There are legal ways to minimize the impact of non-discrimination rules for retirement plans.

When It's Time to Retire

Because of industry pay structures, many constractors face a major obstacle when attempting to set up tax-qualified retirement plans. That problem is called "nondiscrimination"; by law, companies must generally include all employees in any tax-qualified plan.

In the construction industry, where there are many workers either unwilling or unable to defer income in a pension plan, highly paid owners and key employees sometimes do not utilize the benefits that tax-qualified plans offer. However, with proper research and consultation, most contractors can find plans to suit their specific and unique needs.

It may take more creativity to establish a company retirement plan in the building industry than in industries with more uniformity in pay. But there are several alternatives for contractors to capture the same tax advantages on retirement plans that other professionals get.

There are actually three types of plans contractors may be able to use to fund their retirements. Each option allows for the large pay differences between contractors and their employees. TWO are forms of taxqualified retirement plans and provide current tax deductions; the other uses existing tax treatment of life insurance plans to create tax-advantaged retirement income.

Of the taxqualified plans, the easiest to both describe and set up is the Simplified Employee Pension. The "SEP" allows an employer to make annual contributions up to 15 percent of his income (or $30,000, whichever is lower) into an IRA-type account, and deduct contributions from income tax liability.

The employer must also fund the employees' IRAs, but when determining employee contributions the business owner may take into account the amount of PICA (Social Security) taxes paid on behalf of employees. This "Social Security Integration Method" can *substantially* reduce mandatory employer contributions into the employees SEP account.

Example: Joe is a contractor who made $100,000 in 1988, while his employee Mike made $20,000. Joe wants to defer as much taxable income as possible, but does not feel obligated to reward Mike the same 15 percent contribution of income Joe uses for himself. Using a SEP under the Social Security Integrated Method, with 1988 guidelines, Joe can put up to $13,135 into his SEP account and take a tax deduction on that amount, as well as the minimum $20 he must contribute to Mike's IRA.

As stated above, SEPs are extremely easy to set up. Only IRS-approved plan documents are necessary, no annual filing is required, and investment options are as flexible as they are for IRAs.

A second option is a defined benefit plan, by which the business owner specifies an amount of retirement income he wants to draw at a specific age. Using an assumed interest rate, an actuary can determine what contributions are necessary each year to provide that benefit.

The older a contractor is when he establishes the plan, the more he can contribute annually. By the same token, if he employs laborers significantly younger than he is, their required contributions may be minimal.

Additionally, a vesting schedule may be set up which requires employees to remain with the contractor for up to six years before they qualify to receive plan assets upon separation. Read another way, with the turnover inherent in the building industry, chances are that all contributions into a company's defined benefit plan will provide benefits to the few long-term key employees which stay in the company.

Defined benefit plans may allow contractors to make much larger annual contributions than the SEP allows. However, plan documents are more complex, an actuarial service must be used, and annual (5500 Series) forms must be filed along with other company tax forms.

The third alternative is a non-qualified deferred compensation plan that offers the immediate benefits of life insurance and the long-term benefits of retirement income. Contractors can establish universal life insurance policies for key employees and have annual contributions paid by the company. Such plans offer two short-term advantages, as well as long-term security.

The primary short-term advantage is requiring the company to pay for employee life insurance-a gracious fringe benefit. An additional advantage is that such insurance makes bonding companies more comfortable in establishing agreements. The bonding company knows that, if a key employee dies, the company will receive a large lump sum of money which will enable them to hire another employee to finish the job.

There are several alternatives to capture tax advantages others get.

There are also long-term benefits with such plans for both contractors and employees. By providing life insurance and a comfortable retirement—providing the employee remains at that company—the business owner creates "golden handcuffs" that help retain key employees.

Example: Robert is a 55-year-old contractor. Because he has several

Comfortable retirement creates "olden handcuffs" to retain key employees.

"subsistence-level" employees which he cannot afford to include in a SEP or defined benefit plan, Robert decided to fund a life insurance policy for Tim, his right hand man (a 35-year-old non-smoker). The policy is funded by Robert's company at a rate of $5,000 per year, and the agreement stipulates if Tim stays on the job until retirement at age 65, he will be the benefactor of a life insurance policy that will pay him $65,000 annually. However, if Tim leaves before age 65, he gets nothing.

Each of these plans have strengths and weaknesses. Because each situation is unique, contractors should thoroughly analyze their personal and company objectives to determine what type of plan is best. However, there *are* tax advantaged plans which will work for contractors, large and small.

Any company contemplating a retirement plan should check with their tax advisor. This article is meant only to present various highlights, and in no way constitutes legal or tax advice.

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