Qualified Retirement Plans are considered by most financial planners to be the best tax deferral program available today. Current contributions to the plan are not subject to corporate or personal income tax - in fact, the plan sponsor gets to deduct the contribution (subject to certain limitations). Earnings on the funds in the plan accumulate tax deferred, with the plan participants paying the income tax on earnings at the time they take the plan benefits into income, at which time they are normally in a lower income tax bracket.

There are two basic types of retirement plans: Defined Contribution and Defined Benefit.

Defined Contribution Plans

Defined Contribution Plans are plans in which the annual contribution is generally allocated to participants based on each participant's compensation. The allocation may be the same percentage of pay for everyone or may vary by age or compensation level (within certain limits). Each participant's account is adjusted based on the earnings of the plan's investments. At retirement (or termination of employment) the participant is entitled to the balance in his or her account (subject to the vesting schedule). There are various types of defined contribution plans; Profit Sharing, Money Purchase, Target Benefit, and 401(k) Profit Sharing Plans are the most common.

A 401(k) Profit Sharing Plan is the only plan that allows the participants to contribute some of their own money into the plan. The "salary deferral" is a portion of the participant's salary that is put into the plan rather than paid to the participant. A regular salary deferral is not subject to income tax, but is subject to Social Security tax. A Roth deferral can be made from after-tax dollars. The 401(k) Profit Sharing Plan may also have an employer matching contribution, and/or a profit sharing contribution. The 401(k) Profit Sharing Plan must also meet additional nondiscrimination requirements.

Good investment returns benefit the plan participants; poor investment returns are also passed on to the participants. The investment return has no bearing on the amount of the required contribution to the plan. Many 401(k) profit sharing plans allow participants to self-direct the investment of their accounts from a menu of investment options.

Defined Benefit Plans

Defined Benefit Plans are plans in which there is a specific pension benefit at retirement and the annual contribution to fund that benefit is actuarially determined. The annual contribution is an "amortization" of the amount necessary to pay benefits as they become due. The contribution is based on the ages, compensations, and lengths of service of the participants in the plan, the value of the assets already in the plan and assumptions about future events. At retirement (or termination of employment), the participant is entitled to a monthly benefit. For purposes of payment, the monthly benefit may be "converted" into a lump sum payment. The lump sum payment is based on the monthly benefit and the age of the participant at the time of the distribution; not how much money is in the plan.

Since the value of the plan's assets are a part of the calculation of the contribution, a good investment return will help lower the required contributions, while a less than expected return may increase the required contribution. Other factors, such as changes in compensation, new plan participants, and employee turnover will affect the required contribution.

Contribution Requirements

The employer is required to make contributions to fund a defined benefit plan, as well as the following defined contribution plans: money purchase and target benefit plans. Also, some 401(k) profit sharing plans are written so that the matching contributions or Safe Harbor contributions are required contributions. In order to reduce a required contribution, the plan must be amended before participants accrue a "Year of Service". Even then, an amendment might not completely eliminate the required contribution. Failure to contribute the required amount will result in an excise tax.

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Employer contributions to fund a plan with minimum funding requirements can be deposited up to 8½ months after the end of the plan year.

Except as noted above, contributions to profit sharing plans are generally discretionary - the amount of the contribution (if any) is determined annually by the plan sponsor.

Contribution/Deduction Limits

The employer deduction limit for a defined benefit plan is a function of the contribution calculation, not a percentage of compensation. Generally, there will be a range of contributions, and the employer can deposit an amount anywhere in that range between the minimum and the maximum. For some plans, however, the minimum and maximum are the same.

The annual employer deduction limit for an employer with a defined contribution plan is 25% of the eligible compensation of the plan participants (eligible compensation is compensation up to $200,000 as adjusted; for plan years beginning in 2017, the limit is $270,000). The employee salary deferral contributions **do not** count toward this employer deduction limit.

The annual employer deduction limit for an employer **not subject to PBGC coverage** with two or more qualified retirement plans is 25% of eligible compensation of plan participants, **or the minimum required contribution to a defined benefit plan, plus up to 6% of compensation for the defined contribution plan, if greater**. Again, eligible compensation is limited to $200,000 (as adjusted), and salary deferrals do not count toward the limit. If the employer has a defined benefit plan that is subject to PBGC coverage, then the employer has separate limits as described above for each plan.

Individual Contribution Limits

Since the contribution to a defined benefit plan is not allocated to individuals, there is no individual contribution limit for a defined benefit plan. Instead, there are annual benefit limits (see section on individual benefit limits for more information). A summary of limits that apply to retirement plans can be found in the resources section of our website.

For 2017, the individual annual contribution limit for a defined contribution plan is the lesser of $54,000 or 100% of eligible compensation (as limited). This limit is not an individual plan limit, but rather applies to the total of all contributions, salary deferrals, matching contributions and forfeitures credited to all of a participant's accounts for all defined contribution plans of the employer. In addition, the annual 401(k) deferral limit for 2017 is $18,000 per calendar year, and the catch-up limit (for a participant who is at least age 50 by the end of the 2017) is $6,000.

Individual Benefit Limits

Since the contributions to defined contribution plans are limited, there are no benefit limits for these plans.

In a defined benefit plan, the benefit for each participant is limited to the average of the highest three consecutive years of their eligible compensation. This limit is further reduced if the participant will have less than 10 years of employment at his or her normal retirement age. For very highly compensated employees, the benefit is also limited by a monthly dollar limit, which is reduced for a retirement age less than age 62 and for less than 10 years of participation in the plan at his or her retirement date. This limit generally only affects owners and very highly compensated employees.

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