

WHICH RETIREMENT PLAN IS BEST FOR OUR BUSINESS?

The first step in the selection of the best retirement plan for a business depends on the objective or purpose of the plan and often there is more than one. The most common objectives or purposes of a retirement plan are:

- To help attract and retain valuable employees in the competitive employment marketplace.
- To help the owners/shareholders/principals of the employer accumulate wealth for retirement in the most efficient manner possible.
- To help employees to save for their retirement years.
- To align employer contributions with employer budget constraints and cash flow.

The second step is to understand the basic tax principles for all qualified retirement plans. The comparison of after-tax accumulations both with and without a qualified retirement plan shows that a qualified retirement plan is the best and most efficient way to accumulate wealth for retirement on a tax-deferred basis under Federal tax laws. Withdrawals from a qualified retirement plan are subject to Federal income tax. Paying such tax after several years of tax-deferred investment growth, especially when your tax rate is likely to be lower, provides you with substantially more after-tax retirement income than you would have from personal after-tax savings without a qualified retirement plan.

BASIC TAX PRINCIPLES FOR ALL QUALIFIED RETIREMENT PLANS

- Vested employee pre-tax 401(k) contributions are not subject to current Federal income tax, but they are subject to current FICA/Medicare tax. Investment earnings on employee 401(k) contributions are not subject to current Federal income tax.
- Vested benefits or contributions by the employer for the employee and investment earnings on such benefits/contributions are not subject to current Federal income tax or to current FICA/Medicare tax.
- Upon termination of employment or retirement, vested employee 401(k) contributions, vested employer benefits/contributions, and accumulated investment earnings on both are subject to Federal income tax (plus an extra 10% early distribution tax if under age 59-1/2) if such amounts are distributed directly to the employee.
- Distributable vested amounts may be rolled over to an IRA without current Federal income tax owed until IRA withdrawals are made starting no later than age 70-1/2. Similarly, a more than 5% owner of the employer must start taking minimum required distributions at age 70-1/2 from vested amounts in a qualified retirement plan.
- Employer contributions to and administrative costs for any qualified retirement plan are deductible business expenses for the employer.

COMPARISON OF AFTER-TAX ACCUMULATIONS WITH AND WITHOUT A QUALIFIED RETIREMENT PLAN

<u>Number of Years of Accumulation</u>	<u>After-Tax Accumulation With Plan</u>	<u>After-Tax Accumulation Without Plan</u>	<u>Additional After-Tax Accumulation With Plan</u>
10	837,000	726,000	111,000
15	1,457,000	1,191,000	266,000
20	2,266,000	1,742,000	524,000
25	3,325,000	2,393,000	932,000

- \$100,000 annual contribution/investment during accumulation period.
- 5.5% annual investment earnings during accumulation period.
- 37.9% FIT plus Medicare tax rate during accumulation period.
- 35% FIT rate at end of accumulation period.

The third step is to learn about the various types of retirement plans, their basic features, and some of their pros and cons. The next few pages provide this information for the most common types of retirement plans. There are volumes of Federal laws and regulations for all retirement plans and the brief information for each type of retirement plan which follows only touches on their highlights.

TYPES OF QUALIFIED RETIREMENT PLANS

Defined Benefit Pension Plan

A defined benefit pension plan is the “traditional” pension plan which promises to pay an employee a specified lifetime retirement income. The lifetime retirement income amount generally depends on the employee’s years of plan participation and on the employee’s compensation received from the employer.

Contributions to the plan are determined by an enrolled actuary and are made by the employer. Because the plan promises to pay a specified lifetime income at the retirement, contributions to the plan are required every year and the employer bears the investment risk. If plan investments earn high returns, future contributions may be reduced until the plan’s liabilities exceed the value of plan assets. On the other hand, if plan investments earn low returns or have losses, future contributions may be higher than anticipated to compensate for inadequate plan investment returns. In turn, these plans generally use balanced conservative to moderate investment approaches with emphasis on low investment risk and volatility.

There is no maximum annual contribution limit for an employee under this type of plan. Instead, there is a maximum annual lifetime retirement income that can be provided for an employee depending on the employee’s years of plan participation, compensation, and retirement age. Because there is no maximum annual contribution amount, it is possible that the annual contribution for an older employee such as the business owner may be greater than the maximum annual contribution permitted under a defined contribution plan (\$49,000 for 2010).

IRS funding rules for these plans focus on the plans being well-funded with the value of a plan’s assets being equal to the plan’s liabilities sooner rather than later. However, there is a wide range of contributions permitted each year from a minimum contribution of about 25% of the “right” annual contribution up to a maximum contribution of about 150% of the “right” annual contribution. Contributions which are below the “right” annual contribution (the amount needed to keep the plan on the path toward being fully funded) will have to be made up in the future. Contributions which are above the “right” annual contribution build up funding credits to reduce or eliminate future annual contributions if the plan becomes fully funded or if the employer needs to make a lower future annual contribution due to business needs.

For owners/shareholders/principals of the employer, a defined benefit pension plan can help them generate substantial annual tax-deductible contributions to accelerate their retirement accumulations over shorter periods and to help them restore the retirement savings that they may have lost under other types of retirement plans due to poor investment performance. These annual contributions can be \$80,000 or more at age 40, \$170,000 or more at age 50, and \$200,000 or more at age 60.

TYPES OF QUALIFIED RETIREMENT PLANS

Cash Balance Pension Plan

A cash balance pension plan is a form of defined benefit pension plan often referred to as a “hybrid” pension plan. These plans have recently received wide media coverage.

Under this type of plan, each employee has a hypothetical account for the accumulation of annual hypothetical employer contribution credits and annual hypothetical investment earnings credits. At retirement, the hypothetical account can be converted to an actual lifetime retirement income using conversion factors specified in the plan document.

Converted lifetime retirement incomes and the accumulated values of the hypothetical accounts cannot exceed IRS statutory limits. Annual hypothetical investment earnings credits may be a fixed rate of return such as 5.5% per year or a variable rate of return tied to an index such as the S&P 500 Index. Annual hypothetical employer contribution credits are usually predetermined percentages of pay and can be higher for older employees.

Part of the appeal of a cash balance pension plan is that it is much easier to understand or grasp than a traditional defined benefit pension plan. In fact, a cash balance pension plan is very similar to a 401(k) plan. Employees do not have to deal with lifetime retirement income benefit formulas involving percentages of average compensation multiplied by years of plan participation. Instead, each employee has an opening cash balance account value and employer “contributions” and investment “earnings” are added to reach the accumulated account value at the retirement age.

Upon retirement, a relatively simple conversion factor is applied to determine the actual lifetime retirement income. For example, there may be \$100 of annual lifetime retirement income for each \$1,000 in the account at retirement age 65.

Younger employees (who often do not spend their entire working careers with the same employer) may find that their cash balance accounts are larger than what they would have received from a traditional defined benefit pension plan when leaving the employer at age 35 or 40. Many employers favor cash balance pension plans over traditional defined benefit pension plans because: (1) they represent a good addition to overall benefit packages for employers seeking to attract younger employees, (2) they often have lower charges to expenses than the traditional defined benefit pension plans they may replace, and (3) actual employer contributions may be more flexible when replacing over-funded traditional defined benefit pension plans or if actual plan investment earnings outpace the hypothetical investment earnings credited to plan accounts.

Just like for a traditional defined benefit pension plan, contributions to a cash balance pension plan are required every year and the employer bears the investment risk. If plan investments earn high returns, future contributions may be reduced until the value of the plan’s accounts exceed the value of plan assets. On the other hand, if plan investments earn low returns or have losses, future contributions may be higher than anticipated to compensate for inadequate plan investment returns. In turn, these plans generally use investment approaches with low investment risk and volatility and which are aligned with the plans’ annual hypothetical investment earnings credits added to plan accounts.

TYPES OF QUALIFIED RETIREMENT PLANS

401(k) Plan

The most popular qualified retirement plan among employers and employees is a 401(k) plan. Under this type of plan, an employee may make voluntary pre-tax salary deferral contributions by payroll deduction. Some 401(k) plans also permit employee voluntary after-tax Roth 401(k) salary deferral contributions. These plans offer employers and employees a number of advantages.

- **Competitive Advantage** – A 401(k) plan is an excellent employee incentive to help the employer recruit and retain valuable employees.
- **Tax Advantages** – Employees reduce their own current tax liabilities by contributing to a 401(k) plan. Contributions and investment earnings grow on a tax-deferred basis resulting in potentially greater savings upon retirement.
- **Control** – Depending on the plan's design, a 401(k) can provide employees with a greater sense of control over their retirement because they have the freedom to determine how their contributions are invested from a wide array of investment options. Employers and plan trustees have much less fiduciary liability by allowing employees to decide how their contributions are invested.
- **Convenience** – Payroll deductions enable employees to save for retirement automatically.

401(k) plans can have only employee salary deferral contributions or they may include employer matching contributions and/or employer discretionary profit sharing contributions. Combining employee salary deferral contributions with employer profit sharing contributions can provide an employer with a strong incentive package. Depending on the 401(k) plan design and the allocation formula for employer profit sharing contributions, key employees can defer up to a \$16,500 in 2010 and receive \$32,500 employer profit sharing contribution allocations. Employees age 50 or more in 2010 may also defer an additional \$5,500 from their pay.

Under a 401(k) plan, employees bear the investment risk. The freedom given to employees to invest their own contributions has proven to be a negative aspect of 401(k) plans since their creation a little more than 20 years ago. Employee-directed investment returns have been consistently less than managed plan trustee-directed investment returns. The recent adverse market conditions and investment losses have created severe setbacks for older employees approaching retirement.

TYPES OF QUALIFIED RETIREMENT PLANS

Profit Sharing Plan

A profit sharing plan is a popular means of providing retirement income for employees. These plans have two main advantages: (1) employer contributions reduce the employer's current taxes, and (2) the contributions are discretionary and may be changed from year-to-year.

A profit sharing plan allows an employer to make annual tax-deductible contributions of up to 25% of the total compensation of the eligible employees. Contributions and investment earnings grow on a tax-deferred basis resulting in potentially higher retirement savings for employees.

A profit sharing plan also offers an employer flexibility because no fixed contribution is required each year. Contributions are based on the employer's profitability, tax needs, and incentives for its employees. Plan contributions may be allocated among employees in a number of ways depending on the goals of the employer. Shown below is one sophisticated plan design technique geared toward maximizing contributions for key employees.

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 2010 between a conventional profit sharing plan and a "cross tested" profit sharing plan:

<u>Participant Categories</u>	<u>Current Age</u>	<u>Annual Salary</u>	<u>Conventional Contribution</u>	<u>Cross Tested Contribution</u>
Owner 1	59	245,000	19,160	49,000
Owner 2	54	245,000	19,160	49,000
Owner 3	49	245,000	19,160	49,000
Subtotal	54	735,000	57,480	147,000
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	1,015,000	71,480	161,000

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WHICH RETIREMENT PLAN IS BEST FOR OUR BUSINESS?

The fourth and final step to answer this question is, of course, the most difficult. Do you have objective(s) or purpose(s) for a retirement plan? Do you understand the basic tax principles for all retirement plans and how after-tax accumulations with a retirement plan are better than (more than) after-tax accumulations without a retirement plan? Have you reviewed the brief information for each type of retirement plan? Based on the preceding, can you now select the best retirement plan for your business with a high comfort level that you are right? For most people, the answer to this last question is NO. Some things about retirement plans may be clearer, but other things may be more confusing due to the many details involved.

We can help you with this fourth and final step in selecting which retirement plan is best for your business. Just as a picture is worth more than a thousand words, some actual numbers (contributions and benefits) applied to your situation and employees will make more sense than anything we can say or write.

We prepare retirement plan feasibility reports which include: (1) projected benefits and contributions, (2) comments about the projections, (3) some more specific retirement plan details, and (4) a summary of our services and plan installation/annual administrative fees.

We want every retirement plan feasibility report to “speak for itself.” That is, the report needs to be brief and clear enough for you to determine with comfort whether a particular type of retirement plan makes good business sense for your situation, your employees, and your retirement plan objective(s) or purpose(s). With our experience and independence, we can provide an immediate objective assessment when a particular type of retirement plan does not make good business sense for you.

We prepare retirement plan feasibility reports for new retirement plans, replacement retirement plans, and redesigned existing retirement plans. If you have 25 or fewer employees, we prepare these reports free of charge. If you have more than 25 employees, we charge a nominal fee to cover our costs, and if you move forward with us to set up a retirement plan, this nominal feasibility report fee will be applied as a credit toward plan installation fees.

If you want to learn more about retirement plans or if you want us to prepare a retirement plan feasibility report for you, please contact us by phone or by e-mail using the “Contact Us” section of our website shown below. Upon receipt of a request to prepare a retirement plan feasibility report, we will send you employer and employee data templates by e-mail for you to complete and return to us by fax or e-mail. Our turnaround time for preparation of a retirement plan feasibility report is 5 to 10 business days after we receive all of the employer and employee information that we need.

NOTE: The types of retirement plans we have described are in top tier of all retirement plans. There are other types of retirement plans such as SEPs, SIMPLE IRAs, and personal IRAs. We do not handle these other types of retirement plans, but one of them may be the retirement plan which is best for your business.