Profit-Sharing Plan

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John Smith, with his brother William, owns all of the stock of a small manufacturing company. They are the principal officers — as well as the stockholders; John being President and Treasurer and William being Vice-President and Secretary. Each of them draws a salary of $12,000 per year. They have heard from a friend that there may be substantial income tax advantages to the company, as well as to them personally, by setting up a profit-sharing plan.

The friend is right.

Since John and William are principal officers as well as owners there is a substantial income tax advantage to the company and to them personally from a profit-sharing plan. Similar advantages would accrue from a pension plan but neither John nor William feel that the company is sufficiently well established to incur a fixed obligation, regardless of whether or not the company has profits in any given year.

The income tax advantages of a profit-sharing plan, where the owners are employees, have recently been illustrated by Prentice-Hall, Inc. (Pension and Profit Sharing Service, Report No. 24). Since the company contribution to a proper profit-sharing plan is deductible in computing the federal income tax, the illustration, based on certain minor assumptions, shows that a contribution of $12,750 will cost the company $2,295. In other words, $10,455 of the contribution would have gone for federal income taxes. As a matter of fact, the contribution is also deductible from the South Carolina income tax so the cost will be even less than that shown. However, the Prentice-Hall illustration is based on the federal tax alone. It is assumed, in the illustration, that the corporation will earn a net profit this year of $60,000 and its total payroll will be approximately $85,000. Its excess tax credit is $40,000. The contribution cannot be in excess of 15% of the payroll. The tax situation with no plan as compared to that which will exist where there is a plan is as follows:

	No Plan	*With a Plan*
Profit before taxes	$60,000	$60,000
Contribution to plan	-------	12,750

*Member of South Carolina and New York Bar Associations. Member of the firm of Bruton & Bruton of Columbia, South Carolina. Contributor to legal periodicals.

Income subject to tax	$60,000	$47,250
Normal tax and surtax	25,700	19,070
Income after normal tax and surtax	$34,300	$28,180
Excess profits tax	6,000	2,175
Income after taxes	$28,300	$26,005

Naturally if the corporation is not subject to the excess profits tax (if, for example, its excess profits tax credit is equal to its profits) the cost will be $3,825.00 more. This is the cost to the corporation — but where the stockholders, or some of them, are also employees there is a further substantial financial advantage to them. Thus the plan provides that company contributions are to be allocated to employees in the same proportion as the compensation paid to the employees bears to the total compensation paid to all employees. Therefore, under the plan $3,600 of the contribution is allocated to the credit of John and William. Since this credit is put into a trust for the brothers from which the earnings are tax exempt, if the contributions are maintained until the brothers retire (assuming they are now forty) and if the trust earns 4% return, and credits from forfeitures amount to 3% per year, they will have a credit of $121,800 in the profit sharing trust.

If approximately half of the corporate profits are distributed to the stockholders as dividends (if the corporation already has an adequate surplus a distribution of dividends will be necessary to avoid the imposition of the penalty tax under Section 102 of the Internal Revenue Code, which prohibits an unreasonable accumulation of surplus), the following computation shows that while the brothers would lose about $713.00 each in immediate return, they would each have to their credit in the profit-sharing trust approximately $1,800. (In making this computation certain assumptions are necessary. We will assume that John Smith is forty years old, married and has two children. William's family situation is the same. Both of them have additional income from private investments of $3,200 per year and the wives have no separate income. Approximately half of the corporate profits should be distributed so we will assume that without the profit-sharing plan the corporate dividends to each brother would have been $7,150, and with the plan $6,000.)

	No Plan	With a Plan
Each brother's 1952 income before tax	$22,350	$21,200
Federal income taxes	5,513	5,076
Income after taxes	$16,837	$16,124
Living costs	11,000	11,000
Available for private investments	$ 5,837	$ 5,124
Credit in profit-sharing trust	....	1,800

Assuming that the federal income tax rates continue the same, as do the profits, payroll, etc. of the corporation, for the next twenty-five years, and assuming further a rate of 5% earned on private investments but only 4% earned on investments in the profit-sharing trust, and a forfeiture increase in the share of the brothers in the trust of only 3% per annum, at the end of twenty-five years when John and William may wish to retire, they will have available in the profit-sharing trust $121,800 each, whereas without the plan they would have been able to save only $27,200. The assumption that the earnings on private investments would have been at the rate of 5% per year is earnings before taxes. The tax rate of the brothers is 38% and if this is applied to the earnings on investments the rate after taxes becomes 3.1%. Since the trust is tax exempt, its earnings are not subject to federal income tax. The assumption that forfeitures of credit by other employees increase the credit of other employees in the fund by an amount of 3% per year is very conservative, as experience has shown that forfeitures are considerably more than that amount.

It must be considered that the savings fund of $27,200 is after taxes whereas the credits of $121,800 of John and William are before taxes. But under the Code if the amount due is paid in one taxable year the profit will be taxed at capital gains rates, which today is a maximum of 26%. Thus, after taxes both John and William will have left the sum of $90,132 — which is $62,932 *more* than they would have had without the profit-sharing plan. Moreover, the plan would have provided a credit of almost $1,000,000 to the other employees of the company.

Thus it is apparent that a profit sharing plan has substantial advantages taxwise where the stockholders, or some of them are employees. But what, John Smith asks, would be its advantage if taxes were materially reduced?

Naturally the income tax advantages of a profit-sharing plan for employees varies with the tax rates. But an employee would be shortsighted if he considers the advisability of a profit-sharing plan as dependent upon income tax savings. It is a preservative of the capitalistic system. Where the employees share in the profits of an employer they will have a present interest in trying to make those profits as large as possible. In these days where it is at best difficult to obtain competent employees, profit-sharing plans make the task easier. The benefits of establishing a profit-sharing plan where tax rates do not make it advantageous taxwise, or where the owners of the business are not also employees have been forcefully presented by Prentice-Hall as follows:

"*Why a profit-sharing plan is sound business practice.* Few decisions involving long-term business policy give directors and managers of business a greater sense of satisfaction than the decision to establish a profit-sharing plan. As the years go by and the fund grows, the soundness of the original decision becomes more and more apparent, for the advantages are steady and some even cumulative.

"Specifically, these advantages may be enumerated as follows:

(1) Employee efficiency is increased.
(2) Labor turnover is decreased.
(3) The employer makes no fixed commitment.
(4) Profit-sharing serves as a dismissal wage.
(5) Other advantages such as attracting better class of workers, promoting public goodwill, and fulfilling a social obligation of the employer are obtained.
(6) Employee satisfaction is high.
(7) Employer and employee are benefited taxwise if the plan is approved.

"*Employee efficiency is increased.* All the incentives for increased employee cooperation and efficiency that are found in pension plans, are present under profit-sharing plans but to a greater extent. For example, the contributions of an employer to a pension plan generally are fixed and are made each year whether or not there is a profit. For this reason, the employee is apt to take the contributions of the employer for granted and relax. True, the fact that there is a pension plan will encourage the employee to greater efforts than if one had not been created. Under a profit-sharing plan, however, since contributions depend directly on the profits the employer makes, the employee knows that he will benefit *only* if he exerts himself to help his employer create profit.

"*Labor turnover decreased.* A profit-sharing plan furnishes the employee with benefits that are more immediate than pension benefits when distribution is not postponed until the employee has reached an advanced age as in the case of a pension plan. Distribution under a profit-sharing plan, if the provisions of the plan so stipulate, may be made at any time for any reason. Overlooking the wisdom of the attitude taken by many younger employees, it nevertheless is a fact that they prefer the more immediate distribution of the profit-sharing plan to the long-delayed payment under the pension plan. Whereas the contrary is not necessarily true with older employees, still they are sold more easily on the pension plan idea than the younger employees. From this point of view, employers, the majority of whose employees are young, may find that a profit-sharing plan is more effective in reducing employee turnover * * *.

"*The employer makes no fixed commitment.* Another advantage of profit-sharing plans over pension plans is that under the former plan the employer need not encumber his business with an annual fixed liability which may be difficult to meet in lean years. A series of years in which profit is negligible or non-existent may be fatal to a pension plan. The profit-sharing plan continues to exist regardless of amount of profit, but contributions vary.

"*Profit-sharing serves as a dismissal wage.* Finally, there is one particularly outstanding job which may be performed by the profit-sharing trust today. It is a purpose that can not be adequately accomplished by a pension plan. Under a profit-sharing plan provision may be made to give an employee a dismissal wage. It must be remembered, however, that any plan which is primarily a dismissal wage plan does not come within the meaning of Section 165 (a).

"When the reconversion period set in after World War II many industrial plants either were discontinued entirely or converted to some other type of production. Hundreds of thousands of workers were thrown out of work. In many instances, however, a dismissal wage served to lessen the impact of discharge by providing a financial cushion during reconversion until their services were once more in demand. A distribution from a profit-sharing plan at termination of employment, as explained at Sec. 3056, acts as a dismissal wage. Because of the tax deduction available to the employer for contributions to a profit-sharing trust meeting the requirements of Sec. 165 (a) of the Internal Revenue Code, the dismissal wage payment may be accumulated inexpensively.

"Other advantages of profit-sharing plans. In addition to the advantages mentioned above, the following advantages described in connection with pension plans are equally obtainable through profit-sharing plans: a better class of workers is attracted; public goodwill is promoted; and a social obligation of the employer may be fulfilled where the benefits of the profit-sharing plan are available at retirement.

"Employee satisfaction is high. A profit-sharing plan has a striking appeal to employees from the outset because:

1. Generally it costs them absolutely nothing; there are no employee contributions and hence no deductions from pay checks.
2. They see in the plan a means of obtaining deferred salary increases at a time when present increases are subjected to high income taxes.
3. They can look forward to receiving some day a much larger sum of money than they would be likely to accumulate by themselves.
4. They like the idea that their shares may be immediately available if they are disabled, retire, or die.

With these advantages so obviously apparent to employees even the youngest person in the company can be enthusiastic about the plan."

The question then arises as to how to install a plan.

Section 23 (p) of the Internal Revenue Code permits the deduction as a business expense of any reasonable contribution to a trust for the sole benefit of employees, under a plan of profit sharing with the employees. Qualification of the plan under Section 165 (a) of the Code is not a legal necessity for deduction of the contribution, but is a practical one. The basic requirements for qualification are outlined below.

1. *Qualification.* The trust is eligible for qualification under Section 165 (a) if (I) contributions thereto are pursuant to (1) a plan for the exclusive benefit of employees (2) the sole purpose of the plan is to offer employees (or their beneficiaries) a share of the profits of the business (3) the plan is permanent (4) is in writing and (5) is communicated to the employees (II) it is impossible under the trust instrument for any of the corpus or income to the trust to be used other than for the exclusive benefit of the employees (or their beneficiaries) (III) contributions must be for the purpose of accumulating funds for distribution to employees (or their beneficiaries) and (IV) the plan covers 70% of all employees, or 80% of all eligible employees, or any reasonable classification of employees

if there is no discrimination in favor of officers, shareholders, supervisory or highly paid employees.

2. *Limitation on contributions.* A profit-sharing plan must have a definite formula for determining profits to be shared (Reg. 111, Sec. 29.165 (1)). The formula must be fixed and certain with nothing left to the discretion of the company or its directors (PS No. 33,9-20-44). However, the total deductible contribution in any one year cannot exceed 15% of the compensation paid in that year to all participants ("contribution" does not include bonuses and overtime pay — Prentice-Hall, Pension and Profit Sharing Service, Section 4133). If the 15% of compensation is not used up in any one year, or series of years, it may be carried over. If an employer wishes to change the formula for contributions so as to increase or decrease the annual contributions, such an amendment may be made. (*E. R. Magner Manufacturing Co.,* 18 TC........, No. 76.)

The definite formula for determining contributions is usually stated to be a percentage of the net income of the corporation, but not in excess of 15% of the compensation paid during the period to participants. If the formula is applicable only to profits remaining after dividends are declared it is not sufficiently definite since the directors have discretion in determining dividend declarations. It has been ruled that either a graduated or a declining scale or percentages is sufficiently definite. It will probably be satisfactory to the Bureau, to have a specified amount of net income excluded; such as the first $25,000 or $50,000 of net income. Certainly the owners would be entitled to a fair return on their investment in the business of the company, prior to a division of profits with the employees. (This assumes, of course, that the company has consistently earned *more* than the minimum — if it has not, there might be a question as to whether the plan is in actuality a "profit" sharing plan or is merely a plan to lure prospective employees.) There would seem to be no provision in the law or the regulations which would prevent a company from appropriating its entire net income, in excess of the minimum, to profit-sharing — so long as the amount appropriated does not exceed the legal limitation of 15% of the payroll.

Where a contribution is made subject to repayment if the contribution is not allowed as a deductible contribution under Section 23 (p) of the Code, the Bureau will not give an advance ruling on qualification under Section 165 (a) of the Code. This, however, will not apply where the contribution itself is conditioned upon an advance ruling holding the trust exempt. Although generally contributions must be unconditional, contributions to the trust conditional upon repayment if the plan is not approved by the Stabilization Boards will not preclude an advance ruling.

If the company keeps its accounts on an accrual basis a contribution is deductible if the plan is approved prior to 60 days after the close of the corporation's year in which the contribution is to be made. If, however, the employer is on a cash basis, the plan must be effective before the end of the year, to permit the deduction of the contribution made for that year. Regardless of whether the employer is on a cash or accrual basis, the trust must be complete, under State law, in the year the contribution is made.

The contribution to a profit-sharing plan may be based on *estimated* net earnings if the estimate is a sound accounting one and not merely an arbitrary estimate or haphazard guess (P. S. No. 46).

The 30% rule. Prior to its revocation in 1950, the Commissioner of Internal Revenue had ruled (IT 3674 and IT 3675) that a company contribution of which more than 30% was for the benefit of employees owning 10% or more of the stock of a company, prevented the contribution from being deductible for income tax purposes, on the ground that it was not primarily for the benefit of all employees of the company. Since this rule had been in effect for several years prior to its revocation, it is widely thought to be still applicable. However, in the case of *Bolckening, Inc. v. Commissioner,* 13 TC 723, the Court held that this rule was arbitrary and improper. There, over 50% of the contribution was for the benefit of the owners, but, nevertheless, was sustained. The Bureau thereupon revoked its former ruling (IT 4020). In revoking its earlier rule then known as the "30% rule" the Bureau called attention to the prohibition in Regulation 111, Section 25.165-1 (a) which states: "If the plan is so designed as to amount to a subterfuge of distribution of profits to shareholders, even if other employees were not shareholders or included under the plan, it will not qualify as a plan for the exclusive benefit of employees."

3. *Allocations to employees.* A provision in the plan for allocating or apportioning the profit contributed by the company to the profit-sharing plan is required. The formula for allocating or apportioning profits may be based on compensation, or length of time of employment, or on both these factors. However, it must not, under any circumstances, be discriminatory in favor of officers, shareholders, supervisory or highly compensated employees.

The usual formula for allocating the company's contribution is for each participating employee to be apportioned that percentage of the contribution as is equal to the percentage of his compensation, during the year, while a participant, to all compensation paid to participants during that year. If it is desired to give weight to the length of time the employee has been with the company, the contribution may be apportioned on the basis of compensation weighted by his period of service.

Earnings and profits from the trust fund and net changes in the value of the fund itself, including losses or gains in trust assets, whether realized or not, naturally affect a participant only to the extent that he has a credit in the fund. Accordingly, the formula should provide for allocating the earnings and profits of the trust and net changes in the trust during the year, based on a trustee's valuation at the end of the preceding fiscal year and a similar valuation at the end of the current fiscal year, on the basis of the interest in the trust fund of each participating employee at the end of the preceding fiscal year. Amounts available by reason of forfeitures should be allocated in the same manner.

If separate accounts are maintained for each employee the trustee may credit the account with the employee's allocated share of the company's contribution during each fiscal year and similarly may credit such employee's account with the employee's interest in the earnings of the trust fund and the employee's interest in all forfeited credit or credits which cannot be paid to a participant and which inure to other participants. The earnings and profits of the trust fund should be credited to the respective participant in proportion to the sums standing to the credit of the respective participants on the books of the trust fund as of the end of each year preceding the year in which such earnings shall have been made. If this method is followed there should be a valuation of the accumulated fund as of the end of each year and the participant's individual account should be adjusted to conform to the valuations so ascertained. In view of the South Carolina law requiring segregation of trust assets, the trust instrument should provide that although separate accounts are maintained for each participant the trust is designed to be one for the benefit of all employees and that the invested assets shall not be deemed to constitute only one fund.

4. *Forfeitures.* Funds derived from forfeitures of employees' credit in a profit-sharing fund shall be allocated to the remaining participants in such manner as to effect no possible discrimination in

favor of officers, shareholders, supervisory and highly compensated employees (Reg. 111, Sec. 29.165-4).

A provision for forfeitures when an employee resigns or where he is discharged for cause will usually be acceptable to the Bureau but where the discharge for "cause" may be arbitrary and the discharged employee has no recourse, the Bureau may question the provision (see *Prentice-Hall, supra,* Sec. 4173).

Where credits cannot be paid to participants on account of Wage or Salary Stabilization rules, or provisions of the trust instrument provides for only a limited vesting of benefits in the case of voluntarily resignations, the trust instruments usually provide that such amount shall be distributable to the credit of other participants in the plan. The result is precisely the same as if the amounts were 'forfeited'.

5. *Termination and amendment.* The Internal Revenue provides that a plan can be terminated at any time. However, in view of the provision also in the IRC that the plan must be a permanent one, the provision permitting termination has been interpreted as applicable only to a termination for "business necessity". The Code also provides that a plan can be amended at any time. Insofar as the amendment is purely a formal or procedural one it can be amended without a change in its status as an exempt trust. If, however, the amendment is one of substance and may affect the formula for determining contributions or allocations among participants, or may affect coverage, the amendment should be cleared with the Commissioner.

6. *Must a corporate trustee be appointed?* There is nothing in the law or regulations which provides that a trust company must act as a trustee. The Tax Court has held that it is of no consequence that seven out of eight trustees were officers and directors of the employing corporation, and a majority were stockholders owning 63% of its stock (*Forcum-James Co.,* 7 TC 1195). However, the appointment of an unrelated person or trust company as trustee may facilitate the Commissioner's approval of the trust.

7. *Wage and Salary Stabilization requirements.* The Salary Stabilization Board has jurisdiction over the amounts paid to all executive, administrative, professional and outside sales employees. The Wage Stabilization Board has jurisdiction over the amounts paid to all other employees. Under the Salary as well as the Wage Stabilization Board a profit-sharing plan that meets certain requirements

need not be submitted for advance approval. It is sufficient if it is filed before it is to become effective and no objections are made within 30 days from that time. The requirements eliminating advance approval in substance are: (a) The trust must qualify under Section 165 (a) of the Internal Revenue Code (b) the employer's contribution cannot exceed the amount deductible under Section 23 (p) of the Internal Revenue Code (c) payments or distribution of benefits to participants (or loans based on the benefits), except in the case of death or permanent and total disability, require participation in the plan for at least 10 years (d) in the case of the Wage Stabilization Board (applicable to all employees except executive, administrative, professional and outside sales employees) payments or distribution of benefits must be spread over a ten-year period in every case except where an employee dies.

This permits lump sum payments at retirement only to executive, administrative, professional and outside sales employees. Thus, the long term capital gain privilege is barred to other employees so long as the Wage Stabilization Board has jurisdiction over the plan. There is apparently nothing in the stabilization laws, however, which would prevent payments in a lump sum to executive employees but spread over a ten-year period in the case of all others.

8. *Tax consequences upon employees afer distribution.* If the payments of the credits available to the employees are received in one lump sum, the proceeds are taxable as capital gain. If, however, the payments are made in installments the proceeds are taxable to the employee as ordinary income. Some plans provide that the amount payable to the employee shall be used to purchase an annuity for the employee. In such case the payment will be deemed a lump sum payment and the amounts received over the annuity taxable as an annuity — that is, 3% of the proceeds is subject to ordinary income tax until the amount received free from tax equals the consideration paid the annuity.

9. *Miscellaneous.* A profit-sharing plan is usually administered by an advisory or administrative committee, this committee consists of from two to five members, appointed by the company to serve at the pleasure of the company. The committee, in addition to its function as administrator, acts as *liason* between the company and the trustee and is charged with keeping the trustee informed as to the eligible employees.

The trustee or trustees should be given broad powers of investment and administration of trust funds. If they are not given special powers of investment they are limited to so-called "legals", that is, investments authorized by law for trustees; usually only Government securities or first mortgage bonds qualify.

The question has been raised as to whether such a trust does not violate the rule against perpetuities, since it is not limited to a life in being. In many states statutes have been enacted expressly exempting profit-sharing employees trusts from the application of the rule. South Carolina has not passed any such statute. It is likely, however, that such a trust will be regarded as an eleemosynary one which is exempt from the rule. The Tax Court in the case of *T. J. Moss Tie Company v. Commissioner,* 18 TC........ (May 7, 1952) held that a trust for the benefit of its needy employees was a charitable trust and the contribution thereto was deductible as a charitable deduction under Section 23 (o) of the Internal Revenue Code, even though the trust had not qualified under Section 165 (a) of the Internal Revenue Code.

10. *State tax laws.* If the plan is irrevocable, non-discriminatory and substantially all employees are covered, without discrimination, the contributions will be deductible in computing the State income tax. However, deductibility of the contributions does not necessarily follow the Federal procedure. While the trust itself is exempt from Federal income tax, it is not exempt from State income tax. When, therefore, the employees are paid benefits from the fund, the proportion representing earnings is not subject to further State income tax.

Once the plan has been executed and cleared with the Treasury Department and the Wage and Hour Stabilization Boards, it is necessary that it be communicated to the employees. The proper communication at this point involves a high degree of employer-employee relations. The profit-sharing plan is one of the biggest steps an employer ever takes for the benefit of his employees. For this reason the appropriate information advising the employees of this step is of utmost importance. Moreover, by its nature an employee profit-sharing trust must be highly technical and complicated. It must be reduced to very simple terms so that the employees will fully understand what is being done for them and the conditions and extent to which they will participate.

It would seem desirable, therefore, to prepare and give to each employee a simple statement, preferably in question-and-answer form, describing the plan to those who would like to participate therein. In order to be sure, however, that the employee is not misled in any particular, the trust agreement itself should be appended as a part of the booklet; and the announcement should be made in the form of a letter to employees, which probably should be coincident with the first annual contribution.