

Qualified retirement plans – The Basics

Excerpted From IRS Form 560

Qualified plans offer favorable tax treatment, including tax deferral and availability of forward averaging, but they demand compliance with nondiscrimination requirements. Favorable tax treatment is the most distinct contrast between a qualified and nonqualified plan, and there are several choices of qualified plans, each offering different features. In selecting a qualified plan for your company, begin by choosing between defined contribution or defined benefit according to the descriptions below.

Qualified retirement plans set up by self-employed individuals are sometimes called Keogh or H.R.10 plans. A sole proprietor or a partnership can set up a qualified plan. A common-law employee or a partner cannot set up a qualified plan. The plans described here can also be set up and maintained by employers that are corporations. All the rules discussed here apply to corporations except where specifically limited to the self-employed.

The plan must be for the exclusive benefit of employees or their beneficiaries. A qualified plan can include coverage for a self-employed individual.

As an employer, you can usually deduct, subject to limits, contributions you make to a qualified plan, including those made for your own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan.

There are two basic kinds of qualified plans—defined contribution plans and defined benefit plans—and different rules apply to each. You can have more than one qualified plan, but your contributions to all the plans must not total more than the overall limits.

Defined Contribution Plan

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Benefits are also affected by any income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan

A profit-sharing plan is a plan for sharing your business profits with your employees. However, you do not have to make contributions out of net profits to have a profit-sharing plan.

The plan does not need to provide a definite formula for figuring the profits to be shared. But, if there is no formula, there must be systematic and substantial contributions.

The plan must provide a definite formula for allocating the contribution among the participants and for distributing the accumulated funds to the employees after they reach a certain age, after a fixed number of years, or upon certain other occurrences.

In general, you can be more flexible in making contributions to a profit-sharing plan than to a money purchase pension plan (discussed next) or a defined benefit plan (discussed later).

Forfeitures under a profit-sharing plan can be allocated to the accounts of remaining participants in a nondiscriminatory way or they can be used to reduce your contributions.

Money purchase pension plan

Contributions to a money purchase pension plan are fixed and are not based on your business profits. For example, if the plan requires that contributions be 10% of the participants' compensation without regard to whether you have profits (or the self-employed person has earned income), the plan is a money purchase pension plan. This applies even though the compensation of a self-employed individual as a participant is based on earned income derived from business profits.

Contributions

For 2004, a defined contribution plan's annual contributions and other additions (excluding earnings) to the account of a participant cannot exceed the lesser of the following amounts.

1. 100% of the participant's compensation.
2. \$41,000 (\$42,000 for 2005).

Catch-up contributions (discussed later under *Limit on Elective Deferrals*) are not subject to the above limit.

Defined Benefit Plan

A defined benefit plan is any qualified plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Generally, you will need continuing professional help to have a defined benefit plan.

Forfeitures under a defined benefit plan cannot be used to increase the benefits any employee would otherwise receive under the plan. Forfeitures must be used instead to reduce employer contributions.

For 2004, the annual benefit for a participant under a defined benefit plan cannot exceed the lesser of the following amounts.

1. 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.
2. \$165,000 (\$170,000 for 2005).