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# Business Management Advisory

*For Precision Custom Manufacturers*

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## SHOULD YOUR COMPANY SPONSOR A RETIREMENT PLAN?

### SUMMARY

**A retirement plan represents one of the more significant tax planning devices for owners of a closely-held business and may also provide a competitive yet cost effective employee benefit program. Despite legislation that has increased the administrative complexity of retirement plans, they remain an advantageous business planning tool for most employers to consider.**

Properly designed, the qualified retirement plan is one of the most efficient tax shelters available for the owners of closely-held businesses. For employees of larger firms, the advantages provided through 401 (k) salary reduction plans represent one of the best and perhaps first alternative for personal savings growth and building financial security.

There are certain advantages common to all qualified retirement plans. First, a one-to-one deduction against business earnings for all company contributions into the retirement plan. Second, tax deferred growth on funds in the retirement plan while they remain in the plan. Third, possible favorable tax treatment on distributions from the plan.

The term . . . qualified retirement plan ... means that the plan qualifies for a tax deduction by meeting the terms and requirements of applicable tax code.

To qualify for favorable tax treatment the retirement plan must meet specific requirements both in structure and in operation. The laws in large part seek to protect the interests of the employees participating in such plans and prevent discrimination in favor of highly compensated and key employees. Many of the other rules and regulations deal with restrictions on plan deductions by the employer and on the use of the funds while in the plan.

There are basically four categories of plan types:

1. Profit sharing or variable contribution
2. Money purchase pension plans
3. Target benefit pension plans
4. Defined benefit pension plans.

Notice that in three of the four plan types the term pension plan is used. A pension plan features a fixed formula and required annual contribution by the plan sponsor which may only be changed through plan amendment. On the other hand, the variable contribution plan, commonly known as the profit sharing plan, is the only plan which permits a variable contribution elected at the discretion of the board of directors, partners, or owners annually.

It is generally recognized that there are four types of businesses:

1. C-corporation
2. S-corporation
3. Sole proprietorship
4. Partnership

Thus, the expression, four X four, is a convenient shorthand for remembering that there are four plans: the profit sharing plan, the money purchase pension plan, the target benefit pension plan, and the defined benefit pension plan. All business types (corporations, partnerships, sole proprietors and S-corporations) may use any of the four plan types.

Let's review the characteristics common to all four plan types:

1. Plan Document - The plan must be in a written format and communicated to all participants.
2. Non-discrimination - The plan must not discriminate in favor of highly compensated or key employees.
3. Vesting Schedule - Refers to the period of time and the rate at which the participant achieves a non-forfeitable right to their retirement plan benefits.
4. Social Security Integration - The retirement plan may be designed to provide additional contributions or benefits for employees who do not have all of their income covered by employer payments to Social Security. Generally this will benefit higher income individuals.
5. Annual Reports are required to plan participants and to the government.

6. Fiduciary Responsibility The plan fiduciaries must act in accordance with the provisions of the plan and follow certain guidelines while investing the plan assets and operating the plan.

Most plans have a corresponding trust agreement. The trust is a separate legal entity which holds the assets of the retirement plan. The plan trustees are the legal agents appointed by the plan sponsor to transact business on behalf of the trust. The plan trustees maybe individuals from within the company, such as the owners or officers, or the sponsors may name an outside institution such as a bank or trust company as the plan trustee.

The profit sharing plan family has several variations or subsets. Among the subsets:

The Profit Sharing Plan is a defined contribution plan with a variable contribution limit between 0-15% of compensation.

The Employee Stock Ownership Plan or ESOP is a profit sharing plan where company stock is permitted as a substantial investment of the trust.

The 401 (k) Salary Reduction plan is also a form of the basic profit sharing plan. Under the 401 (k) format employees may defer income that would otherwise be paid to them as compensation or receive income which would otherwise be contributed to the plan on their behalf.

The Simplified Employee Pension plan or SEP is also a variable contribution plan. However, the SEP is funded only through IRA accounts and operates differently from other variable plans in the areas of distributions, eligibility, vesting, and investments.

As members of the same family of plans they share two common characteristics; the contributions made to the plan are variable not fixed, and the overall contribution limit to these plans is 15% of the payroll of all eligible participants.

The IRS limits the amounts of annual deductible contributions which may be made into any retirement plan or combination of retirement plans. For the profit sharing plan the maximum annual contribution is 15% of eligible payroll. For the money purchase plan and the target benefit plan, the annual maximum contribution and deduction is 25% of compensation. The maximum individual limit for each participant is 25% or $30,000 annually, even where they participate in two plans. The percentage and dollar limits also include any additional deferrals made by the participant under a 401 (k) arrangement and includes any other voluntary after-tax contributions by the participant.

The three plans just mentioned, the profit sharing, money purchase and target benefit plans are all defined contribution plans. Defined contribution plans are limited by the amount of annual contributions.

Since the profit sharing plan is limited to 15% of compensation, employers who are looking for the highest deduction may add a second plan to bring the total contributions up to the individual limits of 25% of compensation.

The defined benefit plan operates differently from defined contribution plans. Under a defined benefit plan the distribution or payout is defined by a benefit formula in the plan document. Usually this benefit is stated as a monthly amount to be paid at a specific retirement date. The monthly benefit is usually defined as a percentage of the participants average monthly compensation while employed by the firm. Currently, the maximum annual retirement benefit is limited by the tax code to $125,000 per year at an employee's Social Security normal retirement age or 100% of the participant's highest 3 year average compensation, whichever is lowest. For example, an individual earning $60,000 per year would receive a maximum annual payment of $60,000, i.e., 100% of compensation.

Distributions from any retirement plan may be taken in one lump sum, if the plan provides. It is not necessary to take periodic payments. Lump sum payments or periodic payments are available from each of the four plan types, in most cases, the participants will elect to receive a lump sum distribution and then roll those funds to IRAS.

Let's now look at some of the advantages and disadvantages of each plan type, beginning with the profit sharing plan.

The Profit Sharing plan is the most widely recognized, the most flexible, and for most, the easiest to understand. The term profit sharing derives from a requirement prior to 1986 that all contributions under these plans come from company profits. This is no longer a requirement and we are now beginning to see these plans referred to as variable contribution plans.

The amount contributed to the profit sharing plan is determined annually by the owner(s). The contributions are then allocated into individual accounts for each eligible participant. The contributions plus any earnings while inside the trust are paid to the participant at retirement, separation from service, death or disability. Should a participant leave before they are fully vested, the dollars which are forfeited will remain in the trust to benefit the remaining participants. The flexibility of contributions will make this plan a good choice for new businesses with unpredictable income and for those firms with younger owners. Employee turnover will increase the amount of forfeitures which in turn will benefit the longer term employees.

When a 410(k) salary reduction provision is added to the plan, the individual participants may agree with the employer through a salary reduction agreement to have a specified dollar amount or compensation percentage withheld and contributed by the employer into the profit sharing trust. All dollars contributed under this arrangement are 100% vested to the participant and are accounted for separately. The current maximum amount of deferral may be no greater than $9,500 annually. Many larger employers are establishing the 401 (k) salary reduction feature since it provides a low cost, convenient, and flexible way for employees to save on a before-tax basis.

The Simplified Employee Pension plan or SEP was developed by congress to allow employers to establish retirement plans for their employees and avoid the annual IRS reporting which is required on other retirement plans. Unfortunately, the cost of such simplicity may be higher than expected. The employer must follow different contribution and eligibility rules and the participants may have less favorable tax treatment on distribution.

For the employer, all contributions under the SEP are immediately 100 percent vested profit sharing plans, on the other hand, most plans normally permit graduated vesting programs. For SEP plans all employees who earned $200 in three of the last five years must be included regardless of the hours worked, whereas profit sharing plans may normally exclude part-time employees.

For the employees, SEP accounts, since they are In IRAS, will not qualify for a special five averaging method in calculating the tax on lump sum distributions which is available under other plans. Additionally, under profit sharing plans the employer could provide for a loan provision in the plan which would permit participants to borrow from their accounts in an emergency. This is not permitted under SEP plans.

The Money Purchase Plan operates in much the same way as the profit sharing plan, however, the contribution percentage is stated in the document and is an annual commitment unless amended by the employer. The big advantage of the money purchase plan is found in the ability to make contributions up to 25% of compensation. A popular combination of plans features a 10% money purchase plan together with a variable 15% profit sharing plan.

The Target Benefit Plan which has been available for many years and has gained in popularity in 1988 also features a maximum 25% contribution. Individual accounts are maintained for each participant as in the profit sharing and money purchase plans and the total amount of the contributions and accumulated earnings represents the amount of future distributions for the participant. Similar to the money purchase plan, the company will have a fixed commitment for annual contributions unless the plan is amended.

The allocation method for annual contributions is quite different from either the profit sharing or money purchase plan arrangement. The plan targets a specific retirement benefit to be paid a retirement. The target benefit amount is expressed as a percentage of compensation. As an example, “the target retirement benefit will be 50% of average compensation.” The effect of such an allocation method is to require higher contribution for older employees closer to retirement. Such a program will be important for older owners who have not previously set aside money for retirement. It is especially valuable where the owners are generally older than the rest of the employees. As with the money purchase plan, the target benefit plan may be used in combination with a profit sharing plan to accomplish specific goals.

The defined benefit plan offers opportunity to benefit older, higher paid, and longer term employees. Contributions are not restricted in the same manner as defined contribution plans.

For the owner who is over age 50 and looking for the highest deductible contribution the defined benefit plan should be closely examined.

On the other hand, since they require the annual services of an actuary, the plans are typically more expensive. (An actuary is a professional certified to calculate the required contributions for defined benefit plans. To qualify for deductions, every defined benefit plan must file an accurate certification.)

A footnote may be appropriate at this point. Sole proprietors and partnerships for many years followed a different set of rules than corporations. The plans which were maintained by sole proprietors or partnerships were generally referred to as KEOGH plans and were more restrictive than corporate plans. The Tax Equity and Fiscal Responsibility Act of 1982 ... also known as TEFRA, eliminated the KEOGH restrictions.

You may also encounter from time to time, the term thrift plan. Thrift plans are retirement plans which feature mandatory employee contributions. These contributions come from after-tax dollars and form part of the overall 25% limitation on contributions. Most thrift plans are being replaced with the before-tax options of the 401 (k) salary reduction plan.

In summary, younger owners should generally look to establish some form of variable contribution plan. Owners between 35 and 50 should examine both a target benefit and a money purchase plan. Owners over 50, and some owners who want to maximize contributions, should consider defined benefit plans together with the other plan options.

When we look at client concerns in the pension plan area, we find they generally fall in 6 or 7 different areas. Not necessarily ranked in order of importance, they are:

1. Contribution and deduction levels
2. Cost of employee benefits
3. IRS compliance and reporting requirements
4. Investment flexibility and investment rate of return
5. Quality of service and support
6. The cost of annual service and investments
7. Basic employee benefits needs.

In light of the significant changes brought by recent legislation, a comprehensive proposal prepared by a qualified pension consulting firm such as Benetech, Inc. is the best strategy to follow in making your decisions about the company retirement plan.

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