Understanding Qualified Retirement Plans

What exactly is a qualified plan?

If you're a business owner seeking to compete and win in the marketplace, how do you attract talented and loyal employees? How do you accumulate significant retirement savings and offset current taxable earnings and protect assets from creditors? One answer is with a *qualified retirement plan*, or more simply put, a *qualified plan*. So, what exactly is a qualified plan?

A *qualified plan*, is an employer-sponsored retirement plan that receives specific federal and state tax advantages in return for following specific Internal Revenue Service (IRS) regulations. These requirements must be satisfied in both form and operation. Compliance in form means you have a definite written program, known as a plan document, that is kept current as required. Compliance in operation means all mechanical aspects of plan administration (deposits, distributions, eligibility, vesting…) comply with both the plan document and the regulations. Advantage of compliance is tax-advantaged plan contributions. Egregious failures of form or operation can result in disqualification, and that's bad. Most failures are not egregious however, and remedies are readily available.

Defined Contribution (DC) Plans

In DC plans, employers promise only contributions made today. The benefit, i.e., the accumulation of the contributions, is NOT guaranteed. The IRS issues limits to restrict the level of annual contributions made. Employer contributions to the plan are usually discretionary; but a 3% of pay minimum will typically apply. The employer can choose to direct the investment of plan assets (trustee-directed). The employer can also authorize participants to direct the investment of their account (participant-directed). A participant's retirement benefit is the accumulated value of the account, which again, is not guaranteed. Contributions, investment gains and losses will directly affect account values. The participant bears the investment risk associated with the account. Two of the most used DC arrangements by small businesses are the Simplified Employee Pension (SEP blog link) (SEP), and the Profit Sharing §401(k) Plan.

Defined Benefit (DB) Plans

In DB plans, employers promise only the benefits paid tomorrow. The contribution is the annual amount actuarially determined to fund the benefits and can vary from year to year. They are often called Pensions because the annual contribution is required. Interestingly, IRC §414(j) defines a DB plan to be "Any plan that is not a DC plan." IRS issues limits to restrict the level of annual benefits paid. The annual contribution is required. The annual contribution is calculated by an Enrolled Actuary. All plan assets must be pooled — individual participant accounts or participant-direction are not allowed. The employer bears the investment risk.

In general, it's helpful to think of DC plans as relatively discretionary, flexible plans but in return for such flexibility the annual limits are relatively low. In contrast, DB plans are neither discretionary nor flexible in the immediate sense; and in return for assuming such a substantive obligation, the employer is rewarded with much higher limits in terms of annual contributions. The most common DB arrangement adopted by small businesses is the Cash Balance Plan.

Why Do Business Owners Choose to Adopt Qualified Plans?

Taxes

Regarding taxes, qualified plans have 2 specific advantages. First, any contributions made to the plan by the employer will offset the business's taxable earnings on a dollar-for-dollar basis, as indicated in the table below. Any contributions made by plan participants may also be made before income taxes.

XYZ, Inc.	Before QP	After QP
Net Earnings	$1,000,000	$1,000,000
QP Contribution	$0	$250,000
Taxable earnings	$1,000,000	$750,000

Second, while remaining in the plan, assets grow income tax-deferred, so long as the plan remains qualified. The advantage of tax-deferral is that assets can accumulate throughout a participant's working career, without the negative drag of income taxes — which are typically highest when working. At retirement, income taxes are paid as participants draw down their retirement assets. But since income tax rates in retirement are generally lower than rates while working, the amount of taxes ultimately paid is ostensibly minimized.

Competition

Businesses with non-owner employees use qualified plans as a part of their overall benefits package, to attract and retain talented and loyal recruits. Imagine you're one of those talented recruits, choosing between two employment offers. Both employer's offer the same income. One employer offers a qualified plan, and the other does not. All else remaining equal, which employer would you choose?

Creditor Protection

Not necessarily a driver of plan adoption, but often an appreciated consequence, is that qualified plan assets are not subject to the claims of an employer's creditors. This is particularly true of business owners in litigious professions. As an example, if an engineering firm designs a machine that causes an injury and is sued for renumeration, the assets in that employers qualified plan will not be attachable by any creditor.

What Questions Should Business Owners Ask?

How much will it cost?

The costs associated with a qualified plan can be placed into 3 basic categories:

Service Provider Fees
Administrative & Investment Costs

Procedural Impact on the Business
Time Cost

Employer Plan Contributions
Benefit Cost

Business owners must be acutely aware of fees, particularly fees paid by plan assets. Importantly though, a tax credit is available for new plans. For employers with 50 or fewer employees the credit is 100% of plan administrative costs per year for 3 years, up to a maximum of $5,000 a year. For employers of 51 to 100 employees, the credit is 50% of costs up to $5,000 a year. The tax credit is **not** available to owner-only plans — plans covering no non-owner participants.

"How do we change it, or get out of it altogether?"

As with many things, it depends — mostly on the plan type. With very simple DC plans the discretionary nature of the contribution is very flexible. In other words, the plan is so flexible that the employer doesn't have to make any contribution at all. And in years where a contribution is made, it's controllable — i.e., *everyone gets X% of pay.* These types of plans are easy to change and/or terminate.

With DB plans and more complex DC plans, changes — including terminations — are generally made with formal plan amendments, which must be drafted, signed and maintained with the plan document. These changes often require participant notifications and must follow certain timelines. Some DB plans must file for government approval as a requirement of termination. Additional fees often apply for plan amendments and terminations.

It's important to note that regulations require a qualified plan to be permanent in nature. However, there is no required length of time for which a plan must exist either. So, while a plan adopted with documented and plainly visible contemplation of termination after only a one-time tax offset may be at risk for inquiry, regulations also contemplate that there are valid business reasons for terminating a qualified plan sooner rather than later. Terminations soon after adoption aren't exactly unexpected.

How much of every dollar contributed to the plan will attribute to owners?

The answer to this question often determines whether the business owner will choose to adopt the plan. Most business owners understand that they can't contribute more for themselves than they can for their employees. While this is true generally, regulations do allow flexibility in the way employer plan contributions can be allocated to different groups or classifications of employees, so long as certain non-discrimination tests are met.

Again, with very simple DC plans, there is little ability to maximize owner allocations while controlling allocations for non-owners. But with DB plans and more complex DC plans, complex testing methods can help business owners control the cost of allocations to non-owners, while preserving desired allocations for themselves and other executives. More information can be found in our Profit Sharing Allocation Methods white paper.

Learn more about the most common qualified plan arrangements:

- Simplified Employee Pension — "SEP"
- Profit Sharing 401(k) Plan — "401(k)"
- Cash Balance & 401(k) Combination

How Can Business Owners Determine if a Qualified Plan is Appropriate?

The very first step for business owners considering a qualified plan is to get a plan design done by a professional. TPA and actuarial firms offer this sort of work, oftentimes for a fee. Actuaries and other pension professionals are uniquely skilled at the design and implementation of qualified retirement plans. Common actuarial and pension professional designations are:

- **ASA** — Associate of the Society of Actuaries
- **EA** — Enrolled Actuary
- **QPA** — Qualified Pension Administrator
- **CPC** — Certified Pension Consultant

The plan design professional will request the employer's census data for all employees. Typical census data includes:

- Business structure:
- Corporation (C or S), Limited Liability Company, Partnership, Sole Proprietorship
- Names or job titles, ownership percentages, lineal relatives of owners,
- Birth dates, hire dates, annual hours, annual compensation, and
- Related businesses, maybe more depending on the situation.

Sample Profit Sharing Plan Design

Position	Age	W2 Pay	Employee 401(k)	Employer PS %	Employer PS $	Total
Owner A	**55**	**$235,000**	**$30,000**	**18.5%**	**$43,500**	**$73,500**
Owner B	**50**	**$235,000**	**$30,000**	**18.5%**	**$43,500**	**$73,500**
Staff 1	50	$65,000	--	5.0%	$3,250	$3,250
Staff 2	55	$40,000	--	5.0%	$2,000	$2,000
Staff 3	35	$30,000	--	5.0%	$1,500	$1,500
Staff 4	30	$25,000	--	5.0%	$1,250	$1,250
Staff 5	25	$20,000	--	5.0%	$1,000	$1,000

Owners	**$147,000**
Non-Owners	$9,000
Total	$156,000
% to Owners	**94%**

For illustrative purposes only.

An effective plan design will project the employer's cost obligation in terms of discretionary and non-discretionary contributions. Based on the employer's specific demographics, the plan design will identify how to maximize owner benefits while controlling the cost of benefits for non-owners. Equally important, the plan design will help business owners understand how census changes can impact the allocation of contributions in future years.

Even if a plan is not ultimately adopted, the plan design process can help business owners understand when and how a qualified plan will benefit them; as well as provide valuable insight regarding the structure of owner compensation (earned income vs. salary vs. earnings distribution) as it relates to self-employment taxes.

If you're considering or need help with a qualified retirement plan, Manning & Napier has professionals on staff with decades of experience evaluating and implementing a wide range of plan designs. Contact your Manning & Napier representative today to learn more.

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