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A BUSINESS OWNER'S OVERVIEW OF QUALIFIED RETIREMENT PLANS

There are various types of tax qualified retirement plans available today. All of these plans share the common characteristic of permitting tax-deductible contributions and tax deferral on the earnings in the plan. Benefits or withdrawals are taxed to participants when received. The principal differences among the various types of retirement plans are:

1. How much can be contributed
2. Whether a contribution is required each year
3. Whether the allocation of contributions among the participants is at all related to their ages, and
4. Whether the company or the participants bear the risks of the plan's investment experience.

There are no longer major differences among plans depending upon whether the employer is an LLC corporation, partnership, or sole proprietorship. However, there are some special rules that apply to "top-heavy" plans, which most small business plans will be. A top-heavy plan is a plan in which 60% or more of the benefits are for the "key employees" (owners and highly-paid employees). Under a top-heavy plan, the maximum compensation that may be counted is \$150,000. Top-heavy plans also have to provide for rapid vesting of employees' benefits.

I. DEFINED CONTRIBUTION

A. Profit Sharing Plan

A profit sharing plan permits an employer to make discretionary contributions each year of up to 15 % of all eligible participants' compensation, with a maximum of \$35,000 for any participant. The employer decides on a year-by-year basis whether or not to make a contribution and how large the contribution will be. Despite the name, an employer does not have to have profits in order to make a contribution to a profit sharing plan. The contributions are generally divided in proportion to compensation, except that the employer's share of Social Security tax may be taken into account. This adjustment is known as Social Security. Once contributions are allocated to participants' accounts, they share pro-ratably in the plan's investment experience, whether good or bad. An employee's benefits are a function of his account balance when he leaves; the employer makes no commitment as to ultimate benefit amounts.

B. 401(k) Plan

A 401(k) plan is a profit sharing plan whereby employees may elect to take a salary reduction and have the employer put this amount into their 401(k) plan account. This, in effect, permits the employees to make tax deductible contributions to the plan. (Note that the employee salary reduction amounts are subject to FICA tax.) In addition to the overall profit sharing plan contribution limitation of 15% of all eligible employees' compensation, the amount of each employee's salary reduction is limited to \$10,000 (1998) per year. This \$10,000 figure is adjusted on a year-to-year basis by the IRS. Also, the maximum total employer and employee contributions for any one employee is limited to the lesser of 25% of pay or \$30,000. There are special nondiscrimination rules for 401(k) plans: the average ratio of total contributions (employer and employee) to

compensation for the highly-paid participants can't be greater than the average ratio of contributions to compensation for the other participants. For this reason, 401(k) plans frequently provide matching contributions by the employer against the employees' contributions to encourage participation by the rank and file. If only highly-paid management level employees chose to participate in the 401(k) plan, then the employer may have to make an additional contribution to "make up" for the lower paid employees.

C. Money Purchase Plan

A money purchase plan is almost identical to a profit sharing plan, with two major exceptions. The limitation on annual employer contributions is the lesser of 25 % of pay or \$35,000 per participant. The second is that a mandatory contribution is required each year. Thus, to get the additional 10% contribution over a profit sharing plan, an employer must be willing to commit to making a contribution each year, regardless of the profit picture. To mitigate the mandatory contribution requirement of a money purchase plan and still have the ability to make contributions of up to 25 % of pay in good years, many employers adopt both a profit sharing plan and a money purchase plan. The money purchase plan can have a required contribution of 10% of pay, and the profit sharing plan permits a discretionary contribution of between 0% and 15% of pay. A money purchase plan can be integrated with Social Security taxes in the same manner as a profit sharing plan. However, if the employer is using two combined plans, only one of the plans can be integrated. As with profit sharing and 401(k) plans, the participants' accounts are adjusted each year (or more often) for their share of the plan's investment experience, and their ultimate benefits are a function of their account balances.

D. Cross-Tested and Super-Integrated Plans

Both Cross-Tested and Super-Integrated Plans are types of Defined Contribution Plans which may allow for the primary wage earner to contribute a lower percentage for staff while maintaining the \$35,000 maximum limitation for himself or herself. A Cross-tested Plan is a hybrid between a Defined Contribution and Defined Benefit Plan. A \$35,000 maximum contribution is the same as a Defined Contribution Plan; however, the contribution for each participant is determined based upon a calculation which includes length of service, age and average compensation. Thus, there are some actuarial calculations like a Defined Benefit Plan. The net result in certain circumstances can be a lower ratio of funding for staff, especially where the primary wage earner is significantly older than all of the employees.

A Super-Integrated Plan categorizes employees into different groups based upon their job descriptions. Thus, secretarial, laborer, and managerial employees can be set into different categories and different percentages of plan contributions can be based upon those categorizations. This is allowed under the Federal law because it does not discriminate against a person based upon race, gender or sex. Instead, this is a nondiscriminatory ranking of people according to job description. This can often result in lowering the ratio of contributions to staff.

Both Cross-Tested and Super-Integrated Plans may not be a good choice for an employer who experiences a lot of employee turnover. These plans are better suited for a relatively stable work force where the ages and job descriptions of various employees do not often change.

II. DEFINED BENEFIT PLAN

A defined benefit plan operates in a very different manner from the other retirement plans. As its name implies, the plan is designed to provide a specific benefit at retirement rather than a specific contribution in each year. A defined benefit plan promises to pay a retiring employee an annuity benefit, i.e., monthly payments begin at retirement age and continue until the employee's death. The payments begin at retirement age and continue until the employee's death. The amount of the monthly payment is calculated under a formula based on an employee's length of service and his average compensation over some period (such as his final five years) and an assumed retirement age. The benefit formula can factor in expected Social Security benefits to focus the plan's benefits more on the highly paid participants.

With a defined benefit plan, there are limitations on the benefits which may be paid at retirement rather than on the maximum annual contribution limits. The maximum benefit beginning at age 65 is the lesser of \$135,000 per year (subject to annual COLA adjustments) or 100% of the participant's average compensation for his or her

three highest-earning years. If the benefit begins before age 65, the maximum benefit is reduced. The amount that the employer must contribute to the plan each year is determined by an actuary based upon the age and compensation of the participants and the amount of plan assets already accumulated. Unlike all of the other plans discussed above, the participants have separately stated accounts, and the plans' investment experience only affects how much the employer has to contribute to fund the promised benefits. It is sometimes possible for older employees to have contributions equal to or more than their pay, in a given year. For this reason, defined benefit plans are advantageous for older owners who are interested in making retirement plan contributions for themselves beyond the 25%-of-pay and \$35,000.00 limits which apply to all the other types of plans.

A caveat for defined benefit owners: Unlike the other types of plans, a defined benefit plan can grow too much and exceed the actuarial calculation. The IRS presumes a maximum growth of 6%. In reality, most participants experience growth far greater than that.

If you remain aware of the dollar amount which will cause you to be over funded, simply change to a defined contribution plan (where growth is unlimited) before you reach that amount. If you do not do this and become over funded, there are significant penalties in excess of 50%!