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Swerdlin & Company

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Alternatives to the 401(k) Plan

In the past few years the 401(k) plan has become the most popular retirement plan. Employees are asking for 401(k) plans, and employers feel they cannot continue to attract and retain qualified employees without a 401(k) plan. There is no question these plans offer great employee benefits; however, they do not provide owners, company officers and other highly paid employees as great a benefit as they might get from a traditional defined benefit or defined contribution plan.

Employees who make salary deferral contributions receive the greatest benefit from a 401(k) plan. These employees may not always be the ones who add the most to your company's bottom line, nor those you consider the most valuable. Although it's important to encourage employees to save for retirement, you can use other plan designs to target those employees you want to reward.

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IN THIS ISSUE

Dorn's Corner

In my very first "Dorn's Corner," published in the fall of 1994, I announced the beginning of a five year research project which ends at the end of next year. The focus of this project is to create or find a new business application for actuarial science. Here we are over 60% into the five year period and I would like to give you a progress report.

Some of you were left with the impression that I was going away somewhere (perhaps to a mountain top in the Himalayas) to conduct this research project. Unfortunately, I had to stay down here on earth and do mundane things like go to work and take out the garbage. However, the project has seen quite a bit of my attention so far. I was elected to the Section Council for The Actuary of the Future of the Society of Actuaries. I have been on the Program Committee for the Society of Actuaries

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Alternatives to the 401(k) Plan

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Here are brief descriptions of other plan design choices. No single design is better than another. The "best" plan is one which meets your objectives and provides the maximum benefit to those you want to reward.

"the best plan is one which meets your objectives"

Traditional Profit Sharing Plans allocate contributions among employees based on their pay. Therefore, the more an employee earns, the larger his share of the contribution. Assuming your most valuable employees are the highest paid, then they clearly benefit under this type of plan. The company contribution to a profit sharing plan is discretionary, so you have the flexibility to adjust each year's contribution according to the company's performance.

You can also choose a contribution formula which gives those who make more than the Social Security wage base ($68,400 in 1998), an additional contribution of up to 5.7% of their earnings in excess of the wage base. This integrated formula allows you to compensate your higher paid employees for the fact that no Social Security contributions are made on their wages in excess of the wage base

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Non-Traditional Profit Sharing Plans, such as cross-tested and age-weighted, allow you to divide your employees into groups and use a disproportionate contribution formula for each group. Contribution formulas may be complex and require annual monitoring. However, careful planning allows you to target contributions to a key group of employees. Contributions to these plans are discretionary, giving you the flexibility of a traditional profit sharing plan.

Money Purchase Pension Plans require a contribution every year. In exchange for giving up the flexibility of a discretionary contribution, the money purchase plan has a higher deduction limit. The employer contribution to a money purchase plan can be as high as 25% of eligible compensation, where profit sharing plans are limited to 15%.

Defined Benefit Pension Plans promise a benefit at retirement. This type of plan provides the largest benefit to older, long-term employees. Defined benefit plans can be designed to produce the maximum deductible contribution. For more details, see the article on defined benefit plans on page seven.

If you would like to consider a new retirement plan or change your current plan, give us a call. We have the knowledge and experience to help you design and implement any type of retirement plan. Our highly trained staff can answer your questions and help you make a decision to meet your objectives.■

Dorn's Corner

(Continued from page one)

Spring Meetings for two years. I recently became the Vice Chairman of the Section Council. I also recently joined the Committee for Management and Personal Development of the Society of Actuaries.

These activities are allowing me to be involved with people who are determining the future of the actuarial profession, and my focus is on the training and development we will need to truly become the actuaries of the future. We are excited about how new business applications for actuarial science are taking shape.■

The time limit for correcting certain plan violations under the IRS Administrative Policy Regarding Self-Correction (APRSC) has been extended to 2 years following the close of the plan year in which the violation occurred.

The excise tax on prohibited transactions has increased from 10% to 15%.

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Vision Statement

We strive for financial strength for our clients, our employees and our company by caring to be the best. We are committed to being the leading pension consulting firm in our market. We achieve this through cooperative teamwork, community building and continuous learning and development.

Mission Statement

We focus primarily on design and administration of qualified retirement plans. Our mission is to develop relationships with our clients, our employees and our community so that all parties grow and develop financially and otherwise.

Plan Loans

A recent report from the United States General Accounting Office (GAO) indicates that allowing plan loans may encourage lower paid employees to participate in your plan. They found that participants will save more of their pay if their plan has a loan provision. At the same time, the GAO cautions that a loan is a "double-edged sword." While a plan loan provision may encourage workers to save for retirement, it may also reduce their retirement income.

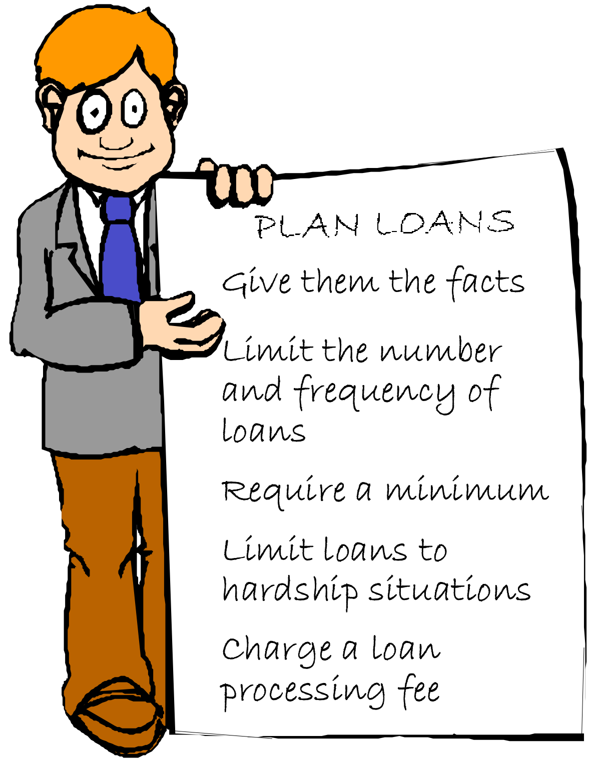
To illustrate how this can occur, the Wall Street Journal recently provided this example. Let's say a participant borrows $10,000 from his account at 10% interest. After the loan is repaid, he has $11,000 in his account. However, if he had not taken the loan, the $10,000 would have been invested and earning income. Also, the $1,000 interest he paid to the plan would still be in his bank account.

The participant pays taxes twice on the money he borrows. The loan payment and interest is repaid with after-tax dollars, and this same money will be taxed again when it is withdrawn at termination or retirement. Depending on the tax bracket and number of years involved, the hidden tax cost can almost double the total cost of the loan.

The GAO found plan participants often repay loans at interest rates much lower than their money could have earned if it had stayed in the plan. They report that plan loans could result in a loss of as much as 28% of a participant's retirement income.

So what do you do? You want to encourage lower paid employees to save for retirement but you don't want them to use the plan like a checking account. If you feel the plan must allow loans, you can do several things to reduce the number of loans.

Give them the facts. Make sure participants understand that a plan loan may negatively affect their retirement income. Also, make it clear that should they leave the company, the loan becomes immediately payable. If they don't pay it off, they will pay taxes and penalties on the outstanding loan amount.



Limit the number and frequency of loans. Allow participants to have only one outstanding loan at a time. Limit the frequency of new loans to one in any twelve-month period. Each of these suggestions minimizes the number of loans.

Require a minimum. Requiring a loan minimum, such as $1,000 will eliminate small, frivolous loans. Just be sure the minimum is not so high as to make your loan program discriminatory.

Limit loans to hardship situations. Loans can be limited by allowing them only for certain purposes such as medical bills, education or the purchase of a home.

Charge a loan processing fee. Your participants will think twice if they have to write a check for $100 every time they want a plan loan.

Remember that all parts of your plan must be operated in a nondiscriminatory manner. Provisions that reduce the number of loans must be equally applied to all participants.■

FAQ

Frequently Asked Questions

Q I am a little confused over the issue of 401(k) deferrals and the maximum compensation limit. I have several participants who will reach the $160,000 compensation limit early in 1998. Should I stop withholding 401(k) deferrals from their pay when they reach $160,000, or should I continue to withhold until the deferral limit is reached ($10,000 for 1998)?

A The IRS has recently revised its interpretation of how the maximum compensation limit affects deferrals, both at a conference in Washington, D.C. and in a recent newsletter to practitioners. Although these are not official statements from the IRS, they give us some guidance on how the IRS views this issue.

You do not have to stop withholding 401(k) deferrals when someone reaches the $160,000 compensation limit. If the employee is a participant for the entire plan year, all twelve months of compensation are eligible for deferral. You can withhold up to the $10,000 limit if both the participant's election and the plan document allow for it.

It is important to follow the terms of your plan document. For example, the plan may limit pay to the first $160,000 earned, so you would stop withholding as soon as this point is reached. Or it may limit salary deferral contributions to a specific percentage, such as 10%.

Q Is Swerdlin & Company the Plan Administrator?

A We are often asked this question, so we thought we should answer it here. We are not the Plan Administrator; we are a Third Party Administrator, or TPA.

The role of Plan Administrator is a legal designation, assigned in the plan document, and reported on the Internal Revenue Service Form 5500 series. It is the Plan Administrator's responsibility to run the plan, set policy, hire plan advisors, report to the government and advise participants of their rights.

The TPA performs many functions for the Plan Administrator including calculating eligibility, vesting and benefits. As a TPA, Swerdlin & Company provides services, assistance and guidance at the request of and on behalf of the Plan Administrator. While we are responsible for our work, the final authority and responsibility for operating the plan remains with the Plan Administrator.

Q A new employee was a participant in a 403(b) plan (he worked for a hospital). Now that he has joined our 401(k) plan, he asked if he can roll the money out of his old plan and into ours.

A Unfortunately, he cannot roll over this money. The IRS does not allow money to be rolled from a 403(b) plan into a 401(k) plan (or vice versa). If he does not want to leave his money in the old plan, his only option is to roll it into an IRA account, which will preserve the tax favored status of his retirement savings and give him control over how his money is invested.

Q Another new employee wants to know if he can roll over his defined benefit plan money into our 401(k) Plan.

A Yes. If the money is still in his old plan, he can roll it over into any qualified plan. However, the defined benefit plan must permit lump sum distributions, and the new plan must be able to accept rollovers.■

We can help you with the following services:

- Actuarial Consulting
- Plan Consulting and Design
- Plan Installation
- Annual Administration
- Employee Communication
- Regulatory Compliance
- Educational Presentations
- Special Studies

We are dedicated to making your employee benefit program a tool for reaching your organizational goals.

We provide services for:

- Profit Sharing Plans
- 401(k) Plans
- Money Purchase Plans
- Target Benefit Plans
- Defined Benefit Plans
- ESOPs
- Age-Weighted Plans
- New Comparability (Cross-Tested Plans)
- TSAs/403(b)/457 Plans
- Comprehensive Employee Benefit Statements
- Supplemental Executive Programs.

Give us a call to discuss how we can help you make the most of your employee benefit program.

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How to Get Outstanding Plan Service

What does it take to get outstanding service for your retirement plan? Here are some pointers:

- Keep your plan advisers informed. Let them know about changes in your business as they occur.

- Seek out partners who will help make your business grow. Use service providers who understand your needs and are committed to help you achieve your goals.

- Ask questions. Don't hesitate to pick up the phone and ask: Why is that necessary? How much will that cost? What opportunities are available to me?

- State your expectations. The best way to get what you want is to let people know what you expect.

Let us be your retirement plan resource. We have the expertise and experience to help you select, implement and administer any type of retirement program. Let us show you how to use your retirement plan as a tool to make your business grow. ■

What's Happenin'

Dorn Swerdlin has been elected Vice Chairman of the Actuary of the Future Section Council of the Society of Actuaries (SOA). Dorn has also been appointed to serve on the SOA's Committee on Management and Personal Development.

Laura Matlock has been promoted to Vice President of Client Services and has become a Swerdlin & Company shareholder.

Welcome back to Melodi Kline, who has returned to Swerdlin & Company as an administrative assistant.

Welcome aboard to Rebecca Drumm, who has joined our actuarial team.

Commonly Asked Questions About Defined Benefit Plans

Defined Benefit plans are not new. They have been around for many years, yet few people know much about them. Following are some of the commonly asked questions about defined benefit plans.

What Is a Defined Benefit Plan? A defined benefit plan is a retirement plan which promises a fixed benefit to participants when they retire. An example of a defined benefit formula is 2% of pay for every year an employee is a participant in the plan. Under this formula, an employee who participates for ten years, receives lifetime annual payments equal to 20% of his pre-retirement pay.

Who Benefits Most from this Type of Plan? Your older and longer-term employees, often the owners, benefit the most from a defined benefit plan.

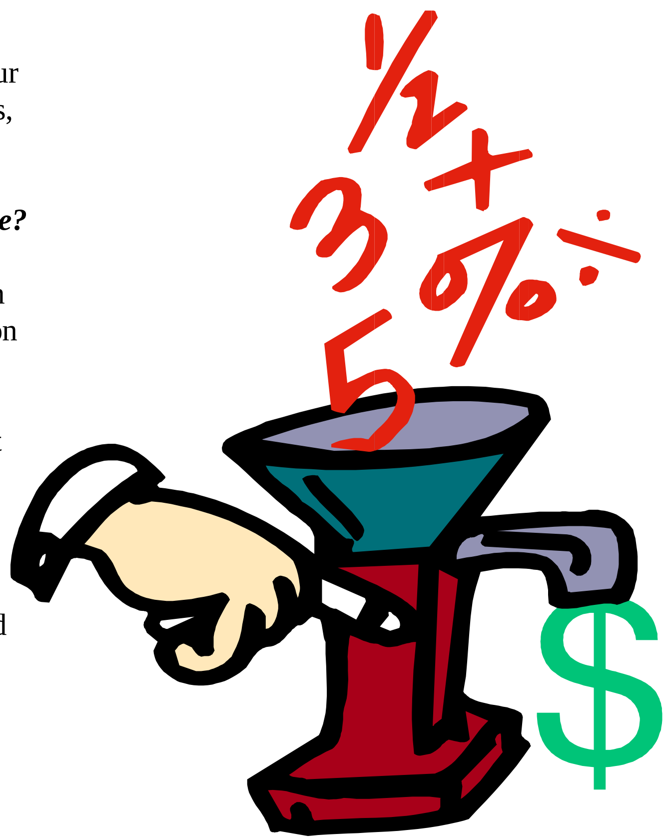
What Is the Maximum Benefit You Can Receive? A defined benefit plan provides annual benefits as much as 100% of average pay, up to the maximum dollar limit ($130,000 for 1998). There is no limit on the annual contribution to the plan. In addition, the $30,000 annual additions limit imposed on defined contribution plans does not apply to defined benefit plans.

Is The Company Required to Make a Contribution Every Year? Each year the company must make at least the minimum required contribution which is calculated by the plan's actuary.

How Is The Annual Contribution Determined? An actuary calculates the minimum funding requirement and the annual contribution that will fund the promised retirement benefits. The contribution varies depending on the plan's investment results and changes in the employee census.

Are Defined Benefit Plans Tax-favored? Yes, a defined benefit plan is a tax-qualified plan, and receives tax-favored treatment. Within certain limits, employer contributions to the plan are tax deductible and investment earnings are not currently taxable. Participants are not taxed on their plan benefits until they withdraw their money.

Are Defined Benefit Plans Insured? Most defined benefit plans are required to participate in the government's insurance program under the Pension Benefit Guaranty Corporation.■



Where in the World (Wide Web)

We have received many inquiries as to how we can be contacted over the internet. This quarter, instead of web sites, we provide a list of our e-mail addresses.■

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Involuntary Cash-Out Limit Increased to $5,000

Under the Taxpayer Relief Act of 1997, signed into law by President Clinton on August 5, 1997, a qualified plan may increase the involuntary cash-out limit from $3,500 to $5,000. This new elective limit is effective for plan years beginning after August 5, 1997.

A plan must be amended to include the new $5,000 involuntary cash-out limit. However, this change may be adopted at any time before the end of the plan year for which it is first effective.

IRS regulations require that if a participant's benefit at the time of distribution exceeds the limit, a subsequent distribution is treated as if it also exceeds the limit, regardless of amount. The involuntary cash-out limit in effect at the time of the distribution applies to all subsequent distributions.

Here is an example of the effect of the new regulations. A participant has an account balance in a defined contribution plan of $6,000, receives a termination distribution of the entire amount, and subsequently receives an employer contribution of $550 for his final year of employment. This final distribution is subject to the same rules as the initial distribution. Therefore, the participant must be notified of payment options, spousal consent requirements and the ability to leave the money in the plan.

Please call us if you want to make this change for the 1998 plan year.■