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White Paper

Money Purchase Pension Plan

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Money Purchase Pension Plan

What is it?

A money purchase pension plan is a type of qualified defined contribution plan in which you, the employer, make annual required contributions to the accounts of participating employees. The amount of your employer contributions is generally determined based on a preset formula that cannot be changed without amending the plan, even if your business profits are low or nonexistent.

A money purchase pension plan is very similar to a profit-sharing plan. In fact, the two plans are so similar that each type of plan is specifically required to identify itself as either a "money purchase pension plan" or a "profit-sharing plan" in the plan document. The most significant distinction between the two types of plans is the money purchase pension plan's mandatory fixed contribution formula (in contrast, contributions to a profit-sharing plan are generally discretionary).

> **Tip:** Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("2001 Tax Act"), limits on the tax-deductibility of employer contributions to retirement plans favored money purchase pension plans over profit-sharing plans (employers could deduct up to 25 percent of total compensation for contributions made to a money purchase pension plan, but only up to 15 percent of total compensation for contributions made to a profit-sharing plan). The 2001 Tax Act, however, increased the limitation on tax-deductible contributions to profit-sharing plans to 25 percent. With this change, most employers will find it to their advantage to adopt the more flexible profit-sharing plan rather than a money purchase pension plan.

> **Caution:** From an employee perspective, however, a money purchase pension plan's mandatory fixed annual contribution is generally seen as an advantage.

> **Tip:** On August 17, 2006, President Bush signed the Pension Protection Act of 2006 into law. The law attempts to shore up the nation's pension system by making sweeping changes to the funding rules that apply to defined benefit plans. The Act also protects workers' retirement benefits and encourages savings by making numerous changes to the rules governing defined contribution plans. Finally, the Act makes permanent the IRA and retirement plan provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which had been scheduled to expire at the end of 2010. Many of the provisions of the Act are discussed in this article. For a fuller discussion, see The Pension Protection Act of 2006.

Contributions

Contribution formulas

Typically, annual employer contributions to a money purchase pension plan are based on a flat percentage of participating employees' pretax compensation. In most cases, individual participants receive an allocation that mirrors the percentage of overall compensation being contributed. For example, a plan might specify that annual contributions to each participant's account will be made in an amount equal to 15 percent of each participant's compensation.

This does not have to be the case, however. A money purchase pension plan, like other defined contribution plans, can allocate additional contributions to higher-paid employees by incorporating permitted disparity in its contribution formula (this is often referred to as "integrating with Social Security").

Although less common, contributions to money purchase pension plans can also utilize a formula that is based on years (or units) of service. Like profit-sharing plans, money purchase pension plans can utilize other contribution formulas designed to pass nondiscrimination guidelines, including formulas that meet nondiscrimination guidelines based on "cross-testing" rules.

> **Tip:** In calculating eligible compensation under the plan, the maximum compensation that can be considered for any single individual is $230,000 for 2008 ($225,000 for 2007).

> **Tip:** The maximum annual tax-deductible contribution that you, the employer, are allowed to make cannot exceed 25 percent of the total compensation of all employees covered under the plan. (Special rules apply if you also maintain a defined benefit pension plan or another defined contribution plan.)

Zero percent contribution formulas

A money purchase pension plan may have a zero percent compensation contribution formula. In such a case the employer is not required to make any contributions. A "zero percent" money purchase pension plan might be established solely for the purpose of receiving rollover contributions or transfers from other qualified plans. Consult a retirement plan specialist regarding the requirements for a zero percent plan.

> **Tip:** A profit-sharing plan would not be appropriate to establish for such a purpose. Even though contributions to profit-sharing plans can be made on a discretionary basis, contributions must be made on a "substantial and recurring" basis.

Annual contributions are required

Once a formula for determining annual employer contributions has been decided on and set forth in the plan document, you are required to make the specified contribution to participants' accounts every year

unless you amend the plan. This is generally the case regardless of whether your business profits have met expectations, or even if there have been no profits at all. This is in contrast to some other types of plans (e.g., a profit-sharing plan), which may give the employer some discretion in determining the level of annual contributions.

What types of employers can adopt a money purchase pension plan?

Virtually any employer can establish a money purchase pension plan. However, this type of plan is not necessarily appropriate for all employers. Given that these plans require specified contributions each year, they are generally most suitable for employers that have consistent cash flow and who do not need to have discretion over the level of annual contributions.

Prior to the 2001 Tax Act, money purchase pension plans appealed to employers who wanted to maximize tax-deductible contributions to a defined contribution plan. At the time, employers could deduct up to 25 percent of total compensation for contributions made to a money purchase pension plan, but only up to 15 percent of total compensation for contributions made to a profit-sharing plan. The 2001 Tax Act, however, increased the limitation on tax-deductible contributions to profit-sharing plans to 25 percent. With this change, most employers will find it to their advantage to adopt the more flexible profit-sharing plan rather than a money purchase pension plan.

> **Tip:** Nevertheless, the fixed contribution obligation that is part of a money purchase pension plan may appeal to employees, and an employer might consider adopting a money purchase pension plan for that reason.

> **Tip:** If you are self-employed, the specific type of money purchase plan that you may adopt is sometimes called a Keogh plan.

Tax benefits of money purchase pension plans

Tax considerations for employees

When you contribute to a money purchase pension plan on behalf of your participating employees, those employer contributions are not currently included in the employees' taxable income. The employees will not pay income tax on the money contributed to their plan accounts as long as that money remains in the plan. Similarly, funds held in the money purchase pension plan grow on a tax-deferred basis. This means that any earnings from plan investments are not included in the employees' taxable income as long as they remain in the plan. Depending on investment performance, this creates the potential for more rapid growth (and a larger retirement fund) than if the funds were invested in identical investments outside the plan.

Of course, when a participating employee begins to receive distributions from the money purchase pension plan during retirement, he or she will be subject to federal (and possibly state) income tax on both plan contributions and related investment earnings. However, the rate at which a plan distribution

is taxed depends on the employee's federal income tax bracket in the year of receipt, and many employees may be in a lower tax bracket by the time they begin receiving distributions. If an employee receives a distribution from the plan prior to age 59 1/2, he or she may be subject to a federal 10 percent premature distribution penalty tax (unless an exception applies), in addition to ordinary income tax.

Tip: If a participating employee takes a lump-sum distribution from the money purchase pension plan, he or she may be eligible for special tax treatment. For more information, see Lump-sum Distributions from Employer-sponsored Retirement Plans.

Tax deduction for employer

As an employer maintaining a money purchase pension plan, your contributions to the plan are generally tax deductible on your business's federal income return for the year in which you make them.

The maximum tax-deductible employer contribution that you are allowed to make to a money purchase pension plan is 25 percent of the total compensation of all employees covered under the plan. Any contribution in excess of this limit is not tax deductible, and may also be subject to a 10 percent federal penalty. For purposes of calculating your maximum tax-deductible contribution, the maximum compensation base that can be used for any single plan participant is $230,000 for 2008 ($225,000 for 2007).

Caution: For 2008, annual additions by an employer and employee combined to the employee's plan account (or accounts if the employer offers more than one type of defined contribution plan) are limited to the lesser of $46,000 ($45,000 for 2007) or 100 percent of the employee's pretax compensation. Annual additions include total contributions and any reallocated forfeitures from other plan participants' accounts. You must treat all qualified defined contribution plans you maintain as a single plan for purposes of calculating the annual additions limit.

Other advantages of money purchase pension plans

A money purchase pension plan may allow participant loans

As with a profit-sharing plan, you can include a provision in your money purchase pension plan to allow participating employees to take loans from the plan. (You are not required to permit loans, however.) Typically, a loan provision will enable participants to borrow a portion of their vested plan benefits. In contrast to a plan distribution, a plan loan will generally not be taxable or subject to the early withdrawal penalty tax (assuming that the loan is repaid on time and all other requirements are met). As a result, a loan provision can be an attractive feature to allow participants access to their plan funds.

Caution: Plan loans must not be made available in a discriminatory manner. That is, loans must not be made available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to other employees. In addition, the loans must bear a

reasonable rate of interest and must be adequately secured. (In most cases, a loan is secured by the participant's vested plan benefits.) A loan must be repaid in regular installments within five years to avoid being treated as a taxable distribution (except for loans used to purchase a principal residence).

Caution: In the past, plan loans generally could not be made to an "owner-employee" (a sole proprietor or a more than 10 percent partner in an unincorporated business), or to an S corporation employee who was a more than 5 percent shareholder in the corporation. However, the 2001 Tax Act allows plans to incorporate language to provide for loans to subchapter S shareholders, partners in partnerships, and sole proprietors.

A money purchase pension plan may be "integrated" with Social Security

A money purchase pension plan, like other defined contribution plans, can allocate additional contributions to higher-paid employees by incorporating permitted disparity in its contribution formula (this is often referred to as "integrating with Social Security").

Technical Note: Despite the non-discrimination requirements that generally govern qualified retirement plans, the benefits provided by a qualified plan and those provided by Social Security are viewed to some extent as one retirement program. Because Social Security benefits for lower-paid employees represent a greater percentage of salary than for higher-paid employees, a qualified plan is allowed to favor higher-paid employees within specified limits. This is generally accomplished by having one allocation percentage for the portion of a participant's compensation below the Social Security taxable wage base, and a separate allocation percentage for any portion of a participant's compensation that exceeds the Social Security taxable wage base. Consult a retirement plan specialist for more information.

Disadvantages of money purchase pension plans

Employer must make mandatory annual contributions

As discussed, if you have a money purchase pension plan, you are required to make annual contributions to each participating employee's account, according to the plan's contribution formula. For example, if the plan formula provides that each participant is to receive an annual contribution in the amount of 10 percent of the participant's compensation, this is the amount that the employer must contribute every year unless the plan is amended.

If you are unable to meet your funding obligation in any year, you may be subject to penalties. By contrast, there are generally no unfavorable consequences for a company if it fails to contribute to a profit-sharing plan in a given year.

A money purchase pension is subject to detailed requirements

Like all defined contribution plans, a money purchase pension plan is subject to strict non-discrimination requirements under the Internal Revenue Code (IRC). Basically, this means that a money purchase pension plan cannot provide more favorable benefits or contributions for highly compensated employees than for non-highly compensated employees. An example of a plan that might discriminate would be one that provides a contribution equal to 25 percent of compensation for high-paid executives, but only 10 percent for all other employees. To ensure that this does not happen, your money purchase pension plan is generally required to undergo some form of annual non-discrimination testing. Consult a retirement plans specialist for details regarding the testing requirements.

A money purchase pension plan is also subject to federal "top-heavy" requirements. A money purchase pension plan is considered to be "top-heavy" if more than 60 percent of the account balances in the plan belong to the "key employees." (Generally, the key employees are the owners and/or company officers.) If your plan is top-heavy, you generally must make a minimum annual contribution of 3 percent of compensation to the accounts of all non-key employees. In addition, the plan must provide a more rapid vesting schedule than would otherwise be allowed.

> **Caution:** The Pension Protection Act applies this faster top-heavy vesting schedule to all employer money purchase pension plan contributions, whether or not the plan is top-heavy, generally effective for contributions made for plan years beginning after 2006. A later effective date applies to certain collectively bargained plans. See "When do employees have part or full ownership of the funds in their accounts?" in the Questions and Answers below.

Finally, a money purchase pension plan is subject to the federal reporting, disclosure, and other requirements that apply to most qualified plans under the Employee Retirement Income Security Act of 1974 (ERISA) and the IRC.

> **Tip:** ERISA doesn't apply to governmental and most church retirement plans, plans maintained solely for the benefit of non-employees (for example, company directors), plans that cover only partners (and their spouses) and plans that cover only a sole proprietor (and his or her spouse).

A money purchase pension plan can only allow employee contributions on an after-tax basis

Your participating employees cannot choose to defer a portion of their pretax compensation to a money purchase pension plan. Unlike a profit-sharing plan, money purchase pension plans are not permitted to include a 401(k) arrangement. With a money purchase pension plan, you can permit your employees to contribute to the plan on an after-tax basis only. In other words, income taxes would need to be withheld from an employee's salary before his or her contributions could be allocated to the plan. (However, once invested in the plan, the employee contributions would grow tax deferred just like your employer contributions.)

A money purchase pension plan is subject to strict distribution rules

In general, a pension plan, including a money purchase pension plan, can't pay benefits to a participant until the participant separates from service, becomes disabled, retires, or dies. In-service distributions are generally permitted only after an employee reaches the plan's normal retirement age (typically age 65).

> **Tip:** If the plan allows employee after-tax contributions, the plan can let employees withdraw those dollars, and any accumulated earnings, at any time.

> **Tip:** The Pension Protection Act of 2006 encourages "phased retirement" programs by permitting the distribution of pension benefits to employees who have attained age 62, but haven't yet separated from service or reached the plan's normal retirement age. The IRS has also issued proposed regulations that allow plans to make phased retirement payments in certain limited circumstances.

How to set up a money purchase pension plan

Have a plan developed for your business

Due to the nature of the rules governing qualified retirement plans, you will most likely need a retirement plan specialist to develop a money purchase pension plan that meets legal requirements, as well as the needs of your business. You will need to do the following:

- Determine the plan features most appropriate for your business--Carefully review your business, looking at factors such as your cash flow and profits, your desired tax deduction, how much you and your employees will benefit from the plan, and facts about your employee population (including years of service, ages, salaries, and turnover rate). This will assist you in determining appropriate plan features, including investment vehicles, contribution levels, and employee eligibility requirements.
- Choose the plan trustee--The assets of the money purchase pension plan must be held in a trust by a trustee. The trustee has overall responsibility for managing and controlling the plan assets, preparing the trust account statements, maintaining a checking account, retaining records of contributions and distributions, filing tax reports with the IRS, and withholding appropriate taxes. The plan trustee can be you or a third party, such as a bank.
- Choose the plan administrator--Administering the money purchase pension plan involves many duties, including determining who is eligible to participate in the plan, determining the amount of benefits and when they must be paid, and complying with reporting and disclosure requirements. The plan administrator may also be responsible for investing plan assets, and/or providing informational and required investment educational services to plan participants. The employer is legally permitted to handle these responsibilities in-house, but plan sponsors often hire a third-party firm to assist with the duties of plan administration.

Submit the plan to the IRS for its approval

Once a plan is developed, if it is not a prototype plan previously approved by the IRS, the plan should be submitted to the IRS for approval. As there are a number of formal requirements that must be met (for example, you must provide a formal notice to employees), a retirement plan specialist should assist you with this task. Submission of the plan to the IRS is not a legal requirement, but it is highly recommended. The IRS will carefully review the plan and make sure that it meets all of the applicable legal requirements. If the plan meets all requirements, the IRS will issue a favorable "determination letter." Otherwise, the IRS will issue an adverse determination letter indicating the deficiencies in the plan that must be corrected.

Adopt the plan during the year for which it is to become effective

You must officially adopt your plan during the year for which it is to become effective, so plan ahead and allow enough time to set up your plan before your company's year end. A corporation generally adopts a money purchase pension plan or other retirement plan by a formal action of the corporation's board of directors. An unincorporated business should adopt a written resolution in a form similar to a corporate resolution.

Provide copies of the summary plan description (SPD) to all eligible employees

Federal law requires you to provide a copy of the summary plan description (SPD) to all eligible employees within 120 days after your money purchase pension plan is adopted. A SPD is a booklet that describes the plan's provisions and the participants' benefits, rights, and obligations in simple language. On an ongoing basis you must provide new participants with a copy of the SPD within 90 days after they become participants. You must also provide employees (and in some cases former employees and beneficiaries) with summaries of material modifications to the plan. In most cases you can provide these documents electronically (for example, through email or via your company's intranet site).

File the appropriate annual report with the IRS

Each employer that maintains a qualified retirement plan is generally required to file an annual report. The annual report is commonly referred to as the Form 5500 series return/report. You must file the appropriate Form 5500 series return/report for your money purchase pension plan for each plan year in which the plan has assets. Consult a tax or retirement plans specialist for more information.

Questions & Answers

What employees do you have to include in your money purchase pension plan?

In general, with respect to those employees who are eligible to be covered by the plan, you must include in your money purchase pension plan all employees who are at least 21 years old and have at least one

year of service. Two years of service may be required for participation as long as the employee will be 100 percent vested immediately upon entering the plan. If desired, you can impose less (but not more) restrictive requirements.

> **Tip:** For eligibility purposes, one year of service refers to a 12-month period during which the employee has at least 1,000 hours of service.

When must plan participation begin?

An employee who meets the plan's minimum age and service requirements must be allowed to participate in the plan no later than the earlier of:

- The first day of the plan year beginning after the date the employee met the age and service requirements, or
- The date six months after these conditions are met

> Example(s): Marcus, age 48, was hired by No-name Company on September 1, 2005. The company has a money purchase pension plan, and the plan year begins on January 1 of each year. Frank will have one year of service as of September 1, 2006. He must be allowed to participate in the money purchase pension plan by January 1, 2007.

How is compensation defined?

Compensation may defined differently for different plan purposes. For determining the annual additions limitation, compensation generally includes all taxable personal services income, such as wages, salaries, fees, commissions, bonuses, and tips. It does not include pension-type income, such as payments from qualified plans, nonqualified pensions, and taxable compensation due to participation in various types of stock and stock option plans. In addition, compensation includes voluntary salary deferrals to 401(k) plans and cafeteria plans. (Employers have some flexibility to include or exclude certain items of compensation.) This definition also applies when determining which employees are highly compensated.

What is a highly compensated employee?

For 2008, a highly compensated employee is an individual who:

- Was a 5 percent owner (i.e., an employee who owns more than a 5 percent interest) of the employer during 2007 or 2008, or
- Had compensation in 2007 in excess of $100,000 and, at the election of the employer, was in the top 20 percent of employees in terms of compensation for that year. (This $100,000 limit is subject to cost of living adjustments each year.)

When do employees have full ownership of the funds in their accounts?

The process by which employees acquire full ownership of their plan benefits is called "vesting." Employee contributions must vest immediately. In general, employer contributions either must vest 100

percent after three years of service ("cliff" vesting), or must gradually vest with 20 percent after two years of service, followed by 20 percent per year until 100 percent vesting is achieved after six years ("graded" or "graduated" vesting). Prior to the Pension Protection Act of 2006 employer contributions other than matching contributions could have a slower vesting schedule (unless the plan was top-heavy). Prior to the Act, these contributions could either vest 100 percent after five years of service, or gradually vest with 20 percent vesting after three years of service, followed by 20 percent per year until 100 percent vesting was achieved after seven years.

> **Caution:** The Pension Protection Act provision generally applies to plan years beginning on or after January 1, 2007, with respect to employees who are credited with an hour of service on or after that date. A later effective date applies to certain collectively bargained plans.

> **Caution:** Plans that require two years of service before employees are eligible to participate must vest 100 percent after two years of service.

> **Tip:** A plan can have a faster vesting schedule than the law requires, but not a slower one.

What happens to an employee's account if the employee terminates before he or she is 100 percent vested?

If a participant in your money purchase pension plan separates from service before being 100 percent vested in the plan, the employee will forfeit the amount that is not vested. The amount forfeited can then be used to reduce future employer contributions under the plan, or can be reallocated among the remaining plan participants' account balances. The IRS requires that forfeitures be reallocated in a non-discriminatory manner. This usually requires forfeiture reallocation in proportion to participants' compensation, rather than in proportion to their existing account balances.

Do you need to receive a favorable determination letter from the IRS in order for your plan to be qualified?

No, a plan does not need to receive a favorable IRS determination letter in order to be qualified. If the plan provisions meet IRC and ERISA requirements, the plan is considered qualified and is entitled to the accompanying tax benefits. However, without a determination letter, the issue of plan qualification for a given year does not arise until the IRS audits your tax returns for that year. By that time, it may be too late for you to amend your plan to correct any disqualifying provisions. A determination letter helps to avoid this problem because auditing agents generally will not raise the issue of plan qualification if you have a favorable determination letter (or if a pre-approved "prototype" plan is used).

What happens if the IRS determines that your plan no longer meets the qualified plan requirements?

The IRS has established programs for plan sponsors to correct defects. These programs are designed to allow correction with sanctions that are less severe than outright disqualification. Your tax professional will be able to assist you in utilizing these programs should the need arise. However, if you are unable to

correct the defects in your plan as required, the plan may be disqualified. Loss of a plan's qualified status results in the following consequences:

- Employees could be taxed on employer contributions when they are made, rather than when benefits are paid
- Your deduction for employer contributions may be limited
- The plan trust would have to pay taxes on its earnings
- Distributions from the plan become ineligible for special tax treatment, and cannot be rolled over tax free

Do you have fiduciary responsibility for your employees' accounts?

You have a fiduciary responsibility to exercise care and prudence in the selection and appropriate diversification of plan investments. Your liability for investment returns, however, is generally significantly reduced if you allow participants to "direct the investments" of their own accounts. A plan is considered "participant-directed" if, among other requirements, it:

- Allows participants to choose from a broad range of investments with different risk and return characteristics
- Allows participants to give investment instructions at least as often as every three months
- Gives participants the ability to diversify investments, both generally and within specific investment categories
- Gives participants sufficient information to make informed investment decisions

Caution: If you sponsor a participant-directed plan, you assume a responsibility for investment education of your participating employees. The challenge is to provide the appropriate level of investment education. This is an issue to consider carefully when implementing a money purchase pension plan or other qualified retirement plan.

Tip: The Pension Protection Act of 2006 creates a new prohibited transaction exemption under ERISA that allows certain related parties ("fiduciary advisers") to provide investment advice (including, for example, recommendation of the advisor's own funds) to profit-sharing (and other defined contribution) plan participants if either (a) the advisor's fees don't vary based on the investment selected by the participant, or (b) the advice is based on a computer model certified by an independent expert, and certain other requirements, including detailed disclosure requirements, are satisfied. The Act also provides protection to retirement plan fiduciaries where an employee's account is placed in a default investment in accordance with DOL regulations because the participant failed to make an affirmative investment election. These provisions are generally effective January 1,2007.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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