WRMarketplace

An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Selecting a Qualified Retirement Plan – The Basics.

MARKET TREND: Compensation planning has become the "hot topic" among executives and employers, with wealth preservation and employee retention as the main focus. A tax-qualified retirement plan remains a key vehicle to accomplishing both of these objectives. These plans are available to a broader participant population than are nonqualified deferred compensation plans, and they provide greater security against loss that could result from an employer's financial difficulties.

SYNOPSIS: Tax-qualified retirement plans generally come in two forms – "defined contribution" plans and "defined benefit" plan – with varying plan types within each category. Differences among plans include how the benefits for participants are determined, whether the employer or the employee has an obligation to make contributions, whether the employer or the employee bears the investment risk with respect to plan assets, the maximum benefit the plan can provide to the participant, the amount the employer can deduct in connection with the plan contributions, and when benefits can be paid. The table set forth below highlights the salient features for the most common types of plans.

TAKE AWAY: Combining an understanding of the conceptual and practical differences among plans, as described herein, with the technical aspects of the plan types will be valuable in advising executives and their organizations in the selection and implementation of an effective compensation plan that will appeal to both parties. To assist, see the attached table summarizing the key differences among the various types of retirement plans from the perspective of the tax-qualification requirements and restrictions.

DIFFERENT TYPES OF TAX-QUALIFIED RETIREMENT PLANS

Generally

Tax-qualified retirement plans are typically thought of as being either "defined contribution" plans or "defined benefit" plans.

Defined Contribution Plans. Under a defined contribution plan: (1) the amount that is contributed each year on behalf of a participant is established, (2) these contributions are held in accounts established for participants and invested (generally, as the participant directs), and (3) the amount of retirement income ultimately payable to a plan participant is determined by the balance credited to his or her account under the plan.

Defined Benefit Plans. A defined benefit plan works essentially in the opposite manner: (1) a specified benefit is payable to a participant at retirement, and (2) the amount contributed to the plan for any year is an amount actuarially determined to be necessary for the plan to be adequately funded to pay benefits when they become due, as determined in accordance with the rules established under relevant provisions of the Internal Revenue Code ("**Code**").

Defined Contribution Plans

The most basic type of defined contribution plan is the ***profit sharing plan***. Under this type of plan, the employer sponsoring the plan makes a contribution in an amount either set forth in the governing plan document or as determined by the employer for the year. This contribution is allocated among plan participants in the manner described in the plan document – generally, in proportion to the amount of compensation earned by the participant for the year.

The most common retirement plan is a form of profit sharing plan – the ***401(k) plan***. Under this type of plan, participants elect the amount they wish to contribute to the plan on their behalf for the year, subject to various limits established under the Code. Historically, these amounts were contributed on a pre-tax basis, with the employee being taxable when amounts were distributed to him or her. Several years ago, a feature known as a "Roth 401(k)" feature was allowed to be added to these plans. Under a Roth feature, amounts are contributed on an after-tax basis, and distributions are made tax-free, provided they are not made before the end of the fifth year after the first year in which the participant first made Roth contributions. Under both a traditional and Roth 401(k) plans, there are general restrictions on distributions being made before the participant has a severance from employment, attains age 59½, dies, or becomes disabled.

The employer sponsoring a 401(k) plan may make its own contributions to the plan. These contributions may be made in proportion to the amounts deferred by participants (*i.e.*, matching contributions) or without regard to employee deferrals (*i.e.*, nonelective contributions) or a combination of the two.

There are limits (inflation-adjusted annually) on the amount of the various types of contributions that can be made under a profit sharing plan, either with or without a 401(k) feature:

- The maximum amount that can be deferred under a 401(k) feature (traditional or Roth) for calendar year 2014 is **$17,500**, with participants who are at least 50 years old during the year able to contribute an additional **$5,500**.

- The maximum total amount allocable to a participant's account for 2014 is **the lesser of $52,000 or 100%** of the participant's compensation for the year, but the maximum amount of compensation that can be taken into account in determining a participant's contributions or benefits for a 2014 plan year is **$260,000**.

The maximum amount an employer can deduct for any year with respect to contributions to a defined contribution plan is **25%** of the compensation of the plan participants.

Profit sharing plans are subject to requirements prohibiting discrimination in the amount of contributions and other aspects of the operation of the plan in favor of highly compensated employees (for 2014, generally individuals who made more than $115,000 in the previous year). Nonelective contributions generally satisfy these requirements automatically on the basis of the design of the plan, typically by making allocations in proportion to participants' compensation. Plans can be designed to satisfy these nondiscrimination requirements by allocating higher amounts to certain groups of participants, but complicated tests must be performed each year that can be very susceptible to changes in the plan's demographics.

Elective deferrals and matching contributions frequently satisfy the nondiscrimination requirements on the basis of mathematical tests that demonstrate that the average amount deferred or contributed on behalf of highly compensated individuals does not exceed the average amount contributed on behalf of nonhighly compensated individuals by more than a specified amount. Alternatively, a plan can be structured to satisfy these tests automatically on the basis of a "safe harbor" that requires a certain rate of nonelective or matching contribution to be made on behalf of all nonhighly compensated individuals.

The tax-qualification rules require that contributions made on behalf of participants be fully vested either within six years based on a graded schedule or three years if a cliff schedule is applied. In any event, a participant must always be fully vested in the portion of his or her account balance attributable to elective deferrals (whether traditional or Roth).

Defined Benefit Plans

Under a ***traditional defined benefit plan***, a participant is generally entitled to a specified benefit at retirement. The benefit is typically based on a formula that takes into account the participant's compensation and number of years of service. This amount is generally specified as the amount payable as of the participant's "normal retirement date." Most plans also allow a participant to receive a benefit as of an "early retirement date" if certain conditions are satisfied, and the amount of the benefit is often reduced from the normal retirement benefit to reflect early commencement and, therefore, a longer anticipated period of payout.

A different type of defined benefit plan is known as a ***"cash balance" plan***. Under such a plan, the employer promises to contribute a certain amount each year to an account maintained on behalf of a participant. This account is then credited each year with a specified "earnings" credit. Although this type of arrangement sounds like a defined contribution plan, because the amount contributed is specified, it is treated as a defined benefit plan for most purposes because the amount ultimately payable to the participant is defined by the amount the plan specifies as the earnings credit. The employer is responsible for ensuring that a participant's account contains the amount derived by application of the specified earnings credit, even if the plan investments do not produce that result.

A defined benefit plan is required to provide that the payment of a participant's benefit be made in the form of a life annuity (if the participant is unmarried) or a joint-and-50%-survivor annuity, with the participant's spouse as the survivor annuitant, unless the participant's spouse consents in writing to another form of distribution. The maximum benefit payable to a participant as of normal retirement date is the lesser of his or her average annual compensation over a specified number of years or **$210,000** (or such other number as determined by inflation). Even though a participant's benefit under a cash balance plan is typically expressed in terms of the "lump sum value" of his or her account, the maximum benefit is determined by converting that amount to an annuity and comparing it to the limit applicable for the year to a traditional defined benefit plan.

The amount deductible by an employer for any year with respect to a defined benefit plan is the amount actually contributed by the employer to the plan, which amount is based on the calculations of an actuary, made applying the plan's benefit formula, required funding rules, and required and permitted actuarial assumptions.

In one respect, cash balance plans are treated like defined contribution plans. While a participant's benefit under a traditional defined benefit plan is required to be fully vested either within seven years based on a graded schedule or five years if a cliff schedule is applied, a participant's cash balance plan benefit must be vested according to the shorter schedule required of defined contribution plans (*i.e.*, fully vested either within six years based on a graded schedule or three years if a cliff schedule is applied).

HOW TO SELECT BETWEEN PLAN TYPES

Employers considering the creation of a qualified plan should consider the following factors when selecting between the plan categories:

Defined Contribution Plans

- Generally best suited to employers who want ***flexibility*** in determining their annual contribution requirement.

- Desirable to employers who do not want to bear the ***risk of the investment performance*** of plan assets.

- The 401(k) features are particularly useful for employers who want to ***reduce cost*** and/or ***make employees responsible*** for some or all of their planning and saving for retirement.

- Matching and/or nonelective contributions allow an employer to ***protect more from tax***, both individually (in his or her capacity as a participant) and overall (in his or her capacity as the plan sponsor -- *i.e.*, these contributions increase the employer's deduction).

Defined Benefit Plans

- Generally, far ***less prevalent*** than defined contribution plans, with the majority of new defined benefit plans being implemented by ***small employers***, rather than large corporations.

- Desirable to an employer who wants to make ***larger contributions*** and derive greater retirement benefits than are available under a defined contribution plan.

- Generally produces a ***greater contribution deduction***, thereby increasing an employer's deduction.

- Cash balance plans are typically favored by employers who want to provide ***greater benefits*** than are available under defined contribution plans, because the amount that can be contributed on behalf of a participant is limited by the amount necessary to produce an annual lifetime benefit of $210,000, which is generally more than the $52,000 limit applicable to defined contribution plans.

- Because of the manner in which a participant's benefit accrues under a cash balance plan, this plan makes ***pension costs more predictable and easier to control*** than under a traditional defined benefit plan.

- Cash balance plans require an employer to have ***more stable cash flows*** than do defined contribution plans, because the contributions to the cash balance plan are mandatory, whereas those to a profit sharing plan are generally discretionary.

SUMMARY AND TAKE-AWAY

- Combining an understanding of the conceptual and practical differences among plans, as described above, with the technical aspects of the plan types will be valuable in advising executives and their organizations in the selection and implementation of an effective compensation plan that will appeal to both parties.

- To assist, see the attached table summarizing the key differences among the various types of retirement plans from the perspective of the tax-qualification requirements and restrictions.

SUMMARY OF SIGNIFICANT PLAN ATTRIBUTES AND REQUIREMENTS (2014)

	Profit Sharing Plan	401(k) Plan	Defined Benefit Plan	Cash Balance Plan
Annual Limits on Participant Contributions	$17,500, plus additional $5,500 for participants age 50 and older	$17,500, plus additional $5,500 for participants age 50 and older	Typically not permitted	Typically not permitted
Annual Limits on Aggregate Contributions (Participant and Employer)	Lesser of $52,000 and 100% of compensation	Lesser of $52,000 and 100% of compensation	Amount determined by application of funding rules	Amount determined by application of funding rules
Limits on Annual Benefits	Not applicable	Not applicable	Lesser of 100% of average compensation and $210,000	Lesser of 100% of average compensation and $210,000.
Maximum Annual Amount Deductible	25% of aggregate compensation of participant population	25% of aggregate compensation of participant population	Amount determined by application of funding rules	Amount determined by application of funding rules
Nondiscrimination Testing	None required if allocations made in proportion to participants' compensation; required if different allocation formula	Annual testing of elective deferrals and employer matching contributions required, unless plan established as "safe harbor" plan	May not be required if plan formula meets various safe harbor requirements	Typically required annually
Vesting	Within 6 years (if graded schedule used); within 3 years (if cliff schedule used)	100% immediate vesting of elective deferrals. Within 6 years (if graded schedule used); within 3 years (if cliff schedule used) for other contributions	Within 7 years (if graded schedule used); within 5 years (if cliff schedule used)	Within 6 years (if graded schedule used); within 3 years (if cliff schedule used)
Form of Distribution	Typically, lump sum	Typically, lump sum	Single life annuity to unmarried participant; 50% J&S annuity with spouse, unless spouse consents to different form	Single life annuity to unmarried participant; 50% J&S annuity with spouse, unless spouse consents to different form
Taxation of Distributions	Taxable as ordinary income upon distribution, unless rolled over	Traditional 401(k) contributions and earnings taxed as ordinary income upon distribution unless rolled over; Roth 401(k) contributions and earnings distributed tax-free	Taxed as ordinary income upon distribution unless rolled over; annuity payments not eligible for rollover.	Taxed as ordinary income upon distribution unless rolled over; annuity payments not eligible for rollover.

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