

Nontraditional Defined Contribution Plan

The basics: These plans are different from traditional money purchase pension and profit sharing plans in that they define different participant groups who will receive different levels of employer contributions. They must comply with very detailed and complicated regulations under IRC Sec. 401(a)(4). They are typically called either cross-tested, tiered or super-integrated money purchase pension or profit sharing plans.



How It Works

- 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 pension plans to make 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 deduction:** Up to 25% of covered payroll may be contributed and deducted by the employer.
- **Compensation 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.
- **Employer contributions**
 - For money purchase pension plans, the employer contribution for the specified participant groups is determined by the plan formula and will be fixed unless amended at some future date.
 - Profit sharing plans have a discretionary employer contribution on behalf of the specified participant groups. If there are profits, the employer is expected to make “substantial and recurring” contributions.³
- **Individual limits:** The allocation of contributions to a participant’s account may not exceed the lesser of 100% of compensation⁴ or \$46,000 per year.

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 See IRS Reg. 1.401-(b)(2).

⁴ 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.

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- **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 can be invested in equity products like mutual funds, stocks and debt-free real estate; debt instruments like T-Bills and CDs. Insurance products like life insurance and annuity policies may also be used.
- **Social Security integration:** While these plans may recognize the impact of Social Security, the differential realized by integrating with Social Security may be minimal.
- **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.
- **Parties which are favored:** Cross-tested and super-integrated plans are typically designed to favor the most highly compensated participants in the plan. While these participants will often be the older employees, such is not necessarily the case. In fact, the use of these types of plans is one way in which equity can be achieved between an older owner/professional and a younger owner/professional. At the same time, other participants often receive allocations that are greater than the 3% top-heavy contributions minimum. These types of plans also may aid in allowing owner(s) to reach the maximum \$46,000 allocation permitted without having to use a second plan.

How Much Will There Be at Retirement?

This will depend on three factors.

1. The frequency and amount of contributions,
2. The number of years until retirement, and
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

¹ The rates of return used in this illustration are not indicative of any actual investment and will fluctuate in value.

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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 up to the first 3% of includable compensation (higher in some instances). The plan is typically structured to provide top-heavy benefits for all participants before providing additional allocations to any specified group.

Gateway Contributions

Beginning in 2002 an additional contribution was required on behalf of the nonhighly-compensated participants.² The nonhighly-compensated participants must receive a contribution that is the lesser of 5% of compensation or one third the highest allocation percentage of the highly-compensated participants. Any top-heavy contribution is applied to satisfying this requirement.

Advantages to Employer

- A. Contributions are tax deductible.
- B. For profit sharing plans, contributions and costs are totally flexible. For money purchase pension plans, the employer contribution is known in advance.
- C. The plan is easily understood by employees.
- D. Forfeitures of terminating employees may reduce future costs or be reallocated among the accounts of those still in the plan.
- E. It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- F. The employer can direct investments.
- G. 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.

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.

² Highly-compensated employees generally include 5% or more owners and those earning more than \$100,000 in the prior year.

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Allocation of Employer Contributions ¹			
Participant	Age	Annual Compensation	Cross-Tested Allocation
Owner A	55	\$230,000	\$46,000 ²
Owner B	50	150,000	\$46,000 ²
Employee 1	40	55,000	\$2,750 ³
Employee 2	35	30,000	\$1,500 ³
Employee 3	30	30,000	\$1,500 ³
Employee 4	25	30,000	\$1,500 ³
Totals		\$525,000	\$99,250

The cross-tested plan maximizes the contribution for both owners.

Advantages to Employees

- A. Annual employer contributions are not taxed to the participant.
- B. Earnings on the account are not currently taxed.
- C. Participants can have 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 level 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. Purchase of life insurance will create taxable income to the employee.
- G. The forfeited, unvested portion of accounts of former participants may be reallocated to the accounts of active participants. This can have a substantial impact on future benefits.
- H. Participant may borrow from the plan within certain guidelines if provided for in the plan documents.
- I. Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

¹ Assumes a profit sharing plan.

² Specified allocation to maximum limits.

³ Specified allocation of 5.0% of compensation.

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Disadvantages to Employer

A. Money purchase pension plans

1. In low profit years, the employer is still obligated to make contributions.
2. While the plan may be amended to change contribution levels from time to time, this should not be done annually.

B. Profit sharing plans: Deductible contributions are limited to 25% of covered payroll.

Disadvantages to Employees

A. There is no guarantee as to future benefits.

B. Investment risk rests on the participant.

How a Nontraditional Defined Contribution Plan Works



Employer

- Allows definition of different participant groups who can receive different levels of employer contributions.
- Typically called cross-tested, tiered or super-integrated plans.
- Must comply with detailed and complex regulations under IRC Sec. 401(a)(4).



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- Employer contributions¹ 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 direct investments.



Early Withdrawal

- 10% penalty generally applies if withdrawals 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 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 may 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.