

Traditional Money Purchase Plan

The basics: The employer contributes a defined or fixed percentage of the participating employee's compensation each year. The amount to which the fund grows is the amount the retiring employee receives.

How It Works

- Employer contributes a fixed percentage of the participant's compensation each year to the plan.
- The total employer contribution is then allocated on that basis or on a separately defined basis, such as tiered or integrated with Social Security.
- Employer contributions are tax deductible.
- Contributions are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging¹, or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA² or to another employer plan if that plan will accept such a rollover. Federal law allows retirement distributions to employees who are at least age 62 even if they have not separated from employment at the time distributions begin.



Additional Considerations

- **Maximum annual contribution:** Up to 25% of covered payroll can be contributed and deducted by the employer.
- **Contribution base:** Plan contributions are normally based on total compensation; e.g., base salary, bonuses, overtime, etc. The maximum compensation recognized in 2008 is \$230,000.
- **Individual limits:** The allocation of contributions to a participant's account may not exceed the lesser of 100% of compensation³ or \$46,000 per year.
- **Excluding persons:** Certain persons can be eliminated on the basis of months of service, age or coverage in a union plan; for example, persons under age 21 can be excluded from the plan.
- **Investment of plan assets:** Investments must be diversified and prudent. Subject to plan provisions, plan assets may be invested in equity products like mutual funds, stocks and debt-free real estate; or debt instruments like T-Bills and CDs. Insurance products like life insurance and annuity policies may also be used.

¹ Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

² Beginning in 2008, distributions from qualified retirement plans, IRC Sec. 457 plans, and tax-sheltered annuities may be rolled directly into a Roth IRA. These rollover distributions are taxable events, subject to the same requirements as a Roth conversion.

³ For those self employed, this rate applies to "net" self-employment income of the owner or partner, less the contribution and the deduction allowed for one-half of the self-employment tax.

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- **Social Security integration:** Since the employer already contributes to the employee's Social Security retirement benefit, these contributions can be integrated into the contribution and/or allocation formulas of the plan.
- **Parties which are favored:** Typically, younger participants are favored because their fund may grow for a longer period and, in some instances, they share in forfeitures that other participants do not.
- **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures, or forfeitures may be used to reduce future employer contributions.

How Much Will There Be at Retirement?

This will depend upon three factors.

1. The amount of contributions
2. The number of years until retirement
3. The investment return

The risk of poor investment returns rests upon the employee; however, if investment results are favorable, the participant will have a larger fund at retirement age.

An Example of What \$10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax¹				
Years	4.00%	6.00%	8.00%	10.00%
5	\$54,163	\$56,371	\$58,666	\$61,051
10	\$120,061	\$131,808	\$144,866	\$159,374
15	\$200,236	\$232,760	\$271,521	\$317,725
20	\$297,781	\$367,856	\$457,620	\$572,750
25	\$416,459	\$548,645	\$731,059	\$983,471
30	\$560,849	\$790,582	\$1,132,832	\$1,644,940
35	\$736,522	\$1,114,348	\$1,723,168	\$2,710,244

Future Contributions

An employer must make annual contributions to the plan; but to the extent that the future payroll can be forecast, so can the approximate amount of future contributions. Changes may be made prospectively in the level of employer contributions by plan amendment, with advance notice to plan participants.

¹ The rates of return used in this illustration are not indicative of any actual investment and will fluctuate in value. An investment will not provide a consistent rate of return; years with lower (or negative) returns than the hypothetical returns shown may substantially affect the scenario presented.

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Zero Percent Plans

In some special situations an employer may maintain a money purchase plan that requires no contributions. Creditor protection and self-trusted asset management are the most common reasons for this.

Top-Heavy Plans

If more than 60% of the plan assets are allocated to “key” employees¹, the employer must contribute at least as much for “non-key” participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includable compensation (higher in some instances).

Advantages to Employer

- A. Contributions are tax deductible.
- B. Contributions and costs are known in advance.
- C. Contributions will rise as compensation rises, but they are controllable both by formula and absolute dollar amounts.
- D. Forfeitures of terminating employees may reduce future costs or be reallocated among the accounts of those still in the plan.
- E. The plan is easier to understand by the employees than is a defined benefit plan.
- F. It can provide employees with permanent life insurance benefits that need not expire nor require costly conversion at retirement age.
- G. The employer can direct investments.
- H. If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than \$5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds \$1,000 to a Rollover IRA in the former participant’s name. A plan may allow direct rollovers of less than \$1,000.

Advantages to Employees

- A. Annual employer contributions are not taxed to the participant.
- B. Earnings on the account are not currently taxed.

¹ A “key” employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded \$150,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded \$150,000.

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- C. Participants can be given the right to direct investments.
- D. Federal law allows a qualified plan to establish an “eligible investment advice arrangement” under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.
- E. Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- F. If the plan allows, there is the ability to purchase significant permanent life insurance under the plan. Purchasing life insurance will create taxable income to the employee.
- G. Younger employees can accumulate a larger fund than with a defined benefit plan.
- H. Participant may borrow from the plan within certain guidelines if provided for in the plan documents.
- I. The forfeited, unvested portion of accounts of former participants may be reallocated to the active participants’ accounts. This can have a substantial impact on future benefits. Forfeitures may also be used to reduce employer contributions.
- J. Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

Disadvantages to Employer

- A. In low profit years, the employer is still obligated to make contributions pursuant to the plan’s contribution formula.
- B. While the plan may be amended to change contribution levels from time to time, this should not be done annually.¹
- C. The money purchase plan will generally not produce as large of a contribution and deduction for employees in their late 30’s and older, as will a defined benefit plan.

Disadvantages to Employees

- A. There is no guarantee as to future benefits.
- B. Investment risks rest on the participant.
- C. Older participants may not receive as great of a benefit as with a defined benefit plan.

¹ In 2002, the overall profit sharing plan contribution limit increased to 25% of covered compensation with much greater employer flexibility. However, there are still instances where the employer will want to have a money purchase plan.

How a Traditional Money Purchase Plan Works



Employer

- Contributes a fixed percentage of each participant's compensation.
- Total employer contribution is then allocated on that basis or on a separately defined basis.
- Contributions are tax deductible to the business.¹
- Nondiscrimination rules apply.



Money Purchase Plan

- Employer contributions are not currently taxable to employee and account growth is tax deferred.
- Investment risk remains on employee.
- The forfeited, unvested portion of former employee's accounts may be reallocated to current participants.



Employee

- The allocation of contributions to an employee's account may not exceed the lesser of 100%² of compensation or \$46,000² per year.
- The maximum compensation recognized in 2008 is \$230,000.³
- Employee may be given right to direct investments.



Early Withdrawal

- A 10% penalty generally applies if withdrawals are made before age 59½.
- Some exceptions to 10% penalty are available.
- Employee may borrow from plan within certain guidelines if provided for in plan documents.

Retirement

- Distributions must begin by specified date.⁴
- Funds may be distributed as lump sum or periodic payments.
- Distributions are generally taxed as ordinary income and may be eligible for 10-year income averaging or rolled over into an IRA.

Death

- Value of account is included in owner's gross estate.
- Proceeds can pass to surviving spouse with payments made over survivor's lifetime.
- Income and estate taxes can severely reduce funds left to nonspousal heirs.

¹ Up to 25% of covered payroll can be contributed and deducted by the employer.

² These are 2008 limits.

³ For those self-employed, compensation is limited to net self-employment income, e.g. gross income less the contribution and the deduction allowed for one-half of the self-employment tax.

⁴ Except for more than 5% owners, distributions must begin by the later of (1) April 1 of the year following the year in which the participant reaches age 70½, or (2) the year following the year in which the participant retires.