

One Plus One Equals More

How combining Defined Benefit and Defined Contribution plans may greatly increase deductions

by Bob Eastwood

The Year 2000 repeal of the limit on combined defined benefit and defined contribution plan benefits has given rise to a potent new retirement plan combination: defined benefit plans in combination with defined contribution plans.

The \$30,000 limit on individual allocations to a defined contribution plan has remained unchanged for 18 years. The defined benefit limit, on the other hand, has increased 50% since the 1986 Tax Reform Act put a cap on defined benefit plan benefits, but with a cost of living escalator. Depending on the participant's age, deductible defined benefit contributions can greatly exceed \$30,000 annually.

The use of combined plans is becoming quite popular with smaller employee groups which have owners in their 50's or older. Under these arrangements, a defined benefit plan is usually layered on top of an existing profit sharing plan that might also include a 401(k) feature, a very popular feature with employees.

Generally the new defined benefit plan provides different benefit levels: a generous benefit for owners and a very modest benefit for other employees. Some of these plans cover only a mandatory 40% of the work force, while others cover all employees. It is common to see 95%-99% of annual contributions being made on the owner's behalf. Standing alone, the defined benefit plan would be rejected under tax law as discriminatory in favor of the highly paid. However, staff employees also receive substantial benefits in the companion profit sharing plan, generally in the 5% to 8% of pay range. This justifies the owner's relatively larger benefits in the defined benefit plan.

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Combining DB & DC Plans *Continued from page 1*

One of our clients, a husband and wife team in their late fifties, were pleasantly surprised by the power of the combination plan. They were used to paying 6% of pay to their employees through the company profit sharing plan. Business success was creating lots of taxable income, but they had to be content with the \$30,000 individual annual contribution limit, producing a \$60,000 family deduction. Introduction of a defined benefit plan covering the owners and some of their lower paid workers

boosted the couple's annual deduction to nearly \$150,000. A modest 1% to 1 ½% of pay contribution increase in the profit sharing plan was enough to justify the added owner deductions.

While defined benefit plans deliver large deductions for older individuals, they also have their drawbacks. Federally mandated insurance to protect workers from losing benefits when an under-funded plan terminates is required for most plans. The plans are also more complex than defined contribution plans. Plans which terminate after extraordinary investment yields increase assets beyond plan ob-

ligations may find that the lion's share of the surplus money must be paid to the Federal government in the form of ordinary income and excise taxes. These drawbacks are often easily tolerated because the plan can provide a significant individual retirement benefit, often around \$1 million or more. This is accomplished through substantial annual contributions over a relatively short period of time.

Do you think a combination of defined contribution and defined benefit plans might be right for you or one of your clients? ACI can conduct a feasibility study to see if this arrangement is right for you. Just ask your administrator or an ACI consultant.

In the News...

GUST Plan Amendment Deadline Extended

The IRS has announced a one-year extension of the period during which qualified retirement plans must be amended to comply with GUST (GATT, USERRA, SBJPA '96 and TRA '97). The deadline is now December 31, 2001 or later. ACI has already begun amending clients' plans, and will continue to do so during the next 18 months.

Auto-Enrollment for Current Employees Approved

The IRS has confirmed that plan sponsors may require current employees, as well as new employees, to *elect out* of automatic elective deferrals. The trend towards "automatic enrollment" is becoming increasingly popular among 401(k) plan sponsors. If you have any questions regarding auto-enrollment, please contact your administrator or an ACI consultant.

Pension Reform Gaining Momentum

On July 19th, the Comprehensive Retirement Security and Pension Reform Act was overwhelmingly approved by the House of Representatives. This legislation includes many provisions designed to enhance the private retirement system, including increases in the contribution limits on 401(k) plans and IRAs.

The legislation next heads to the Senate for consideration. While it is possible that this bill could be approved as a stand-alone measure before Congress adjourns for elections in late August, it appears more likely that it will be addressed as part of an omnibus package negotiated with the White House at the end of Congress.

We'll keep you posted of any major developments.

Los Angeles Benefits Conference **September 14 - 15**

The 2000 Los Angeles Benefits Conference will be held on September 14 and 15 at the Hilton Universal City Hotel. The Conference is sponsored by the American Society of Pension Actuaries (ASPA) and the IRS. ACI's President, Pat Byrnes, is a founding co-chair of the Conference and will act as a moderator at this year's event.

The conference is a great opportunity to hear the latest information concerning benefits regulations, litigation, enforcement, and compliance. It also features prominent speakers from government agencies, as well as the private sector. For information regarding the conference, log onto the ASPA web site at www.ASPA.org, and go to the "Conferences" page.

What Should a Plan Sponsor Expect from an Accountant's Audit?

Submitted by Bill Warburton

If you have over 100 participants in your company's retirement plan, the IRS requires an audit of your plan by an accountant.

As a plan sponsor, you want an auditor who specializes in benefit plan audits, understands your plan, and understands your needs. An experienced auditor can save you money by keeping the internal costs of the audit to a minimum. Also, with the various self-correction programs now available, an experienced and technically proficient auditor could save you significant amounts of money, should an error or defect be discovered.

Are there risks in a benefit plan audit? There are some. Aside from obvious plan qualification issues, you should be aware that the Department of Labor (DOL) has an auditor quality control program. They select plans and review the workpapers prepared by your auditor. If they deem the audit to be faulty, they deem the 5500 filing as a "non-filer" and may assess penalties against the plan sponsor. Your auditor should understand the expected regulatory requirements of the DOL.

How can an auditor save you money by finding errors? If your auditor discovers an error, in most cases, you can self-correct the error. In the few instances when you cannot self-correct, it is normally less costly if you approach the applicable regulatory agency rather than if they find it through their own audit.

At a minimum, a plan sponsor should expect the following from their plan auditor:

Knowledge

You should expect your auditor to be knowledgeable about the technical requirements associated with auditing benefit plans. Your auditor should be technically current and familiar with the types of available reporting options. Your auditor should be familiar with and understand the basic terminology. One of the key words is "basic." You cannot expect your auditor to be a plan administrator or have that level of knowledge, however, you should expect your auditor to recognize when it is time for you to go to your plan administrator if there is an issue or problem.

Responsiveness

You should expect your auditor to be responsive to your needs, questions and specific situation. Your auditor should be able to respond to your questions in a timely matter, and if unable to get you an answer immediately, at least have the appropriate resources to get a correct answer to you.

Diligence

Your auditor should help you and your plan administrator by monitoring due dates and relevant extensions. During the audit, the auditor should look for possible operational errors or plan defects.

Efficiency

You should expect your auditor to be efficient. A knowledgeable auditor will not waste your time or the administrator's time looking for unnecessary information. A good plan auditor will monitor and limit their communications to the administrator or provider so as not to waste their time and help keep their fees to a minimum. A good auditor will also be mindful of keeping the client's internal cost of supporting the audit to a minimum.

Experience

Benefit plan auditing should be a specialty of the auditor. An auditor who specializes in this area is more likely able to successfully service the needs of the plan and sponsor.

Peer Review

To serve you better, your auditor should participate in a peer review program. The DOL is proposing that all plan auditors be required to participate in a peer review program.

In providing good service to you and your plan, you will want your auditor to attend meetings and training sessions such as the Annual AICPA Employee Benefits Conference and the Western Benefits Conference, as well as events sponsored by the National Institute of Pension Administrators, and the American Society of Pension Actuaries. An auditor who

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Treasury Review of Cross-Testing Continues

by Jeff Wallace

As noted in a previous issue of *Action Items*, the Treasury Department announced on February 24th that they were reviewing the nondiscrimination regulations relating to cross testing, a technique common in the small-business market. Several organizations, including the American Society of Pension Actuaries (ASPA), immediately expressed their concern over this review. Since February, the Treasury has agreed to a delayed effective date for any changes to regulations for most cross-tested plans, and ASPA has released a study verifying the importance of cross-testing in the small business market.

For most plans, any new regulations will not be effective until the first plan year beginning after December 31, 2001. This date would apply to:

- Cross-tested plans adopted before February 24, 2000.
- New cross-tested plans where the plan sponsor currently does not have a retirement plan in effect.
- New cross-tested plans (or an amendment to an existing plan), where the only previous plan in effect since February 24, 2000 has been a 401(k) plan allowing deferrals and matching contributions only, a SEP, or SIMPLE.

The only plans excluded from the 2002 plan year effective date are existing plans that add cross testing after February 24, 2000 (with the exception of the plans described above). For example, if the sponsor of an integrated profit sharing plan were to convert that plan to a cross-

tested design today, the plan might be subject to any new cross-testing rules established by the Treasury, *retroactive to February 24, 2000*. In other words, if the Treasury announces new rules in mid-2001, it is possible that the sponsor of a “converted” plan would need to apply the new requirements to the plan for both the 2001 and the 2000 plan year.

It is important to note that the Treasury has not emphatically stated that converted plans would be subject to retroactive application of new nondiscrimination rules. However, conversions are the only types of plans expressly omitted from the announced effective date.

In the midst of the Treasury review, ASPA has conducted a survey of 10,000 plan sponsors of cross-tested profit sharing plans. The results of the survey clearly indicate that cross testing provides both valuable retirement coverage for small business employees, while expanding access to those who previously had no coverage.

Some of the key findings in the ASPA study include:

- Cross-tested plans expand small business retirement plan coverage. 58% of the plans surveyed were adopted by small businesses with no previous retirement plan coverage. An additional 20% of the cross-tested plans were adopted where the only previous plan was a 401(k) plan funded only by employee

What to Expect from an Auditor

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attends those organizations' meetings and classes will likely be aware of the pitfalls a sponsor can fall into and help find solutions.

As a plan sponsor, you will find that an auditor who specializes in benefit plan auditing and is passionate about keeping technically current in this area will most likely provide you and the plan the best service.

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and matching contributions. Thus, cross testing has produced significant new retirement benefits for small business employees where, in many cases, they were receiving no retirement benefits at all.

- Small business plans would terminate without cross testing. 50% of the surveyed small businesses with a cross-tested plan would not adopt another qualified plan for their employees if cross-tested plans were no longer permitted.
- Cross testing provides substantial benefits to small business employees. 21% of the plan surveyed provide at least a 7% of pay contribution to small business employees, regardless of any employee savings to the plan, while 49% provide at least a 5% of pay contribution. Virtually all (96%) provide at least 3% of pay contributions.
- Cross-tested plans are *small business* retirement plans. Of the more than 10,000 plans surveyed, 35% were maintained by small businesses with less than 10 employees. 35% were maintained by those employing between 10 and 25 employees, while 19% were maintained by those employing 26 to 50 employees. A mere 10% were maintained by businesses with more than 50 employees.

It appears that the critical issue from the Treasury's perspective is the frequent disparity in contribution rates between highly and non-highly compensated employees in cross-tested plans. However, sponsors of cross-tested plans argue that these disparities are justified by the levels of risk assumed by small business owners and members of senior management. They also point out that these disparities are what justify the expenses associated with retirement plans. Eliminate the ability of plan sponsors to grant higher levels of retirement benefits to highly compensated employees, and you may end up eliminating the retirement plans entirely. In essence, what makes retirement plans financially viable in small businesses is cross testing.

ASPA's survey supports the argument that significant changes to cross testing rules could result in the termination of many small business retirement plans, thus eliminating retirement benefits to many of the employees they are seeking to "protect." We are hopeful that the Treasury will recognize this fact, and approach the issue accordingly. ACI will continue to monitor this situation carefully, and keep you apprised of any significant events. If you have any questions or concerns regarding this issue, feel free to contact an ACI consultant or your plan administrator.

As We Go to Press...

Auto-Enrollment Update...

Automatic 401(k) plan enrollments (December 1998 Action Items) got another boost recently when Treasury announced approval of the practice for plans using prototype documents. This move demonstrates the Administration's ringing endorsement of automatically setting employee's money aside in a 401(k) plan unless the employee objects (see "In the News" on page 2 for additional information on Auto Enrollment).

"Same Desk" Rule...

Retirement plan complications associated with company mergers and acquisitions are being alleviated through recent private rulings and a revenue ruling (RR2000-27).

Benefit anti-cutback rules, which provide a disincentive to merge retirement plans, are being relaxed by proposed regulations. Similarly, Treasury's long standing "same desk rule" is being significantly relaxed. The "same desk rule" holds that an employee should not be entitled to receive his retirement plan benefit merely because another company bought out his employer. If he does the same job at the same desk, Treasury reasoned, there is no "separation from the service of the employer."

The new revenue ruling holds that when a business sells less than 85% of the assets of a trade or business, affected employees are entitled to receive retirement plan benefits. The subject of company mergers and acquisitions will be addressed in depth in an upcoming *Action Items* article.

Dot.Com Mania? Take a Deep Breath

Submitted by Ramon J. Polin, Esq.

Some of your employees may need a healthy reality check when it comes to measuring investment strategies. These investors may see the three-digit gains posted by some specialized Internet mutual funds or the four-digit gains from a handful of individual Internet stocks, and they may begin questioning their own more conservative investment strategy. These investors, particularly if they are saving for their own retirement or saving to supplement their pension plan, probably need to remind themselves that attempting to pick hot performers can put their financial future in jeopardy.

Today, of course, everyone knows that buying a few star Internet performers was an astute investment choice for some investors. The problem is timing. Discovering these astute choices early-while avoiding the less successful choices-can be very profitable. Unfortunately, these same investments can also be very unprofitable if the timing isn't right.

Let's look at Amazon.com, as an example. This stock has, of course, been a stellar performer, but some

investors probably don't see it that way. For example, investors paid a high of \$113 per share for Amazon.com on December 9, 1999, according to historical data from Bloomberg, a financial information provider. On February 8, 2000, the stock traded as low as \$74 per share. Investors who paid the high on December 9 lost \$39 per share-or about 30% of their money-if they sold at the low on February 8, just two months later. How many investors would feel comfortable if their nest egg lost 30% of its value in just 60 days?

Volatility is the watchword for Internet stocks. Some rise to nose-bleed levels, sweeping investors along for what can be a bumpy ride. Other Internet stocks languish or fall, never reaching the potential investors expected. Building a future based on the fortunes of these volatile stocks can be nerve wracking.

So take a deep breath. Investors don't need to grab a white-knuckle ride on the Internet roller coaster. Retirement planning is a long-term proposition with a specific goal-

building enough financial security to provide an enjoyable retirement lifestyle.

A diversified investment strategy may potentially help investors build their retirement, while offering freedom from the stress that dot.com investors endure. Diversification can help investors reach their goals without fraying their nerves. Do your employees need a reminder?

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Have an Idea for an Article?

We produce *Action Items* in order to provide our clients and their advisors with articles that address relevant, timely issues. If you have a particular topic that you would like us to address, a question you would like answered, or if you would like to submit an article for publication,

please let us know! We welcome your feedback and input.

If you have any comments or suggestions regarding *Action Items*, please contact Jeff Wallace at extension 138, or via e-mail at jeff@actuarial-consultants.com.

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