Qualified Retirement Plans

Basics and Beyond

Today's Topics

- Basics of Qualified Retirement Plans
- Designing and Operating a Plan
- EGTRRA Update and Pension Changes
- Tax and Compensation Planning—When Does a Qualified Plan Make Sense

Qualified Retirement Plans

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Basics of Qualified Plans

- Types of Plans
- Qualification Issues
- Fiduciary Issues and Sponsor Responsibilities
- Goals of the Qualified Plan
Types of Plans

- Qualified Retirement Plans
- Nonqualified Retirement Plans
- “Qualified” refers primarily to whether the plan qualifies under the Internal Revenue for generally preferential tax treatment

Qualified Plan Characteristics

- Sponsor gets current deduction for funding plan—cash basis taxpayers even get “early” credit for such funding
- Beneficiary only pays tax when funds withdrawn from the plan
- Ability to skew benefits/contributions is limited somewhat by law (nondiscrimination)
- Limits on benefits or contributions

Nonqualified Plan Characteristics

- Generally tax “mirror” treatment for sponsor and beneficiary
- Effectively unlimited ability to skew benefits to selected individuals
- Only have IRC §162 limits on amount
  - Must be an ordinary and necessary expense
  - Must be reasonable compensation

Plan Types

- Officially classified by whether plan provides a specified benefit at retirement or provides for a specified contribution to participant account
- Defined Benefit Plans
- Defined Contribution Plans
- IRA Variants
**Defined Benefit Plans**
- "Traditional" Pension Plans
- Plan provides for a specified benefit at retirement
- Sponsor funds actuarially computed amount to provide for benefits
- Benefits and risks of investments lie with the sponsor

**Defined Benefit Plans**
- Traditional designs favor older employees
  - In small plans, quite often the oldest employees are the owners
  - Essentially, the benefit to be paid at retirement is the same, so the closer we are to retirement the more that needs to be funded
- Nontraditional designs change the above
  - Do not share bias for older workers
  - Investment performance (positive or negative) still to the sponsor

**Defined Benefit Plans**
- Limitations
  - Compensation up to $200,000 per year
  - Annual Benefit capped at lower of
    - 100% of average of high three years
    - $160,000
    - Above at age 62
  - Contributions limited based on funding actuarially determined necessary

**Defined Contribution Plans**
- Provide account balance for employees
- Contribution specified and allocated by the plan
- Traditional designs favor younger participants
  - Allocation does not consider age in simple version, only compensation
  - Younger worker has more years to have funds grow, and more contributions to account
Defined Contribution Plans

- Types of Defined Contribution Plans
  - Profit Sharing Plans
  - Money Purchase Pension Plans
  - Target Benefit Pension Plans
  - After EGTRRA—the Profit Sharing Plan Rules

Defined Contribution Plans

- Special Case of 401(k) Plan
  - Special feature added to another type of defined contribution plan
  - Generally part of a Profit Sharing Plan
  - Historical footnote—could also be part of a pre-ERISA money purchase pension plan

Defined Contribution Plans

- Limitations on Contributions and Allocations
  - One limit for deductible contribution by employer
  - Second limit on amount that can be allocated to any particular participant
  - Must understand this distinction

Defined Contribution Plans

- Employer can deduct up to 25% of covered compensation (note prior to 2002 type of plan impacted this)
- Up to $200,000 of compensation per employee can be considered
- New in 2002—employee deferrals do not count in this
- Has nothing to do with how funds are allocated to individual participants
Defined Contribution Plans

- Allocation does not have to be prorata
- Maximum allocated to any one participant limited to lesser of
  - 100% of compensation
  - $40,000 (potentially adjusted upward for those over 50)
- Count employee deferrals

Profit Sharing Plans

- Fully discretionary employer contribution
- Can vary from 0% to 25% of compensation
- Participant has individual accounts
- Participant gets investment gains or losses
- No income or payroll taxes on employer contribution

401(k) Plans

- Feature added to a profit sharing plan
- Allows for employees to defer amounts from their salary to plan
- No income tax on employee contribution
- However, do owe payroll taxes on amounts deferred
- Employer may or may not contribute (remember 0% is an option for a profit sharing plan)

Lesser Used Plans

- Pre-EGTRRA Profit Sharing Plans limited to 15%
- Money Purchase Pension Plan
  - Annual *required* contribution
  - Simple pre-EGTRRA design would be a 10% plan
  - Caveat: subject to minimum funding rules which tripped up some in unincorporated entities
- Target Benefit Pension Plans
IRA Variants

- Simplified Employee Pensions (SEP)
- SIMPLE-IRA
- Use individual IRA accounts in lieu of employer sponsored trust
- Generally have less flexibility in design and are limited to smaller employers

Simplified Employee Pension

- SEP Coverage Rules
  - Age 21
  - Services 3 of previous 5 years
  - Received minimum compensation ($450 for 2002)
  - Can be established after end of tax year
  - Limited allocation flexibility (permitted disparity only)
  - Can have SEP and other type of plan

Simplified Employee Pension

- Employer places contribution in individual retirement account for each employee
- Employer has no involvement after making contribution
- Every contribution 100% vested
- No annual reporting
- Unless deferral mechanism in place prior to 1997, employee cannot do elective deferrals (can make standard IRA contributions)

Simplified Employee Pensions

- Quite often not operated in accordance with law
- Problems often seen
  - What plan?
  - Pick and choose
  - Employees who leave during year
  - Part time employees
  - Different rule for owner and rank and file on when receive contribution
Savings Incentive Match Plan for Employees (SIMPLE)

- 1997 Act Creation
  - Replaced the SARSEP
  - Meant to be a simplified 401(k)
  - Actually can be set up as a 401(k) (though rarely seen)
- Uses a “special” IRA to hold contributions
- Unlike 401(k), there is no testing

SIMPLE-IRA

- Employer Qualification
  - 100 or less employees who received less than $5,000 in preceding year
  - No other qualified plan maintained
- Employees Covered
  - Earned $5,000 in any two preceding years
  - Expected to earn $5,000 in current year
  - Note that level is higher than in SEP

SIMPLE-IRA

- Required Employer Contribution
  - 2% contribution for all employees, whether or not they defer or
  - Matching contribution only for employees who actually defer
  - Must notify employees prior to beginning of year which option will be used

SIMPLE-IRA Matching Contribution

- General rule, 3%
- Can reduce to 1% two of every five years
- Must announce at same time as make announcement about using match that will use the reduced percentage
**SIMPLE-IRA Employee Contributions**

- Annual deferral limits
  - 2002 limit was $7,000
  - Increase by $1,000 per year through 2005
  - Over 50 have catch-up contributions
    - $1,000 in 2002 (Error in manual)
    - Increased by $500 per year through 2006, when it maxes out at $2,500 and then is subject to indexing
  - Matching Contribution based on percentage of compensation—effective maximum for 2003 is $266,667

**SIMPLE-IRA Compliance Problems**

- What plan???
- 3% of what???
- Paying over deferrals late
  - 30 days after end of month in which deferral made
  - Employer contributions can go as late as extended due date
- Different eligibility rules for owners
- Pick and choose employees who are let in
- Failure to provide notice before year

**Plan Qualification Issues**

- Standard for plan to remain qualified
- Issue for other than IRA plans is qualification under IRC §401(a)
  - 34 paragraphs in §401(a) alone
  - In addition, plan faces compliance with ERISA

**Written Document**

- Must be a written plan document
- Plan document defines the details of the plan
  - Must meet minimum requirements of IRC and ERISA
  - But has wide discretion
  - Much confusion among participants about this fact
- Must have plan document to administer plan—not just the adoption agreement
### Permanent Plan
- Intended to be a long term
- Not a "one shot" device
- However, employer can terminate plan
- Really a "smell" test

### Coverage Tests
- Concentrates on comparing
  - Highly compensated (as defined in IRC §414(g)) to
  - All other employees
- Two special cases
  - Plan covers only nonhighly compensated individuals
  - Employer only has highly compensated individuals

### Highly Compensated
- 5% owner at any time in current or preceding year or
- In preceding year
  - Had salary in excess of specified amount ($90,000 currently) and
  - If employer elects, was in the top paid group of employees for the preceding year

### 5% Owner
- Corporation, includes attribution under §318—generally related parties
- Unincorporated entities, own 5% of either
  - Capital interest
  - Profits interest
**Top Paid Group**
- Top paid group is top 20% of employees based on compensation
- Election is made on annual basis
- Does not require the consent of the IRS

**Coverage Tests**
- Two methods of meeting
  - Percentage tests (and have two of these to choose from)
  - Average Benefits Percentage Test

**Percentage Tests**
- First determine all of those eligible to participate based on
  - Age
  - Years of Service
  - Hours
- First option—cover 70% of all non-highly compensated employees

**Percentage Tests**
- Second option
  - Covers a percentage of non-highly compensated employees that is at least
  - 70% of the percentage of highly compensated covered
  - Look at an example
Example: Facts

- Bob and Charles each own ½ of the stock of Able, Inc.
- Able, Inc. has 10 other employees
  - All paid less than $90,000
  - All meet hours, age and years of service requirements
- Bob is not interested in retirement funds, so plan does not cover him

Example: Computations

- 50% of the highly compensated are covered (1 of 2)
- Must cover at least 35% of the non-highly compensated (70% of 50%)
- Must cover at least 4 of the other employees (3.5 is 35% of 10, so have to round up)

Coverage Test: Average Benefits Test

- Classification of employees benefitting cannot discriminate in favor of highly compensated employees and
- Average benefit percentage for the non-highly compensated is at 70% of the ABP for the highly compensated
- Both tests must be met

Classification Test

- Must be a reasonable classification (based on the facts and circumstances) and
- Not a discriminatory classification (and we have two tests there)
Discriminatory Classification
- Safe harbor—meet it and you have a nondiscriminatory classification
- Unsafe harbor—fall into this group and you have a discriminatory classification and we can end the analysis
- Gray area—back to facts and circumstances
- Covered in Reg. §1.410(b)-4(c)

Average Benefits Percentage
- After jumping through the first hoop, have to get through this one
- Detailed at §1.410(b)-5

Nondiscrimination Rules
- §401(a)(4)
- A little sentence that has spawned volumes
- Reg. §1.401(a)(4)-0 through §1.401(a)(4)-13
- Will cover more in detail later, but...

Cross-testing, etc.
- Advanced designs make use of cross-testing
- Reg. §1.401(a)(4)-8
- Test defined benefit plan for discrimination based on equivalent contributions
- Test defined benefit plans based on equivalent benefit
**Why Cross Test?**
- To get a defined benefit plan that doesn't skew to older, long term workers
- To skew a defined contribution plan to older owners

**Contributions vs. Allocation**
- IRC §404
  - Controls the amount the employer can deduct
  - Is the first hurdle we clear
- IRC §415
  - Controls the maximum amount of benefit or allocation per employee
  - Independent of the §404 limitation

**Defined Contribution Analysis §404**
- Maximum deduction is 25% of covered compensation
- Can consider up to $200,000 of compensation per employee
- Computed in the aggregate, not on an employee by employee basis
- Does not count employee deferrals under §401(k)

**Defined Contribution Analysis §415**
- Maximum allocation per participant is
  - $40,000 or
  - 100% of compensation
Example: Deduction

- Three employees of corporation
  - 100% Owner – paid $200,000
  - Spouse – paid $20,000
  - Child – paid $50,000
- Covered compensation is $270,000
- Deductible limit is $67,500

Example: Allocation

- Maximum we can allocate:
  - 100% Owner – $40,000 (only 20% of compensation)
  - Spouse – $20,000 (100% of compensation)
  - Child - $40,000 (80% of compensation—hit the $40,000 cap)
- Most overall we could allocate is $100,000

Example: Integrate Results

- We would generally contribute $67,500
- Could allocate in the following ranges:
  - 100% owner – $7,500 to $40,000
  - Spouse – $0 to $20,000
  - Child – $7,500 to $40,000

Even Better

- Put a 401(k) in and we can do this

<table>
<thead>
<tr>
<th>Employer</th>
<th>401(k) Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner</td>
<td>$28,000 $12,000 $40,000</td>
</tr>
<tr>
<td>Spouse</td>
<td>11,500 8,500 20,000</td>
</tr>
<tr>
<td>Son</td>
<td>28,000 12,000 40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$67,500 $32,500 $100,000</strong></td>
</tr>
</tbody>
</table>
Important Observations

- All employees are highly compensated
  - Eliminated a number of issues
  - If we had other employees, things get more complex—but not unable to solve
  - Same type of allocate at will would be possible if we had a plan that covered only non-highly compensated
- We could have moved the “shortfall” in the 401(k) deferral to any of the participants

Reporting Requirements

- Annual Report
  - Form 5500 (5500EZ for one participant/spouse plans)
  - Due date
    - Seven months after the end of the plan year
    - Can be extended by two and a half months
    - Can also “piggyback” on sponsor's income tax extension—however, can't apply for extra extension if that period is not long enough

Reporting Requirements

- Filed with the Pension Welfare Benefit Administration of the Department of Labor
- Also counts as filing with the IRS
- Some 5500 information not required for small plans
  - Used to use separate forms 5500C/5500R
  - Now everyone uses the same forms

Reporting Requirements

- Small plans do not have to include a financial statement
- However, must qualify in order to get out of the following
  - Engage an independent certified public accountant to examine (audit) the financial statement of the plan
  - Include the report of the independent CPA with the 5500
Reporting Requirements
- Forms 5500 are public documents
- See http://www.freeerisa.com
- Very significant penalties if file late

Sponsor Responsibilities
- Sponsors must cover their responsibilities
  - ERISA Compliance
  - IRS Compliance

Sponsor Responsibilities
- Reports
- Keeping plan document current
- Plan accounting
- Operational issues
- Distribution issues
  - Notice to participants
  - Annual reports
- And more...

Sponsor Responsibilities
- Ultimate responsibility falls on the sponsor
- If buy a “turnkey” plan be clear on responsibilities
  - Some plans are “inexpensive” because certain functions are left to the sponsor
  - Failure to do what is required can expose sponsor to
    - Plan disqualification
    - Significant penalties
    - Liability to employees and former employees
ERISA Fiduciary Responsibilities

- ERISA §3(21)(A) defines a fiduciary, in part, as one who
  - Exercises discretionary authority or control on plan management
  - Exercises authority or control on management or disposition of assets
  - Has any discretionary authority or responsibility in administration of the plan
  - A plan must have at least one named fiduciary

Corporate sponsor can be the fiduciary, but Ninth Circuit has held that an officer of that corporation can end up with personal responsibility

- Kayes v. Pacific Lumber
  - Officer of corporation acted in official capacity on behalf of the corporation
- Service providers are not fiduciaries by merely providing services, but their actions can make them one (so no perfect shield)

Duties of a Fiduciary

- Duties in ERISA §404(a)
  - Prudent man standard of care
    - Act solely in the interests of the participants and beneficiaries
    - For exclusive purpose of providing benefits and defraying reasonable expenses of administering plan
    - Care, skill, prudence and diligence of a prudent man

Duties of Fiduciary

- Prudent man (continued)
  - Diversifying investments so as to minimize the risk of large losses
  - Shall act in accordance with the documents governing the plan to the extent consistent with ERISA
- Bonding Requirement
  - All fiduciaries must be bonded
  - At least 10% of assets being handled up to maximum of $500,000 bond
Duties of Fiduciary

- Investment Duties
  - 29 CFR §2550.404a-1 reproduced in manual
  - Generally need to be sure prudent steps are followed
  - Would expect some issues here with the recent market declines

Selecting Service Providers

- Selection is an exercise of fiduciary duty
- Remember—must act for the benefit of plan participants in this area
- DOL has been interested in fees imposed
  - Direct fees (check to provider for service)
  - Indirect fees (fees recovered via expense charges on investments of plan)
- Must be prepared to defend reasonableness

Goals of the Qualified Plan

- Plan can accomplish a number of different goals
  - Providing retirement benefits and tax savings for the benefit of the owner
  - Providing an employee benefit in order to retain or attract employees at a reasonable cost
  - Compensating specific non-highly compensated employees (or a class of the same)
- However, different goals call for different plans—so we'll overgeneralize

Goals for the Large Organization

- Normally a benefit for the rank and file
  - Will generally use nonqualified plans for executives
- Costs of the plan as compared to the benefits received is a crucial consideration
- Emphasis on lowest cost option to accomplish the goal
Goals of the Closely Held Organization

- Normally more concerned with driving benefits for certain key employees
- Employee funding cost, to the extent the funding goes to the “preferred” participants, is something to maximize, not minimize
- Concerned with tax advantages and minimizing the costs involved with coverage of “non-preferred” participants

Overgeneralizing

- The last two slides grossly exaggerated the differences
- Rather than assume you know what the sponsor wants, it's best to ask
- Similarly, if you are working with the plan, it's important to understand what the goals of the plan are