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Profit Sharing Used in American Business

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PROFIT SHARING USED IN AMERICAN BUSINESS

by

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This independent study submitted by William M. Milne in partial fulfillment of the requirements for the Degree of Master of Science in the University of North Dakota is hereby approved by the Committee under whom the work has been done.

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ABSTRACT

Profit sharing, as I stated in my introduction, is a relatively new idea being used in businesses. It can be a very important part of a business. I believe we will see the day when young people seeking a job will ask, "do you have a profit-sharing plan?" It could very likely be one of the personal requirements they want in a job.

In my paper I go the beginning of profit sharing to show that it has shown a tremendous growth since it was born. Then I discuss the types of plans there are; each plan is suited to a particular type of business. To fully understand the value of profit sharing one must know the two types in their entirety.

Then finally, I discussed the profit sharing plan which the corporation I am joining uses. I included this to show a concrete example of the plan. It is always easier to understand a problem if one can see an actual working case.

In this paper I have tried to show the values of profit-sharing and I believe if a proper understanding is found the average person will also realize these values.

CHAPTER I

INTRODUCTION

Profit sharing is a relatively new idea being used in businesses today; it was born approximately 300 years ago in the mind of Albert Gallatin. Before an employer ventures into a program of profit sharing he must seriously consider the future under such a program. To consider it seriously he must have a basic understanding of the factors involved in starting such a plan.

My paper is a discussion of the various phases of profit sharing. The second chapter deals largely with the history of profit sharing. This was included since any basic understanding of a problem must go back to its very beginnings.

The second section of this chapter deals with practice; what provisions can be included in a plan, what cannot be included and why it cannot be included.

The third chapter discusses the two types of profit sharing: immediate distribution and deferred-distribution. A wage dividend plan is also discussed in this chapter.

The corporation which I am joining after my graduation has a profit sharing plan. To further explain what a profit sharing plan is and to use an example from actual business, the final section or chapter of my paper discusses the profit sharing plan of First Bank Stock Corporation.

CHAPTER II

History of Profit Sharing

The term profit sharing is often applied to many types of employee benefit programs which are really something quite different. Almost any program that is paid for by the employer has been called a profit sharing plan, therefore my first step will be to see what true profit sharing is.

The classic definition is "A form of remuneration of employees which is voluntary on the employer's part and is supplemental to the regular wage, and which distributes to a representative portion of the working force, for the purpose of securing its cooperation and loyalty, a percentage, fixed in advance of the net profits of the enterprise."[1]

The requirement that the amount to be shared must be directly related to the profit clearly distinquishes true profit sharing from bonuses, pension plans, a guaranteed annual wage, employees stock purchase, etc. Although all of these benefits are paid for out of the employer's gross income, their cost is not dependent on the amount of the profits and they will not qualify as profit sharing.

Profit sharing has had a long record of experience in the United States. The first known attempt to operate such a plan was

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[1]Practical Experience with Profit Sharing in Industrial Establishments (Boston, Mass.: 1920), p. 5.

made in 1794 when Albert Gallatin, Secretary of the Treasury under Presidents Jefferson and Madison, tried it in his glass works.[2] Sources failed to reveal any more information on the details of Gallatin's plan.

Profit sharing has had its trial on the largest scale in the United States in the Pillsbury's Flour Mills in Minneapolis, Minnesota.

"Pillsbury's scheme for profit sharing was announced on September 1, 1882."[3] Of the four hundred to five hundred men of the company, about one fourth were selected for the experiment the first year. This included all the responsible employees in the offices and the mills. and any other employees who had worked for the firm for five continuous years. The plan had two provisions, one of which was that the men had to stay with the firm during the year and also that every man included in the arrangement shall perform his work and conduct himself in a manner satisfactory to the company. The first year each man received checks averaging about $400.00. The bonus was calculated upon the wages of each man. It averaged about 33 per cent of the yearly earnings of each man. The system gave complete satisfaction to the firm as well as to the individual employee.

In 1886 a profit sharing plan was established by the N. O. Nelson Manufacturing Company of St. Louis, Missouri.[4] Under the original plan, capital invested in the company received a return of 7 per cent interest, and the remaining profits should be divided between capital and wages in the proportion which these bore to one

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[2]Nicholas P. Gilman, Profit Sharing Between Employer and Employee. (Houghton Mifflin and Co., 1891), p. 296.

[3]*Ibid.*, p. 302.

[4]*Ibid.*, p. 305.

another. During the first four years of operation of the plan, employees could take their payments in cash or in company stock. Later all payments were made in stock. A unique feature of the Nelson Company plan provided for sharing profits with customers. These shares were in the form of stock of the company. This method was continued until the early 1900's, when customer profit sharing was abolished. The company was satisfied that customers did not appreciate their payments. More important was the increasing number of customers withdrawing from the company because of failures and various other reasons. At this time, payment of shares of profits to employees was changed from stock to cash. This plan was followed until 1930 when dividends stopped because of the depression.

Profit sharing first came to general notice during and immediately following the first World War, when profits were high and management could afford to be generous. The principle of sharing profits was advocated as a means of insuring cooperative relations between management and labor by giving to employees a return over and above wages as a reward for their efforts in making the enterprise profitable. It was opposed by some because it tended to obscure the line between management and working force which should be maintained. It was opposed by organized labor sympathizers on the ground that it was paternalistic and sought to conceal the fact that higher wages should be paid.

Profit Sharing Practices

More recently, the profit sharing idea has been employed to meet two general situations. Companies which believed that successful operation resulted from the efforts of a selected group of executives another. During the first four years of operation of the plan, employees could take their payments in cash or in company stock. Later all payments were made in stock. A unique feature of the Nelson Company plan provided for sharing profits with customers. These shares were in the form of stock of the company. This method was continued until the early 1900's, when customer profit sharing was abolished. The company was satisfied that customers did not appreciate their payments. More important was the increasing number of customers withdrawing from the company because of failures and various other reasons. At this time, payment of shares of profits to employees was changed from stock to cash. This plan was followed until 1930 when dividends stopped because of the depression.

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Profit Sharing Practices

More recently, the profit sharing idea has been employed to meet two general situations. Companies which believed that successful operation resulted from the efforts of a selected group of executives have sought to stimulate these executives with the use of a financial return substantially in excess of their salaries. Profit sharing has also been considered particularly effective in the case of small companies, manufacturing a specialty product, where the management wishes to reward and to retain a group of long-service employees who have contributed substantially to the profitability of the company and whose continued loyalty to the company is considered an important asset.

No comprehensive survey of profit sharing in the United States was undertaken until the investigation by the United States Department of Labor in 1916.[5] In that year, 60 companies had profit sharing systems, more than two-thirds of which had been in operation less than ten years. Of these sixty profit sharing establishments, 33 were manufacturing concerns, of which seven have since abandoned their plans. In a survey of companies using profit sharing, conducted in 1954, there were a total of 308 companies utilizing profit sharing plans.[6]

Although profit sharing has repeatedly been declared impracticable, and contrary to sound economic principles, it continues to grow and thus overwhelms its critics. Like any other industrial relations activity, it is probably not universally applicable nor necessarily equally adaptable to all industrial situations. It naturally raises administrative and psychological problems that in many cases have led to its abandonment. However, as history has improved so many things, it has also improved profit sharing. Certain general plan requirements

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[5] Practical Experience, op. cit., p. 10.

[6] P. A. Knowlton, Profit Sharing Patterns, Profit Sharing Research Foundation, 1954, p. 5.

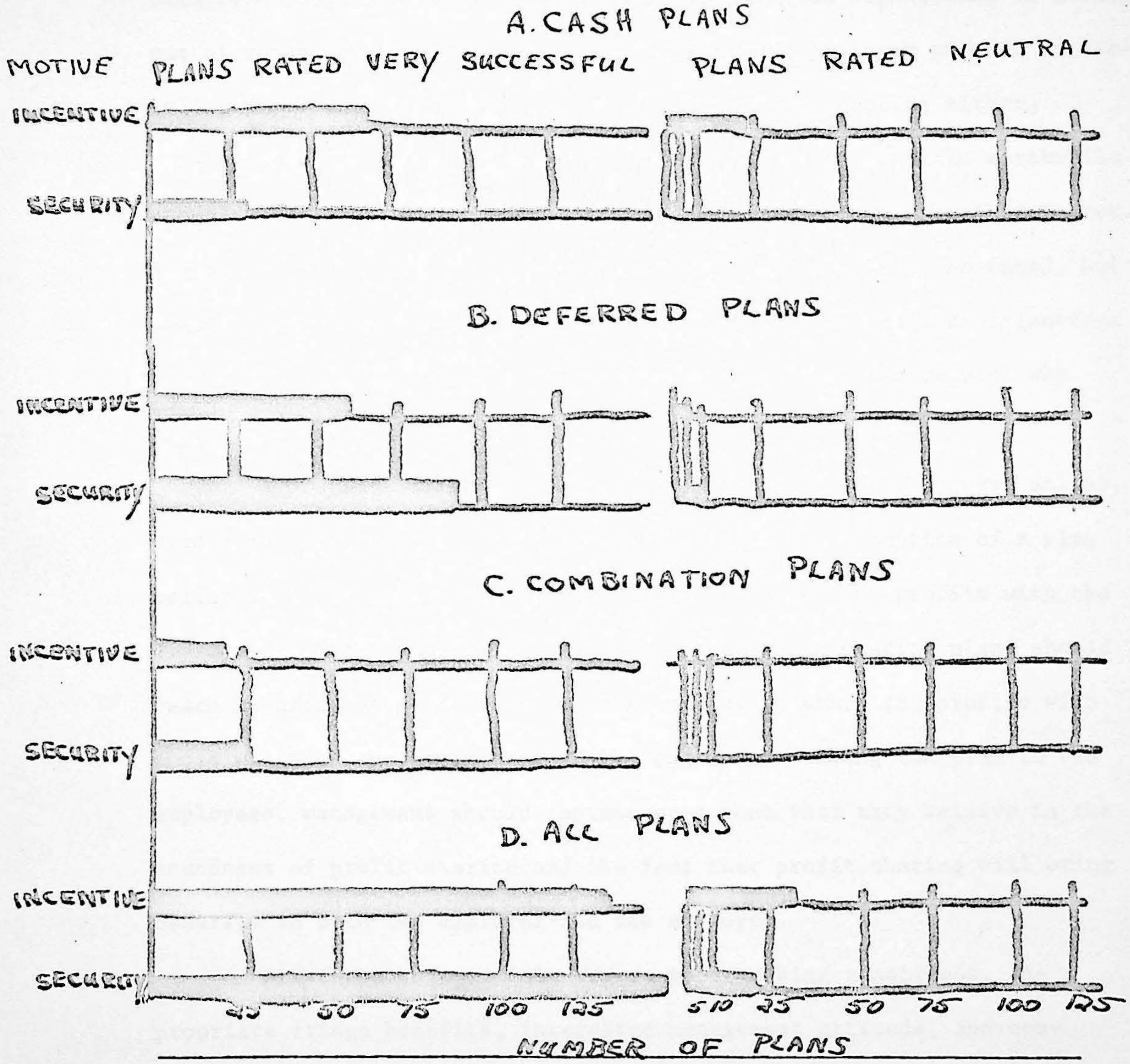
have come into being for profit sharing and these will be discussed in the next few pages.

The failures among profit sharing plans have clearly shown that certain conditions must exist before a successful plan can be established and that, once established, the plan must be carefully cared for and supervised. A plan which fails is worse than no plan at all.

Take home pay is by far the most important thing to the employees; it is the main reason they are working. Under no circumstances should a profit sharing plan be a substitute for fair and equitable salaries. If salaries are not adequate and in line with those paid by other local employers in the same industry, a profit sharing plan has little chance of succeeding. The conditions under which the men must work, the number of hours they must work per week, as well as the holidays which the employees have off from work, vacations and sick pay or sick leave must also compare favorably with those in the area. If these conditions are not equalled, there is no incentive for the workers and their morale is low. Following is a chart showing incentive and security motives for plan installation.

There may be certain other fringe benefits that are equally as important to employees as profit sharing, and a plan should not be installed unless these other benefits are already available. These include life insurance, medical coverage, retirement benefits, and so forth. A profit sharing plan, no matter how generous, cannot be designed to be a satisfactory substitute for these other fringe benefits. Also, if an employer has been paying a cash bonus each year, the employees may not welcome profit sharing as a replacement. A profit

RELATIVE FREQUENCY OF INCENTIVE AND SECURITY MOTIVES FOR PLAN INSTALLATION, BY PLAN TYPES AND REPORTED DEGREE OF PLAN SUCCESS



[7]Ibid., p. 61.

sharing plan has certain defects as a retirement medium because a profit sharing plan lacks definiteness regarding the ultimate amount available for retirement benefits. Thus an employer should not adopt profit sharing without first considering the possibility of a pension plan. Either plan is a long range program which will involve the expenditure of a large sum of money over the years, and a future minded employer owes it to himself and his employees to investigate both before adopting either.

Lack of profits or lack of sufficient profits to make worthwhile annual contributions has caused more plans to fail than any other factor. A failure to make a contribution in a single year will not be fatal, but a series of years in which no contributions, or only small contributions are made will result in failure. Because of this it can be seen why profit sharing would not be practical for marginal firms.

A profit sharing plan will have little chance of success unless each member of the management team recommending the adoption of a plan believes in the principles of sharing a portion of the profits with the employees. Management, before installing a profit sharing plan, should reach an affirmative decision that it wishes to share the profits with those who make the profits possible, and in presenting the plan to the employees, management should impress upon them that they believe in the soundness of profit sharing and the fact that profit sharing will bring benefits to both the employer and the employee.

All these things: fair wages, good working conditions, appropriate fringe benefits, interested management attitude, and continuing profits will insure the success of a plan as far as the initial employee reaction is concerned. The employees will then welcome a profit sharing plan. However, in order for the employer to receive his benefits he must sell the plan to the employees and keep it sold. If he does not, the employees will soon take the plan for granted as part of their regular compensation. The employer should not consider this necessity a "chore", it is an opportunity. A profit sharing plan is perhaps the ideal medium for a communication from management. When management is considering a profit sharing plan there are two occasions when they must communicate with the employees. The first is the initial presentation. When the plan is established the employees must be informed of its provision. The plan will be a technical document in legal language and, whether or not copies of the plan are distributed, each employee should be given a summary written in ordinary language. Also, it would be advisable to hold a meeting or a series of meetings in which an officer or supervisor could explain the various provisions and answer any questions.

Secondly, the management must follow up the plan. Each time the employer makes a contribution to the plan each employee should be advised of his prorata share of the contribution, as well as of the value of his interest in the fund. It is important that the plan be kept in front of the employees at all times.

Although these are the only communications which are absolutely necessary, it is desirable for the employer to furnish the employees with additional information. An annual report of the financial transactions in the trust showing income, receipts and disbursements, benefits paid, a statement of investments, etc. should be distributed to the employees at the year-end. Many employers also give their employees interim reports of operating earnings to date. Other communications to the employees reminding them of the plan can be made at group meetings or by letters from the president, by articles in the company magazine, by notices on bulletin boards. The form of communication will depend upon the organization since what would be appropriate for one firm might be entirely inappropriate for another. Regardless of the means used to give information about the plan to the employees, the employer should make use of these occasions to keep the employees convinced that he is interested in their welfare and that he sincerely believes in the principle of profit sharing. The employer can use these opportunities to explain the profit and loss system and to point out that the entire staff is engaged in a joint enterprise, the success of which depends upon the cooperation of all, and that every person on the staff can make a contribution to the welfare of the organization.

CHAPTER III

Types of Profit Sharing

There are two main types of profit sharing plans, immediate-distribution profit sharing plans and deferred-distribution profit sharing plans.

Immediate Distribution

The immediate-distribution profit sharing plan is the simplest of the two. This plan provides compensation addition to take-home pay as a reward for better than average performance as measured by the profits of the enterprise. None of the shared profits are stored for future delivery. The plan is thus essentially a bonus plan dependent upon profits, the distributions usually being made annually. This type of plan offers the greatest production incentive to rank and file employees but is less beneficial to management personnel.[8]

Among reasons for establishing immediate-distribution profit sharing plans have been a desire to unify the interests of the business and employees and to install a feeling of partnership, to increase employee initiative and efficiency, to eliminate wasteful practices, and to improve employee goodwill and loyalty.[9]

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[8] Clark C. Havighurst, Deferred Compensation for Key Employees. (Durham, North Carolina, Callaghan and Co., 1964), p. 43.

[9] Jules I. Bogen, Financial Handbook. (New York: Ronald Press Company, 1950), p. 1024.

Immediate-distribution profit sharing plans may include one or more employees. The employer may decide who are to receive the bonuses and the division of the shared profits. It is up to the employer whether the plan be formal or entirely discretionary. In contract, deferred-distribution profit sharing plans which qualify under the Internal Revenue Code must include a fixed formula to fix the portion of profits to be shared and a nondiscriminating method of allocation among the employees. Most deferred-distribution profit sharing plans include all regular employees who have completed a specified period of service.

The formula to determine the portion of profits to be shared under an immediate-distribution profit-sharing plan may be based on profits before or after taxes. The percentage used will be lower if it is applied to profits before taxes. In order to have a fair return to stockholders, many plans provide that dividends will be deducted before determining the amount of profits to be divided among employees. Under this type of plan it is possible to weigh allocations to participants according to length of service as well as compensation. In many cases, no formal method of allocation is specified, the distributions being based on merit and in the discretion of the employer. Profit sharing plans of the immediate-distribution type are sometimes established to give compensation increases in prosperous times that will automatically lapse during periods of poor business. Employees will not usually accept such a basis of compensation unless it is a supplement to a competitive wage scale. If good employee relations are to be maintained, basic rates of compensation must be paid that are in line with those paid by industry and the community.

A profit sharing plan must provide reasonably large returns to individual participants if it is to promote employee goodwill and efficiency. Profit sharing is likely to be most effective in industries where labor cost is a low percentage of gross sales, making it possible to make substantial payments to individual employees.[10] Employee dissatisfaction has been a leading cause for the failure of many immediate-distribution profit sharing plans. The employees become accustomed to receiving extra compensation when profits permit and gear their living standards accordingly, when the extra compensation is reduced or eliminated because business is poor, they tend to look upon the reduction as a pay cut. Also, dissatisfaction results from delay in making distributions, which may occur as much as a year after the profits from employee efforts have actually been earned. This practice goes against the psychological practice of rewarding an accomplishment immediately for better and faster results. This distribution can go so far as to be made by a single annual payment. While employees are likely to be enthusiastic at exactly that time, interest will be lower for the rest of that particular year. In a survey conducted of 41 companies with profit sharing plans, 29 instances of dissatisfaction with the plan itself was the reason given for abandonment. In 15 of the 29 cases the company expressed itself as generally dissatisfied with the results. In a few of these there was a feeling that, although the plan was appreciated by a substantial proportion of the workers,

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[10] Ibid., p. 1025.

results under it failed to compensate for the outlay of money. In 6 instances of the 15, apathy of the workers was given as the cause of the company's dissatisfaction. In 14 of the 29 cases the reason for abandonment was given as the dissatisfaction of the workers themselves, although not always in protest to the profit sharing plan. In seven of these cases, labor trouble was given as the reason. In three others, the workers preferred to receive increases in the weekly wage rather than profit sharing distributions. In the remaining four cases, trade union opposition was the reason given.[11]

It is essential that a continuous educational effort be made to impress employees with the principles of the plan so that there will be a minimum of dissatisfaction when the profit-sharing distribution is reduced or eliminated.

The history of immedaite-distribution profit sharing plans shows no growth in usage. More plans are established during periods of prosperity, but there is a high rate of discontinuance during depressions.

Under the immediate-distribution type of profit sharing, the amounts received by employees are subject to personal income tax in the year they are received. The employer's profit sharing contributions are deductible from his taxable income if the test of the Internal Revenue Service regulations as to reasonableness of total employee compensation is met. The employer cannot make unreasonable contributions to some key executives or employees just to reduce his income tax.

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[11] <u>Practical Experience</u>, <u>op</u>. <u>cit</u>., P. 22. 23.

Deferred Distribution

The second main type of profit sharing plan is the deferred-distribution plan.

A deferred-distribution profit-sharing plan is one designed to qualify under the Internal Revenue Code, so that the employer may deduct his contributions from taxable income and no income tax needs to be paid by employee participants until the year when benefits are actually received.

Section 401 of the Internal Revenue Code provides that in order to qualify a plan must benefit either:

1.) 70% of all employees

2.) 80% or more of all the employees who are eligible, if at least 70% are eligible, or

3.) Any class or classes of employees approved by the Commissioner of Internal Revenue as not being discriminatory in favor of officers, supervisory employees, and so forth.[12]

A deferred-distribution profit-sharing plan may be defined as one in which a prescribed share of each year's profits is placed in a trust fund or invested. The distribution to an employee of his share in the trust is deferred for a period of years or until the occurrence of a specified event such as death, disability, retirement, or other separation from service.[13]

Objectives of deferred-distribution profit sharing plans are the same as in immediate-distribution plans. Most of the plans established during the war years were designed as a substitute for wage

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[12] An Introduction to Profit Sharing. (Chicago, Illinois: The National Association of Bank Auditors and Comptrollers, 1957), p. 12.

[13] Ibid., p. 10.

and salary increases. Some employers have sought to use profit sharing to finance retirement benefits.

In establishing a deferred-distribution profit sharing plan, the employer must decide which employees will participate, and in making this decision he must meet certain requirements. The plan must be established for the employees in general and not for the high executives alone. This doesn't mean that every employee must be a participant, but it does mean that membership in the plan can't be confined to officers, supervisors, and the like, or even to those persons who have rendered the most valuable service to the employer. The company's decision regarding eligibility will be a matter of policy and will usually depend upon the main purpose of the plan. If the main purpose is to provide retirement benefits it would be wise to impose severe eligibility restrictions or to provide that employees who resign shall forfeit a large portion of their shares. Such a provision would concentrate the benefits to employees who stay with the company until retirement age. There is also a disadvantage to this in that the company might keep a non-productive employee on the payroll until retirement just to avoid trouble with the labor union. On the other hand, if the main purpose of the plan is to provide an incentive to the employees, then the plan should permit them to become eligible at an early date.

At the present time a definite predetermined formula for calculating the employer's annual contribution is not legally essential to the qualification of a profit sharing plan. However, it seems doubtful that employees will appreciate a plan that gives them no assurance of some share of the profits. For this reason it is desirable that a plan contain a definite predetermined formula for calculating the employer's annual contributions.

In order to be deductible for income tax purposes the employers contributions must meet three requirements.

1.) They must be made from current or accumulated profits. A contribution that is not made from profits is not deductible.

2.) The contribution may not be in excess of that determined by the formula (If the plan contains a formula). If the formula results in an indicated contribution of $10,000 and the employer contributes $15,000, only the $10,000 is deductible.

3.) The contribution in any year cannot exceed 15% of the total compensation paid to the participants during the year, and the maximum amount deductible for the cinbined contribution to a pension plan and a profit sharing plan is 25% of such compensation. (This is the general rule, although provision is made for carry-over contributions when the contributions in previous years have been less than the permissible limit.)[14]

A good formula for one company might be inappropriate for another. It will depend upon the relation of earnings to payroll, upon the capital structure, and upon whether there is an adequate existing pension plan. Company plans frequently apply the formula to operating earnings, excluding capital gains and losses. The contribution formula will be a matter of company policy and will vary from company to company. It is usual to find that the generosity of a formula depends upon whether there is an already existing pension plan.

When a plan requires or permits the employees to make contributions to the plan, the result is usually a tax free savings program within the structure of the profit sharing plan. The amount of the employee's contribution usually doesn't affect his share of the em-

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[14] Ibid., p. 13.

ployer's contributions. There are a few plans, however, that require the employees to contribute a minimum percentage of their salaries. These permit any member to increase the amount of his contribution if he desires. If the employer's contribution is allocated among the employees on the basis of their own contributions, care must be taken that the minimum required percentage is not so high that the lower paid employees will not join the plan.

The deferred-distribution profit sharing plan must contain a definite formula for the allocation of the employer's contribution among the employees. This is usually done on the basis of the employe's basic compensation. The plan will describe in detail those profits which are to be shared with the employees. Particularly if the plan is to serve an incentive function, it will usually deny to the participants a share in such non-operation income as earnings from investments on other companies, increased inventories, value because of a particular method of valuation, and capital gains that may result from the sale of the companies asset. Also, in order to protect the interests of the stockholders, plans will commonly allow employees to participate only after some specified profit level is reached. Great flexibility is possible in the contribution formula, and some firms provide stepped up rates of employee participation at higher profit levels. If desired, profit sharing contributions in good years may be reduced where loss years have intervened in order to assure that shareholders are not prejudiced. Usually the profits to be shared are determined on a before-taxes basis so that changes in tax rates, or refunds do not affect the formula or make a re-calculation necessary.

Following are two examples of contribution formulas: One firm, computing its contributions after taxes, reserves the first $7,500 of profits to itself and allows the employees to divide the next $10,000 among themselves. It pays to the employees 30% of the first $10,000 of any additional profits, 40% of the next $10,000, and 50% of any balance which might remain. The Board of Directors is authorized to make a contribution of up to $5,000 if the formula yields less than that amount.[15]

One major company has adopted the following formula: The Company will pay over to the trustee, as its annual contribution to the trust fund, a sum of money equal to the sum of 2% of any earnings before taxes in excess of the amount required to produce after-tax earnings per share of 50¢ and an additional 3% of any earnings before taxes in excess of the amount required to produce after-tax earnings per share of 75¢.[15]

In those cases where the employer has no pension plan and where the profit sharing plan is established primarily to provide retirement benefits, it is not unusual to weigh the allocation in favor of the older employees who will not have enough prospective participation in the plan to build up any substantial benefits. This is usually done by allocating the contributions on the basis of units, giving each employee one unit for each $100 of annual salary and one unit for each year of previous service.[17] There

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[15] Deferred Compensation, op. cit., p. 46.

[16] Ibid., p. 47.

[17] Introduction to Profit Sharing, op. cit., p. 15.

are other ways of weighing the formula in favor of older employees. Any method will be acceptable provided it does not discriminate in favor of officers and higher paid employees.

The formula may simply commit the employer to contribute a certain percentage of the profits each year, but it is more common to have contributions based on a specified percentage of the profits in excess of either a set dollar figure, a percentage of invested capital or in excess of the dividends paid to the stockholders. Under some plans, the profits are shared with employees on a progressive scale, so that the larger the profits the larger will be the proportion contributed under the profit sharing plan.

A maximum on annual contributions of 15% of the compensation of participating employees is set by the Internal Revenue Service and the company is only allowed deductible contributions to that amount.[18] But it is not necessary to restrict contributions to the 15%, since the law allows larger contributions if less than 15% of the compensation of participants was contributed in previous years. It is possible to contribute and deduct in one year as much as 30% of the compensation.

The plan may establish individual accounts in dollars for participating employees. Individual accounts are sometimes established in terms of units having an initial stated value, which are revalued in the future by dividing total assets held under the plan by the number of outstanding units. This unit method makes accounting computations easier.

Under a unit formula, the interests of new and old participants

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[18]Bogen, op. cit., p. 1029.

should be protected from dilution by dividing the amount in the fund, before a new contribution is made by the number of units outstanding before the addition of new units, to determine the unit value used in apportioning current contributions.[19]

It is usual under deferred-distribution profit sharing plans to provide for normal retirement of employees, usually when they reach age 65. Because of the absence of any fixed retirement annuity concept such as is usually applicable under a pension plan, profit sharing plans generally do not include provisions for annuity payments to employees who retire before the normal retirement date. If the profit sharing plan uses a group annuity contract, such a provision may be included, and reduced incomes beginning at earlier ages are available if individual policies are used. Unless operated with a pension plan, a profit sharing plan does not usually contain detailed provisions for retirement of employees after the normal retirement date or a provision preventing employees who continue to work after the normal retirement age from receiving an allocation from the subsequent annual contribution of the employer.

Retirement benefits payable for life are usually absent under profit sharing plans. Instead, provision is made for a lum-sum instead of for life payments. The reason for this is a lump-sum payment will receive capital gains treatment and will be subject to 25% personal income tax. After a plan has operated successfully for a number of years and amounts credited to participants have become quite high, it may be changed to provide for life benefits through the purchase

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[19] Ibid., p. 103.

of annuities or a self-administered fund. Because detailed accounting cannot usually be taken of past services under a profit sharing plan, it cannot fulfill the functions of a pension plan for many years after it is established.

While death benefits are not absolutely necessary under profit sharing plans, they are logical if the plan is to stimulate employee cooperation. Under the usual deferred-distribution profit sharing plan with assets held in a trust fund, the accumulated share of an employee who dies is normally paid to a beneficiary designated by the employee. If no beneficiary has been designated, or if the beneficiary is also dead, provision is usually made for payment to the employee's estate. The employee has the right to change the beneficiary at any time.

If the objective of a deferred-distribution profit sharing plan is to provide basic security against old age, unemployment or death, it is desirable to restrict investments to securities that would normally be secure.

Some employees have felt that investment in securities of the employer may be desirable in profit sharing plans; (1) to secure a greater return on the fund, or (2) to promote the "partnership principle" through greater participation in the success of the business.[20] Investments of this type have been successful for companies that have been consistently profitable. However, it is not advisable to invest a profit sharing fund in securities of your own company.

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[20] *Ibid.*, p. 1034.

Employers are required to report investments in their own securities to the Director of Internal Revenue, to make certain that the plan qualifies under the Internal Revenue Code. Some plans give employees a voice in the investments to be made and also grants them a right to veto certain proposals.

An administrative committee is needed to operate a deferred-distribution profit sharing plan. This committee, usually consisting of 3 to 5 members, may be appointed by the board of directors, employees are sometimes permitted to select one or more of the committee members. In some cases members are selected by each of the classes of employees. The fact that a member of the committee is also an officer, director, stockholder, or a participant, does not disqualify him from serving as a committee member, except for decisions affecting his own rights under the plan.

Members of the committee usually act without pay but they are reimbursed for expenses. Reimbursement is usually made from the trust fund. The members of the committee are not liable for any act or decision, except his own when made in bad faith.

The committee decides administrative questions under the plan for all participants. The actions or instructions of the committee may not discriminate in favor of a certain group or groups. Depending upon arrangements with the trustee, the committee may supervise the keeping of employee accounts and also the distribution of employer distributions. The committee maintains contact with the employees, supplying information and assistance to the participants. If individual policies are used under the plan, the committee provides for the issuance of the policies and their delivery to the trustee. The committee may pass on benefit payments out of the fund by the trustee or make these payments itself.

To obtain full tax advantages, an irrevocable trust must be created for a deferred-distribution profit sharing plan, and a trustee appointed to hold title to and invest the trust fund.[21] The majority of employers prefer to name a trust company because of its experience and financial responsibility. Also, the appointment of a trust company will assure that the plan will be continually administered and the employees will probably be more content if they know that the assets of the plan are being held and managed by an established trustee.

The trust agreement should state very clearly the powers that the trustee shall have in making investments. These powers may be classified as follows:

1.) Sole Power. Since corporate trustees have special skills in investing trust funds, most employers prefer to have the sole responsibility and control in the trustee.

2.) Initiative Power, Subject to Approval. Some of the agreements provide that the trustee shall initiate the investment programs, but that no final action shall be taken without the approval of the employer. Other agreements provide that the trustee shall proceed as if it had sole control, but that the employer may veto any action and may direct the purchase or sale of specific investments.

3.) Direction. Some employers prefer to retain complete

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[21] Ibid., p. 1036.

control over the investment of the funds. In such cases the trust agreements specifically state that the trustee shall take no action except upon the written direction of the employee.[22]

The trustee is usually paid for his services, as established in a separate agreement, except where the trustee is an employee of the employer and willing to act without pay.

Even though certain amounts have been allocated to an employee's account under a deferred-distribution plan, it does not necessarily mean that they will be paid to him. The majority of plans require the employee to fulfill certain conditions before his rights to his share become non-forfeitable.[23] A common practice is to vest a certain percentage of the employee's interest for each year of service; for example, if the vesting were at the rate of 5% per year of service and the employee resigned at the end of ten years, he would be entitled to 50% of the balance standing to his credit. The current trend is to vest the employee's interests more quickly.

There are three requirements regarding the vesting feature in a deferred-distribution profit sharing plan:

1. The vesting provision must not discriminate in favor of officers, stockholders, or higher paid employees. Such discrimination is apt to occur in the plan of a company consisting of a few officers and a large number of floating or transient employees. In such a situation the forfeited shares of the employees who left would inure

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[22] Intro. to Profit Sharing, op. cit., p. 19.

[23] Ibid., p. 15.

to the credit of the officers, who would end up with almost all of the assets of the plan.

2. The plan must contain a provision which fully vests the employee's shares at retirement or the attainment of a specified retirement age. In addition to these events, all plans include death and most plans include disability as events which will fully vest the employee's interests.

3. The plan must provide that upon its termination the interests of all employees vest immediately.[24]

A few plans include a provision that even though the employee has met the requirements for vesting, he will forfeit his share if he engages in conduct harmful to his employer or is guilty of a felony. Such a provision is permissible if the conditions are clearly set forth in the plan.

Unless a plan provides for immediate vesting there will be forfeitures when an employee leaves before meeting the vestint conditions. Therefore the plan must provide for the disposition of such forfeited balances. There are three methods:

1. The amounts forfeited during any year are allocated to the remaining employees in the same ratio that the company contribution for that year is allocated. This is the most usual method.

2. The amounts forfeited during any year are allocated to the remaining employees in the ratio that the accumulated balance standing to the credit of each bears to the accumulated balance standing to the credit of all.

3. The amounts forfeited during any year are used to reduce

[24]Ibid., p. 15.

the contribution of the employer for the next year. This method is rarely used.[25]

In no event can the forfeitures be paid back to the employer, and the method used cannot discriminate against a certain group. As can be seen, method #1 above will usually eliminate such discrimination.

The plan must contain a provision regarding when and how the vested shares of the employees are to be distributed to them or their beneficiaries.

Payment may be made upon death. Amounts payable by reason of the employee's death are taxable income to his beneficiary. However, the first $5,000 is exempt from tax and if the entire distribution is made within one taxable year of the beneficiary it is taxable as a long term capital gain. If the distribution consists of the proceeds of life insurance, it will constitute income to the amount of the reserves held under the policy.

Payments may be made upon separation from service. Amounts distributed to an employee because of separation from service constitute taxable income if paid within one taxable year of the employee. If the lump sum distribution includes securities of the employer, the value of such securities for the purpose of tax is the current market value or the cost to the trustee, whichever is lower. If the distribution includes an annuity contract, the employer will realize no taxable income until he begins to receive payments under the contract.

A few deferred-distribution plans permit loans during employ-

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[25]Ibid., p. 16.

ment. Such loans will be made for medical expenses, financial hardship or some other worthy cause. Such a provision makes the benefits of the plan seem more immediate to the employees, thus having a greater incentive value. The restriction on this type of provision is that the amount of the loan must not exceed the employee's vested interest.

Following is a summary of provisions that a deferred-distribution profit sharing plan must contain and requirements it must meet in order to qualify.

1. It must be in writing and must be communicated to the employees.

2. It must contain a provision that at no time will any part of the fund be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.

3. It must be a permanent program, not to be abandoned without a good business reason.

4. The assets of the plan must be valued at least annually and gains or losses allocated among the employees.

5. The plan should contain a provision permitting amendment and termination. The right to amend must be limited so that the amendment cannot divest any employee of his share of the assets on hand at the time of the amendment. The termination clause must specify the method of distribution to the employees the assets on hand at the time of termination, no portion can ever revert to the employer.

6. The plan also should include provisions regarding com-

position of a committee that will manage the plan, retirement age, what constitutes disability, leaves of absence, military service, and spend-thrift clauses.[26]

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[26] Ibid., p. 17, 18.

Wage Dividend Plan

Wage dividend plans base the company's contribution not on profits as such but on dividends paid to stockholders in a given year. This division of profits between capital and labor is usually made according to a fixed formula so that a wage dividend is paid on stock. Payments may be made immediately after the dividends are declared, as in the typical cash distribution plan, or may be deferred for a period of years until retirement.

This type of plan tends to emphasize the partnership between employee and stockholder. The philosophy underlying this is simple. The stockholder invests his capital and his return in a profitable year, in addition to his usual wage or salary, is a bonus connected in a direct way to dividends.

The oldest and most famous plan of this type is that of the Eastman Kodak Company, Rochester, New York. Over the years the Eastman Kodak Company has established various plans to provide its employees with security and allow them to share in the company's operating success. For security, the company has plans that pay sickness, medical expense, vacation, disability, life insurance and retirement benefits.

Since 1912, the company has paid an annual wage dividend to

Kodak people. Individual payments are based on an employee's earnings and length of service and the amount of dividends declared on the common stock of the company during the previous year. The wage dividend is subject to authorization by the board of directors each year.

The formula according to which the wage dividend is paid is briefly this:

The wage dividend rate varies with dividends on the company's stock, according to the following scale:

1.) One-half of one per cent (.005) for every ten cents by which cash dividends declared exceed 35 cents, this rate applying up to but not above 90 cents.

2.) One-tenth of one per cent (.001) for every ten cents by which cash dividends declared, exceed 90 cents, up to but not above $1.40;

3.) One-twentieth of one per cent (.005) for every ten cents, by which cash dividends declared exceed $1.40, up to, but not above $2.20.[27]

All Kodak people who were actively at work at the end of the preceding year and had been hired on or before December 1 are eligible for wage dividend payments, generally made in March. Exceptions to these rules in the individual's favor are made in the case of absence for certain reasons.

Employees who have five or more years of service may participate in the wage dividend plan or they may decide prior to the declaration of the wage dividend to participate in the savings and investment plan, the company contributes an amount equal to all or

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[27]Prentice Hall, Inc. (ed.) Pension and Profit Sharing. (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1965).

part of the wage dividend to the savings and investment plan. The amount contributed by the company depends on the extent of the employee's participation in the plan.

Another type of profit sharing plan is the thrift or savings plan. Thrift plan is an expression used when an employee savings feature is added to a profit sharing plan. The beginning of a thrift plan is the employee's contribution. The employer's contribution provides the incentive for employee savings.

Thrift plans were pioneered in the oil and gas industry and have since increased in popularity with both large and small companies.

From a company point of view, a thrift plan is a good way to stimulate employee savings for future financial security. In many cases a thrift plan is used to supplement a company's regular retirement plan and to provide additional retirement income to employees based on their own savings and the company's contributions.

Since the company's contribution depends upon profits, the relation between the amount saved by the individual employee and the added incentive for that saving provided by the plan will vary from year to year.

In most thrift plans benefits are deferred until retirement and the major purpose of the plan is to supplement the employee's retirement income. Some thrift plans have both a long-term program and a short-term program geared to temporary savings. Generally, the short-term account pays off after a savings cycle of a few years. Each year's deposits are kept as a separate class and the entire amount accumulated to that class is distributed at the end of the cycle.

Most thrift plans permit an employee to withdraw his own contributions at any time, but usually he loses his rights to employer contributions and must terminate membership in the plan for six months, or suffer some other type of penalty.

CHAPTER IV

First Bank Stock Corporation Plan

The First Bank Stock Corporation profit sharing plan started in 1957 with over 1600 members. To be a member one has to have at least one year of service, if he is between 30 and 65 years old. The plan is a deferred profit sharing plan. The member's salary is terminated and he can then receive the benefits from the plan.

First Bank Stock affiliates will pay into the Trust Fund:

a.) 3% of annual net earnings before taxes, so long as this is not more than:

b.) 25% of net profits over 6% of invested capital.

The members have accounts of their own. Each year a share of the total contribution is allocated to this account. This share will depend on the employee's base salary and on how well his group of banks has done compared to other banks in the corporation. The total contribution (after a pro rata portion set aside for those who serve the entire system) is divided into two equal parts. One part is allocated directly to members in proportion to their base salaries. The other is divided among each of the three bank groups in the Corporation on the basis of the share of total profits they produce, and then allocated to members in each group in proportion to base salary.

Instead of holding the Plan contributions in cash, the

Trustees of the Fund invest one-half of the Trust Fund into stock of First Bank Stock Corporation (subject to approval by the U. S. Treasury and a limit of 10% of issued shares). The other half of the Fund is used to purchase other securities. An investment committee appointed by the Corporation's Board of Directors selects the purchases, including probably a large proportion of common stocks. Since they already have basic pension plans throughout the system, the committee can adopt an investment policy designed to produce more appreciation at a higher return on the securities in the Fund.

One of the purposes of the Plan is to enable employees to own stock in the business for which they work. As stockholders, the employees have a right to share in its earnings, and take an active part in the progress and prosperity of the whole organization.

If an employee leaves the corporation he is still entitled to the full value of his account, payable normally in cash or securities at or after age 65, if your employment terminates:

a.) after 12 years of Plan membership,

b.) after age 45 and 10 years in the Plan,

c.) after age 60, regardless of service.

One will be similarly entitled to part of the value of his account if he leaves with three years or more in the Plan: 10% after 3 years, 20% after 4 years, and so on up to 90% for 11 years of membership.

If an employee dies the Plan member's beneficiary receives the full value of his account, no matter how few years of membership he may have.

If he retires and then dies before receiving the full value of his account, his beneficiary would get the balance. If he dies without leaving a beneficiary, his account would be paid to his wife, his children, or his estate.

CHAPTER V

CONCLUSION

There have been four principal reasons why management has established profit sharing plans: First, to accomplish a more equitable distribution of income from production; Second, to build up for employees a financial reserve for emergencies; Third, to stabilize the wage scale; Fourth, to create an incentive.

The initiation of profit sharing plans has not been confined to any particular period. New plans have been started quite regularly during the last 30 years and a few date back to the 19th century.

Profit sharing plans have had indifferent success in stimulating the efficiency of rank and file employees and in improving morale.

There seems to be no close connection between the particular specifications to a profit sharing plan and its success. Plans for stabilizing the wage scale must offset relatively low earnings from regular wages during unprofitable years by a correspondingly high return during prosperous years.

In addition to the formal profit sharing plans, there are a number of informal plans. Under these, a share of profits is paid to employees when and if the management believes that such a payment is warranted and not according to definitely established items.

Conditions peculiar to the local situation have played a large part in the success and failure of profit sharing plans. An obvious drawback in profit sharing is that the reward cannot follow closely the effort of loyalty and cooperation that it is intended to compensate. It must, therefore, appeal more strongly to the more intelligent employees who can understand why the reward is deferred and are willing to wait for it, and who can understand why profits vary in amount and sometimes are nonexistent.

The future of profit sharing is no longer questionable. Companies with a long record of success with profit sharing will continue it. Other companies who see in the profit sharing principle the type of program they want, will adopt such plans.

Whether the plan adopted is an immediate-distribution or a deferred-distribution profit sharing plan, depends upon the objectives the company wishes to achieve. No matter which type of plan is adopted, a careful and detailed study of profit sharing should be conducted by the management of the company. There are certain income tax advantages to each type and in order to experience these advantages, the plan must meet and follow rigid requirements of the Internal Revenue Service.

In the early years of profit sharing, it was doubtful whether profit sharing would survive. However, in our present days of big business and mass production, I don't think there is doubt in anyone's mind as to the future of profit sharing.

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