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QUALIFIED PLANS: YEAR IN REVIEW
AND EMERGING ISSUES

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I. "INTRODUCTION"

This article addresses the advantages of a Qualified Retirement Plan for an owner of a small business. The goal is to structure a Qualified Retirement Plan which will maximize the contribution for the owner of a small business while keeping common law employee costs at a minimum. Numerous planning techniques are available which will attain such goals for some clients, especially older owner employers who have not yet accumulated large retirement plan assets. This article has been updated to take into account changes enacted under The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act").

II. "TAX ADVANTAGES OF QUALIFIED PLANS"

Employers receive substantial income tax advantages from qualified retirement plans. The tax deferral advantages of a qualified retirement plan may continue not only beyond the owner's retirement but beyond the owner's death, when those assets that survive the owner, are rolled into an IRA by a surviving spouse.

The income tax advantages available to the business owner under a qualified retirement plan are:

- (1) defer taxation on otherwise taxable compensation until its distribution;
- (2) deduct the deferred compensation currently; and
- (3) income tax exemption for plan earnings.

Although Qualified Retirement Plan assets will be included in the owner's estate upon death, the deferral of income tax for both the owner and the owner's heirs produce significant financial advantages.

III. "DISTRIBUTIONS FROM QUALIFIED PLANS"

A participant or a participant's spouse may, to a large extent, control the timing and amount of taxable distributions by rolling over the taxable part of a qualified plan distribution to an individual retirement account (IRA) or to another

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qualified plan. Qualified Retirement Plans must generally give owner-participants the ability to roll over the pretax distribution, other than required minimum distributions commencing at age 70½ or annuity payments, directly into another qualified retirement plan or IRA.

Under the Act, eligible rollover distributions from qualified plans, 403(b) annuities and Section 457 plans generally will be permitted to be rolled over to any of such plans or arrangements. Similarly, distributions from an IRA generally will be permitted to be rolled over into a qualified plan, 403(b) annuity or Section 457 plan. Employee after-tax contributions will be allowed to be rolled over into another qualified plan or a traditional IRA. Surviving spouses will be allowed to rollover plan distributions to a qualified plan, 403(b) annuity or 457 plan in which such spouse is a participant.

Participants, other than five percent owners, may defer taking required minimum distributions until retirement. There is also a special favorable set of income tax rules applicable to qualified plan distributions. Further, additional taxes apply to owners where (i) distributions are taken prior to age 59½, and (ii) certain minimum amounts are not distributed after age 70½. This article will not address these issues.

IV. "QUALIFIED RETIREMENT PLANNING"

Retirement planning should focus on the business owner's preferences and beneficiaries' expected needs. A qualified retirement plan should attempt to maximize tax deferrals for the business owner(s), as well as minimizing the costs of the retirement plan for rank and file employees. The above two goals will be customized to the levels desired by the owner(s).

1. **Defined Benefit Plan.** A defined benefit plan provides for a definitely determinable benefit at retirement. For example, a defined benefit plan may provide a benefit equal to 25% of an employee's compensation payable in monthly installments beginning at age 65. Compensation taken into account for any employee under a defined benefit plan or defined contribution plan (discussed below) can not exceed \$200,000. Actuarial calculations are made annually to

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determine the necessary contributions so that the plan has sufficient funds to satisfy the plan's obligations. Generally, for an older business owner, a defined benefit plan will generate large contributions and a large tax deduction. However, if the rank and file employees are also old, high contributions will be necessary to fund the staff's benefits.

Contributions under defined benefit plans are not limited to \$40,000 as they are in certain defined contribution plans (discussed below). The law **requires** that certain minimum funding contributions be made to defined benefit plans regardless of the profits of the business. Distributions under this plan require spousal consent. Also, IRS regulations require that the same benefit formula apply to all employees (as described above).

Finally, the annual benefit limit under a defined benefit plan is \$160,000 effective for plan years ending after December 31, 2001. This limit will be adjusted for inflation. This annual benefit limitation will be reduced if benefits commence prior to age 62 and increase if benefits commence after age 65.

This provision should precipitate the resurgence of defined benefit plans. Under the Act, a defined benefit plan may now be viable for individuals who are age 40 and even younger. Previously, defined benefit plans were only suitable for individuals who were approximately 50 years of age and older.

2. **Defined Contribution Plan. (a) Profit-Sharing Plan.** A profit-sharing plan generally provides for discretionary employer contributions not to exceed 25% of employee compensation. The amount payable at retirement depends upon the amount of the yearly contributions, and the investment experience of the fund. Such contributions are deductible by the employer. Contributions are generally allocated to employees in proportion to compensation. Compensation taken into account for any employee can not exceed \$200,000. Generally, the maximum contribution will not exceed \$40,000. Also, contributions do not have to be made each year like in a defined benefit plan or money purchase pension plan discussed below. Generally, distributions from a profit-sharing plan are not subject to spousal consent.

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Under the Act, because of the increase to 25% of compensation contribution with a \$40,000. maximum under a Profit-Sharing Plan, it may not be desirable to maintain both a Profit-Sharing Plan and a Money Purchase Pension Plan starting in 2002.

In addition, starting in 2002 the compensation limitation on annual additions under a defined contribution plan has increased to one hundred percent (100%) of a participant's compensation. This Act provision may allow "mom and pop" businesses to contribute 100% of the lower paid spouse's compensation (up to the then applicable 415 dollar limit) under certain circumstances. This provision will also allow lower paid participants to contribute more to 401(k) plans.

(b) **Integration.** Another version of a profit-sharing or money purchase plan is an integrated plan. In this plan, the contribution is coordinated with the Social Security Taxable Wage Base. This permits a slightly greater contribution as a percentage of salary for employees earning in excess of the Social Security Taxable Wage Base. An example of this formula would be a contribution by the employer for each employee of 10% of compensation, and an additional contribution equal to 5.7% of the amount by which the employee's compensation (up to \$200,000.) exceeds the Social Security Taxable Wage base for the year (\$87,000. for 2003). For example, an employee with compensation of \$200,000. would receive a 2003 contribution of \$26,441. (10% of \$200,000. plus 5.7% of \$113,000. (\$200,000. - \$87,000.)). An employee earning \$30,000. would receive a \$3,000. contribution.

(c) **401(k) Plan.** This is a plan under which employees are given the option to elect to reduce a portion of their salary and have the amounts contributed to the plan. In this plan the contribution is coming from the employee's salary. The employee is not taxed on the amounts contributed to the plan, and his W-2 income is reduced by the salary deferred into the plan. On the other hand, the employer receives a tax deduction for the salary reduction contribution. In 2003, the salary reduction contribution is limited to \$12,000. In order for this plan to work, the salary reduction amounts of the highly compensated employees ("HCEs") (e.g., the owners and high paid company

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employees) can be slightly greater as a percentage of pay than the non HCEs salary deferrals, but not in excess of amounts prescribed under the Internal Revenue Code.

The current dollar limit on annual elective deferrals under 401(k) plans will be increased under the Act as follows:

<u>Year</u>	<u>Maximum Elective Deferral</u>
2003	12,000
2004	13,000
2005	14,000
2006	15,000

Beginning in 2007, the \$15,000 limit will be adjusted for inflation in \$500 increments.

Also, effective in 2002, the applicable annual limit on elective deferrals to a 401(k) plan will be increased for individuals who attain age 50 by the end of the applicable plan year. The additional amount of elective contributions that could be made will be the lesser of: (i) the applicable dollar amount (set forth below), or (ii) the participant’s compensation reduced by any other elective deferrals made by the participant for the year.

The applicable dollar amount will be as follows:

<u>Year</u>	<u>Applicable Dollar Amount</u>
2003	2,000
2004	3,000
2005	4,000
2006	5,000

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The applicable dollar amount will be indexed for inflation in \$500 increments in 2007 and thereafter.

These additional elective deferrals are intended to allow older individuals to save for retirement at an accelerated rate. The contributions will not be subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, these contributions are not subject to applicable nondiscrimination rules.

Effective January 1, 1999, Internal Revenue Code Section 401(k) (12), which provides for safe harbor matching or employer contributions, is significant for small business 401(k) plans. If the employer makes a safe harbor contribution, the IRS nondiscrimination tests are satisfied permitting the owner to make the maximum 401(k) election. The safe harbor contribution is 100% vested.

Further under the Act, elective deferrals to a 401(k) plan will no longer be subject to the generally applicable deduction limits. Under the Act, all participants, including lower paid participants, will be able to contribute amounts up to the then applicable 401(k) plan limit if permitted under the plan, and plan administrators will no longer be required to monitor elective deferrals to make sure they do not run afoul of the deduction limit. This provision will also give 401(k) plan sponsors the ability to contribute and deduct more under the profit-sharing component of their 401(k) plans.

(d) **New Comparability Plan.** This is a defined contribution plan which can be structured to provide **significantly** greater contributions for business owners who are **older** than their employees. The disparity in contributions in favor of the HCEs compared with the non-HCEs can far exceed any disparity in contributions for the HCEs permitted under profit-sharing, money purchase, 401(k) or integrated plans. Under this variation, greater allocations are permitted for an owner who is older than his employees because the plan can be treated like a defined benefit plan. The contribution allocations for each participant are projected to a testing age (usually 65) and converted into an annual benefit. The annual benefit is divided by current compensation to obtain a benefit percentage. The benefit percentages for the HCEs are compared to the benefit percentages of non-HCEs in testing for nondiscrimination. As long as the plan satisfies the IRS

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rules for nondiscrimination based upon the benefit percentages, disproportionately greater contributions for the **older** business owner are acceptable. Older means the owner is generally older than the average age of the rank and file employees.

The IRS has issued new guidance in this area which would **not** restrict the rules, but requires the plan administrator to satisfy certain prerequisites to take advantage of the rules. For example, non-highly compensated employees must receive a minimum allocation equal to the lesser of five percent (5%) of compensation or one-third (1/3) of the highest allocation provided to any highly compensated employee. Employees who only receive a top heavy minimum benefit would have to receive an additional contribution to pass this new test.

(e) **New Comparability Combined with 401(k) Plan.**

It seems as though many employers are adopting a flexible plan design with new comparability and a non-elective 3 percent safe harbor employer contribution. Since many small business owners maintain top heavy plans, it is just easier to do the 3 percent contribution. Employers know that the safe harbor is a year-to-year option, so they can change the type of safe harbor used the next year. Appropriate notices must be given to employees in accordance with IRS Notices 98-52 and 2000-3.

The employer gives up forfeitures to have the ability to incorporate the \$12,000. cap in the profit-sharing side of the retirement plan. For companies with more than one shareholder, that flexibility is almost too good to pass up. Using new comparability to differentiate benefits to the shareholder while offering them the ability to defer up to \$12,000. is a terrific bonus. However, the safe harbor non-elective three percent (3%) contribution has to be supplemented in order to pass the new comparability test. The same problem does not occur if the safe harbor is satisfied by the safe harbor matching contribution.

(f) **Other Rules Which Affect Defined Contribution Plans**

With respect to defined contribution plans, the Small Business Job Protection Act of 1996 eliminated the minimum participation rule, i.e. that a plan must cover the lesser of 50 employees, or 40% of employees. Thus, assume a

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company has three owners, and three employees. Each owner could have a separate defined contribution plan as long as there is a similar fourth plan for the employees. The company would be the plan sponsor for each plan.

V. "CONCLUSION"

Retirement plan design depends upon the client's needs (tax and personal) and the facts and circumstances of the owner's business. This article only describes a few examples but provides the concepts that maybe utilized in your practice. The use of the foregoing plans and concepts will enable your clients to take advantage of the rules governing Qualified Retirement Plans to optimize and customize the appropriate plan for the small business owner. Significant changes have been enacted and you should contact an individual who is an expert in this area if you need assistance.