South Carolina Law Review

Volume 9 | Issue 2 Article 3

Winter 1957

Recent Developments in Qualified Profit-Sharing Plans

R. E. Houston Jr.

Follow this and additional works at: https://scholarcommons.sc.edu/sclr

Part of the Law Commons

Recommended Citation
Houston, R. E. Jr. (1957) "Recent Developments in Qualified Profit-Sharing Plans," *South Carolina Law Review*: Vol. 9 : Iss. 2 , Article 3.
Available at: https://scholarcommons.sc.edu/sclr/vol9/iss2/3

This Article is brought to you by the Law Reviews and Journals at Scholar Commons. It has been accepted for inclusion in South Carolina Law Review by an authorized editor of Scholar Commons. For more information, please contact dillarda@mailbox.sc.edu.

RECENT DEVELOPMENTS IN QUALIFIED PROFIT-SHARING PLANS

R. E. HOUSTON, JR.*

The purpose of this article is to outline some of the more important recent developments in "qualified profit-sharing plans" — that is, definite written plans established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries, communicated to the employees, and approved by the Treasury Department pursuant to the applicable provisions of the Internal Revenue Code and the Regulations issued thereunder.[1]

The December, 1952 issue of the *South Carolina Law Quarterly* contains a very complete and helpful summary of the tax and other advantages of such qualified profit-sharing plans.[2] Since 1952, the 1939 Internal Revenue Code, then in effect, has been superseded by the 1954 Code with comparable provisions relating to "employees' trusts" — which include pension and stock bonus plans as well as profit-sharing plans. These comprehensive provisions[3] are substantially similar to the corresponding provisions of the 1939 Code,[4] though a few of the changes should be noted.

1954 INTERNAL REVENUE CODE CHANGES

Long-term capital gain treatment (on total distributions in one taxable year of the distributee because of a participant's death or separation from service) has been extended under the 1954 Code to cover death *after* separation from service.[5] Further, in this connection, the $5,000.00 death benefit exclusion provided under the 1954 Code, for amounts received by beneficiaries of an employee paid by an employer by reason of the employee's death, is made specifically available to beneficiaries of a deceased participant of a qualified plan even though the employee had a nonforfeitable right to such amounts during his lifetime.[6]

Another change in the 1954 Code is with respect to the time allowed an employer on the accrual basis to pay a contribution to the profit-

*Member of the South Carolina Bar and the New York Bar; Special Counsel, Haynsworth, Perry, Bryant, Marion & Johnstone. For assistance in writing this article, the writer wishes to thank J. Wesley Drawdy, University of South Carolina Law School, 1955.

1. U. S. Treas. Reg., § 1.401-1, subdivisions (a)(2), (b)(1)(ii), and (b)(2). Note that the last cited Regulation states that the term "plan" implies a permanent as distinguished from a temporary program, and that such "permanency of the plan will be indicated by all of the surrounding facts and circumstances.
2. Bruton, *Profit Sharing Plan,* 5 S.C.L.Q. 201.
3. INT. REV. CODE OF 1954, §§ 401, 402, 403, 404, 501(a), *et. seq.*
4. INT. REV. CODE OF 1939, § 23(p), 53 STAT. 1 (now INT. REV. CODE OF 1954, § 404).
5. INT. REV. CODE OF 1954, § 402(a)(2).
6. INT. REV. CODE OF 1954, § 101(b)(2)(A).

Published by Scholar Commons, 1957

sharing trust. It is expressly provided that such an employer is deemed to have paid the annual contribution to the trust on the last day of the year of accrual if payment is made not later than the time prescribed by law, as extended, for filing his tax return for that taxable year, instead of having only sixty days after the close of the taxable year as previously construed.[7]

Certain "prohibited transactions" are specifically set out in the 1954 Code. Broadly stated, these are transactions between the trustee and the "creator" of the trust tending to favor the employer beyond ordinary business standards, which if engaged in by the trustee will cause the loss of the tax-exempt status of the trust.[8]

OTHER CHANGES

In addition to Federal Code changes, it is of special interest to South Carolinians that in May of last year, a new subsection (9) was added to Section 65-226 of the 1952 Code of Laws of South Carolina, providing in effect that after January 1, 1954, qualified profit-sharing trusts (and also pension, stock bonus and annuity trusts) shall be exempt from taxation in this State, exemption of such trusts under Federal Income Tax Law to be "a prima facie basis" for exemption in South Carolina.[9] The Tax Commission, Income Tax Division, has confirmed that this subsection is designed to afford in South Carolina the same tax advantages (noted below) as provided in the Federal Internal Revenue Code, and has stated that no "rules or regulations in connection with employee-benefit plans" have been issued under this new subsection.[10]

A very recent innovation in qualified profit-sharing plans is the feature of allowing eligible employees to elect whether the amount credited to their respective accounts each year will be paid as a current cash bonus, or will be placed in the profit-sharing trust pursuant to the plan. Paragraph 1.401-3(c) of the final Federal Regulations on such plans implies that a plan is not disqualified by reason of permitting such election, but states specifically that the coverage and discrimination requirements of qualified plans are to be determined by taking into account only the participants who elect to have their credits contributed to the profit-sharing trust. Thus, a ruling under this para-

7. INT. REV. CODE OF 1939, § 23(p)(1)(E), 53 STAT. 1 (now INT. REV. CODE OF 1954, § 404(a)(6)), as construed in Crow-Burlingame, 15 T.C. 738 (1950), appeal dismissed and affirmed, 192 F. 2d 574 (2d Cir. 1951); 555, *Inc.*, 15 T.C. 671 (1950), appeal dismissed and affirmed, 192 F. 2d 575 (8th Cir. 1951).
8. INT. REV. CODE OF 1954, § 503(a)(c); *cf.* Rev. Rul. 56-366, 1956 INT. REV. BULL. No. 31.
9. S. C. Acts 1955, No. 266, approved May 11, 1955.
10. Letter to author dated October 27, 1956 and November 1, 1956.

graph of the Regulations approved a plan where more than half of the participants in the trust were among the lowest paid two-thirds of all eligible employees, but ruled *not* to qualify a plan where less than half of the employees selecting the trust were in the lowest paid two-thirds of eligible employees.[11]

PREDETERMINED CONTRIBUTION FORMULA NO LONGER REQUIRED

The most significant recent development in qualified profit-sharing plans is the acquiescence this year by the Treasury Department that such plans need no longer specify a fixed percentage of net profits for computing contributions to the trust. The 1939 Code required such a predetermined contribution formula as a condition for qualification of the plan,[12] but several Circuit Court of Appeals decisions held that the Code provisions themselves do not warrant this requirement.[13] Hence, a few months ago these 1939 Code Regulations were retroactively revised so as to eliminate the requirement entirely.[14] Accordingly, the final Regulations under the 1954 Code are very specific in permitting a flexible percentage of net profits to be contributed to the trust fund, provided that such contributions are "recurring and substantial."[15] See discussion *infra* pages 201-202, 206-208.

In order that the above mentioned changes and developments may be considered in proper perspective, brief reference will be made to the major tax advantages, and also to the basic requisite provisions, of a qualified profit-sharing plan.

MAJOR TAX ADVANTAGES

To summarize the four most important tax advantages of a qualified profit-sharing plan:

(1) The employer gets an immediate tax deduction, in each taxable year, for the amount of his annual contribution to the profit-sharing trust. However, such deduction is not to exceed 15% of the compensation "otherwise paid or accrued" that year to all participants under the plan.[16]

(2) The participating employees are not taxed when the contributions are made, but only in the year or years, and to the ex-

11. Rev. Rul. 56-497, 1956 INT. REV. BULL. No. 41, at 68.
12. U. S. Treas. Reg. 118, § 39.165-1(a)(2).
13. Lincoln Electric Co. v. Comm'r., 190 F. 2d 326 (6th Cir. 1951); Produce Reporter Co. v. Comm'r., 207 F. 2d 86 (7th Cir. 1953).
14. 14 T.D. 6189, 1956 INT. REV. BULL. No. 29, at 58; see also Rev. Proc. 56-22, 1956 INT. REV. BULL. No. 31.
15. U. S. Treas. Reg., § 1.401-1(b)(2) (1956).
16. INT. REV. CODE OF 1954, § 404(a)(3) and (6); note particularly § 404(a)(3)(A) as to available carryovers.

South Carolina Law Review, Vol. 9, Iss. 2 [1957], Art. 3

tent, their respective shares of the trust fund are actually distributed or "made available" to them (ordinarily after retirement, when they are in a lower tax bracket).[17]

(3) If the total distribution payable under the plan is made within one taxable year of the distributee, on account of the participant's death or other separation from service (or on account of his death after separation from service), the participant or his beneficiaries get long-term capital gain treatment on the lump-sum payment when received.[18]

(4) The income of the profit-sharing trust fund, from investment or otherwise, accumulates and compounds tax-free.[19]

To qualify for such highly favorable tax treatment, a profit-sharing plan must meet a number of specific requirements (some of them very technical) which are set forth in detail in the applicable provisions of the Internal Revenue Code and Treasury Department Regulations. Without attempting to discuss them separately, it may be said in general that the underlying import of all these requirements is that the plan must be established and operated for the exclusive benefit of the employees or their beneficiaries and, both as drafted and administered, must not discriminate in favor of employees who are officers, stockholders, supervisory or highly compensated employees.[20]

BASIC PROVISIONS OF A QUALIFIED PROFIT-SHARING PLAN

There are certain basic provisions that a profit-sharing plan must, or usually does, have in order to qualify under the Code and Regulations. All of these provisions are subject to the most careful scrutiny and analysis by the Internal Revenue Service to prevent the discrimination referred to above. The following sections will present a broad survey of the principal matters to be covered.

Eligibility to Participate.

It is expressly provided in the 1954 Code Regulations that the plan must prescribe a definite method for determining the employees eligible to participate in the employer's contributions to the trust.[21]

17. INT. REV. CODE OF 1954, § 402(a) (1).
18. INT. REV. CODE OF 1954, § 402(a) (2).
19. INT. REV. CODE OF 1954, §§ 402(a), 501(a); see U. S. Treas. Reg., § 1.402(a)-1; Rev. Rul. 61, 1953-1 CUM. BULL. 17.
20. INT. REV. CODE OF 1954, § 401(a) and detailed Regulations issued under § 401-402, particularly U. S. Treas. Reg., § 1.404(a)-2 (1956).
21. U. S. Treas. Reg., § 1.401-1(a), based on specific Code requirements referred to below.

Wide latitude is given in this connection. Eligibility provisions are acceptable if the plan benefits 70% or more of all eligible employees, or 80% or more of all employees if at least 70% of all employees are eligible. For the purpose of this determination, it is necessary to exclude employees who have been employed for not more than a minimum period specified in the plan — which period must not exceed five years — and part-time employees whose customary employment is not more than twenty hours in a week or is not more than five months in a year.[22]

The Code also specifically provides an alternative to these percentage requirements, to the effect that the plan may determine eligibility to participate by "classification" of employees, provided such classification is not discriminatory under the pertinent provisions of the Code and Regulations.[23] A classification is not discriminatory because it excludes employees whose entire remuneration constitutes "wages" under the Federal Insurance Contributions Act, i. e., subject to Social Security, or because it is limited to "salaried or clerical workers."[24] Nor is the plan discriminatory because contributions bear a uniform relationship to total or basic compensation of employees covered, or because contributions based on that part of an employee's remuneration which is excluded from "wages," as above defined, differs from contributions based on such "wages."[25] With respect to the above permitted classifications, if a minimum salary requirement determines eligibility, or if the plan covers only employees earning over $4,200.00 per year — the maximum amount subject to Social Security tax — then the plan must be "integrated" with Social Security, involving very detailed and complicated requirements in order to prevent discrimination.[26]

Further, such permitted "classifications" may limit eligibility to employees in a prescribed age group, employees who have been in the employ of the company for a stated number of years, employees whose work is in designated departments, and employees in other reasonable classifications, provided there is no resulting discrimination in favor of officers, stockholders, supervisory or highly paid employees.[27] Also,

---

22. INT. REV. CODE OF 1954, § 401(a)(2)(A). (Note that Rev. Rul. 56-497, 1956 INT. REV. BULL. No. 41, at 68, does not apply the "percentage" requirement for coverage under this section. Presumably, the ruling is made on the basis of proper "classification." See *supra*, p. 198.)
23. INT. REV. CODE OF 1954, § 401(a)(3)(B).
24. INT. REV. CODE OF 1954, § 401(a)(5).
25. *Ibid.*
26. U. S. Treas. Reg., § 1.401-3(e) (1956); Mim. 6641, 1951-1 CUM. BULL. 41; Rev. Rul. 13, 1953-1 CUM. BULL. 294.
27. Rev. Rul. 33, Part 4(c), 1953-1 CUM. BULL. 267, (under substantially similar provisions of the INT. REV. CODE OF 1939).

South Carolina Law Review, Vol. 9, Iss. 2 [1957], Art. 3

it is specifically permissible for a plan to provide different eligibility requirements for present and future employees and still satisfy the above mentioned requirements against discrimination.[28]

In general, it should be noted that in determining eligibility to participate under the plan, within the foregoing specific requirements, the express terms of the plan itself control.

Employer Contributions.

The provision that the employer shall contribute part of the profits of the business to the trust is the very heart of the profit-sharing plan, since these contributions constitute the profit fund to be shared by the participating employees in accordance with all the other provisions of the plan. As previously discussed, until just a few months ago the Treasury Department specifically required that a qualified profit-sharing plan contain a predetermined contribution formula definitely fixing the percentage of profits to be contributed to the trust each taxable year. However, pursuant to the Circuit Court of Appeals decisions overruling the Tax Court on the point, the applicable Regulations under the 1939 Code have been revised to omit this requirement entirely, and the final Regulations under the 1954 Code expressly permit great flexibility in employer contributions of profits, though making it very clear that a single or occasional contribution of profits will not be sufficient to establish or maintain a qualified profit-sharing plan. The final 1954 Code Regulations state in this connection:

> In the case of a profit-sharing plan, it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees.[29]

It should be noted, of course, that this expressly permitted flexibility in making employer contributions to the plan does not affect the 15% statutory limitation on the amount deductible in any taxable year; that is, such contributions cannot exceed 15% of the total compensation of all employees covered by the plan during such taxable

28. Rev. Rul. 33, Part 4(d), *ibid.*
29. U. S. Treas. Reg., § 1.401-1(b)(2) (1956).

year, plus available credit carryovers allowed under the applicable provisions of the Internal Revenue Code.[30]

The requisite procedure for taking advantage of this now-permitted flexible contribution formula has been made very simple and easy to follow.[31] Presumably, new profit-sharing plans will include a provision along the lines suggested, *infra* page 207. As to plans already qualified, an amendment may be made to the plan (or trust agreement incorporating the plan) replacing the definite predetermined contribution formula with the flexible type of provision mentioned above, without having to submit such amendment to the District Director of Internal Revenue for another determination letter qualifying the amended plan.[32] Moreover, the predetermined percentage of profits to be contributed, contained in a previously qualified plan, is not binding in any taxable year the employer wishes to exceed the percentage limitation,[33] but if the employer wishes to decrease the percentage contribution, the plan must be amended accordingly. Probably in the latter case it would be more practicable to adopt the broader amendment referred to in the preceding sentence.[34]

It may be noted further in connection with employer contributions that an accrual basis employer now has until the prescribed tax return filing date for actually paying the contribution for any taxable year.[35]

Allocation of Employer's Contributions.

A qualified profit-sharing plan must contain "a definite predetermined formula for allocating the contributions made to the plan among the participants."[36] Such a formula is definite if, for example, it provides for an allocation in proportion to the basic compensation

30. INT. REV. CODE OF 1954, § 404(a)(3); see *supra*, p. 198. (Note also, with respect to credit carryovers under INT. REV. CODE OF 1939, § 23(p), 53 STAT. 1, INT. REV. CODE OF 1954, § 404(d) expressly permits such deductions for taxable years to which the 1954 Code does not apply to the extent that they "would be allowable as deductions in later years had such § 23(p) remained in effect.")
31. Rev. Proc. 56-22, 1956 INT. REV. BULL. No. 31.
32. Rev. Proc. 56-22, 1956 INT. REV. BULL. No. 31, expressly states that the previously issued determination letter will apply to the plan as amended and that any such amended plan is "not to be resubmitted for further determination and no new determination letter will be issued."
33. This is allowed provided the excess payment is made pursuant to a legal obligation incurred prior to the close of the taxable year. (Rev. Rul. 56-366, 1956 INT. REV. BULL. No. 31.)
34. Rev. Rul. 56-366, 1956 INT. REV. BULL. No. 31; Rev. Proc. 56-22, 1956 INT. REV. BULL. No. 31. (See also August 20, 1956 issue of Prentice-Hall's *Lawyer's Weekly Report.*) The procedure outlined above has been discussed informally with a representative of the Internal Revenue Service, Columbia, South Carolina.
35. This is one of the INT. REV. CODE OF 1954 changes discussed in the body of the article.
36. U. S. Treas. Reg., § 1.401-1(b)(ii) (1956).

of each participant.[37] The formula may also take into consideration the years of service in determining the allocation, so that a formula providing for allocation of contributions among participants based on one unit for each full $100.00 of compensation and one unit for each full year of completed service of such participants, respectively, is not discriminatory.[38] Any one of many variations in the allocation formula may be included in the plan, provided that the plan, when viewed as a whole, is for the exclusive benefit of the employees and does not discriminate in favor of officers, stockholders, supervisory or highly compensated employees.[39]

Distribution of Benefits.

Similarly, such a plan must contain a definite predetermined formula for distributing the funds accumulated under the plan, after a fixed number of years, upon the attainment of a stated age, and/or upon the prior occurrence of an event such as layoff, illness, disability, retirement, death or severance.[40] Such formula may provide for distribution of the benefits to an employee or to his beneficiary in a lump-sum or in installments, or it may provide for purchase of an annuity contract for the participant.[41] In order to secure long-term capital gain treatment, there must be a distribution of total benefits payable within one taxable year of the distributee, on account of the participant's death or other separation from service, or on account of his death *after* separation from service.[42] Distribution to an employee, within one year after his separation from service, of an annuity and a cash sum representing his total interest in the trust fund, also qualifies for long-term capital gain treatment.[43]

With a view to distributing benefits as advantageously as possible for each participant, most plans expressly provide that a retiring participant shall have the option of selecting which of the foregoing methods of payment he prefers. Usually, such option is exercisable only after the participant has consulted with the administrative committee as to the nature and tax consequences of adopting a particular method, and often, the choice of some or all of such methods of payment is subject to approval by the committee.[44]

37. *Ibid.*
38. I.T. 3685, 1944 CUM. BULL. 324.
39. U. S. Treas. Reg., § 1.401-4(2)(iii) (1956).
40. U. S. Treas. Reg., § 1.401-1(b)(1)(ii) (1956).
41. INT. REV. CODE OF 1954, § 402(a)(1); U. S. Treas. Reg., § 1.402(a)-1(a)(2); see *supra*, p. 198; *cf.* Rev. Rul. 33, Part 5(j), 1953-1 CUM. BULL. 267.
42. INT. REV. CODE OF 1954, § 402(a)(2); see *supra*, pp. 196 and 199.
43. P-H 1956 Pension and Profit-Sharing Serv. § 9916.
44. As to such options generally, see Rev. Rul. 33, Part 5(j), 1953-1 CUM. BULL. 267 (issued under substantially similar provisions of the INT. REV. CODE OF 1939.)

Vesting.

There is no language in the Internal Revenue Code Sections requiring that an employee be credited with immediate vested rights in his employer's contributions as a condition for qualifications of a plan. The term "vested" or "vesting" is used to denote the portion of a participant's interest in an employee-benefit trust which is nonforfeitable in that the participant is entitled to have it paid to him upon termination of his employment. Various provisions for vesting are used, ranging from complete and immediate vesting through different forms of graduated vesting, upon completion of stated service or participation requirements, to no vesting until attainment of stated or normal retirement age.[45]

Benefits may be discontinued for cause, which must be specified in the plan; for instance, a plan providing for complete forfeiture in event of discharge before retirement for dishonesty, insubordination, or commission of a crime, has been approved. Also, a provision that benefits be fully vested after a reasonable waiting period will usually satisfy the requirement against discrimination. However, all provisions for vesting of rights of employees are subject to the general requirement that there must be no resulting discrimination in favor of officers, stockholders, supervisory or highly compensated employees.[46] Of course, in view of the many varied types of vesting in different kinds of plans, any determination as to satisfactory provisions of vesting will necessarily depend on the facts in each particular case.[47]

Most plans provide that any part of a participant's interest in the trust fund which has not vested on termination of employment, in conformity with the vesting provisions, will be forfeited. Usually the forfeited amounts become part of the trust fund and thus serve to increase the respective interests of other participants. Again, the overriding requirement is that forfeitures may not inure to the principal benefit of officers, stockholders, supervisory or highly compensated employees, and of course, under no circumstances may "substantial funds derived from forfeitures" revert to the employer upon termination of the plan.[48]

The Trustee and Trust Investments.

Since the applicable Sections of the Internal Revenue Code require that there be a trust into which the employer's contributions

45. Rev. Rul. 33, Part 5(b), 1953-1 CUM. BULL. 267; P.S. No. 22, 9-2-44.
46. Rev. Rul. 33, Part 5(b)(2), 1953-1 CUM. BULL. 267; P.S. No. 22, 9-2-44.
47. Rev. Rul. 33, Part 5(b)(1), 1953-1 CUM. BULL. 267.
48. P.S. No. 22, 9-2-44.

South Carolina Law Review, Vol. 9, Iss. 2 [1957], Art. 3

under a qualified profit-sharing plan may be paid,[49] it is necessary for the employer to designate a trustee or trustees to hold and administer the trust funds — either an individual or a group of individuals, or a corporate trustee. The Tax Court has specifically held that officers and directors of the employer may serve as trustees,[50] though usually in such a case there is also at least one "independent" trustee. Ordinarily a bank or trust company is named as trustee, not only because of its experience and financial responsibility in trust administration, but also because such independent control over the trust funds facilitates getting Treasury approval of the plan. Under the terms of the trust agreement, and in actual operation, there must be no use or diversion of any part of the trust funds for, or to, purposes other than the exclusive benefit of the employees or their beneficiaries.[51]

In general, except as noted below, no limitations are imposed by the Code or Regulations on the scope of investments which may be made by the trustee. Thus, in practically all plans, broad powers of investment are expressly authorized in the trust instrument itself. However, the exercise of these broad powers is subject to any contrary applicable provisions of State law,[52] and also to certain specific Sections of the 1954 Internal Revenue Code:

> Under Section 502 the trust may lose its tax-exempt status if it comes under the "Feeder Organization" provisions relating to operations for the primary purpose of carrying on a trade or business, and under Section 503, if it engages or has engaged in "prohibited transactions" after March 1, 1954.
>
> Section 511 provides that the trust will be taxed on "unrelated business income," that is, income derived from any unrelated trade or business which it regularly carries on.
>
> Section 503(c) sets forth the "prohibited transactions" discussed previously, *supra* page 197 (to the general effect that the trustee's transactions with the employer must be based on arms-length dealing involving full consideration and adequate security, or the trust will lose its tax exemption). As an example of the way these provisions operate in practice, the Treasury has just issued a Release to the effect that if the trustee purchases debentures of the employer corporation, even on the open market, it will be considered a loan made to the employer without "ade-

49. INT. REV. CODE OF 1954, §§ 401(a), 402(a), 404(a)(3); see P.S. 55, 1-9-56.
50. Forcum-James Co., 7 T.C. 1195 (1946); see other such cases noted in P-H 1956 Pension and Profit-Sharing Serv. § 9901.
51. INT. REV. CODE OF 1954, § 401(a)(2).
52. U. S. Treas. Reg., § 1.401-(b)(5)(i) (1956).

quate security," debentures being unsecured loans, and, therefore, a "prohibited transaction."[53]

Other Usual Provisions.

Other less fundamental provisions usually included in a qualified profit-sharing plan should merely be listed:

Definitions, defining all the principal terms used throughout the plan (such as "Effective Date," "Employee," "Participant," "Compensation," "Net Profit," "Disability," "Continuous Service," "Contribution," etc.).

The Committee, establishing an administrative committee with specific powers and duties to operate the plan, instruct and furnish requisite data to the trustee, consult with the participants as to their options and other rights, determine questions of construction under the plan, etc.

Distribution of Benefits (already discussed in general, *supra* page 203), usually setting out separate provisions or "Articles" on Retirement Benefits, Death Benefits, Disability Benefits, and Benefits Upon Termination of Employment Other Than by Reason of Retirement, Death or Disability.

Rights and Duties of Trustee, providing in detail the responsibilities, powers and protective rights of the trustee, as to keeping records and individual segregated accounts, investing and making periodic valuations of the trust fund, etc.

Amendment and Termination, giving the Board of Directors of the employer broad powers, but stating requisite limitations under the Code and Regulations as to the basic purpose of the plan, permanency except for sound business reasons, full distribution to participants on termination, etc.

Miscellaneous Provisions, as to limited legal effect of adopting the plan, application of South Carolina law, spendthrift trust provisions, etc.

Scope and Importance of Flexible Contribution Formula

Reviewing the various recent changes and developments in the framework of the basic provisions of a qualified profit-sharing plan, it seems very obvious that the Treasury Department's acceptance of the flexible contribution formula is the most important — and far-

53. Treas. Rul. TIR-27, 11-8-56.

reaching in its practical effect — of any development in this field that has taken place since the institution of tax-exempt employee-benefit plans or trusts. To indicate more concretely the tremendous scope of this change, it might be helpful to contrast the type of employer contribution provision used before this change, with a suggested type of such provision for use in new plans.

Provision in a plan that was qualified before the change (the employer being referred to as the "Company," and defined terms being designated by initial capitals):[54]

> For the Taxable Year 1955 and for each Taxable Year thereafter during the continuance of the Trust, the Company shall contribute to the Trust Fund an amount equal to seven (7%) per cent of its annual Net Income for such year, such Contribution not to exceed, however, fifteen (15%) per cent of the aggregate Compensation of all Participants for such year, plus available carryovers under the applicable provisions of the Internal Revenue Code.

Proposed revision for new plans (not yet covered by determination letter):

> For the Taxable Year 1956 and from time to time thereafter during the continuance of the Trust, the Company shall make recurring and substantial Contributions of Net Profits for any Taxable Year in which a Contribution is to be made, shall be determined by the Board of Directors before the end of such year, and shall be communicated to the Trustee and the Participants within the year determined; provided, however, that the amount of any such Contribution for any Taxable Year shall not exceed fifteen (15%) per cent of the aggregate Compensation of all Participants for such year, plus available carryovers under the applicable provisions of the Internal Revenue Code.

It is too early after such a vital change to do more than merely speculate on its ultimate effect. One result seems certain. The language of the final Regulations under the 1954 Code, *supra* page 201, requiring "recurring and substantial" employer contributions to the plan, is bound to give rise to conflicting interpretation, perhaps to a surge of litigation. "Recurring" and "substantial" are broad terms. The Regulations state that "recurring" does not mean contributing "every year," but the question remains as to how many years

54. Letter of determination of District Director of Internal Revenue, Columbia, South Carolina, received issue just a month before the Treasury's acquiescence in change.

can be skipped, i. e., more than two years, or one year in every three or four years? "Substantial" could mean a large sum of money relative to the size of the company, or it could mean a substantial percentage of the annual profits, or a big proportion of the first contribution. Even recognizing that questions like these depend on the particular facts and circumstances involved, there is ample opportunity for argument on any set of facts.

GROWTH AND POPULARITY OF PROFIT-SHARING PLANS — OVER-ALL BENEFITS

On the other hand, this major development of permitting a flexible contribution formula will undoubtedly stimulate even further the already amazing growth and popularity of qualified profit-sharing plans. A current periodical[55] points out that such plans have now increased in number to over 10,000, while another publication[56] elaborates on the statistics by noting that during the twenty-one year period of Social Security's existence (the Government's) "employee-benefit plan," that private plans have mushroomed.

It makes the observation that in 1935 there were fewer than 1,000 pension and profit-sharing plans and today there are more than 30,000, that the number is increasing at the rate of several thousand a year, and that 22 million employees (estimated) are now covered by private retirement plans.

In this connection, and by way of conclusion, it ought to be clearly emphasized — or this article would be very misleading — that the tax advantages of such employee-benefit plans are by no means the only reason for their unprecedented popularity.

Probably the biggest benefit of all is the improved employee-morale factor. Real profit-sharing in the business operation, particularly through such an ideal medium, naturally adds incentive to work harder and more efficiently to make the business a success. Watching one's interest in the profit-sharing trust grow steadily each year — usually more rapidly than expected because of tax-free income accumulations — is bound to "pep up" an employee's outlook on life and give him a sense of loyalty and proprietorship which is invaluable to a successful business.

This financial stake in the profit-results not only boosts efficiency, but also inevitably cuts down grievances and absenteeism, while the forfeiture provisions (*supra,* page 204) definitely tend to hold the

55. *Lawyers' Weekly Report,* October 1, 1956 (Prentice-Hall).
56. *The Hanover Pension Bulletin,* September, 1956.

South Carolina Law Review, Vol. 9, Iss. 2 [1957], Art. 3

good employees against competition and thus substantially decrease the labor-turnover cost.[57]

All this adds up to the most effective method yet developed for increasing the profits of the business, and at the same time helping greatly to harmonize the relations between labor and management. It is not too broad a prediction to say that history will probably refer to this phenomenal rise and growth of profit-sharing in American industry as the most constructive and significant economic development of our era.

57. In addition to giving the employee a feeling of security, qualified profit-sharing plans are also proving to be a tremendous help in creating and conserving a business owner's estate, especially small or closely held businesses. See *The Hanover Pension Bulletin,* November, 1956.