TRISTAR PENSION CONSULTING

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Choosing the Right Plan

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Regardless of the size of your business, or whether it is a sole proprietorship, partnership, LLC or a corporation, there are several types of retirement plans to choose from that can reduce your tax liability and increase the retirement savings of you and your employees.

Recent studies have confirmed that a retirement plan is becoming an increasingly important employee benefit. In fact, more and more job candidates will not consider a job offer that does not include retirement benefits.

The benefits a business can derive from sponsoring a retirement plan include:

- Boosting morale and productivity;
- Retaining good employees and thereby saving on hiring and training costs;
- Attracting experienced employees in today's competitive environment; and
- Helping employees save for their future since Social Security retirement benefits alone will be an inadequate source of income for most retirees.

When choosing the type of plan or plans to establish, it is first necessary to consider the following questions:

- Do you want to provide similar benefits to all employees or reward specific employees (i.e., the owners and key employees) more than others?
- Are the owners and key employees older or younger?
- Will you be able to make a contribution each year, or do you need the flexibility to skip contributions in bad years?
- Do you want a plan where no employer contributions are required?
- What types of plans are being offered by your competitors?

The answers to these questions will narrow down your choices. Sometimes a combination of plans will provide the best arrangement for a company. Multiple plans can be maintained as long as certain required limitations are not exceeded.

Following is a brief overview of some of the more popular types of retirement plans.

QUALIFIED RETIREMENT PLANS

In a qualified plan, the contributions are generally deductible when paid by the employer, but numerous guidelines must be followed to maintain the qualification of the plan. These guidelines relate to the coverage of employees, eligibility to participate, vesting requirements, distribution rules, contribution and benefit limitations, special top heavy rules, nondiscrimination rules, and other miscellaneous provisions.

Some of the primary benefits of maintaining a qualified retirement plan are:

- Employer contributions to the plan are tax deductible;
- Earnings on investments accumulate tax-free which allows contributions and earnings to compound at a faster rate; and
- Plan assets are protected from creditors.

DEFINED CONTRIBUTION PLANS

Defined contribution ("DC") plans maintain a separate account for each participant. The account grows through employer and/or employee contributions, earnings and, in some cases, forfeitures from the nonvested portion of the accounts of terminated participants that are reallocated to the remaining participants.

Total contributions (employer and employee) plus forfeitures credited to the participant's account during the year are limited for 2004 to the lesser of 100% of compensation or $41,000. In addition, employer contributions cannot exceed 25% of the total compensation (capped at $205,000) of all eligible employees.

Since the contributions, investment results and forfeiture allocations vary year by year, the ultimate retirement benefit in a DC plan cannot be predicted. The most common types of DC plans are described below.

PROFIT SHARING PLANS

The profit sharing plan is one of the most flexible qualified plans available. Company contributions to a profit sharing plan are usually made on a discretionary basis. Each year the employer decides the amount, if any, to be contributed to the plan.

The contribution is usually allocated to employees in proportion to compensation and may be integrated with Social Security which results in larger contributions for higher paid employees.

Profit sharing plans may also use an age-weighted allocation formula that takes into account each employee's age and compensation. This formula results in a significantly larger allocation of the contribution to the employees who are closer to retirement age. Age-weighted plans combine the flexibility of a profit sharing plan with the ability of a pension plan to skew benefits in favor of older employees.

An Employee Stock Ownership Plan ("ESOP") is a type of profit sharing plan that is required to invest primarily in the employer's stock. As owners, employees may be more motivated to improve corporate performance because they can benefit directly from company profitability. Other benefits of these plans are tax deductions without having to make cash contributions and establishing a market for closely held stock.

401(K) PLANS

A 401(k) plan is a type of profit sharing or stock bonus plan that allows employees to defer a portion of their salary into the plan on a pre-tax basis. For 2004, the deferral limitation is $13,000. The plan may also permit employees who are age 50 and older to make additional "catch-up" deferrals ($3,000 for 2004).

The advantage of a 401(k) plan is that the employees bear the cost of the deferral contributions to the plan. Although no employer contributions are required, most companies make matching contributions to the plan to encourage employee participation.

The disadvantages are the maximum annual deferral contribution is only $13,000 per participant (for 2004), and nondiscrimination testing (referred to as "ADP testing") limits the annual deferral amounts for owners and highly compensated employees based upon how much the non-highly compensated employees defer.

SAFE HARBOR 401(K) PLANS

A 401(k) plan that includes safe harbor provisions will not need to perform ADP testing if the employer makes certain safe harbor contributions. To avoid the ADP test, the employer must make a minimum contribution of either 3% of compensation or a basic matching contribution of 100% on the first 3% of salary deferred and 50% of the next 2% deferred (or an enhanced match at least equal to the basic match, i.e., 100% up to 4% deferred).

Avoiding the ADP test will allow owners and highly compensated employees to make the maximum annual deferral regardless of the deferrals made by the non-highly compensated employees.

If the plan provides exclusively for safe harbor contributions, it may be exempt from top heavy testing. If the plan is subject to top heavy rules, the safe harbor contributions count toward satisfying the 3% top heavy minimum contribution requirements.

Disadvantages of the safe harbor plan are that no allocation requirements may be imposed, such as 1000 hours of service or employment on the last day of the plan year, and employer contributions must be fully vested and may not be withdrawn due to hardship.

MONEY PURCHASE PENSION PLANS

A money purchase pension plan operates like a profit sharing plan. The major difference is that, unlike profit sharing plans where employers are permitted to make discretionary contributions each year, the employer has a set contribution rate which is stated in the plan document. These mandatory contributions must be made each year regardless of the employer's profits.

Prior to recent legislation, profit sharing plans were limited to 15% of compensation while money purchase plans were permitted to make contributions as high as 25%. The increased profit sharing deduction limit to 25% may render the money purchase pension plan obsolete.

NEW COMPARABILITY PLANS

These plans, sometimes referred to as "cross-tested plans," are DC plans that are tested for nondiscrimination as though they were providing monthly benefits from a defined benefit plan. By doing so, older employees may receive much higher allocations than would be permitted by DC plan nondiscrimination testing.

New comparability plans are generally utilized by small businesses that want to maximize contributions to owners and higher paid employees while minimizing those for all other employees. Employees are separated into two or more identifiable groups, such as owners and non-owners. Each group may receive a different contribution percentage. For example, a higher contribution may be given to the owner group than the non-owner group, as long as the plan satisfies the nondiscrimination requirements.

SIMPLIFIED PLANS

There are two plans available for smaller employers who want simplified rules and reporting. Contributions are made directly to the employee's IRA. In a Simplified Employee Pension ("SEP") plan, the employer makes discretionary contributions similar to a profit sharing plan. A Savings Incentive Match Plan for Employees ("SIMPLE") plan permits employees to make pre-tax elective deferrals, and the employer makes mandatory matching or non-elective contributions.

The disadvantages of these plans are that many part-time employees must be covered, contributions are 100% immediately vested and there is little flexibility in plan design.

DEFINED BENEFIT PLANS

Defined benefit ("DB") plans are pension plans that promise the employee a specific monthly benefit payable at the retirement age specified in the plan. Benefits are usually based on the employee's compensation and years of service which rewards long term employees. The maximum annual benefit for 2004 is $165,000.

Aging business owners who want to shelter more than the annual DC plan limit (lesser of 100% of compensation or $41,000 for 2004), may want to consider a DB plan since contributions can be substantially higher, resulting in fast accumulation of retirement funds.

The funding for a DB plan is determined actuarially in accordance with reasonable assumptions for mortality, interest rates, turnover, etc., and is usually funded entirely by the employer. The employer is responsible for contributing enough funds to the plan to pay the promised benefits even if it lost money during the year.

In addition, a DB plan may be more costly to administer than a DC plan because of actuarial fees and the expense of insurance premium payments if the plan is covered by the Pension Benefit Guaranty Corporation ("PBGC"). The PBGC is a government agency which guarantees certain pension benefits in DB plans.

NONQUALIFIED PLANS

Generally, a nonqualified deferred compensation plan provides additional benefits for key employees whose contributions to a qualified plan are restricted by the plan or legal limits. The advantages of a nonqualified plan are that there are no coverage restrictions and benefits can be provided as an added incentive to attract and retain specific key employees. In addition, there are no contribution or benefit limitations as there are with qualified plans.

The disadvantages are that the employer generally does not receive a tax deduction until the employee takes a distribution and, if the employer files for bankruptcy, the employees become general creditors and may lose their money.

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CONCLUSION

As you can see, there are a number of things to consider when deciding on the type of retirement plan to adopt. The selection of the right plan for your business can both satisfy your business goals and provide you and your employees with a secure retirement.

Changes can be made to a plan after it has been established, as long as benefits that have accrued are not reduced. Periodic evaluation of a company's plan will ensure that the company is getting the most out of its retirement plan.

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