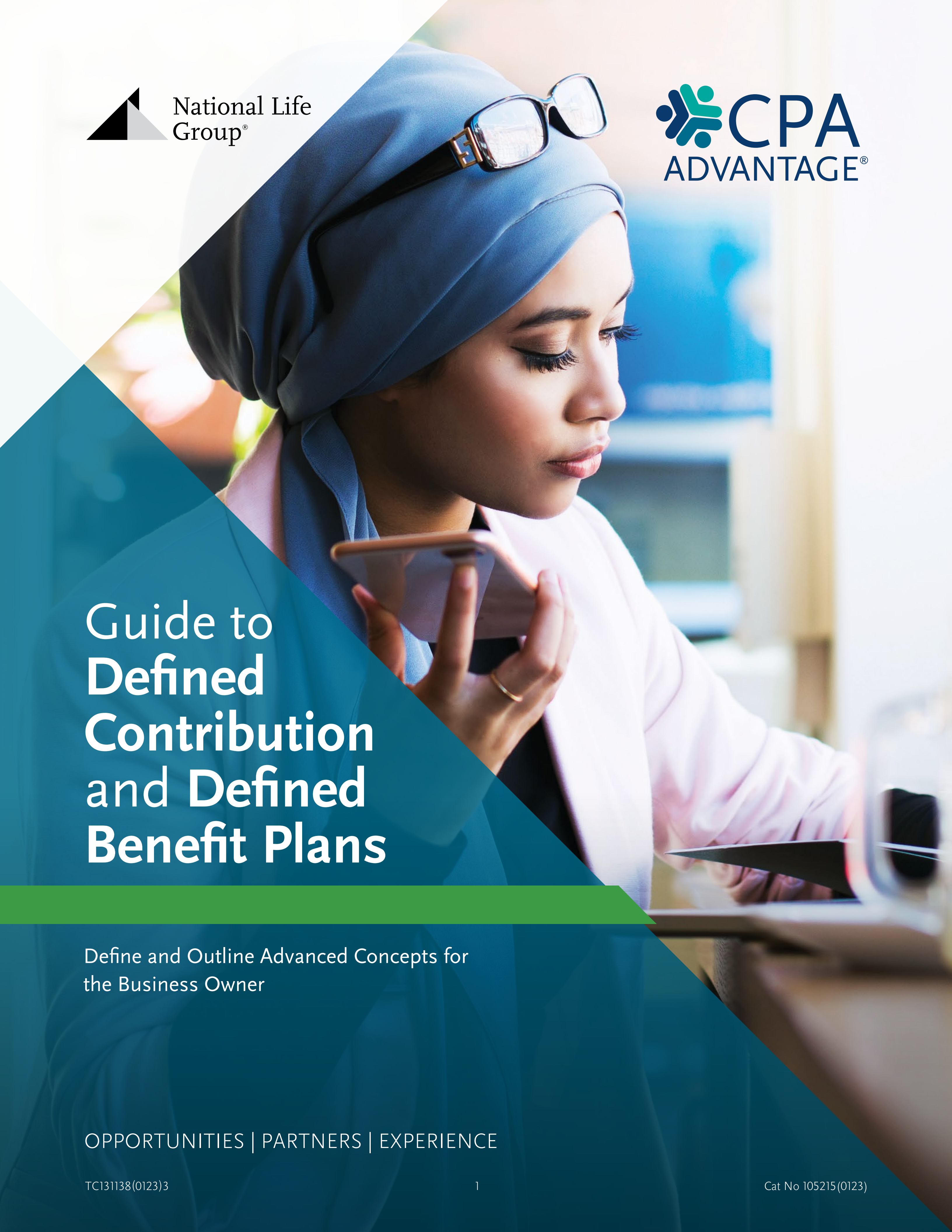


National Life Group®

CPA ADVANTAGE®

Guide to **Defined Contribution** and **Defined Benefit Plans**

Define and Outline Advanced Concepts for the Business Owner

OPPORTUNITIES | PARTNERS | EXPERIENCE

What is a **Qualified Plan**?

Qualified plans provide essential retirement benefits for employers and employees and can also provide death benefit protection by purchasing life insurance within the plan. As a small employer, you may offer a qualified plan primarily for business and tax reasons. A qualified plan can give you a critical edge in attracting and retaining highly qualified employees, and it provides tax advantages to you, your key executives and your employees.

Plans that meet Internal Revenue Code requirements are “qualified” for special tax advantages, including tax deductibility of contributions. Contributions are also not currently taxable to employees, and all funds within the plan accumulate on a tax-deferred basis. Distributions from the plan may also qualify for special tax treatment.

Many employers cite start-up costs and administrative burdens as reasons for not sponsoring a plan. If you do not currently sponsor a qualified plan for your business, you may not be aware that legislation over the past few years has addressed these issues. There are tax credits that could help with the start-up costs and third-party administrative firms can administer the qualified plan.

When discussing qualified plans, there are two general categories: “defined contribution” plans and “defined benefit” plans. Within each category are different plans with different provisions, allowing you to choose the best plan for your circumstances. There may be a plan available to meet your individual needs, no matter how close you may be to retirement.

Who may establish a qualified plan?

- C Corporations
- S Corporations
- Partnerships
- Sole proprietorships
- LLCs
- Non-profit organizations

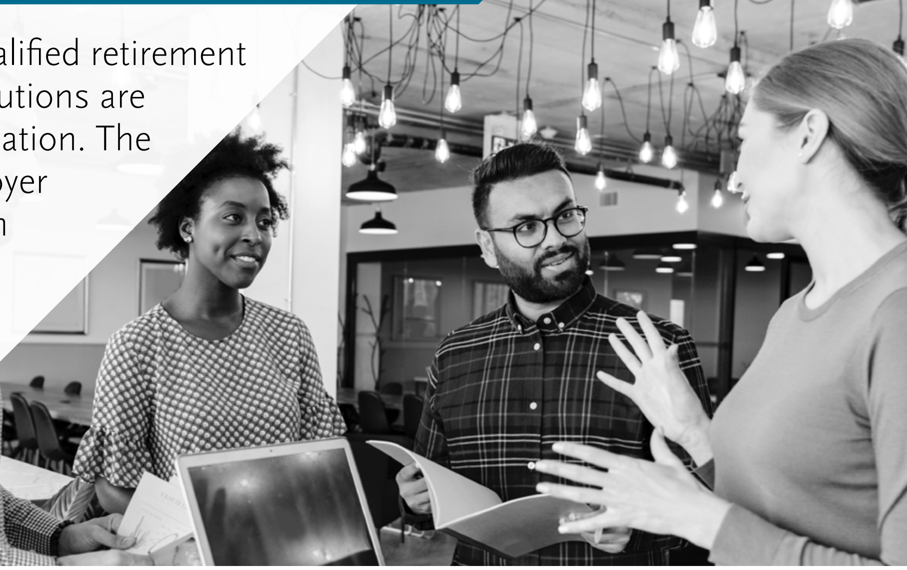
Who may participate in a qualified plan?

All full-time employees who are age 21 and older and have completed one year of service must be eligible to participate. (A two year service requirement may be used if the plan provides for 100% immediate vesting after two years.) Part-time or seasonal employees, if employed less than 1,000 hours annually, may be excluded depending on the terms of the plan. However, 401(k) plans, starting as of January 1, 2024, must allow long-term “part-time” employees working more than 500 hours but less than 1,000 hours per year the opportunity to defer. A long-term part-time participant has 3 consecutive years of service where they worked at least 500 hours each year. Nonresident aliens with no source of U.S. income and employees covered by a collective bargaining agreement may also be excluded.

It might be possible to exclude some additional employees as long as the plan follows very specific coverage testing guidelines established by the IRS.

What is a **Defined Contribution Plan**?

A defined contribution plan is a tax-qualified retirement plan in which annual employer contributions are generally based on employee compensation. The annual contribution made by an employer on the employees' behalf is specified in the plan. There is no specific defined benefit in retirement. For that reason, a participant would not know what they would have accumulated for retirement until they reach retirement age.



How do defined contribution plans work?

In order to implement a defined contribution plan, you, as the employer, must first create a pension trust, to which tax-deductible contributions are made for each eligible plan participant. Set up of the trust is typically done with the assistance of a third party administrator who is engaged in the plan implementation process. Employer contributions accumulate tax-deferred and are not currently taxable as income to the employees (except for the economic benefit of any life insurance purchased on an employee's behalf in an "insured" plan, i.e., a plan that includes life insurance). At retirement, the amount available in the employee's account is used to fund a retirement benefit. The amount of this benefit is directly affected by the performance of the plan's underlying investments. Thus, the greater the return, the greater the retirement benefit.

Maximum tax-deductible contribution/benefits

Your employer contributions to a defined contribution plan may not exceed 25% of payroll. But there is also an individual annual contribution maximum per plan participant. This amount is set by the IRS each year. The maximum contribution will be the lesser of 25% of salary or the individual limit set by the IRS.

What is a profit sharing plan?

Profit sharing plans are defined contribution plans. A profit sharing plan is designed to help companies share their success with their employees. You, as the business owner, are allowed to make discretionary contributions to employees in the profit sharing plan. While the contribution could be based on company profits it is not a requirement. Types of profit sharing plans include:

- Traditional profit sharing
- Age-weighted profit sharing
- Cross-tested profit sharing (a.k.a profit sharing select)
- 401(k) plans

Types of profit sharing plans

Traditional profit sharing plans divide the employer's annual contribution among participants equally. Whatever percentage of salary you allocate to yourself, as the owner, is the same percentage of salary that is given to each eligible employee. The primary advantage to this plan is flexible contributions. You, as the business owner, choose the percentage of salary used to determine the plan contribution each year.

Integrated profit sharing plans allow more of the employer's contribution to be directed to those whose earnings exceed the Social Security Taxable Wage Base. Social Security benefits generally replace a larger percentage of lower-paid employees' compensation. Therefore, Social Security integration can effectively give higher-compensated employees total benefits that are a similar percentage of salary compared with the benefits received by lower-compensated employees. Integration is a non-discriminatory way to get more contributions to highly compensated plan participants that does not jeopardize the plan's tax-qualified status. The primary advantage of this plan is more of the contribution may be directed to you, as the business owner, if your salary is greater than rank and file employees.

Age-weighted profit-sharing plan allow employers to allocate more of the contribution to older employees who are closer to retirement age, and less to younger employees who have more time to save for retirement. The primary advantage of this plan is it is useful for attracting and retaining older, more experienced employees. These plans are also beneficial to you, as the owner of the business, if you are older than the rank and file employees.

Cross-tested profit sharing (profit sharing select) plans give the employer the flexibility to define groups of employees and to allocate contributions differently to each group. The primary advantage of this plan is that the employer has more freedom to decide who will benefit and how much they will receive. The IRS does require a minimum contribution be given to rank and file employees. The minimum contribution is either 5% of the participant's salary or 1/3rd of the percentage allocated to the owner, if less than 5%.

Each plan is unique and contributions to non-highly compensated employees will depend on the age and salary of the owners and key/highly compensated plan participants. But if owners and key/highly compensated plan participants are older and/or make a higher salary than non-highly compensated employees, it may be possible for owners to benefit specific employees, while keeping contributions low.

What is a 401(k) profit sharing plan?

401(k) profit sharing plans are different than profit sharing plans because 401(k) plans allow highly and non-highly compensated employees to defer income on a pre-tax or after-tax basis. The 401(k) plan may include an employer match, employer non-elective contribution and/or discretionary profit sharing contributions.

A 401(k) plan is qualified under the same rules as Profit-Sharing plans. A business owner may either set up a new plan or amend an existing profit-sharing plan to allow for employee salary deferral contributions in addition to employer contributions.

Because 401(k) plans are defined contribution plans, they tend to favor younger participants, so the growth of relatively small annual contributions can compound substantially over the years.

Advantages of a 401(k) profit sharing plan

In addition to the benefits of defined contribution profit-sharing plans, 401(k) plans offer the following advantages:

- Flexible contributions and pre-tax salary deferrals
- Considerable funding flexibility
- Encourage thrift and employee loyalty
- Contributions and salary deferrals are tax-deductible to the employer
- Tax-deferred accumulations
- Employer contributions are not currently taxed to the participants
- Plan costs are shared with participating employees

Here's how it works

The maximum annual contribution to an individual's account, including forfeitures, is 100% of compensation up to a maximum contribution amount defined by the IRS each year. In a 401(k) plan, the maximum contribution includes salary deferrals, employer matching or non-elective contributions, and any employer profit-sharing contributions. For those people age 50 or older in the current year, the IRS does allow an additional deferral amount, known as a catch-up deferral.

In addition to the individual maximum annual contribution limit, the plan has an overall total contribution that cannot exceed 25% of the gross covered payroll. Gross covered payroll would be the salaries of all employees eligible to defer in the 401(k) plan. The 25% limitation includes employer matching or non-elective contributions and any employer profit sharing contributions, but does not include the plan participant deferrals.

Actual Deferral Percentage (ADP) test

Employee deferrals can be made on a pre-tax basis, after-tax basis, or a combination of both. In a traditional 401(k) plan, the amount of salary deferral allowed for highly compensated employees depends on the level of deferrals made by non-highly compensated employees. There is testing done each year by the third-party administrative firm to ensure that the highly compensated employees do not defer over the limits allowed. This test is called the Actual Deferral Percentage test. All employees who are considered highly compensated, whether owners or highly paid employees, cannot defer more than 2% of salary over the average deferral of the rank and file employees. This could limit your ability, as the owner, to defer the individual maximum allowed under the 401(k) plan.

A business owner is under no obligation to provide any match of employee deferrals in a traditional 401(k) plan.

Safe harbor 401(k) plans

Safe harbor 401(k) plans were specifically designed to make 401(k) plans more attractive and accessible to small business owners by eliminating the need to apply the ADP test. With the safe harbor 401(k) plan, any highly compensated plan participant can defer the individual maximum amount allowed, regardless of what non-highly compensated employees defer. However, you do have to give something to your employees. These are known as the “safe harbor” options. They are:

1. An employer matching contribution. The match is dollar-for-dollar up to the first 3% of salary that an employee defers and $.50 on the dollar on the next 2% of salary that an employee defers. The match goes only to those employees who defer.

   or

2. An employer non-elective contribution. The non-elective contribution is 3% of salary and is given to all employees who are eligible to defer in the 401(k) plan, even if they elect not to defer.

Whether the match or non-elective contribution is selected, it is 100% immediately vested to the participants.

The safe harbor 401(k) plan may not be required in all situations, but it is a useful tool for designing 401(k) plans either alone or in combination with other plans (especially cross-tested profit sharing plans) for many small businesses.

One-life 401(k) plans

A one-life 401(k) plan, also known as a solo 401(k), is available for a business that has only highly compensated employees eligible to participate in the plan. This could be a sole proprietorship, or a partnership with two partners or a husband and wife business with no rank and file employees. The one-life 401(k) plan in combination with a profit sharing contribution is a way to allow a business owner to receive a higher contribution and tax-deduction than could be achieved with just a 401(k) deferral or just a profit sharing contribution. Take a situation where a business owner takes a $50,000 salary. The maximum contribution the business owner could make in a profit sharing plan is 25% of eligible salary. But if the plan were a one-life 401(k) plan the owner could make a 401(k) deferral up to the maximum allowed, as well as a 25% of salary profit sharing contribution.

Combined plans

Combining a 401(k) with other plans can be very appealing for a business owner who wants to receive a higher contribution than can be achieved with just the 401(k) plan. With the elimination of deferrals in calculating the employer's maximum tax deduction, small businesses may make a substantially increased profit sharing contribution to the plan. For the employer who wants even greater deductions, the 401(k) profit sharing plan can be combined with a defined benefit plan.

Any business can have a 401(k) plan and a defined benefit plan. However, any employer contributions made under the 401(k) plan will be limited if the business is a professional service firm. Professional service firms include lawyers, advertising professionals, architects, accountants, financial advisers, engineers, and consultants, among others. It is any organization or profession that offers customized, knowledge-based services to clients. The maximum employer contribution would be no more than 6% of eligible payroll. Employer contributions would be any match, non-elective or profit sharing contribution. Eligible payroll would be the salaries of all employees who are eligible to defer in the 401(k) plan. This rule came about under the Pension Protection Act of 2006. If the business is not a professional service firm, then up to 25% of eligible payroll may be contributed to the 401(k) profit-sharing plan in addition to maximum funding of a defined benefit plan.

A popular design combines a safe harbor 401(k) with a cross-tested profit-sharing plan allocation. This design is most advantageous for a business that has older key employees and younger rank and file employees. It will often allow older key employees to reach their individual contribution limit with the 3% non-elective contribution being used to satisfy the 401(k) safe harbor, cross-testing and top heavy minimums.

Additional Benefits

Early distributions

Hardship withdrawals may be made within guidelines for immediate and substantial financial need. Participants may pay a 10% penalty on unauthorized withdrawals made before age 59 ½. Participants taking a hardship withdrawal are subject to a 12 month waiting period before deferrals can be made to the plan. Loans may also be allowed.

401(k) deferrals may be directed to a variety of funding vehicles, which accumulate on a tax-deferred basis. Taxes are, of course, payable upon distribution.

Survivor Benefits

If a participant dies prior to retirement, an insured pension plan could either pay a death benefit in the form of ongoing income or in a lump-sum payment to a surviving beneficiary.

In an insured plan, the plan participant's account has two parts:

- The insurance account, which is made up of individual or group life insurance. The life insurance provides pre-retirement death benefits for participants' beneficiaries. The percentage of contributions used to pay the insurance premium will buy proportionally larger amounts of life insurance for younger employees than for older employees.
- The individual investment account(s), which are comprised of various financial vehicles that enable employer contributions to the participant's accounts to grow tax-deferred.

What is a **Defined Benefit Plan**?

Defined benefit plans are tax-qualified retirement plans under Internal Revenue Code Section 401. Contributions made to a defined benefit plan are made entirely by the employer. There are no employee deferrals allowed in a defined benefit plan. The contributions made to the plan are tax-deductible to the business, and participating employees pay no current tax on contributions and earnings until the funds are distributed.

A defined benefit plan is a permanent retirement plan established by you, as the employer, and funded for the exclusive benefit of the employees and their beneficiaries. This plan is the only type of pension plan that provides eligible employees a guaranteed monthly benefit at retirement. The contributions made to the plan must be sufficient to pay future benefits, as promised.

There are different types of defined benefit plans:

- **Traditional defined benefit** plan is a permanent retirement plan established by the business and funded for the exclusive benefit of employees and their beneficiaries. This plan is best suited for your business if you have six or fewer employees eligible to receive a contribution.
- **Defined benefit select** plan is a hybrid of the Traditional Defined Benefit plan. You, as plan trustee, can place employees in "tiered" groupings, with the objective of contributing less to employees while maintaining high contributions for yourself, as the employer. This plan is best suited for your business if you have between five and twenty-five employees eligible to receive a contribution.
- **Defined benefit advantage/cash balance** plan is a hybrid pension plan, blending attributes of a traditional defined benefit plan with a defined contribution plan. The plan defines a contribution, which is a percentage of salary, like a defined contribution plan, but contribution maximums fall under defined benefit rules. This plan is best suited for your business if you have a large number of employees eligible to receive a contribution and are interested in making a large contribution.
- **412(e)(3) defined benefit** plan is a defined benefit plan that is funded using life insurance company products that have guarantees. The plan can be funded entirely with an annuity or a combination of an annuity and whole life insurance. Found under Internal Revenue Code Section 412(e)(3), this plan provides guaranteed retirement benefits and may also include an insured death benefit. The maximum contributions and tax deductions may be greater than is permitted in other defined benefit plan types because the products used have low guarantees, which in turn generates high plan contributions.

How do defined benefit plans work?

Traditional defined benefit, defined benefit select, and defined benefit advantage

Your business would create a pension trust and make tax-deductible annual contributions for all eligible plan participants. You, as the employer and trustee of the plan, select the investments, which can include life insurance. Once every year, an enrolled actuary determines the cost of funding the plan – the amount your business must contribute. In a traditional defined benefit plan or DB select, this amount is based on assumptions about future earnings of the plan participant, salary increases, and other factors. Certification of the plan's funding by an enrolled actuary is required each year.

Benefits of these types of defined benefit plans include:

- Individuals may receive the maximum amount available when they reach normal retirement age.
  - The maximum benefit is 100% of the highest consecutive three years of average compensation, up to the current maximum indexed annually by the IRS.
  - This amount is reduced if it is received prior to normal retirement age.
- There is no specific limit on the amount of contribution to the plan per plan participant.
- To prevent defined benefit plans from discriminating in favor of highly compensated employees, each year the IRS defines the amount of compensation for each participant that can be used in calculating contributions to the plan.

412(e)(3) defined benefit

In a 412(e)(3) plan, each participant is provided with a guaranteed, predetermined benefit amount that is fully insured by the purchase of an annuity or a combination of whole life insurance and an annuity. Because plan benefits are guaranteed , any "excess" interest earnings (or dividends, if paid) over and above the life or annuity contract guarantees are used to reduce the next year's premium.

In addition to the benefits available in a traditional defined benefit or DB select plan, the 412(e)(3) plan includes two additional benefits:

- No enrolled actuary's certification is needed since the plan is funded entirely with insurance contracts.
- Quarterly contributions are not required; and "accrued benefits" are easy to understand. Each participant's accrued benefit at any point is simply the guaranteed cash value of the underlying life and annuity contracts.

Is a defined benefit plan suitable for your business?

Defined Benefit plans are most suitable for stable, well-established businesses or professional practices. Moreover, because they can provide more substantial retirement benefits and greater tax deductions than other types of plans, defined benefit plans are usually favored by older or highly compensated owners.

Other candidates for defined benefit plans include sole proprietors, partnerships and LLCs filing other than as a corporation, but they must have bottom line earned income each year at least equal to the plan cost. Earned income less than the contribution due can result in a nondeductible employer contribution.

Note: If your business does establish a defined benefit plan, the business must be able to commit to a high, annual funding schedule and, in some cases, more complicated and costly administrative requirements.

There are also a number of other questions and suitability issues to consider as well, including:

- **Contribution flexibility** – traditional defined benefit and DB select plans do have some contribution flexibility in that the plan will define a minimum up to a maximum contribution range each plan year. A contribution must be made, but it can be any amount within the defined contribution range. If you are an employer looking for a plan that allows you to make no contribution in a given plan year, then you would not be a good candidate for a defined benefit plan.
- **Large, one time tax deductions** – If you do not intend to fund the plan in the future then you should not consider a defined benefit plan. Why? Because the IRS also looks at the permanency of a plan when it terminates. If the intent was to fund the plan for less than 5 years, the IRS could question its permanency, which in turn could put prior tax deductions in jeopardy.

412(e)(3) have additional suitability issues to consider:

- **Length of funding** – Funding a 412(e)(3) plan for only a couple of years prior to retirement could result in guaranteed contract values which are too large to take as a lump sum. If that occurred, the only option would be to annuitize the contract values to take a stream of income over your lifetime.
- **Investment diversification** – There is little investment diversification in a 412(e)(3) plan. IRC § 412(e)(3) specifies that plan contributions must be made to specifically designed fixed annuity contracts or a combination of guaranteed annuities and whole life insurance contracts. If you would prefer investment diversification, you should consider a traditional defined benefit plan as an alternative.
- **Fluctuating profit history** – The contribution to a 412(e)(3) plan, once established, must be paid every year. If your business has a fluctuating profit history or the potential for significant profit fluctuations in the future, then a 412(e)(3) plan would probably not be appropriate for your business. A more flexible plan might be the more appropriate solution.
- **Conversion** from a traditional defined benefit plan to a 412(e)(3) plan – It is possible to amend and restate a traditional defined benefit plan to a 412(e)(3) plan, but only under very specific timing deadlines. All assets of the existing plan must be moved to the 412(e)(3) plan's fixed investments within the first 30 days of the plan year for which the amendment is effective. The plan must remain a 412(e)(3) for a minimum of 3 years, or deductions will be disallowed by the IRS.

What else do I need to know about qualified plans?

Top-heavy plans

Defined Contribution and Defined Benefit plans may be considered "top-heavy" if, at the end of the plan year, more than 60% of the individual account balances belong to "key" employees. A key employee is defined as any employee who at any time during the plan year is:

- More than 5% owner of the business regardless of salary.
- More than 1% owner of the business with compensation in excess of $150,000 (not indexed for inflation).
- In excess of the limit imposed by IRC section 416(i)(1) (as indexed for inflation).

If a defined contribution plan is top-heavy, a minimum contribution of the lesser of 3% of compensation or the maximum percentage amount contributed to a key employee must be made each year on behalf of non-key employees. This minimum contribution may not be integrated with Social Security.

In a defined benefit plan, each non-key employee must accrue benefits equal to at least 2% of compensation times years of service, up to a maximum of 20%. Many small or closely held businesses and professional practices design their defined benefit plans to comply with top-heavy plan requirements.

What's more, a defined benefit plan is considered "super top-heavy" when key employees have account balances that exceed 90% of the present value of all account balances.

Vesting requirements

Defined contribution plans:

Participants in defined contribution plans must eventually have a non-forfeitable right to their benefits based on a predetermined vesting schedule. Because vesting essentially delays an employee's ownership of the funds set aside to pay his or her retirement benefits, defined contribution plans come with two vesting requirements:

- Employee contributions, such as salary deferrals into a 401(k) plan and safe harbor matching or non-elective contributions must be fully and immediately 100% vested.
- Employer contributions can be fully and immediately 100% vested or they can be subject to a vesting schedule. Vesting schedules must be no less generous than:
  - Three year cliff vesting – Participants are vested after three years of service, or
  - Two-to-six year graded vesting – Participants must be at least 20% vested after two years of service, resulting in 100% vesting after six years of service.

Full vesting of employer matching contributions in a traditional 401(k) plan can be immediate or based on one of the following vesting schedules:

- Three year cliff vesting – Participants are 100% vested after three years of service, or
- Two-to-six year graded vesting – Participants must be at least 20% vested after two years of service, resulting in 100% vesting after six years of service.

Note: If a plan is considered to be top-heavy, either 100% immediate vesting, three-year cliff vesting, or six-year graded vesting is required.

Defined benefit plans:

Participants in defined benefit plans must eventually have a non-forfeitable right to their benefits based on a predetermined vesting schedule. In effect, vesting delays an employee's ownership of the funds which have been set aside to pay his or her retirement benefits.

The plan trustee (i.e., business owner) selects the plan vesting schedule. Full vesting of contributions can be immediate or based on a vesting schedule. Vesting schedules must be no less generous than:

- Five-year cliff – Participants are 100% vested after five years of service.
- Three-to-seven year graded – Participants must be at least 20% vested after three years of service and acquire another 20% for each additional year of service, resulting in 100% vesting after seven years of service.
- If the plan is top-heavy, employer contributions can be fully vested immediately or one of the following vesting schedules is required:
  - Three year cliff vesting – Participants are vested after three years of service, or
  - Two-to-six year graded vesting – Participants must be at least 20% vested after two years of service and acquire another 20% for each additional year of service, resulting in 100% vesting after six years of service.

Forfeitures

Forfeitures result when employees who are not fully vested in the plan terminate employment.

Defined contribution plans:

In a defined contribution plan, any non-vested forfeiture amounts must be reallocated to the accounts of remaining participants or used to reduce employer contributions to the plan.

Defined benefit plans:

In a defined benefit plan, if an employee is not 100% vested, any non-vested forfeiture amounts must be used in the plan to reduce the employer's plan contribution in the next year.

Plan distributions*

Distributions from defined contribution and defined benefit plans may be made in the event of retirement, permanent disability, termination of employment, or death before or after retirement. Distributions may be paid to participants or their beneficiaries in the form of monthly installments or in a lump-sum, if permitted by the plan.

In addition, certain profit sharing plans enable participants who are age 59½ or older to withdraw funds while they are still working for the employer.

Special rules for defined benefit plans:

- At retirement, benefit payments are paid to participants, as guaranteed under the plan.
- In addition to retirement benefits, the plan provides a survivor death benefit (as required by the IRS), and may provide larger insured death benefits, as well as early retirement and disability benefits.
- If a participant dies prior to retirement, an insured pension plan pays a death benefit in the form of an income or lump sum payment to the participants named beneficiary.

*See the Distributions from a Qualified Plan Advisor Planning Concepts brochure for more information.

Tax treatment

At retirement or death, non-insurance distributions from the plan are taxed as ordinary income as they are received by the participant, or the participant's beneficiary. If the death benefit includes life insurance, the face amount of the insurance that is in excess of the insurance cash value is received income tax-free. This is known as the "net amount at risk."

Life insurance death benefits are included in any federal estate tax computation. However, amounts paid to a surviving spouse qualify for the unlimited marital deduction.

Note: Certain distributions paid to the plan participant prior to normal retirement age, death, disability or termination before age 59 ½ are subject to an additional 10% early distribution tax penalty. The 10% early distribution penalty tax does not apply to beneficiaries.

Loans

Defined contribution and traditional defined benefit plans may allow loans to participants prior to retirement or termination of service. (Note that 412(e)(3) plans do not allow loans.) Outstanding loans may not exceed the maximum of $50,000 or 50% of the participant's vested accrued account balance. The $50,000 limit is reduced by the excess of the highest outstanding loan balance within one year of a new loan. The loan must be repaid in equal installments, at least on a quarterly basis, within five years, unless the loan is secured for the purchase of the participant's principal residence. Loan interest is not deductible.

Reporting and disclosure

Full ERISA reporting is required with defined contribution plans. Form 5500 must be filed annually for the plan. An actuarial report for traditional defined benefit plans and Form PBGC-1 are also required annually. You, as plan trustee, would not have to file these forms. A third-party administrative firm would provide the IRS approved plan adoption agreement when the plan is established and they would do the annual tax reporting and required filings with the IRS. Third party administrative firms will charge a fee for their services.

"Incidental" death benefits

Life insurance can be included in a plan if it is incidental to the primary purpose of the plan, which is providing retirement benefits. In an insured plan, the plan participant's account has two parts:

- The insurance account, which is made up of individual or group life insurance. The life insurance provides pre-retirement death benefits for participants' beneficiaries. The percentage of contributions used to pay the insurance premium will buy proportionally larger amounts of life insurance for younger employees than for older employees.
- The individual investment account(s), which are comprised of various financial vehicles that enable employer contributions to the participant's accounts to grow tax-deferred.

Because the life insurance must be incidental to the reason for establishing the plan, the IRS defines how much of each annual contribution can be used for the life insurance premium in the plan.

Defined contribution plans:

There are two ways to calculate the amount of the contribution allocated to life insurance premium.

If universal life insurance is in the plan, each participant is allowed to allocate up to 25% of their annual contribution for the life insurance premium.

If whole life insurance is in the plan, each participant is allowed to allocate up to 49.9% of their annual contribution for the life insurance premium.

You should be cautious when including life insurance in a qualified plan that allows for fluctuating contributions. Because the life insurance premium is a percentage of the total plan contribution, changing the plan contribution in the first two years the plan is funded, could result in some reduction in the amount of insurance. One way to avoid that is to not use the maximum 25% or 49.9% that could be allocated to life insurance.

After the insurance has been in the plan for two years, Profit Sharing plans have specific rules for funding the insurance premium, which are known as the “seasoned money” rules.

- **The two-year rule:** 100% of the money in a participant’s account, including earnings, that has been in the account at least 2 years old, can be used entirely to pay the life insurance premium under the profit sharing plan.
- **The five-year rule:** Anyone who has actively participated in the profit sharing plan for at least 60 months is allowed to direct up to 100% of their account, both old and new money, to pay the life insurance premium under the profit sharing plan.

Defined benefit plans:

There are two ways to calculate the amount of the contribution allocated to life insurance premium.

- **The “100-times test”** calculates a pre-retirement death benefit that does not exceed 100 times the participant’s monthly retirement benefit or the present value of the accrued benefit, whichever is greater. The insurance death benefit formula is expressed as a multiple of the monthly retirement benefit.
  - Example: If a defined benefit plan participant is entitled to a $1,500 monthly retirement benefit, the plan could purchase a life insurance policy with a face amount up to $150,000.
- **The “two-thirds rule”** uses an actuarial formula to calculate the amount of the contribution going to the life insurance premium. This method will generally produce larger face amounts of insurance than the 100-times test.

Why include life insurance in a qualified plan?*

Including life insurance inside the qualified plan provides a number of benefits.

1. The premiums are paid using pre-tax dollars. This frees up personal dollars. It would require greater earnings to pay income taxes as well as the life insurance premium using after-tax dollars outside of the qualified plan.
2. The policy is portable. At termination or retirement, the insurance coverage can be continued outside of the plan. This would be beneficial if a plan participant’s age or health issues may make purchasing new insurance outside of the plan cost prohibitive or impossible.

*See the catalog number 64049 Guide to Life Insurance in Qualified Plans brochure for more information.

Which Qualified Plan Type is **Right for Your Business?**

Advantages and disadvantages of defined contribution plans

Advantages

- Flexible contributions and, in 401(k) plans, pre-tax and after-tax salary deferrals are available.
- Tax-deductible contributions. As long as contributions do not exceed the current limits, the employer's costs for providing this important employee benefit are tax-deductible.
- Employer contributions grow tax-deferred. Favorable performance in each participant's individual account increases the person's retirement benefit. What's more, forfeitures may be used to further increase the participants' benefits.
- Contributions not currently taxable to employees, except for the economic benefit of life insurance in an insured plan.
- Can favor older participants. Different allocation formulas may be used in order to favor older participants.
- Plan administration is less complicated and expensive than for defined benefit plans.
- Life insurance is available. Insured plans can use a percentage of contributions to buy incidental life insurance protection for plan participants.
- Helps employers attract, motivate, and retain valued employees. The plan provides retirement income for employees, reducing their concerns about future financial security.

Disadvantages

- Contributions are restricted to specific limits.
- Older participants may have lower retirement benefits than under defined benefit plans.
- Recognizing past service to the company may not be possible.
- Since benefit amounts vary, participants may not be able to plan as accurately for retirement as they would with a defined benefit plan.
- In an insured plan, older or rated participants may not be able to buy as much life insurance as they could purchase in a defined benefit plan.

Advantages and disadvantages of defined benefit plans

Advantages

- Defined benefit plans will generally provide for a larger contribution than a defined contribution plan.
- Benefits are guaranteed, which makes it easier for participating employees to plan for retirement. It's also good for morale and for reducing employee turnover.
- When life insurance is included in a defined benefit plan it increases the total plan contribution and deduction.
- The contributions made to the plan are tax deductible to the business.
- The plan can favor older participants (such as owners or principals of the organization), since the annual cost to fund their benefits is higher.

Disadvantages

- Defined benefit plans can become costly as participants approach retirement age. However, this can be seen as an advantage if the objective is to create a substantial tax shelter.
- You, as the employer, are contractually obligated to provide the benefits guaranteed under the plan. However, for certain defined benefit plans, government insurance through the Pension Benefit Guaranty Corporation is provided to protect participants against the loss of benefits through default.
- Administration as well as reporting and disclosure are more complication and costly in traditional defined benefit plans than with other types of qualified retirement plans. However, some types of defined benefit plans, such as 412(e)(3) plans, are much less complicated, easier to administer, and do not require a pension actuary.

Next Steps: How to Establish and Implement a Qualified Plan

Step 1: Planning stage

The first step in establishing and implementing a qualified plan is to determine what your goals are and which type of plan may best achieve these goals. These goals may be a combination of retirement savings, tax deferred growth, and tax deductions.

With the many different qualified plan types and design features available, which type best suits your business's needs will depend on a variety of factors. It is important to consider the available plan types in conjunction with a review of the business data, business owner goals and cost objectives. This consideration through a robust fact finding process will assist in making the right choice of plan type for your business.

Step 2: Implementation stage

Once you have made the decision to establish and sponsor a qualified plan for your business, the implementation of the qualified plan is done through engagement with a Third Party Administrator. Many qualified plans have deadlines for implementation and funding in order to provide that the contributions are tax deductible for a particular taxable year. Establishing a qualified plan does take time and communication with the business owner, third party administrator, and eventually the employees. It is vital to ensure that information is provided in a timely manner so that the objectives and goals determined in the planning stage are met.

Step 3: Funding stage

With a properly planned and implemented qualified plan, the last step is to fund the plan. During the implementation stage it will be determined what funding vehicles will be used as investment options in the plan. Depending on the type of plan, the available options may change. If you are choosing to include life insurance as an incidental benefit in the plan, please refer to the Guide to Life Insurance in a Qualified Plan brochure for more information.

Contact Information for National Life Group Representatives

For more information on these topics or for assistance with case design, proposals, sales assistance, marketing and technical support, contact your Qualified Plan Marketing Team:

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