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# **Qualified Retirement Plans**

## **A Retirement Plan *Revolution*:**

### **Pension Protection Act of 2006**

#### **THE EVOLUTION OF DEFINED BENEFIT PENSION PLANS**

- CROSS TESTED PROFIT SHARING PLANS
- JUMBO PLANS
- DEFINED BENEFIT PENSION PLAN – HYBRID
- CASH BALANCE DEFINED BENEFIT PLAN
- FLOOR OFFSET DEFINED BENEFIT PLAN

*Why does the fully insured Hybrid plan work best?*

- CONGRESSIONAL INTENT
- MAXIMIZE BENEFITS/DEDUCTIONS FOR OWNERS/HCEs
- MINIMIZE BENEFITS/CONTRIBUTIONS FOR NHCEs
- NO UNDERFUNDING, NO OVERFUNDING
- FLEXIBLE DISTRIBUTION OPTIONS
- LIFE INSURANCE PROCEEDS PAID FROM A QUALIFIED PLAN ARE NON-TAXABLE

# UNDERSTANDING CROSS-TESTED PROFIT SHARING PLANS

Profit sharing plans have long been the retirement plan of choice for the small business. However, with "traditional" plans, flexibility exists only in the contribution level. Typically, each employee's share of the firm's contribution is identical. If one employee receives an allocation of 10 percent of salary, all employees receive an allocation of 10 percent of salary.

Most small business owners would like more options in the amount of their contribution to employees. Flexibility is now available. Section 401(a)(4) of the Internal Revenue Code allows profit sharing allocations to be divided differently among employees based upon identifiable classification groups. Not only is the amount of contribution flexible, but there is flexibility in the way it is divided among the employees.

This Cross-Tested profit sharing plan allows the owner to decide who will benefit more from the firm's profit sharing contribution based upon objective criteria. For example, the owner may divide employees by job classification, salary level, length of service or each employee may be deemed their own class.

Under IRS regulation 1.401(a)(4) - 8(b)(3) and IRS regulation 1.401(a)(4) – 8a (b)(1)(vi) (A) and (B), the Gateway Safe Harbor rule is introduced which states that the discrimination rule will be satisfied if each non-highly compensated employee allocates a minimum of 5% of compensation. This will allow the employer to contribute the maximum amount to the highly compensated employee which is \$46,000 in 2008.

The options for classification groups and contribution amounts maximize the effectiveness of the firm's retirement plan using a New Comparability plan design. To find out more about how New Comparability and Cross-Testing plans can benefit your business, contact Willow Financial Services today at 800-662-9847.

*This material is for information purposes only.*

*The client's personal or legal tax advisors should always be consulted and relied upon for advice.*

## JUMBO PLANS

Effective for plan years beginning after December 31, 2007 "Jumbo Plans" may be installed. This would consist of a fully funded Defined Benefit Plan, a 25% Profit Sharing Plan, and 6% elective deferrals.

There has been some controversy over the 25% + 6%, but that is to be cleared up through the Technical Corrections Bill.

# EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) 29 U.S. CODE CHAPTER 18

Despite the enormous growth in such plans, many employees with long years of employment are losing anticipated retirement benefits owing to lack of vesting provisions in such plans. Because of the inadequacy of current minimum standards, the soundness and stability of plans with respect to promised benefits may be endangered. Due to the termination of plans before requisite funds have been accumulated, employees and their beneficiaries have been deprived of anticipated benefits. Therefore it is desirable to the interests of employees and their beneficiaries, for the protection of the revenue of the United States, and to provide for the free flow of commerce, that minimum standards be provided assuring the equitable character of such plans and their financial soundness.

## THE TRUTH ABOUT DEFINED BENEFIT PLANS

- **MYTH** – Defined Benefit Plans work best in small professional corporations with few rank and file employees.
- **REALITY** – Any business with Owners/Highly Compensated Employees and numerous other employees can have a Defined Benefit Plan that benefits **only** the Owners/HCEs and has the Profit Sharing Plan benefit all the other employees.

### ***EXAMPLE:***

*6 OWNERS = \$1,200,000 DEFINED BENEFIT*

*47 RANK & FILE EMPLOYEES = \$82,000 PROFIT SHARING*

*PERCENTAGE OF TOTAL OWNERS = 94 %*

# HYBRID DEFINED BENEFIT PLANS

# FLOOR OFFSET

A Hybrid Defined Benefit Plan has combined characteristics from both Defined Benefit and Defined Contribution Plans. There are two types of Hybrid Defined Benefits Plans. The first type is the Floor Offset Plan.

A **Floor-Offset Plan** is a combination of two plans:

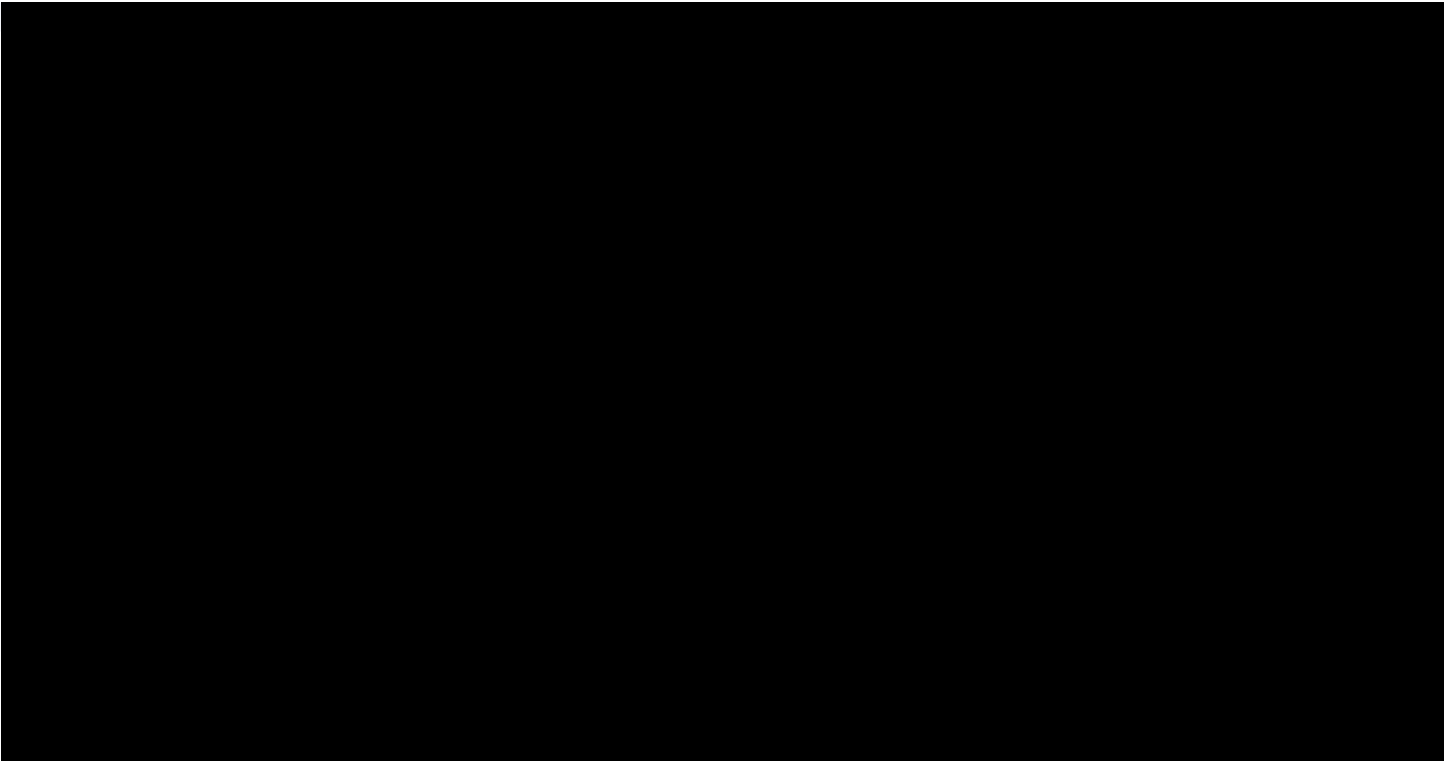
1. Defined Benefit Plan.
2. Defined Contribution Plan (typically a safe-harbor Profit Sharing Plan)

Floor Offset Plans work by:

1. Projecting the Profit Sharing Contribution and Account Balance to Normal Retirement at an assumed rate of return no greater than 8 ½ % and continuing contributions to the Profit Sharing Plan of 5 % - 7 ½ %.
2. Then this is converted by the Annuity Purchase Rate.
3. If calculated properly this “offset” amount will always be greater than the Defined Benefit Plan resulting in only a contribution to the Profit Sharing Plan.

*Safe-harbor Defined Benefit Formula*  
*Projecting Contributions*  
*Projecting Account Balances*  
*Interest Rate allowed by IRS in projecting*

## SAMPLE FLOOR OFFSET PROJECTION



The 401(a)(26) is for less than 50 employees or 40% of all employees

Exceptions:

401(a)(26) – 5(2)(iii)(A) Concurrent Benefit Offset arrangements.

The employees who benefit under the formula being tested also benefit under the other plan on reasonable and uniform basis.

Cross-testing by individual class is reasonable and uniform or it would not be allowed.

# HYBRID DEFINED BENEFIT PLANS

## CASH BALANCE

A Cash Balance plan is a Hybrid plan with Defined Benefit plan with Defined Contribution features. From the employee's perspective a Cash Balance Plan mirrors a Money Purchase Plan .

### *Relevant Vocabulary:*

Accumulation Account (Account Balance)

Pay Credit (Contribution)

Interest Credit (Gain/Loss)

## 412(i) CASH BALANCE PLAN EXAMPLE

### Maximize HCE (Highly Compensated Employees)

- Find maximum benefit from settlement option rates
- NRA 65 = \$267,488
- Give pay credit of \$267,488 in cash balance plan to HCE and perform calculations
- Determine HCE's benefit accrual rate
- Determine pay credit rate for NHCE's using IRS meaningful benefit table

### CENSUS

	<u>Age</u>	<u>Comp.</u>	<u>NRB</u>	<u>Funding</u>	<u>Traditional DB</u>
*HCE 1	53	\$ 220,000	\$ 180,000	\$ 267,488	\$ 131,295
NHCE 1	27	\$ 25,000 x 17.94		\$ 4,485	\$ 2,340
NHCE 2	43	\$ 36,000 x 17.94		\$ 6,458	\$ 1,479
NHCE 3	67	\$ 45,000 x 17.94		\$ 8,073	\$ 5,360
NHCE 4	27	\$ 27,000 x 17.94		\$ 4,844	\$ 1,270
<b>Total Contribution</b>				<b>\$ 291,348</b>	<b>\$ 141,744</b>
<i>91.81 Benefit to HCE</i>					

### Maximize HCE

- Determine appropriate pay credit for youngest NHCE
- \*\*  $6.81 / 1.8978 = 3.5883$
- $3.5883 \times 5\% = 17.94$
- Give pay credit of 17.94 to NHCE's

\*Benefit Accrual Rate = 6.81

\*\*1.8978 is 1994 GAR at 5% for meaningful benefits

# CASH BALANCE PLAN REGULATION

**Lump Sum Based Benefit Formula:** A benefit formula used to determine all or any part of a participant's accumulated benefit under which the benefit provided under the formula is expressed as a balance of a Hypothetical Account maintained for the participant.

Similarly, a formula would not fail to be a lump sum based benefit formula merely because the plan's terms state that the accrued benefit is an annuity at the normal retirement age that is actuarially equivalent to a Hypothetical Account Balance.

A fully insured Cash Balance Plan stabilizes the Hypothetical Account Balance.

The key to the success of the formula for these plans is to structure the formula to pass the Average Benefit Test of Section 410(b) and the General Test of 401(a)(4).

## ARGUMENTS FOR LIFE INSURANCE INSIDE A 412(i) PLAN

1. Higher Deductions
2. (a) Death Benefit Proceeds Paid Out Tax Free
  - Face Amount Less CSV (IRC Sec 72(m) (3) B
  - IRC Reg 1.72-(16)(b)
- (b) Accrued Benefit (including CSV) Paid Out as Taxable Death Benefit
3. Insurance Premiums Tax Deductible
4. At Retirement, Insured can purchase policy at value and take advantage of tax free policy loans.