
About Defined Contribution Plans

A Defined Contribution Plan allows an employer to make retirement plan contributions that are eligible for special tax treatment. Tax advantages of plan sponsorship include:

- Employer contributions to the plan are tax deductible to the company.
- Contributions to the plan are not currently taxable to the employees.
- Investment earnings within the trust are not currently taxable (that is, they accumulate tax deferred).

In order to qualify for this special tax treatment, the plan must meet certain requirements to ensure that the plan, among other things, does not discriminate in favor of owners or other “*Highly Compensated Employees*.”

There are a number of IRS-approved options for designing a qualified retirement plan, some of which are described below.

What follows is some important information about Defined Contribution Plans. The information is general in nature, and is not intended to be taken as a comprehensive description of the regulations covering qualified plan sponsorship.

Plan Types

There are two principle types of Defined Contribution Plans qualified under IRC 401(a): Profit Sharing Plans and Money Purchase Pension Plans. The two types of plans have many features in common.

Common Features

Company Deduction Limit. For each type of plan, an employer may deduct contributions up to 25% of covered compensation of all participants.

Participant Allocation Limit. The maximum that a participant may be allocated in a plan year is the lesser of 100% of compensation or \$49,000 (2011 limit, indexed).

Maximum Compensation. The maximum compensation that can be considered for one employee is \$245,000 (2011 limit, indexed). Compensation exceeding this amount is not considered for plan purposes.

Vesting Schedule. Generally, the most restrictive vesting schedule a small plan should consider is a 6-year graded vesting schedule (beginning with 20% in the 2nd year, and increasing in 20% increments each year thereafter), or a 3-year “cliff vesting” (100% after 3 years). However, schedules more liberal than this may be used. Forfeitures resulting from the use of a vesting schedule generally end up reducing the employer’s cost of future contributions.

Eligibility Requirements. The employer can require up to 12 months of service to be eligible for the plan, while still retaining the plan’s vesting schedule. The employer may also require a minimum age (not greater than age 21) for plan eligibility.

Entry Dates. Once an employee has met the *Eligibility Requirements*, they enter the plan on the next *Entry Date*. Generally, the plan would be setup with *Entry Dates* on two or more specific dates during the year.

For example, consider a plan requiring 12 months of service for eligibility, with entry dates of January 1 and July 1. If an employee completes his first 12 months of service on August 7, **he does not enter the plan until the next plan entry date which is January 1 of the next year.**

Highly Compensated Employees. This is an important group for plan discrimination testing purposes: plans must not discriminate in favor of these employees. Currently, *Highly Compensated Employees* include the following:

- Any employee who received compensation in excess of \$110,000 (limit for 2011 test year) in the **prior** plan year.
- Any owner with an interest greater-than-5% in either the current year or prior year.
- The spouse of a greater-than-5% owner, as well as their children, parents and grandparents.

Distributions. Normal distributions of a participant’s account may occur when the participant terminates employment with the company, retires, or becomes disabled. Generally, participants may “roll” all of the pre-tax distribution into an Individual Retirement Account (IRA) and continue tax-deferred earnings, or they may elect to take a lump-sum distribution and pay the tax required. Any taxable distribution before age 59 ½ (or age 55, with separation of service) may be subject to an additional 10% excise tax.

Profit Sharing Plans

The Profit Sharing Plan is usually the most flexible and cost-effective option available to a small employer. Company contributions are at the discretion of the employer, and are not required in any particular year. Allocation methods available include basic formulas, such as “pro rata” and “Social Security integration”, as well as special age-sensitive formulas, such as the “Tiered” allocation method.

Company contributions to a Profit Sharing Plan are limited to 25% of covered compensation. If an employer would prefer to make contributions in excess of 25% of covered compensation, or would prefer to make contributions for a targeted employee in excess of \$49,000, a Defined Benefit Plan should be considered.

401(k) Profit Sharing Plan

A 401(k) Plan is a type of Profit Sharing Plan, with additional provisions that allow employees to defer part of their compensation. Company contributions, such as company match or profit sharing contributions are a deduction to the Employer.

Salary deferrals lower participant compensation for most federal and (in most states) state tax purposes, though the participant and employer continue to pay Social Security and Federal Unemployment taxes on the gross wages before deferrals.

Money Purchase Pension Plans

The principle feature that distinguishes a Money Purchase Pension Plan (“MPPP”) from a Profit Sharing Plan is the fact that contributions to a MPPP are required based on a formula in the plan document. If a change in the contribution level is desired, an amendment to the plan document is required. Most other plan features, including available allocation formulas, are similar to those of a Profit Sharing Plan.

Prior to 2002, some employers adopted a MPPP to get higher contribution levels than were then available with a Profit Sharing Plan. Up until that time, a Profit Sharing Plan’s deduction limit was 15% of covered compensation (rather than the current 25% of covered compensation), but the limit for a MPPP was 25%. In 2002, the deduction limit for a Profit Sharing Plan was raised to that of a MPPP, so the higher deduction limit was no longer a reason to sponsor a MPPP.

There are still certain situations when an employer may want to sponsor a MPPP. For this reason, Benetech still sponsors prototype MPPP documents to support these plan sponsors.

Contribution Allocation Formulas

Company contributions to a Defined Contribution Plan must not be allocated in such a way as to discriminate in favor of *Highly Compensated Employees*. The allocation formula describes how company contributions to the plan are allocated among the participants. There are a number of IRS-approved allocation methods a plan may use.

The standard allocation formulas are nondiscriminatory because they are uniformly applied according to certain rules. These formulas include “Pro Rata” and “Social Security Integration.”

However, there are also special formulas for allocating contributions. These methods require additional discrimination testing, but may result in a substantially higher percentage of the total company contribution allocated to targeted *Highly Compensated Employees* such as owners.

Benetech’s WAVE and Tiered Plans use special formulas that are “cross tested,” in that they are Defined Contribution Plans that are tested like Defined Benefit Plans. By taking advantage of alternate means of discrimination testing, these plans can allocate up to 90% of a company’s contribution to the accounts of targeted employees.

Standard Allocation Formulas

Standard allocation formulas found in most Defined Contribution Plans follow fairly restrictive procedures. There are two common options: “pro rata” and “Social Security integration.” When one of these procedures is followed, the allocation is automatically deemed to meet nondiscrimination requirements.

Pro Rata Formula

This formula allocates the contribution on the basis of the ratio of the participant’s eligible compensation to the total covered compensation of all eligible employees. The result is that each eligible participant receives **the same percentage of covered compensation**.

Owners and other *Highly Compensated Employees* generally make more than other employees, so they are generally allocated a higher dollar amount than other employees. However, since they are allocated the same percentage of compensation as the other employees, the basic allocation meets nondiscrimination requirements.

Social Security Integration (aka “Permitted Disparity”)

This method takes into account amounts that employees and employers pay in to Social Security. The idea is that employees who make more than the Social Security Taxable Wage Base (“TWB,” which is \$106,800 in 2011) are limited in what they will receive from Social Security after retirement.

For this reason, an “integrated” plan defines an “integration level” (usually the TWB), and then allocates a modest additional contribution for compensation in excess of the integration level. The result is a slightly higher allocation to employees whose compensation is in excess of the integration level when compared to the pro rata formula.

Special Allocation Formulas

Benetech’s Tiered Plans use an alternate method of satisfying nondiscrimination requirements: it considers the benefit at retirement funded by each participant’s allocation.

The idea rests on the premise that older employees have less time to accumulate retirement benefits. Therefore a larger current-year contribution may need to be made on behalf of each older employee to make their benefits at retirement equivalent to those of younger employees.

The targeted employees (such as owners) tend to be older than other employees. As a result, these types of plans tend to allocate a greater percentage of the total contribution to the targeted employees when compared to a plan using a standard allocation formula.

Tiered Formula

The basic idea of the Tiered formula is similar to that of the WAVE. However, it adds a couple of features that greatly enhances the power of the “cross tested” allocation method.

First, a Tiered Plan allows allocation categories based on legitimate business distinctions, such as job classifications. For example, legitimate business categories include “Owners” and “All Others”.

Second, it applies two separate discrimination tests. The first compares the benefit at retirement that the allocation is funding for each participant (like the WAVE method); **however**, only a fraction of the eligible employees are included in this test.

The second test includes all participants. However, this test **averages** the benefit at retirement of all of the participants in each discrimination testing category.

The result is a plan design where the targeted *Highly Compensated Employees* only need to be older than **most** of the employees for the program to be effective. The result is that the percentage of the total contribution allocated to the targeted employees is higher in most cases than that of the WAVE Plan.