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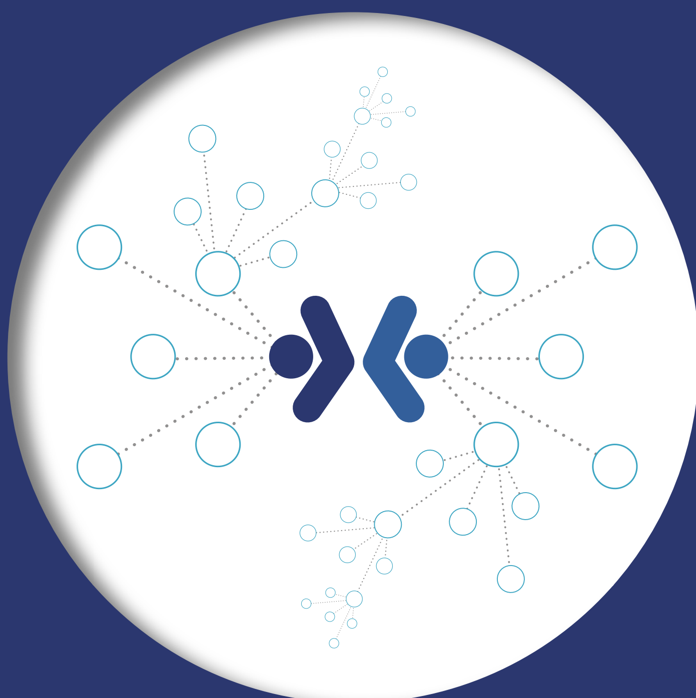
Qualified Plans

Advisor Planning Concept



Qualified plans provide essential retirement benefits for the employer and employee and can also provide death and disability benefits.

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Qualified Plans

Qualified plans provide essential retirement benefits for the employer and employee and can also provide death and disability benefits. Small employers that do offer a qualified plan do so primarily for business and tax reasons. A qualified plan gives employers a critical edge in attracting and retaining highly qualified employees, and it provides tax advantages to employees, key executives and the business owner.

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.

Legislation over the past decade, including EGTRRA 2001 and the Pension Protection Act of 2006, have eased the start-up costs and administration of qualified plans. Under EGTRRA 2001, a nonrefundable business tax credit equal to 50% of the qualified startup costs paid or incurred by a small employer is now available. A "small employer" is an employer that has no more than 100 employees with compensation in excess of $5,000 for the previous year. Qualified startup costs are ordinary and necessary expenses of an employer, that are paid or incurred in connection with the establishment or administration of an employer plan or the retirement-related education of employees with respect to the plan. The maximum credit is $500 per year. The credit may be taken during the plan's first three years or for the year preceding the year the plan becomes effective and the first two years of the plan. To be eligible for the credit, the plan must cover at least one non-highly compensated employee. Many small employers who do not sponsor a plan are not aware of this credit, and many still cite start-up costs and administrative burdens as reasons for not sponsoring a plan.

Education of the small employer and business professional with regard to their retirement needs and the benefits of a qualified plan is clearly more important than ever before.

There is a plan available to meet the individual needs of each business owner no matter how close they may be to retirement.

Qualified plans fall into two general categories: Defined Contribution plans and Defined Benefit plans. Within each category are different plans with different provisions, allowing an employer to choose the best plan for the employer's circumstances.

Defined Contribution plans specify the contribution to be made for each participant, generally as a percentage of compensation. The benefit that will be available at retirement depends upon the accumulation of contributions within each person's account.

Defined Benefit plans specify the amount of retirement benefit in the plan formula. The annual cost of the plan is determined by an Enrolled Actuary based on projected future interest earnings, salary increases and other factors. In addition to salary levels, the calculation may recognize length of service.

Defined Contribution Plans

What is a Defined Contribution plan?

A Defined Contribution plan is a tax-qualified retirement plan in which annual employer contributions, specified by the plan, are generally based on employee compensation. The plan must be permanent and it must be established for the exclusive benefit of employees and their beneficiaries.

The amount contributed by the employer on the employees' behalf is specified in the plan – not a benefit at retirement. For that reason, a participant's actual benefit cannot be determined until retirement.

There are two categories of Defined Contribution plans: Pension plans and Profit Sharing plans.

Pension plans require a fixed annual employer contribution. Types of Defined Contribution pension plans include:

- Money Purchase plans
- Target Benefit plans

Profit Sharing plans permit a degree of flexibility in annual employer contributions. Types of profit sharing plans include:

- Traditional Profit Sharing
- Age Weighted Profit Sharing
- Profit Sharing Select
  (a.k.a. Cross Tested Profit Sharing)
- 401(k) plans

We'll look a little more closely at each of the above profit sharing plans later in this booklet.

Who may establish a Defined Contribution plan?

Defined Contribution plans may be established by:

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

Who may participant in a Defined Contribution plan?

All employees who are at least age 21, complete at least one year of service (two years if the plan provides full and immediate vesting), and work 1,000 hours or more annually must be eligible to participate. Part-time or seasonal employees, if employed less than 1,000 hours annually, may be excluded depending upon the terms of the plan. Non-resident aliens with no source of U.S. income and employees covered by a collective bargaining agreement may also be excluded. Other non-discriminatory classifications of employees may be excluded subject to the plan satisfying coverage requirements.

How do Defined Contribution plans work?

In order to implement a Defined Contribution plan, an employer must first create a **pension trust**, to which tax-deductible contributions are made for each eligible plan participant. 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.

Some Defined Contribution plans offer **survivor benefits** to the families of participants who die after retirement. 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.

Maximum tax-deductible contribution/benefits

Employer contributions to any Defined Contribution plan may not exceed 25% of payroll. The maximum annual contribution per participant is the lesser of 100% of compensation, or $53,000 (subject to cost-of-living adjustments). As noted, the higher the investment return in a Defined Contribution plan, the higher the retirement benefit that can be paid.

Example:
Consider two Defined Contribution plans – Plan A and Plan B – both of which require employer contributions each year of 10% of each participant's annual compensation. Both plans have a 40 year old employee who earns $50,000 a year and who will retire at age 65. Consider the difference in retirement benefits if Plan A has an average growth rate of 8%, compared to Plan B, which earns 6%.

Examples of Defined Contribution Plans

	Plan A	**Plan B**
Years to retirement:	25	25
Annual contribution (.10 x $50,000)	$5,000	$5,000
Accumulation at age 65 (Average Annual Return (AAR))	$394,772 (8% AAR)	$290,782 (6% AAR)
Projected monthly benefit	$2,470	$1,819

Based on annuity purchase rate equal to $6.26 per $1,000

Top-heavy plans

Defined Contribution 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:

- A more than 5% owner of the business.
- A more than 1% owner of the business with compensation in excess of $150,000.
- An officer of the employer with compensation in excess of $165,000 (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.

Social Security integration

Defined Contribution plans may be integrated with Social Security, so that the employer's contributions to both plans are coordinated into a single retirement plan. This can substantially reduce the cost of including lower-paid employees in the Defined Contribution plan. What's more, because Social Security benefits generally replace a larger percentage of lower-paid employees' compensation, Social Security integration also effectively gives higher-compensated employees total benefits that are a similar percentage

Defined Contribution Plans *(Cont'd)*

of salary compared with the benefits received by lower-compensated employees. As a result, larger contributions and benefits can be allowed to highly compensated employees in a non-discriminatory way that does not jeopardize the plan's tax-qualified status.

Age-based plans are another tool employers can use to allocate proportionally more of their contributions to older, more highly compensated employees. Otherwise, these plans have the same requirements as other types of profit sharing plans.

Vesting requirements

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.

Forfeitures

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

Plan distributions

Distributions from Defined Contribution 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 59 ½ or older to withdraw funds while they are still working for the employer.

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 by his or her beneficiary(s). If the distribution includes life insurance, the net amount at risk (face amount in excess of cash value) is received income tax-free.

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

Note: Distributions prior to age 59 ½, death, disability, or termination before age 55 are subject to an additional 10% tax penalty.

Loans

Defined Contribution plans may allow loans to participants prior to retirement or termination of service. Outstanding loans may not exceed the maximum of $50,000 or 50% of the participant's 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 or 5500-EZ must be filed annually.

"Incidental" death benefits

Life insurance can be included in a Defined Contribution plan if it is "incidental" to the primary purpose of the plan, which is providing retirement benefits. To satisfy the incidental death benefit test, the cost of any participant's death benefit cannot exceed 25% of the total cost of all benefits for that participant.

If ordinary, level premium life insurance is used, this test is met if premiums are less than 50% of the employer's total contribution for that participant. If term, non-level premium whole life, universal or variable life insurance is used, this percentage reduces to 25%.

Profit-sharing plans

Profit-sharing plans – a type of Defined Contribution plan – are designed to help companies share their success with their employees. Profit sharing plans are tax-qualified, and they allow employers to make discretionary contributions to employees based on company profits. (Note: it is not a requirement that these discretionary contributions actually be based on profits.)

Types of plans

Traditional profit-sharing – Traditional plans divide the employer's annual contribution among participants as a uniform percentage of pay. The primary advantage to this plan is flexible contributions. Plan contributions are determined each year by the employer.

Integrated profit-sharing – Integrated plans allow more of the employer's contribution to be directed to those whose earnings exceed the Social Security Taxable Wage Base. The primary advantage of this plan is more of the contribution may be directed to benefit highly paid employees. Frequently this includes the business owner and key employees.

Age weighted profit-sharing – Age Weighted plans allow employers to allocate more of the contribution to older employees who are nearer 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 owners and key employees who are older than the rank and file employees.

Profit Sharing Select – (cross-tested profit-sharing) Profit Sharing Select is a cross-tested plan that gives 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 gateway minimum contribution to rank and file employees. There are two gateway allocations that can be used: 1) 1/3rd of the percentage allocation to the highly compensated employees or 2) 5% of salary.

401(k) profit-sharing – A 401(k) plan allows employees to defer income on a pre-tax basis. It may include an employer match in addition to any employer discretionary contributions.

Defined Contribution Plans *(Cont'd)*

Example:

Profit-sharing plans

Age	Annual salary	Traditional profit-sharing	Integrated profit-sharing	Age weighted profit-sharing	Profit Sharing Select
52[1]	$265,000	$53,000	$53,000	$53,000	$53,000
47[1]	180,000	36,000	33,833	23,941	53,000
40	50,000	10,000	8,424	3,757	2,500
35	40,000	8,000	6,739	1,999	2,000
30	30,000	6,000	5,055	997	1,500
25	20,000	4,000	3,370	600	1,000
Total	**$585,000**	**$117,000**	**$110,421**	**$84,294**	**$113,000**
% to Key EEs:		76%	79%	91%	94%

1 Key, Highly Compensated Employee

Profit Sharing Select: Group 1 – NHCEs – 5%; Group 2 – Owner 1 – 20%; Group 3 – Owner 2 – 29.44%

Depending upon which type of profit sharing plan is selected, employers can choose whom to benefit and how much. As is evident in the above example, employers can elect to allocate more contribution to themselves and their key employees, while keeping costs low.

Who may establish profit-sharing plans?

A profit-sharing plan is usually most appropriate for businesses or professional practices with a history of fluctuating profits, or whose owners do not wish to commit to a fixed annual contribution schedule. Because of their contribution flexibility, profit sharing plans are most popular with owners and key employees who are younger and have enough time to accumulate reasonable retirement benefits. However, age-based profit sharing plans can favor older, more highly paid participants.

Maximum tax-deduction contributions/benefits

Employer contributions, which are optional year-to-year, may not exceed 25% of payroll. The maximum annual contribution per participant is the lesser of 100% of compensation or $53,000 (subject to cost-of-living adjustments).

For continuing profit sharing plans, employer contributions must be recurring and substantial. That is, if there are revenues and profits, the IRS looks for contributions. They do not however, have to be made every year, and they do not have to be the same amount every year.

An allocation formula is used to determine how employer contributions are allocated to the individual plan participants' accounts. Typically, the formula ties each participant's compensation to total covered compensation.

"Incidental" death benefits

As with all Defined Contribution plans, life insurance can be included in a profit sharing plan if it is "incidental" to the primary purpose of the plan, which is providing retirement benefits. However, employers should be cautious when including life insurance in a qualified plan that allows for fluctuating contributions.

Total premiums paid for ordinary life insurance must account for less than 50% of the total contributions and forfeitures allocated to a participant's account at any time. To satisfy the incidental death benefit test, when using ordinary level-premium whole life insurance, the test is met if premiums are no greater than 49.9% of the employer's total contribution for that participant. If term, universal or variable life insurance is used, this percentage reduces to 25%.

In a profit sharing plan, that incidental death benefit test will not apply if the life insurance premiums are paid from funds that have accumulated in the plan for a period of years. This is known as the "seasoned money" and the exceptions are known as the two-year and five-year rules.

The two-year rule: 100% of the money in a participant's account, including forfeitures, that are at least 2 years old, may be used entirely to fund life insurance under the profit sharing plan.

The five-year rule: Active participants of the plan for at least 60 months may direct up to 100% of their account, both old and new money, to purchase life insurance.

What is a 401(k) plan?

A 401(k) Plan is qualified under the same rules as Defined Contribution profit sharing plans. Employers 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.

Under a 401(k) profit sharing plan employees and employers may elect to make contributions. Employees make salary deferrals to the plan and the employer may contribute a matching contribution, a non-elective contribution and/or a profit sharing contribution.

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

Here's how it works

As was discussed with profit sharing plans, the maximum annual contribution to an individual's account, including forfeitures, is 100% of compensation to a maximum of $53,000 (subject to cost-of-living adjustments). In a 401(k) plan, the $53,000 maximum includes salary deferrals, employer matching or non-elective contributions, and any traditional profit sharing contributions. For those people age 50 or older in the current year, an additional $6,000 "catch-up" amount may be deferred, for a total contribution of $59,000.

The employer's annual deduction is limited to 25% of gross covered payroll. This includes employer matching or non-elective contributions and any traditional profit sharing contributions, but does not include employee deferrals.

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. The maximum salary deferral that may be made in the current calendar year is $18,000. Participants who will be age 50 or older in the current calendar year may also make a catch-up deferral of $6,000.

Let's look at some examples of how a 401(k) plan might look in a typical small or closely held business.

Defined Contribution Plan *(Cont'd)*

The first example shows a traditional 401(k) with salary deferrals and an employer match.

Example:
Traditional 401(k) profit-sharing plan
Elective Deferrals: Subject to Non-Discrimination Testing
Employer Match: Dollar-for-Dollar match up to 3%

Employee	Age	Annual salary	%	Deferral amount	Matching contribution	Total
Owner A	57	$265,000	5.25	$19,913	$7,950	$27,863
Owner B	55	180,000	5.25	15,450	5,400	20,850
Employee 1	52	50,000	6.00	3,000	1,500	4,500
Employee 2	47	45,000	5.00	2,250	1,350	3,600
Employee 3	44	40,000	4.00	1,600	1,200	2,800
Employee 4	41	35,000	4.00	1,400	1,050	2,450
Employee 5	37	32000	3.50	1,120	960	2080
Employee 6	32	25,000	3.00	750	750	1,500
Employee 7	30	20,000	3.00	600	600	1,200
Employee 8	28	20,000	2.00	400	400	800
Employee 9	26	18,000	2.00	360	360	720
Employee 10	22	15,000	0.00	0	0	0
Plan Totals		**$745,000**		**$46,843**	**$21,520**	**$68,363**
Key Total		445,000		35,363	13,350	48,713
Key Percent		60%		75%	62%	71%

Actual Deferral Percentage (ADP) test

Traditional 401(k) plans determine the deferral for the Highly Compensated employees by using the Actual Deferral Percentage (ADP) test. The purpose of the ADP test is to limit (or control) the amount of deferrals that could be made on behalf of the Highly Compensated employees. Using traditional 401(k) testing in the first example, the average deferral for the rank and file employees is 3.25% which holds the highly compensated employees to a deferral no greater than 5.25%. If the owners wish to defer more than 5.25%, they may adopt a Safe Harbor 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. Provided one of the two safe harbors are met, this test can be eliminated, essentially simplifying the process and making 401(k) plans more accessible to small businesses.

The ADP test will be considered satisfied if the employer either:

1. Makes a matching contribution of 100% of the employee's elective deferral up to the first 3% of the employee's compensation and 50% of the employee's elective deferrals between 3% and 5% of the employee's compensation (the match goes only to employees who defer); or
2. Makes a 3% of compensation non-elective contribution to each eligible Non-Highly Compensated employee (regardless of whether or not that employee makes an elective deferral contribution).

The match and non-elective contribution are 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.

The following two examples show how the Safe Harbor provisions will permit the business owners to substantially increase their own elective deferrals with little additional outlay for other employees.

Example:

Option 1 – Safe Harbor match

Employee	Age	Annual salary	Deferral amount	Match	Total
Owner A	57	$265,000	$24,000[1]	$10,600	$34,600
Owner B	55	180,000	24,000[1]	7,200	31,200
Employee 1	52	50,000	3,000	2,000	5,000
Employee 2	47	45,000	2,250	1,800	4,050
Employee 3	44	40,000	1,600	1,400	3,000
Employee 4	41	35,000	1,400	1,225	2,625
Employee 5	37	32,000	1,120	1,040	2,160
Employee 6	32	25,000	750	750	1,500
Employee 7	30	20,000	600	600	1,200
Employee 8	28	20,000	400	400	800
Employee 9	26	18,000	360	360	720
Employee 10	22	15,000	0	0	0
Plan Totals		**$745,000**	**$54,480**	**$27,375**	**$86,855**
Key Total		445,000	48,000	17,800	65,800
Key Percent		60%	81%	65%	76%

1 Assumes the owners defer the $5,500 catch-up deferral.

Defined Contribution Plans *(Cont'd)*

Example:

Option 2 – Safe Harbor 3% employer non-elective contribution

Employee	Age	Annual salary	Deferral amount	3% Non-elective	Total
Owner A	57	$265,000	$24,000[1]	$7,950	$31,950
Owner B	55	180,000	24,000[1]	5,400	29,400
Employee 1	52	50,000	3,000	1,500	4,500
Employee 2	47	45,000	2,250	1,350	3,600
Employee 3	44	40,000	1,600	1,200	2,800
Employee 4	41	35,000	1,400	1,050	2,450
Employee 5	37	32,000	1,120	960	2,080
Employee 6	32	25,000	750	750	1,500
Employee 7	30	20,000	600	600	1,200
Employee 8	28	20,000	400	600	1,000
Employee 9	26	18,000	360	540	900
Employee 10	22	15,000	0	450	450
Plan Totals		**$745,000**	**$59,480**	**$22,350**	**$81,830**
Key Total		445,000	48,000	13,350	61,350
Key Percent		60%	81%	60%	75%

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.

Under the Pension Protection Act of 2006, a business that is covered under the Pension Benefit Guaranty Corporation (PBGC) can have a 401(k) plan combined with a profit sharing plan under which the employer can contribute up to 25% of eligible salary. In addition, the business can have a Defined Benefit plan in which the employer can make a maximum contribution. The employer receives a tax deduction for all contributions. If the business is not covered under the PBGC, the employer profit sharing contribution cannot exceed 6% of eligible salary in order for all contributions to be tax-deductible.

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.

1 Assumes the owners defer the $5,500 catch-up deferral.

Example:
Safe Harbor 401(k) with cross-tested profit-sharing allocation

Employee	Age	Annual salary	Deferral amount	3% Non-elective	Profit-sharing contribution	Total
Owner A	57	$265,000	$24,000[1]	$7,950	$27,050	$59,000
Owner B	55	180,000	24,000[1]	5,400	29,600	59,000
Employee 1	52	50,000	3,000	1,500	1,000	5,500
Employee 2	47	45,000	2,250	1,350	900	4,500
Employee 3	44	40,000	1,600	1,200	800	3,600
Employee 4	41	35,000	1,400	1,050	700	3,150
Employee 5	37	32,000	1,120	960	640	2,720
Employee 6	32	25,000	750	750	500	2,000
Employee 7	30	20,000	600	600	400	1,600
Employee 8	28	20,000	400	600	400	1,400
Employee 9	26	18,000	360	540	360	1,260
Employee 10	22	15,000	0	450	300	750
Plan Totals		**$745,000**	**$59,480**	**$22,350**	**$62,650**	**$144,480**
Key Total		445,000	48,000	13,350	56,650	118,000
Key Percent		60%	81%	60%	90%	82%

One-life 401(k) plans

A one-life 401(k) plan 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 $40,000 salary. The maximum contribution the business owner could make in a profit sharing plan is 25% of eligible salary, or $10,000. But let's look at an example of how much could be contributed if he combined a profit sharing plan with a one-life 401(k) plan.

Example:
Profit-sharing plan combined with a one-life 401(k) plan

	Age	Salary	Maximum profit-sharing	401(k)	Total
Owner	57	$40,000	$10,000	$24,000[1]	$34,000

The owner is able to shelter more than two-thirds of his salary!

1 Assumes the owners defer the $6,000 catch-up deferral.

Defined Contribution Plans *(Cont'd)*

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 compared to a Defined Benefit plan.

Defined Benefit Plans

What is a Defined Benefit plan?

Defined Benefit plans are tax-qualified retirement plans under Internal Revenue Code Section 401. As with other types of qualified plans, contributions made by employers are tax-deductible, and participating employees pay no current tax on contributions and earnings until the funds are distributed.

Often referred to as an "employer pay-all pension," a Defined Benefit plan is the only type of pension plan that provides eligible employees with a guaranteed monthly benefit at retirement. The employer's contributions to the plan must be sufficient to pay future benefits, as promised.

The types of Defined Benefit plans are:

- **Traditional Defined Benefit plans (Split-funded)** – which are permanent retirement plans established by employers and funded for the exclusive benefit of employees and their beneficiaries. This plan is best suited for businesses or professional practices with six or fewer employees.
- **Defined Benefit Select plans (Split-funded)** – which are a hybrid of the Traditional Defined Benefit Pension plans. The employer can place employees in "tiered" groupings, with the objective of contributing less to employees while maintaining high contributions for the employer. This plan is best suited for businesses or professional practices with between five and twenty-five employees.
- **DB Advantage Cash Balance plans (Split-funded)** – which are a hybrid pension plan, blending attributes of a traditional Defined Benefit plan with a Defined Contribution plan. The plan defines a contribution (called the Contribution Credit), like a Defined Contribution plan, but contribution maximums fall under Defined Benefit plan rules. This plan is best suited for businesses or professional practices with between five and fifty employees. It is also suited to businesses where owners wish to receive a greater contribution than they could receive in a 401(k) plan.
- **412(e)(3) Defined Benefit plans** – which are a Defined Benefit plan that is funded using life insurance company products that have guarantees. The plan provides guaranteed retirement benefits and may also include an insured death benefit. The maximum contributions and tax deductions will be greater than is permitted in other Defined Benefit plans. As required by the IRS, these plans also provide a survivor death benefit.

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 and employees.

How do Defined Benefit plans work?

Traditional Defined Benefit / DB Select

The employer creates a pension trust and makes tax-deductible annual contributions for all eligible plan participants. The employer selects the investments, which can include life insurance. Once every year, an Enrolled Actuary determines the cost of funding the plan – the amount the employer must contribute. This amount is based on future earnings assumptions, salary increases, and other factors. Certification of the plan's funding by an Enrolled Actuary is required each year.

DB Advantage

The employer creates a pension trust and makes tax-deductible annual contributions for all eligible plan participants. The employer selects the investments, which can include life insurance. Once every year, an Enrolled Actuary determines the cost of funding the plan – the amount the employer must contribute. Each employee has a hypothetical account or "cash balance" to which contributions and interest payments are credited. The plan participants receive annual statements showing the value of their hypothetical account.

Defined Benefit Plans *(Cont'd)*

Benefits of these plans include:

- Individuals may receive the maximum amount available when they reach normal retirement age. This amount is reduced if it is received prior to that date.
- The maximum benefit is 100% of the highest consecutive three years of average compensation, up to the current maximum of $210,000 (indexed annually for cost-of-living).
- No specific limits apply to the deductible employer contribution.

412(e)(3)

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 life insurance and an annuity. Because plan benefits are guaranteed,[1] 412(e)(3) plans are exempt from the funding requirements of the Internal Revenue Code. 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.

412(e)(3) plans tend to generate larger employer deductions than split-funded (traditional) Defined Benefit plans because the assumptions used in determining 412(e)(3) plan costs are those mandated by IRC Section 412(e)(3) to be guaranteed life and annuity rates – assumptions which are much lower than those commonly used in a split-funded (traditional) Defined Benefit plan.

In addition to the benefits available in a split-funded (traditional) Defined Benefit plan, the 412(e)(3) plan includes an additional benefit:

- There are fewer complications. No Enrolled Actuary's certification is needed since the plan is funded entirely with insurance contracts. Quarterly contributions are not required; no full funding limitations are applied to limit contributions; and "accrued benefits" are easy to understand. Rather than being based on pro rata service or participation, each participant's accrued benefit at any point is simply the guaranteed cash value of the underlying life and annuity contracts. As with other types of qualified retirement plans, 412(e)(3) plan contributions are tax deductible to the business and are not currently taxable to the participants.

Suitability

Who may establish a Defined Benefit plan?

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

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: Employers must be able to commit to a permanent 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** – plan contributions follow a fixed schedule, which is intended to fund a specific benefit at a specified retirement date. Employers looking for a flexible contribution schedule are not good candidates for Defined Benefit plans.
- **Large, one time tax deductions** – Employers who do not intend to fund the plan in the future 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.

1 Guarantees are made by the insurance company underwriting the underlying annuity and/or life insurance policies.

412(e)(3) plans also come with suitability issues:

- Length of funding – Funding a 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 due to GATT limitations.
- Investment diversification – IRC Section 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 investment diversification is important, consider a split-funded (traditional) Defined Benefit plan as an alternative.
- What about companies with a fluctuating profit history or the potential for significant profit fluctuations in the future? Fluctuations in profits can make it difficult to pay the fixed annual contributions to the plan as they come due. The inability to make a contribution when it comes due can result in IRS penalties. This must be given serious consideration, with a determination made as to whether a more flexible plan would be appropriate.
- Conversion from a split-funded (traditional) Defined Benefit plan to a 412(e)(3) plan – It is possible to amend and restate a split-funded 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.

Who may participate in a Defined Benefit plan?

All full-time employees who are age 21 and older and have completed one year of service (two years if the plan provides full and immediate vesting) must be eligible to participate. Part-time or seasonal employees, if employed less than 1,000 hours, may be excluded depending on the terms of the plan. Nonresident aliens with no source of U.S. income and employees covered by a collective bargaining agreement may also be excluded.

Other nondiscriminatory classifications of employees may be excluded subject to the plan satisfying coverage and participation requirements.

Maximum tax-deductible contributions/benefits

Employers may contribute and deduct the amount needed to fund the guaranteed monthly benefit amount at normal retirement age. Employer contributions accumulate tax-deferred and are not currently taxable income to the employees (except in an insured plan, where the economic benefit of life insurance may be taxable).

Whether based on a fixed-dollar amount, percentage-of-salary, or length of service/compensation benefit formula approach, the maximum benefit available in a Defined Benefit plan is 100% of the highest consecutive three years of average compensation, up to the current maximum of $210,000 (indexed).

However, to prevent Defined Benefit plans from discriminating in favor of highly compensated employees, only the first $265,000 (indexed) of compensation for each participant can be used in applying these limits for any plan year.

Defined Benefit Plans *(Cont'd)*

Top-Heavy plans

A Defined Benefit plan may be considered "top-heavy" if, at the end of the plan year, more than 60% of the accrued benefits belong to highly compensated or "key" employees. A key employee is any employee who at any time during the plan year is:

- A more than 5% owner of the business;
- A more than 1% owner of the business with compensation in excess of $150,000; or
- An officer of the employer with compensation in excess of $170,000 (indexed for inflation)

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.

Social Security integration

Defined Benefit plans may be integrated with Social Security, so that the employer's contributions to both plans are coordinated into a single retirement program. Since Social Security payroll taxes represent a large expenditure for most employers, this integration can reduce the cost of including lower paid employees in the plan.

What's more, because Social Security benefits generally replace a larger percentage of lower-paid employees' compensation, integration with Social Security can effectively give higher compensated employees total benefits that are about the same percentage of salary as the total benefits received by lower compensated employees.

As a result, these plans may provide larger benefits and contributions to highly compensated employees in a nondiscriminatory way, and in a manner that does not jeopardize the plan's tax qualified status.

Vesting requirements

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.

Full vesting of employer 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. In a Defined Benefit plan any nonvested forfeiture amounts must be used to reduce employer costs.

Plan distributions

Distributions from 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.

- 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 surviving beneficiary.

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 beneficiaries. If the death benefit includes life insurance, the net amount at risk (face amount in excess of cash value) is received income tax-free.
- 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 prior to normal retirement age, death, disability or termination before age 59½ are subject to an additional 10% tax penalty.

Loans

Defined Benefit plans may allow participants to take loans prior to retirement or termination of service. Outstanding loans may not exceed the lesser of $50,000 or 50% of the participant's vested accrued benefit. What's more, loans must be repaid within five years with at least quarterly installments.

Reporting and disclosure

Full ERISA reporting is required with Defined Benefit plans. Form 5500, 5500-C/R or 5500-EZ must be filed annually. An actuarial report (for split-funded [traditional] Defined Benefit plans) and Form PBGC-1 are also required annually.

"Incidental" death benefits

Life insurance can be included in a Defined Benefit plan if it is incidental to the primary purpose of the plan, which is providing retirement benefits.

One method used in Defined Benefit plans is the "100-Times Test." To satisfy the incidental death benefit test, the pre-retirement death benefit must 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 of up to $150,000.

Alternately, the percent-of-cost method may be used. This method has a special calculation to determine how much premium can be used. Briefly, up to two-thirds of the plan cost on an uninsured basis may be used to define the amount of the premium.

The second method, also called the "Two-Thirds Rule," generally produces larger insurance amounts than the 100-Times Test for participants closer to retirement age and the ultimate death benefit payable is greater because both the insurance and present value of the participant's accrued pension benefit are paid at death.

Including life insurance inside of the qualified plan allows the premiums to be paid using pre-tax dollars. This frees up personal dollars. The participant would require greater earnings to pay income taxes as well as the life insurance premium using after-tax dollars outside of the qualified plan. Finally, 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.

Defined Benefit Plans *(Cont'd)*

Combining plans

A Defined Benefit plan may be combined with a 401(k) and/or profit sharing plan. The contribution to the Defined Benefit plan would be deductible. The contribution to the 401(k) and/or profit sharing will be deductible if the rules established under the Pension Protection Act of 2006 are followed. If the business is covered under the Pension Benefit Guaranty Corporation (PBGC), then the employer contribution to the 401(k) and/or profit sharing plan can be as much as 25% of eligible payroll, and will be deductible to the business. However, if the business is not covered under the PBGC, the 401(k) and/or profit sharing contribution should not exceed 6% of eligible payroll. A contribution in excess of 6% of eligible payroll would not be deductible.

Example:

Traditional Defined Benefit / DB Select plans[1]

	Age	Salary Average	Traditional DB with insurance[2]	Life Insurance Death Benefit	Cash at 65	DB Select with insurance[1]	Life Insurance Death Benefit	Cash at 65
Owner A	55	$260,000	$195,966	$3,799,853	$2,374,491	$195,966	$3,799,853	$2,374,491
Owner B	50	260,000	123,158	2,940,246	$2,374,491	123,158	2,940,246	$2,374,491
Hygienist 1	37	60,000	10,599	565,671	679,104	10,599	565,671	679,104
Hygienist 2	33	55,000	6,802	478,266	622,524	6,802	478,266	622,524
Hygienist 3	30	52,000	4,797	431,978	588,467	4,797	431,978	588,467
Office Mgr	49	40,000	18,336	536,493	452,646	5,409	189,823	161,465
Receptionist	57	30,000	26,337	457,796	247,286	6,805	117,532	64,111
Total		**$757,000**	**$385,995**	**$9,210,303**		**$353,536**	**$8,523,369**	
Total to Keys			$319,124			$319,124		
% of Keys			83%			90%		

Example:

DB Advantage cash balance plans[3, 4]

	Age	Cash balance contribution credits	Cash balance w/out insurance contribution	Cash balance with insurance contribution	Life insurance death benefit
Owner	55	$162,816	$158,990	$258,574	$4,079,615
Owner	50	96,365	116,084	159,764	3,064,710
Hygienist 1	37	5,100	5,022	6,843	289,882
Hygienist 2	33	4,675	4,209	5,829	318,843
Hygienist 3	30	4,420	3,615	5,173	348,554
Office Mgr	49	14,160	17,329	23,258	470,219
Receptionist	57	22,200	24,986	41,642	507,895
Total		**$309,736**	**$330,235**	**$501,083**	
Total to Keys			$275,074	$418,338	
% of Keys			84%	84%	

412(e)(3) plan

As illustrated in the following example, 412(e)(3) plan deductions can be significantly higher than any other plan type. If the goal of the business owner is maximum contribution and maximum deduction, the 412(e)(3) plan will generally be the plan that best meets that objective.

Example:

412(e)(3) plan[5]

	Age	Salary Average	412(e)(3) DB with insurance[6]	Life Premium	Life Insurance Death Benefit	Cash @ 65
Owner A	55	$260,000	$266,813	$137,275	$4,806,477	$2,431,648
Owner B	50	260,000	160,941	84,615	3,873,791	2,431,648
Hygienist 1	37	60,000	18,995	10,474	888,629	694,725
Hygienist 2	33	55,000	13,987	7,851	801,700	636,923
Hygienist 3	30	50,000	10,836	6,197	732,703	578,901
Office Mgr	49	40,000	28,196	14,871	714,618	463,077
Receptionist	57	30,000	34,429	16,588	491,043	196,481
Total		**$755,000**	**$534,197**	**$277,871**	**$524,545**	
Total to Keys			$427,754	$211,890	$417,576	
% of Keys			80%		80%	

1 Retirement age: 65 Traditional DB Benefit Formula: 8.1% of compensation for each year of participation less than 25 years. DB Select Benefit Formula: Owners 8.1% and Hygienists 8.1%; Office Manager and Receptionist 2.1% NL LifeBuilder whole life insurance, form series 8311/8311ID(0306), unisex non-smoker rate – max 2/3rd rule and flexible premium annuity, form series 9614/9614ID(0307), issued by National Life Insurance Company, Montpelier, Vermont.

Note: The true cost of a split-funded (traditional) Defined Benefit plan is not so much the annual required contribution, but the amount required to pay out benefits. A common concern of traditional Defined Benefit plans is the cost of rank-and-file employees, especially if those employees terminate employment after becoming eligible for the plan. In reality, if a younger employee terminates after only a few years, he or she is only entitled to a pro rata benefit based on the individual's years of service. The amount required to pay out the reduced benefit at the younger termination age is often only a few hundred dollars, not thousands of dollars, the employer may think.

2 Pre-Retirement: 6% interest, 4% salary scale

3 Contribution Credits: Owner A - 61.44%; Owner B - 36.36%; Hygienists - 8.5%; Office Manager - 35.4%; Receptionist - 74.0% NL LifeBuilder whole life insurance, form series 8310/8311/8310ID(0306)/8311ID(0306), unisex non-smoker rate - max 2/3rd issued by National Life Insurance Company, Montpelier, Vermont plus a fixed annuity.

4 Retirement age 65

5 Benefit Formula: 127.66% of compensation for each year of participation less than 25 years.

NL LifeBuilder whole life insurance, form series 8311/8311ID(0306), unisex non-smoker rate – max 2/3rd rule and flexible premium annuity, form series 9614/9614ID(0307), issued by National Life Insurance Company, Montpelier, Vermont.

The above examples are purely hypothetical and for illustrative purposes only. The examples shown above do not represent the setup of any particular plan and your results likely will differ. Products may not be available in all states. Contributions are actuarially determined and may change based on actual experience.

6 Retirement age: 65

Defined Benefit Plans *(Cont'd)*

Advantages and disadvantages of Defined Benefit plans

Advantages

- **Large maximum deductions**
  Defined Benefit plans are favored by employers, since this is the only qualified retirement plan that permits deductions larger than $49,000 – larger, in fact, than available in any type of Defined Contribution plan.

- **Guaranteed benefits**
  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.

- **Life insurance is available**
  Life insurance can be included in a Defined Benefit plan. Life insurance increases the employer's deduction.

- **Tax-deductible contributions**
  As long as contributions are actuarially reasonable, the employer's cost of funding the plan is tax-deductible.

- **Can favor older participants**
  The plan can favor older participants (such as the owners or principals of the organization), since the annual cost to fund their benefits is higher.

Disadvantages

- **Cost**
  Defined Benefit plans can become costly as participants approach retirement age. However, this can be seen as an advantage for employers whose objective is to create a substantial tax shelter.

- **Liability**
  The employer is 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.

- **Complexity**
  Administration as well as reporting and disclosure are more complicated and costly in split-funded (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 an actuary.

Centralized Mailing Address: One National Life Drive, Montpelier, VT 05604 | 800-732-8939 | www.NationalLifeGroup.com