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## Overview of Pension and Retirement Plans:

Tax-deductible qualified plans fall into 2 specific categories:

1. Defined Contribution plans – commonly referred to as Retirement plans and
2. Defined Benefit plans – commonly referred to as Pension plans.

**Defined Contribution plans** - limited on an annual basis by a number of factors but are generally discretionary in their annual contributions and are always based on contributions as a percentage of annual compensation albeit not always uniform. The plan design can allow for disparity in contributions based on several design strategies further described in the Profit Sharing section of this presentation.

The most common and simple form of Retirement plan is the 401(k), a Profit Sharing plan with a provision (under code section IRC 401(k)) which allows employees to defer a portion of their compensation into a tax exempt, tax deferred trust (under code section IRC 401(a)). Contributions to certain "Highly Compensated Employees" (HCEs - generally 5% owners and those earning over $90,000) are limited by the deferral participation of all other eligible employees. This requirement can sometimes cause refunds of part of the 401(k) deferrals for HCEs.

**Defined Benefit Plans** - limited by a retirement "benefit" (income stream) of up to 100% of a 3-year high average of income limited to a maximum as defined by a table (under code section IRC 415)). Contributions are required each year to fund a ratable portion of the retirement lump sum calculated to provide the projected retirement "benefit". The contributions may change each year as the plans investment assets grow or shrink beyond the plan's actuarial prediction. These contribution variations based on investment performance become more extreme as the participant approaches the plans assumed retirement age.

All pension plans were impacted (generally favorably) by H.R. 1836, the "Economic Growth and Tax Relief Act of 2001" (EGTRRA).

Companies installing a new retirement plan (where no prior plan existed) receive a tax credit of up to $500.00 per year for each of the first 3 years of the plan.

## Key Advantages of Retirement and Pension Plans:

Qualified plan contributions are generally 100% tax-deductible (IRC 401(a))

Qualified plan trust assets are generally exempt from current taxes (IRC 401(a))

Qualified plan assets, when non-owner employees participate, are generally protected from creditors including creditors of the business and of the individual participant (ERISA)

Distributions from a qualified plan may be received when the participant is in a lesser or more advantageous tax situation

## 401(k) Plans Updates and Highlights:

Increased Limits on 401(k) Deferrals and additional 401(k) deferrals (for plan participant's age 50 or older):

| Increased deferrals | Catch-up deferrals | Total deferrals |
|---|---|---|
| 2011 = $16,500 | 2011 = $ 5,500 | 2011 = $22,000 |
| 2012 = $17,000 | 2012 = $ 5,500 | 2012 = $22,500 |
| 2013 = $17,500 | 2013 = $ 5,500 | 2013 = $23,000 |

Compensation considered for contribution and deferral calculations was increased from $250,000 to $255,000 for 2013. This allows Highly Compensated Employees (with income in excess of $255,000) to defer more into their 401(k) plans without increasing their deferral percentages.

"Pension Portability" now allows for all IRA (except ROTH IRA) to be rolled-over into 401(k) and other retirement plans. In addition, in certain circumstances, the requirement that rollovers must be completed within 60 days to avoid current taxation may be waived.

401(k) participants may now elect to defer up to 100% of their applicable W2 compensation net of their required FICA withholding. Certain HCEs (generally 5% owners, their family members and those earning in excess of $90,000) are subject to non-discrimination testing (ADP) that may limit their deferral participation to (generally) the average deferral percentage for the non-highly compensated employees plus 2%; not to exceed 200% of non-highly compensated average deferral percentage.

401(k) and other retirement plans now enjoy an increased deduction limit of 25% of eligible compensation (total compensation of all employees eligible to participate in the plan irrespective of their actual participation). This represents a significant increase; deductions were formally limited to 15% of eligible compensation Minus 401(k) deferrals.

Total contributions for all Defined Contribution retirement plans has increased to $51,000 including 401(k) deferrals but not including "catch-up" contributions (see above). This means that for 2013, a participant age 50 or older could receive a Profit Sharing contribution of $28,000, a 401(k) deferral of $17,500 and a catch-up contribution of $5,500 for a total deductible contribution of $51,000.

Loans are now allowed to the owners of all business entity types for all plans that allow for employee loans. Loans were previously restricted (not allowable) for owners of Sole Proprietorships, General Partners, Limited Liability Members and share-holders of Sub-S corporations (and owners of other business types except C-Corporations).

## Profit Sharing Plans Updates and Highlights:

Profit Sharing plans now enjoy an increased deduction limit of 25% of eligible compensation (total compensation of all employees eligible to participate in the plan irrespective of their actual participation). The need for Money Purchase plans in the traditional sense, "paired" with a Profit Sharing plan, is eliminated for 2002 and beyond. "Paired" Money Purchase plans have generally been "merged" with their complimentary Profit Sharing plans to provide increased discretion in annual contributions and to provide for greater design flexibility.

Profit Sharing plans have realized a number of design enhancement opportunities over the past 10 years. The most substantial and most often utilized of these design opportunities is "Cross-testing" often referred to as "New Comparability". This strategy along with "Age Weighted" and "Social Security Integrated" plans are described below.

**Traditional Profit Sharing plans** – utilize a specific and uniform percentage of compensation to determine the annual contribution for each eligible participant. These are similar in contribution amounts to SEP-IRAs.

**Social Security Integrated Profit Sharing plans** – provide a uniform percentage of compensation (generally 5.7%) up to the Social Security Wage Limitation ($87,900 for 2004) and an "excess" contribution (generally an additional 5.7%) for income beyond. This allow for greater contribution percentages for high wage earners (typically owners and key employees). This concept requires higher W2 compensation to be effective and may therefore not be appropriate for Sub-S corporations, Partnerships or other entities where minimized W2 (income subject to FICA) compensation is desired.

**Age Weighted Profit Sharing plans** – takes into account the specific individual age of each participant and assigns a point value based on age. The Profit Sharing contributions are then pro-rated based on individual income and assigned points. This plan generally favors the older, highly compensated (typically the owners and key employees). Diversity in age of owners may cause diversity in their allocated contributions. Older non-owner employees may incur substantial contribution costs.

**Cross-Tested (New Comparability) Profit Sharing plans** - the most popular of all Profit Sharing plan strategies, Cross-tested (an IRS term) plans are subject to a series of non-discrimination tests but will generally provide the greatest disparity of contribution percentages to the owners and key employees. These plans may designate classifications of employees and provide multiple levels of contribution percentages based on these classifications. When the non-discrimination tests are satisfied, the contribution percentage for the Highly Compensated Employees (generally 5% owners, their family members and those earning in excess of $90,000) may be the greater of: 1. 3 times the contribution percentage for the non-highly compensated eligible employees or 2. Unlimited (up to $41,000) for the highly compensated when the non-highly compensated employees receive a minimum of 5% of compensation.

## Money Purchase Plans Updates and Highlights:

Because Profit Sharing plans now enjoy an increased deduction limit of 25% of eligible compensation (total compensation of all employees eligible to participate in the plan), the need for Money Purchase plans in the traditional sense, “paired” with a Profit Sharing plan, is eliminated for 2002 and beyond. “Paired” Money Purchase plans have generally been “merged” with their complimentary Profit Sharing plans to provide increased discretion in annual contributions and to provide for greater design flexibility.

A Money Purchase plan is still applicable in the following limited applications:

1. **For Prevailing Wage** strategies where required (non-discretionary) contributions are desired or required for compliance.

2. **For certain Union plans** where required contributions are desired or required for contract compliance.

3. **When paired with a Defined Benefit plan** for certain situations where required contributions are desired.

4. **When ongoing contributions are NOT desired.** For certain situations where a qualified plan is desired (generally to allow loans, to provide enhanced investment flexibility and/or for asset protection) but ongoing contributions are NOT desired. These plans are designed using a 0% of compensation formula so no contribution is anticipated or allowed.

## Defined Benefit Plans Updates and Highlights:

Contributions to Defined Benefit plans have increased dramatically based on the following:

1. The table (IRC 415) that limits the amount of potential retirement benefits (income) that a Defined Benefit plan may fund for has substantially increased for all retirement ages.

2. The allowable retirement age for maximum benefit (generally age 65) has aligned with the Social Security retirement age of 62; allowing larger contributions because of the decreased time of funding and the increased time of distribution.

Compensation considered for contribution calculations was increased from $250,000 to $255,000 for 2013. This does not increase contributions for high wage earners (those with earned income in excess of $255,000) but rather decreases the amount of contribution required for their employees.

To assist in marketing efforts, below is a table of estimated maximum contributions to a Defined Benefit plan, a Defined Contribution plan and a 401(k) deferral during 2013 for the age and income given. The incomes shown are the minimum to maximize the Defined Benefit contributions.

| Age* | Compensation | Defined Benefit | Profit Sharing | 401(k)** |
|---|---|---|---|---|
| 30 | $102,500 | $ 37,800 | $ 25,600 | $ 13,000 |
| 35 | 102,500 | 52,300 | 25,600 | 13,000 |
| 40 | 102,500 | 74,900 | 25,600 | 13,000 |
| 45 | 102,500 | 113,000 | 25,600 | 13,000 |
| 50 | 133,900 | 156,400 | 33,500 | 16,000 |
| 55 | 132,000 | 195,800 | 33,000 | 16,000 |
| 60 | 99,000 | 201,200 | 24,700 | 16,000 |
| 65 | 144,500 | 255,400 | 36,100 | 16,000 |

This table is provided for comparative convenience. Actual contributions may vary dependent upon individual circumstances and prior Defined Benefit plan contributions. Please contact our office for specific contribution calculations.

* Age as of nearest birthday at plan year-end. Employee is assumed to have at least 5 years of service as of 1/1/2014.

** 401(k) deferrals no longer apply to the maximum deductible contribution limit; deferrals may be contributed in addition to other qualified plan contributions shown. Employees age 50 and over may make additional “catch-up” contributions of up to $5,500 for 2013.

## IRC 412(i) Defined Benefit Plans Updates and Highlights:

A "IRC 412(i) Defined Benefit plan" is a special type of defined benefit pension plan, with three significant characteristics:

Fully Guaranteed Retirement Benefit
Must be funded with Insurance Contracts
Typically generates largest possible tax deduction

Defined Benefit 412(i) Plans allow deductible contributions in excess of 25% of compensation.

412(i) Plans are ideally suited for the small business employer who was unable to save in the early years and now, with stable future business profits, desires to put away a very large, tax deductible contribution. Self employed individuals, with expectations of stable future income, may find the features of the 412(i) attractive. Business owners, starting a second career, should give consideration to the creation of a 412(i) Defined Benefit Plan. Additional protection for family and heirs may be provided with the addition of an insured death benefit to the plan. This also further reduces taxable income and increases tax deductions.

In order for a plan to qualify under Section 412(i), certain requirements must be met:

- The plan must be funded solely with individual or group life insurance and annuity contracts that are part of the same series and use same mortality tables and rate assumptions for all participants.
- Insurance contracts must fund benefits using level premiums for all benefits. Payments begin when a participant enters the plan and may extend no later than the retirement date specified under the plan.
- Plan benefits must be provided only by these contracts and be guaranteed by an insurance company. In effect, the plan is "fully insured."
- Participants may not take loans.

**Advantages:**

A "fully insured" plan can provide substantial retirement benefits under this simple and secure program. The accrued benefit for participants is simply the cash surrender value of all insurance contracts. It provides a maximum current tax-deductible contribution for the business. Some of its other advantages include:

- No full-funding limitation under ERISA Section 404(a)(1)(A) or current liability test to limit contributions.
- There can be no over-funding.
- There can be no under-funding. Contributions are based solely on the guaranteed provision of the level premium contracts.
- No actuarial certification required.
- Substantial administrative savings through the use of an IRS-approved plan document. Innovative Pension can advise on special programs available for very reasonable administrative fees.
- No quarterly contributions are required, unlike a traditional defined benefit plan; the "fully insured" model may be funded annually without having to pay interest.

- The IRS will not challenge the plan assumptions, thus permitting higher deductions. It is the contract guarantees that govern the required contributions.

**Disadvantages:**

The 412(i) plan may not be the ideal plan for all situations and businesses. Given the large, required contributions that must be made each year, it works only when the business is established and highly profitable. It works best when there are very few employees (less than five); and where the owner is fifty years old or within 10 years of retirement and is older than any of the firm's employees. In brief, its disadvantages include:

- No policy loans can be outstanding at yearend. This is not normally an issue, as many owners of a small business cannot normally participate in any retirement plan loan program.
- No flexibility in investments. The plan must be funded exclusively through insurance contracts in order for all benefits to be guaranteed.

**HOW 412(i) WORKS:**

When compared with other types of defined benefit plans, larger current contributions are created with a 412(i) plan. Life insurance and annuity guaranteed assumptions are conservative. A Traditional Defined Benefit Plan will have an interest rate assumption much higher than the guaranteed interest rate in a "fully insured" plan. The lower the plan assumptions, the higher the required contribution.

**INVESTMENTS & GAINS:**

It can be expected that some insurance contracts may earn interest above the guaranteed rate. Dividends may be paid on "participating" life insurance contracts. Both dividends and interest in excess of the guaranteed rate will decrease the employer's contribution in a following year. It should be noted that life insurance dividends for all defined benefit plans must be used to reduce the premium.

Such gains will tend to increase over time, essentially lowering the cost of the 412(i) plan. Hence, if all else remains unchanged, the "fully insured" plan's tax-deductible contributions will be greater in the early years. In contrast, due to limitations imposed by the Omnibus Budget Reconciliation Act of 1987 (OBRA), the funding costs for traditional defined benefit plans will often tend to increase over time.

Contributions for traditional defined benefit plans fluctuate due to actuarial and investment experience. To ensure minimum funding standards are met, an enrolled actuary is required to certify the plan each year. Investment rates are not known and can vary greatly over time. It is this type of variability that can cause a traditional defined benefit plan to become over-funded (a higher investment return than expected) or under-funded (not enough contributions, given the actual investment return and benefits paid.)

A 412(i) plan needs no actuarial certification, as only enough money to provide the guaranteed benefits can be paid to the plan. There are generally no over-funding or under-funding problems.

## Unique Strategies Regarding Pension and Retirement Plans:

**Strategy #1 – Safe Harbor 401(k) plans –** Plans that routinely fail to satisfy 401(k) non-discrimination testing resulting in refunds to the Highly Compensated Employees (5% owners, their relatives and those earning in excess of $90,000/year) may elect a Safe Harbor provision. This will exclude the non-discrimination testing requirement (ADP) but will require one of two employer contributions: 1. 401(k) matching contributions of 100% of the employee's deferral of the first 3% of their compensation and 50% of their deferral on an additional 2 % of their compensation 2. An employer contribution of 3% of compensation to all eligible participants irrespective of their deferral percentages.

**Strategy #2 – Optimized Profit Sharing plan design –** Those employers that currently have a Profit Sharing plan (including those with a 401(k)) can elect to amend their plan to (generally) allow for greater contributions for the owners or reduced contributions to their employees. These designs are outlined and illustrated elsewhere in this presentation. These modifications are generally not allowed mid-year; to accommodate this, a new Profit Sharing plan using the appropriate strategy is established during the initial year and merged with the existing plan at the beginning of the second year.

**Strategy #3 – For employers who provide services under government contracts** known as Prevailing Wage contracts, the FICA tax and Workers Compensation premium savings can be substantial. These plan can generally shelter a specific percentage of the employees income to "fringe benefits" including retirement plan contributions. Employers are generally excluded from participation in these plans however; a separate Profit Sharing plan may be established that allow substantial contributions for the owners with little or no additional contributions for the employees.

**Strategy #4 – When an employer has a SEP-IRA**, conventional IRA, rollover IRA, 403(b) or 457 IRA and wishes to: 1. Borrow from the plan assets or, 2. Invest in non-conventional investments, a qualified retirement plan may be established and the IRA assets rolled-over to accommodate these needs. If ongoing contributions are not desired, a 0% (of compensation) Money Purchase plan may be utilized.

**Strategy #5 – Defined Benefit plans -** may provide exceptional annual contributions and allow older employers to contribute substantially towards upcoming retirement. If contributions in excess of $40,000/year and flexibility of annual contributions are desired, a combination of Defined Benefit, Profit Sharing and 401(k) may provide large contributions with partial annual contribution amount discretion. This strategy is complex and will incur greater administrative fees.

**Strategy #6 - Defined Benefit plans -** may provide exceptional annual contributions but employee contributions may be significant. To control required contributions for employees, these plans may be paired with a Defined Contribution (generally Money Purchase). This strategy allows the contributions of both plans to be tested using a strategy similar to "Cross-testing" where contributions to younger, lesser-compensated employees may be dramatically reduced beyond those of a Defined Benefit plan only. This strategy is also effective when a few of the employees are older or highly compensated and a Defined Benefit only plan would result in substantial contributions.