



YOUR MONEY:

Key Considerations Regarding Money Purchase and Profit Sharing Plans

Money purchase pension plans may be old-fashioned, but they aren't necessarily obsolete.

February 2008, by Guy McPhail

Today, more than 60 percent of small business owners don't offer any retirement plan for their employees and 47 percent are unsure about how they plan to handle their own retirement, according to a survey by Harris Interactive for ShareBuilder, an online brokerage company. Planning on working until you drop or relying solely on the sale of a business is a dangerous tactic. If you don't have a reliable retirement plan in place or one that's outdated, it's time to re-evaluate your retirement strategy.

In previous articles I addressed the more common types of pension plans available to small business owners and examined their individual merits. Most companies have moved to these newer retirement plan options. However, I have found a few small business owners that still have an older money purchase plan in place. Some business owners aren't familiar with tax law changes related to pensions (a clear downside to neglecting ongoing financial business planning). Other business owners simply haven't taken the time to re-evaluate their pension plan options.

In what now seems like the distant past (before 2002), a money purchase plan offered the highest contribution percentage (limit) of any defined contribution plan type, including profit sharing, 401(k)s, SEPs and others. With a money purchase plan a fixed percentage contribution was required annually; otherwise, "underfunding" penalties were incurred. For example, let's say that your money purchase plan was designed for 10 percent of each eligible employee's annual pay. You, as the employer, would need to contribute 10 of each eligible employee's pay to his or her pension account. Most small businesses looked at this as an annual liability. In order to maximize the contribution and minimize the liability of the small business, the "paired plan" concept was invented.

The pros and cons of the paired plan

A paired plan combined a 15 percent discretionary profit sharing plan contribution with a 10 percent required money purchase plan contribution. The small business then had some flexibility. In a profitable year, the maximum 25 percent (15 percent + 10 percent) could be contributed for each employee. (For this example, I'm intentionally assuming there was no vesting schedule and that all employees were fully vested.) In a less profitable year, the company could change its discretionary profit sharing contribution to 0 percent, and was required to contribute only the 10 percent money purchase amount. In this situation, the Keogh Plan allows but does not require annual contributions of up to 25 percent of earned income.

This paired plan method created flexibility with limited liability. There were drawbacks, however. The two plans cost the business owner more to operate because they require separate maintenance, including necessary employee disclosure and additional government reporting.

After 2002, when the government increased the maximum profit sharing contribution to 25 percent, the paired plan strategy lost much of its appeal. With the tax law changes eliminating the need to maintain two plans, the money purchase plan became much less popular. The flexibility enjoyed by companies with paired plans is now available with the profit sharing plan because the total contribution percentage (limit) is discretionary. For 2008, the 25 percent contribution is capped at \$46,000. In fact, the increase in the profit sharing contribution may now allow employers who still have money purchase plans to terminate those plans and eliminate the associated liability.

Money purchase plans are attractive to some employees

If you still have a money purchase plan you may want to consider keeping it in place. Say you are a small business owner who has reliable profits from year to year and you want to attract new employees from large corporations. The prospective employee may be used to receiving large benefits from a big corporation. Having a money purchase plan could be a strong selling point for attracting job candidates who are used to having a company-contributed type of pension plan and enjoy the retirement security it offers. They might find it quite appealing if you guarantee a fixed employer contribution. The plan costs are also tax deductible for the employer up to 25 percent of total payroll compensation (subject to individual limitations), and plan earnings are tax deferred.

Plan conversion considerations

If you have a money purchase plan and want to convert to a plan that offers you more flexibility, you must handle the conversion properly to avoid unwanted tax consequences. As with any pension plan change, you should discuss this with your financial planner (who should be a CPA) and with a pension plan administrator or attorney. Also, remember that plan termination or merger requires distinct government reporting.

The rules regarding employer-sponsored retirement plans are complex and easy to misinterpret. Even after you've selected a specific type of plan there's frequently a number of options in terms of how the plan is designed and operated. These options can have a significant impact on the number of employees that have to be covered, the amount of contributions that have to be made, and the way those contributions are allocated.

I can't stress enough the importance of having a qualified financial advisor to run the numbers and help determine the best pension plan for your company, whether it be a defined contribution plan, defined benefit plan or combination of both. In fact, without running the numbers every two or three years you could easily miss opportunities to save more money. So, if you haven't reviewed your pension plan in the last few years I recommended you do so. I find that there are many creative ways for you, the small business owner, to create more wealth with proper pension planning, and the rules governing them change frequently.

If you think that you may be paying more than need be in taxes and feel that you aren't putting enough money away for retirement, having a strategic pension planning session with your financial planner should be added to your "To Do" list.

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