Qualified Retirement Plans

Basics and Beyond

Qualified Retirement Plans

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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

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- Beneficiary only pays tax when funds withdrawn from the plan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 contributon
- 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 partipate 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 BenefitsTest

- 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

	Employer Contribution	**401(k)**	**Total**
Owner	$28,000	$12,000	$40,000
Spouse	11,500	8,500	20,000
Son	28,000	12,000	40,000
Total	**$67,500**	**$32,500**	**$100,000**

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 documemts
- 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

ERISA Fiduciary Responsibilities

- 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