



**Parker Financial Services, LLC**

**Owner: David E. Parker, CPA, CFP®**

[www.retireontime.net](http://www.retireontime.net)

[dave@retireontime.net](mailto:dave@retireontime.net)



**3830 Packard Road; Suite 260**

**Office: 734-975-8711**

**Ann Arbor, MI 48108**

**Fax: 734-418-2106**

**"Helping Business Owners and Professionals Retire on Time"**

## **Qualified Plans for Business Owners**

If you are a business owner who has employees, then you are going to want to have a retirement plan. Retirement plans allow your employees to save for the future. They can direct a portion of their income into these plans, and they put off paying taxes on that income until they retire. Most of the plans require or allow the employer to contribute to their employees' retirement. The plan that you choose will affect your net income, the amount of taxes you will have to pay, and the amount of future obligations that you will have to pay out. Therefore it is important to make sure you choose a plan that is best for your business. This chapter will describe the different types of retirement plans that are available.

### **Simplified Employee Pension (SEP)**

A SEP is a form of profit sharing having a contribution limitation of the lesser of 100% of compensation or \$42,000. The major advantage to this form of plan is reduced documentation and reporting requirements.

In exchange for simplicity, it requires very early eligibility for employees and equal treatment for all those covered.

Ideal Investor:

A small firm seeking to minimize filings and paperwork. One short form sets it up and investments are made to an IRA. May exclude employees with less than 3 of previous 5 years of service and those under 21.

Plan Contribution features and limits:

Contributions are limited to the lesser of 100% of earned income or \$45,000 for each individual.

Special Features:

- Easy to establish.
- No government filings.
- Extended deadline for plan set up.
- Full flexibility of contributions.
- 100% usually vested immediately.

## Salary Reduction (SARSEP)

A Salary Reduction Simplified Employee Pension plan (SARSEP) is a Simplified Employee Pension (SEP) plan set up before 1997 that permits contributions to be made through employee salary reductions, referred to as “employee elective deferrals.” Under a SARSEP, employees and employers make contributions to traditional Individual Retirement Arrangements (IRAs) set up for the employees, subject to certain percentage-of-pay and dollar limits.

Employees can play an active role in funding for their retirement by choosing to have the employer contribute part of their pay to their separate IRAs, referred to as SEP-IRAs. SEP-IRAs need to be established for each participant, even those becoming eligible after December 31, 1996, with a bank, insurance company or other qualified financial institution.

No new SARSEPs can be established after December 31, 1996. However, employers who established SARSEPs prior to January 1, 1997, can continue to maintain them and new employees of the employers hired after December 31, 1996, can participate in the existing SARSEP.

### Ideal Investor:

A business with 25 or fewer employees wanting to offer employees a way to invest through convenient salary reduction in before-tax dollars. Limit contribution by the business. Special non-discrimination test. May exclude employees with less than 3 of previous 5 years of service and those under 21.

### Plan Contribution Features and Limits:

Salary reduction arrangement up to the lesser of \$15,500 for 2007. Regulations may require a business contribution in “top-heavy” plans. New SARSEP plans cannot be created.

Catch up contributions allowed for those over 50 years old.

### Special Features:

- Simple, inexpensive “401(k)”.
- IRA replacement.
- Promote employee participation.
- 100% usually vested immediately.
- Special non-discrimination test.
- New SARSEP cannot be established.

## Simple IRA

The SIMPLE (Savings Incentive Match Plan for Employees) IRA is a simplified, tax-favored retirement plan for small employers that provides for elective contributions by employees and meets certain vesting, participation and administrative requirements. This plan permits contributions only under a qualified salary reduction arrangement. A qualified salary reduction arrangement is defined as a written arrangement of an “eligible employer” under which:

1. Employees eligible to participate may elect to receive payments in cash or contribute them to the SIMPLE IRA account.
2. The amount to which such an election applies must be expressed as a percentage, or dollar amount, of compensation and may not exceed \$10,500 per year (2007).

3. The employer must also make matching contributions or non-elective contributions to the account.
4. No other contributions may be made to the account.

The maximum elective deferral amount is \$10,500 for 2007 and catch-up contributions of \$2,500 in 2007.

An individual who defers \$10,000 to a SIMPLE IRA of one employer and participates in a 401(k) plan of another employer would be limited to an elective deferral of \$5,500 in 2007 (\$15,500 - \$10,000) to the 401(k) plan.

The requirements for the employer's matching contributions or non-elective contributions are as follows:

#### MATCHING FORMULA

Under this formula, the employer is generally required to match employee elective contributions dollar-for-dollar up to an amount not exceeding 3% of the employee's compensation. However, a special rule permits the employer to elect a lower percentage matching contribution for all eligible employees (not less than 1% of each employee's compensation). To get the lower percentage, the employer has to notify the employees of the election within a reasonable period of time before the 60-day election period for electing to participate in the plan.

The employer may not use the lower percentage if the election would result in the percentage being lower than 3% in more than two out of the five years ending with the current year. If the employer (or a predecessor employer) has maintained the plan for less than five years, the employer will be treated as if the percentage was 3% in the prior years during which the arrangement was not in effect. If the employer made non-elective contributions for a year (instead of matching contributions) under the formula described below, it will be treated as having a percentage of 3% in that year.

The compensation limit under IRC Section 401(a)(17) does not apply for purposes of the matching formula; therefore, the 3% match could reach the maximum of \$10,500 (2007) for an employee with compensation of \$350,000 in a year.

A matching contribution made under this provision on behalf of a self-employed individual is not treated as an elective employer contribution for purposes of the limit on such contributions. The purpose of this provision is to treat self-employed individuals in the same manner as employees for purposes of the limit on elective contributions.

#### NON-ELECTIVE CONTRIBUTION FORMULA

Instead of making matching contributions, an employer can elect to make a non-elective contribution of 2% of compensation on behalf of each eligible employee with at least \$5,000 in compensation from the employer for the year.

If the employer makes this election, it must notify the employees within a reasonable time before the 60-day election period for electing to participate in the plan. The compensation limit under Section 401(a)(17) applies for purposes of this formula. Thus, the maximum amount that could be contributed in non-elective contributions for an employee would be \$4,500 (i.e., 2% of \$225,000 in 2007).

An arrangement will not be treated as a *qualified salary reduction arrangement* if the employer or a predecessor employer maintained another qualified plan (including a 403(a) annuity, a 403(b) tax-sheltered annuity, a SEP, or a governmental plan other than a Section 457 plan) under which contributions were made or benefits accrued for service during any year in which the Simple IRA plan was in effect.

However, if only employees *other than* those covered under a collectively bargained agreement are eligible to participate in the SIMPLE IRA plan, this rule will be applied without regard to a collectively bargained plan. In addition, for purposes of this rule, transfers, rollovers or forfeitures are disregarded except to the extent that forfeitures replace otherwise required contributions.

## ELIGIBLE EMPLOYER

Only an *eligible employer* may adopt a SIMPLE IRA plan. An “eligible employer” is defined as an employer who employed no more than 100 employees earning at least \$5,000 from the employer during the preceding year.

For purposes of this limitation, *all* employees employed at any time during the calendar year are taken into account, even those who are excludable or are ineligible to participate. Furthermore, certain self-employed individuals who receive earned income from the employer during the year must be counted for purposes of the 100-employee limitation. An employer who maintains a plan in which only collectively bargained employees may participate is not precluded from offering a SIMPLE IRA to its non-collectively bargained employees.

Generally, an eligible employer who ceases to be eligible after having established and maintained a SIMPLE IRA plan for at least one year will, nonetheless, continue to be treated as eligible for the following two years. However, special rules apply where a failure to remain eligible (or to meet any other requirement of Section 408(p)) was due to an acquisition, disposition or similar transaction involving another eligible employer.

Contributions under a SIMPLE IRA plan may be made only to a SIMPLE IRA, and a SIMPLE IRA may receive only the defined contributions and rollovers or transfers from another SIMPLE IRA account. All contributions to a SIMPLE IRA account must be fully vested and may not be subject to any prohibition on withdrawals, nor conditioned on their retention in the account. However, the premature distribution penalty for withdrawals is increased to 25% during the first two years of participation.

## PARTICIPATION REQUIREMENTS

The participation requirements for SIMPLE IRAs state that all non-excludable employees who received at least \$5,000 in compensation from the employer during any two preceding years, and are reasonably expected to receive at least \$5,000 in compensation during the year, must be eligible to make the cash or deferred election (if the matching formula is used) or to receive non-elective contributions (if the non-elective formula is used).

Of course, employers are free to impose less restrictive eligibility requirements, such as a \$3,000 compensation threshold, but they may not impose ones that are more restrictive. The \$5,000 threshold compensation amount is not scheduled to be indexed for inflation. Nonresident aliens who received no U.S. income and employees subject to a collective bargaining agreement generally are excludable employees for purposes of the participation requirement. An employee who participates in another plan of a different employer may participate in a SIMPLE IRA plan, but will be subject to the aggregate limit of

\$15,000 (in 2006) on the exclusion for elective deferrals. An employer who establishes a SIMPLE IRA plan is not responsible for monitoring compliance with this limitation.

Tax-exempt employers and governmental entities are permitted to maintain SIMPLE IRA plans. Excludable contributions may be made to the SIMPLE IRA of employees of tax-exempt employers and governmental entities on the same basis as contributions may be made to employees of other eligible employers. Related employers (i.e., controlled groups, partnerships or sole proprietorships under common control, and affiliated service groups) must be treated as a single employer for purposes of the SIMPLE IRA rules, and leased employees will be treated as employed by the employer. Consequently, all employees (and leased employees) of an employer who satisfy the eligibility requirements must be permitted to participate in the SIMPLE IRA of a related employer.

A SIMPLE IRA is not subject to nondiscrimination or top-heavy rules, and the reporting requirements it must meet are simplified. A SIMPLE IRA plan must be maintained on a calendar year basis.

Compensation, for purposes of most of the SIMPLE IRA provisions, includes wages (as defined for income tax withholding purposes), elective contributions made under a SIMPLE IRA plan, and elective deferrals, including compensation deferred under a Section 457 plan. A self-employed individual who is treated as an employee may be a participant in a SIMPLE IRA plan; for this purpose, "compensation" means net earnings from self-employment, prior to subtracting the SIMPLE IRA plan contribution. An employee's elective deferrals under a 401(k) plan, a SAR-SEP, and a 403(b) annuity contract are also included in the meaning of compensation for purposes of the 100-employee limitation (i.e., the \$5,000 threshold) and the eligibility requirements.

## ADMINISTRATIVE REQUIREMENTS

The administrative requirements for SIMPLE IRA plans state that an employer must make elective employer contributions within 30 days after the last day of the month with respect to which the contributions are to be made, and that matching and non-elective contributions must be made no later than the filing date for the return for the taxable year (including extensions).

## EMPLOYEES RIGHT TO TERMINATE

Employees must have the right to terminate participation at any time during the year; however, the plan may preclude the employee from resuming participation thereafter until the beginning of the next year. A plan may (but is not required to) permit an individual to make other changes to his salary reduction election during the year (e.g., such as reducing the contribution amount).

Generally, each employee must have 60 days before the first day of any year, (and 60 days before the first day the employee is eligible to participate) to elect whether to participate in the plan, or to modify his deferral amount.

### Special Features:

- Smaller and Simpler version of a 401(k).

## Keogh or HR-10 Plan

Self employed proprietors or partners may establish a tax sheltered retirement plan under the provision of HR-10, the Keogh Act. The result is a tax deferral of the top dollars earned, plus a shelter of all earnings on these deposits until retirement.

The fund can grow substantially by the “magic” of compound interest and the interest on dollars that would have been paid in taxes during the accumulation years. The maximum contribution is the lesser of 100% of current earned income or \$44,000 (for 2006 as amended by EGTRRA and subject to indexing for inflation in future years).

For purposes of the deduction limit, “earned income” of a self-employed individual does not include the contribution on behalf of the self-employed person. In determining his adjusted gross income, a self-employed person deducts his plan contributions directly from gross income – the deduction is allowable whether or not he itemizes deductions.

Execution of a Keogh Plan requires guidance by a financial planner since there are traps one may fall into unknowingly. There are several options.

#### DEFINED CONTRIBUTION PENSION

Option 1 - The contribution formula you initially establish locks a person in at that percentage. In other words, no flexibility exists. The formula might be a fixed percentage of all employees' wages, such as 10 percent.

Option 2 - Each year an individual determines what percent of wages is desired to contribute, retaining total flexibility. This is referred to as a profit sharing type of Keogh plan.

The combination of both options provides for flexible planning. For example under Option 1, five percent (5%) could be committed and then under Option 2, a percentage may be determined not exceeding the maximums for defined contribution plans.

#### DEFINED BENEFIT PENSION

Option 3 - A plan may also be established that will allow larger contributions, based on funding a specific retirement benefit. If there were only a few years until retirement, this would produce a very large payment, which may be very desirable for some individuals. This type of plan calls for a large fixed contribution and is normally suitable for older owner(s).

#### INVESTING PENSION PROCEEDS

Funding may occur through a variety of investment vehicles including bank accounts, money market funds, annuities, mutual funds, real estate and bonds. There are advantages to each.

The situation, time until retirement and other investment holdings will dictate the most effective funding method.

#### RECEIVING THE BENEFITS

Funds may be withdrawn in a lump sum and taxes paid on the entire amount (special ten-year averaging rules are available if you were age 50 on or before January 1, 1986). A series of payments can also be taken such as an annuity guaranteed for a lifetime and perhaps the spouse's lifetime too.

A tax penalty of 10% is required for withdrawals made by plan participants prior to age 59 ½, unless disabled; withdrawal used for higher education expenses; up to \$10,000 for a new home purchase; or self-employed health care expenditures.

Keogh funds are includible in the gross estate for Federal estate tax purposes. The funds may be paid to a non-marital trust in order to escape taxation at the death of the surviving spouse.

Accumulated funds may also be converted to an annuity, using a variety of the funding products offered by life insurance companies.

## REPORTING REQUIREMENTS

In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) were signed into law by the President. The effect on Keogh plans is described in the following paragraphs.

On or before July 31, 1985, individuals who have established Keogh plans must have filed IRS form 5500-C. Form 5500-C covers investments, income and expenses from the previous year and is five pages long with questions related to plan administrators, funding arrangements and vesting.

Form 5500-C must be filed in the first year of reporting and every third year thereafter.

Form 5500-R, a two-page form, can be filed in intervening years, or Form 5500-C can be filed for each and every year.

Failure to file could result in IRS penalties of \$25 per day per Keogh account up to a maximum of \$15,000 unless reasonable cause is established.

For taxpayers on a calendar year basis, IRS extension Form 5558 must be filed on or before July 31 of the current reporting year for a two and one-half month extension. For taxpayers on a fiscal year, the deadline is the last day of the seventh month following the end of their fiscal year.

## Profit Sharing Plan

A Profit Sharing Plan is normally considered by a young company with a history of fluctuating profits. Due to uncertain future earnings, the amount the owner would be willing to contribute is relatively small. However, if the company has a particularly good year it would like the ability to make a larger contribution.

Also, consider the age of the owner and employees. If they are young (40's), it is another indicator for profit sharing. The reason is that a Profit Sharing Plan is a form of Defined Contribution Plan which favors the younger employees due to the greater number of years for making contributions, time for investments to produce significant yield and, in this case, the allocation of forfeitures to the long term employees.

Look for turnover and tenure. Even an older owner may benefit from a Profit Sharing Plan if turnover is high since he or she will normally receive the greatest portion of non-vested forfeitures.

Ideal Investor:

A firm where cash flow and income are somewhat variable. Ideal for a firm wanting flexible contribution levels from year to year. May exclude employees under age 21 and those with less than 2 years of service.

Plan Contribution Features and Limits:

The lesser of 100% of earned income or \$45,000 for each individual. Contributions may vary based on profits. The Thrift Plan version permits employee contributions. Employer deduction limit is 25% of employee compensation.

Catch up contributions are allowed for those over 50 years old.

Special Features:

- Full flexibility of contributions.
- Part-time employees may be excluded.
- Vesting schedule may be used.
- Full reporting.
- Integration available.
- Employee contribution is permitted.

### **Money Purchase Pension**

A Money Purchase Pension Plan is a type of Defined Contribution Plan. That is, the actuary or plan administrator determines (usually by formula based on gross or net profit) the contributions that will be made on behalf of the participants. This is the only plan discussed here that has required contributions. Once the plan is contribution is set, that amount must be contributed each year and an excise tax applies if the minimum contribution is not satisfied.

The maximum contribution is similar to most defined contribution plans, the lesser of the participant's compensation or \$42,000 (in 2005) per participant. A Money purchase plan is **not** precluded by another retirement plan.

The owner usually is fairly young or is trying to benefit young key employees, such as younger siblings or children in the firm.

This plan holds appeal when profits have been stable and/or growing with a promising future. The contribution commitment is higher than with a Profit Sharing Plan.

Ideal Investor:

A firm with substantial income. Ideal for a firm wanting to maximize contributions at a fixed percentage. May exclude employees under age 21 and those with less than 2 years of service.

Plan Contribution Features and Limits:

The lesser of 100% of earned income or \$45,000. Annual contribution is generally required once installed.

Special Features:

- Maximizes deductible contributions.
- Part-time employees may be excluded.
- Vesting schedule may be used.
- Full reporting.
- Integration available.

## 401(k) Plan

A 401(K) Plan is a type of Profit Sharing Plan. The employer can choose to match the employee savings in this plan. This provision acts like a “sweetener” or extra benefit for rank and file employees. The important feature is that the employee’s contributions are treated as adjustments from gross earnings rather than a deduction as with an IRA. Even though it is subject to the overall contribution limitation, most employee/employer contributions will not be that high.

Consider the 401(K) when an employer is forced to provide an additional benefit due to possible union involvement or lack of funds to provide additional benefit packages.

This plan is also suitable when the employer may not be able to commit to a large contribution, but employees are extremely interested in contributing on the most tax favorable basis. Furthermore, if the employer has a year of high earnings, additional contributions may be made.

Ideal Investor:

Larger firm where the majority of employees defer a portion of their salary. Ideal for business desiring to contribute on a match basis. Special non-discrimination tests for deferrals. May exclude employees under 21 and those with less than 1 year of service.

Plan Contribution Features and Benefits:

There is a \$15,500 (for 2007) cap on elective deferrals.

Catch up contributions allowed for those over 50 years old.

Special Features:

- Consulting and plan design.
- Comprehensive record keeping.
- Competitive fees.
- Employee communications package.
- Vesting schedule may be used for the employer contribution.

## Defined Benefit Pension

### DEFINED BENEFIT PLAN WITH A FLAT BENEFIT FORMULA

There are two areas to review with this type of plan. The first is the plan itself with the second being a type of formula.

A Defined Benefit Plan is one in which an actuary determines the benefits each participant will receive at retirement. Using those figures, it is simply a matter of determining funding (payments) needed to arrive at future values. Therefore, the benefit is known but the contribution is not. Each year the actuary recalculates the contribution since the assumptions are rarely going to be exact. Interest earnings, or losses, will have a great effect on annual plan costs.

This type of plan is frequently used when dealing with an older owner who is looking to shelter a large sum of money. In the case of a defined benefit plan, the highest “annual benefit” payable under the plan (or under all such plans aggregated, if the employer has more than one) must not exceed the lesser of: (a) 100% of the participant’s average compensation in his highest three consecutive years of employment while he was an active participant, or (b) \$170,000(in 2005 as indexed). Depending upon

the age of the owner, it could take substantial sums, especially for older individuals since there may not be much time to fund the plan. The Defined Benefit Plan is an ideal plan for older ages, because it offers the ability to make a large financial commitment. It is suitable for companies with stable profits and taxable income.

A Flat Benefit Formula deals only with salary, that is, when the actuary is determining the benefit, only salary is taken into consideration.

For example, a Flat Benefit Pension Formula may state that the participant will be eligible for 50% of compensation. Therefore, if compensation were \$50,000, the participant would be eligible for a retirement benefit of \$25,000 per year. A larger portion of the contribution is given to the owner under these conditions. Quite often, the owner will be seeking maximum contributions since he or she is usually making a substantial income and retirement is near.

## DEFINED BENEFIT PLAN WITH A UNIT BENEFIT FORMULA

The facts stated above hold true under the Unit Benefit Formula except for the way retirement benefits are determined. Under the unit benefit formula, compensation as well as years of service are taken into consideration.

For example, the formula may state that each participant will receive 2% of salary for each year employed. Therefore, Mr. A, who makes \$50,000, would be eligible for \$1,000 times the number of years he has been under the plan. If he had been employed for 40 years, the benefit would be \$40,000 per year at retirement.

Frequently, the owner or key person of a small to medium sized business will have worked for the organization since he or she was quite young and consequently accumulated a substantial number of years of service. He or she may also have valued employees who also contributed much of their lives to the organization. Here, the Unit Benefit Formula may be the answer.

Look at the personnel profile sheet. Check to see how long the owner and key employees have worked in relation to the rank and file. If there is a difference great enough to provide greater benefits to those the owner would like to reward, use the Unit Benefit Formula.

### Plan Contribution Features and Limits:

Costs are normally borne by the employer, but some plans require the employee to make non-deductible contributions, generally as a percent of compensation.

## Sec. 457 Deferred Compensation

Plans of deferred compensation described in IRC section 457 are available for certain state and local governments and non-governmental entities tax exempt under IRC 501. They can be either eligible plans under IRC 457(b) or ineligible plans under IRC 457(f). Plans eligible under 457(b) allow employees of sponsoring organizations to defer income taxation on retirement savings into future years. Ineligible plans may trigger different tax treatment under IRC 457(f).

### Ideal Investor:

Installed and administered by the government agency that can limit choices.

### Plan Features and Contributions:

Employees may contribute up to 100% of earned income, subject to a maximum of \$15,500 (for 2007).

Special Features:

- Administration of payroll adjustments
- Contributions to a 457(b) plan are tax deferred.
- Earnings on the retirement money are tax deferred.
- Administration of payroll adjustments
- Individual enrollment and investments by the employee.

## COMMON QUALIFIED PLANS

These are the key features of the most popular qualified plans. Some firms use a combination to derive maximum benefit.

	<b>Profit Sharing</b>	<b>Money Purchase</b>	<b>401(K) Plans</b>	<b>Defined Benefit</b>
<b>Administrative Costs</b>	Low	Low	Relatively high	Relatively high
<b>Employer Contribution</b>	Discretionary	Required contribution	None required	Required, actuarially determined
<b>Amount which can be contributed</b>	Maximum is 25% of covered payroll	Maximum is 25% of covered payroll	No minimum; discretionary matching	Maximum and minimum vary according to benefit established and investment results
<b>Employee Contribution</b>	None	None	Up to \$15,500 in 2007	None
<b>Suitability of this type of plan</b>	Companies that want maximum flexibility	Consistently profitable companies	Most companies	Companies that want to benefit older and/or highly compensated

	<b>SEP</b>	<b>SARSEP</b>	<b>SIMPLE IRA</b>	<b>Keogh</b>	<b>Sec 457 (b)</b>
<b>Administrative Costs</b>	Low	Low	Low	Moderate	Low
<b>Employer Contribution</b>	Varies based on plan	None Required	Required Contribution	Required	Discretionary
<b>Amount which can be contributed</b>	Lesser of 25% of covered payroll or \$45,000 in 2007 (\$46,000 in 2008)	Lesser of 25% of covered payroll or \$45,000 (in 2007-2008) (\$46,000 in 2008)	Either matching Employees contribution dollar-for-dollar up to 3% of pay, or 2% contribution for each eligible employee	Up to \$44,000	Up to \$15,500
<b>Employee Contribution</b>	None Employer Contributions only	Up to \$15,500 in 2007 or \$20,500 if over age 50	Up to \$10,500 in 2007 or \$13,000 if over age 50	None	Up to \$15,500
<b>Suitability of this type of plan</b>	Small Business with variable earnings	Small business of 25 or fewer employees, Plan must have started before 2007	Small business with fewer than 100 employees	Self-employed or partners	State and Local Government or Non-profit Organizations

## Sources:

Financial Planning Consultants, Inc.

TMI Tax Services, Inc.

Tax Facts 2007, National Underwriter Company

Tax Facts 2006, National Underwriter Company

Tax Facts 2003, National Underwriter Company

<http://www.irs.gov/retirement/article/0,,id=117337,00.html> –SARSEP<http://www.irs.gov/retirement/article/0,,id=108940,00.html> – SEP<http://www.irs.gov/retirement/article/0,,id=108941,00.html> – Simple IRA<http://www.irs.gov/retirement/article/0,,id=172437,00.html> – 457(b)