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DEDUCTION, DEDUCTIONS AND MORE DEDUCTIONS

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Our experience shows that of our 2,000 plus clients we found that at least two thirds of them have only one question when it comes to their qualified retirement plan: "What is my contribution/deduction?" When we explain that the plan also provides valuable retirement benefits they are not nearly impressed as they are with the amount of their contribution/deduction for the current plan year.

Prior to the Employee Retirement Income Security Act of 1974, (ERISA) enacted into law on Labor Day of that year, plan contributions/deductions could never be predicted prior to receiving approval from the IRS of the plan documents and the benefit formulas contained therein. The reason being that the various IRS Districts did not adhere to the same set of rules. In some Districts you could get a 35% Money Purchase Plan approved but not in others. Sometimes you were able to get an 85% Defined Benefit Plan formula approved, but not always. Approval of the plan formula was contingent solely upon the opinion of the local District Director and whether or not it was deemed to be "proper."

With the advent of ERISA, and since then, all of the IRS Districts have had to comply with the same set of rules and regulations. The ERISA limits were set at the lesser of 25% of compensation or \$25,000 for a Money Purchase Plan and the lesser of the high three-year average of compensation or \$75,000 for a Defined Benefit Plan. The 1.4 rule permitted one to have a full Defined Benefit Plan and a Money Purchase Plan equal to 40% of the maximum Money Purchase benefit or \$10,000. Profit Sharing Plans were limited to 15% of compensation. Defined Benefit Keogh Plans (for the self-employed or S-Corporations) generated contributions of up to \$15,000 per year.

Over the next eight years, cost of living adjustments (COLAS) brought these limits up to \$45,475 for Money Purchase Plans and \$136,425 for Defined Benefit Plans. When taken in combination one could have an annual pension of \$136,425 commencing at age 55 plus a Money Purchase contribution of \$18,190.

For the twelve-year period from 1982 to 1994 the government, commencing with the Tax Equity and Fiscal Responsibility Act, (TEFRA) passed a series of pension laws that were designed to reduce benefits and cut back on contributions/deductions. If you put in too much or too little, or did it too soon or too late, or if you took out too much or too little, too soon or too late, you would be penalized. Such was the order of the day. The only advantage to TEFRA was that it put Defined Benefit Keoghs on the same benefit level as C-Corporation sponsored plans.

Starting in 1996, the pendulum began to swing back the other way with the passage of the Small Business Job Protection Act, (SBJPA) followed by the Taxpayers Relief Act, (TRA) in 1998. On June 7 of 2001 President Bush signed the Economic Growth and Tax Relief Reconstruction

Act of 2001, or EGTRRA. A sampling of the key provisions of this law as they apply to 2004 are as follows:

DEFINED BENEFIT PLANS

Starting with plan years ending in 2004, the following schedule can serve as an approximation for maximum deductions (contributions may be higher or salaries lower in some cases).

<u>Age</u>	<u>Minimum Compensation</u>	<u>Maximum Contribution</u>
25	\$25,000	\$65,000
30	\$35,000	\$80,000
35	\$45,000	\$100,000
40	\$55,000	\$130,000
45	\$70,000	\$165,000
50	\$90,000	\$215,000
55	\$100,000	\$230,000
60	\$100,000	\$265,000
65	\$100,000	\$325,000

These contribution amounts are based on new plans. Existing plans will have lower contribution levels due to the current value of the assets already in the plan. For example, an existing Defined Benefit Plan, with a 55-year-old participant and \$750,000 in the plan, would be able to support a contribution of up to \$105,000 per year for 7 years. These contribution amounts do not use insurance products of any kind, nor do they include 401(k) contributions. If a spouse is included, the above contribution levels could possibly double.

PROFIT SHARING PLANS

Starting with plan years beginning January 1, 2004, the new individual allocation limits will be the lesser of \$41,000 or 100% of the participants compensation but with an overall deductible limit of 25% of the plan sponsors total eligible compensation.

Cross Tested Profit Sharing Plans are modified wherein the non-highly compensated employees (NHCE) must generally, but not always, receive an allocation of not less than the lesser of 5% of compensation or one third of the highest allocation percentage for the highly compensated employee (HCE) in the plan. If combined with a Defined Benefit Plan the minimum NHCE percentage allocation is generally, but not always, increased to 7 ½%.

With these new limits and percentages, Money Purchase Plans may no longer be practical. Profit Sharing Plans have the same limits as Money Purchase Pension Plans, but are more flexible in the amount of contributions from year to year. Therefore, if anyone still sponsors a Money Purchase Plan it is advisable to consider whether it should be terminated and replaced with a Profit Sharing Plan.

401(k) PLANS

The limit for voluntary deferrals will increase to the lesser of \$13,000 or 100% of compensation in the year 2004, increasing by \$1,000 per year thereafter, going up to \$15,000 by 2006.

Catch up contributions will be permitted for those who reach age 50 by the end of the plan year. The additional pre-tax contributions can be up to \$3,000 in 2004, increasing by \$1,000 per year thereafter, going up to \$5,000 by 2006.

In this manner, those age 50 and older can make total 401(k) contributions of \$16,000 in 2004, increasing by \$2,000 per year thereafter, going up to \$20,000 by 2006.

In the case of corporations, 401(k) plans that benefit the owner-employee can be established in addition to a Defined benefit Plan. If there are non-owner employees, then the standard ADP/ACP Test requirements must be met.

LOANS

Participant loans to owner-employees have been permitted only on behalf of those participants in plans that were sponsored by C-corporations. As of January 1, 2002, participant loans have been permitted to all owner-employees regardless of the type of plan sponsor. Loans are still subject to a maximum equal to the lesser of \$50,000 or 50% of the participant's vested accrued benefit or \$10,000 if applied for under the de-minimus rule. Unless the loan is for the purchase of the participant's principle residence it must be repaid within five years with payments amortized not less than quarterly at an appropriate rate of interest, which is currently acceptable to IRS as "prime plus two."

CREDITOR PROTECTION

Although not generally known, ERISA qualified plans (those that cover at least one non-owner employee) have creditor protection which means that the plan assets are protected and exempt from attachment.

COMPENSATION

In 2004, the maximum permissible compensation for purposes of calculating benefits or contributions is \$205,000. What this means is that future contribution or benefit formulas can be reduced without decreasing benefits or contributions for the highly paid.

TAX CREDITS

Expenses for the establishment or maintenance of a qualified retirement plan have always been deductible. For taxable years commencing January 1, 2002, actual tax credits for plan expenses of up to \$500 per year for three years will be available. In order to be eligible for this tax credit the plan must be established after 2001, include at least one NHCE and have no more than 100 employees with compensation in excess of \$5,000 each.

USER FEES

User or submission fees are required for all plans or amendments that are submitted for IRS approval. Requests for IRS determination letters made after 2001 will not require User Fees provided the plan has 100 or fewer employees and at least one NHCE.

IRA ROLLOVERS

Originally, IRA transfers or rollovers to qualified retirement plans were permitted only in the case of “conduit” IRA’s, that is IRA accounts that were from another qualified plan including any growth thereon, provided said IRA’s were not commingled with “standard” IRA funds. Starting in 2002, “standard” IRA’s could be transferred or rolled over to a qualified plan. What is not clear at this time is whether the “conduit” and “standard” IRA’s can be merged or if they must be segregated. In the case of a Defined Benefit Plan they must be segregated.

GUILD AGGREGATION

While a number of CPA’s, attorneys, and actuaries have been of the opinion that plan benefits of “loan out” corporations had to be aggregated with the benefits of the Guild Plans to which they belong to for purposes of IRC Section 415, this has never been an issue in IRS audits.

This situation has been defused with the elimination of Section 415(e) of the IRC as of January 1, 2000, which negated the offsetting of Defined Benefit and Defined Contribution Plans against one another. In 2002, multi-employer plans (Guild Plans) will not have to be aggregated with single employer or other multi-employer plans for purposes of the percentage of compensation limits.

PLAN AMENDMENTS

The benefit/contribution features described above are not automatic. In order to avail yourself of these provisions, a plan amendment is required.

AUDITS AND PROHIBITED TRANSACTIONS

Every vigilant against abuses, both real and perceived, the IRS has stepped up its audit campaign, not against contributions per se, but against prohibited transactions or PT's.

What is a PT? It is anything that you are not supposed to do. This can include: improper exclusion of otherwise eligible participants such as, but not limited to, "leased employees;" improper calculation of employee benefits; lack of notification of substantive changes in the plan; improper loans that may be excessive, un-documented or not repaid timely; lack of documentation regarding plan contributions; lack of timeliness in remitting employee deferrals and of course improperly valued plan assets. Errors in asset valuation could understate or overstate a participant's account in a Defined Contribution Plan (i.e., Money Purchase Pension Plan, or Profit Sharing Plan). Improperly valued assets in a Defined Benefit Plan could generate contributions that are higher or lower than what is proper for minimum or maximum funding requirements.

412(i) PLANS

Section 412(i) of the IRC says that if you have a fully insured plan (all assets are in life insurance and/annuities with a commercial carrier) you can rely on the issuing insurance company guaranteed interest rates for purposes of developing the contributions.

During the period of the Small Plan Actuarial Audit Program wherein the IRS was attempting to require the use of interest rates of not less than 8% and retirement ages of not less than 65, the prospect of a fully insured 412(i) plan looked enticing. A 4% interest assumption for a 45 year old retiring at 65 compared to an 8% interest assumption meant a contribution increase of 60%. However, when the IRS lost its case in Tax Court (12 out of 13 Tax court judges ruled against the IRS. One of the judges abstained because he "didn't know enough about the subject"), actuaries routinely began to use 5% interest assumption (or 4% in special circumstances). A 4% interest assumption generates a contribution in the above example of only 12% more than what is obtainable with a 5% interest assumption. Immediately, the "interest" advantage of a 412(i) plan was minimized.

However, it is important to note that when a 412(i) plan prematurely terminates, the plan suffers a large decrease in the surrender values, which pays for commissions and the cost of medicals and underwriting. Additionally, there can be no investments of the plan other than in insurance products. No mutual funds, stocks, bonds, real estate, collectables, etc. Employee costs can become exorbitant since they too must receive benefits that are comparable and/or non-discriminatory when compared to that of the owners.

We are aware of cases whereby some insurance companies have been promoting 412(i) plans that use Whole Life insurance exclusively. This violates two IRS principles. First, a plan that uses only insurance is not a qualified plan. Second, the maximum amount of insurance is subject to either 100 times the projected monthly pension or if RR74-307 is used the maximum amount of insurance is limited to the Whole Life premium, which is restricted to no more than 2/3 of the Normal Cost. The insurance industries response was "use 5% for annuities and 95% for whole life insurance." This addressed the first principal but the resulting face amount was still far in

excess of the incidental death benefit rule. Their next response was, “lets name the trust as beneficiary who will then pay out the appropriate maximum death benefit.” What happens to the plan in the event of such a windfall? If, for example, only 2.5 million out of a 6 million dollar death benefit is paid out the plan will become fully funded and be subject to all kinds of problems besides not permitting any future contributions on behalf of the remaining owners.

The IRS has stated that they are fully aware of the abuses in this area (including the usage of policies with jumping cash values) and will be taking steps to correct the problems and revisit those plans that have already been approved to determine if there have been any violations.

There is nothing wrong with including insurance in a qualified Defined Benefit plan. If this is what the client wants and understands the advantage and disadvantages of providing life insurance in a plan, then you can achieve similar results without implementing a 412(i) plan. Our experience shows that we can achieve equal or better results with a Defined Benefit plan that incorporates whole life insurance with far greater flexibility since 412(i) plans can use only one funding method and cannot have any investments outside that of insurance or annuities.

419A(f)(6) PLANS

With the passage of TEFRA in 1982 section 419A(f)(6) of the IRC was of interest once again. It appeared to be the answer to the cutbacks imposed by TEFRA except that it could not be used to provide retirement benefits of any kind. It could make available all kinds of ancillary benefits, almost all of them requiring some form of insurance. This plan could provide a “severance” benefit of up to two times the individual’s salary. Since this had to be funded by insurance it required a large face amount and premium in order to generate the required cash values.

While a number of prestigious law and accounting firms have issued their own favorable opinion letters on 419A(f)(6) plans, the one opinion letter that truly counts, the one from the IRS, has never been issued.

If you are going to venture down this road, our recommendation is to first implement a plan where you can get a favorable IRS Determination Letter. This not only provides added protection for the client, but you as well.

CONCLUSION

EGTRRA was passed with a ten-year “sunset” provision, which means that in the absence of any new legislation extending this law, all benefits that have not been properly grandfathered will revert back to the 2001 limits after 2010. If you have clients that are able to take advantage of the larger deductions now permissible it is our recommendation that they do so while they can.