Chapter 39

Qualified Retirement Plans*

I. INTRODUCTION

II. TAX-QUALIFIED RETIREMENT PLANS

III. BASIC RULES FOR QUALIFIED PLANS

A. PARTICIPATION AND NONDISCRIMINATION STANDARDS

B. MINIMUM VESTING STANDARDS

*Marcia Beth Stairman Wagner, B.A. summa cum laude, Cornell University (1984); J.D., Harvard University (1987); member of the Massachusetts Bar and District of Columbia Bar since 1987; member, The Wagner Law Group, A Professional Corporation, Boston, Massachusetts.

Reprinted from Steven C. Alberty, Advising Small Businesses ch. 39 (2009) with permission (Thomson Reuters/West). This publication can be purchased at http://west.thomson.com/productdetail/2927/13511907/productdetail.aspx.

I. INTRODUCTION

§ 39:1 In general

This chapter addresses qualified retirement plans. A qualified plan permits payment of remuneration to an employee, as well as the tax on such remuneration, to be deferred until after the employee's retirement. In fact, unlike non-qualified deferred compensation plans, qualified retirement plans allow an employer to deduct contributions to a qualified plan when they are made rather than when the employee is paid such benefits. The employer's contributions to such a plan are placed into a trust which is not subject to being reached by the employer's creditors. Additionally, because this trust is tax exempt, interest earned on trust contributions accumulates tax free. Further, the employer receives no tax liability for such earnings, and the employee is taxed only after the receipt of plan benefits. This chapter examines these tax benefits as well as varying retirement plan options in depth.

Two interlocking statutory frameworks govern the employee benefits area, including all of the plans discussed in this chapter: the Employee Retirement Income Security Act of 1974 ("ERISA")[1] and the Internal Revenue Code of 1986 (the "Code" or "I.R.C.").[2] Violations of these statutes (even if unintentional, innocent, or non-injurious) can result in severe sanctions and, in certain cases, personal liability for plan fiduciaries.

II. TAX-QUALIFIED RETIREMENT PLANS

§ 39:2 Definition

A tax-qualified plan is a "pension plan" or "employee pension plan" within the meaning of ERISA § 3(2)(A) which also meets the vast array of qualification requirements contained in Code § 401(a) *et seq*. There are two broad categories of qualified plans, "defined benefit plans" and "defined contribution plans."

An employer may adopt and maintain one or more qualified plans. Any type of legal entity (proprietor, partnership, corporation) can adopt a qualified plan covering its employees and, if applicable, the self-employed persons (proprietor or partnership) working in the business.

Plans referred to as "Keogh" or "H.R.10" plans are quali-

[Section 39:1]

[1] 29 U.S.C.A. §§ 1001 et seq.

[2] 26 U.S.C.A. §§ 1 et seq.

fied defined benefit or contribution plans adopted by a proprietorship or partnership, rather than a corporation. The special rules and limitations formerly applicable to these types of plans were largely abolished by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), which imposed, instead, the so-called "top-heavy" rules.

§ 39:3 Advantages of maintaining a tax-qualified plan

One of the key advantages of maintaining a tax-qualified plan is that employers receive an immediate tax deduction for contributions to the plan, subject to the following limits: (1) profit sharing plans—25 percent of all participants' compensation for the year;[1] (2) money purchase pension plans—25 percent of all participants' compensation;[2] (3) defined benefit plans—a "full funding limitation;" (4) combination (i.e., both pension and profit sharing plan sponsored by the same employer) limit is the greater of 25 percent of the compensation of participants under the plans, or the defined benefit contribution necessary to satisfy the minimum funding rules of section 412 of the Code.[3] However, if the defined contribution plan is a salary reduction only 401(k) plan, there is no applicable 25 percent of compensation limitation. Special rules exist for ESOPs, terminating pension plans, carryovers, and timing of contributions.

Additionally, employees are not currently taxed on employer contributions, and earnings on assets in trust accumulate tax free.[4] On receipt of distributions, employees can often defer recognition of income by "rolling over" the distributions to an individual retirement account ("IRA") or another qualified plan.

Assets in the qualified trust are protected from the employer and from creditors of both the employer and the employee.[5] Participants in certain plans (defined benefit pension plans) qualify for Pension Benefit Guaranty Corporation

---

[Section 39:3]

[1] I.R.C. § 404(a)(3)(A), as amended by the Economic Growth and Tax relief Reconciliation Act of 2001 ("EGTRRA").

[2] I.R.C. § 404(a)(1); Rev. Rul. 72-302, 1972-1 C.B. 110.

[3] I.R.C. § 404(a)(7). This limitation has been significantly liberalized effective in 2008 by the Pension Protection Act of 2006.

[4] I.R.C. §§ 402(a)(1), 501(a).

[5] I.R.C. §§ 401(a)(2), 401(a)(13).

("PBGC") guarantees of certain levels of benefits if the plan terminates without sufficient funds to pay all promised benefits.[6] Qualified plan benefits are becoming increasingly portable, particularly since the advent of the "direct rollover" rules.[7]

§ 39:4 Definition of defined benefit plan

A "defined benefit plan" provides the employee with a certain amount of pension beginning at retirement. The amount of the pension may be determined with reference to several factors; ordinarily a formula is based on the employee's compensation, years of employment, and, perhaps, Social Security benefits. Benefits are normally stated in terms of, and actually paid as, an annuity for life after retirement. The employer's regular annual contributions toward the cost of the plan are determined actuarially. The trust or other investment fund supporting a defined benefit plan is not segregated into "accounts" for individual employees, but instead is invested as a single fund and available for payment of all pensions and death benefits arising under the plan.

A floor offset plan is a defined benefit pension plan providing for a calculated pension amount, but then offsetting or reducing that pension by the pension payable under another qualified plan (typically, a profit sharing plan) covering the employee. The floor offset plan thus establishes a basic benefit or floor amount which is guaranteed if the other plan does not produce a greater pension.

§ 39:5 Types of defined benefit plans

(a) Fixed Benefit Plan

A fixed benefit plan is a scheme where the benefit payable at normal retirement is a stated dollar amount (e.g., $100 per month commencing upon retirement on or after age 65). This approach provides the employer inflation protection, but not the employee. Changes in compensation to reflect inflation, deflation, promotion, or demotion will not affect the

[6] ERISA § 4022.

[7] I.R.C. § 402(c), as amended by P.L. 102-318, applicable to distributions after December 31, 1992, and, more recently, the expanded rollover rules in the pension portability provisions of EGTRRA, effective for 2002 and later years.

amount of the pension. As a result, this approach favors lower paid employees by providing a higher benefit as a percentage of compensation.

(b) Flat Benefit Plan

A flat benefit plan provides a benefit to the employee that is a stated percentage of the employee's pay (e.g., 30 percent of pay commencing upon retirement on or after age 65). This approach automatically adjusts the pension for changes in compensation due to inflation, deflation, promotion, or demotion. The definition of "pay" is very important and must be nondiscriminatory both on its face and in operation.

(c) Unit Benefit Plan

A unit benefit plan is a system where the benefit payable to an employee upon normal retirement depends upon the period of service with the employer (or under the plan) prior to retirement, (e.g., 1 percent of pay for each year of service; or, $10 per month for each year of service). This approach rewards longer service employees but may not provide a large enough pension for a key employee recruited later in his or her career.

(d) Cash Balance Plan

A cash balance plan is a defined benefit plan which looks, from the employee's point of view, like a defined contribution plan. Each employee's benefit is converted into a lump sum equivalent to which "interest" is credited at a specified, guaranteed rate. The result is that each participant appears to have an individual account which is earning interest. However, the plan does not really maintain individual accounts; the "balance" an employee sees is simply the lump sum actuarial equivalent of his or her accrued benefit, which may or may not be fully funded by assets actually in trust.

§ 39:6 Methods for calculating pay

A compensation-based pension formula (such as either the flat benefit or unit benefit formulas described above) requires a definition of the compensation to be used to calculate the pension to be paid. Two methods are used to determine compensation for the purpose of establishing the pension benefit—final average pay and career average pay.

Under the final average pay method, the benefit paid to the employee at normal retirement is based upon the employee's average compensation over a defined period of time (e.g., final five years preceding retirement or highest five consecutive years of the ten consecutive years preceding retirement). This approach has a leveling effect on changes in compensation occurring during a short period preceding retirement. Increases in compensation later in an employee's career significantly increase the pension paid with respect to his or her entire career with the employer. Further, inflation tends to take the decision to increase pension costs out of the hands of the employer.

Under the career average pay method, the benefit paid at normal retirement is based upon the participant's average compensation during the entire period he is either employed by the plan sponsor or is a participant in the plan. This approach will produce a lower benefit in an inflationary economy than the final average pay approach. However, rather than experiencing increasing costs due to inflation, the decision to increase pensions to match inflation is retained by the employer. As a result, this method tends to penalize a "fast track" employee whose pay rises significantly during his or her career when comparing his or her pension as a percentage of final average pay to the pension of an employee whose earnings stay relatively the same throughout his or her career.

One important note of consequence regarding both methods is that a pension plan may consider no more than $225,000 (for 2007) of pay per year in fixing an employee's retirement benefit.[1]

§ 39:7 Integration with Social Security

Social Security generally produces a higher benefit as a percentage of pay for lower paid employees than it does for employees whose pay exceeds the Social Security taxable wage base. For that reason, employers often prefer to adjust the benefit provided under their qualified plans to provide a relatively higher benefit for higher paid employees. The Tax Reform Act of 1986 amended Code § 401(l) to strictly limit the differentiation permitted in integrated plans between higher and lower paid employees. There are three ways to integrate a defined benefit plan with Social Security.

[Section 39:6]

[1] I.R.C. § 401(a)(17). This limit is indexed for inflation and may be increased.

First, under an excess plan, no benefit is paid on compensation below a certain level (e.g., 30 percent of the final average compensation in excess of $6,600).

Under an offset plan, the benefit paid by the employer into the pension plan is reduced by a portion of the Social Security benefit payable (e.g., 50 percent of final average pay reduced by 50 percent of the Social Security benefit payable at age 65).

Under a step rate plan, the benefit paid on compensation below a certain level is less than the benefit paid on compensation above that level (e.g., 30 percent of the final average compensation equal to or less than $6,600 and 50 percent of the final average compensation in excess of $6,600). If the employee's final average compensation equals $20,000, the employee's benefit equals $8,680. (30 percent of $6,600 = $1,980; 50 percent of ($20,000 – $6,600) = $6,700; $1,980 + $6,700 = $8,680).

One form of step rate plan is a unit step rate plan. A unit step rate plan would contain a formula such as: 1.5 percent of pay below $6,600 per year and 2 percent of pay in excess of $6,600 for each year. The annual "units" would be aggregated to determine the benefit payable at retirement.

§ 39:8 Characteristics of defined benefit plans

Under a defined benefit plan, the employer will have a fixed commitment to contribute to the plan which must be expressed as definitely determinable benefits. As well, the investment risk is borne by employer. A defined benefit plan can better recognize past service benefits, than can a defined contribution plan. For that reason, defined benefit plans generally favor older employees because of their ability to provide benefits based on past service. Under defined benefit plans it is generally easier to provide cost of living allowances ("COLAs"), and defined benefit plans may pay disability and incidental death benefits as well as retirement benefits. However, a defined benefit plan generally may not pay layoff, sickness, accident, hospitalization, or medical benefits. But also note that payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and dependents is authorized under certain circumstances.[1]

Although employee contributions are permitted under defined benefit plans, defined benefit plans are less likely to provide for such contributions. As well, in-service distributions are generally not permitted under defined benefit plans. Finally, PBGC guarantees the employees' benefits under defined benefit plans, and employers must pay PBGC premiums.

§ 39:9 Definition of a defined contribution plan

Code § 414(i) specifically classifies a defined contribution plan as "a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gain and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." A defined contribution plan is as well referred to as an "individual account plan." These plans maintain separate bookkeeping accounts in the trust fund or other funding medium for each covered employee; the employee's share of the employer's contributions are allocated to his or her account; and investment gains and losses are allocated to the employee's account. The benefits available to the employee from the plan are limited to his or her vested interest in the value account. The account could be paid out in the form of a life annuity (for example, by using the account to purchase an insurance company annuity contract), but more commonly benefits from defined contribution plans are paid in a lump sum or in a fixed number of annual installments.

§ 39:10 Types of defined contribution plans

(a) Money Purchase Pension Plan

A money purchase pension plan provides for a fixed rate of annual employer contributions for allocation to the accounts of employees. Normally, the contribution rate is stated as a percentage of each employee's compensation. The employer's

[Section 39:8]

[1]I.R.C. § 401(h). See also I.R.C. § 420 which permits excess pension assets to be used to fund retiree medical benefits.

contribution is a legal obligation, as long as the plan remains in effect, and must be paid quarterly to the plan's trust fund regardless of whether the employer is currently profitable.[1]

A target benefit plan is a money purchase pension plan which determines the employer's annual contribution with reference to a projected or "target" pension benefit that the plan expects to provide to each covered employee. The target plan is like a defined benefit plan in that the employer's annual contribution for each employee is determined pursuant to actuarial computations working backward from the targeted benefit for that employee. The target plan is a defined contribution plan, however, in that individual accounts are maintained and the amount of pension actually payable will be determined solely on the basis of the value of the employee's account when benefits commence.

(b) Profit Sharing Plan

A profit sharing plan typically provides for employer contributions only to the extent of the employer's current or accumulated profits. The employer's contributions from year to year can be a fixed amount or rate or determined in accordance with a formula, or contributions may be subject to the discretion of the employer, or some combination of the foregoing. However, there is no legal requirement that contributions to a profit sharing plan be limited to current or accumulated profits.

Some profit sharing plans are established as "age weighted" or "new comparability" plans whereby different categories of employees receive different benefits, with the older, more highly compensated employees receiving greater annual allocations than younger, less well-paid employees. As a result of the time value of money, whereby a dollar contributed on behalf of a 25 year old with 40 years to retirement is worth significantly more than a dollar contributed on behalf of an older person who will retire in only a few years, thus enabling the older person to receive a greater dollar allocation while the plan provides actuarially equivalent benefits.

(c) Code Section 40l(k) Plan

A Code § 40l(k) plan is a profit sharing plan (or a stock

[Section 39:10]

[1] I.R.C. § 412.

bonus plan) which meets the additional requirements in Code § 40l(k) for a "cash or deferred arrangement" (thus sometimes being referred to as a "CODA"). Under a 40l(k) plan, within certain limits, covered employees may elect to have a portion of the compensation they would otherwise have received from the employer in cash contributed to the plan. Contributions made in this manner are excludable from the employee's current income for federal income tax purposes. Employer contributions, such a "matching contributions," may be added to the employee's account.

Effective in 2006, 401(k) plans may be so-called Roth 401(k) plans, where by employees make after-tax contributions to the plan and a distribution from the principal and earnings are tax-free.

The maximum amount a participant may elect to contribute to a 401(k) plan in 2006 is $15,500 (as indexed), and, if he or she is over 50, a "catch up" contribution of $5,000 (as indexed). This limit applies to contributions to both 401(k) plans and Roth 401(k) plans.

(d) Thrift Plan

The term "thrift plan" typically describes a profit sharing plan or money purchase pension plan under which, in order to participate, the employee must make contributions from his or her own funds which are then matched to some extent by employer contributions, all of which are allocated to the employee's account. Before enactment of Code § 40l(k), such employee contributions were made from an employee's after-tax income; most thrift plans are now structured to enable employee contributions to be excluded from the employee's current income under 40l(k) plans.

(e) Stock Bonus Plan

A stock bonus plan is similar in most respects to a profit sharing plan adopted by a corporation, with one important difference: benefits from the plan are paid in the form of stock of the employer corporation. Stock bonus plans normally invest substantially all of the plan's trust fund in stock of the employer corporation.

(f) Employee Stock Ownership Plan

An employee stock ownership plan ("ESOP") is primarily a stock bonus plan which meets certain additional tax law requirements. The ESOP can borrow funds to acquire stock of the employer corporation. Benefit distributions from an ESOP are normally made in the form of stock of the employer corporation, but cash may be distributed in lieu of stock if the employee consents.

§ 39:11 Characteristics of defined contribution plans

In general, defined contribution plans provide employers with several key benefits in comparison to defined benefit plans. First, there is greater flexibility in the employer's contribution commitment under defined contribution plans as opposed to the rigid requirements associated with defined benefit plans. Additionally, there are lower administrative costs, no actuary is required for minimum funding standards, the terms and structure of defined contribution plans are easier to communicate and understand, and the investment risk is on the employee. As well, defined contribution plans generally favor younger employees as there is little flexibility to provide for past service, and defined contribution plans often permit in-service (e.g., hardship) distributions. Furthermore, with defined contribution plans, there is the possibility of allowing the employee to direct the investment of assets in his or her account (e.g., ERISA § 404(c) plans). Finally, there are no PBGC premium payments required for most defined contribution plans (but, as a result, there is no PBGC coverage for benefits).

III. BASIC RULES FOR QUALIFIED PLANS

A. PARTICIPATION AND NONDISCRIMINATION STANDARDS

§ 39:12 In general

While it may appear, from the foregoing sections, that an employer has a great deal of flexibility with respect to structuring its retirement system, in fact, ERISA and the Code impose a variety of very strict rules with which qualified plans must comply. The philosophy behind all of these regulations is that, in order to be deserving of special tax treatment, an employer's retirement system must help advance certain government social policies.

The best example of this can be seen in the nondiscrimination rules and regulations which are, in general, designed to insure that: (a) an employer provides retirement benefits for its less compensated employees that are comparable (although not necessarily equal) to the retirement benefits provided to highly compensated employees, (b) lower and higher compensated employees have comparable opportunities to participate in the retirement system, and (c) a participant can be fully vested in his or her benefit after a certain number of years of service (so that an employer cannot deprive an employee of retirement benefits as the employee approaches his or her retirement date). Below is a discussion of some of the more important rules with which an employer should be familiar when deciding how to design its retirement system.

§ 39:13 Participation

Pursuant to the Code, a plan may not exclude an employee from participation on account of age beyond the date the employee attains age 21 and may not impose a maximum age for participation.[1] As well, a plan generally may not exclude an employee from participation on account of a minimum service requirement greater than one year of service, although a two-year service requirement may be imposed if the plan provides for all benefits to be 100 percent vested and non-forfeitable at all times.[2] Under the Code, a year of service is a 12-consecutive month period during which the employee completes at least 1,000 hours of service.[3] Such period initially is required to be based on the 12-month period beginning with the employee's employment commencement date. As well, a plan must permit an employee who has satisfied its age and service requirements to commence participation in the plan within 6 months.[4]

Beginning in 1989, a plan must satisfy one of three tests (excluding from consideration employees who have not met the statutory minimum age and service requirements referred to above) to determine if the minimum coverage requirements found in the Code are met.[5] Under the percentage test, a plan must benefit at least 70 percent of all non-highly compensated employees. Under the ratio test, the

---

[Section 39:13]

[1] I.R.C. § 410(a)(1), (a)(2).

[2] I.R.C. § 410(a)(1).

[3] I.R.C. § 410(a)(3).

[4] I.R.C. § 410(a)(4).

[5] See I.R.C. § 410(b).

percentage of non-highly compensated employees benefited under a plan must be at least 70 percent of the percentage of highly compensated employees benefited under the plan. Finally, under the average benefit percentage test, a plan must (a) benefit a classification of employees that does not discriminate in favor of highly compensated employees, and (b) the average benefit percentage (i.e., employer-provided contributions or benefits expressed as a percentage of compensation) for non-highly compensated employees must be at least 70 percent of the average benefit percentage of highly compensated employees. The above-stated tests are applied on a controlled group basis or, at the election of the employer, on a separate line of business basis.[6] As well, a defined benefit pension plan must meet a minimum participation standard by benefiting, at the least, the lesser of 50 employees or 40 percent of the employer's employees.

§ 39:14 Nondiscrimination

A plan is qualified only if: (a) the contributions to or benefits provided under the plan do not, in either form or effect, discriminate in favor of highly compensated employees; (b) the benefits, rights and features provided under the plan are available to participants on a nondiscriminatory basis; and (c) the effect of the plan in certain special circumstances (amendment, termination and grant of past service credit) is nondiscriminatory.[1]

B. MINIMUM VESTING STANDARDS

§ 39:15 Employee contributions

Pursuant to the Code, an employee's rights in his or her accrued benefit derived from employee contributions must be 100 percent vested and non-forfeitable at all times.[1]

§ 39:16 Employer contributions

According to the Code, a plan must satisfy one of two vest-

---

[6] I.R.C. § 414(r).

[Section 39:14]

[1] I.R.C. § 410(a)(4).

[Section 39:15]

[1] I.R.C. § 411(a)(1).

ing requirements for employer contributions.[1] Employees with three or more years of service must be 100 percent vested (3-year "cliff" vesting), or employees must vested at least as quickly as required by the following table:

Years of Service	***Non-forfeitable Percentage***
Less than 2	0 percent
At least 2	20 percent
At least 3	40 percent
At least 4	60 percent
At least 5	80 percent
6 or more	100 percent

The Pension Protection Act of 2006 provides that effective for plan years beginning after 2006, these vesting requirements apply to all employer contributions made to defined contribution plans as opposed to only matching contributions made to defined contribution plans.

For years prior to 2007, plans could provide 5-year cliff vesting and 7-year graded vesting (20 percent vesting per year commencing in year 3). However, employer matching contributions and contributions to top-heavy plans (i.e., when more than 60 percent of the benefits provided under the plan are on behalf of "key employees") were required to meet the current statutory vesting requirements.[2]

§ 39:17 Vesting upon attainment of normal retirement age

A plan must provide that an employee's right to his or her normal retirement benefit is non-forfeitable upon attainment of normal retirement age. Normal retirement age is the age set forth in the plan, but not may not be later of age 65, or if the employee commenced plan participation within five years

[Section 39:16]

[1] I.R.C. § 411(a)(2).

[2] See I.R.C. § 416.

of the plan's normal retirement age, the fifth anniversary of commencement of participation.[1]

§ 39:18 Years of service for vesting purposes

A year of service is a 12 consecutive month period during which the employee completes at least 1,000 hours of service. Such period can be designated by the plan. Moreover, all service is required to be counted except: (a) years of service prior to age 18; (b) years of service during which the employee declined to make required employee contributions; (c) years of service during which neither the plan nor a predecessor plan was maintained; and (d) service disregarded under the "break in service" rules.[1]

C. ACCRUED BENEFIT REQUIREMENTS

§ 39:19 Defined benefit plans

A defined benefit plan does not provide separate accounts for each participant in which the participant's rights can vest. However, a defined benefit plan must satisfy one of the three rules set forth in Code § 411(b) relating to the portion of participants' retirement benefits that have accrued at a given time: (a) the 3-percent method; (b) the 133-1/3 percent rule; or (c) the fractional rule.

D. MINIMUM FUNDING STANDARD

§ 39:20 Purpose of minimum funding rules

The minimum funding rules are intended to ensure that inadequate financing does not result in benefit plans being unable to satisfy their obligations to pay benefits to participants when such obligations become due. Thus, ERISA and the Code require plans (other than those specifically exempted) to be funded in a manner which Congress has determined would help ensure solvency. The funding rules require that employers make contributions with respect to benefits accrued both for current and past service and require that contributions be made to fund accrued benefits even if they are not vested. The requirements are backed by

---

[Section 39:17]

[1] I.R.C. § 411(a)(8).

[Section 39:18]

[1] I.R.C. § 411(a)(5).

a 10 percent excise tax in the event the funding rules are not satisfied. A 100 percent excise tax is imposed if the deficiency is not corrected. The excise tax liability is applied on a controlled group basis.

§ 39:21 Plans exempt from minimum funding rules

The minimum funding rules apply to all plans qualified under Code § 401(a) and to all qualified annuity plans described in Code § 403(a) except that the rules do not apply to profit sharing or stock bonus plans.[1]

E. LIMITATION ON CONTRIBUTIONS AND BENEFITS

§ 39:22 Defined contribution plans

The Code imposes limits on the "annual additions" which may be made to a plan on behalf of an employee. Annual additions are limited to the lesser of 100 percent of compensation or $45,000 (in 2007, as indexed). Annual additions consist of employer contributions, employee contributions, and forfeitures allocated to an employee's account.[1]

§ 39:23 Defined benefit plans

The Code imposes limits on the annual benefits which may be paid from a defined benefit plan. Benefits payable annually in the form of a straight-life annuity derived from employer contributions may not exceed the lesser of $180,000, as adjusted for increases in the cost of living, or 100 percent of an employee's average compensation for his or her high three consecutive years.[1]

The limits are actuarially adjusted if benefits are paid in a form other than as a straight-life annuity, or if employee contributions or rollovers have been made to the plan. The dollar limits are actuarially adjusted if benefits commence prior to Social Security retirement age (i.e., age 65 if born

---

[Section 39:21]

[1] I.R.C. § 412(h).

[Section 39:22]

[1] I.R.C. § 415(c).

[Section 39:23]

[1] I.R.C. § 415(b).

prior to 1938; age 66 if born between 1938 and 1954; and age 67 if born after 1954). The dollar limit applicable to benefits which commence after Social Security retirement age is actuarially increased, and the dollar limit is reduced proportionately for participants with less than 10 years of participation.

IV. WHICH TAX-QUALIFIED PLAN IS RIGHT FOR YOUR CLIENT?

§ 39:24 In general

Once the employer understands the various types of qualified requirement benefit plans available, a determination must be made as to which plan best meets its needs. In making such a decision, it is important to gather information about both (a) the nature of the employer and its business goals, and (b) the needs of the employees who are targeted to benefit from the plan.

§ 39:25 Nature of the employer and its business goals

Below are numerous questions relating to the employer's business goals that must be answered before organizing a qualified requirement benefit plan for the employer:

- How is the business organized?
- What is the business's relationship with other entities?
- Is it part of a controlled group?[1]
- Is it an affiliated service organization?[2]
- Does it lease employees?[3]
- How long has it been in existence? Does it have predecessors or successors?
- What fringe benefits does the business presently offer? Are any changes currently being contemplated?
- With whom must the business compete with respect to its benefits package?
- Is the business unionized or concerned about an organizational campaign?
- What are the ages, years of service and earnings of individuals to be covered?

[Section 39:25]

[1] I.R.C. §§ 414(b), (c), (o).

[2] I.R.C. § 414(m).

[3] I.R.C. § 414(n).

- Does the business experience significant employee turnover?
- How much is the employer willing and able to spend for retirement benefits?
- What is the employer's financial history and projections?
  - (a) Is it cash rich or poor; profit rich or poor?
  - (b) Does it have accumulated earnings problems?
  - (c) Is its business cyclical and, if so, to what degree?
- What discretion does the business have with respect to funding a plan? Would it be able to make a commitment to fund quarterly?
- Does the business want employees to partially or fully share in the cost of funding a plan?

§ 39:26 Needs of employees

Owners employed in the business will typically have three main needs that should be addressed by a qualified requirement benefit plan: enhancing current income, deferring income for retirement, and estate planning.

Key employees (generally, long-term, highly compensated employees in management positions who are critical to the functioning of the business[1]) will have the same basic needs as owners. Rewarding these employees for past service and retention of valuable employees should also be considered.

Rank and file employees (including salaried employees, union and non-union employees, salespeople, employees of a particular division or plant) will have the following needs that that should be addressed when creating a qualified requirement benefit plan: (a) reward for past service; (b) retention (i.e., benefits are comparable to those offered by competitors); (c) retirement planning, considering the total benefits package, including: federal programs (Social Security, Medicare), state programs (workers' compensation, mandated health benefits), and previous employers' programs).

§ 39:27 Examples of qualified plans specifically designed to meet a business's needs

(a) To maximally benefit owners, upper management and/or key employees:

[Section 39:26]

[1]See also definition in I.R.C. § 416.

- If the owners, upper management, and key employees are generally older than the rank and file employees, an age-weighted or new comparability discretionary profit sharing plan (by which contributions are made to fund benefits payable at retirement) could be designed which would allow smaller contributions to be made on behalf of younger employees and larger contribution to be made on behalf of older employees (the theory being that, since younger employees have more time to accrue benefits, comparable retirement benefits would result).
- If there is generally a large turnover among the rank and file employees, a defined benefit pension plan could be designed using a benefit formula which takes into account years of service.
- A defined benefit pension plan could be designed using a benefit formula which takes into account final average pay.
- A defined benefit pension plan or defined contribution plan could be designed which is integrated with Social Security, such that employees above the Social Security wage base ($97,500 for 2007) would receive a greater benefit than employees below the wage base.[1]

(b) To provide retirement benefits at minimal cost to the employer:

- A 401(k) plan can be funded in whole or in part with employees' own monies.
- The employer may choose to provide matching contributions (or discretionary profit sharing contributions) if it so desires.

(c) To encourage long-term employment with the company:

- A defined benefit plan by its nature rewards older employees and employees with the most years of service (both highly and non-highly compensated employees). Cost of living adjustments are generally built into such plans.

[Section 39:27]

[1]See, however, the limitations on permitted disparity contained in I.R.C. § 401(l).

(d) To give the employer flexibility from year to year as to whether or not it will make contributions to a retirement plan:

- Profit sharing plans can be tied to company profits such that an employer has great flexibility with respect to its plan contributions.

(e) To provide employees with a fixed contribution (where there is a desire, above all, for certainty):

- The annual contribution made under a money purchase pension plan is generally a fixed percentage of the employee's compensation.

§ 39:28 Prototype plans

A plan to serve the needs of a particular business as described above, is usually an individually-designed prepared by a lawyer and can be expensive to implement (of course, in the long run, it may save the employer money since it will be designed to specifically meet the employer's needs). A less expensive approach may be the "prototype plan"—a form plan available through many large financial institutions (e.g., life insurance companies and investment companies) which is, in most cases, qualified (and has received an opinion or notification letter to that effect from the IRS) and which usually makes use of the financial institution's own investment vehicles. A company which is considering adopting a prototype plan should always have the prototype documents first reviewed by its lawyer.

V. OTHER APPROACHES TO PROVIDING RETIREMENT BENEFITS

§ 39:29 In general

If the employer does not wish to maintain a "full blown" qualified plan, it may encourage its employees to contribute to their own individual retirement accounts ("IRAs") or purchase individual retirement annuities. Alternatively, the employer might establish a retirement plan arrangement that is simple to implement and administer because it utilizes employees' IRAs.

§ 39:30 Individual retirement accounts ("IRAs")

(a) Deductible IRAs

Certain individuals may deduct up to $4,000 ($5,000 in

2008) of contributions to an IRA in a tax year. However, if the individual or his or her spouse is an active participant in a tax-qualified plan, the $4,000 ($5,000 in 2008) is phased out for adjusted gross income ("AGI") above certain levels.

An IRA must meet the requirements of Code § 408(a). Additionally, it must be a trust or a custodial account, the trustee or custodian of which is a bank or similar "qualified person" and may not be invested in life insurance contracts. Contributions to an IRA may only be made only in cash. The individual's account balance must be fully vested and nonforfeitable at all times. The IRA must be maintained pursuant to a written document.[1] In this regard, the IRS has published Forms 5305 and 5305-A which may be used to establish an IRA.

A married individual who wishes to make contributions to an IRA for the benefit of his or her non-working spouse may establish a separate IRA for that purpose (usually referred to as a "spousal IRA"). The spousal IRA need contain no special terms or particular designations (although it must meet the requirements set forth above for all IRAs).

(b) Non-deductible IRAs

Small Business Job Protection Act of 1997 ("SBJPA") added a new nondeductible tax-free IRA, commonly referred to as the "Roth IRA". Qualified distributions (including earnings) from these IRAs are tax-free. A qualified distribution generally is a distribution made at least five years after the contribution was made, and that is made due to one of the following: (a) the individual's attainment of age 59-1/2; (b) the death of the individual; (c) the disability of the individual; or (d) incurrence of first-time homebuyer expenses by the individual.

There is an annual limit on contributions made to a Roth IRA of $4,000 ($5,000 in 2008), which phases out for individual and joint tax filers with higher AGIs.[2] The contribution limit is also reduced by the amount of any deductible IRA contributions and contributions made to an individual retirement annuity made during the year. Contributions are permitted to be made to a Roth IRA for all individuals,

[Section 39:30]

[1] Treas. Reg. § 1.408-2(b).

[2] I.R.C. § 408A.

including those who are age 70-1/2 or older. Also, the minimum required distribution rules of Code § 401(a)(9) do not apply to Roth IRAs.

(c) Exemption from Early Withdrawal Tax

The SBJPA provides that withdrawals from any type of IRA before age 59-1/2 that are used for first-time homebuyer expenses or for qualified higher education expenses are exempt from the 10 percent early withdrawal tax.

§ 39:31 Individual retirement annuity

An individual retirement annuity is a type of IRA pursuant to a contract issued by an insurance company for which the individual pays all premiums. The individual retirement annuity may not be transferable to another owner and has an annual premium that is not fixed and is not over $4,000 ($5,000 for 2008). Any refund of premium must be applied, within a prescribed period of time, to purchase additional benefits or pay future premiums. The entire interest of the owner is non-forfeitable.[1]

§ 39:32 Simplified employee pension plans ("SEPs")

(a) Requirements

Through a SEP, an employer may offer a very simple retirement program by funding IRAs for its employees. Code § 408(k) requires that a SEP must meet the following requirements each year:

- The SEP must be in the form of an IRA or an individual retirement annuity (and must meet all of the requirements applicable to an IRA or an individual retirement annuity);
- An employer must make contributions to the SEP for each employee (with certain exceptions) who during the calendar year has attained age 21 and who has "performed service" for the employer in at least 3 of the 5 years immediately preceding the year in question;
- Except as noted below, the rate of contribution must not discriminate in favor of highly compensated or key employees;

[Section 39:31]

[1] I.R.C. § 408(b); see also Treas. Reg. § 1.408-3(a).

- Employee withdrawal of employer contributions must be permitted without penalty; and
- Contributions must be made pursuant to a “definite written allocation formula” which specifies the requirements an employee must satisfy to share in the allocation and how the amount allocated is computed.

If the foregoing requirements are met, an IRA contribution or an individual retirement annuity premium may be paid by the employer to the employee’s SEP in an amount upon to $45,000, as indexed.[1] Because a SEP is also an IRA, the employee may also be eligible to make contributions to the SEP.[2]

(b) Nondiscrimination

As noted above, contributions to a SEP may not discriminate in favor of highly-compensated employees as defined in Code § 414(q). Under the nondiscrimination rules, contributions must represent the same percentage of the compensation (not in excess of the first $200,000) for all SEP participants.[3] However, Code § 408(k)(3)(D) permits contributions under a SEP to be integrated with Social Security in accordance with the rules that apply to qualified defined contribution plans, under which limits are placed on the permitted disparity and contribution percentages applicable to compensation above and below the Social Security wage base. Note that nondiscrimination rule does not prohibit non-uniform contributions to integrated arrangements or to salary reduction SEPs.

SEPs are also subject to the minimum contribution rules that apply to “top-heavy” plans.[4] Thus, even if a SEP satisfies the nondiscrimination rules, if the sum of the account balances in the SEP established for key employees exceeds 60 percent of the sum for all employees of the employer, the employer must contribute to the SEP, as percentage of compensation, a minimum of 3 percent for non-key employ-

---

[Section 39:32]

[1] I.R.C. § 408(j).

[2] I.R.C. § 408(j). The employee’s contributions are subject to the limits discussed in § 30:39, above.

[3] I.R.C. § 408(k)(3)(D).

[4] I.R.C. § 408(k)(1)(B).

ees or, if lesser, the highest percentage the employer contributed for the key employee.[5]

(c) How to Establish a SEP

The employer must execute a written instrument within the time prescribed for making deductible employer contributions.[6] Note that this rule is more generous than the rule for qualified plans, which must be executed (but not necessarily funded) by the end of the taxable year for which the employer desires a deduction. Generally, an employer may establish a qualified SEP by filing IRS Form 5305-SEP.[7] An employer may also establish a SEP by adopting a prototype SEP which has been approved by the IRS National Office or the employer may prepare an individually-designed SEP arrangement.

(d) Deductibility of Employer Contributions to a SEP

An employer cannot deduct SEP contributions in excess of 25 percent of the aggregate compensation paid to employees who are SEP participants during the calendar year.[8]

(e) Salary Reduction SEP (a "SARSEP")

SARSEPs are designed for employers who have 25 or fewer employees eligible to participate, at least 50 percent of whom actually do participate.[9] Under a SARSEP, elective pre-tax contributions are permitted pursuant to rules similar to those that apply to 401(k) plans. However, SARSEPs have been supplanted by SIMPLE Retirement Accounts for plans created after 1996.[10]

§ 39:33 Simple plans

The Small Business Job Protection Act of 1997 ("SBJPA") created a new type of savings plan for small employers called the "simple retirement account," which takes the place of

[5] I.R.C. § 416.

[6] Prop. Reg. § 1.408-7(b).

[7] Rev. Proc. 1987-50, 1987-2 C.B. 647.

[8] I.R.C. § 404(h)(1)(C).

[9] I.R.C. § 408(k)(5).

[10] See § 39:33.

SARSEPs.[1] Employers with 100 or fewer employees who sponsor no other qualified retirement plan may establish these accounts for their employees beginning in 1997.

Generally, employees earning $5,000 or more per year are considered to be eligible to participate, and eligible employees may make salary reduction contributions up to $10,500 (as indexed) plus a catch up contribution of $2,500 (as indexed) if the participant is over age 50. The employer must either: (a) contribute 2 percent of compensation for all eligible employees; or (b) match 100 percent of employees' contributions, up to 3 percent of compensation (with a limited ability to reduce the level of matching contributions). The accounts can be funded through IRAs or a 401(k) plan and are subject to ADP or top-heavy testing. If IRAs are used, simplified reporting and disclosure rules apply.

§ 39:34 Non-qualified plans

Although this chapter does not discuss non-qualified retirement plans in-depth, employers should be aware that this is also an option that is available to them. Non-qualified plans are almost always individually-designed and may be desirable in cases where, for example, an employer wishes to provide retirement benefits only to certain highly compensated employees.

The most common function for non-qualified retirement plans is to supplement benefits payable under the qualified plans of an employer. For example, most sizable employers maintain one or more supplemental executive retirement plans ("SERPs"), for executive employees. These include:

- "Excess benefits plans"—ERISA § 3(36) defines an excess benefit plan as one maintained "solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by § 415 of the Internal Revenue Code of 1986 . . ." ERISA § 4(b)(5) completely exempts such plans from ERISA coverage if they are unfunded.
- "Top hat plans"—these are plans which are unfunded and are maintained by an employer "primarily for the purpose of providing deferred compensation for a select

[Section 39:33]

[1] See I.R.C. § 408(p).

group of management or highly compensated employees."[1]

Because excess benefit plans and top hat plans are unfunded, they do not need tax qualified status under Code § 401(a), and therefore do not need to be nondiscriminatory. By design, they do discriminate in favor of highly compensated employees.

Funding such plans through a "rabbi trust" (a trust whose assets are subject to the claims of creditors on the company's bankruptcy) will not result in their being treated as "funded" for ERISA or tax purposes.[2]

[Section 39:34]

[1]See, e.g., ERISA §§ 201(2), 301(a)(3), and 401(a)(1), which exempt such plans from the participation, funding and vesting requirements of ERISA. Such plans are still subject to abbreviated reporting and disclosure requirements, and also to the fiduciary provisions of ERISA.

[2]For further discussion of nonqualified deferred compensation plans, see §§ 38:10 to 38:21.