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H.R. 10 - Plans and Problems

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H. R. 10 PLANS AND PROBLEMS

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I Introduction

Qualified corporate retirement plans giving tax benefits to employers and employees, including stockholder employees, have been in existence for a long time. HR 10 is an extension of the Code provisions[1] covering such plans and gives similar, but much more limited, benefits to self-employed persons. It is important to remember this fact (i.e. that HR 10 is merely an amendment to the original provisions) because the qualification requirements applicable to corporate plans also apply to self-employed plans. Broadly speaking these requirements are:

1) The plan must be in writing.
2) It must be in effect within the taxable year for which qualification is sought.
3) It must be the type of plan contemplated by the statute, that is, it must be a pension, profit sharing, annuity, or bond purchase plan, as defined in the Regulations.
4) It must be established by the employer for the benefit of his employees or their beneficiaries.
5) It must be a funded plan, that is, trust, custodial account, insured or bond purchase plan.
6) It must be nondiscriminatory in favor of highly paid or supervisory employees.

Additionally there are special rules and limitations which apply only to self-employed plans. It is these special rules that I shall discuss this morning.

II Definitions

In order clearly to understand these rules we must first crystallize the distinction between an "owner-employee" and a "self-employed" person. An individual proprietor or a partner owning more than a 10% capital or profits interest in the business is an "owner-employee".[2] A partner

[1] §§ 401-407.

[2] § 401(c) (3).

owning 10% or less of such interest is a "self-employed" person, referred to in the statute and Regulations as an "employee".[3] Thus all "owner-employees" are self employed, but not all self-employeds are "owner-employees." In either case such a person must have "earned income" in order to be covered by a plan.[4] If a person renders personal services in connection with the business, his share of the income will be considered to be "earned income" even though a substantial portion of it may result from the use of capital in the business.[5] On the other hand, if an individual renders no personal services or is merely an investor, he cannot be covered by a retirement plan.[6] To state it another way, substantially full time employment in the business will be treated as resulting in earned income, whereas less than full time employment will require a determination as to whether the personal services rendered are a material income producing factor vis-a-vis the contribution to earnings by the capital in the business.[7] To put it more concisely, earned income is equivalent to that kind of income which is subject to the self employment social security tax. Additionally we must understand the meaning of the term "employer". Within the context of HR 10 a sole proprietor is treated as his own employer and a partnership is treated as the employer of each partner.[8] This means that the partnership and not the partner or partners must adopt the HR 10 plan.[9] The significance of this will appear later in this discussion.

III Coverage

And now let's turn to the substantive or technical requirements of a qualified HR 10 plan. First of all, who must be covered? This depends upon whether or not the plan is to include "owner-employees". If of the partners only "self employeds" are to be included then reasonable classification of common law employees to be covered is permitted as long as the classification is not slanted towards supervisory and highly paid employees.[10] In other words the plan would have to cover a certain percentage of all employees or all employees in a classification acceptable to the Treasury. A classification covering only salaried and clerical employees would not permit coverage of "self-employeds", since they

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[3] § 401(c) (1).

[4] § 401(c) (1); Reg. § 1.401-10(c)(1).

[5] § 401 (c)(2)(A)(i).

[6] Reg. § 1.401-10(c)(3)(i).

[7] IRS Document No. 5592 (10-67), Part 2(g).

[8] § 401 (c)(4); Reg. § 1.401-10(c)(1).

[9] Rev. Rul. 67-3, C.B. 67-1, 94.

[10] § 401(a)(3)(B); Reg. § 1.401-11(c)(2)(i).

could not be so classified.[11] In effect this requirement is probably more stringent than the 70%-80% rule. On the other hand, if "owner-employees" *are* to be covered under the plan then all full time employees with more than three years service *must* be covered.[12] A full time employee is defined as any person whose customary period of employment has been for more than twenty hours a week for more than five months during each of three consecutive periods of twelve calendar months.[13]

IV Vesting

Next, the vesting requirements. Pension plans not covering "owner-employees" can provide for vesting as late as retirement age.[14] In this respect it is not different from corporate plans. The drawback is that this delayed vesting must apply to the "self-employeds" (partners) as well, and a partner leaving a firm prior to the vesting of his pension interest forfeits his interest in the retirement fund. Nor may forfeitures of common law employees be credited to partners' accounts in the plan, but must be credited to the other common law employee's accounts.[15] But if an "owner-employee" is included in the plan, the employees' interest must vest at the time the contribution is paid to the fund.[16] This means, of course, that if an employee quits or is fired the balance in his account may not be credited to the accounts of the other employees but must remain in his account until the time arrives for distribution thereof to him or his beneficiaries according to the terms of the plan. This requirement of immediate vesting is obviously a great disadvantage not only from the standpoint of economics, that is, that an employer is footing the cost of retirement of an employee who has left employment long before retirement, but also from the standpoint that it might actually encourage employees to leave before retirement. Let me illustrate. Suppose you have an employee who started with you at age 18. At age 21 he must be included in the retirement plan. By age 40 he has accumulated, let us say, $15,000. If the plan does not prohibit withdrawal of accumulated funds at the time of leaving the employment then the employee might quit just to get his money for whatever purpose

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[11]Reg. § 1.401-1(c)(2)(iii).

[12]§ 401(d)(3); Reg. § 1.401-12(e).

[13]Ibid.

[14]Rev. Rul. 65-178, CB65-2, 94.

[15]Reg. § 1.401-11(b)(3). This refers to profit sharing plans. In pension plans forfeitures must be used to reduce future contributions.

[16]§ 401(d)(2); Reg. § 1.401-12(g)(j)(i).

he might need it. Solution: the plan should provide that distribution of funds shall not be available until normal retirement age, or total disability or death, whichever is earlier.

V Contributions

Next let us examine the requirements and limitations of contributions to the plan. As to "owner-employees" the maximum contribution is limited to 10% of earned income (as heretofore defined) or \$2,500.00, whichever is less, which is also the maximum amount deductible in respect to "owner-employees."[17] As to "self-employeds," 10% of earned income, but the deduction is limited to \$2,500.00 maximum.[18] As to common law employees there is no limit to the amount of the contribution, but in no event may it be less than proportionate to contributions made on behalf of "owner-employees" or "self-employeds" covered under the plan.[19] These aforementioned contributions are referred to as "employer" contributions.[20] A plan covering "owner-employees" may not require, but can permit, employees to make additional voluntary contributions limited to 10% of their pay.[21] This will then permit owners and partners to do the same, limited to the same rate as the employees, with "owner-employees" being absolutely limited to \$2,500.00. These voluntary contributions are referred to as "employee" contributions. An "owner-employee" who has no employees cannot make voluntary contributions to his plan.[22]

Apropos the subject of contributions is the problem of excess contributions. An excess contribution, in reference to an "owner-employee", is the excess of his allowable contribution as an "employer" (the lesser of \$2,500 or 10% of his earned income) plus any voluntary contribution he is allowed to make as an employee".[23] The penalty for making an excess contribution depends on whether or not it was willful. A cash basis taxpayer must remit his contribution to the fund before the last day of the taxable year. Therefore, it is quite possible to miscalculate the earned income for the year and remit more than the allowable amount. This would not be a willful excess contribution. In such a case the "penalty" is not really a penalty. What must be done

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[17]§ 404(e)(1); Reg. § 1.401-12(i).

[18]§ 404(e)(1).

[19]Reg. § 1.401-11(d); Reg. § 1.401-12 (f).

[20]§ 401(d)(5)(A).

[21]§ 401(e)(1)(B)(ii); Reg. §1.401-12(e); Reg §1.401-13(b)(3)(ii) (iii).

[22]Reg. § 1.401-13(b)(2)(i).

[23]§§ 401 (d)(5), 401(e); Reg. § 1.401-13(b)(2).

is that the trustee must return[24] the excess amount and any income earned thereon to the "owner-employee", who must include the returned amount on his income tax return.[25] If the excess contribution is not repaid within six months after the "owner-employee" has been notified by the District Director that the contribution was excessive, the plan is temporarily disqualified as to him. Until the excess is returned he is taxed on the earnings of the fund which are attributable to his share.[26] At this point I should explain however that if the retirement plan includes (partly) the purchase of an annuity, retirement income, endowment or accident and health policy, then the cost of current insurance protection is not counted in the contribution,[27] nor is it deductible,[28] and therefore excess contributions do not include such net cost of life or health insurance.[29] One way that an "owner-employee" can avoid making excess contributions is by having his plan funded only by level premium life insurance, endowment or annuity policies.[30] If he uses this method he is allowed to pay level premiums based on his average earned income over a three year period limited to the lesser of $2,500 or 10% of such average earned income.[31] Thus once he starts paying these premiums he will not have to reduce his annual contribution simply because his earned income dropped. However his deduction is determined by the earned income of his taxable year,[32] and the portion of his contribution which is non-deductible but not excess will be treated as an "employee" contribution to determine whether any other "employee" contribution on behalf of the "owner-

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[24]An "adequate adjustment" may be made instead of returning. If the amount of the excess contribution and net income attributable thereto is taken into account as a contribution for the year in which the Director notified the taxpayer of the excess contribution and such amount is included in the gross income of the taxpayer for such year, this is considered an "adequate adjustment" Reg. § 1.401-(d)(2)(iii).

[25]§§ 401 (d)(8), 401(e)(2); Reg. § 1.401-13(d)(2)(iv).

[26]§ 401(e)(2)(D); Reg. § 1.401-13(d)(3) & (5).

[27]§ 404(e)(3).

[28]§ 404(a)(8); Reg. § 1.404(e)-1(b).

[29]Reg. § 1.401-13(b).

[30]Reg. § 1.401-13(c).

[31]The 3-year earned income average under a 10% contribution formula may not exceed $25,000 for *any* one year, thus the maximum allowable contribution in *any* one may not exceed $2,500. However when the plan calls for a less than 10% rate the $25,000 limit on earned income is inapplicable and the actual 3-year average may be used but limiting the contribution to $2,500. For example if the rate of contribution is 5%, earned income up to $50,000 in any one year could be used in detemining the 3-year average. IRS Document 5592 (10-67), Part 6(c)(2).

[32]§ 401(e)(3); Reg. § 1.401-13(c).

employee" is excessive.[33] Furthermore if his current earned income increases above the 3-year average, then he can recompute such average[34] and buy additional policies or enlarge the original policies and continue paying the larger contribution. Remember however that $2,500 is the absolute maximum annual "employer" contribution allowed on behalf of an "owner-employee". There is one fly in the ointment as regards these 3-year averaging plans; whereas in other plans the cost of current insurance is not counted towards the $2,500 or 10% limitation, in these plans they are.[35]

And now let's examine the results of a willful excess contribution. Here the penalty is indeed a penalty. The "owner-employee's" full account must be returned to him and he is barred from participating in *any*[36] plan as a self employed individual for 5 years. The returned amount (which includes not only his contributions, but also the earnings thereon) must be included in his income tax return (excepting the voluntary nondeductible contributions) for the current taxable year and the penalty tax provisions of § 72 (m)(5) apply,[37] about which I shall speak later. It is interesting to note that although these penalty provisions for excess contributions are provided for in the Code, the plan itself, in order to qualify, must spell this out in the trust indenture, otherwise qualification will be denied.

And finally one more item in regards to contributions, namely integration with social security. As you know many corporate plans reduce the amount of employer contributions allocable to lower paid employees by integrating the private plan retirement benefits with those provided under social security.[38] Such plans must use a formula that gives each covered employee a *total benefit,* including the social security benefit, that does not discriminate in favor of higher paid employees.[39] The rules applicable to plans covering "owner-employees" are different. To be able to integrate, self employment and FICA taxes will be treated as employer contributions. Integration is permitted only if not more than 1/3 of the total employer contributions under the plan is made

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[33]Reg. § 1.401-13(c)(5).

[34]Based on the 2 years next preceding plus the current year.

[35]Reg. § 1.401-13(c)(1)(ii).

[36]Reg. § 1.401-13(e). If an individual controls two or more businesses he may participate in plans set up for all of them provided the requirements and limitations of all the plans when combined satisfy the rules applicable to a single plan, e.g. the $2,500 limitation. Reg. § 1.401-12(e).

[37]§§ 1.401-13(e), 1.72-17(e)(2); § 72(m)(5)(B).

[38]§ 401(a)(5); Reg. § 1.401-3(e).

[39]§ 401(a)(5); Reg. § 1.401-3(e); Rev. Rul. 65-178 Part 4(j) C. B. 65-2, 94.

for "owner-employees."[40] Then the amounts of self employment tax paid by the "owner-employees" can be counted towards their behalf and the employer's share of FICA taxes paid can be counted towards contributions payable on behalf of employees.[41] This requirement of 1/3 and 2/3 applies only to plans under which "owner-employees" are covered and obviously restricts the ability to reduce costs through integration. HR 10 plans that cover only employees or "self-employeds" (other than owner-employees) are not thus restricted and the savings of integration are available just as under corporate plans.

VI Distributions

Up to this point we discussed the technical requirements and limitations of coverage, vesting, contributions, deductibility, integration, etc. The next logical question would be, how, when, and at what (tax) cost will I get my money back, in other words what advantage is there in going into a retirement plan? As pointed out earlier, the employer contributions on behalf of "owner-employees" or "self-employeds" are deductible up to a maximum of $2,500. Obviously this is quite a tax saving. Furthermore the income earned on the invested money (both on the "employer" contributions and "employee" contributions) is also tax free, that is, not subject to current income taxation.[42] Does it mean that the contribution and income therefrom escape taxation permanently? Hardly. The amount of tax an "owner-employee" or "self-employed" will eventually pay will depend on how he will withdraw his funds, that is, lump sum withdrawal or monthly annuity. But before we discuss that let's determine whether there are any restrictions on distributions. Unfortunately yes. An "owner-employee" cannot draw out any benefits before he is 59-1/2[43] years old or before the retirement age set forth in the plan if such age is later than 59-1/2.[44] Furthermore, he *must* begin to draw out his benefits not later than age 70-1/2[45] even though he does not retire at that age. However, he can continue making deductible contributions for himself after age 70-1/2.[46] These harsh rules do not apply to other participants in the plan; employees and self-employeds" need to start withdrawing benefits by the end of

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[40]§ 401(d)(6); Reg. § 1.401-12(h).

[41]See Appendix for illustration.

[42]§ 501(a).

[43]except for total disability or death prior to that age, § 401(d)(7); Reg. § 1.401-12(m).

[44]§ 401(d)(4)(B); Reg § 1.401-12(m).

[45]§ 401(a)(9)(A).

[46]Reg. § 1.401-11(e)(7).

the year in which they reach age 70-1/2 or in the year in which they retire, whichever is later, and are not restricted from starting to draw before age 59-1/2.[47] What happens if an "owner-employee" or former "owner-employee" receives a distribution before age 59-1/2? He gets penalized, that's what. Under § 72(m)(5)[48] if the amount of distribution is more than $2,500 (after deducting "employee" contributions) he will have to pay a tax which will not be less than 110% of the increase in tax that he would have paid if he had received such amount ratably over the current and four preceding years;[49] if it is less than $2,500 the tax will be 110% of the increase in tax as a result of including in gross income the amount of the taxable portion of the distribution.[50] In either case, his *taxable* income in the year of premature distribution will not be permitted to be computed at a figure lower than the taxable portion of the distribution minus the personal exemptions he is entitled to.[51] This treatment is applicable to the preceding four years as well. Also he is barred from participating in the plan for five years.[52] Furthermore, the above penalties apply in a situation where on account of a willful excess contribution the balance in the account of the offender has to be distributed to him, as I mentioned earlier. By definition such a forced distribution is a premature distribution, subject to § 72(m)(5). And I might also point out that a loan against an annuity or life insurance policy or assignment of any portion of his share of the trust fund before age 59-1/2 is deemed to be a premature distribution.[53] All right. Let's now get back to the tax consequences of *proper* distribution at retirement time. There are two ways to receive the distribution, either in a lump sum or in installments beginning at the required time and continuing over the retiree's life, or over his and his spouse's lives, or over a fixed period which is not longer than their life expectancies.[54] These provisions as to length of time apply not only to "owner-employees" but also to "self-employeds" and common law employees. Now then, as you know, lump sum distributions in a corporate plan entitle the recipients to capital gains treatment of the taxable portion of the distribution. This tax break does

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[47] § 401(a)(9)(A); Reg. § 1.401-11(e)(3).

[48] Reg. § 1.72-17(b).

[49] § 72(m)(5)(B); Reg. § 1.72-17(e)(2).

[50] § 72(m)(5)(C).

[51] § 72(n)(3); Reg. § 1.72-17(e).

[52] § 401(d)(5)(C).

[53] § 72(m)(4); Reg. § 1.72-17(d).

[54] § 401(a)(9); Reg. § 1.401-11(e).

not apply to "owner-employees" or "self-employeds".[55] It does apply to regular employees covered under HR 10 plans. In lieu of capital gains a special formula [56] is provided to give some relief from the bunching of income into one year, taxable at straight income tax rates. The portion of the lump sum distribution[57] that is taxable is the *gain* from the plan. The gain from the plan is the total distribution minus the sum of the cost of current insurance through the life of the plan and the total "employee" contributions (i.e. the voluntary contributions which are non-deductible).[58] The tax on this *gain* is the greater of the following two tax computations: (1) 5 times the tax resulting from treating 20% of the gain, after subtracting from the total gain personal exemptions only, as taxable income,[59] or (2) 5 times the increase in tax resulting from adding 20% of the gain to other gross income.[60] Obviously in most cases lump sum distributions are too expensive taxwise. Generally therefore it is better to take the retirement benefits in installments, that is taking it in annuity form. Annuity payments are taxed only as and when they are received. The usual rules for taxing annuities will apply, that is, part of each payment will be a tax free recovery of the participant's cost in the plan, the rest is taxable.[61] His cost in the plan ("investment in the contract") is the sum of contributions that were not deductible, the so-called "employee" contributions.[62] By spreading the payments over a period of years the tax will most probably be less than in case of a lump sum distribution. The preceding tax results apply where the retiree[63] receives the distribution. What are the tax results in case he dies? If the distribution takes place within one year in a lump sum the five year averaging provisions discussed above apply. If the distribution is used to purchase an annuity or the plan was an annuity plan then the usual rules of § 72 (relating to annuities) apply. If the retirement plan included life insurance, then the pure insur-

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[55]§ 72(n).

[56]applicable only where contributions were made for 5 or more years prior to the year of distribution. § 72(n)(C)(ii).

[57]All annuity contracts must be distributed along with all other amounts standin to the distributee's credit. Reg. § 1.72-18(b)(1).

[58]§ 72(n)(1)(C).

[59]§ 72(n)(2)(B); Reg. § 1.72-18(d)(ii).

[60]§ 72(n)(2)(A); Reg. § 1.72-18(d)(i).

[61]In the case of owners or partners it is unlikely that the cost in the annuity would be recovered within 3 years and therefore it is superfluous to mention *that* special rule for purposes of this discussion.

[62]But the cost of current insurance protection (even though non-deductible) is not part of the cost. Reg § 1.72-17(d). cf to text footnoted 58 *supra*.

[63]Other than common law employees.

ance proceeds, that is, the total life insurance proceeds minus the cash surrender value at the moment of death, is not subject to income tax.[64] As for the cash surrender value portion of the proceeds, the beneficiary pays income tax only on that portion which exceeds the nondeductible contributions[65] made by the participant. This excess goes into the gross income of the beneficiary. However the $5,000 death benefit exclusion provided by § 101(b)(2)(A) does not apply to the widow of a self employed.[66] Furthermore the total distribution, regardless of the form it takes, is includable in the self employed's gross estate for estate tax purposes.[67] Nor can he take advantage of the gift tax exemption available under corporate plans in designating plan beneficiaries,[68] such as a multiple inter vivos trust.

Types of plans and funding media

Now that we have some broad concept as to the technicalities involved in the qualification requirements and distribution benefits and limitations, the next logical step would be an examination of the types of plans available and the method of funding them. Two categories of plans are available, pension plans and profit sharing plans. At first impression one would think that all HR 10 plans would be profit sharing plans since the contributions of partners and owners depend on earned income. This is not so. The determining factor as to whether it is a pension plan or profit sharing plan is the formula used to determine contributions on behalf of common law employees. If the formula provides for contributions on their behalf without regard to profits then it is a pension plan. If contributions depend on profits then it is a profit sharing plan.[69] What difference does it make which it is? Well, aside from the fact that some qualification requirements differ as between the two categories, the most important difference is that if it is a pension plan the employer must contribute each year on behalf of the employees even though he can't contribute for himself because of lack of earned income. Therefore profit sharing plans are preferable and in fact are more popular. However in order to qualify as such the plan must contain a definite formula for determining employer contributions on

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[64] § 72(m)(3); Reg. § 1.72-16(c).

[65] apportioned to purchase of permanent life insurance.

[66] § 101(b)(3); Reg § 1.101-2(f).

[67] § 2039(c); Reg. § 20.2039-2.

[68] § 2517(b); Reg. § 25.2517.

[69] Reg. § 1.401-11(b)(1).

behalf of employees and must define the profits to be shared.[70] Contributions under the formula may vary from year to year so long as the formula is fixed. It may contain variable factors provided the amounts to be contributed are definitely determinable each year and not subject to employer discretion. For example contributions may be geared to profits on a graduated scale such as a stated percentage of profits in excess of a stipulated amount. Or the formula could limit the amount to be contributed on behalf of common law employees to the percentage of compensation equal to the maximum percentage of earned income that may be contributed on behalf of owners or partners.[71] Pension plans can be classified into three types: (1) Money purchase plans, under which a percentage of a participant's compensation is contributed to the fund each year. This sum, plus all accumulated earnings thereon, is used to purchase benefits in an actuarially determined amount; generally a single premium annuity policy is purchased with the total accumulation at the time of retirement. Thus the amount of monthly annuity benefits will depend on the total accumulation. Therefore one drawback would be that benefits provided for employees advanced in age when the plan takes effect may be inadequate, causing dissatisfaction. Prior service credit would have to be considered then, and this might prove rather costly, especially since "owner-employees" can't take advantage of prior service for themselves.[72]

(2) Flat percentage plans, under which the participant receives a retirement benefit equal to a fixed percentage of annual salary, regardless of length of service, for example 50% of average salary, or 30% of average salary for the last five years of service, etc. Contributions to the plan are determined on an actuarial basis, the amount necessary to produce the predetermined benefit is contributed each year and it will probably vary as the salary changes. This type of plan has the drawback that employees with long service will feel that it is unfair that fienefits are determined strictly on salary level, disregarding years of service.

(3) The unit benefit method does take into consideration length of service. A small percentage of salary is the benefit for each year of service. Thus a 1-1/2% rate for 30 years of service would provide an annual benefit of 45% of the average salary. Contributions to the plan are actuarily determined as described under the flat percentage method.

Thus we can observe that money purchase plans are contribution-

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[70]§ 401(d)(2)(B).

[71]Reg. § 1.401-12(d).

[72]Reg. § 1.401-10(b)(4).

oriented, whereas the other two types are benefit oriented. One may notice the similarity between profit sharing plans and money purchase plans, the benefits will depend upon the size and frequency of contributions.

Which plan or type does one select? The answer is subjective, it depends on numerous variables not the least of which is the cost factor. But assuming that a selection has been made, how do we fund it? The Code permits five types of investment:

(1) Trusteed plans. If a trustee is to be used then the trustee must be a bank or trust company.[73] The trustee, depending on the trust instrument, may invest in stocks, bonds, mutual funds, group annuities, individual annuities, retirement income policies or other forms of permanent insurance. The employer however may reserve the right to control or direct the investment. If the funds are to be invested only in annuities, endowment policies or life insurance policies payable to the participant or his beneficiary, then the trustee need not be a bank, as a matter of fact the employer himself can be the trustee.[74]

(2) Custodial accounts. Instead of a trust a custodial account may be set up with a bank provided that the funds are solely invested in mutual fund shares held in the name of the custodian until distributed or solely in annuity, endowment or life insurance policies held by the custodian until distributed. Furthermore it must satisfy all the qualification requirements that any retirement plan is subject to under § 401. Then it will qualify as a trust under § 501.[75] The one drawback of a custodial account is that if the money is to be invested partly in mutual funds and partly in insurance then separate custodial accounts will be needed.[76] A regular trust can invest in both.

(3) Insurance plan: Contributions can be paid directly to an insurance company to buy nontransferable annuity contracts.[77] The annuity contract may have incidental life insurance protection which is defined as death benefits not exceeding 100 times the monthly retirement income.[78] An income retirement policy would be suitable for this requirement. You will recall that the cost of term insurance included in the premiums for such policies are not deductible and do not count

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[73] § 401(d)(1); Reg. § 1.401-12(c).

[74] Reg. § 1.401-12(c)(4).

[75] § 401(f).

[76] Reg. § 1.401-12(c)(5).

[77] § 404(a)(2); Reg. § 1.401-9.

[78] §Reg. § 1.403(a)-1(d).

towards the $2,500 maximum limitation. From the standpoint of administrative costs insurance plans are the cheapest. However they are not much of a hedge against inflation.

(4) United States Bonds. § 405 authorizes investments into United States Retirement Plan Bonds. All the requirements of a qualified retirement plan must be observed[79] with the further proviso that each bond must be issued in the individual name of the participant[80] and must be non-transferable[81] and non-forfeitable and cannot be redeemed prior to age 59-1/2 except in case of death or permanent disability.[82] There are several disadvantages and few advantages to such a plan. The disadvantages are: low yield on the investment (4.15% compounded semi-annually); income realized on the redemption of the bonds (principal plus interest minus voluntary nondeductible contributions of the participant) is ordinary income[83] and capital gains treatment does not apply to common law employees even for lump sum distribution,[84] nor the special averaging method to partners and owners. The advantages are: no costs of administration of such a plan since the bonds are bought directly from the Federal Reserve Bank[85]; the plan itself is extremely simple to set up, just fill out Part I and III of form 3673 and this then constitutes a bond purchase plan (upon filing with I.R.S.); and apparently there is no such thing as an "excess contribution" under such a plan, although the limit purchaseable by any person is $5,000 per annum. The big advantage is that no tax event takes place upon the distribution of these bonds, the participant is taxed only when he cashes them, thus he can control the amount of taxable income therefrom by cashing them over a long period of time. However if the participant dies, interest stops accumulating five years after his death and thus the beneficiary may be impelled to cash them within such period.

(5) Face amount certificates. The plan contributions may be invested in these nontransferable contracts issued by face amount certificate companies registered under the Investment Company Act of 1940. They can be bought directly, without a trustee or custodian account, and upon maturity redeemed for the face amount in a lump sum or as an annuity.

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[79] § 405(a)(1).

[80] § 405(b)(2).

[81] § 405(b)(i)(E).

[82] § 405(b)(1)(D)(i).

[83] § 405(d)(1).

[84] § 405(e).

[85] Commercial banks take applications for issue and redemption of these bonds.

Prototype or Master Plans

Are these foregoing rules, regulations, requirements, traps, etc., that we have examined in this very brief survey so insurmountable that it should discourage a small organization from forming a plan? Probably not, but for those who would like the easy and simple way there is such a route, namely joining a Master Plan or a Prototype plan. A master plan is one in which separate plans are funded and administered in common by a bank or trust company. A prototype plan is one which is sponsored by a trade or professional association (or a mutual fund company) but which is separately administered for each employer. Under either type the retirement plan would already have been qualified by the Revenue Service and all the employer would need to do to "hook" onto it is to fill out and file form 3673 with the I.R.S. Obviously, however, these plans are standard plans and a particular employer may not find his association's plan suitable for his needs and will have to have a custom tailored one drawn up.

Conclusion

All in all, notwithstanding the complexities involved (which in most cases are superficial), HR 10 plans are worthwhile tax saving devices, especially for employers with very few or no employees. Even employers with several employees may find that although the costs may exceed the tax savings it nevertheless may "pay" to set up a plan for the fringe benefits it gives to the employer: employee loyalty, less turnover, more efficiency (especially if it is a profit sharing plan), etc. It behooves the attorney and the CPA to bring HR 10 to the attention of his self-employed clients and also for serious consideration on their own part. Thank you.

TABLE I

Accumulation of Retirement Fund at 5% Cumulative Interest
Annual Investment of $2500.00

	Under Qualified Plan	*NO PLAN* Assume 40% bracket (i.e. 3% net return)	Assume 50% bracket (i.e. 2½% net return)	Assume 60% bracket (i.e. 2% net return)
After 5 years	14,155.00	8,082.50	6,652.50	5,255.00
After 10 years	32,222.50	17,452.50	14,177.50	11,057.50
After 15 years	55,280.00	28,312.50	22,692.50	17,465.00
After 20 years	84,707.50	40,905.00	32,327.50	24,540.00
After 25 years	122,265.00	55,502.50	43,227.50	32,350.00
After 30 years	170,200.00	72,425.00	55,560.00	40,972.50
After 35 years	231,377.50	92,042.50	69,512.50	50,492.50

TABLE II

Annual Contributions and Projected Annual Pensions on Retirement at 65
(Figures Approximate)

Annual Compensation	Age	Plan A* Contribution	Plan A* Pension	Plan B** Contribution	Plan B** Pension	Plan C*** Contribution	Plan C*** Pension	Plan D**** Contribution	Plan D**** Pension
$ 5,200	43	$ 522	$ 1652	$ 261	$ 826	$ 89	$ 282	$ 356	$1126
7,500	45	747	2046	417	1143	186	510	552	1513
5,400	57	540	440	270	220	133	108	531	432
7,800	58	780	542	450	312	301	209	824	572
9,600	48	960	2545	630	1670	299	794	619	1640
24,200	36	2420	14947	2090	12909	904	5583	1136	7019
27,200	42	2500	10491	2394	10046	1212	5088	1482	6218
37,900	42	2500	10491	2500	10491	1792	7520	2061	8650
58,600	50	2500	5546	2500	5546	2500	5546	2500	5546

*Plan A is a money purchase plan with an annual contribution for each person equal to 10% of pay (but not more than $2500).

**Plan B is a money purchase plan with a contribution for each person equal to 5% of pay up to $6600 and 10% on the excess (but not more than $2500).

***Plan C is a unit credit plan with a pension benefit for each person equal to ¼% on pay up to $6600 and 1% on the excess (with a maximum equal to that which can be funded by a maximum contribution equal to the lesser of 10% of pay and $2500).

****Plan D is a unit credit plan with a pension benefit equal to 1% of pay (subject to a maximum equal to that which can be funded by a maximum contribution equal to the lesser of 10% of pay and $2500).

Tables I and II are from the June 1967 issue of the Massachusetts Law Quarterly.

TABLE III

ANNUAL INCOME TAX SAVINGS TABLE

I† Net Earnings From Business	II Maximum Contribution for Employer	III Federal Income Tax saved on Contribution for Employer's Benefit	IV Savings after the following Contributions for employees A $500	B $1,000	C $1,500
$15,000	$1,500	$ 375	$ 0	$ (375)*	$ (750)*
20,000	2,000	560	200	(160)*	(520)*
30,000	2,500	960	640	320	0
40,000	2,500	1,125	850	575	300
50,000	2,500	1,250	1,000	750	500
60,000	2,500	1,325	1,090	855	620
70,000	2,500	1,375	1,150	925	700
80,000	2,500	1,450	1,250	1,030	820
90,000	2,500	1,490	1,280	1,070	860

†This figure is also considered to be the individual's taxable income.

*Fgures in parentheses represent the annual after-tax cost of the plan.

TABLE IV

COMPARATIVE ACCUMULATION TABLE*

I Years of Accumulation	II Income Compounding at 4% in a Tax-Free Trust	III Income and Capital Appreciation Compounding at 7% in a Tax-Free Trust	IV After-tax accumulation at 4% compounded earnings by individuals in the following tax brackets			
			A 66% Rate	B 60% Rate	C 50% Rate	D 36% Rate
5	$ 5,416.32	$ 5,750.74	$ 1,746.87	$ 2,065.03	$ 2,602.02	$ 3,368.09
10	12,006.10	13,816.45	3,615.80	4,300.63	5,474.86	7,189.93
12	15,025.80	17,888.45	4,399.45	5,245.76	6,706.04	8,859.15
14	18,291.90	22,550.48	5,204.55	6,221.36	7,986.97	10,614.93
16	21,824.52	27,888.05	6,031.70	7,228.44	9,319.64	12,461.76
18	25,645.40	33,999.02	6,881.50	8,268.00	10,706.15	14,404.35
20	29,778.07	40,995.48	7,754.57	9,341.09	12,148.68	16,447.67
22	34,247.96	49,005.73	8,651.55	10,448.79	13,649.48	18,596.96
24	39,082.59	58,176.65	9,573.10	11,592.23	15,210.92	20,857.69
25	41,645.89	63,249.02	10,043.29	12,177.70	16,015.14	22,031.65
26	44,311.73	68,676.45	10,519.88	12,772.54	16,835.44	23,235.66
27	47,084.19	74,483.80	11,002.95	13,376.90	17,672.15	24,470.49
28	49,967.56	80,697.67	11,492.59	13,990.93	18,525.59	25,736.93
29	52,966.26	87,346.50	11,988.89	14,614.79	19,396.10	27,035.80
30	56,084.91	94,460.76	12,491.94	15,248.62	20,284.03	28,367.91

*Columns II and III assume that $1,000 is added to the trust at the end of each year. Column IV assumes that the after-tax residue of $1,000 is invested at the end of each year. While $1,000 a year is used as the base figure, the table can be used when other amounts are invested annually. For example, if the base figure is $2,500 a year the approximate comparison can be found by multiplying the figure in the table by 2½.

Tables III and IV are from the April issue of *Taxes & Estates.*

TABLE V

CPA, sole practitioner, age 40, has an annual earned income of $60,000
and an eligible employee payroll of 20,000
Expects to retire in 30 years

	Through Use of HR 10 Plan	Without, HR 10 Plan
Self-employed retirement annual contributions:		
Makes maximum deductible contribution (only 4.16% of $60,000)	$ 2,500	
Makes maximum voluntary contribution (if he had no employees or did not provide for employee voluntary contributions, no voluntary contribution privilege available) (1)	2,500	
Total self-employed contribution	5,000	
Makes employee contribution (4.16% of $20,000) (2)	832	
Total contribution	5,832	
Less tax savings (3)	1,766	
Net annual cost of tax shelter savings for this CPA	$ 4,066	
Amount invested, not tax sheltered		$ 4,066

Self-employed retirement fund:		
a. Invest $5,000 under HR 10 or invest $4,066 not under HR 10 (payments are made at the beginning of each year) for 30 years at 6% compounded annually	$419,000	$340,737
b. Tax basis of plan (30 times $2,500 or $4,066, respectively) (4)	75,000	121,980
c. Ordinary income before tax	$344,000	$218,757
d. Total tax (5)	$172,110	
e. Total tax—53% federal rate		$115,941
f. Net after-tax accumulation of retirement fund ((a) (d) or (a)-(e), respectively	$246,890	$224,796

(1) Not tax deductible, but can be invested tax free until retirement.

(2) Employee contributions need not be at any greater rate than self-employed contribution.

(3) Tax saved by this CPA on his $2,500 contribution and his employee deduction of $832 at 53% federal rate.

(4) Represents amount not deductible for tax purposes at the time of contribution.

(5) The computation is based upon the use of the five-year averaging provision available for lump sum distribution by a single person using current tax rates (without surcharge). Assumption being that other outside income exactly offsets personal exemptions and deductions.

TABLE VI

Doctor, age 60, has an annual earned income of $18,000
and an eligible employee payroll of 4,000
Expects to retire in 10 years

	Through Use of HR 10 Plan	Without HR 10 Plan
Self-employed retirement annual contribution:		
Makes maximum deductible contribution (only 10% of $18,000) (1)	$ 1,800	
Makes employee contribution (10% of $4,000) (2)	400	
Total contribution	2,200	
Less tax savings (3)	616	
Net annual cost of tax shelter savings for this doctor	$ 1,584	
Amount invested, not tax sheltered		$ 1,584
Self-employed retirement fund:		
a. Invest $1,800 under HR 10 or invest $1,584 not under HR 10 (payments are made at the beginning of each year) for 10 years at 6% compounded annually	$ 25,149	$ 22,131
b. Tax basis of plan (10 times nil or $1,584 respectively) (4)	nil	15,840
c. Ordinary income before tax	$ 25,149	$ 6,291
d. Total tax (5)	$ 4,583	
e. Total tax—28% federal rate		$ 1,761
f. Net after-tax accumulation of retirement fund ((a)—(d) or (a)—(e), respectively	$ 20,566	$ 20,370

(1) Maximum rate of self employed deductible contribution—10%.

(2) Employee contributions must be at a rate at least equal to that of the self-employed contribution.

(3) Tax saved by this doctor on his contribution of $1,800 and his employee deduction of $400 at 28% federal rate.

(4) Represents amount not deductible for tax purposes at the time of contribution.

(5) The computation is based upon the use of the five-year averaging provision available for lump sum distribution by a single person using current tax rates (without surcharge). Assumption being that other outside income exactly offsets personal exemptions and deductions.

TABLE VII

Lawyer, age 50 has an annual earned income of $22,000
and an eligible employee payroll of 12,000
Expects to retire in 20 years

	Through Use of HR 10 Plan	*Without HR 10 Plan*
Self-employed retirement annual contribution:		
Makes maximum deductible contribution (only 10% of $22,000) (1)	$ 2,200	
Makes voluntary contribution (if he had no employees or did not provide for employee voluntary contributions, no voluntary contribution privilege available) (2)	800	
Total self-employed contribution	3,000	
Makes employee contribution (10% of $12,000) (3)	1,200	
Total contribution	4,200	
Less tax savings (4)	1,408	
Net annual cost of tax shelter savings for this lawyer	$ 2,792	
Amount invested, not tax sheltered		$ 2,792
Self-employed retirement fund:		
a. Invest $3,000 under HR 10 or invest $2,792 not under HR 10 (payments are made at the beginning of each year) for 20 years at 6% compounded annually	$116,977	$108,868
b. Tax basis of plan (20 times $800 or $2,792, respectively (5)	16,000	55,840
c. Ordinary income before tax	$100,977	$ 53,028
d. Total tax (6)	$ 30,820	
e. Total tax—32% federal rate		$ 16,968
f. Net after-tax accumulation of retirement fund ((a)—(d) or (a)—(e), respectively	$ 86,157	$ 91,900

(1) Maximum rate of self-employed deductible contribution—10%.

(2) Not tax deductible but can be invested tax free until retirement.

(3) Employee contributions must be at a rate at least equal to that of the self-employed contribution.

(4) Tax saved by lawyer on his $2,200 contribution and his employee deduction of $1,200 at 32% federal rate.

(5) Represents amount not deductible for tax purposes at the time of contribution.

(6) The computation is based upon the use of the five-year averaging provision available for lump sum distribution by a single person using current tax rates (without surcharge). Assumption being that other outside income exactly offsets personal exemptions and deductions.

TABLE VIII

CPA, sole practitioner, age 50, annual earned income of ....$ 30,000
and his wife is the sole employee (1) and is paid 5,000

	Through Use of HR 10 Plan	Without HR 10 Plan
Self-employed retirement annual contribution:		
Takes maximum deductible contribution	$ 2,500	
Makes maximum voluntary contribution (plan must provide for employee voluntary contributions at same rate as self-employed) (2)	2,500	
Total self-employed contribution	5,000	
Makes employee contribution (10% of $5,000) (3)	500	
Wife makes voluntary contribution (2)	500	
Total contribution for taxpayer and his wife	6,000	
Less tax savings (4)	1,170	
Net annual cost of tax shelter saving for this CPA and his wife	$ 4,830	
Amount invested by this CPA and his wife, not tax sheltered		$ 4,830
Self-employed retirement fund (including wife's portion):		
a. Invest $6,000 under HR 10 or invest $4,830 not under HR 10 (payments are made at the beginning of each year) for 20 years at 6% compounded annually	$233,954	$188,335
b. Tax basis of plan (20 times $3,000 or $4,830, respectively) (5)	60,000	96,600
c. Ordinary income before tax	$173,954	$ 91,735
d. Total tax ((6)	$ 49,160	
e. Total tax—39% federal rate		$35,777
f. Net after-tax accumulation of retirement fund ((a)—(d) or (a)—(e), respectively)	$184,794	$152,558

(1) Wife must be *gainfully* employed for 20 hours or more in at least 5 months of each year.
(2) Not tax deductible, but can be invested tax free until retirement.
(3) Employee contribution must be at a rate at least equal to that of the self-employed contribution.
(4) Tax saved by this CPA on his $2,500 contribution and his (wife) employee deduction of $500 at 39% federal rate.
(5) Represents amount not deductible for tax purposes at the time of contribution by this CPA and his wife.
(6) The computation is based upon the use of the five-year averaging provision available for lump sum distribution by a married person filing a joint return using current tax rates (without surcharge). Assumption being that other outside income exactly offsets personal exemptions and deductions.

TABLE IX

CPA partnership—consists of 4 partners of various ages who expect to retire in 25 years—the annual average income for each partner is	$ 28,000	
with a total partnership eligible employee payroll of	100,000	
(Below represents results for each partner)		
	Through Use of HR 10 Plan	*Without HR 10 Plan*
Self-employed retirement annual contribution:		
Makes maximum deductible contribution (3% of $28,000) (1)	$ 840	
Makes maximum voluntary controbution (2) (available only if plan provides for employee voluntary contributions at same rate as self-employed)	2,500	
Total self-employed contribution	3,340	
Makes employee contribution (3% of $100,000 ÷ 4) (rate determined by provision in plan established in this example) (employee need not make voluntary contributions even though plan so provides)	750	
Total contribution	4,090	
Less tax savings (3)	572	
Net annual cost of tax shelter savings for each CPA partner	$ 3,518	
Amount invested, not tax sheltered		$ 3,518
Self-employed retirement fund:		
a. Invest $3,340 under HR 10 or invest $3,518 not under HR 10 (payments are made at the beginning of each year) for 25 years at 6% compounded annually	$194,242	$204,594
b. Tax basis of plan (25 times $2,500 or $3,518, respectively) (4)	62,500	87,950
c. Ordinary income before tax	$131,742	$116.644
d. Total tax (5)	$ 46,070	
e. Total tax—39% federal rate		$ 45,491
f. Net after-tax accumulation of retirement fund ((a)—(d) or (a)—(e), respectively)	$148,172	$159,103

(1) Self-employed deduction limited to rate not to exceed that used by employee contribution.
(2) Not tax deductible, but can be invested tax free until retirement.
(3) Tax saved by each CPA partner on his $840 contribution and his share of employee deduction of $750 at 39% federal rate.
(4) Represents amount not deductible for tax purposes at the time of contribution.
(5) The computation is based upon the use of the five-year averaging provision available for lump sum distribution by a single person using current tax rates (without surcharge). Assumption being that other outside income exactly offsets personal exemptions and deductions.

Tables V through IX are from the September 1968 issue of the *Journal of Accountancy.*

TABLE X

Example of Integration with Social Security

Y has a successful accounting firm. He wants to keep his top employees who have been eyeing jobs in industry where they can get tax-favored fringe benefits. So he's going to set up a qualified retirement plan in which he, too, can participate. Three of the accountants who work for him get $13,500 a year each, one gets $8,500, his secretary, $6,000 and a clerical assistant, $4,000. The retirement plan calls for a contribution of 10% of earned income for the accountant and 10% of salary for the covered employees. The table below shows how the plan can coordinate the employer's contributions with Social Security.

	Net profits or wages			Contributions	
	Per person	Total	10%	Social Security taxes[1]	Net contributions
Accountant	$40,000	$40,000	$2,500[2]	$ 389.40	$2,110.60
3 employees	13,500	40,500	4,050	772.20	3,277.80
1 employee	8,500	8,500	850	257.40	592.60
1 employee	6,000	6,000	600	234.00	366.00
1 employee	4,000	4,000	400	156.00	244.00
Total, owner		$40,000	$2,500	$ 389.40	$2,110.60
Total, employees		59,000	5,900	1,419.60	4,480.40
Total, owner and employees		$99,000	$8,400	$1,809.00	$6,591.00

[1]Self-employment tax, 5.9% of self-employment earnings up to $6,600; employer portion of Social Security taxes 3.9% of employee earnings up to $6,600; (rates eff. 1-1-67). Does *not* include Medicare tax.

[2]Maximum contribution allowed.

Note: Contributions for Y after integration with Social Security ($2,110.00) are less than a third of net contributions under the plan ($6,591.00), taking Social Security taxes into account.

Table X is from Prentice-Hall Pamphlet 462-3, 11/67

TABLE XI

Comparison of Corporate Plans and HR 10 Plans

	HR 10 Plan which includes owner-employee	*Corporate*
Coverage	Plan must cover all employees with 3 or more years' service.	Plan must cover (a) 70% or more of all employees; or (b) 80% or more of all eligible employees, provided 70% of all employees are eligible; or (c) special classification which doesn't discriminate in favor of higher-ups.
"Employer" contribution	Owner-employees contribute on their own behalf up to 10% of earnings or $2,500, whichever is smaller. Where both capital and personal services are material-income producing factors, "earned income" means all of income from business (for tax years starting after 12-31-67). Contributions for employees must be at least proportionate to contributions for owner-employee. Otherwise contribution limits for employees of owner-employee are same as for corporate employees.	No maximum dollar limitation. (See deduction limits.)
"Employee" contributions	Voluntary employee contributions permitted. Where covered employees may contribute, owner-employee may make proportionate contributions, up to lesser of 10% of earned income or $2,500.	Voluntary or compulsory employee contributions permitted.
Integration with Social Security	Integration is permitted if contributions for owner-employee don't exceed third of total contributions. Plan given credit only for actual Social Security taxes paid by employer for employees.	Plan benefits plus Social Security benefits for higher-ups must not be larger in relation to salary than plan benefits (if any) plus Social Security benefits for lower-paid employees.

TABLE XI (Continued)

	HR 10 Plan which includes owner-employee	*Corporate*
Yearly deduction limits	Owner-employee can deduct all of "employer" contributions on own behalf (for tax years starting after 12-31-67). They can deduct all of contributions for employees if within same limits as apply to corporate plans. Deductions for owner-employee on year-to-year basis, no carryovers. Carryover permitted for contributions for employees.	No maximum dollar limitation. If employer's contributions are reasonable additional compensation, it can deduct (1) for pension contributions either (a) 5% of pay of covered employees plus any sum necessary to pay past and current service actuarially determined, or (b) normal cost of plan plus 10% of past service costs; (2) for profit-sharing contributions, up to 15% of total payroll of covered employees. Credit and contribution carryovers permitted.
Vesting	Plan must provide for immediate vesting of benefits for all covered employees.	Plan may provide complete vesting, partial vesting, or no vesting until retirement (provided lack of vesting doesn't produce prohibited discrimination.) Vesting required on termination of plan.
Funding Media	Trust, insurance policies, custodial account (invested solely in mutual funds or insurance contracts), face-amount certificates, or special Government retirement bonds. Trustee must be bank, except where all investments in insurance company contracts and all proceeds payable directly to employee or beneficiary.	Same, except can have individual trustees.
Distributions	No benefits for owner-employee before age 59-1/2, disability or death. Benefits must begin for owner-employee not later than 70-1/2 and for employees, not later than 70-1/2 or year of retirement. Distributions payable on death of owner-employee must be within 5 years of death (or death of wife) or used to buy immediate annuity.	Pension and profit-sharing benefits are payable at retirement, disability, death, discharge, or quit. Profit-sharing distributions can also be made during employment.

TABLE XI (Continued)

	HR 10 Plan which includes owner-employee	*Corporate*
Penalties	Penalties apply if contributions for owner-employee exceed allowable amount. Penalties also apply to premature distributions to them.	No comparable provisions.
Lump-sum distributions	No capital-gain treatment for owner-employee. Distributions after age 59-1/2 or because of disability or death taxed under special "divide-by-five, multiply-by-five" method. Capital gain available to employees.	Capital gain treatment.
Estate, gift and income taxation	Owner-employee can't get these exclusions: (a) Estate tax; (b) Gift tax; (c) $5,000 death benefits; (d) Sick pay exclusion.	All employees can get these exclusions.
Retirement Income credit	Self-employed individuals and employees eligible.	All employees eligible.
Prohibited transactions	Owner-employee owning more than 10% of business (or a member of his famiily or his 50%-or-more controlled corporation) can't: (a) Borrow money from trust; (b) Buy from or sell property to trust; (c) Charge for any services to trust.	Corporate employer can: (a) Borrow money from trust with adequate security and reasonable rate of return; (b) Buy from or sell property to trust if consideration adequate; (c) Charge reasonable fee.

Table XI is from Prentice Hall pamphlet 462-3, 11/67.

TABLE XII

Examples of types of pension and profit-sharing plans

(a) Money Purchase pension plan.

Under this method, the percentage of Earnings selected will remain the same every year. You may change the percentage only by amending your Plan. Contributions will vary in direct relationship with the Earnings of each Participant. For example, you earn $20,000 and pay an eligible employee an annual salary of $4,500. If you were to select Method (a) and specify a 10% contribution, the contribution on your behalf would be $2,000 (10% of $20,000) and for your employee $450 (10% of $4,500).

(b) Flat Percentage benefit pension plan.

Under this method, the Firm's contribution for each Participant is an amount actuarially computed each year to be sufficient to provide each Participant with a retirement income equal to a specified percentage of Earnings. This method differs in concept from other methods in that the amount of pension rather than the cost is computed first. Special calculations are necessary to compute the applicable percentage required under this method. An illustration of the procedure used based on the assumption that an annuity would be purchased at age 65 is illustrated below.

Assume you are a sole practitioner, age 45, with earnings of $50,000 per year. You have a 25 year old male employee, earning $5,000 per year, who would be eligible for the Plan. You wish to contribute $2,500 to the Plan for yourself (5% of your earnings) and a minimum amount for your employee.

On the basis of 3-1/2% assumed interest earnings, your $2,500 contribution will accumulate to $70,700 in the twenty years remaining before your normal retirement age. On the basis of the price of an annuity, this $70,700 will purchase an annual pension of $6,000. A pension of $6,000 is 12% of your current pay. This 12% would be the specified percentage of earnings that would be the annual benefit.

Twelve percent of your employee's pay of $5,000 per year would be a pension of $600 per year commencing at age 65. The accumulated value necessary to provide this pension is assumed to be $7,070. If this is discounted at 3-1/2% interest as specified, the required contribution for your employee would be only $84 this year which is 1.6% of your employee's pay.

(c) Profit sharing by Variable Factor

Under this method, whenever the earnings of the lowest paid owner-employee who is a Participant exceeds $25,000, the contribution to be made on behalf of employees will be determined by dividing $2,500 by the earnings of the Attorney-owner with the lowest earnings.

This method is useful as a cost control device in that each year the contribution on behalf of your employees is automatically computed to be the lowest percentage which would allow you to contribute the maximum on your behalf. For example:

This year, you earn $25,000 and you have one eligible employee to whom you pay an annual salary of $5,000. You select Method (c) and specify a

TABLE XII (Continued)

10% contribution. The contribution on your behalf would be $2,500 and for your employee $500.

Next year, you earn $50,000 while your employee's salary remains at $5,000. The contribution on your behalf would continue to be $2,500 but the contribution you would make to the Plan for your employee would be reduced to 5% of his earnings or $250 ($2,500 divided by $50,000=5%).

(d) Profit sharing by Percentage of Net Income Over Specified Amounts.

You can avoid the possibility that contributions to your plan may prove to be burdensome in years of low Firm earnings. Under this method, you specify a level of the Firm's net income which, if not exceeded in a given year, will preclude a contribution to the Plan. Net income in excess of this minimum figure is the source of the total contribution and this contribution is the lesser of (1) a percentage of the total earnings of the Participants or (2) the maximum deductible amount allowed by the Internal Revenue Code. For example:

You select Method (d) and specify that contributions will be made only out of net income which exceeds $15,000, You further specify that you will contribute an amount equal to the lesser of:

(i) 10% of the aggregate earnings of the Participants for the taxable year, or

(ii) the maximum deductible amount allowed by the Internal Revenue Service.

Let's assume total earnings of Participants amount to $100,000 and net income is $60,000. Under (i) above, the contribution would be $10,000 (10% of (100,000).

Under (ii), the maximum deductible amount for self-employed individuals under current law is the lesser of 10% of earnings or $2,500. For employees, the maximum deductible amount is 15% of earnings. For this case, let's assume you are the only self-employed individual (with annual earnings of $60,000) and the balance of the earnings ($40,000) are attributable to employees.

The maximum deductible amount would be computed as follows:

10% of $60,000 or $2,500, whichever is less	$ 2,500
15% of $40,000	$ 6,000
Maximum Deductible Contribution	$ 8,500

Selecting the smallest contribution amount produced by (i) or (ii), you would contribute to the Plan for the first year $8,500 as computed in (ii). This procedure would be used to compute the contribution each year the Plan is in effect. Of course, if net income falls below $15,000 in any year, there would be no contribution to the Plan for that year.

Table XII is adapted from the Virginia State Bar Master Retirement Plan.