

IV. Review of Qualified Plan Choices

A chart showing basic types of Qualified Plans allowed under IRC § 401(a) follows:

Tax Qualified Savings Plans By Category

Qualified Plans		Individual Retirement Accounts
<u>Defined Contribution</u> <ul style="list-style-type: none"> - Profit Sharing Plans - 401(k) Plans - Money Purchase Plans - Target Benefit Plans - Age Weighted (or Rate Group) Profit Sharing or Money Purchase Pension Plans - Employee Stock Ownership Plans (ESOPs) - Stock Bonus Plans 	<u>Defined Benefit</u> <ul style="list-style-type: none"> - Fixed benefit with numerous benefit formula options - Cash Balance 	<ul style="list-style-type: none"> - Simplified Employee Plans (SEP) - Individual Retirement Accounts - SIMPLE
vs.		

Brief overview of features of each type:

1. Profit Sharing Plan

Discretionary contribution. 0-25% of salary deductions limit (subject to \$200,000 annual salary cap). Requires periodic contributions for qualification unless contributions formally discontinued. PSP can allow “second-to-die” life insurance and allow premiums to exceed 50% of contributions (25% for universal or variable life) if contributions “season” over 2 years.

Comment: Limit of \$42,000 (\$44,000 for 2006) per participant (or if less 100% of compensation) applies to a Defined Contribution Plan for 2005.

2. Money Purchase Pension Plan

Fixed contribution percentage (percentage of salary). (Not recommended except in niche situations.) Plan amendment needed for a change (at least

15 days prior to year end of Plan Year – more if no year end employment requirement). Can (as can a PSP) be integrated with Social Security to give slightly more to higher compensated. 0-25% of salary range permitted for formula (individual participants can exceed 25% of salary but overall deductions is 25% of participant compensation).

3. 401(k) Plan

PSP variation allowing employee deferral. If elected by Employer, matching contributions by Employer. \$15,000 annual deferral limit (subject to COLA). Catch up contributions allowed for those 50 or older. 100% of compensation limit applies to limit deferrals. Average Deferral Percent/Average Contribution Percentage Tests under IRC § 401(a) limit how much Highly Compensated Employees (IRC § 414(q)) can contribute in relation to others. “Safe Harbors” can eliminate ADP/ACP testing if the Employer makes specified minimum contributions.

Comment: Allows individual employee flexibility. Need not to be employer funded except to extent needed for top heavy rules of IRC § 416 (if “key” employees contributed).

4. Target Benefit Plans

A Money Purchase/Defined Benefit hybrid. Not used much now due to availability of Age Weighted Options. 25% of salary deduction limit applies, but formula is based on anticipated level of benefits (as a percentage of compensation or compensation based formula) at retirement age. Age weighted plan.

Comment: Ideal if older owners, younger employees and owner is satisfied with mandated contributions and 25% of salary deduction limit.

5. Age Weighted Plans

A Profit Sharing plan or Money Purchase Plan can use age weighted formulas or rate group formulas under IRC § 401(a)(4) regulations. 25% deduction limit applies.

Age Weighted – Each participant’s contribution varies based on compensation and age.

Rate Group – Employees are grouped in nondiscriminatory (per Regs) classifications. Employees in same group get same contribution percentage.

Comment: Ideal for older owners and (on average) younger employees. Rate group can help eliminate age based disparities within groups.

6. Employee Stock Ownership Plans (ESOP)

A Profit Sharing type of Plan in which over 50% of Plan assets are intended to be invested in employer stock. Special ESOP exemptions from IRC § 4975 “Prohibited Transaction” rules allow employer or owner loans to an ESOP, or guarantees of such loans. ESOPs are also normally exempt from asset diversification rules (to the extent of employer stock).

Comment: Suitable for C corporations (and now S corporations in limited instances) desiring to give employees indirect ownership of stock, or help finance shareholder buyouts with pre-tax (at least for the time being) dollars, voting rights issues, depending on type of corporate governance issue.

Pros – Include pre-tax contributions of funds to acquire corporate stock, potential tax deferred stock exchanges under IRC § 1042 and potential employee motivation.

Cons – Include valuation costs, heightened fiduciary liability for loss in value, loss of flexibility in deal negotiations due to fiduciary obligations to ESOP, eventual repurchase liability to reacquire shares, potential the “owner(s)” are financing their own buyout.

7. Defined Benefit

Different type of Plan family from Defined Contribution. Specifies a monthly benefit at retirement age and an actuary, under IRC § 404 and § 412 determines the annual contribution minimum and maximum.

Pros – No 25% of salary deduction limit, if owners are old enough. Allows investment losses to be recovered through tax deductible contributions.

Cons – More costly to establish and administer. Minimum funding rules can mandate re-funding losses. Employee costs (e.g., top heavy minimums) can be more than other approaches. Pension Benefit Guaranty Corporation premium and coverage involvement in all but owner only (or small professional practice entities). Can become fully funded and then no contributions to the Defined Benefit may be possible. Investment growth above assumed rate reduces contributions. Not ideal for multiple owners “sharing” same plan.

Comment: Defined Benefit Plans normally work best as “tax shelter” devices in small businesses without multiple owners and with older owners (late 40’s or older) and younger employees.

8. SIMPLE

Form 5304/5305-SIMPLE incorporates the SIMPLE/IRA plan. The SIMPLE/IRA offers an option many employers of under 100 employees will desire.

SIMPLE/IRA allows deferrals up to \$10,000 per calendar year.

Pros - \$10,000 deferral limit applies without regard to percentage of salary limit (\$2,500 more if age 50+). Example - \$10,000 salary - \$10,000 deferral contribution okay. No business fiduciary exposure after contribution. No IRS 5500 forms. No ADP/ACP top heavy testing (SIMPLE contributions are required).

Cons – Requires either a 3% match (can go to 1% in 2 of 5 years) or 2% across board contribution. 25% penalty if withdrawn within 2 years of first contribution. Less creditor protection than qualified plan. No loans to participant. Calendar year requirement means deductions are not properly matched to fiscal year taxpayers. No other qualified plans can accrue or be funded in a year a SIMPLE plan is used.

9. SEPS (IRC § 408)

IRA arrangement similar to Profit Sharing Plan. 25% deduction limit (20% for sole proprietor, self-employed). Can be integrated with Social Security with proper Adoption Agreement. Can be set up on a fiscal year with proper Adoption Agreement.

Pros – Contribution flexibility. Employee withdrawal flexibility (subject to tax penalties). No IRS 5500 forms. No fiduciary exposure after contribution. Can allow channeling “bonuses” through SEP (based on percentage of pay) to allow owner(s) to “piggyback” on SEP/bonus. 3-year eligibility (comparable to 2-year eligibility in qualified plan as to how it works).

Cons – See attached chart for IRA features vs. qualified plans. Cannot use “year end employment” feature (even if IRC § 410(b) coverage test met) or 1,000 hours per year minimum for eligibility. No exclusion of categories of employees even if 410(b) can be met.

10. Comments on Eligibility

Qualified Plans eligibility rules are contained in IRC § 410, as modified by IRC § 401(a)(26) (see later discussion about partial repeal of 401(a)(26)).

Plan choices are:

- A. One-year eligibility and a vesting schedule (as long as 7 years if the Plan is not “top heavy” under IRC § 416). Top heavy status reduces vesting maximums to 6 years (20% per year beginning with the second year). A Plan is top heavy if over 60% of benefits (under all aggregated plans) accrued for “key employees.” Most smaller businesses face the top heavy issue. 401(k) Plans must use 1-year or less eligibility.
- B. Two-year eligibility and 100% vesting (not available for 401(k)).

Comment: One-year eligibility with 6-year graduated vesting is comparable mathematically in “cost” from an employee perspective to 2-year/100% vesting. This is not intuitive but here is a comparison:

	Benefit 1-year/6-year vesting	Benefit 2-year/100%
Year 1	0	0
Year 2	1000/200	0
Year 3	2000/800	1000
Year 4	3000/1800	2000
Year 5	4000/3200	3000
Year 6	5000/5000	4000

- C. A 1000 hour minimum per year can be imposed on plan eligibility (qualified plans – not SEPS or SIMPLE). “Part-time” is not a permissible exclusion category for employees who work over 1000 hours per year.
- D. Age 21 is the minimum age limit. There is no allowable maximum age restriction.
- E. Completion of eligibility requirements requires actual entry to Plan within 6 months. Plans can use quarterly or semi-annual entry dates for compliance or (to stretch eligibility to the maximum) have an added 180-day wait or if earlier, beginning of next Plan Year, until plan entry (but no earlier than beginning of the next plan year).
- F. IRC § 410(b) contains added complex rules on meeting coverage tests. Plans can provide specified exclusions for business reasons other than “part time,” age, race, religion, etc. so as to help reduce

employee cost and tailor the plan to the business. See 70% test of IRC § 410(b).

Example –

Business has 4 employees other than owner who meet 1-year eligibility test of a qualified profit sharing plan. One is the full-time sales manager. Owner desires to exclude him/her. The PSP can be amended to specifically exclude him/her (assume there is no age discrimination issue). Covering 3/4ths of “nonhighly compensated employees” is 75% (over 70)%. Assume the PSP required employment at year end for a contribution. Assume one of the other 3 terminates during the year with over 501 hours of employment. The Plan will flunk 410(b) if it covers only 2/4ths of NHCEs. The PSP must be amended to include one of the two excluded people. IRC § 410(b) coverage tests can occupy an entire seminar.

Differences and Similarities After The Initial Contribution

	Qualified Plans	Individual Retirement Accounts (non Roth IRAs)
1. Tax Deferred Growth?	Yes (with exceptions: UBTI, margin accounts).	Yes (with similar exceptions).
2. Rollover Option To Participant Upon Distribution	Yes – to other Qualified Plans or IRAs with nonperiodic payments.	Yes – to other IRAs and Qualified Plans that accept transfers of IRA funds that did not originate from a Qualified Plan.
3. 10-Year Income Averaging On Lump Sum Distribution?	Yes if age 50 before 1-1-86.	No.
4. Any Capital Gains Treatment On Lump Sum?	Yes, only for funds attributable to pre-1974 participation.	No.
5. Subject To Estate Tax At Death?	Yes (subject to marital and/or charitable deductions and any available exemption).	Yes (subject to marital and/or charitable deduction and any available exemption).
6. Stepped Up Income Tax Basis At Death?	No.	No. Nondeductible contributions basis retained.
7. Pre-Age 59½ Penalty Taxes Apply?	Yes (subject to exceptions described later). Termination of employment needed for “annuity exception.” Exception for terminating employment after age 54 applies.	Yes (subject to exceptions described later). No need to terminate employment for “annuity” option. No exception for terminating employment after age 54.
8. Potential Of Tax-Free Disability Benefits?	Yes, with special language, particularly Profit Sharing Plans.	No.
9. Post Age 70½ Minimum Apply?	Yes. If <u>not</u> 5% owner, deferral until retirement okay, depending on Plan language.	Yes. No exception for retiring after 70½.
10. Mandatory Federal Tax Withholding Rules Apply?	Yes – except for post 70½ minimums.	No.
11. Individual Trustee OK?	Yes.	No.
12. Life Insurance A Permissible Investment?	Yes, if Plan allows.	No.

	Qualified Plans	Individual Retirement Accounts (non Roth IRAs)
13. Investment In “Collectibles” Allowed Without Current Tax?	Yes, if not in an earmarked self-directed account.	No.
14. Loans To Participants Allowed?	Yes, within strict limits.	No.
15. Leveraged Real Estate Allowed As Tax Deferred Investment?	Yes, within limits.	No, with some exceptions.
16. Creditor Protection?	Significant potential protection in California, if incorporated, or nonowners are Plan participants.	Less potential protection under California law than Qualified Plans.
17. Prohibited Transaction Penalty?	15% tax penalty.	Entire account is taxed as ordinary income.

The outline does not contain a discussion of Roth IRAs, an option for certain eligible individuals. A Roth IRA is not a employer level benefit.