Pension Plans

Pension plans qualified under the US Internal Revenue Code receive favorable tax treatments. There are significant tax advantages where employer contributions are tax deductible and investment returns are tax deferred. Pension benefits are taxed when paid at retirement, disability or separation from service. Retirement pensions maybe taxed at a lower rate than a person's current income tax rate.

Pension plans are effective financial programs for attracting, retaining and rewarding employees. Some of the common features of a pension plan are:

1. Most plans have an age 21 and one year of service requirement before an employee starts to participate and accrue pension benefits.
2. Depending on the plan design, a participating employee may be required to work five years to gain full vesting (right to receive a benefit at retirement) on the accrued benefits. Some plans use a graded vesting schedule of three years of service for 20% to seven years for 100% vesting.
3. Pension benefit accruals are usually determined by a formula based on an employee's compensation and years of service (e.g. 2% of last five years' average compensation times the years of service).
4. The benefit is payable at retirement over the employee's lifetime or other equivalent form of payments.

*Items 1 and 2 allow a plan to focus on providing pension benefits to longer service employees, thus reducing ongoing cost and plan administration effort.

Based on an organization's objectives, a benefit formula can be designed, within the regulatory rules, to provide different benefit levels according to the service and compensation of the employees. With the 2002 regulatory changes, the benefit limits have been liberalized to offer greater value to employees (especially to key senior persons) and plan sponsors. For closely held organizations (i.e., professional groups, partnerships, and entrepreneurs), pension plans offer a tremendous opportunity for owners to defer compensation and provide for a high level of retirement income.

Illustrations

A professional organization has two employees and established a pension plan. The plan uses a pension benefit formula of 1.5% of the average last five years' compensation at retirement up to $50,000 and 2% above for each year of service.

Pension Plan Illustrations

Plan Participant	Current Age	Current Compensation	Total years of Service at retirement	Annual benefit At retirement	Annual Contributions
A	45	$200,000	25	$127,950	$68,200
B	35	$ 40,000	20	$ 30,060	$10,100

The above illustrations highlight the flexibility that a benefit formula can be designed to deliver different amounts of pension benefits for high and low pay employees. With participant 'A' being older and more highly paid than 'B', most of the annual contributions would be attributable to 'A'.

If participant 'B' terminates employment before retirement, he/ she is entitled to the following pension benefits:

Years of Service	Vested Annual Pension
Under 5	$ 0
10	$ 8,236
15	$15,843

This illustration assumes the pension plan uses a five-year 100% vesting schedule. If participant 'B' terminates before five years of service, the contributions already made will be used to offset future contributions for participant 'A' and any new employee(s).

This summary provides a realistic outline of the major plan design and features of a pension plan. If you have any questions or would like to discuss the establishment of a pension plan, please contact us at (858) 538-3566 or jgeng@actbenefit.com.