

## Defined Benefit Plan Basics for Defined Contribution People

by Lorraine Dorsa, MSPA



IN RECENT YEARS, THERE HAS BEEN A RESURGENCE OF INTEREST IN DEFINED BENEFIT PLANS. THIS INTEREST HAS BEEN DUE TO A NUMBER OF FACTORS – CHANGES IN PENSION LAW THAT MAKE DEFINED BENEFIT PLANS MORE ATTRACTIVE, AGING OF THE BABY BOOMER GENERATION, GREATER AWARENESS OF THE IMPACT OF MARKET FLUCTUATIONS ON 401(k) PLANS, AND INCREASED INTEREST IN RETIREMENT INCOME.

Most plan service providers who entered the business in the last 15-20 years focused on defined contribution plans, and in particular, 401(k) plans. Now, they are faced with the challenge of learning about defined benefit plans, knowing when to recommend them to their clients and how to service them.

Defined benefit plans are simply another kind of pension plan subject to many of the same rules that apply to defined contribution plans. Much of what defined contribution practitioners already know also applies

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## WASHINGTON UPDATE

### Cafeteria Plans for Small Business

by Brian H. Graff, Esq.



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ALTHOUGH ASPA'S GOVERNMENT AFFAIRS COMMITTEE FOCUSES PRIMARILY ON RETIREMENT POLICY ISSUES, WE ALSO GET INVOLVED IN CAFETERIA PLAN REGULATORY AND LEGISLATIVE MATTERS BECAUSE A LARGE NUMBER OF OUR MEMBERS WORK ON THESE PLANS. RECENTLY, WE HAVE BEEN WORKING WITH OTHER GROUPS, PRINCIPALLY THE US CHAMBER OF COMMERCE AND THE SMALL BUSINESS COUNCIL OF AMERICA, TO DEVELOP PROPOSALS TO FURTHER ENCOURAGE SMALL BUSINESS CAFETERIA PLANS. THESE PROPOSALS ARE DESIGNED TO ELIMINATE SOME OF THE MAJOR ROADBLOCKS TO SMALL BUSINESS CAFETERIA PLANS, THUS MAKING CAFETERIA PLAN BENEFITS MUCH MORE ACCESSIBLE TO SMALL BUSINESS EMPLOYEES.

As many of you know, the law contains a number of impediments that make cafeteria plans unattractive to small businesses. For example, sole proprietors, partners, LLCs, and Subchapter S shareholders presently cannot participate in cafeteria plans. Naturally, if business owners cannot participate in a plan, they are significantly less likely to adopt a plan for their employees. Current law should not discriminate against business owners merely because of the type of business entity chosen. Further, even if business owners are permitted to participate in a cafeteria plan, there are special cafeteria plan nondiscrimination rules that are extremely difficult for small businesses to satisfy. These rules are particularly true of the 25 percent concentration test, which provides that no more than 25 percent of cafeteria plan benefits provided can be allocated to key employees. Like the

top-heavy rules, this test clearly discriminates against a small business for being small.

A driving force behind cafeteria plan proposals has been a recent push by larger businesses to address the "use it or lose it" problem. They would like to permit cafeteria plan participants to carry over a certain portion of unused amounts in their flexible spending account. In fact, such a proposal was included in last year's Bush Administration budget. If a "use it or lose it" proposal were enacted, it would likely be accompanied by renewed IRS enforcement of cafeteria plans because carryover amounts are involved. Consequently, ASPA's Government Affairs Committee wants to make sure that any cafeteria plan legislation moving through Congress addresses the needs of

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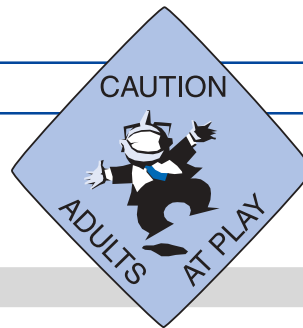
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FROM THE EDITOR

Putting Some FUN into  
Pension FUNding

by Chris L. Stroud, MSPA



MANY OF US IN THIS PROFESSION ARE PASSIONATE ABOUT WHAT WE DO. WE GET INVOLVED POLITICALLY. WE STRIVE TO ACHIEVE PROFESSIONAL DESIGNATIONS AND PROFICIENCY. WE FEEL A DEEP SENSE OF SATISFACTION IN KNOWING THAT OUR WORK HAS SOCIAL VALUE. HOWEVER, WE SOMETIMES GET SO CAUGHT UP IN THE DETAILS THAT WE FORGET TO HAVE A LITTLE FUN.

March 31 and April 15 have passed by – whew! What looms ahead? Stacks of 5500 filings and documents waiting to be restated! At times like these, our jobs can tend to seem tedious, repetitious, and often overwhelming. It is important to remember that while you are doing these less than exciting tasks that help ensure others' retirement, you need to feel like you are doing more than simply treading water until you, too, can retire.

If we can all get our jobs done AND have **fun** at the same time, morale in the workplace improves. Improved morale directly affects customer service. Add a little creativity to the **fun**, and you are likely to develop some techniques to brand your firm and convey a special feeling, underscoring the fact that you offer unique value that is not readily available in the marketplace. You just might show the clients and prospects that they can have **fun** while dealing with you, which will keep them coming back for more! If you could create a special feeling in the workplace and/or in the marketplace, what would you want that feeling to be?

As a teenager, I sold shoes in my father's shoe store. It was a family shoe store, but we focused on children's shoes. I learned many things from my father, but two of the most important things he taught me were that work could be **fun** and that customer service was one of the most important aspects of work. (Years ago, I was discussing my early shoe-selling years with a former boss, and he told me that my experience selling shoes with my father was probably as valuable as my college education and my professional designations. At the time, the comment seemed strange, but

as time passed, I came to realize how much my father's philosophy had helped to shape the way I go about my work.) The shoe store has been closed for many years, but when I go back to my hometown, I occasionally run into people that remember the special things about the shoe store. The life-size cardboard Roy Rogers standing in the corner. The treasure chest of toys that children got to select from on their way out – compliments of *PF Flyers*, *Keds*, and *Poll Parrot* shoes. (Okay – how many of you remember those decoder rings, telescopes, and parrot whistles?) And for those who fell prey to our favorite trick (bringing out a pair of men's size 15 sneakers and trying them on some young child's feet), they chuckle as they recall the experience. It was my father's way of branding. He took a typically boring job (selling shoes) and a mundane task for a customer (buying shoes) and made the experience **fun** for everyone.

So, what does all this have to do with our profession? Think about how you can add some **fun** to your workplace. As I recently wandered through an airport bookstore, I selected a best seller called *Fish*, by Stephen C. Lundin, PhD, Harry Paul, and John Christensen. It was a quick read – slightly over 100 pages. The four secrets and suggested strategies that the book promotes are very simple and they can easily be applied to our working environment as well as to selling shoes or selling fish. Do you want to try to put some **FUN** into Pension **FUN**ding? Read the book. (No, I don't have a commission agreement – it was just **fun** to read!) And like the cover of the book says – "Work Made **Fun** Gets Done!" ▲

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The purpose of ASPA is to educate pension actuaries, consultants, administrators, and other benefits professionals, and to preserve and enhance the private pension system as part of the development of a cohesive and coherent national retirement income policy.

ASPA members are retirement plan professionals in a highly diversified, technical, and regulated industry. ASPA is made up of individuals who have chosen to be among the most dedicated practicing in the profession, and who view retirement plan work as a career.

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# Letters to the Editor

## WHAT'S IN A NAME? – PART 2

*In response to the Letter to the Editor titled What's In a Name? from Eric Kranke, printed in the Mar/Apr 2002 issue.*

I think a discussion of our name is long overdue. The stated purpose of ASPA is 1) to educate pension actuaries, consultants, administrators, and other benefits professionals, and 2) to preserve and enhance the private pension system.

Whether we like to acknowledge it or not, the retirement system in our country has changed since 1975 when I first started administering plans. No matter what set of statistics one reviews, it is clear that the defined contribution plan has become the plan of choice for most employers adopting new plans. More specifically, the 401(k) plan is the plan of choice for many smaller employers. Participants, the competitive global business environment, the popular press, and politics are the driving forces behind this. ASPA has changed as this trend has matured, creating the CPC designation twenty or so years ago, then the QPA designation, and most recently, the QKA designation. Today, of over 4,300 ASPA designations, over 3,500 are CPC, QPA, or QKA. This is where we are in 2002.

ASPA is definitely succeeding at the first goal of education as over 8,000 professionals took our entry level exams (PA-1 and Daily Valuation) in 2001. Many of these will move up in future years to credentialed membership in the organization as QKAs, QPAs, or CPCs. ASPA is also succeeding in the second goal through the efforts of the Government Affairs Committee as evidenced by our increased involvement in the legislative process. Our input to members of Congress is instrumental in achieving and molding a private pension system that works for all of us. This is increasingly important as the social security debate continues.

Many professional organizations have changed their name over the recent past to more accurately reflect their goals, objectives, membership, etc. ASPA has evolved into a diverse organization with many professionals who serve their clients using a variety of special skills and knowledge. Why not present a name to the public that more accurately reflects this?

Michael B. Kimball, CPC

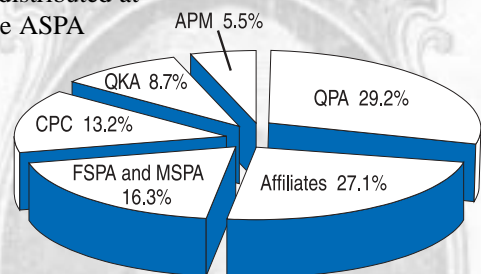
**Editor's Note:** As of July 1, 2002, there are now over 4,600 ASPA designations. Of the 4,600 designations, over 3,600 are CPC, QPA, or QKA.

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*The ASPA Journal* is mailed to all ASPA members and distributed at industry-wide conferences and regional meetings of the ASPA Benefits Councils (ABCs).

ASPA's membership, nearly 5,000 strong, is comprised of actuaries, retirement plan professionals who have earned ASPA's credentials, associated professional members such as attorneys, CPAs, CLUs, ChFCs, and affiliate members. The chart represents ASPA's membership composition.



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# Single-Participant 401(k) Plan Sales Strategies for Third Party Administrators

by Ben Norquist, CPC, and Lauren Durchsprung



A LOT HAS BEEN WRITTEN LATELY SURROUNDING THE BENEFITS OF THE RECENT TAX LAW CHANGES FOR INDIVIDUAL INVESTORS, IN PARTICULAR THE CREATION OF ONE-PERSON 401(k) RETIREMENT PLANS, AND THE BENEFITS TO SELF-EMPLOYED INDIVIDUALS LOOKING FOR A SIMPLE SOLUTION TO THEIR RETIREMENT NEEDS. HOWEVER, LITTLE HAS BEEN DISCUSSED ABOUT THE INTERMEDIARIES, THE CERTIFIED PUBLIC ACCOUNTANTS (CPAs), REGISTERED INVESTMENT ADVISORS (RIAs), AND THIRD PARTY ADMINISTRATORS (TPAs) WHO PROVIDE RETIREMENT PLAN SERVICES. DO THEIR CLIENTS HAVE A NEED AND WILL THEY BENEFIT FROM THE INTRODUCTION OF THIS NEW TYPE OF RETIREMENT PLAN PRODUCT? IF SO, WHAT OPTIONS ARE AVAILABLE FOR TPAs AND OTHER RETIREMENT PROFESSIONALS WHO WANT TO GET INVOLVED IN THIS NEW MARKET? THIS ARTICLE PROVIDES INSIGHT INTO THE BENEFITS OF THIS NEW RETIREMENT PRODUCT AND OFFERS TIPS ON HOW RETIREMENT INDUSTRY PROFESSIONALS CAN GET INVOLVED IN THIS RAPIDLY EVOLVING MARKET.

## WHAT IS A SINGLE-PARTICIPANT 401(k) PLAN?

The single-participant 401(k) is the new one-person plan alternative that became available as of January 2002, thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In a nutshell, the single-participant 401(k) is an extremely cost-effective 401(k)-based retirement plan product designed exclusively for small business owners. In particular, the single-participant 401(k) plan is designed for small businesses with no common-law employees or those whose common-law employees may be excluded from the plan (*e.g.*, part time employees working less than 1,000 hours per year).

## WHAT PROMPTED THE CREATION OF SINGLE-PARTICIPANT 401(k) PLANS?

Prior to the passage of EGTRRA, there was no compelling reason for an owner-only business to establish a 401(k)-based plan because the business owner could realize virtually all the same benefits by adopting a profit sharing or Simplified Employee Pension (SEP) plan. What's more, the pricing models used by most full-service 401(k) providers precluded the 401(k) from being considered a cost-effective alternative for the owner-only business.

All of this changed, however, with the passage of EGTRRA in 2001. EGTRRA exempted salary deferral contributions from the 25% deductible contribution limit under IRC Sec. 404 (formerly 15%) and increased the annual additions limit for defined contribution plans from 25% to 100% of compensation. As a direct result of these changes, there arose a compelling case for owner-only businesses to begin taking advantage of the provisions of IRC Sec. 401(k).

## HOW WILL SMALL BUSINESS OWNERS BENEFIT FROM A SINGLE-PARTICIPANT 401(k) PLAN?

The hallmark benefits of a single-participant 401(k) plan include: higher contribution limits, access to tax-free loans, complete funding flexibility, flexible dis-

tribution options, and cost effective administration – all of which we will discuss in detail below.

**Higher Contribution Limits** – Because 401(k) salary deferral contributions are now exempt from the 25% deductible contribution limit under IRC Sec. 404, single-participant 401(k) plans allow small business owners to contribute a full salary deferral contribution of \$11,000 (\$12,000 if age 50 or older) plus 25% of compensation in the form of a profit sharing contribution, for a maximum of up to 100% of compensation or \$40,000 (\$41,000 for those age 50 or older). For self-employed individuals with net profits of \$250,000 or less, this can mean substantially larger contributions when compared to conventional small business retirement plans, as the chart on page 16 demonstrates.

Continued on page 16

## INSTRUCTOR:

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ASPA's Conferences Committee is looking for volunteers that know how to give effective technical presentations using Microsoft® PowerPoint® and can help our members upgrade their skills in this area. If volunteer instructors can be located, we intend to give classes during our east and west coast annual conferences simultaneous with our other educational sessions. The end goal is to improve the overall attendee satisfaction by increasing the skill level within our cadre of speakers and potential speakers. Please submit a note of interest to [tbrost@aspa.org](mailto:tbrost@aspa.org)



## Washington Update

small businesses and does not leave small business workers behind.

Following is a brief summary of the proposals being considered:

### **ALLOW SMALL BUSINESS OWNERS TO PARTICIPATE**

Sole proprietors, partners, LLCs, and Subchapter S shareholders would no longer be prevented from participating in a cafeteria plan.

### **CREATION OF "SIMPLE" SAFE HARBOR CAFETERIA PLAN FOR SMALL BUSINESS**

Similar to SIMPLE retirement plans, small businesses with no more than 100 employees could establish a "Simple Cafeteria Plan" for employees. Simple Cafeteria Plans would be exempt from all the relevant nondiscrimination rules, including the 25 percent concentration test. Sponsoring employers would be required to make a contribution to the plan on behalf of each participating employee equal to 2 percent of such employee's compensation. This could be in the form of a contribution to the employee's flexible spending account or dependent care assistance account, or it could be satisfied by direct employer payment of the employee's health insurance premium, or other cafeteria plan benefits. All full time employees with one year of service would have to be eligible to participate in the cafeteria plan. Simple Cafeteria Plans would have simplified reporting rules.

### **ALLOW CARRYOVER OF FLEXIBLE SPENDING ACCOUNT**

The "use it or lose it" rule is a source of tremendous frustration for many employees. They simply do not understand why they lose amounts in the account, particularly since it was their money to begin with. Sponsors of cafeteria plans are also frustrated because they are typically the ones who are blamed for the rule. The problems associated with the "use it or lose it" rule have been recognized for some time. Several bills have been introduced permitting carryover of unused amounts. Typically, there is a cap on the amount that can be carried forward. ASPA supports these proposals, but also believes that employees should be given the option of rolling over unused flexible spending account (FSA) amounts into a 401(k) plan.

### **TREAT FSAs LIKE REIMBURSEMENT ACCOUNTS, NOT INSURANCE**

IRS regulations treat flexible spending accounts like insurance policies. In other words, benefits have to be paid to an employee during the year even if the amount in the account is insufficient to cover the claim. This is very unpalatable to many small businesses that are sometimes forced to reimburse claims out of their own funds until future contributions are made to the

account by the employee or to pay claims that are never recovered due to an employee's separation from service. Under the proposal, employers would have the option of holding the reimbursement of a claim until there are amounts sufficient in the account to cover the claim. Further, no reimbursement would be necessary beyond the amount in an employee's account if that employee terminated employment.

### **PERMIT LONG-TERM CARE AS A CAFETERIA PLAN BENEFIT**

A quality long-term care insurance policy is becoming increasingly important as Americans live longer. Under the proposal, employees could pay long-term care insurance premiums on a pre-tax basis through a cafeteria plan.

### **INCREASE LIMIT ON DEPENDENT CARE ASSISTANCE**

The current annual limit on dependent care assistance through a cafeteria plan is \$5,000. This dollar limit has been in place for the last 20 years and it is absurd to think that any employee can obtain qualified day care today for \$100 per week, particularly in major metropolitan areas. The limit needs to be increased (to perhaps \$7,500) and then indexed to keep pace with inflation. Further, the limit should be greater when more than one dependent is involved (perhaps \$10,000) to cover additional costs.

### **PERMIT EMPLOYEES TO CHANGE CAFETERIA PLAN ELECTIONS DURING THE YEAR**

Cafeteria plan elections must be made before the beginning of the plan year. Under current IRS regulations, employees are only allowed to change their cafeteria plan benefit elections if there is a major change in their life (*e.g.*, the death of a spouse). Again, this allowance is based on theoretical concepts of insurance as opposed to practical reality. There really is no valid policy reason for not allowing an employee to change elections as frequently as the employer is willing. Employees should have the freedom to change elections to meet the changing needs of their families.

Senior Senate and House members have already expressed interest in taking the lead on this legislation. However, it is unlikely that anything on this issue will happen this year. Like pension reform, legislation for cafeteria plans will likely take some time to develop, although it should not take as long as pension reform did. Throughout the process, ASPA's Government Affairs Committee will be actively involved. ▲

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*Brian H. Graff, Esq., is Executive Director of ASPA. Before joining ASPA, Brian was legislation counsel to the US Congress Joint Committee on Taxation.*

## FOCUS ON E&E

### C-2(DB) Exam Tests New Grade Delivery Method in Fall 2002!

ASPA's Education and Examination Committee (E&E) is piloting a new delivery system at Prometric that allows grades and grade reports to be given upon completion of exams. The benefit to ASPA exam candidates is that candidates will immediately receive their actual grade (not just a pass or fail) and also a grade report, listing the chapters and areas in which the candidate needs to improve.

For fall 2002, C-1 and C-2(DC) candidates will receive a pass or fail upon completion of their exams at a Prometric site and will receive their grade and grade report within 12 weeks of the close of the fall 2002 exam window, which is November 30, 2002. If the pilot program goes well, it is anticipated that the C-1 and C-2(DC) exams will also use the new delivery system in spring 2003.

It's not too early to register for the fall 2002 exams! The early registration deadline is September 30 and the final registration deadline is October 31. The fall 2002 exam window is November 1 through November 30.

E&E is committed to providing candidates with the benefits of technology on an ongoing basis. ASPA has worked with Prometric to improve exam services and to address candidates' suggestions and concerns. E&E welcomes comments from employers and candidates, which can be submitted to [educaspa@aspa.org](mailto:educaspa@aspa.org). ▲

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# Breaking The Code

by Coni King, CPC, QPA

QUALIFIED RETIREMENT PLAN PRACTITIONERS TEND TO TALK IN A SECRET LANGUAGE. IT MAY SOUND LIKE SECRET "CODE," BUT IT IS ACTUALLY THE INTERNAL REVENUE CODE. THE NUMBERS REFER TO SPECIFIC SECTIONS OF THE INTERNAL REVENUE CODE AND THE LETTERS ARE SUBSECTIONS OF THOSE SECTIONS. GENERALLY, WHEN PEOPLE SPEAK OF A "CASH OR DEFERRED" PLAN, THEY CALL IT A "401(k)" PLAN. SIMILARLY, IF TOO MUCH MONEY IS CONTRIBUTED FOR AN INDIVIDUAL IN A DEFINED CONTRIBUTION PLAN, IT IS CALLED A "415" VIOLATION, AND IF A DEFINED BENEFIT PLAN IS NOT PROPERLY FUNDED, IT IS CONSIDERED TO HAVE A "412" VIOLATION. IT IS ESSENTIAL THAT A PRACTITIONER BE FAMILIAR WITH THIS LINGO. THE FOLLOWING TABLE IS INTENDED TO SERVE AS A GUIDE TO THE MAJOR PROVISIONS OF THE INTERNAL REVENUE CODE THAT IMPACT QUALIFIED RETIREMENT PLANS. (NOTE: THE INTERNAL REVENUE CODE IS SOMETIMES REFERRED TO AS "THE CODE.")

Code Section	Subject	Rule
72	Annuities, Certain Proceeds of Endowment and Life Insurance Contracts	Primary focus is taxation of annuities, defaulted loans, and premature distributions
72 (p)	Plan Loans	Rules and limitations on loans from a qualified plan
72 (t)	10% Excise Tax on Premature Distributions	10% excise tax is due on amounts distributed prior to age 59 1/2
133	Interest on Certain Loans Used to Acquire Employer Securities	
318	Constructive Ownership of Stock	Attribution rules
401	Qualification Rules	General qualification requirements that apply to all qualified plans. Violation of any of the rules under Code Section 401(a) can result in plan disqualification.
401 (a)(4)	Nondiscrimination Requirements	Nonelective employer contributions must be nondiscriminatory in amount. Nondiscrimination is proven by either a safe harbor plan design or use of rate group testing using the general test.
(a)(5)	Special Rules	Special rules with respect to application of the nondiscrimination tests
(a)(6)	Timing of Testing	Plan will be deemed to be nondiscriminatory for the year if the plan passes testing quarterly
(a)(7)	Vesting	Makes minimum vesting a qualification requirement
(a)(8)	Defined Benefit Forfeitures	Must be applied to reduce future plan costs
(a)(9)	Minimum Distribution Requirements	Minimum distributions must commence by the April 1 following attainment of age 70 1/2 for 5% owners
(a)(11)	QJSA and QPSA	With limited exception, benefits payable to married participants must be in the form of an annuity continuing for the joint lives of the participant and the participant's spouse unless the spouse waives such right With respect to death benefits, the spouse is required to be the beneficiary of any death benefit unless he or she waives such right.
(a)(12)	Mergers and Acquisitions	Special rules with respect to mergers and consolidations
(a)(13)	Assignment or Alienation	Benefits can not be assigned or alienated except in the case of tax lien or QDRO
(a)(14)	Payment of Benefits	Sets forth the deadline for commencement of benefit distributions
(a)(15)	Trust	
(a)(16)	Coordination with Code Section 415	Makes annual addition and benefit limitations a qualification issue
(a)(17)	Compensation Limit	Compensation used to determine benefits or contributions in a plan may not exceed \$200,000.
(a)(19)	Withdrawal of Voluntary Contributions	Participants can withdrawal voluntary contributions without losing accrued benefit





<b>Code Section</b>	<b>Subject</b>	<b>Rule</b>
401 (a)(22)	Thinly Traded Stock	Special rules for the valuation of thinly traded stock in a defined contribution plan
(a)(25)	Actuarial Assumptions	Defined benefits must state the actuarial assumptions used in determining actuarial equivalence.
(a)(26)	Minimum Participation	A defined benefit plan must benefit the lesser of 50 employees or 40% of employees (but not less than 2).
(a)(27)	Defined Contribution Plans	Do not need to be contingent on employer profits and plan must designate under which type of defined contribution plan it intends to qualify ( <i>i.e.</i> , profit sharing plan or money purchase plan)
(a)(28)	ESOPs	Additional guidance regarding valuation of employer stock
(a)(29)	Security Required Upon Amendment Resulting in Underfunding	Special guidance with respect to bonding for defined benefit plans amended to increase current liabilities
(a)(30)	Salary Deferrals	Ties the 402(g) limitation on elective deferrals to the qualification requirements
(a)(31)	Direct Transfers	All eligible rollover contributions must be able to be directly transferred to another eligible retirement plan.
(a)(32)	Liquidity Shortfall	Rules with respect to ceasing benefit payments if the plan experiences a liquidity shortfall
(a)(33)	Prohibition on Benefit Increases in Times of Bankruptcy	Rules with respect to amending plans to increase benefits if the employer is bankrupt
(a)(34)	Benefits of Missing Participants on Plan Termination	PBGC program for lost participants
(b)	Remedial Amendment Period	Rules with respect to timing of the plan amendments
(c)	Definitions for the Self-Employed	Rules with respect to earned income and other matters concerning the self-employed
(d)	Rules for the Self-Employed	Contributions limitations for the self-employed
(f)	Custodial Accounts	Rules with respect to the use of custodial accounts instead of trusts
(g)	Annuities	Definition
(h)	Medical Benefits	Retiree medical benefits
(i)	Union Negotiated Benefits	Rules with respect to collectively bargained trusts
(k)	Salary Deferral Arrangements	Employees may elect to defer a portion of their salary into a retirement plan.
(k)(1)	General Rule	Types of plans that can include a cash or deferred arrangement
(k)(2)	Qualified Cash or Deferred Arrangement	Distribution restrictions
(k)(3)	Application of Discrimination Standards	ADP tests, including all special rules
(k)(4)	Other Requirements	Special rules including rules with respect to the coordination of match and deferrals
(k)(5)	Highly Compensated Employee	Cross reference to 414(q) definition
(k)(6)	Pre-ERISA Money Purchase Plan	Rules with respect to certain money purchase plans that can maintain 401(k) plans
(k)(7)	Rural Cooperative Plans	Special rules with respect to 401(k) plans maintained by rural cooperatives
(k)(8)	Arrangement not Disqualified if Excess Distributions are Distributed	Rules with respect to corrective distributions
(k)(9)	Compensation	Definition of compensation used for ADP testing
(k)(10)	Distributions upon Termination of Plan	Special rules with respect to the distribution of 401(k) assets upon termination or sale of a subsidiary; a.k.a. the "same desk" rule
(k)(11)	SIMPLE 401(k)	Rules with respect to SIMPLE 401(k) plans

Continued on page 19

## Defined Benefit Plan Basics for Defined Contribution People

to defined benefit plans. For example, the following concepts/rules are similar for both types of plans:

- Entry dates
- Statutory eligibility
- Coverage [IRC 410(b)]
- Qualified joint & survivor rules
- Hour of service
- Top-heavy vesting
- Contribution due date
- Non-discrimination [IRC 401(a)(4)]
- Fiduciary responsibility
- Highly compensated employee
- Key employee
- Fiscal year
- Vesting
- Year of service
- Normal retirement age
- 5500 filing requirements
- 401(a)(17) compensation
- Plan year
- Break in service rules
- Trustee
- Affiliated service group rules
- Forfeitures
- Family attribution [IRC 318]

This article uses defined contribution plan terminology to explain defined benefit plan concepts and procedures. It offers defined contribution people a way to start learning about, and working with, defined benefit plans.

### WHAT IS A DEFINED BENEFIT PLAN?

A defined benefit plan is a pension plan in which the *benefit* to be provided at retirement is defined in the plan. Contributions are not defined in the plan, but are actuarially computed as the amount necessary to provide the benefit. Benefits are usually defined in terms of the participant's compensation and service or participation, and they are generally expressed in terms of a *monthly benefit* commencing at the *participant's normal retirement date*.

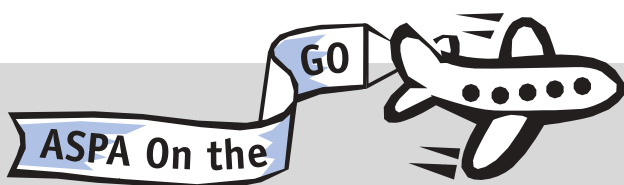
The benefit defined by the plan is the plan's *normal form of benefit*. In most cases, it is a monthly annuity payable for the life of the participant, commencing at the participant's normal retirement age. In many cases, the actual payment of the benefit is in a form other than the plan's normal form. These other forms of benefit are called *alternate forms* and are generally *actuarially equivalent* (of an equal value, using the *actuarial equivalent* factors defined in the plan) to the normal form of benefit.

### WHEN IS A DEFINED BENEFIT PLAN APPROPRIATE?

An employer may decide to establish a defined benefit plan rather than a defined contribution plan if the goal is to provide a stated level of benefit at retirement. A defined benefit plan allows the employer to select the desired level of benefits and to provide those benefits to all employees. A defined contribution plan only allows the employer to determine the level of contributions, which will ordinarily provide different levels of retirement benefits to different employees due to the employees' ages, return on plan assets, and other factors.

Defined contribution plans tend to favor employees who are younger at plan commencement and therefore can expect to receive contributions and investment earnings for many years. Older participants who have fewer years of contributions and investment growth are often better served by a defined benefit plan. Age-weighted and target benefit allocation methods adjust somewhat for this difference.

Some employers choose to sponsor both a defined benefit plan and a defined contribution plan. This combination allows the employer to take advantage of the features of both types of plans, although generally at



On June 20, 2002, ASPA President-Elect Scott Miller, FSPA, CPC, testified on ASPA's behalf before Congress during the House Committee on Ways & Means, Oversight Subcommittee, hearing entitled "Retirement Security and Defined Benefit Pension Plans." Scott testified that the current plight of the Enron 401(k) plan participants highlights the need to expand and reform the private pension system. He stated that the need for reform is especially acute with respect to encouraging plan sponsors to adopt and provide defined benefit pension plans. Since the passage of ERISA, many restrictive and complex laws have been enacted and complicated regulations have been issued, which have seriously impeded the ability of large and small businesses alike to maintain defined benefit pension plans for their employees.

ASPA President Craig Hoffman, APM, was recently inducted as a Fellow to the American College of Employee Benefits Counsel. The American College of Employee Benefits Counsel is a nationwide professional organization formed to recognize benefits practitioners who have demonstrated a commitment to creating greater public awareness of employee benefits law and have provided exceptional professional services to the public, the bar, and clients.

### Illustration 1 – Defined Benefit Plan for Sample Closely Held Small Company

Benefit Formula = 8.00% of compensation, multiplied by years of participation (maximum 13)  
NRA = 62 (safe harbor formula; non-discrimination testing not required)

	Current Age	Compensation	Monthly Benefit At NRA	Contribution*
Owner	52	\$ 200,000	\$ 13,333	\$ 130,287
EE1	47	120,000	8,000	44,269
EE2	40	40,000	2,667	7,916
EE3	35	30,000	2,000	4,044
EE4	30	20,000	1,333	1,889
EE5	25	20,000	1,333	1,349
		<u>\$ 430,000</u>		<u>\$ 189,754</u>

\* Contributions are not allocated to each participant, but represent the annual cost of providing the monthly retirement benefit. Contributions have been computed using 6% interest and 1983 GAM mortality.

some additional cost and complexity. (A discussion of the plan design, non-discrimination testing, and deductibility issues that may arise when an employer sponsors more than one plan is beyond the scope of this article.)

Illustration 1 shows the benefits and contributions for a defined benefit plan of a sample closely held small company.

Employers often adopt defined benefit plans so they can provide full retirement benefits to employees who are older at plan commencement. Since defined benefit plans provide specified benefits, rather than just whatever benefit can be provided by the participant's account balance at retirement, defined benefit plans are well suited to situations in which the employer establishes the plan late in an employee's career and wants to provide a significant retirement benefit.

In general, the favored employee must be over age 40 in order for the defined benefit plan to provide a larger benefit/equivalent contribution than that which can be provided in a defined contribution plan.

#### CONTRIBUTIONS AND INVESTMENT ACCOUNT

Since the amount of benefit is defined, the employer's contribution is a variable. The amount of the contribution depends on the level of benefits, the ages and compensations of the participants, and expectations regarding investment earnings, salary increases, turnover, and other factors. This situation is unlike a defined contribution plan where the contribution or allocation is fixed and the benefit the participant will receive at retirement is the variable. Accordingly, assets in a defined benefit plan are not individually directed, but are pooled. Contributions are paid into the pool and benefits are paid from the pool.

Due to the different rules applied by IRC 412 (which defines the minimum required contributions) and IRC 404 (which defines the maximum deductible contri-

butions), it is possible that the recommended contribution to the plan is not a single amount, but rather a range. For example, the minimum required contribution may be \$100,000 and the maximum deductible contribution may be \$120,000. The employer may contribute any amount between \$100,000 and \$120,000 for the plan year. (See below for more details.)

#### FUNDING AND FUNDING METHODS

The process of making contributions to a defined benefit plan is called *funding* the plan.

Contributions are determined for the plan as a whole, not as individual amounts for each participant.

Some employers, especially those who are familiar with defined contribution plans and accustomed to seeing a profit sharing or money purchase contribution for each individual, may ask for individual participant contributions in a defined benefit plan. To satisfy these employers, some actuaries and service providers prorate or otherwise allocate the plan contribution into amounts "attributable" to each individual's participation in the plan in a given year. If this is done, it is important to explain to the employer that these amounts are not credited to these individuals and should not be used to estimate or project amounts that will be payable upon termination of employment.

Each year, the plan's *enrolled actuary* determines the amount of contributions required to fund the plan and certifies to the appropriateness of this amount on Schedule B of Form 5500. The actuary applies a specific set of actuarial calculations, called a *funding method*, to compute the contribution. The actuary selects the funding method most appropriate to the plan and uses this method to determine the contributions. The actuary is also responsible for selecting the *actuarial assumptions*. As a whole, these calculations and their results are called the *actuarial valuation*.

## ACTUARIAL ASSUMPTIONS

The data used in the calculations include participant census information (age, salary, service, etc.), value of plan assets, benefit formula, and the *actuarial assumptions* selected by the plan's actuary. *Actuarial assumptions* are the projections and estimates made by the actuary regarding future experience of the plan. The *actuarial assumptions* considered in *funding* the plan generally include assumptions regarding rates of return on plan assets, expected salary increases, mortality, and turnover (due to termination, retirement or disability).

The interest assumption is confusing to many non-actuaries who sometimes assume that it is in some way a limitation on the rate of return the assets can realize. It is only an assumption – not a limitation or an expression of the exact rate of return the actuary expects the assets to achieve in any one year. Rather, it is the actuary's best estimate of the expected rate of return on assets over the future lifetime of the plan, which is often somewhat conservative.

## MINIMUM FUNDING STANDARDS

Like all pension plans, a defined benefit plan is subject to the minimum funding requirements of IRC 412. The minimum funding requirements are often called the *minimum funding standards*. The enrolled actuary applies the plan's actuarial *funding method* and the minimum funding rules of IRC 412 to determine the minimum contribution that must be made to the plan to meet the minimum funding standards. This amount, along with other actuarial information, is reported on the Schedule B. In signing the Form 5500 Schedule B, the actuary certifies that this amount is the minimum funding requirement for the plan. To show that the appropriate contribution that meets the minimum funding standards has been made, the actuary reconciles a balancing account called the *funding standard account* on Schedule B each year.

IRC 412 contains a requirement that contributions to certain defined benefit plans be made on a quarterly basis. Such quarterly contributions are due on the 15th day of the month following each plan quarter. For a calendar year plan, quarterly contributions are due on April 15, July 15, October 15 of the plan year, and January 15 of the following plan year. The minimum quarterly contribution is 25% of the lesser of 100% of the prior year's minimum funding requirement or 90% of the current year's minimum funding requirement.

Plans in which the plan's *funded current liability percentage* equals or exceeds 100% are exempt from the quarterly contribution requirement. Generally, the plan's *funded current liability percentage* is the value of the plan assets divided by the present value of accrued benefits. (The present value is computed using prescribed interest and mortality factors.)

The failure to make required quarterly contributions on a timely basis, in addition to a requirement that the plan participants be notified of such failure, requires an additional interest charge to the *funding standard account*, thus increasing the required contribution under IRC 412.

This additional interest charge, commonly called the *quarterly contribution penalty*, is interest on the amount of the underpayment from the date the quarterly contribution was due through the date the contribution is made (but not beyond 8½ months after the end of the plan year). The interest rate used in this computation is the greater of 175% of the federal mid-term rate or the interest rate otherwise used to determine contributions.

## MAXIMUM DEDUCTIBLE CONTRIBUTION

Under the rules of IRC 404, the maximum amount that may be contributed to a pension or profit sharing plan each year and deducted by the employer is limited. The actuary applies the plan's actuarial *funding method* and the deduction rules of IRC 404 to determine the maximum contribution that may be contributed to the plan and deducted by the employer. The maximum deductible amount is not reported on the Schedule B, but is generally included in the *actuarial valuation report* provided to the employer.

## 415 LIMITS

The 415 limit for a participant in a defined benefit plan is defined in terms of the maximum benefit that can be provided at retirement, not in terms of a maximum contribution. Since the concept of individual contributions does not exist under a defined benefit plan, contributions for each participant are not limited to the lesser of 100% of pay or \$40,000 as they are in a defined contribution plan.

EGTRRA made significant changes to the 415 limits, dramatically increasing the maximum allowable benefits in defined benefit plans. These limits are effective for plan years ending in 2002 and subsequent years. Under EGTRRA, the maximum benefit that can be provided in a defined benefit plan is a benefit equal to the lesser of 100% of the participant's highest 3 year average compensation or \$160,000. The percentage of pay limit is reduced for participants with less than 10 years of service at retirement. The dollar limit is reduced for participants retiring prior to age 62 or with less than 10 years of participation at retirement.

Illustration 2 shows the maximum benefits under EGTRRA and the annual contributions needed to fund such benefits and compares them with the maximums available under prior law.

## TOP-HEAVY MINIMUMS

In a defined benefit plan, top-heavy minimums are determined in terms of benefits, not contributions. If a plan is top-heavy, each non-key participant must earn



### Illustration 2 – Maximum Benefits/Equivalent Contributions

	Participant Age at Plan Effective Date	Compensation Required For Maximum Benefit	Normal Retirement Age	Monthly Retirement Benefit	Annual Contribution
Pre-EGTRRA	45	\$ 105,000	62	\$ 8,750	\$ 48,500
EGTRRA	45	\$ 160,000	62	\$ 13,333	\$ 60,871
Pre-EGTRRA	50	\$ 105,000	62	\$ 8,750	\$ 85,500
EGTRRA	50	\$ 160,000	62	\$ 13,333	\$ 101,800
Pre-EGTRRA	55	\$ 130,669	65	\$ 10,889	\$ 98,300
EGTRRA	55	\$ 160,000	65	\$ 13,333	\$ 120,300
Pre-EGTRRA	60	\$ 65,334	65	\$ 5,444	\$ 115,000
EGTRRA	60	\$ 80,000	65	\$ 6,667	\$ 140,800

Compensation required is highest 3 year average compensation.

Contribution has been computed using 6% interest and the 1983 GAM mortality table.

or accrue a benefit of 2% of compensation for each year of participation during which the plan is top-heavy, up to 10 years. All non-key participants who complete 1,000 hours of service must accrue a top-heavy minimum benefit. This differs from defined contribution plans in which all participants employed on the last day of the plan year receive the top-heavy minimum contribution.

A defined benefit plan is top-heavy if more than 60% of the present value of the accrued benefits is attributable to key employees. The minimum vesting requirements for top-heavy defined benefit plans are the same as for top-heavy defined contribution plans.

#### BENEFIT FORMULAS AND RETIREMENT BENEFITS

Benefit formulas can be defined in a number of ways, taking into account a number of different factors. The type of formula, as well as the specific components used in the formula, should be considered when designing a plan.

Formulas can be categorized by the components considered in the formula. Some formulas consider compensation and/or service or participation. Other formulas may provide the same benefit to all participants, without regard to compensation, service, or participation.

The compensation used in the benefit formula must be clearly defined. In a defined contribution plan, compensation in the plan's allocation formula is compensation for the current year since each year's contribution is an independent calculation. In a defined benefit plan, the situation is more complex – the participant's benefit is the benefit for his/her entire career and must somehow recognize this fact.

There are two ways to determine compensation for purposes of determining benefits – one is to define compensation as the participant's average compensation over his/her entire career; the other is to define compensation over a few years of a participant's career.

A final average definition – which uses only a few years of compensation to compute the average and often only the final years of a participant's career – is more common. Examples of final average compensation definitions are:

- Average of the highest 5 consecutive years of service
- Average of the highest 3 years of service in the last 10 years of employment

#### ACCRUED BENEFITS

The current value of the participant's accrued benefit is akin to his/her account balance; that is, the portion of his/her retirement benefit that he/she has accrued to date. The plan will define the formula used to determine the participant's accrued benefit. The most common methods are the *fractional accrual* and the *unit credit* methods.

Under the fractional method, the participant's accrued benefit is the participant's retirement benefit multiplied by a fraction based on the number of years of service or participation he/she has to date and the number of years of service or participation he/she would have at retirement if he/she continued working until retirement. For example, a participant with a retirement benefit as determined under the plan's benefit formula of \$1,000 per month who terminated with 10 years of service, but would have had 25 years of service if he/she continued to work until normal retirement age, would have an accrued benefit of \$400 per month ( $\$1,000 \times 10/25$ ).

Under the unit credit method, the plan's benefit formula is applied, but rather than using the years of service or participation at retirement, only the number of years through the date of termination is used. For example, in a plan with a benefit formula of 2% of monthly compensation times years of service, a participant with monthly compensation of \$3,000 would have an accrued benefit of \$300 per month if

he/she terminated after 5 years of service ( $\$3,000 \times 2\% \times 5$ ).

If the plan is top-heavy, a non-key participant's accrued benefit is the greater of the accrued benefit computed under the plan's benefit formula or the top-heavy minimum accrued benefit.

The current value of the participant's vested accrued benefit is simply the value of his/her accrued benefit multiplied by the vested percentage. This is akin to the participant's vested account balance.

### BENEFIT PAYMENTS AND DISTRIBUTIONS

Benefits may be paid in any of the alternate forms of distribution allowed by the plan – generally annuities payable monthly or lump sums. While plans are not required to offer a lump sum, most small and medium size plans do. Larger plans may not offer a lump sum, but rather may pay annuity benefits to terminated employees when they reach retirement age. (As a practical matter, most terminatees in plans that offer lump sum distributions elect to receive their benefits in the form of a lump sum.)

On an ongoing basis, benefits are defined in terms of the *normal form of benefit* that is generally an annuity payable at normal retirement age. Upon termination, a participant may elect to receive a distribution in the normal form or in one of the alternate forms, such as joint & survivor annuities, other forms of life annuities, or lump sums. As a pension plan, defined benefit plans are subject to the qualified joint and survivor rules. Therefore, unless elected by both the participant and the spouse, distributions must be made in the form of a qualified joint and survivor annuity.

To determine the monthly benefit in each of the alternate forms or the lump sum alternate form of benefit, the administrator must first calculate the participant's *accrued benefit and vested accrued benefit* in the plan's normal form. Then, using the plan's *actuarial equivalent* factors, the administrator can compute the equivalent benefit in each alternate form. Each alternate benefit is *actuarially equivalent* to the normal form of benefit.

The factors used to convert the *monthly benefit* payable at retirement to a lump sum payable currently are defined in the plan and are called the plan's *actuarial equivalent factors* or just *actuarial equivalence*. (They are sometimes called the plan's *actuarial equivalence* assumptions, but are not to be confused with the *actuarial* assumptions selected by the plan's actuary for purposes of *funding*.)

For example, a plan might define the *actuarial equivalent* factors as 6% interest prior to retirement and 6% interest and 1983 GAM mortality after retirement. If a participant is age 55 and his/her vested accrued benefit is \$300 per month payable at age 65, the present value of the vested accrued benefit, which is the lump sum equivalent of the retirement benefit in the nor-

mal form, would be  $\$19,935 \{ [300 \times 119 \text{ (factor based on 6\% and 1983 GAM)}] / 1.06^{10} \}$ .

In many cases, the plan's actuarial equivalence is defined by reference to specific interest rates and commonly used mortality tables. In other cases, the plan document will contain a list of factors that are used to convert from one form of benefit to another.

Under the rules of IRC 417(e), the plan's minimum lump sum benefit is the greater of the lump sum computed under the plan's *actuarial equivalence* or the lump sum computed using the rates defined in IRC 417(e).

### PBGC COVERAGE

Defined benefit plans, with certain exceptions, are required to be covered by the Pension Benefit Guaranty Corporation (PBGC), which provides a guarantee of certain plan benefits to participants. Plans that are covered by the PBGC must pay annual premiums to the PBGC. Plans that are exempt from PBGC coverage and premiums include plans that cover only substantial owners and plans of professional service employers with less than 26 employees.

The amount of the premium is computed on Form PBGC-1 or Form PBGC-1 EZ. The form must be filed and the premium paid within 9½ months after the beginning of the plan year. Plans with more than 500 participants must pay an estimated premium earlier in the year and a final amount by the regular due date. The annual PBGC premium is \$19 per participant plus an additional variable amount based on the funded status of the plan.

The additional variable premium is equal to \$9 per \$1,000 of underfunding. Underfunding is computed by comparing the value of the plan's assets to *vested current liability* (generally, the present value of vested accrued benefits computed using prescribed interest and mortality factors).

### VALUATION DATE AND ADMINISTRATIVE CYCLE

A defined benefit plan can be valued (*i.e.*, computations performed) as of any date in the plan year. Practically speaking, the plan will be valued at either the first or last day of the plan year. The *valuation date* is part of the plan's *funding method* and, like the plan's *funding method*, can only be changed in certain circumstances.

Since first day of the plan year valuations are somewhat more common, this document will assume that the valuation date is the first day of the plan year. For many employers (and seasoned defined contribution service providers), the concept of a beginning of year valuation date is confusing.

In a defined contribution plan, the valuation date is the last day of the plan year. This is so because the participant's contribution is determined each year based on compensation earned that year and earnings

are allocated each year based on plan earnings during each year. Therefore, it is appropriate that the valuation date be the last day of the plan year (the point at which plan year compensation and plan earnings are known).

In a defined benefit plan, the benefit at retirement cannot be known until the participant actually retires. At any time prior to retirement, the amount of the benefit is only an estimate. Contributions for each plan year are not directly related to compensation earned for the plan year, but are the amount needed to fund the expected benefits at retirement. There are no individual accounts to be updated with current year earnings. Therefore, it is just as easy to value the plan at the beginning of the plan year as at the end.

In many cases, a beginning of year valuation date is chosen for convenience. Since an employer cannot easily estimate the contribution that will be required for the plan each year, the more lead time that can be provided between the time the employer is informed of the contribution amount and the time the employer actually has to make the contribution, the easier it will be to budget for that contribution.

Assuming census and asset data is provided by the employer soon after it is requested by the actuarial firm, the employer could be provided with the contribution amount for a given plan year during the first quarter of the year, but would not be required to actually make the contribution until 8½ months after the plan year (assuming the plan is exempt from the quarterly contribution requirement or the employer elects not to make quarterly contributions).

#### For a calendar year plan, the following schedule would apply:

Plan Year:	Jan. 1-Dec. 31, 2002
Valuation Date:	Jan. 1, 2002
Data Request Sent:	Dec. 31, 2001
Data Received:	Feb. 15, 2002
Valuation Completed:	Mar. 15, 2002
Valuation to Employer:	Mar. 31, 2002
Contribution Due Date:	Sept. 15, 2003

#### DATA ISSUES

The data needed to value a defined benefit plan is generally the same as that needed to recordkeep a defined contribution plan. The major difference is the period for which the data is requested.

To value defined contribution plans and defined benefit plans with end of year valuation dates, data for the plan year should be requested (e.g., data for the period January 1-December 31, 2002 for a December 31, 2002 valuation). To value a defined benefit plan with a beginning of year valuation date, data for the plan year *preceding* the valuation date should be requested (e.g., data for the period January 1-December 31, 2001 for a January 1, 2002 valuation).

Another difference is that historical data, not just data for the current plan year, is needed for valuing defined benefit plans. Compensation and service history is generally needed to compute retirement and accrued benefits. In most cases, this data has been reported in previous years. However, in the case of a takeover or new plan, historical data must be requested.

#### ACTUARIAL SERVICES

Providing actuarial services to a defined benefit plan has two distinct major parts – the *actuarial valuation* and the Schedule B/*funding standard account* reconciliation. (With the exception of processing termines or retirees and tracking employer deposits, there are very few other tasks that take place during the year for a defined benefit plan.)

The *actuarial valuation* may be prepared either at the beginning of the plan year (if the valuation date is the first day of the plan year) or at the end of the plan year (if the valuation date is the last day of the plan year).

The *funding standard account* reconciliation is always performed at the end of the plan year since it can only be reconciled at (or after) the end of the plan year when the amount of all contributions made to the plan for the plan year are known. This reconciliation is reported on Schedule B, which also reports the actuarial methods and assumptions used in the *actuarial valuation*.

#### CONCLUSION

This article provides a simple introductory overview into the world of defined benefit plans. Although the resurgence of interest in defined benefit plans can create opportunities for those service providers who have traditionally worked only in the defined contribution marketplace, the complexities of defined benefit plans should not be overlooked. If you decide to enter this marketplace, the need to involve an enrolled actuary, and possibly other defined benefit specialists, is a necessity. ASPA's CPC and MSPA designation study courses can help defined contribution specialists increase their familiarity with defined benefit plans. ▲

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*Lorraine is a frequent speaker at employee benefits conferences including ASPA's annual and regional conferences, the Enrolled Actuaries Meeting, and the Ohio State University School of Law Creative Pension and Benefits Seminar. She is also a columnist and a contributing editor of the Journal of Pension Benefits and an author of The Life Insurance Answer Book.*

## Single-Participant 401(k) Plan Sales Strategies for Third Party Administrators

Maximum Contribution Comparison			
Sole Proprietor Net Profits	SIMPLE IRA	SEP/Profit Sharing/Money Purchase	Single-Participant 401(k)*
\$ 10,000	\$ 7,277	\$ 1,859	\$ 9,293
\$ 30,000	\$ 7,835	\$ 5,576	\$ 16,576
\$ 50,000	\$ 8,385	\$ 9,294	\$ 20,694
\$ 75,000	\$ 9,078	\$ 13,940	\$ 24,940
\$ 100,000	\$ 9,771	\$ 18,678	\$ 29,678
\$ 150,000	\$ 11,156	\$ 28,544	\$ 39,544
\$ 200,000	\$ 12,541	\$ 38,410	\$ 40,000

\* Maximum single-participant 401(k) contribution limits do not reflect the additional \$1,000 "catch-up" contribution available to individuals age 50 or older.

**Access to Tax-Free Loans** – Many small business owners are hesitant to put money into vehicles, such as IRAs or SEP plans, where they have limited or no access to their money without paying substantial penalties for early withdrawal. As a result of EGTRRA, unincorporated business owners may now take tax-free loans from their qualified plan savings. While access to tax-free loans is not limited exclusively to single-participant 401(k)-type plans, many financial service providers who offer traditional "Keogh" plans such as profit sharing and money purchase pension plans do not have the systems capabilities to support loan programs for their small business clients. Single-participant 401(k) plans, on the other hand, often reside on 401(k) recordkeeping platforms and are, therefore, able to support loan programs.

**Complete Funding Flexibility** – With the instability of today's market, many employers are not comfortable or cannot afford to commit to the pre-set funding levels required in traditional types of retirement plans like money purchase plans and defined benefit plans. These traditional plans provide little, if any, flexibility to the employer to increase or decrease plan funding from year to year in response to changes in business or personal financial circumstances. Single-participant 401(k) plans, on the other hand, provide complete funding flexibility allowing business owners to contribute as little or as much as they desire on an annual basis (within the prescribed maximum limits).

**Flexible Distribution Options** – The types of traditional retirement plans generally used to achieve maximum tax-deferred savings (*e.g.*, defined benefit and money purchase plans) generally restrict business owners from taking distributions except in the case of retirement or plan termination. Single-participant

401(k) plans, however, are not subject to these same distribution limitations because they are 401(k)-based. Properly designed single-participant 401(k) plans afford business owners far more liberal distribution options, including in-service withdrawals and hardship withdrawals, thereby helping to ensure that business owners generally have access to their retirement savings should the need arise.

**Cost-Effective Administration** – Historically, 401(k) plans and 401(k) pricing models have been geared exclusively to the multi-participant market – a market in which the numerous costly discrimination and coverage testing requirements have tended to drive prices upward. However, single-participant 401(k) plans are designed explicitly for use by small businesses that qualify for owner-only coverage. Consequently, single-participant 401(k) plans automatically pass virtually all of the nondiscrimination and minimum coverage tests that account for a significant portion of the administration expenses generally associated with 401(k) plans.

In addition, because these plans are designed for owner-only coverage situations, they automatically qualify for filing IRS Form 5500-EZ, which is far less burdensome to complete than Form 5500. Thanks to these unique aspects, the costs of maintaining a single-participant 401(k) plan for most small business owners will be far less than the costs generally associated with maintaining a traditional 401(k) plan and, in most cases, comparable to or less than the cost of maintaining other traditional types of small business retirement plans.

### WHAT TYPES OF BUSINESSES QUALIFY FOR A SINGLE-PARTICIPANT 401(k) PLAN?

Although much of the industry attention regarding this new plan type has focused on unincorporated



businesses (e.g., sole proprietors and partnerships), it is worth noting that the features and benefits of the single-participant 401(k) plan are also available to incorporated businesses. The key to determining eligibility is by focusing on whether or not the business employs any *eligible* common-law employees.

Single-participant 401(k) plans can be especially effective for businesses in which the business owner employs his or her spouse. The spouse is considered a business owner for purposes of determining eligibility for single-participant 401(k) plan coverage. If the spouse works part time and receives W-2 compensation of \$15,000, he or she could defer \$11,000 (\$12,000 if age 50 or older) in addition to receiving a 25% profit sharing contribution of \$3,750 – for a total annual contribution of \$14,750.

#### **DEVELOPING A SINGLE-PARTICIPANT 401(k) PLAN SALES STRATEGY – TIPS FOR THE TPA**

**2002: A Window of Opportunity** – As retirement professionals are well aware, 2002 will be a year of significant activity due to the fact that most qualified retirement plans nationwide will need to be amended for the numerous legislative changes that have oc-

curred in recent years (collectively referred to as the GUST Amendments). This means that virtually every small business owner that currently maintains a business retirement plan will need to restate his or her plan at some point during 2002, creating an ideal opportunity to consider new and better alternatives to their existing retirement plan. What's more, business owners who currently sponsor a retirement plan have already demonstrated they are serious about saving for retirement. Based on these factors, 2002 presents an ideal opportunity for advisors and TPAs to cultivate new relationships with small business owners by offering a level of one-on-one service they may not be receiving from their current plan provider – while at the same time presenting these small business owners with a new, more flexible retirement savings alternative.

**Economic Trends Indicate a Growing Market Opportunity** – With a variety of economic factors, including corporate downsizing, and the rising cost of commuting and daycare, self-employment is on the rise. An estimated 13,000,000 owner-only businesses are currently operating in the US. Of this total, it is estimated that over 85% (11,500,000) of the business

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owners in this category have self-employment income as their primary source of income.<sup>1</sup>

**Starting Small Can Lead to a Big Payoff** – When an advisor or TPA sets-up a single-participant 401(k) plan for a small business owner, it is not only the beginning of their relationship, but it also opens the door to future possibilities including:

1. Many large corporations start out as “mom and pop” shops. There is always the chance that a company will grow to the point where they need to establish a traditional 401(k) or defined benefit plan. Since the TPA already has the relationship, it is likely that he/she will retain the business.
2. Small business owners talk. When a client is happy with a single-participant 401(k), he/she is likely to refer other small business owners to the TPA for similar services.
3. The single-participant 401(k) presents an excellent opportunity for a client to consolidate all of his/ her tax-sheltered retirement savings under one umbrella. Virtually every type of qualified, tax-sheltered retirement savings can be rolled over or transferred into a single-participant 401(k) plan. TPAs will have the opportunity to capture retirement assets the client may have accumulated, including assets in a 401(k) plan, pension plan, 457(b) plan, 403(b) plan, rollover IRA, and traditional IRA.

**Use Presentations to Open New Doors** – An advisor or TPA who is fortunate enough to be one of the first in his or her area to offer this unique type of product can capitalize on the situation. One of the best ways to do this is to use a speaking platform to present himself or herself as an expert in the arena. At first glance, legal/tax advisors and small business owners may not understand all of the benefits of the single-participant 401(k).

Advisors and TPAs should consider hosting “lunch and learn” programs or dinner workshops for both legal/tax advisors and small business owners in the community. Focus the presentation on the benefits of the single-participant 401(k) plan and the ways in which this product can help clients better meet their personal retirement and financial planning objectives. Using direct mail to increase attendance at these workshops is another tactic.

**Promote Retirement Asset Consolidation** – Another benefit derived from EGTRRA is increased portability of retirement plan assets. Thanks to the pension portability changes in EGTRRA, most types of tax-qualified retirement plan assets can be rolled or transferred into an single-participant 401(k) plan, making

these plans the perfect vehicle for asset consolidation. Many small business owners will welcome the thought of being able to consolidate their disparate retirement savings such as traditional IRAs, rollover IRAs, SEP and SIMPLE IRA assets, and other qualified retirement plan assets under one plan.

## CONCLUSION

The creation of the one-person 401(k) plan is likely to be one of the more far-reaching results of EGTRRA. Not only does the introduction of the single-participant 401(k) plan open a world of opportunity for the small business owner, but it opens the door for intermediaries as well. As the paradigm shifts and more of the population start their own businesses, the industry should see an ever-increasing demand for this new type of retirement plan. For the advisors and TPAs who get in on the ground floor, the possibilities are extensive.

Educating the legal/tax advisors and the small business owners in a community is a great starting point. It is often said that knowledge is power, and the more a small business owner feels empowered to make educated decisions about the financial future, the better.

Small business owners, by their very nature, will appreciate the benefits associated with single-participant 401(k) plans including the opportunity for increased funding, increased access to retirement savings, greater funding flexibility, and asset consolidation. The small business community needs to be made aware of the new opportunities available to them. The press has already begun touting the benefits of one-person 401(k) plans. What remains is for retirement plan professionals to drive home the message on a local level. ▲

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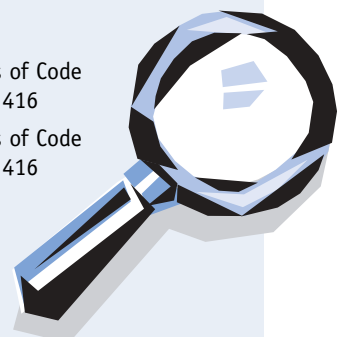
*Lauren K. Durchsprung is a Communications Manager at BISYS® Retirement Services. In this role, Lauren develops and executes internal and external communication campaigns geared towards increasing industry awareness of new products and services and updating clients on regulatory changes and industry news.*

1. Brightwork Partners, LLC Perspectives on Small Business, Retirement Services Drill-Down (RSD), Conducted Q2, 2001. n= 2359 small business owners or decision makers.

## Breaking The Code

Code Section	Subject	Rule
401 (k)(12)	Safe Harbor for ADP	Provide a non-elective contribution of 3% of compensation or a match of 100% of the first 3% of deferrals and 50% of the next 2% of deferrals to avoid ADP testing
(k)(3)	Actual Deferral Percentage Test	The average of ADRs (actual deferral ratios) for the HCE group may not exceed 1.25 times or 2 plus or 2 times the average of ADRs for NHCEs.
(l)	Permitted Disparity	Benefit formula may be integrated with projected social security benefits
401 (m)	Matching Contributions	Rules with respect to matching contributions made to a plan
(m)(1)	In General	General rules with respect to matching contributions
(m)(2)	ACP Testing Rules	Rules with respect to performing the ACP test
(m)(3)	Contribution Percentages	Rules with respect to calculating percentages
(m)(4)	Definitions	Various definitions important to ACP testing
(m)(5)	Employees Taken into Consideration	Rules for whom to include in the ACP test
(m)(6)	Plan not Disqualified	Rules with respect to the timing of the removal of excess aggregate contributions
(m)(7)	Treatment of Distributions	Taxation of excess aggregate contributions
(m)(8)	Highly Compensated Employees	Cross reference to 414(q) definition
(m)(10)	Safe Harbor for ACP	Rules with respect to the ACP safe harbor
(m)(11)	Safe Harbor for ACP	Additional rules with respect to the ACP safe harbor
402 (a)(b)(c) (d)(e)(f)	Taxability	General taxation rules cross referencing Code Section 72, rollover rules
(g)	Dollar Limit on Deferrals	Participant deferrals in any calendar year are limited to \$11,000.
(h)	Special Rules for SEPs	Contribution limits for SEPs
(j)	Disposition of Stock	Net unrealized appreciation rules
402A	Elective Deferrals	Option to treat elective deferrals as after-tax Roth contributions
403 (b)	Tax Sheltered Annuity Plans	Tax sheltered annuities for certain tax-exempt organizations
404 (a)	Plan Deduction Limits	Employer's deductible contribution is limited to the lesser of 25% of compensation or the amount necessary to satisfy minimum funding
(h)	SEP Deduction Limits	Deductible limits for SEPs
(j)	Coordination with Code Section 415	Clarifies that contributions in excess of applicable 415 limitations are not deductible
(k)	Dividends	Rules with respect to the deduction of dividends on employer securities
(l)	Limitation on the Amount of Annual Compensation Taken into Account	Coordination with the Code Section 401(a)(17) compensation limitation
(m)	Special Rules with Respect to SIMPLEs	Deduction rules for SIMPLEs
(n)	Elective Deferrals	Elective deferrals are not treated as employer contributions for deduction purposes
408	IRAs	Rules with respect to IRA contributions
409	ESOPs	Tax credits for Employee Stock Ownership Plans
410 (a)	Minimum Participant Standards	Age and service requirements
(b)	Minimum Coverage Requirements	Plan must demonstrate availability to a cross section of employees by passing the Ratio Percentage test or the Average Benefit Percentage test
(c)	Special Coverage Rules	Application to certain government and church plans
(d)	Electing Church Plans	Special rules for church plans that elect coverage under ERISA

Code Section	Subject	Rule
411	Minimum Vesting Standards	
(a)	General Vesting Rules	Minimum vesting standards including required vesting schedules; service crediting, including vesting of matching contributions
(a)(11)	Cash Out Rules	Restrictions on certain mandatory distributions and disregarding rollovers for purposes of the cash-out rules
(b)	Accrued Benefit Rules	Defined benefit minimum accrual rules: fractional accrual rule, 133 1/3% accrual rule, unit credit accrual
(c)	Allocation of Accrued Benefits Between Employee and Employer Contributions	Coordination of accrual rules with employee contributions
(d)	Special Rules	Rules with respect to amendments with patterns of abuse, termination, and partial termination
411 (d)(6)	Protected Benefits	Benefits, rights, and features may not be eliminated from a plan
412	Minimum Funding Requirements	Minimum contributions required to fund pension plans
(a)	General Rule	General funding guidelines
(b)	Funding Standard Account	Applicable charges and credits to the funding standard account
(c)	Special Rules	Actuarial assumptions and other valuation rules
(d)	Variance from Minimum Funding	Waivers of funding rules
(e)	Extension of Amortization Period	Modifications to amortization rules
(f)	Requirements Related to Waivers and Extensions	Special rules, security, and exceptions to waiver of funding rules
(g)	Alternative Minimum Funding Standards	Charges and credits under the alternative minimum funding standard account
(h)	Exceptions	Exceptions to the minimum funding rules that apply in the case of profit sharing plans, insurance contract plans, governmental plans, church plans, and other not-for-profit entities
(i)	Insurance Contract Plans	Rules with respect to insurance contract plans
(j)	Terminated Multi-employer Plans	Funding obligations with respect to terminated multi-employer pension plans
(l)	Additional Funding Requirements	Deficit reduction contribution required of certain defined benefit plans
(m)	Quarterly Contribution Requirements	Rules with respect to quarterly contributions required of defined benefit pension plans
(n)	Liens	Imposition of liens to the extent that required minimum distributions are not made
413	Collective Bargained Plans, etc.	
(a)	Definition	Defines to whom rules apply
(b)	General Rules	General rules with respect to collective bargaining agreements
(c)	Multiple Employer Plans	Rules with respect to a single plan maintained by more than one unrelated employer
414	Definitions and Special Rules	
(a)	Predecessor Employer	Service with a predecessor employer
(b)	Employees of Controlled Groups of Corporations	Specific requirements for aggregation for purposes of Code Sections 401, 408(k), 408(p), 410, 411, 415, and 416
(c)	Employees of Partnerships under Common Control	Specific requirements for aggregation for purposes of Code Sections 401, 408(k), 408(p), 410, 411, 415, and 416
(d)	Governmental Plans	Rules with respect to governmental plans
(e)	Church Plans	Rules with respect to church plans
(f)	Multi-employer Plan	Rules with respect to plans maintained for one or more entity pursuant to a collective bargaining agreement
(g)	Plan Administrator	Definition





<b>Code Section</b>	<b>Subject</b>	<b>Rule</b>
414 (l)	Merger and Consolidation	Special rules with respect to plan mergers and other similar events
(m)	Affiliated Service Groups	Entities considered part of an affiliated service group are aggregated for most qualification requirements including Code Sections 410, 411, 415, and 416
(n)	Leased Employees	Rules for exclusion and inclusion of leased employees for qualified plan purposes
(o)	Other Organizations	Authorization to prescribe additional regulations with respect to other related organizations
(p)	Qualified Domestic Relations Orders	Specific rules with respect to recognizing a qualified domestic relations order with respect to a participant's benefit in a qualified retirement plan
414 (q)	Highly Compensated Employees	Defined as more than 5% owners or employees earning more than \$85,000 (as indexed) in the look back year
414 (r)	Separate Lines of Business (SLOB) Rules	Plans may elect to apply 410(b) and 401(a)(26) separately to separate lines of business
414 (s)	Safe Harbor Compensation	Compensation definitions used for nondiscrimination testing and safe harbor plan design which are deemed to be non-discriminatory
(t)	Controlled Group Rules	Rules with respect to entities considered to be a controlled group based on ownership
(u)	USERRA	Rules with respect to reemployment rights under USERRA
(v)	Catch-Up Contributions	Special rules for employees who have attained age 50 with respect to extra deferrals that can be made to the plan
415 (a)	Limitations on Benefits and Contributions	Annual addition and benefit limitations
(b)	Limitation on Benefits Under DB Plan	Projected benefits may not exceed the lesser of 100% of high 3 year average compensation or the DB dollar limit (subject to adjustments for commencement prior to SSRA, participation or service less than 10 years).
(c)	Limitation on Benefits Under DC Plan (Annual Additions Limit)	Contributions and forfeiture allocated to any participant in a plan year are limited to the lesser of a 100% of compensation or \$40,000
(d)	Cost of Living Adjustments	Methodology for adjusting defined benefit and defined contribution 415 limitations
(e)	Combined Plan Limitations	The sum of the ratio of DB benefits and DC contributions to compensation may not exceed 1 (repealed).
(f)	Combining Plans	Rules with respect to combining defined benefit and defined contribution plans
(k)	Special Rules	Special 415 rules
416	Special Rules for Top-Heavy Plans	Special rules with respect to plans considered to be top-heavy
(a)	General Rules	Vesting and minimum accrual rules that apply to top-heavy plans
(b)	Vesting Requirements	Minimum vesting schedules that apply to top-heavy plans
(c)	Minimum Benefits	Defined benefit and defined contribution top-heavy minimum benefits
(e)	Social Security and Similar Contribution Benefits	Plan can not rely on social security or permitted disparity to satisfy top-heavy minimums
(f)	Coordination of Plans	Rules with respect to duplication of top-heavy minimums
(g)	Look Back Rule	Look back period for determining top-heavy status
(i)	Key Employees	Defined as an officer earning more than \$130,000; more than 5% owner; or, more than 1% owner with compensation greater than \$150,000
417	Definitions and Special Rules for Purposes of Minimum Survivor Annuity Requirements	
(a)	Election to Waive	Rules with respect to the election to waive QJSA and QPSA
(b)	Definition	Definition of QJSA
(c)	Definition	Definition of QPSA

Code Section	Subject	Rule
417 (d)	One-Year Rule	QJSA and QPSA not required if participant is married for less than one year
(e)	Restrictions on Cash-Outs	Tied to Code Section 411(a)(11) cash out amount
(f)	Special Rules	Definition of Vested, Annuity Starting Date and Earliest Retirement Age
420	Transfer of Excess Assets to Retiree Health Plan	Qualified transfer of excess assets
421	General Rules for Qualifying Transfers	Effect of qualifying and disqualifying disposition
423	Employee Stock Purchase Plans	Rules with respect to employee stock purchase
457	457 Plans	Nonqualified plans maintained by state or local government or tax exempt employer
501 (a)	Tax Exempt	Tax exempt organizations
501 (b)	Unrelated Business Income	Taxation of unrelated business taxable income
(c)	List of Exempt Organization	Tax exempt organizations
1563 (a)	Controlled Group	Definition
(e)	Constructive Ownership	Attribution rules
4971	Taxes on Failure to Meet Minimum Funding	Initial and additional taxes on funding deficiencies
4972	Taxes on Nondeductible Contributions	Excise tax levied on nondeductible contributions
4973	Taxes on Excess Contributions to IRAs and 403(b)s	Excise tax levied on excess IRA or 403(b) contributions
4974	Excise Tax on Certain Accumulations	Required Minimum Distribution tax
4975	Tax on Prohibited Transaction	Definition of prohibited transaction, exemptions and excise tax
4978	Tax on ESOP Distributions	Applies to disposition before end of required holding period
4979	Tax on Excess Distributions	Applies to excess contributions or excess aggregate contributions not removed from the plan in a timely manner
4980	Tax on Reversion	Applies to reversions of defined benefit assets upon plan termination
6047	Information	Reporting and disclosure
6057	Annual Registration	Registration with respect to deferred vested benefits

If you look at these specific Internal Revenue Code references, you will notice that many of them are rather short. It is hard to understand how a single sentence set forth in 401(a)(4), "...contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees" could give rise to the concept of nondiscrimination testing, safe harbor plan design, cross-testing, and imputed permitted disparity. The "Code" simply lays out the guidelines. The IRS generally issues regulations with respect to

each major code section. A regulation is designed to clarify the sections and offer operational guidance for a specific code section. For the most part, regulations are first issued in proposed form and then, based on feedback from practitioners, are later finalized. Sometimes, if a matter needs immediate but short-lived attention, temporary regulations are issued. ▲

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## Notice of ASPA's Annual Business Meeting

The ASPA Annual Business Meeting will be held during the 2002 ASPA Annual Conference at 3:15 p.m. on Sunday, October 27 at the new conference location, the Washington Hilton and Towers. Watch for the ASPA 2002 Annual Conference brochure, available in August, for a full conference schedule.

All ASPA members are invited to attend and participate in the business meeting discussion. Credentialed members are encouraged to attend the meeting and vote for the new members of ASPA's 2003 Board of Directors.



# EGTRRA's Impact on Employee Stock Ownership Plans

by Dennis J. Long

IN THE COURSE OF THE PAST 25 YEARS, NUMEROUS LEGISLATIVE CHANGES HAVE OCCURRED RESULTING IN THE EXPANSION OF EMPLOYEE OWNERSHIP USING EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs). TAX INCENTIVES FOR SHAREHOLDERS, PLAN SPONSORS, AND PLAN PARTICIPANTS HAVE ENCOURAGED THE GROWTH OF ESOPs. TODAY, ABOUT 13,000 COMPANIES AND 16 MILLION EMPLOYEES PARTICIPATE IN ESOP ARRANGEMENTS.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) has had the positive impact of improving qualified retirement plans in general. EGTRRA also offers specific advantages for ESOPs, and enhances the tax-favored attractiveness of these arrangements enormously. This article will address the ESOP-specific changes made by EGTRRA but will not discuss any of the general qualified plan rules that were also significantly enhanced by this new legislation.

On June 7, 2001, EGTRRA became law. It is, arguably, the most significant pension reform bill in the last 15 years. For ESOPs, it may be the most important reform since 1974, when ERISA codified ESOPs. In addition to expanding planning opportunities for all qualified plans, EGTRRA greatly increases the tax incentives for C corporation ESOP sponsors and solidifies the legislative and regulatory environment for companies sponsoring S corporation ESOPs.

## INCREASED DEDUCTION LIMITS

For plan years beginning after December 31, 2001, the basic defined contribution plan deduction limitation increased from 15% to 25% of covered compensation. Previously, an ESOP plan sponsor wanting to avail itself of a 25% deduction had to have a leveraged ESOP and be a C corporation or have a combination ESOP and money purchase pension plan with a fixed contribution of no less than 10% of pay. The new deduction limitation will be very attractive to S corporations who enter into new leveraged ESOP transactions because it will increase the deduction limit for amortizing loans made to the ESOP to acquire stock.

## DIVIDEND REINVESTMENT

EGTRRA simplified and expanded, for the first time, a major tax incentive for C corporations. It expanded the deduction for reinvested dividends paid on company stock owned by an ESOP. Section 662 retains the provisions of prior law relating to dividend deductions but expands the dividend deduction to include dividends that, at the

election of the participant, are paid to the ESOP and remain in the ESOP (not paid out to the participant or used by the ESOP to pay down ESOP debt). This new provision is effective for taxable years beginning after December 31, 2001. This change means that plan sponsors will not have to suffer the expense and time to create more complicated "dividend switchback" arrangements, as is currently the case, in order to take advantage of the dividend reinvestment feature. Under pre-EGTRRA law, a Private Letter Ruling would be the normal route to protect the plan sponsor's tax deduction. The process was also more complex, as the ESOP dividend was paid to the ESOP and then distributed to the participant, who had to then defer the dividend back into a 401(k) plan feature of an ESOP in order to achieve a deduction under Section 404(k) of the Code.

## S CORPORATION ESOPs SURVIVE – NEW ANTI-ABUSE PROVISIONS ADDED

The biggest change for ESOPs by EGTRRA may be the new anti-abuse S corporation ESOP rules.

By way of background, the 1999 and 2000 budget proposals of the Clinton administration called for the virtual elimination of S corporation ESOPs. There were two years of uncertainty over the survival of ESOPs for S corporations, making planning very difficult for plan sponsors contemplating an ESOP transaction, and for professionals advising such companies. EGTRRA has made it clear that ESOPs can be used effectively as a planning tool by S corporations. Section 656 of EGTRRA, entitled "Prohibited Allocations of Securities in an S Corporation," contains the features of the "Breux-Ramstad" anti-abuse bill and is designed to preserve the tax benefits associated with S corporation ESOPs.

The new "anti-abuse" or "non-allocation" provisions are rather complex and designed to prevent the adoption of an ESOP by an S corporation that does not provide broad-based employee ownership. EGTRRA requires that an S corporation ESOP be "broadly

based” by subjecting it to a new two-part test. As this article will explain, the test can be complex and difficult to apply.

The new anti-abuse rules are found in newly added Internal Revenue Code Section 409(p). The new rules are effective immediately for:

- ESOPs adopted by S corporations after March 14, 2001,
- ESOPs sponsored by corporations that elect S corporation status after March 14, 2001, and
- Any ESOP established on or before March 14, 2001, if the employer stock was not held by the ESOP on March 14, 2001.

Otherwise, the new provisions are effective for plan years beginning after December 31, 2004.

In general, the anti-abuse provisions call for penalties assessed on several items, most notably allocations to certain participants in any non-allocation year. A “non-allocation year” means any plan year in which “disqualified persons” own, or are deemed to own, at least 50% of the shares of the S corporation plan sponsor. In a non-allocation year, it is not permissible to allocate shares to disqualified persons, nor is it permissible to allocate, in lieu of shares, other assets of the ESOP or make another allocation under any other tax qualified plan maintained by the plan sponsor.

The penalties or consequences of failing the tests are:

#### *A substantial excise tax*

- In any non-allocation year, an excise tax will be charged to the plan sponsor equal to 50% of the fair market value of ESOP allocations to disqualified persons, plus the value of any synthetic equity held by disqualified persons.

In the first non-allocation year, the excise tax on ESOP allocations will apply to any stock that had been allocated up to that date to any disqualified person (as if it was all allocated in that year), as well as any synthetic equity held by the disqualified person.

#### *Income tax*

- In addition to the above-mentioned excise tax, the disqualified persons will, for income tax purposes, be taxed as if they received a distribution of the amount allocated.

EGTRRA also empowers the Secretary of the Treasury, by regulation or other guidance, to provide that a non-allocation year (and the triggering prohibited allocation and adverse excise and income tax consequences mentioned above) occurs in any case in which the principal purpose of the ownership structure is to avoid or evade the Act’s provisions. This provision is intended to be helpful in

eliminating S corporation ESOPs that have no real substance and are implemented primarily to benefit the selling shareholders.

Key definitions to understand are:

- A “disqualified person” is:
  1. Any individual who is a holder of 10% or more of the “deemed owned shares” of the corporation, or
  2. Any individual and his/her “family” who owns 20% or more of the “deemed owned shares” of the corporation.
- “Deemed owned shares” is a new concept in ESOP law and includes stock allocated in the individual’s accounts in the ESOP, plus the individual’s relative portion of the unallocated shares (suspense account shares) held by the ESOP (assuming they had been allocated in the same manner as the most recent contribution was allocated), plus any “synthetic equity.” In other words, this “phantom allocation” process requires the unallocated shares to be allocated and treated as “deemed owned” in a manner based on the shares that were allocated to the ESOP participant’s account in the most recent allocation. Additionally, the “synthetic equity” held by the individual is counted only if the “synthetic equity” held causes the person to be disqualified. In other words, a company cannot circumvent the problem by just issuing stock options to all employees.
- “Synthetic equity” is another new concept in ESOP law and is a broad term that includes any stock options, warrants, restricted stock, or any other instrument that gives a person the right to obtain stock in the future. The term also includes any stock appreciation rights (SARs) or phantom stock whose value is based upon the S corporation’s underlying stock. The law appears to require that each unit be counted as if they were actual shares of stock – but again, only if by counting them causes a person to be disqualified or causes a non-allocation year. In other words, the counting of synthetic equity can only hurt the testing results, not make the test results more favorable.
- “Family” for purposes of the “disqualified persons” rule, includes:
  1. A person’s spouse,
  2. Ancestors or lineal descendants of the individual or spouse,
  3. A brother or sister of an individual or spouse and any lineal descendant of the brother or sister, and
  4. The spouse of any person in 2 or 3.



In addition, individuals are considered to own shares that are held in trusts, partnerships, estates, and corporations that they control.

This definition is much broader than the definition found in the general attribution rules of Section 318 of the Code.

## CONCLUSION

This article illustrates one very significant law change for C corporations – the dividend reinvestment deduction. This feature alone has prompted thousands of public companies with significant holdings of employer securities in a 401(k) plan, and paying dividends on employer stock, to amend the plan to be considered an ESOP and take advantage of deductible dividends reinvested in the plan. Secondly, the general expansion of the tax deductible contributions has impacted and greatly simplified the plan design of C corporation and S corporation ESOPs for sponsors that want to maximize deductible contributions. Lastly, the new and somewhat confusing anti-abuse rules for S corporation ESOPs are very important. Significant penalties apply for failing these new tests. Great care should be taken to ensure compliance with the new provisions of EGTRRA. However, the new rules solidify the environment for S corporation ESOPs and eliminate the cloud of uncertainty that existed, with respect to S corporation ESOPs, prior to the enactment of EGTRRA. ▲

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*Dennis J. Long is the founder, CEO, and chairman of BCI Group, a leading provider of ESOP consulting and administration services. BCI Group has offices in nine US cities and clients in nearly every state.*

*Dennis is a member of The ESOP Association, the National Center for Employee Ownership (NCEO), the Employee-Owned S Corporation of America (ESCA), and an affiliate member of the American Society of Pension Actuaries (ASPA). He has served in numerous leadership positions in these and other professional organizations. Dennis is a frequent author and speaker on ESOP-related topics.*

## WELCOME NEW MEMBERS

Welcome and congratulations to ASPA's new members and recent designees.

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Susan E. Witt

## JBEA Renewal of Enrollment

The Joint Board is currently processing applications for renewal of enrollment. Some questions have been raised about the enrollment number for the current cycle, which began on April 1, 2002. The renewal notices that the Joint Board has been issuing are computer generated and a zero precedes every four-digit enrollment number. In completing the 2001 Schedule B, or any prior year, this zero should be ignored and you should continue to use your four-digit enrollment number, preceded by the prefix "02".

You may begin using the "02" prefix as soon as you receive the letter from the Joint Board approving the renewal of your enrollment and it must be used by September 1, 2002.

# Central Florida Benefits Council Mixes Business with Pleasure

by Nadine Schaal

IN NOVEMBER 2001, WE HAD OUR ANNUAL SOCIAL FOR MEMBERS AND GUESTS AT THE "SLEUTHS MYSTERY DINNER SHOW." OUR ENTERTAINMENT OCCURRED AT THE "SQUIRE'S INN," WHERE A MURDER AND THEFT HAD OCCURRED. AUDIENCE PARTICIPATION WAS REQUIRED TO SOLVE THE "WHO DONE IT" PLAY. THIS OUTING GAVE US A CHANCE TO MIX AND MINGLE WITH MEMBERS AND THEIR GUESTS IN A MORE RELAXED ATMOSPHERE THAN OUR FORMAL MEMBER MEETINGS. THIS WAS A WELL-ATTENDED EVENT THAT PROVIDED A WONDERFUL DEPARTURE FROM OUR TECHNICAL MEETINGS AND SET A NEW LEVEL OF EXPECTATION REGARDING THE ENTERTAINMENT AT OUR NEXT SOCIAL EVENT.

Beginning in 2002, we returned to our more typical format of technical member meetings, with the first one in January entitled "ERISA Fiduciary Concepts in Benefit Plan Administration and the Unauthorized Practice of Law." Our presenter was Ray Maddock, an attorney and consultant at Hewitt Associates, LLC. Ray defined the parties who are or become fiduciaries, their fiduciary responsibilities, and the potential to become a fiduciary unintentionally. He further explained how the unauthorized practice of law can occur in plan administration and how negative consequences can result from the unauthorized practice of law.

Joan Gucciardi, MSPA, CPC, presented the topic, "Designing Plans in the Post-EGTRRA Era" at our February meeting. Joan, a nationally recognized speaker, presented a number of examples to demonstrate how EGTRRA will significantly impact plan

design due to the increases in contribution limits and compensation limits as a basis for allocation of contributions as well as other changes, such as the revised 204(h) notice requirements.

Most recently, Richard Hochman, APM, an attorney with McKay, Hochman Co., Inc., was the speaker for our May meeting and addressed new and revised 401(k) plan operational issues. Items addressed on this topic included the audit requirements as revised for small plans and plan loan regulations. ▲

*Nadine Schaal is an attorney with Akerman Senterfitt & Eidson, PA in Orlando, FL. Nadine has eighteen years of experience in design and drafting, and applying corrective compliance methods with regard to qualified and nonqualified plans. She currently serves as the vice president, and ASPA liaison on the Board of Directors of the Central Florida ABC.*

## ASPA BENEFITS COUNCILS CALENDAR OF EVENTS

Date	Location	Event	Speakers
July 10	Dallas/Ft. Worth	Unearthing Business Strategies for Qualified Plan Success	E. Thomas Foster, Jr., Esq.
July 16	South Florida	Changing 401(k) Vendors – Issues to Consider in the Post-Enron Environment	Cynthia Groskiewicz, MSPA, QPA Jeffrey Kahn, APM
July 17	Atlanta	Potential Pension Legislation in Response to Enron	Brian Graff, Executive Director, ASPA
September 2002	Atlanta	Annual Meeting	TBA
Fall 2002	Atlanta	Plan Investments, Fiduciary Liability, and How to Determine Underlying Fees	TBA
November 13	Dallas/Ft. Worth	Keeping Current	Sal Tripodi, Esq., APM

# Key Changes Resulting from EGTRRA and JCWAA

by Jeffery Mandell



THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 (EGTRRA) MADE THE MOST COMPREHENSIVE CHANGES IN PENSION LAWS SINCE THE EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) WAS PASSED TWENTY-EIGHT YEARS AGO. EGTRRA SUBSEQUENTLY WAS MODIFIED BY CERTAIN PRIMARILY TECHNICAL REVISIONS THAT WERE INCORPORATED IN THE JOB CREATION AND WORKERS ASSISTANCE ACT OF 2002 (JCWAA).

**An explanatory chart has been included as a supplement to this issue of *The ASPA Journal*.** The chart summarizes the changes from EGTRRA and JCWAA that most affect qualified retirement plans and offers explanation and commentary on various provisions. Several common themes are present throughout the technical changes, including: promoting greater retirement savings, increasing portability among plans, enhancing and simplifying distribution provisions, and harmonizing the various different rules applicable to different types of plans. On the one hand, these changes continue recent trends (e.g., allowing loans to owner-employees continues to eliminate distinctions applicable to Keogh plans). On the other hand, the changes reflect new thinking in Washington (e.g., the increase in contribution and benefit limits recognizes for the first time the reality that these plans often only make sense for small businesses if the owners themselves obtain some meaningful personal benefit from the program).

As with prior changes in the pension rules, some of the provisions present new risks (e.g., applying the catch-up provisions), other changes present opportunities (e.g., defined benefit plans), and yet other changes simply make us scratch our heads (e.g., the significant yet subtle differences between government §457(b) plans versus tax-exempt §457(b) plans).

All in all, the benefits community will most likely view these changes to be beneficial. Some exasperated practitioners might question that conclusion on the basis that the law is already obtuse enough. Enhancements, although beneficial, can definitely add to the unending complexity of our pension system. Hopefully, the enclosed chart will assist you in navigating through the new rules and will help you better understand some of the complexities of these new provisions. ▲

*Jeffery Mandell is founder and president of The ERISA Law Group, P.A. in Boise, Idaho. Since 1982, Jeffery has concentrated his practice solely in retirement plans, welfare plans, and other ERISA and deferred compensation matters.*

*Jeffery is a nationally recognized practitioner, speaker, and author on ERISA topics, and has been voted by his peers to be listed in the Best Lawyers in America since 1995. He is an Adjunct Professor at the University of Idaho College of Law and was previously an Adjunct Professor at the University of Wisconsin Law School. He authored a textbook regarding ERISA plan administrative and legal matters that was published in 1998 by Panel Publishers. Jeffery is the founder of Employee Benefit Publications and Seminars. He is an affiliate member of the American Society of Pension Actuaries (ASPA), the National Institute of Pension Administrators (NIPA), and The Group.*

A special supplement covering this topic is enclosed.



Below is a listing of the ASPA ASAPs published through June 2002.

- |       |   |       |  |
|-------|---|-------|--|
| 02-01 | Notice 2002-3 Replaces Safe Harbor Rollover Notice                                    | 02-09 | Proposed Regulations for ERISA Section 204(h) Notices Issued                           |
| 02-02 | IRS Issues Guidance on the Elimination of User Fees for Determination Letter Requests | 02-10 | Treasury Issues Final 401(a)(9) Regulations  |
| 02-03 | 2001 Form 5500 Released   | 02-11 | IRS Issues Guidance on Professional Employer Organization Plans                        |
| 02-04 | Scaled Down Economic Stimulus Act Passed  | 02-12 | Streamlined Procedures for Plans That Have Not Been Updated for GUST on a Timely Basis |
| 02-05 | Government Rates Summary  | 02-13 | Proposed Regulations Under Section 457   |
| 02-06 | IRS Releases 30-Year Rate and Current Liability Rates                                 | 02-14 | Government Rates Summary   |
| 02-07 | DOL Overhauls Delinquent Filer Program  | 02-15 | Money Purchase to Profit Sharing Merger/Conversion Does Not Trigger 100% Vesting       |
| 02-08 | IRS Says No More 5500s for Cafeteria Plans and Other Fringe Benefit Plans             |       |  |

If you need a particular ASPA ASAP, it can be downloaded from our Web site at <https://router.aspa.org>. From there, go to the "Members Only" section, and then to ASPA ASAPs.



## Message from the Conference of Consulting Actuaries and the American Academy of Actuaries



by Ken Hohman, Chair, EA Meeting Committee

The 2002 Enrolled Actuaries Meeting was held March 10-13 in Washington, DC. The Conference of Consulting Actuaries (CCA) and the American Academy of Actuaries (AAA) co-sponsored the event. Thank you to all those who made the meeting a success: the speakers who volunteered their time, the CCA staff that handled the countless logistical and organizational issues, and most importantly, those of you who attended.

Of the nearly 1,000 attendees, about one third returned the meeting survey. Most survey respondents indicated they liked the meeting location in Washington, but several suggested moving the meeting to other parts of the country (with one request for Hawaii). The desire to encourage sig-

nificant government participation and the size of the meeting restricts our location options; however, we will consider the viability of other locations for future meetings.

Our mission is to provide relevant information to Enrolled Actuaries in an understandable format and in a conducive setting. One of our primary goals is to allow EAs the opportunity to earn all their required continuing education credits by attending two EA meetings during any three year enrollment cycle – a lot of CE credit is packed into two and a half days!

We are hard at work planning the 2003 Enrolled Meeting, to be held March 17-19 in Washington, DC. We hope to see you there!

## 2002 BEST OF GREAT LAKES WORKSHOPS



**Thursday**  
**September 19, 2002**  
**Minneapolis, MN**

**Monday**  
**September 23, 2002**  
**Indianapolis, IN**

**Friday**  
**September 27, 2002**  
**Milwaukee, WI**

**Co-Sponsored by:** ASPA Internal Revenue Service, Great Lakes Area Tax Exempt and Government Entities (TE/GE)

### WORKSHOP OVERVIEW

In order to bring education to you on a local level, ASPA is teaming up with the IRS to present the 2002 Best of Great Lakes Workshops. These interactive workshops highlight the most popular topics from the highly successful 2002 Great Lakes Area Benefits Conference. Each session will address the most recent legislative changes and rulings associated with pension reform. The speakers are your colleagues from organizations in the area and also feature local and national IRS representatives. Attend and qualify for eight ASPA CE credits, as well as three core and five non-core JBEA credits.

### SESSION TOPICS

Topics covered will be:

- Secrets of a Successful EP Audit, Including an Update on Voluntary Compliance
- EGTRRA and GUST Amendments
- Determination Letter Update
- 401(k) Plan Design Post-EGTRRA
- DB Design Opportunities
- 401(k) Testing Issues
- Designing and Administering 457 Plans
- 403(b) Update

VISIT OUR WEB SITE AT [WWW.ASPA.ORG](http://WWW.ASPA.ORG)  
FOR ADDITIONAL INFORMATION!

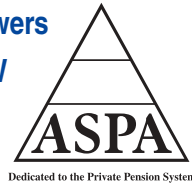




# 2002 ASPA Annual Conference

**OCTOBER 27-30  
WASHINGTON, DC**

Washington Hilton and Towers  
1919 Connecticut Ave., NW  
Washington, DC 20009  
(202) 483-3000



**Change is in the air. Let ASPA help you navigate through these changing times!**

Join more than 1,400 retirement plan professionals and learn about the latest changes and developments in the retirement plan industry at the **2002 ASPA Annual Conference**. The Conference is an excellent opportunity to exchange information on the newest trends and developments in the pension field and to take advantage of continuing education opportunities. Join us at our **new location, the Washington Hilton and Towers**, where you will find the entire conference under one roof!

Conference highlights include the Sunday **President's Welcome Reception** in the Exhibit Hall, featuring face-to-face time with exhibitors in a casual atmosphere, a lively Tuesday night reception featuring **The Sound Connection**, and a wide variety of timely and important **educational sessions** designed to not only keep you updated, but also to challenge you and keep you ahead of the curve in the rapidly changing pension field. The Conference promises to be **bigger and better** than ever and is not to be missed!

## WHO SHOULD ATTEND

The ASPA Annual Conference is attended by retirement plan professionals from across the country.

- Accountants
- Actuaries
- Administrators
- Attorneys
- Banking Professionals in Plan Administration
- Benefits Directors
- Consultants
- Employee Benefit Software Consultants
- Financial Planners
- Human Resource Personnel
- Insurance Company Employee Benefit Specialists
- Trust Officers

## BENEFITS OF ATTENDING

- More than 50 interactive workshop sessions on diverse, educational topics
- 20 hours of ASPA continuing education credit, and up to 21.5 JBEA credit hours for enrolled actuaries, can be earned
- CD-ROM of conference materials provided to each attendee
- Over 50 vendor displays in the exhibit hall
- Cassette tapes of each workshop available for sale on-site
- President's Welcome Reception on Sunday
- Special luncheon entertainment on Monday, October 28
- Gala Tuesday evening featuring music by **The Sound Connection**
- New location – all events under one roof!

Visit our Web site at [www.aspa.org](http://www.aspa.org)  
and register online!



# FUN-da-MENTALs

## Baby Contest Winner & Answers!

Congratulations to those who correctly identified all eight photos from May/June 2002 issue's "When I Grow Up, I Want to Be President (of ASPA, that is!)". A drawing took place July 15, and [Brian Cheney, CPC](#), was randomly picked as the winner of the ASPA Polo Shirt. The correct matches are:

- |                               |   |                                 |   |
|-------------------------------|---|---------------------------------|---|
| 1. Edward E. Burrows, MSPA    | C | 5. Howard M. Phillips, MSPA     | F |
| 2. Karen A. Jordan, CPC, QPA  | G | 6. Carol R. Sears, FSPA, CPC    | A |
| 3. George J. Taylor, MSPA     | E | 7. Richard D. Pearce, FSPA, CPC | H |
| 4. Curtis Hamilton, MSPA, CPC | B | 8. Ruth F. Frew, FSPA, CPC      | D |

SIDE FUN



"I think my stock portfolio in my 401(k) plan is a little TOO aggressive."

## Pension Poetry

There once was a consultant named Jack  
Whose records were somewhat "off-track".  
With distributions galore –  
And an audit in store –  
Jack left town and never "looked back"!

### A TPA's Prayer

As each day goes by,  
She looks up to the sky  
And gives thanks for the new plans she gets.  
As she leaves work each day,  
She continues to pray  
That on EGTRRA, the sun never sets!

## WORD SCRAMBLE

Unscramble these four puzzles – one letter to each space – to reveal four pension-related words. Answers will be posted on the eASPA portion of ASPA's Web site at <https://router.aspa.org>. Login, go to Members Only>Newsletter, and look near the bottom.

- GET RAT      ○ \_ ○ ○ \_ \_
- ROVER LOL    \_ ○ \_ \_ ○ \_ ○ \_
- HER FAT GRAND    \_ \_ \_ \_ \_ ○ \_ \_ ○ ○ \_
- DON CUT ME    ○ ○ ○ \_ \_ \_ \_ ○

BONUS: Arrange the circled letters to form the Mystery Answer as suggested by the cartoon.


### Mystery Answer:

He "○○○○○○○ ○○○ ○○○○."



Why the pension attorney was locked out of the meeting

QKA. Three letters that spell success.



KAREN TAYLOR, QKA  
SENIOR 401(k) CONSULTANT

2224 WALTHAM STREET  
ROCKVILLE, NEW YORK 14601-1942  
TEL: 516.434-0925 Fax: 516.434-0922  
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*Administrative Issues of Defined Contribution Plans Course*

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ADVANCING THE PROFESSION. ENHANCING THE PROFESSIONAL.

**Bulletin Board**

**EDUCATION**

- September 30: Early registration deadline for fall exams
- October 31: Final registration deadline for fall exams
- November 1: Registration deadline for fall weekend courses

**CONFERENCES**

- THREE BEST OF GREAT LAKES
- Sept 19: Minneapolis, MN
- Sept 23: Indianapolis, IN
- Sept 27: Milwaukee, WI
- Oct. 27-30: Annual Conference, Washington, DC

## Reach the Pinnacle of Success in 2003!

You asked for it! The 2002 event was so successful, we've planned one for 2003!

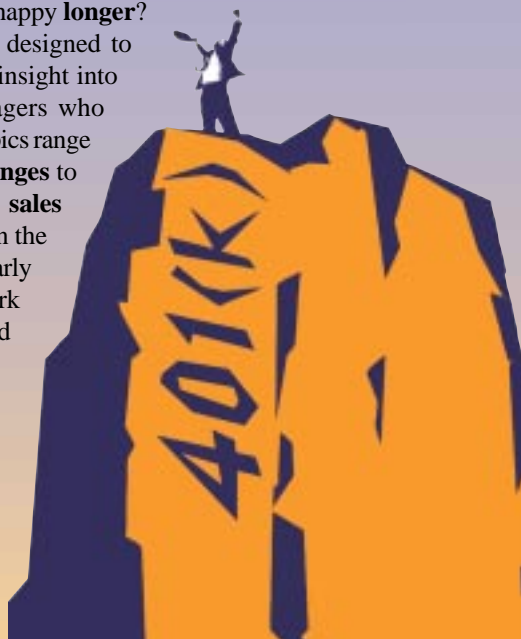
Do you actively sell, market, support, or influence the sale of 401(k) plans? Do you want to sell **more** plans? Do you want to design **better** plans? Do you want to keep your clients happy **longer**? The **401(k) Sales Summit** is designed to help the best get better! Gain insight into opportunities and meet managers who manage your clients' assets. Topics range from **trends** to **legislative changes** to **economic updates** to **proven sales techniques**, all from the best in the business. The 2002 Summit, nearly 600 strong, was a sellout, so mark your calendar for next year and get ready to reach for your best!

**401(k) Sales Summit**

**Feb. 27 - Mar. 1, 2003**

**The Westin Kierland Resort and Spa**

**Scottsdale, Arizona**



## CALENDAR OF EVENTS

### 2002

ASPA CE  
CREDIT

Jul 28-31	Summer Academy San Diego, CA	20
Aug 15	Webcast: TBD	2
Aug 27	Webcast: TBD – Timeless Topic Series	2
Sep 19	Best of Great Lakes, Minneapolis, MN	8
Sep 23	Best of Great Lakes, Indianapolis, IN	8
Sep 27	Best of Great Lakes, Milwaukee, WI	8
Sep 30	Early registration deadline for fall exams	
Oct 27-30	Annual Conference Washington, DC	20
Oct 31	Final registration deadline for fall exams	
Nov 1	Registration deadline for fall weekend courses	
Nov 1-30	C-1, C-2(DB), C-2(DC) fall exam window	*
Nov 9-10	Weekend courses, Chicago, IL	15
Nov 15	Postponement deadline for fall exams	
Dec 4	C-3, C-4, and A-4 exams	*
Dec 31	Deadline for 2002 edition exams for PA-1 (A&B)	**
Dec 31	Deadline for 2002 edition exams for Daily Valuation	***

### 2003

Jan 30-31	Los Angeles Benefits Conference Universal City, CA	16
Feb 26-Mar 1	401(k) Sales Summit Scottsdale, AZ	15
Jul 27-30	Summer Academy Irvine, CA	20
Oct 26-29	Annual Conference Washington, DC	20

- \* Exam candidates earn 20 hours of ASPA continuing education credit for passing exams, 15 hours of credit for failing an exam with a score of 5 or 6, and no credit for failing with a score lower than 5.
- \*\* PA-1A and B exams earn five hours of ASPA continuing education credits each for passing grades.
- \*\*\* Daily Valuation exams earn 10 hours of ASPA continuing education credits each for passing grade.

## DID YOU KNOW?

On Friday, June 21, 2002, the House voted, 308 to 70, to permanently extend the pension reform provisions of EGTRRA. The Senate is not expected to take up the legislation this year. The strong vote made it clear to Congress and the Administration that eliminating the sunset on pension reform is a priority for Americans. Thank you to the more than 1,350 ASPA members who contacted their representative to ask for support of H.R. 4931.