Pension Plans: Still The Ultimate Tax Shelter

Part III

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. In January 1983, he discussed some of the reasons why Congress still favors pension plans and described some of the new mechanics of pensions following the passage of TEFRA. This month, the concluding article in this series describes the vesting requirements of pension plans and then observes that there are limitations to what a pension plan can accomplish.

I/R Code: 5400.00 Pensions

Vesting Benefits

Vesting means that a participant has a nonforfeitable right to a percentage of his accrued benefit at the termination of his employment. Accrued benefit, for a defined benefit plan, means a certain percentage of a participant's annual benefit at the normal retirement date (or the lump sum actuarial present value thereof), determined by the employer in accordance with one of the methods prescribed by the Internal Revenue Code. In a defined contribution plan, accrued benefit means the employee's account balance.

A participant is always 100% vested in the separate account derived from his own voluntary contributions. Likewise, at the pension plan's specified retirement age, a participant's accrued benefit is always 100% vested.

If a participant terminates employment before his retirement age, however, he may be less than 100% vested in his accrued benefit. This depends on his years of service at termination and on the vesting schedule. He forfeits the percentage of accrued benefit not vested in him at complete termination of employment. This forfeiture benefits the employer in a pension plan because it reduces later contributions. It benefits the remaining participants in a profit sharing plan, since the forfeiture is allocated to their separate accounts. *(See vesting schedule, p.81.)*

Retirement Trust

Contributions are made from the corporation to a retirement trust.

Stephen M. Margolin is the senior partner of Margolin and Brandwein, Ltd., a tax law firm specializing in tax related problems of closely held companies. After graduating from the University of Illinois in 1957, he spent five years with the Internal Revenue Service while attending John Marshall Law School. Since receiving his law degree in 1964, he has concentrated on the tax burdens of businessmen. He is on the Taxation and Employee Benefit committees of both the American Bar Association and the Illinois State Bar Association. He is a member of the Midwest Pension Conference and of the Employee Benefit Subcommittee of the Chicago Association of Commerce and Industry. He has published numerous scholarly articles on taxation and has lectured frequently on pensions, estate planning and financial planning.
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His address: 180 North LaSalle Street, Chicago, Illinois 60601.

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

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. ☐

The following sets forth some of the various permissible vesting configurations:

10% Vesting Per Year

Number of Completed Years of Service	Vested Percentage
Less than 1 year	0
At least 1 year, less than 2	10%
At least 2 years, less than 3	20%
At least 3 years, less than 4	30%
At least 4 years, less than 5	40%
At least 5 years, less than 6	50%
At least 6 years, less than 7	60%
At least 7 years, less than 8	70%
At least 8 years, less than 9	80%
At least 9 years, less than 10	90%
10 years or more	100%

Five 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.

4/40 Vesting

Number of Completed Years of Service	Vested Percentage
Less than 4 years	0
At least 4 years, less than 5	40%
At least 5 years, less than 6	45%
At least 6 years, less than 7	50%
At least 7 years, less than 8	60%
At least 8 years, less than 9	70%
At least 9 years, less than 10	80%
At least 10 years, less than 11	90%
11 years or more	100%

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.

Cliff Vesting

Zero before and 100% after 10 years of service.

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