Qualified Retirement Plans

Qualified retirement plans often prove to be an excellent tax shelter. The sponsoring company is allowed a current deduction for its contributions to the plan; the employee pays no current tax on money contributed on their behalf; earnings from investments made with funds in the plan may accumulate tax deferred; and distributions from the plan may be afforded favorable income tax treatment. Plans may also be used to; attract employees, reduce employee turnover, increase employee incentive, and accumulate funds for retirement.

These plans are especially attractive to working owners of closely held corporations and to self-employed individuals. The key to effective plan selection is to devise a contribution formula that produces an optimal combination of employee benefits and employer deductions without violating qualification requirements. The selection of the type of plan and the contribution formula will depend largely on the type of group to be covered and the benefits desired for certain members within the group.

Even though a qualified plan is not allowed to discriminate in favor of highly compensated employees, under certain circumstances it may provide greater benefits for some groups of employees than for others. The nondiscrimination rules only require that the benefits that are provided to non-highly compensated employees be at least comparable to those provided to the highly compensated employees.

Plans generally fit into one of two categories: ***defined contribution*** and ***defined benefit***.

Defined Benefit

A defined benefit plan is the traditional company pension plan. The ultimate retirement ***benefit*** is definite and determinable. To determine these amounts, defined benefit plans usually base the benefit calculation on a combination of years of employment, wages, and/or age. These plans are funded entirely by the employer, and the responsibility for the payment of the benefit and all risk on monies invested to fund that benefit rests with the employer. An actuary determines the amount required to be contributed by the plan sponsor each year to fund the anticipated retirement benefit.

Defined Contribution

A defined contribution plan is one in which the ***contribution*** is defined, but the ultimate benefit is not. Each participant has an individual account. The benefit at retirement depends on the amounts contributed and on the investment performance. The investment risk is shifted to the employee. Defined contribution plans include profit sharing, 401(k), 403(b), money purchase, age weighted and new comparability plans. Total contributions are capped at the lesser of $50,000 (*adjusted annually for inflation*) or 100% of an individual's annual salary.

Before the employer can evaluate the relative merits of the various types of plans and choose the most appropriate plan, the employer must know what each type of plan offers.

Cash Balance – While technically a defined benefit plan, a cash balance plan is actually a hybrid plan. In such plans, the employer credits the participant's account with a "Contribution Credit" (such as 5% of compensation) and an "Interest Credit" (either a fixed rate or a variable rate that is linked to an index). Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. The investment risk is borne solely by the employer. As with traditional defined benefit plans, minimum funding standards apply and required contributions are determined by the plan's actuary.

Floor-Offset – A floor-offset plan is a hybrid arrangement in which the employer maintains both a defined benefit plan and a defined contribution plan. The benefits provided under the defined benefit plan are reduced by the value of the participant's account in the defined contribution plan. The defined benefit plan provides a guaranteed "floor" benefit. If the value of the participant's account in the defined contribution plan declines, the participant will be protected from the risk of investment loss. Alternatively, if the value of the participant's account exceeds the amount of the benefit under the defined benefit plan, the employer will benefit from lower required contributions to the defined benefit plan.

Profit-Sharing – The most popular type of qualified defined contribution plan. Contributions are made at the discretion of the employer. They may be used to encourage productivity and reward employees with part of a employer's annual profits. Employers can make contributions even when there are no profits for the year and no contribution is required during a profitable year. These plans are often coupled with a 401(k) arrangement to allow voluntary pre-tax contributions by employees from their wages.

401(k) – 401(k) plans permit employees to defer receipt of compensation by contributing to an account in the plan. Deferred amounts are generally made on a pre-tax basis and may permit after-tax (Roth) contributions. Contributions and all earnings remain untaxed until withdrawn from the plan. Employee contributions are capped at the lesser of $17,000 or 100% of an individual's annual salary. The dollar limit is increased to $22,500 for employees at least age 50 is adjusted annually for inflation.

403(b) – 403(b) plans are also known as a tax-sheltered annuity (TSA) or a tax-deferred annuity (TDA) program. This plan may only be sponsored by educational, religious, and charitable (i.e. 501(c)(3)) organizations. It operates under similar maximum contribution rules and withdrawal privileges as a 401(k) plan.

Age-Weighted – An age-weighted plan uses both age and compensation as a basis for allocating employer contributions among plan participants. Contributions can be at the discretion of the employer. Because age is a factor, this type of plan favors older employees who have fewer years than younger employees to accumulate sufficient funds for retirement.

New-Comparability –A new-comparability plan is generally a profit sharing plan that defines a separate contribution formula for varying categories of participants. The contributions are discretionary and tested under "cross-testing" rules to satisfy ERISA's nondiscrimination requirements.

Money Purchase – Also a qualified defined contribution plan, a money purchase plan is one in which the employer is required to make an annual contribution to each employee's account regardless of the firm's profitability for the year. Contributions usually defined as a percentage of compensation or may be tied to years of service.