

Preliminary Concerns

Learning Objectives

An understanding of the material in this chapter should enable you to

- 3-1. Describe the fact-finding process for helping an employer select the appropriate tax-advantaged retirement plan.
- 3-2. Identify the rule differences between defined-benefit and defined-contribution plans.
- 3-3. Compare the defined-benefit with the defined-contribution plan approach.
- 3-4. Compare plans in the pension category with those in the profit-sharing category.
- 3-5. Define the term "Keogh" plan and calculate the maximum allowable deduction under a defined-contribution plan

One of the most promising and lucrative opportunities in the retirement market is the chance to design a client's retirement program. Financial services professionals who act as consultants in this area provide a valuable service that not only leads to the sale of retirement-plan products, but also to the investment of their client's retirement assets. Furthermore, financial services professionals who bring technical expertise to the retirement-decision process gain the confidence of clients and may be entrusted with sales opportunities in other areas of the business. Conversely, financial services professionals who desire only to manage plan assets or sell investment products find themselves at a competitive disadvantage if they cannot offer the technical expertise expected.

For these reasons, it is essential that financial services professionals learn how to select the most appropriate retirement plan or plans for their clients. The study of this process starts with the selection of the most appropriate tax-advantaged plan for your client (chapters 3–6). We discuss the design of plan features, such as the plan's eligibility and vesting provisions, in chapters 7–10. Next, a thorough review of the issues involved in investing plan assets precedes a brief discussion of the various administrative issues involved with maintaining retirement plans. Before moving on to individual retirement planning we also discuss supplemental nonqualified plans, generally for executives (chapters 15 and 16), and the role of individual retirement plans.

3.1

In order to choose the best retirement plan, you must identify the client's needs and objectives, understand the various plan options, and match the client's needs and objectives with the proper tax-advantaged retirement plan or plans.

IDENTIFYING NEEDS AND OBJECTIVES

When advising a client on retirement-plan choices, your initial step is to focus the client on the important issues he or she faces, both personally and professionally. In addition, you need to discern the organization's needs and objectives that are relevant to plan selection. The device used to accomplish these steps is a pension planning fact finder (found at the end of this chapter). Although this seven-step fact finder gives you one perspective on the task, other choices in fact finding may work better for you. In any case, you should use this fact finder or an alternative to

- guide the client toward focusing on important issues
- gather the information necessary for you to make insightful recommendations
- provide a systematic approach for solving the client's retirement puzzle
- serve as a due diligence checklist that will ensure the selection of the most appropriate plan
- record your dealings with the client for liability protection

Understanding the Fact Finder

Even basic information about the company will impact the plan design. For example, the type of entity may limit the type of plan that can be established. Another key issue is whether or not the entity has any related entities. Under the rules that apply to tax-advantaged retirement plans, certain related employers have to be aggregated to determine whether a plan satisfies coverage requirements. Because the rules are quite complex it is best to write down all related companies that fit the description in the fact finder, and then have a qualified tax expert carefully analyze the aggregation issues.

Step 1 of the fact finder helps you begin to identify organizational needs, the foundation for proper plan choice. The important comparative analysis that is started in step 2 (involving the interplay between these factors) requires additional discussion with the client to establish the relative desirability of each objective. For example, when an employer has the multiple objectives of attracting and retaining key employees, avoiding an annual financial commitment to fund the plan, and providing tax shelter for top executives, you must gauge which need is most important and to what degree the other needs will have to be subordinated in order to choose the best plan for your client.

Step 3 lists the primary and secondary reasons for establishing the plan, and is a culmination of steps 1 and 2. It forces your client to set priorities

on the motives for establishing the plan. Motives can be disparate even in similarly structured organizations, but several generalizations about motives can be made:

- Large organizations typically want to meet the needs of the business while getting the most for the employees out of a given expenditure.
- Small organizations, such as closely held businesses, are particularly concerned with providing tax shelter and extensive retirement benefits to owners and key employees.
- Some organizations (both large and small) desire to adequately provide for rank-and-file employees; others want to favor key employees and will only grudgingly meet the minimum statutory requirements for other employees; and still others fall somewhere between these two polar viewpoints.
- Some organizations establish plans to attract and retain key employees or to motivate employees, and they want the most cost-effective system to meet those goals.
- Some organizations are interested in resolving problems with older, unproductive employees and in creating a graceful transition out of the workforce.
- In today's world, more and more employers want to form a retirement savings partnership with employees and want employer contributions to primarily match employee contributions.

The first three steps provide some insight into the type of plan to be chosen. Steps 4 and 5 (discussing cost objectives and cash flow) are, however, perhaps the most important determinants of the type of plan the client will adopt. The price tag the client can comfortably live with is sometimes a product of the client's objectives (what he or she wants to provide) and sometimes a product of the economics of the situation (what he or she can afford). What clients can afford will vary according to what they want and what they consider a cost-effective price. When considering cost objectives, the organization's ability to make the economic commitment year in and year out should be carefully studied. Some industries have fluctuating profits that ebb and flow with certain uncontrollable economic conditions, while others are fairly stable. In other words, it is not just a question of how much, but also how consistently a certain payment level can be maintained or how much flexibility is needed in order to meet benefit commitments. Carefully examine the following issues before deciding on a price range:

- annual variations in profits
- future cash needs for capital expansion
- potential changes in the prospect's industry over the next 5 years
- length of time until the principals retire
- tax-shelter needs of owner-employees

Step 6 (distinguishing between personal and organizational goals) helps you to better understand the priorities laid out in step 3 and the cost objectives laid out in step 4 by differentiating between the client's personal needs and

corporate objectives. You may find that, in the small-plan market, the client's personal needs are of the utmost importance and, as the size of the company grows, the organizational needs become more central to the decision-making process.

Step 7 (analyzing the company's census) is perhaps the most important step in the fact-finding process. A thorough understanding of the ages and salary levels of the people who will be covered by the plan is essential in establishing the best possible plan design. For example, if all the members of the firm are "older" (by pension standards, over age 45), then it may be desirable to put in a defined-benefit plan that accounts for past service (discussed later). If, however, salary levels are low and employees are young, a defined-contribution plan, such as a 401(k) plan, may be desirable. The employee census also can have an impact on cost. For example, in a defined-benefit plan the cost of funding a benefit for an older participant can be quite high, as there is a short time to fund the retirement benefit.

The last question in step 7 is also crucial. Under the plan rules, certain related employers have to be aggregated for purposes of determining whether a plan satisfies coverage requirements. The rules are quite complex; therefore, it is best to ask broad questions that will enable a qualified tax professional to analyze the ownership relationships to determine whether aggregation issues exist.

YOUR FINANCIAL SERVICES PRACTICE: INFORMATION GATHERING

The pension planning fact finder is just the jumping-off point in your quest to identify your client's needs and objectives. The initial interview should be followed by open communication lines that allow the client's concerns to be more clearly developed over time. The following points typify what can happen in this intervening time:

- Frequently, the person you speak with will not correctly represent the desires of the entire body of authority within the organization. The company will need time to sort out its collective feelings and come up with a response. Try not to get involved in the infighting that may occur, and try to remain as diplomatic and neutral as possible.
- The company's attorney or accountant should be brought into the process in the early stages. A common problem is that the attorney or accountant may resent playing the subordinate role (even though he or she may know little about pension plans). Once again, the solution is diplomacy.

Choosing between a Qualified Plan and the Other Tax-Sheltered Plan

Chapters 4 and 5 discuss the various types of qualified plans. Chapter 6 addresses those tax-advantaged plans that are not categorized as qualified plans. For the for-profit employer, the other types of plans available include the SEP

and the SIMPLE. The nonprofit employer that is a 501(c)(3) organization also has the option to sponsor a 403(b) tax-sheltered annuity plan.

As we have already begun to discuss (and as described in detail in later chapters), establishing and maintaining a qualified plan requires a significant amount of documentation, government reporting, and employee communication. For the small business, these requirements can be quite onerous. SEPs and SIMPLEs are intended to provide the small business with some less complicated options. Plan documents are less complicated, and there are fewer IRS reporting requirements. Simplicity translates into lower administrative expenses and less time spent operating the plan. However, in exchange for simplicity is a rigidity in plan design. These plans have less flexibility than qualified plans in most regards. The important differences include

- *Coverage.* While the qualified plan rules provide significant flexibility in the number and makeup of the employees covered by the plan, the SEP and SIMPLE eligibility requirements are set in stone.
- *Vesting.* Contributions must be fully and immediately vested in the contributions to SEPs and SIMPLEs, while qualified plans can have a vesting schedule.
- *Contributions.* In some cases in a qualified plan, benefits or contributions can be different for different classes of employees. This is not the case in SEPs and SIMPLEs, where all participants must receive essentially the same level of benefits.
- *Maximum contributions.* In most regards, the limits are lower for SEPs and SIMPLEs than for qualified plans.

The SEP is the appropriate plan option when the employer is going to fund all of the plan benefits. In a SEP, as in a profit-sharing plan, the employer can make contributions annually (or more often) on a discretionary basis. When the employer wants to allow employees the opportunity to make additional contributions on a pretax basis (making it similar to a 401(k) plan), then the SIMPLE is the appropriate choice.

The 403(b) tax-sheltered annuity is a unique retirement planning vehicle. Only tax-exempt 501(c)(3) organizations and public school systems are allowed to sponsor such plans. At one time, there were relatively few rules governing these plans. However, over time, the situation has evolved, and more and more of the rules that apply to qualified plans now also apply to 403(b) plans. One type of plan that still operates quite differently from the way a qualified plan does is the 403(b) plan that involves only employee pretax contributions. This type of plan is not subject to many of the requirements of ERISA (as long as certain requirements are met). With this type of arrangement, the employer has little involvement; the service provider works directly with the employees. When the employer makes contributions to a 403(b) plan, then the plan operates very much like a qualified plan. (The distinctions between the plans are covered further in chapter 6.)

CHOOSING BETWEEN A DEFINED-BENEFIT AND A DEFINED-CONTRIBUTION PLAN

defined-benefit plan

Assuming the employer is going to choose from among the qualified plan options, the first consideration is whether the employer wants a plan of the defined-benefit or defined-contribution type. All qualified plans fall into one of those two categories and each category represents a different philosophy of retirement planning. This philosophy is reflected in the definition of each term. A defined-benefit plan specifies the benefits each employee receives at retirement. In most plans, the benefit is stated as a percentage of preretirement salary, which is payable for the participant's remaining life. Under a defined-benefit plan, the contributions required by the employer vary depending upon what is needed to pay the promised benefit, and the amount of annual funding is determined each year by the plan's actuary.

In many ways, the defined-benefit plan looks like an insurance solution to the retirement problem. The risk that is being insured is the loss of income due to the inability to work any longer. Another risk is that an individual will outlive his or her money in retirement. The traditional defined-benefit plan addresses both of these issues. The amount of the benefit is tied to what will be lost—employment income. To address the issue of longevity, in the traditional plan, the benefit is payable for the retired employee's entire life. It is interesting to note that this plan design is due in part to the fact that the first defined-benefit plans were funded with insurance products, although today many "self-fund" the promised benefits.

defined-contribution plan

In a defined-contribution plan, on the other hand, employer contributions are allocated to the accounts of individual employees. This approach is similar to a personal savings approach in which an individual opens a bank account and makes regular contributions, and the account grows based on the rate of investment return. Because of this characteristic, defined-contribution plans are sometimes called individual account plans. One way to look at these dissimilar approaches is to say that defined-benefit plans provide a fixed predetermined benefit that has an uncertain cost to the employer, whereas defined-contribution plans have a predetermined cost to the employer and provide a variable benefit to employees (based upon the rate of return).

All qualified plans fall into either the defined-benefit or the defined-contribution category. The names of the various qualified plans and the categories into which they fall are listed below. Note, however, that two types of plans are referred to as hybrid plans. First is the cash-balance plan, which is a defined-benefit plan that has some of the characteristics of a plan using the defined-contribution approach. Second is the target-benefit plan, which is a defined-contribution plan that has some of the characteristics of a defined-benefit plan. These distinctions will become more clear in the next two chapters, where the plans are discussed in more detail. Also note that the SEP, the SIMPLE, and the 403(b) tax-sheltered annuity plan all use a defined-contribution approach and share the same strengths and limitations

of other defined-contribution plans (in comparison to the defined-benefit approach).

Qualified Plan Categories	
<u>Defined-Benefit Plans</u>	<u>Defined-Contribution Plans</u>
<ul style="list-style-type: none"> • Defined-benefit pension plan • Cash-balance pension plan 	<ul style="list-style-type: none"> • Money-purchase pension plan • Target-benefit pension plan • Profit-sharing plan • 401(k) plan • Stock bonus plan • ESOP

Rule Differences

Because of their vastly different natures, there are a number of important rule differences that apply to defined-benefit and defined-contribution plans. First is how the maximum contribution and benefit rules of Code Sec. 415 apply. Code Sec. 415(b) limits the maximum annual benefit that can be provided in a defined-benefit plan. The rule allows payment of a life annuity beginning at age 65 in the amount of the lesser of 100 percent of the highest consecutive 3-year average compensation or \$195,000 (as indexed in 2009, with no actuarial reductions if benefits begin as early as age 62). If payments begin before age 62, the dollar limit is reduced to reflect early commencement. The dollar limit is also increased to reflect commencement after age 65. If the form of payment is other than a life annuity, the benefit generally must be actuarially adjusted.

In a defined-contribution plan, the maximum contribution each year is limited under Code Sec. 415(c). The rule is that the maximum annual additions for any participant for the year cannot exceed the lesser of \$49,000 (indexed for 2009) or 100 percent of salary. Annual additions include all employer contributions, employee contributions (of any type), and forfeitures that are allocated to the participant's account. There is one exception: catchup salary deferral contributions made for those individuals over age 50 are not counted under the limit.

Compensation under Code Sec. 415 includes taxable wage income as well as salary deferral contributions to all types of tax-sheltered plans as well as pretax contributions to cafeteria plans and fringe benefit programs. Compensation cannot exceed the cap stated in Code Sec. 417. In 2009, the compensation cap is \$245,000.

All defined-contribution plans of related employers are added together to determine whether the annual additions limit of Code Sec. 415(c) has been satisfied. Similarly, defined-benefit plans are aggregated to determine whether Code Sec. 415(b) has been satisfied. This means if an individual participated in two defined-contribution plans of a single or related employers, the maximum

annual addition for 2009 would be the lesser of 100 percent of compensation or \$49,000. Related employers generally means aggregated under the controlled group, affiliated service group, or leased employees rules (discussed in chapter 7), except that under the parent-sub subsidiary rules, aggregation exists if the parent owns more than 50 percent of the subsidiary (instead of the 80 percent or more rule that normally applies).

The next rule difference has to do with the PBGC. As mentioned in chapter 2, the PBGC insurance program guarantees certain benefit payments from most privately sponsored defined-benefit plans (with the exception of plans with fewer than 25 participants sponsored by professional services organizations). In a defined-benefit plan, the amount of assets never exactly matches the promised benefits, and the PBGC program is there to provide assistance if the company is in financial trouble and the plan does not have sufficient assets to pay the promised benefits. This program does not cover defined-contribution plans because the plan's assets always match the promised benefits owed to participants.

**minimum-participation
rule**

Another important rule difference is that defined-benefit plans are subject to a special coverage provision referred to as the minimum-participation rule, which is discussed in detail in chapter 7. Defined-contribution plans are not subject to this rule.

Another distinction is the way the maximum deductible contribution is calculated. In defined-contribution plans, the maximum deductible contribution is 25 percent of aggregate compensation of all covered participants. In a defined-benefit plan, the limit is based on actuarial calculations and is not limited to a specific percentage of compensation.

Today, defined-contribution plans are required to have more accelerated vesting schedules than defined-benefit plans. Defined-contribution plans must use a vesting schedule as favorable as either a 3-year cliff (participants become fully vested after 3 years of service) or a 6-year graded schedule (participants must be 20 percent vested after 2 years and earn an additional 20 percent for each additional year of service). Defined-benefit plans can choose a more extended schedule—either 5-year cliff vesting or 7-year graded vesting. This distinction is discussed further in chapter 9.

**Table 3-1
Rule Differences (2009)**

Defined-Benefit Plans	Defined-Contribution Plans
Maximum annual benefit limited to lesser of 100% of average compensation or \$195,000	Maximum annual additions limited to the lesser of 100% of compensation or \$49,000
Subject to the PBGC insurance program	Exempt from the PBGC insurance program

Defined-Benefit Plans	Defined-Contribution Plans
Satisfy Sec. 401(a)(26) minimum-participation rule	Not subject to the minimum-participation rule
Deductible contribution based on actuarial calculations	Deductible contribution limited to 25% of aggregate compensation
5-year cliff or 7-year graded vesting	3-year cliff or 6-year graded vesting

Comparing the Defined-Benefit and Defined-Contribution Approaches

Because defined-benefit plans typically describe benefits as a percentage of final-average compensation, benefits can be geared to replace a specified percentage of salary for the long-service employee. Also, defined-benefit plans can provide benefits based on past service (that is, years worked before the plan was initiated), while defined-contribution plans cannot. This means that benefits can accumulate more quickly for the older employee in a defined-benefit plan. Such plans reward those employees who continue employment until retirement, because benefits are usually tied to both length of service and final income.

In defined-benefit plans, the burden of providing an adequate retirement income is placed solely on the employer, because the employer promises to fund the plan sufficiently to pay promised benefits. This means the risk of the investment experience is on the employer; contributions will increase if investment experience is worse than expected and will decrease if performance is better than expected. Even though the employer is responsible to make required contributions, it is important to note that there is generally some funding flexibility in defined-benefit plans. There is, typically, some range (as determined with the help of an actuary) from the required minimum to the maximum allowable deductible contribution.

Also, defined-benefit plans generally provide for a built-in "preretirement" inflation factor by tying benefit payments to salary levels received just prior to retirement. However, defined-benefit plans generally do not increase automatically for inflation occurring after retirement—although it is not unusual for an employer to provide periodic ad hoc benefit increases for retirees. This makes the defined-benefit plan unique, because defined-contribution plans cannot imitate this inflation protection.

Tying benefits to final-average salary does have one down side. When a participant changes jobs, the benefit can be reduced significantly because of the loss of the highest years of salary in the calculation. This means the benefit is not as portable as in a defined-contribution plan where benefits accrue more ratably over the years. This lack of portability ties the employee to the

employer, which has a benefit for the employer who offers the defined-benefit plan.

For these reasons, employers looking to (1) maximize benefits for older workers, (2) give long-term employees (including key people) a secure and specified retirement income, and (3) tie employees to the company through the benefit program will be interested in the defined-benefit plan. Still, the defined-benefit plan is only an option if the company is in the financial position and competitive posture to be able to meet the financial obligation of maintaining this type of plan.

Plans in the defined-contribution category are significantly different. From the perspective of both the employer and the employee, such plans look and feel more like deferred-compensation plans. A specified amount is set aside for the employee's benefit, which is paid out at termination of employment (as long as the participant is "vested") or, in some cases, even earlier.

This means that defined-contribution plans do not provide a retirement benefit that is closely tied to the individual's retirement needs (as in a defined-benefit plan). This does not mean that defined-contribution plans will not provide adequate retirement income; it is just much harder to pinpoint the benefit. Also, in a very real way, the employee is at more risk because the benefit is tied to the plan's investment return. In other words, if stock market prices fall drastically, it is the employee who must worry in a defined-contribution plan, but the employer who must worry in a defined-benefit plan.

With a defined-contribution plan, the employer's cost is determinable and will not vary with the plan's investment return. Also, these plans cost less to administer as there are fewer administrative functions. The cost is higher with a defined-benefit plan primarily because the sponsor needs to hire an actuary to determine the cost of providing benefits. The actuary has to make multiple calculations as required by funding, accounting, and PBGC rules.

Employees can more easily follow the growth of their benefits with a defined-contribution plan and can more readily appreciate the value of the cost of the plan to the employer. Defined benefits can have great value, but the cost of the benefit to the employer is not as transparent.

Defined-contribution plans may also allow employees to direct the investments in their individual accounts. As well, the participant's benefit is stated as a single account balance and lump-sum distributions are generally allowed—which is not always the case in a defined-benefit plan.

This account balance is more portable should an employee switch jobs. The lump-sum value can be rolled over to an IRA or to the new employer's plan. Because the benefit grows with annual contributions and investment experience, a participant is not penalized by changing employers, as can be the case with a defined-benefit plan.

Easily determinable costs appeal to employers whose financial positions dictate caution (typically organizations with volatile cash flow). What is more, key employees tend to feel more comfortable about individual accounts that they invest, portable benefits, and the lump-sum distributions traditionally

offered under defined-contribution plans. As a result of this employer and key-employee appeal, defined-contribution plans have become a hot ticket for financial services professionals in the pension field.

Table 3-2
Types of Plans Compared

Defined-Benefit Plans	Defined-Contribution Plans
Defines the benefit	Defines the employer's contribution
Contributions not attributed to specified employees	All contributions allocated to individual employee accounts
Employer assumes risk of preretirement inflation, investment performance, and adequacy of retirement income	Employee assumes risk of preretirement inflation, investment performance, and adequacy of retirement income
Can provide benefits based on past service	Cannot provide benefits for past service
Costly to administer	Lower administrative costs
Can be difficult to communicate both the amount of benefits and the value of benefit (amount it costs the employer)	Easy to communicate the amount of employer contributions and the "bank-account" type accumulation
Unpredictable costs	Predictable costs

The Realities of the Marketplace Today

A look at the contrast between the defined-benefit and the defined-contribution approach would not be complete without a discussion of the realities of today's marketplace. Even though the defined-benefit approach still has the strengths that have been mentioned, few small businesses today are maintaining defined-benefit plans. The 2006 Bureau of Labor Statistics National Compensation Survey identified fewer than 10 percent of employers in private industry with 99 employees or less offering a defined-benefit plan.

This does not mean, however, that defined-benefit plans are not an important part of the retirement planning landscape. The same study revealed one third of workers in mid-size and large companies in private industry (100 or more employees) are covered by defined-benefit plans. Also, in the small-plan marketplace, the pension industry has begun to recognize that defined-benefit plans could play an important role for the older business owner who has not accumulated enough for retirement, has a strong cash flow, and is looking for a significant tax shelter. With the number of aging baby boomers today, we may see more defined-benefit plans installed.

Nevertheless, defined-contribution products have become the bread-and-butter sale for those who deal in qualified deferred compensation. The defined-contribution approach appears to appeal both to senior managers,

who are looking for simplicity and contribution certainty, and to employees, who like that they can more easily understand the plan and appreciate that benefits are more portable. The number of employees in the private sector covered by defined-contribution plans has grown to over 50 million. In the small-plan market, almost all plans being installed are 401(k) plans and SIMPLEs (see the 2003 EBRI Small Employer Retirement Survey).

Multiple Plans—Combining Defined-Benefit and Defined-Contribution Plans

Defined-benefit plans and defined-contribution plans are not mutually exclusive, and two or more plans can be set up for any one employer. If defined-benefit and defined-contribution plans are used together, restrictions apply to the overall deduction limits.

Today, a combination defined-benefit and defined-contribution plan is typically used in a larger company to provide a comprehensive benefits package. A defined-benefit/defined-contribution combination may be appropriate in the small-plan marketplace as well, when the business owner is looking to maximize benefits and deductible contributions. Theoretically, a plan sponsor could contribute the maximum Code Sec. 415(c) amount to a defined-contribution plan on behalf of the owner and fund the Code Sec. 415(b) maximum allowable benefit in a defined-benefit plan for the owner as well. In practice, this may be beneficial in some cases, but this type of arrangement could run up against the maximum deductible contribution limits. When a sponsor maintains both a defined-benefit and a defined-contribution plan for the same group of employees, the maximum deductible contribution will generally be the greater of the cost of funding the defined-benefit plan or 25 percent of aggregate compensation. There are several important exceptions. First, if the defined-benefit plan is subject to the PBGC insurance program this combined limit does not apply. Also, when applying the combined limit, the first 6 percent contributed to the defined-contribution plan is not counted (essentially making the limit 31 percent of compensation).

A combination of a defined-benefit plan and a 401(k)/profit-sharing plan can also work quite well for the small business owner (at least 45 years old to get a significant deduction for the defined-benefit plan) with the goals of both maximizing retirement benefits and maximizing tax deductions.

Example:

Betty, age 50, has an office organization business called EZ Order, Inc. She is 100 percent owner of the corporation and her annual W-2 pay is \$200,000. Her goal is to maximize her retirement benefits. She plans to retire in 12 years when she is 62. A traditional defined-benefit plan established in 2009 will provide Betty with an annual benefit of \$195,000 at age 62, assuming that she participates in the plan for at least 10 years and sustains a 3-year average salary of at least \$195,000. The actuary working for Betty's business estimates that she can contribute \$132,000 per year to the defined-benefit plan. In addition, she can contribute 6 percent of pay (\$12,000) to the profit sharing plan and maximize her salary deferral of \$22,000 (\$16,500 plus the \$5,500 catchup). So the total annual contribution for EZ Order, Inc. will be \$166,500 (\$132,000 + \$12,000 + \$22,000). Future contributions to the defined-benefit plan will depend on the performance of the plan assets, as well as the amount of Betty's W-2 income.

CHOOSING BETWEEN A PENSION PLAN AND A PROFIT-SHARING PLAN

All qualified plans fall into either the defined-benefit or defined-contribution categories. Similarly, all plans are also classified as either pension plans or profit-sharing plans. As you can see in the chart below, both types of defined-benefit plans, along with target-benefit and money-purchase plans, are categorized as pension plans. All other defined-contribution plans are profit-sharing plans.

Qualified Plan Categories	
<u>Pension Plans</u>	<u>Profit-Sharing Plans</u>
<ul style="list-style-type: none"> • Defined-benefit pension plan • Cash-balance pension plan • Money-purchase pension plan • Target-benefit pension plan 	<ul style="list-style-type: none"> • Profit-sharing plan • 401(k) plan • Stock bonus plan • ESOP

pension plan category
profit-sharing plan
category

The most important difference between a plan in the pension plan category and one in the profit-sharing plan category concerns the employer's commitment to the plan. Under a pension plan, the organization is legally required to make annual payments to the plan because the plan's main purpose is to provide a retirement benefit. Under a profit-sharing-type plan, however, an organization is not required to make annual contributions. The reasoning here seems to be that profit-sharing plans are not necessarily intended to provide retirement benefits as much as to provide a sharing of profits on a tax-deferred basis.

Consistent with this rationale, the law generally allows that profit-sharing-type plans may be written to permit distributions during employment. These are often referred to as in-service distributions. The plan can distribute funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, financial hardship, disability, retirement, death, or severance of employment. The IRS has interpreted "a fixed number of years" to mean that:

- Distributions can be made of any contributions that have been held in the plan for 2 years or more.
- Any participant who has 5 or more years of plan participation can receive a distribution of his or her entire account balance.

Note that salary deferral contributions to 401(k) plans are subject to special, more restrictive in-service withdrawal limitations (discussed in chapter 5).

Since pension plans are meant to provide retirement income, the rules generally require that benefits cannot begin until termination of employment. However, plans are allowed to begin payments when a participant attains normal retirement age, even if the participant does not retire. To ensure that plans don't take advantage of this exception, the IRS has issued rules establishing the earliest allowable normal retirement age in a pension plan. The rules provide that a normal retirement age of 62 or later is always acceptable, and that an age earlier than 55 is presumed to be unreasonable, unless the sponsor can demonstrate that the normal retirement age is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. The rules give some deference to an employer's judgement in applying this same "industry" standard to retirement between ages 55 and 62.

A final distinction between pension and profit-sharing plans concerns the ability of these plans to invest in company stock. Plans in the pension category can invest only up to 10 percent of plan assets in employer stock. Plans in the profit-sharing category, on the other hand, have no restrictions; all plan assets can be used to purchase employer stock (although this is seldom the case). See table 3-3 for a summary of plan differences.

Table 3-3
Differences between Pension and Profit-Sharing Plans

Characteristic	Pension Plan	Profit-Sharing Plan
Employer commitment to annual funding	Yes	No
Withdrawal flexibility for employees	In-service withdrawals restricted	In-service withdrawals freely permitted
Investment in company stock	Limited to 10%	Unlimited

KEOGH PLANS

Keogh plans

In addition to categorizing plans either as defined-benefit or defined-contribution, or as pension or profit-sharing, qualified plans are categorized by the type of business organization they serve. Today, all types of businesses choose from among the same group of qualified plans. Historically, that was not always true. At one time, plans for partnerships and self-employed persons were governed by separate statutory provisions, and plans for such organizations were referred to as Keogh plans. Unfortunately, the name still sticks—generally creating more confusion than information. Today, a sole proprietor does not establish a Keogh plan; he or she establishes a profit-sharing, defined-benefit, or other plan from the array of tax-advantaged retirement plans. And, except as described below, the rules for sole proprietorships and partnerships are entirely the same as for corporate entities, and the same considerations regarding plan choice and plan design apply.

There is, however, one remaining distinction between plans of sole proprietorships and partnerships⁶ and corporate plans: The self-employed person's contribution or benefit is based on net earnings instead of salary. This creates some complications because net earnings can be determined only after taking into account all appropriate business deductions, including the deduction for the retirement contribution—thus, the amount of net earnings and the amount of the deduction are dependent on each other.

6. Limited-liability companies that are taxed as partnerships are subject to the same limitations as those that apply to partnerships.

Table 3-4
Keogh Deduction Work Sheet

Step I: Self-employed person's work sheet		Value
1.	Plan contribution as a decimal (for example, 25% would be 0.25)	
2.	Rate in Line 1 plus 1, shown as a decimal (for example, 0.25 plus 1 would be 1.25)	
3.	Divide Line 1 by Line 2. This is the self-employed contribution rate. (For example, $0.25 \div 1.25 = .20$)	
Step II: Figure the deduction		
1.	Enter the self-employed contribution rate from Line 3 of Step I.	
2.	Enter the amount of net earnings that the business owner has from Schedule C (Form 1040) or Schedule F (Form 1040).	\$
3.	Enter the deduction for self-employment tax from the front page of Form 1040.	\$
4.	Subtract Line 3 from Line 2 and enter the amount.	\$
5.	Multiply Line 4 by Line 1.	\$
6.	Multiply \$245,000 (2009 compensation cap) by Line 1.	\$
7.	Enter the smaller of line 5 or 6.	\$
8.	Enter the smaller of line 7 or \$49,000 (the maximum allocation allowed for 2009).	\$
Total		\$

If a defined-benefit plan is used, an actuary is needed to straighten out the confusion and to determine the plan contribution amount itself. In a profit-sharing plan, this means that a sole proprietor or partner can only contribute 20 percent of Schedule C earnings (not 25 percent of compensation as with a corporate plan). Further complicating matters is the fact that self-employed individuals get a deduction for income tax purposes equal to one-half of their Social Security self-employment tax on their federal tax return. Also, the contribution amounts still cannot exceed the Code Sec. 415(c) annual limit or take into consideration earnings in excess of the compensation cap. To ensure compliance with this rule it is useful to follow the formula in the Keogh Deduction Work Sheet to calculate the maximum contribution in a defined-contribution plan.

ADDITIONAL PRELIMINARY CONCERNS

Before we study the menu of qualified plans, it should be noted that choosing the best retirement plan is not as simple as picking one type of plan

from the menu. The plan's design must also be considered in order to make the proper choice. This is because qualified plans are principally differentiated by only one design feature—their benefit formulas. The many other design choices, however, also affect your plan choice. To put it another way, plan choice is a function of plan design, and plan design is a function of plan choice. (The plan-design details that help you to make a more informed decision are presented in chapters 7 through 10.)

A second consideration when choosing a qualified plan is the makeup of the entire benefits package. For example, if there is a nonqualified plan for key employees, the choice of a qualified plan for all employees should be dovetailed with the nonqualified plan to reach the desired result. When group life and group disability plans are involved, other considerations arise. As a general rule, the choice of a retirement plan should reflect the fact that it is only one part of a benefits package. Special care should be taken to ensure that benefits are not duplicated under the different employee benefit plans.

Example:

The professional corporation of Davis and Wickstrom is primarily interested in providing tax-sheltered savings for key employees and minimizing costs attributable to rank-and-file employees. Davis and Wickstrom asks you to help choose the best retirement plan for them. A defined-benefit plan designed with a benefit formula that is integrated with Social Security, and with restrictive eligibility and vesting provisions, is the preferable choice. But if you had only considered the menu of retirement plans without noting the design features, you might have chosen a 401(k) plan instead. At first blush, the 401(k) seems to be a likely fit because it allows tax-sheltered savings for key employees and minimizes costs attributable to the rank and file. On closer inspection, however, you will see that 401(k) plans may not provide enough tax shelter for the principals because such plans must be designed to meet a special nondiscrimination test known as the actual deferral percentage (ADP) test. (See chapter 5.)

PENSION PLANNING FACT FINDER

Client's Name			
Address			
Phone Numbers			
Key Contacts	Name		
	Title	Phone No.	
	Name		
	Title	Phone No.	
	Name		
	Title	Phone No.	
	Attorney	Phone No.	
	Accountant	Phone No.	
Employer Identification Number			
Fiscal Year			
Accounting Method (Circle One)	Cash	Accrual	
Business Structure (Circle One)	C Corp.	S Corp.	Municipal Corp.
	Partnership	Limited Liability Company	Sole Proprietorship
	Exempt Organization	Professional Corp.	Government Agency
State of Incorporation or Domicile			
Date of Incorporation or Establishment			
Were there any predecessor entities? (Circle One)	Yes	No	
Describe Relationship			

Affiliated Entities Identify (1) other entities that the owner of this entity own in full or in part, (2) other entities that this entity owns in full or in part, (3) other entities that own this entity in full or in part, and (4) other entities that work with this entity to provide a single product or service. Describe in detail the chain of ownership and how the entities work together.	1.
	2.
	3.
	4.
Name	
Address	
Phone No.	
Describe Relationship	

Step 1: Set retirement priorities.

Listed below are some typical concerns that organizations have when instituting a retirement program. Grade each of these concerns by scoring 1 for very valuable, 2 for valuable, 3 for moderately valuable, and 4 for least valuable.

- | | |
|--|-----------------|
| 1. To what extent is it important to use a qualified plan as a tax shelter for owner-employees and key employees? | [1] [2] [3] [4] |
| 2. To what extent is it important to maximize benefits for long-service employees by including service prior to the inception of the plan? | [1] [2] [3] [4] |
| 3. To what extent is it important to place the risk of investing plan assets with the employee? | [1] [2] [3] [4] |
| 4. To what extent is it important to institute a plan that is easily communicated to employees? | [1] [2] [3] [4] |
| 5. To what extent is it important to institute a plan that is administratively convenient? | [1] [2] [3] [4] |
| 6. To what extent is it important to institute a plan that has predictable costs? | [1] [2] [3] [4] |
| 7. To what extent is it important to avoid an annual financial commitment? | [1] [2] [3] [4] |
| 8. To what extent is it important to allow employees (including owner-employees) to withdraw funds? | [1] [2] [3] [4] |
| 9. To what extent is it important to minimize plan costs by limiting benefits for lower-paid employees? | [1] [2] [3] [4] |
| 10. To what extent is it important to create a market for employer stock? | [1] [2] [3] [4] |
| 11. To what extent is it important that the plan be able to borrow to purchase employer stock? | [1] [2] [3] [4] |
| 12. To what extent is it important to attract key employees? | [1] [2] [3] [4] |

- | | |
|---|-----------------|
| 13. To what extent is it important to retain experienced personnel? | [1] [2] [3] [4] |
| 14. To what extent is it important to motivate the workforce? | [1] [2] [3] [4] |
| 15. To what extent is it important to encourage the retirement of superannuated employees? | [1] [2] [3] [4] |
| 16. To what extent is it important to give participants the opportunity to save additional amounts on a pretax basis? | [1] [2] [3] [4] |
| 17. To what extent is it important that employer contributions be made only for employees who elect to contribute? | [1] [2] [3] [4] |
| 18. To what extent is it important that benefits for those who terminate prior to retirement be portable? | [1] [2] [3] [4] |
| 19. To what extent is it important for participants with a salary deferral option to be able to choose between tax-deferred and tax-free withdrawals? | [1] [2] [3] [4] |

Step 2: Discuss with the client the interplay between various factors in step 1. For example:

- | | <u>Yes / No</u> |
|--|-----------------|
| 1. Does the desire to provide tax shelter for owner-employees and key employees outweigh the need to cut costs attributable to lower-paid employees? | [Y] [N] |
| 2. Does the desire to provide tax shelter for owner-employees and key employees outweigh the need to have an easily communicated and administratively convenient plan? | [Y] [N] |
| 3. Does the need to provide tax shelter for owner-employees and key employees outweigh the need to have predictable costs and payment flexibility? | [Y] [N] |
| 4. Is it more important to retain employees than to attract employees? | [Y] [N] |
| 5. Is it more important to motivate employees than to attract or retain them? | [Y] [N] |
| 6. Is it more important to provide an adequate retirement standard of living than to cut plan costs? | [Y] [N] |
| 7. Is it more important to provide an adequate retirement standard of living than to have predictable costs? | [Y] [N] |
| 8. Is it more important to provide an adequate standard of living during retirement than to avoid an annual commitment to funding the plan? | [Y] [N] |
| 9. Is it more important to provide an adequate standard of living during retirement than to allow employees (including owner-employees) to withdraw funds? | [Y] [N] |
| 10. Is it more important to provide an adequate standard of living during retirement than to have administrative convenience and an easily communicated plan? | [Y] [N] |

11. Is it more important that contributions go only to employees who elect to participate than to provide retirement benefits to all workers? [Y] [N]

Additional Comments

Step 3: List the primary reason(s) for establishing the plan and the secondary reason(s) for establishing the plan.

- | | |
|-----------|----|
| Primary | 1. |
| | 2. |
| | 3. |
| Secondary | 1. |
| | 2. |
| | 3. |

Step 4: Discuss the employer's cost objectives. Discuss the price range that is desired both now and in the future.

Step 5: (A) What are the current and future cash-flow situations?

- 3-1. for the company
- 3-2. for the industry in general

- (B) Attach balance sheets from the last 3 years.
- (C) Attach appropriate profit and loss statements.

Step 6: Distinguish between the personal needs that the plan will satisfy for the principals and the organizational goals that are sought.

Step 7: Analyze the company's census (list of employees).

1. What percentage of employees can be expected to turn over before retirement?

- _____ % leave before they complete one year of service
- _____ % leave between their first and second years of service
- _____ % leave between their second and third years of service
- _____ % leave between their third and fourth years of service
- _____ % leave between their fourth and fifth years of service
- _____ % leave between their fifth and sixth years of service
- _____ % leave between their sixth and seventh years of service
- _____ % leave with more than seven years of service
- _____ % are "lifers" with the company

2. What groups of employees exist?

- ____ salaried employees
 ____ hourly paid employees
 ____ collective-bargaining unit employees
 ____ leased employees

3. To what extent are part-time employees used?

- ____ part-time employees are used
 ____ no part-time employees are used
 ____ part-time employees work less than 500 hours
 ____ part-time employees work between 500 and 999 hours
 ____ part-time employees work 1000 or more hours

4. How many offices (profit centers) are there?

- ____ number of different locations

5. What benefit programs do chief competitors offer?

6. Attach employee census.

7. Attach other group benefit plans.

Step 8: Identify other related employers and the relationship to this one. The list should include any entities with interrelated ownership and other entities that work together with this one to produce a product. Describe in detail the chain of ownership and how the entities work together.

CHAPTER REVIEW

Key Terms and Concepts

defined-benefit plan	pension plan category
defined-contribution plan	profit-sharing plan category
minimum-participation rule	Keogh plans

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [3-3] at the end of a question means that the question is based on learning objective 3-3. If there are multiple objectives, they are all listed

- 3-1. June Jones is thinking of installing a retirement plan for her budding flower business. June has indicated that she knows nothing about retirement plans and would like to speak with her financial advisor on the issue. What steps should the advisor take to help June focus on the important issues facing both her and the business and to gather the appropriate information that would enable the advisor to make recommendations? [3-1]

-
- 3-2. What are two typical stumbling blocks that financial services professionals face when helping to plan a client's retirement program? [3-1]
- 3-3. Answer these client questions about Code Sec. 415. [3-2]
- Can a defined-benefit plan pay the owner \$195,000 (2009 indexed limit) a year for life beginning at age 60?
 - I've heard that in 2009, an owner aged 50 or older can actually receive an allocation in a 401(k) plan of \$54,500. Is this correct?
 - Is it true that, if an individual works for a company and participates in two defined-contribution plans with that employer, up to \$49,000 (2009 indexed limit) can be allocated to the participant in each plan.
- 3-4. Sam Doyle, owner of Doyle's Furniture, Inc., has requested a qualified plan that (1) provides an adequate pension for his employees, regardless of what the stock market does, (2) takes care of employees who have been with him for a long time, (3) provides a pension that reflects his employees' salaries at retirement, and (4) ties his long-service employees to the company. Should Doyle's Furniture, Inc., use a defined-benefit or a defined-contribution plan? Explain. [3-3]
- 3-5. What advantages are available to the employer under a defined-contribution plan? [3-2]
- 3-6. Indicate whether the following statements describe a defined-benefit plan or a defined-contribution plan: [3-3]
- Benefits accrue based on all years of salary.
 - Benefit costs are less predictable.
 - Administrative costs are lower.
 - Plan assets are allocated to individual accounts for each participant.
 - Annual additions for any participant cannot exceed the limits of Code Sec. 415(c).
 - It can provide benefits based on past service.
- 3-7. Under what circumstances is it desirable to use a combination defined-benefit plan and defined-contribution plan? [3-3]
- 3-8. What are three basic differences between plans that fall into the pension family and plans that fall into the profit-sharing family? [3-4]
- 3-9. Faye is a sole proprietor with a qualified profit-sharing plan that enables her to contribute 25 percent of earned income. Faye's net earnings from schedule C are \$100,000. Faye's deduction for one-half of her self-employment tax is \$7,200. What is the maximum deduction that Faye is allowed to take under her profit-sharing plan for the year? [3-5]

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Bryn Mawr, PA 19010
(888) AMERCOL (263-7265)
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