PENSION PLAN FUNDAMENTALS

WHAT IS A TRADITIONAL DEFINED BENEFIT PENSION PLAN?
Many owners, partners, and professionals are looking for larger tax deductions and accelerated retirement savings. Traditional defined benefit pension plans may be the perfect solution for them.

A traditional DB pension plan promises to pay each employee a specified lifetime retirement income which is generally based on the employee's years of participation and compensation received from the employer. The plan actuary determines annual contribution requirements, prepares annual benefit statements, and converts retirement benefits to equivalent lump sum amounts for distributions and rollovers.

WHAT IS A CASH BALANCE PENSION PLAN?
Cash balance pension plans may also be the perfect solution for owners, partners, and professionals who are looking for larger tax deductions and accelerated retirement savings.

A CB pension plan (also referred to as a "hybrid" defined benefit pension plan) specifies both an annual contribution to be credited to each employee and an annual rate of assumed investment earnings to be credited to the contributions. Each employee has an account that resembles a 401(k) or profit sharing plan account. The plan actuary determines actual annual contribution requirements, prepares annual account statements, and the account balances are the amounts for distributions and rollovers.

WHAT ARE THE DIFFERENCES BETWEEN DB AND CB PENSION PLANS?
These pension plans are much more alike than different. Their common features are: (1) availability of larger tax deductions and accelerated retirement savings for owners, partners, and professionals, (2) required annual contributions determined by an enrolled actuary, and (3) the employer bears the investment risk. If plan investments earn low returns or have losses, then future contributions will be more than expected. If plan investments earn high returns, then future contributions will be less than expected.

The significant differences between a DB pension plan and a CB pension plan are how their benefits are expressed and how their benefits are understood by employees. Under a CB pension plan, employees have their own plan accounts and upon termination of employment or retirement, the vested account balances are available for distributions and rollovers. These features are often easier for employees to understand that those of DB pension plans – lifetime retirement incomes and conversion of vested retirement benefits to equivalent lump sum amounts for distributions and rollovers.

ARE YOU A GOOD CANDIDATE FOR A PENSION PLAN?
After designing and setting up pension plans for over 35 years, we have found the following to be top candidates for a pension plan:

- Partners or owners who want to make tax-deductible contributions for retirement of more than $50,000 per year.
- Professionals and entrepreneurs age 40 or more who have neglected their personal retirement savings while they were building their practice or their company. Consequently they need to catch up on their retirement savings. Adding a pension plan allows for acceleration of savings. Pre-tax contributions of $100,000 to $200,000 per year are not unheard of.
- Companies already contributing 3% to 4% of pay for covered non-owner employees to a 401(k) profit sharing plan, or who are willing to do so. While pension plans are often established for the benefit of key executives and other highly compensated employees, other employees will also have to benefit. A pension plan normally has a minimum contribution of between 5% and 7.5% of pay for covered non-owner employees directly to the pension plan or indirectly to a separate 401(k) profit sharing plan.
- Companies which have demonstrated consistent profit patterns. Because a pension plan has required contributions, a consistent cash flow and profit is very important.
- Family businesses can use a pension plan as a component of succession planning.
- Law firms, medical groups, other professional firms (CPAs, engineers, architects) and closely held businesses can benefit from pension plans with their enhanced contributions and asset protection features.
- Sole proprietors with income exceeding $250,000 per year.

CAN PENSION PLANS BE OFFERED IN ADDITION TO 401(k) PLANS OR OTHER PLANS?
Yes. An employer can offer a combination of qualified retirement plans in order to have larger contribution amounts. Just as a profit sharing contribution feature can be added to a 401(k) plan, an employer can add a pension plan as well. In fact, a 401(k) plan in combination with a pension plan can be the ideal plan design for many companies and partnerships.

HOW DO PENSION PLAN DESIGN AND ADMINISTRATIVE COSTS COMPARE WITH THOSE FOR 401(k) PS PLANS?
It is more expensive to set up and administer a pension plan than a 401(k) profit sharing plan because the plan's funding must be certified by an actuary each year. However, the tax benefits of the pension plan will often significantly exceed the additional cost. Expenses will vary by size of plan and annual testing requirements.

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HOW MUCH CAN I CONTRIBUTE TO A PENSION PLAN?
Pension plan contributions are age-dependent. The older the participant, the higher the amount is. The reason for this difference is that an older person has fewer years to save toward the approximate $2.5 million maximum lump sum accumulation that is allowed in a pension plan. Subject to IRS limits, the actual contribution is determined by a formula specified in the plan document. It can be either a percentage of pay or a flat dollar amount.

MUST EVERYONE PARTICIPATE EQUALLY IN A PENSION PLAN?
No. Each participant can have a different contribution amount, subject to IRS rules for maximum and minimum contributions and to nondiscrimination rules for benefits/contributions. The contribution can be a percentage of pay or a flat dollar amount.

WHAT ARE THE DISTRIBUTION OPTIONS UPON RETIREMENT OR TERMINATION OF EMPLOYMENT?
Pension plan assets are portable. When participants terminate employment, they become eligible to receive the vested portions of their equivalent lump sum amounts based on the plan's vesting schedule. The vested amounts in a pension plan can be paid as lump sum distributions or annuities. Lump sum distributions can be rolled over to an IRA or to another qualified retirement plan.

CAN PENSION PLAN CONTRIBUTIONS CHANGE FROM YEAR TO YEAR?
Profit sharing plans allow contributions to vary from year to year depending on profitability, but pension plans must usually be amended in order to change contribution levels.

Employers can designate different pension plan contribution amounts for various participants, but there is a restriction on the frequency of amendments unless a valid economic reason exists. For example, if an employer’s profits are not expected to support its pension plan contributions, then the plan can be amended. Any contribution reductions must be made before an employee works 1,000 hours during a plan year. For contribution increases, the plan must be amended within 2-1/2 months following the end of a plan year. In addition, a pension plan can also be frozen or terminated before an employee works 1,000 hours during a plan year.

ARE PENSION PLAN CONTRIBUTIONS TAX-DEDUCTIBLE EXPENSES?
Yes. Pension plans are qualified plans, they have tax-favored status with the IRS, and contributions to qualified plans are tax-deductible expenses. Tax advisors generally agree that these plans should be funded to their maximum before other tax-efficient strategies are explored.

Tax deductions are hard to come by, especially those that directly reduce ordinary income dollar for dollar. Contributions to pension plans have the same tax effect as a deduction that reduces ordinary income dollar for dollar. With combined Federal and State income tax rates as high as 45%, the tax savings from the contributions and the subsequent earnings on these contributions can be very significant.

For example, one single contribution of $130,000 earning 5% a year for 30 years would be worth $562,000 before taxes or $309,000 after taxes at the end of 30 years. However, if the $130,000 had been taxed in the year contributed so that the after tax amount was invested, and if subsequent earnings on this contribution had also been taxed in each year (assuming the highest tax rates indicated above), then at the end of 30 years the total value would be only $163,000, or 47% less than the $309,000 after-tax amount shown above.

For partnerships, tax deductions for contributions made on behalf of non-partner employees are taken on the partnership tax return. Tax deductions for contributions made on behalf of partners are taken on their personal tax returns. To be sure that the amount deducted for tax purposes by a partner as shown on Schedule K-1 is the same as the amount contributed on behalf of the partner, the partnership agreement must permit this method of allocation. Most partnerships that adopt pension plans do not want the partners' contributions allocated like most other firm expenses in proportion to ownership. Either the partnership agreement or internal policy should assure that each partner is allocated an appropriate share of the plan's cost.

In summary, contributing to a pension plan can provide tremendous tax benefits. These tax benefits apply to both the amounts contributed and the subsequent investment earnings on these contributions. Also, do not forget that the investment earnings on the contributions will compound enabling them to grow to a very significant amount.

DO PENSION PLANS PROVIDE CREDITOR PROTECTION?
Yes. A pension plan is a qualified plan and as such its assets are protected from creditors in the event of bankruptcy and other legal claims. The anti-alienation provision of ERISA states that "each pension plan shall provide that benefits provided under the plan may not be assigned or alienated." This means that the assets in a qualified plan are not available to creditors. Since professionals and business owners often consider asset protection a premium, it is very advantageous to accrue retirement savings in an asset-protected vehicle, like a qualified plan. These plans provide a means for business owners and partners to move assets from their businesses to a pension plan. Once in the qualified plan, these assets are then protected from creditors as a "nest egg" for retirement or to pass on to heirs.

CROSS TESTED PROFIT SHARING PLAN FUNDAMENTALS

Under a "cross tested" profit sharing plan, the employer selects and contributes a percentage of each owner's pay (either the same percentage for all owners or a different percentage for each owner) and the employer also selects and contributes a percentage of each staff employee's pay (generally, the same percentage for all staff employees).

Current contributions are converted to projected benefits at retirement age and these benefits are then tested according to IRS nondiscrimination rules for benefits. If the IRS rules are not satisfied when contributions are tested as benefits, then the employer would have to contribute more for staff employees and/or less for one or more owners. The respective contribution percentages are flexible and may be adjusted from one year to the next.

Generally, a "cross tested" plan will work best when the average age of the owners is at least 5 years more than the average age of the staff employees. The following chart compares contributions for year 2012 between a conventional profit sharing plan and a "cross tested" profit sharing plan:

Participant Categories	Current Age	Annual Salary	**Conventional Contribution**	**Cross Tested Contribution**
Owner 1	59	250,000	**19,495**	**50,000**
Owner 2	54	250,000	**19,495**	**50,000**
Owner 3	49	250,000	**19,495**	**50,000**
Subtotal	54	750,000	**58,485**	**150,000**
Staff 1	59	55,000	**2,750**	**2,750**
Staff 2	54	50,000	**2,500**	**2,500**
Staff 3	49	45,000	**2,250**	**2,250**
Staff 4	44	40,000	**2,000**	**2,000**
Staff 5	39	35,000	**1,750**	**1,750**
Staff 6	34	30,000	**1,500**	**1,500**
Staff 7	29	25,000	**1,250**	**1,250**
Subtotal	44	280,000	**14,000**	**14,000**
Grand Total	47	1,030,000	**72,485**	**164,000**

LOGIC FOR CROSS TESTING

The owner's 20% of salary contribution is too high in relation to the employee's 5% of salary contribution according to IRS nondiscrimination rules for contributions. However, when contributions are converted to and cross tested as benefits at retirement age 65, the owner's 5.0% of salary benefit is less than the employee's 6.4% of salary benefit and this satisfies IRS nondiscrimination rules for benefits.

Participant Categories	Current Age	Current Salary	Current Contrib.	Contrib. as a % of Salary	Converted Benefit at Age 65	Benefit as a % of Salary
Owner	54	250,000	50,000	20%	12,452	5.0%
Employee	34	30,000	1,500	5%	1,910	6.4%

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COMMON QUESTIONS ABOUT CROSS TESTING

WHAT IS CROSS TESTING?

Cross testing is a method which may be used by a qualified retirement plan to demonstrate that its benefits or contributions do not discriminate in favor of highly compensated employees (HCEs). A plan which allocates employer contributions to participants' accounts may test its contributions for compliance with IRS nondiscrimination rules for contributions. Alternatively, the plan may "cross over" by converting its contributions to benefits and then testing these benefits for compliance with IRS nondiscrimination rules for benefits.

WHICH PLANS ARE ELIGIBLE TO USE CROSS TESTING?

With few exceptions, almost every type of qualified retirement plan may use cross testing. Voluntary 401(k) salary deferral contributions and employer matching contributions cannot be cross tested because they have their own special nondiscrimination rules and tests. However, discretionary employer profit sharing contributions, which are part of the same plan along with 401(k) and matching contributions, may be cross tested.

WHAT ARE SOME PRACTICAL APPLICATIONS FOR CROSS TESTING?

The best application is to enable a defined contribution plan to satisfy IRS nondiscrimination rules for benefits when the defined contribution plan cannot satisfy IRS nondiscrimination rules for contributions. Cross testing may also be used when an employer wants to have one level of contribution for a group of participants (such as owners, partners, or shareholders) and a different level of contribution for another group of participants (such as non-legal or non-professional staff employees) within the same plan.

WHY DOES CROSS TESTING WORK SO WELL?

Cross testing often produces a substantial employer contribution bias in favor of owners, partners, or shareholders because these individuals are usually in the upper half of the age profile for the employer's entire workforce. In other words, because the older owners, partners, or shareholders will have smaller converted benefits at age 65 than the converted benefits for the younger staff employees, the current contributions for the owners, partners, or shareholders can be much larger than the current contributions for the staff employees to "even things out" under the nondiscrimination rules.

DOES AN EMPLOYER NEED A NEW PLAN TO USE CROSS TESTING?

No. An existing plan may be amended to change the way employer contributions are allocated to participants. A 401(k) plan may be amended to add a discretionary employer contribution component to the plan. If necessary, the employer contributions are then cross tested as benefits.

HOW OFTEN MUST CROSS TESTING OCCUR?

A plan must comply with IRS nondiscrimination rules for benefits or contributions every year. If cross testing enables a plan to satisfy these IRS nondiscrimination rules, then cross testing must also occur every year.

WHAT HAPPENS IF CROSS TESTING FAILS?

Cross testing is only a method which may be used to determine whether a plan's benefits or contributions satisfy IRS nondiscrimination rules for a particular year. If cross testing fails, then the plan's benefits or contributions for that year must be adjusted until cross testing is successful.

ARE THERE ANY SPECIAL CROSS TESTING RULES?

Yes. For plan years beginning after 2001, a defined contribution plan cannot use cross testing for its employer contributions unless the actual rate of employer contribution for each non-highly compensated employee (NHCE) is at least 5% of pay or, if less, 1/3 of the highest actual rate of employer contribution for any highly compensated employee (HCE).

DOES THE IRS APPROVE PLANS WHICH USE CROSS TESTING?

Yes. The IRS reviews and approves cross tested plans.