DESIGNING QUALIFIED PLANS TO MEET  
EMPLOYER OBJECTIVES

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# Chapter 1 Characteristics of Qualified Plans

## Important Lesson Points

The important points addressed in this lesson are:

* The qualified plan that is suitable for a prospect depends on that employer’s objectives
* The three general employer objectives in establishing a qualified plan include what it should accomplish, whom it should benefit and the plan budget
* Defined benefit plans are qualified plans that guarantee a particular benefit at retirement and generally favor older plan participants
* Defined contribution plans are qualified plans that have individual plan participant accounts and are described in terms of the contribution to be made rather than the benefit to be provided
* Target benefit plans are hybrid qualified plans that resemble defined benefit plans at the outset and defined contribution plans during the accumulation period
* Profit sharing plans are defined contribution plans with maximum contribution flexibility
* Traditional profit sharing plans are profit sharing plans whose contribution allocation is based solely on plan participants’ compensation
* Age-based profit sharing plans are profit sharing plans whose contribution allocation is based on both participant compensation and age
* A 401(k) plan, known as a Cash or Deferred Arrangement (CODA), is a plan that permits plan participants to make elective deferrals
* A Simplified Employee Pension plan (SEP) involves an employer’s agreement to contribute to employee-owned traditional IRAs
* A Savings Incentive Match Plan for Employees (SIMPLE) is a simplified plan limited to small employers that provides for elective contributions by employees and requires certain annual employer contributions that may be matching contributions or nonelective contributions

## Introduction

There are many issues that are normally addressed in the design of a qualified plan; this course has been developed to introduce you to them. In it, we will discuss qualified plan design issues in large and small companies. Our emphasis, however, will be on the plans of small companies. Although “small” means many different things in different contexts, the meaning given to the term “small company” in this course is an employer that has fewer than 25 employees.

We will begin our treatment of qualified plan design with a discussion of the characteristics of particular qualified plans. This should help you understand, in a general way, what they can accomplish for an employer. Our examination will then proceed to a look at the three areas that employers need to address in deciding on which plan is the right one for their organization. We will look at how to identify employer objectives and then turn our attention to the more analytical aspect of plan design. That analytic job involves matching the common employer objectives with an appropriate qualified plan that will help the employer to realize those objectives.

Generally, the qualified plan that is the appropriate one for an employer will depend on the employer’s objectives in three important areas:

1. What the plan should accomplish for the company
2. Who the plan should favor
3. How much can be allocated to pay for the plan.

As the course continues, we will revisit these objectives time and again. As a jumping-off point, we will begin the substantive part of the course by reviewing the qualified plans that an employer can establish and their characteristics. This should help us gain a better sense of what specific qualified plans can accomplish.

## Defined Benefit Plans

A qualified plan can be couched in terms of the contribution to be made to it or in terms of the benefit to be received at retirement. In the first case, the plan is a defined *contribution* plan; in the second, it is a defined *benefit* plan. As we will discuss in some detail, this simple distinction makes an enormous difference.

A qualified plan that is designed to provide participants with a definite benefit at retirement is known as a defined benefit plan. When traditional pension plans are referred to, it is a defined benefit plan that is meant. The benefits that are provided by the plan determine the contributions that must be made to it. In simple terms - and without considering the effects of plan earnings - if the employer must accumulate $100,000 to fund a particular participant’s income benefit beginning at his age 65 and the participant enters the plan at age 55, the employer must contribute $10,000 each year to the plan to accumulate it. ($10,000 annual contribution x 10 years = $100,000) However, if the same participant entered the plan at age 45 (thereby giving the employer 20 years to accumulate the needed funds), the employer’s annual contribution is cut in half. ($5,000 annual contribution x 20 years = $100,000) Plan earnings or losses will affect the amount that the employer must contribute to the plan each year. Because of that plan design, the length of the participant’s accumulation period before he or she retires has a very significant effect on the size of the required contribution. Clearly, the shorter that the accumulation period is, the larger the contribution must generally be. It is principally for this reason—the need for higher employer contributions for older participants—that defined benefit plans are said to favor older plan participants.

Each year, the contribution in a defined benefit plan will change - although, usually, only slightly - from the previous year. As a result of this variability, however, defined benefit plans must calculate the contribution needed to fund each participant’s benefit that is promised by the plan, a calculation normally performed by a pension actuary that increases the cost of administering the plan. Furthermore, the calculation is repeated each year, taking into account the plan’s *past* investment experience and assumptions about *future* participant compensation increases and plan investment performance.

Contributions to defined benefit plans are required each year and may change from year to year. Except for changes in the covered participants, the contribution changes are based principally on how well or how poorly plan assets perform and meet the growth assumptions underlying the annual actuarial calculation. The employer assumes the investment risk in a defined benefit plan, and *all* contributions are generally made by the employer[[1]](#footnote-1). The employer is charged with the responsibility to fund the plan adequately, despite the plan’s investment experience. As a result, if the investment experience is good, the required employer contributions may decline; if it is bad, they will probably increase.

Since an employer must make the necessary contributions to adequately fund for the stated benefit, regardless of the participant’s age at plan entry, a defined benefit plan’s contributions are disproportionately higher for older employees than for younger employees. Because older entrants to the plan normally have fewer years of plan participation before they retire, a larger portion of annual contributions goes towards providing benefits for them. Although younger employees will receive their promised benefit, they are clearly not favored in terms of a defined benefit plan’s allocation of contributions.

Benefits under defined benefit plans are often, although not always, stated in terms of a percentage of the participant’s final compensation. In such a case, the higher the level of the participant’s compensation, the greater the plan contribution must be. To illustrate, assume that two employees, each age 45, participate in a defined benefit plan promising to pay a retirement income of 60 percent of their final compensation. Employee A earns $50,000 annually, and employee B earns $100,000 annually. Without considering their likely compensation growth occurring in the years leading up to retirement, if each of these two employees continued to earn the same income until retirement, employee A could look forward to receiving a monthly retirement income of $2,500. ($50,000 X 60% = $30,000 ÷ 12 months = $2,500) Employee B could expect to receive a monthly retirement income of $5,000 each month. Clearly, the employer would need to make substantially higher contributions - perhaps double the amount - to fund employee B’s benefit.

### Defined Benefit/401(k) Plans

Defined benefit/401(k) plans are authorized for years after 2009. Under a defined benefit/401(k) hybrid plan, the sponsoring employer guarantees the benefit at retirement under the defined benefit portion of the plan. In addition to the defined benefit, however, the plan participant may increase his or her retirement savings through elective deferrals made to the 401(k) part of the plan.

Under current law, eligibility to sponsor a defined benefit/401(k) plan is limited to employers with at least 2 employees but no more than 500 employees, provided the plan meets certain benefit and contribution requirements. The defined benefit part of the plan must provide a retirement benefit of at least a) 1% of plan participants’ final average compensation multiplied by years of service, or b) 20% of final average compensation. Under the 401(k) portion of the plan, the plan must provide for an automatic employee contribution of 4% of compensation unless the employee opts out or changes the contribution level. Employers must match at least 50% of employee deferrals up to a required match equal to 2% of compensation.

### Summary

A participant’s compensation and age are the principal determinants of employer contributions under a defined benefit plan. Because of that characteristic of the plan, a defined benefit plan generally requires disproportionately larger employer contributions for older, higher paid employees. Significantly larger portions of the employer’s annual contributions will go toward providing benefits for older employees with fewer years of plan participation over which to accrue their benefits. In plain terms, these defined benefit plans *favor* older, higher paid employees.

## Defined Contribution Plans

It is no secret that defined benefit plans tend to be fairly complicated and somewhat more expensive to administer than many other qualified plans. In contrast, defined contribution plans are generally simpler than defined benefit plans. For these defined contribution plans, there are generally no actuarial calculations required to determine contributions for each participant (target benefit plans being the exception), nor is there any stated benefit provided by the plan.

Falling into the category of defined contribution plans are:

* Money purchase pension plans
* Target benefit plans
* Profit sharing plans
* Thrift plans
* 401(k) plans
* Stock bonus plans
* Employee stock ownership plans (ESOPs)
* Simplified employee pensions (SEPs)
* Savings incentive match plans for employees (SIMPLEs)

Rather than being determined by the benefit that will be provided at retirement - as is the case in defined benefit plans - contributions to defined contribution plans are simply made as required by the plan formula and are generally based on the participant’s compensation. For example, a defined contribution plan’s formula may state that the employer is required to make contributions equal to 10 percent of a participant’s compensation. As a result, the ultimate value of the retirement income benefit provided by the plan is based on the value of the participant’s account balance at that time. If the participant has an account balance of $500,000 at retirement, the monthly retirement benefit under a money purchase pension plan might be $4,000; if the account balance is $625,000, the benefit might be $5,000 a month. What happens at the time of the participant’s retirement is that his or her pension plan account balance may be applied to purchase an income, or the participant may simply take annual distributions from the account balance.

Since the benefit at retirement in a defined contribution plan depends principally on the performance of the plan assets, the participant - rather than the employer - assumes all investment risk. (If investment performance is particularly good, the plan participant may have a large benefit at retirement. Conversely, if investment performance is poor, the participant’s benefit at retirement may be quite a lot smaller.) Because it is impossible to determine the future investment performance of the plan assets with any certainty, the defined contribution retirement benefit is unknown. Furthermore, in certain profit sharing plan designs, under which an employer may make *discretionary* contributions, future contributions are also unknown. In these defined contribution plans to which contributions are discretionary, the ultimate benefit at retirement is impossible even to estimate.

Participants in defined contribution plans may have the option of directing the investment of their own plan account balances; a well-known example of this type of plan is a 401(k), wherein the participant generally has the right to allocate his or her elective deferrals and matching employer contributions to a wide range of investment options. Regardless of who has the right and duty to direct individual account investment, the defined contribution plan participant’s benefit may be higher than he or she expected if the plan investments perform well. If they perform more poorly than expected, ultimate plan benefits may be lower than anticipated.

Individual plan participant accounts are the defining feature of defined contribution plans, and such an account is established for each participant. Accordingly, defined contribution plans are sometimes referred to as “individual account plans.” One of the benefits of individual account creation is that participants generally have a better understanding and appreciation of the plan. (Because of the nature and complexity of a defined benefit plan, the plan and its operation is generally a complete mystery for the majority of participants until just prior to their retirement.) Furthermore, contributions are also easily understood by the defined contribution plan participants. They are typically stated as a fixed dollar amount or fixed percentage of employee compensation and—except in the case of plans allowing discretionary contributions—must be made at the same level each year.

Since younger participants at the time the defined contribution plan begins generally have a longer period of time until retirement, the magic of compound earnings coupled with the tax deferral characteristic of qualified plans can make a substantial difference in the amount accumulated at retirement for them. As a result, the benefits at retirement in a defined contribution plan generally are greater - sometimes much greater - for younger participants than for older participants. A defined contribution plan does not favor employees who are older at the time that they become covered under the plan; these older employees will usually have fewer years until retirement during which plan assets can grow.

### Summary

Because they will have generally longer periods of service at retirement, a defined contribution plan tends to favor younger participants. Since they have a longer period of employment and plan participation, their accounts can grow and compound in a tax-deferred environment for a greater time period.

Let’s consider the specific qualified plans that fall under the defined contribution plan rubric.

## Target Benefit Plans

Defined benefit plans are generally preferred by older plan participants because they usually receive the lion’s share of the contribution allocation. However, better than expected plan investment performance in a defined benefit plan doesn’t increase the participant’s benefit. Instead, it just reduces the employer’s future cost. A target benefit plan, however, provides much of the benefit to the older participant that he or she finds in a defined benefit plan but also permits the benefit to increase if plan performance exceeds expectations. (The downside of that, of course, is that the actual benefit at retirement may also be less than the “target” benefit if plan assets perform poorly. Thus, the plan participant bears the investment risk under this type of defined contribution plan as well.)

Not unexpectedly, a target benefit plan can be seen as a hybrid of a defined benefit and a defined contribution plan. It begins by looking like a defined benefit plan. At plan inception, an annual contribution level is calculated that, based upon plan assumptions, will provide the target benefit at retirement, much like a defined benefit plan. It is important to remember, however, that this is a *target* benefit rather than a *defined* benefit, and this distinction is critical. The employer does not guarantee that the target benefit plan will actually produce the target benefit (unlike a defined benefit plan in which the employer does guarantee the benefit).

At plan inception the actuarial calculation—the only defined contribution plan that customarily requires such a calculation—determines the level, fixed contribution that will be made by the employer. This contribution will be made to the plan each year for each plan participant. It is important to understand that once the calculation is made to determine the fixed level contributions to the target benefit plan, there are no additional actuarial calculations that are normally required. Now that the level of contributions is fixed, the target benefit plan behaves like the defined contribution plan it is rather than like a defined benefit plan. The plan simply accumulates funds in individual accounts that are established for the plan participants. *Each participant’s benefit at retirement depends on the amount in his or her account.*

The investment risk in a target benefit plan is borne by the plan participant just as he or she would bear it in any other defined contribution plan, such as a money purchase pension plan. In the event plan investments perform better than at the rate assumed in the actuarial calculation that was made to determine the contribution level, the plan participant will have a higher benefit than the target benefit stated in the plan. In contrast, if plan investments perform more poorly, the benefit will be lower than the target benefit stated in the plan. An important thing to remember with respect to target benefit plans is that the employer is not required to increase its contributions to make up for poor investment performance, nor may it reduce its contributions in years when investment performance exceeds assumptions (both of which actions are normally implemented in the case of defined benefit plans).

Although target benefit plans have elements of both defined benefit and defined contribution plans, they generally favor older plan participants; however, they also provide some advantages to younger plan participants. Because older plan participants have fewer years in which to accumulate the needed funds, older participants will receive a greater percentage allocation of the fixed annual target benefit plan contribution for each dollar of target benefit at retirement. As we noted earlier, however, actual investment results will determine the benefit at retirement, which may be larger or smaller than the target benefit.

The benefit to younger participants in a target benefit plan comes from their having a longer period for their contributions to earn tax-deferred interest and compound in a tax-deferred environment. A target benefit plan has favorable elements for every party to the plan: the employer gets a break because it doesn’t bear the risk of poor plan investment performance; the older employee receives a generally greater allocation of each contribution, and the younger employee can look forward to a longer period of tax-deferred accumulation and increased benefits following better-than-anticipated performance.

### Summary

Offering benefits of both defined benefit and defined contribution plans, a target benefit plan can be seen as a hybrid plan. It begins by resembling a defined benefit plan with respect to its greater allocation of contributions to older employees. However, the target benefit plan acts like a defined contribution plan in accumulating individual account balances.

## Profit Sharing Plans

A profit sharing plan is one of the important types of defined contribution plans; it has become even more important because of changes in permitted contribution levels. For many companies - especially companies that experience substantial cash flow variations from time to time - a profit sharing plan, because of its discretionary contributions, may be just the right choice. This is particularly true in cases in which an employer feels it can’t commit to a fixed annual plan contribution.

Profit sharing plans can also be suitable in situations in which an employer wants to provide an incentive to employees. In such a case, an employer may be able to motivate employees to greater productivity and increase company profits by funding plan contributions based on a particular level of profits. Like all defined contribution plans, benefits under a profit sharing plan are not guaranteed by the employer and depend on the value of the participant’s account balance.

### Traditional Profit Sharing Plans

A substantial benefit of profit sharing plans, from the point of view of the plan sponsor, is that contributions are not required each and every year as they are in pension plans. Under the law, profit sharing plan contributions simply must be “substantial and recurring” for the plan to retain its qualified status. The amount of profit sharing plan contribution to be made - even whether or not to make a profit sharing plan contribution in a given year - may be determined by the plan sponsor each year. As in the case of other defined contribution plans, each participant has an individual account. Frequently, participants may direct the investment of own account balances - a characteristic normally observed in a profit sharing plan with a cash or deferred arrangement (CODA) known as a 401(k) plan.

In years past, there was a substantial disadvantage to profit sharing plans: their maximum permitted contribution level was lower than in most other defined contribution plans. Previously, deductible contributions to a profit sharing plan were limited to no more than 15 percent of compensation, even though the maximum deductible contribution level in other defined contribution plans was 25 percent of compensation. Fortunately, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the maximum profit sharing contribution level to 25 percent, so that profit sharing plan maximum deductible contribution levels are consistent with the maximum deductible contribution levels permitted in other defined contribution plans.

Just as they do in other defined contribution plans, participants in profit sharing plans bear the investment risk with respect to their plan assets. As a result, benefits received by participants in the plan are affected not only by the level of contributions made over the years but also by the performance achieved by the investments to which the plan participant’s account is allocated.

Since the allocation of employer contributions in a traditional profit sharing plan normally depends solely on the participant’s compensation level rather than on his or her age, traditional profit sharing plans generally favor younger participants. Although there is a limit to the amount of compensation that is considered for purposes of the contribution allocation, the higher that an individual’s compensation is, the greater his or her annual contribution allocation will be. Furthermore, a younger participant has a longer period in which plan contributions may grow and compound in a tax-deferred environment. Since there is no consideration given in a traditional profit sharing plan to the fewer years that older participants will have to accumulate substantial funds, these traditional profit sharing plans generally serve the interests of older employees less well. (We will shortly see, however, that another type of profit sharing plan can make very favorable contribution allocations to older participants.)

Integration with Social Security - a process that has generally come to be known as *permitted disparity* - is permitted in profit sharing plans. Integration generally reduces plan contributions for lower-paid participants and increases them for higher-paid participants, just as it does in other qualified plans in which integration with Social Security is permitted.

### Summary

Younger plan participants are generally favored in traditional profit sharing plans since they have a longer period during which to accumulate benefits, and their contribution allocation is not reduced because of their younger age as it is in defined benefit plans. Profit sharing plan integration generally permits the plan sponsor to make disproportionately larger contributions for higher-paid plan participants.

## Age-Based Profit Sharing Plans

The defining characteristics of a traditional profit sharing plan include its allocation of contributions based solely on the participants’ compensation and the relationship of the compensation to the plan sponsor’s overall payroll.

Under a traditional profit sharing plan, an employer could not make a greater allocation of the traditional profit sharing plan’s contributions based on a participant’s age. Since small business owners generally are among the older employees - and, typically, such owners are also active in the business, so they are also plan participants - the fact that traditional profit sharing plans cannot make greater contributions based solely on the fact that a participant is older has generally been seen as a disadvantage by many potential plan sponsors.

An age-based profit sharing plan has changed that perception of profit sharing plans. Age based profit sharing plans enable a plan sponsor to provide disproportionately higher contributions for older participants. Since one of the older participants is usually the individual writing the corporate check for the annual contribution to the plan, this change is an important one. Age-based profit sharing plans favor older plan participants. They accomplish this favoring by using both compensation *and* age as bases for allocating employer contributions to the plan. Age-based profit sharing plans are very similar in their allocation concept to target benefit plans. As we noted earlier, target benefit plans are defined contribution plans that use age and compensation in their allocation of employer contributions.

Although it may appear to be complex, the basis for allocating contributions in age-weighted profit sharing plans is really quite simple. Determining the allocation of the contribution in an age-based profit sharing plan requires that we calculate the present value of a life annuity that begins at the testing age.

In an age-based profit sharing plan, the testing age is either:

* The normal retirement age specified in the plan or
* Age 65, if the plan does not provide a uniform normal retirement age

To calculate the present value for this purpose, you must use:

1. An interest rate between 7.5 percent and 8.5 percent compounded annually and
2. A straight life annuity factor that is based on a standard interest rate (may be the same interest rate used in a. above, but need not be) and on a standard mortality table

|  |
| --- |
| Present Value of Life Annuity |
| The present value of a future sum - whether it is a single sum or an income stream - is the current value of that future sum discounted by a given percentage. The question that a present value calculation answers is:  ***How much would have to be deposited today into an account paying an interest rate equal to the discount rate in order to equal a specified sum to be received in the future?***  For example, if you wanted to have exactly $100 in an account in one year and that account offers 8 percent interest, how much would you need to deposit at the beginning of the year? What you have really asked, in more technical terms, is “what is the present value of $100 due in one year at an 8 percent discount?” The equation used to derive an answer is:  *x*(1 + .08) = $100  Then isolate *x* by dividing both sides of the equation by 1.08, and the answer is $92.59.  *X* = $100 ÷ 1.08 = $92.59  Calculating this simple equation has told you that you need to put exactly $92.59 into the account at the beginning of the year. The 8 percent interest will add the $7.41 that you need to have the $100. Determining the present value of an annuity is essentially the same calculation repeated over and over again to determine the present value of each subsequent payment. Fortunately, there is a simpler method that enables you to consult a financial table of present-value interest factors for annuities or use a financial calculator. |

### Summary

Age-based profit sharing plans generally provide greater contributions to older plan participants than traditional profit sharing plans. In these age-based profit sharing plans, a disparity in the participants’ ages is used to provide a larger portion of the allocation of employer profit sharing plan contributions to older plan participants. As a result of this disproportionate allocation of contributions to older participants coupled with the increase in the maximum deductible profit sharing plan contribution to 25 percent from its former 15 percent level, age-based profit sharing plans have become increasingly popular among small employers.

## 401(k) Plans

Although the funding of retirement plans has traditionally been seen as the responsibility of employers, that perception began to change dramatically in the decade of the 1980s as many employers scrambled to shore up their bottom lines by downsizing their employee population and jettisoning their costly pension plans in favor of the then-new 401(k) plans. These 401(k) plans enable an employer to provide employees with an opportunity to make pre-tax contributions (or after-tax contributions and tax-free qualified distributions in the case of contributions allocated to designated Roth accounts) to a plan in which earnings are tax-deferred.

Also referred to as a cash or deferred arrangement (CODA), a 401(k) plan is funded primarily by employee salary deferrals, rather than employer contributions. By installing a 401(k) plan, an employer choosing not to match any employee elective deferrals may limit its costs principally to certain expenses for plan administration. Even these plan administration expenses, however, may be borne by plan participants if the employer allocates these expenses to participant accounts.

Although not required, many employers offer to match some percentage of each participant’s deferred amount. This employer matching is designed to encourage plan use by employees. Although an employer’s matching of employee deferrals is certainly a benefit to participants, it is seldom altruistic. Instead, it helps to increase the amount of salary that may be deferred by higher-paid participants, such as business owners and executives. Various tests that must be performed by 401(k) plan administrators limit the amount that may be deferred by higher-paid participants to a percentage of the amounts deferred by lower-paid participants. Because of this mandated attempt to limit discrimination in favor of higher-paid plan participants, business owners generally have a vested interest in encouraging lower-paid employees to participate.

Largely because of the flexibility of 401(k) plans and their complex testing requirements, their administration has been relatively complicated and expensive. The level of required plan administration has been reduced, however - and the plans have become even more attractive to smaller employers - with the introduction of SIMPLE 401(k)s.

401(k) plan participants have considerable flexibility in determining annual plan deferral amounts as well as many choices in their investment. These deferral amounts, known as *elective deferrals*, are expressed as a percentage of each participant’s compensation. The plan participant determines the amount of compensation to be deferred within IRS limits that permit a regular deferral of up to $18,000 and a catch-up contribution of up to $6,000 for age 50 and older participants in 2015. In order to meet the safe harbor requirements that eliminate the plan sponsor’s fiduciary responsibility for investment performance, the 401(k) plan must provide at least three diversified investment options. Each of these options must offer plan participants a different risk and return profile.

Because of the fact that 401(k) plan sponsors cannot make larger matching contributions to older participants based on age, these plans tend to favor younger employees. As we noted in our discussion of other defined contribution plans, younger employees benefit from having a longer period of time over which their deferrals and the employer’s matching contributions can grow and compound in a tax-deferred environment.

The plan’s limitation on contributions severely curtails the highly-paid participant’s use of a 401(k) plan to accumulate the needed retirement income, since a lower-paid employee may make deferrals of a larger percentage of compensation than a higher-paid one. For example, if the current elective deferral limit is $18,000, an employee earning $90,000 could defer 20 percent of salary and meet the deferral limit. A key employee making $180,000 can defer the same $18,000. However, for that key employee, the deferral is only 10 percent of pay.

### Summary

The plan choice for an employer who wishes principally to provide employees an opportunity to make pre-tax contributions (or after-tax contributions and receive tax-free qualified distributions) to a plan in which earnings are tax-deferred is a 401(k) plan, referred to as a cash or deferral arrangement (CODA). This type of plan is principally funded by employee salary deferrals, rather than employer contributions - although the plan may call for the employer to match some portion of participant contributions. This generally limits employer cost—assuming the employer is unwilling to make matching contributions—to certain plan administration expenses.

## Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is nothing more than an employer’s agreement to contribute to IRAs that are maintained by employees. The plan can be adopted by an employer by completing a fairly simple IRS form, rather than the much more complicated procedure involved in installing a qualified retirement plan. As in all tax-favored plans, the contributions must be on a nondiscriminatory basis. A SEP, because of its utter simplicity, is significantly easier and less expensive to install and administer than a qualified retirement plan. As a result, the need for the various consultants normally associated with the establishment of a qualified retirement is minimized; further reducing the employer’s cost. Furthermore, the employer’s contribution is discretionary, enabling the employer to discontinue contributions in times of reduced cash flow.

When SEPs were initially introduced, employers with 25 or fewer employees were also permitted to establish plans that offer employees the opportunity to defer a portion of their income under a salary reduction SEP known as a SAR-SEP - an arrangement similar to a 401(k) elective deferral. These SAR-SEPs were replaced for employers seeking to allow employees to make elective deferrals for years beginning after 1996 by savings incentive match plans for employees, more commonly known as SIMPLEs. We will examine SIMPLE IRA plans in the next section. Although employers may not establish new SAR-SEPs after 1996, employers are permitted to continue to make contributions to existing SAR-SEPs, and employees hired after 1996 by employers offering SAR-SEPs may participate in the salary reduction SEP. Elective deferrals under a SAR-SEP are treated much like 401(k) elective deferrals and are subject to the usual annual limitation on elective deferrals.

A SEP allows for higher contribution levels than traditional or Roth IRAs, has fewer restrictions than qualified retirement plans and, unlike SIMPLEs, there is no limit on the number of employees in the plan. Employer contributions are entirely discretionary, and employees are immediately 100 percent vested in their accounts.

### Summary

Simplified employee pension plans permit employers of any size to sponsor a tax-favored retirement plan. These plans are comprised of employee-owned individual retirement accounts to which an employer may make discretionary contributions. Their principal attractiveness to employers is their inexpensiveness to install and their lack of an annual contribution commitment.

## Savings Incentive Match Plan for Employees (SIMPLE)

The fundamental concept behind savings incentive match plans for employees (SIMPLEs) is identical to that for SEPs: plan design and administrative convenience result in a plan that is relatively inexpensive to implement and produces employer savings when compared to traditional qualified plans. Unlike SEPs, however, eligibility to establish a SIMPLE is restricted to small employers.

In the context of SIMPLE plans, a “small employer” is one with 100 or fewer employees earning at least $5,000 annually. For purposes of this small employer limitation, all employees who are employed at any time during the calendar year are considered, even those employees who are excludable or ineligible to participate. In addition to regular employees that must be counted towards the 100 or fewer employees limitation, certain self-employed individuals who received earned income from the employer during the year must also be counted! However, an employer that ceases to be eligible - because of an increase in the number of employees, for example - after having installed and maintained a SIMPLE for at least 1 year will continue to be treated as eligible for the following 2 years.

The eligible employer must not only meet the “small employer” definition, the SIMPLE must generally be the employer’s sole retirement plan. A SIMPLE is not subject to nondiscrimination or top-heavy rules and may be in the form of a SIMPLE IRA or a SIMPLE 401(k).

In addition to the more economical administration of SIMPLEs, when compared to traditional qualified plans, an employer that employs a large number of part-time employees earning less than $5,000 may find a SIMPLE a more desirable plan than a SEP. Unlike a SEP, which must include any employee earning at least $600, a SIMPLE may generally exclude employees that are expected to earn less than $5,000. By excluding these part-time, lower-paid employees, the employer reduces required contributions and, compared to traditional qualified plans, the expense of many small accounts that are likely to be forfeited under the traditional plan’s deferred vesting schedule.

Contributions to a SIMPLE may come from two sources:

1. Elective contributions by employees, and
2. Employer contributions

Employee elective contributions are made under a qualified salary reduction arrangement. A qualified salary reduction arrangement is a written arrangement of an eligible employer under which employees that are eligible to participate may elect to receive payments in cash or contribute them to a SIMPLE and to which the employer may make matching contributions or nonelective contributions.

Except for certain catch-up contributions that may be made by employees age 50 or older, elective contributions to a SIMPLE are limited to no more than $12,500 in 2015. Elective contributions to a SIMPLE are counted in the overall limit on elective deferrals that may be made by any individual. The practical result of the overall limit on elective deferrals in this case is to reduce the amount that may be contributed by an employee who is covered under the plans of two employers. For example, an employee in a SIMPLE would be able to make elective contributions in 2015 of $12,500. However, if that employee was also employed by an employer that maintained a 401(k) plan, he or she would be permitted only to defer up to an additional $5,500 in 2015 because of the $18,000 overall limit on elective deferrals.

Each year, each employee that is eligible to participate in a SIMPLE can elect, during the 60-day period preceding that year, to participate in the salary reduction arrangement or modify the amount of the elective contribution.

Employer contributions to a SIMPLE may be:

* Matching contributions; or
* Nonelective contributions

Under the matching contribution method, an employer is required to match employee contributions dollar-for-dollar up to 3 percent of the participating employee’s compensation. Alternatively, an employer may choose to make nonelective contributions equal to 2 percent of each eligible employee’s compensation, whether or not the employee is a plan participant. No other contributions may be made to the plan.

### Summary

SIMPLEs enable employers with no more than 100 employees to establish and maintain a tax-favored retirement plan - designed as an IRA or 401(k) - at minimal administrative cost. Although the employer is not permitted to make discretionary contributions as under a SEP, it is allowed a certain flexibility to make either matching or nonelective contributions. The principal attractiveness of a SIMPLE to an employer is its lower administrative costs and modest level of required contributions.

## Chapter 1 Test Your Comprehension

1. **A disproportionately larger contribution to a defined benefit plan must be made for participants who are:**
2. Older, lower paid, with few years of service remaining
3. Younger, higher paid with many years of service ahead
4. Older, higher paid, with few years of service remaining
5. Younger, lower paid, with many years of service ahead
6. **A participant’s \_\_\_\_\_ is the primary determinant of the plan contribution made to a defined contribution plan.**
7. Age
8. Gender
9. Service
10. Compensation
11. **An actuarial calculation for a target benefit plan is generally performed:**
12. once and only at plan inception
13. once and only when the plan participant retires
14. every year on the plan anniversary date
15. every five years on the plan anniversary date
16. **Which of the following plan sponsor characteristics would suggest that a traditional profit sharing plan may be suitable?**
17. **A desire to maximize the plan contribution for a specific group of participants**
18. **A desire to provide an incentive to employees**
19. **A need for contribution flexibility**
20. I & II only
21. I & III only
22. II & III only
23. I, II & III
24. **When allocating employer profit sharing contributions in an age-based profit sharing plan, what factors are taken into consideration?**
25. **Participant’s age**
26. **Participant’s compensation**
27. **Employer’s Social Security contributions**
28. I & II only
29. I & III only
30. II & III only
31. I, II & III
32. **\_\_\_\_\_\_\_\_\_ are the main funding source of 401(k) plans.**
33. Employer non-matching contributions
34. Employer matching contributions
35. Employee deferrals
36. Employee bonuses
37. **What is likely to make a simplified employee pension (SEP) attractive to a prospective sponsor?**
38. **Plan is inexpensive to install**
39. **Contributions are discretionary**
40. I only
41. II only
42. Both I & II
43. Neither I nor II
44. **Contributions to a SIMPLE are made by:**
45. **employees**
46. **employers**
47. I only
48. II only
49. Both I & II
50. Neither I nor II

**Answers located in Appendix C**

# Chapter 2 Designing the Plan Based on Employer Objectives

## Important Lesson Points

The important points addressed in this lesson are:

* Owners of small companies often view qualified plans as tools to help them accomplish their personal wealth accumulation goals
* Small employers installing qualified plans normally want the plans to favor the company’s key employees, including its owners
* The qualified plan budget generally impacts the type of plan chosen as well as the source of both contributions and allocation of administrative expenses

## Introduction

Three principal employer objectives generally drive the qualified plan sale and determine the direction taken by the plan design. These broad objectives concern:

1. What the plan should accomplish for the employer
2. Whom the plan should favor, and
3. How much money the employer is willing to spend on the plan

Let’s consider each of these objectives and its effect on plan design.

## What Should Be Accomplished

Although all companies seem to share many concerns, there are other concerns that are more related to company size. For example, larger companies often see qualified retirement plans as human resources tools. Accordingly, they are used to attract, retain and reward employees, particularly key employees. Being able to offer a qualified plan makes the company more competitive in the job marketplace. Simply stated, it becomes better able to compete with companies in the same industry for competent, skilled workers. In the competitive marketplace for top talent in any industry, benefits packages often play an important role.

A large company might install a qualified plan to meet employee expectations and increase job satisfaction. When a company installs a qualified plan for its employees - especially if that company is a leader in its marketplace - its competitors usually need to follow suit if they want to be able to offer a competitive package of benefits.

Sometimes altruistic reasons are the impetus to create a qualified plan, particularly in companies that dominate industries. The company management may feel it is their duty to help employees provide for their financial security in retirement by rewarding employees with compensation today and financial security tomorrow. Certainly, some smaller employers may act from these motives; such an attitude, unfortunately, is less common.

The reasons why large employers establish qualified plans and why small employers do so are ordinarily quite different. Although small businesses may have some of the concerns that are usually evident in larger companies, there are often substantial differences between them. And, it is those differing motivations that influence the design of a qualified plan for a small company. The principal cause of those differences lies in the ownership of these companies. Small companies are usually characterized by owners that take an active part in the daily operations and management of the business, and they work at the business to improve their financial situation.

In large corporations, ownership may be distributed over thousands or even millions of shareholders; in the small business, ownership usually vests in just a few people. Since these owners are often the managers of these small companies, the funds that comprise the qualified plan budget are funds the owners could distribute to themselves as current compensation. As a result of that identity between owners and managers and the trade-off between qualified plan benefits and current compensation, the primary concern in the market of small employers is often that most of the benefits go into the accounts of the owners.

The managers that run large companies don’t consider themselves owners in the same sense that small company owners do. While these managers often are also shareholders, their stock positions are principally for investment purposes. Additionally, a lot of the stock they own may have found its way into their portfolios under a compensation arrangement providing stock bonuses or stock options.

When directors of large companies authorize the disbursement of funds to establish and maintain a qualified plan, they seldom view the authorization as spending their own money. Instead, these directors may look upon the expenditure as company money and feel they have given up nothing *personally* by funding the plan.

Small company owners view the transaction quite differently. Typically, they may feel - and rightly so - that they have forgone compensation by making qualified plan contributions. For this reason - that they feel the plan should provide greater benefits for owners and key employees - many small company plans are considered top heavy or super top heavy under the qualified plan rules. (A plan that is top heavy plan provides more than 60 percent of plan benefits to key employees, including owners. A plan that is super top heavy plan provides more than 90 percent of plan benefits to key employees.)

It should be no secret, considering the differing perspectives of the owners of small companies and the directors of large companies, that the objectives concerning what the plan should accomplish will also differ. While directors of large companies may be primarily interested in attracting, retaining and rewarding key people, owners of small companies are often interested principally in rewarding themselves and look to the plan to help them attain their personal wealth accumulation goals. That is not to say, of course, that small company owners don’t also want to make their company more competitive in the search for talented executives. Rather, it is a matter of priority.

### Summary

Small company owners usually view their use of company funds to purchase a qualified plan as spending their own money, while large company directors often do not. It is that difference in perception that makes the design of qualified plans for these two types of companies different from one another. While the large company director may be motivated to vote for the establishment of a qualified plan because it is the *right* thing to do for employees from a social perspective, that motivation is less frequently found in the small employer market. Instead, the small company owner is usually more interested in finding out what is in it for him - or her.

## Whom to Favor

The stated rule is that qualified plans cannot discriminate in favor of one employee group over another. Despite that general proscription against discrimination within a plan, the plan’s design can clearly favor certain employees or employee groups. So, the second objective of the small employer - that is, whom should the plan favor - has a substantial impact on the design of any plan in the small plan market. The determination of this objective tells the plan designer what benefits will generally be provided for the non-key employees. And, as we have already discussed, small employers usually want to provide the largest slice of the benefit pie to their most important employees. In the view of many small employers, their most important employees are the company’s key people, including themselves.

For a small company, the qualified plan that is most suitable is normally the one that favors its key people. To the extent that it favors key employees over non-key employees, it will probably be attractive to the owner. In determining *how* to favor the selected employee or employee group, the employee’s age and income are significant. Usually, the employees that are the older and higher paid are the same employees with the longest period of service with the company.

As we noted earlier, older employees have shorter periods of time in which to accumulate retirement savings. These older key employees - a category that frequently includes the owners themselves - are usually favored in those qualified plans that permit them to make up for the years before the plan was established. That fact alone tells the plan designer that a defined benefit plan or an age-based profit sharing plan may be the plan that captures the small company owner’s interest.

### Summary

Determining whom to favor in a qualified plan for the small employer has an overwhelming impact on plan design. By answering the question concerning whom to favor, it also answers the question about the relative extent of benefits that will be provided for rank and file employees. As we have seen, small employers are often most concerned about providing the majority of benefits to the most important employees, their key people.

## The Plan Budget

Now that we have looked at what the prospect wants to accomplish and who it wants to favor, we need to consider the wherewithal the prospect has to make it all happen. It is this third objective—the prospect’s budget—that will finally determine the benefits available to plan participants. Not surprisingly, it will affect plan design in several important ways, but principally with respect to the source of the contributions, the type of plan and the generosity of the benefits. The extent of the company’s plan budget will impact the source of plan contributions and benefits. Plan benefits may be provided under a plan:

* Solely through employer contributions
* Solely through employee contributions, or
* Through a combination of employer and employee contributions

Also, the more a company is able to allocate to the plan, the higher its participant benefits will be. Furthermore, the plan budget will impact the type of plan the company chooses since the annual administrative costs are dictated, in part, by the type of plan chosen.

It is fairly obvious that when funds available for plan contributions are limited, a plan that is more costly to administer will usually be avoided in favor of one that is simpler and less costly to administer. That may mean that a regular 401(k) plan, with its generally greater administrative costs, may be rejected in favor of a traditional profit sharing plan or a SIMPLE 401(k). Certainly, making that kind of a decision normally would leave more employer funds available for plan contributions.

Summary

The greater a company’s plan budget, the higher will be the ultimate plan benefits - at least in the aggregate. When the plan budget is very limited, an administratively expensive plan will often be avoided in favor of a plan that is cheaper to administer. Making that choice leaves more of the funds available to pay for plan benefits.

## Chapter 2 Test Your Comprehension

1. **Which of the following is more characteristic of small company owners considering the installation of a qualified plan?**
2. Owners feel they are spending money on the qualified plan that they could otherwise take as compensation
3. Owners feel they are funding the plan with unknown stockholders’ money
4. Owners believe they are using budgeted money to help make the company more competitive, productive and profitable
5. Owners usually believe that they have not given up anything by installing a qualified plan
6. **The \_\_\_\_\_\_\_\_\_ is determined by the small employer’s objective concerning whom to favor.**
7. extent to which benefits will be provided to rank and file employees
8. extent to which benefits will be provided to non-owner key employees
9. extent to which benefits will be provided to non-employee stockholders
10. extent to which benefits will be provided through the purchase of life insurance policies on the lives of plan participants
11. **What can a prospect do to increase benefits when its plan budget is limited?**
12. Choose a plan that requires larger contributions over one that requires smaller contributions
13. Choose a plan that has lower administration expenses over one that has higher administration expenses
14. Choose a plan that has higher plan benefits than one with lower benefits
15. Choose a plan that provides life insurance protection instead of one that provides no life insurance protection

**Answers located in Appendix C**

# Chapter 3 Getting the Important Facts

## Important Lesson Points

The important points addressed in this lesson are:

* A recommended qualified plan needs to meet prospects’ needs and objectives to be suitable and salable
* Qualified plan data-gathering principally involves identifying employer objectives and obtaining the prospect’s financial data
* Using a standard qualified plan data-gathering form helps focus the prospect’s and adviser’s attention on important issues, serves as a due-diligence checklist and provides a place to record the prospect’s information
* Since certain employer objectives in installing a qualified plan conflict, the employer needs to prioritize its goals and objectives

## Qualified Plan Data Gathering

Selling, regardless of the product, involves the matching of customer needs with the seller’s product. That applies to a qualified plan as much as it does to the sale of an individual security or insurance policy. In other words, the qualified plan must meet the needs and objectives of the prospect for it to be suitable and salable. In the small business market, meeting the needs of the prospect usually means meeting the needs and objectives of the decision maker since the decision maker is often the business owner.

Our consideration of the typical employer objectives was designed to set the stage for a discussion of how the prospective plan sponsor’s needs and objectives are discovered. That important step is accomplished in the data-gathering session.

Data gathering for qualified plan sales requires that the fact finder accomplish two tasks:

1. Identify employer objectives
2. Obtain “hard” data

## Identifying the Employer - Page 1

Getting the hard data in a fact-finding session is often easier than getting the prospective plan sponsor to identify and establish a priority to his or her objectives. Additionally, the prospect’s objectives may be mutually exclusive such that if one objective is fully satisfied another will be unmet. Because of this, it is important that the prospect rank the objectives of installing a plan in the order of their importance.

There are many good information-gathering forms that may be used to obtain the data needed to make a suitable qualified plan recommendation. A sample qualified plan fact-finding form is available in the Appendix. It contains a place to record the minimum amount of information needed to design a plan to meet a prospect’s objectives and circumstances.

The use of a standard fact-finding form offers the plan designer several important benefits.

* It helps to focus the prospect’s attention on important issues
* It serves as a due diligence checklist
* It provides a place to record the data to ensure (and be able to prove) the steps taken for suitability

The first page of the fact-finding form includes a place to record all of the basic employer and advisor information. It is important to obtain the names and telephone numbers of certain other employer contacts in addition to the contact information for the prospect’s attorney and accountant. These additional contacts include the organization’s chief financial officer, any in-house legal counsel and the bookkeeper.

The decision maker needs to inform these contacts that they can expect to be asked to provide information to the designer and that they should supply it. It is usually a worthwhile idea for the individual to telephone each of these contacts and introduce himself or herself before the need for additional information arises.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Qualified Plan Fact-Finding Form - Page 1 | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | Accounting method (check one) Cash \_\_\_\_\_\_ Accrual \_\_\_\_\_ | Regular corp \_\_\_\_ Partnership \_\_\_\_ | S corp \_\_\_\_ Sole proprietorship\_\_\_\_ | Professional corp \_\_\_\_ Limited Liability Company\_\_\_\_ | Date business established or incorporated? \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | Any predecessor or affiliated companies? (explain) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
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| Name  Title | Name  Title | Name  Title | Name | Name |
| Plan Sponsor’s Name | Address | Telephone Number | Plan Sponsor Contacts | | | Plan Sponsor’s Attorney | Plan Sponsor’s Accountant | Business organized as (check one) | | |

## Obtaining & Prioritizing Objectives - Page 2

Although all of the information that is gathered on the form is useful and valuable, some of the most important information that is obtained concerns the employer’s objectives and their relative importance. The goal priority scale lets the employer place a value of 1 to 4 on each of the common goals and concerns that employers usually have when considering a qualified plan. This allows the plan designer to list the employer’s goals according to an initial priority.

Most plan designers schedule an appointment to review the goals with the prospect when they have been prioritized and find that the goals usually require some revision.

Many prospective plan sponsors will initially consider most of the goals listed on the fact-finding form to be either “important” or “very important.” Since the importance matrix is designed to help the prospect to prioritize goals, deeming everything “very important” should be avoided, if possible. Prefacing goal questions in order to put the question in proper context can sometimes help the employer to prioritize. One approach to that problem could involve saying the following to the prospect:

*“In selecting and designing the most appropriate qualified plan for a business, it is important to understand the goals that the employer wants to meet through the plan and how important the employer considers each goal to be. For that reason, you will be asked to assign a priority number from 1 to 4 to each of them.”*

*“In assigning these priorities, you should assign a “1” only to those goals that are absolutely essential for the plan to achieve. A “2” means the goals are important but not essential. A “3” indicates that a goal would be nice to have but is not particularly important. Finally, a “4” indicates that a particular goal is relatively unimportant.”*

*“How important to the organization is using a qualified plan as a tax shelter for owners and key employees?”*

Obtaining answers to each of the questions on the form gives the designer a fairly clear idea of what is important to the prospect, provided that not everything is considered in the “very important” category.

Some of the goal questions will usually surprise the prospect and require explanation. For example, question 7 on the sample form asks about financial commitment, and a prospect may be surprised that any qualified plan could have no annual financial commitment. The question is a good one and requires an answer. It is important, however, that the prospect remain focused on the broader issue of qualified plan goals. For that reason, plan designers will normally avoid a detailed discussion of particular plans at this point in the process. Full and complete explanations of the characteristics of particular plans are important. However, the explanation should be accomplished only at the appropriate time in the interview process.

After a priority number has been assigned to each goal, the prospect needs to list the three most important reasons that the employer has for establishing a qualified plan. Although similar to the assigning of priorities to the goals, the question is not the same and can act as a validity check. At this point, two things normally happen:

1. The prospect’s goal priorities emerge
2. Goal conflicts appear

It is usually counter-productive to attempt resolution of the goal conflicts in this interview. A more favorable outcome usually results if another meeting is scheduled with the prospect to discuss and resolve them.

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| --- |
| Qualified Plan Fact-Finding Form - Page 2 |
| Employer’s Objectives and Relative Importance  **I. Goal Priority Matrix**  How important to the organization are the following concerns? (Grade on a 1 through 4 basis with:   1. *very important*, 2. *important,* 3. *somewhat important* 4. *relatively unimportant*.  |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | **1** | **2** | **3** | **4** | | Using a qualified plan as a tax shelter for owners and key employees? |  |  |  |  | | Maximizing benefits for long-service employees? |  |  |  |  | | Investment risk borne by employees instead of the company? |  |  |  |  | | Plan is easily communicated to employees? |  |  |  |  | | Plan is easy to administer? |  |  |  |  | | Plan has predictable costs? |  |  |  |  | | Plan has no annual financial commitment? |  |  |  |  | | Plan allows employees to withdraw funds? |  |  |  |  | | Plan minimizes costs by restricting payments to lower-paid employees? |  |  |  |  | | Plan operates to attract key employees? |  |  |  |  | | Plan helps to retain experienced employees? |  |  |  |  | | Plan motivates the employees to improve performance? |  |  |  |  | | Plan encourages older employees to retire? |  |  |  |  |   **II. What are the employer’s three most important reasons for establishing a qualified plan?**  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |

## Getting the Hard Data - Page 3

The prospect’s financial status is the subject of discussion as the data-gathering session continues. It is important to obtain the company’s balance sheet and income statement for the most recent three-year period. In asking questions about the company’s finances, the questioner is trying to determine:

* The prospect’s plan budget
* The likelihood that the same level of funds will be available each year for purposes of plan contributions

|  |
| --- |
| Qualified Plan Fact-Finding Form - Page 3 |
| **III. Company Financial Information**  1. Describe the company’s current cash flow situation: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  2. Describe the company’s anticipated future cash flow situation: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  3. What is the company’s budget for making contributions to a qualified plan? \_\_\_\_\_\_\_\_  4. Is it reasonable to anticipate that this amount will be available each year to fund a plan? \_\_\_\_\_\_\_\_  5. Obtain the following financial documents:  Company balance sheets for last three years  Company income statements for last three years | |

## Getting the Employee Census - Page 4

Obtaining the employee census generally concludes the initial data-gathering session. In questioning the prospect about employee turnover on page 4 of the form, the designer is obtaining important information to determine an appropriate eligibility period and vesting schedule for the recommended plan.

In addition, the question about other firms’ qualified plans addresses the employer goals of attracting key employees and retaining experienced employees. It also gives the designer a sense of the competitive environment in which the employer’s qualified plan will operate.

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| Qualified Plan Fact-Finding Form - Page 4 |
| **IV. Employee Census**  1. Employee Turnover  What is the company’s experience concerning the turnover of employees?   |  |  | | --- | --- | | Percentage Leaving | | | \_\_\_\_\_ | Before completing one year of service | | \_\_\_\_\_ | During their second year of service | | \_\_\_\_\_ | During their third year of service | | \_\_\_\_\_ | During their fourth year of service | | \_\_\_\_\_ | During their fifth year of service | | \_\_\_\_\_ | During their sixth year of service | | \_\_\_\_\_ | During their seventh year of service |   2. What are the employee groups?   |  |  |  |  | | --- | --- | --- | --- | | \_\_\_\_\_ | Salaried employees | \_\_\_\_\_\_ | Collective bargaining unit employees | | \_\_\_\_\_ | Hourly employees | \_\_\_\_\_\_ | Leased employees |   3. Part time employee use:   |  |  | | --- | --- | | \_\_\_\_\_ | No part time employees are used | | \_\_\_\_\_ | Part time employees are used | | \_\_\_\_\_ | Part time employees work fewer than 500 hours | | \_\_\_\_\_ | Part time employees work between 500-999 hours | | \_\_\_\_\_ | Part time employees work 1000 or more hours |   4. How many offices does the company have? \_\_\_\_\_\_  5. What are the benefit plans generally offered by those companies with which you compete for employees? \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  6. What other benefit plans are offered by the company to employees?  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |

### Summary

Getting sufficient information about the prospective plan sponsor and the sponsor’s plan goals is essential in order to recommend a plan that is suitable for the prospect. By following a standard fact-finding form in the interview, the designer has a place to record the prospect’s answers, has a due diligence checklist and a record for the plan designer’s protection against possible future claims of unsuitability.

## Chapter 3 Test Your Comprehension

1. **Which of the following accurately describes how the prospect’s questions about particular characteristics of qualified plans should be handled by the plan designer during the data-gathering interview?**
2. Questions from the prospect should be avoided during the data-gathering interview.
3. Questions from the prospect during the data-gathering interview should be answered completely when they are raised.
4. Questions from the prospect during the data-gathering interview should be answered briefly, with a fuller answer being given at an appropriate time.
5. The prospect should be referred to his or her accountant or attorney for answers to qualified plan questions.

**Answers located in Appendix C**

# Chapter 4 Meeting the Employer’s Objectives

## Important Lesson Points

The important points addressed in this lesson are:

* No single qualified plan can provide all of the possible benefits that can be obtained in qualified plans
* Key employees are generally among the oldest employees, have the longest period of service with the employer and are among the highest paid
* A qualified plan must provide comparable contributions or comparable benefits; it need not provide both
* A defined benefit plan generally favors older participants by providing a larger contribution to account for the fewer years in which plans have to accumulate the needed funds to provide promised benefits for older participants
* A defined benefit plan may favor long-service employees by a unit benefit formula that provides higher benefits (and contributions) to plan participants with longer periods of service
* A defined benefit plan may favor higher-paid plan participants by being integrated with Social Security, a process known as permitted disparity
* Defined contribution plans include a wide range of qualified plans, all of which are characterized by individual accounts
* An employer wishing to emphasize the perception of a qualified plan’s value to its participants may want to consider a defined contribution plan because of its individual account format
* An adequate level of income replacement at retirement is generally placed at 60 – 80 percent of pre-retirement income
* The only qualified plan that can ensure a particular retirement income replacement level is a defined benefit plan
* Vesting refers to the percentage of the participant’s account or accrued value that is nonforfeitable
* An employer whose objective in installing a qualified plan is to minimize turnover should consider a defined benefit plan, especially one with a long vesting period
* An employer wishing to improve employee performance through a qualified plan should consider a profit sharing plan or stock bonus plan
* An employer wishing to encourage retirement should consider a defined benefit plan with a specified maximum accrual period and early retirement subsidization
* Maximum employer contribution flexibility is found in profit sharing plans and in SEPs

## Introduction

Successfully installing a qualified plan begins with a thoroughgoing data-gathering session to determine objectives. At the conclusion of data gathering, the task becomes an analytical one as the plan designer matches the prospect’s objectives, resources and census with the capabilities and characteristics of the various plans. In this chapter we will examine how to match the common employer needs and objectives with specific qualified plan designs.

There are seven common objectives that qualified plans can help the employer meet, including:

* Maximizing the plan benefits for key employees; these employees often meet the definition of highly compensated employees (HCEs)
* Offering employees a valuable retirement savings vehicle
* Providing adequate replacement income for employees at retirement
* Reducing employee turnover
* Improving employee performance
* Encouraging retirement of older, less productive employees
* Maximizing the flexibility that the employer has in maintaining the qualified plan

Although all these benefits are worthwhile, no single plan is likely to meet all of them. As we noted earlier, some of these objectives will conflict with one another. For that reason, the prospect will often be required to forgo one objective to meet another.

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| Highly Compensated Employee |
| A highly compensated employee (HCE) is an employee who meets either one of two criteria. The employee need not meet both criteria. A highly compensated employee is an employee who:   * Owns more than 5% of the business, or * Earned more than $120,000 (2015 limit, indexed for inflation) in the preceding year and, if the employer chooses to follow the “top paid group” rule, was in the top paid group.   The “top paid group” is comprised of the top 20% of employees, ranked by compensation. An NHCE is an employee who meets neither of the above criteria. |

## Maximizing Key Employee Benefits

The small-plan market is dominated by employers with fewer than 25 employees; in this market, qualified plans are sometimes considered worthwhile to an employer only to the extent that they provide significant tax-advantaged benefits for key employees. These key employees, of course, generally include the business owner.

Critical to an understanding of how a qualified plan can maximize the plan benefits for key employees is an appreciation of the typical characteristics of a key employee in these small businesses. In this marketplace, key employees may usually be distinguished from non-key employees by three characteristics.

* They are generally among the older employees
* They often have the longest service with the employer
* They are usually among the highest paid in the company

Because key employees (and, remember, that designation normally includes the owner) are often among the oldest employees, they are likely to be favored by the plan types that allocate larger contributions to older participants. One of those important plan types is a defined benefit plan.

A qualified plan generally must provide comparable benefits *or* comparable contributions in order to be considered nondiscriminatory under federal law. It is not required to - nor, in most cases, could it - do both. While a defined contribution plan provides comparable contributions, a defined benefit plan provides comparable benefits. In order to provide comparable benefits, a defined benefit plan requires much larger contributions for older participants. In allocating plan contributions to meet the plan’s need to provide equal benefits at retirement age, a defined benefit plan must allocate a larger percentage of the contribution to older participants for each dollar of benefit. The reason for that is simple: there are fewer years in which to accumulate the necessary funds required to provide the retirement benefit. Therefore, older participants in defined benefit plans generally receive a larger allocation of the annual plan contribution.

Not only are key employees usually older, we also noted that they generally had longer service with their company. They were more likely to begin their employment earlier and less likely to terminate it before retirement. A qualified plan can also be designed to favor long service employees and, in so doing, also favor these key employees.

The way that a defined benefit plan favors the long-service employee is through the plan’s benefit and is accomplished by a unit benefit formula. A unit benefit formula determines the benefit at retirement based on both compensation at retirement and the number of years of service up to retirement. A typical defined benefit plan formula may provide that:

**The annual benefit at normal retirement age shall be equal to 2.5 percent of the participants’ average annual compensation for each year of service up to a maximum of 35 years.**

Using a unit benefit formula similar to this one, the long-service key employee with 35 years of service would receive a retirement benefit equal to 87.5 percent of compensation. The employee with 10 years of service at retirement, however, would only receive a benefit of 25 percent of compensation. Clearly, these benefits are not equal; they are, however, comparable and nondiscriminatory under federal law.

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| The Need to Provide a Larger Percentage of Contributions to Older Participants |
| We can understand why contributions must be greater for older participants in a defined benefit plan if we consider the following example.  Suppose that a defined benefit plan provides a flat dollar annual benefit of $50,000 at retirement. The Cheery Berry Company, Inc. has five employees, and the required accumulation at age 65 to fund the annual benefit is $654,000. The employee census is as follows:   |  |  | | --- | --- | | Employee | Age at Plan Inception | | George Berry | 50 | | Bob Berry | 45 | | Jerry Berry | 40 | | Brenda Smith | 35 | | Carol Witt | 25 |   If the plan’s assumed interest rate was 5 percent, the following contributions would need to be made each year for the employees:   |  |  |  |  | | --- | --- | --- | --- | | Employee | Age at  Plan Inception | Annual  Contribution | Percentage  Contribution | | George Berry | 50 | $28,877 | 38% | | Bob Berry | 45 | $18,844 | 25% | | Jerry Berry | 40 | $13,056 | 17% | | Brenda Smith | 35 | $9,379 | 12% | | Carol Witt | 25 | $5,159 | 7% | | Total contribution | | $75,315 | 99%\* |   \* Normal rounding error.  In this case, 83 percent of the annual contribution goes to the three key employees - all of whom also happen to be family members. |

Key employees typically earn a lot more compensation than non-key employees. That characteristic can also be used to favor key employees through Social Security integration, often referred to as permitted disparity. Accordingly, the unit benefit formula that we just looked at can be modified to account for the employer’s Social Security contributions. The modified formula provides that:

**The annual benefit at normal retirement age shall be equal to 2.5 percent of the participant’s average annual compensation up to a maximum of 35 years reduced by .75 percent of the participant’s final average compensation up to covered compensation.**

The result of this use of permitted disparity or Social Security integration is to further reduce the contributions that the employer is required to make for lower-paid individuals and, as a result, increase the relative contributions made for key employees.

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| Permitted Disparity |
| Permitted disparity refers to the rules allowing a qualified plan to recognize the Social Security contributions made by an employer in determining the allocation of nonelective contributions to the company’s qualified plan. It is another term for Social Security integration. Qualified plans may use permitted disparity in the calculation of required benefits or contributions. This exception to the rule against discrimination recognizes that employers, in their payment of Social Security taxes, already make a contribution to a retirement benefit for their employees.  Social Security for lower-paid employees provides a retirement benefit of a higher percentage of their annual compensation than the percentage provided for higher-paid employees. Permitted disparity rules permit qualified plans to take this disparity into account to reduce benefits under, or contributions to, the plan. As a result, when plan-provided benefits are added to Social Security-provided benefits, a uniform percentage of compensation is provided at retirement to all participants under the Social Security plan and the private retirement plan combined. |

### Summary

Small employers often seek to maximize the benefits for key employees in their qualified plans. Key employees are usually distinguished by three characteristics: age, length of service and income. In trying to maximize benefits for these key employees (who are usually older), the plan sponsor may turn to a defined benefit plan, since it must allocate a larger percentage of the annual plan contribution to older participants.

The key employees of a small employer typically have longer periods of service than non-key employees at the time of their retirement. A defined benefit plan method that can favor these long-service employees is to increase the percentage benefit at retirement for each year of service through a unit benefit formula. A unit benefit formula usually provides a benefit at retirement that is equal to a percentage of compensation multiplied by the number of years of service the participant has completed at the time he or she retires.

Key employees also usually earn more compensation than non-key employees. This characteristic can also be utilized by the defined benefit plan to provide proportionately greater contributions or benefits for these higher-paid participants through the plan’s integration with Social Security. By using the concept of integration or permitted disparity, a plan may make greater contributions or provide higher benefits to participants whose income exceeds a certain level. That income level is called the covered compensation level.

## Providing Value to Employees

There is little question but that all qualified plans provide some value to their participants. However, there are certain qualified plans that are often viewed by employees as having greater value. Those plans that are often seen as providing greater value are plans that have an individual account in which the employees can see some growth as contributions are made and earnings are added.

If the prospect is interested principally in offering a retirement savings plan that employees will view as valuable, a defined contribution plan should be considered. While the extreme favoring of key employees that is permitted in a defined benefit plan cannot be accomplished under these defined *contribution* plans, key employees can still be favored somewhat through the use of target benefit plans, service-related formulas and permitted disparity.

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| Defined Contribution Plan |
| Defined contribution plans are characterized by fixed annual plan contributions made on behalf of participants. Contributions made to the plan are invested, and the account value at retirement provides the income benefit to the employee at retirement. The value of the plan account will be the result of the total contributions made to the account and the performance of the invested funds.  Defined contribution plans include:   * Stock bonus plans * Money purchase pension plans * Profit sharing plans * Cash or deferred arrangements, also known as 401(k) plans * Simplified employee pensions (SEPs) * SIMPLEs * Target benefit plans   Each of these plans has an individual account whose growth the employee can follow. |

The individual account character of defined contribution plans, such as a money purchase pension plan or a profit sharing plan, has considerable appeal to employees generally. These accounts are particularly attractive, however, to younger employees who may see their employment with the plan sponsor to be just one step along a career path. 401(k) plans, because of their possible pre-tax contributions, may appear to employees to be tax-favored savings accounts made available by the employer.

### Summary

Sometimes perception is as important as reality. As a result, for some plans to accomplish the employer’s objective they must be ***viewed*** by plan participants as providing value. This perception of value is often enhanced through the individual account nature of defined contribution plans. These plans permit the plan participant to watch his or her account grow through employer contributions, employee contributions (if permitted) and plan earnings.

## Replacement Income at Retirement

An employer may want to ensure that each employee receives adequate replacement income at retirement. While an adequate level of replacement income varies depending upon the participant’s other assets, various studies have suggested that a replacement ratio of from 60 percent to 80 percent is a reasonable target.

If the employer wants to ensure a particular income replacement level for employees, the most desirable plan is a defined benefit pension plan. There are four reasons why a defined benefit plan is indicated in those cases where an employer’s objective in establishing a qualified plan is to provide an adequate level of replacement income:

1. A defined benefit pension plan is the only plan that can provide a retirement benefit based on an employee’s final average compensation, without regard to years of service. A defined contribution plan usually requires many years of service to provide a substantial retirement benefit for the employee.
2. The employer, rather than the employee, bears the investment risk in a defined benefit plan; in a defined contribution plan the opposite is true. The employer guarantees the benefit under a defined *benefit* plan, irrespective of plan investment performance. If the plan performs poorly, the employer must make larger contributions. The Pension Benefit Guaranty Corporation (PBGC) also provides a limited benefit guarantee.
3. The defined benefit plan’s stated benefit must be funded for by the employer, even in a bad year. Despite a decline in profits, the contribution must still be made. A plan sponsor that failed to make the required contribution could face underfunding penalties that could further compound an employer’s financial problems. If the qualified plan were a profit sharing plan, the employer could choose to reduce the plan contribution or even choose not to make one in any given year.
4. Higher levels of life insurance can usually be provided in a defined benefit plan than in a defined contribution plan and could ensure an adequate level of retirement income for the participant’s beneficiary. In defined benefit plans a death benefit equal to 100 times the participant’s monthly retirement benefit may be provided - and still be considered incidental to the plan - irrespective of the premium level required to maintain it.

### Summary

The most appropriate qualified plan is a defined benefit plan when the employer’s objective is to provide a particular level of replacement income to plan participants at retirement. While an adequate level of replacement income varies depending upon the participant’s other assets, various studies have suggested that a replacement ratio of from 60 percent to 80 percent is a reasonable target.

## Reducing Employee Turnover

No particular type of qualified plan ensures that employee turnover will be reduced. There are certain plan and design *features* that can be built into qualified plans, however, that will tend to reduce turnover. Generally, the most satisfactory approach to reducing employee turnover arises out of a combination of a defined benefit plan choice and a lengthy vesting schedule.

We noted earlier that defined contribution plans employ an individual-account format and give the employees an opportunity to watch its value grow from year to year as contributions are made and earnings accumulate. Insofar as the attraction of increasing benefits can encourage employees to stay with the employer, such a plan may help to minimize employee turnover. A defined benefit plan, however, may be more effective with respect to reducing employee turnover for the reasons that we will consider momentarily.

The most significant drawback to a defined benefit plan when compared to a defined contribution plan is its generally more complicated nature and lack of the individual account format characteristic of a defined contribution plan. As a result, if the defined benefit plan is not well communicated to and clearly understood by employees, its use in reducing turnover is adversely affected.

A defined benefit plan may be more effective in reducing employee turnover for the following two reasons:

1. The plan’s benefit formula can base benefits on the employees’ years of service. Known as a unit benefit plan, this type of defined benefit plan design dramatically increases benefits for long-service employees; to the extent that employees understand the plan dynamics, it is likely to encourage them to stay with the employer.
2. The benefits in a defined benefit plan can be based on the participant’s highest annual compensation. Since the participant’s highest annual compensation is ordinarily found at the conclusion of the participant’s career, this plan design - if understood by employees - may help reduce turnover.

For a defined benefit plan to be effective in reducing employee turnover, the plan sponsor must, of course, ensure that employees understand and appreciate the plan. Since qualified plans tend to be somewhat complicated - and defined benefit plans much more so than defined contribution plans - that is a goal that is often difficult to achieve.

### Vesting

Vesting is the plan design feature that was noted as possibly having a beneficial effect on employee turnover. Vesting refers to the percentage of the benefit that is owned by the plan participant at any point and may play a role in reducing turnover. Because of the rules applying to vesting, however, the role may be a somewhat limited one. Under the rules that apply to vesting, a participant who terminates employment before becoming fully vested loses the non-vested portion of his or her benefit. Insofar as a plan participant remains only partially vested, this vesting schedule may cause a participant to re-think terminating employment—at least until he or she is fully vested.

Although more rapid vesting schedules sometimes apply when the plan is top-heavy or other conditions exist, the rules applicable to defined benefit plans generally require that vesting may not be slower than under two minimum vesting schedules. Of course, an employer may always provide for faster vesting.

Unless a more rapid minimum vesting schedule is mandated (see inset below), a participant’s benefit in a defined benefit plan must vest at least as quickly as in one of the following vesting schedules:

* Five-year cliff vesting in which a participant with at least five years of service with the employer must be 100% vested in the benefit, or
* Seven-year graded vesting

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| Early Vesting Requirements |
| Although 5-year cliff vesting and 7-year graded vesting schedules are the usual minimum vesting schedules that have long applied to qualified plans, a particular plan or certain contributions may mandate a more rapid vesting schedule. More rapid minimum vesting schedules apply when:   * The plan is being terminated by the plan sponsor * The minimum service requirement for participation in the plan is greater than one year * The employee reaches normal retirement age * The plan is a 401(k) plan, and the benefit is derived from an employee’s elective deferrals * The qualified plan is a defined contribution plan, * The contributions are employer matching contributions, or * The plan is top heavy |

The 7-year graded vesting schedule requires that vesting not be any slower than as follows:

|  |  |
| --- | --- |
| **Participant’s Years of Service** | **Minimum Required Vesting** |
| Less than 3 | 0% |
| 3 | 20% |
| 4 | 40% |
| 5 | 60% |
| 6 | 80% |
| 7 | 100% |

The 5-year cliff vesting schedule requires that vesting not be any slower than as follows:

|  |  |
| --- | --- |
| Participant’s Years of Service | Minimum Required Vesting |
| less than 5 | 0% |
| 5 or more | 100% |

Under defined contribution plans and in those defined benefit plans requiring faster vesting—in top heavy plans, for example—than under the 5 or 7 year schedules, the rules call for 3-year cliff vesting or 6-year graded vesting schedules as minimum. Those schedules are as shown below:

|  |  |
| --- | --- |
| 6-Year Graded Vesting Schedule | |
| Participant’s Years of Service | Minimum Required Vesting |
| Less than 2 | 0% |
| 2 | 20% |
| 3 | 40% |
| 4 | 60% |
| 5 | 80% |
| 6 | 100% |

|  |  |
| --- | --- |
| 3-Year Cliff Vesting Schedule | |
| Participant’s Years of Service | Minimum Required Vesting |
| Less than 3 | 0% |
| 3 or more years | 100% |

The qualified plan rules also provide some flexibility to allow a plan sponsor to apply differing vesting schedules to different groups of plan participants. However, the plan must satisfy one of the vesting schedule requirements with respect to all participants. A plan sponsor may, of course, choose to provide an even shorter vesting period. For example, the plan document may specify that employer contributions are immediately vested in the participants. The intent of these vesting rules is to ensure that plans meet at least the minimum requirements.

### Summary

Although either a defined contribution or a defined benefit plan may encourage plan participants to continue employment in the plan sponsor, the most effective plan in that regard - provided that it is properly communicated - is usually a defined benefit plan. Such a plan is likely to be most effective in reducing turnover because it can increase retirement benefits significantly for long-service employees.

Furthermore, in a defined benefit plan, benefits can be based on the participant’s highest annual compensation, which usually occurs about the time the employee retires. While the selection of the right plan is likely to have the most effect on reducing turnover, vesting schedules may also help reduce turnover. Specifically, the lengthier the vesting schedule, the more likely it is that it may play a role in reducing employee turnover.

## Improving Employee Performance

Employers routinely seek to improve the performance of their employees, and that may be a prospect’s objective that it seeks to accomplish with a qualified plan. If favorably affecting employee performance is a plan objective, the plan should probably be a defined contribution plan.

While a defined contribution plan of any type - money purchase pension plan, profit sharing plan or some other defined contribution plan - may tend to improve employee performance because plan participants can see their accounts grow as soon as they enter the plan, the plan most effective in affecting employee performance is one whose contributions depend on such performance. Two defined contribution plans can provide that kind of impact: profit sharing plans and stock bonus plans.

Formerly, an employer needed to show a profit before it could make a contribution to its profit sharing plan. Although that profit requirement is no longer applicable, a profit sharing plan *may* be designed to provide for contributions only when there is a profit. Additionally, an employer *may* elect to make a larger or smaller contribution to the plan based upon the extent of profits.

By establishing a contribution level that is based on the extent of profits, the connection between employee performance and reward is made clearer to participants. If properly communicated, this approach can be expected to impact employee performance - sometimes dramatically. There is, of course, a possible disadvantage to designing a profit sharing plan in that manner. That possible disadvantage is that some of the contribution flexibility associated with profit sharing plans is lost since a contribution would be required when the profit objective is accomplished.

A stock bonus plan may also provide participant motivation to perform more effectively. An employee stock ownership plan - ordinarily referred to as an ESOP - is a defined contribution plan that invests primarily in qualifying employer securities. Qualifying employer securities are securities of the plan sponsor that:

1. Are readily tradable on an established securities market, or
2. Meet certain other conditions if the stock is not readily tradable on an established securities market

Insofar as the plan invests in employer securities, the value of each participant’s account will be directly affected by the securities’ price which generally reflects the company’s profitability. Clearly, the participant’s account value is directly tied to the company’s performance. If the participant understands the connection between the results achieved by the employer and his or her plan balance, the stock bonus plan can have a strongly positive influence on employee performance.

### Summary

An employer whose plan objective is to maximize employee performance may find that a defined contribution plan will offer the best result. Those defined contribution plans most likely to have the greatest impact on employee performance are profit sharing plans and stock bonus plans.

A profit sharing plan may help to maximize employee performance if the employer’s annual contribution level is tied to its meeting certain performance levels. Those performance levels may be couched in terms of company profits or sales levels. By investing in employer securities, a stock bonus plan also creates a direct link between company profitability and plan participant reward because the value of each participant’s account is directly affected to the value of company stock.

## Encouraging Retirement

As America ages, some employers are keeping older employees on the payroll well beyond the age that has traditionally been seen as the date of retirement. Also, while we may be familiar with the story of Grandma Moses, who didn’t begin to paint until very late in life, stories such as these are interesting primarily because they are exceptions to the generally-held belief that employees tend to become less productive as they age. Considering the possible loss of productivity that may accompany aging, an employer’s plan objective might include encouraging its older, less productive employees to retire.

Even though a retirement plan of any type can act as an incentive to encourage employees to retire, a defined benefit plan may work most effectively because:

* It can be designed so that full benefits accrue after a specified period of service has been met - 35 years, for example - but permit no additional benefits to accrue beyond that point. As a result of that design, employees will have a retirement income motivation to work up to the maximum number of years but will have no retirement income motivation to work beyond it because no further retirement benefits will be earned, and
* A defined benefit plan can subsidize early retirement and make it more attractive by providing a benefit at a particular early-retirement age - age 55, for example - whose actuarial equivalent is greater than the participant’s benefit at the plan’s normal retirement age.

Additionally, the plan’s encouraging older workers to retire may have other advantages in terms of workforce productivity. By making room for younger workers in the management hierarchy, younger and, presumably, more productive employees may be more likely to remain with the employer for longer periods.

### Summary

The most effective plan design in terms of encouraging older employees to retire is a defined benefit plan, although other qualified plans may have some value in that regard. Defined benefit plans work most effectively to encourage retirement because of the benefit accrual flexibility that permits a defined benefit plan to cease benefit accruals beyond a particular length of service. In other words, if the retirement benefit no longer increases after a specified period of employment, participants are more likely to retire at the end of that period. Furthermore, early retirement may be subsidized in a defined benefit plan, making it a more attractive option.

## Maximizing Contribution Flexibility

Business is inherently uncertain. Consider, for a moment, what technology has done in that regard. Once-thriving businesses that manufactured electric typewriters and cash registers became almost as obsolete as buggy whip producers when personal computers became commonplace. Although the example may be extreme, many employers feel a need for contribution flexibility in their choice of a qualified plan because of that uncertainty. While the need is felt most keenly by younger organizations, it is not confined to them.

The qualified plans offering the most flexibility in making contributions are traditional profit sharing plans and SEPs. In both plans, the employer’s annual contribution may be entirely at its discretion. As a result, contributions may be omitted completely in any year without affecting the plan’s qualified status, as long as contributions meet the “substantial and recurring” requirement.

Defined benefit plans and defined contribution plans that require regular annual or matching contributions, such as money purchase pension plans, 401(k) plans or SIMPLEs tend to offer far less contribution flexibility than either a traditional profit sharing plan or a SEP. For example, although plan sponsors of money purchase and defined benefit plans may receive a waiver of the minimum funding rules during periods of economic distress, minimum funding penalties may apply for the failure to make the required contribution.

Minimum funding penalties include a 10 percent excise tax and, if the minimum funding deficiency isn’t corrected, an excise tax equal to 100 percent of the uncorrected amount is imposed. A failure to meet minimum funding requirements in the case of a defined benefit plan may also require that any shortfall be amortized in level annual installments over a seven-year period.

Plans that require an employer to match employee contributions also introduce an additional element of uncertainty for the plan sponsor. Such plans involve a legally-binding commitment by the plan sponsor to make the promised matching contributions. And, since the employer’s cost to match employee contributions depends entirely on who contributes and how much, it is out of the employer’s control.

### Summary

The ability to continue to make a profit is uncertain for many businesses. Because of that uncertainty, an employer may be interested in having the greatest amount of flexibility in making qualified plan contributions. When plan contribution flexibility is an employer plan objective, the plan designer should consider recommending either a traditional profit sharing plan or a SEP. Both of these plans may permit a plan sponsor to decide, from year to year, how large a contribution will be made to the plan or even if one will be made at all.

## Chapter 4 Test Your Comprehension

1. **What is the name of the concept that a qualified plan may use in order to provide disproportionately higher qualified plan contributions or benefits to participants who earn higher levels of compensation?**
2. Actuarial equivalence
3. Curtailment
4. Excess deferral
5. Permitted disparity
6. **Qualified plans that enable participants to watch their account balances grow are:**
7. **Defined benefit plans**
8. **Money purchase pension plans**
9. **Profit sharing plans**
10. I & II only
11. I & III only
12. II & III only
13. I, II & III
14. **What is the generally considered the acceptable minimum income replacement level at retirement?**
15. 25% - 35%
16. 40% - 50%
17. 60% - 80%
18. 90% - 110%
19. **Which of the following would be most likely to favorably affect the plan sponsor’s employee turnover?**
20. **Installing a defined benefit plan**
21. **Having a lengthy vesting schedule**
22. **Installing a defined contribution plan**
23. I & II only
24. I & III only
25. II & III only
26. I, II & III
27. **Which of the following qualified plans is likely to more favorably affect employee performance?**
28. A defined benefit plan
29. A stock bonus plan
30. A cash balance plan
31. A cash or deferred arrangement
32. **Which of the following defined benefit plan characteristics are most likely to encourage older employees to retire?**
33. **A plan design that may allow additional benefit accruals to stop after a specific period of employee service**
34. **The plan’s individual accounts**
35. **Subsidized early retirement**
36. I & II only
37. I & III only
38. II & III only
39. I, II & III
40. **A plan sponsor may choose NOT to make a contribution in a particular year to a:**
41. **defined benefit plan**
42. **simplified employee pension**
43. **traditional profit sharing plan**
44. I & II only
45. I & III only
46. II & III only
47. I, II & III

**Answers located in Appendix C**

# Glossary

**Age-based profit sharing plan:** An age-based profit sharing plan is a profit sharing plan in which allocation of annual contributions takes into account the age of plan participants, skewing contributions towards older plan participants.

**CODA:** CODA is an acronym for a cash or deferred arrangement. This type of qualified plan is funded principally by plan participants’ elective deferrals that (unless allocated to a Roth account) are made on a pre-tax basis. Some arrangements include an employer matching feature or a small, fixed employer contribution. It is also known as a 401(k) plan.

**Defined benefit plan:** A defined benefit plan is a qualified plan in which definitely determinable participant benefits at retirement are promised, and annual actuarial calculations determine the plan sponsor’s contributions. Benefits are usually based on a participant’s compensation and may also be based on years of service. Investment risk is borne by the sponsor of the plan.

**Defined contribution plan:** A defined contribution plan is a qualified plan characterized by individual accounts and annual employer contributions expressed as either a fixed dollar amount or a percentage of employee compensation. Benefits at retirement are based on the value of the participant’s individual account. In this plan, the participant bears the investment risk. Defined contribution plans include:

* Money purchase pension plans
* Target benefit plans
* Profit sharing plans
* Thrift plans
* 401(k) plans
* 403(b) tax sheltered annuity plans
* Stock bonus plans
* Employee stock ownership plans (ESOPs)
* Simplified employee pensions (SEPs)
* Savings incentive match plans for employees (SIMPLEs)

**Permitted disparity:** Permitted disparity is a process whereby a plan sponsor may offset plan contributions to an integrated qualified plan in order to account for contributions made to the retirement plan portion of Social Security. The net effect of permitted disparity is generally to increase the level of contributions made for higher-paid plan participants compared to the contributions made for lower-paid participants.

**Profit sharing plan:** A profit sharing plan is a qualified plan characterized by year-to-year contribution flexibility, with permitted total plan contributions ranging from 0% to 25% of total compensation. Contributions are made to individual employee accounts, and benefits are linked to the value of the participant’s individual account when distributed. The participant bears the investment risk. The allocation of plan contributions is generally based on the participant’s compensation, although the participant’s age may also be a determinant of the allocation in an age-based profit sharing plan.

**SIMPLE:** SIMPLE is an acronym for a Savings Incentive Match Plan for Employees. Two types of tax-favored retirement plans were created under provisions of the Small Business Jobs Protection Act of 1996: the SIMPLE 401(k) and the SIMPLE IRA. Both plans are designed for employers with no more than 100 eligible employees. These plans provide access for participants to cash or deferred arrangements in which reporting and administration requirements have been simplified.

**Small company:** Although the definition of the term “small company” varies depending on the context in which it is used, it is generally used in reference to companies with 25 or fewer employees. Frequently small companies have as few as 10 people, and may sometimes be composed solely of one or two employee-owners, often including spouses or other related parties. (When used in connection with a SIMPLE, “small employer” means an employer with no more than 100 employees.)

**Super top heavy plan:** A super top heavy plan is a qualified plan in which more than 90% of all benefits for plan participants are payable to key employees.

**Target benefit plan:** A target benefit plan is a defined contribution qualified plan that has characteristics of both a defined benefit plan and a defined contribution plan. At inception an actuarial calculation is performed, similar to the calculation made for a defined benefit plan, to determine the annual contribution that would provide the employee with a target benefit at the assumed plan earnings rate. This contribution thus determined becomes the fixed contribution paid into the plan annually, and the plan then operates like a defined contribution plan.

**Top heavy plan:** A top heavy plan is a qualified plan in which more than 60% of plan benefits are paid to key employees.

# Appendix A

## Goal Priority Matrix

|  |
| --- |
| Qualified Plan Fact-Finding Form |
| Employer’s Objectives and Relative Importance  **Goal Priority Matrix**  How important to the organization are the following concerns? (Grade on a 1 through 4 basis with:   1. *very important*, 2. *important,* 3. *somewhat important* 4. *relatively unimportant*.  |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | **1** | **2** | **3** | **4** | | Using a qualified plan as a tax shelter for owners and key employees? |  |  |  |  | | Maximizing benefits for long-service employees? |  |  |  |  | | Investment risk borne by employees instead of the company? |  |  |  |  | | Plan is easily communicated to employees? |  |  |  |  | | Plan is easy to administer? |  |  |  |  | | Plan has predictable costs? |  |  |  |  | | Plan has no annual financial commitment? |  |  |  |  | | Plan allows employees to withdraw funds? |  |  |  |  | | Plan minimizes costs by restricting payments to lower-paid employees? |  |  |  |  | | Plan operates to attract key employees? |  |  |  |  | | Plan helps to retain experienced employees? |  |  |  |  | | Plan motivates the employees to improve performance? |  |  |  |  | | Plan encourages older employees to retire? |  |  |  |  |   **II. What are the employer’s three most important reasons for establishing a qualified plan?**  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |

## Qualified Plan Fact-Finding Form

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Qualified Plan Fact-Finding Form | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | Accounting method (check one) Cash \_\_\_\_\_\_ Accrual \_\_\_\_\_ | Regular corp \_\_\_\_ Partnership \_\_\_\_ | S corp \_\_\_\_ Sole proprietorship\_\_\_\_ | Professional corp \_\_\_\_ Limited Liability Company\_\_\_\_ | Date business established or incorporated? \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | Any predecessor or affiliated companies? (explain) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| Phone No. | Phone No. | Phone No. | Phone No. | Phone No. |
| \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| Name  Title | Name  Title | Name  Title | Name | Name |
| Plan Sponsor’s Name | Address | Telephone Number | Plan Sponsor Contacts | | | Plan Sponsor’s Attorney | Plan Sponsor’s Accountant | Business organized as (check one) | | |

## Company Financial Information

|  |
| --- |
| Qualified Plan Fact-Finding Form |
| **Company Financial Information**  1. Describe the company’s current cash flow situation: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  2. Describe the company’s anticipated future cash flow situation: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  3. What is the company’s budget for making contributions to a qualified plan? \_\_\_\_\_\_\_\_  4. Is it reasonable to anticipate that this amount will be available each year to fund a plan? \_\_\_\_\_\_\_\_  5. Obtain the following financial documents:  Company balance sheets for last three years  Company income statements for last three years | |

## Employee Census

|  |
| --- |
| Qualified Plan Fact-Finding Form |
| **IV. Employee Census**  1. Employee Turnover  What is the company’s experience concerning the turnover of employees?   |  |  | | --- | --- | | Percentage Leaving | | | \_\_\_\_\_ | Before completing one year of service | | \_\_\_\_\_ | During their second year of service | | \_\_\_\_\_ | During their third year of service | | \_\_\_\_\_ | During their fourth year of service | | \_\_\_\_\_ | During their fifth year of service | | \_\_\_\_\_ | During their sixth year of service | | \_\_\_\_\_ | During their seventh year of service |   2. What are the employee groups?   |  |  |  |  | | --- | --- | --- | --- | | \_\_\_\_\_ | Salaried employees | \_\_\_\_\_\_ | Collective bargaining unit employees | | \_\_\_\_\_ | Hourly employees | \_\_\_\_\_\_ | Leased employees |   3. Part time employee use:   |  |  | | --- | --- | | \_\_\_\_\_ | No part time employees are used | | \_\_\_\_\_ | Part time employees are used | | \_\_\_\_\_ | Part time employees work fewer than 500 hours | | \_\_\_\_\_ | Part time employees work between 500-999 hours | | \_\_\_\_\_ | Part time employees work 1000 or more hours |   4. How many offices does the company have? \_\_\_\_\_\_  5. What are the benefit plans generally offered by those companies with which you compete for employees? \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  6. What other benefit plans are offered by the company to employees?  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |

## Employee Census Information

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Annual Non-Deferred Compensation | Total |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Overtime |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Bonus |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Basic |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Percent of Voting Stock |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Highly Compensated (h) or key (k) |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Position |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Date Hired |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Date of Birth |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Sex |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Social Security Number |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Name |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

# Appendix B

## Decisional Factors in Qualified Plan Selection

|  |  |
| --- | --- |
| Employer’s Plan Objective | Type/Design/Features Indicated |
| Favor key employees | Defined benefit plan Unit benefit formula Integrated with Social Security |
| Provide perception of value to employees | Defined contribution plan |
| Ensure a particular retirement income replacement level | Defined benefit plan |
| Reduce employee turnover | Defined benefit plan Unit benefit formula Lengthy vesting period |
| Increase employee productivity | Traditional profit sharing plan with contributions tied to productivity Stock bonus plan |
| Encourage retirement | Defined benefit plan Subsidize early retirement Specify a maximum benefit accrual period |
| Maximize contribution flexibility | Traditional profit sharing plan SEP |

# Appendix C Answers to Chapter Quizzes

Chapter 1

1. **C** - Since an employer must make the necessary contributions to fund the stated benefit adequately, regardless of the participant’s age at plan entry, a defined benefit plan’s contributions are disproportionately higher for older employees than for younger employees. Because older entrants to the plan have fewer years of plan participation before they retire, a larger portion of annual contributions goes towards providing benefits for them. Although younger employees will receive their promised benefit, they are clearly not favored in terms of the plan’s allocation of contributions.
2. **D** - Rather than being couched in terms of the benefit that will be provided at retirement - as is the case in defined benefit plans - contributions to defined contribution plans are simply made as required by the plan formula and are generally based on the participant’s compensation; for example, the formula may state that the employer is required to make contributions equal to 10 percent of a participant’s compensation.
3. **A** - At plan inception the actuarial calculation determines the level, fixed contribution that will be made. This contribution will be made to the plan each year for each plan participant. It is important to understand that once this calculation is made to determine the fixed level contributions to the target benefit plan, there are no additional actuarial calculations that are required. Now that the level of contributions is fixed, the target benefit plan behaves like a defined contribution plan rather than a defined benefit plan. The plan simply accumulates funds in individual accounts that are established for the plan participants. Each participant’s benefit at retirement depends on the amount in his or her account.
4. **C** - A profit sharing plan is one of the important types of defined contribution plans. For many companies - especially companies that experience substantial cash flow variations from time to time - a profit sharing plan may be just the right choice. This is particularly true when an employer feels it can’t commit to a fixed annual plan contribution.

Profit sharing plans can also be suitable in situations in which an employer wants to provide an incentive to employees. In such a case, an employer may be able to urge employees to greater productivity and increase company profits by funding plan contributions based on a particular level of profits. Like all defined contribution plans, benefits under a profit sharing plan depend on the value of the participant’s account balance.

1. **A** - Age based profit sharing plans enable a plan sponsor to provide disproportionately higher benefits for older participants. Since one of the older participants is usually the individual writing the corporate check for the annual contribution to the plan, this change is an important one. Age-based profit sharing plans favor older plan participants. They accomplish this favoring by using both compensation and age as bases for allocating employer contributions to the plan. Age-based profit sharing plans are very similar in their allocation concept to target benefit plans.
2. **C** - Although the funding of retirement plans has traditionally been seen as the responsibility of employers, that perception began to change dramatically in the decade of the 1980s as many employers scrambled to shore up their bottom lines by downsizing their employee population and jettisoning their costly pension plans in favor of the then-new 401(k) plans. These 401(k) plans enable an employer to provide employees with an opportunity to make pre-tax contributions to a plan in which earnings are tax-deferred. Also referred to as a cash or deferred arrangement (CODA), a 401(k) plan is funded primarily by employee salary deferrals, rather than employer contributions. By installing a 401(k) plan, an employer may limit its costs principally to certain expenses for plan administration. Even these plan administration expenses, however, may be borne by plan participants.
3. **C** - A SEP is nothing more than an employer’s agreement to contribute to IRAs that are maintained by employees. The plan can be adopted by an employer by completing a fairly simple IRS form, rather than the much more complicated procedure involved in installing a qualified retirement plan. As in all tax-favored plans, the contributions must be on a nondiscriminatory basis. A SEP, because of its utter simplicity, is significantly easier and less expensive to install and administer than a qualified retirement plan. As a result, the need for the various consultants normally associated with the establishment of a qualified retirement is minimized, further reducing the employer’s cost. Furthermore, the employer’s contribution is discretionary, enabling the employer to discontinue contributions in times of reduced cash flow.
4. **C** - Contributions to a SIMPLE may come from two sources:

* Elective contributions by employees
* Employer contributions

Chapter 2

1. **A** - In large corporations, ownership may be distributed over thousands or even millions of shareholders; in the small business, ownership usually vests in just a few people. Since these owners are often the managers of these small companies, the funds that comprise the qualified plan budget are funds the owners could distribute to themselves as current compensation. As a result of that identity between owners and managers and the trade-off between qualified plan benefits and current compensation, the primary concern in the market of small employers is often that most of the benefits go into the accounts of the owners.
2. **A** - The stated rule is that qualified plans cannot discriminate in favor of one employee group over another. Despite that general proscription, the plan’s design can clearly favor certain employees or employee groups. So, the second objective of the small employer - that is, whom should the plan favor - has a substantial impact on the design of any plan in the small plan market. The determination of this objective tells the plan designer what benefits will generally be provided for the non-key employees. And, as we have already discussed, small employers usually want to provide the largest slice of the benefit pie to their most important employees. In the view of many small employers, their most important employees are the company’s key people, including themselves.
3. **B** - The plan budget will impact the type of plan the company chooses since the annual administrative costs are dictated, in part, by the type of plan chosen. It is fairly obvious that when funds available for plan contributions are limited, a plan that is more costly to administer will usually be avoided in favor of one that is simpler and less costly to administer. That may mean that a regular 401(k) plan, with its generally greater administrative costs, may be rejected in favor of a traditional profit sharing plan or a SIMPLE 401(k). Certainly, making that kind of a decision would leave more funds available for plan contributions.

Chapter 3

1. **C** - Some of the goal questions posed during the fact-finding interview will usually surprise the prospect and require explanation. It is important, however, that the prospect remain focused on the broader issue of qualified plan goals during the fact-finding interview. For that reason, plan designers will normally avoid a detailed discussion of particular plans at this point in the process. Full and complete explanations of the characteristics of particular plans are important. However, the explanation should be accomplished only at the appropriate time in the interview process.

Chapter 4

1. **D** - Key employees typically earn a lot more compensation than non-key employees. That characteristic can also be used to favor key employees through Social Security integration, often referred to as permitted disparity.
2. **C** - The individual account character of defined contribution plans, such as a money purchase pension plan or a profit sharing plan, has considerable appeal to employees generally. These accounts are particularly attractive, however, to younger employees who may see their employment with the plan sponsor to be just one step along a career path. 401(k) plans, because of their pre-tax contributions, may appear to employees to be tax-favored savings accounts made available by the employer.
3. **C** - An employer may want to ensure that each employee receives adequate replacement income at retirement. While an adequate level of replacement income varies depending upon the participant’s other assets, various studies have suggested that a replacement ratio of from 60 percent to 80 percent from the plan is a reasonable target. This plan level is in addition to any Social Security retirement benefits payable to the participant.
4. **A** - No particular type of qualified plan ensures that employee turnover will be reduced. There are certain plans and design features that can be built into qualified plans, however, that will tend to ameliorate turnover. Generally, the most satisfactory approach arises out of a combination of a defined benefit plan choice and a lengthy vesting schedule.
5. **B** - A stock bonus plan may provide participant motivation to perform more effectively. An employee stock ownership plan - ordinarily referred to as an ESOP - is a defined contribution plan that invests primarily in qualifying employer securities. Qualifying employer securities are securities of the plan sponsor that:
   * Are readily tradable on an established securities market, or
   * Meet certain other conditions if the stock is not readily tradable on an established securities market

Insofar as the plan invests in employer securities, the value of each participant’s account will be directly affected by the securities’ price which generally reflects the company’s profitability. Clearly, the participant’s account value is directly tied to the company’s performance. If the participant clearly understands the connection between the results achieved by the employer and his or her plan balance, the stock bonus plan can have a strongly positive influence on employee performance.

1. **B** - Even though a retirement plan of any type can act as an incentive to encourage employees to retire, a defined benefit plan may work most effectively because:
   * It can be designed so that full benefits accrue after a specified period of service has been met - 35 years, for example - but permit no additional benefits to accrue beyond that point. As a result of that design, employees will have a retirement income motivation to work up to the maximum number of years but will have no retirement income motivation to work beyond it because no further retirement benefits will be earned, and
   * A defined benefit plan can subsidize early retirement and make it more attractive by providing a benefit at a particular early-retirement age - age 55, for example - whose actuarial equivalent is greater than the participant’s benefit at the plan’s normal retirement age.
2. **C** - The qualified plans offering the most flexibility in making contributions are traditional profit sharing plans and SEPs. In both plans, the employer’s annual contribution may be entirely at its discretion. As a result, contributions may be omitted completely in any year without affecting the plan’s qualified status, as long as contributions are substantial and recurring.

# References

Students may wish to consult the following sources for additional study of qualified plans, their operation and taxation:

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Tacchino, K.B. and D.A. Littell. 1994. *Planning for Retirement Needs*. Bryn Mawr: The American College.

*401(k) Plans, 3rd Edition*. 1999, Chicago: Dearborn.

*Pension Planning Concepts*. 1998, Indianapolis: Pictorial.

1. Beginning in 2010, eligible employers may offer a hybrid qualified plan that combines features of a defined benefit plan and a 401(k) plan. In such a plan, the employer makes all contributions to and assumes the investment risk in the portion of the plan providing defined benefits; the participant may make contributions to, and assumes the investment risk with respect to, the 401(k) part of the plan. [↑](#footnote-ref-1)