Pension and profit-sharing plans, long important wealth-building and asset-protection tools, are more valuable than ever thanks to legislation passed early in this decade. Here's an overview for business advisors about these plans and what they can do for employers.

A Primer on Qualified Pension and Profit Sharing Plans

By Stephen M. Margolin and Harvey S. Shifrin

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[1] made defined benefit, profit-sharing, and 401(k) plans even more attractive than before. In addition to (i) disproportionately large contributions that can be made by an employer on behalf of key employees, (ii) income tax deductible contributions to the employer, (iii) tax free accumulation of plan assets, (iv) asset protection from non-family creditors, (v) no current taxability to the employees, and (vi) the accumulated benefits being tax deferred until payment to a participant or his beneficiary, possibly over decades, EGTRRA provides for higher levels of compensation which can be taken into account in calculating benefits as well as removing participants' elective deferrals from the deduction limit.

1. PL 107-16, 115 Stat 38, effective for plan years beginning after December 31, 2001, available at http://www.irs.gov/pub/irs-utl/egtrra_law.pdf.

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The Pension Protection Act of 2006 (PPA)[2] makes permanent the EGTRRA enhancements as well as adding a number of attractive features. In addition, the new Bankruptcy Act[3] strengthens asset protection of qualified plans.

Every advisor to employers should have some familiarity with the various legally encouraged tax and asset shelters. This article offers an overview, including an illustration of the deductions, contributions, or benefits available to key employees, and the total costs to the employer under different fact patterns. For a related article aimed directly at lawyers (especially small-firm lawyers) as employers, see Michael R. Maryn, *Choosing the Right Retirement Plan for Your Law Firm*, in the April 2007 *Journal*.

What is a qualified plan?

Qualified plans are plans of deferred compensation sponsored by employers on behalf of employees which satisfy the requirements of the Internal Revenue Code of 1986, as amended (the Code).

Qualified plans are established to provide for the payment of definitely determinable benefits over a period of years, or for life, after retirement.[4] The two main types of qualified plans are defined contribution (e.g., profit-sharing/401(k)) and defined benefit plans. A defined contribution plan provides each participant with his own account.[5] Defined benefits plans are all plans that are not defined contribution plans.[6]

Upon application by an employer, the Internal Revenue Service is liberal in issuing a favorable determination letter on plan qualification.

Deductions and limits

Annual addition limit. The Code imposes an individual participant limit on annual additions to defined contribution plans. The sum of employer contributions, employee contributions, and forfeitures ("annual addition")[7] which are allocated to an individual participant's account cannot exceed the lesser of 100 percent of his compensation or $45,000 (inflation adjusted).[8]

For example, Fred age 60, George age 49, and Susan age 35, are owner employees of Wealthmaker Corporation. They have compensation of $200,000, $200,000 and $100,000, respectively. The annual addition limit operates so each participant (i.e. Fred, George and Susan) cannot receive an allocation greater than $45,000 for a total contribution of $135,000 ($45,000 x 3 participants).

Defined contribution deduction limit. For defined contribution plans, the general employer contribution deduction limit is 25 percent of total participant compensation.[9] Revisiting Wealthmaker, the general employer contribution deduction limit of 25 percent of participant compensation equals $125,000 ($500,000 x 25 percent). The general employer contribution deduction limit of $125,000 applies, since it is less than the aggregate annual addition limit of $135,000.

Elective deferral limitation. 401(k) plans are profit-sharing plans with a cash or deferred arrangement.[10] These "cash or deferred arrangements" allow participants to make elective deferrals of their compensation otherwise includible in their income.[11] Elective deferrals are treated somewhat differently from non-elective contributions.[12] The maximum deductible elective deferrals for 401(k) plans are adjusted annually for inflation. For 2007, the maximum 401(k) deferral is $15,500.[13]

Elective deferrals not subject to limitations on deductions. Elective deferral contributions to a 401(k) plan are no longer subject to the employer contribution deduction limit of 25 percent.[14] So, the full 25 percent employer deduction for contributions is allowed in addition to the above maximum elective deferrals limits.

For example, Bill and Hillary's corporate compensation each is $100,000. Their employer establishes a profit-sharing plan with a 401(k) (cash or deferred) arrangement. The profit-sharing contribution deduction limit is 25 percent of the $200,000 compensation, or $50,000. If, however, each of them made a 401(k) elective deferral, then each can have an additional $15,500 withheld and contributed, making the company contribution $81,000.

"Catch-up" contributions. Individuals who participate in 401(k) plans and attain age 50 by plan year end are permitted to make additional "catch-up" contributions.[15] These individuals are allowed to make these "catch-up" deferrals without regard to the limitations that ordinarily apply to elective deferrals or annual additions.[16] Participants may make catch-up contributions only if permitted under the terms of the plan. Catch-up contributions are adjusted for inflation annually. The 2007 catch-up contribution limit is $5,000.[17]

For example, Bill, a 50-year-old plan participant, defers $15,500 in 2007. He also has profit-sharing contributions of $29,500 for total annual additions of $45,000. Bill may also elect to defer an additional $5,000 catch-up contribution for a total 401(k) deferral of $20,500.

The Bankruptcy Abuse and Consumer Protection Act of 2005 increased the protection for qualified plans afforded debtors electing bankruptcy protection.

The $5,000 contribution acts to increase the annual addition limit of $45,000 to $50,000. Furthermore, the $5,000 contribution is not subject to any 401(k) discrimination testing.

Compensation limitation. The term "compensation," defined in the plan, may include base compensation, bonuses, commissions, and salary reduction deferrals not included in an employee's income.

In year 2007, the maximum annual compensation used to determine allocations or benefits is $225,000 (inflation

2. PL 109-280, HR 4, with various effective dates, available at http://www.dol.gov/ebsa/pdf/ppa2006.pdf.
3. The Bankruptcy Abuse and Consumer Protection Act of 2005. PL 109-08, available at http://www.dpw.com/practice/code.blackline.pdf.
4. Employee Retirement Income Security Act of 1974 (ERISA), PL 93-406, 88 Stat 829, §3(2)(A), available at http://www.ssa.gov/OP_Home/comp2/F093-406.html.
5. IRC §414(i).
6. IRC §414(j).
7. IRC §415(c)(2)
8. IRC §415(c)(1).
9. IRC §404(a)(3)(A).
10. IRC §401(k).
11. IRC §401(k)(2)(A).
12. Employer contributions, which are other than salary reduction contributions.
13. IRC §402(g)(1)(B) as modified by IR 2006-162.
14. IRC §404(n).
15. IRC §414(v)(1) and (5).
16. IRC §414(v)(3).
17. IRC §414(v)(2)(B)(i).

adjusted).[18] In the earlier Wealthmaker example, if Fred and George each earned $300,000, the contribution limits would change, but the increase would be limited as only the first $225,000 of compensation could be considered, not the full $300,000.

Defined benefit deduction limits. The deduction limits for contributions made for key employees in defined benefit plans are very flexible. Limits to defined benefit plans are based upon the maximum amount a participant may receive upon retirement (generally at age 65), currently $180,000, and adjusted annually for inflation.[19]

Defined benefit plan contributions are actuarially determined based on age, earnings assumptions, compensation and years of service. The deduction[20] could approximate the amounts listed in the sidebar, assuming $225,000 compensation of a participant.

The defined benefit plan's flexibility can be best demonstrated by examining the sidebar on this page in conjunction with the following example.

Jack is a high-powered attorney who practices in Washington, DC. Jack is 50 years old and is the sole owner of his business, Jack, PC. Jack, PC has one other employee, Jill. Jill is a 30-year-old assistant, paralegal, and office administrator. Jack's practice is very prosperous and he desires to maximize the deductions created for his company at minimal costs.

The defined benefit plan works nicely here due to the age disparity of Jack, PC's employees. The highly compensated Jack ("HCE"), is 20 years older than his employee.

Under the sidebar example, if the Jack, PC defined benefit plan contained a normal retirement age of 62, Jack's estimated per annum deduction would be at least $123,000. He anticipates a prosperous year, and even considering the $123,000-plus deduction created for him and Jill, he felt it would not shelter his income. Could he obtain a larger deductible contribution?

Maximizing plan benefits

A company may use multiple plans to maximize plan benefits for key employees. These strategies are permissible provided the plans meet Code qualification,[21] participation[22] and discrimination testing,[23] some of which are described below.

For example, Wealthmaker employs Fred, George, and Susan. If favoring key employees (i.e., Fred and George) is desirable, it could adopt both a defined benefit plan and a 401(k) plan. EGTRRA added subparagraph (n) to Section 404 of the Code. It provides that elective deferrals are not subject to limitations on deductions. Therefore, it promotes both a defined benefit pension plan and a stand-alone 401(k) plan. The 401(k) permits only elective deferrals and accepts neither employer contributions nor matching contributions.

Furthermore, the employer may contribute an additional 6 percent of eligible compensation to a profit-sharing or 401(k) plan for years beginning after December 31, 2005.[24] By having both a defined benefit plan and a 401(k) plan, Fred and George can each contribute an additional $15,500 to the 401(k) in 2007. In addition, Fred (over age 50) could make a $5,000 catch-up contribution to the 401(k) plan.

All three employees could participate in both plans. Because of the great flexibility of these plans, Fred and George could enjoy massive defined benefit and 401(k) contributions and Susan more modest contributions, if the employer desired.

In short, employers can mix and match plans to achieve contribution and allocation objectives. There are more sophisticated techniques which can be applied to provide even higher disparity in contribution between key employees and the rank and file.

Characteristics of defined contribution plans

Any benefit under a defined contribution plan is based solely on the amounts contributed to such participant's account, plus any income, expenses, gains or losses, and any forfeitures of the accounts of other participants allocated to his account. Though the contribution to a defined contribution plan is definite, the ultimate accrued benefit is not.

Employer contributions under a profit-sharing plan may be either a fixed percentage of an employee's income for a plan year or a completely discretionary amount. The employer has great flexibility in allocating these contributions provided the plan document allows for such flexibility and certain participation and nondiscrimination tests are met.[25] When a distributable event occurs, such as retirement, a participant's account balance will consist of the contributions made to the trust for every plan year in which he was a participant and any forfeitures and earnings or losses allocated thereto.

Most new defined contribution plans are profit-sharing plans with or without 401(k) features. Under EGTRRA, profit-sharing plan contributions after

18. IRC §401(a)(17).
19. IRC §415(b)(1)(A) as modified by IR 2006-162.
20. IRC §404(a)(1).
21. IRC §401(a).
22. IRC §410(a).
23. IRC §§401(a)(4), 401(a)(5), and 410(b), and in Profit Sharing Plan with cash or deferred arrangements must satisfy the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) test under IRC Section 401(k) and 401(m) of the Code, respectively.
24. IRC §404(a)(7)(C)(iii), as added by PPA.
25. IRC §§401(a)(4), 401(a)(5) and 410(b).

Defined benefit deduction limits

Based on the 94 GAR Mortality Table (as published in Rev Rul 2001-62) at 4.5 percent and 6.5 percent post-retirement interest.

Present Age	Retire Age 62	Retire Age 65	Retire Age 70
35	$32,000-$47,000		
40	$48,000-$65,000		
45	$72,000-$96,000		
50	$123,000-$154,000	$84,000-$106,000	
55	$174,000-$208,000	$148,000-$180,000	
60		$173,000-$202,000	
65			$152,000-$175,000

2001 are subject to the same employer deduction limit of 25 percent as money purchase pension plans, but are more flexible; since the contributions are discretionary from year to year, whereas money purchase pension plans require annual contributions defined by formula. Thus, the use of money purchase pension plans has diminished. Other defined contribution plans are stock bonus plans, target benefit pension plans and employee stock ownership plans.

Profit-sharing plans theoretically provide for participation by employees in the employer's profits. Previously, the Code required any profit-sharing contributions be made from current or accumulated profits.

However, it is now permissible for contributions to be made solely at the discretion of the employer without regard to profits.[26] The plan must provide for allocating contributions among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the occurrence of some event such as disability, retirement, death or severance of employment.

Characteristics of defined benefit plans

Defined benefit plans provide for payment of definitely determinable benefits over a period of years, or for life, after retirement.[27] Retirement benefits are generally based on some combination of age, years of service, and compensation of each employee.[28]

Employer contributions to the plan are mandatory.[29] Contributions, however, are not a 'fixed percentage' of compensation inasmuch as they are calculated using applicable funding rules and actuarial assumptions. The amount of contribution must be sufficient to bring the assets to the appropriate levels each year to fund the benefits offered under the plan.

Unlike defined contribution plans, no individual accounts are established under a defined benefit plan. Generally, participants earn additional benefits over time, but no assets are segregated within the plan for those benefits.

Rather, participants' benefits are stated as amounts payable at a specified time, normally, the participant's retirement. Benefits may be based upon compensation earned during the employee's entire career or on the average of either the final or the consecutive high number of years (typically the final 10 years or the consecutive high three or five years).

Plan participation

A qualified plan must satisfy the minimum participation rules of Code Section 410(a). Under these rules, a plan may only impose limited minimum age requirements and may not impose maximum age requirements for participation. Certain employees may be excluded in determining the statutory requirement for participation.

For example, a unit of employees covered by a collective bargaining agreement between employee representatives and one or more employers in which retirement benefits were the subject to good faith bargaining can be excluded. It's important to note that retirement benefits do not have to be provided, but merely that they were the subject of good-faith negotiation.

For defined benefit plans, Code Section 401(a)(26) imposes an additional employee coverage requirement. The plan must cover the lesser of 50 eligible employees or 40 percent of all eligible employees. In a two-person plan, both employees must be covered.

A qualified plan generally may not require an employee to complete a period of service extending beyond the later of the date the employee attains age 21 or the date on which he or she completes one year of service. However, an employer may require that an employee complete two years of service to participate, if it provides that after the two years of service each participant is fully vested.

A year of service for this purpose is a 12-month period during which the employee has completed at least 1,000 hours of service. Typically, the 12-month period begins on the date the employee commences employment.

An employer may choose less restrictive entry conditions. Thus, a plan may allow employees to participate as soon as they commence employment, if desired.

Once an employee has attained both the minimum age and service requirements, he must participate on the first day of the plan year or six months after he satisfies these requirements, whichever is earlier.[30] January 1 and July 1 are typical entry dates for plans that operate on the calendar year, although entry dates may be more frequent (such as quarterly or monthly).

Vesting and forfeitures

A qualified plan may impose vesting standards that require the participant to complete a certain number of years of service before his accrued benefit derived from employer contributions is fully vested or nonforfeitable. A "year of service" is a calendar or fixed year designated by the plan, during which the participant completes 1,000 hours of service (although some plans operate using an elapsed time system). Code Section 411 provides two minimum vesting schedules for defined benefit pension plans:

1) Five year cliff vesting, under which an employee must be fully vested in benefits attributable to employer contributions when he has completed at least five years of vesting service; and

2) Three to seven year graded vesting, under which an employee must be vested in a percentage of benefits derived from employer contributions according to the following table:

Years of service	*Vesting percentage*
3 years of service	20%
4 years of service	40%
5 years of service	60%
6 years of service	80%
7 or more years of service	100%

If key employees are credited with more than 60 percent of a plan's accrued benefits, it is considered "top heavy." Then, in lieu of five-year cliff vesting, three-year cliff vesting applies. Instead of cliff vesting, an employer may utilize the following top heavy schedule.

Years of service	*Vesting percentage*
2 years of service	20%
3 years of service	40%
4 years of service	60%
5 years of service	80%
6 or more years of service	100%

26. IRC §401(a)(27)(A).
27. ERISA, PL 93-406, 88 Stat 829, §3(2)(A) and IRC §414(j).
28. BNA – Tax Management Portfolios, Plan Selection – Pension and Profit Sharing Plans, No 350, III.C.2.c.
29. IRC §412(h). This subsection provides six exceptions when the "minimum funding standards" of IRC §412 do not apply. A defined benefit pension plan does not fall within any of these six exceptions.
30. IRC § 410(a)(4).

For plan years beginning after December 31, 2006, these two vesting schedules also apply to all matching contributions in defined contribution plans.[31] Of course, an employer may have a less restrictive vesting schedule.

An employee must be fully vested in his benefit under the plan when he attains normal retirement age.[32] Normal retirement age is the later of his 65th birthday or the fifth anniversary of commencement of participation, or the age specified in the plan, whichever is earlier.[33] An employee is always fully vested in benefits attributable to his own elective deferrals (i.e. 401(k) contribution). Also, an employee is fully vested upon termination of the plan.[34]

Once an employee is fully vested in his benefits, such benefits are nonforfeitable. In other words, the employee's rights to vested benefits are unconditional and may not be conditioned on any subsequent event.

Generally, all years of service are taken into account under the vesting rules although the employer may exclude years of service before age 18, years of service with an employer when the employer did not maintain the plan or predecessor plan, and certain years of service when the employee has a five-year break in service.

A plan may not amend its vesting schedule unless the vested percentage of every employee is at least as great as it was before the amendment.[35]

Asset protection – common law employees

Code section 401(a)(13) and the Employee Retirement Income Security Act ("ERISA") section 206(d) provide that a plan must include language that benefits may not be assigned or alienated. In *Patterson v Shumate*,[36] the United States Supreme Court held that for a qualified plan subject to ERISA, benefits are protected from a participant's creditors in bankruptcy. A plan is subject to ERISA when it covers at least one common law employee.

No common law employees

For plans covering only owner employees, state law, not ERISA, controls. For example, in *In re Stern*,[37] the ninth circuit held that, under California law, assets in a retirement plan are exempt from distribution to a participant's creditors. The general exception to the inalienability of a participant's benefit is a qualified domestic relations order relating to child support, alimony, or marital property rights of a spouse, former spouse or dependent.

New bankruptcy act

The Bankruptcy Abuse and Consumer Protection Act of 2005 increased the protection for qualified plans afforded debtors electing bankruptcy protection.

All assets held in qualified retirement plans are exempt from the bankruptcy estate. SEP and SIMPLE IRAs as well as rollover IRAs and the earnings thereon are similarly exempt. In contrast, Roth IRAs and Traditional IRAs funded with individual taxpayer contributions are only exempt up to $1 million of value.

No creditor, including the federal government, may reach assets that are exempt from the bankruptcy estate. However, a "fine, penalty, or forfeiture payable to and for the benefit of a governmental unit" is not discharged by a bankruptcy.[38]

In addition, the following taxes are not discharged by the bankruptcy: federal income tax for any return due in the past three years, property tax for any return due in the past year, withholding tax for all years, employment tax for any return due in the past three years, excise tax for any return due in the past three years, customs tax for any return due in the past year, penalty for actual pecuniary loss in any year.[39] Such claims will remain valid after the bankruptcy is completed and can be collected after the bankruptcy, both from assets that were exempt from the bankruptcy estate and newly acquired assets.

Required minimum distributions are not exempt from the bankruptcy estate. Once in the hands of the debtor, they are subject to creditors. No distinction is made between the federal government as a creditor and other creditors.

All other distributions, including hardship distributions and those part of a series of substantially equal periodic payments over the life expectancy of the employee or for a period of 10 years or more, are not exempt from the bankruptcy estate. Once in the hands of the debtor, they are subject to creditors.

Distributions

Participants in qualified plans are not subject to income tax on contributions when made to the plan by the employer or employee. Earnings on contributions are not taxed while they accumulate within the plan. Taxation occurs when money is distributed from the plan.

Thanks to EGTRRA, disproportionately large income tax deductible contributions can be made by an employer on behalf of key employees.

If the participant does not incur a tax when the money is placed into the plan, a tax is incurred when the money is distributed from the plan. Taxation can be further deferred by having the distribution proceeds transferred, or "rolled over," to another qualified plan or an individual retirement account ("IRA").

Distributions from qualified plans may be taken in several different forms. Among the forms of distributions that may be made are lump sum distributions, installments over a fixed period of time and life annuity distributions.

In general, when a participant receives a distribution, such distribution is taxed as ordinary income in the year of receipt. Distributions of non-deductible employee contributions are possible (but not typical). When they are part of a lump sum distribution, they may be withdrawn from the plan without any tax on the basis.

31. IRC §411(a)(2)(B) as amended by PPA.
32. IRC § 411 (a).
33. IRC § 411 (8)(A).
34. IRC § 411 (d)(3).
35. IRC §411(a)(10).
36. 504 US 753, KTC 1992-198 (S Ct 1992).
37. 317 F3d 1111 (9th Cir 2002).
38. 11 USC §523(a)(7).
39. 11 USC §§523(a)(1) 507(a)(2) and 507(a)(8).

Conclusion

Qualified plans are extraordinarily attractive, today more than ever before. This is because disproportionately large income tax deductible contributions can be made by an employer on behalf of key employees. Earnings and gains accrue tax free.

While in trust, plan benefits are protected from non-family creditors even in bankruptcy. Tax is deferred until distribution to a participant or his beneficiary is made, possibly over decades. In addition, the Internal Revenue Service readily and routinely issues favorable determination letters on plan qualification before implementation. ■

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