StatonWalsh

Financial Clarity Through Transparency

Prepared for:

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Qualified Retirement Plans

Qualified retirement plans are Congressionally-approved retirement plans which have several major tax benefits.

- The employer's contributions can be deducted for income tax purposes.
- The earnings on the plan's investments accumulate on a tax-deferred basis.
- When the funds are distributed at retirement age, they may be eligible for favorable tax treatment.[1]
- Taxpayers may be in a lower income tax bracket after retirement.

Two Principal Types of Plans

Qualified retirement plans can generally be classified as either defined *benefit* or defined *contribution plans*.[2]

Defined benefit plans: Specify the dollar amount each participant will receive at retirement age and then estimate how much must be contributed each year to accumulate the necessary future fund. Interest rates, ages of participants, etc., will have an effect on the calculation. The amount of the contribution is generally determined by an actuary. The investment risk rests on the *employer*.

Defined contribution plans: Generally put a percentage of current salaries into the plan each year. The amount at retirement will depend on the amount contributed, the investment return and the number of years until a participant retires. The investment risk rests on the *participant*.

Plan Type	Contributions	Retirement Benefits	Investment Risk
Defined benefit	Vary	Fixed	Employer
Defined contribution	Pension – Fixed Profit sharing – Vary	Vary	Employee

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

[2] Note that some plans have features of both types.

What Is the Best Type of Plan?

There is no best type of plan. The choice of what type of plan to use is an individual one. The answer depends on factors such as employer goals and available cash flow.

Defined Benefit Plans

The employer contributes an actuarially-determined amount sufficient to pay each participant a fixed or defined dollar amount at his or her retirement. The benefit may be defined as a flat percentage of compensation, a percentage which increases with years of service, or a percentage which changes at certain compensation levels, etc.

This type of plan generally favors older employees, because more of the employer's contributions must go into his or her account to make certain that there will be enough to pay the promised (or defined) benefit at retirement age.

Defined Contribution Plans

There are several variations of defined contribution plans. Some of the more common ones include the following:

- **Money purchase pension:** The employer contributes a specified percentage of the participating employee's salary each year. Whatever that fund grows to is what the retiring employee receives.
- **Profit sharing plan:** Similar to the money purchase pension, except that contributions do not need to be a specific percentage and they do not need to be made every year, as long as they are substantial and recurring.
- **Stock bonus plan:** Similar to the traditional profit sharing plan. The plan may, but is not required to, invest primarily in the employer's stock.
- **ESOP - Employee stock ownership plan:** Like a stock bonus plan, to which the employer can contribute company stock instead of cash. The plan must be primarily invested in company stock.

- **IRC Sec. 401(k) plan:** Also called a cash or deferred plan, this plan is any stock bonus plan or profit sharing plan which meets certain participation requirements of IRC Sec. 401(k). An employee can agree to a salary reduction or to defer a bonus which he or she has coming.
- **SIMPLE plans:** SIMPLE stands for Savings Incentive Match Plan for Employees. SIMPLE plans can be in either an IRA format or a 401(k) format.
- **SEP:** This stands for Simplified Employee Plan. A SEP is a group of individual IRAs established for employees to which the employer contributes. Contributions to a SEP may exceed what an individual employee could contribute to a traditional IRA or a Roth IRA.

Qualified Plans Compared

Plan Type	Defined Benefit		Defined Contribution	
Benefit or Feature	Traditional Defined Benefit	Cash Balance Plan	Nontraditional Defined Contribution Plan	401(k) Plan
Employer contributions deductible?	Yes	Yes	Yes	Yes
Employer contributions currently taxable to participant?	No	No	No	No
Earnings accumulate income tax deferred?	Yes	Yes	Yes	Yes
Distributions can be tax favored using 10-year income averaging?	Maybe[1]	Maybe[1]	Maybe[1]	Maybe[1]
Contribution benefit base is total compensation up to $305,000?	Yes	Yes	Yes	Yes
Maximum employer annual contribution/deduction:	Determined by actuary	Determined by actuary	25% of covered payroll	25% of covered payroll excluding deferral, if plan specifies
Employer contributions required?	Yes	Yes	Money purchase – yes Profit sharing - no	No

[1] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment.

Qualified Plans Compared

Plan Type	Defined Benefit		Defined Contribution	
Benefit or Feature	Traditional Defined Benefit	Cash Balance Plan	Nontraditional Defined Contribution Plan	401(k) Plan
Employer contributions discretionary?	No	No	Profit sharing - yes	Yes[1]
Voluntary employer matching contributions allowed?	N/A	N/A	N/A	Yes
Employer contribution allocation	N/A	Usually tiered - defined in plan	1. Age Weighted 2. Cross Tested 3. Super Integrated 4. Tiered	1. Pro rata by compensation 2. Integrated with Soc. Sec. 3. Age-weighted or 4. Cross tested 5. Tiered
Employee contributions **Required?** **Permitted?**	 No Rarely	 No No	 No Rarely	 Maybe[2] Yes
Maximum participant benefits (defined benefit plans only)	Lesser of 100% of compensation or $245,000[2] annually	Lesser of 100% of compensation or $245,000[2] annually	N/A	N/A
Maximum participant allocations (employer and employee) (defined contribution plans only)	N/A	Actuarial equivalent of maximum benefit above	Lesser of 100% of compensation or $61,000[2]	Lesser of 100% of compensation or $61,000[2]
Catch-up provisions for those age 50 and older	N/A	N/A	No	Yes $6,500[2]

[1] Top-heavy minimum employer contribution may be required.

[2] Applies to 2022.

Qualified Plans Compared

Plan Type	Defined Benefit		Defined Contribution	
Benefit or Feature	Traditional Defined Benefit	Cash Balance Plan	Nontraditional Defined Contribution Plan	401(k) Plan
Required discrimination tests **Coverage?** Benefits/Contributions?	Yes	Yes	Yes	Yes
Deferral rates of highly compensated/non-highly compensated?	N/A	N/A	N/A	Yes
Can exclude employees from plan participation on basis of age, length of service, or union membership?	Yes[1]	Yes[1]	Yes[1]	Yes[2]
Can exclude employees from plan participation on the basis of collective bargaining, and certain non-resident aliens?	Yes	Yes	Yes	Yes
Investments Self-directed by participants or can be invested at participant discretion (most plans impose some practical considerations) and/or	N/A	N/A	Yes	Yes
Directed by the trustee, must be diversified and prudent	Yes	Yes	Yes	Yes
Self-dealing is prohibited between plan and a number of related persons?	Yes	Yes	Yes	Yes

[1] Must allow participation if the employee is at least age 21 and has performed 1 or 2 years (1,000 hours per year) of service.

[2] Must allow participation if the employee is at least age 21 and has performed 1 or 2 years (1,000 hours per year) of service. Effective January 1, 2024, part-time employees working at least 500 hours per year for three years must be allowed to make 401(k) deferrals, but need not be included in employer contributions.

Qualified Plans Compared

Plan Type	Defined Benefit		Defined Contribution	
Benefit or Feature	Traditional Defined Benefit	Cash Balance Plan	Nontraditional Defined Contribution Plan	401(k) Plan
Plan may recognize employer contributions or benefits of Social Security?	Yes	Yes	Yes	Yes
Participants who are favored	Older and closer to retirement	Older and closer to retirement	Highly compensated and older	Younger
How much will there be at retirement?				
Benefits specified in plan?	Yes	Yes	N/A	N/A
Investment return affects retirement benefits?	No	No	Yes	Yes
Benefits guaranteed at retirement?	Yes	Yes	No	No
Who bears investment risk?	Employer	Employer	Employee	Employee
Ease of understanding by participants	Difficult	Easy – Benefit defined as a contribution amount	Difficult to Easy	Easy
Can life insurance be provided?	Yes	Yes	Yes	Yes
Can participants have a traditional, deductible IRA, or a Roth IRA, subject to income level limitations based on filing status?	Yes	Yes	Yes	Yes
Forfeitures are used to:	Reduce employer contribution	Reduce employer contribution	Reduce employer contribution or are reallocated among participants	Reduce employer contribution or are reallocated among participants

Qualified Plans Compared

Plan Type	Defined Benefit		Defined Contribution	
Benefit or Feature	Traditional Defined Benefit	Cash Balance Plan	Nontraditional Defined Contribution Plan	401(k) Plan
Can participants take loans subject to strict rules?	Yes	Yes	Yes	Yes
Are hardship withdrawals permitted under well-defined circumstances? (Participant cannot defer for 6 months thereafter.)	N/A	N/A	N/A	Yes
Top heavy requirements, if applicable[1]				
Defined benefit plans	Yes - 2% annual benefit for 10 years	Yes – Contribution is equivalent to a 2% annual benefit for 10 years		
Defined contribution plans			Up to 3% of compensation[2]	Up to 3% of compensation[3]

[1] If more than 60% of the plan assets or accrued benefits are allocated to key employees, the plan is top heavy. A "Key" employee is someone who, at any time during the plan year was (1) an officer of the employer whose compensation from the employer exceeded $200,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000

[2] This amount may be greater in some circumstances.

[3] This amount depends on facts and circumstances.

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Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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