Guide to Qualified Retirement Plans:

A Plain Language Primer

by Stephen Abramson

INTERNATIONAL FOUNDATION OF EMPLOYEE BENEFIT PLANS

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About the Author

Stephen Abramson is president and co-founder of APS Pension & Financial Services, established in 1977. APS is a midsized actuarial firm that specializes in pension and pension-related services. For over 26 years, APS has been providing closely held businesses with financial services—including pension design and administration, business succession planning and wealth preservation planning. In addition to his business management background, Mr. Abramson is a certified pension consultant (CPC) who has taught professional-level education programs for the American Society of Pension Actuaries; been interviewed several times on "Dollars and Sense," a financial talk show on cable television; lectured to various professional groups, including the Nassau Bar Association and the C.W. Post Tax Institute; and conducted continuing education seminars for certified public accountants for the past 26 years. He has written *Financial Professional's Guide to Qualified Retirement Plans* and co-written *Plan Smart, Retire Rich.* He is the lead author of *Retirement Financial Management for Clients At or Near Retirement.* Mr. Abramson is also a chartered financial consultant (ChFC) and chartered life underwriter (CLU). He earned his degree in finance and business management from Cornell University.

Introduction

CASE SCENARIO

You're the benefits manager at the National Construction Company, Inc., a privately held, family-owned business employing 2,500. You've just been advised by the CFO that the purchase of Local Construction Company, Inc. by National has been signed, sealed and delivered. This is the first you've learned of this transaction.

Local employs 50 nonunion employees and offers a safe harbor 401(k) plan (see Chapter 5) using a third-party administrator's prototype plan document (see Chapter 2). Almost two years later, during an internal audit of National's retirement plan(s) and subsidiaries, it is discovered that Local Construction Company's plan document requires coverage of all companies in the controlled group of companies (see Chapter 10). Because National Construction Company and Local Construction Company, Inc. are a parent-subsidiary controlled group, the employees of both companies must be covered beginning in the plan year starting January 1, 2003.

Absent any negotiated settlement with the Internal Revenue Service (IRS) (see Chapter 14), National Construction Company would be responsible for a 3% safe harbor contribution for their employees plus investment earnings based on the performance of the assets in Local's plan for the plan year. In addition, National Construction Company's plan document may require it to cover the employees of Local Construction Company, Inc. in its plan.

To avoid this nightmare, financial professionals and benefit administrators should be aware of the basic issues to be addressed during a merger of two companies or the acquisition of one by another (see Chapter 10).

CASE SCENARIO

You've just received the day's mail. Prominent on top of the pile is a letter from the IRS. Concerned, you open it to find that your retirement plan has been selected for audit. You call your financial advisor/stockbroker who assisted you in setting up your plan.

You: Jack, I just got a letter from the Internal Revenue Service. They want to audit my company retirement plan. What should I do?

Jack: I wouldn't worry. Most of these audits are pretty simple. Remember the plan was prepared by our company (e.g., brokerage firm). I'm sure they know what they're doing.

You: Well, who should handle the audit for me? My accountant doesn't

know that much about pension audits and my benefits administrator is on vacation.

Jack: Just let the agent come to the office and give him the papers he asks for. You should have everything he needs in your office.

You: OK. I'll let you know what happens.

THREE WEEKS LATER

You, noticeably upset, call Jack.

You: Jack, IRS disqualified my plan! They said it wasn't complying with IRS and Department of Labor regulations. My deductions for the last two years were disallowed. I owe back taxes, interest and penalties that will probably be more than I contributed to the plan. How could this happen? You assured me that the plan was OK. You're responsible for this.

Jack: I just handle the investments. I'm not a pension expert. I depended on my company to provide the plan.

You: I dealt with you, not your company. I expect you to take care of this. If you don't, I'll sue you and your company!

Although this scenario is extreme, it is not uncommon. Many of the qualified plans established by medium-sized companies (under 500 employees) are set up by financial advisors who are not well versed in the complexities of the qualified pension plan rules and regulations. If the company is too small to have a benefits administrator familiar with the complexities of qualified plans, defects could result during the operation of the plan, causing adverse results as above.

As readers will learn in this book, establishing and operating a qualified retirement plan involves much more than filling in the blanks on one of these financial institution's plan documents. Before completing these "simple" prototype documents, readers must understand what they are doing and why:

- Which option should you choose for entry date? What does *entry date* mean? (See Chapter 2, Effective Date of Participation/Entry Date)
- Which *vesting schedule* can you use? (See Chapter 2, Vesting)
- Should the *plan year* be the same as the company's tax year? (See Chapter 2 and Chapter 3)
- Should the plan be a *profit-sharing plan* or a *pension plan?* (See Chapter 1)
- Should the company adopt one plan to satisfy its needs or two plans? (See Chapter 11)
- What are the issues to be considered in the ongoing administration of the plan? (See Chapter 13).

These types of questions go on and on. The answers can easily be found in the pages of this book. Although it is not the intention of this book to make readers a pension expert, it is the intention to be sure no one becomes a statistic on the IRS' audit database.

The best way to understand that what *seems* simple is not, is to consider these examples:

- Most prototype plan documents offer several choices for vesting. The most common are 100% immediate vesting and a seven-year graded vesting schedule that provides 20% vesting in year three, increasing by 20% per year, until 100% vesting is reached in year seven. Also, most plan documents offer dif-

ferent choices for eligibility. The most common is one year of service and two years of service. Since the stated purpose of many qualified retirement plans is to retain employees, it would seem logical to choose two years of service for eligibility and seven-year graded vesting to encourage the employees to stay. Unfortunately, those choices do not comply with IRS regulations. If more than one year of service is required for eligibility, you must then provide 100% immediate vesting. This is a seemingly simple issue that could cause the plan to be disqualified on audit.

- Although there is a three-year statute of limitations which would imply that generally only three years of deductions could be disallowed on audit, that is only true if the plan filed a Schedule P, the trustee's statement, with the Form 5500 each year. Again, a seemingly simple issue.
- The concept of entry dates is widely misunderstood. Let's consider a typical situation in which a company adopts a profit-sharing plan. The owner and his accountant are told by the financial advisor that set up the plan that eligibility is two years and the employee must be at least 21 years old. Jane, the receptionist, was hired November 15, 2001. As of the end of 2002, Jack and his accountant determine that Jane does not have the required two years of service and therefore do not make a contribution for her. As of the end of the year 2003, Jane has satisfied the two-year requirement and Jack and his accountant advise her that she will be receiving a contribution in the year 2004 now that she has satisfied the two-year requirement. Early in 2005, the IRS audits Jack's plan for 2003 on a random audit program. When they check eligibility they determine that Jane should have been included in the plan in the year 2003 since the definition of *entry date* is "the first day of the plan year in which the eligibility requirements are satisfied." Since Jane is well past age 21 and satisfied the two-year requirement on November 15, 2003 she should have become a participant as of January 1, 2003 (the first day of the plan year *in which* she satisfied the requirements) and received a contribution for 2003. At the least Jack will have to make up the contribution with all past investment earnings based on the plan's past experience and at the worst, although unlikely, the plan could be disqualified.

The purpose of this book is to provide an overview that in most cases will avoid the types of problems described above and familiarize readers with the basics of qualified retirement plans. Most pension literature is written for the pension specialist at a very high technical level or for the financial professional at a somewhat lower technical level. It is my intention to communicate these concepts in terms that are clear, understandable and that can assist in avoiding costly plan defects. We will cover the practical and most prevalent aspects of qualified retirement plans, those that are most likely to be encountered. All numerical examples used to illustrate a concept will be based on a limited number of participants for simplicity but applies to larger plans as well.

In the following chapters, we will cover how to choose the "best" plan depending on employer goals and priorities (see Chapter 1). Once a plan type is decided, we will follow the process of establishing that plan and the rules that guide the process (Chapter 2). Now that the plan is established, what are the rules we have to play by? How do we comply with those rules and monitor that compliance? If we inadvertently overlook one of those rules, how do we correct our error with the least amount of pain, financially or otherwise (Chapter 14)?

Since there are marked differences in the rules depending on the type of plan adopted, we will cover the nature of each type of plan that would normally be considered, including the advantages and disadvantages of that plan type, the benefit and/or contribution limitations and the potential pitfalls (see Chapters 3 through 7).

Last, since nothing is forever, we will discuss terminating a plan (see Chapter 15). Depending on the type of plan, termination rules will vary. In some cases, a simple company resolution and filing of a final Form 5500 with the IRS is sufficient. For other plans, a filing with at least two federal agencies—the Pension Benefit Guaranty Corporation (for defined benefit plans only) and the IRS—may be necessary.

So now the tone is set. Readers may want to follow this book from cover to cover or use it as a reference book when an issue arises. In either case, it will help readers stay out of trouble and ensure that the qualified plan adopted accomplishes its purpose: to provide a comfortable retirement for the plans' participants with minimum burden.