Qualified Retirement Plans for Small Businesses and Professional Firms

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I. Introduction

Small businesses and professional firms face unique problems in designing qualified retirements that meet the retirement savings needs of their owners and employees. However, a substantial variety of retirement savings vehicles is available to small business owners under the Internal Revenue Code, and recent legislation has enhanced this variety. Each of these vehicles has its own unique requirements and advantages and disadvantages.

II. Differences between retirement plan design for small and large businesses

A. While the focus of large businesses is on labor market competitiveness, the focus of small businesses tends to be on financial rewards and costs for owners

The decision-makers with respect to the design of qualified retirement plans for large businesses are typically professional managers; moreover, and substantial input regarding retirement plan design for large businesses will typically come from the human resources function. The decision-makers' focus is primarily on the benefit levels that the business needs to provide to its rank and file, managerial, and executive employees in order to be competitive in the labor market. For example, the starting point for a large business considering a redesign of its retirement program will typically be survey data regarding what its labor market competitors provide and trends in the marketplace.

The decision-makers with respect to the design of qualified retirement plans for small businesses are usually the business's owners. Rightly or wrongly, they are often convinced that most of their employees will not value a dollar of retirement contributions as highly as they will value a dollar of current taxable compensation. Their focus tends to be on maximizing the financial benefits of the plan for themselves, while ensuring that the costs of the plan in terms of employer-funded benefits for non-highly compensated employees is justified. Depending on the size of the business and the nature of its nonowner workforce, the decision-makers may need to be convinced that having a plan at all is justified, since it will entail administrative burdens and may also entail some exposure to fiduciary liability, in addition to contribution costs.

Nevertheless, although data regarding the benefits practices of small businesses is harder to come by than data regarding the benefit levels of larger businesses, in many cases the best design starting point for a small business is also a survey of the qualified retirement plan benefits provided by the firm's labor market competitors. This data will tend to be location- and industry-specific. Determining a competitive benefit level for a small business's nonowner workforce at the outset will simplify other parts of the design effort, since the

benefits that can be provided to owners will, because of the Internal Revenue Code's participation and nondiscrimination rules, be dependent on the benefits provided for nonowners. Moreover, the current recessionary economic climate aside, owners of small businesses sometimes have an unrealistically low appraisal of the retirement benefits they need to provide in order to attract a qualified workforce. If they can make a long-term commitment at the outset to a reasonably high level of retirement benefits for their nonowner workforce, it will be much easier to design a plan with attractive benefits for the owners without needing frequent modification.

B. **In multiple-owner small businesses, the owners may differ in their retirement savings aspirations**

Managers of large businesses spend their shareholders' money to provide retirement benefits for themselves and their coworkers. They need only to know that the benefit levels they choose to implement are justified from a competitive standpoint, and that the plans are constructed in a way that promotes the company's HR goals. While there may be significant intracompany debate about the impact of benefit levels on the company's overall profitability, it is unlikely that any decision-maker will perceive any direct, immediate trade-off between his or her current cash take-home pay and the company's retirement benefit levels.

Owners of small businesses, on the other hand, typically pay for the benefits they receive, either directly in the case of a partnership by allocating all of the individual cost of each individual partner's benefits back to the partner, or indirectly in the case of an incorporated business in determining year-end bonuses. Because their retirement contributions impact them directly and immediately, some owners may sometimes want to spend less of their money on retirement benefits than their co-owners do. Unfortunately, as will be discussed in greater detail below, the ability for owners to vary their individual contribution levels from year to year is limited.

C. **Defined benefit plans have a special financial impact on small businesses and professional firms**

Demographic and cultural forces have made defined benefit plans a tough sell even with large businesses. However, with the end of the sustained bull market of the 1990's, and the continued erosion of the Social Security trust fund, that may begin to change. In brief, because of their high benefit to low long-term cost ratio, their ability to fund large guaranteed retirement benefits over a relatively short period of time for those closest to retirement, and their ability to generate large contributions for older individuals nearing retirement and with the greatest need for tax shelter, defined benefit plans would appear in many ways ideal for some small businesses. However, defined benefit plans have associated with them significant long-term liabilities and funding complexities that may make them inappropriate for many small businesses, or may at least require that they be approached with special care. Additionally, since the amortization periods for certain liabilities may be very long, issues of equity among generations of owners may arise.

Large businesses typically have substantial balance sheets, with substantial long-term assets and substantial long-term liabilities. They will typically be more comfortable with the fact that a defined benefit plan may place a substantial

liability on their balance sheet. Moreover, intergenerational equity is typically not an issue, since in a large business the retirement benefits decision-makers are not paying for their benefits in any but the most indirect sense.

D. Large businesses have more retirement income tools at their disposal than do small businesses

If the benefit levels that a large business seeks to provide to a group of executives or managers, or to an individual executive, are greater than permitted under the qualified plan rules, either absolutely or because of the nondiscrimination rules, a large business will typically be able to solve the problem with a nonqualified plan. There are several reasons for this. First, because of its typically longer operating history, deeper balance sheet, and impersonality, a large business's unfunded promise to pay benefits in the future will typically be more credible, or at least it will be perceived as more credible, by the executives who receive the promise.

Second, and probably even more important, the deferral of the employer's federal income tax deduction that is a corollary of the executive's deferral of income (*See* IRC §404(a)(5)) gets lost in a large company's financial statements. Even though it may have a long-term cost to the business owners (i.e., the company's shareholders), it is one that the shareholders typically do not perceive acutely.

On the other hand, small businesses are often pass-through entities for federal income tax purposes, and therefore their owners keenly perceive the loss of any deduction, i.e., the receipt of taxable income without cash. The loss of the deduction for cash that is retained at the corporate level but that cannot be used in the corporation's business (e.g., where the cash is deposited in a rabbi trust) is typically also unwelcome for a small business organized as a C corporation.

In other words, for a small business, retirement plan contributions either go into a qualified plan or onto the company's (or its partners' or shareholders') tax return(s). Because of this, in the author's experience nonqualified deferred compensation in the small business setting is typically confined to programs for key nonowner executives, and often takes the form of phantom equity or equity appreciation plans which do not require a set-aside of assets.

III. Despite these challenges, qualified retirement plans can be important for the owners and employees of small businesses

Fundamental demographic and economic factors point small business owners in the direction of increasing qualified retirement plan contribution levels for both themselves and their employees. The needs of both a small business's owners and its employees to accumulate funds for retirement have generally increased due to:

- The increase in life expectancy and the increase in the costs associated with maintaining that life expectancy (e.g., prescription drugs and custodial care).
- The lack of any credible long-term solution to the looming crisis in the social security and medicare trust funds.

- The recent diminution of investment expectations with the collapse of the bull market of the 1990's.

IV. Key Internal Revenue Code provisions that especially impact qualified retirement plans of small businesses

The Code sets up a number of barriers that prevent small businesses from doing what they would typically like to do, which is to save in a tax-sheltered manner for the retirement needs of the business's owners based on the individual abilities and needs of the owners, while saving for the retirement needs of nonowners based on the effect of such savings on the company's profitability. The key obstacles are:

- The generally applicable qualified retirement plan coverage and nondiscrimination rules
- The controlled and affiliated service group rules
- The 401(a)(17) compensation limit
- The "top-heavy" rules
- The "minimum participation" rule
- The “401(k) preemption" rule

A. Minimum coverage and nondiscrimination rules

The Internal Revenue Code's minimum coverage and nondiscrimination rules divide the world into "highly compensated employees" and "non-highly compensated employees," or "HCE's" and "NHCE's" respectively. Under current law, HCE's are individuals who are more than 5% owners of the employer or who in the year before the year being tested earned more than in 2003, $90,000 from the employer. IRC § 414(q). Under an additional rule, in determining its HCE's, an employer more than 20% of whose workforce earns $90,000 or more may elect to limit the HCE group to the top 20% of its workforce. IRC § 414(q)(1)(B)(ii).

Note that in the case of some small businesses, e.g. professional firms, there may be a substantial number of nonowner HCE's, especially where the employer does not elect the 20% cutoff. Where this occurs, it is very important from a plan design perspective because the Code permits discrimination against HCE's. That is, it is completely permissible for one group of HCE's (e.g., the partners in a law firm) to discriminate against the nonowner HCE's (e.g., the firm's associates, some of whom may be barely above the $90,000 HCE cutoff). Discriminating against (i.e., providing lower, or no, benefits to) a subgroup of HCE's not only eliminates the cost of providing that group with benefits, but, under the most commonly used testing methods, boosts the amount by which the owner HCE's may discriminate in their own favor in comparison with the NHCE's, because generally in doing nondiscrimination testing we compare the average benefits of all HCE's with the average benefits of all NHCE's; the lower (or zero) benefit level

of the subgroup of HCE's receiving reduced (or no) benefits will be averaged with, and therefore dilute, the higher benefits of the owner HCE's.

In very broad outline, the minimum coverage rules require that a plan either:

- Cover a percentage of the employer's NHCE's that is at least 70% of the percentage of HCE's that is covered. IRC § 410(b) (1). E.g., if 50% of the HCE's are covered, 35% (70% of 50%) of the NHCE's must be covered.

- Or cover a "reasonable classification" of HCE's and NHCE's that includes a percentage of the NHCE's that is smaller than 70% and that is determined from a table contained in Treasury regulations, but only if the average benefits for all NHCE's (including those not covered by the plan) is at least 70% of the average benefits for all HCE's (again, including those not covered by the plan). IRC § 410(b)(2); Treas. reg. § 1.410(b)-4.

In performing either of these alternative tests, employees who have not yet attained age 21 or who have less than one year of service with the employer may be ignored. IRC § 410(b)(3).

The first of the two alternative tests described above is referred to as the "ratio percentage" test. Note that an important feature of the ratio percentage test is that if a plan passes it, there is no need for included and excluded employees to be determined under a "reasonable classification," and therefore the IRS permits employers to specifically name included and/or excluded individuals. This can be very useful in small business settings, where it may be undesirable to cover some owners or employees, but difficult to describe such individuals by job classification or on any other objective basis.

This second test is referred to as the "average benefits test." The coverage percentages available under IRS regulations under the "reasonable classification" component of this test essentially relaxes the 70% NHCE coverage percentage by a minimum of 20 to 30 percentage points (i.e., drops the 70% to at most a percentage falling between 40% and 50%), and relaxes it even further as the highly compensated group becomes a smaller and smaller percentage of the workforce. See Treas. reg. § 1.410(b)-4(c)(4)(iv).

Thus, under the reasonable classification component the average benefits test, small businesses that provide large numbers of jobs for NHCE's with only a small HCE overhead need to cover only a relatively small percentage of all their NHCE's, while businesses with a relatively large number of HCEs as compared with NHCE's need to cover a larger percentage of their NHCE's. For example, a small business with three HCE's, all of whom were owners covered under the plan, and 97 NHCE's, would need to cover only around 22% of its NHCE's, or around 21 individual NHCEs. On the other hand, a professional firm, only around 60% of whose total workforce might consist of NHCE's, and all of whose HCE's were covered by the plan, would need to cover around 45% of its NHCE's.

While the preceding example might seem to indicate that small businesses with small numbers of HCE's in relation to the size of their NHCE workforces might be able to enjoy substantially discriminatory qualified retirement plans under the average benefits test, the rules do contain a "backstop" against excessive

skewing of benefits to owners. This backstop is that in order to pass the average benefits component of the "average benefits" test, the average benefits under all plans of the employer of all the employer's NHCE's, whether or not covered under a plan, must be at least 70% of the average benefits of all the employer's HCE's. Thus, a substantial number of "zero" benefit percentages for NHCE's (i.e., NHCE's not covered) will cause the test to be failed, unless offset by a substantial number of zero's for HCE's, and/or unless the covered NHCE's tend to be substantially younger than the HCE's and contribution allocations are tested as benefits (i.e., as pension benefits commencing at age 65), rather than as allocations of contributions.

Note that, just as was the case with the ratio percentage test, the percentage of NHCE's required to be covered drops as the percentage of HCE's covered drops. For example, in the case of a professional firm 60% of whose employees are NHCE's, so that only 45% of the firm's NHCE's are required to be covered under the reasonable classification component of the average benefits test, if we drop the coverage of HCE's from 100% to 40% (e.g., if we exclude the percentage of the highly compensated workforce at a professional firm that consists of nonowner professionals, such as the associates at a law firm, and this group happens to constitute 60% of the HCE's), then the percentage of the professional firm's NHCE's that needs to be covered drops by 60% as well (e.g., from 45% to 18%, i.e., by 60% of 45%). Passing the average benefits part of the test would also become much easier, because, as previously noted, that test is based on the relative average benefits of the entire HCE and NHCE groups, both those covered and those not covered by the plan, and the excluded HCE's would dilute the average benefit levels of the HCE group as a whole.

Finally, note that one aspect of the "reasonable classification" component of the average benefits test is the requirement that the classifications of employees included and excluded from the plan be reasonable, which means that, unlike the case with the ratio percentage test, including or excluding employees by name or social security number is not permissible in the case of the average benefits test. Treas. reg. § 1.410(b)-4(b).

B. Nondiscrimination rules

Generally, the nondiscrimination rules, which are found primarily in IRC § 401(a)(4) and Treas. reg. §§ 1.401(a)(4)-1 through -13, require that the average benefits of NHCE's covered by a plan be equivalent to the average benefits of HCE's covered by the plan. However, the way this relatively simple principle is applied is extremely complicated. These rules are explored to some extent later in this article as part of the discussion of cross-tested profit sharing plans.

C. Controlled group and affiliated service group rules

The controlled group and affiliated service group rules of Sections 414(b) and (c) of the, Code apply to both large and small businesses. The affiliated service group rules of Sections 401(m) and (o) of the Code are similar in effect, but apply almost exclusively to small businesses, chiefly professional service firms.

These rules prevent a business from avoiding the impact of the minimum coverage and nondiscrimination rules through the use of separate entities. In other words, since the coverage and nondiscrimination rules require that the

qualified retirement plans of "employers" cover both owners and nonowners, e.g., including both executives and rank and file employees, and since the ordinary legal definition of "employer" is based on the legal entity with the employment relationship (i.e., a particular corporation, partnership, etc.), it would, without special rules preventing this, be relatively easy for businesses to avoid at least much of the impact of the coverage and nondiscrimination rules by creating separate, but commonly owned, entities and moving employees among them.

The IRC §§ 414(b) and (c) controlled groups require businesses that have substantially common ownership, whether in a parent subsidiary or brother-sister structure, to test compliance with the minimum coverage and nondiscrimination rules as if the businesses that share common ownership were a single "employer." The IRC §§ 414(m) and (o) "affiliated service group" rules do the same thing, but require very little or, in the case of a so-called "management services group" under IRC § 414(m)(5), no, common ownership, if certain management “loan-out” or other business affiliations are determined to exist.

The bottom line on the affiliated service group rules as they affect professional firms and other small businesses is that it is difficult, if not impossible, for professionals who are affiliated with a single larger professional firm, or that work for a single larger business through an independent contractor or similar arrangement, to carve themselves out as separate employers and thus be able to maintain their own separate qualified retirement plans without being weighed down by the obligation of making contributions for the nonowner employees of the larger business to which they provide services, or with which they are associated in the performance of services. Thus, for example, in the case of a law firm some of the partners of which are professional corporations, all of those professional corporations, no matter how small their ownership percentage in the firm, will need to be treated as part of a single employer with the firm for purposes of the Code's minimum coverage, minimum participation, and nondiscrimination rules. *See* IRC § 414(m)(2)(A).

D. **The "top-heavy" rules**

In 1982, as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress enacted the "top-heavy" rules to tighten up the nondiscrimination and minimum vesting rules applicable to plans dominated by a business's owners. In contrast to the minimum coverage and nondiscrimination rules, which divide the working world into HCE's and NHCE's, the top-heavy rules focus on what will in larger small businesses and professional firms be a subset of the HCE group, the members of which are referred to as "key employees," making everyone else "nonkey employees" ("keys" and "nonkeys," respectively). In the case of a very small business, the keys are typically all of the owners and the members of their families (and sometimes one or more nonowner officers), while in the case of more widely held small businesses, such as larger professional firms, the key employees are usually a senior subset of the owner group. A plan is "top-heavy" if, on a particular date called the "determination date," more than 60% of the plan's accumulated benefits are for key employees. IRC § 416(g).

By focusing on accumulated benefits as of a given date for "keys" as compared with "non-keys," instead of focusing on annual contributions, the top-heavy rules focus not so much on plans in which a large percentage of the annual

contributions are allocated, or go to fund, the benefits of a business's owners, but rather on plans where the owner group is very stable, while nonowners tend to have high turnover.

For example, a plan's annual contributions might be, say, 40% for keys and 60% for nonkeys. However, over a period of years the non-keys will come and go, taking their benefits with them in the form of distributions. The keys will stay, and their accumulated benefits will grow with additional contributions and earnings. Eventually, even though the percentage of total annual benefits or contributions for keys may be substantially less than 60%, the accumulated benefits for keys may exceed 60%. At a particular determination date, even if only a very small percentage of the plan's participants are key employees, the plan may be top-heavy because their benefits will, on average, represent many more years' accumulations.

The top-heavy rules contain complex aggregation rules. IRC § 416(g)(2). Essentially, if an employer has multiple plans, all of the plans must be considered together. The only plans of the employer excepted from this required aggregation are plans that do not currently benefit even a single key employee. Thus, if an employer has two plans and virtually all of the employer's key employees are in one of the plans that also benefits a large number of nonkeys, and the other plan benefits almost exclusively non-keys, but benefits even one key, the latter plan must be aggregated with the former in determining whether the employer's plans are top-heavy. If more than 60% of the benefits of the combined plans are for keys, then each separate plan will be top-heavy, even the plan that benefits only one key employee that, standing alone, would not appear to be top-heavy (i.e., the benefits of the one key employee in the plan would likely comprise far less than 60% of all of the benefits of that plan, standing alone). Moreover, because, on an aggregated basis, the employer's plans in this example would be top-heavy, each of its two plans must provide the top-heavy minimum benefit or allocation to all of the non-key's in the plan. IRC § 416(g)(1)(B). Thus the plan that has one key and 100 non-keys must provide the top-heavy minimum allocation or benefit to all 100 non-keys because of the presence of the one key in that plan. This is the main reason why law firms and other professional firms typically maintain a separate 401(k) plan for their associates or other nonowner professionals, and will exclude all key employees from the 401(k) plan for the associates or other nonowner professionals.

Once a plan is determined to be top-heavy, or a part of a top-heavy aggregation group, the minimum benefits that it must provide depend on whether it is a defined benefit or a defined contribution plan. A top-heavy defined benefit plan must provide to each non-key employee participant a minimum benefit of 2% of pay times his or her years of service up to 10 years. IRC § 416(c)(i). A top-heavy defined contribution plan must provide a minimum defined contribution allocation of 3% of pay for each top-heavy year. IRC § 416(c)(2).[1]

[1] Note that there is an exception to the 3% top-heavy defined contribution plan minimum where the highest allocation rate for any key under the plan is less than 3%. IRS § 416(c)(2)(B). However, this rule rarely impacts on practice, because in calculating the highest contribution rate received by any key employee, the key employee's elective deferrals under a 401(k) plan are included (i.e., if even one key employee makes elective deferrals under a 401(k) plan of 3% or more, you're under the 3% minimum

The minimum vesting requirement for a top-heavy plan is the so-called "6-year graded" vesting schedule:

After this many years of service	The employee must be vested at least
2	20%
3	40%
4	60%
5	80%
6	100%

IRC § 416(b)(1). This schedule is only one year faster than the regular 7-year graded schedule, and is in fact identical to the new EGTRRA minimum vesting schedule for matching contributions that has been applicable since 2002. See IRC § 41 I (a)(12) as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). However, the top-heavy rules do preclude the use of the 5-year cliff vesting schedule still available after 2001 to non-top-heavy plans for contributions other than matching contributions. *See* IRC § 411(a)(2)(A).

The rules for determining who are an employer's "key employees," and for determining the accumulated benefits of key employees, are, like the rest of the top-heavy rules, very complex. These rules were also changed substantially by EGTRRA. There are now three categories of key employee:

- Officers of the employer whose annual compensation exceeds $130,000.;[2]
- All “5% owners” (defined as owners of ***more than*** 5%); and
- All “1 % owners” (defined as owners of ***more than*** 1%) whose annual compensation exceeds $150,000.

IRC § 416(i)(1). For purposes of determining an individual’s ownership of the employer for purposes of determining whether the individual is a key employee, the attribution rules of Section 318 generally apply, so that, generally, all family members are treated as owning each other's ownership interests. Thus in family run businesses, if one member of the family is a key employee, generally all members of the family will be.

However, note that, importantly in the context of professional firms, while the top-heavy rules are generally applied with regard to the Code's controlled group and affiliated service group rules, those rules do not apply for purposes of determining an individual participant's ownership percentage in any separate

contribution requirement), while non-key employees' 401(k) contributions are not counted towards their 3% contribution requirement.

[2] There is a limit on the total percentage of the workforce that can be considered "officers." *See* IRC § 416(I)(1)(A) (flush language).

legal entity that is part of a controlled or affiliated service group. Thus, for example, in the case of a professional corporation ("PC") that is a 7/10ths of 1% partner in a law firm, the sole owner-employee of the PC will be treated as a 5% owner with respect to the "employer" (i.e., with respect to the combination of the PC and the partnership), because he or she owns more than 5% (presumably, owns 100%) of his or her PC. IRC § 416(i)(1)(C).

A difficult administrative aspect of the top-heavy rules is that for the purposes of determining whether more than 60% of a plan's benefits are for key employees, a one-year lookbacks rule applies. That is, in determining the benefits of key employees for purposes of the more than 60% test (i.e., determining whether 60% of all benefits are for key employees), some distributions made within the preceding year must be added back to plan benefits. IRC § 416(g)(13).

In 1982, when the top-heavy rules were enacted, plans were permitted to be "fully integrated" (i.e., provide a benefit based only on compensation in excess of the OASDI wage base), the defined benefit plan nondiscrimination rules (e.g., the testing of past service benefits) were much looser than they are today, and vesting schedules were permitted to be longer than they generally can be today. So today, the top-heavy rules are largely an anachronism. Their chief consequences for small business and professional firm plans are:

- A 3% "pay to play" minimum employer contribution requirement for any small business that wants to be in the qualified plan "game."

- In the case of professional firms, which typically don't need or want to provide employer-paid retirement benefits for the nonowner professional staff (e.g., a law firm's associates), but need to provide a vehicle for the nonowner professional staff to make 401(k) elective deferral contributions, a requirement to have a separate plan for the nonowner professional staff.[3]

As discussed below, EGTRRA frees safe harbor 401(k) plans from the top-heavy requirements and in non-safe harbor 401(k) plans permits matching contributions to be counted towards the 3% top-heavy minimum contribution requirement. However, while EGTRRA brought welcome simplification to the administration of the top-heavy rules, it did little to change the top-heavy requirements for most small businesses and professional firms. Many will still be top-heavy and will still need to make the 3% top-heavy minimum contribution or provide the 2% minimum benefit for non-keys, and will have to use the 6-year graded top-heavy

[3] Note, that the inadvertent inclusion of even a single key employee in a professional firm's non-partner professional 401(k) plan would generally result in the firm's being required to make top-heavy minimum contributions for all of the non-partner professionals in that plan for the year. However, if the non-partner professionals' 401(k) plan is properly drafted to exclude all "key employees" (i.e., not just to exclude classes of employees, such as partners, who will likely be key employees, but in fact to exclude "key employees" as an explicit category), then in the case of an inadvertent inclusion of a key employee (e.g., a former partner who becomes of counsel and is placed by the plan administrator into the associates' plan because the former partner, now of counsel, wants only to make elective deferral contributions), it is possible to treat the inclusion as a plan operational failure the correction for which is to remove the key employee and his or her contributions retroactively from the non-key plan, rather than having to provide the top-heavy minimum contribution to all of the non-keys. *See* Rev. Proc. 2003-44, explaining the Employee Plans Compliance Resolution System ("EPCRS").

vesting schedule. However, these plans will at least be able to determine their top-heavy status more easily. Moreover, by eliminating the 5-year lookbacks for determining key employees and accumulated benefits, EGTRRA will enable some companies (e.g., expanding professional firms) to stop being top-heavy sooner than they otherwise would have.

E. **The IRC § 401(a)(26) minimum participation rule**

In its current incarnation, IRC § 401(a)(26) applies only to defined benefit plans and provides that no defined benefit plan can be a qualified plan unless it benefits at least 50 individuals or 40% of the employer's (as the employer is determined after application of the controlled and affiliated service group rules) eligible workforce. First enacted in 1986, this rule originally applied to both defined benefit and defined contribution plans and forced the termination of thousands of individual defined benefit plans ("IDBs") that had theretofore been maintained as individual, personal pension plans by law firm partners and other business owners. These IDBs met the minimum coverage, nondiscrimination, and top-heavy rules by using testing techniques that were precursors of the current restructuring, cross-testing, and aggregation rules discussed later in this outline. *See* Rev. Rul. 81-202, 1981-2 C.B. 93.

F. **The 401(k) Preemption rule**

What I refer to as the "401(k) preemption rule" is the rule that essentially provides that, except within the confines of an election for any given year to make or not make elective deferral contributions of up to the 401(k) elective deferral limit for that year ($12,000 for 2003), individual plan participants, whether owners or nonowners, cannot be permitted to vary the rate of contributions that will apply to them from year to year, or determine from year to year whether they will participate in the business's retirement plan. In other words, the employer generally must determine the classes of employees who will participate in the plan and their contribution rates. *See* Treas. reg. § 1.401(k)-1(a)(3).

The only exception to the rule that an individual participant may not (outside the limited 401(k) elective deferral context) have individual discretion over the amount contributed for him or her, is that a potential participant may, if this occurs before he or she becomes a participant in the plan, make a "one-time irrevocable election" never to participate in any qualified plan of the employer, or to participate at a reduced rate. Treas. reg. § 1.401(k)-1(a)(3)(iv). Of course, in all but the rarest of factual circumstances, usually involving older participants who already have substantial retirement accumulations, a small business's permitting an owner to make such a "one-time, irrevocable election" in order to avoid the financial burdens of participation will be ill-considered, since at some point the employee or partner is likely to want to begin saving for retirement, and at that point will have to change employers or firms in order to do so.

There are a number of interesting observations that can be made about the "401(k) preemption rule." First, obviously this rule is interesting only in the context of business arrangements in which, but for the 401(k) preemption rule, individuals who believe they need higher current income and who are willing to trade retirement savings for higher current income may elect to have a lower rate of contributions apply to themselves in exchange for receiving personally all or a portion of the amount that otherwise would have gone into the qualified

retirement plan for them. In the case of a partnership, the tradeoff would be direct, because the amount by which a partner chose to reduce his or her plan contribution would simply not be charged to him or her as a special partnership expense allocation for the year, as it otherwise would be. In the case of a corporation, the tradeoff would have to be indirect, by way of an arrangement to take the amount of the reduction into account in calculating the shareholder-employee's year end bonus.

Second, the "401(k) preemption rule" can be (and has been) easily criticized as denying flexibility to business owners in a way that has no obvious tax policy justification, since allowing multiple owners of a business to elect to participate in the business's retirement plan at a rate lower than applies generally to the business's other owners and to its nonowner employees, or not to participate at all, would not in any way hurt the nonowners or owners receiving the higher contributions, and would increase tax revenue (since the partners electing the lower plan contribution rate would have more taxable income and pay more tax than they otherwise would). *See* Barrett, Robert J., and Bailey, Luke D., "New 401(k) Regulations Target Certain Time-Honored Elections," Prentice Hall's *Pension & Profit Sharing*, New Ideas ¶1145 (10-7-88). Treasury's response in defense of the rule has been that partners and other business owners or insiders shouldn't be able, effectively, to raise the 401(k) elective deferral limit for themselves to the defined contribution section 415 limit ($40,000 in 2003), when everyone else is required to live with the 402(g) limit ($12,000 in 2003). According to Treasury this would fly in the face of Congress's apparent purpose when, as part of the Tax Reform Act of 1986, it lowered the elective deferral limit from being equal to the Section 415(c) limit ($30,000 in 1987) to the lower 402(g) amount (in 1987, $7,000).

In any event, the practical effect of the 401(k) preemption rule is that in a business with multiple owners, some of whom want to make retirement plan contributions substantially in excess of the 402(g) elective deferral limit, and others of whom do not, some form of compromise is typically required. One way to facilitate such a compromise is to shift as much as possible of the firm's retirement contributions for nonowner employees to 401(k) elective deferrals and matching contributions. This reduces the portion of the total potential "pie" (e.g., the Section 415(c) defined contribution dollar limit of $40,000 in 2003) that needs to be comprised of nonelective, or mandatory, contributions. The business then communicates to its owners that they will all be required to have contributions made to the plan equal to the reduced mandatory amount selected by the firm, and anyone wanting to contribute no more than the mandatory amount should be careful not to make elective deferral contributions. In situations where the owners will effectively fund their own matching contributions (e.g., professional partnerships, or situations where matching contributions can be taken into account in setting individual year-end bonuses), the owners should also be informed that every dollar they elect to contribute as an elective deferral is in effect a commitment to contribute a larger amount to the plan, i.e., every elective deferral dollar commits the owner to contribute an amount equal to 1+X, where "X" is the amount of matching contributions under the plan.

Another interesting question regarding the 401(k) preemption rule is what exactly constitutes an election to receive a lower benefit or not participate in exchange for more cash. For example, assume that in 2003 a partnership with a substantial number of partners and a small number of nonowner employees

(e.g., an emergency room physician practice group) that wants to give each partner complete discretion over how much he or she will receive in qualified retirement plan contributions adopts a 401(k) plan with a 200% match. A partner who wants the maximum contributions made for the year to his or her account defers the $12,000 elective deferral limit and receives $24,000 in matching contributions, for total contributions of $36,000, all of which is allocated back to the partner as a special allocation of partnership expense, so that in effect the partner individually contributes this amount, while a partner who does not want to make any retirement plan contribution for the year defers $0, receives $0 in matching contributions, and has $0 allocated to him or her as a special allocation of partnership expense. It seems pretty clear that this strategy (which, again, would obviously be prohibitively expensive for any partnership with a substantial number of nonowner employees, but would work well where the nonowner workforce was very small relative to the owner workforce, and was also sophisticated enough to value the 200% match highly as part of their total compensation package) accomplishes what the 401(k) preemption rule seeks to prohibit, and yet does not violate the 401(k) preemption rule.

But what if the same business is incorporated, so that, instead of the cost of each owner's own contributions being allocated back to him or under the partnership agreement, the firm must enter into an agreement with each owner to increase his or her annual bonus by the amount, if any, by which his or her total matching contributions are less than $24,000? That would appear to violate the 401(k) preemption rule.

Another example: What if, in the course of designing their retirement program, a partnership's partners have several meetings to share views on what the required partner contribution rate ought to be. After awhile it becomes clear that the partners' views on contributions fall into three distinct groups: Those who want to contribute the maximum, those who want to contribute nothing, and those who want to contribute between the two extremes. Suppose the firm's management simply assigns these groups letters A, B, and C, names the members of each group in the plan document based on its recollection of each partner's preference as expressed generally at the meeting in discussing what they thought the firm's contributions rate ought to be for partners, and provides that the mandatory contribution rate for each group will be set annually, by the employer?

Consider, finally, a partnership including professional corporations. All of the PC partners are in an affiliated service group relationship with the partnership, and all of the PC's have duly adopted the firm's retirement plan, which specifically permits adoption by "related employers," defined to include the partnership and PC partners. The sole shareholder-employee of one of the PC partners requests not to be required to make his or her mandatory retirement plan contribution for the year. Upon being informed by the firm's pension counsel that the plan does not permit such waivers of participation, the sole shareholder-employee of the PC holds a board meeting with himself and the shareholders vote "unanimously" (i.e., the single shareholder votes to withdraw from participation in the firm's retirement plan. The PC's sole shareholder-employee certifies these board resolutions in his or her capacity as the PC's corporate secretary, and sends a copy of the certified resolutions to the firm's pension counsel. Does this violate the 401(k) preemption rule? If it might, is there anything the firm can or should do about it to require the PC to participate in the retirement plan? What if a few years later the PC readopts the firm's retirement plan?

G. The IRC § 401(a)(17) compensation limit

Introduced as part of the Tax Reform Act of 1986 ("TRA `86"), the IRC § 401(a)(17) restricts the amount of compensation that a plan can take into account for any individual participant. After a legislated decrease and a legislated increase, this amount is $200,000. It will increase in future years to keep up with inflation.

- Example: Assume an employer has a profit sharing plan to which it makes a 5% of pay contribution for all participants. Assume also that Owner X earns $300,000 in 2003. A 5% contribution for Owner X would be $15,000. However, since in 2003 the maximum amount of compensation that can be taken into account under a qualified plan for any individual is $200,000, a 5% contribution for Owner X is in fact only $10,000.

Note that this rule requires not only that nondiscrimination testing not take into account compensation in excess of $200,000 (in 2001), but that the plan not take such compensation "into account."

- Example: A partnership would like to make a $30,000 contribution for partner Q, who earns $300,000, and a $20,000 contribution for partner R, who makes $200,000. Assume the partnership would contribute 15% for all NHCE's, so that the contribution for A ($30,000/$200,000 = 15%) would be nondiscriminatory. Because of IRC § 401(a)(17), the plan cannot simply make 10% contributions for A to achieve its goals, because this would distinguish between A and B based on compensation exceeding $200,000. It must find some other basis for calculating the contributions.

V. Beginning in the late 1990's, the legislative tide turned more favorable for small business retirement plans

Notwithstanding the complex web of rules described above that were developed (many of them in the 1980's and early 1990's) to limit the qualified retirement plan benefits that small businesses can provide to their owners, and to limit the flexibility they have in providing such benefits, changes made to the Code in the last seven years have to some extent turned the tide back and enhanced the ability of small business owners to save for retirement.

- The Small Business Jobs Protection Act of 1996 ("SBJPA") suspended the operation of the 15% excise tax on large distributions from qualified plans and IRAs during life (not otherwise discussed in this article) , and then the Taxpayer Relief Act of 1997 ("TRA 97") repealed it both for distributions during life and accumulations at death.

- SBJPA repealed the rule that 401(k) plan matching contributions for partners would be treated as elective deferrals and be subject to the elective deferral limit, thereby returning to partnerships some of their flexibility to vary contribution rates that they had lost with the advent of the 401(k) preemption rule.

- SBJPA restricted the application of the 401(a)(26) minimum participation rule so that it now applies only to defined benefit plans.

- SBJPA introduced SIMPLE IRA's, SIMPLE 401(k)'s, and safe harbor 401(k)'s into the Code, all of which are discussed below.

- TRA `97 repealed, effective in 2000, the Section 415(e) combined limit on defined contribution plan allocations and defined benefit plan accruals for the same individual.

- EGTRRA has substantially increased the qualified retirement plan contribution and benefit limits, including increasing the IRC § 401(a)(17) compensation limit to $200,000 and then adding to the Code special "catch up" contributions for individuals age 50 and over.

VI. A survey of the types of qualified retirement plans available to small businesses

A. Traditional (i.e., non-Roth, noneducational) individual retirement accounts (traditional IRA's).

Obviously, traditional IRA's are not really business retirement plans. Generally, any individual taxpayer can set one up, and they require no business involvement., although they do generally require earned income Nevertheless, a business owner may make contributions to an IRA without having to establish a retirement plan for his or her business, and without being required to make contributions for the business's employees. Moreover, as explained below, for most successful business owners, establishing a retirement plan for their business will preclude their being able to deduct contributions to an IRA. Thus, arguably, traditional IRA's can be viewed as establishing a baseline against which other types of retirement plans that a small business might sponsor can be measured.[4]

The 2003 traditional IRA contribution limit is $3,000, with the ability of individuals 50 years old and older to make "catch up" contributions of an additional $500. *See* IRC § 219(b)(5). However, assuming a married business owner, determining how much he or she, or he or she and his or her spouse, can deduct as traditional IRA contributions is complex.

If we assume that the IRA owner's spouse is not him- or herself an active participant in an employer-sponsored qualified retirement plan, and that the total retirement savings of the household is the appropriate measuring rod, then since an equal amount can be contributed for the business owner's spouse (assuming that the business owner's and his or her spouse's joint AGI is sufficient to cover both IRA contributions), the household total for 2003 is $6,000 to $7,000, depending on whether one or both spouses is/are 50 or older so as to qualify to make the $500 catch up contribution available. This would be the case whether the spouse works in the small business or stays at home. *See* IRC § 219(c).

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[4] Note that because only s business owner's AGI, not his or her participation in an employer-sponsored qualified retirement plan, will determine whether he or she may contribute to a Roth IRA, *see* IRC § 408A(b)(3), the Roth IRA is not an alternative baseline against which to measure other retirement plans that a small business might sponsor.

On the other hand, if the business owner's spouse works in a separate business and is an active participant in an employer-sponsored qualified retirement plan, and if the couple's AGI exceeds $150,000, then not only will the business owner's spouse not be able to deduct any IRA contributions, but the business owner him- or herself will have a reduced IRA deduction, with the deduction's being eliminated if the couple's AGI hits $160,000, and the phaseout between $150,000 and $160,000 occurring at the rate of 30¢ on the dollar. See IRC § 219(g)(7). On the other hand, if the couple's AGI does not exceed $60,000, then both husband and spouse can deduct all of their IRA contributions, even if the spouse is an active participant in an employer-sponsored qualified retirement plan, with another 30¢ on the dollar phaseout occurring for AGI between $60,000 and $70,000. *See* IRC § 219(g)(1)-(3).

The "bottom line" on the IRA as a retirement savings alternative for a hypothetical business owner is that it will typically be an attractive vehicle for business owners where the owners' spouses either work in the same business or stay at home, the business owners can't afford to save much more for retirement than $6,000 per year, and the business faces little pressure from nonowner employees to establish a vehicle to permit them to save for their retirement on a tax-deductible basis.

B. **Simplified Employee Pensions ("SEP's")**

Although they are typically confined to smaller employers, simplified employee pensions, or SEP's, are available to employers without limitation as to the employer's size. *See* IRC § 408(k). As amended by EGTRRA, SEP's permit business owners to deduct contributions of up to 25% of pay up to the IRC § 401(a)(17) compensation limit ($200,000 in 2003), but contributions for an owner or any other individual participant cannot exceed the generally applicable 415(c) dollar limit ($40,000 in 2003).

If a business sponsors a SEP for its owners, it must make uniform contributions for every owner and employee meeting the SEP participation requirements. The SEP participation requirements are that to be eligible the employee must be age 21 or older; have performed services (any paid services, in any capacity) for the employer in any 3 out of the 5 preceding years; and must have earned at least a small threshold amount from the employer in the current year.[5]

SEP contributions may taken into account "permitted disparity" (i.e., the employer's social security contributions, as described below), but otherwise the formula for all covered employees, owners and nonowners, must be the same (i.e., contributions cannot be "cross-tested" actuarially as benefits). Very importantly, note that while before EGTRRA (i.e., before 2002), SEP's only permitted a deduction of up to 15% of pay., EGTRRA has brought SEP's to parity (25% of pay) with qualified defined contribution retirement plans as regards their contribution limit, and this should lead to a substantial increase in the number of SEP's.

SEP contributions must be nonforfeitable when made (i.e., the employer's contributions may not be subject to vesting).

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[5] The amount changes from time to time. It is $450 in 2001.

SEP contributions are made to IRA's using IRS-approved forms, and each individual SEP participant has control of his or her own IRA.

SEP's are subject to most of the rules applicable to qualified plans generally, including the top-heavy and affiliated service group rules.

Because their contribution limit is the same as the contribution limit for a qualified defined contribution plan, their exclusion of employees who turn over within three to four years, and (especially after EGTRRA), their rich contribution structure, SEP's are an ideal vehicle for small businesses with few, if any, long-term nonowner employees, provided that, if the business has multiple owners, the owners can reach a consensus on contribution levels. In fact, at least after EGTRRA, businesses that fit this description need look no further for their preferred retirement savings vehicle. Small businesses with large numbers of long-term nonowner employees, however, will typically not find SEP's attractive.

C. **Salary Reduction SEP's ("SARSEP'S")**

Section 1421(c) of SBJPA precludes any employer that did not already have a SARSEP as of December 31, 1996 from adopting one now. Except in long-grandfathered situations, they have no current relevance to small business retirement planning.

D. **SIMPLE IRA's**

Officially called "simple retirement accounts," SIMPLE IRA's entered the Code as part of SBJPA and function like simplified, half-sized safe-harbor 401(k) plans for small employers. *See*, generally, IRC § 408(p). Unlike SEP's, SIMPLE IRA's are only available to small employers who do not currently maintain any other tax-favored retirement plan (i.e., a small business that sponsors a SIMPLE may not sponsor a SEP, 401(k), pension, ESOP, or any other type of qualified retirement plan. IRC § 408(p)(2)(D). To qualify as a "small employer" eligible to sponsor a SIMPLE IRA, a small business must not in the preceding year have had more than 100 employees who received $5,000 or more in compensation. IRC § 408(p)(2)(C)(I). There is a two-year "safety valve" for employers that grow out of eligibility. IRC § 408)p)(2)(C)(II).

The employees of the employer who are eligible to participate in the employer's SIMPLE IRA program are all employees who (a) received at least $5,000 in compensation from the employer in any two preceding years, and (b) can reasonably be expected to earn at least $5,000 from the employer in the current year. IRC § 408(p)(4).

The way SIMPLE IRA's work is that the employer arranges with a mutual fund company or other IRA provider to establish a SIMPLE IRA for each of the employer's eligible employees. Eligible employees are then free to contribute as much as they want of their compensation (there is no percentage limit) to their SIMPLE IRA's, up to an annual dollar limit. The limit is $8,000 in 2003. IRC § 408(p)(1) and (2) as amended by EGTRRA. The employer must contribute to each eligible employee's SIMPLE IRA either a 100% (i.e., a "dollar for dollar ") match on contributions not in excess of 3% of pay, or a 2% of pay nonelective contribution (i.e., whether or not the eligible employee makes a contribution).

IRC §§ 408(p)(2)(A)(iii) and (p)(2)(B). These contributions are nonforfeitable (i.e., they are not subject to vesting). IRC § 408(p)(3).

Here are some examples of the SIMPLE IRA contribution rules as they apply in 2003:

- Employee A earns $25,000 in compensation from XYZ Co. and does not contribute to XYZ Co.'s SIMPLE IRA. Employee A receives $0 in matching contributions. Employee B earns $18,000 from XYZ Co. and contributes $540 (3% of $18,000) to XYZ Co.'s SIMPLE IRA. Employee B receives $540 in matching contributions. Employee C earns $60,000 from XYZ Co. and contributes $4,800 (8% of compensation) to XYZ Co.'s SIMPLE IRA. Employee C receives $1,800 (3% of $60,000) in matching contributions. Owner X earns $200,000 and contributes $8,000 to XYZ Co.'s SIMPLE IRA. Owner X receives $6,000 in matching contributions. Owner X's total tax shelter from having a SIMPLE IRA program is $14,000 ($8,000 deferral plus $6,000 in matching contributions). The total cost of the arrangement to the business is $2,340.

- Assume the same facts as in preceding example, except that, even though XYZ Co. provides all of the business's employees who are eligible with the required notice of their eligibility to make contributions to their SIMPLE IRA's and have them matched dollar for dollar, none of employees A, B, or C participates. None of employees A, B, or C will receive any employer matching contributions. Owner X will still receive $14,000 in total contributions, but the total cost is $0.

- Same facts as in the two preceding examples, except that XYZ Co. chooses to make 2% nonelective contributions instead of 3% matching contributions. Regardless of how much employees A, B, or C contribute to their SIMPLE IRA's, and even if it is zero, their employer nonelective contribution amounts will be $500, $360, and $1,200 respectively, and owner X's total contributions will be $12,000 ($8,000 elective contribution maximum + 2% of $200,000, or $4,000). The total cost is $2,060.

Note that simple IRA's are not subject to the top-heavy rules.

Bottom line on SIMPLE IRA's: Like SEP's, SIMPLE IRA's do not involve the employer in the establishment of an employee benefit trust and are light on documentation and filing requirements, making them, again like SEP's, a practical retirement savings vehicle for small businesses. However, because of their much lower contribution ceilings than SEP's or qualified plans, SIMPLE IRA's are really only well-suited to two types of small businesses. The first is small businesses that have a substantial number of long-term employees, so that a SEP would be prohibitively expensive, but (a) do not believe that enough of their employees will elect to participate in the SIMPLE IRA arrangement to make the business's matching contributions requirement a meaningful consideration, and (b) the owners of which have a need for retirement savings that can be meaningfully served by the SIMPLE IRA (up to $14,000 per year per owner in 2003, $15,000 for individuals age 50 and over when "catch up" contributions are included). The other type of small business for which SIMPLE IRA's are attractive are those whose owners, again, have relatively modest abilities to save

for retirement, but who also need to address similarly modest needs of their core (i.e., those who have worked for them in at least 2 previous years) employees.

E. SIMPLE 401(k)'s

SIMPLE 401(k)'s are identical in many respects to SIMPLE IRA's, but they use an ERISA trust as the repository for all employee and employer contributions, and they use the traditional IRC § 410(b) minimum coverage rules, not the special SIMPLE IRA minimum coverage rules which, as indicated earlier, are based on employees who had compensation in excess of $5,000 in either of the two preceding years and the current year. IRC § 401(k)(11).

The employer qualification requirements to sponsor a SIMPLE 401(k) are the same as for SIMPLE IRA's. The employer may have no more than 100 employees with compensation of $5,000 or more. IRC § 401 (k)(11)(D).

The exclusive plan requirement also applies. That is, an employer that has a SIMPLE 401(k) cannot sponsor any other qualified retirement plan. IRC § 401 (k)(11)(C).

The contribution requirements are also the same as for SIMPLE IRA's. That is, the employer can choose to make either a dollar for dollar match on employee contributions of up to 3%, or a 2% nonelective contribution. IRC § 401 (k)(11)(B).

The 100% vesting requirement is the same as for SIMPLE IRA's. IRC § 401 (k)(11)(A)(iii).

The main consequences of use the regular Section 410(b) minimum coverage rules instead of the SIMPLE IRA "minimum coverage" rule are that:

- You can exclude individuals who have worked for you for many years and earn $5,000 or more, but who have never had 1,000 hours of service in a year (i.e., who have never attained a "year of service" under the general qualified plan rules);
- You can exclude 30% of the nonhighly compensated workforce (e.g., by job category or work site); and
- If not all of the HCE's will participate, you can exclude an even larger percentage of NHCE's than 30%.

The main consequence of using an ERISA trust as the contribution vehicle for SIMPLE 401(k)'s is that the employees do not control when distributions are made, and therefore cannot "raid" their accounts before separation from service. Note, however, that SIMPLE 401(k)'s may contain the typical 401(k) hardship distribution and participant loan rules, which SIMPLE IRA's cannot.

Bottom line on SIMPLE 401(k)'s: Given that the contribution limits and vesting rules for SIMPLE 401(k)'s are the same as for SIMPLE IRA's, but SIMPLE 401(k)'s are more complex to administer, SIMPLE 401(k)'s appeal primarily to employers with existing 401(k) plans who find that their owner and employee contribution levels are low enough that they can be accommodated by the

SIMPLE contribution structure, but who prefer to keep their old 401(k) plan and its investment structure intact, rather than terminating the plan and distributing all of its benefits, or freezing it, in order to start a SIMPLE IRA program. Moreover, in a limited number of cases, SIMPLE 401(k)'s may appeal to employers who want to utilize the flexibility provided by the regular qualified plan minimum coverage rules to target participation to those NHCE's and HCE's who will most appreciate the plan. However, since after 2001 Safe Harbor 401(k)'s are no longer subject to the top-heavy rules, SIMPLE 401(k)'s should appeal only to that narrow niche of employers for whom the 1% reduction of the SIMPLE 401(k) contribution requirements, as opposed to the Safe Harbor 401(k) contribution requirements (effectively, a 3% as opposed to a 4% match, or a 2% as opposed to a 3% nonelective contribution), are a desirable tradeoff for the reduced contribution limits.

F. Safe Harbor 401(k)'s

Safe Harbor 401 (k)'s are like regular 401 (k)'s in every respect except two: they replace the ADP and in most cases the ACP test with a required matching or nonelective contribution and a notice requirement. Second, they get a pass on the top-heavy rules.

The Safe Harbor 401(k) contribution requirements are that the employer must either:

- Match each employee's elective deferrals up to 3% of pay dollar for dollar, and match the portion of deferrals from 3% to 5% of pay 50¢ on the dollar. IRC § 401(k)(12)(B); or

- Make a 3% nonelective contribution for every participant in the Plan. IRC § 401(k)(12)(C).

Note that in the case of matching contributions, the employer can elect a different matching formula, as long as it is at least as generous as the dollar for dollar up to 3%/50¢ from 3% to 5% formula at all elective deferral contribution levels up to 5%. Many employers use a dollar for dollar up to 4% of pay match, figuring it will cost about as much and is simpler to communicate. IRC § 401 (k)(1 2)(B)(iii).

In addition to meeting the special employer matching or nonelective contribution requirements outlined above, Safe Harbor 401(k) plans must annually provide participants with a notice intended to ensure that every eligible employee understands that he or she is eligible to contribute and, in the case of a Safe Harbor 401(k) using safe harbor matching contributions, inform the employee of the very substantial matching contributions that will be made to his or her account if he or she makes elective deferrals. IRC § 401(k)(12)(D). *See* IRS Notices 98-52 and 2000-3.

All Safe Harbor 401(k) matching or nonelective contributions must be fully vested and subject to the same distribution restrictions (separation from employment, death, disability, or hardship) as elective deferral contributions in a regular 401(k) plan. IRC § 401(k)(12)(E).

Note that if for some reason the employer prefers to put its safe harbor matching or nonelective contributions in a different plan (e.g., it's 401(k) plan is run by a mutual fund company, but it's profit sharing plan is not, and the employer wants to put its matching or safe harbor nonelective contributions into its profit sharing plan), the employer can do that.

Note also that if an employer with a Safe Harbor 401(k) uses the safe harbor matching contributions alternative, then, assuming it makes no other matching contributions and that it does not permit after-tax contributions, it gets a pass on both the ADP and the ACP tests that apply to regular 401(k) plans (see below). If a plan uses the 3% nonelective contribution safe harbor, then it gets a pass on the ADP test and will also get a pass on the ACP test as long as (a) its matching contributions are provided under a formula that doesn't provide matching contributions at a higher rate for higher deferral percentages and (b) it does not match contributions in excess of 6% of compensation.

For a variety of reasons, many employers already provide a 3% nonelective contribution for most of their employees. Under the Safe Harbor 401(k) rules, whether that 3% nonelective contribution is in a 401(k) plan or in a separate plan covering the same NHCE's as are covered by the 401(k) plan, if the employer is willing to fully vest the 3% nonelective contribution and subject it to the 401(k) rules preventing in-service withdrawals other than for hardship, the employer can dispense with the 401(k) ADP test, and with the ACP test as long as it restricts matching contributions to elective deferrals not in excess of 6% of pay.

Importantly, an employer using the 3% nonelective contribution safe harbor can use this contribution as the basis for a cross-tested defined contribution allocation for the employer's owners. *See* IRS Notice 98-52, VIII, B., 1998-2. C.B. 632, 637. However, if the 401(k) safe harbor 3% nonelective contribution is used in cross-testing, the cross-testing calculations cannot take into account permitted disparity for the portion of the cross tested allocation supported by the 3% 401(k) safe harbor nonelective contribution. Id.

Finally, note that the 3% 401(k) safe harbor nonelective contribution can also be used to satisfy the top-heavy contribution requirement for a top-heavy plan. IRC Notice 98-52, VIII, C., 1998-2 C.B. 632, 637. However, this is less important after 2001, since under EGTRRA a 401(k) plan the only contributions to which consist of elective deferrals and safe harbor matching contributions gets an automatic pass on top-heavy anyway. *See* IRC § 416(g)(4)(H) as added by EGTRRA. However, use of the 3% nonelective contribution as a top-heavy minimum could still be useful in some circumstances, since an employer could have additional qualified plan contribution structures, either in its Safe Harbor 401(k) plan or in a separate plan that would render EGTRRA's inoculation of the safe harbor arrangement itself from the top-heavy rules incomplete. For example, if the employer had a cross-tested profit sharing allocation, either inside the safe harbor 401(k) or in a separate plan, that structure would not get EGTRRA's 401(k) safe harbor "free pass" on top-heavy. Instead, If it were part of the safe harbor 401(k) plan, it would apparently "taint" the entire safe harbor 401(k) plan and potentially make it top-heavy, while if it were a separate plan, then only that separate plan would be top-heavy, and only the non-key employees in that separate plan would be required to receive the top-heavy minimum allocation or benefit.

There may nevertheless be a small planning opportunity here, e.g. for professional firms who want all partners and staff to be able to receive 401(k) elective deferrals and matching contributions, but don't want all staff to receive a nonelective contribution. E.g., you could have a 401(k) plan for the firm that would cover all partners and staff, and include a safe harbor match, and you could have a cross-tested profit sharing plan that would cover all partners and some staff. The cross-tested profit sharing plan seemingly could aggregate with the 401(k) plan to demonstrate compliance with the coverage test if it needed to, without causing the Safe Harbor 401(k) plan to become top-heavy.

Bottom line on who will use Safe Harbor 401(k)'s: Certainly, any employer that wants/needs a 401(k) plan for some combination of reasons having to do with the aspirations of its owners or nonowner employees to be able to save for their own retirement at the higher deferral rates permitted under a real 401(k) Plan, as contrasted with a SIMPLE 401(k) or SIMPLE IRA, and that has had difficulty in the past passing the ADP and/or the ACP test should consider a safe harbor 401(k), especially now that safe harbor 401(k)'s are no longer subject to the top-heavy rules. For example, an employer whose plan would otherwise be top-heavy and that expects that even with a dollar for dollar match on contributions up to the first 4% of pay only about half of its workforce will participate, while all of the owners will participate, can in 2003 effectively permit its owners to each contribute $20,000 ($12,000 elective deferral plus match of $8,000, which is the lesser of 100% x $12,000 or 400% x 4% x $200,000), while average staff cost will be just 2% of payroll (50% participation rate times 4% match).

G. Regular (i.e., non-SIMPLE, non-safe harbor) 401(k) Plans.

401(k) plans are defined contribution retirement plans that permit employee "elective deferral" contributions of up to (in 2003) $12,000. IRC §402(g). Employers may, and often do, offer to match employees' contributions at some rate determined by the employer. Elective deferral contributions are subject to a special nondiscrimination test called the "actual deferral percentage," or "ADP," test, and any matching contributions are subject to a special nondiscrimination test called the "actual contribution percentage," or "ACP," test.

Under the ADP test, the average of the deferral percentages for HCE's may not exceed the average of the deferral percentages for NHCE's by more than the greater of (i) 25% (i.e., the ADP of the HCE's may not be more than 125% of the ADP of the NHCE's) or (ii) the lesser of (A) 100% (i.e., the ADP of the HCE's may not be more than 200% of the ADP of the NHCE's) or (B) 2 percentage points (i.e., the ADP of the HCE's may not be more than the ADP of the NHCE's, plus 2%). IRC §401 (k)(3)(A)(ii). This sounds complicated when you say it that way, but it's actually pretty simple:

If the NHCE ADEP is	Then the HCE ADP cannot exceed
Under 2%	2 x the NHCE ADP
Between 2% and 8%	The NCHE ADP + 2%
Over 8%	1.25 x the NHCE ADP

The ACP test is virtually identical to the ADP test, except that it applies to matching contributions. IRC § 401(m).

HCEs' elective deferral or matching contributions that do not pass the ADP and/or ACP tests must be distributed and/or forfeited in the next year. IRC § 401(k)(8); IRC § 401 (m)(6).

SBJPA substantially changed the ADP and ACP tests. After SBJPA, a 401(k) plan may, if it wants, but is not required to, use so-called "prior year" testing, in which the HCEs' current year ADP or ACP is compared with the prior year NHCEs' ADP or ACP, as the case may be. IRC §§ 401(k)(3)(A) and 401(m)(2) as amended by SBJPA. SBJPA also changed the rules regarding how to determine the amount of excess contributions that need to be returned to HCE's if the ADP or ACP test is failed. Before SBJPA, this was done based on a progressive leveling of offending deferral or matching contribution percentages, which had the effect of favoring the higher-paid HCE's, since the 402(g) limit is a lower percentage of the compensation of someone earning $200,000 than it is of someone earning a lower amount. After SBJPA, the aggregate amount that needs to be distributed by a plan to correct excess amounts is determined based on the same leveling of percentages, but then that aggregate amount is divvied up among HCE's based on the relative amounts that they each deferred. IRC §§ 401 (k)(8)(c) and (m)(6)(C).

Note also that EGTRRA has repealed, effective in 2002, the so-called "multiple use" test that prevented a plan from using the "200% or 2 percentage point" prong of the ADP/ACP tests to demonstrate HCEs' compliance with both the ADP and ACP tests. IRC § 401(m)(9), as amended by EGTRRA.

A key factor to consider in comparing a regular 401(k) with a SIMPLE IRA arrangement or a SIMPLE 401(k) for employers that qualify for SIMPLE's (i.e., 100 or fewer employees with $5,000 or more in compensation) is that the elective deferral limit for both types of SIMPLE's ($8,000 in 2003) is less than the 401(k) elective deferral limit ($12,000 in 2003) so, assuming that NHCE's respond well to the plan (e.g., contribute at least around 4% on average), the owners, if they earn substantially more than $120,000 or so, on average, will be able to contribute 50% more (in 2003, $12,000 as compared with $7,000) under a regular 401(k) plan than they will be able to contribute under a SIMPLE IRA or SIMPLE 401(k) (4% + 2% = 6%; 6% x $200,000 = $12,000; $12,000 is 150% of $8,000).

Bottom line on who will use regular 401(k) plans: For small businesses with more than 100 employees who wish to make an elective pre-tax savings vehicle available to their owners and employees, the regular 401(k) plan, or its cousin the safe harbor 401(k) plan, discussed above, is the only game in town. For employers that qualify for both SIMPLE'S and regular 401(k)'s, the considerations are more complex, but fairly obvious. Very small employers for whom SEP's are not the appropriate vehicle (i.e., those with a significant number of long-term employees who don't care enough about benefits to value SEP contributions fully in their compensation package) may well prefer SIMPLE IRA's because they are, in fact, simple, and the size of the business does not justify the administrative complexity of a 401(k). For somewhat larger businesses, a frank appraisal of the nonowner workforce must be undertaken. If the nonowner workforce is relatively well paid and well educated, so that many NHCE's will

want to contribute substantially in excess of $7,000 even if the employer doesn't offer a generous match, then the regular 401(k) is likely the preferred choice, since the $8,000 (in 2003) SIMPLE elective deferral limit will not satisfy even many of the nonowners, and, perhaps with a match that is at a significantly lower rate than the SIMPLE rate, the owners may also be able to contribute substantially more than $8,000.[6] On the other hand, if the employer estimates that its nonowner workforce is unlikely to contribute much even with the offer of a significant match, then the SIMPLE IRA's $8,000 deferral limit and $6,000 match limit are likely to look as good as or better than what could be obtained for the owners with a regular 401(k) plan, and the 3% match is going to look relatively inexpensive.

H. **Money Purchase Pension Plans**

Money purchase pension plans are defined contribution plans that are virtually identical to profit sharing plans, except that contributions are a fixed percentage (e.g., 5%, 10%, etc.) of each covered employee's annual pay. This percentage is written into the plan document and cannot be changed except by amendment.

Until EGTRRA, effective in 2002, the only thing that you could accomplish with a money purchase pension plan that you couldn't accomplish with greater flexibility using a profit sharing plan was to get a deduction of more than 15% of covered payroll. That is, the maximum percentage of total covered payroll that an employer could deduct under all profit sharing plans (including 401(k) plans, since technically these are a type of profit sharing plan), was 15%. See IRC § 404(a)(3)(A)(i)(I). Therefore if, as many small employers did, you wanted to achieve a contribution of more than 15%, you needed to use a money purchase pension plan. The maximum annual deduction for all money purchase pension plans of the employer is 25%. IRC § 404(a)(7).

However, most employers wanted to keep as much flexibility as they could with respect to contribution levels, e.g., to be able to decide from year to year how much to contribute, with the option of going as high as 25%. So many small employers adopted both a profit sharing and a money purchase pension plan. The fixed contribution percentage under the money purchase pension plan would be whatever percentage the employer thought it might want to do in excess of 15%, but was willing to commit to more or less on a year-in, year-out basis. Annually the employer would contribute under its money purchase pension plan whatever fixed percentage it had committed to in that plan (e.g., 10%), and then would contribute between 0% and 15% under its profit sharing plan, so that in a good year contributions could be made of the maximum deductible amount (i.e., 25%), but in bad years contributions above 10% (or some higher percentage that had been selected for the money purchase pension plan) were not required.

However, because EGTRRA amended the Code, effective beginning in 2002, to permit an employer to deduct contributions of up to 25% of pay to a profit sharing plan (including to a 401(k) plan), see IRC § 404(a)(3)(A)(i)(p) as amended by EGTRRA, most money purchase pension plans in the United States have been terminated.

[6] However, the employer in this situation does need to examine whether the plan will likely be top-heavy so as to trigger a 3% employer contribution requirement, an unpleasant surprise that has come back to bite many small businesses that have implemented 401(k) plans.

I. Profit sharing plans

Profit sharing plans are defined contribution plans. In their simplest form, the employer decides annually the total amount it wants to contribute to the plan (i.e., the total "contribution pie" for the year). The contribution pie can be any dollar amount between 0 and, after 2001 under EGTRRA, 25% of the total payroll of all of the plan's participants.

Each participant in the plan then receives a slice of the profit sharing plan annual contribution pie that is proportionate to his or her slice of the "current payroll" pie for the year. For example, if a particular employee's current pay for the year is 3% of all participants' pay (e.g., is $30,000 out of a $1,000,000 payroll), then that participant's share of the profit sharing plan contribution pie for the year would be 3%. Mechanically, the allocation to a particular employee's plan account is typically thought of as involving the creation of a fraction for each covered employee, the numerator of which is the covered employee's compensation for the year, and the denominator of which is the sum of the numerators for all covered employees. Two rules must be applied to limit the share of the contribution pie allocated to any particular individual:

- In creating the allocation fraction, the compensation of any individual covered employee that exceeds the IRC § 401(a)(17) limit ($200,000 in 2003) is not taken into account in either the numerator or the denominator of the allocation fraction; and

- The allocation to any single individual's account under all defined contribution plans of the employer cannot exceed the IRC § 415(c) limit ($40,000 in 2003).

A variation on the straight percentage of pay design is a conventional (i.e., non-cross-tested) integrated design. In a conventional integrated design, there are essentially two annual contribution pies. The first contribution pie is allocated as described above. The second is also allocated as described above, except that employees whose compensation does not exceed the OASDI wage base ($87,000 in 2003) are disregarded, and the contribution pie slices are determined by looking only at the amount of compensation that each remaining employee earned in excess of the OASDI wage base (but not in excess of the IRC § 401(a)(17) limit (e.g., for 2003 the pie slices would be determined based on compensation between $87,000 and $200,000). Additionally, the resulting contribution rate based on each covered employee's compensation in excess of the OASDI wage base (so-called "excess comp"), cannot exceed the lesser of (i) the "base rate," i.e., the rate applied to all compensation in allocating the first "pie slice" or (ii) 5.7%, which is approximately the retirement benefit portion of the OASDI tax.

To illustrate, permissible combinations of "comp and excess comp" rates would be 3% and 3%, 5% and 5%,5.7% and 5.7%, 10% and 5.7%.

Again, note that until recently the maximum percentage of the annual payroll of all covered employees that an employer could contribute to all of its profit sharing plans (including 401(k) plans) was 15%, but this was increased by EGTRRA after 2001 to 25%.

J. **"Cross-tested" profit sharing plans.**

Unfortunately, in order to understand cross-tested profit sharing plans, you need to have some understanding of the complexities of the flexible and complex nondiscrimination rules that apply to qualified plans once we get beyond SEP's, SIMPLE's, and safe harbor formulas.

Plans can demonstrate compliance with the coverage and nondiscrimination rules of IRC §§ 410(b) and 401(a)(4) using several techniques that are not obvious to the nonspecialist and aggregation: These techniques are: permitted disparity, cross-testing, and restructuring.

1. **Permitted disparity.**

The "permitted disparity" rules give the employer credit for the retirement portion of the employer's share of FICA (more technically, for the old age portion of the Old Age, Survivors', and Disability Insurance ("OASDI") portion of the employer's portion of the Federal Insurance Contribution Act tax). Because the OASDI portion is only imposed on compensation up to the so-called OASDI "wage base" ($87,000 in 2003), and the OASDI wage base is a larger percentage of compensation for NHCE's than for HCE's (e.g., it is 100% of the compensation of any employee earning $87,000 or less in 2003, and will be only 50% of the compensation of someone earning $174,000), the portion of a benefit percentage consisting of the employer's share of the OASDI portion of FICA will be larger for an NHCE than for an HCE.

2. **Cross-testing.**

Cross-testing permits defined contribution allocations to be tested based on the retirement benefits that the allocations are projected to provide at retirement age. Because it will be projected to have 40 years to grow with investment earnings, a $300 contribution allocation for a 25 year-old NHCE earning $30,000, which on a straight percentage basis would support a $2,000 contribution for an HCE earning $200,000 ($300/$30,000 = 1%; 1% x $200,000 = $2,000,) may when "cross-tested" be equivalent to a $20,000 contribution allocation for a 55 year-old HCE, a 10-fold increase.[7]

3. **Restructuring and Aggregation**

"Restructuring" permits a single actual retirement plan to be split up into notional plans for testing purposes, as well as for multiple actual plans to be considered together as a single plan. For example, suppose that Plan P benefits HCE A at the rate of 10%, HCE B at the rate of 6%, and HCE C at the rate of 2%, while benefiting NHCE's X, Y, and Z at the rates of 10%, 6%, and 2%. By breaking up Plan P into three notional plans for testing purposes (Plan P1 benefiting HCE A and NHCE X, Plan P2 benefiting HCE B and NHCE Y, and Plan P3 benefiting HCE C and

[7] $300 x 1.0840^{40} exponent° = $6,517; $6,517/$30,000 = 21.72%; 21.72% x $200,000 = $43,449; $43,449/$1.10810^{10}$ = $20,125. Note that a preretirement mortality factor is not used. Treas. Reg. § 1.401 (a)-8(b)(2)(ii)(B).

NHCE Z), it can be demonstrated that each notional subplan does not discriminate, and therefore neither does Plan P as a whole.

Aggregation, on the other hand, permits multiple actual plans to be considered as a single plan. Suppose employer E has two plans, Plan H benefiting 50 HCE's out of a total employer-wide population of 80 HCE's, but no NHCE's, and plan N, which benefits 100 NHCE's out of a total employer-wide population of 200 NHCE's. Because Plan H covers 62.5% of the employer's HCE's, it needs to cover 43.75% (70% of 62.5%) of E's NHCE's in order to pass the ratio percentage test (a smaller percentage to pass the average benefits test, if it meets the other requirements of the average benefits test). Since on its own it covers 0% of E's NHCE's, it obviously would fail either test. However, by aggregating both plans (which can be done only if the benefits under the resulting notional single plan do not discriminate in favor of HCE's), combined notional plan HN will cover 50% of E's NHCE's, aid therefore pass. In testing whether notionally combined plan HN is nondiscriminatory, permitted disparity, cross-testing, and disaggregation can be used.

K. **Defined benefit pension plans.**

These are traditional, formula-based "pension plans." They provide a promise to each covered employee of a benefit. The basic promise is expressed in the form of a fixed monthly benefit commencing at some age (e.g., 65) and continuing for life. The amount of the fixed monthly benefit is determined by a formula, e.g., "At retirement, if you have 30 or more years of service with us, you will receive an annual benefit equal to 60% of the average annual compensation that you received from us in your last three years of working for us. For each year you work for us up to 30 years, you earn 1/30th (i.e., 2 percentage points) of the 60% maximum benefit."

Note that in all of the other types of plans we have described until this point, the employer's commitment was to contribute a certain amount to the plan each year, and then the employer was done. Although we didn't mention this, obviously in all of those other plans, the money that was contributed by both the employee and the employer was invested on a tax-deferred basis. If the investments did well, the employee's ultimate payout would be good in relation to the contribution amounts. If the investment performance was mediocre, the payout would be mediocre.

In a defined benefit plan, on the other hand, the covered employee's ultimate payout is fixed by a formula. The ultimate promise grows over time, and the amount of the promise that each employee has earned to date, determined by the portion of the formula that describes how the ultimate benefit is earned over time, is the covered employee's "accrued benefit." At any point in time, each individual employee's accrued benefit is a plan liability, and the sum of all of those liabilities is the plan's total liability for benefits. This liability amount must be determined annually by an actuary. Additionally, the actuary calculates annually the amount of contributions that the employer must make to the plan's trust to ensure that, over time, a trust fund separate from the employer is created to pay off the benefit liabilities. If the investments of the fund do better than expected, and assuming that the plan is not amended to increase benefits, then over time the employer can contribute less to the plan. If the investments

perform worse than expected, then generally the employer's contributions must be higher than originally anticipated. Additionally, since most defined benefit plans of small businesses will provide for lump sum distribution options (i.e., will permit the employee to receive his or her benefit in the form of the single cash payment calculated as the value of the promised annuity stream, using the same sort of calculation that an insurance company uses to determine how much to charge a person who wants to purchase an annuity from it), the value of benefit liabilities is also sensitive to interest rate fluctuations (higher interest rates reduce annuity purchase prices, lower interest rates increase them).

Thus under a defined benefit plan, the risk of sustained poor investment performance and of a low interest rate environment (which, except in the 1990's, tend to be associated with each other such as in the case as of the date of this writing) is placed on the employer.

But while defined benefit plans have drawbacks, the Internal Revenue Code's limits on employer contributions generally favor them. For example, an individual age 50 who wants to retire at age 62 with an additional $1.2 million in retirement savings could with a defined contribution plan receive at most deductions totaling $534,000 over the next 12 years.[8] In order to have $1.2 million at age 62, he or she would have to achieve an annual investment return of approximately 14% for each of the 12 years, which to many observers seems unrealistic.[9] If the annual investment return was 8%, the individual would have only approximately $840,000 at age 62. With a defined benefit plan, this individual could have $ 1.2 million accumulated by age 62. If his or her investment return was 14% each year, then the average contributions would need to be $44,000. If it was 8%, then the employer's annual contributions would need to be $63,000.

Whether a defined benefit plan sounds good or bad to the owners of a small businesses is going to depend on several factors:

- How old are the owners and what are the amounts of their existing retirement savings accumulations?

- How serious are the owners about wanting to make sure that they have a certain retirement savings amount in a tax-qualified plan at retirement?

- If there is a significant number of nonowner employees that would need to be covered by the plan, how appreciative would they be of the security of their benefits, i.e., to what extent would they be willing to take the value of those benefits into consideration in determining the competitiveness of their entire compensation package?

- How substantial are the owners' current incomes, i.e.; what is their appetite for tax-deductible contributions?

[8] 12 years times $40,000 per year + $54,000 in "catch up" contributions under EGTRRA.

[9] Note that an average rate of return of 14% would produce a fund of less than $1.2 million if returns in the early years of the 12-year period were less than 14% and the rates of return in the later years were above 14%.

- How strong and cohesive is the business? I.e., is it feasible for the business to accept a potential liability on its balance sheet, perhaps similar to a long-term lease or loan?

The last point bears elaboration. Defined benefit plans can place a long-term liability for underfunding, often at least temporarily substantial in size in relation to other long-term liabilities of the business, on the firm's balance sheet. This liability may arise from the plan's granting past service credit or from adverse investment or even actuarial experience. The balance sheet liability is required to be amortized annually over fixed periods, thus introducing a long-term fixed cost into the company's annual earnings equation. For many small businesses, e.g., professional firms, the number you're most interested in is the plan's termination liability, that is, the cost of immediately making the plan sufficient for all remaining unfunded accrued benefits, so that the plan is sufficient to pay all benefit liabilities and can be closed out in a "standard termination."

Many professional firms' partnership agreements provide that the firm's accounts will generally be maintained in accordance with GAAP. GAAP generally does not require a defined benefit plan's termination liability to be placed on a firm's balance sheet. *See* FAS 87. However, any professional firm that maintains a defined benefit plan and that has not already done so should carefully consider whether the plan's termination liability should be placed on the firm's balance sheet in order to properly charge withdrawing partners for their share of that liability.

Dealing with a defined benefit plan's balance sheet and income statement impacts in the aggregate is only the starting point for multiple owner small businesses such as professional firms that sponsor or are considering sponsoring a defined benefit plan. In the author's experience, most small businesses share the cost of funding contributions for staff employees in proportion to individual profit and loss ratios, like any other overhead item, but allocate the funding cost of each individual owner's benefit to that owner, either directly in the case of a partnership as a special allocation of expense, or perhaps indirectly in the case of a corporation in the determination of year-end bonuses. Although there is a negative inference in Treasury regulations that the practice violates a plan qualification rule (Treas. Reg. § 1.401(a)(26)-2(d)(1)(iii)(A)), the author believes that it does not, and, again, in the author's experience, the practice is widespread, at least among professional firms.

Also, it could be argued that if the cost of nonowner employees' benefits (i.e., the cost of staff contributions) under the plan is larger than the business would have accepted or needed to incur, but for its desire to secure very large contributions on the part of some owners, then at least a portion of the staff cost should be shared in proportion to individual owner plan benefits or contributions instead of current profit and loss shares.

Traditionally, the relative stability of professional firms and their hierarchical nature may have supported an argument that since every partner's benefit level would ultimately be the same, any balance sheet unfunded liability for the plan should be shared in proportion to ownership of the firm. However, as over the past 10 to 20 years profit and loss sharing percentages have become more and more divorced from capital ownership percentages, and as defined benefit plans

are understood to benefit different classes of owners differently, an argument can be made for a special sharing of the balance sheet liability based on relative benefits under the plan.

Where the question arises as to whether the cost of, and liability for funding, nonowner benefits (either on an annual basis or in the context of a plan termination) should be borne in proportion to profit and loss ratios, or in proportion to relative plan benefits, the question arises as to what is the proper measure of each owner's plan benefit, e.g. the present value of each owner's lump sum, each owner's projected relative retirement benefit at age 65, or simply the relative amounts of the tax deductions enjoyed by each owner.

Finally, to the extent (and, again, this is in fact common), that each partner is required to contribute the amount calculated annually by the plan's actuary as that partner's own portion of the plan's funding cost for the year, since each partner's respective amount may vary substantially, and since, structurally, investment gains in a defined benefit plan become an asset of the plan generally and as such reduce future employer contributions, and cannot be allocated as increases in participants' benefits based on their relative past contributions, a mechanism is often sought to ensure that each partner receives the full upside benefit of his or her past contributions, as well as being charged with the cost of any investment losses (i.e., a rate of return less than the actuarially assumed rate).

The author is aware of cases where there has been an attempt to create a defined benefit plan with two alternative benefit structures, similar to a floor offset arrangement within the confines of a single plan. In this structure, each partner's contributions to the defined benefit plan to fund his or her own benefit, as well as the contributions made by the firm for staff employees, are accumulated in a notional account within the plan, sometimes called a "funded reserve," and the plan provides that each participant will receive a benefit equal to the greater of the plan's conventional formula benefit or the value of the notional account, which is credited each year with its allocated share of plan contributions as well as a proportional share of the actual earnings of the trust. It would appear that as long as the formula used each year to determine the credits to such notional accounts for both partners and staff is fixed and objective, the plan will not fail to be qualified merely because of its dual benefit formula. *See* Rev. Rul. 74-385,1974-2 C.B. 130. Cf. Rev. Rul. 78-403, 1978-2 C.B. 153 (credits to account depended on employer contributions, which were subject to discretion). However, in practice, such plans may have significant drawbacks.

First, if in order to increase deductions for partners, credits to the participants' notional accounts are calculated using an aggressive formula (e.g., by determining the contributions that would be required for each participant under the individual level premium funding method), then the cost of contributions for nonowners may also be front-loaded, creating significant inter-generational equity issues for partners, inviting the partnership to fund the plan at a less than realistic level, or both. Second, if the plan's full normal cost, including the normal cost of the notional account benefit, if that is higher, is not contributed annually by the firm, the firm runs the risk of experiencing dramatic, unpredictable increases in its termination liability, since each participant's notional account, including nonowners, will need to be credited with its proportional share of the trust's investment earnings, including notional earnings on any unfunded portion

of the account. Finally, if the investment performance of the plan as a whole is sufficiently strong to increase the value of a partner's account to an amount in excess of the maximum lump sum that can be paid under IRC § 415(b), then either the partner will be required to forfeit the excess, or some mechanism will need to be found to either distribute the amount to the partner or compensate him or her for the forfeiture. Any such mechanism will need to come to terms with Treas. reg. § 1.401(a)(26)(d)(I)(B)(iii), which on its face would appear to be targeted against at least some possible mechanisms for accomplishing this.

A better approach to addressing this perceived problem would appear to be not to accumulate partners' respective contributions within a notional account in the plan, but to track them outside the plan, and then to determine annually, with the benefit of hindsight over the period from the date of the partner's commencement of participation in the plan through the date of the Current calculation, the amount by which the partner's prior contributions exceeded or underestimated the amount actually required to fund his or her conventional benefit. Any excess funding would be owed by the partnership to the partner as additional compensation, while any shortfall would need to be made up by the partner as additional plan contributions.

Type of Plan	Maximum Contribution in 2003 for individual owner earning at least $200,000 (exclusive of catch-up contributions)	Contribution Requirements for Nonowners	Special Availability Restrictions	Who's it good for	Funding Vehicle	Comments
Traditional IRA	$3,000 - $6,000	$0	None	Owners of small businesses with very low retirement savings aspirations and with spouses who work in the small business or who stay at home	IRA	$3,000 to $6,000 contribution swing depends on whether spouse is covered by a qualified retirement plan (if spouse is covered by a qualified retirement plan, ability to deduct contributions phased out at joint AGI between $150,000 and $160,000)
SEP	$40,000	Same contribution percentage as for owners must be provided to all employees who have received at least a minimum amount ($450 in 2003) of compensation from employer in at least 3 of 5 preceding years; contributions can be leveraged somewhat by integrating with social security	None	Small businesses with no or very few nonowner employees who meet "three out of five year" participation requirements	IRA	(1) Even taking social security integration into account, to get an owner making $200,000 per year to $40,000 in contributions requires a contribution for all covered employees of 17% of pay below Social Security wage base; (2) because of the use of IRA vehicle, employer cannot control employees' withdrawals of funds
SIMPLE IRA's	$14,000	Employer must either match eligible employees' contributions dollar for dollar up to 3% of pay or make 2% of pay nonelective contribution for all covered employees; all employees whose W-2 pay was at least $5,000 in any 2 preceding years, and who will likely earn $5,000 in current year, must be covered	Employer must have 100 or fewer employees earning $5,000 or more; employer cannot maintain any other qualified retirement plan	Small businesses whose owners have relatively low retirement savings aspirations, but who want to make significant contributions for themselves and expect low participation by their employees and/or need to address employee retirement savings aspirations	IRA	(1) If nonowner workforce generally cannot afford to make election deferral contributions even when offered 100% match, plan will have low cost for owners if matching used; (2) because of use of IRA's, employer cannot control employees' withdrawals of funds, but 25% excise tax of IRC § 72(t)(6) strongly discourages withdrawals in first two years of participation; (3) in multiple owner situations, can address issue of differing savings aspirations among individual owners in ways that SEP can't

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Type of Plan	Maximum Contribution in 2003 for individual owner earning at least $200,000 (exclusive of catch-up contributions)	Contribution Requirements for Nonowners	Special Availability Restrictions	Who's it good for	Funding Vehicle	Comments
SIMPLE 401(k)	$14,000	Same as for SIMPLE IRA's except eligibility is based on 1 year of service (1,000 hours in previous 12-month period) and 30% of nonowner workforce may be excluded under regular Section 410(b) coverage rules	Same as for SIMPLE IRA's	Same as for SIMPLE IRA's, except requirement to use ERISA trust likely to limit appeal to those converting existing 401(k) to SIMPLE 401(k)	Employer-sponsored trust	(1) More complexity because uses ERISA trust; (2) substantially same as safe harbor 401(k) described below, except contribution limit about 1/3 lower and matching or nonelective contribution requirement about 1% lower; (3) use of trust limits employees' ability to withdraw funds; regular 401(k) or profit sharing plan can be converted to SIMPLE 401(k)
Safe Harbor 401(k)	$20,000 (can reach $40,000 with discretionary employer contributions)	Eligibility based on 1 year of service (1,000 hours in 12-month period); 30% of non-owner workforce may be excluded under Section 410(b) coverage rules; employer must match employees' elective deferrals 100% on contributions up to 3% of pay and 50% on contributions up to next 2% of pay, or make 3% nonelective contribution	None	Large and small businesses whose owners and employees have substantial retirement savings aspirations and who can't pass, or don't want to worry about, ADP and ACP testing	Employer-sponsored trust	(1) EGTRRA's "pass" on top-heavy rules for safe harbor 401(k)'s means safe-harbor matching plans now more attractive to small employers; (2) fact that many large businesses have adopted Safe Harbor 401(k)'s enhances labor market attractiveness of small businesses that adopt them
Conventional 401(k)	$12,000+ (can reach $40,000 with matching and discretionary employer contributions	Eligibility based on 1 year of service (1,000 hours in previous 12-month period); 30% of non-owner workforce may be excluded under Section 410(b) coverage rules; average contribution rate for owners generally cannot exceed average for nonowners plus 2%	None	Small businesses whose owners and employees have significant retirement savings aspirations, but who cannot afford safe harbor 401(k) or who are confident of passing ADP and ACP tests based on substantial non-HCE participation rate	Employer-sponsored trust	Employers that have trouble meeting ADP test and/or that already make a 4% match or a 3% nonelective contribution to another plan should carefully consider Safe Harbor 401(k) as alternatives

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Type of Plan	Maximum Contribution in 2003 for individual owner earning at least $200,000 (exclusive of catch-up contributions)	Contribution Requirements for Nonowners	Special Availability Restrictions	Who's it good for	Funding Vehicle	Comments
Money Purchase Pension Plan	$40,000	Eligibility based on 1 year of service (1,000 hours in previous 12-month period); 30% of non-owner workforce may be excluded under Section 410(b) coverage rules; contribution rate for non-owner employees must be same as for owner employees except for social security integration	None	Before 2002, small businesses that wanted to make contributions that exceeded 15% of pay profit sharing plan contribution limit; after 2001, probably no one	Employer-sponsored trust	EGTRAA's increase of profit sharing plan and SEP deduction limits has led to mass termination of money purchase pension plans
Conventional Profit Sharing Plan (including using traditional integrated formula**)**	$40,000	Eligibility based on 1 year of service (1,000 hours in previous 12-month period); 30% of non-owner workforce may be excluded under Section 410(b) coverage rules; contribution rate for non-owner employees must be same as for owner employees except for social security integration	None	Small businesses with few non-owner employees, an egalitarian culture, and/or whose HCE and non-HCE workforces are very similar in average age	Employer-sponsored trust	Because generally provide more "leveraged" contributions, cross-tested profit sharing plans, discussed below, have become more popular with small businesses and professional firms
Cross-tested Profit Sharing Plan	$40,000	Eligibility based on 1 year of service (1,000 hours in previous 12-month period); 30% of non-owner workforce may be excluded under regular Section 410(b) coverage rules; if average age of owners is significantly older than average age of non-owners, can significantly leverage contributions in favor of owners	None	Small businesses whose owners have relatively high retirement savings aspirations and who, while willing to contribute a significant amount for non-owners, want to minimize cost of providing benefits to non-owners	Employer-sponsored trust	Because of their flexibility and efficiency, have become very popular over last 15 years

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Type of Plan	Maximum Contribution in 2003 for individual owner earning at least $200,000 (exclusive of catch-up contributions)	Contribution Requirements for Nonowners	Special Availability Restrictions	Who's it good for	Funding Vehicle	Comments
Cross-tested Profit Sharing Plan combined with 401(k) Plan	$40,000	Eligibility based on 1 year of service (1,000 hours in previous 12-month period); 30% of non-owner workforce may be excluded under regular Section 410(b) coverage rules; if average age of owners is significantly older than average age of nonowners, can significantly weight benefits in favor of owners	None	Small businesses whose owners have relatively high retirement savings aspirations and who, while willing to contribute a significant amount for nonowners, want to minimize cost, and who also want to accommodate different retirement savings aspirations or abilities among multiple owners	Employer-sponsored trust	(1) The new standard in defined contribution plans for professional firms; (2) with a 4% to 7% commitment to contributions for staff, most owners will be able to get to the $40,000 maximum, while owners who only want to contribute around $20,000, or any amount between $20,000 and $40,000, can to do that as well
Defined Benefit Plan	$80,000+	Eligibility based on 1 year of service (1,000 hours in previous 12-month period); 30% of workforce may be excluded under regular Section 410(b) coverage rules; at last 40% of workforce (or 50 individuals, if less) must be covered; if average age of owner is significantly older than average age of nonowner group, can significantly weight contributions in favor of owners	None	Small businesses whose owners have annual retirement savings aspirations significantly in excess of $40,000, e.g., who have only a relatively short period of time to accumulate retirement savings, or who have large income opportunity	Employer-sponsored trust	(1) Can put a lease-like liability on a small business's or professional firm's balance sheet; (2) in small business and professional firm situations, careful up-front planning and negotiations necessary among owners with respect to sharing of contributions and liabilities

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