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# A survey of the forms of compensation beyond base salary and wages

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BOSTON UNIVERSITY  
COLLEGE OF BUSINESS ADMINISTRATION

THESIS

A SURVEY OF THE FORMS OF  
COMPENSATION  
BEYOND BASE SALARY AND WAGES

by

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A.B. TUFTS COLLEGE, 1951




Submitted in partial fulfillment of the  
requirements for the degree of

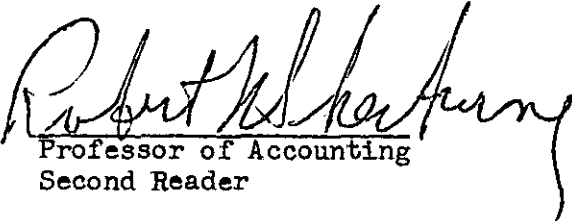
MASTER OF BUSINESS ADMINISTRATION

1960

This thesis was prepared under my supervision  
and approval is hereby indicated.

  
Professor of Accounting  
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This thesis was read by me and is approved.

  
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## CHAPTER I

## INTRODUCTION

A. SCOPE OF STUDY

In the past decade supplemental compensation plans have become an increasingly important aspect of the overall wage and salary structure of the American worker. The rapid growth of supplemental pay systems has been fostered by a sustained era of business prosperity. Although the recession during 1958 largely curtailed new and more costly benefits, it did not result in any wholesale discontinuation of the existing plans. With the return to increased earnings and prosperity in 1959, pressures for additional wage supplements and benefits have been forthcoming in the form of bargaining demands by the various labor unions. A second impetus to the rapid growth of this type of compensation is attributable to certain tax laws which make it possible for the employer to save more economically for his employees' retirement than the employees are able to save for themselves.

Supplemental income may be provided to an employee in many forms. Pension plans provide the employees with fixed periodical payments generally beginning at retirement and paid by the employer in consideration of past services. Profit sharing plans may provide the employees with present and/or future benefits. A cash bonus plan is generally designed to stimulate the worker to a special effort for which he shares in the increased cash result of an industry. Fringe benefits are commonly employed to provide services and forms of pay

which the employee would not want to lose. A company may have a single incentive plan or it may have an integrated group of plans and benefits which have been designed to attract, retain, and stimulate desirable employees.

Today, most bonuses and wage supplements paid to all classes of employees are the results of contracts, agreements, or company policy. Generally, there is some stipulated method of arriving at the amount of the bonus which is based on factors over which the executives, salaried personnel, and hourly-rated workers have some degree of control. To be sure, there are arrangements over which the worker has no control. In one plant which the author visited, the president of the firm simply listed beside the name of each salaried employee the amount of bonus each was to receive. However, such an arbitrary method is not generally found in industry today. The types of plans and their variations are innumerable. It is perfectly true that specific variations of a particular plan may make it either more or less favorable, but to attempt to elaborate each and every plan possible would not be feasible in a work of this type. It is a well-known fact that most bonus plans are tailored to fit the company in question, and therefore, the author cannot presume to have encountered every conceivable bonus arrangement. There are also bonus plans which are, in fact, not bonus plans at all, in that they do not reward performance, nor are they based on an earnings figure or other important figure related to the company's activity. Chapter II is devoted to just such a plan as this, to show what an important source of supplemental income it can be to the employees of the company having the plan.

Therefore, it will be the purpose of this paper to investigate and analyze the various supplemental compensation plans in broad general categories and discuss them with regard to their mechanics of operation, advantages, and disadvantages. Accounting and tax consequences will also be considered. The author will look at these various facets from both the company and employee viewpoint.

#### B. THE PROBLEM

The problem to be studied deals with paying people, not merely as wage earners, but as sharers in the earnings of business. These payments which generally vary with the earnings of the business or the performance of its people and which are paid in addition to the fixed wages, are the theme of this paper. This study is an attempt to identify the various forms of employee compensation based on their performance rather than on the number of hours they work.

A major difficulty in industry today is that of hiring, training, and retaining capable personnel. It is no longer possible simply to offer the executive more money to retain or reward him for his performance. After the various taxing authorities take out their respective shares, the balance left to the person concerned is not large enough to be of any real motivating consequence. As one moves from high executive status down the managerial ladder, this problem reoccurs, although to a lesser and lesser degree. How acute this problem is depends upon the employees. The man who is paying half or more of his current income in taxes is more concerned with deferred compensation bonus plans which will guarantee his security in retirement, whereas the man who has to spend his entire weekly paycheck and is in a low tax

bracket is concerned with bonus plans which provide primarily cash and secondarily retirement benefits.

### C. RESULTS HOPED FOR

The author hopes that this thesis will present an objective survey of the various forms which supplemental wage payments take. Some plans are simple, others more complex, but all have the objective of offering the employee something more than an hourly wage or fixed salary. Bonus payment plans are an effective means of recognizing employees and there are any number of reasons for which an employee might be specially rewarded. An executive might be given a large bonus because of a profitable increase in sales, or for fostering the company's growth beyond pre-set goals. Supervisors and managers might be rewarded for increased production, maintenance of schedules, prevention of waste, cost reduction, or for improved quality. Individual factory and clerical workers might receive additional supplements to their wages for regularity of attendance, length of service, cost-saving suggestions, prevention of waste, improved quality or output, or for general merit.<sup>2</sup>

A bonus plan is offered as an incentive to the person or group in the expectation that the plan will pay for itself and return something to the company over what might otherwise be realized. Even in an unprofitable year of operation, most companies regard bonus plans as self-supporting. It is felt that the average man works harder to earn his bonus and thereby decreases the loss of that year. In the good year, similarly, his efforts increase the profits by more than they would have been.<sup>3</sup> Motivation, however, is a highly individualized

matter. It varies with the worker and changes from time to time during his working career. Motivation also varies with the nature of the organization, with the attitudes prevailing among the people within the organization, and with the time in the history of the organization. Any number of external factors may change the effectiveness of a plan and these factors influence the drafting, installation, and operation of a specific plan.

#### D. METHOD

Data for this paper is provided from four major sources. A survey was made of printed material already in existence. Since a large percentage of this material was ten to thirty years old, attention was focused on the objectives and philosophy, as well as the arguments for and against the various forms of supplemental wage payments. From the more recent publications, information pertinent to the current problems of taxes and income has been carefully examined.

Current textbooks have been consulted in order to provide accepted theory and correct accounting presentation.

The author has also corresponded with acquaintances employed in various firms for information concerning bonuses, pensions, and supplemental payment arrangements existing there.

Lastly, the bonus plans, profit sharing plan, and fringe benefits of the firm which employs this writer and the firm's companion company, have been carefully examined and discussed at length in this paper. Discussion with other employees of both firms has provided a wealth of information and many interesting appraisals of these plans.

E. REASON FOR STUDY

Aside from the basic reason of the degree requirement for which this paper is submitted, it is designed as an objective appraisal of supplementary compensation plans available for consideration by the firm employing the author. This work will provide alternatives which may be discussed by those who believe certain aspects of the current plans are not entirely satisfactory.

## CHAPTER II

## THE BONUS BASED ON A PERCENTAGE OF BASE PAY

A. HOW THE PLAN OPERATES

Is a bonus based on a percentage of the employee's base pay really a bonus, or is it, in fact, a form of involuntary savings? We shall examine the mechanics under which this type of payment is made to the employees of a small New England firm engaged in supplying original equipment materials to the Detroit automobile manufacturers and replacement material to jobbers throughout the country.

The most effective way to demonstrate this type of bonus is to cite an example. This will readily show what the employee may expect for compensation during the year and in what amounts it will be received.

A secretary at the start of the year is paid \$50 per week. On the last Friday in March, June, September, and December, she can expect a quarterly bonus. Those at the end of the first and third quarters are equal to 40 per cent of her base pay in that quarter, or \$260. The June bonus is equal to 20 per cent of her base pay for the first six months, or \$260. In December, a rate of 20 per cent of her base pay for the whole year is used, which in this case will result in a bonus of \$520. At the close of the year, our secretary has earned \$2600 in base pay and \$1300 in bonus pay for a total of \$3900, or exactly \$75 per week. It can be seen, as demonstrated in Illustration I, that our secretary's bonus amounts to an additional 50 per cent of

## ILLUSTRATION I

## BONUS COMPUTATION OF SECRETARY WITH BASE PAY OF \$50 PER WEEK

	Base Pay	Base Pay For Bonus Calculation	Bonus %	Amount	Ave. Wkly. Earnings	Wages In Quarter
1st Quarter	\$ 650	\$ 650	40	\$ 260	\$ 70	\$ 910
2nd Quarter	650	1300	20	260	70	910
3rd Quarter	650	650	40	260	70	910
4th Quarter	650	2600	20	520	90	1170
TOTAL	\$2600	-----	50%	\$1300	\$ 75	\$2900

her base pay. This formula holds true for all salaried employees in this firm, except when either or both of two things happen. The first is when a calendar year has 53 paydays. This occurred in 1959 when December 31st fell on a Thursday, and since Friday, January 1, 1960, was a legal holiday, the company paid employees fourteen times in the last quarter. Any quarter having fourteen paydays is treated as having only thirteen when figuring bonus payments. This "extra" payday will reduce the average weekly earnings if divided by 53 weeks, or slightly increase it if divided by 52 weeks. It seems preferable to divide by the former, however, as there is no question that a full week has elapsed between each payday and although part of the extra week was in another year, there had to be 53 weeks to have 53 paydays.

The other item which may slightly reduce the overall 50 per cent figure, as shown in Illustration II, is an increase in pay at any time during the year other than at the beginning. Another example will clearly show the results. Assume that our secretary in the previous example receives a \$10 pay raise on July 1. She will receive \$650 base pay in the first two quarters and bonuses of \$260 in each quarter. However, in the third quarter she will receive \$780 base pay with an accompanying bonus of \$312. In the last quarter, she will again receive \$780 base pay, but her bonus will be 20 per cent of her total base pay for the year, which is \$2860. The bonus will be \$572, making total bonus payments of \$1404, which is less than 50 per cent of her base pay.

The hourly-rated workers of the firm were also paid in the

## ILLUSTRATION II

BONUS COMPUTATION OF SECRETARY WITH BASE PAY OF \$50 PER WEEK  
RECEIVING WAGE INCREASE TO \$60 PER WEEK IN MIDDLE OF YEAR

	Base Pay	Base Pay For Bonus Calculation	Bonus %	Amount	Ave. Wkly. Earnings	Wages in Quarter
1st Quarter	\$ 650	\$ 650	40	\$ 260	\$ 70	\$ 910
2nd Quarter	650	1300	20	260	70	910
3rd Quarter	780	780	40	312	84	1092
4th Quarter	780	2860	20	572	104	1352
TOTAL	\$2860	-----	49.1%	\$1404	\$ 82	\$4264

above manner, the only difference being the percentages used. In this instance, the percentages were about 10 per cent less than the salaried employees, so that total bonus payments would come to 40 per cent of their base pay in a year. However, two major difficulties arose with regard to these payments made to hourly-rated employees. First, the Wages and Hours Division of the Commonwealth of Massachusetts ruled that since the bonus was paid at regular intervals without regard to the profitable operations of the company, the bonus was actually part of the hourly worker's base rate and would have to be included when computing overtime premium payments whenever worked. The outcome was that the bonus payments for hourly employees were no longer computed with their base pay as the criterion. Rather, an arbitrary percentage of total earnings in the quarter was applied uniformly to each category of workers. The second problem was that most of the hourly-rated employees felt that their weekly take-home pay was too small to live comfortably on between the bonus payment dates. This was rectified to their satisfaction by eliminating the first and third quarter bonuses and dividing this amount equally over the 52 weeks. Together with an increase in hourly wages, their weekly pay was lifted to a level in line with other workers in the area doing similar work. In addition to their weekly wages, they received a bonus at the end of June and at the end of December. The total of these two payments was \$900.

#### B. ADVANTAGES

The advantages of a bonus based on a percentage of their base pay as far as the individual employees are concerned may be enumerated as follows:

1. The bonus payments are made in good and poor years alike. The payments are secure in the minds of the employees. It is a figure which may be quickly calculated and the date of each payment is clearly known.

2. The individual can plan his capital expenditures for such things as a washing machine, a television set, a refrigerator or an air conditioner without becoming involved with expensive interest payments which are added to the cost of the article purchased on an installment plan. A large periodic wage payment is also helpful for large and extraordinary expenses such as painting the house or repairing the roof. It is also believed that because of the dates on which the bonus payments are made, certain other debts which accrue over the year are not to be feared. Both federal and state income tax returns are due and payable on April 15. Since a bonus has been paid at the end of March, it is relatively simple to hold aside enough to cover any additional tax which may not have been withheld. The tax reason was considerably more important in past years than it will be in the future. Withholding of taxes at both state and federal levels has lessened or eliminated the tax payments which must be made when the tax returns are filed. The bonus at the end of June makes the planning of the family vacation a much more pleasant task, as it is a recognized fact that most of the household expenses continue while the family is away from home, and in addition, travel expenses are considerably higher than at any other time during the year. The bonus payment at the end of September is just in time to pay the local real estate taxes which must be paid in this state by the first of October. To be sure,

there are many people who pay their real estate taxes on a monthly basis to the bank which holds their mortgage. On the other hand, there are those who own their homes outright, and others who are not required by the terms of their mortgage to make these monthly payments in advance on their estimated real estate tax liability. Those who pay their own realty tax have the advantage of the cash when they need it and do not lose the working power of their money by having to make tax deposits monthly as part of the mortgage payment. Such deposits earn no interest for them. The bonus payment at the end of the year is ideal for paying for Christmas purchases and other holiday expenses. Massachusetts Compulsory Automobile Insurance is due in January on all cars registered as of January 1. Because of this fairly substantial expense, it is necessary for many to budget this item over a six-month period, and in doing so, pay an additional carrying charge. The impact of life insurance and property insurance premiums, medical and hospital bills, to name but a few, are all lessened with the knowledge that large lump sum payments are to be received periodically.

3. To those people who are able to budget their weekly wage payments to cover all their expenses as they occur, the periodic bonus offers an excellent opportunity to have cash available for investments and increased savings. The bonus check also acts as a curb against those who have a tendency to spend their entire weekly pay as they receive it. Each time this type of person receives a salary increase, their weekly cost of living goes up by the amount of the increase. Assuming that they were receiving a living wage before the pay raise, they should now be able to save a portion, but they, in fact, do not.

It has been the experience of those working for the firm being considered in this chapter that the single employees contemplating marriage make a strong effort to save all bonus payments to prepare themselves for the financial responsibilities of marriage, and the young married employees, when both husband and wife work, have savings programs which allow them to save all bonuses and as much of one of the weekly paychecks as possible. This permits them to build an equity which may be used for their own home, a new automobile, or in time, both. Such a plan also helps the newly-married couple to build barriers against the financial difficulties which often beset them and endanger the marriage.

4. Wage increases are actually larger than they appear to be on the surface. The secretary who received a ten dollar weekly increase at the first of the year will actually receive an average of fifteen dollars a week more, as the ten dollars increment is subject to a fifty per cent bonus. Whether she might have received a fifteen dollar raise instead of ten dollars, had there been no bonus system such as this, is debatable. The tendency, however, is for the person giving the raise to feel that a person is worth so many dollars more and not to consider the fact that a bonus will increase the amount.

Let us now consider briefly what advantages there may be to the company which has such a bonus plan. There is no question that the computation is simple. The formula is not dependent upon sales nor any other phase of the business activity of the firm. It can be computed before the end of each quarter, thereby avoiding delay in payment and allowing the cash disbursements to be made in the period in which the

bonus was paid. This obviously avoids accruals at the end of the fiscal period. The company also has the use of the cash during the period, which might possibly allow it to operate with less working capital.

Finally, all bonus payments are fully deductible expenses for tax purposes, as compensation for services rendered paid to employees in addition to their regular salary is deductible by the employer if the total amount of the bonuses and basic salary are not in excess of a reasonable compensation for the services rendered.<sup>5</sup> The "reasonableness" of compensation generally causes no tax problem unless there is a relationship other than employee-employer. If the employee is also a stockholder of the corporate employer and the excessive bonus payments correspond or bear a close relationship to the stock holdings, these excessive payments will be treated as a dividend by the tax authorities.<sup>6</sup> There are no set rules for measuring the reasonableness of salaries and wages. Therefore, the facts of each case are the basis for determination.

### C. DISADVANTAGES

Let us now direct our attention to the disadvantages of such a plan to the employees and the firm.

1. There tends to be a very real problem when it is necessary to hire new personnel. A new filing clerk will not come to work for \$30 a week even if she is told that bonus payments will make her weekly average \$45. To new personnel, a bonus of any type is something which is not concrete. One may or may not receive it. In several instances, people have been hired at a rate somewhere between the starting salary offered and the salary-plus-bonus figure, with no bonus provision, in

order to secure competent personnel. In all instances where this was done, at a later date, after the new employee was able to understand and see in operation this particular plan, he or she asked to have the weekly pay adjusted so that he or she could enjoy the larger overall yearly income.

2. This type of bonus plan bears no relationship to how hard a person works. If the personnel exert extra effort and the company has an unusually profitable year, the people creating this situation are not rewarded with larger bonus checks. (The particular firm in question here does have a profit-sharing trust which does include certain employees. This aspect will be covered at length in Chapters IV and V.) Of course, the same employees are protected in an unprofitable year, as they will receive the bonus payments in any event. It can be seen that some employees can work harder than others, but in the final analysis, all will share in direct relation to the base pay they earn. One's efforts, then, are directed toward earning a larger base pay so that the bonus payments will be greater than before.

3. Another difficulty arises if the employee's base pay is too small to provide what is commonly called a "living wage". The employee then charges many necessary items, accumulates debts and falls behind in payments. By the time he receives his quarterly bonus, he owes it all to his creditors. This problem was demonstrated earlier in the chapter in the case of the hourly-rated employees. Their total annual wages were equal to or above those of employees in comparable jobs in other firms, but such a large proportion came in the form of the bonus payments, it resulted in only a minimum living wage on a

weekly basis and, therefore, was unsatisfactory.

4. Bonus plans of this type tend to be taken for granted. Under the terms as illustrated, this is easily seen and understood. Taking anything for granted is not a healthy attitude. It leads to complacency and mediocrity. The plan does not present "a pot of gold" to be striven for, but rather, the pot is placed out in the open for the enjoyment of all. Incentive is not a product of such an arrangement, although there is no question that the employees for the most part strive to do a good job so that the present payment system will not be destroyed.

5. Finally, the bonus arrangement as illustrated can be called an involuntary savings plan. Many employees freely admit that if they did not receive these supplemental payments, they would have to look elsewhere for employment. These employees consider the bonus as part of their regular pay (although not base pay) which the company accrues over a three-month period of time. They feel that they have earned the money each week, although they receive it only periodically. Suggestions to change the plan with the idea of eliminating either two or all bonuses of this type in favor of weekly payments equal to the amounts received under the plan have been rejected by the majority of the employees. They felt that they saved more, and were better able to handle their personal finances if the company continued to set aside a portion of their income for periodic lump-sum payments.

#### D. APPRAISAL

Although the plan was originally instituted as a bonus plan to supplement the wages of the employees in prosperous years, it can

no longer be considered a true bonus plan. Its continuity through good and poor years alike has fostered the idea that these periodic payments are merely salary which the employer accrues and pays over known periods of time. That the plan is a success can be attested to by the fact that the large majority of the employees do not wish to have it changed or modified. However, after all is said both for and against any particular plan, the success and survival of any bonus arrangement is dependent upon the employees who participate in the plan. The author believes that such a plan could be even more effective were it designed to offer monetary goals which could be actively worked for by the various employees. In this way, the ceiling on one's bonus payments would not be limited by one's basic wage, and therefore, could conceivably increase the incentive and motivation of the individuals employed by this firm.

## CHAPTER III

## THE BONUS BASED ON A PERCENTAGE OF SALES

A. INTRODUCTION

A bonus based on a percentage of a company's sales is a very common vehicle for rewarding various classes of employees for their performance. Commissions paid to salesmen are probably the outstanding example of this method of compensation although this form of remuneration is certainly not limited to sales personnel alone. Others such as the president, foremen, or general managers have been known to receive a variable portion of their income based on the sales volume. Those who receive royalties for books, inventions, and musical compositions and recordings usually receive a nominal fee for their work, plus a specified percentage based upon the sales of the article involved. This may be compared to the salesman who receives some fixed salary plus a commission or bonus for the number of sales he makes during a period. This bonus may be based on one or more of several figures. It may be a certain percentage of gross sales dollars. It may be based on net sales; that is, gross sales less returns and allowances, or it may be based on varying percentages of sales dollars for the different products of a firm. Again, the number of variations of plans which may be worked out is too numerous to list, but it is possible to make an appraisal of such plans and consider their part in the field of compensation. In order to clarify the material which follows, the term "commission" where it appears is construed to be a form of supplemental wage or bonus, since it is a plan for stimulating effort and for reward-

ing it in relationship to that effort.

## B. FACTORS TO CONSIDER

There are basically three ways of paying a firm's sales personnel. These are straight salary, straight commission, or a combination plan involving some salary and some commission. Which of these plans is used depends entirely upon the results the firm and salesmen hope to attain. Generally, four factors and the degree of importance which is attributed to each factor will determine the type of plan used.

The first factor is that of control. The more control that is desired over the sales force activities, the larger the percentage of salary will be in a combination plan. Some sales activities such as repair work, delivery services, and missionary selling dictate straight salary, therefore, will not be considered any further here. As the percentage of commission is increased, the amount of control the firm exerts over the sales force decreases.

The second factor is that of incentive. The portion of pay in a combination plan that is not base salary usually represents incentive compensation. The more the salesman sells, the greater his income. The incentive percentage should be large only where the salesman's efforts have a direct relationship to the sales objectives of the company. On the other hand, the percentage should be the smallest when several people contribute to the sales efforts. A salesman may very well need the combined efforts of company engineers and management to design and make the product to the specifications of his customers if he is to get the sale at all.

The third and most difficult factor to obtain is that of

flexibility. Flexibility is one of the major reasons for the popular use of combination plans where part of the salesman's wages are bonus commissions. Sales potentials in various territories are often different. Unless the plan compensates for this fact, the sales force in a growing area will have steadily growing income, whereas the sales force in a poor territory will have very little to show for its efforts. The pay plan should also be able to compensate for differences among the sales force. Differences in skill and experience must be recognized. Also to be considered are special formulas for trainees. Consideration must also be given to the products. Differences in effort may be required to sell each product, and, unless the pay plan allows for this, the salesman may well neglect that part of the market from which he earns the least money to concentrate on items from which he will realize larger earnings.

The last factor is that of simplicity. The more complicated any pay plan is made, the harder it is to comprehend and it is the more expensive to administer. It can result in considerable dissatisfaction unless those participating can see some relationship between their earnings and their efforts. The ultimate in simplicity is that of paying a straight commission. This form relates most closely to selling costs. As sales go down, so do commissions and as they go up, so do the selling costs in direct relationship. Generally, it is considered better to give up a little simplicity for the sake of some control, incentive, and flexibility.

Accounting for the commissions earned by salesmen presents no particular problem. The commission is classified as a selling ex-

pense and is paid periodically to the salesmen. Withholding and social security taxes are computed from his gross income figure the same as for salaried employees, as commissions which represent compensation for services are subject to the same rules as ordinary salaries.

#### C. ADVANTAGES

The advantages of a well-conceived commission plan can be summarized as follows: it provides an incentive which bears a direct relationship to the effort expended. The more the man sells, the larger he can expect his earnings to be. For the most part, commissions are easily computed and readily understandable both by the employee and the employer. Payments are made more promptly because it is not necessary to close the books to determine the individual's sales record. Because the calculation of the commission is simple and can be done promptly, it is possible to pay those earning this type of income more frequently than can be done with bonuses based on profits for an operating period or on other figures not readily obtainable.

The sales bonus can also be used as an award for extraordinary accomplishment. A sales manager may receive a small commission on all sales made by his office, or a bonus on all sales above a pre-set quota. A bonus can also be offered on the estimated profits from sales of certain lines of merchandise only, thereby inducing more concentrated efforts on the higher margin items.

#### D. DISADVANTAGES

A bonus based on sales can become unduly costly to a concern. There is the case of the correspondence school which was founded by one man. He later sold his interests to his stockholders in return for

a contract which paid him 1 per cent of the yearly sales. The correspondence school is now a million-dollar business and the founder's contributions to the firm do not warrant the fees he is receiving. <sup>10</sup> Commissions can also result in sales at any cost by an over-aggressive sales force. Overexpansion and sales at reduced prices will both result in diminishing returns to a point where losses occur, yet the sales bonus is paid. <sup>11</sup> Also, as a business concern grows, it very often happens that some share of a commission is paid to one man for work which is now done by others. <sup>12</sup> A plan that has a high commission factor in it may prove unsatisfactory during periods of low business activity. No matter how hard a salesman works, conditions over which he has no control will limit his income earning ability.

#### E. APPRAISAL

A bonus based on a percentage of sales can be a most effective way of promoting sales and encouraging the growth and development of the company. However, careful thought must be given to the factors of the commission plan and of the sales program. The method and level of compensation, the incentive provisions, the control of sales-force activity, and flexibility with regard to products, territories, costs, and personnel are factors which the plan must be designed to fulfill. The plan should be amendable to allow for changes in economic factors over which the parties concerned have no knowledge, control, or conception. Business booms and declines, as well as changes in taste and technology, cannot be predetermined. That equitable and well-conceived plans can be a successful tool of management is attested by the wide - spread practice of straight commission, and combination salary and com-

mission plans in use today.

## CHAPTER IV

## THE BONUS BASED ON A PERCENTAGE OF PROFIT

A. SHARING THE PROFITS

The profits earned by a company are the basis for many bonus plans. Chapter IV will consider those plans which result in current income to the participants and Chapter V will deal with those plans which result in deferred and retirement income to the participants. It is, of course, possible to have plans which include both current and deferred income aspects.

In a resolution passed by the International Congress on Profit Sharing in Paris in 1889, profit sharing was defined as a system

whereby, according to an arrangement voluntarily made by the management, a number of employees in a business enterprise receive in addition to their regular wages, a definite, previously determined part of the net profits. 13

Participation in the success of a company can have a great incentive value in increasing the efforts to achieve and continue the success. The higher the echelon of management involved, the more effective this participation will be because it is their basic decisions which will affect the profitability of the firm. Profit sharing may be made available to management employees only, or it may be extended to all employees. It has been offered as a possible solution for the problems of incentives, pensions, fringe benefits, employee morale, labor problems and wage difficulties. Generally, however, the most successful cash bonus plans based on the profits of the com-

pany have been those which included middle and upper management personnel.

Profit sharing has been advanced as a method of identifying the interests of workers and management more closely and fostering joint operative efforts. Unfortunately, during the long history of profit sharing, both in this country and abroad, the experience of these plans has been unfavorable, especially the plans established for lower level wage earners. Upwards of 60 per cent of such plans have been discontinued. Workers in one large firm felt that the annual distribution had no effect on either their output or effort during the year because they could not see any direct relationship between their individual efforts and the company's profits. Further, when general business conditions worsened and company profits declined, they resent-<sup>15</sup>ed the drop in bonuses. The two factors which seemed to have caused the failure and abandonment of this type of bonus plan for rank and file workers were first, too many participants could not relate their efforts to the profits, and secondly, the distribution of bonuses on a salary basis which did not reflect the individual's effort.

Measuring the contributions of individual managers and employees in relation to company profits is a very difficult task, im-<sup>16</sup>perfect at best. For this very reason, many plans have been limited to the top management executives. Two such plans follow.

A steel foundry pays in cash bonus to its top five men, 10 per cent of the net income. This is divided in relation to their salaries.

Bethlehem Steel Company's old bonus plan paid 8 per cent of

its net profit to its top officers and executives. Each man's portion was determined by the chairman of the board of directors. To illustrate how large these bonuses could be, Eugene Grace, who was president of Bethlehem received in 1929 a modest salary of \$12,000 plus a bonus of \$1,623,700.<sup>17</sup>

Bethlehem in 1936 found it necessary to change its plan because it had defined net income as not including depreciation, depletion, and obsolescence.<sup>18</sup> During the period of 1936 to 1958, the bonus was based on  $\frac{1}{2}$  per cent of the total paid in dividends. To illustrate again how lucrative to the members of top management this was, Eugene Grace, then chairman of the board, received \$456,654 in 1953.<sup>19</sup> This again was a cash bonus plan.

Because of the tremendous tax payments its executives paid, Bethlehem saw fit to revise its plan in 1959. The bonus is computed on a basis of corporate net income for the year, rather than on a percent of dividends paid. Instead of cash, the executive will receive dividend units, which are the rights to collect cash equivalent to dividends paid on a given number of shares of common stock. The dividend units are divided among the director-executives in proportion to their cash compensation for the year. Aggregate compensation to director - executives including both dividend unit payments and any salary increases beyond their present base cannot exceed  $\frac{1}{4}$  per cent of dividends paid.<sup>20</sup>

It can be seen that a cash bonus regardless of its basis is a useful management tool with a purpose. When a plan no longer fulfills its purpose, it is time to reappraise the plan and modify it to bring about the best results. Different periods in a company's history,

significant tax law changes, and law suits brought by stockholders may all contribute to the evolution of bonus plans based on profits.

#### B. ACCOUNTING FOR THE BONUS

Special problems often arise in computing a bonus based on company profits. Terms of the bonus should state whether the bonus is based on:

1. The profit before the deductions for bonus and federal income taxes.
2. The profit after the deduction for income taxes, but before the deduction for bonus, or
3. The profit after deductions for both the bonus and income taxes.

To illustrate the computations required in each of the three instances, assume the following facts: a company pays its president 10 per cent of the annual profit which is \$100,000 before any charges for bonus or income taxes. Income taxes were 40 per cent of net profit.

Let B = Bonus and T = Taxes.

- a. Assuming that the bonus is based on profit before deductions for bonus or income taxes:

$$\begin{aligned} B &= .10 \times \$100,000 \\ B &= \$10,000 \end{aligned}$$

- b. Assuming that the bonus is based on profit after deduction for income taxes but before deduction for bonus:

$$\begin{aligned} B &= .10 (\$100,000 - T) \\ T &= .40 (\$100,000 - B) \end{aligned}$$

Substituting for T in the first equation and solving for B:

$$\begin{aligned}
 B &= .10 (\$100,000 - .40(\$100,000 - B)) \\
 B &= .10 (\$100,000 - \$40,000 + .40B) \\
 B &= \$10,000 - \$4,000 + .04B \\
 B - .04B &= \$6,000 \\
 .96B &= \$6,000 \\
 B &= \underline{\underline{\$6,250}}
 \end{aligned}$$

Substituting for B in the second equation and solving for T:

$$\begin{aligned}
 T &= .40 (\$100,000 - \$6,250) \\
 T &= .40 \times \$93,750 \\
 T &= \underline{\underline{\$37,500}}
 \end{aligned}$$

Calculation of the bonus may be proved as follows:

Profit before bonus and income taxes	\$100,000
Deduct income taxes	<u>37,500</u>
Profit after income taxes	\$62,500
Bonus applied to profit after income taxes	<u>10%</u>
Bonus	<u><u>\$ 6,250</u></u>

c. Assuming that the bonus is based on profit after deductions for bonus and income taxes:

$$\begin{aligned}
 B &= .10 (\$100,000 - B - T) \\
 T &= .40 (\$100,000 - B)
 \end{aligned}$$

Substituting for T in the first equation and solving for B:

$$\begin{aligned}
 B &= .10 (\$100,000 - B - .40 (\$100,000 - B)) \\
 B &= .10 (\$100,000 - B - \$40,000 + .40B) \\
 B &= \$10,000 - .1B - \$4,000 + .04B \\
 B - .1B + .04B &= \$10,000 - \$4,000 \\
 1.06B &= \$6,000 \\
 B &= \underline{\underline{\$5,660.38}}
 \end{aligned}$$

Substituting for B in the second equation and solving for T:

$$\begin{aligned}
 T &= .40 (\$100,000 - \$5,660.38) \\
 T &= .40 \times \$94,339.62 \\
 T &= \$37,735.85
 \end{aligned}$$

Calculation of the bonus is proved in the following summary:

Profit before bonus and income taxes		\$100,000.00
Deduct: Bonus	\$ 5,660.38	
Income Taxes	<u>37,735.85</u>	<u>43,396.23</u>
Profit after bonus and income taxes		56,603.77
Bonus applied to profit after bonus and income taxes		<u>10%</u>
Bonus		<u>\$ 5,660.38</u> 21

### C. APPRAISAL

A cash bonus based on a company's profit has a varying degree of attraction and meaning to each participant. The bonus presents the possibility for supplemental income which may be used for a multitude of purposes as outlined in Chapter II. A carefully planned program of employee education must be maintained so that the participants are aware that there may be years in which no bonus is paid. This is usually difficult to do, as those employees at the lower income levels generally are not able to identify their activities with the profits of the concern. The larger the company, the more this problem holds true. Conversely, in a very small firm of less than 100 employees, errors, waste, and poor quality may be more clearly identified with the profits. To these employees, a cash bonus plan can be a positive incentive.

Profits provide a flexible basis for supplemental payments. From the company viewpoint, if the profits don't exist, then no bonus need be paid. If profits do exist, then the basis for paying the bonus is provided and can more readily be justified in the eyes of stockholders, management, employees, and the government regulatory authorities. To warrant bonus payments based on the profits, a formula generally guarantees that stockholders will receive their dividends before bonus payments are made. Such an arrangement prevents management from for-

getting its responsibility to the shareholders.

## CHAPTER V

## DEFERRED COMPENSATION

A. INTRODUCTION

This chapter covers profit sharing and pension plans which are often spoken of together. In many ways they are similar. However, they do differ in that:

Under a profit sharing plan, the benefits are always related to profits. The employee cannot determine in advance how much he will receive, and if there are no profits, there will be no benefits at all.

Under a pension plan, the pensions or other benefits are based on the amount of an employee's wages or salary, or his length of service, or both. They are not based on the employer's profits. An employee can determine in advance the amount of his pension, and can count on it, regardless of the company's earnings, so long as the pension plan is in effect. 22

The number of plans in operation has increased 25 times in the past 18 years. This has been caused primarily by the tax advantages of plans qualifying under section 165(a) of the Revenue Code. Prior to September, 1942, less than 1900 such plans were in existence in this country. By March 31, 1945, over 7500 plans had been submitted to the Internal Revenue Service for advance ruling on their qualification under section 165(a).<sup>23</sup> On December 31, 1954, a total of 26,573 plans<sup>24</sup> met the requirements and were approved by the Internal Revenue Service.

In the years since 1954, it is estimated that new qualified plans are being approved at an average rate of 4000 per year.<sup>25</sup> At

this rate of increase, there would be close to 50,000 approved plans by the end of 1959. This figure would also include "thrift" plans and stock bonus plans, both of which may be qualified as profit sharing plans. Thrift plans are discussed in this chapter, and stock bonus plans are discussed in Chapter VI. The Appendix presents a detailed outline of a qualified profit sharing plan which has now been in force 14 years at the firm which employs the author. This plan provides a practical illustration of the various aspects of a qualified plan including membership rules, vesting, forfeitures, withdrawals, contributions, retirements, and the duties of the trustees.

Also included in this chapter is a discussion of Old Age, Survivors, and Disability Insurance Benefits as provided under the Social Security law.

#### B. REQUIREMENTS OF A QUALIFIED PLAN

The following are the requirements which a plan must fulfill if it is to be approved by the Internal Revenue Service and receive favorable tax treatment:

1. The plan must be funded. This can be done by the employer who creates a trust to hold, invest, and distribute the fund at the same time the plan is established. Turning the funds over to a trust company or insurance company for administration will also meet this requirement.
2. The plan must be for the exclusive benefit of employees or their beneficiaries. This requirement is met if 70 per cent or more of all the employees participate in the plan, or 70 per cent or more of all the employees are eligible and

80 per cent of those eligible are in the plan, or the plan benefits employees qualifying under a classification set up by the employer and which the Revenue Service does not find discriminatory.

3. The benefits or contributions provided by the plan do not discriminate in favor of employees who are officers, stockholders, supervisors, or highly compensated employees.

4. It is the intent of the employer that the plan be permanent.

5. The plan is in writing.

6. The plan is communicated to the employees.

7. It must be impossible under terms of the trust for any of the trust corpus or income at any time to be used other than for the exclusive benefit of the employees, or their beneficiaries.

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### C. PROFIT SHARING PLANS

A profit sharing plan is basically one in which an employer agrees to make a contribution out of the annual profits to a trust for investment and accumulation for eventual distribution on prescribed occasions to employees or their beneficiaries.

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1. Tax advantages. Assuming a plan has met all the above requirements, let us consider the tax advantages which accrue to the parties to the agreement.

First, there is the tax deduction to the employer in the year he makes the contribution or accrues the liability to make the contribution. The amount of the deduction is limited to 15 per cent

of the compensation otherwise paid or accrued during the taxable year to all the beneficiaries of the plan. When the amount in any taxable year is less than 15 per cent of the maximum deduction allowed, as in a year of no profit, the difference between the amount contributed and the 15 per cent maximum may be carried forward in succeeding years and deducted by the employer when contributed, provided no more than 30 per cent of the participants' pay is contributed in one year. <sup>28</sup>

The second major tax advantage is that all the income earned by the trust fund is tax free. The implication of this aspect is easily seen. A trust fund of \$100,000 may earn \$3500 at current interest rates in a savings bank. Taxes could normally be expected to take a quarter to a half of this amount. Funds which have been invested in stocks have grown even more rapidly. In the case of the Material Service Corporation, investment acumen by Henry Crown, the head of the company, has paid handsome dividends to the employees' profit sharing fund. At the beginning of 1958, the value of the fund was \$4,334,887. During 1958, the company added \$644,055 out of profits. In addition, the fund which is invested in 14 preferred stocks, 27 bonds, and 68 common stock issues, increased by \$1,745,558. This represents a 40 per cent increase made up of interest, dividends, and increased market value of the securities. A \$5000 a year secretary who has had the 15 per cent maximum contributed to the fund since its inception in 1945 had her profit sharing account balance increased by \$5365 in 1958. <sup>29</sup>

With increases like this, it is obvious that capital accumulation of this magnitude is legally possible no other way.

The third advantage, taxwise, is that which the employee

receives when payment from the profit sharing funds is made to him. The Revenue Service will allow a long term capital gain treatment if the total amounts payable are distributed to the employee in a lump sum distribution within one taxable year of the employee's retirement, separation from service, or his death. If the employee at retirement elects to receive periodic payments, he will be taxed on the amounts received in each taxable year. Excluded from this taxable income is the percentage which the employee contributed to the plan, if any.

The employer must incorporate into a deferred profit sharing plan a set of rules governing the termination of employment by a participant before the time fixed for the distribution of funds. A common manner of solving this problem is to have the funds vest gradually to the recipient over a period of years, so that the cash or deferred benefit is not so large as to make it worthwhile for the employee to leave before retirement. "Conditional" vesting is another means of handling this problem. This form of vesting allows the employee an interest in the employer's contributions, but makes the vested right obtainable only in the form of a pension at retirement.

Vesting is not a prerequisite for a qualified profit sharing, pension, or stock bonus plan. However, the plan will not qualify if forfeitures, which result because of a lack of or slowness of vesting, may "inure principally to the benefit of employees who are stockholders, officers, or highly compensated employees".

Under profit sharing and also stock bonus plans, amounts forfeited may be used to reduce the employer's future cost. The more common practice is to use forfeited amounts to provide additional

benefits for the remaining members. Again, care must be exercised to prevent any discrimination in favor of certain stockholders, officers, and highly compensated employees.

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In any event, the profit sharing plan must contain provisions for full vesting if contributions are discontinued, as discrimination might result. Furthermore, the plan will not qualify

unless an employee who has reached normal retirement age or a stated age and has satisfied any reasonable and uniformly applicable requirements as to length of service or participation is permitted to receive the benefits under the plan without the consent of the employer. 34

Tax treatment such as this makes it possible to build a larger retirement equity under a qualified plan than otherwise would be possible by an individual saving for his own retirement. Not only is the employer entitled to a current expense deduction for his contributions, but the employee has the advantage of having to pay no income taxes until such monies are received, and, in a majority of cases, this is after retirement when the employee has less income and double exemptions because of reaching age 65.

The individual may also be entitled to a retirement income credit which will further reduce the tax liability. The factors to be considered when computing this credit are as follows:

- a. For persons 65 or older, retirement income means pensions, annuities, interest, dividends and gross rents.
- b. For persons under 65, retirement income means pensions or annuities paid under a public retirement system.

- c. The credit for retirement income is 20 per cent.
- d. The maximum retirement income upon which the 20 per cent credit may be taken is \$1200.
- e. The retirement income is to be reduced by Social Security or Railroad Retirement pensions, which are tax free.
- f. The retirement income is also to be reduced by the amount of earned income in excess of \$900 yearly, received by a person not yet 65. Persons between the ages of 65 and 72 will reduce their retirement income by the amount of earned income in excess of \$1200 for the year. No reduction of retirement income need be made on account of any amount of earned income received by a person 72 years or older.
- g. The retirement credit will be allowed only to persons having received earned income (wages, professional fees, and other personal compensation) of over \$600 in each of any 10 preceding years. Widows or widowers whose spouses received such earned income shall be considered to have received earned income.

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2. Other advantages. To the employer, a deferred profit sharing plan has the value of creating incentive. It also has the advantage of being tied to the company's profits. This makes the plan attractive to the employer in both good and bad years. In the prosperous year, profits are available for distribution, and in times of business recession, there is no obligation to be fulfilled if profits do not exist.

3. Disadvantages. A deferred profit sharing plan is substan-

tially inferior to a pension plan in providing retirement income for the following reasons:

- a. It is not possible to predetermine the benefits to be paid.
- b. The inclusion of past service costs is discouraged by the Revenue Service.
- c. Under a profit sharing plan, forfeitures are usually distributed among the remaining participants. In order to prevent discrimination, vesting generally is more rapid and this makes the plan more costly when compared to a pension contract in which benefits may be forfeitable up to retirement.

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#### D. PENSION PLANS

A pension plan basically is one in which an employer undertakes to provide systematically for the payment of definitely determinable benefits to his employees or the beneficiaries of deceased employees over a period of years, usually for life, after retirement.

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1. Pensions compared to Profit Sharing. A pension plan, although having many of the same purposes as a profit sharing plan, such as providing benefits for retirement or death and for deferring compensation to years of lower income, has several major differences from a profit sharing plan:

- a. Pension plans are based and computed on actuarial figures which allow for such factors as lay-offs, separations, and death before retirement age.
- b. Whereas the cost of profit sharing plans is necessarily related to profits, the cost of the pension plan is the amount necessary to provide predetermined benefits.

c. Pension plans are payable to the employee at his retirement or to his beneficiaries at his death, as opposed to a profit sharing plan which may allow for payments to the employee during his employment.

d. Pension plan payments are always made in installments to the recipients, whereas profit sharing benefits not only may be paid in installments, but also may be taken in a lump sum.

e. Amounts forfeited under a pension plan must be used to reduce the cost of the plan, while amounts forfeited under a profit sharing plan are usually distributed to the other members of the plan.

f. Generally speaking, the dollar deposited in a pension fund provides a greater retirement benefit than a dollar contributed to a profit sharing plan. The reason is that in a profit sharing plan, vesting of the funds to the employee takes place after a few years of service. Under a pension plan, there may be no such right until the employee retires.

Consequently, more of the funds in a profit sharing plan are paid out to employees who die or leave the company prior to retirement age. Hence, a smaller part of the profit sharing dollar is left for retirement benefits. 38

g. "The earnings on the investments held in a pension fund are applicable to reduce the cost of the plan to the employer." 39

In a profit sharing plan, such earnings are distributed among the participants in the same relationship in which they share any contributions made by the employer.

h. A profit sharing plan must contain full vesting if contributions are discontinued. So long as the benefits to be paid or made available under a pension plan are not affected at any time by the suspension of contributions, and so long as the unfunded past service cost does not exceed that cost as of the establishment date of the plan, vesting will not be required.<sup>40</sup>

2. Tax Advantages of a Pension Plan. Pension plans may be approved by the Revenue Service by fulfilling the requirements presented in section B of this chapter.

Like the profit sharing plan, there is the deduction to the employer in the year he makes the contribution or accrues the liability to make the contribution. However, the amount of deduction for a qualified pension plan is generally limited to 5 per cent of the compensation paid or accrued during the taxable year to all employees under the plan, plus any excess over 5 per cent necessary to provide, with respect to all of the employees under the plan, the remaining unfunded costs of their past and current service credits actuarially determined in terms of level percentage of compensation over the remaining future service of all such employees. An alternative to this rule is that the employer may deduct each year instead of the amounts noted above, the normal cost of the plan, plus up to 10 per cent of the estimated cost of pensions attributable to services in years before the plan started.

Also advantageous to the employer are the "carry back" and "carry forward" provisions of the law, which permit the employer to use the deductible feature of the pension contribution in other years ----

years in which there are profits and in which a tax is payable. The law also provides that contributions in excess of the amount that may be deducted may be carried over to following years, if less is contributed than could normally be taken as a tax deduction. <sup>41</sup>

Income earned by the funds in the pension trust, whether in the form of dividends, interest, or gains on securities is not subject to income taxes, either to the trust or to the employer. <sup>42</sup>

To the employee beneficiary under the qualified pension plan go the same tax advantages as to a beneficiary under a qualified profit sharing plan. No taxable income is reported by the employee until benefits are received. Benefit payments which continue over a period of years are taxed as ordinary income. However, if the beneficiary is at least 65 years of age, he may consider such benefits as retirement income and claim a retirement income credit with the usual limitations on that credit. If the employee has contributed to the pension plan, he may come under the "3 year rule". Under this rule, an employee excludes from gross income all annuity installments he receives until he has recovered his cost tax free, if the amounts he will receive in the first three years equal or exceed his cost for the annuity. <sup>43</sup> If the employee has contributed to the plan and does not qualify under the above rule, he then includes in his income the percentage of the benefits which are attributable to the employer's contributions to the fund.

Long term capital gain treatment is available where:

the total distributions payable with respect to any

employee are paid to the distributee within 1 taxable year of the distributee on account of the employee's death or other separation from service, or on account of the death of the employee after his separation from the service. 44

3. Cost of a Pension Plan. Each pension plan is, or at least should be, designed to suit the conditions which exist in a company and among the employees, "and in putting together such a plan, the employer is at liberty to choose among features that add to the total cost or reduce the total cost." 45

The scale of pension benefits is the largest single factor in determining a pension plan's cost. The pension should be large enough to prevent dissatisfaction among the employees, and to assure an adequate income for life to the worker who remains on the job until retirement. By providing sufficient benefits, a pension plan may bring stability to the working force. 46

Most pensions are based on the employee's basic compensation and length of service. If overtime, bonuses, and commissions are included, higher pensions will result, but the cost of the plan will also increase. If pensions are based on the final five years of earnings, the benefits will bear a closer relationship to the employee's accustomed income. "But for salaried employees, it will frequently be as much as 50 per cent more expensive than a plan based on total average earnings." 47

Some pension plans provide no pension benefits for the portion of income covered by social security. The amounts of the pensions are set to provide an adequate retirement income which includes social security benefits. A pension plan which omits compensation covered by social security is less expensive than one which includes every dollar of pay.

The average period over which the pension will be paid and how the pension is paid will cause variations in the cost of a plan. A joint-and-survivor annuity will cost more than an annuity during the life of the retired worker.

Of considerable importance in determining the cost of a pension plan to the employer is the method in which the funds are invested. The employer's annual costs will be reduced by about 5 per cent for every increase of  $\frac{1}{4}$  of 1 per cent in the earnings of fund investments. In order to meet changing investment conditions advantageously, the pension plan should allow some degree of latitude in classes of investments which may be purchased.

Employee contributions to the plan, expenses of administering the fund, the treatment of benefits for employees who leave before retirement, the number of employees to reach retirement age each year, and corporate tax rates are other considerations which will influence the cost of the pension plan.

4. Accounting for a Pension Plan. It is possible for an employer to establish a non-qualified plan whereby the funds are not turned over to a trustee. Instead, the employer at the end of the period contributes predetermined amounts to the pension fund account. This may be done by a debit to a pension expense account and a credit to a special pension fund liability account. The accompanying transfer from the general cash account to a pension fund cash account, from which payments will be made to the employees, completes the transaction.

The major drawback of this type of plan is that it does not

qualify for the major tax savings advantages that an approved funded plan receives. Instead, the employer's contributions to the account of each employee must be included in the employee's gross income in the year the contribution was made, if the employee's rights to the funds were non-forfeitable at that time. If the employee's rights to the funds are forfeitable, the employee is taxed at the time the benefits are distributed or made available to him. Neither the long term capital gain privilege, nor the "3 year rule" is available to the employee taxpayer when the benefits are distributed.<sup>50</sup> In addition, any income earned by such funds is taxable to the employee in the year earned.

Pension plans which are administered by trusts and insurance companies to secure the tax benefits make unnecessary the need for sinking funds and pension liability accounts. All receipts and distributions are handled by the trustee of the plan. The employer has only the debit to an expense account and a credit to cash in the amount of the company's pension liability.

One problem that arises in dealing with pension plans concerns the cost of recognizing past services. Should these costs be considered extraordinary charges to be deducted from earned surplus on the theory they represent costs that are related to revenues of preceding periods? Should these costs be charged to current and future periods on the grounds that they are incurred in contemplation of present and future benefits accruing to the company?<sup>51</sup> The answer to this problem would appear to be provided by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants, which has stated:

Costs of annuities based on past service should be allocated to current and future periods; provided, that if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year. Costs of annuities based on past service should not be charged to surplus. 52

#### E. SAVINGS OR THRIFT PLANS

A savings or thrift plan is an investment program designed to encourage a regular savings habit by an employee and to supplement the employee's income at retirement. 53

This is the only type of qualified plan that always is contributory on the part of the employee. The employer agrees to contribute to the fund a given percentage of the amount deposited by the employee. Care should be exercised to ensure that such plans are qualified as profit sharing plans; otherwise, the employer is likely to lose its deduction unless its contributions vest during the taxable year when made. 54

The Thrift-Incentive Plan of the First National Bank of Boston and the Old Colony Trust Company, inaugurated January 1, 1958, presents an opportunity to examine more closely this type of deferred income plan.

Membership in the plan is open to any full-time domestic permanent staff member who has had a year of continuous service.

Voluntary contributions are made through payroll deduction in the amount of 2 per cent, 4 per cent, or 6 per cent of the employee's basic salary as of January 1 of each year. Once a year, an employee may change to another percentage if he desires, by giving 30 days' written notice of his intention. An employee may also suspend his contributions without forfeiting any of the contributions made by the

Banks. 30 days' written notice prior to the beginning of any calendar quarter is required. Only one suspension is allowed in any one year and it must cover at least one quarterly period, but it may not exceed more than four consecutive quarters.

The employee has his choice of the following two funds for contributions:

Fund A --- A fund containing obligations of the United States Government, having maturities not in excess of five years, or

Fund B --- A diversified fund containing bonds, common and preferred stocks, and other investments.

Contributions by the Banks are based on the net operating earnings of the two Banks, divided by the combined capital structure of the two Banks as of January 1 each year. A figure of less than 6 per cent results in no contributions by the Banks, while a figure exceeding 15 per cent results in a contribution by the Banks of an amount equal to the total amounts paid into funds A and B by the staff members during the year. Between 6 per cent and 15 per cent, the Banks contribute predetermined percentages of the deposits made by the employees. All funds contributed by the Banks to each employee's account are invested in fund B. The Banks have the right to end the plan at any time. In this event, the trustee will distribute to each participant the total amount credited to his account.

Benefits under the plan are payable on retirement, death, or total disability. These payments may be either in a lump sum or in installments, as determined by the employee. Benefits payable on any other type of termination are subject to a forfeiture amounting to the

last three years of the Banks' contributions to the individual's account, adjusted by investment earnings and changes in market value.

Withdrawals are also subject to one to three years' forfeiture of the Banks' contributions, depending upon the amount withdrawn.

The Thrift-Incentive Plan offers the same tax advantages as other qualified plans. The Banks' contributions to fund B are not taxable to the employee until actually received. Similarly deferred are all taxes on the investment income and profits from the investment. Under the present federal tax laws, if the employee receives the entire amount due him within one taxable year, the amount received in excess of his own contributions will be taxable to him as long term capital gain.

If the amount due the participant is distributed in installments over a period of years and the amount distributed during the first three years is equal to or in excess of the total amount contributed by the participant, no Federal income taxes will be payable thereon until the participant has received an amount equal to the total amount of his contributions, and thereafter all amounts received will be taxable.

If the total of the installment amounts during the first three years is not at least equal to the total amount contributed by the participant, the present federal tax laws provide for the use of a formula for determining what portion of each installment constitutes a return of the participant's own contributions and that portion will not be subject to Federal income taxes. Under the formula, the percentage of each installment which is exempt from taxation is arrived at by dividing the total amount contributed by the participant by the total amount payable under the plan to the participant.

Under present Massachusetts tax laws, a portion of the amount distributed to a participant, whether in a lump sum or in installments, will be exempt from Massachusetts tax, but it is not clear under present Massachusetts law whether all amounts received by a participant

will be exempt from tax until he has received an amount equal to the total amount of his contributions, or whether some formula similar to the formulas provided under federal law referred to above will be applied to each amount received by the participant. 55

Such a plan is generally integrated with a pension, profit sharing, or stock purchase plan to emphasize thrift on the part of the employee, and at the same time supplement the other features of the company's employee benefit program. 56

#### F. OLD AGE, SURVIVORS, AND DISABILITY INSURANCE BENEFITS

Possibly the most important changes in the area of deferred compensation have been in the Social Security law. Under this law, old age annuities have been increased substantially, the women's age limit for receiving benefits has been reduced from 65 to 62, additional groups of workers are now covered, and employer-employee contributions are higher. The basic concept of old age and survivors insurance under the Social Security law is a simple one:

During working years, employers, their employees, and self-employed people pay social security taxes which go into special funds, and

when earnings have stopped because the worker has retired, died, or is disabled and is 50 years of age or over, benefit payments are made from the funds to replace part of the earnings the family has lost. 57

In view of the fact that the author is attempting to limit the discussion of supplemental compensation to an area encompassing only the employer-employee relationship, the self-employment aspects of the Social Security law will not be considered.

1. Benefits. Determination of whether or not a worker is

insured under social security is measured in "quarters of coverage". For most kinds of employment, a worker receives credit for one quarter of coverage for each calendar quarter in which he is paid at least \$50 in wages. The number of quarters of coverage is used only to ascertain if the worker is insured. The size of the monthly benefit payable to a covered individual depends upon his average earnings in covered employment up to the time he reaches retirement age or up to the time he actually retires, whichever occurs later. The retirement age is 65 for men and 62 for women. The exact amount cannot be figured until the worker actually retires, but it is possible to estimate what the benefits will be from tables published for this purpose. Illustration III on page 59 shows some examples of monthly payments.

In addition to the benefits which the retired worker may receive, monthly supplements to the worker's spouse or dependent child may also be made, provided certain requirements are met. A child must be unmarried, under 18 years of age, or if over 18, he must have been disabled before he reached 18 and have remained so to receive a supplement. A wife of any age, if she is caring for a child who is receiving the monthly supplement, or a wife, age 62 or over, may be eligible for the supplement. A dependent husband must be age 65 or over to receive the monthly supplement.

Survivors insurance payments may be paid to the same dependents listed in the previous paragraph, or to a deceased worker's dependent parents (father 65, mother 62), provided the deceased left neither a surviving widow or widower, nor a child who is eligible for the benefits. In addition, a lump-sum death benefit equal to three

## ILLUSTRATION III

## EXAMPLES OF MONTHLY PAYMENTS OF SOCIAL SECURITY BENEFITS BEGINNING AFTER 1958

Average Monthly Earnings After 1950 <sup>1</sup>	\$50 or less	\$100	\$200	\$300	\$350	\$400 <sup>2</sup>
Retirement at 65, Disability at 50	\$33.00	\$59.00	\$84.00	\$105.00	\$116.00	\$127.00
Retired woman worker starting at:						
62 <sup>3</sup>	26.40	47.20	67.20	84.00	92.80	101.60
63	28.60	51.20	72.80	91.00	100.60	110.10
64	30.80	55.10	78.40	98.00	108.30	118.60
Retired couple - Wife starting at:						
62 <sup>3</sup>	45.40	81.20	115.50	130.70	159.50	174.70
63	46.80	83.60	119.00	148.80	164.40	180.00
64	48.20	86.10	122.50	153.20	169.20	185.30
65	49.50	88.50	126.00	157.50	174.00	190.50
Widow, surviving child, or dependent parent	33.00	44.30	63.00	78.80	87.00	95.30
Widow and one child or two dependent parents	49.60	88.60	126.00	157.60	174.00	190.60
Widow and two children	53.10	88.60	161.60	210.20	232.00	254.10
Usual maximum family payment	53.00	88.50	161.60	240.00	254.00	254.00
Single lump-sum death payment	99.00	177.00	252.00	255.00	255.00	255.00

Source: U. S. Department of Health, Education, and Welfare: Your Social Security, Washington, D. C. U. S. Government Printing Office, January, 1959. p.11

- Footnotes:
1. In figuring your average, you may omit up to 5 years of lowest earnings, and any period your record was frozen because you were disabled.
  2. A \$400 monthly average will generally not be possible for anyone who has reached the age of 27 before 1959.
  3. Retirement payments to women are permanently reduced if started before age 65.

times the amount of the primary monthly retirement benefit, or \$255, whichever is the lesser, is payable to the widow, widower, or the person who paid the burial expenses.

A worker between the ages of 50 and 65 may be paid monthly benefits if he is disabled and unable to work in any "substantially gainful job". Supplemental monthly payments may be made to any children who are under age 18, or who have been totally disabled before they reached age 18. If a disabled worker's wife cares for a child who is eligible for dependent benefits, she may also receive a benefit. Otherwise, she may qualify for payments when she reaches age 62.<sup>58</sup>

2. Financing. Since January 1, 1937, all employers of one or more persons, except for certain classes of employment, have been required to pay an excise tax on wages paid to employees. Beginning in 1959, earnings up to \$4,800 in a year were taxable for social security purposes. The rate of tax in 1959 was  $2\frac{1}{2}$  per cent. In the 1960 - 62 period, the tax rate is to be 3 per cent. Thereafter, it is scheduled to increase at the rate of  $\frac{1}{2}$  of 1 per cent every three years until it reaches a rate of  $4\frac{1}{2}$  per cent in 1969.

In addition to the employer excise tax, an income tax is levied on the wages received by all employees not engaged in exempt employment. The income base upon which the tax is paid and the tax rate are the same as for the employer.<sup>59</sup>

The social security taxes are collected by the Internal Revenue Service. They are deposited in the Federal Old Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. The funds may be used only to pay the benefits and administrative ex-

penses of the program. The portion of the trust funds not required for current disbursement is invested in interest-bearing United States Government securities.

3. Forfeitures. A beneficiary who has not reached age 72, and who does not earn more than \$1200 in a year is entitled to receive 12 monthly benefit payments. The beneficiary who earns over \$1200 generally will forfeit one monthly benefit payment for each additional \$80 or fraction thereof. On this basis, the beneficiary will forfeit all 12 monthly benefit payments if his earnings exceed \$2080.01 in a year. An exception to this rule is that no matter how much a beneficiary earns in a year, monthly benefits are payable for any month in which wages of not more than \$100 were earned. Income from savings, investments, pensions and insurance are not counted as earnings for this computation. For the recipient age 72 or older, benefits are payable every month, regardless of the amount of wages earned.

Certain other events cause the forfeiture of any future benefits. Payments are ended when any recipient of monthly benefits dies. If a recipient of disability benefits recovers, his payments and any received by his dependents will be stopped.

The court may revoke the insurance benefits of a person convicted of crimes against the United States. If a person is deported, his benefits are stopped. In neither of these cases are the benefits to his dependents and survivors affected.

Generally, if a person receiving monthly benefit payments as a dependent or as a survivor marries a person who is not also a beneficiary, his or her right to payment stops. However, if the beneficiary marries

another adult beneficiary, payments to both may continue. Moreover, if a widow remarries and her second husband dies within a year after their marriage and is not fully insured, she may regain her right to any benefits payable to her at age 62 under the social security account of her first husband.

Payments to a wife or dependent husband are ended if a divorce is granted, except in the case of a wife who has in her care a child entitled to benefits.

Payments to a wife or widow under 62, or the divorced wife of an insured person, will stop when she no longer has in her care a child who is also entitled to monthly payments.

Payments to a child under 18 stop when the child marries.

When a child entitled to benefits reaches age 18, his payments are stopped unless he is disabled. When the child of a deceased insured person is adopted, his payments end unless the adopting person is the child's stepparent, grandparent, aunt, or uncle. 60

4. Taxes. Benefits received under the Social Security Act are not subject to Federal income tax, nor are they subject to the Federal estate tax. In the past years, the Commonwealth of Massachusetts has taxed social security benefits as "business income". However, in a decision handed down by the Massachusetts Supreme Court early in 1960, taxation of such benefits was ruled to be unconstitutional.

#### G. APPRAISAL

Deferred compensation is a method for increasing the employee's pay in the future rather than in the present. The individual gains a measure of retirement security and can have substantial tax advantages resulting from having some compensation continue into years when his total taxable income is likely to be less. Since he must stay with the same firm until retirement to get many of these benefits, the incentive

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to stay with his present employer is great. This tends to stabilize the work force and reduce the hiring and training expenses which accompany a rapid employee turnover. Such plans help the employer to promote company loyalty, increase production, improve quality, and to reduce waste of time, material, and equipment.

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By means of these plans, the employer is able to save more cheaply and efficiently for his employees than they can for themselves, making it possible to build larger retirement incomes or estates. In addition to the tax privileges which have been discussed in this chapter, section 2039(c) of the 1954 Internal Revenue Code provides that for estate tax purposes, the gross estate of the person dying after December 31, 1953, shall not include "the value of an annuity or other payment under a qualified plan, to the extent the annuity or other payment is attributable to employer contributions".

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If the employee has contributed funds to a plan, the payment to the widow or other beneficiary is includable in the employee's estate for Federal estate tax purposes to the extent the payment is attributable to the employee's contributions. If an employee names his estate as beneficiary, all proceeds are included in the estate for Federal estate tax purposes. Even then, there may be no estate tax payable. The estate of a decedent is entitled to a \$60,000 exemption. If the gross estate less allowable deductions leaves a net estate not exceeding \$60,000 there is no estate tax payable. If part of a death benefit payable to the employee's surviving spouse is includable in his gross estate because of his contributions to a plan, it may give rise to the "marital deduction". A deduction limited to 50 per cent of the adjusted

gross estate is allowed for the value of property passing at death to a surviving spouse. To the extent that this deduction is allowed, the property passes free of tax.

The laws of Massachusetts specifically exempt city, county, and state retirement plans from inheritance taxes. Pension and profit sharing benefits which are paid to heirs or named beneficiaries are included for inheritance tax purposes. No tax is payable on the amount received by a spouse, parent, or child unless the sum received from all sources exceeds \$10,000. All other beneficiaries may inherit up to \$1000 tax free.

Deferred compensation, properly planned and presented in conjunction with the social security retirement benefits, is the employer's way of providing a greater degree of financial security for his employees when they reach retirement. Society recognizes the part these plans play in providing security and financial independence for that segment of the population of retirement age, and has further contributed to this independence in the form of preferential tax treatment for these plans.

## CHAPTER VI

## STOCK BONUSES AND STOCK OPTIONS

A. STOCK BONUS PLANS

A stock bonus plan is one in which the employer provides benefits similar to a profit sharing plan, except that the employer's contributions are not necessarily dependent on the profits, and that the benefits are distributed in stock of the employer corporation. Like other bonus plans, the income from participation may be either current, deferred, or a combination of both. The form this participation takes is established by the terms of the plan.

As a means of supplementing employee income, some firms have experimented by issuing stock to employees. Others have encouraged the purchase of common stock in the company by the employees at prices below the market price. Unfortunately, many of these stock ownership plans have been unsuccessful. When stock prices declined, those employees owning shares tended to lose faith, both in the stock as a form of incentive compensation and in the management that had sponsored the plan. Furthermore, since such payments in stock represent income to the recipient, it often becomes necessary to sell a major portion of the stock, sometimes at a less favorable price, if it is not an actively traded stock, in order to pay the income taxes on the bonus. For this reason, some firms have developed combination cash and stock bonus plans, thereby providing current funds with which to pay the taxes.

By far the most popular types of stock bonus plans are those

which are accepted by the Internal Revenue Service. The restrictions which the plan must meet are identical with those of a qualified profit sharing, pension, or thrift plan. One major difference in this type of plan is that instead of cash being turned over to the plan's trustees, shares of the company stock are given. Another distinction is that the number of shares given need not be predicated on the company's profits, although the 15 per cent limitation of the participant's total wages still holds as the maximum annual contribution the employer can make, unless there have been deficiencies in prior years. In the case of a deficiency of 5 per cent, the employer may then contribute stock, the fair market value of which equals 20 per cent. In the case of a deficiency of 15 per cent, he may contribute stock with a fair market value of 30 per cent. In the case of a deficiency of 20 per cent, the employer may again contribute stock with a fair market value of 30 per cent, since this is the legal maximum contribution for any one year. The employer may then carry over to a succeeding year the remaining 5 per cent deficiency.

The only other exception to the 15 per cent rule occurs in a combination of qualified plans, such as a pension plan, a stock bonus plan, and a retirement annuity. In this case, an amount not exceeding 25 per cent of the compensation paid or accrued to the participating employees may be contributed. This limit is based on the fact that the present law allows the employer to contribute up to 5 per cent of the employee beneficiaries' wages for pension plans, 5 per cent for annuity contracts, and 15 per cent for stock bonus or profit sharing plans. In any event, the maximum contribution in any one year is limited to 30 per

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cent, which would include a carryover deficiency.

As stated earlier, the tax advantages granted to a qualified stock bonus plan permit the trustees to amass wealth from the company's contributions and tax free income on investments at a far faster rate than an individual would be able to do. The net result, then, is that larger amounts are available to the beneficiaries at the time of retirement or withdrawal from the plan than otherwise would have been possible.

#### B. STOCK OPTIONS

A company may provide options to purchase stock to officers or employees as compensation or as a bonus for past, present, or future services. The opportunity to buy into a company through a stock option offers incentive advantages in that this device tends to encourage a longer term company point of view. The interests of those holding the options and the owners of the company become the same. Moreover, if those who hold and exercise the options help to build value into the equity, they will, in turn, share in the increased value. At the time the shares are sold, the profit resulting from this increased value will be taxed as a long-term capital gain which offers lower tax rates than ordinary income.

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The usual stock option plan provides that the employees may purchase a certain number of shares of company stock at a specified price, that price generally being less than the market value of the stock. The contract will also specify the date the option is granted, the date by which the grantee must perform any conditions precedent to exercising the option, the date when the option may first be exercised,

and the date when the option expires.

C. TAX TREATMENT OF STOCK OPTIONS

Stock options fall into two categories as far as the Revenue Service is concerned. Options either come under the "general rule", or they qualify as "restricted stock options". The general rule for stock options is that if property is transferred by an employer to an employee at less than its fair market value, then the difference in the amount paid for the property and the fair market value is compensation to the employee and taxed as such. Normally, the income so received is not taxed to the recipient until the option is exercised. If the stock is later sold, then the gain or loss on the transaction is the difference between the total of the option purchase price plus the income recognized when the option was exercised and the receipts of the sale. <sup>70</sup>

However, if the following ten conditions are all complied with, then the option is deemed to be a "restricted stock option", and there is no income to the employee when he exercises the option or acquires the stock. Likewise, if these conditions are met, the employer is not entitled to any expense deduction with respect to the stock transferred to the employee, and no amount other than the price paid under the terms of the option is considered as received by the employer for the stock.

These ten conditions are as follows:

1. The option must be granted in connection with the employment of the taxpayer.
2. The option must have been granted after February 26, 1945.
3. The option price when granted must be at least 85 per cent of the fair market value of the stock.

4. The employee must not be able to transfer the option except upon death.

5. The employee at the time the option is granted must not own more than 10 per cent of the voting stock of the employer.

6. During his lifetime, only the employee can exercise the option.

7. The option must be exercised after 1949.

8. The option must be exercised while the taxpayer is an employee of the grantor or within three months after termination of employment.

9. Stock so acquired must be held by the employee at least six months from the acquisition date of the stock or two years from the date he received the option.

10. Options granted after June 21, 1954, must be exercised within ten years from the date of grant.

If after meeting all these requirements, the holder of the stock decides to sell, he may still have to recognize some ordinary income. If the option price was 95 per cent or more of the fair market value at the time the option was exercised, all gain will be treated as long-term capital gain. However, if the purchase price was between 85 and 95 per cent, income is recognized to the extent of the difference between the option price and the fair market value at the time the stock option was granted or at the time the stock was sold, whichever was the lesser figure.

#### D. ACCOUNTING FOR STOCK OPTIONS

The date on which the option is granted to an employee is the date when the company formally acknowledges the claim and takes action by setting aside a specific number of shares of stock which it must hold until the option is either exercised or expires. No other disposition of these shares from this date is possible. Therefore, the value of the option is calculated from the date the option is granted, and this value is deemed to be the excess of the fair market value of the stock over the price that must be paid by the employee for it.

To illustrate this situation, assume the following:

On January 4, 1960, the board of directors of X Company authorizes the issuance of a stock option to a key employee who has been with the firm for 5 years in recognition of her service. The option enables this employee to subscribe to 100 shares of \$25 par value stock at a price of 45 during the next 5 years. The fair market value is 50. The value of the option at the date it is granted is \$500. ( $\$50 - \$45 = \$5$ ;  $\$5 \times 100 = \$500$ ).

Consideration must also be given to whether a past, present, or future period is being covered by the compensation which the option represents. Options which represent recognition of services that contributed to the revenues of past periods may be charged to past periods in one of two ways. A charge to earned surplus is in order if the firm limits its income statement to normally recurring items. This is referred to as a "current operating performance" statement. A charge to profits of prior periods is in order if the firm follows the "clean surplus theory" and includes extraordinary items in its income statement.

If the option is related to current compensation, then the charge must be to current expense. If the option is considered to result in future benefits, then it may be recorded as a deferred charge to be assigned to the periods in which the benefits will be recognized.

If the employee in the preceding example exercised her option during 1960, the following entries would be made to record the granting of the option and the exercise of the option.

Compensation Chargeable to Profits of Prior Periods (or Earned Surplus)	500	
Common stock options outstanding		500
Cash	4500	
Common Stock Options Outstanding	500	
Common Stock		2500
Premium on Common Stock		2500

If it is assumed that this option meets all the qualifications of a restricted stock option, it is possible to show that acceptable accounting procedures and the tax laws are not always in agreement. In the example, the value of the option is a compensation expense, and as such is chargeable against the revenue in the period to which the expense is related. However, the Revenue Service will not allow such an expense deduction, for the difference between the fair market value of the stock and the reduced price is not considered compensation, and therefore is not deductible by the corporation.

#### E. ADVANTAGES AND DISADVANTAGES

Stock bonuses and stock options serve several useful purposes. They afford management additional tools with which to stimulate employees to better performance, and to help employees provide for security in retirement. They may be offered as a reward for long service based

upon the premise that such a bonus will tend to identify the employee with his employer more closely, and to solidify the loyalty already developed.

Stock plans also offer a method of compensating employees during a period when the company is growing and lacks working capital. When the employee exercises his option and purchases stock, he provides the company with additional cash and in return receives shares of stock which he may, in turn, sell or hold for dividend income and growth appreciation.

Another consideration deals with the small and closely held corporation. If the owner eventually sells all the stock to the management and employees, the possibility of a disruption of the business activity caused by his death is avoided and potentially difficult estate problems are eliminated.<sup>74</sup>

In cases where voting control is important, it is possible to initiate plans which will give management and employees some equity interest and a worthwhile share in the profits. This can be done by means of a special class of stock which may share equally in dividends with the voting common stock but does not carry any voting privileges.<sup>75</sup>

The greatest disadvantage to stock bonus and stock option plans is that they have in some cases driven away the employees they were designed to keep. The market value of the company stock which they owned or on which they held options rose to a point where the employees found it financially desirable to dispose of the stock. In doing so, the employees felt they had shown disloyalty to the company and subse-

quently resigned their positions.

Two other major problems which confront the option holder are the income tax and the matter of financing the purchase.

If the option arrangement conforms in all essential respects with the rules laid down by Congress for restricted stock options, there are no tax problems until the option is exercised and the stock is about to be sold. Provided that sale of the option stock does not occur within two years from the date the option was granted or within six months after the option was exercised, and assuming that the option price was 95 per cent or more of the market value at the time the option was granted, any profit on the sale will be long-term capital gain; if the value was between 85 and 95 per cent of the market value, an ordinary income element may be present. 76

While a restricted stock option may improve the tax problem by delaying or reducing the tax liability, financing the stock purchase may

take away much of the attractiveness because the minimum option price of 85 per cent or more of the market value on the day the option is issued will be beyond the means of many optionees. 77

It very often becomes necessary to sell a portion of the option stock immediately after the six-month holding period expires to pay the taxes and any financing charges incurred. This tends to defeat the actual purpose of the plan which is to give the holder of the option an equity in the business.

## CHAPTER VII

## THE BONUS BASED UPON OUTPUT

A. WHY A WAGE INCENTIVE PLAN?

One of the two methods of computing pay for labor is that based on output by the piece, or by the time spent in completing the piece. The other basic method, payment on the basis of time, be it by the hour, day, week, or year, will not be considered in this paper. The usual methods of payment for output are normally by straight piece rates or by a wage incentive plan in which time rates may be combined with a special payment for output above a predetermined standard. The primary purpose of the wage incentive plan is to induce the worker to produce larger quantities by offering him a higher wage and, at the same time, to reduce the total production cost per unit. Payment on the basis of output is not always feasible or desirable, but, when certain circumstances and situations are present, this type of payment is more satisfactory than payments based on time alone. Conditions favorable to such a wage incentive are as follows:

1. The units of output are clearly measurable.
2. There exists a clear relationship between the employee's effort and the quantity of output.
3. The job is standardized, the flow of work continuous, and breakdowns few.
4. Quality is a less important factor than quantity.

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When the conditions seem to favor it, a wage incentive system needs to

be carefully planned before it is introduced.

## B. TYPES OF PLANS

The following are incentive wage systems which typify a large number of such plans currently in use. It is common to find plans which incorporate factors from two or more of these plans in order to arrive at the plan which will do the job management is trying to achieve.

1. Straight Piecework and Piecework. The principal of straight piecework is to pay the worker a specified amount for each unit he produces. His wage is the number of pieces produced multiplied by the rate per piece. The faster a worker produces a piece, the higher his wage will be. A variation of piecework is to pay the worker a base rate and for production in excess of the standard, to pay a piece rate incentive. The production standard is calculated in minutes per piece, which in turn is translated into dollars or cents per piece. To illustrate this plan, assume that the worker's base pay is \$1.00 per hour and that 3 minutes is the standard time for producing the unit. The unit price for labor is then 5¢. If the worker produces 20 or less units per hour, he will receive his base rate, but for each unit in excess of 20 per hour, he can expect to receive an additional 5¢. In other words, if he produces 25 units per hour, his rate will be \$1.25 per hour under this type of plan.

It is considered essential to a piecework system to have an expert investigate in detail every manual operation to find the best and fastest method of doing the job with the equipment available. From this, a standard method is set up which allows a maximum time for a

good worker to do the job. It is then necessary to secure capable workers who can perform within the set limits and to compensate them when high efficiency is achieved.

2. 100 Per Cent Bonus or Hour-For-Hour Plan. This plan is sometimes called the "standard hour - 100 per cent premium plan" and it is a variation of the piecework method. This plan is typified by the computation of an "efficiency ratio" which is then applied to the worker's base pay rate. The number of units produced are compared to the standard number of units that should be produced in the hours worked, and the result is the rate of efficiency attained. If a worker whose base rate is \$1.50 per hour works 8 hours and he produces 80 units against a standard of 60 units, he has attained an efficiency ratio of 133 per cent. Multiplying his hourly rate by 133 per cent gives the worker earnings of \$2.00 per hour or \$16 for the day.

3. Premium Bonus Plans. Such plans, as typified by the Halsey plan, reward the worker with a percentage of the savings which production in excess of the average or standard creates. To illustrate this type of plan, assume the worker has a guaranteed minimum wage of \$1.50 per hour, that he is expected to produce 10 units during an hour, and that he receives payment amounting to 50 per cent of his rate for the time saved. If the worker delivers 12 units per hour he will be paid for the 12 minutes he saves at 50 per cent of his regular rate. Since 12 minutes equal one-fifth of an hour, his incentive premium will be 15¢, making a total pay per hour of \$1.65.

4. Premium Point Plans. Under point plans, each hour is divided into 60 points, and, at standard performance, a worker produces

at a rate of a point per minute. If 15 units are considered a standard hour's production, then each unit has a value of 4 points. For production in excess of standard, it is a common practice to pay the worker 75 per cent of his rate, and the remaining 25 per cent goes to other personnel indirectly involved with the production. To illustrate this plan, assume that the worker receives a base rate of \$1.20 per hour and that this wage is guaranteed for all production up to the standard of 15 units an hour. This means that each unit is worth 4 points and the rate would be 2¢ per point. For each point in excess of 60 per hour, the worker would earn  $1\frac{1}{2}$ ¢ while the other  $\frac{1}{2}$ ¢ would go into an indirect labor and supervisory pool.

5. Measured Daywork. Generally, the mean efficiency of the worker over a period of time is the basis for his rate in the next period. As a starting point, workers are paid an hourly base rate. To the actual hours worked, the total standard hours of work done is compared, and, if the worker has exceeded a stated minimum for a fixed period, he will receive a wage increase. This ratio of standard hours of work done to actual hours worked is computed for each pay period for each worker.

A second measured daywork plan is to pay a worker a base rate for what is considered normal production. A quota is set which may be 5, 10, 20 per cent higher than normal, and for which the worker receives a correspondingly higher percentage applied to his base rate. If he does not produce this quota, he receives only his base pay. If he equals the quota, he receives the higher pay but if he exceeds the quota, he does not receive any additional bonus.

### C. ADVANTAGES AND DISADVANTAGES

When wage incentives are being used, a worker will generally produce more in exchange for the opportunity of earning higher wages. Increased production in most incentive systems does not reduce the labor cost, but in most instances it will result in a more efficient use of plant and equipment. Expenses such as depreciation, rent, taxes, insurance, pensions, and certain salaries are fixed charges which do not vary with production. The greater the number of units these costs are distributed to, the smaller will be the cost of producing each unit.

A disadvantage of wage incentives is the additional clerical cost of timekeeping and payroll computation. It is expected that the increased output will more than compensate for these increased costs.

A second disadvantage arises when it becomes necessary for rates to be changed or adjusted. Workers often feel that any change is an attempt by management to reduce their wages even if new methods or equipment justify the change.

### D. APPRAISAL

In appraising wage incentive plans, it is important to consider the essential elements of a good plan, but the best conceived plan will be a dismal failure if it does not have employee acceptance.

As Carroll E. French said,

There are many wage incentive plans that are successful because the employers are carrying out the basic principle of consultation with their employees. These results are the by-products of this cooperation rather than the direct result of time study and rate setting. The plan is working primarily because the employer has as a background the respect and loyalty of his employees. If this kind of relationship is lacking, it matters

little how well worked out the plan is, it will fall short of the results expected of it. 81

With this in mind, let us examine some of the important factors of good plans.

1. Discuss with all personnel concerned why a wage incentive plan is needed. Explain the proposed system before installation begins. Changes are always more acceptable by employees if they know about them in advance.

2. The plan should be simple and understandable. An employee should be able to compute his own pay. Unfortunately, wage incentive plans tend to be complex, which is always a major drawback.

3. Standardized procedures must be determined for each job. Use of a recognized system of predetermined times for basic motions, such as Methods-Time Measurement, Work Factor, or Basic Motion Time-study provide a methodical way of estimating direct labor. Such methods give consistent results in terms of manhours for the manual portion of an operation. 82

4. The standard of output on which the incentive earnings are based must also be established by competent time study methods.

5. A standard or base rate should be established for each job on incentive pay. This will provide some sort of payment for "waiting time" caused by delays beyond the control of the worker. Establishing this rate is done by means of job evaluation, which in itself involves the four basic steps of analyzing the job, writing up the job sheet, making the classification, and pricing the job. Piece 83

rates and bonus rates are then set up with the idea that the worker will earn 10 to 25 per cent more than his guaranteed rate.

6. Earnings above standard should be in direct relation to the increase in output above the standard.

7. Records of inspection and quantity output should be kept and the results should be posted as frequently as possible so that the employee knows what he has produced.

8. Rates and standards should be guaranteed against change after establishment, except for major changes in methods, materials or equipment.

9. Every system of incentives should be checked to see that standards are maintained and the reasons for failures ascertained and corrected.

10. A formal complaint procedure should be available and employees encouraged to use it, when they believe new standards and rates are not right.

11. The plan should cover all workers whose jobs can be adapted to the incentive method. This makes it possible for the largest number of workers to have an opportunity to participate in the higher earnings possible under the plan.<sup>84</sup>

12. The plan should give the workers a feeling of security by providing adjustment for failures, delays, and breakdowns that are beyond the control of the employee.<sup>85</sup>

The variations of the wage incentive plans presented are many. Their success is greatest when both employees and management are in agreement as to what is accurate and fair. It is not only necessary

that these systems be accurate and fair, but that the employees believe them to be so.

Even where basic conditions seem to favor it, a wage incentive system needs to be carefully considered before it is introduced. It is not a panacea for poor morale and low output. 86

## CHAPTER VIII

## THE BONUS BASED ON GROUP OUTPUT

A. ILLUSTRATION OF A GROUP BONUS PLAN

In instances where it is difficult to measure individual performance, group and plant-wide incentive bonus plans may be more appropriate. Modern plant operations sometimes require men to work as a team in order to run a complex machine or to keep an assembly line operation moving smoothly. In such situations, it is impossible for the individual worker to speed up his pace to earn a larger wage unless all the workers perform more efficiently or all increase their rate of output.

Generally, the bonus is determined by the same methods as in the various types of wage incentive programs for individuals: i.e., piece work, 100 per cent bonus, point plans, etc. The major difference is that the output of the group as a whole is rated against a set group standard, and the bonus earned for production in excess of this standard is then divided among the members of the group, generally in relation to their base pay rates.

To illustrate this type of plan more fully, the case of a shipping department will be considered. The plan is called a Straight Incentive Standard Unit Plan in the plant where it is used, and it incorporates some features of four of the plans described in Chapter VII. Time studies have been made of all the operations of the shipping department such as wrapping, crating, stenciling, and the filling out of the necessary papers such as packing lists and bills of lading. All

of these various operations are then reassigned unit values. Since one standard hour equals 100 standard units, one standard unit equals  $\frac{3}{5}$  of a minute or 36 seconds. The standard time necessary for each operation is divided by 36 seconds to arrive at a standard unit value for each operation. Allowances for rest, fatigue, and delay are incorporated into the standards. To each man's base wage, a factor of 20 per cent is added, making what is termed his "occupational wage" 120 per cent of his basic wage. Production at the rate of 75 per cent of standard is considered "day labor", and 100 per cent of standard is considered "normal incentive effort". Therefore, if one worker produces at  $83 \frac{1}{3}$  per cent of standard, he will earn his basic wage. ( $83 \frac{1}{3}$  multiplied by 1.20 is equal to 100). If he produces at 100 per cent, he will earn his "occupational wage" which is his base rate plus 20 per cent. To double his basic wage, he will need to produce at a rate of  $166 \frac{2}{3}$  per cent. The mathematics are relatively simple in that a man will earn a figure which is the product of his "occupational wage", (120 per cent of his base rate), multiplied by the percentage of standard at which he produces.

For the shipping department, the total earned hours for the whole group are divided by the normal incentive effort, or standard hours, to arrive at a percentage of effort. This percentage is then applied to each man in the department in the same manner. When a new worker comes into the shipping department, the other members are paid on a previous rate basis since it is expected that the new worker will, initially, lower the rate of the others while he is learning. The new worker then has four weeks during which he is considered to be a student.

At the end of this period, he must earn his incentive 20 per cent or be transferred out of the shipping department, because inability to produce at standard would unduly penalize the other workers in the group by lowering the average group effort factor.

#### B. ADVANTAGES AND DISADVANTAGES

Group plans tend to develop a higher degree of cooperation among the workers. The better workers tend to keep the poorer workers on their toes so that earnings will not be jeopardized. There is also a responsibility for each member of the group to help his companions, thereby developing teamwork and maintaining production outputs. Other advantages of a group incentive plan are that the individual members of a group do not bear the entire loss if they have to perform a particular task with a "tight" rate, or a job that requires more than normal care, and charges of "favoritism" involving the assignment of certain jobs to certain individuals are less likely to occur.

The obvious drawback to a group incentive plan is that individual effort is not in direct relationship to output. A second objection arises when the standards are based on past performance, rather than careful time studies. It is almost impossible to determine whether increased output is the result of procedural changes by management or increased skill and effort by the workers.

#### C. ACCOUNTING AND TAX TREATMENT

Wage incentives, as considered in Chapter VII and in this chapter, are either direct or indirect labor costs, depending upon the type of work the employee does in the factory. Wage incentives, therefore, present cost accounting problems because it is necessary to assign

not only the basic wage to the job or product, but also the production incentives which constitute additional labor costs. The task of collecting the total and specific times worked on a job, process, or product, is done by timekeepers. From these records, the payroll unit computes the earnings of each worker. From the costs incurred, as evidenced by the payroll distribution, the cost department assigns the applicable charges to each job, product, process, or department.

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Wage incentives present no particular tax problems. Incentive expense is part of the labor cost and as such is an expense of manufacturing the product.

To the employee, the incentive bonus is simply the variable part of his weekly paycheck. Taxes have been withheld on his total gross earnings for the period by his employer, thereby satisfying his obligations to the state and federal tax authorities.

#### D. APPRAISAL

In any wage incentive plan, whether it be individual or group, one fundamental question arises: will the plan provide for greater production and employee earnings so that both company and worker gain, or will it create misunderstandings, low morale, and decreased production? The basic job conditions, labor relations, and the procedure in which the incentive plan is introduced and administered will be important factors in answering this question.

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## CHAPTER IX

## FACTOR CONTROL AS A BASIS FOR BONUSES

A. TYPES OF PLANS

Bonus plans specifically devised for foremen, supervisors, and low level management personnel are relatively few. By the same token, the number of employees in these categories who participate in bonus plans are proportionately fewer than either incentive-rated factory workers or middle and upper management employees. The chief obstacles to the participation of these employees are the very real difficulty of setting a fair standard to be reached and the imperfect methods of measuring the contributions of the individual managers.<sup>90</sup>  
<sup>91</sup>  
The difficulties are obvious, since these employees are neither production workers whose output is measurable, nor are they the people who make the policy decisions which point the direction of the company and bear on its profitability.

How, then, is it possible to have bonus incentives for these employees? It is necessary to determine the factors over which the foreman, supervisor, or manager exercises some degree of control, to set up standards which measure how well the employee exercises that control, and, finally, to reward him if his performance is superior to the standards which have been determined to be normal or average. Closer examination of three plans will provide better understanding and insight into the problems of this type of bonus. The first and second plans were devised for foremen in particular, and the third was devel-

oped with supervisors and managers in mind.

Plan I. Under the terms of this arrangement, it is possible for the foremen of the company to earn a bonus as high as  $17\frac{1}{2}$  per cent of their base salary. The plan is based on points earned by each of the foremen in three separate areas of control as measured against standard points in each of the three areas. Area A is that of departmental expenses. The actual expenses are compared to the budgeted expenses. Area B is that of expenses for the entire production division. In these first two areas the foremen have a high degree of personal control. By means of maintenance of schedule, control of quality, prevention of waste and cost reducing suggestions, the foremen are able to earn bonus points. Area C covers the growth goals of actual sales versus the quota established for sales. The foremen can earn credits in this area, although they have no direct control. High quality and prompt delivery, however, are considered as contributing factors to the sales potential of the company.

Every three months the performance of the foremen is checked and the bonus is computed. 100 earned points is considered standard and receives no bonus. 105 earned points merits a  $7\frac{1}{2}$  per cent bonus, 110 points receives  $12\frac{1}{2}$  per cent, 115 points is rewarded with a 15 per cent bonus and 125 earned points will earn the maximum  $17\frac{1}{2}$  per cent. Repeated absenteeism, tardiness, or breach of company discipline are considered as cause for excluding that particular foreman from bonus participation.

Plan II. This plan allows a foreman to earn in bonuses up to 25 per cent of his base salary in a year. Average or standard per-

formance is measured by incentive factors at budget. Individual incentive performance is measured on a performance rating scale. The factors on which each foreman is rated vary with the duties of each man, and a positive attempt is made to include only the factors over which each foreman has substantial control. This policy tends to keep the foreman's interest and actions channeled along the lines where his positive effort will be of benefit both to himself and the company.

At the end of each quarter, his actual performance is compared to the budgeted performance, and any credits made by the foreman are added to his account. Subnormal effort in a quarter does not offset any credits already earned. At the end of the year, each foreman's credits are totaled and the bonus paid according to predetermined schedules.

Plan III. The purpose of this bonus plan is to develop an awareness in the supervisory and lower management personnel of the costs and profits of the company, and also to have these employees identify themselves with the general management of the company. The factors considered are importance of the job, length of service in a managerial position, and the extra workload responsibilities. All three factors are measured and graded. Each grade for each factor carries a corresponding point value which increases as the importance of the factor increases. The total points awarded to each supervisor and manager then becomes the basis for participation in the bonus pool. This pool amounts to  $\frac{2}{3}$  of 1 per cent of the net profit before taxes for each six-month period. Although the computation is made only on a

yearly basis, approximately one-half the amount shown is paid at midyear, and corrections are made either upward or downward at the end of the year when the books are closed.

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#### B. OTHER CONSIDERATIONS

Bonuses to foremen, supervisors, and managers are certainly not limited to the three plans just presented. Again, the idea and use of a bonus is a management tool, which when properly conceived and presented, will reward both the employee and the company. A bonus plan which fills the particular needs of the firm concerned is the best. Attempts to make one company's plan solve another company's problems are very likely to be unsuccessful.

Although in any plan it is generally considered preferable to have only factors over which the foremen and managers have some degree of control, it is possible to have a plan where this control is indirect. One small firm of the suthor's acquaintance pays its foremen, factory superintendent, chief chemist, and development engineer an annual bonus based on a percentage of sales dollars and gross profit. By showing these people how their efforts and actions contribute to these two aspects, it has been possible to create an interest and incentive which is beneficial to all concerned.

Another firm initiated a bonus or "savings" plan. Each department manager received 10 per cent of the savings made in his department. To illustrate this plan, assume that the item being produced has a standard unit cost of \$22 and that 6000 units are manufactured during the month. At the end of the month, the manager has been able to initiate savings which allowed each unit to be manufactured for \$21.50. There

has been a saving of \$ .50 per unit, or \$3000, or which the manager receives \$300 and the company \$2700. It was felt by the top management of this company that even if the company had lost money, the losses would have been greater if managers had not worked for bonuses. The opportunity to show what they could do when given the incentive was the stimulus for these men.

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One very real problem which may arise with regard to a bonus based on savings concerns inventory values. If a standard unit cost is not kept up to date, then actual costs for materials in rising price periods will raise the unit cost regardless of how hard the manager works, and in declining periods will lower the unit cost making savings appear larger than they are. By the same token, if a company owns a large inventory at a low price and the standard cost is based on a higher current market price, the savings will appear to be very large. There is the case of the store manager who was paid a bonus on a ratio of expense to sales. The company made \$5 for each \$1 the manager received. Inventory prices moved upward and sales prices were correspondingly moved forward. However, this particular store had a very large inventory purchased at lower prices, so that when these goods were sold at the new prices, the profits were extraordinarily large. The store manager insisted on his full share, which company officials thought unreasonable and as a result, the manager was later replaced. This plan lacked the flexibility that was needed, and instead of being a mutually beneficial plan, it defeated itself since it resulted in the discharge of the worker it was intended to keep.

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Bonuses received by foremen and supervisors are, in most in-

stances, overhead expenses, and bonuses paid to management workers are normally administrative expenses. The cash bonuses received by the employees are subject to the same income tax rates as ordinary salaries and wages as they represent compensation for services.

### C. APPRAISAL

These plans demonstrate that top management realizes the contributions made by employees in the lower management classes, and with this in mind, is attempting to devise ways and means in the form of incentives and bonuses to sharpen the awareness in these employees of the relationship of expenses to profits. A main problem, however, is the design of a properly balanced plan. It is necessary to determine the major areas over which the employee exercises control, such as costs, quality, and every type of waste. It is also necessary to have factors that may be measured in order to determine if the employee is performing in a manner which is at least standard, or preferably, above the standards set. It has also been suggested that payments be made for bonuses either every six months or annually, in order to be able to present the employee with sizeable payments. A bonus of a few dollars each week or month makes less of an impression than a large sum less frequently. The more frequently the bonuses are paid, the more they tend to be taken for granted, and this is not a proper attitude to encourage.

## CHAPTER X

### MAJOR FRINGE BENEFITS

#### A. INTRODUCTION

Most employers realize that their employees look upon fringe benefits as a part of their compensation. They also realize that if industry does not provide these benefits, it is an invitation for the state and federal governments to step further into the picture.

Fringe benefits can be a direct and positive incentive to cut operating costs, raise production, lessen waste, and reduce absenteeism and turnover. But they will return those results only if they are superimposed upon an adequate wage and salary structure, and are intelligently selected, installed, and administered. 96

High morale, efficiency, and a good public opinion of the employer may also be developed and maintained by a well-conceived plan of employee benefits. The worker who is either sick or unemployed and who is receiving some form of benefit payment usually realizes that if the fringe benefits did not exist, he would be receiving nothing.

Chapters X and XI will be devoted to a survey of the type of fringe benefits which are quite common today. These described in this chapter are generally more extensive in their coverage, benefits, and costs than those described in the following chapter.

#### B. TYPES OF MAJOR FRINGE BENEFITS

1. Federal and Massachusetts Unemployment Insurance. In the federal - state system of unemployment insurance established under the Social Security Act, now the Federal Unemployment Tax Act, the individual

state is free to develop the particular program that seems best adapted to conditions prevailing within the state. Consequently, no two states have laws that are alike, and the differences are increased by amendments from year to year.

The Federal Act, as amended in 1954 by Public Law 767, 83rd Congress, is applicable to employers of 4 or more workers on at least 1 day of each of 20 weeks during the calendar year. The employment so covered is defined mainly in terms of services excluded from coverage. Under this law, the employer's contribution is based on the first \$3000 paid to a worker within a calendar year. The tax rate is 3 per cent. The employer may credit state contributions which he pays under an approved state plan toward the 3 per cent federal payroll tax. He may also credit any savings on the state tax under an approved experience rating plan. However, the total credit may not exceed 90 per cent of the 3 per cent federal tax. The funds collected are held for the states in the unemployment trust fund in the U. S. Treasury, and interest is credited to the state accounts. It is from this fund that money is drawn to pay the benefits.

The Social Security Act contains no standards for benefits to be paid, no requirements for eligibility and disqualification provisions, nor any requirements concerning the form of state administrative organization. The Act does undertake to assure adequate provision for administering the program in all states by authorizing federal grants from the general treasury, so that the states do not have to collect any tax for administration from the employers, or use general state revenues for this purpose.

Liability for contributions in Massachusetts is applicable to employers of 1 or more persons on a permanent, temporary, or part-time basis on 1 or more days in each of 13 weeks during a calendar year. Certain employments, which closely parallel the exclusions under the Federal Unemployment Tax Act, are specifically excluded from coverage under the Massachusetts Employment Security Law. This law requires each employer subject to it to pay unemployment insurance taxes on the first \$3000 of wages he pays to an employee during the calendar year. The standard rate of contribution is 2.7 per cent.

An employer may become eligible for a rate of less than 2.7 per cent if the balance shown in his experience rating account justifies a reduction. From this account a reserve percentage is computed, dividing the closing balance on September 30 by the total taxable payroll of the employer for the 12-month period ending on that date. To determine the actual tax rate, the employer's reserve percentage is applied to a table of rates appearing in the law and shown in Illustration IV.

The law provides certain safeguards against the depletion of the Unemployment Compensation Trust Fund. If the balance of the fund on September 30 is 7 per cent or more of total taxable payrolls of the state, the tax table with a minimum rate of  $\frac{1}{2}$  per cent is used. If the balance is less than 7 per cent but more than  $5\frac{1}{2}$  per cent, the table in Illustration V with a minimum of 1 per cent is used. If the fund balance is less than  $5\frac{1}{2}$  per cent, all employers must pay the full 2.7 per cent until the fund is replenished.

A claimant who meets the eligibility requirements of being unemployed through no fault of his own, of being capable of and avail-

## ILLUSTRATION IV

MASSACHUSETTS UNEMPLOYMENT COMPENSATION  
 SCHEDULE OF TAX RATES APPLICABLE TO EMPLOYERS  
 WHEN TOTAL FUND RESERVES ARE IN EXCESS OF 7 %

Reserve Percentage (Per Cent)	Experience Rate (Per Cent)
Under 5.5 . . . . .	2.7
5.5 but less than 6.0 . . . . .	2.5
6.0 but less than 6.5 . . . . .	2.3
6.5 but less than 7.0 . . . . .	2.1
7.0 but less than 7.5 . . . . .	1.9
7.5 but less than 8.0 . . . . .	1.7
8.0 but less than 8.5 . . . . .	1.5
8.5 but less than 9.0 . . . . .	1.3
9.0 but less than 9.5 . . . . .	1.1
9.5 but less than 10.0 . . . . .	0.9
10.0 but less than 10.5 . . . . .	0.7
10.5 or more . . . . .	0.5

Source: The Commonwealth of Massachusetts, Division of Employment Security: Simplifying The Employment Security Law for Employers. Boston, August, 1957. p. 13.

## ILLUSTRATION V

MASSACHUSETTS UNEMPLOYMENT COMPENSATION  
 SCHEDULE OF TAX RATES APPLICABLE TO EMPLOYERS WHEN  
 TOTAL FUND RESERVES ARE LESS THAN 7% BUT MORE THAN 5-1/2%

Reserve Percentage (Per Cent)	Experience Rate (Per Cent)
Under 5.5 . . . . .	2.7
5.5 but less than 6.0 . . . . .	2.5
6.0 but less than 6.5 . . . . .	2.3
6.5 but less than 7.0 . . . . .	2.1
7.0 but less than 7.5 . . . . .	1.9
7.5 but less than 8.0 . . . . .	1.7
8.0 but less than 8.5 . . . . .	1.5
8.5 but less than 9.0 . . . . .	1.3
9.0 but less than 9.5 . . . . .	1.1
9.5 or more . . . . .	1.0

Source: The Commonwealth of Massachusetts, Division of Employment Security: Simplifying The Employment Security Law for Employers. Boston, August, 1957. p. 12.

able for work and unable to obtain work, and who earned at least \$650 in his base period, may be entitled to benefits ranging from \$10 to \$40 a week. The total amount any claimant can receive during his benefit year is limited to 34 per cent of his total base wages, or 26 times his weekly benefit rate, whichever is the lesser. In addition to the weekly benefit payments, dependency allowances of \$6 for each dependent child under 18 years of age may be applied for.

Benefits paid to the unemployed are not subject to federal or state income tax, even though the tax expenditures by the employer are deductible expenses when computing income taxes.

2. Guaranteed Annual Wages. Labor contracts which call for a company to pay employees who are laid off are relatively few in number, but they do show an attempt by progressive management to provide greater employment and income security for their employees. One example of such a plan is illustrated by Procter & Gamble Company, whose workers in some plants were guaranteed that they would not be unemployed more than 4 weeks in any one year after 24 months of consecutive service. The plan was first adopted in 1923. In 1935, the Nunn-Bush Shoe Company inaugurated a plan which guarantees an annual wage. The George A. Hormel Company and the Tobin Packing Company, both meat packing concerns, provide unconditionally for 52 regular and almost equal wage payments per year. The Beryllium Corporation guarantees to workers of 5 years continuous service 2080 hours of work each year.

Another example of a guaranteed wage is the Supplemental Unemployment Benefits paid to the workers in the auto industry. SUB, as the plan is dubbed, provides the unemployed auto worker with 60 to 65

per cent of his normal take-home pay. Payments begin the second week of the layoff and continue for 26 weeks. The company payment is a supplement to the state unemployment benefits and is entirely financed by the employers.<sup>99</sup>

The federal income taxes which covered participants must pay on benefits under guaranteed annual wage plans depend upon how the plan is set up and the nature of the employee's interest in the plan. The employee will be taxed on the employer's contribution to the plan if the employee has exclusive rights of ownership of his account and a non-forfeitable beneficial interest in the cash benefits payable under the plan. But when, to be eligible, it is necessary for the employee to meet prescribed conditions after being laid off, the tax is imposed on the benefits actually received, rather than on the employer's contribution.<sup>100</sup> The cost to employers of such plans is deductible as expenses of operating the business.

Accounting for guaranteed wage plans involves the concept that the employee is actually earning more per hour than he is being paid, and that this additional sum is being accumulated for payment when there is not enough work to justify keeping the employee on the payroll. Under these conditions, it is acceptable to charge the appropriate expense account such as work in process, manufacturing expense, or salary expense, followed by a credit to a liability account for the portion which is being held for later disbursement to the unemployed worker.<sup>101</sup>

3. Accident and Health Benefits. It is a common practice in many companies to provide accident, health, hospital, medical, and sur-

gical benefits. Some firms pay the entire cost of these plans, while others share the expense with their employees. In a survey of 18 different labor areas in this country, it was found that health insurance, life insurance, and pension plans were available to about 80 per cent of the office workers and to about 70 per cent of the factory

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workers. The amount of coverage which any employee has depends upon the plan itself. Generally, the more benefits covered by any plan, the more costly the premiums are to finance the program.

The Revenue Service interpretation of the amounts received as benefits under these health and accident policies tend to leave some room for confusion. It defines such plans in the following manner:

An accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. It may cover one or more employees, and there may be different plans for different employees or classes of employees. A plan may be either insured or uninsured, and it is not necessary that it be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice of the plan was reasonably available to the employee. It is immaterial who pays the benefits provided by the plan. 103

Generally, amounts received by an employee through accident and health insurance for sickness and personal injuries, or under an accident and health plan, are taxable to the extent that they result from contributions by the employer that were not taxable to the employee, or are  
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paid by the employer. In the case of a plan where both employee and

employer contribute, the amount of benefit taxable to the employee is in the same relationship to their respective contributions. If the employee contributes  $\frac{1}{4}$  of the premiums and the employer contributes the other  $\frac{3}{4}$ , then the employee will have taxable income on  $\frac{3}{4}$  of all the benefits he receives.

Like many of the tax laws, there are exceptions to the above rule. These are three in number, and they result in the benefit received under accident and health plans not being taxable income to the recipient even though paid for by the employer's contributions. First, benefits received to reimburse the taxpayer for expenses incurred for medical care for himself, spouse, or his dependents are not taxable unless he has taken a medical expense deduction. If he has taken a medical expense deduction for actual medical expenses incurred and at some later date receives reimbursement, he must include the reimbursement in his income for the period.

The second exception is when the benefit paid is not related to the absence from work. Payments for the permanent loss of a limb, permanent loss of a bodily function, or permanent disfigurement to the employee, his spouse, or dependent are calculated with reference to the loss rather than any period of absence from work.

The third exception concerns benefits to compensate for loss of wages during temporary absence from work due to sickness or personal injuries to the employee. Such payments may be excluded from income to the extent that they do not exceed \$100 per week. The benefits for the first seven calendar days are taxable unless the employee is a hospital -

bed patient for at least one day during his illness, or his absence  
 from work is due to an injury. <sup>105</sup> Whereas the benefits received under  
 an accident and health plan may or may not be taxable income to the  
 recipient, depending upon the circumstances, the premiums paid by the  
 employer for these plans are never included in the employee's gross  
 income, regardless of whether the plan covers one employee or a group. <sup>106</sup>

As far as the Commonwealth of Massachusetts is concerned, all  
 sick benefits paid in lieu of salaries and wages are to be included in  
 business income and are taxed at a rate of  $2\frac{1}{2}$  per cent plus a 23 per  
 cent surtax. <sup>107</sup>

In the accounting for accident and health plans, care must be  
 exercised to charge the correct accounts for the expenses incurred. If  
 the employee pays the whole premium, then this amount is simply with-  
 held from his pay to be forwarded to the insurance or trust company  
 administering the plan. If both employee and employer contribute to  
 the premiums, or the employer pays the entire premium, then in addition  
 to the amounts withheld, the cost to the employer must be charged to  
 the proper labor or wage account, depending upon the classification of  
 the employee. Amounts paid for the benefit of salesmen would be charged  
 to selling expense, and amounts paid for the benefit of office person-  
 nel would be charged to administrative expenses.

4. Cost-of-Living Escalator Clauses. About 4 million workers  
 in this country have their wages and salaries linked to the consumer  
 price levels. As these levels rise, as indicated by the price index  
 issued monthly by the Department of Labor, Bureau of Labor Statistics,  
 the employees' wages are increased by certain specified amounts. Be-

tween April and July 1959, the index rose a full point, which meant that those workers covered would receive 2¢ an hour more beginning in September. <sup>108</sup> If the price levels fall, then the cost-of-living portion of the workers' pay may be reduced. The theory behind these payments is that the cost-of-living adjustment protects the worker against increased living costs by providing him with increased income to counteract the rise in prices. Unfortunately, it is now believed that linking wages to the cost-of-living helped create the inflationary price-wage spiral by bidding up prices even further. <sup>109</sup> The recent settlement of the steel strike contained a cost-of-living adjustment, but, contrary to previous settlements in the basic steel industry, this particular adjustment should be considerably less inflationary than any of its predecessors. The steelworkers obtained a clause which stated that if consumer price levels increased, they were entitled to a cost-of-living adjustment of no more than 3¢ an hour on December 1, 1960, and another adjustment on October 1, 1961, providing both adjustments do not total more than 6¢. However, in the same contract, the steel companies took over complete payment of the hospital, sickness and accident insurance for the workers with the proviso that if there was a rise in the insurance costs, this increase would be compensated for out of the cost-of-living adjustment to the workers. That the companies' insurance costs would rise was considered a certainty, and therefore the 6¢ maximum <sup>110</sup> adjustment was going to shrink to about 6/10 of a cent.

5. Vacations. Paid vacations are pretty much taken for granted, but again, the cost to the employer while the employee is on vacation

is a very real one. Two-week paid vacations are common, while three and four-week vacations are becoming more prevalent as time passes. Allied with vacations are paid holidays. The average in 1959 was  $7\frac{1}{2}$ <sup>111</sup> paid holidays per year. Holiday expense is generally charged to the labor or salary expense for the period in which the holiday falls. Many firms do the same with vacation pay even though the summer months carry the burden of the expense. Whereas this practice is acceptable where salaried workers are concerned, it is preferable in the case of factory workers to accrue the liability for the vacation pay over the entire year, thereby showing the cost as a labor expense chargeable to the output for the 48 to 50 weeks the employee actually works during the year.

### C. APPRAISAL

Fringe benefits have become a very important aspect of supplemental income. Their cost to the employer ranges from a low of about 10 per cent to a high in excess of 20 per cent.<sup>112</sup> The average employee tends not to recognize these fringe benefits as the supplements they really are. However, pay checks would be much smaller if the worker had to pay for all the benefits, and very few people would be able to take two or more weeks of vacation every year if they received no pay at all for the period.

That fringe benefits have become involved in high finance because of their costliness, is attested to by the fact that a federal<sup>\*</sup> law was passed which made it mandatory for any company whose activities

\*The Welfare and Pension Plan Disclosure Act (P.L. 85-836, 72 Stat. 997, effective 1/1/59)

even "affect" interstate commerce to file by April 1, 1959, and annually thereafter, reports on any benefit plan covering more than 25 employees. Health insurance, pension programs, deferred compensation, profit sharing, sick leave, and supplemental unemployment benefits are all included. If the funds are held by a trustee or an administrator, then he must file the annual report. The report covers the wording of the agreement or the contract, the schedule of the benefits, and the details of the procedure to be followed when claims are filed. The law also requires the companies, upon request, to supply a summary of their reports to any employee covered by the plan. Finally, these reports, which are on file in Washington, D.C., are open for public inspection. <sup>113</sup> The Commonwealth of Massachusetts in Chapter 665, Acts of 1958, effective January 1, 1959, also requires "health, welfare, and retirement funds" to register, to file annual reports, and to submit their records to examinations. Fines and prison terms are provided for falsification <sup>114</sup> of records or embezzlement of funds.

To stress the size of these funds, the auto industry paid \$265 million into the SUB plans during the first three years that these plans were negotiated by the United Auto Workers Union. Of this amount, \$108 million was paid out in benefits to unemployed automobile workers, and the reserves which have been swelled by investment income now amount to about \$180 million. Walter Reuther, president of the United Auto Workers, said that three years of experience with SUB provided "a conclusive demonstration of the practicability and of the great value of the protection they provide." <sup>115</sup> That Mr. Reuther is pleased with the results of SUB so far, still does not satisfy his aims. Bigger weekly

SUB payments, along with changes in the duration and eligibility rules, separation pay and relocation allowances, are but a few of the additional fringe benefits that the United Auto Workers will be seeking when their contracts with the automobile industry expire in September, 1959.

All in all, these major fringe benefits add a degree of security and enjoyment to the employee's life. The threat of being hospitalized or laid off is lessened to some degree by the protection these plans afford. The author believes it reasonable to assume that in an economy where much emphasis is placed on continuity of income, fringe plans of various types will be expended both in coverage and benefits in the years to come.

## CHAPTER XI

## PERQUISITES AND MINOR FRINGE BENEFITS

A. TYPES OF MINOR FRINGE BENEFITS

Benefits in this category are of considerably lesser value than those considered in the previous chapter and are therefore relegated to a section by themselves for appraisal.

1. Company Cafeterias and Restaurants. Many firms make available to their employees cafeterias and restaurants in which meals can be purchased at cost, and in many instances, at less than cost. It is literally less expensive to eat at work than at a commercial restaurant or at home. Not only are these meals economical, but generally they are planned by a dietician to provide balance and variety.

2. Coffee and Doughnuts. One small firm known to the author provides coffee and doughnuts to its employees free of charge. Coffee is made on the premises by one of the employees and is available throughout the day.

3. Stores and Libraries. Many companies provide in their plants retail stores in which the employees are able to purchase company products at reduced prices. Other firms have stores which sell general merchandise at prices substantially below the suggested retail prices. Libraries which stock all the popular magazines and latest books are provided by many companies. Charges for the use of this facility are very nominal.

4. Tickets to Public Events. Some companies buy large blocks of tickets to sports events, concerts and theatricals. Through company

purchases in large quantities for nights that are not the most popular, the employee is able to secure tickets, the price of which offers a substantial saving over the box-office price.

5. Educational Programs. It has become a common practice for companies, both large and small, to encourage their employees to attend educational classes. Generally, the courses to be taken are in a field relating to the employee's work, although some firms will sponsor a complete degree program. Classroom work enables the employee to keep abreast of changes and developments in a particular field, increases the employee's value to the company, and increases the employee's value to himself. The company pays for part or all the expenses. It may pay in proportion to the grade the employee receives as a student, thereby providing the incentive for the employee to earn a higher rank.

6. Split Dollar Insurance. This type of arrangement permits the employee to purchase more insurance than he would otherwise be able to carry at a time when he needs it most, while his children are growing up. The employer takes out insurance on the employee's life. The employee pays for the first year's premium. Each year thereafter the employer pays that part of the premium which represents the year's increase in the cash surrender value of the policy. The employee pays the balance of the premium, if any. The employer is named as beneficiary to the extent of the cash surrender value of the policy, and the employee names his own beneficiary to take the balance. In this manner,<sup>117</sup> the employer is protected for the amount of the advances he has made.

This type of insurance was virtually unknown until the issu-

ance of Revenue Rule 55-713, 1955-2 CB23.

This ruling likened the advances by the employer to an interest-free loan and reached the conclusion that no taxable income resulted to the individual from such advances. 118

The major drawback to the use of this type of insurance is the high premium cost to the employee in the first year of the policy.

#### B. TYPES OF PERQUISITES

A perquisite is a gain or profit which is made incidentally from employment in addition to a regular salary or wage. The distinction between perquisites and fringe benefits in many cases is indistinguishable. For the purpose of this paper, the author has considered fringe benefits as those plans and policies which result in income, security, protection, recreation, or a combination of these because, in fact, these are the intended purposes of these benefits. On the other hand, the benefits obtained from perquisites are the result of necessary expenditures for material, supplies, equipment, and general items to maintain the operations of the enterprise. A perquisite may provide the beneficiary with income, either in the form of additional cash or in the form of goods and services for which the recipient would have had to make a cash outlay. A perquisite may also lengthen the life of some duplicate asset owned by the person benefiting from the use of the company-owned asset. Some illustrations of perquisites and the type of benefit accruing to the employee will help to clarify this form of compensation.

1. Expense Allowances. Allowances for travel, entertainment, and living expenses while on company business have always been difficult

to control. Abuse of these allowances, even though condoned by management, has been widespread and therefore has received much publicity. Expense allowances can be used to furnish additional income by inflating the actual expenses and pocketing the difference, or by purchasing items for personal use which are charged to the company as a part of the legitimate business expenses. In most cases, employees with expense allowances do not try to justify which expenses are the most necessary, and those which are not. The feeling that the company is paying for it is the only thought considered.

Because of these abuses, the Internal Revenue Service in its audits of corporation tax returns has placed special emphasis on expenses charged to travel, entertainment, advertising, and the like. Where the expenses have been unreasonable or unsubstantiated by vouchers, the deduction allowed for these expenses has been reduced. In other instances, the Revenue Service has issued additional tax bills to individuals who received expense allowances and did not account for them, as it was concluded that these allowances were no more than additional income to the person concerned.

2. Use of Company-Owned Transportation. Use of cars, trucks, and airplanes owned by the company is a widespread practice with many variations. Some personnel have a company vehicle at their disposal at all times. Other firms allow their employees to borrow a car, truck, plane, or boat over a weekend or during a period when they are not normally in use. The cost to the employee may be nil or it may amount to some stipulated fee. The Proctor & Gamble Company allows their salesmen to use company cars for personal use at the rate of 3¢ per mile. This is for considerably less than one can generally operate an auto-

mobile. It is obvious that the use of a company vehicle can save wear and tear on the family car, thereby lengthening its useful life, and, depending upon the policy of the company involved, can save cash outlays which would be needed to operate the family car.

3. Company-Owned Houses and Estates. Many firms own properties which are used to house visiting personnel and dignitaries. Deering-Milliken Company, Inc., maintains just such an estate in Georgia to which salesmen for the firm bring customers for visits and inspections of their various textile mills in the area. Again, like the automobiles and airplanes, these facilities are often available to employees for weekends or during other periods when the facility is not in use. The amount of gain realized has to be measured by what it would have cost for the same facility if the employee had had to pay for it.

4. Samples and Other Merchandise. Samples and gifts which have been purchased and charged to advertising and promotion expense accounts are sometimes left over and given to various employees, either free of charge or at a nominal price. In other instances, small, defective, but useful quantities of a product may become available to employees. An example of this would be a fabric coating operation where 1 to 10-yard pieces of cloth are culled out because they are not satisfactory for the coating process. Such pieces very often make acceptable covers, curtains, and drapes.

5. Dues and Subscriptions. Many companies maintain memberships for their employees in industrial associations and societies. Sometimes a company may maintain a country-club membership which is used

for entertaining customers. In either event, whether the membership is for keeping abreast of the technological changes or for favorably impressing customers, such participation will provide a certain amount of social enjoyment for which the employee pays nothing.

Subscriptions to various publications by the company often provide certain employees with magazines, periodicals, and papers that might be normally purchased by the individuals. Time, Business Week, Nation's Business and the Wall Street Journal are but a few of the publications which are useful and informative to business personnel.

#### C. APPRAISAL

Fringe benefits and perquisites are a means of making various jobs more attractive and are also valuable as incentives for holding good men with a firm. Of course, plain honesty and the tax laws require that these devices be used legitimately. <sup>120</sup> Where any of these devices are used, it is obvious that small increments of additional income accrue to the recipient because he saved wither part or all the money the enjoyment of the particular benefit would have cost him, or because he has received some actual cash. In most cases, bonus income of this type is not taxable because it is not considered income to the individual. The exception is in the field of "expense allowances". Here, if an employee receives reimbursement for expenses incurred, he must include any excess <sup>121</sup> reimbursement over his actual expenses in his taxable income. In order to avoid tax difficulties in this area, it is well for the employer to keep accurate records of expense allowance payments and to require a full accounting from the employee for the expense. In this manner, both are protected.

## CHAPTER XII

## MISCELLANEOUS BONUS PLANS

A. INTRODUCTION

During the research on this paper, several bonus plans and ideas that would result in cash bonuses to employees were found. None of these plans seemed to fit into any particular situation which has been discussed.

1. The Bonus for Quitting. One of the nation's largest newspapers, the Philadelphia Inquirer, offered bonuses to all who resigned during the last six months of 1958. The reason for this was to reduce the 700-man editorial and office staff. The plan offered one week's pay for each year of service, plus full severance pay, the maximum being 31 weeks. 142 employees resigned to take advantage of the bonus. The total cost to the Inquirer was in excess of \$400,000. Some felt the idea was a big success in that it substantially lowered the number of editorial and office employees. Others felt the plan was a failure because monies were spent to get rid of not only deadwood, but also good men who took positions with competing papers because they, in turn, felt they could not pass up the bonus.

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2. Mechanization Fund. The West Coast Warehousemen's Union secured in their latest contract a clause whereby the employers would contribute a fund of \$1.5 million to let the employees share in the savings which were expected to develop through the use of labor-saving machinery and changes in the dock work rules. If the anticipated savings materialize, there will be bonuses for all the employees.

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3. Bonus for Overtime. The Fair Labor Standards Acts currently sets as a minimum wage \$1 per hour based on a 40-hour week with time and one-half for overtime for all firms engaged in interstate commerce. A man who works 50 hours in a week at a base pay of \$2 per hour will receive \$100 of regular time wages, and a bonus of \$1 per hour for each of the 10 hours , or gross wages of \$110 for the week. Some firms follow a policy which provides for a bonus which is equal to the base pay for overtime work done on Sundays and holidays.

4. The Shift Differential Bonus. Another common practice is the generally small bonus which is paid for different work shifts in a factory. No bonus is paid for the day shift because it is the normal time in which most work is done. The second shift starting about 4:00 p.m. and ending at midnight might command a 5¢ per hour bonus for the workers, while the least popular shift, midnight to 8:00 a.m., would carry a 10¢ per hour premium. Usually, the terms of both overtime and shift differential bonuses are incorporated into the union contract where the firm is unionized, or are part of the company policies where the firm is not.

5. The Construction Bonus. Bonus and penalty clauses are quite common in the field of construction. To illustrate, a town promises to pay the contractor a bonus of \$3500 if he completes a new school by April 1, 1960. For each day after this date, the contractor is penalized \$100. If the school is completed May 5, the contractor is then 35 days late and has lost all the bonus, and if the school is still uncompleted, he then must pay the town \$100 a day for each additional day he is late in the completion of the construction. Such

bonus plans offer the contractor an opportunity to earn more money by keeping the project moving along and yet does not severely penalize him until he has lost the entire amount of the bonus. At this point, it becomes very expensive to him, as he not only has his workers on the payroll, but also the town or party involved.

6. Suggestion Systems. A large number of concerns have elaborate suggestion systems whereby an employee can submit ideas which, if acceptable, will result in a cash bonus being paid. The suggestion may be one which will save the company money, increase its profits, or simply improve working conditions or employee relations. In the John Hancock Mutual Life Insurance Company, all suggestions go to a special department which studies the idea presented. If it is found to have some merit, it is then discussed with the executive or manager to whose department the suggestion pertains. At this stage, an acceptable suggestion is worked out in complete detail and forwarded to an Awards Committee made up of vice presidents and the head of the suggestion department. This committee decides the bonus to be paid the originator of the idea.

Such plans tend to keep the employees thinking of ways and means to improve operations of the company by offering them cash for acceptable suggestions.

#### B. APPRAISAL

These plans for bonus compensation represent various areas of thinking. The first four plans deal with what might be considered social justice. Whether initiated by management, the federal government or a union, the benefits from all these plans are more subsidies

for the prevention of social iniquities than they are bonuses for performance. The management of the Philadelphia Inquirer didn't wish to accept public stigma for discharging large numbers of excess employees, and therefore offered bonuses to those who resigned. Social pressure brought about the law which necessitates the payment of a premium after 40 hours' work. Late afternoon, night and early morning work hours are not as socially acceptable as the normal day shift, and therefore command a bonus payment. The mechanization fund is an attempt to provide funds for those who will be partially or fully displaced by machines or new labor-saving methods.

The last two plans offer incentives to the person, or persons, concerned. A bonus based on performance, with penalties where the performance is not up to par, is not a common arrangement. Most bonus plans allow the worker to keep whatever credits he earns by not penalizing him when his production is below normal. However, in the case of the contractor with a deadline to meet, his bonus becomes smaller and smaller for each day of delay in completing the project.

The suggestion system offers bonuses for ideas. Ideas to improve operations, printed forms and manuals, work rules, cafeteria operations, elevator service, and working conditions, are but a few areas which employee suggestions cover. Such a plan develops an awareness by the employees of their jobs and surroundings by paying them for ideas which will improve the overall operations.

## CHAPTER XIII

## CONCLUSIONS

The general objectives of any bonus plan or integrated group of plans are to hire and hold personnel of high competence, obtain a high level of current individual performance, and to build a strong and profitable business. The tools which management has at its command to do this job are many and varied, but the success of any bonus system depends upon the attitude of those using it. The management must be 100 per cent interested in the employee participation. It must also encourage the maximum response from the employees and never fail to recognize the dignity of the individual employee. <sup>124</sup>

Effective bonuses and incentives must be designed to recognize the employee's needs and wants. Not all considerations are financial, although this motive must be given high priority. Job satisfaction, current compensation, security, and possibly estate building, must all be considered when compensation plans are conceived. As it has been pointed out, the current tax structure makes certain plans more acceptable to some employees than to others. The executive who has half or more of his current income taxed away has a higher interest in bonus plans which will provide deferred income for retirement security and which will enable him to accumulate a larger estate, while the production line worker who pays only a small per cent of his income in taxes is interested in plans which will provide him with current income. The idea of pensions and retirement income is appealing, but it is very remote when the current problem is the need for more cash.

There is no doubt that well-conceived and fully accepted bonus plans are a mutual benefit to both employee and employer. The idea has been advanced that a successful bonus plan will provide an incentive to employees to put forth their best effort. By so doing, the employee's further rewards lie in the advancement to higher and more important positions in the company, together with their higher incomes. By the same token, the company benefits by its ability to fill these positions, as they become vacant, with men whose ability has already been demonstrated. It is therefore necessary that incentive and bonus plans be of broad enough coverage to give suitable recognition to all employees at all levels.

Caution must also be exercised when plans are drafted. Aside from the fact that plans must be understandable and acceptable to the employees to be successful, the company must realize that the wide range of pension, profit sharing, death, accident, and health plans involve important legal and tax aspects. To receive full benefits of the tax law, these plans must be qualified by the Revenue Service. They also involve the future of the company. It is simple to take on commitments in prosperous periods, but these plans may be a great burden at a later date.

The expense of any plan, bonus, or benefit is probably the major factor which the employer considers. Even though many plans are designed to be self-supporting, the employer is bound to be skeptical until the plan has proven itself. In many cases, the employer recognizes that the plan or benefit is going to result in additional expenses. In order to secure workers, the employer may have to offer

benefits which are at least equal to those being offered by competitors, and although he may not wish to incur this expense, he may have no other alternative.

It is best to keep fixed commitments to a minimum and to protect contingent payments by tying them to profits or insuring against them. Both profit sharing plans and stock purchase plans can be used to help keep the financial risks to a minimum. The individual employees gain only when the company shows a profit and makes a financial gain.

Plans should be reviewed periodically so that inconsistencies are not incorporated into existing plans by proposed changes. The addition of a managerial incentive bonus can be largely negated by an existing profit sharing plan if the profit sharing bonus is much larger than the incentive bonus and is not based on performance. Provisions for amending these various plans should be incorporated into the agreements. Plans which cannot be modified for justifiable reasons may result in excessive expense and ultimate abandonment of the plan.

The reasons why incentives are needed and the objectives desired should never be forgotten. All the plans, fringe benefits, and perquisites are management tools which, when used, must add up to the total compensation plan. From the total plan, management should expect to achieve higher production and efficiency, lower costs, new ideas, new products, and satisfactory employee relations, which will all help the firm to prosper. From the total plan, in return for his labor and loyalty, the employee may expect to have higher income, greater security, and job satisfaction. His tax and accounting problems should be very

few in number, with the major problem being the determination of what is and what is not current income. The terms of all bonus plans should be explained and clarified to the employees concerned on this point, and, if part of a deferred compensation plan does result in current income, the amount should be computed and the employee informed of that figure by the company or trustee in charge of administering the plan.

In conclusion, it is the author's belief that the advantages of bonus compensation outweigh the disadvantages. If they did not, the plans and policies adopted by so many firms could not be justified to the owners and stockholders. Furthermore, because tax laws have been adopted which offer preferential treatment to all the plans "qualified" by the Internal Revenue Service, there is every reason to expect a continued growth in the use of such plans.

## APPENDIX

## PROFIT SHARING TRUST AGREEMENT

Article I A. The Corporation reserves no right to any property held by the Trustees. The Trustees hold property for members and their beneficiaries.

B. The selection of original members and future members.

1. Original. One who is a full-time male employee as of (date) and has been employed less than one year and is at least 25 years of age.

2. Future. A full-time employee as of (date) in any succeeding year. He must have completed one year of service and be at least 25 years of age.

3. Less than 20 hours per week and 5 months per year is part-time employment.

4. Membership is not required and ceases on the withdrawal or end of employment with the Corporation.

5. Each member must execute an application.

6. Employees now in the military service are not now included, but are eligible on return to active employment under said terms with prior service and military service considered as total prior service.

7. The effective date of this agreement is (date) and the anniversary date is (date).

Article II A. On or before March 1 of each succeeding year, the Corporation will pay to the Trustees 10% of the net profits of the Corporation before Federal Taxes on income during the previous year which will be in excess of \$15,000, such payments not to exceed 15% of the aggregate compensation of the members thereunder. Compensation does not include overtime, bonuses, or other non-recurring income compensation.

B. The Corporation desires the Trust to be a permanent instrument, but cannot guarantee against every conceivable circumstance, therefore, the Corporation reserves the right to amend or terminate the obligation to contribute to the Trust but shall not receive back any property held by the Trustees.

Article III A. After the first contribution is made by the Corporation, the Trustees shall open separate accounts for each member and credit each as entitled:

1. Two units for each year of service with the Corporation.
2. One unit for each full \$100 of annual basic compensation.

Each member's share shall be that percentage of the total contribution as his total units bear to the total number of units of all the members.

B. On the anniversary date, the Trustees will apportion pro rata among all the accounts of the full members the net income earned by the Trust during the previous year.

C. Except as otherwise provided, no distribution of any part of the principal or income of the Trust shall be made until ten full years have elapsed from the commencement date of the Trust.

Article IV A. Retirement. Distribution shall be made at the normal retirement date as follows:

1. In the case of a member age 60 and under at eligibility, the anniversary date nearest age 65.
2. In the case of a member over 60 at eligibility, the 5th anniversary of the date of his eligibility.
3. In the case of a member, age 65 at eligibility with 10 years service, at any anniversary date.
4. In the case of a member who is disabled and cannot continue, retirement may be at the insistence of the Trustees, provided such shall not effect discrimination in favor of officers, stockholders, supervisors or highly compensated employees.
5. In the case of a member who requests retirement after 10 years participation, he shall be considered to have reached retirement age.

B. Withdrawal. In a case of a member leaving by reason other than death or retirement, he will receive the following presents:

- |                     |      |
|---------------------|------|
| 1. Three full years | 25%  |
| 2. Four full years  | 50%  |
| 3. Five full years  | 100% |

Culpable act or culpable omission receives no benefit. Any forfeited amount is to be applied proportionately among the remaining members, provided that such does not principally benefit officers, etc..

C. Death. The account is to be paid without interest within 30 days to the beneficiary or beneficiaries. If no such designation, the amount will be payable to those persons who would have received the personal property of the deceased under the intestacy laws of the Commonwealth of Massachusetts. If over \$1000, the payment will be in installments as determined by the Trustees.

D. Method of Distribution. Each year after retirement, 1/10 of the account will be paid to the members to which will be added the income earned each year on the balance.

#### Article V

- A. The Trustees will be three in number.
- B. The terms of service of the Trustees will be for three years each.
- C. The Trustees serve without compensation.

D. The Trustees act specifically for the purposes set forth.

E. The Trustees may resign by written notice to the Corporation or to the other Trustees.

F. The remaining Trustees have power to act until the vacancy is filled.

G. A majority of the Trustees are needed to effect documents or instruments.

H. No Trustee is liable for an act or failure to act, if done in good faith.

I. The Trustees may employ any person or corporation to perform as agents for services needed.

#### Article VI

A. The Trustees may purchase with 75% of the amount credited to each member, one or more contracts on the life of the member from an insurance company or companies. The contract shall be in the so-called annuity or retirement income form which shall also provide death benefits at least equal to the amount of the premiums paid thereon and in the case of members acceptable as standard risks, such death benefits shall equal 100 times the monthly retirement pension so purchased. If extra premiums are necessary to obtain this, members may request the Trustees to pay such premiums, reducing the outstanding credit balance of the member by the amount of the extra payment.

B. The Trustees shall be the owners at law of all the contracts.

C. In the event the Corporation makes no profit, the Trustees shall pay the premiums from the credit balance of the member's account.

D. No insurance company is a party to this agreement.

E. The Trustees may invest in securities, stocks and mortgages, if, after investigation, they are believed to be sound.

F. The Trustees shall on March 1 render a report to the Corporation.

Article VII The Corporation shall furnish the names, length of service, and compensations paid to the members.

Article VIII Member's interests are non-assignable.

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