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Retirement Plans – Do They *Have* to be so Complicated?

Most employers want to provide a competitive fringe benefit package to their employees. Next to offering health insurance, providing future retirement benefits ranks at the top of the list of desired benefits. Unfortunately, retirement plans can be both very costly and complicated. Everyone has heard horror stories of well-meaning employers who either accidentally mishandled retirement funds or simply ran afoul of the complicated rules and regulations. In answer to the question, Do they *have* to be so complicated? – the answer is *not always*. This short article will outline two types of simplified plans that just might be a perfect fit for your organization.

The first type is called the **SIMPLE IRA** (*Savings Incentive Match Plan for Employees*). It is a relatively new creation of the tax law that allows smaller companies, those with under 100 employees earning more than $5,000 annually, to sponsor a retirement plan with very few rules. Since it is not a "qualified plan", it does not require annual Form 5500 reporting. Instead it has some very basic requirements as follows:

Employees must be considered eligible if they have earned $5,000 or more per year in each of the two prior years and can reasonably be expected to do so again.

For employees - compensation is calculated as wages prior to the elective deferral. For self employed business owners – compensation is "earned income", defined as net earnings from self employment (92.35% of business income) less the company deduction for the pension contribution on behalf of that individual.

There can be no age restriction (either minimum or maximum) on eligibility to participate in a SIMPLE plan.

Employee contributions are limited to the lesser of 100% of compensation or $9,000 and $10,000 in 2004 and 2005, respectively. "Catch up" deferrals of employees over 50 years of age can be $1,500 in 2004 and $2,000 in 2005.

The employer must not make contributions to any other qualified plan starting with the year the SIMPLE plan goes into effect – (exception to this rule – a SIMPLE plan can cover nonunion employees, at the same time the company maintains a union plan).

The only tricky part of the SIMPLE plan is the required annual employer contributions. Employer contributions can take either of two forms:

Matching Contributions — The employer can match the employee's elective deferral up to 3% of compensation prior to the employee's deferral. In any two out of five years, the match can be as low as 1% of the employee's total compensation. There is no dollar limitation on the employee's total compensation that can be used as the basis for the match and the employer has no obligation to match any "catch-up" deferrals.

Nonelective 2% Contributions — The employer can contribute 2% of every eligible employee's compensation, whether or not that employee elects a deferral in that year. This 2% is limited to $200,000 of compensation. Any year that a nonelective match is made counts as a 3% matching year.

There is a 60 day period prior to the beginning of the year when employees can choose what percentage of their compensation will be contributed for the next calendar year. Prior to this, the employer must notify employees what the employer match will be. An employee may terminate participation in the plan at any time during a calendar year. However, the plan may prohibit that employee from reentry until the beginning of the following calendar year.

One of the best rules concerning the SIMPLE plan is the more liberal length of time to remit the employee deferral contributions. Employers can deposit the funds up 30 days from the end of the month in which the deferral was deducted. Comparing this to a qualified plan where deferral contributions must be remitted as soon

as possible after the funds can be segregated from company assets, basically remitting at every payroll. This is a reason in itself to elect this type of plan. As with other retirement plans, the employer has until the due date of the employer's income tax return (including extensions) to make the company match contributions. Even a cash basis taxpayer is allowed the deduction for the company contribution in the year it is earned, not paid.

In order to discourage premature withdrawal of funds, during the first two years of participation in a SIMPLE plan, all distributions to participants under 59 years are subject to a 25% penalty and cannot be rolled over to any plan other than another SIMPLE plan. Thereafter, they are subject to the normal 10% early withdrawal penalty. All distributions are fully taxable as income and employees are fully vested in their accounts at all times.

Unfortunately, retirement plans can be both very costly and complicated.

Although the SIMPLE plan is easy to administer, it is not the answer for everyone. All employees are vested immediately in company contributions. For many employers, a retirement plan is a reward and an incentive to long term employees. A SIMPLE plan will never meet this important goal of management. Additionally, employees can defer less money under a SIMPLE plan and no additional employer money can ever be contributed regardless of the profitability of the company.

Therefore, if any of these factors are a concern, you may want to consider the **Safe-Harbor 401(k) Plan**. Unlike a SIMPLE IRA, this savings vehicle is a "qualified plan", which unfortunately means a few more restrictions and complications. The annual Form 5500 reporting is required and employee deferral contributions must be remitted as soon as the assets can be segregated from the employers general assets'. As with a normal 401(k) plan, any company match or profit sharing contributions above the required basic company contribution described below, can be subject to vesting which rewards longer term employees.

What makes this safe harbor plan attractive is the lack of discrimination rules that are present in other "qualified plans". The discrimination tests are the dreaded calculations that limit the deferrals of highly compensated employees of the company based on the average contribution deferral rate of the rest of the employees. These rules often take the incentive away from employers for providing any benefit to employees, since their own contributions are so limited. This safe harbor plan was established as an incentive to employers to provide a basic employer contribution to employees. The lawmakers felt that if a company was willing to agree to a minimum contribution, then it was OK for the higher paid employees to maximize their benefits.

Basically, a normal 401(k) plan becomes a "safe-harbor plan" when management revises its plan agreement to include safe-harbor language and when it agrees to the basic contribution in writing to employees prior to the beginning of the plan year. The basic contribution is as follows:

3% profit sharing for all eligible employees, or

100% match of all employees' deferrals up to 3% and 50% match of all deferrals between 3% and 5%.

For many employers that normally provide a match or profit sharing contribution anyway, this is a simple step that can be taken, and it really increases the benefit to the owners and highly paid employees.

In a competitive job market where companies want to retain their top performers, a retirement plan can be an attractive employee benefit as long as it is without undue administrative burden and cost. If you are without a current plan, consider the SIMPLE plan. If you already have a 401(k) or profit sharing plan in place, consider adding the safe-harbor provisions that make a normal plan that much more flexible and beneficial to management.

— Karen L. Benson, CPA, PFS

— Editor's note --- Karen is a Manager in the firm's Erie Office. She is considered by many to be among the most knowledgeable professionals in the region in the area of retirement plans. She offers compliance reviews of pension plans as a service, and manages many of the firm's pension plan audits. She is on the Virtual Planning Committee of the AICPA National 2005 Employee Benefit Plan Conference. This article is derived from the section of a course that Karen taught to other CPAs in various locations in Western Pennsylvania, under sponsorship of Penn State University. McGill, Power, Bell & Associates, LLP is a member of the AICPA Employee Benefit Plan Audit Quality Center, which adheres to a high standard of employee education and monitoring all work related to employee benefit plans.

To GAAP or not to GAAP... The Quest for "More Realistic and Accurate" Financial Data.

Applying generally-accepted accounting procedures (GAAP) presents an overview of a company's financial position at a moment in time. But the "snapshot" represents a single view point and can be two-dimensional. Does booking a company's "non-recurring expenses" provide a true picture of its operating performance. Where on a GAAP compliant financial statement is the company's potential for growth measured or presented?

Investors and lenders were looking for more "realistic" procedures for determining the financial attractiveness of a company. Particularly in the boom years of the 90's in the technology sector, a company might have tremendous potential, but limited assets. Non-GAAP financial analysis methodologies were developed to provide a more realistic view of a company's performance, trends, and potential.

EBITA

One of these non-GAAP measurements of financial performance was EBITA (Earnings Before Interest, Taxes, Depreciation, and Amortization). The purpose of EBITA was to quantify what management was generating in the way of earnings from its operations.

The obvious problem with this analysis is that it does not reflect the cost of debt. It also provides a distorted picture of the financial position of a company highly dependent upon its equipment to do business. At some point the equipment will have to be replaced, so the cost of financing the equipment (interest and the repayment of principal) and of "wear and tear" on it (depreciation) are real components of the cost of doing business for this company. Additionally, corporate taxes must be paid out of pretax profits, and realistically are subtracted from the money available to pay investors or repay loans.

EBITA Abused

Some obvious ways in which EBITA can be abused are for a company, for which plant and equipment are critical cost issues, to rely exclusively on EBITA. WorldCom began to use EBITA to accurately reflect its telecommunications operating income separately from its depreciation and long-term amortization. However, investors were not advised of future capital expenses that would be required. WorldCom began to abuse the use of this analysis, when it booked ordinary expenses as capital expenditures, which are not accounted for by EBITA.

Different Methodologies; Radically Different Results

Non-GAAP analysis can produce widely varying results. Consider the company with the following financial information:

Operating Revenues $3,000,000
Non Recurring Revenues $1,000,000
Non Recurring Expenses $2,500,000
Operating Expenses $2,000,000

What should be reported as the Company's income?

GAAP would report a loss of $500,000:

Operating Revenues $3,000,000
Non Recurring Revenues $1,000,000

Total Revenue $4,000,000

Non Recurring Expenses $2,500,000
Operating Expenses $2,000,000

Total Expenses $4,500,000

Total Revenues
less Total Expenses ....$ (500,000)

EBITDA would report a profit of $1,000,000 as the "true" operating profit.

Operating Revenues $3,000,000
Operating Expenses.............$2,000,000

Total Operating Revenues
Less Operating Expenses $1,000,000

This significant variation could be increased even further to $2,000,000 by some analysts who might include non recurring revenue without recognizing non recurring expense.

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The Ethical Dimension

In some cases, non-GAAP financial analyses, such as EBIDA, are useful. These are best used in conjunction with GAAP financial statements. The methodologies should be clearly represented. The purpose of these procedures is analysis, not misrepresentation or the concealment of future costs. When they are used primarily to present a misleadingly positive financial picture, their use is clearly unprofessional and generally unethical.

—John C. Stillwaggon, CPA, CGFM

Editor's Note — John is the firm's newest Partner. He practices from the Grove City Office, and is the director of the firm's Nonprofit Services Group. John has twenty years of audit experience and remains current on all GAAP guidelines.

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