.S. Treasury Regulations, U.S. Treasury Revenue Rulings, case law and the interpretations of the above mentioned provisions by the commercial publications services of Prentice-Hall, Commerce Clearing House and Merten's. In addition, various technical and professional publications, such as the monthly magazines *Taxes*, *Journal of Taxation* and *Journal of Accountancy*, have been explored in order to support the hypothesis. Cognizance should be taken of the fact that the source data mentioned here are not all inclusive. Additional data from numerous other publications in the form of articles in professional accounting and taxation journals and monograms have been scrutinized and studied in preparation of the writing of this thesis. Detailed source data appear in the bibliography.
CHAPTER II

QUALIFIED PENSION--PROFIT-SHARING PLANS

1954 INTERNAL REVENUE CODE PROVISIONS

In this chapter, the detail provisions of the Internal Revenue Code will be analyzed as they pertain to qualified Pension and Profit-Sharing plans. Further, the plans will be contrasted as to their utility to the employer and employee. An attempt will be made to prove that the advantages to the employer and employee will outweigh the disadvantages. This is particularly true as far as the employee is concerned.

Sections 401 through 405 of the 1954 Internal Revenue Code relate to pension, profit-sharing, stock bonus, annuity plans and compensation paid under a deferred payment plan. Code Section 401, is primarily directed at funded pension and profit-sharing plans, that is, those plans in which contributions by employers, employees or both are set aside in a separate fund held by a third party and invested. The Code section lays down qualification rules which, if met by the plans, will result in special tax benefits, such as, tax-free
accumulation of earnings on a plan's investment funds, deduction of employer contributions, and favorable tax treatment of fund distributions to the employees and their beneficiaries.

Code Section 402 governs the taxability of an employee beneficiary under either qualified or non-qualified employees' trusts. Code Section 403 treats the taxation of beneficiaries under both qualified and non-qualified plans. Code Section 404 lays down the rules for the deductibility of employer contributions. Code Section 405 governs the deduction of employer contributions and the taxation of beneficiaries under such plans.

**Major Requirements**

A qualified pension and/or profit-sharing plan must meet these requirements for formal qualification under the provisions of the 1954 Internal Revenue Code.

1. There must be a program.
2. It must be definite.
3. It must be written.
4. It must be communicated to the employees.
5. It must be solely designed and applied to enable the employees or their beneficiaries to share in the capital or profits of the trade or business or to provide for the livelihood of such employees or their beneficiaries after retirement.
Further, such plan must benefit:

a. Either 70 per cent of all employees (excluding new, part-time and seasonal employees),

b. or 80 per cent of all eligible employees (excluding new, part-time and seasonal employees) if 70 per cent of all employees are eligible,

c. or, such employees as qualify under a classification found by the Commissioner not to discriminate in favor of officers, shareholders, supervisory or highly compensated employees.1

The contributions or benefits under the plan must not discriminate in favor of officers, stockholders, supervisory or highly compensated employees. Each plan must provide that, upon termination or upon complete discontinuance of contributions, each employee under the plan will have an immediate vested right to benefits then accrued and funded. If a pension plan, this plan must provide that forfeiture must not be applied to increase the benefits any employee would otherwise receive under the plan.

Profit-Sharing Plans

A profit-sharing plan under Section 401 is a plan which is established and maintained to enable

1U.S. Internal Revenue Service Regulations, Section 1-401-1 (a) and (b).
employees or their beneficiaries to participate in the
profits of the employer's trade or business, pursuant
to a definite formula for allocating the contributions
and for distributing the funds accumulated under the
plan. Distribution must be provided after a fixed
number of years, the attainment of a stated age, or
upon the occurrence of some event such as layoff, illness,
disability, retirement, death or severance of employment.
A formula for allocating the contributions among all
the participants is definite if, for example, it provides
for an allocation in proportion to the basic compensation
of each participant.  

The regulations under the 1939 Code, prior to
retroactive amendment in 1956, required also that a
profit-sharing plan be based on "a definite and pre-
determined formula for determining the profits to be
shared." This restriction was held invalid by several
courts. In the leading case, it was held that a lump
sum contribution out of profits could constitute the
corpus of an exempt profit-sharing trust, even though
there was no "formula" related to the corporation's
profits and no provision for any future contributions.  

2 U.S. Internal Revenue Service Regulations,
Section 1-401-1 (a) and (b).

Lincoln Electric Co., 190 E2d 236 Court of
Appeals-6, 1951.
The regulations state that merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing, and they require that there be recurring and substantial contributions out of profits for the employees. However, discontinuance of contributions will not affect the qualifications of a profit-sharing plan if there is provision for granting fully vested rights.

Although the regulations no longer require a definite and predetermined formula for determining the profits to be shared, they do contain two other requirements, (1) a definite predetermined formula for distributing funds which are accumulated after a fixed number of years (not less than two) on the attainment of a stated age, and (2) the happening of a particular event. However, in order to take advantage of the special grace period for accrual basis taxpayers, an employer must, during the taxable year, incur a liability to make the contribution.

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4 U.S. Internal Revenue Service Regulations, Section 1-401-1 (b) (2).


6 Ibid.

7 U.S. Internal Revenue Service Regulations, Section 1-404 (a)-1(c).
A profit-sharing plan is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance. The Revenue Service does not permit an unlimited use of profit-sharing funds for life insurance premiums, but it does permit such use to the extent of an amount which, when added to the total contributions and forfeitures previously allocated to the purchase of ordinary life insurance for the participant, is less than one-half of the total contributions and forfeitures allocated to the employee's account. If no part of the life insurance element continues after retirement, such element prior to retirement is considered to be incidental to the primary purpose of the plan. The purchase by a trust established under an employee's profit-sharing plan of incidental amounts of life, accident or health insurance for the benefit of an employee or his family, with funds allocated to his account that have not been accumulated for the period

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8 Ibid.
10 U.S. Internal Revenue Service, Revenue Ruling 60-83.
prescribed by the plan for the deferment of distributions, will not prevent qualification of the plan.\textsuperscript{11}

A plan which provides for supplemental unemployment insurance benefits may qualify (Special Ruling, 12-29-55), as may a profit-sharing plan (but not a pension plan) which permits participants to withdraw funds in times of financial needs.\textsuperscript{12} An employee may elect each year to participate in the trust or to take his entire share in cash.\textsuperscript{13}

A plan may qualify which provides cash payments to some employees and deferred payments to other employees if it satisfies the other conditions of Section 401.\textsuperscript{14}

\textbf{Pension Plans}

A pension plan within the meaning of Section 401 (a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement.

\textsuperscript{11}\textbf{U.S. Internal Revenue Service, Revenue Ruling} 61-164.

\textsuperscript{12}\textbf{U.S. Internal Revenue Service, Revenue Ruling} 56-693.

\textsuperscript{13}\textbf{U.S. Internal Revenue Service, Revenue Ruling} 61-157, Part 2(p).

\textsuperscript{14}\textbf{U.S. Internal Revenue Service, Revenue Ruling} 61-157, Part 4 (c).
Neither the benefits nor the contributions are determined by reference to profits. Benefits are generally measured by years of service and compensation. Contributions are based on the cost of the benefits.

On the ground that benefits would not otherwise be "definitely determinable," the regulations require that any pension trust funds arising from forfeitures on termination of services be used to reduce future contributions by the employer, and not to provide increased benefits for the remaining participants.\(^\text{15}\)

This rule is equally applicable to pension plans of the money-purchase type.\(^\text{16}\) If benefits can be suspended after retirement without case, they are not "definitely determinable."\(^\text{17}\)

Although the existence of fixed benefits normally precludes a fixed contribution, the Service has approved a pension trust negotiated between the employer and a union, requiring both fixed contributions and fixed benefits, where the contributions were based

\(^{15}\text{U.S. Internal Revenue Service, Regulations Section 1.401-1(b)(1)(i).}\)

\(^{16}\text{U.S. Internal Revenue Service, Revenue Ruling 61-157, Part 5 (d).}\)

\(^{17}\text{U.S. Internal Revenue Service, Revenue Ruling 61-157, Part 2 (m).}\)
benefits related to the market value of the assets from which the benefits are payable, and to a provision for adjustment according to a specified and generally recognized cost of living index.\(^{18}\)

A pension trust may qualify under Section 401(a) even though the employer does not contribute to the trust fund (created from employee contributions) but does obligate himself to pay the full amount of stipulated retirement benefits after the trust funds have been exhausted.\(^{19}\)

A self-insured, trustee plan providing normal pension benefits for a time certain with no life contingencies may qualify.\(^{20}\) A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident.

\(^{18}\)Ibid.
\(^{19}\)Ibid., Part 2 (f).
\(^{20}\)U.S. Internal Revenue Service, Revenue Ruling 57-312.
hospitalization, or medical expenses. 21 A death benefit payable under a qualified pension plan will be considered incidental where the value of the death benefit does not exceed the benefit that would have been paid had the benefit been funded under a typical retirement income contract. 22 In the case of a pension or annuity plan, the life insurance protection is deemed to be incidental where the insurance protection is not greater than 100 times the monthly annuity, e.g., $1,000 of life insurance for each $10 of monthly annuity. 23 A plan will qualify where it provides that a death benefit after retirement will be paid which is equal to 50 per cent of the salary of the participant in the last year before retirement and where the death benefit will cost less than 10 per cent of the cost of the pension plan as determined by excluding the cost of such a death benefit. 24

A pension plan may permit the withdrawal of

22 U.S. Internal Revenue Service, Revenue Ruling 61-121.
voluntary contributions (as contrasted with employer contributions, compulsory employee contributions, and increments) provided the withdrawals do not affect a member's participation in the plan, the employer's past or future contributions on his behalf, the basic benefits provided by both the participant's and the employer's nonwithdrawals either at the time of withdrawal or in computing benefits on retirement.25 A contributory plan which is amended so as to make it a non-contributory plan, accompanied by a refund of employee contributions and reduced benefits, will not lose its exempt status.26

Upon discontinuance of his participation under a pension plan, an employee may withdraw his own contribution plus the interest actually earned on his contribution without affecting the qualifications of the plan.27

Suspension of contributions will not affect the qualification of a pension plan if (1) the benefits to be paid or made available under the plan are not affected at any time by the suspension, and (2) the unfunded past

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service cost at any time does not exceed the unfunded past service cost as of the date of establishment of the plan. Otherwise, the suspension will be treated as a termination or partial termination of the plan, and the exemption will be re-examined. 28

Benefits

The first condition to be met for qualification of a pension, profit-sharing or stock bonus plan is that contributions are to be made to the trust by the employer, or employees, or both, and the corpus and income of the fund accumulated by the trust are to be made for their exclusive benefit. 29-

The term "beneficiaries" includes not only the employee's estate or dependents and the natural objects of his bounty but also any person designated by him to share in the benefits of the plan after his death. 30 A qualified plan may restrict the "beneficiaries" to the estate of the employee, dependents of the employee, or persons who are the natural objects of the employee's

28 U.S. Internal Revenue Service, Revenue Ruling 56-596.

29 U.S. Internal Revenue Code, Section 401(a)(1).

bounty. An employee may not irrevocably elect, prior to retirement, to defer until after death his vested profit-sharing plan benefits.

Also the plan must cover some employees, active or retired, and will cease to qualify as such at the time the employer has no employees, active or retired.

The position of the Revenue Service is that the entire plan is disqualified if any participant is not an "employee." An attorney or other professional person may be an employee if he qualifies as such for other purposes, including social security and income tax withholding even though he has an independent income from his professional practice. A principal in an association taxable as a corporation under Section 7701 and a full-time life insurance agent may qualify to participate. A stockholder may be a participant if he is an employee.


32 U.S. Internal Revenue Service, Revenue Ruling 56-656.


In order to qualify, the plan must be intended to be permanent when set up. The regulations do not specify a minimum period of time the plan must be in existence in order to qualify. Instead, they indicate what might happen if the plan were to be terminated or abandoned within a few years after it has taken effect. First, the regulations sound the warning that an early termination may be evidence that the plan was never a qualified plan. 36 Second, special rules are laid down limiting the amount of money that may be paid employees, if the plan is terminated within ten years after it is established (or within ten years after an amendment increasing the possibility of discrimination as to contributions and benefits.) 37 Third, it has been ruled that the interests of participants must become vested when the plan is terminated. 38

The Commissioner has ruled, however, that the test of permanency is met where, under a union negotiated contract, a pension plan cannot be changed for five years and then may be modified in accordance with the terms of

36U.S. Internal Revenue Service, Regulations 1.401-1(b) (2).

37U.S. Internal Revenue Service, Revenue Ruling 61-10 (Mim. 5717).

a contract to be renegotiated at that time. The assumption here is that the plan itself is continuous even though the contract is of limited duration. 39

A termination in the first year of operation because of employee dissatisfaction has been permitted. 40

A discontinuance of contributions is in reality a termination of a qualified plan. On the other hand, a suspension of contributions is an event which may or may not evolve into a discontinuance. In order to determine whether a suspension actually constitutes a discontinuance, it is necessary to take into consideration the following factors, in addition to the provisions of the plan itself:

(a) Whether a discontinuance is called a suspension in order to avoid vesting requirement?
(b) Whether the contributions are recurring and substantial?
(c) Whether the lack of contributions is likely to continue indefinitely?
(d) Whether, as of the end of any years for which no substantial contribution has been made, the lack of full vesting for employees whose services have already terminated has produced the prohibited discrimination in favor of continuing participants? 41

40 Kana Chevrolet Co., 32 Tax Court No. 52.
The Code does not specifically limit the investment which may be made by the trustee of an exempt trust. 42 Whatever investments are made by the trustee, however, must be made for the exclusive benefit of the employees or their beneficiaries. This does not mean that another party cannot also benefit. So long as the trustee and the other party consummate an arms-length transaction, which encompasses a fair market value cost, a fair rate of return and proper liquidity, the plan's qualification will not be endangered. Generally, if the appropriate state law governing the action of trustees is complied with, the trustee will be above criticism.

If a trust loans funds to an employer to furnish capital or property for use in the employer's business at a time when it is unable to borrow through normal channels, such action may disqualify the plan. Likewise the plan may be disqualified if the trust invests in the securities of, or otherwise consummates a transaction with, an employer, or an entity closely related to it, if the transaction results in a return in excess of that normally expected, and if the excessive return has the effect of a contribution to the trust in excess of the

42 U.S. Internal Revenue Service, Regulations 1.401-1 (b) (5).
statutory limitations set forth in Section 404.43

The trust is subject to the provisions relating to "prohibited transactions" and "unrelated business taxable income."

The trust may invest in stock or other securities of the employer provided such an investment is beneficial to the purpose of the plan and does not constitute a prohibited transaction. The investment must be reported to the Commissioner so that a determination can be made whether the trust serves a purpose other than that contemplated under the plan. The information which must be reported is as follows:

1. Balance sheets of the employer for the last two taxable years, comparative income statements for the last five years, and an analysis of the surplus account for the last five years, specifically setting forth the amount and rate of dividends paid;

2. A statement which accounts for all material changes in the financial statements from the end of the last taxable year to the date of filing the information;

3. A statement of trust assets;

4. A statement concerning the investment - covering amount, type, present rate of return, security if a loan is involved and reason for investment.


44 U.S. Internal Revenue Service, Revenue Procedure 56-12.
The required information must be filed by the trust with its annual Form 990-P if the transaction has been consummated or with a request for determination if one is sought prior to consummation.

In the case of a profit-sharing or stock bonus plan, or of a self-administered money purchase pension plan, any securities held by the trust must be valued at least once a year on a specified inventory date, and each participant's account must then be adjusted in accordance with the valuation. No amounts may be withheld from allocation in a profit-sharing or stock bonus plan through the setting up of reserves.45

If an affiliated group of corporations maintains a profit-sharing or stock bonus plan, employees may share in profits of the group.46

A single pension trust or plan may qualify for an entire group of corporate employers, regardless of whether or not the employers are "affiliated" for purposes of filing a consolidated return.47

45U.S. Internal Revenue Service, Revenue Ruling 61-157, Parts 2(s)(t).
47U.S. Internal Revenue Service, Regulations 1.401-1 (d).
Diversion of Funds

The second condition to be met for qualification is that it must be impossible under the trust for the funds to be diverted to any other purpose until all the liabilities under the trust to the employees or their beneficiaries have been satisfied. 48

In the case of a pension trust, after all liabilities under the plan are satisfied, the employer may recover any remaining surplus provided such surplus is the result of an erroneous actuarial computation. 49 Allocations under profit-sharing plans are not based on amounts necessary to provide stipulated retirement benefits and, consequently, there can be no erroneous actuarial computation and thus no recovery. 50

A pension plan will not fail to qualify merely because it provides that, except as to claims of the employer, the rights of the employee are not subject to claims of creditors. 51

48U.S. Internal Revenue Code, Section 401 (a) (2).
49U.S. Internal Revenue Service, Regulations 1.401-2(b) (1).
A plan may qualify even though it contains a provision for recovery of conditional contributions in the event that the Commissioner rules that the plan is not qualified. No diversion of funds exists.\footnote{Ibid., Part 3 (c).}

**Discrimination**

An employee's trust cannot qualify for tax exemption if contributions or benefits discriminate in favor of officers, stockholders, or supervisory or highly compensated employees.\footnote{U.S. Internal Revenue Code, Section 401 (a) (4).} Variations in contributions or benefits are permitted so long as the plan, viewed as a whole for the benefit of employees in general, does not discriminate in favor of the enumerated classes.

A classification is not discriminatory merely because:

1. It excludes employees the whole of whose compensation is subject to social security taxes; in other words, employees whose total compensation for the year is $5,200 or less.

2. It is limited to salaried or clerical employees.

3. Contributions or benefits are graduated according to total compensation, or basic or regular rates of compensation.
4. The contributions or benefits based on that part of the compensation subject to social security taxes, that is, the first $5,200 paid to any employee for the year, differ from the contributions or benefits based on compensation in excess of that amount.

5. The contributions or benefits differ because of retirement benefits created under state or federal law. 54

The five situations described above as not being discriminatory in classifying employees also apply in finding whether contributions or benefits are discriminatory.

If a contributory plan is offered to all the employees, but the contributions required of the employee participants are so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees. 55 Generally, the Revenue Service will consider compulsory employee contributions up to 60 per cent of compensation as not burdensome. 56

A plan may provide for voluntary contributions by employees of up to ten per cent of their compensation.

54 U.S. Internal Revenue Code, Section 401 (a)(5).
55 U.S. Internal Revenue Service, Regulations 1.401-3(d).
provided the employer's contribution or the benefits are not geared to employee contributions.\footnote{U.S. Internal Revenue Service, Revenue Ruling 61-157, Part 4(h).} Presumably the voluntary contribution is in addition to the compulsory contribution.

**Comparison of Pension and Profit-Sharing Plans**

The pension plan establishes a definite retirement program for employees with stated benefits payable upon such retirement. The employer, and the employee if the plan is contributory, must meet the actual cost of the benefits to be given the employees at retirement. Under the profit-sharing plan considered in this thesis the employer agrees to place some percentage of company profits in trust for its employees, with those profits being distributed at some later date to those retiring under the plan. A profit-sharing plan can be used to perform some of the functions of a pension plan by deferring all distributions until the retirement time specified, at which time the amount allocated to the employee may be paid out in the form of a life income. A profit-sharing plan does not guarantee any specific amount to the employee, but from the employer's point of view, it does have a theoretical advantage in that the
contribution to be made to the trust each year is
determined and dependent on the amount of the profits
earned during the year. It does not, however, perform
some of the functions of a pension plan in assuring
the orderly retirement of older employees on a living
pension because of the inability to adequately provide
for past services for older employees.58

Because of vesting requirement differences be-
tween pension and profit-sharing plans, it may be more
desirable from the company's standpoint to adopt a
pension plan. Under a pension plan, vesting is not
required until the employee reaches retirement age and
retires, whereas under the usual profit-sharing plan,
a participating employee acquires a 10 per cent vested
right annually in his interest from the date he becomes
a member of the plan, thus ten years would be required
to obtain 100 per cent vesting. Employees terminating
their vested amounts, the nonvested balance being
reallocated to participating employees terminating
service prior to retirement, usually forfeit all amounts
credited on their behalf except as to their own contribu-
tion plus interest. The forfeited amounts are used, and

58 Arthur Young & Co., Tax Aspects of Deferred
Compensation (Arthur Young & Co., C.P.A.'s, New York,
in effect reduce future company contributions needed
to pay for the cost of the benefits of the employees
who remain.

In addition, it might be said that the greater
the vesting, the lesser the holding power over an employee.
Hence, pension plans generally tend to have greater hold-
ing power than profit-sharing plans, since vesting pro-
visions in pension plans are usually less liberal in this
regard.

A feature in a profit-sharing plan that can be
objectionable is that, for practical purposes, it can
provide little or no past service benefits, particularly
for key employees, whereas a pension plan can do so
immediately upon adoption. Hence, a newly adopted
profit-sharing plan cannot adequately provide for the
immediate or near immediate retirement of older
employees, whereas a pension plan can meet this need.

Finally, contributions by the company to profit-
sharing plans depend on annual profits and/or accumulated
earnings of the company, contributions being limited to
15 per cent of the compensation of the employees covered
under the plan, whereas there are no similar percentage
limitations applicable to pension plan contributions.
For both types of plans, an over-all reasonable compensa-
tion test must be met. This latter requirement demands
that the total of the pension or profit-sharing contributions and the employees' other amounts of compensation represent reasonable compensation under the Internal Revenue Laws. An over-all limitation, however, is imposed if a company covers the same group of employees with both a qualified profit-sharing and a pension plan, limiting contributions that the company may make to 25 per cent of the total compensation of the employees covered.

General Advantages of Pension and Profit-Sharing Plans to Employer and Employee

Because of the five major tax advantages as noted below bestowed on pension plans that meet Treasury requirements, each dollar so spent by an employer will produce far greater benefits for the employees than under any other type of arrangement:

1. Amounts contributed by an employer to a qualified plan are deductible on his income tax return, within liberal limits, for that year. This of itself is not startling, because the employer gets a comparable deduction for other types of compensation he pays his employees. But where a qualified plan is concerned, he gets the deduction currently despite the fact that the employee may receive no benefits from the plan that year. That lets the employer accumulate funds for his employees,
and at the same time suffer no current tax disadvantage.

2. The earning and gains on the funds accumulated under the plan are wholly exempt from tax all during the accumulation period. Thus, the funds compound tax-free and increase at a far greater rate than if they were subject to tax.

Example: For illustration purposes and simplicity, it is assumed that the funds earn 5 per cent per annum, which is approximately the rate paid currently by the savings and loan associations in Southern California. (Cents omitted—rounded off to nearest dollar.)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>AMOUNT CONTRIBUTED*</th>
<th>EARNINGS COMPOUNDED ANNUALLY ON DECEMBER 31</th>
<th>AMOUNT IN FUND CUMULATIVE</th>
<th>TAXABLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000</td>
<td>500</td>
<td>10,500</td>
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</tr>
<tr>
<td>2</td>
<td>10,000</td>
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<td>21,525</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
<td>1,576</td>
<td>33,104</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>10,000</td>
<td>2,155</td>
<td>45,256</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>10,000</td>
<td>2,763</td>
<td>58,019</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>50,000</td>
<td></td>
<td>8,019</td>
<td></td>
</tr>
</tbody>
</table>

*Amount contributed to the fund and deducted by the employer on behalf of 10 employees every January 1st.

It can be noted from the above that the fund accumulated $8,019 tax free during the period of 5 years. If the trust fund was taxable at the corporate rate of 48 per cent and State Franchise rate of 5.5 per cent (in California) or a total of 53.5 per cent the earnings
of $8,019 would be diminished to $3,728 for distribution to employees.

3. The employees under the plan are not taxed while their benefit funds are accumulating. They are taxed only on benefits when and as they are actually received or made available to them, and then in many cases not at personal tax bracket rates but at the much lower long-term capital gains rate.

Example: Assume that one of the employees mentioned in the preceding example terminates and receives his proportionate of 1/10th of $58,019 or $5,801.90 in one payment and in one taxable year. Under Section 402 of the Code such amount is taxable to him at capital gain rates which means he can exclude 50 per cent of the amount received from his income or alternatively be taxed at a maximum rate of 25 per cent.

4. On his death, the amount credited to the employee's account under the plan can pass to his beneficiary (other than his estate) free of estate tax, to the extent attributable to company contributions. And the first $5,000 of the lump-sum benefit from a deceased employee's account (attributable to company contributions) can go to his beneficiary free of income tax.

Example: Assume the same employee mentioned in
the preceding example dies, and he has designated a beneficiary, say his wife. The amount of $5,801.90 passed on to his wife is subject to the exclusion from tax to the extent of $5,000 which represents the company contribution. The balance of $801.90 which represents the funds' earnings is subject to the favorable capital gain rates mentioned in the preceding example.

5. In general, an employee with a vested interest in a qualified plan need not pay any gift tax when he irrevocably designates a beneficiary to receive payments at his death, to the extent the survivorship interest is attributable to employer contributions.

Profit-Sharing Plans—Specific Advantages

Dollar for dollar of actual outlay, there is no other employee benefit arrangement that can do so much for everybody concerned—employee, management, owners. It is one of the ideal ways to accumulate the funds that an employee will need for himself and his family after his working days are over, and yet have those funds available during employment should an emergency occur.59

In the opinion of some people a profit-sharing plan is peculiarly adaptable to fit the needs of all types of employees—stockholder-employees, other executives, and the rank and file. "Management has

found the profit-sharing plan a good tool to stimulate incentive throughout the organization.\textsuperscript{60}

**Advantages to The Executive and Employee**

Usually the executive is stymied by high individual tax rates and living costs.\textsuperscript{61} Increases in current compensation such as salary boosts and bonuses lose much of their charm when the executive's top-bracket tax rate takes its toll. And when, the after-tax remnant of a pay increase is invested, the top-bracket tax rate reduces the investment return to a yield that is often ridiculously inadequate for the risks involved.

Due to our unprecedented prosperity, today's executives usually live very well.

Their prime need is not more spending take-home income. Instead, it's more capital to accumulate for his family and for his own use during retirement. That is a need which the qualified profit-sharing plan is admirably suited to fill.\textsuperscript{62}

In effect, the profit-sharing trust takes the place of the executive's own investment program but with two important differences:

1. The extra compensation, that would otherwise

\textsuperscript{60} Ibid.

\textsuperscript{61} Ibid.

be paid over directly to the executive and thus be subject to current personal income tax at his top tax rate, goes into the trust for him unreduced by any tax at all. This means that a far greater amount goes into the fund each year.

2. Since the trust is tax exempt, the trust's return on investments is uncut by any tax and thus the fund compounds at a rate far greater than would be the executive's private investment fund.

The twin advantages of the profit-sharing plan result in the executive's accumulating an amount under the plan that is so much greater than he could on his own account that the comparison is substantial. The following table will show the comparison between the results achieved privately by executives in various income-tax brackets, and what a qualified profit-sharing trust can do with the same annual outlay by the employer:

Example: Assume that each employee of "A" Company is given a choice (a) either to receive a bonus of $1,000 each year so that he can manage his own investment program, or (b) to have the employer contribute the $1,000 each year to a qualified profit-sharing plan for his benefit.

The first column in the table that follows shows how much income each employee would pay tax on for 1965
exclusive of the $1,000 bonus but after all deductions and personal exceptions. (Each employee is assumed to be married and to use the income-splitting joint tax return.) The second column shows how much the trust would invest for each employee each year, and how much the employee himself would invest after paying his income tax on the extra $1,000. The third column shows the effective after-tax yield on investments. The fourth, fifth and sixth columns show the accumulations, respectively, at the end of the indicated periods. For simplicity it is assumed that tax rates will remain constant and ignored changes in the employee’s top tax bracket in subsequent years.

See Chart A next page.

It should be noted that the amounts under the trust have not been taxed as yet. Ordinarily, an employee’s accumulation under the trust will be taxed as long-term capital gain, which means a tax on only one-half the amount with a maximum tax limit of 25 per cent, at 1965 rates, on the entire sum.

Even the long-term capital gains tax can be avoided, entirely legitimately, by having the trustee use the amount in the employee’s account to buy an annuity contract from an insurance company, or arrange to have the amount distributed by the trust as annuity
CHART A

COMPARISON OF INVESTMENTS BY EMPLOYER VERSUS EMPLOYEE CONTRIBUTION TO TAX EXEMPT TRUST

<table>
<thead>
<tr>
<th>Other Taxable Income</th>
<th>Balance of $1,000 After Tax</th>
<th>After-Tax Yield on 5% Return</th>
<th>20 years</th>
<th>25 years</th>
<th>30 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Trust</td>
<td>$1,000</td>
<td>5.0%</td>
<td>$34,700</td>
<td>$50,100</td>
<td>$70,700</td>
</tr>
<tr>
<td>$ 3,000</td>
<td>830</td>
<td>4.2</td>
<td>26,300</td>
<td>37,000</td>
<td>50,200</td>
</tr>
<tr>
<td>5,000</td>
<td>810</td>
<td>4.1</td>
<td>25,400</td>
<td>35,600</td>
<td>48,100</td>
</tr>
<tr>
<td>10,000</td>
<td>780</td>
<td>3.9</td>
<td>23,900</td>
<td>33,300</td>
<td>44,700</td>
</tr>
<tr>
<td>15,000</td>
<td>750</td>
<td>3.8</td>
<td>22,700</td>
<td>31,600</td>
<td>42,300</td>
</tr>
<tr>
<td>20,000</td>
<td>680</td>
<td>3.4</td>
<td>19,700</td>
<td>27,000</td>
<td>35,700</td>
</tr>
<tr>
<td>25,000</td>
<td>640</td>
<td>3.2</td>
<td>18,100</td>
<td>24,700</td>
<td>32,500</td>
</tr>
<tr>
<td>30,000</td>
<td>610</td>
<td>3.1</td>
<td>17,100</td>
<td>23,200</td>
<td>30,400</td>
</tr>
<tr>
<td>40,000</td>
<td>520</td>
<td>2.6</td>
<td>13,800</td>
<td>18,500</td>
<td>23,800</td>
</tr>
<tr>
<td>50,000</td>
<td>500</td>
<td>2.5</td>
<td>13,100</td>
<td>17,500</td>
<td>22,500</td>
</tr>
</tbody>
</table>
payments or periodical installments. In either case, the employee (or beneficiary of a deceased employee) will be taxed under ordinary income bracket rates when, and to the extent that, amounts are actually received.

The profit-sharing plan is a good vehicle to let the employee accumulate stock of the employer corporation or its parent or subsidiary. When the employee receives such stock at termination of employment for any reason the appreciation in value of the stock while under the trust is not taxed to the recipient at that time—in fact is not taxed unless and until the stock is parted with in a taxable transaction.

A typical example is the Sears and Roebuck Profit-Sharing Plan. This plan was installed by Sears and Roebuck in 1916, long before projects of this type had gained much popularity or tax advantages. Over the years, the plan has grown to substantial proportions. At the end of 1958, it had assets over $1 billion. Through this plan the employees of Sears own about one fourth of all outstanding company stock and thus as a group, are the largest stockholders of the company.63

Under the Sears plan each employee contributes a

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specified amount, which is based on his income and the company matches such contribution in stock and deposits such funds and stock in a trust. When the stock appreciates due to the good fortunes of the company the participants prosper accordingly. It should be noted that it is not a guaranteed plan in a sense that the employee is assured a favorable return. Market fluctuations, bad times or depressions can depreciate the funds assets and reduce the company contributions. However, in the postwar period the fund has appreciated substantially.

The significance of the plan to employees is best exemplified, not by over-all figures such as these, but by actual examples of typical employee experience. One young woman left to be married after nine years in the fund. During these nine years she herself had deposited $1,120 in profit-sharing, but she withdrew on leaving $4,025. A woman who had been a member of the fund for twenty-five years deposited $3,450 and withdrew $47,125. A man who had made a lifetime career with Sears and who had been a member of profit-sharing since its inception deposited $4,820. When he retired his share of the fund was valued at $174,980. These cases are typical. It has not been unusual for employees who have retired in recent years and who have been in the fund since the beginning to withdraw on leaving more than they have earned in wages during their entire working lives. Unquestionably, the profit-sharing plan has had a highly favorable influence on the attitudes of Sears employees. It is the most talked about of all company policies. Employees

64 Ibid.
are not around long before they begin to hear about the plan from their fellow workers. The nature of the plan is explained to new employees as part of the regular induction procedure, and its current operations are reviewed once a year with all members at the time they receive their personal annual statements. But the plan does not need to be "sold"; the employees take care of that themselves—much more effectively than would be possible for management.65

Further it should be noted that the employer gets a deduction for the contributions to the plan (Fair Market Value of the stock contribution) within specified limits. The employee gets a favorable tax advantage in the form of capital gain rates on the amount he receives upon termination in one lump sum, which includes the employer contribution, and the appreciation of his proportionate share of the trusts' assets.

A contrary example where the employee and employer's contribution are invested in stock of other corporations (not necessarily its own) is at the Lockheed Aircraft Corporation. The Lockheed plan is a voluntary plan whereby the employee can authorize deductions of 2 per cent, 4 per cent or 6 per cent of his base salary from his paycheck each week. In turn Lockheed will match 50 per cent of the employee's contribution. Such contributions are put in a trust and administered by an

65 Ibid.
Independent trustee which is requirement for tax purposes in order to be qualified. Further, the employee has a choice of the type of funds. He can specify that his account be invested in the securities fund or bond fund or a combination of both. The securities fund will include stocks, securities and other types of investments. It does not include Lockheed Securities. The bond fund money is invested solely in obligations fully guaranteed by the United States government and in savings banks deposits guaranteed by the government. Upon termination of employment, the participant that receives his prorate share of the fund in one lump sum is subject to the favorable capital gain tax rates on the amount the company contributed plus appreciation and income of the fund.

Were it not for Social Security benefits and benefit plans sponsored by the employer, the average employee would appear to be in financial difficulty when his working days came to an end. This can be illustrated as follows by the amount of Social Security a worker receives:

Average weekly benefits for total unemployment declined from 41 per cent of average taxable weekly

wages in the states in 1939 to 33 per cent in 1952. Since the impact on beneficiaries of these provisions is felt primarily by the higher-paid workers, it is not surprising that in 1952 workers making $50 a week or less could count on receiving a benefit at least equal to 50 per cent of weekly wages. But those earning more, who by that date constituted the majority, received a considerably small proportion, the average in the majority of states being less than 45 per cent. The $80-a-week worker received less than a third of his wages in most states.67

Further, the adequacy of Social Security has been found wanting as follows:

In 1935, when the Social Security Act was passed, it was predicted that old age insurance would ultimately take on the main task of supporting the aged. This has not as yet been accomplished. The coverage of Old-Age and Survivors Insurance has been limited. Furthermore, the benefits have been low, have not reflected the rising cost of living. Persons who become disabled before reaching sixty-five have been unable to work so as to protect their old age insurance coverage.68

Soaring living costs and crippling tax rates leave the average employee little after he has paid for the basic necessities of life. Yet he is quite aware in most cases that he must make some provision for the future, and that he must give his family some protection in case he should die prematurely. But he just can not seem to do the job himself. And that is where his

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Today's employee has become security-conscious—partly through the activities of unions and partly through the activities of government. He looks beyond the daily wage when he decides where to go for a job. To him employee benefit plans have real meaning. Employers recognize this attitude and provide employee benefits in an effort to retain good workers and attract satisfactory men and women to fill vacancies. Employers also know today that freeing employees from worry and fear of the future increases the efficiency of the entire organization. Employers who have tried profit-sharing have found it the best tool next to adequate wages to make an employee want to do the best job he can.

Cognizance should be taken of the fact that other profit-sharing plans have found to be adequate compensation tools for companies that utilize them. A good example is Kaiser Steel Corporation plan where profit-sharing is paid out on a current basis. Due to the current payment basis, such plan(s) does not qualify under Section 401 of the Code thus losing the tax advantages discussed in this thesis.

What can a qualified profit-sharing plan do for the employee? It can accumulate security funds at a far greater rate, per dollar of employer outlay, than the employee himself could do if the job were turned over to him. At the same time, the fund being accumulated

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70 Ibid.
for an employee under the plan is available should an emergency arise during working years. The accumulating amount also represents life insurance protection, in the sense that under most plans it is all paid to the family of the employee should he die in harness. The fund can also represent a tide-over allowance under most plans, to help out if the employee should be laid off or quit before reaching retirement age.

The profit-sharing plan can also function as a safe vehicle to carry any savings the employee can accumulate outside the plan. This can be done by making the plan "Contributory," in which case it will usually be called a "savings" or "thrift" plan. The plan can also be used to pay premiums on life insurance contracts to provide higher death benefits, or to pay premiums on annuity contracts to guarantee a certain level of retirement benefits. It can also be the medium by which the employee acquires a stake in the company—by having some of the funds in his profit-sharing account invested in stock of the employer company.

The variety of uses to which a profit-sharing plan can be put indicates the extreme flexibility of the framework within which each employer can devise an arrangement to meet his own intimate situation.
Advantages to The Employer

The following editorial comments from Pension and Profit-Sharing Report by Prentice Hall, Inc., appear to highlight some of the advantages to the employer:

Competition in business is intense today and will probably get rougher in the future. Costs are going up at such a rate that profits often drop though sales may increase. For most companies the way out of this spot is greater productivity. Profit-sharing can be a spur to increased productivity. Psychologists say that most people utilize only a small part of their potential. If they tapped their entire resources, progress everywhere would be tremendous. Profit-sharing taps the unused resources of employees by giving them a direct interest in doing their jobs well—they get to feel and act like stockholders. It encourages acceptance of improved equipment and better production techniques, cuts labor turnover, and attracts higher calibre people.71

One executive had this to say about profit-sharing plans:

The employee enthusiasm is the thing we like most about profit-sharing. Everybody gets into the act. For the first time, the employees feel that they are on the same level with the president of the company. Foremen have to be planners when they hear all day, 'I'm finished, what's next?' I came across this fellow separating salvageable parts from discards. He told me the salvage meant more money for the profit-sharing fund.72

The profit-sharing plan at Prexy's, a chain of New York City luncheonettes, was started in 1950, after

72Ibid.
an earlier incentive plan had broken down. "We needed an incentive for employees, and a way to educate them in the making of profit," says president John M. Ely. "Now, we couldn't run our business without profit-sharing. It gives the employees a sense of belonging and a real understanding of profits." The plan was started as a nonqualified cash arrangement, but later the employees voted in favor of placing half the company's contributions in a qualified profit-sharing trust, with all its tax advantages.73

At Zenith Radio, too, many employees are finding out that deferred profit-sharing is what really counts. Deferred profit-sharing may grow on a new employee somewhat more slowly than cash sharing, but its ultimate impact is stronger. For as the years go by, employees appreciate the growth of their retirement nest eggs.

Lower turnover.—Companies that install profit-sharing plans in order to attract and retain desirable employees are delighted with the results. Perhaps the most intensive study ever made of the motives of employers in establishing profit-sharing plans shows that 14 of every 15 companies that sought to reduce turnover rated their plans either "very successful" or

73 Ibid.
"successful" in achieving this result.74

Take the example of the Signode Steel Strapping Company, Chicago. When it moved almost 150 employees from one plant to another, it did not lose a single worker, even though they had to commute farther and arrange car pools because there was no public transportation.75

News of a sound profit-sharing plan gets around in labor markets. Signode credits its profit-sharing plan with keeping it well supplied with skilled workers. At one time, only one skilled job in its plant remained unfilled in what was a tight labor area.76

Just how do profit-sharing plans achieve such results? The answer is easy—by means of deferred vesting. A great majority of qualified profit-sharing plans defer vesting, usually basing it on years of participation in the plan or (less often) on years of service with the employer or on employee age. Some utilize various combinations of years of participation, years of service, and employee age.

Profit-sharing plans that defer vesting frequently

74 P.A. Knowlton, Profit Sharing Patterns (Evans-


76 Ibid.
provide for deferred graduated vesting. The most prevalent graduated vesting arrangement gives an employee an additional 10 per cent of the total amount in his profit-sharing account for each year of participation, so that after 10 years' participation he has a vested right to the entire amount. The knowledge that the longer one participates in the plan the larger will be the vested portion of his account is a strong deterrent to turnover. Some turnover may not be undesirable, such as retirement or discharge of nonproductive superannuated employees. This point is debatable and is considered a subject in itself.

It should be noted that in a profit-sharing plan, the amounts forfeited by employees who leave before satisfying the vesting conditions generally increase the accumulations on behalf of the remaining participants. It is no mere coincidence that the termination rate has declined as employee benefit plans have multiplied.

The Commissioner of Labor Statistics attributes at least part of the decline in turnover to the 'tremendous growth' of the profit-sharing, pension, health, and welfare plans in private industry since World War II.77

77 Ibid.
Disadvantages of Profit-Sharing Plans to the Employer

Although an employer pays his contribution in 48-cent dollars, due to the corporate income tax, he anticipates full return on his investment. The return on profit-sharing contributions are not always evident at the outset. It takes time to measure the effect or impact of such a plan on the employees and their attitude. Sometimes employees who do not see a tangible effect at the beginning may be disappointed. Also, the employer is obligated to contribute in profitable years to the plan even though he may have a need of such funds for other purposes such as expansion or bargain purchase of inventories.

Further, the cost of administering such a plan may be costly. Additional personnel may be required, trust fees incurred and considerable man hours spent in preparation of governmental reports in connection with such plan. However, it should be noted that the employer is not liable for payroll taxes on indirect compensation such as profit-sharing. Accordingly such savings will usually offset the additional cost of administering such plan.

Disadvantages of Profit-Sharing Plans to the Employee

Employees are usually disappointed when a
contribution is skipped by the employer. Of course this is due to an unprofitable year. An employee covered under a profit-sharing plan is like a partner in the business. He shares in the fruits only if there are profits.

The main disadvantage of a profit-sharing plan is that it is primarily beneficial to employees who start young with a company and stay on the job for a considerable period of time, thus accumulating a sizable sum in the plan. On the other hand, the older employee, say, at age 50 or 55, who commences employment with a company that has a profit-sharing plan and who stays on the job until retirement, say, 65 years of age or 10 years, will have a rather small "nest egg" on retirement due to the relatively short span of employment prior to retirement.

Pension Plans

Advantages to Employees

The problem of the employee under Pension Plan coverage is similar to a certain extent as to the one under profit-sharing plan because high tax rates and living costs eat up much of their earnings, too. The lower down an employee finds himself on the compensation scale, the less he is able to retain from his earnings
for future security. A qualified pension plan is a necessity for practically every employee, because through such a plan he can be reasonably assured that he will not walk out of a lifetime of productive work into a precarious retirement period of genteel penury.\textsuperscript{78}

The more definite assurance of some fixed level of retirement security makes a pension plan more appealing than a profit-sharing plan to many older employees, because they do not have sufficient time to accrue the full benefit possible under a profit-sharing plan. Moreover, there is usually no way to award adequate benefits for past service under a profit-sharing plan, as there is under a pension plan. So for them, the choice between fixed benefit levels under a pension plan and fluctuating, even though possibly higher, benefits under a profit-sharing plan is generally resolved in favor of the former. The younger employees are far more likely to feel the other way.

\textbf{Advantages to the Employer}

If it did not do anything else, a pension plan has often more than paid its way, insofar as the employer is concerned, by removing the spectre of a penniless old

\textsuperscript{78}Ibid., p. 1571.
age from the minds of employees. The ensuing contentment has often contributed largely to stabilization of the working force, lower absenteeism, fewer accidents, and generally improved industrial and community relations.79

A recent study by the U.S. Department of Labor in cooperation with state agencies showed clearly that companies with pension plans have a far more stable work force than those without pension plans. The annual separation rate per 100 employees was only 34 for companies with pension plans, as compared to 62 for companies without pension plans.80 These figures are based on data from companies with 50 or more employees in six major labor markets—Detroit, Los Angeles, Minneapolis-St. Paul, Philadelphia, Seattle, and Worcester, Massachusetts. But there is every reason to believe that they are typical of the country as a whole.

Just how do pension plans achieve such a result? The answer is simple—by means of deferred vesting. The great majority of pension plans defer vesting. Usually they make vesting before retirement hinge upon an employee's completing a certain period of service.

79 Ibid., p. 1572.

80 Ibid.
(generally ranging from 10 to 25 years) and attaining a certain age (generally 50, 55, or 60). Less common are those that require only completion of a stipulated period of service or attainment of an age. Few plans provide for no vesting at all if the employee leaves before normal retirement age.

It is no mere coincidence that employee benefit plans have multiplied as the quit rate has declined. The Commissioner of Labor Statistics attributes at least part of the decline in turnover to the "tremendous growth of pension, health, and welfare plans in private industry" since World War II. 81 It should be recognized, however, that other factors play a part; automation (a real threat to some employees), personal financial commitments, social status in a community and the desire to remain therein, undoubtedly are deterrents in the turnover rate. As the employment concept has changed and as workers have built up an attachment to a particular firm and have accumulated certain benefits and rights there, they are less likely to move from job to job as freely as they did two or three decades ago. 82

81 Ewan Clague, Long-Term Trends in Quit Rate, Employment and Earnings, for December, 1956.

The following comment from an editorial in Prentice Hall Inc. Pension and Profit Sharing report shows further benefit:

A pension plan returns other dividends to the employer. It keeps the working force young and alert by providing a humane way to retire employees from the payroll when they cease to pull their share of the load. It is important to remember that not all of the deadwood is at the bottom of the ladder. A lot of it is at the top in supervisory and sometimes policy-making posts when a slowing down can do much harm to efficient operations. By providing an orderly way of retiring employees after their period of usefulness has come to an end, the pension plan not only helps the business to keep pace with its competitors but keeps the avenue of promotion open all up and down the line, thus giving younger employees an incentive to do their best work.\(^{83}\)

A classic statement of the function of a pension plan in clearing promotional avenues for younger men was made by Benjamin F. Fairless, when he reached the age of 65 in 1955. Announcing his retirement as Chairman of the Board of the United States Steel Corporation, Mr. Fairless said:

... I am firmly convinced that there must always be room at the top of our management team for young men with young ideas and a fresh, new outlook upon the problems that our company must face if it is to keep pace with its growing responsibilities toward a young and growing nation.

Unless this chance for advancement is constantly kept alive, at every level of

management, it would only be a matter of time until the most able of our younger executives would seek opportunities elsewhere. Thus our entire organization would soon become stagnant—set in its ways, and dangerously unprogressive in its views. And that, of course, must never, never happen at U.S. Steel.\textsuperscript{84}

**Disadvantages of Pension Plans**

The main objection to a pension plan is from the employer's point of view. That is, that the employer is bound in advance to meet fixed payments in the future. The ill-feeling engendered by untimely termination of the plan may be out of all proportion to the goodwill created by the plan's establishment and may ultimately cost the employer more than it would have cost to keep the plan operating. Furthermore, discontinuing the plan could have an adverse tax effect on employer and employee.

Actually, a plan is not recommended if the employer has reason to believe that he may not be able to finance it subsequently. However, the necessity for discontinuance will be minimized if the plan is established on a basis of normal or usual business conditions. Temporary periods of prosperity should be discounted, and benefit levels should be kept well within the employer's ability to provide the funds for them.\textsuperscript{85}

\textsuperscript{84}Ibid.

\textsuperscript{85}Ibid., p. 1574.
From the employee's point of view, there are hardly any disadvantages. Usually, the employee does not contribute anything to the plan and has everything to gain. With proper vesting he stands to gain even upon termination before retirement. In the event an employee had a choice between a higher monetary wage versus the benefits of a pension plan, he may in some instances choose the former.

However, it is conjecture whether an employer would pay a higher monetary wage without a pension plan and whether the employer would be willing to forfeit the advantages of such a plan, namely the deferral of income to future low income and tax favored years.

Summary

The preceding presentation indicates that the advantages of establishing and expanding Pension and Profit-Sharing Plans are substantial. This is due to a certain extent to the benefits bestowed to the contributor and recipient by the United States Government in the form of tax benefits. As to which plan is better for any particular firm or enterprise is dependent upon the facts and circumstances in each case. The factors of the composition of the work force as to age and income, the objectives of the plan itself, and the
projected profit plan of the company and the desires of employer and employee have to be taken into consideration before a suitable plan is chosen. The relative advantages of each plan have already been prescribed. It appears that the Profit-Sharing plan is somewhat more popular due to its appeal to younger individuals and employers. This is based on the premise that a larger amount of equity will be accumulated by the young employee who spends substantially all his working life in one company. From the employer's point of view, the main appeal is that contributions to the trust are made only in the years when there are profits.

Although the source of the data in this chapter comes primarily from the Internal Revenue Code, Revenue Rulings and Pension Profit-Sharing Reports by Prentice Hall Inc., similar data can be found in the commercial publications of Commerce Clearing House, Merten's and Research Institute of America dealing with the same subject. In the next chapter, the technical aspects of contribution deductibility and limitations will be discussed.
CHAPTER III

DEDUCTIBILITY OF PENSION AND PROFIT-SHARING PLAN CONTRIBUTIONS

One of the main advantages to the employer in establishing Pension and Profit-Sharing Plans is its tax deductibility. For every dollar contributed to the trust, the employer receives approximately 53 cents in tax benefit (Current Federal and California States rates.)

In this Chapter, Section 404 of the 1954 Internal Revenue Code, the applicable regulations and rulings thereunder will be discussed in connection with the deductibility of the contributions to a qualified Pension and Profit-Sharing plan, with particular emphasis or warning as to the "limitations." Under the provisions of Section 404 (a) of the Code as amended, a contribution to be deductible under this section must first of all constitute an ordinary and necessary business expense. This means that the amount of any contribution for the benefit of an employee, together with all other compensation paid the employee, must not exceed reasonable
compensation for services actually rendered.¹

Pension Plan contributions are deductible, initially for any taxable year in an amount not in excess of 5 per cent of the total compensation otherwise paid or accrued to all employees participating in the plan. The amount deductible, however, may not exceed the amount reasonably necessary to fund the cost of the plan, and for this purpose the Commissioner may recompute the amount of the second year and at not less than five-year intervals thereafter.²

If more than 5 per cent is necessary to provide the unfunded cost of the participant's past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each participant, such excess over 5 per cent is also deductible. However, if the unfunded cost for any three individuals is more than 50 per cent of the total unfunded cost, the unfunded cost attributable to those three individuals must be spread over a period of at least five taxable years. It appears that this spread over is primarily intended to guard against

¹U.S. Internal Revenue Service Regulations, Section 1-404 (a)-(1)(b).
the possibility of high salaried executives in a closely held corporation (with only few other employees qualified under the plan) being the primary beneficiaries of such plan. Further, this applies whether the plan is a trustee plan or an annuity contract plan.3

Example: The XYZ Corporation sets up a pension trust for all its employees over 35 years of age with three years or more of full employment. It is determined that the pension trust qualifies for exemption. Under the plan, pensions are provided at age 65 equal annually to 1 per cent of the total compensation received by the employee after age 35. The minimum pension is $20 per month. Compensation of past years is computed on the basis of the calendar year preceding establishment of the plan. An analysis of the first year under the plan shows the following:

1. Total payroll of participants. . . $ 642,000
2. 5 per cent thereof . . . . . . . . . 42,100
3. Value of all benefits expected to be paid after the beginning of the year for benefit of all beneficiaries. . . . . . . . . 1,136,700
4. Value of all funds in the plan at the beginning of the year. . . . . 000

5. Amount to be distributed as a level percentage . . . . . . $1,136,700

6. Maximum amount attributable to any three employees . . . . . 400,000

7. Value of all compensation to be paid to covered employees after the beginning of the year. . . . . 12,630,000

8. Accrual rate for level percentage
   Computation - item (5) - item (7). 9%

9. Excess percentage over 5%. . . . . 4%

10. Excess over 5% of payroll - item (9) X item (1) . . . . . . . . . . 33,680

Since item (6) is less than 50 per cent of item (5), that factor is ineffective. The deduction, therefore, is $75,780, of which $42,100 is deductible under Section 404(a)(1)(A) and $33,680 is deductible under Section 404(a)(1)(B).

A taxpayer may also claim a deduction for the normal cost of the plan plus 10 per cent of the past service cost of the plan. The "normal cost" of the plan for any year is the amount, actuarially determined, which would be required as a contribution to maintain the plan if the plan had been in effect from the beginning of service of each then-included employee and if the cost for prior years had been paid and all assumptions as to interest, mortality, time of payment, et cetera, had been fulfilled. The "past service cost" is the amount which would be required to completely fund or purchase
the pension or annuity credits as of the date when they are included in the plan, and which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal cost. "Past service costs" is deductible at a rate not in excess of 10 per cent each year.4

Under the general limitations, the taxpayer is entitled to deduct in full the amount paid to an employee's pension trust which is actuarially necessary to provide with respect to all employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount over the remaining future service of each such employee, even though such amount exceeds the amount deductible under Section 404 (a)(1)(C) mentioned in the preceding paragraph. That is, normal cost plus 10 per cent of past service cost. In other words, Section 404 (a)(1)(C) does not represent a ceiling on the amount deductible.5

It should be noted that any expenses incurred by an employer in connection with the plan, such as fees and compensation of a trustee or actuary, which are not


5Saalfeld Publishing Co. 11 Tax Court 756.
provided for by contributions under the plan, are not subject to the limitations heretofore mentioned, but are fully deductible to the extent that they are ordinary and necessary business expenses. 6

**Profit-Sharing Plan**

In the case of profit-sharing plans, the contributions by an employer to an exempt profit-sharing trust are limited to 15 per cent of the compensation otherwise paid or accrued during the year to the employees under the plan. This is the primary limitation. A secondary limitation is operative in the case of a credit carryover. 7

As is the case with Pension Plans, a contribution to a qualified profit-sharing plan in order to be deductible must be reasonable. This is considered along with the other compensation paid to covered employee. 8 The reasonableness of compensation for any one year is determined by reference to services rendered and compensation paid in prior years as well as in the current

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6 *U.S. Internal Revenue Service Regulations*, Section 1-404 (a) (3) (d).

7 *U.S. Internal Revenue Code* of 1954 as amended, Section 404 (a) (3).

8 *Bardahl Manufacturing Corporation* Tax Court Memorandum 1960-223.
year. Under a profit-sharing plan, if more than 15 per cent is paid in one year, the excess may be carried forward as a part of the contributions of succeeding years to the extent needed to bring the deductions up to the 15 per cent limit. (Note illustration on the following page) If the employer pays less than 15 per cent in one year the resulting credit may be carried forward and added to the maximum amount otherwise deductible; but the amount so added cannot exceed 15 per cent of the compensation paid during the succeeding year, subject to the limitation explained in the next paragraph.

The operation of the credit carryover is subject to a secondary limitation for any given year equal to the lesser of (1) an amount equal to twice the primary limitation for such year, or (2) any excess of (a) the aggregate of the primary limitations for such year and for all prior years over (b) the aggregate of the deductions allowed or allowable under the limitations provided

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9U.S. Internal Revenue Service Regulations, Section 1-404 (a)-(b).

## Chart B
### Utilization of Credit Carry-overs

<table>
<thead>
<tr>
<th>Year of Plan</th>
<th>Payroll of Participating Employees</th>
<th>Basic Allowable Deduction (15% of Col. 1)</th>
<th>Amount Actually Contributed and Deducted</th>
<th>Credit Carry-Overs from previous Years (Total of Col. 2 less Col. 3 for All Previous Years)</th>
<th>Maximum Allowable Deduction (Lesser of: 15% Basic Deduction Plus Accumulated Credit Carry-Over; or 30% of Col. 1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,000</td>
<td>$45,000</td>
<td>$30,000</td>
<td>......</td>
<td>$45,000</td>
</tr>
<tr>
<td>2</td>
<td>300,000</td>
<td>45,000</td>
<td>40,000</td>
<td>$15,000</td>
<td>60,000</td>
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<tr>
<td>3</td>
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<td>45,000</td>
<td>60,000</td>
<td>20,000</td>
<td>65,000</td>
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<tr>
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<td>300,000</td>
<td>45,000</td>
<td>50,000</td>
<td>5,000</td>
<td>50,000</td>
</tr>
<tr>
<td>5</td>
<td>300,000</td>
<td>45,000</td>
<td>10,000</td>
<td>0</td>
<td>45,000</td>
</tr>
<tr>
<td>6</td>
<td>100,000</td>
<td>15,000</td>
<td>30,000</td>
<td>35,000</td>
<td>30,000 (30% limitation)</td>
</tr>
<tr>
<td>7</td>
<td>100,000</td>
<td>15,000</td>
<td>30,000</td>
<td>20,000</td>
<td>30,000 (30% limitation)</td>
</tr>
<tr>
<td>8</td>
<td>100,000</td>
<td>15,000</td>
<td>15,000</td>
<td>5,000</td>
<td>20,000</td>
</tr>
<tr>
<td>9</td>
<td>100,000</td>
<td>15,000</td>
<td>20,000</td>
<td>5,000</td>
<td>20,000</td>
</tr>
<tr>
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<td>100,000</td>
<td>15,000</td>
<td>15,000</td>
<td>0</td>
<td>15,000</td>
</tr>
</tbody>
</table>

**TEN YEAR TOTALS**

$2,000,000  $300,000  $300,000
It should be noted that the credit carry-over, each year, is the cumulative total of the basic allowable deduction (Col. 2) for all previous years less the cumulative total of the amount actually deducted in all previous years (Col. 3). Thus, in the 6th year, above, when covered payroll dropped, sufficient credit carry-overs had been accumulated so that the company was able to draw on them in the 6th, 7th and 9th years to make "over 15%" contributions. Also, the table assumes that there was a "ceiling," on contributions each year, of the amount deductible in that year. If the plan's formula had not contained such a ceiling and, for example, in the 7th year, the company had contributed $35,000, instead of $30,000, the excess contribution of $5,000 which was not deductible in the 7th year (because of the 30% over-all limitation) could have been carried forward and deducted in the 8th year by utilizing the $5,000 credit carry-over at that time. In such case, the company would have received a $20,000 deduction in the 8th year ($15,000 contribution plus $5,000 excess contribution carry-over from preceding year). However, there would then have been no credit carry-over available in the 9th year.
in Section 404 (a)(3)(A) for all prior years.11

Time and Method Of Making Contribution
(Pension and Profit-Sharing Plans)

Contribution by an employee to an exempt employee's trust are deductible only in the taxable year in which they are paid, with one exception. In the case of a taxpayer on the accrual basis, contributions accrued within the taxable year are deemed to have been paid on the last day of the taxable year if paid not later than the time prescribed by law for filing the return for the taxable year. i.e., for a calendar year taxpayer corporation, such contribution in order to be deductible must be paid by an accrual basis corporation not later than March 15.12

If an employer transfers tangible property to a qualified employee's trust, the employer may deduct the fair market value of the property as a contribution under Section 404. If the property has a fair market value in excess of the employer's tax basis in the property (usually its cost less depreciation allowed or allowable), the employer will realize a gain in the amount of such

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11U.S. Internal Revenue Service Regulations, Section 1-404 (a)-9(d).

excess. However, if the reverse occurs and a loss is sustained, such loss is denied, because the transaction is between two related parties, namely, the exempt trust and its grantor.

Summary

The significance of this chapter is to show that a company can avail itself for a substantial tax deduction by following the provisions outlined in Section 404 of the Code and the Regulations thereunder. Of further significance is the fact that the provisions as mentioned in this chapter appear to be liberal indeed. As can be noted from the example on page 63, a deduction of 9 percent of the total payroll of the participants can be obtained for contributions to a pension trust. A more liberal deduction is available under the Profit-Sharing Plan (15 percent). Further, in the case of a profit-sharing plan credit, carry-overs can be utilized when necessary, permitting the company to plan its deductions accordingly. In the event that cash is not available for contributions, a contribution in tangible property is permitted which may be of significant help to a company overstocked in specific tangible property but short of cash.

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13 General Shoe Corp. 238 F. 2nd 514 CA-6 1960.

CHAPTER IV

STOCK OPTIONS

One of the most common methods of providing incentives or compensating corporate executives has been through the use of restricted stock options; such options permitted the executive to acquire stock in his employer corporation at less than fair market value without realizing income at the time of acquisition.\(^1\)

Prior to the passage of the 1964 Revenue Act the provisions dealing with restricted stock options were contained in Section 421 of the Code. Such provisions stated that if the stock were not disposed of within two years after the option was granted or within six months after acquisition, gain on the disposition would be taxed at the favorable capital gain rates provided that the option price was at least 95 per cent of the fair market value of the stock on the date the option was granted. Further, if the option price was between

85 and 95 per cent of the fair market value of the stock on the date the option was granted, no income was recognized upon exercise of the option. However, upon death of the employee or disposition of the stock after the two year and six month holding period mentioned above, the lesser of the difference between the option price and the fair market value of the stock on either the date the option was granted or the date of death (or disposition) constituted ordinary income. Additional gain, if any, realized upon disposition, constituted capital gain.

In the event of a disposition of the stock by the employee prior to the expiration of the two year and six month holding periods (called an early disposition), ordinary income was recognized to the extent of the difference between the option price and the fair market value of the stock on the date the option was exercised. No deduction was permitted for the employer corporation unless there was an early disposition of the stock by the employee, in which case the employer was permitted to deduct the amount taxed to the employee as ordinary income.

In order to qualify as a restricted stock option, however, the following requirements had to be satisfied:

1. Within the three months immediately preceding exercise of the option, the person to whom the option was granted must have been an employee of the grantor
corporation, its parent or subsidiary.

2. At the time the option was granted, the option price was at least 85 per cent of the fair market value of the stock.

3. By its terms the option was not transferable during the lifetime of the grantee.

4. The grantee did not own more than 10 per cent of the total combined voting power of all classes of stock of the employer, its parent or subsidiary, unless the option price was at least 110 per cent of the fair market value of the stock at the date of grant, and expired within five years. Special attribution rules applied in determining stock ownership.

5. The term of the option did not exceed ten years.\(^2\)

All of the foregoing rules and requirements were in effect prior to the 1964 Revenue Act and are presented herein for comparison purposes. Analysis of the above provisions would indicate the tremendous tax benefits which resulted in many instances. For example, an executive could be granted a restricted stock option and wait for a period of up to ten years before electing to exercise it. Assuming an inflationary market trend, a substantial amount of the compensation, all taxed at the favorable capital gain rates (limited to 25 per cent), could be realized with a nominal risk of investment, provided the option price was 95 per cent of

\(^2\text{U.S. Internal Revenue Code of 1954 as amended, Section 421.}\)
the fair market value of the stock on the date the option was granted. Further, if such executive or employee waited at least 18 months after the option was granted before exercising it, he would only have to hold the stock six months in order to qualify for long term capital gain treatment. Substantial appreciation of the fair market value since the date the option was granted virtually precluded the loss of any portion of the option price within the six month period following exercise of the option.

In order to minimize the tremendous tax effect which resulted from restricted stock options, Congress in the Revenue Act of 1964 made some rather significant changes in the tax treatment of employee stock options.

In general, a new qualified stock option was formed which supplants the restricted stock option of the old laws. As was the case prior to the adoption of the 1964 Act, an employee who wants to receive the favorable income tax treatment accorded must be concerned not only with the provisions of the option itself, but also with his holding period for the stock and his

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employment status at the time of the grant and at the
time of exercise. In addition, the 1964 Act adds new
requirements which must be met by the "plan." These
three different kinds of requirements are discussed
separately below. 5

Requirements Relating to the Option

1. Under the 1964 Act a qualified stock option
must be granted after December 31, 1963. A restricted
stock option, on the other hand, must in general have
been granted prior to January 1, 1964, except that
options granted after December 31, 1963 may be restricted
stock options if granted pursuant to a binding written
contract entered into before January 1, 1964 or pursuant
to a written plan adopted and approved before January 1,
1964, which met certain nondiscriminatory requirements.

2. The period of time during which a qualified
stock option may be exercisable is limited to five years
from the date of grant.

3. The option price in a qualified stock option
must not be less than the fair market value of the stock
at the time of grant, whereas the price in a restricted

5U.S. Internal Revenue Code of 1954 as amended,
Section 422.
stock option could be as low as 85 per cent of the fair market value of the stock at time of grant.

The price requirements of restricted stock options have produced many problems, particularly for closely held corporations whose stock is not actively traded. Under the old law, if the option price failed to meet the 85 per cent requirement, the option simply did not constitute a restricted stock option. Thus, if the price was $84 when it should have been $85 and the option was exercised at a time when the stock was worth $200 per share, the employee had $116 of ordinary income per share at time of exercise.

The new law provides that if the option price is less than fair market value at time of grant, the option will still be a qualified option if there was a good faith attempt to fix the price at not less than fair market value. In such event the individual who exercised the option must include in his gross income for the taxable year in which the option is exercised an amount equal to the lesser of (1) one and one-half times the difference between the option price and the fair market value at time of grant or (2) the difference between the option price and the fair market value at time of exercise. This amount of income is treated as compensation and the basis of the stock acquired is
increased by the same amount. 6

The variable price provisions of the prior law do not apply to qualified stock options. The Senate Finance Committee Report states that the modifications to require that the option price be at least the fair market value of the stock and to remove the variable price provisions "are made to decrease the compensatory nature of the existing stock option provision and to place greater emphasis on the employee's efforts to improve his company's business and thereby raise the price level of the stock." 7

Section 422 (a)(1) provides as a condition for favorable tax treatment that the individual who acquires stock on exercise of a qualified stock option must make no disposition of the stock within the three-year period beginning on the day after the day on which the stock is transferred to him.

According to the Report of the Committee on Ways and Means the following was stated:

This is designed to give assurance that the key employees actually are acquiring a stake in the business and are not merely turning the stock


over as fast as the option can be exercised. 8

Requirements As to The Plan

Under the prior law a stock option plan was not necessary. Under the 1964 Act a qualified stock option must be granted pursuant to a plan which includes the aggregate number of shares which may be issued under options, and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is approved. Moreover, the option must be granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever, is earlier. 9

Employee Stock Purchase Plans

Section 423 deals with employee stock purchase plans. According to the Report of the Committee on Ways and Means, 10 options issued under stock purchase plans

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8 U.S., Congress, House, Committee on Ways and Means Report, 89th Congress 1964, p. 64.


10 U.S., Congress, House, Committee on Ways and Means Report, 89th Congress, 1964, p. 64.
are designed primarily as a means of raising capital, and the discounts from market price made available to the employees usually correspond approximately with the costs the company would incur in floating a new stock issue. In general, the rules applicable to options granted under such plans are much the same as those applicable to restricted stock options, with some exceptions such as employment status where the individual must be an employee of the corporation granting the option or of its parent or subsidiary.

**Summary**

As can be noted from the comparison of the pre-1964 and post 1964 Stock Option provisions, the latter appear to be more restrictive. However, the changes promulgated in the 1964 Act, although restrictive, appear to have eliminated certain abuses in the stock option area inherent in the old law. To put it more bluntly, stock option provisions were written by Congress with a specific purpose in mind; namely, to afford certain employees to share in the fortunes of the company and to act as an incentive and reward for executive and managerial talent. As mentioned heretofore, the tax provisions deferred the payment of tax on such indirect compensation to a future date, more suitable or
advantageous to the employee. Further, stock options afforded the company an avenue of rewarding or compensating an employee without utilizing needed working capital, namely, cash.

Even with the crackdown on stock options as promulgated by the 1964 Act, such method of compensation will continue to be used widely. Reason: The executive will still be able to get his capital gain. It gives him a free ride on the market. He does not have to exercise the option and he does not have to lay out any cash until he is ready, willing and able. The main benefits to the employee or executive are as follows:

1. There is no income at the time the option is granted.

2. There is no income at the time he exercises the option.

3. When he sells the stock, the gain will be tax favored long-term capital gain.

The above can be illustrated as follows: Mr. Jones is an executive or valued employee of XYZ Corporation. On January 15, 1965, XYZ Corporation grants Mr. Jones an option to purchase 100 shares of XYZ Common Stock at $50.00 a share (fair market value $50.00). Such option can be exercised by Mr. Jones at any time prior to December 31, 1968. If not exercised
by such date the option lapses. On January 15, 1966, Mr. Jones exercises the option and acquires 100 shares at $50.00 and transmits a check of $5,000 to the XYZ Company for such stock. (Fair Market Value on exercise date is $75.00.) On January 16, 1966, Mr. Jones sells such stock in the open market for $100.00 per share or $10,000. The tax aspects are as follows:

1. On January 15, 1965, the grant date, Mr. Jones has no taxable income. (It should be noted that the option price and fair market value are the same on the grant date.)

2. On January 16, 1966, the exercise date, Mr. Jones has no taxable income. On this date he merely purchased the stock assuming a basis of $5,000, his purchase price.

3. On January 16, 1969, Mr. Jones sold such stock, having held it over 3 years, the holding period required for favorable full capital gain treatment; he has a taxable gain of $5,000 (Sales price of $10,000 less cost basis of $5,000) which is taxed at the maximum rate of 25 per cent. (Capital gain.)

The benefit to Mr. Jones stems from the fact that between the grant date and exercise date, the stock appreciated $25.00; consequently it became advantageous for him to exercise the option. (Under the 1964 Act the
option price and fair market value must be the same on the grant date.) If the fair market value on the exercise date would be $45.00, he undoubtedly would not exercise such option. To put it simply, Mr. Jones enjoyed a "ride" on the market at the company's expense to the extent of $25.00 per share - the difference between the fair market value at the grant date and exercise date.

Further, attention is invited to the holding period in which an option can be exercisable, which was changed from ten to five years. This change appears to have taken the speculative "momentum" out of the option privilege in an inflationary period which is prevalent at this time.

Further, under the new act, there is no requirement that the price of the new 1964 qualified option be tested against the higher of the two fair market values mentioned in the preceding chapter as was required under the old laws. The new act provides as did the prior law, that the modification of an option is considered as the granting of an option.11 Overall, it can be said that the new act is not as liberal as the prior

provisions; however, in this writer's opinion it is still an important and advantageous type of indirect compensation from the tax point of view for rewarding key personnel and simultaneously benefiting the grantor. Analysis of the new provisions, as presented in this chapter, will have proved my contention.
Although the development of private pension, profit-sharing and other retirement plans has largely been the result of business and labor initiative, public policy has encouraged and protected these plans through tax laws. In a letter to the President of the United States, dated January 15, 1965 transmitting the report of the Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, Mr. W. Willard Wirtz, U.S. Secretary of Labor and Chairman of the aforementioned committee stated the following:

The report emphasizes the important role that private plans now play in providing retirement security to an increasing proportion of the labor force. Much of this progress was made practicable by special incentives in the Federal Tax Law.

The last sentence of the above quotation amply supports the hypothesis of this thesis.

The prevailing tax provisions for private pensions make it possible to provide such plans at a substantially lower cost than that which would result if no special tax provisions were available for such plans. Regardless of how the worker and the employer may share the benefits—in the form of higher pensions or reduced costs—which the special tax provisions for pensions make possible, it is evident that the advantages for both employers and workers are very significant. The loss of revenue to the federal government as a result of this special tax treatment is estimated to be more than $1 billion annually.\(^2\)

Several points that underline the breadth and depth of the public interest in private retirement plans is well summarized in the conclusion of the President's Committee on Corporate Pension Funds and other Private Retirement and Welfare Programs in its report of January 1965. Page vii of conclusions is quoted as follows:

1. They represent a major element in the economic security of millions of American workers and their families.

2. They are a significant, growing source of economic and financial power.

3. They have an important impact on manpower in our economy.

\(^2\)Ibid.
4. They have a major, growing significance for Federal taxpayers because the special tax concessions reduce the tax base and put more burden on other tax sources.

The growth of private retirement plans in the form of pension and profit-sharing plans (with which this paper has been mainly concerned) has been tremendous in the United States.

In 1940 private retirement plans covered about 4 million employees. By 1950, the total had risen to 10 million. Since then another 15 million employees have been covered. While some plans expanded with employment, the bulk of these newly covered employees was accounted for by new plans. A total of 25 million employees, or about half of these working in private non-agriculture establishments were covered by private retirement plans at the end of 1964.

To further support my hypothesis that the Federal Income Tax provisions have encouraged the establishment and expansion of indirect compensation in the form of pension, profit-sharing and other deferred compensation plans, the following is quoted from the President's Committee on Corporate Pension Funds and other Private

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3 Ibid.

4 Ibid.

**Internal Revenue Code.** The tax advantages granted private pension plans have contributed significantly to their growth, to their design, and to the relative importance of noncontributory plans. The Internal Revenue Code provides several special tax advantages to qualified plans. Employers' contributions are not taxed to employees at the time they are made but only upon distribution at a later date, when they are given additional favored treatment. Earnings accumulated on contributions remain free of tax until distributed. Employers' contributions in general are deductible as business expenses in the year in which they are accrued or made; in contrast, non-qualified plans are subject to substantial restrictions in this respect. Thus, employer contributions to non-qualified plans are deductible when accrued or made only to the limited extent that employee rights are vested.

The Internal Revenue Code treats similarly to pension plans both deferred profit-sharing plans and stock-bonus plans which meet the tests for qualification under the qualified plan provision. Deferred profit-sharing plans and stock-bonus plans frequently serve the same purpose as pension plans, that of primarily providing retirement benefits. All pension plans must be designed primarily to provide retirement benefits in order to qualify for special tax treatment. Profit-sharing plans, however, may qualify even though they primarily provide for benefits at a time when the beneficiary is still an employee of the company. Only those qualified profit-sharing plans which primarily provide benefits on retirement are here considered a part of the private retirement system. Stock-bonus plans, in general, are similar to profit-sharing plans, but contributions are not necessarily dependent on profits, and distributions, which are more likely to be made before retirement, are made only in stock in the employer corporation.
Tax considerations contributed strongly to the growth of pension plans in the World War II and Korean conflict periods. Sharp increases in corporate tax rates beginning in 1940 and, more specifically, the excess profits tax during both periods added a financial incentive toward the establishment of qualified plans. Wartime economic stabilization measures, which limited wage increases during both periods, added another incentive.

The most recent change in law affecting the tax status of private pension plans was the extension of tax advantages to self-employed persons by the Self-Employed Individuals Tax Retirement Act of 1962. While experience under this Act is limited, it may be expected to influence the establishment and design of plans covering the self-employed and their employees.
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Books


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