QUALIFIED RETIREMENT PLANS:
CHOOSING THE PROPER PLAN AND DESIGN FEATURES

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I. Types of Plans Covered.

A. IRA-Based Retirement Plans.

1. Simplified Employee Pension Plans (SEPs).

2. SIMPLE Plans.

B. Employer Trust-Based Retirement Plans.

1. Profit Sharing Plans.

a. Traditional profit sharing plans.
b. Cross-tested profit sharing plans.

2. Money Purchase Pension Plans.

3. 401(k) Plans.

a. Traditional 401(k) Plans.
b. "Solo" or "Uni" 401(k) Plans.
c. Safe Harbor 401(k) Plans.
d. "DASH" 401(k) Plans.
e. Roth 401(k) Plans.

4. Employee Stock Ownership Plans (ESOPs).

5. Defined Benefit Plans.

C. Each of the foregoing plans can be adopted by a C Corporation, S Corporation, LLC, partnership, or sole proprietorship. In addition, each of the foregoing plans (other

than an ESOP) can be adopted by a non-profit employer. Non-profit employers also can adopt 403(b) annuities and 457 plans, which are not covered in this presentation.

II. Why Adopt a Qualified Plan?

A. Employers adopt qualified plans to attract and retain qualified employees.

B. Employers adopt qualified plans to provide benefits and nontaxable compensation to business owners.

C. Employers adopt qualified plans to take advantage of the "Triple Tax Benefit":

1. Employer contributions are deductible if they are within limits specified by the IRS.

2. Employer contributions are not included in employees' taxable income when made and, with the exception of an employee's own elective deferrals to a SIMPLE plan or 401(k) plan, are not included in the FICA/FUTA wage base.

3. Earnings on plan investments are not taxed until they are distributed (earnings on qualified Roth 401(k) contributions are *never* taxed).

D. Other advantages:

1. Distributions from retirement plans can be rolled over to another retirement plan or an IRA, further deferring the tax.

2. Retirement plans are the single-most effective "forced savings" vehicle most people have today.

3. Retirement plans are an effective way for an employer to share its success and motivate employees in a tax-favored manner.

4. Many small employers are eligible for a new plan start-up credit (IRC § 45E).

a. The employer must have no more than 100 employees who receive at least $5,000 of compensation and at least one employee must be a non-highly compensated employee.

b. The employer must not have maintained a qualified plan (including a SEP or SIMPLE) during the three years prior to the year the credit otherwise would be allowable.

c. The credit is equal to 50% of plan start-up costs, and the credit cannot exceed $500 per year.

d. The credit is available only for the first three years the plan is in effect.

e. Start-up costs eligible for the credit include plan installation and administration fees and retirement education expenses.

f. The controlled group rules apply in determining who is eligible for the credit.

III. Common Themes.

A. Affiliated Employers. In designing and administering a plan, it is critical to determine if the employer is a member of a group of trades or businesses under common control or an affiliated service group. Affiliated employers are treated as a single employer for purposes of the qualified plan rules. Such aggregation is required if two or more employers are:

1. A brother-sister controlled group of corporations or group of trades or businesses under common control. IRC § 414(b) and 414(c); IRC § 1563.

a. The same five or fewer people must own at least 80% of each entity, taking into account the stock ownership of these people only to the extent they own an interest in each entity.

b. Example: Company X is owned 70% by Art and 30% by Brad. Company Y is owned 85% by Art and 15% by Carol. X and Y are not controlled group members – the interests of Brad and Carol are disregarded because neither owns an interest in *both* entities.

c. Example: Company X is owned 70% by Art and 30% by Brad. Company Y is owned 75% by Art, 10% by Brad, and 15% by Carol. X and Y are controlled group members – Art and Brad, together, own 100% of X and 85% of Y.

d. Be Careful: The aggregation rules of IRC § 1563 apply, and the regulations disregard interests owned by employees who are subject to certain restrictive buy-sell agreements.

Example: Bob owns 100% of Company X. Bob owns 60% of Company Y and an unrelated employee, Sam, owns 40% of Company

Y. Sam is subject to a buy-sell agreement stating that Bob can purchase Sam's stock in Company Y upon the termination of his employment. Bob, by virtue of his control of Company Y, can terminate Sam's employment. Sam's stock must be disregarded for purposes of the controlled group rules, and Company X and Company Y constitute a controlled group.

2. A parent-subsidiary controlled group of corporations or group of trades or businesses under common control.

   a. Direct or indirect 80% ownership is required.

   b. Example: LLC X owns 100% of Corp. Y. Corp. Y owns 90% of Partnership Z. All three entities are members of a parent-subsidiary controlled group and are treated as one employer.

3. An affiliated service group under IRC § 414(m).

   a. A Org Test: One service organization (1) owns an interest in another service organization and (2) regularly performs services for that organization or is associated on a regular basis with that organization in performing services for others.

   b. B Org Test: (1) A significant portion of an entity's business is performing services for a service organization, (2) at least 10% of the entity is owned by HCEs of the service organization, and (3) those services are of a type typically performed by that service organization.

   c. Management Org Test: A management organization, as its principal business, performs services for a recipient organization.

   d. Example. CPA Firm X employs all of its staff. CPA Firm X is owned 25% each by four professional corporations, each of which is owned by one CPA and has only one employee (the CPA). CPA Firm X performs accounting services for clients, and each of the four owners assists with these services and bills CPA Firm X for such services. All five entities are aggregated as a single employer under the A Org test.

B. <u>High Compensated Employees</u>. The design and operation of a retirement plan frequently requires identification of highly compensated employees ("**HCE**"). Employees who are not HCEs are called non-highly compensated employees ("**NHCE**"). Under IRC § 414(q), a HCE is an employee who:

1. Was a 5% owner at any time during the current or preceding plan year (attribution rules apply); or

2. For the preceding plan year, (a) had compensation in excess of an amount set by the IRS ($100,000 in 2006), and (b) if the employer elects, was in the top-paid group (top 20% of active employees ranked by compensation).

C. Participant Accounts. With the exception of defined benefit plans, all of the retirement plans discussed in this manuscript are "defined contribution" account-based plans, meaning that the employee's own contributions and/or the employee's share of the employer's contribution, together with the earnings on those contributions, are separately accounted for in an account.

1. Contributions to a SEP or SIMPLE IRA plan are made to a separate IRA in employee's name.

2. Contributions to an ERISA qualified plan are placed into an employer trust and accounted for in a separate book account for each employee.

D. Considered Compensation. Under IRC § 401(a)(17), an employer must disregard an employee's compensation in excess of a designated amount in determining the contribution made to that employee. For 2006, the compensation limit is $220,000. This rule applies to all types of plans discussed in this manuscript, except for one aspect of a SIMPLE plan.

E. Discrimination. As the price for the Triple Tax Benefit (deductible, non-includible contributions and tax-deferred growth), the tax laws generally require qualified retirement plans to be nondiscriminatory – that is, to cover a broad cross-section of the employer's workforce and provide for contributions in a non-discriminatory manner. The rules differ depending on the type of plan involved.

F. Investment of Plan Assets.

1. SIMPLEs and SEPs. Because contributions are made to an IRA for each employee, employees in SIMPLEs and SEPs generally direct the investment of their own funds as they see fit.

2. Qualified Retirement Plans. By plan design, contributions to qualified retirement plans are either trustee-directed or participant-directed.

a. Employees do not have the right to have participant directed accounts, even in 401(k) plans. The plan must provide for this.

b. Employees in participant-directed plans generally choose among a given number of pre-selected diversified investment options. However, a plan can permit an employee to completely control the investment of his or her account (i.e., each employee can have his or her own brokerage account).

c. Trustees of plans that permit participant direction may be relieved of fiduciary liability for plan investments under IRC § 404(c).

3. Prohibited Transaction Rules. Employers adopting SIMPLEs, SEPs, or qualified plans are subject to detailed rules prohibiting certain transactions between the employer and the plan, as well as other conflicts of interest.

G. Vesting.

1. SIMPLEs and SEPs. The accounts of employees in SIMPLE plans and SEPs must be 100% vested and nonforfeitable at all times.

2. Qualified Retirement Plans. Qualified retirement plans can be designed to include vesting schedules under which an employee forfeits all or a portion of his or her account in the event of termination of employment. Under IRC §§ 401(a)(7) and 411(a), the basic vesting rules are:

a. An employee must be 100% vested in his or her own 401(k) deferrals and safe harbor employer contributions at all times.

b. An employee must be 100% vested in other employer contributions upon reaching normal retirement age, which is the earlier of (a) the date set forth in the plan, or (b) the later of age 65 or the 5th anniversary of plan participation.

c. Plans that have a vesting schedule frequently provide for 100% vesting upon death or disability, but are not required to do so.

d. The selection of a vesting schedule depends on whether a plan is "top heavy" or not.

i. Generally, a plan is top heavy if the aggregate accounts of key "employees" exceed 60% of the aggregate accounts of all employees in the plan.

ii. An employee is a key employee if he or she (1) is an officer whose annual compensation exceeds $140,000 (in 2006), (2)

a 1% owner who annual compensation exceeds $150,000, or (3) a 5% owner regardless of compensation (IRC § 416(i)).

e. In a non-top heavy plan, the plan must satisfy one of two vesting alternatives:

i. Five-year cliff vesting, under which the employee must by 100% vested after five years; or

ii. Seven-year graded vesting as follows:

Years of Service	Vested Percentage
0	0%
1	0%
2	0%
3	20%
4	40%
5	60%
6	80%
7	100%

iii. However, under the Pension Protection Act of 2006, effective for plan years beginning after 2006, the foregoing non-top heavy vesting schedules are only available for defined benefit plans. Defined contribution plans must satisfy one of the two following top-heavy vesting schedules, even if the plan is not top-heavy.

f. In a top heavy plan (and for all defined contribution plans after 2006) the plan must satisfy one of two vesting alternatives:

i. Three-year cliff vesting, under which the employee must be 100% vested after three years; or

ii. Six-year graded vesting as follows:

Years of Service	Vested Percentage
0	0%
1	0%
2	20%
3	40%

4	60%
5	80%
6	100%

g. Before 2007, even if a plan is not top heavy, matching contributions to a 401(k) plan must vest at least as rapidly as under one of the two top heavy vesting schedules.

h. An employer, by plan design, can provide a more liberal vesting schedule allowing faster vesting than shown above, or can provide for immediate 100% vesting at all times.

i. To the extent an employee is not vested upon termination of employment, the unvested portion is forfeited. By plan design, forfeited benefits can either be applied as additional employer contributions or to reduce employer contributions.

j. If all or a portion of an employee's account is forfeited and the employee returns to work with that employer before he or she has five one-year breaks in service, the employee must be allowed to pay back the amount of his or her distribution (if any), and in such case the employer must restore the forfeited amount. IRC § 411(a)(17).

H. Distributions.

1. SIMPLEs and SEPs. Because SIMPLE and SEP contributions are deposited into IRAs owned by the employees, an employee can withdraw his or her account at any time, in the employee's discretion, either before or after termination of employment.

2. Qualified Retirement Plans. A qualified retirement plan, by plan design, controls when an employee can receive distributions from his or her account:

i. Hardship distributions during employment.

ii. In-service distributions during employment.

iii. Plan loans during employment.

iv. Distributions after separation from service.

1. The employer can dictate by plan design when the employee's money is available. For example, distributions can be made

available:

(a) Upon termination of employment.

(b) In the first plan year following termination of employment.

(c) Five years following termination of employment.

(d) Upon reaching normal retirement age.

2. However, if an employee's vested benefits at the time of distribution exceed $5,000, the employee has the right to leave his or her money in the plan until retirement age.

(a) If the employee's vested benefits are less than $5,000, the employer can "cash out" the employee's distribution without consent.

(b) If a cash out distribution exceeds $1,000, the employer must roll over the distribution to an IRA set up for the employee, unless the employee elects to receive the distribution.

(c) In order to avoid this automatic rollover requirement, many employers by plan design reduce the cash out threshold to $1,000. That is, if the employee's vested account is more than $1,000, the employee must consent before a distribution can be made.

3. In defined benefit plans and money purchase pension plans, if an employee's vested benefits at the time of distribution exceed $5,000, then once a distribution is payable, it must be paid as a joint and survivor annuity unless the employee consents to a different form of payment.

(a) Otherwise, a plan, by design, can pay distributions in a lump sum, and may (but is not required to) offer an installment distribution option.

(b) Profit sharing plans and 401(k) plans that hold pension plan money via plan merger or transfer of assets must offer a joint and survivor annuity with

respect to that money. This does not apply to rollovers from a pension plan to a profit sharing or 401(k) plan.

3. Taxation.

a. Distributions from all types of plans (SIMPLEs, SEPs, and qualified retirement plans) are subject to income taxes at ordinary income tax rates in the year received, unless the distributions are rolled over to another plan or an IRA. As a result of a recent change in the law, almost all distributions are eligible for rollover.

b. Distributions received (and not rolled over) before age 59-1/2 are subject to a 10% premature distribution tax, unless an exception applies. IRC § 72(t).

c. Under IRC § 401(a)(9), minimum annual distributions must commence by the year after the employee's required beginning date.

d. For a detailed discussion of the taxation of plan and IRA distributions, see J. Scott Dillon, *Distribution Planning for Qualified Retirement Plans and IRAs: A Fresh Look*, 2005 NCACPA Symposium.

IV. SIMPLE IRA Plans.

A. Definition. A SIMPLE IRA plan is an IRA-based plan under IRC § 408(p) under which an eligible employee may elect to receive cash compensation or have the employer make an elective contribution to an IRA for the employee.

B. Eligible Employer. To maintain a SIMPLE plan, the employer (a) must have employed, during the preceding calendar year, not more than 100 employees earning more than $5,000/year, and (b) must not maintain any other type of employer plan (including a SEP). The affiliated employer rules apply for this purpose.

1. An employer that maintains a SIMPLE plan has a two-year grace period to keep the plan once it becomes ineligible.

C. Eligible Employee. At a minimum, a SIMPLE plan must allow plan participation for any employee who received at least $5,000 in compensation from the employer during any two preceding years and whom the employer reasonably expects will receive at least $5,000 in the current year. The affiliated employer rules apply, and all eligible employees of affiliated group members must be eligible to participate.

D. Deferral Limitation. Each year, an eligible employee may make elective deferrals in an amount not exceeding $10,000 (adjusted for inflation in $500 increments). The limit is $10,000 for 2006.

1. In addition, an eligible employee who has reached age 50 may make an additional $2,500 catch up deferral each year.

E. Employer Contribution Requirement. An employer must make a mandatory contribution each year to each eligible employee's IRA. The contribution must either be:

1. A 100% matching contribution up to 3% of the employee's compensation, except that the employer can elect for any 2 years in a 5-year period to match less than 3% but not less than 1%. Notice of the reduced match must be given to employees no later than October 31 of the year before the year the reduction is effective.

2. A 2% nonelective contribution to each eligible employee (even those who choose not to defer).

3. No discrimination testing is required.

4. "Compensation" is defined as W-2 compensation plus elective deferrals.

5. The IRC § 401(a)(17) compensation limit ($220,000 in 2006) applies to the 2% nonelective option but not the 3% matching option.

6. Example:

Employee	Comp.	Deferral	Match	2% Nonelective
A	$150,000	$12,500	$4,500	$3,000
B	85,000	7,500	2,550	1,700
C	70,000	0	0	1,400
D	40,000	1,000	1,000	800
E	30,000	0	0	600
			8,050	7,500

F. Vesting; Distributions. Employees must be 100% vested in their SIMPLE IRAs at all times. An employee can withdraw his or her vested benefit from the SIMPLE IRA at any time.

G. Suitability.

1. A SIMPLE IRA plan is suitable for small companies (usually start-ups) who desire to provide a vehicle for business owners and their employees to accumulate a meaningful retirement benefit but, with respect to the business owners, cannot afford to contribute more than the SIMPLE limit.

    a. The SIMPLE allows business owners and key executives to receive significant tax-deferred contributions at the minimum company expense.

    b. If the business owners or key executives can afford a greater annual contribution, another type of plan should be considered.

2. A SIMPLE IRA plan is suitable for companies that are administratively handicapped.

    a. Ease of adoption – IRS Form 5304-SIMPLE or 5305-SIMPLE.

    b. No IRS filing.

    c. No IRS Form 5500 reporting.

    d. No discrimination testing.

    e. Virtually no plan administration costs.

    f. No fiduciary liability for employee investment of their SIMPLE IRAs.

3. A SIMPLE IRA plan is not suitable for employers who need more flexibility in plan design.

    a. Vesting.

    b. Exclusion of controlled group member.

    c. Exclusion of class of employees.

    d. Need to restrict distributions until termination of employment.

    e. Desire to be paternalistic (25% premature distribution tax in first two years of plan participation).

    f. Desire to provide loan program.

4. A SIMPLE IRA plan is not suitable for an employer who cannot predict the company's profitability and its resulting ability to make the employer contribution from year-to-year. The legal commitment to make the employer contribution arises at the time employee elective deferrals are made.

V. Simplified Employee Pension Plans (SEPs).

A. Definition. A SEP is an IRA-based plan under IRC § 408(k) under which an employer makes discretionary employer contributions to IRAs established for eligible employees.

B. Eligible Employees. Each year that the employer contributes to the SEP, the employer must allocate the contribution among all employees (of all affiliated group members) except for the following employees, who may be excluded in the plan document:

1. An employee who has not attained age 21.

2. An employee who has not performed any service for the employer during at least three of the preceding five years (seasonal or part-time employees who meet this requirement cannot be excluded).

3. The employee's compensation for the year is less than $450.

4. The employee is a non-resident alien or covered by a union contract.

C. Employer Contributions. Employer contributions to the SEP must be allocated to eligible employees in proportion to their compensation (i.e., each employee must receive the same percentage of compensation).

1. SEPs that are set up using a prototype document (as opposed to the IRS form) may be integrated with social security in the same manner as an employer profit sharing plan. See the discussion of social security integration under Section VI.

2. Employer contributions to an employee for a year cannot exceed the lesser of (a) 25% of the employee's compensation, or (b) the current annual addition limit ($44,000 in 2006).

3. An employer can deduct annual contributions not exceeding 25% of the compensation of employees participating in the SEP.

4. Example: Company X maintains a SEP and decides to contribute $20,000 this year.

Employee	Comp.	Contrib.	% of Comp.
A	$150,000	$8,000	5.3%
B	85,000	4,533	5.3%
C	70,000	3,733	5.3%
D	40,000	2,133	5.3%
E	30,000	1,600	5.3%
		$20,000	

D. Vesting; Distributions. Employees must be 100% vested in their SEP IRAs at all times. An employee can withdraw his or her vested benefit from the SEP IRA at any time.

E. Suitability.

1. A SEP is suitable for small companies (a) who desire an administratively simple program under which they can make meaningful employer contributions for employees and (b) who are not concerned about discriminating in favor of business owners and key employees. If giving as much of the contribution as possible to owners and key employees is a priority, the employer should look to SIMPLE IRAs or qualified retirement plans.

2. A SIMPLE IRA plan is suitable for companies that are administratively handicapped.

   a. Ease of adoption – IRS Form 5305-SEP.

   b. No IRS filing.

   c. No IRS Form 5500 reporting in most cases.

   d. No discrimination testing.

   e. Virtually no plan administration costs.

   f. No fiduciary liability for employee investment of their SEP IRAs.

3. A SEP is suitable for an employer who decides to make a deductible retirement plan contribution for a particular year after year-end. The employer has until the due date of its tax return, including extensions, to establish the SEP and make the contribution. A SIMPLE IRA would not be

an option since it requires employee deferrals during the year, nor would a qualified retirement plan since the plan document would have to be signed by the last day of the year for which the contribution is made.

4. A SEP is not suitable for employers who need more flexibility in plan design.

   a. Vesting.

   b. Exclusion of controlled group member.

   c. Exclusion of class of employees.

   d. Need to restrict distributions until termination of employment.

   e. Desire to provide loan program.

5. A SEP is not suitable for an employer who desires maximum discrimination in favor of HCEs.

6. An employer with a SEP cannot also maintain a SIMPLE IRA plan, and an employer with a SIMPLE IRA plan cannot maintain a SEP. If an employer desires to maintain a plan allowing both employee deferrals and significant employer contributions, the employer must use a 401(k) plan.

VI. Profit Sharing Plans.

A. Definition. A profit sharing plan is an ERISA qualified plan established by an employer as a vehicle to receive and invest discretionary employer contributions for the benefit of plan participants. Each year, the employer decides how much it can afford to contribute to the plan. The contribution is then allocated to accounts of the participants in accordance with the plan's contribution allocation formula.

1. An employer does not need to have profits to contribute to a profit sharing plan. The name is a carryover from the days when a contribution could only be made to the extent of the employer's profits.

2. A profit sharing plan must have an element of permanence. If an employer goes too many years without contributing to the plan, the plan will be deemed terminated.

3. A 401(k) plan is a profit sharing plan with 401(k) features. However, a profit sharing plan does not have to include 401(k) features and can just allow employer contributions.

B. Discrimination. As a general rule, profit sharing plans and other ERISA qualified plans must be nondiscriminatory (as defined by the Internal Revenue Code) as to participation and the allocation of employer contributions. They also must be nondiscriminatory in operation.

C. Nondiscriminatory Participation.

1. Excludible Employees. Under IRC § 410(b), an employer can disregard the following employees prior to applying the discrimination test that governs whether the plan covers a sufficiently broad number of employees:

a. An employee who has not reached age 21.

b. An employee who does not have a year of service (i.e., a 12 consecutive month period in which the employee works at least 1,000 hours).

c. A union employee.

d. Nonresident aliens.

2. Coverage. After disregarding excludible employees, the plan must benefit a percentage of NHCEs that is at least 70% of the percentage of HCEs benefitting under the plan. If it does so, then it covers a sufficient number of employees and will not be deemed discriminatory.

a. Example: The Company X profit sharing plan is designed to exclude hourly paid employees from participation. Company X has 2 salaried HCEs, 7 salaried NHCEs, and 2 hourly paid employees, and none of them can be disregarded.. The plan covers 100% of the HCEs and 78% of the NHCEs (7/9). Therefore, it passes the coverage test.

b. Example: Company X and Company Y constitute a controlled group of corporations. X maintains a profit sharing plan for its employees, but Y does not. X has 2 HCEs and 10 NHCEs. Y has 3 HCEs and 20 NHCEs. None of them can be disregarded. 2 of 5, or 40%, of the HCEs of the controlled group are covered, so the plan must cover 28% of the NHCEs of the group to pass the coverage test (40% X 70% = 28%). In fact, the plan covers 33% of the group's NHCEs (10/30), so the plan passes the coverage test.

c. If a plan fails to pass the foregoing test, it will still meet the coverage

test if it passes a complicated average benefits test under IRC § 410(b). This test is rarely relied upon to pass coverage.

d. If an employer maintains two separate lines of business, the employer may test each line of business for coverage separately under the QSLOB rules. IRC §§ 410(b) and 414(r). To constitute a QSLOB, each separate line of business (i) must have at least 50 employees, (ii) must provide property or services to its own customers, and (iii) must be a separate organizational unit under separate management and with a separate workforce.

D. Nondiscriminatory Contributions.

1. Three Testing Methods. A profit sharing plan (or money purchase pension plan) must provide for nondiscriminatory contributions. Under IRC § 401(a)(4), the following three testing methods are available for demonstrating nondiscrimination:

a. Design-based safe harbor for uniform allocation formulas.

b. Safe harbor for uniform points allocation provisions.

c. General nondiscrimination test.

2. Uniform Allocation Formula.

a. Same Percentage of Comp. Under this method, each participant in the plan must receive the same percentage of compensation or the same dollar amount.

i. Example: Company X maintains a profit sharing plan and decides to contribute $20,000 this year.

Employee	Comp.	Contrib.	% of Comp.
A	$150,000	$8,000	5.3%
B	85,000	4,533	5.3%
C	70,000	3,733	5.3%
D	40,000	2,133	5.3%
E	30,000	1,600	5.3%
		$20,000	

b. Social Security Integration. A profit sharing plan (or money purchase pension plan) may also satisfy the nondiscrimination requirements by

taking into account the employer's contribution to social security on behalf of plan participants. This is referred to as "permitted disparity". Under social security integration, a base contribution is made to all participants in the same percentage of compensation and the employer makes an additional contribution for certain participants with compensation in excess of the "integration level". IRC § 401(l).

i. Maximum Disparity. The additional contribution permitted for compensation exceeding the integration level is the lesser of (i) the base contribution percentage, or (ii) 5.7%.

ii. Integration Level. The integration level cannot exceed the social security taxable wage base ("TWB") in effect at the beginning of the plan year ($94,200 as of January 1, 2006). If the integration level is set at less than the TWB, then the following adjustments to the 5.7% maximum permitted disparity limit must be made:

Integration Level	Adjusted Percentage
More than 80% TWB	5.4%
More than 20% TWB but not more than 80% TWB	4.3%
20% of TWB or less	No adjustment (5.7%)

iii. Example: Company X maintains a profit sharing plan and decides to contribute $20,000 this year plus the additional amount that can be contributed with respect to compensation over the TWB.

Employee	Comp.	Base Contrib	Base %	Excess Contrib	Excess %
A	$150,000	$8,000	5.3%	$2,957*	5.3%
B	85,000	4,533	5.3%	0	
C	70,000	3,733	5.3%	0	
D	40,000	2,133	5.3%	0	
E	30,000	1,600	5.3%	0	
		$20,000			

* ($150,000 - $94,200) X 5.3% (note that Company X could also select an integration level of 80.1% of the TWB

($75,454) and make a larger excess contribution for A provided that Company X also is willing to make a contribution for B.

3. Uniform Points Plan. An employer can allocate its contribution to a profit sharing plan on the basis of "points" if the average allocation rate of the HCEs does not exceed the average allocation rate of the NHCEs.

   a. Points can be awarded for age, for service, and/or for units of compensation (not in excess of $200).

   b. Example. Company X maintains a profit sharing plan that allocates company contributions on the basis of points. A participant gets one point for each year of service and one point for each $100 of compensation. Company X makes a $10,000 contribution.

Employee	Comp.	Yrs of Serv.	Points	Contrib.	% of Comp.
A	$80,000	25	825	$6,288	7.86%
B	20,000	3	203	1,547	7.74%
C	15,000	10	160	1,220	8.13%
D	12,000	4	124	945	7.88%

   A is the sole HCE. B, C, and D are NHCEs, and their average allocation rate is 7.92% ((7.74%+8.13%+7.88%)/3). Therefore, the plan passes the uniform points safe harbor test.

   c. Note that, unlike the previous design based safe harbors, the uniform points safe harbor is not design based, meaning that the contribution must be tested for discrimination each year.

   d. The uniform points safe harbor test works best for a large employer who desires to reward employees with many years of service. Many small employers want to design their plans to discriminate in favor of HCEs to the maximum extent permitted, and a uniform points plan is not well-suited to that purpose.

4. General Nondiscrimination Test. Under IRC § 401(a)(4), a plan satisfies the general nondiscimination test if each "allocation rate group" satisfies one of the 410(b) coverage tests. An allocation rate group consists of a HCE plus all other employees (HCEs or NHCEs) with an allocation rate greater than or equal to the HCE's allocation rate. Typically, some employees will be includable in more than one group.

a. Example: Company X maintains a profit sharing plan and contributes the following percentages of compensation to the following employees:

HCEs	NHCEs
Art - 10%	Carol - 10%
Brad - 6%	Don - 10%
	Ellen - 6%
	Fred - 6%
	Gail - 3%

There are two rate groups – a 10% rate group and a 6% rate group. The 3% contribution received by Gail does not establish a rate group because she is a NHCE. Each rate group consists of the employees with an allocation rate equal to or greater than that rate. The 10% rate group consists of Art, Carol, and Don. The 6% rate group consists of everyone but Gail.

In this case, each of the two rate groups passes the 410(b) ratio percentage coverage test.

i. The 10% rate group covers 40% of the NCHEs (2 of 5) and 50% of the HCEs, producing a coverage ratio of 80% (40% divided by 50%). In other words, in order to pass, at least 35% (50% X 70%) of the NCHEs would have to be covered by this rate group, and in fact 40% of the NCHEs were covered.

ii. The 6% rate group covers 80% of the NCHEs (4 of 5) and 100% of the HCEs, producing a coverage ratio of 80% (80% divided by 100%).

b. The general nondiscrimination test is most typically used in conjunction with a cross-tested profit sharing plan, discussed in Section VIII below.

E. Employer Deductions. Employer contributions to a profit sharing plan are deductible by an employer to the extent they do not exceed 25% of the combined compensation of all participants in the plan for the plan year. Employee elective deferrals to a profit sharing plan containing a 401(k) feature do not count toward the 25% limit and are deductible separately by the employer. IRC § 404.

F. Annual Addition Limit. Under IRC § 415, the maximum contribution that can be allocated to any participant in a profit sharing plan is the lesser of (a) 100% of the employee's compensation for the year, or (b) the § 415 annual addition limit, which is $44,000 for 2006. Employee elective deferrals (other than catch up contributions) to a profit sharing plan containing a 401(k) feature count toward the 25% limit. Catch up contributions do not count toward the $44,000 limit.

G. Suitability.

1. A traditional profit sharing plan is best suited to an employer who desires to make meaningful employer contributions to a broad cross-section of its employees under a more sophisticated plan design arrangement.

   a. The employer can exclude certain classes of employees, or employees of a particular controlled group member, from participation.

   b. The employer can apply a vesting schedule in order to encourage employees to work on a long-term basis and reward those who do. Forfeited benefits can be reallocated to continuing employees at the expense of employees who terminate employment.

   c. The employer can control when distributions from the plan are available, requiring employees to wait until after they terminate employment to receive their contributions.

   d. The employer can add a loan program, enabling employees to borrow from their accounts in the plan.

   e. The employer can add a social security integration feature, allowing additional contributions to HCEs without having to make them to NHCEs as well.

2. A traditional profit sharing plan that only provides for employer contributions feature is not suitable for an employer who desire to provide for maximum discrimination in favor of HCEs. If this is the goal, a cross-tested profit sharing plan or a 401(k) plan (or a combination of both) is better suited.

3. A profit sharing plan (or any other ERISA qualified plan for that matter) is not suitable for an employer that is administratively handicapped. If the employer does not intend to continue the plan indefinitely or is not committed to handling the administration of the plan in a prudent manner, a SEP or SIMPLE plan is a much better option.

a. The employer must establish a trust to hold contributions. The trust must name a Trustee (typically an owner of the business) to manage the trust investments. The Trustee has fiduciary duties to plan participants under ERISA.

b. The employer and the Trustee must determine what kind of investment platform is best suited for the plan. If the plan allows participant direction of accounts, the employer must administer participant directions according to their terms.

c. The employer must assure that the plan is operated in accordance with its terms and properly administered. It must be able to keep track of participant accounts, including contribution allocations, earnings allocations, and distributions. It is always advisable to hire a third party retirement plan administration firm for this purpose.

d. If an employer fails to operate a plan in accordance with its terms, the IRS can disqualify the plan, resulting in the immediate taxation of vested contributions and earnings and the denial of previous deductions for contributions to unvested accounts. Correcting a plan administration error can be tedious and expensive.

e. The employer must administer the distribution process, distribute distribution notices to employees entitled to receive distributions, obtain all necessary spousal consents to distributions, collect beneficiary designation forms, joint and survivor annuity election forms, and other permitted elections from participants, and assure that benefits are distributed at the right time and to the right person.

f. The employer must distribute an ERISA summary plan description to each participant.

g. The employer must routinely amend the plan so that the plan language complies with constantly-changing pension laws. Failure to amend a plan in a timely manner results in plan disqualification unless the defect is corrected in accordance with tedious IRS procedures.

h. The employer must file IRS Form 5500 for the plan each year.

i. Termination of the plan is a cumbersome process.

VII. Money Purchase Pension Plans.

A. Definition. A money purchase pension plan is a defined contribution plan under which the employer contractually commits to make a designated contribution to the plan each year. For example, the employer may promise in the plan to make a 10% of compensation annual contribution to the plan for each eligible employee. Unlike a profit sharing plan or a SEP, the contribution is not discretionary, and the employer is legally liable to make the promised contribution, regardless of the employer's financial condition. The employer faces IRS penalties and plan disqualification by not making a required contribution. The employer's contribution formula in a money purchase pension plan is subject to the same discrimination rules applicable to profit sharing plans, as discussed in Section VI above.

B. Suitability.

1. Prior to EGTRRA, an employer's deduction for contributions to a profit sharing plan (including 401(k) elective deferrals) could not exceed 15% of the combined compensation of all participants in the plan. On the other hand, contributions to a money purchase pension plan were (and still are) deductible to the extent of 25% of the combined compensation of all participants in the plan. Accordingly, many employers adopted money purchase pension plans in order to take advantage of the higher deduction limits and make larger contributions than otherwise would be available to a profit sharing plan. Many employers maintained money purchase pension plans as stand alone plans, and many others adopted paired money purchase pension plans and profit sharing plans. Under the paired arrangement, the employer would make a fixed annual contribution (say 10%) to the money purchase plan and then make a discretionary annual contribution of up to 15% to the profit sharing based upon the employer's profitability. By maintaining a money purchase pension plan, the employer could significantly increase the amount of its annual deductible contribution.

2. The money purchase pension plan became a dinosaur as a result of EGTRRA, which increased the employer deduction for contributions to a profit sharing plan to 25% of participant compensation, plus 401(k) elective deferrals. As a result, many money purchase plans were terminated or merged into paired profit sharing plans. However, a significant number of money purchase plans still exist today, either due to simple business inertia or out of a desire to keep the plan investments separate where separate investment structures previously were put into place. Today, there is seldom a reason for an employer considering the adoption of a new retirement plan to choose a money purchase pension plan.

VIII. Cross-Tested Profit Sharing Plans.

A. Definition. A cross-tested plan, also sometimes referred to as a "new comparability plan", is nothing more than a traditional profit sharing plan that, under IRC § 401(a)(4), tests the employer's contributions to the plan for discrimination under the general discrimination test using a benefits analysis (similar to a defined benefit plan). In all other respects, the cross-tested plan is subject to the same rules, principles, and considerations that apply to any other profit sharing plan, as discussed above.

B. Plan Design. In a cross-tested plan, the employer most often will designate several categories of employees who are entitled to receive contributions and then designate a different percentage of compensation to be paid as a plan contribution to each category. The employer then tests the contribution for discrimination under § 401(a)(4).

1. Example #1. Company X categorizes its employees into the broom division, the clothing division, and the toy division, and its profit sharing plan gives Company X discretion to determine the amount of contribution paid to each division each year, with the contribution being allocated to the employees in each division in proportion to their compensation. For 2006, Company X decides to contribute 15% of compensation to the broom division (based on the total compensation of the employees in that division), 10% of compensation to the clothing division, and only 3% of compensation to the toy division.

2. Example #2. Company Y categorizes its employees into three groups: (a) corporate officers, (b) salaried employees who are not officers, and (c) hourly paid employees. Its profit sharing plan gives Company Y discretion to determine the amount of contribution paid to each group each year, with the contribution being allocated to the employees in each group in proportion to their compensation. For 2006, Company Y decides to contribute 21% of compensation to the officer group (based on the total compensation of the employees in that group), 10% of compensation to the salaried employee group, and 5% of compensation to the hourly paid group.

A cross-tested plan also may be designed as an "age-weighted plan", under which each employee's contribution is based on the employee's age, or a "super integrated plan", under which the plan provides for an integration level above the social security taxable wage base, a disparity percentage above the 5.7% permitted disparity limit, or both.

C. Basic Concept. The basic concept under the cross-testing regulations is that older

employees have less years to retirement and less years to accumulate a retirement benefit than do younger employees. Therefore, older employees can receive larger contributions (expressed as a percentage of their compensation) than younger employees without the arrangement being deemed discriminatory. For example, in Example #2 above, the 21% contribution to the officer group may pass the discrimination test if the officers are significantly older on average than the employees in the other two groups. This is the same concept that applies in a defined benefit plan.

D. Minimum Gateway. As a condition to using cross-testing to test profit sharing plan contributions for discrimination, the plan generally must provide a "gateway allocation" to each eligible NHCE equal to the lesser of (a) 5% of compensation, or (b) 1/3rd of the allocation rate of the HCE with the highest allocation rate. For example, in Example #2, if all of the highly compensated employees are in the officer group, then the employees in the other two groups would need to receive at least 5% of their compensation. This does not guarantee that the plan passes the cross-testing discrimination test – it just makes the plan eligible to use cross-testing.

1. A cross-tested plan does not have to provide the minimum gateway contribution if provides "broadly available" allocation rates as defined in the regulations or if it provides for age-based allocation rates. Due to the fact that age-based allocation rates typically do not provide for the desired level of disparity for all HCEs and that the regulations defining "broadly available" allocation rates are somewhat difficult to apply, most cross-tested plans are designed to provide the minimum gateway allocation.

2. These regulations state that a cross-tested plan provides broadly available allocation rates if either (a) each allocation rate (expressed as a percentage of compensation) under the plan is available to a group of employees that satisfies the nondiscriminatory classification portion of the average benefit test under the IRS § 410(b) coverage rules, or (b) the plan's allocation rates increase "smoothly" as an employee increases in age or accumulates additional service.

E. Cross-Testing Methodology.

1. Cross-testing a profit sharing plan's contributions is really an alternative method of applying the general discrimination test discussed in Section VI above. However, instead of using allocation rates, the employer determines rate groups on the basis of equivalent benefit rates, and then each equivalent benefit rate group must contain a sufficient number of NHCEs to pass the 410(b) coverage test.

a. Therefore, if the percentage of the employer's eligible NHCEs in the each group is at least 70% of the percentage of the employer's eligible HCEs in the group (or if each group passes the alternate average benefit test), the plan passes.

b. The older an employee is, the lower his equivalent benefit at a given percentage of compensation. Therefore, when HCEs are significantly older on average than NHCEs, they can receive significantly greater contributions and still pass cross-testing.

2. Example. Cross-Testing a Profit Sharing Plan Allocated Solely on Basis of Compensation ("New Comparability")

	Age	Plan Comp.	Conversion Factor	Allocation	Percent of Plan Comp	Benefit Rate
P	50	$120,000	2805.60	$40,000	33.3%	14.26%
B	40	$ 35,000	361.94	$ 2,283	6.52%	6.31%
C	35	$ 25,000	171.93	$ 1,631	6.52%	9.49%
D	30	$ 20,000	91.48	$ 1,305	6.52%	14.26%
E	25	$ 15,000	45.63	$ 978	6.52%	21.45%
		$215,000		$46,197	21.49%	

Assumptions: Plan divides the participants into two allocation groups. The plan designates HCEs in one group and NHCEs in the other group. The plan must have a definite allocation formula to divide the employer contribution between or among the designated groups. A contribution for a particular group is allocable on a pro rata basis to the eligible participants in that group, based on the compensation of each eligible participant. The employer contributes $46,197. The allocation formula provides a first tier allocation equal to 6.52% of each NHCE's compensation. The next tier provides an allocation equal to not more than 33.33% of each HCE's compensation, with the actual percentage being 33.33% of P's compensation to enable P's allocation to equal P's 2003 415 limit. The designated contributions will reflect a total amount that does the following: (1) stays within the employer's contribution budget; (2) provides a significantly higher contribution for P without violating the deduction limits; and (3) satisfies Code §401(a)(4) (explained below). In the example, the allocation rate for P is 33% and the allocation rate for B, C, D and E is 6.52%. Note, this approach to plan design maintains an equal allocation percentage for the NHCEs.

Top heavy: Satisfied. All employees have received an allocation rate of at least 3%.

Code §401(a)(4): Even though the plan does not *allocate* on the basis of age-weighted factors, it may *test* the contributions on the basis of benefits. See Treas. Reg. §1.401(a)(4)-8(b). To test for nondiscrimination, the plan converts each participant's contribution to an equivalent benefit rate (shown as the benefit rate in the illustration). Determine the equivalent benefit rate by dividing the allocation by the participant's conversion factor. The plan also satisfies the "gateway" allocation requirement by providing an allocation of 5% of compensation for each NHCE.

The plan then tests P's benefit rate group (14.26%) to determine if it satisfies Code §410(b). The 14.26% rate group covers 50% of the NHCE group (D and E) and 100% of the HCE group (P). Although a ratio of 50%/100% does not satisfy the ratio percentage test under Code §410(b), it *does* satisfy the nondiscriminatory classification test under Treas. Reg. §1.410(b)-4. Since the rate group must rely on the nondiscriminatory classification test, the rate group does not satisfy Code §401(a)(4) unless the plan satisfies the average benefit percentage test. The plan may compute the average benefit percentage test on the basis of the equivalent benefit rates. The average of the equivalent benefit rates for the NHCEs is 12.88% [6.31% + 9.49% + 14.26% + 21.45%)/4]. The average benefit ratio is 12.88%/14.26% or 90.31%. Since the average benefit ratio is at least 70%, and P's rate group passes the nondiscriminatory classification test, the plan satisfies Code §401(a)(4).

F. Suitability.

1. Most of the suitability and unsuitability factors applicable to profit sharing plans that are outlined in Article VI above (other than the factors dealing with contribution allocations) apply to cross-tested profit sharing plans.

2. Where an employer is willing to make a significant contribution to rank-and-file employees but desires to make a very large, disproportionate contribution to a particular class of HCE employees, cross-tested plans work very well provided that the class receiving the large contribution is older on average than the rank-and-file.

3. Cross-tested plans work very well in many professional firms (doctors, lawyers, CPAs) where the practice desires to maximize the contributions to the professionals and make a reasonable contribution to staff.

4. Cross-tested plans do not work well in very small companies or in companies with a lot of turn over, because a relatively small change in census data can have a huge impact on the amount of the contribution the company can make

to the preferred class.

5. Cross-tested plans can be somewhat expensive to administer, due to the annual testing requirements. It is typically necessary to run preliminary tests close to year-end to determine the level of contribution that can be made.

IX. <u>401(k) Plans</u>.

A. <u>Definition</u>. A 401(k) plan is a profit sharing plan containing provisions that permit employees to make elective 401(k) salary and/or bonus deferral contributions to the plan. The amount deferred into the plan by employees is not included in their taxable income for the year of deferral. A 401(k) plan also may (but is not required to) provide for employer matching contributions to the plan. A 401(k) plan often will provide for discretionary employer contributions as well.

1. Some 401(k) plans contain automatic deferral (negative election) provisions requiring an automatic reduction of an employee's compensation by a stated percentage that is contributed to the plan unless the employee elects to contribute a different percentage of compensation (or none at all). Such a provision is permissible so long as employees have an effective opportunity to elect cash.

2. Elective deferrals to 401(k) plans are <u>employer</u> contributions for all purposes.

a. Employers may now deduct annual plan contributions up to 25% of the compensation of all participants in the plan, <u>plus</u> 401(k) deferrals.

b. An employee's individual 415 annual addition limit (currently $44,000) applies to all employer contributions allocated to the employee, <u>including</u> 401(k) deferrals, but not including catch up contributions.

B. <u>Maximum Deferral Limitation</u>. Under IRC § 402(g), an employee's total elective deferrals for a calendar year (to all employer plans in which the employee participates) may not exceed the amount designated under 402(g) ($15,000 in 2006).

1. The 402(g) limit is a single limit applicable to all plans in which the employee participates, including plans of unrelated employers.

2. Deferrals in excess of the 402(g) limit, plus or minus allocable income or loss, must be distributed by April 15 of the year after the deferrals were made.

a. Timely distributions of excess deferrals are taxed in the year the deferrals were made, whereas allocable income is taxed in the year distributed.

b. Distributions of excess deferrals made after April 15 are double taxed – once on the year the deferrals were made and again in the year distributed.

C. Catch-Up Contributions. An employee who is age 50 or more can make an additional deferral, over and above the 402(g) limit, referred to as a catch-up contribution. The catch-up contribution limit is $5,000 for 2006.

1. Catch-up contributions can be made over and above the 415 annual addition limit. Therefore, in 2006, the total aggregate contributions that an employee who is age 50 or older can receive in a 401(k) plan is $49,000 ($44,000 annual addition limit plus $5,000 catch-up limit).

2. A catch-up contribution is an elective deferral for purposes of the employer's matching contribution, unless the plan provides to the contrary. A catch-up contribution is not included in the ADP test (discussed below), but a matching contribution with respect to a catch-up contribution is included in the ACP test (discussed below).

D. ADP Test. A 401(k) plan must satisfy annually the actual deferral percentage (ADP) test with respect to employee elective deferrals. The ADP test is an objective test that compares the average rate of deferrals (expressed as a percentage of compensation) made by HCEs for the plan year to the average rate of deferrals (expressed as a percentage of compensation) made by NHCEs for the plan year. The ADP of the HCEs cannot exceed:

If NHCE ADP is:	Maximum HCE ADP is:
Less than 2%	2 X NHCE ADP
2% - 8%	2% + NHCE ADP
More than 8%	1.25 X NHCE ADP

1. The 401(k) plan may calculate NHCE ADPs using the current year or prior year testing method. Using the prior year method has the advantage of enabling the HCEs to know how much they can contribute in any given year.

2. QMACs and QNECs are counted in determining the ADP.

3. Catch-up contributions are not included in calculating the ADP of either

group.

4. Eligible employees who made no elective deferrals to the plan are still counted in determining the ADP.

5. Example. Company X maintains a 401(k) plan. For the plan year, the employees make elective deferrals in the following amounts:

Employee	Compensation	Deferral	Deferral %
A (HCE)	$120,000	$12,000	10%
B (HCE)	$100,000	$10,000	10%
C	$50,000	$5,000	10%
D	$40,000	$4,000	10%
E	$25,000	0	0%
F	$20,000	0	0%

The ADP of the HCEs is 10%. The ADP of the NHCEs is 5% ((10%+10%+0%+0%)/4). The plan fails the ADP test, since the maximum HCE ADP is 7% (2%+NHCE ADP).

E. Correcting ADP Test Failures.

1. Excluding Early Participants. If a 401(k) plan permits employees to participate before they have completed one year of service and reached age 21, the plan may exclude employees who have not met these thresholds. In the prior example, if E and F were employed six months ago, they could be excluded from the NHCE ADP test, in which case the plan would pass.

2. QNECs and QMACs. A 401(k) plan can cure a failed ADP test by making a qualified nonelective contribution or a qualified matching contribution to NHCEs. These contributions must be 100% vested and be subject to the 401(k) distribution restrictions (discussed below). QNECs and QMACs are included in the ADP test. For example, in the prior example, Company X could make a 3% QNEC to the four NHCEs and pass the ADP test, since their ADP would then become 8% (2% + the 8% NHCE ADP = the 10% HCE ADP).

3. Distribution of Excess Contributions. Under this method of correcting ADP failures, the plan first determines the corrective distribution amount necessary to pass the ADP test and then distributes the excess HCE contribution amount, plus allocable income, to the HCEs.

a. To determine the excess contribution amount, the plan starts with the HCE with the *highest* deferral percentage and reduces the deferral percentage to the extent required to satisfy the ADP test or to the level of the next highest deferral percentage of an HCE. The plan repeats the process, if necessary, until the reduced HCE ADP average passes the ADP test. The plan then converts the percentage reduction for each HCE into a dollar amount. The sum of the dollar amounts is the excess contribution amount.

b. Example: Assume the Company X 401(k) plan NHCE ADP is 4% and the HCE ADP is 7% (calculated below). Company X wishes to correct the ADP test violation by distributing excess contributions. The HCE data is as follows:

	Compensation	Deferral	ADP
Art	$150,000	$9,000	6%
Brad	$100,000	$8,000	8%

The HCE ADP average is 7%. Using the leveling method, the plan begins with Brad, the HCE with the highest deferral percentage. The plan must reduce Brad's ADP to 6%, which will result in an HCE average ADP of 6%, which will pass the ADP test. The plan then converts the percentage reduction (2%) in Brad's ADP to dollars. 2% of Brad's compensation is $2,000. The corrective distribution amount is $2,000.

c. The plan determines the *total amount* of the excess contributions under the "highest percentage" leveling method described above, but the plan must apportion the excess contributions among the HCEs based on the *highest dollar amount of elective contribution* by each HCE.

d. Example: In the prior example, the plan first apportions excess contributions to *Art,* not Brad, because Art is the HCE with the highest deferral dollar. Using the leveling method, the plan first apportions $1,000 to Art, which reduces Art's deferral dollars to the amount of Brad's deferrals. Then the plan apportions equally to Art and to Brad until the plan has apportioned the remaining $1,000 of excess contributions so that each receives $500. Therefore, Art's total excess contribution distribution is $1,500 (plus allocable income); Brad's total excess contribution distribution is $500 (plus allocable income).

e. If the excess contribution is distributed within 2-1/2 months after the close of the plan year, the corrective distribution generally is includable in income on the earliest date(s) the employee would have received cash compensation in the absence of his election (i.e., the prior calendar year in the case of a calendar year plan). If the excess contribution is distributed after 2-1/2 months following the close of the plan year, the corrective distribution generally is includable in income in the taxable year in which distributed and the employer must pay a 10% excise tax.

4. Recharacterization. A plan may correct excess contributions by recharacterizing them as after-tax employee contributions, subject to the ACP test. Because this usually triggers an ACP test failure, employers rarely use this method.

F. Matching Contributions. 401(k) plans frequently provide for employer matching contributions with respect to employee deferrals. Matching contributions are frequently offered to entice employees to make 401(k) elective deferrals so that HCEs can make larger deferrals and still pass the ADP test.

1. Types of Matching Contributions. A 401(k) plan can provide for a fixed matching contribution, a discretionary matching contribution, or both.

a. An example of a fixed matching contribution is 50% of the employee's deferral, not exceeding 5% of the employee's compensation.

b. In lieu of a fixed match, the plan can provide for a discretionary match under which the employer decides late in the year how much it can afford to match and this amount is allocated among the employees in proportion to their 401(k) deferrals (or the portion of their deferrals not in excess of a designated percentage of compensation). A discretionary match may not motivate NHCEs to defer as much as a fixed match would.

2. ACP Test. Matching contributions to a 401(k) plan must satisfy the actual contribution percentage (ACP) test under IRC § 401(m). The mechanics of the ACP test are generally the same as the ADP test that applies to 401(k) elective deferrals. That is, the average rate of matching contributions (expressed as a percentage of compensation) received by HCEs for the plan year is compared to the average rate of matching contributions (expressed as a percentage of compensation) received by NHCEs for the plan year. The ACP of the HCEs cannot exceed:

If NHCE ACP is:	Maximum HCE ACP is:
Less than 2%	2 X NHCE ACP
2% - 8%	2% + NHCE ACP
More than 8%	1.25 X NHCE ACP

a. If a 401(k) plan allows employees to make after-tax voluntary contributions to the plan (which few plans do), then these contributions also are included in the ACP test along with any matching contributions.

b. If a plan fails the ACP test, then there are several methods for correcting the failure.

i. QNECs. The employer may make QNECs to the NHCEs and may include them in performing the ACP test, provided that the same QNECs were not used to pass the ADP test.

ii. Corrective Distribution. The employer may make corrective distributions to HCEs. The corrective distribution process generally is the same as for the ADP test.

iii. "Moving" ADP. If the 401(k) deferrals satisfy the ADP test by more than the minimum amount, then the excess that is not needed to satisfy the ADP test may be credited to the ACP test.

Example:

	ADP	ACP
HCE	4.5%	2.5%
NHCE	3.5%	1.0%

The plan passes the ADP test with room to spare. Solely for testing purposes, the plan may credit .25% of the NHCE ADP to the ACP test. As a result, the ACP is 1.25%, which passes.

G. Vesting.

1. Elective Deferrals. An employee's 401(k) elective deferrals must be immediately vested and nonforfeitable. A vesting schedule cannot be applied to them.

2. Matching Contributions. Matching contributions (other than QMACs) to a 401(k) plan can be subjected to a vesting schedule. The vesting schedule must vest the employee at least as rapidly as either the 3-year cliff vesting schedule or the 6-year graded vested schedule. IRC § 411(a)(12).

H. 401(k) Distribution Restrictions. A 401(k) plan may not permit distribution of elective deferrals, QNECs, or QMACs before one of the distribution events enumerated in IRC § 401(k)(2)(b) and 401(k)(10). These 401(k) distribution restrictions do not apply to the employer's nonelective profit sharing contributions or matching contributions unless the plan so provides. The qualifying distribution events are:

1. Severance from Employment. Severance from employment means (a) the employee no longer is an employee of the employer maintaining the plan or of an affiliated employer, and (b) the employee's new employer does not maintain the plan of the former employer.

2. Death or Disability. The employee's death or disability.

3. Age 59½. The employee's attainment of age 59½.

4. Termination of Plan. Termination of the plan unless the employer maintains an "alternative defined contribution plan". An alternative defined contribution plan is a defined contribution plan (other than an ESOP, a SEP, or a SIMPLE) maintained or established by the same employer or an affiliated employer during the period beginning on the date of the plan termination and ending twelve (12) months after the date of final distribution of assets.

5. Hardship. The employee's hardship. A hardship distribution must be (a) on account of an immediate and heavy financial need of the employee, and (b) necessary to meet that need.

   a. The plan must include nondiscriminatory and objective criteria for determining hardship.

   b. The employer determines whether an employee has an immediate and heavy financial need on the basis of all relevant facts and circumstances.

   c. A plan may include deemed hardship standards which automatically establish an immediate and heavy financial need. Deemed hardship events consist of:

i. Medical expenses that would be deductible under IRC §213(d).

ii. Costs directly related to the purchase (excluding mortgage payments) of the employee's principal residence.

iii. The payment of tuition, related educational fees, and room and board for the next twelve (12) months of post-secondary education for the employee or the employee's spouse, children, or dependents.

iv. An amount necessary to prevent eviction from the employee's principal residence or foreclosure on the mortgage of the employee's principal residence.

v. Payments for burial or funeral expenses for the employee's deceased parent, spouse, child, or dependents.

vi. Expenses for repair of damage to the employee's principal residence that would qualify for a casualty deduction under IRC §165.

The save harbor hardship rules apply a necessity standard. On the basis of the facts and circumstances, the distribution may not exceed the amount necessary to relieve the financial need and the employee may not have other resources reasonably available to satisfy that need. The plan may deem the employee to have satisfied the necessity requirement if (a) the distribution is not in excess of the amount necessary to meet the need; (b) the employee has obtained all non-hardship distributions and nontaxable loans currently available under all plans maintained by the employer; and (c) all plans maintained by the employer suspend the employee's right to make elective contributions and after-tax employee contributions for at least six (6) months after the hardship distribution.

I. Suitability.

1. The 401(k) plan has become the plan of choice for many employers. Frequently, employers must offer a 401(k) plan option in order to attract and retain key employees. On the other hand, the 401(k) plan offers a means for the employer to provide a very meaningful retirement benefit at a modest employer cost, due to the fact that a significant portion of the benefit is funded by the employee's own contributions.

2. 401(k) plans are particularly suitable in very large companies and in companies with a stable, white collar workforce.

3. In smaller companies with high employee turnover or with a blue collar workforce, 401(k) plans often do not work very well, especially if the desire is to enable HCEs to make significant contributions. Frequently, due to the ADP test, the lack of participation by rank-and-file employees will severely limit the amount HCEs can contribute. In these companies, a SIMPLE IRA or a safe harbor 401(k) plan frequently will work better.

4. 401(k) plans often do not work well in professional firms having a large number of HCEs. Frequently, the level of participation by the staff will not support the level of contributions that the HCEs desire to make.

5. A 401(k) plan is not suitable for an employer that is administratively handicapped. There are numerous administrative requirements, such as employee salary reduction agreements, participant investment allocation elections, participant loan transactions (in plans that allow loans), maintenance of accurate employee census and compensation data, ADP and ACP testing, corrective distributions, distribution election forms, Form 5500 reporting, etc. A company that does not have the necessary support in bookkeeping and human resources frequently will find the operation of a 401(k) plan to be quite daunting and often will make errors that can lead to fines or plan disqualification. In these companies, a SIMPLE IRA frequently will work better.

X. <u>Solo 401(k) Plans</u>.

A. <u>Definition</u>. A Solo 401(k) plan, also called a Mini 401(k) plan or a Uni 401(k) plan, is simply a traditional 401(k) plan set up for a business that has, as its sole employee(s), the business owner and perhaps his or her spouse. It is subject to all of the rules discussed in Section IX.

B. <u>Enabling Provisions</u>. EGTRRA, in particular, made Solo 401(k) plans quite appealing to single employee businesses. Solo 401(k) plans can provide very significant benefits to business owners due to the following statutory and regulatory provisions:

1. <u>No ADP Testing</u>. A 401(k) plan that covers only HCEs is not subject to ADP testing or other form of discrimination testing. By definition, the sole owner of a business (whether a sole proprietorship, a corporation, or an LLC) is a HCE, and the owner's spouse also is a HCE by attribution.

2. Increased 401(k) Deferral Limits. The elective deferral limit is $15,000 per year plus $5,000 catch-up for participants age 50 and over.

3. Increased Annual Addition Limits. A participant's § 415 annual addition limit is the lesser of 100% of compensation or $44,000 (for 2006) plus the $5,000 catch-up contribution.

4. Increased Deduction Limit. The employer's deduction limit is now 25% of participant compensation plus 401(k) deferrals.

C. Example. Company X, a consulting firm, has two employees: John (the owner) and his wife Sue. John is 52 years of age and Sue is 50. For 2006, John expects to pay $50,000 to Sue, leaving about $200,000 of profit available to make retirement plan contributions or to compensate himself. John sets up a profit sharing plan with a 401(k) feature for himself and Sue. For 2006, the contributions are as follows:

Employee	Comp.	Profit Sharing	401(k)	Catch-up	Total
John	$160,000	$29,000	$15,000	$5,000	$49,000
Sue	$ 50,000	$ 9,063	$15,000	$5,000	$29,063
					$78,063

1. The total contribution is deductible, since the profit sharing contribution is about 18% of compensation (less than 25% of compensation plus 401(k) deferral limit.

2. John's $49,000 is equal to his annual addition limit (lesser of 100% of comp or $44,000 plus catch-up). Sue's is within her annual addition limit as well, even though her total contribution is almost 60% of her compensation.

3. John and Sue have deferred 31% of the total $250,000 available for distribution.

D. Example. Jim is age 51. His wife has a lucrative career. Jim runs a small company having total profits available for distribution in 2006 of $30,000. Jim wants to defer the maximum amount possible to a retirement plan. Jim sets up a 401(k) profit sharing plan for this purpose and makes the following contributions:

Comp.	Profit Sharing	401(k)	Catch-up	Total
$24,000	$6,000	$15,000	$5,000	$26,000

1. The total contribution is deductible, since the profit sharing contribution is 25% of compensation not including the 401(k) deferral and catch-up.

2. Jim's $26,000 is less than his annual addition limit (lesser of 100% of comp or $44,000 plus catch-up). The catch-up contribution is not counted in determining whether the annual addition limit is exceeded.

3. Jim has deferred 87% of the $30,000 available for distribution.

E. Suitability. The solo 401(k) plan works very well in any situation involving a single owner/employee business that has no employees other than the business owner and his or her spouse. The plan is simple to administer, since no ADP testing is required. In addition, the annual IRS reporting is greatly simplified by using Form 5500-EZ.

XI. Safe Harbor 401(k) Plans.

A. Definition. A safe harbor 401(k) plan is a 401(k) plan that provides for a "safe harbor" employer contribution in an amount specified by the Internal Revenue Code in order to avoid ADP discrimination testing. HCEs in a safe harbor 401(k) plan can make the maximum annual 401(k) deferral ($15,000 plus $5,000 catch up in 2006) without fear of making excess deferrals that otherwise would have to be reimbursed. The safe harbor contribution eliminates ADP and ACP testing when the plan satisfies the safe harbor requirements. IRC § 401(k)(12).

B. Safe Harbor Contribution Requirements. A safe harbor 401(k) plan must provide for a fixed minimum employer contribution each year.

1. The safe harbor contribution cannot be subject to "accrual requirements" that require an employee to have 1,000 hours and/or be employed on the last day of the plan year in order to receive the contribution. All eligible employees who participate in the plan during the year must receive the safe harbor contribution.

2. The safe harbor contributions and the earnings thereon must be accounted for in a separate safe harbor contributions account in the plan.

3. The safe harbor contributions account must be immediately 100% vested.

4. The safe harbor contributions account must be subject to the distribution restrictions applicable to 401(k) elective deferrals (termination of employment, age 59-1/2, death, disability, hardship).

5. Technically, the safe harbor contributions are only required to be made for eligible NHCEs. However, as a practical matter, employers that makes safe harbor contributions typically will do so for all eligible employees, whether HCEs or NHCEs, since this is permitted and is deemed nondiscriminatory without any testing requirement.

6. A safe harbor plan must satisfy the employee notice requirement discussed in Section E below.

C. Safe Harbor Contributions. A safe harbor 401(k) plan must provide, for the entire plan year, either a safe harbor nonelective contribution or a safe harbor matching contribution.

1. Safe Harbor Nonelective Contribution. If the employer chooses to satisfy the safe harbor with a safe harbor nonelective contribution, the employer must make a contribution to the plan equal to 3% of the compensation of each eligible NHCE employee, regardless of whether or how much the employee elects to defer.

2. Safe Harbor Matching Contribution. In lieu of making a safe harbor nonelective contribution, the employer can make a safe harbor matching contribution.

a. Basic Match. The employer must make a matching contribution to each NHCE equal to (a) 100% of the employee's elective deferrals (if any) up to 3% of his compensation, plus (b) 50% of the employee's elective deferrals (if any) between 3% and 5% of his compensation.

b. Enhanced Match. In lieu of the basic match, the employer can provide a matching contribution that, at any rate of elective deferrals, is at least equal to what the employee would have received under the basic match, so long as the rate of match doesn't increase as the rate of elective deferrals increases.

i. For example, the employer can provide a matching contribution equal to 100% of the employee's deferrals up to 4% of his compensation.

ii. Alternatively, the employer can provide a matching contribution equal to 150% of the employee's deferrals up to 3% of compensation.

c. ACP Safe Harbor. A plan that satisfies the ADP test using the 3% nonelective contribution is not subject to ACP testing. However, all matching contributions, even if used to satisfy the ADP test, must satisfy a separate ACP safe harbor to avoid ACP testing.

i. Basic Match. A plan that satisfies the ADP test safe harbor using the basic match and that does not provide any other matching contribution automatically satisfies the ACP test safe harbor.

ii. Enhanced Match. A plan that satisfies the ADP test safe harbor using an enhanced match will automatically satisfy the ACP safe harbor if the plan (a) does not match elective deferrals exceeding 6% of compensation and (b) does not provide any other matching contribution.

1. For example, a plan that matched 100% of elective deferrals up to 8% of compensation would satisfy the ADP safe harbor but would be subject to ACP testing.

D. Other Matching Contributions; ACP Safe Harbor. A plan that satisfies the ADP test safe harbor (using either the nonelective or matching alternative) also may provide for other matching contributions that are not designed to satisfy the ADP safe harbor. These additional matching contributions will satisfy the ACP test safe harbor if:

1. The additional match is available on elective deferrals not exceeding 6% of compensation;

2. The rate of match does not increase as the rate of elective deferrals increases; and

3. The rate of match at any rate of elective deferrals is not greater for any HCE than it is for any NHCE.

Example: A plan satisfies the ADP safe harbor using the 3% nonelective contribution alternative. The plan also provides a match equal to 50% of an employee's deferrals up to 6% of compensation. The plan automatically satisfies the ACP test safe harbor.

The match may be discretionary and still satisfy the ACP test safe harbor if the match, in the aggregate, cannot exceed 4% of an employee's compensation. In the foregoing example, if the matching contribution were

a discretionary match that disregarded deferrals in excess of 6% of compensation and capped the discretionary matching amount for any participant at 4% of compensation, the plan would satisfy the ACP test safe harbor.

A matching contribution may satisfy the ACP test safe harbor even if it is subject to a vesting schedule (and even though it is not subject to the 401(k) distribution restrictions), so long as it is not used to satisfy the ADP safe harbor. However, under the final 401(k) regulations, a match that is subject to accrual requirements (1,000 hours of service or last day of plan year) cannot qualify for the ACP safe harbor.

E. Employee Notice Requirement. In order to take advantage of the safe harbor provisions and avoid ADP and ACP testing, the employer must provide a safe harbor notice to eligible employees within a reasonable time before the beginning of the plan year. The employer will be deemed to satisfy this requirement if the notice is provided at least 30 days and not more than 90 days before the beginning of the plan year. Failure to give proper notice within this time frame is fatal to the application of the safe harbor. The safe harbor notice must, at a minimum, set forth:

1. The safe harbor matching or nonelective contribution formula used by the plan.

2. Any other required or discretionary contributions.

3. The type and amount of compensation that may be deferred.

4. The procedure for making elective deferrals.

5. The withdrawal and vesting provisions applicable to plan contributions.

6. Where a participant can obtain additional information about the plan.

F. Plan Year. The plan year of a safe harbor 401(k) plan generally must be for a full 12 months.

1. An existing 401(k) plan cannot be amended to include safe harbor 401(k) provisions effective in the middle of a plan year. The plan must be amended effective as of the first day of the following plan year.

2. An employer that does not already have a 401(k) plan can adopt a new safe harbor 401(k) plan in mid-year, so long as the short plan year is at least 3 months.

3. An employer maintaining a profit sharing plan without 401(k) provisions may amend the plan mid-year to add safe harbor 401(k) provisions, so long as the short plan year is at least 3 months.

4. An employer may change the plan year of a safe harbor 401(k) plan and may terminate a safe harbor 401(k) plan mid-year.

G. Suitability.

1. A safe harbor 401(k) plan is suitable for employers with a large number of HCEs relative to NHCEs, since otherwise the deferrals available to HCEs typically will be severely limited based on the NHCE deferrals.

2. A safe harbor 401(k) plan is very suitable for professional firms (doctors, attorneys, CPAs), especially where the employer maintained a retirement plan previously.

3. Example: CPA firm has 10 employees, 4 of whom are partners. The firm has maintained a profit sharing plan providing, on average, for a 5% annual contribution for all employees. The partners determined in the past that a 401(k) plan was not feasible due to anticipated lack of participation by the staff.

For 2007, the firm amends its profit sharing plan into a safe harbor 401(k) plan providing for a 3% nonelective safe harbor contribution. In addition, the firm agrees to make a matching contribution equal to 50% of each employee's deferrals up to a maximum of 6% of compensation.

For 2007, the plan participation is as follows:

Employee	Comp.	Safe Harbor Nonelective	401(k) Deferral	Catch Up	Match	Total Contrib
A	$220,000	$6,600	$15,000	$5,000	$6,600	$33,200
B	210,000	6,300	15,000	5,000	6,300	32,600
C	200,000	6,000	15,000	5,000	6,000	32,000
D	180,000	5,400	15,000		5,400	25,800
E	80,000	2,400	8,000		2,400	12,800
F	60,000	1,800	3,000		1,500	6,300
G	45,000	1,350	2,000		1,000	4,350
H	40,000	1,200	2,000		1,000	4,200
I	35,000	1,050	0		0	1,050
J	35,000	1,050	0		0	1,050

Under the old 5% profit sharing plan, the firm would have contributed $14,750 for non-partners, and Partner A (for example) would have received a contribution of $11,000. Under the safe harbor plan, the firm contributes $14,750 for non-partners, but the partners' contributions are tripled. The plan uses the ADP and ACP safe harbors, and it is excused from the ADP/ACP testing requirements (which it would have failed miserably!).

XII. DASH Plans.

A. Definition. DASH (meaning Double Advantage Safe Harbor) is a term of art used in the retirement plan sales industry to describe a cross-tested profit sharing plan with safe harbor 401(k) provisions.

B. Double Advantage. The "double advantage" of the DASH plan is that the employer's 3% nonelective safe harbor contribution is also credited to the minimum gateway contribution that is required as a condition to using cross-testing. In other words, the 3% safe harbor contribution will enable the plan to avoid ADP discrimination testing of 401(k) elective deferrals and will also count toward the employer contribution threshold that is required to be met in order to test employer contributions to a classification of HCEs for discrimination using the cross-testing regulations under IRC § 401(a)(4).

C. Suitability. DASH plans are frequently established in professional firms and other companies with a disproportionate number of HCEs in order to take advantage of cross-testing and also accommodate 401(k) elective deferrals.

XIII. Roth 401(k) Plans.

A. Definition. A Roth 401(k) plan is a 401(k) plan that gives each participant the option to make either traditional pre-tax 401(k) deferrals or Roth after-tax 401(k) contributions.

B. Roth 401(k) in General.

1. Congress enacted new IRC § 402A as part of EGTRRA , establishing the Roth 401(k) plan. Under EGTRRA, the Roth 401(k) provisions were set to expire after 2010 if not extended. The Pension Protection Act of 2006 made the Roth 401(k) permanent.

2. Proposed regulations for Roth 401(k) plans were issued in March of 2005. On January 3, 2006, the IRS issued final Roth 401(k) regulations, effective for plan years beginning on or after January 1, 2006. On January 26, 2006, the IRS issued proposed regulations regarding Roth taxation deferral issues.

3. Plans adopting Roth 401(k) provisions must be amended by the last day of the plan year in which the Roth provisions are effective.

B. Roth 401(k) Contributions.

1. A participant may designate 401(k) contributions as regular pre-tax deferrals or as Roth 401(k) contributions. Once made, the designation is irrevocable. Each participant must be given a choice between regular 401(k) and Roth 401(k) contributions – the plan cannot limit deferrals to Roth contributions.

2. Aggregate deferrals to a Roth 401(k) plan (including Roth 401(k) contributions) cannot exceed the $15,000 402(g) limit plus the $5,000 catch up.

   a. There is no AGI limit on the ability to make Roth 401(k) contributions.

   b. Therefore, in 2006, a 50 year old participant can make $20,000 of Roth 401(k) contributions, subject to passing the ADP test.

3. Roth 401(k) contributions are included in wages when made – normal withholding applies.

4. A Roth 401(k) plan must separately account for Roth 401(k) contributions and earnings.

5. Roth 401(k) contributions are included in the ADP test, unless the plan is a safe harbor plan excused from ADP testing.

6. A Roth 401(k) plan providing for matching contributions must match Roth 401(k) contributions to the same extent as regular 401(k) deferrals.

C. Distributions.

1. Roth 401(k) distributions can be rolled over to another Roth 401(k) or to a Roth IRA – not to a regular 401(k) or IRA.

2. Roth 401(k) contributions are subject to the regular 401(k) distribution restrictions:

   a. Separation from employment.

   b. Age 59 ½.

c. Death or disability

d. Plan termination.

e. Hardship (contributions only – not earnings)

3. However, if a distribution of Roth contributions is not a "qualified distribution", the earnings are taxed. A qualified distribution is a distribution:

   a. Made after age 59 ½, death, or disability; and

   b. Made at least 5 years after the earlier of (i) the first taxable year Roth contributions are made to the plan, or (ii) if Roth 401(k) contributions were rolled over to the plan from another Roth 401(k) plan, the first taxable year for which the employee previously made a Roth 401(k) contribution.

   Therefore, hardship distributions before age 59½ are not tax-free as to earnings – contributions are still tax-free. The proposed regulations provide for <u>pro rata basis recovery</u> for each nonqualified distribution.

4. Distributions of excess deferrals (402(g)) and excess contributions by HCEs (ADP) are never qualified distributions. Returned Roth contributions are tax-free but the allocable earnings are taxed.

   a. If a participant has both a regular 401(k) account and a Roth 401(k) account, the plan can allow the participant to choose the source of the refund.

5. If an employee has both a Roth 401(k) account and a regular 401(k) account, the accounts are treated as separate accounts for purposes of taxation – the employee (to the extent allowed by the plan) can receive a nontaxable Roth distribution without receiving a taxable distribution from his regular 401(k) account.

6. Roth 401(k) plans are subject to the normal lifetime required minimum distribution rules under IRC § 409A. Roth <u>IRAs</u> are not.

   a. However, to avoid lifetime MRDs of Roth contributions, a participant who is eligible to receive distributions from the plan can roll the Roth contributions and allocable earnings into a Roth IRA before the

required beginning date.

D. Implementation by Plan Sponsor. To implement a Roth 401(k) plan, an employer must:

1. Modify its salary deferral election form, distribution form, and safe harbor notice form.

2. Establish fields in its payroll system for tracking Roth and pre-tax deferrals.

3. Establish fields in its plan accounting system to track Roth deferrals, earnings, distributions, etc.

4. Create a system for tracking the 5-year holding period for determining qualified distributions.

5. Adopt an appropriate Roth 401(k) amendment by the end of the plan year in which the Roth provisions are effective.

6. Track distributions from Roth accounts and from pre-tax accounts.

7. Modify its 402(f) special tax notice to explain Roth 401(k) distribution, rollover, and taxation issues.

E. Suitability.

1. If a participant spends the current tax savings from regular 401(k) deferrals, the forced savings imposed by the Roth 401(k) contributions will beat regular 401(k) deferrals every time.

2. If a participant saves the tax savings from regular 401(k) in a taxable side fund, whether the regular 401(k) contribution or the Roth 401(k) contribution is more advantageous will depend on (a) the tax bracket of the participant at time of deferral versus the time of retirement and (b) the length of the deferral period.

3. Example. How does the Roth 401(k) stack up against the traditional 401(k)? That depends on a few key factors: how long you have to invest, whether your tax rate will change in retirement, and whether you invest or spend the annual tax savings you get if you fund a traditional 401(k), thanks to its pre-tax contributions. The examples below assume an investor starts out in the 28% tax bracket earning $100,000, gets a 3% annual raise, and contributes 6% of his annual salary to a traditional 401(k) or a Roth 401(k), earning an

average annual 8.5%. Here's how much the investor would have after taxes under various circumstances:

Assuming the same 28% tax rate before and after retirement:

Years	401(k)	Tax Savings	Total	Roth 401(k)	How the Roth Stacks up* (w/savings)	How the Roth Stacks up* (w/out savings)
5	$53,007	$19,252	$72,259	$73,621	1.9%	38.9%
10	$141,155	$48,228	$189,383	$196,049	3.5%	38.9%
35	$1,085,025	$212,927	$1,297,953	$1,506,979	16.1%	38.9%

Assuming your tax rate drops to 15% from 28% in retirement:

Years	401(k)	Tax Savings	Total	Roth 401(k)	How the Roth Stacks up* (w/savings)	How the Roth Stacks up* (w/out savings)
5	$62,578	$19,252	$ 81,830	$ 73,621	-10.0%	17.6%
10	$166,641	$48,228	$214,869	$196,049	-8.8%	17.6%
35	$1,280,933	$212,927	$1,493.860	$1,506,979	0.9%	17.6%

Assuming your tax rate rises to 33% from 28% in retirement:

Years	401(k)	Tax Savings	Total	Roth 401(k)	How the Roth Stacks up* (w/savings)	How the Roth Stacks up* (w/out savings)
5	$49,326	$19,252	$68,578	$73,621	7.4%	49.3%
10	$131,353	$48,228	$179,581	$196,049	9.2%	49.3%
35	$1,009,676	$212,927	$1,222,604	$1,506,979	23.3%	49.3%

*Percentage higher or lower than traditional 401(k) with tax savings or without tax savings
Note: For traditional 401(k)s, these examples assume a lump-sum distribution at the retirement tax rate.

XIV. Employee Stock Ownership Plans (ESOPs).

A. Definition. An ESOP is a qualified plan designed to invest primarily in the employer's securities and thus provide participants with an ownership interest in their employer. An ESOP is typically a profit sharing plan with special ESOP provisions. The plan must satisfy all of the requirements generally applicable to profit sharing plans as well as several requirements specifically applicable to ESOPs. ESOPs can serve a number of objectives, such as:

1. Borrowing at a reduced after-tax cost.

2. Solving ownership succession issues and providing a business owner a tax-favored means of selling the business to employees.

3. Financing acquisitions.

4. Providing employees with an incentive for productivity.

5. Eliminating federal income taxes at both corporate and shareholder levels.

Not all plans that own employer securities are ESOPs. It is not uncommon for regular profit sharing plans or 401(k) plans to own employer securities. However, only an ESOP is eligible for the exemption from the prohibited transaction rules that allows for ESOP financing (discussed below).

B. Specific ESOP Requirements.

1. Designed to Invest Primarily in Employer Securities. An ESOP must be designed to invest primarily in "employer securities". However, there is no quantitative standard applicable to this requirement, and this requirement generally will be satisfied if a significant portion of plan assets are invested in employer securities.

a. "Employer securities" means common stock issued by an employer which is either publicly traded or which has a combination of voting power and dividend rights equal to or exceeding the class of common stock having the greatest voting power and dividend rights. IRC § 409(l).

b. Employer securities include stock issued by a member of the employer's controlled group of corporations.

c. A partnership, including an LLC taxed as a partnership, cannot create an ESOP.

2. Voting Rights. If an ESOP owns publicly traded stock, the ESOP must permit each participant to direct the voting of shares allocated to the participant's account. If an ESOP owns non-publicly traded stock, then the trustee of the plan votes all of the stock, except that voting rights must be passed through to participants in the case of mergers, sales of all or substantially all of assets, recapitalizations, liquidations, and dissolutions. IRC § 409(e).

3. Distribution Requirements. Unless an ESOP provides for a mandatory earlier distribution date, an ESOP must give each participant an election to commence distributions:

   a. Not later than one year after the end of the plan year in which the participant terminates employment due to death or retirement on or after the plan's normal retirement age or disability; and

   b. Not later than one year after the end of the fifth plan year following the end of the plan year in which the participant terminates for some other reason. IRC § 409(o)

   Unless a participant elects otherwise, once the participant's account is distributable, it must be distributed in equal periodic payments (at least annually) over a period not exceeding five years (unless the account exceeds $800,000, in which case the distribution period is increased).

4. Right to Demand Employer Securities; Put Option.

   a. An ESOP must provide that a participant who is entitled to receive a distribution may demand that his benefits be distributed in the form of employer securities. IRC § 409(h). Absent a demand for a stock distribution, benefits may be distributed in cash.

   b. However, if the employer's charter or bylaws restrict ownership of employer securities to employees or the ESOP, or if the employer is an S corporation, the ESOP (i) may distribute all benefits in cash without granting a demand right, or (ii) may distribute stock subject to a buy-sell option in favor of the employer.

   c. If an ESOP distributes non-publicly traded stock, then the plan must give the participant the option to require the employer to purchase the stock under a fair valuation formula to be determined by an independent appraiser. The purchase price must be paid in cash or in installments over a period not exceeding five years. If paid in

installments, the payment must be adequately secured and bear a reasonable rate of interest.

i. A closely-held company that establishes an ESOP must consider the liquidity needs which will arise in the future and the repurchase liability the ESOP will create. In other words, the company must plan to purchase the stock twice – once when the ESOP initially acquires the stock and again when participants are paid out.

5. Diversification.

a. ESOPs must provide participants who are at least 55 years old and who have at least 10 years of plan participation the option to diversify their plan holdings into assets other than employer stock. Under these rules, the plan must permit a qualifying participant to direct the investment of at least 25% of his account into other investment options during the 5-year period following the plan year in which he qualifies for diversification. This increases to 50% during the 5th year of the 5-year period. IRC § 401(a)(28).

b. An ESOP may satisfy the diversification election in two ways:

i. The plan may distribute the portion of the participant's account subject to the election.

ii. The plan may provide at least three investment options other than employer stock.

6. Annual Additions. If no more than 1/3rd of the contributions to an ESOP are allocated to HCEs, then contributions that are used to pay interest on a loan obtained by the ESOP to purchase employer securities, as well as forfeitures allocated to remaining participants of employer securities acquired with the loan, are excluded from the calculation of the annual addition limitation applicable to each participant (lesser of $44,000 or 100% of compensation). IRC § 415(c)(6).

7. ESOP Contribution Deductions. Under IRC § 404(a)(9), there is no limit on a C Corporation employer's deduction for contributions to an ESOP used to repay interest on an exempt loan. This does not apply to a S Corporation, so the normal 25% deduction limit applies.

8. Independent Appraiser. Under IRC § 401(a)(28), an ESOP that holds non-publicly traded employer securities must have valuations performed (at least annually) by a qualified independent appraiser. Proper valuation of employer securities contributed or sold to an ESOP is an important aspect of plan administration.

9. ESOP Loan Exemption.

   a. The prohibited transaction rules generally prohibit any direct or indirect lending of money or other extension of credit between a plan and a related party.

   b. ERISA 408(b)(3) and IRC § 4975(d)(3) allow an ESOP to borrow money using a direct loan, loan guaranty, or installment sale from a related party (including the employer or a stockholder of the employer) to effect its acquisition of employer stock.

      i. An ESOP can borrow money from the employer to purchase employer securities.

      ii. An ESOP can purchase stock from an individual stockholder of the employer under an installment sale arrangement

      iii. An employer sponsoring an ESOP can guarantee a bank loan obtained by the ESOP to purchase employer securities.

   The ESOP prohibited transaction exemption distinguishes an ESOP from other plans that invest in employer stock and enables the ESOP to be a tool of corporate finance.

   c. To be exempt, a ESOP loan must be used to acquire employer securities or to refinance a prior exempt loan. Any collateral pledged by the ESOP must be limited to the shares acquired with the proceeds of the loan. Any such pledged shares must be released from the pledge on a pro rata basis as the loan is repaid. The ESOP's liability for repayment of the loan must be limited to (i) the employer securities given as collateral, (ii) contributions made to the ESOP for loan repayment purposes, (iii) earnings on such contributions and collateral, and (iv) dividends paid on employer securities owned by the ESOP.

10. Allocation of Employer Securities. Employer securities acquired by an ESOP must be allocated to participant accounts unless the securities are acquired

with the proceeds of an exempt loan. Employer securities acquired with an exempt loan are placed in a suspense account. As the loan is paid down, a pro rata amount of the securities in the suspense account must be released and allocated to participant accounts under a release schedule set forth in the regulations.

11. Deduction of Dividends. A C corporation may deduct dividends paid on employer securities held by an ESOP so long as the dividends paid are either:

    a. Paid in cash directly or through the ESOP to ESOP participants;

    b. Reinvested in employer securities, provided that participants were first given the option to receive the dividends in cash; or

    c. Used to repay an ESOP loan to the extent the loan was used to acquire the stock on which the dividends are paid.

C. IRC § 1042 – Tax Deferred Rollover Treatment on Sales to ESOPs.

1. Generally. IRC § 1042 generally provides that no gain will be recognized by a taxpayer on certain sales of stock to an ESOP if the seller reinvests an amount equal to the proceeds in "qualified replacement property". Instead, the seller's tax basis in the stock sold to the ESOP carries over to the qualified replacement property.

2. Qualified Securities. To qualify under § 1042, the stock must be employer securities issued by a domestic C corporation (not an S corporation) that does not have (and is not a member of a controlled group that has) publicly-traded stock outstanding. Also, the stock must not have been received by the seller in a distribution from a qualified plan or pursuant to an option or other right to acquire stock to which Section 83, 422, or 423 applied.

3. 30% Test. To qualify under § 1042, immediately after the sale, the ESOP must own at least 30% of each class of outstanding stock of the corporation, or at least 30% of the value of all outstanding stock of the corporation. Straight preferred stock is excluded, but options to acquire stock are included.

4. Qualified Replacement Property. The seller must acquire "qualified replacement property", which is defined as stock, rights to acquire stock, bonds, debentures, notes, or other evidence of indebtedness issued by a domestic operating corporation. Securities issues by a government or political subdivision are excluded. To be considered a domestic operating corporation, (a) more than 50% of a corporation's assets must be used in the

active conduct of a trade or business, and (b) the corporation may not have passive income exceeding 25% of its gross receipts. A real estate investment company can qualify if the company is actively involved in developing and managing properties.

5. Replacement Period. To qualify under § 1042, the seller must effect the reinvestment within a 15 month period beginning three months before the sale and ending 12 months thereafter. There is no tracing of proceeds, so there is no requirement that the actual funds received be invested.

   a. If the sale to the ESOP is done on an installment basis, the 15-month period still starts three months before the sale. This may force the seller to buy qualified replacement property equal to the total amount realized long before he or she has received full payment. For this reason, installment sellers often arrange to purchase bonds on margin to satisfy their qualified replacement property requirements.

6. Prohibited Allocation Rule. IRC § 409(n)(1) prohibits the allocation of employer securities acquired by an ESOP in a sale to which § 1042 applies for the benefit of the seller, his family members, or 25% stockholders of the corporation within the 10 year period following the later of (a) the date of the sale, or (b) the final payment of the acquisition indebtedness incurred in connection with the sale.

7. Excise Tax. In most cases, the corporation maintaining the ESOP must pay a 10% excise tax if it disposes of the shares purchased in a § 1042 transaction within three years following the date of the acquisition. IRC § 4978.

D. S Corporation ESOPs.

1. ESOP Ownership. IRC § 1361 permits ESOPs to be S corporation shareholders. An ESOP is considered a single stockholder, regardless of the number of participants in the plan.

2. Advantage of S Corporation ESOPs. An S corporation ESOP enables the ESOP participants to receive tax-free S corporation earnings:

   a. There is no corporate tax on S corporation earnings under the S corporation rules.

   b. The S corporation earnings allocated to the ESOP are not taxed, since the ESOP is a tax exempt entity.

Example: Kindermusik International is a 100% ESOP-owned company. The company pays no tax on its earnings because it is an S corporation. The ESOP pays no tax on its 100% shares of the earnings because it is a tax-exempt entity. No tax is paid until a terminated participant receives a distribution of his or her accrued benefits in the ESOP, which can be further deferred by rollover to an IRA.

3. Special Tax Provisions applicable to S Corp ESOPs. The following special tax provisions apply to S Corporation ESOPs:

   a. Under IRC § 404(a)(9), there is no limit on a C Corporation employer's deduction for contributions to an ESOP used to repay interest on an exempt loan. This does not apply to a S Corporation, so the normal 25% deduction limit applies.

   b. An S Corporation cannot deduct dividends paid on employer securities held in an ESOP. IRC § 404(k)(1).

   c. Gain on the sale of S corporation stock to an ESOP cannot be rolled over under IRC § 1042.

   d. An ESOP is not subject to unrelated business income tax on the ESOP's share of S corporation earnings. IRC § 512(e).

   e. Under IRC § 409(h)(2), an S corporation ESOP may deny participants the right to demand their distributions in the form of employer securities in the same manner as a corporation whose charter or bylaws restrict ownership to current employees (thus enabling the S corporation to protect its S election).

   f. S Corporation ESOPs are prohibited from allocating S corporation stock to certain disqualified stockholders. (see Section 4 below).

4. Prohibited Allocations of Employer Securities in an S Corporation ESOP.

   a. The prohibited allocation rules are intended to limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as HCEs and owners. Congress was concerned with two potential types of abuse:

      i. A professional puts his business into an S corporation, which establishes an ESOP to acquire all of the shares and employs

the professional as its sole employee. All of the professional's earnings would be tax-free except to the extent paid out in salary.

ii. The owner of an S corporation with 1,000 outstanding shares sells 10 of them to an ESOP and converts the remaining 990 shares into warrants. The corporation can now grow quickly on a tax-free basis. Shortly before the corporation is sold many years from now, the owner exercises the warrants and captures 99% of the value of the corporation's tax-free growth.

b. Under IRC § 409(p), an S corporation ESOP must provide that no portion of the ESOP's assets consisting of or attributable to employer securities can accrue or be allocated to the benefit of a "disqualified person" during a "non-allocation year". A plan that fails to meet this requirement is disqualified as an ESOP.

c. A person is a "disqualified person" if he is either (i) a member of a "20% shareholder group" or (ii) a "deemed 10% shareholder".

i. A person is a member of a deemed 20% shareholder group if the aggregate number of "deemed-owned shares" of the person and his family members is at least 20% of the number of deemed-owned shares in the corporation.

ii. A person is a deemed 10% shareholder is he is not a member of a deemed 20% shareholder group and the number of his deemed-owned shares is at least 10% of the number of deemed-owned shares in the corporation.

iii. "Deemed-owned shares" means (a) stock allocated to the account of an individual under the ESOP, and (b) an individual's share of any unallocated stock held by the ESOP. Deemed-owned shares includes "synthetic equity", such as stock options, stock warrants, restricted stock, and stock appreciation rights.

d. A "non-allocation year" is any plan year during which disqualified persons own either (i) at least 50% of the outstanding shares of the S corporation (including deemed-owned shares), or (ii) at least 50% of the sum of the outstanding shares of the S corporation (including deemed-owned shares) plus the shares of synthetic equity.

E. Leveraged ESOP Transactions.

1. Description of Leveraged Transactions. The key characteristic of a leveraged ESOP is that it may borrow money to purchase employer securities using credit from a party in interest, which otherwise would be prohibited by the prohibited transaction rules. Normally, loans to the plan will be from the employer or the selling stockholder or guaranteed by the employer because the only collateral the plan may give the lender are the securities purchased with the loan proceeds. The employer's guarantee will sometimes be supplemented by a promise to make annual cash contributions to the plan sufficient to amortize the loan. By virtue of (a) the unlimited deduction for contributions used to repay interest, (b) the general 25% deduction limit, and (c) the deductibility of dividends applied to repay an ESOP loan, an employer generally can repay all principal and interest on a tax-deductible basis.

   The basic leveraged ESOP financing transaction is as follows:

   a. The employer establishes an ESOP.

   b. The employer or selling shareholder contracts to sell to the ESOP and the leveraged ESOP contracts to purchase an agreed-upon number of the employer's shares at their fair market value.

   c. The ESOP borrows the money to purchase the shares from a bank or other lender, thereby becoming a leveraged ESOP. Generally, the employer borrows funds from the lender and, in turn, lends the loan proceeds to the leveraged ESOP. This avoids the need for the lender to comply with the many restrictions on ESOP exempt loans. Alternatively, the loan may be made directly to the ESOP and guaranteed by the employer, and the securities to be purchased with the loan proceeds are pledged as collateral.

   d. The leveraged ESOP pays the loan proceeds to the employer or selling shareholder in payment for the shares it has contracted to purchase.

   e. In future years, the employer will make contributions and dividend payments to the leveraged ESOP in the amount needed to repay loan principal and interest.

   The result of the transaction described above is that the employer or selling shareholder has received the loan proceeds and the leveraged ESOP has received the employer securities. In future years the employer will make

deductible payments to the leveraged ESOP which, in turn, will repay the loan.

2. Comparison of Leveraged ESOP Financing with Debt Financing. It has been suggested that the chief advantage of leveraged ESOP financing over regular debt financing is that the principal (as well as the interest) payments are deductible. For example, assume a corporation wishes to raise $1 million and can obtain conventional debt financing, repayable over 10 years in equal annual installments of principal plus interest at the annual rate of 8%. Further assume that the fair market value of the corporation's stock is $10 per share and the corporation is in the 34% income tax bracket. The effect of conventional borrowing is summarized in Table A below.

TABLE A

Direct Borrowing by Corporation
No ESOP (000 omitted)

Year	Payments to Corporation	Payments by Corporation Cash	Stock	Cash Value of Deductions	After-Tax Cash Cost
1	$1,000	$ 180	- -	$27.20	$152.80
2	- -	$ 172	- -	$24.48	$147.52
3	- -	$ 164	- -	$21.76	$142.24
4	- -	$ 156	- -	$19.04	$136.96
5	- -	$ 148	- -	$16.32	$131.68
6	- -	$ 140	- -	$13.60	$126.40
7	- -	$ 132	- -	$10.88	$121.12
8	- -	$ 124	- -	$8.16	$115.84
9	- -	$ 116	- -	$5.44	$110.56
10	- -	$ 108	- -	$2.72	$105.28
	$1,000	$1,440	- -	$149.60	$1,290.40

Table A shows that over the 10-year period, the employer receives $1,000,000 (the loan proceeds), repays the lender $1,440,000 ($1,000,000 principal plus $440,000 interest) and receives $440,000 in interest deductions (with a cash value of $149,600 to a 34% bracket taxpayer), for a total after-tax cash cost of $1,290,400.

If, instead of engaging in conventional debt financing, the employer uses a leveraged ESOP financing transaction, the employer will receive the proceeds of the loan in return for transferring 100,000 shares of its stock to the leveraged ESOP. In future years, the employer must make contributions to the ESOP to amortize the loan. Table B below summarizes the effect of the transaction.

TABLE B

Borrowing by Leveraged ESOP
(000 omitted)

Year	Payments to Corporation	Payments by Corporation Cash	Stock	Cash Value of Deductions	After-Tax Cash Cost
1	$1,000	$ 180	1,000	$61.20	$118.80
2	- -	$ 172	- -	$58.48	$113.52
3	- -	$ 164	- -	$55.76	$108.24
4	- -	$ 156	- -	$53.04	$102.96
5	- -	$ 148	- -	$50.32	$97.68
6	- -	$ 140	- -	$47.60	$92.40
7	- -	$ 132	- -	$44.88	$87.12
8	- -	$ 124	- -	$42.16	$81.84
9	- -	$ 116	- -	$39.44	$76.56
10	- -	$ 108	- -	$36.72	$71.28
	$1,000	$1,440	1,000	$489.60	$950.40

Table B shows that over the 10-year period, the employer receives $1,000,000 (the proceeds from the sale of shares to the leveraged ESOP), makes contributions to the leveraged ESOP of $1,440,000 (the amount necessary to repay the funds borrowed by the ESOP to purchase the shares), transfers shares with a fair market value of $1,000,000 to the leveraged ESOP, and receives $1,440,000 in deductions for its contributions to the ESOP (with a cash value of $489,000 to a 34% bracket taxpayer), for a total after-tax cash cost of $950,400. Thus, compared to direct borrowing by the corporation, ESOP financing results in an after-tax cash savings of $340,000.

The after-tax cost to the corporation, where the $1,000,000 of shares transferred to the leveraged ESOP is added to the cash cost, increases to $1,950,400, for a total after-tax cash cost that is $660,000 greater than the cost of direct borrowing by the corporation. Existing shareholders have been diluted to the extent of the extra $1,000,000 of leveraged ESOP shares outstanding.

3. Examples of Leveraged Transactions

a. General. Theoretically, leveraged ESOP financing can be used any time a corporation would use conventional debt financing. Thus, it can be used for financing corporate growth, tender offers, acquisitions, going private, or increasing the corporation's working capital. Leveraged ESOPs are thought to be especially useful in mergers or divestitures of subsidiaries and shareholder buy-outs. Proponents also claim that banks and other lenders will be more willing to provide loans to support a leveraged ESOP because the use of tax-deductible dollars for repayment makes the ESOP company a more viable borrower.

b. Use of Leveraged ESOP in a Merger or Divestiture. A leveraged ESOP may be used to acquire another company. This procedure involves four steps.

i. The leveraged ESOP borrows sufficient funds to buy the stock or assets of the selected company.

ii. The leveraged ESOP buys the stock of the (a) employer corporation or (b) newly formed subsidiary of the employer corporation.

iii. The employer corporation or new subsidiary purchases the stock or assets of the target company.

iv. The employer corporation guarantees the ESOP loan and makes annual contributions to the leveraged ESOP until the loan is amortized.

The tax savings by using this method are the same as described above. Assuming the corporation is in the 34% tax bracket, it is able to make the acquisition at approximately 66% of the cash cost of conventional debt financing. However, earnings and equity have been diluted.

c. Leveraged ESOP Purchase of a Shareholder's Interest. Normally, a large shareholder of a closely held corporation must seek a corporate redemption if he wishes to sell all or some of his stock. If the redemption cannot be structured to fall within IRS § 302, the shareholder's gain will be taxed at ordinary income rates. This adverse tax consequence may be avoided by using a leveraged ESOP. The familiar leveraged ESOP financing transaction is as follows:

i. The leveraged ESOP borrows funds with which to buy the shareholder's stock.

ii. The shareholder then sells his stock to the leveraged ESOP.

iii. The employer corporation makes contributions to the leveraged ESOP to amortize the loan.

Note that the selling shareholder's interest is now owned by the leveraged ESOP. The corporation's cash balance compared to its cash balance after a conventional redemption is enhanced. However, the remaining shareholders may be in a more advantageous position after a redemption.

A C corporation selling shareholder may pay taxes on his sale to an ESOP, or the gain on the sale may be tax-deferred pursuant to §1042 if the sale would otherwise qualify for long-term capital gains treatment.

The IRS will issue an advance ruling that a proposed sale to an ESOP will qualify for capital gains only if three conditions are satisfied:

i. The beneficial interest in the plan of the selling shareholder and related parties does not exceed 20%;

ii. Except for a right of first refusal, any restrictions on the stock are no more onerous than restrictions applicable to employer stock generally; and

iii. There is no intention for the employer to redeem stock from the plan.

For example, in PLR 7802015, the IRS concluded that a shareholder would receive capital gains treatment on a sale of stock to an ESOP. The shareholder owned 45%of the outstanding stock, and another 17% was owned directly or indirectly by the shareholder's wife and their children. The stockholder was a participant in the ESOP, and his covered compensation was approximately 5% of total covered compensation. The shareholder proposed to sell an unspecified number of shares to the ESOP and represented that the company had no plan or intention to redeem stock from the ESOP and that the ESOP would be offered a "first option" (apparently, a right of first refusal) on the remaining shares owned by the shareholder.

d. ESOP § 1042 Seller-Financial Sale Followed by S Corporation Election. A common transaction since the advent of ESOPs as permitted S corporation shareholders has been as follows:

i A subchapter C corporation, worth $10 million, establishes an ESOP.

ii. Sellers borrow $10 million from a bank and immediately loan $10 million to the corporation. Sellers charge minimum cash interest on this loan but receive a significant number of warrants to purchase newly issued shares, valued so that the total interest charge (cash plus value of the warrants) is reasonable.

iii. Corporation lends $10 million to the ESOP, at minimum interest rates.

iv. The ESOP purchases 100% of the outstanding stock from the sellers for $10 million cash. Sellers use the $10 million sale proceeds to retire their debt to the bank, which is now out of the picture. All future interest payments will flow to the sellers rather than to an outside institution.

v. Sellers elect § 1042 treatment on their sale, so they owe no capital gains taxes. They purchase qualified replacement property on margin in order to qualify for § 1042 treatment.

vi. The C Corporation elects to be taxed as an S corporation immediately after the sale. By completely exempting the corporation from all federal (and most state) income taxation, this election substantially increases the corporation's cash flow and permits more rapid repayment of the $10 million owed to the sellers.

vii. As the debt is paid down, employees receive ownership of a tax-exempt corporation. Moreover, the warrants provided to the sellers allow them to continue to share in a portion of the corporation's tax-free growth.

F. Suitability.

1. ESOPs generally are not suitable for small employers or for employers who do not have a history of stable, substantial earnings. ESOPs are very expensive to create and administer. Significant long-term financial and business planning is necessary to successfully establish an ESOP in order to deal with the repayment of any debt incurred to acquire employer stock and with the stock repurchase liability upon the termination of employees who participate in the ESOP.

2. ESOPs may be suitable for larger employers with a history of stable, substantial earnings (a) in order to provide an incentive program that rewards employee productivity, (b) as a vehicle for corporate finance on a tax-preferred basis, or (c) as a succession plan for a business owner who otherwise might not have an adequate market for his or her company stock.

XV. Defined Benefit Plans.

A. Definition. A defined benefit pension plan is a qualified retirement plan under which the employer contractually agrees to provide participants with a designated retirement benefit upon retirement. The employer makes contributions to the plan in an amount actuarially determined to be sufficient to pay the promised benefits.

1. A defined benefit plan should be contrasted with a defined contribution plan, under which an employer makes annual contributions in amounts provided by the plan but the benefit at retirement is not assured. Instead, at retirement,

the participant's benefit in a defined contribution plan is based on the total contributions to his account plus earnings on those contributions.

2. A participant in a traditional defined benefit plan does not have an account. Instead, the stipulated retirement benefit is contractually defined in the plan document.

B. Types of Defined Benefit Plans.

1. Final Average Pay Plans. Under a final average pay plan, an employee's benefit is based on the average of the employee's compensation for a certain number of years (e.g., three or five years). Generally, the years taken into account are the most recent years (e.g., the three or five most recent years) or, if applicable, an earlier period of years in which the employee's average compensation is the highest (sometimes referred to as "average annual compensation").

The formula used to determine an employee's normal retirement benefit under a final average pay plan may be a unit credit formula or a flat benefit formula.

a. A unit credit formula provides a specified rate of benefit for each year of service, often with a limit on the years of service taken into account. For example, a plan may provide a normal retirement benefit of 1.5 percent of final average pay for each year of service up to 30 years. A unit credit formula may provide different benefit rates for different years of service (e.g., 1 percent of final average pay for each year of service up to 15 years and 1.5 percent of final average pay for each year of service from 16 to 30 years), subject to the accrual rules discussed below.

b. A flat benefit formula provides a normal retirement benefit of a specified percentage without regard to years of service, for example, 50 percent of final average pay.

Because the normal retirement benefit under a final average pay plan is based on an employee's most recent or highest pay, increases in an employee's pay are reflected in the employee's entire benefit. As a result, under a unit credit benefit formula, for an employee with a long period of service, compensation increases generally result in significant benefit increases because the compensation increase is reflected in the benefit attributable to all years of service. In addition, in the case of an employee who works for the employer

until retirement, the retirement benefit is based on the employee's most recent or highest pay at the time of retirement.

The benefit formula describes the benefit payable under the plan at normal retirement age. However, the benefit payable to an employee in the case of termination of employment (or termination of the plan) before normal retirement age depends on the portion of the normal retirement benefit that has accrued, which is determined under the plan's accrual method. In addition, the amount of the accrued benefit payable to the employee depends on the extent to which the employee's right to the accrued benefit is vested.

Generally the amount of an employee's annual retirement benefit from a defined benefit plan is determined at retirement and does not change. However, some defined benefit plans provide for post-retirement benefit increases based on cost-of-living adjustments ("COLAs"). A COLA may be provided automatically as part of the normal retirement benefit under the plan (an "automatic" COLA) or may be provided by a plan amendment made at the time (or times) the employer decides a COLA to be appropriate (an "ad hoc" COLA).

2. Career Average Pay Plans**.** Under a career average pay plan, an employee's normal retirement benefit consists of the sum of separate benefits determined for each year of service, based on compensation for the year of service. For example, a career average plan may provide a benefit of 1.5 percent of compensation for each year of service, with the total normal retirement benefit consisting of the sum of the separate benefits determined for each year of service. This plan design is also referred to sometimes as an "accumulation" plan. Under a career average pay plan, an increase in an employee's compensation does not affect the portion of the employee's normal retirement benefit attributable to previous years of service.

3. Use of Permitted Disparity. The permitted disparity rules allow a defined benefit plan to provide a higher rate of benefit with respect to compensation above a certain amount without violating the prohibition on discrimination in favor of highly compensated employees. The amount of disparity that is permitted under a defined benefit plan is based roughly on the rate at which Social Security benefits replace earnings.

Two methods may be used for applying permitted disparity under a defined benefit plan: the excess benefit method and the offset method. Under the excess benefit method, the plan provides one rate of benefit with respect to compensation up to a specified amount (i.e., the "integration level") and a higher rate of benefit with respect to compensation in excess of the

integration level. Under the offset method, the plan provides the same rate of benefit with respect to all compensation (the "gross benefit") and offsets the gross benefit by a specified percentage of compensation up to the integration level or by a portion of the employee's estimated benefits under the Social Security program.

4. Cash Balance Plans. A cash balance plan is a defined benefit plan under which benefits are defined by reference to a hypothetical account balance. An employee's hypothetical account is determined by reference to hypothetical annual allocations to the account (e g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account. Depending on the design of the cash balance plan, an employee who receives a hypothetical allocation to his or her account for a year may be automatically entitled to future hypothetical earnings on that allocation, or the right to future hypothetical earnings on the allocation (or the amount of the earnings) may depend on whether the employee continues employment with the employer maintaining the plan.

   Hypothetical earnings on the account may be determined in the form of hypothetical interest on the account at a rate specified in the plan or based on a specified market index, such as the rate of interest on certain Treasury securities. Alternatively, hypothetical earnings on the account may be based on hypothetical assets held in the account, similar to earnings on an account under a defined contribution plan, which are based on the assets held in the account. In that case, the plan may permit the employee to designate the hypothetical assets on which hypothetical earnings are based or permit the employee to choose from hypothetical investment options.

   Under defined benefit plans generally, normal retirement benefits are payable in the form of an annual benefit commencing at normal retirement age. Under a cash balance plan, the annual benefit payable to an employee at normal retirement age is generally determined as the actuarial equivalent of the amount of the employee's hypothetical account balance at normal retirement age, using actuarial factors specified in the plan. In addition, cash balance plans generally provide for lump sum distributions based on the employee's hypothetical account balance at the time the distribution is made.

5. 412(i) Insurance Contract Plans. An insurance contract plan is a defined benefit plan that meets the following requirements: (a) the plan is funded exclusively by the purchase of individual insurance contracts, (b) the contracts are paid for by level annual premiums over the period of the individual's participation in the plan, (c) benefits under the plan equal the benefits provided under the contracts at normal retirement age under the plan and are guaranteed by the insurance carrier, (d) premiums payable for the

plan year, and all prior plan years, have been paid, (e) no rights under the contracts have been subject to a security interest at any time during the plan year, and (e) no policy loans are outstanding at any time during the plan year. Special accrual and funding rules apply to insurance contract plans.

a. Attached at the end of this manuscript is a good article entitled *Fully Insured 412(i) Pension Plans Offer Simplicity and Low Risk*, by John J. McFadden and Stephan R. Leimberg.

C. <u>Benefit Accrual Requirements</u>.

1. <u>In General</u>. In the case of a defined benefit plan, a participant's accrued benefit is the portion of the normal retirement benefit (i.e., the annuity payable at normal retirement age under the plan's benefit formula, based on the participant's compensation and years of service) that has accrued under the accrual method provided under the plan. For example, if a participant terminates employment before reaching normal retirement age, the benefit to which the participant is entitled is the accrued benefit. The accrual method under a defined benefit plan must satisfy one of three accrual methods provided under the Internal Revenue Code.

2. <u>Permissible Accrual Methods</u>. The three permissible accrual methods are (a) the 133-1/3 percent method, (b) the fractional method, and (c) the three percent method. Most defined benefit plans use the 133-1/3 percent method or the fractional method.

a. Under the 133-1/3 percent method, (1) the accrued benefit payable at normal retirement age must equal the normal retirement benefit under the plan, and (2) the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age for any plan year cannot be more than 133-1/3 percent of the annual rate at which he or she can accrue benefits for any earlier plan year. For example, if the plan provides that a participant accrues a benefit of 1.5 percent of compensation for each year of service up to 20 and 2 percent of compensation for each year of service in excess of 20, the plan satisfies the requirements of the 133-1/3 percent method. However, a benefit that accrues at the rate of one percent of compensation for each year of service up to 20 and 1.5 percent of compensation for each year of service in excess of 20 does not satisfy the requirements of the 133-1/3 percent method.

b. Under the fractional method, the accrued benefit to which a participant is entitled at any time must equal or exceed the participant's "fractional rule benefit", multiplied by a fraction (not exceeding one), the numerator of which is the participant's total years of participation in the plan, and the denominator of which is the total number of years of plan participation the participant would have if he or she separated from service at normal retirement age. A participant's "fractional rule benefit" is the normal retirement benefit to which the participant would be entitled under the plan if the participant attained normal retirement age on the date the benefit is being determined (i.e., based on the participant's current amount of compensation and years of service).

c. Under the three-percent method, the accrued benefit to which each participant is entitled (computed as if the participant separated from the service as of the end of the plan year) must be at least three percent of the "three-percent method benefit," multiplied by the participant's years of plan participation as of the end of the year (but not more than 33-1/3 years). A participant's "three-percent method benefit" is the normal retirement benefit to which the participant would be entitled if he or she began participation at the earliest age possible under the plan and participated in the plan continuously until the earlier of age 65 or the normal retirement age under the plan.

d. The fractional method and the three-percent method provide the minimum rate at which a participant's benefit must accrue. Therefore, a plan may use an accrual method under which participants' accrued benefits exceed the minimum, provided that no participant's accrued benefit can be less than the minimum.

D. Limits on Benefits. Annual benefits payable under a defined benefit plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $175,000 (for 2006). All defined benefit plans of the employer are aggregated for purposes of this limit. The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan. The compensation limit is reduced proportionately for individuals with less than 10 years of service.

The dollar limit on annual benefits is reduced if benefits under the plan begin before age 62. If benefits under a defined benefit plan begin after age 65, the dollar limit is increased so that it is the actuarial equivalent of a benefit beginning at age 65 in the amount of the dollar limit.

The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning at age 65. If a benefit is payable in another form, the benefit must be adjusted to be actuarially equivalent to a straight life annuity that does not exceed the dollar limit.

E. Funding and Deduction Rules.

1. In General. Defined benefit plans are subject to minimum funding requirements. The minimum funding requirements are designed to ensure that plan assets are sufficient to pay plan benefits when due. The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits carried during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods, Additional minimum funding contributions are required in the case of underfunded plans. An employer sponsoring a defined benefit plan generally may deduct amounts contributed to satisfy the minimum funding requirements for a plan year.

2. Funding Standard Account. As an administrative aid in the application of the funding requirements, a defined benefit plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is generally treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan. For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be requited to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency".

3. Funding Methods.

a. In General. A defined benefit plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost

method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as (1) normal cost, and (2) supplemental cost.

____________b. Normal Cost. The normal cost for a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees, Specifically, it is the amount actuarially determined that would be required as a contribution by the employer to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

_____ c. Supplemental Cost. The supplemental cost for a plan year is the cost of future benefits allocated to the year that would not be met by normal costs and employee contributions. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized over a specified number of years.

___________d. Acceptable Methods. Normal cost and supplemental cost are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under one of a number of permissible actuarial cost methods. Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually.

4. Charges and Credits to Funding Standard Account.

a. In General. Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently, On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

b. Normal Cost. Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit. For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

c. Past Service Liability. There are three separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account over a specified period of years, generally 30 years for the first two types of past service liabilities and 40 years for the third type of past service liability. Assuming that there are no other credits in the account to offset a charge for past service liability, an employer contribution will be required for the year to avoid an accumulated funding deficiency.

For example, assume that a plan uses the calendar year as the plan year. Further assume that during 1987 the plan was amended to increase benefits and that the net result of plan amendments for 1987 was an increase in the past service liability under the plan of $500,000. In addition, the plan's actuary uses an interest rate of 8 percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year

to amortize the past service liability. Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of $44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid all accumulated funding deficiency unless the plan becomes fully funded.

________ d. Gains and Losses from Changes in Assumption. If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of ten years, resulting in credits or charges to the funding standard account.

________ e. Experience Gains and Losses. In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable, as discussed below. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized over a five-year period.

_____ f. Waived Funding Deficiencies. Under the funding standard, the amount of a waived funding deficiency is amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater

of (1) the rate used in computing costs under the plan, or (2) 150 percent of the mid-term applicable Federal interest rate (AFR) in effect for the first month of the plan year.

_____ g. Switchback Liability. Certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. Specified annual charges and credits apply to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year. During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of five years.

5. Reasonableness of Actuarial Assumptions. All costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods (1) each of which is reasonable individually or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

6. Additional Contributions for Underfunded Plan. Additional contributions are required under a special funding rule if a single employer defined benefit plan is underfunded. Under the special rule, a plan is considered underfunded for a plan year if the value of the plan assets is less than 90 percent of the plan's current liability. The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage".

If a plan is underfunded, the amount of additional required contributions is based on certain elements, including whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). However, under currently law, the amount of additional contributions cannot exceed the

amount needed to increase the plan's funded current liability percentage to 100 percent.

7. Failure to Make Required Contributions. An employer may request a waiver from the Internal Revenue Service of the employer's minimum required contributions for a year if the employer is unable to make the contribution without substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate.

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the Internal Revenue Service. The excise tax is 10 per cent of the amount of the funding deficiency. In addition, a tax of 100 percent may be imposed if the funding deficiency is not corrected within a certain period. An employer that fails to make minimum required contributions and fails to obtain a waiver must also notify participants.

F. Pension Protection Act of 2006 (Defined Benefit Plan Changes).

1. Revised Funding Rules for Defined Benefit Plans.

a. Revised Minimum Funding Standards for Single Employer Defined Benefit Pension Plans. Under pre-Act law, employers have flexibility in choosing the assumptions and methods used to calculate minimum funding requirements, but they generally must fund plans that are not at least 90% funded on a more accelerated basis under the Deficit Reduction Contribution (DRC) requirements, using specified interest and mortality assumptions. If employers make contributions in excess of the minimum required, the excess is added to the plan's “credit balance”. The credit balance is increased each year by earnings at the interest rate assumed by the plan. The accumulated credit balance can be applied toward future years' minimum contribution requirements.

New law. For plan years beginning after 2007, under the Act, plan liabilities are determined using a 3-segment yield curve developed from a 24-month average of the yield on the top three grades of corporate bonds. IRS will continue to establish the standard mortality table, but certain large companies may develop and use plan-specific mortality tables for minimum contribution calculations.

A plan's credit balance under pre-Act rules becomes the beginning balance of the carryover account under the new rules. Contributions exceeding the minimum required under the new rules are added to a new prefunding balance. Both the carryover and prefunding balances are credited with the plan's actual rate of return each year. Employers may elect to use the carryover and prefunding balances (carryover first) to reduce the minimum required contribution only if the plan's funding target attainment percentage is at least 80%. (For the 80% test, the funding target attainment percentage is determined by subtracting only the prefunding balance from plan assets.)

The liability for benefits earned under the plan in past years is the plan's target liability; the liability for benefit accruals in the current year is the plan's normal cost. A plan's minimum contribution requirement for a year is the normal cost plus amounts required to amortize any funding shortfall over seven years. For the first year under the new rules, the funding shortfall is the target liability minus assets. In subsequent years, a new shortfall amortization base is established to reflect gains or losses during the preceding year. Generally, both the carryover and prefunding balances are deducted from assets to calculate the funding shortfall.

b. “At-Risk” Plans. Liabilities are increased for “at risk” plans (funding target attainment percentage is both less than 80% without regard to at-risk liabilities and less than 70% counting at-risk liabilities). The funded percentage is determined by subtracting both the carryover and prefunding balances from assets. The 80% test is phased in at 65% in 2008, 70% in 2009, 75% in 2010 and 80% for 2011 and thereafter. The plan determines the at-risk liabilities by assuming that workers eligible to retire in the next ten years will retire as early as possible. (An exception applies for auto companies and suppliers that excludes anyone offered an early retirement in 2006.) The additional at-risk liability is phased in at 20% per year for each consecutive year the plan is at-risk. If a plan is at-risk for the current year and two out of the previous four years, a load of 4% of liability plus $700 per participant is added to the at-risk liability. Plans with 500 or fewer participants are not subject to at-risk liability.

c. Benefit Limits for Single-Employer Plans. Under pre-Act law, employers in bankruptcy can't make a benefit increase effective until they reorganize. Where a plan's new current liability funding

percentage is less than 60%, an increase generally can't be effective until the employer has brought funding up to 60%.

New law. Generally for plan years beginning after 2007, the Act prescribes stronger limitations based on the plan's "adjusted funding target attainment percentage" (the ratio of assets (minus carryover and prefunding balances) to target liability (without regard to at-risk status)). The adjusted percentage is determined by adding the amount of annuity purchases for non-highly compensated employees in the last two years to both assets and liabilities. If the adjusted funding target attainment percentage is below 60% for a plan year, the Act prohibits the plan from triggering shutdown benefits, prohibits accelerated payments (including lump sums) during the year, and freezes benefit accruals. If the percentage is below 80%, the plan can't have benefit increases. Between 60% and 80%, lump sum payments are limited to the lesser of the present value of the participant's PBGC guaranteed benefit and 50% of the lump sum he would otherwise receive. (The balance of the benefit is payable as an annuity.) The restrictions do not apply if the plan is 100% funded without reducing assets for credit balances. Collectively bargained plans must convert carryover and prefunding balances to assets if the conversion will eliminate a restriction. Special rules apply to new plans and to plans of employers in bankruptcy. A special collective bargaining rule delays the effective date until the earlier of the expiration of the contract or plan years beginning in 2010.

2. Interest Rate Assumptions.

a. Extension of Corporate Bond Replacement of 30-year Treasury Rates. Pre-Act law required the use of a 30-year Treasury rate for certain calculations. For 2004 and 2005, a long-term corporate bond interest rate was substituted for the 30-year Treasury rate for plan funding and PBGC premiums.

New law. The Act extends the 2004 and 2005 temporary rates to 2006 and 2007.

b. Interest Rate Assumption for Calculating Lump Sum Distributions. A plan's lump sum payment to a participant or beneficiary can't be less than the present value of the annuity to which he would have been entitled. In making this calculation, the plan must use specified

interest and mortality assumptions. Under pre-Act law, the interest rate is the rate on 30-year Treasury bonds.

New law. For plan years beginning after 2007, the Act requires a plan to calculate lump sum values using a three-segment yield curve. The yield curve value is phased in over 5 years at 20% per year (the remainder is based on existing methodology). The yield curve is based on a monthly interest rate.

c. Interest Rate Assumption for Applying Benefit Limitations to Lump Sum Distributions. Annual benefits payable under a defined benefit pension plan generally can't exceed the lesser of (1) 100% of average compensation, or (2) an inflation-indexed figure ($175,000 for 2006). The dollar limit generally applies to a benefit payable in the form of a straight life annuity. If the benefit is not in the form of a straight life annuity (e.g., a lump sum), the benefit generally is adjusted to an equivalent straight life annuity. When adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) the rate applicable in determining minimum lump sums, i.e., the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan. For plan years beginning in 2004 or 2005, the interest rate used generally must be not less than the greater of: (1) 5.5%; or (2) the interest rate specified in the plan.

New law. For distributions made in years beginning after 2005, the Act provides that for purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) 5.5%, (2) the rate that provides a benefit of not more than 105% of the benefit that would be provided if the rate (or rates) applicable in determining minimum lump sums were used, or (3) the interest rate specified in the plan.

3. PBGC Premiums and Related Rules. The Act makes a number of highly technical changes to the rules for PBGC premiums payable by various types of plans, including the following:

a. Single-employer plans that have unfunded vested benefits must pay the PBGC a variable rate premium (VRP) equal to $9 per $1,000 of unfunded vested benefits. The plan owes no VRP if the plan is at the full funding limit. For 2004 and 2005, the unfunded vested benefits

were valued using 85% of a rate based on investment-grade corporate bonds. The Act specifies the extension of that methodology in 2006 and 2007.

b. The Deficit Reduction Act of 2005 created a temporary (five year) termination premium. Starting in 2008, the Act requires use of the yield curve's segment rates for the premium calculation. The yield curve is based on the monthly corporate rate applicable to the plan year.

c. If a plan is amended to increase benefits, the PBGC guarantee of the increased benefits is phased in over five years from the date of the plan amendment. A shutdown benefit is generally based on a provision already in the plan, so the shutdown occurring does not trigger a phase-in period. The Act treats a shutdown or other contingent event as an amendment that triggers the phase-in of guaranteed benefits, effective for benefits that become payable as a result of an event which occurs after July 26, 2005.

d. Pension plans pay a variable rate premium to the PBGC equal to $9 per $1,000 of unfunded vested benefits. Under pre-Act law, there is no special premium for small plans. For plan years beginning after 2006, the Act provides that an employer with 25 or fewer employees pays a special reduced variable rate premium for each participant equal to $5 times the number of participants in the plan. (The total variable premium therefore will be $5 × [(the number of participants) squared].)

4. Deduction Limitations.

a. Increase in Deduction Limit for Single-Employer Plans. Under pre-Act law, generally, plans can deduct contributions up to 100% of the plan's current liability. Contributions in excess of the limit are subject to a 10% excise tax. Because the plan's liability on termination is generally higher than its current liability, there is an exception that allows a deductible contribution equal to 100% of the plan's termination liability, but only in the year of termination.

New law. Under the Act, for tax years beginning in 2006 and 2007, for contributions to a single-employer defined benefit plan, the maximum deductible amount is not less than the excess (if any) of (1) 150% of the plan's current liability, over (2) the value of plan assets. For tax years beginning after 2007, for contributions to a

single-employer defined benefit pension plan, the maximum deductible amount is equal to the greater of: (1) the excess (if any) of the sum of the plan's funding target, the plan's target normal cost, and a cushion amount for a plan year, over the value of plan assets (as determined under minimum funding rules); and (2) the minimum required contribution for the plan year. For plans not in at-risk status, the amount in (1) is not less than the excess (if any) of the sum of the plan's funding target and target normal cost, determined as if the plan was in at-risk status, over the value of plan assets.

The cushion amount for a plan year is the sum of (1) 50% of the plan's funding target for the plan year; and (2) the amount by which the plan's funding target would increase if determined by taking into account increases in participants' compensation for future years or, if the plan does not base benefits attributable to past service on compensation, increases in benefits that are expected to occur in succeeding plans year, determined on the basis of average annual benefit increases over the previous six years. The dollar limits on benefits and on compensation apply, but for plans covered by the PBGC insurance, increases in the compensation limit (under Code Sec. 401(a)(17)) that are expected to occur in succeeding plan years may be taken into account.

G. Examples.

Sample DB Plan for Doctor

Name	Age	Salary	Normal Cost/ Contribution	Lump Sum Value of Benefit at 1/1/2016
Dr. Smith	53	$220,000	$154,796	$2,000,075
A	49	$38,336	$24,233	$286,707
B	36	$22,616	$5,126	$46,517
C	46	$23,992	$11,500	$127,616
Total		$304,944	$195,655	$2,460,915
% to Dr. Smith			79.1%	81.3%

For a high-paid individual, it requires 10 years of plan participation to earn the highest benefit possible. The plan is designed to last for 10 years and then terminate.

Normal Retirement Age; 65

Name	Age	Salary	Normal Cost/ Contribution	Cash at Retirement
The Boss	50	$200,000	$74,579	$1,609,319
EE 1	45	$40,000	$12,328	$407,631
EE 2	40	$35,000	$7,475	$356,773
EE 3	35	$35,000	$5,370	$356,773
EE 4	30	$30,000	$3,385	$305,761
Total		$340,000	$103,137	
% to The Boss			72.3%	

H. <u>Suitability</u>.

1. <u>Excerpt from Article by Commentator Alvin D. Lurie</u>.

"Overall, is the Pension Protection Act of 2006 (PPA) good or bad for defined benefit plans? How can a critique of 900 pages of legislation be encapsulated in a few lines? In brief, I'd say Congress promised much but delivered little. In ostensibly trying simultaneously to: strengthen the private pension scheme, protect workers' pensions, and salvage the governmental pension insurance program, Congress has succeeded in none of its goals. Defined benefit plans, which were the bedrock of the nation's private retirement security system when pensions flourished mid-20th century, have been in steady decline since ERISA's enactment 32 years ago, and have by now been overwhelmed by a combination of successive layers of overregulation and growing attraction of the 401(k) design.

The PPA has now administered the *coup de grace* to defined benefit plans by imposing stringent new funding minimums, restricting interest rates, accelerating the remediation of funding shortfalls and anti-smoothing devices, plus greatly increasing PBGC premiums, that will substantially elevate the ongoing costs of these plans. The consequence of the PPA's enactment will be an increase in the already pronounced rush to terminate existing defined benefit plans, even the great numbers of them that have just been frozen (but not terminated) in recent years. Thus, many more plans will be tossed onto the lap of PBGC (even, it can be predicted, those of the airlines, which have been the principal beneficiaries of Congress' largesse in the new law, but which will doubtless be again parlaying bankruptcy threats and lobbying actions in not too many years).

Adding to the burden on plan sponsors are the imminent Financial Accounting Standards Board (FASB) proposals requiring unfunded defined benefit liabilities to be posted on the balance sheets starting this very year. No more is needed to spell the end of defined benefit plans as we know them; the above will do it."

2. Obviously, defined benefit plans are extremely complex and highly regulated. Employers who have such plans sometimes become overwhelmed with their obscurity and the significant expense to maintain them. However, upon deciding to terminate the plan, the employer often learns that the additional funding required in connection with such termination is prohibitive.

3. Still, defined benefit plans play an important role in many large corporations. Also, if carefully designed, a defined benefit can work very well in a small company when an older business owner with a younger workforce and substantial, sustainable earnings desires to fund a very large benefit in a short period of time.