

PENSION PLANS VS. PROFIT SHARING PLANS

Historically, a retirement plan paid benefits to retired employees until death. Some retirement plans continued the payment of retirement benefits even after the employee's death until the surviving spouse's death. The employee usually did not contribute to the plan, bear any responsibility for investment decisions, or participate in the management of the plan. The employee was simply promised a guaranteed benefit at retirement. Over the past 20 years, however, the number of these types of plans (noncontributory defined benefit plans) has decreased substantially as some employers have not fulfilled the promise of paying the retirement benefit and as employees have begun changing jobs frequently throughout their work life. In fact, between 1985 and 2007 the number of defined benefit pension plans decreased from 112,000 to less than 30,000. Changing jobs even a few times in a lifetime could result in significantly limiting the growth of retirement benefits payable from these types of plans, which generally require many years of continuous service with the same employer to attain the expected retirement benefit.



Key Concepts

Underline/highlight the answers to these questions as you read:

1. Explain the reason for the change from pension plans to profit sharing plans.
2. From a global perspective, what are the differences between defined benefit and defined contribution plans?

With the decline of these “guaranteed” type plans, commonly known as defined benefit pension plans, came the addition of profit sharing plans. Under profit sharing plans, plan participants usually become responsible for the management of the plan's assets (investment decisions) and sometimes even responsible for personal contributions to the plan (contributory plans). The profit sharing plan also changed the employer's funding requirement and began to permit, subject to limitations, in-service withdrawals from qualified plans and investment in the employer's securities. Exhibit 3.2 contrasts the basic differences between pension and profit sharing plans, which are discussed further in Chapters 3, 4, 5, and 6.

THE DIFFERENCES BETWEEN PENSION PLANS AND PROFIT-SHARING PLANS

EXHIBIT 3.2

CHARACTERISTIC	PENSION PLAN	PROFIT-SHARING PLAN
Legal promise of the plan	Paying a pension at retirement	Deferral of compensation and taxation
Are in-service withdrawals permitted?	No*	Yes (after two years) if plan document permits
Is the plan subject to mandatory funding standards?	Yes**	No
Percent of plan assets available to be invested in employer securities	10%	Up to 100%
Must the plan provide qualified joint and survivor annuity and a qualified pre-survivor annuity?	Yes	No

* Under the Pension Protection Act of 2006, defined benefit pension plans can provide for in-service distributions to participants who are age 62 or older.

** For plan years beginning in 2008, the funding rules under IRC Section 412 have been amended by the Pension Protection Act of 2006.

DEFINED BENEFIT VS. DEFINED CONTRIBUTION

As illustrated in Exhibit 3.1, qualified plans can be further divided into defined benefit plans and defined contribution plans. All defined benefit plans are pension plans, but defined contribution plans can be either pension plans or profit sharing plans. The primary differences between the categorization of the plans as defined benefit or defined contribution are the assumption of the investment risk, the allocation of plan forfeitures, coverage under the Pension Benefit Guaranty Corporation (PBGC), the calculation of the accrued benefit or account balance, and the availability to grant credit for prior service. Each of these differences is illustrated in Exhibit 3.3 and discussed in detail below.

Under the Pension Protection Act of 2006, defined contribution plans that hold publicly traded securities of the employer must allow plan participants to diversify their pre-tax deferrals, after-tax contributions, and employer contributions that have been invested in employer securities. The defined contribution plan must offer a choice of at least three investment options, other than employer securities, each of which must be diversified and have materially different risk and return characteristics (e.g., a money market fund, a bond fund, and a stock fund). All plan participants must be allowed to diversify the investment of their elective deferrals and after-tax contributions. In addition, plan participants with three or more years of service must be allowed to diversify the investment of employer contributions made on their behalf. This new investment diversification requirement is being phased in over three years, beginning in January 2007.¹ These requirements do not, however, apply to an ESOP if there are no contributions to the ESOP that are subject to the 401(k) nondiscrimination tests and the ESOP is a separate plan from any other qualified retirement plan.² As detailed in Chapter 6, ESOPs already require diversification under certain circumstances.



Quick Quiz 3.1

Highlight the answer to these questions:

1. Pension plans are currently much more common than profit sharing plans because individual workers stay longer with one employer and, therefore, can receive more insurance.
 - a. True
 - b. False
2. All pension plans are defined benefit plans.
 - a. True
 - b. False

False, False.

1. Under the transition rules, 33% of employer contributions acquired before 2007 must be diversified in the first year during which the new diversification requirements apply to the plan, 66% must be diversified in the second year, and 100% must be diversified in the third year. The applicable percentage applies separately to each class of employer security in an applicable individual's account. The transition rule does not apply to plan participants who have three years of service and who have attained age 55 by the beginning of the first plan year beginning after December 31, 2005.
2. Pension Protection Act of 2006, Section 901.

CHARACTERISTICS	DEFINED BENEFIT	DEFINED CONTRIBUTION
What is the Annual Contribution Limit?	The greater of (1) the sum of the plan's funding target, target normal cost, and a cushion amount, or (2) the minimum required contribution for the plan year.*	25% of covered compensation
Who assumes the investment risk?	Employer	Employee
How are forfeitures allocated?	Reduce plan costs	Reduce plan costs or allocate to other participants
Is the plan subject to Pension Benefit Guaranty Corporation (PBGC) coverage?	Yes (except professional firms with less than 25 employees)**	No
Does the plan have separate investment accounts?	No, they are commingled	Yes, they are usually separate
Can credit be given for prior service for the purpose of benefits?	Yes	No

* This is the annual contribution limit for defined benefit plans beginning in 2008 as a result of the PPA 2006. See Chapter 4 for more detail.

** ERISA Section 4021, 29 U.S.C. Section 1321.

Pension plans can be either defined benefit or defined contribution, while all profit sharing plans are defined contribution plans. The differences among various pension plans are more fully discussed in Chapter 4.

ADVANTAGES OF QUALIFIED PLANS

The U.S. government offers several income tax advantages to both the employers and the employees who elect to maintain and participate in a qualified retirement plan. The plan must be designed and adopted in a fashion “approved” by the government, and the plan must meet certain requirements enumerated in IRC Section 401(a). Most of these requirements are established to ensure that a qualified plan is designed to protect and benefit rank-and-file employees. As distinguished from the senior executives and owners, the rank-and-file are employees such as the factory workers, counter clerks, mechanics, staff accountants, associate attorneys, etc. The government’s primary motivation for the IRC requirements of Section 401(a) is to prevent employers from adopting qualified retirement plans that solely benefit executives and owners of the business. When a plan meets the qualification requirements and is considered a “qualified plan” under section 401(a), the employer and the plan participants will benefit from income tax deferrals, payroll tax savings, and federally provided creditor asset protection. Each of these advantages is discussed below. The trade-offs for the tax advantages of qualified plans are the cost of the plan (both the operational expenses and contributions) and compliance, including vesting, funding, eligibility, non-discrimination testing, IRS reporting, and employee disclosure.



Key Concepts

Underline/highlight the answers to these questions as you read:

1. Explain the matching principle between expenses and income and its application to qualified retirement plans.
2. How does the imposition of payroll taxes on contributions impact qualified retirement plans?
3. How are the investment earnings within a qualified plan taxed?

TAXATION OF CONTRIBUTIONS TO PLANS

Income Tax

In almost all cases in the field of income taxation, when one individual or entity has a tax deductible expense, another entity or individual will have taxable income. This concept is referred to as the matching principle and is prevalent throughout the IRC. Consider an office supply store that sells office supplies to a publishing company for \$600. The office supply store has revenue, or taxable income, of \$600 (subject to its costs), and the publishing company has a tax deductible expense of \$600. This matching of income and expense especially holds true when an employer pays employees’ wages, salaries, or bonuses for performance of services. The employees have taxable income and the employer has a tax deduction for the same amount. This is referred to as the matching principle because of the matching of income and deductions.

EXAMPLE 3.1

Carla works 40 hours a week at Best Feed Supply for \$6.00 per hour. In addition, if Carla sells more than 200 pounds of feed during the week, she receives a bonus of \$200. In a week that Carla works 40 hours and sells 300 pounds of feed, Carla has taxable income of \$440 ($(\$6.00 \times 40) + \200), and Best Feed Supply has a tax deductible wage expense of \$440.



Quick Quiz 3.2

Highlight the answer to these questions:

1. Contributions to qualified retirement plans follow the IRC matching principle of the inclusion of income and the deduction of the expense at the same time.
 - a. True
 - b. False
2. The employer and employee are each responsible for their share of payroll taxes on the employee's compensation.
 - a. True
 - b. False
3. Distributions from a qualified retirement plan are generally taxable as ordinary income.
 - a. True
 - b. False

False, True, True.

Contributions by employers to qualified plans, however, do not have to comply with this “matching” of taxable income with tax deductible expense. An employer may deduct an amount up to 25 percent (or as actuarially determined for defined benefit plans) of the total covered compensation paid to its employees as a contribution to a qualified plan. The employer will immediately have a deductible expense for income tax purposes, but the employee will not have taxable income related to the plan contribution until the funds are later distributed from the plan. This timing “mismatch” of income and expense is provided for in the IRC as a governmental incentive to entice employers to establish and fund qualified retirement plans for their employees. This mismatch is significant as it reduces the current tax revenue for the U.S. Treasury and defers the taxation of the funds until the participant receives a distribution from the qualified plan, generally during retirement years. This tax deferral is certainly a benefit to the participant and to society as it encourages the accumulation of assets specifically for retirement. As demographics have changed over the last several decades and life expectancies have increased, this tax deferral has become even more important. However, because of this tax benefit

and its potential abuse, the government has established, and continues to establish, certain limits for funding and deducting contributions to qualified retirement plans to minimize the reduction of tax revenue and to ensure that a substantial portion of the benefits are available to rank-and-file employees.

Computer Connection, a C Corporation, employs fifteen service technicians, each earning \$40,000 per year. The sole-shareholder of Computer Connection, Jason, who is also a service technician and employee, pays himself \$120,000 per year. For 2010, Computer Connection contributed 20 percent of each employee's salary to a qualified profit sharing plan. For 2010, Computer Connection will have a deductible business expense for contributions to the profit sharing plan of \$144,000 $((15 \times \$40,000) \times 20\% + 20\% \times (\$120,000))$. Neither the employees nor Jason will have any taxable income related to the contribution to the qualified profit sharing plan, but any distributions from the plan will be taxable as ordinary income (and may be subject to penalties) to the recipients at the time of distribution. However,

EXAMPLE 3.2

neither the contributions nor the distributions will ever be subject to payroll tax.

Payroll Taxes

In addition to income taxes, an employee who receives compensation for services rendered to an employer also incurs **payroll taxes** equal to 6.2 percent for Old Age Survivor and Disability Insurance (OASDI) on compensation up to \$106,800 for 2010 and 1.45 percent for Medicare tax on 100 percent of the employee's compensation. The employer is also required to match any payroll taxes paid by the employee, creating a combined total payroll tax of 12.4 percent for OASDI up to \$106,800 and 2.9 percent for Medicare (100 percent of compensation).

However, when the employer makes a contribution to a qualified retirement plan on behalf of its employees, the employer's contribution is not subject to payroll tax even though the contribution was on account of services rendered. This payroll tax savings acts once again to entice employers to fund qualified retirement plans and to view the combination of a qualified retirement plan and an employee's salary as part of an overall compensation package. Since the employee is not subject to payroll taxes on an employer's contribution to a qualified retirement plan either, a total savings of up to 15.3 percent (12.4 percent OASDI and 2.9 percent Medicare tax) on the contribution may be realized. In Example 3.2, the alternative would have been to pay the \$144,000 to the employees as additional salary instead of making the contribution to the qualified retirement plan. In that case, both the employer and the employee would have paid combined payroll taxes up to 15.3 percent on most of the \$144,000.

EXAMPLE 3.3

If Butcher Block paid its two employees \$50,000 each in wages and did not contribute to a qualified profit sharing plan for the year, Butcher Block would incur payroll taxes relating to the wages of \$7,650 ($\$100,000 \times 7.65\%$). Butcher Block's employees would have also incurred payroll taxes of \$7,650 for total payroll taxes of \$15,300.

EXAMPLE 3.4

In comparison, if Butcher Block would have paid its 2 employees \$45,000 each in wages and contributed \$5,000 to a qualified profit sharing plan for each employee, Butcher Block would incur total payroll taxes relating to the wages and profit sharing plan contribution of \$6,885 ($\$90,000 \times 7.65\%$). In this case, Butcher Block's employees would also only incur \$6,885 of payroll taxes for a total of \$13,770 of payroll taxes. The combined payroll tax savings would be \$1,530 ($\$15,300 - \$13,770$); however, Butcher Block's employees received total payments for services rendered equal to \$50,000, \$45,000 as cash compensation and \$5,000 in contributions to a qualified profit sharing plan. Note that even at the time distributions are taken from the qualified profit sharing plan, the distributions will not be subjected to any payroll taxes. The \$1,530 of payroll tax is permanently avoided.