Pension Plans: Still The Ultimate Tax Shelter

Part II

by Stephen M. Margolin

Editor's note: In the December issue of Life Association News, Stephen M. Margolin described the benefits pension plans can still provide following passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and the new contributions limits. This month he discusses the reasons why Congress still favors pension plans, describes some of the new mechanics of pensions following TEFRA and mentions some limitations to pension plans.

Social Rationale

Congress desires to encourage the adoption of private pension plans. This Congressional desire has increased as the financial problems of the Social Security system and other public retirement plans continue to mount.

To fully understand the rationale for this encouragement, consider that there are basically three retirement benefit systems in this country:

1. The federal retirement system, i.e. the Social Security system, which covers retirement, disability, survivors and health insurance benefits;
2. The public retirement system, i.e. benefit plans for state, county, municipal, Civil Service and similar employees; and
3. The private retirement system, i.e. private qualified plans under ERISA.

Only the private retirement system, with its advance funding scheme, is currently on a sound financial footing. The Social Security system remains financially troubled today. The state and municipal public retirement system is a stepchild system—uncared for, underfunded, publicly neglected—and its full problems have yet to come to public attention.

Alice Rivlin, director of the Congressional Budget Office, stated to the National Commission on Social Security Reform on August 20, 1982, that Social Security trust funds will need an additional $11 billion in fiscal 1984 and $3 billion more in 1985.

Further, she said, "the combined reserves of the three trust funds are projected to be about 13% of annual outlays at the beginning of fiscal 1984 and less than 8% by the beginning of 1985." She concluded by saying that Social Security balances are declining and could reach critically low levels as soon as fiscal 1984.

Thus, socially needed and legally encouraged, the private retirement system has existed in one legal form or another for over 60 years. Covering half the U.S. work force, (approximately 40 million employees) with over $250 billion in assets, the private retirement system continues to increase. Each year a greater number of employees is covered by a growing amount of assets. The Employee Benefit Research Institute estimates that 80% of those now working will be eligible for pensions by the turn of the century.

Congressional encouragement of private pension plans influences actions of the Internal Revenue Service: not only will the service approve a qualified plan but it also has a considerable number on its staff who offer technical assistance and guidance to further that purpose.

Mechanics of Operation

All the employees of a firm need not become participants in the firm's pension. The following may

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be excluded:

1. Union employees covered by a collective bargaining agreement between union representatives and the employer with respect to which retirement benefits were the subject of good faith bargaining;

2. Employees under age 25;

3. Employees with less than a year of service. Employees with less than three years of service can be eliminated from the plan, but once they do participate, they are 100% vested;

4. Older employees hired less than five years from the plan's normal retirement date (for a defined benefit plan);

5. A plan may qualify by covering salaried employees only, or by covering one division or company and not another, so long as those covered represent a fair cross section of all employees; and

6. Finally, 30% of the employees (and more in some cases) can be arbitrarily excluded.

5 to 15 Year Vesting

Vesting must accrue at not less than the following rates:

Years of Service	Vesting
0 to less than 5	0
At least 5	25%
6 to 10	5% increase per year
11 to 15	10% increase per year

Thus, at the end of 15 years of service there is 100% vesting.

Top Heavy Plan Vesting

Effective for years beginning after December 31, 1983, if the plan substantially favors key people, accelerated vesting must be provided under either of the following methods:

1. Zero for the first three years and 100% thereafter, or

2. Zero for the first year and 20% for each year thereafter, resulting in 100% vesting after six years of service.

Retirement Trust

Contributions are made from the corporation to a retirement trust. The trustee administers the retirement funds for the exclusive benefit of plan participants (and their beneficiaries). The trustee frequently is the key employee/stockholder.

One of his functions is investing the trust funds. He may invest in any investment that a "prudent man" might invest in, including good, quality stocks, bonds, certificates of deposit, Treasury paper, savings accounts, real estate, and the like. He may also use part of the fund (generally no more than half) to purchase life insurance protection for himself (if he is a plan participant) and/or plan participants.

Limitations on Benefits and Contributions

Under a defined benefit plan, the annual benefit payable to a participant at retirement cannot be higher than 100% of his average earnings during his three highest years of plan participation or $90,000, whichever is lower. If the plan's retirement age is over 65, however, the $90,000 is actuarially increased. If the plan's retirement age is under 62, the $90,000 is actuarially reduced to an amount not less than of $75,000 at age 55. If the plan's retirement age is under 55, the $75,000 is actuarially reduced.

Contributions to a defined contribution plan for any participant may not exceed 25% of his average annual compensation or $30,000, whichever is less.

The basic $90,000 limit for a defined benefit plan and the $30,000 limit for a defined contribution plan will be adjusted in January of each year (starting January 1, 1986) to reflect the increase or decrease in the cost of living.

A defined benefit and a defined contribution plan (a profit sharing plan, money purchase pension plan, etc.) may be used at the same time. However, if the maximum dollar limit of either plan is utilized, then no more than 25% of the maximum dollar limit is available for the other plan.

The penalty for exceeding these maximum limits is disqualification of the plan and loss of benefits.

Conclusion

Over the last 60 years, Congress has consistently encouraged qualified plans. Following passage of the Tax Equity and Fiscal Responsibility Act of 1982, this encouragement continues, primarily in the form of significant tax inducements.

Specifically, employer contributions to qualified plans are deductible, earnings on plan investments are exempt from income taxation, favorable income tax treatment is available upon retirement, participants can borrow from the plan, and federal estate tax on plan proceeds is avoidable, upon death, to the extent of $100,000.

Further, if the plan is properly drafted, the Internal Revenue Service will issue a favorable determination letter in advance. □

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