IRA-BASED RETIREMENT PLANS

Law firms that wish to make retirement benefits available to their attorneys and staff have a broad range of qualified retirement programs from which to choose. The level of firm involvement will depend upon the type of program selected.

- The least complicated programs involve the use of individual retirement accounts or individuals retirement annuities ("IRAs").

- IRAs are particularly attractive because they are not generally viewed as pension benefit plans under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

- The participation, vesting and fiduciary responsibility provisions under Title I of ERISA do not apply to IRAs, and most IRAs are not subject to the reporting and disclosure requirements imposed under Title I of ERISA.

Payroll Deduction IRAs

The simplest form of retirement program is the payroll deduction IRA.
• A law firm simply allows its attorneys and staff to reduce their compensation voluntarily by specified amounts and to direct that those amounts be paid to IRAs that they set up personally.

• The law firm collects contributions through payroll deductions and remits them to the financial institution.

• The employee establishes his or her own IRA using Form 5305 (for an individual retirement trust) or Form 5305-A (for an individual retirement custodial account).

**SIMPLE IRAs**

A more complicated structure is the so-called SIMPLE IRA – a savings incentive match plan for employees of small employers, with no more than 100 employees who earned at least $5,000 in the prior year.

• The sponsor of a SIMPLE IRA must contribute to the plan, which must be its only qualified plan, and participating employees can elect to contribute a portion of their compensation to the plan on a pre-tax basis. Loans to participants are not permitted.

• Employers must make either (i) non-elective contributions for all eligible employees whose annual compensation for the current year equals at least $5,000, or (ii) matching contributions on account of salary reduction contributions made by eligible employees.

• Employees reasonably expected to earn at least $5,000 in the current year and who received at least $5,000 in compensation in any 2 prior years must be eligible to participate.
• The non-elective contribution per employee is 2% of pay. An employer must notify eligible employees of its decision to make non-elective contributions at least 61 days before the start of the plan year with respect to which those contributions will be made.

• Alternatively, an employer can choose to match an employee’s salary reduction contributions up to 3% of pay, subject to the right to lower this percentage to not less than 1%, so long as the match does not fall below 3% in more than two of the years during the 5-year period ending within the current year.

• Employers who choose to make less than a 3% matching contribution for any year are required to notify eligible employees on a timely basis.

The IRS has developed forms for employers who wish to adopt a SIMPLE IRA, and there are corresponding IRA forms for its employees.

• Form 5304-SIMPLE can be used if participating employees select their own IRA sponsor.

• Form 5305-SIMPLE can be used by employers who designate the financial institution to which IRA contributions will initially be made on behalf of its employees.

• Each participating employee must establish his or her own IRA by completing Form 5305-S (for an individual retirement trust account) or Form 5305-SA (for an individual retirement custodial account). These forms are not mandatory, but they will satisfy the statutory requirements.

Also, partners and sole proprietors can participate in a SIMPLE IRA.
• The compensation of a partner or sole proprietor equals his or her net earnings from self-employment before all contributions to the plan, but after reducing self-employment income by 7.65%, which is half of the “regular” old age tax rate.

SIMPLE IRAs are not subject to the participation, vesting and fiduciary responsibility provisions in Title I of ERISA.

ERISA also provides that the reporting and disclosure requirements under Title I will not apply to a SIMPLE IRA so long as certain conditions are met.

• The financial institution to which IRA contributions are made must annually provide the sponsor with a description containing specified information.

• The sponsor must timely notify each employee of his or her election opportunities and include with the notice a copy of the notice provided to it by the financial institution.

Law firms that set up a SIMPLE IRA may qualify for the credit for small employer pension plan startup costs available under Code Sec. 45E.

• The maximum credit is $500 for the first credit year and for each of the two taxable years immediately following the first credit year.

• The credit, which is claimed on Form 8881, is allowed for half of the qualified startup costs paid or incurred during a taxable year.

• These include the costs of establishing and administering a SIMPLE IRA and of making retirement-related education available to employees.
**SEPs**

Pursuant to a simplified employee pension ("SEP"), an employer can annually contribute on behalf of each covered employee up to 25% of compensation capped at the statutory maximum.

- Under current law, newly established SEPs cannot include a salary reduction feature, enabling participating employees to contribute a portion of their compensation on a pre-tax basis.

- So-called SARSEPs, pursuant to which salary reduction contributions are allowed, can remain in effect only if they were in effect on December 31, 1996.

An employer wishing to adopt a SEP must cover all of its employees (other than union employees and nonresident aliens with no U.S. source earned income):

(i) who have attained the age of 21,

(ii) who have performed service for the employer during at least 3 of the prior 5 years, and

(iii) who receive compensation for the current year of at least $550 (in 2012 and 2013).

Also, self-employed individuals may participate in a SEP.

- The computation of the contribution due on behalf of a partner or a sole proprietor is based on net earnings from self-employment before the 7.65% reduction allowed for self-employment tax purposes, but after the deduction for self-employment taxes allowed for income tax purposes.
The contribution rate under the plan for common law employees is adjusted when applied to a self-employed individual, to reflect the fact that the rate applies to net earnings from self-employment before subtracting the contribution to the SEP.

For example, if the sponsor of a SEP contributes 25% of pay on behalf of each eligible common law employee, a self-employed individual will receive a contribution of 20% of adjusted net earnings from self-employment.

The IRS has developed a model SEP form. Form 5305-SEP, Simplified Employee Pension – Individual Retirement Accounts Contribution Agreement, satisfies the statutory requirements, although it need not be used.

The form cannot be used if the employer chooses to allocate plan contributions using a formula integrated with Social Security, pursuant to which a greater portion of contributions can be allocated to individuals whose compensation exceeds the Social Security wage base for the year.

Like SIMPLE IRAs, SEPs are not subject to the participation, vesting and fiduciary responsibility provisions in Title I of ERISA.

SEPs using the IRS model (Form 5305-SEP) need not comply with the reporting and disclosure requirements under Title I, so long as:

- the plan administrator provides a copy of the IRS form to newly eligible employees,

- at the end of each calendar year, the administrator notifies each participant in writing of the employer contributions made to the plan for the year, and
• a further condition is met if the sponsoring employer influences each employee’s choice of IRA into which contributions are made, and the IRA places restrictions on an employee’s ability to withdraw funds beyond those generally applicable to all IRAs.

If the exception to the reporting and disclosure requirements in Title I of ERISA does not apply, the SEP must satisfy alternative reporting and disclosure requirements set forth in the regulations.

• Among these is the obligation of the administrator to notify each participant of the contribution made by the employer to that participant’s IRA.

• The notice must be given no later than January 31 of the year following the year for which the contribution was made or, if later, 30 days after the contribution was made.

The credit for small employer pension plan startup costs available to sponsors of SIMPLE IRAs is also available to sponsors of SEPs, provided that they have no more than 100 employees who earned at least $5,000 in the prior year.

Unlike SIMPLE IRAs, SARSEPs are subject to the top-heavy provisions applicable to qualified retirement plans. Therefore, SARSEP sponsors who wish to avoid violating of the top-heavy provisions will typically make a minimum 3% contribution to their plan on behalf of eligible employees.

401(k) TYPE PLANS

Employer-sponsored qualified retirement plans require an employer-maintained funding vehicle, as well as annual reports to the government.
The statute recognizes a number of different types of qualified retirement plans, including profit sharing plans, money purchase pension plans, annuity plans, and defined benefit pension plans.

- Most often, a law firm will prefer an approach that enables attorneys and staff to contribute voluntarily to a plan using pre-tax dollars, and that enables the sponsor to supplement, in some fashion, the contributions made by those who elect to make pre-tax contributions.

- This goal, and statutory provisions that enable law firms to achieve the goal in differing ways, have lead to a proliferation of so-called 401(k) retirement plans.

The basic 401(k) retirement plan must satisfy provisions set forth in Code Sec. 401(k) and the regulations promulgated under it.

- In addition, plans of this type to which matching employer contributions are made must satisfy the provisions of Code Sec. 401(m) and the regulations promulgated under it.

- Among the provisions that have made it difficult for some employers to maintain cash or deferred (401(k)) arrangements are those that preclude highly compensated employees from disproportionately making salary reduction contributions out of their own compensation and from disproportionately receiving the benefit of matching contributions.

- All standard cash or deferred arrangements must be tested for non-discrimination using the tests set forth in the statute as interpreted by the regulations. These tests are not uncomplicated, and should a plan fail to satisfy them in any particular year, corrective action must be taken or the plan will cease to afford the benefits of a qualified plan.
The statute now includes 3 different ways in which cash or deferred arrangements can be structured so as to avoid non-discrimination, without regard to the application of the complex non-discrimination tests in the basic 401(k) and matching contribution provisions in the statute. All are eligible for the credit for small employer pension plan startup costs, provided the sponsor has no more than 100 employees who earned at least $5,000 in the prior year.

**SIMPLE 401(k) Plans**

So-called SIMPLE 401(k) plans are in many ways like SIMPLE IRAs.

- A law firm can establish a SIMPLE 401(k) plan if it maintains no other qualified retirement plan on behalf of employees eligible to participate in the cash or deferred arrangement.

- All benefits provided under the plan must fully vest from inception.

- Employees covered under the plan may elect to contribute to the plan on a pre-tax salary reduction basis up to the statutory limitations.

The employer-sponsor of a SIMPLE 401(k) plan must make either a 2% non-elective contribution to the plan, or a matching contribution on behalf of contributing employees, not to exceed 3% of pay, for each calendar year while the plan remains in effect.

- An employer can elect to make a non-elective contribution equal to 2% of the compensation of each eligible employee who earns at least $5,000 for the year.

- The employer must notify employees of its decision to make non-elective contributions within a reasonable period before the 60th day prior to the start
of the year with respect to which the non-elective contributions are to be made.

- Alternatively, an employer must contribute on behalf of each participating employee a matching contribution, equal to the employee’s elective contributions up to 3% of pay.

- If an employer satisfies either requirement, the separate matching contribution tests in the statute will not apply.

The regulations indicate that partnerships can maintain a cash or deferred arrangement, and that partners can make cash or deferred elections with respect to their compensation for services rendered.

- Under these circumstances, any matching contributions made on behalf of a partner are not treated as elective contributions made pursuant to a cash or deferred election.

- The amounts that a self-employed individual chooses to contribute to a SIMPLE 401(k) plan, and any required employer contributions under the plan, are determined with reference to net earnings from self-employment as that term is defined for self-employment tax purposes.

- Thus, earnings from self-employment are reduced only by 7.65%, which is half of the “regular” old age tax rate – i.e., by the amount allowed in arriving at net earnings for self-employment to which the self-employment tax rates are applied.

If the only contributions allowed are those required under the statute, SIMPLE 401(k) plans will not be subject to the top-heavy provisions in the Code. Also, plan loans to participants are permitted.
Safe Harbor 401(k) Plans

The features of a safe harbor 401(k) plan resemble those of a SIMPLE 401(k) plan, but the plans differ in important ways. Under a safe harbor 401(k) plan:

- Participating employees may contribute more to the plan than they can to a SIMPLE 401(k) plan.

- Employer contributions need be made only on behalf of non-highly compensated employees.

Employers must decide whether to make matching contributions or non-elective contributions to the plan on behalf of each non-highly compensated employee eligible to participate.

- An employer who chooses non-elective contributions must contribute to the plan on behalf of each eligible non-highly compensated employee an amount equal to at least 3% of the employee’s compensation.

- Alternatively, the employer must make matching contributions on behalf of each non-highly compensated employee totaling 100% of the employee’s elective contributions up to 3% of pay, plus 50% of the employee’s elective contributions between of 3% and 5% of pay,

  (i) so long as matching contributions are not made at a greater rate for high paid individuals, and

  (ii) subject to the ability of the employer to design a different matching formula that is consistent with the statutory guidelines.
• The standard matching formula will satisfy the non-discrimination provisions dealing with matching contributions, so long as the match made on behalf of any employee’s elective deferrals does not exceed 6% of pay and the rate of the employer’s match does not increase as the rate of elective deferrals increases.

In general, safe harbor 401(k) plans are exempt from the top-heavy provisions applicable to qualified retirement plans if non-discrimination testing is not required under the cash or deferred and matching contributions provisions in the statute.

Partners can participate in a safe harbor 401(k) plan. Eligible compensation is determined in the same manner as it is determined for SIMPLE 401(k) plan purposes.

**Automatic Enrollment 401(k) Plans**

Employers can now adopt automatic enrollment 401(k) arrangements, which are deemed to satisfy the non-discrimination requirements in the statute.

• The required employer contributions to an automatic enrollment 401(k) plan could be higher than to a SIMPLE 401(k) or safe harbor 401(k) plan.

• On the other hand, employer contributions made on behalf of an employee need not vest until the employee has completed at least 2 years of service.

Under an automatic enrollment 401(k) arrangement, each eligible employee is deemed to have elected to have elective contributions made on his or her behalf in a defined amount.

• To avoid these elective contributions, an affirmation election out is required.
The required elective contributions are based on a formula applied uniformly, and cannot exceed 10% of pay a year.

Through the period ending on the last day of the first year beginning after his or her first elective contribution, an employee must contribute at least 3% of pay. This minimum increases to 4% in the immediately following year, to 5% in the second immediately following year, and finally to 6% in any subsequent year.

An employer must either contribute at least 3% of compensation to the plan on behalf of each non-highly compensated employee who is eligible to participate, or match employee contributions based on a formula.

An employer who chooses to make matching contributions must contribute on behalf of each non-highly compensated employee an amount equal to 100% of the employee’s elective contributions to the extent they do not exceed 1% of pay, plus half of the employee’s elective contributions to the extent that they exceed 1%, but do not exceed 6%, of pay.

These matching contributions will automatically satisfy the non-discriminatory matching contribution provisions in the statute, pursuant to which a match cannot exceed 6% of pay, so long as (i) the rate of matching contributions does not increase as the rate of elective deferrals increases, and (ii) the matching contributions made on behalf of highly compensated employees are not made at a rate greater than those made on behalf of non-highly compensated employees.

In general, if employee and employer contributions satisfy the new statutory provisions, automatic enrollment 401(k) plans will not be subject to the top-heavy provisions in the Code.
Partners can participate in automatic enrollment 401(k) plans, and their eligible compensation will be determined in the same manner as eligible compensation is determined under the guidance relevant to SIMPLE and safe harbor 401(k) plans.

This written outline is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. [The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.]