Developing the Retirement Benefit Formula - Key to Corporate Pension Planning

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As defined by the first sentence of the "General Rules" under Section 1.401-1 (b) of the Income Tax Regulations:

A pension plan within the meaning of Section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement.\(^1\)

In short, the basic purpose of a qualified pension plan is and must be to provide retirement benefits; and it follows, not illogically, that the single most important step in planning a corporate pension program is development of the retirement benefit formula. The retirement benefit formula determines the major portion of a pension plan’s ultimate cost. Furthermore, in almost every situation, it determines how well a plan accomplishes the employee relations, personnel, benefit, and tax objectives that have been set for it.

Various professional and technical skills enter into pension planning, including a knowledge not only of the legal and tax consequences of qualified plans, but also of the specialized accounting, investment, insurance, actuarial, administrative, and personnel considerations involved. The one specific area, however, that should be understood by anyone concerned with designing a pension program is retirement benefit formulas and how they are developed. The primary purpose of this article is to provide a basis for a better understanding of the retirement benefit formulation process through a description of the various acceptable formulas and the factors that enter into their establishment.\(^2\)

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\(^1\) Treas. Reg. § 1.401-1(b)(l)(i) (1972).

\(^2\) While this article is confined to a discussion of retirement benefit formulas under so-called "corporate" plans (that is, qualified pension plans which do not include self-employed partners or sole-proprietors), most of the comments are equally applicable in the case of pension plans which include partners who are not classified as "owner-employees" under Sec. 401(c)(3) of the Internal Revenue Code. In the case of plans covering "owner-employees" (i.e., generally any self-employed person...
The Internal Revenue Code and the Income Tax Regulations prescribe two general sets of requirements which broadly circumscribe the formulation of the benefit provisions for any pension plan, namely: the prohibited discrimination requirements, and the requirements respecting permissible methods for determining retirement benefits under a qualified pension plan.

**Prohibited Discrimination Requirements**

The so-called "prohibited discrimination" (or "nondiscrimination") requirements of the Code provide that qualified plans may not discriminate either as to coverage\(^3\) or with respect to either contributions or benefits\(^4\) in favor of employees who are officers, shareholders, supervisors, or highly-paid employees. With regard to the latter of these mandates, however, it is not required that both contributions and benefits be nondiscriminatory, but, rather that one or the other not discriminate in favor of the proscribed groups.\(^5\)

Further, the Code provides that prohibited discrimination will not be considered to occur:

(a) merely because the contributions or benefits under a plan bear a uniform relationship to participating employees' total compensation or their basic or regular rate of compensation; or

(b) merely because contributions or benefits under a plan based on wages subject to Social Security taxes differ from those based on earnings excluded from such tax, or differ because of any retirement benefits created under State or Federal law.\(^6\)

It should be noted that these "prohibited discrimination" requirements apply only with respect to discrimination in favor of the proscribed employee groups. Other forms of discrimination among employees are not prohibited by the Internal Revenue Code; and even discrimination in favor of the proscribed groups is permissible so long as it can be substantiated on the basis of their relative compensation or benefits under Social Security or similar programs. This, of course, does not mean that discrimination prohibited under other statutes, such as the civil rights statutes, is permissible under

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qualified plans, but simply that such discrimination is not pro-
scribed under Section 401(a) of the Internal Revenue Code.

**Permissible Methods for Determining Retirement Benefits**

The Income Tax Regulations recognize two acceptable methods or approaches for developing retirement benefits under a qualified pension plan—the "definitely determinable benefit" approach and the "money purchase" approach." This, in turn, has resulted in the creation of two distinct types of qualified pension plans.

Under a defined benefit pension plan (sometimes referred to as stated, fixed, or level-of-benefit pension plan), a formula is established in advance for determining the amount of the pension to be paid an eligible retiring employee. Contributions to the plan are made periodically by the employer, covered employees, or both. These contributions plus any investment increment attributable to them provide the funds necessary to pay the prescribed benefits to retiring employees.

On the other hand, under the money purchase approach, the plan merely establishes a formula, setting forth the amount to be contributed each year by the employer, or employees, or both. The pension itself derives from whatever the accumulated funds contributed on a participating employee's account will either purchase or provide as a retirement benefit.

Neither the Code nor Regulations set forth any particular formulas that will be considered acceptable or unacceptable under either type of plan. They do, however, contain general requirements to the effect that the formula in a defined benefit pension plan must be one under which employer contributions can be determined actuarially and that the formula for employer contributions under a money purchase pension plan must not be dependent on profits. There is also a further requirement that funds deriving from forfeitures may not be used to increase benefits under either type of plan. The Regulations also point out that "retirement benefits generally

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8 Id.
9 Id. However, forfeitures may be anticipated in determining plan costs. See Rev. Rul. 69-421, 1969-2 Cum. Bull. 59, at pt. 2(m). Rev. Rul. 69-421, 1969-2 Cumm. Bull. 59, which is cited in this footnote and a number of subsequent footnotes, is the most recent of a series of compendium-type Revenue Rulings, correlating the various published Rulings relating to qualification of pension, profit-sharing, and stock bonus plans and trusts. This compendium Ruling has recently been updated but apparently not replaced by Internal Revenue Service Publication 778 (2-72) entitled "Guides For Qualification of Pension, Profit-Sharing, and Stock Bonus Plans," available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C., 20402.
are measured by, and based on, such factors as years of service and compensation received by the employees.\textsuperscript{10}

In practice, various basic formulas have evolved for each type of pension plan, with their acceptability being confirmed in Revenue Rulings and administrative decisions of the Internal Revenue Service.\textsuperscript{11} TABLE I illustrates, in summary form, the various acceptable basic formulas that may be utilized under each type of pension plan.

Steps in the Formulation Process

Within the limits of the foregoing general requirements, and as a result of them, the process of establishing a retirement benefit formula breaks down into four steps.

The first step is selection of the basic approach: that is, whether the plan should be based on defined benefits, money purchase, or possibly a combination of the two.

A second and corollary step is establishing the basic formula, or combination of formulas, to be employed for the approach selected, and deciding whether the formula should be integrated with Social Security.

The third and most detailed step is defining the compensation, service, and benefit factors on which the formula will be based and developing the limitations, if any, to be placed on each.

The fourth and final step is determining the other basic plan provisions which may affect the value of retirement benefits payable under the formula. This step includes establishing the various plan provisions which will govern the method and timing of payments, as well as any special offsets to be applied against amounts payable. It also includes decisions on the possible correlation of employee contributions as part of the benefit formula.

The succeeding sections of this article describe the main considerations involved in each of the above steps of the formulation process. Particular attention is paid to the specific guidelines that have been provided in Regulations and Rulings.

\textsuperscript{10} Treas. Reg. § 1.401-1(b)(1)(i) (1972).

\textsuperscript{11} The primary source in the past for determinations regarding formula acceptability has been the various rulings issued from time to time respecting integration of qualified plans with benefits provided under Social Security. More recently, Internal Revenue Service National Office opinions as to the acceptability of the form of a sponsored master or prototype qualified plan have provided additional guidelines in this area.
### TABLE I
BASIC RETIREMENT BENEFIT FORMULAS

#### DEFINED BENEFIT PENSION PLANS
(Fixed or Stated Benefit Plans)

<table>
<thead>
<tr>
<th>Type</th>
<th>Basis</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flat Benefit</td>
<td>Percent of Compensation</td>
<td>Pension of 50% of Compensation</td>
</tr>
<tr>
<td></td>
<td>Fixed Amount</td>
<td>Pension of $300 Monthly</td>
</tr>
<tr>
<td>Unit Benefit (Unit Credit)</td>
<td>Percent of Compensation</td>
<td>Pension of 1 1/2% of Compensation for each year of service</td>
</tr>
<tr>
<td></td>
<td>Fixed Amount</td>
<td>$5 of monthly Pension for each year of service</td>
</tr>
</tbody>
</table>

#### MONEY PURCHASE PENSION PLANS

<table>
<thead>
<tr>
<th>Service Basis</th>
<th>Example*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current (or future) Service</td>
<td>Pension purchasable by Annual Contribution of 10% of current compensation</td>
</tr>
<tr>
<td>Past Service</td>
<td>Pension purchasable by Annual Contributions in each of First Ten Years of Plan equal to 1% of aggregate compensation earned to date of entry into Plan</td>
</tr>
<tr>
<td>Aggregate Service</td>
<td>Annual Contribution equal to:</td>
</tr>
<tr>
<td></td>
<td>(1) 10% of average compensation in last 5 years times expected years of service at normal retirement, less aggregate prior contributions</td>
</tr>
<tr>
<td></td>
<td>Divided by:</td>
</tr>
<tr>
<td></td>
<td>(2) Number of years remaining to normal retirement</td>
</tr>
</tbody>
</table>

*In lieu of percentages, contribution may be established as a fixed amount (such as $300 annually or twenty-five cents per hour worked).*

### SELECTING THE APPROACH AND
ESTABLISHING THE BASIC FORMULA

Selecting the planning approach to be followed, that is, defined benefit or money purchase, and establishing the basic formula in any particular situation will normally depend on the employee relations and benefit objectives set for the plan, the characteristics of the employee group to be covered, and applicable cost considerations.

In situations involving a negotiated pension plan or a plan covering a relatively large group of employees, the primary objective is usually to provide retirement benefits that will be proportionate to the employees’ service, their compensation, or both. Under these circumstances a defined benefit approach is usually preferable. The money purchase approach, as illustrated in the Appendix Tabulation, does not produce pensions that are necessarily proportionate to employees’ service or compensation. Rather, it results in pensions
that are basically a function of the amount contributed to each individual employee's account and what that amount will develop or purchase for him as a benefit over the period of his plan participation.\footnote{12}

Similarly, in situations where the primary emphasis is on benefits for older employees or employees who will have fairly short service at retirement, defined benefit will normally produce the most favorable comparative results. Short-service employees in particular can be favored by establishment of a defined benefit plan with a flat benefit formula.\footnote{18}

Defined benefit plans also have an advantage where it is desired to relate pensions to the level of employee earnings at the time of retirement, since the benefit formula in such situations can usually be based on either an employee's earnings in his final year of service or average earnings over a short period of years prior to retirement. Pensions related to final earnings are not possible under the typical money purchase plan since contributions for an employee's benefit each year are normally determined by his current earnings in that year, and thus the final benefit reflects the average of these earnings over the period of the employee's participation in the plan rather than his final level of earnings.\footnote{14}

On the other hand, in those situations where emphasis is on benefits for younger employees, and particularly where past service is not a major factor, the money purchase approach may have definite advantages. Money purchase is also preferable in any situation

\footnote{12} Many negotiated plans are established on the basis of collective bargaining agreements which specify fixed rates of employer contributions (such as 25¢ per hour worked, or so much per shift, day, or month for each member of the bargaining unit). Care should be taken not to confuse such plans with money purchase plans. With few exceptions, the prescribed contribution rate is simply a measuring device for the employer's current liability for pension contributions to a trust fund from which benefits are paid under a defined benefit pension plan.

\footnote{18} See Appendix. Contribution rates under defined benefit formulas will vary in accordance with such factors as an employee's age, years of service, and nearness to retirement. Variations in contributions between employees produced by such factors are not considered discriminatory. \textit{See Rev. Rul. 55-60, 1955-1 CUM. BULL. 37; Rev. Rul. 69-253, 1960-1 CUM. BULL. 129; and Rev. Rul. 71-255, 1971 CUM. BULL. 125.}

\footnote{14} Aggregate service money purchase formulas, such as the one illustrated in the example in the preceding TABLE I, provide an exception to this rule, since they can produce contributions (and thus benefits) which reflect final pay levels. The use of aggregate service formulas in money purchase plans, however, is not widespread. Most money purchase contribution formulas are based solely on current earnings although it is possible to utilize other factors, such as years of service, in determining contributions. \textit{See Rev. Rul. 68-653, 1968-2 CUM. BULL. 177; and in conjunction therewith the various guideline rulings cited in Rev. Rul. 69-421, 1969-2 CUM. BULL. 59, at pt. 5(b).}
where the objective is relative equality of contributions in terms of compensation of covered employees. Furthermore, the money purchase approach can have greater employee relations appeal, particularly among younger employees. For example, notice of a $300 money purchase contribution to his trust account can be far more impressive to a 30-year-old employee than a statement that he earned $10.00 of monthly pension this year, payable when he reaches age 65.

One obvious advantage of money purchase plans is that they relate pension costs exactly to payroll costs. Once an employer makes a money purchase contribution, he is assured under the typical plan that he has fully discharged his pension cost obligations for that year; whereas, under most defined benefit plans, contributions are only an estimate of expected costs for future benefits. If the estimate proves erroneous, additional costs can be incurred in future years.\(^\text{15}\)

It should be observed that profit sharing retirement plans are, in many respects, similar to current service formula money purchase pension plans, except that deposits, if the employer so desires, can be varied with the employer’s profits. Most of the pros and cons of defined benefit versus money purchase apply equally to a comparison of defined benefit pension plans versus profit sharing retirement plans. In many situations, where a money purchase approach is indicated, the real choice is thus not between defined benefit and money purchase but, rather, between money purchase and profit sharing. While a discussion of the pros and cons of this particular choice is beyond the scope of this article, it should be noted that from a retirement standpoint, the money purchase approach may be preferable to profit sharing on several counts, including the fact that money purchase formulas can recognize past service, which is something profit sharing cannot effectively do under present rulings.\(^\text{16}\) Also, money purchase pension contributions are not subject

\(^{15}\) Against this possible advantage of money purchase should be weighed the funding flexibility open to defined benefit plans. Under a defined benefit plan an employer does not necessarily have to make contributions at the same rate each year; but rather, depending on the actuarial cost method employed, he can make substantial year-to-year variations in his payments and can even under some circumstances “skip” contributions altogether in a poor earnings year. Furthermore, current cost estimates and contributions under defined benefit plans can be adjusted for the potential effect of future developments such as lower costs that may result from anticipated employee terminations or higher costs that may result from benefit increases based on future increases in the level of employees’ earnings. In comparison, employer using money purchase plans cannot make adjustments in current contribution rates to take into consideration future developments which may result in increasing or decreasing plan costs.

to the 15% of compensation limitation on deductibility which apply to profit sharing retirement plan contributions.17

Combining Approaches and Formulas

In the majority of planning situations there is a diversity of benefit objectives. The covered employee group represents a cross-section of characteristics from the standpoint of age, service, and compensation levels. In such situations, a combination of approaches or basic formulas will usually produce the best program.

Between the two types of plans and their alternative formulas, there are literally thousands of combinations which can be put together to solve particular planning problems. For example, where a money purchase approach appears most suitable for the bulk of employees, but at least a basic benefit is desired for those closer to retirement, a combination might provide for a 10% money purchase contribution, subject to a minimum defined benefit pension for any employee of 25% of final average pay.18 Or, benefits for past service might be based on a defined benefit formula (such as 1% of earnings per year of past service) and those for future service on a 7.5% money purchase contribution. In another case, where the situation points toward a fixed benefit approach, but the employer desires to avoid the relatively high cost of covering short-service older employees, the basic formula might be set at 30% of compensation, but with a unit credit reduction of 2% per year of service for each year less than 15 years at retirement.

Integrating Formulas With Social Security

As previously noted, the Code provides that a pension formula will not be considered discriminatory if the benefits or contributions under the plan, when considered together with Social Security, bear a uniform relationship to the compensation of all participating employees.

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17 Section 404(a)(3)(A) of the Code limits deductions for employer profit sharing contributions to an amount which, on average, does not exceed 15% of the compensation of covered employees, and thus as a practical matter limits maximum profit sharing plan benefits to a similar amount. Int. Rev. Code of 1954, § 404 (a)(3)(A). There is no comparable limitation on deductibility of contributions to a money purchase pension plan. Thus a money purchase pension plan (or a combination of a money purchase plan and profit sharing) is indicated in any situation where the cost or benefit objective requires contributions in excess of 15% of covered payroll.

18 Depending on the assumed rate of investment return and pay increases, a 10% annual money purchase contribution might be expected in approximately twenty years to produce a pension benefit at age 65 equivalent to 25% of final average pay. On such a basis, the formula in this example would in effect provide a 25% of pay pension for any employee age 45 or over at the time he entered the plan, and an increasingly greater benefit for employees entering the plan at ages under 45.
The Rulings respecting integration are relatively complex. In summary, however, they provide a basis for integrating benefits under each type of basic retirement benefit formula.

**Defined Benefit Integration.** In the case of defined benefit plans, basic formulas can be integrated in either one of two ways. The first of these is known as the offset method, and the second as the uniform total benefit method.

Under the offset method, the basic formula is applied uniformly to all employees' compensation, but the resultant benefit is then offset by a proportion of the retiring employee's Social Security benefits. (Currently, the maximum for this permissible offset is $83\frac{3}{4}\%$ of an employee's primary Social Security benefit.)

The uniform total benefit method is somewhat more complicated. Under this method, actuarial equivalencies have been derived for the value of Social Security benefits in relation to each of the basic formulas. The formula is then applied only to employee compensation exceeding the amount covered for Social Security purposes (or some other established compensation level), subject to maximums prescribed by the Rulings.

In the case of flat benefit formulas, the current integration maximum is a pension not exceeding $37\frac{1}{2}\%$ of an employee’s 5-year highest average pay in excess of his covered compensation for Social Security benefit purposes. In the case of a unit benefit formula, the maximum depends on the compensation used in determining benefits under the formula. Where the formula applies to current compensation each year the maximum currently allowable is 1.4% per year of service on compensation in excess of the amount subject to Social Security taxes. Where the formula is applied to highest 5-year average compensation, the corresponding percentage is 1% of compensation in excess of the amount subject to Social Security taxes.

Various reductions in these permissible maximums are required where the private plan provides benefits other than a “life only” pension. Reductions are also required under flat benefit integrated formulas in the case of employees retiring with less than 15 years of service.

**Money Purchase Integration.** The integration rules for money purchase plans simply provide that a current service contribution formula will be satisfactorily integrated if the contribution rate does

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not exceed 7% of the employee’s compensation in excess of the current wage base for Social Security tax purposes.

Integrated past service money purchase formulas are also permissible, with a maximum credit rate of 5% for each year of prior service, based on the employee’s highest 5-year average annual compensation prior to entry into the plan in excess of his covered compensation for Social Security benefit purposes.

Integrated formulas obviously provide leverage for benefits under a private pension plan in favor of higher-paid employees. In fact, by themselves, integrated formulas will normally exclude lower-paid employees, whose compensation falls below the formula’s integration level, from pension benefits. As a result, most plans which employ an integrated formula also provide for a basic retirement benefit formula under which lower-paid employees may benefit. This basic formula may take the form of some minimum fixed pension, such as a flat $100 monthly, or the integrated formula may be applied on top of a basic formula.20

DEFINING THE FACTORS
IN A PENSION FORMULA

Defining the various factors that will enter into the computation of benefits under a pension formula—namely, the service factor, the compensation factor, and the amount of the benefit credit—can be compared roughly to detailing an architectural drawing once the basic sketch of a structure has been established. Just as architectural detailing largely determines the final shape, appearance, and ultimate success of a particular design, the definitional process with respect to a formula determines both how and how well a pension plan will operate to accomplish the desired objectives. With respect to each factor of a retirement benefit formula, there are numerous definitional possibilities and interrelationships which together create an almost infinite variety of possible formulations. It is here that the ingenuity of the planner often determines the relative degree of success for a particular plan.

20 A typical flat benefit formula applying integration on top of a basic formula might provide for a pension of 20% of the first $9,000 of a participant’s compensation, plus 50% of his compensation in excess of $9,000. Such a formula is actually two formulas: one providing for a basic 20% of all compensation, and the other an integrated 30% of compensation above $9,000. Plans utilizing such formulas are referred to as “step-rate” plans and are deemed to be two plans for purposes of testing for compliance with the integration requirements. See § 16, Rev. Rul. 71-446, 1971 Int. Rev. Bull. No. 41, at 8.
The Service Factor

There are three instances where the service factor can enter into the determination of benefits under a pension plan. The first of these is in determination of eligibility: that is, what and how much service qualifies an employee for initial coverage under the plan and, thereafter, what service qualifies for continuing coverage. The second is in determination of entitlement to benefits: that is, what and how much service is required to become entitled to a benefit. The third is in determination of how much service will actually be credited for purposes of determining benefits under a formula.

While under some plans the definition of service may be the same for all three purposes, there will normally be at least minor variations in the treatment of service in each of these areas. Generally speaking, the definitions for both credit and entitlement purposes will be more restrictive than those for eligibility.

Before outlining the various aspects of service definitions, however, it is first necessary to define service itself. Service, for purposes of a qualified corporate pension plan, generally implies service only as a common-law employee and cannot include service as a self-employed individual. Prior service as a partner or sole proprietor cannot be counted for purposes of eligibility, entitlement to benefits, or benefit credits under a corporate plan. Furthermore, becoming a partner or sole proprietor must be treated as a termination of service for purposes of a common-law employee plan that is operated by a partnership. There are certain exceptions, however, to the rule that only service as a common-law employee can be considered under a corporate plan. The Code makes a specific exception in the case of full-time life insurance agents who are not common-law employees but who are considered employees for purposes of FICA taxes. The rulings also suggest that subsequent service as a partner might be counted for vesting purposes under a partnership common-law employee plan if all employees receive similar credit for their service with any other employers subsequent to termination.

The fact that an individual is both a common-law employee and self-employed (for example, an attorney employed by a corporation, but who also has an outside independent legal practice) will not preclude counting his common-law employee service.

24 See note 22, supra.
Generally, to be considered a common-law employee an individual must be an employee for all purposes, including coverage under Social Security or similar program and for income tax withholding purposes.

To be covered under a qualified plan, it is not necessary that an individual be currently employed. A plan may include coverage for former employees or may actually cover only former employees; however, at least one current or former employee must be covered by a plan in order for it to constitute a qualified plan. If the plan definitions are such that no employees are eligible, the plan's qualified status is considered terminated.

Beyond these general ground rules, the actual definition of service for purposes of a particular plan requires answers to the following questions: with whom will service be counted for plan purposes; what type of service will be credited; and what period of service and how much service will be counted?

Service With Whom. It is not necessary for the definition of service under a qualified plan to be confined simply to service with the employer sponsoring the program. If so specified, service as an employee with any other designated employer, regardless of the degree of affiliation, may be counted as service for plan purposes, provided that there is no duplication of benefits, that all employees similarly situated are uniformly treated, and that discrimination in favor of prohibited group employees does not result. Thus, many plans credit prior service with specified predecessor businesses for at least eligibility, and often, benefit purposes. Occasionally, the definition is extended to cover service with any employer in a particular industry. In some plans, for purposes of continuing coverage and often for benefit entitlement purposes, subsequent service with designated employers will be credited similarly.

Types of Service. The service definition in most plans normally includes, at least with respect to benefits and often with respect to eligibility, a definition of types of service which will be considered for plan purposes. The most commonly encountered distinction in this connection is between part-time and full-time service. This definitional problem involves not only distinguishing between full-time and part-time service but also establishing the extent to which part-time service will be recognized under a plan.

The Code, for purposes of applying mathematical coverage tests, considers part-time as being employment "for not more than 20 hours in any one week" and "for not more than 5 months in any calendar year." However, such a definition is not required; as long as prohibited discrimination does not result, any reasonable definition is usually acceptable. There are no prescribed rules with respect to recognition of part-time service. While many plans recognize only service as a full-time employee, others recognize part-time service for purposes of initial eligibility or continuing coverage, and often for entitlement and benefit credit purposes.

Service may also be distinguished on the basis of whether it is temporary or permanent. Under most plans, periods of temporary service are not counted for any purpose.

Another commonly encountered set of distinctions relates to the locale at which service takes place and the employee group within which it is performed. Thus, a plan may give benefit credit for service only at a particular plant or within a particular jurisdiction (for example, only service in the United States). Negotiated plans customarily cover only service in a specified bargaining unit or, in the case of multi-employer negotiated plans, under the jurisdiction of a particular union and within a specified geographical area. Under such plans, transfer out of a covered bargaining unit usually constitutes a termination of service for plan purposes.

So-called "white collar" plans normally cover only service as a salaried employee, at least for benefit credit purposes. Service as an hourly employee or service in a collective bargaining unit may be specifically excluded.

Period of Service. Beyond defining service itself and types of service to be counted, the period of service to be credited for various plan purposes must normally be defined.

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30 A commonly encountered misconception is that a qualified plan must cover any eligible employee who works more than 20 hours per week or more than 5 months in any calendar year. Actually, the 20 hour-5 month definition, as used in Section 401(a) of the Code, has only one application, namely: to determine the number of employees to be excluded for computational purposes in determining whether the mathematical tests for acceptable coverage under Sec. 401(a)(3)(A) of the Code are met. See Treas. Reg. § 1.401-3(a) (1972). An exclusionary definition of part-time as being any employee who worked less than 30 hours a week or 10 months per year would be acceptable if the remaining employees covered by a plan constituted an acceptable nondiscriminatory classification under Sec. 401(a)(3)(B) of the Code, or if the remaining covered group totaled at least 70% of all employees of the Company who met the plan's prescribed years of service eligibility requirement (so long as it did not exceed 5 years) and who worked more than 20 hours per week and 5 months per year. See also INT. REV. CODE OF 1954, §§ 401(a)(3)(A) & (B).
31 See Treas. Reg. § 1.401-3(d) (1972).
Among the definitional problems in this area is the treatment of broken periods of service and interruptions in service, such as leave of absence or periods of military service. Under the majority of plans, broken periods of service are not counted (or only counted for eligibility); however, such broken periods can be included, even for purposes of benefit credits, provided that such inclusion does not result in a duplication of benefits for the same period of service.\(^{32}\) Normally, leave of absence or periods of military service will count for continuing eligibility and often for entitlement and benefit purposes, if an employee makes a timely return from his leave.\(^{33}\) Many plans establish age criteria with respect to the periods of service to be credited—for example, attainment of age 25 before service will count for eligibility or benefit purposes, or exclusion of employees hired after attainment of age 55.\(^{34}\) In some plans, the service criteria may be different with respect to original employees and those hired subsequent to the date of a plan's establishment. Such differentials for future employees are usually permissible if original prohibited group employees can meet the most restrictive future requirement to be imposed, or where the differential is not more than one year.\(^{35}\)

Distinctions in the formula are often made with respect to past service (that is, service before the date of a plan's inception) or service prior to date of entry into a plan. While such periods of service normally count for eligibility purposes, they are often either limited or not counted for benefit credit purposes. In the case of past service, limitations are often placed on the amount of such service which will be credited. For example, no credit for more than 15 years of past service, or for service prior to an established cut-off date, or past service prior to attainment of a specified age, or a combination of these restrictions. Overall maximums, such as 30 years, on the amount of service that will be counted for benefit credit purposes are also common.

The Compensation Factor

Formulas which utilize compensation in determining contributions or benefits present two definitional problems: (1) on what

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elements of compensation will contributions or benefits be based; and (2) over what period are these elements to be measured.

Elements of Compensation. The Code provides that a plan will not be considered discriminatory merely because contributions or benefits bear a uniform relationship to "total compensation, or the basic or regular rate of compensation." Beyond this general statement, however, the Code does not further define compensation for purposes of benefits under qualified plans. The planner is left with the responsibility for determining those elements of compensation which will be utilized for formula purposes, subject to the caveat that whatever basis is used "must be consistently and uniformly applicable to all participants" and must not result in prohibited discrimination. Normally, compensation may be defined to include only basic salary or basic wages. The definition, however, may also include such items as overtime pay, bonuses, or commissions; or it may simply be the total of all amounts reportable for Form W-2 purposes.

In the case of integrated formulas, the Internal Revenue Service will normally insist on a definition that includes all items of compensation which would be subject to Social Security taxes. However, if it can be shown that a more restrictive definition, such as basic compensation only, does not result in more favorable benefits for higher-paid employees than for lower-paid employees, the Internal Revenue Service will usually accept a restrictive definition of total compensation.

The definition of compensation does not necessarily have to be limited to items of cash or currently taxable compensation. When dealing with other than integrated formulas, nonwage items may generally be included in the definition. Funded deferred compensation credits, such as allocations under a qualified profit sharing plan or contributions for "tax-sheltered" 403(b) annuities, may also form part of the compensation base. However, credits, under an unfunded deferred compensation arrangement cannot normally be included in the definition of compensation for benefit purposes unless the deferred compensation plan covers a cross-section of employees generally and not just the higher paid. Tips, which are in the nature of gratuities, may be excluded without the definition being

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considered discriminatory.\textsuperscript{42} On the other hand, items which are not compensation, such as dividends payable to shareholder employees, may not be included in the definition.\textsuperscript{43} Imputed compensation during periods of unpaid leave can normally be used; however, such compensation may not be used for purposes of determining benefits for uncompensated employees who are also officers of a company.\textsuperscript{44}

Maximums may normally be placed on the amount of compensation or the amount of any particular element that will be credited for benefit determination purposes.\textsuperscript{46} Where an employee works for two or more employers who maintain a common plan, the aggregate of the compensation paid the employee by the participating employers may be used as the basis for determining any integrated benefits, rather than having such benefits based separately on the amount of compensation paid by each employer.\textsuperscript{48}

\textit{Period of Measurement.} In addition to defining the elements of compensation which will be credited for contribution or benefit determination purposes, it is also necessary to define the period for measurement of the compensation in applying the formula.

Under money purchase formulas, the period of measurement is usually the period for which the contribution is being made (i.e., quarterly or annually). However, it may be some prior period. For example, so long as prohibited discrimination does not result, the contribution might be based on the higher of an employee's compensation in the current period or any prior period.\textsuperscript{47}

In defined benefit plans, various periodizations may be established for measuring compensation. Under "career average" periodizations, the formula is applied to average credited compensation over the employee's period of employment or plan participation. This may be done by computing an actual average of aggregate compensation over the period, or by applying the formula to actual credited compensation each year. Under "final average" periodizations, the benefits are based on average compensation over a specified period, such as the final 5 or 10 years of employment or

\textsuperscript{43} Rev. Rul. 71-26, 1971-1 Cum. Bull. 120.
\textsuperscript{45} Aggregate maximums on credited compensation, such as an overall maximum of $30,000 on compensation for benefit purposes, invariably result in reverse discrimination since their only effect is to limit benefits of higher-paid employees. Where the maximum is applied to a particular compensation element, however, such as a maximum of $5,000 on the amount of any commissions that will be considered as credited compensation in any year, it must usually be demonstrated that the result does not favor prohibited group employees.
the highest 5 years out of the last 10 years prior to retirement. Generally, any such final averaging method is acceptable, provided that in situations where a question of prohibited discrimination can arise (or where the formula is integrated) the average does not exceed average compensation for the highest five consecutive years.48

Some defined benefit plans use a single date or specified period for measurement of compensation. For example, the benefit formula might be based on compensation in the final year of employment, or highest annual compensation in any year prior to attainment of a specified age, such as age 60. Under unit benefit formulas, compensation in the year of entry is often used for purposes of determining past service benefits. Such "single date" periodizations obviously invite discrimination, either through manipulation of compensation during the measurement period or by establishing the measurement period to favor prohibited group employees. Accordingly, "single date" periodizations are usually not acceptable unless it can be demonstrated that prohibited discrimination will not occur, or unless they are modified to obviate possible prohibited discrimination. Thus, if starting date compensation is to be used for determining past service benefits under a unit benefit formula, the Internal Revenue Service may require that compensation for prohibited group employees be averaged over a three or five year period prior to the starting date or that provision be made for increasing benefits of all employees in the future as their compensation increases.49

Where a formula makes provision for increasing benefits based on compensation increases, it is acceptable to specify that compensation increases will not be credited until, in the aggregate, they are sufficient to produce at least a $10 monthly increase in pension benefits.50 There is no similar requirement that benefits be decreased when compensation decreases; and, if a plan so provides, a prior higher level of credited compensation may continue to be used for purposes of determining current benefit credits.51

Amount of Benefit Credit

Establishing the value to be given benefit credits or the contribution rate under a formula is primarily a function of the cost considerations and benefit objectives involved.

While the amounts to be credited (or contributed, as the case

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may be) must be uniformly applicable to all participants, there is no requirement that they be in the same amount with respect to each portion of a formula. Provided that prohibited discrimination does not result, the value of credits for various periods of service under a defined benefit unit benefit formula can be different.\textsuperscript{52} Similarly, different values may be prescribed for the various portions of the compensation element in a formula.\textsuperscript{53} Where there is a "step-up" in the compensation credit rate, rather than a decrease, the stepped-up rate must conform to applicable integration rules.\textsuperscript{54}

There is no limitation, as such, under either the Code or Regulations, on the value of the benefit credit (or rate of contribution) that may be prescribed under a pension formula. Internal Revenue Service rulings have taken the position, however, that current compensation should be substantial in relationship to the amount of the benefit provided under a deferred compensation plan.\textsuperscript{55} While exact limitations have never been prescribed, the Internal Revenue Service has ruled that a pension plan providing benefits of 200\% of compensation will not qualify.\textsuperscript{56} It should probably be assumed that any formula or contribution rate which produces pension benefits in excess of 100\% of compensation will be subject to challenge. However, it has been indicated, as a rule of thumb, that a contribution rate of 25\% of an employee's compensation under a money purchase plan will generally be acceptable without regard to the size of the resultant benefit.\textsuperscript{57}

In establishing benefit credit rates or contribution rates, it should be kept in mind that the Regulations, in order to prevent discrimination in event of early plan termination, provide restrictions on the amount of employer pension contributions that can be used to provide benefits for the highest-paid 25 employees who may be covered under a pension plan.\textsuperscript{58} These restrictions are applicable during the first ten years of a plan, and thereafter, if full current

\textsuperscript{52} For example, 1\% per year for past service and 1\frac{1}{2}\% per year for future service; or $\frac{3}{4}\%$ per year of service prior to age 35 and 1\% per year thereafter.

\textsuperscript{53} For example, a 1\% unit credit per year of service or a 10\% money purchase contribution rate on the first $10,000 of credited compensation, and a $\frac{3}{4}\%$ per year of service credit or a 5\% money purchase contribution rate on amounts above $10,000.

\textsuperscript{54} For example, a money purchase contribution rate of 10\% of the first $10,000 of compensation and 16\% of any compensation above $10,000 would be acceptable under present rules.


\textsuperscript{56} Rev. Rul. 72-3, 1972 INT. REV. BULL. No. 2, at 15.

\textsuperscript{57} Address by Isidore Goodman, Chief, Pension Trust Branch, Internal Revenue Service, Practicing Law Institute, New York City, June 19, 1970 (Question and Answer No. 4 following address), reprinted in, PENSION PLAN GUIDE \S 30.369(D) (Commerce Clearing House, Inc. pub. 1970).

\textsuperscript{58} Treas. Reg. \S 1.401-4(c) (1972). For guides to the application of these termination rules, see Rev. Rul. 69-421, 1969-2 CUM. BULL. 59, at pts. 2(h) & 6(c).
costs of the plan have not been met at the end of the ten-year period. So long as full current costs are paid, and the plan is not terminated, these restrictions will not necessarily limit the amount of current retirement income payments that can be made to a "highest-paid-25 employee" who retires within ten years of a plan's establishment. However, if full current costs are not met, the restrictions may limit payments that can be made to retiring higher-paid employees; and if the plan is terminated during the period the restrictions are effective, they may limit the amount that can be distributed to any employee in the highest-paid-25 group.

Generally speaking, in any case where employer contributions for the benefits of any "highest-paid-25 employee" may exceed the lesser of 20% of his compensation or $10,000 annually, the potential effect of these restrictions should be analyzed at the time a plan's benefit or contribution rate is being established. In the vast majority of situations, these restrictions, even if potentially applicable, will not be a limiting factor in formula planning if it can be reasonably anticipated that the pension plan will remain in existence for at least 10 years. However, if there is a good possibility that a plan will be terminated during its first ten years, as might be the case in a small company whose sole-stockholder president is within ten years of normal retirement at the time a plan is established, the potential effect of the prescribed restrictions should be taken into consideration in establishing benefit or contribution rates.

Variable Benefit Formulas

Normally, the value of retirement benefits credited under a defined benefit formula is tied to a set dollar amount and once established does not change unless the formula itself is amended to increase or decrease the benefits.

This traditional approach has been particularly susceptible in recent years to the erosion of inflation as well as the rapid increases in absolute standards of living. As a result, under many plans pension benefit credits which were once thought to be generous have become woefully inadequate by the time an employee actually reaches retirement.

Various solutions have been devised to cope with this problem. One is simply to upgrade periodically the value of prior service pension credits of active or retired employees. Another is to tie the value of pension credits (or the value of benefits being paid) to some recognized cost of living index, with the upgrading being automatic whenever the index increases by some specified amount. A third

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solution is the equity or variable annuity approach, under which the value of the benefit credit is tied to the investment performance of the underlying assets of the pension fund. Normally, such a fund is heavily invested in common stocks—the theory being that over the long run the value of common stocks will keep pace with inflation and thus result, automatically, in a corresponding increase in the value of pension credits.

Recently, a simplified variation of the equity annuity approach—often referred to as "target benefit" or "assumed benefit"—has received increased attention. Under this variation, a defined benefit formula is first established on either a flat or unit credit basis, reflecting the desired benefit objective for the plan. A rate for funding these benefits is then prescribed in the plan. This rate is usually based on the level deposits each year, which, at a fixed interest rate (such as 5%), will develop a fund actuarially estimated to be sufficient to produce for each employee his "target benefit." The plan then provides that the employer, rather than "guaranteeing" the benefits under the plan, will agree to make contributions in the prescribed amount each year to an invested trust account for the benefit of each covered employee. The employee's actual benefit will then be whatever his accumulated account or contributions actually develops or buys, based on the investment performance of his trust account or the assets constituting his account. If this performance is less than that assumed in developing the deposit rate, the benefit will be less than the targeted amount; but, if it is more, the benefit will be greater.

OTHER PLAN PROVISIONS WHICH AFFECT THE VALUE OF RETIREMENT BENEFITS

While not an intrinsic part of retirement benefit formulas themselves, there are a number of plan provisions which can directly or indirectly affect the value of the benefits payable under a particular formula and which must be considered as part of the retirement benefit formulation process. Primarily, these are the plan provisions governing method and timing of payments, special benefit offsets, and the effect of any required employee contributions on the value of benefits.

various rulings applicable to variable benefit plans. See also Rev. Rul. 68-647, 1968-2 CUM. BULL. 47; and Rev. Rul. 70-448, 1970-2 CUM. BULL. 88.

60 For a description of a "target benefit" plan, see Rev. Rul. 60-337, 1960-2 CUM. BULL. 151.
Method of Payment

A pension plan may provide for various methods of payment of amounts developed by the plan's retirement benefit formula, so long as each method of distribution is equivalent in value to any other that may be specified.\(^6\)

In the case of money purchase plans, this does not present a formulation problem, since the value of benefits whether they be distributed as an annuity, or in installments, or as a lump sum, or in some combination method, will always be related to the amount accumulated in the employee's account.

Under defined benefit formulas, however, it is generally necessary to establish one method of payment as a plan's standard form in order to comply with the equivalent value rule for retirement distributions.\(^6\) This standard form then becomes the measure for determining the appropriate adjustment to be made in the amount of the retirement benefit payable under any optional forms of settlement available under the plan. Thus a particular plan might provide that the prescribed benefits will be paid as a pension for life but with ten years' payment certain, subject to an option on the part of participants to elect to receive an actuarially increased pension payable for life only without the certain feature.

There are no restrictions on the method of settlement which may be used as the standard form nor are there restrictions on the variety of equivalent optional methods that can be specified under a pension plan. However, a plan which provides merely for a lump sum settlement at retirement cannot qualify as a pension plan.\(^6\) Under integrated defined benefit formulas, appropriate adjustments must be made in the maximum benefits payable where the standard form is other than life only.\(^6\)

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\(^6\) The great majority of defined benefit pension plans use either a life only pension or life only with ten years certain as their standard form of payment. Various forms of joint and survivor pensions are probably the most common optional forms of settlement. Lump sum settlement options are also offered under some plans. Under a few plans, the normal benefit is based on a life only pension to the retired employee, with continuance of a percentage of the pension to a surviving spouse. The acceptability of this latter form of benefit is recognized in the rules for integration. See § 9, Rev. Rul. 71-446, 1971 INT. REV. BULL. No. 41, at 8. However, such plans have apparently not been required to provide higher benefits to unmarried employees to compensate them for the additional value of the automatic survivor benefit. It appears that the rationale has been to treat such automatic survivor benefits as incidental death benefits not subject to the equivalent value rule.


\(^6\) See § 9, Rev. Rul. 71-446, 1971 INT. REV. BULL. No. 41, at 8.
Timing of Payments

Plan provisions affecting the timing of payment of retirement benefits include establishing the normal retirement age and defining what, if any, adjustments will be applicable in event of early or late retirement.

Normal retirement age in a pension plan is the lowest age specified in a plan at which an employee has the unilateral right to retire and receive his benefits for service to date at the full rate specified by the formula.\(^6\) Ordinarily, normal retirement age is 65. However, a different age may be specified, provided that if it is lower than 65, it represents an age at which employees customarily retire and is not a device to accelerate plan funding. Thus a provision for normal retirement after 30 years’ service, regardless of age, is usually acceptable, as are provisions that specify a minimum period of required service such as completion of fifteen years of service and attainment of age 65.

Variations from a normal retirement age of 65, depending on a plan’s standard form of distribution, can have a substantial effect both on the cost and the value of benefits under a defined benefit formula. For example, on a life only basis, a full benefit payable commencing at age 60 is worth actuarially approximately 163% of the same benefit payable commencing at age 65. On the other hand, a similar benefit commencing at age 70 has an actuarial value of only 56% of its age 65 counterpart.

Plans may provide for commencement of benefit payments at a date earlier than normal retirement age. However, if the employer’s consent is required for such early retirement, the value of the benefit payable cannot exceed the value of the employee’s vested benefits at such time.\(^6\) Under a money purchase plan, the value of an early retirement benefit is automatically related to the value of accumulated contributions at the early retirement date. On the other hand, under defined benefit plans, it is usually necessary to establish a formula to determine the benefits that will be payable at early retirement. Customarily, this supplementary early retirement formula will provide for an actuarial reduction in the employee’s accrued benefits for each month or year by which early retirement precedes normal retirement, such as a reduction of ½% per month for each month by which early retirement precedes age 65. Where a defined

\(^6\) Id. at pt. 5(f).
benefit formula is integrated with Social Security, the reduction formula must conform to prescribed standards. Nonintegrated formulas, however, are not required to conform to any specific standard. Thus, the supplementary formula for early retirement benefits may be based on any of the following: the proportionate period of an employee's completed service at his early retirement date; the degree to which his benefits have been funded as of an early retirement date; or some modification of a true actuarial reduction formula. Under some plans, provision is made for special increased pensions for those who retire early.

In situations where retirement is not compulsory, the plan must also make provision for handling deferred retirements. Various provisions are acceptable, so long as they are uniformly applied and do not result in the prohibited discrimination. Examples of deferred retirement provisions include: (1) commencement of benefits as if the employee had retired (which is usually undesirable from a current tax standpoint); (2) freezing of accrued benefits, with payments to commence at the deferred retirement date (which has the effect of reducing the value of the retirement benefit); (3) continuing to credit additional benefits for the additional service; (4) actuarially increasing benefits payable at the deferred retirement date; and (5) depositing the reserve value of the employee's benefits in a segregated account, which, together with any accumulated investment increment, will become payable at the deferred retirement date.

Special Benefit Offsets

Under certain circumstances, it may be desirable to include provisions in a plan for offsetting by amounts received from other sources the pension benefits that a given retirement formula would otherwise produce. For example, benefits payable might be offset by the amount of any workmen's compensation or unemployment benefits payable to the employee after retirement. In some situations, a pension plan will be established as a successor to or in conjunction with an existing profit sharing plan. In such cases employees' pension benefits might be reduced by part or all of the ac-

68 Early retirement benefits based on degree of funding are not permissible where the rate for funding benefits is not fixed. See Rev. Rul. 69-427, 1969-2 CUM. BULL. 87.
tuarial value of their profit sharing accounts as of the date the new pension plan is put into effect.71

**Employee Contributions**

To the extent that employee contributions to a pension plan provide additional benefits that are independent of those provided by employer contributions, they do not directly affect the relative employer-provided benefits under a retirement benefit formula. Thus, in a contributory money purchase pension plan, an employee contribution of 5% of pay and an employer compensation rate of 10% of pay will produce proportionate employee/employer provided benefits for all covered employees.

On the other hand, under a defined benefit plan, employee contributions can, and often do, produce disproportionate employee/employer provided benefit ratios for covered employees. As a simplified illustration of the disproportionate benefits that may result under a contributory defined benefit formula, consider two employees—one age 35, and the other age 50, who are each earning $20,000 at the time they enter a contributory pension plan with a 5% employee contribution rate. Assuming no change in compensation, the 35-year-old employee's contributions at 5% interest will amount to approximately $69,800 at age 65, or enough to provide an annual pension of approximately $6,980. The 50-year-old employee's similar accumulation at age 65 will approximate $22,700, or enough to provide approximately $2,270 in annual pension. If retirement benefits under such a plan were based on a unit benefit formula providing an annual pension of 2% per year of service, the 35-year-old's contributions would have provided some 58% of his $12,000 annual pension, whereas the 50-year-old’s contributions would have paid for around 38% of his $6,000 annual pension. In other words, the employer-provided pension for the older employee would on a comparative basis be somewhat over 50% greater than that provided for the younger employee. Take another situation—if the plan's benefits were based on a flat benefit formula of 50% of annual earnings (i.e., $10,000 per year), the comparable percentage differentials would be even greater, with the 35-year-old having “paid for” almost 70% of his pension, whereas the 50-year-old would have “paid for” only around 23% of his benefits. In other words, employer-provided benefits would be approximately 160% greater for the older employee than for the younger employee.

Differentials such as those illustrated obviously carry with

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them a potential for discriminatory benefit planning. In fact, either through design or ignorance, such discrimination has occurred under many contributory defined benefit formulas. To date, however, this type of discrimination has not been considered prohibited discrimination by the Internal Revenue Service. The only requirement imposed to date by the Internal Revenue Service with respect to employee contributions under defined benefit plans is that they not be at so high a rate that lower-paid employees are prevented from participating. For this purpose, anything up to a 6% required employee contribution rate is generally considered acceptable.  

Employee-Pay-All and Salary Reduction Pension Plans

Pension plans can be established by an employer under which benefits are entirely funded by employee contributions. This is rarely done, however, since an employee receives no tax deduction for his contributions to a qualified plan. Thus, there is little incentive for him to make the entire contribution out of his own funds.

Certain recently approved money purchase plans, popularly referred to as salary reduction plans, have attempted to circumvent this tax incentive obstacle to employee-pay-all plans by a device which, in effect, turns what would have been the employee's after-tax contributions into before-tax employer contributions. Under these plans each participating employee is required as a condition of participation to agree in advance to a reduction of his compensation by a set amount. The employer, in turn, agrees to make a contribution to the plan for the employee's benefit equal to the amount by which the employee's compensation has been reduced. In this way, amounts which would have been contributed by employees from their after-tax pay under a normal contributory plan become employer contributions which are currently deductible by the employer but not currently taxable to the employee. Thus, the employee ends up saving currently the amount of income tax which would have been payable with respect to the amount contributed.

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74 Internal Revenue Service approval of so-called "salary reduction" plans is apparently based on the precepts of Rev. Rul. 69-650, 1969-2 Cum. Bull. 106. It is reported that some approvals of such plans have been conditioned on participation levels meeting the guidelines set forth in Rev. Rul. 56-497, 1956-2 Cum. Bull. 284.

75 The mathematics of this approach can be illustrated by an unmarried employee with $36,000 of taxable income and a top bracket of 50%. A normal pension plan contribution of $2,000 annually by this employee would not change his taxable income status and at 1971 rates he would pay a Federal income tax of $12,290. If the employee agrees, however, to a salary reduction of $2,000, which is then contributed by his
Establishing a retirement benefit formula is, of course, only one of many steps in the process of developing a pension program. In most organized planning, it will have been preceded by a careful analysis of the particular corporate situation, and the motives and objectives involved. Furthermore, consideration will already have been given to the feasibility of the various alternatives to a qualified pension plan, such as profit sharing, thrift savings and stock bonus plans, individual and group nonqualified deferred compensation arrangements, unfunded plans, and tax-sheltered annuity programs. Assuming that a qualified pension plan is indicated, the decisions to be made respecting other features of the program, such as collateral death, disability, and vested benefits, method and media of funding, and administrative organization, will in most situations be based on or dictated by the retirement benefit formula. Accordingly, development of a retirement benefit formula that satisfactorily meets the objectives of a particular situation will, in almost all instances, prove to be the key to successful pension planning.

employer to a pension plan, his taxable income becomes $34,000 and his Federal income tax is reduced to $11,290, which results in a savings to him of $1,000 in currently available after-tax income.
### APPENDIX TABULATION

**ILLUSTRATIVE BENEFIT AND CONTRIBUTIONS COMPARISONS FOR VARIOUS BASIC FORMULAS**

<table>
<thead>
<tr>
<th>PENSiON FORMULA</th>
<th>ITEM</th>
<th>EMPLOYEE I $10,000 Annual Salary—Age 50</th>
<th>EMPLOYEE II $10,000 Annual Salary—Age 35</th>
<th>Ratio of I — II</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Flat Benefit</td>
<td>Expected Age 65</td>
<td>$3,000</td>
<td>$3,000</td>
<td>1 — 1</td>
</tr>
<tr>
<td></td>
<td>Annual Pension (Amount/Percent Salary)</td>
<td>(30%)</td>
<td>(30%)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annual Level Deposit Cost without Mortality Discount (Amount/Percent Salary)</td>
<td>$1,270 (12.7%)</td>
<td>$410 (4.1%)</td>
<td>3.10 — 1</td>
</tr>
<tr>
<td></td>
<td>Annual Level Deposit Cost with Mortality Discount (Amount/Percent Salary)</td>
<td>$1,100 (11%)</td>
<td>$340 (3.4%)</td>
<td>3.24 — 1</td>
</tr>
<tr>
<td>2. Unit Benefit</td>
<td>Expected Age 65 Pension (Amount/Percent Salary)</td>
<td>$1,500 (15%)</td>
<td>$3,000 (30%)</td>
<td>0.50 — 1</td>
</tr>
<tr>
<td></td>
<td>Level Deposit without Mortality Discount (Amount/Percent Salary)</td>
<td>$630 (6.3%)</td>
<td>$410 (4.1%)</td>
<td>1.54 — 1</td>
</tr>
<tr>
<td></td>
<td>Level Deposit with Mortality Discount (Amount/Percent Salary)</td>
<td>$550 (5.5%)</td>
<td>$340 (3.4%)</td>
<td>1.62 — 1</td>
</tr>
<tr>
<td>3. Ten Percent Future Service Money Purchase</td>
<td>Annual Level Deposit (Amount/Percent Salary)</td>
<td>$1,000 (10%)</td>
<td>$1,000 (10%)</td>
<td>1 — 1</td>
</tr>
<tr>
<td></td>
<td>Expected Accumulation at Age 65 (5% Interest) (Amount/Percent Salary)</td>
<td>$227,700 (227%)</td>
<td>$69,800 (698%)</td>
<td>0.33 — 1</td>
</tr>
<tr>
<td>4. Ten Percent Aggregate Service Money Purchase (Assumes Each Employee has 30 years' expected service at Age 65)</td>
<td>Annual Level Deposit (Amount/Percent Salary)</td>
<td>$2,000 (20%)</td>
<td>$1,000 (10%)</td>
<td>2 — 1</td>
</tr>
<tr>
<td></td>
<td>Expected Accumulation at Age 65 (5% Interest) (Amount/Percent Salary)</td>
<td>$45,500 (453%)</td>
<td>$69,800 (698%)</td>
<td>0.65 — 1</td>
</tr>
</tbody>
</table>

Computations in this Table are based on a 5% interest assumption and, where applicable, mortality in accordance with the 1951 Group Annuity Table.