CONSIDERATIONS FOR SETTING-UP A PENSION OR 401(K) PLAN

Pension and 401(K) plans have different characteristics and regulatory rules. Therefore, the decision to set up a pension or 401(K) plan should reflect the sponsor's objectives, financial circumstances, employee demographics…etc.

Considerations	Pension Plan	401(K) Plan
Age of employees	For employees over age 40, pension benefits can still be designed to provide a reasonable level of retirement income.	Employees need to contribute and invest over a period of at least 25 years to receive a reasonable level of retirement income.
Pass service recognition (i.e., service from business establishment to initial plan set up)	IRS regulations allow direct recognition of such service in the pension benefit formulas.	A plan needs to add a special employer contribution formula to allow for the recognition of such service. The formula must meet IRS requirements.
IRS benefit/ contribution limits	In 2002, the maximum benefit limit was increased to $160,000 annually payable at age 62.	In 2002, the maximum combined annual employer and employee contribution amount was increased to $40,000.
Retirement planning for key employees (owners, partners…etc)	The new IRS benefit limit increased the value of pension income for key employees by over 100%, which allow for effective retirement and tax planning.	The new IRS contribution limit enhanced retirement and tax planning for key employees. Because contributions need time to grow, older employees (over age 45) may see only marginal gain in retirement income planning.
Maximizing tax-deductible contributions	The new IRS benefit limits allow for annual tax-deductible contributions between $60,000 to over $200,000, depending on the age, compensation and service of key employees relative to the non- key employees.	The combined amount of annual employer and employee contributions is limited to $40,000.
Flexibility in the required annual plan contributions	Some actuarial funding methods can provide for a range of annual contributions, allowing for the flexibility to adjust to business cash flow.	Having employer contributions tied to profitability would allow the flexibility to adjust the amount annually according to business performance.

Plan administration	Plan administration requires only keeping track of participant information (i.e., date of birth, date of hire, compensation etc). Benefits are calculated when a participant retires or leaves employment.	Depending on the plan sponsor's choosing, the participants' accounts are valued monthly, quarterly, semi-annually or annually accounting for employer and employee contributions and investment performance.
Sized of business	For small privately owned businesses, there is more flexibility in designing benefit payable to key and non-key employees. For large businesses that have large number of lower paid employees, IRS nondiscrimination in benefit requirements may limit the difference in the benefits provided to key and non-key employees.	A plan must incorporate a special employer contribution formula to increase the difference of contributions for the key and the non-key employees. The maximum annual $40,000 contribution limit would constrain the difference. Similar to pension plan on the size of employer.

Observations:

1) Pension plans are effective for:
- Firms with older key employee(s) at plan establishment
- Firms with fairly steady cash flow
- Maximizing tax-deductible contributions and benefits for key employee(s)
- Recognizing employment service before plan establishment
- Minimizing benefits provided to younger employees, who terminate with and without vesting
- Fairly simple plan administration

2) 401(K) plans are effective for:
- Firms with key and non-key employees who are 25 or more years to retirement
- Maximizing tax-deductible contribution to key employee(s) is less important
- More flexibility in making annual employer contributions
- Entrepreneurs with moderate income ($80,000 to $150,000) to maximize tax-deductible contributions
- Communicating with employees on account balances and plan features
- Providing employee access to account balance through loans and hardship distributions, subject to IRS limits