Taxation of pensions and profit sharing plans essay sample

Economics, Tax

Personal income is perceived in the United States of America as the appropriate measure of one’s ability to contribute to the federal government operation costs in terms of tax. The personal income normally includes compensations that are paid and not necessary that the compensation should be in cash but rather many forms. Taxable income thus is any economic gain that is conferred to an employee as compensation. Economic gains are of different forms and such there is need for some kind of special treatment of some economic gains and more especially the retirement benefits.

Pensions are treated in a special way in that the employees are exempted from being taxed on their accrued pension benefits, but rather taxed at the end after them receiving their pension in retirement. The deferring of taxes to a time of retirement by an employee can be seen as an interest free loan that is has been given out from the treasury as it in some way reduces the life time taxes of an employee, because they receive part of their compensation in the current state and the rest at their retirement, thus the amount of tax payable by them in the current state is less compared to employees who earn all their compensations in cash wages currently and not contributing anything to their pensions. This special treatment of pensions normally makes the treasury to incur losses from two main sources; First, the revenue that would have been obtained from taxing the amount that is contributed to pensions, and secondly loss of tax which could have to be got from the revenue that was to be generated by the funds held in pension.

The funds that are contributed by the workers to pensions are protected by the Employee Retirement Income Security Act of 1974, which ensures that that the funds are availed when the employees retire. It provides the required standards to be observed for pension plans in the private sector, but it does not have a mandate of instructing employers to institute a pension plan (Frisch., 2002). The Act require plans to provide the participants with all the necessary information, it sets the minimum standard for the participants and also for the benefit accrual and funding, demands the accountability of the plan fiduciaries, guarantees the participants in plans a right to sue for benefits and breaches of fiduciary duty, and lastly it ensures that the payments are made on the termination of a plan.

The profit sharing plans are plans which are laid by organisations, in which they are structured in a such way that employees participate in sharing the organisation's profits due to excellent performance. It can be perceived as a way of rewarding the good performance and promoting the attitude of partnership between the employer and its employees on each and every side trying to promote further excellence of the organisation. The profit sharing concept was first introduced by Pillsburg Mills and Proctor Gamble in 1898, then it was adapted in 1916 by Harris Trust and Saving Bank of Chicago. The Harris Trust and Saving Bank of Chicago adapted the deferred profit sharing plan.(http://www. ebri. org/pdf/publications/books/fundamentals/fund06. pdf.). The profit sharing plan came into the concern of the treasury in 1938, where the legislation clarified the taxation status of profit sharing plans. Following the legislation and the World War II wage freeze, there happened an increase in the adaption of the profit sharing plans in organizations and more especially in the 1940s. This concept of profit sharing plans also received a great boast from the Employment Retirement Income Security of 1974 on it imposing less burdensome regulations on the plans, as compared to the regulations that were set to govern the benefit pension plan, thus making it more attractive compared to the benefit pension plans (McQuown 2004).

There are four main profit sharing plans with their varied taxation and compensation styles and they include; current distribution profit sharing plans, Employee's profit sharing plans, Deferred profit sharing plans and also the registered profit sharing pension plans. They are discusses as given below;

The current distribution profit sharing plans are characterised by them giving periodic cash distribution to the the plan members depending on the profitability level of the employer. The distribution at times may be in terms of the stock of the company and not cash, and this is normally determined by the employer. The distributions are given out periodically rather than waiting until when the plan members retire from work, thus the plan can be perceives to be a form of a direct compensation. This plan seem to be the most simplest type of profits sharing plan because it involves less formalities as the cash or stock is directly given to the employees. Shares are given to the employees by the employer issuing them with share certificates. In this form of plan, taxation on these compensations is made in the current time, that is in occurs in the time when this cash in paid or when the stock certificates are issued. The cash that is paid is normally part of the profits that the company realized and its given to the employees depending on their contribution to attaining certain level of profits, thus its proportional to the employees effort toward attaining such level of profit. This plan does not need to be registered because of its simplicity in administering and in most cases it depends on the will of the employer

(http://smallbusinessreview.
com/finance/money_profit_plans_key_considerations_0207/).

In the Employee's profit sharing plan, the amount of profits that are realized in a year are put into into a trust fund where this funds are shared among the plan members along with their share of accumulated interest contained in the trust fund for that year. A formula to divide this funds is chosen and in this case it may take dividing the funds according to the earning of the employees, the duration in which the employee has been in service or any other agreed formula. The money that is contained in the trust fund is normally retained until the employee retire or his service terminated, although in some cases an employee can be allowed to access the cash. The employee has also an opportunity of contributing to his or her account in the trust fund where this contributions are not taxable.

The time over which the employee can withdraw his cash from the trust fund normally varies from at he can withdraw immediately, on being terminated, on retire or on death. The employee can be barred from accessing the cash for immediate withdraw if it was to be after either retirement or termination because he or she does not have a right over the cash. Despite the condition that the employee can not access the funds before either terminated or retirement, the employee’s share of profits is taxed every year when being transferred to respective employees accounts in the trust fund. The interest that is accrued in the trust and also any capital gains that are realized are also taxed assuming that the employer was in immediate receipt of such cash. The employer’s personal contributions to the trust are not taxed because it is assumed that these funds should have rose from his or her personal income which has already been taxed, thus it is a way of avoiding double taxation.

As pertains to the deferred profit sharing plan, the employer normally assigns a share of profits to all the plan members in every one year and deposits them into a trust account. These funds are then expected to be in the trust account until when the plan member’s employment is terminated. The money that are contributed to the trust as the employee’s share of profit are not subject to tax immediately but they are taxed when the employee is in receipt of the cash. The plans under this category are normally registered under the Employee’s Retirement   income Act and for a plan to qualify for registration is must provide the vesting period, define the retirement age, follow the rules set by the Employee’s Retirement Income Act in comparison to the rules of pension plans, and also assign a significant employer contributions when the profits are earned.

The Deferred profit sharing plan can be seen as being similar to pension plans in the sense that the employer is paid his or her benefits on retire, but in the deferred profit sharing plan, this rule is flexible in that an employer can be allowed to withdrawal part or all of his contributions while still being an employee in that organisation, where this is not the case under pension plan. The lump sum amount that is received by an employee on retirement or terminated is taxed as a revenue (http://opencrs. com/getfile. php? rid= 20380.). The Deferred profit sharing plan differ with the pension plan in the sense that the lump sum of money paid at either termination or retirement is not available in the case of pension, rather it is paid in instalments with the pension, thus even tax in pension is deducible on respective instalments.

The case of registered profit sharing pension plans, it can perceived as a purchase pension plan in which the employer normally contribute to the trust depending on the profitability level of the company, in that the employer is expected to contribute more on realizing more profits and less when low profits are realized. The plan operates under similar rules as the one for the pension plans but they only differ on the style of the employer contributing to the trust. The money that is contributed by the employer to the fund normally remains there until the time when the employee retires or get terminated, thus the employee does not have a right to withdrawal the money until the time when he or she has retired or his or her services has been terminated. The funds in the trust are taxed when the employee is in receipt of the money, that is when he has retired or has been terminated from employment.

Both the profit sharing plans and pensions plans have to meet some set requirements before they qualify for a certain tax treatment, where these rules are determined by the Employee’s Retirement Income Security Act. These rules are designed in a manner that they normally protect the employee’s rights and also make sure that the funds are available to the beneficiary on retirement or termination. The rules address issues like the disclosure of plan information to the members, definition of the responsibilities of the fiduciary, eligibility of the employee’s membership in a plan, the form of benefit payment, and also the funding among other issues. Other than observing the rules set by the Employee’s Retirement Income Security Act, the plans are also expected to observe the Internal Revenue Code nondiscrimination rules(http://pension-administration. org/pension_services. htm).

The plans are expected to be precise on the employer’s contribution to the employees’ accounts, and in this case it should be done following a certain formula of allocation that is likely not to discriminate. The contribution by the employee is normally limited as per to rules set by Internal Revenue Code in that the employee can only contribute to a maximum of 15% of the employee’s compensations and this is what is deducible for the federal tax purposes(http://www. irs. gov/faqs/faq-kw141. html). Initially in the case of profit sharing plan, employer were to contribute with regard to the amount of profits realized but this has changed as the employers are not expected to establish profit sharing plans contribution necessarily proportion to the profit realized in as much as they specify that its a profit sharing plan. In situations when the employer contributes less than the deducible amount, the unused limit is not carried forward, but if the employer contributes in excess of the deduction limit, the excess is carried forward to the following deducible years.

The law demands that members of a given plan should be given all their benefits on retirement, and it also guarantee full benefits on one becoming disabled or dies. In the case of termination, the case is arguable depending of the provisions in the plan, but if the plan was contributory then the member has a right to have all of his or her benefits. The profit sharing plans normally provides a choice of either payments should be made in installments or in lump sum and not in the case of pensions where it is strictly installments on either death or retirement of a plan member. The distribution of benefits are expected to start in the immediate year after one attaining an age of 70 ½ years, unless the employee has not retired.

Conclusion. Taxation of pension and profit sharing plans is not definite as it varies from one plan to another depending on its maturity time and the provisions by law. All the plans are expected to follow the guidelines contained in the Employee’s Retirement Income Security act and also in structuring these plans, they are also expected to exercise the rules of nondiscrimination contained in the Internal revenue code. There are a number of profit sharing plans and they include current distribution plan, employee’s profit sharing plan, deferred profit sharing plan and Registered profit sharing plan. In the current plan, taxation is on wages and other benefits when paid, in employee’s profit sharing, taxation is in every year, in deferred profit sharing, taxation is on when the money is paid out and the same case applies to registered profit sharing plan.

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