Discriminatory Defined Benefit Plans: Finding Retirement Gold in the Least Likely of Places

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In a world in which planning for retirement is increasingly important, but also increasingly difficult, the utilization of the exemption for employees covered by a collective bargaining agreement in Internal Revenue Code Section 410(b)(3)(A) provides a "win-win" situation for the employees and employer. The employees have the guarantee of a minimum pension plan as a result of the collective bargaining agreement while allowing the business owner to establish a pension plan with more substantial benefits—a defined benefit plan.

Overview

We live in politically charged times. Congress seems unable to reach a consensus on anything, including where to have the annual congressional Christmas ball! Years of political crossfire over the Affordable Care Act have drawn renewed focus on employee benefits in general. If the current administration thought that the problem of the uninsured was a national crisis, then the subject of employee retirement plans has to be a problem of even greater magnitude. The topic of retirement benefits has only pinged on the media radar peripherally, as a result of large-scale municipal bankruptcies and the potential impact on retiree benefits and the esoteric topic of pension underfunding.

The reality is that most people do not have the financial resources to retire at the traditional retirement age of 65 and will continue working until their death. The problems are exacerbated by a combination of other factors—complex regulations under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code—that require employers to satisfy a number of participation and contribution requirements; a weak economy; and higher marginal tax rates. It is ironic that the public sentiment about labor

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unions is generally negative, as the bygone days of heavy manufacturing and union organizing in the U.S. (say the 1950s-1970s), seem to be the last time that American workers had secure retirement benefits.

This article is designed to outline the benefits of a forgotten exemption found in virtually every pension plan document and the Internal Revenue Code—the exemption from pension participation for employees covered under a collective bargaining arrangement. It may seem strange that a business owner might find financial peace and harmony in retirement as a result of a partnership with a labor union, but as this article will demonstrate and as former Secretary of State Henry Kissinger is known to say when recounting a story, "It has the additional benefit of being true."

Politics and high taxation make strange bedfellows.

Overview of Retirement Trends in the United States—A Not-So-Pretty Picture

The focus of the article is on small business retirement plans. Why? According to the Small Business Administration (SBA), as of 2013 small businesses (defined as having fewer than 500 employees) there were 23 million small businesses that accounted for 54 percent of all U.S. sales while providing 55 percent of all jobs in the U.S. economy.[1] The 600,000 small business franchises have created 8 million jobs while accounting for 40 percent of all retail sales.[2]

As of 1990, "big business," in its trend towards "offshoring" and efficiency, eliminated 4 million jobs, while small businesses added 8 million jobs.[3] A middle-aged taxpayer in corporate middle management working for "big business" has a very high chance of becoming an "accidental" small business owner. It used to be that big business meant job security, a new watch, and secure retirement at age 65. These days it seems impossible to remain with a single employer for an entire working career regardless of job performance.

Most small businesses—78 percent, according to *Forbes Magazine*—have no additional employees or payroll. Over 50 percent of the working population works in a small business with a high percentage (52 percent) being home-based.[4]

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[1] Jason Nazar, "Sixteen Surprising Statistics about Small Businesses" (Forbes Online, Sept. 9,2013), available at http://www.forbes.com/sites/jasonnazar/2013/09/09/16-surprising-statistics-about-small-businesses/.

[2] Small Business Administration, "Small Business Trends," available at http://www.sba.gov/content/small-business-trends.

[3] Nazar, supra note 1.

[4] Id.

Over the last 30 years, following the adoption of ERISA in 1974, retirement plan trends have changed dramatically. According to a Treasury Inspector General report, the last 40 years have seen not only a dramatic shift in participation but an equally dramatic shift in pension funding—from employers' pockets to those of the individual participants. Between 1977 and 2007, 401(k) participation increased 358 percent while defined benefit participation decreased 31 percent.[5]

In fact, defined benefit plans represent only 9 percent of qualified plan arrangements in small business. However, only 44 percent of the small businesses with fewer than 50 employees have any type of retirement plan in place at all.[6] The average accrued benefit for defined benefit participants, as of 2007 (before the recession) was $62,000; the average benefit that year for defined contribution plans was $42,000 .[7] Meanwhile, as of 2007 only 8 percent of the working population had an Individual Retirement Account (IRA) in place.[8]

According to testimony before the U.S. Senate Special Committee in April 2010, 50 percent of Americans within 10 years of retirement on average had financial assets of $72,000 in 2007, which was roughly equivalent to the median income in the same year.[9] Government actuarial statistics suggest that, for a couple aged 62, there is a 47 percent chance that one of them will survive until age 90.[10] That $72,000 will be very thinly spread.

In contrast, over 90 percent of government workers are still covered by a defined benefit plan. There are 8.8 million employees covered under the federal government pension plan, which had $930 billion in plan assets as of 2007. At the same time 2,547 state and municipal plans with $3.4 trillion in assets, provided defined benefits to 18.6 million participants.[11] In the spirit of *The Millionaire Next Door,* it appears that the neighbor who works for the government is a millionaire as a result of his pension benefits.[12] How can that be?

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[5] Treasury Inspector General for Tax Administration, "Statistical Trends in Retirement Plans" (Aug. 9, 2010), at.7, available at http://www.treasury.gov/tigta/auditreports/2010reports/201010097fr.html [hereinafter TIGTA].

[6] Bureau of Labor Statistics, "Employee Benefits in the United States–March 2013" (July 17, 2013), at .1, available at http://www.bls.gov/news.release/pdf/ebs2.pdf.

[7] TIGTA, supra note 5, at 5.

[8] Id. at.7.

[9] Id. at 14. See also Gen. Accountability Office, "Retirement Income: Challenges for Ensuring Income Throughout Retirement" (GAO-10-632R, Apr. 28, 2010), available at http://www.gao.gov/assets/100/96692.pdf.

[10] Gen. Accountability Office, supra note 9.

[11] TIGTA, supra note 5, at 3.

[12] Thomas J. Stanley & William D. Danko, *The Millionaire Next Door—Surprising Secrets of America's Wealthy* (1996).

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According to Andrews Biggs, a resident scholar at the American Enterprise Institute, as reported by the National Center for Policy Analysis, the average pension benefit for public workers is $64,000 per year in Nevada; $60,420 in Colorado; and $61,500 in California. But the American Federation of State, County and Municipal Employees (AFSCME), the union for state and municipal workers, claims that the average pension benefit for all state and municipal workers is only $19,000 for all state and municipal workers[13] The present value of total benefits discounted at 3.5 percent for a California retiree, age 60, with a 21.5-year life expectancy, is $910,000. State and municipal workers enjoy retirement benefits that are 72 percent to 89 percent higher than those for workers in private industry.[14] The key is the defined benefit retirement plan approach. How does private industry equalize the disparity?

The statistics do not paint a pretty picture. Most Americans are poised to outlive their resources. More and more Americans are finding themselves employed by small businesses that do not offer participation in a qualified retirement plan. If they offer anything, it is likely that the plan is a 401(k) without an employer match or with only a minimal contribution. Business owners are reluctant to add plans because they see the cost of contributing for employees as very high, and do not perceive a sufficient benefit for the business owner. One of the inadvertent effects of pension regulation is that if, as a result of ERISA and tax law, the business owner does not reap enough personal reward then nobody gets a pension plan.

Last, consider the impact of increased marginal tax brackets at the federal and state level. After considering the phase-out of itemized deductions and personal exemptions, a taxpayer residing in New York City, for example, could face an effective tax bracket of 50 percent to 55 percent on ordinary income. Small business owners always focus on individual tax brackets. In 2007, at least 94 percent of all small businesses operated as pass-through entities—an S corporation, or partnership or treated as a sole proprietorship.[15]

But there is a way to make the numbers work in everyone's interest. The utilization of the exemption for employees covered by a collective bargaining agreement in Section 410(b)(3)(A)[16] provides a "win-win" situation:

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[13] National Center for Policy Analysis, "Public Pension Millionaires" (Mar. 27,2014), available at http://www.ncpa.org/sub/dpd/index.php?Article_ID=24250.

[14] The calculation of the present value of annuity was made using Numbercruncher 2014, Steven Leimberg and Robert LeClair.

[15] Randy Neugebauer, "Taxing the Certainty Out of Us" (Townhall.com,July 29, 2010), available at http://townhall.com/tipsheet/townhallcomstaff/2010/07/29/taxing_the_certainty_out_of_us .

[16] Unless stated otherwise, all references in the article to Sections are to sections of the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

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The employees have the guarantee of a minimum pension plan as a result of the collective bargaining agreement, while the business owner is allowed to establish a defined-benefit pension plan with more substantial benefits.

Technical Overview of Qualified Retirement Plans

Tax-deductible qualified plans provide retirement benefits for the business owner and employees, and can also provide death and disability benefits. Employers that offer qualified plans have an edge in attracting and retaining qualified employees. Plans that meet Internal Revenue Code requirements are eligible for special tax advantages, including the tax deductibility of contributions made by the business owner. Contributions are also not currently taxable to employees, and all funds within the plan accumulate on a tax-deferred basis.

Basic Plan Requirements. Section 401(a) outlines a number of basic qualification requirements:

- The plan must be established in the United States by an employer for the benefit of employees or their beneficiaries.[17]
- The plan must prohibit the use of plan assets for purposes other than the exclusive benefit of the employees or their beneficiaries until such time as all liabilities to employees and their beneficiaries have been satisfied.[18]
- The plan must also meet the minimum age and service requirements and service standards and minimum coverage requirements.[19]
- The plan must provide for contributions and benefits that are not discriminatory.[20]
- The plan must provide contributions and benefits that do not exceed the Section 415 limitations.[21]
- The plan must meet minimum vesting standards.[22]
- The plan must provide for distributions that satisfy the commencement rules and minimum distribution requirements.[23]

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[17] See IRC § 401(a); Treas. Reg. § 1.401-1(b)(3).

[18] Id.

[19] See IRC § 401(a)(3); Treas. Reg. § 1.410-3T.

[20] See IRC § 401(a)(4) ; Treas. Reg. § 1.401(a)(4)-1(b)(1).

[21] See IRC § 415(b)(1).

[22] See IRC § 401(a)(7).

[23] See IRC § 401(a)(14), (9); Treas. Reg. § 1.401(a)(4)-1(b)(1).

- The plan must also provide for automatic survivor benefits under certain circumstances.[24]
- The plan must meet the requirements for "top heavy" plans and provide provisions that become effective in the event the plan becomes "top heavy."[25]
- The plan must prohibit the assignment or alienation of benefits.[26]

Types of Qualified Plans. Qualified plans fall into two general categories: defined contribution plans and defined benefit plans. Within each category are different plans with different provisions, allowing an employer to choose the best plan for the employer's circumstances.

Defined Contribution Plans. Defined contribution plans have individual accounts. A defined contribution plan in general allows an employer to make tax deductible contributions up to 25 percent of payroll of all of the participants in the plan (up to a maximum of $52,000 per participant in 2014). The maximum participant salary that can be considered is $260,000.[27]

Contributions to traditional 401(k) profit sharing plans may be made by both the employer and the employee. The maximum employee elective deferral is $17,500 (in 2014). Employee contributions are made by deferral of pre-tax or after-tax salary (or a combination of both). Employees age 50 and older may make an additional pre-tax contribution of $5,500 as a "catch up" contribution.[28]

Defined Benefit Plans. Defined benefit plans provide a predetermined retirement benefit for each employee, based on age, service, and salary. The maximum annual benefit under a defined benefit plan in 2014 is $210,000.[29] The benefit amount may also be integrated with Social Security retirement benefits. The typical formula for a defined benefit plan focuses on the final salary of the plan participant. Unlike a defined contribution plan, where the investment returns earned in each individual account determine a given participant's ultimate retirement benefit, a defined benefit plan's formula is known in advance. There are several versions of defined benefit plans to choose from, however.

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[24] See IRC § 401(a)(11).

[25] See IRC § 401(g)(4).

[26] See IRC §§ 401(a)(13).416(a)(7).

[27] See IRC § 415(c)(1)(A).

[28] See IRC § 402(g)(3).

[29] See IRC § 415.

An employer may choose to offer a traditional defined benefit select plan, which is a tiered defined benefit plan that allows the business owner to place employees in different groupings in order to maximize benefits for the business owner and to minimize the contribution for the employees. Such plans are appropriate for the business that wants to cover all employees in the plan, but reduce the cost of doing so. It is also useful when the goal is to reduce any contribution disparity among the employees caused by age differences, while still maximizing the percentage of contribution for the business owner.

An enrolled actuary annually determines the cost of funding the plan based on assumptions of future earnings, salary increases, and other factors. Enrolled actuary certification of the plan's funding is required each year.

Another option is a cash balance plan. This is a hybrid defined benefit plan that follows many of the same rules as other defined benefit plans, but a hypothetical account balance is credited for each employee and the actual benefit at retirement is based on the accumulation of the contribution and interest credits. Like the traditional defined benefit plan, a cash balance plan is appropriate for a business that wants to cover all employees, but to reduce costs. The plan guarantees a percentage of pay at retirement.

Yet another option is the Section 412(e)(3) defined benefit (also known as a fully insured defined benefit). This type of plan is suited to the established business that wishes to maximize contributions and tax deductions to a greater extent than might be possible in a traditional defined benefit plan. Section 412(e)(3) plans provide each participant with a predetermined benefit amount, which is fully insured by the purchase of life insurance contracts. Other types of funding vehicles are not permitted in this type of plan. The Section 412(e)(3) plan calls for the services of an enrolled actuary, since the plan is funded entirely with insurance contracts.[30]

The Exemption for Collective Bargaining Agreements

Section 410(b)(3)(A) provides an exemption from the minimum coverage rules for minimum participation in qualified retirement plans:

> Employees who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.[31]

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[30] See IRC § 412(e)(3).

[31] IRC § 410(b)(3)(A).

Thus, employees in a corporation who are covered under a collective bargaining agreement and covered under union benefit plans may be excluded from participation in the corporation's benefit plans.

This exemption would allow a business owner to maximize benefit contributions for a select group—the owner and any key employees not covered under the collective bargaining agreement—without running afoul of antidiscrimination rules. In the context of retirement planning, a defined benefit plan has traditionally been the plan type that allows for the largest tax deductible contribution. The maximum contribution under a defined contribution plan for a business owner, assuming a 401(k) catch-up contribution, is $57,500. The actuarial contribution for a business owner age 50 with a retirement age of age 62 in a defined benefit plan could be as high as $250,000.[32] Additionally, the business owner would be able to contribute to a defined contribution plan as well.

Considering Unions in the Context of Professional Services Businesses

Overview of Collective Bargaining Agreements. Collective bargaining is a process of negotiations between employers and a group of employees aimed at reaching agreements to regulate working conditions. The interests of the employees are commonly presented by representatives of a trade union to which the employees belong. The collective bargaining agreements reached by these negotiations usually set out wage scales, working hours, employee benefits, vacation days, sick days, training, health and safety, overtime, grievance mechanisms, and any rights to participate in workplace or company affairs.[33]

Employment relations for almost all private sector employees (other than those in the airline and railroad industries) are covered by the National Labor Relations Act (NLRA). Under the NLRA, an employee cannot be required to be a member of a union or pay it any monies as a condition of employment unless the collective bargaining agreement between an employer and a union contains a provision requiring all employees to either join the union or pay union fees.

Even if there is such a provision in the agreement, the most that can be required of an employee is to pay the union fees (generally called an "agency fee"). In *Pattern Makers v. NLRB*,[34] the United States Supreme Court held in

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[32] Pension actuarial calculations consider a host of factors and assumptions. Simply stated, the maximum contributions to a fully insured defined benefit plan utilizing a maximum annual contribution for life insurance would be as follows: (1) Age 50–$232,000; (2) age 55–$278,000; (3) age 60–$327,000. These contributions are multiples of the defined contribution annual limit.

[33] See Paula L. McDonald, "Judicial Interpretation of Collective Bargaining Agreements: The Danger Inherent in the Determination of Arbitrability," 1983 Duke L.J..848.

[34] 473 U.S. 95 (1985).

1985 that union members have the right to resign their union membership at any time.

A non-union employee is still fully covered by a business's collective bargaining agreement with a trade union, however, and the union is obligated to represent the non-union employee. Any employee benefits provided to employees by the employer pursuant to the collective bargaining agreement (e.g., wages, seniority, vacations, pensions, and health insurance) are not affected by non-membership. The result is that the business owner can still exclude the non-union employee from participation in the business's qualified retirement plan offerings.

Common Perceptions of Labor Unions Don't Fit Professional Services Context. In some respect stories about labor unions are like fishing stories in that they become a little more outrageous each time they are told. Depending upon the region of the country, the legacy of labor unions is historically very deep. In the Northeast, many business owners and employees will have had family members who were union members. Many business owners fear being locked out of their own businesses and losing effective management control. However, in some professional service industries that require professional licensing and certification, it seems far-fetched to imagine a scenario where a union manages to wrestle control from the business owner.

The right-to-work states (24 in total[35]) where, as a matter of state law, union agreements with employers cannot require union membership or the payment of union dues as a requirement of employment, are primarily in the South. Nevertheless, the typical collective bargaining agreement covers items that as a practical matter should be in writing between employers and employees.

In right-to-work states, the absence of a protocol for resolving employee disputes does not mean that the business owner is safe from litigation. Businesses with more than 10 employees have a 12.5 percent chance of employment litigation (surprisingly, the amount of litigation is among the highest in two right-to-work states, Alabama and Mississippi).[36]

While a small business owner would certainly retain the right to hire and fire employees, the small business owner can expect to be sued even in a right-to-work state. In 2001, the U.S. Supreme Court, in *Circuit City Stores,*

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[35] Michigan, Indiana, Florida, Texas, Georgia, Alabama, Tennessee, South Carolina, North Carolina, Tennessee, Mississippi, Louisian, Arkanasas, Georgia, North Dakota, South Dakota, Nebraksa, Kansas, Oklahoma, Nevada, Utah, Idaho, Arizona, Wyoming.

[36] Juliana Kenny, "Employment Litigation is Steeper in Some U.S. States" (Inside Counsel, Apr. 2, 2014), available at http://www.insidecounsel.com/2014/04/02/employee-litigation-is-steeper-in-some-us-states?t=labor-and-employment.

Inc. v. Adams,[37] upheld Circuit City's use of an arbitration clause in employment agreements to reduce costly litigation. It is noteworthy that an employer used the arbitration process that is part of every collective bargaining agreement as a method of resolving disputes between employers and employees.

As a practical matter, the level of hostile management-union relations has largely been relegated to large companies in "dirty" industries, such as coal mining. Hostile union activity in professional service businesses such as medicine, dentistry, chiropractic, architecture, law, and accounting is virtually non-existent. These professions all require licensing at the state or federal level in order to practice in the professional fields. The non-owner workers within these businesses are typically administrative and supporting staff to the licensed professionals. As a result, these types of firms are a perfect target to implement the collective bargaining exemption.

Defined Benefit Plan Considerations

The pension tax rules are complex. ERISA tax attorneys normally operate in the largest law firms and typically represent large employers. Defined benefit plans, which in any case have dramatically fallen out of favor among small businesses over the past three decades, are not well understood. In a defined contribution plan world, a participant's pension benefit at retirement is determined by a combination of contributions and investment earnings. In a defined benefit world, contributions are determined actuarially by a number of factors targeted at a defined benefit at retirement. Unlike a defined contribution plan, the impact of investment earnings does not increase the benefit at retirement. Instead, investment earnings either increase or decrease the sponsoring employer's required level of contributions.

The implication of pension underfunding is a problem affecting defined benefit programs in both the public and private employer realm. In an underfunded pension plan, a company retirement plan has more liabilities than assets; as a result, the money needed to cover current and future retirements is not readily available. Where there is an underfunded pension plan, employees have no assurance that future retirees will receive the pensions they were promised or that current retirees will continue to get their previously established distribution amount. To address the potential for funding shortfalls, the Pension Protection Act of 2006 (PPA) changed the mode of funding for defined benefit plans formed after December 31, 2007.[38] For single-employer defined benefit plans, the minimum funding standards are covered in Section 430.[39]

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[37] 532 U.S. 105 (2001).

[38] P.L. 109-289.

[39] See IRC § 430.

Non-fully Insured Plans. Generally a defined benefit plan that is non-fully insured under Section 412(e)(3) must make quarterly contributions into the plan. If a plan has less than 80 percent of its funding target attainment percentage (FTAP), the employer must contribute enough to meet this requirement and cannot make a plan amendment without increasing benefits under the plan.

Funding below less than 60 percent of FTAP forces the plan to stop benefit accruals. With between 60 and 80 percent funding, the plan may pay a benefit equal to only the lesser of 50 percent of the present value of the total benefit or the PBGC (Pension Benefit Guaranty Corporation) guaranteed benefit.[40]

Fully Insured Plans. A conservative defined benefit funding option that also happens to produce the highest tax deductible contributions for the plan sponsor is the fully insured defined benefit plan under Section 412(e)(3). (The fully insured defined plan actually pre-dates ERISA. These insurance contract plans were originally known as group annuity contracts.[41]) Fully insured defined benefit plans by definition can never be underfunded. Additionally, the investment benefits are contractually guaranteed by investment grade life insurance companies.

To qualify under Section 412(e)(3), a plan must meet certain requirements. Although this subsection allows an exception from the complex funding requirements found in Section 412, it imposes a special set of conditions that must be satisfied:

- The plan must be funded solely by individual or group whole life insurance and fixed annuity contracts that are part of the same series, and that include the same mortality tables and rate assumptions for all participants.
- These contracts must fund benefits using level premiums for all benefits. Payments begin when a participant enters the plan and may extend no later than the retirement date specified under the plan.
- The plan benefits must be provided only by these contracts and be guaranteed by an insurance company. In effect, the plan is fully insured.
- Participants may not take loans against the policies.[42]

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[40] See IRC § 430(i)(4).

[41] The first group annuity contract was issued by the Metropolitan Life Company in 1921. In 1924 The Equitable Life Assurance Society of the United States announced its intention of offering a group annuity. See Kenneth Black Jr., *Group Annuities* 9, 11 (Philadelphia: University of Pennsylvania Press, 1955 p.9 and p.11.), Equitable aggressively marketed this style plan in the late 1970s and 1980s to major law firms and others.

[42] See IRC § 412(e)(3)(F).

A fully insured 412(e)(3) defined benefit plan can provide substantial retirement benefits without market risk. The retirement benefits under the plan are completely dependent upon the contractual guarantees (made by investment grade life insurance companies) of the insurance contracts funding the plan. Because benefits are funded based on the contract guarantees, the plan can provide a maximum current tax-deductible contribution for the business. The contractually guaranteed rate is the interest assumption for funding retirement benefits under the plan. Contributions are approximately 40 percent to 60 percent higher than thoe allowed contributions to a traditional defined benefit plan participant at any age after age 40.

The full-funding limitation under Section 404 (a)(1)(A) does not apply to fully insured defined benefit plans.[43] Further, unlike traditional defined benefit plans, (1) no quarterly contributions are required, and (2) no annual actuarial certification is required.

Setting Up a Fully Insured Defined Benefit Plan for a Professional Services Business

As appealing as the contract guarantees and comparative ease of administration and are, an additional component of benefit for the fully insured defined benefit approach is the value of the reinvested tax savings that arise as a result of the plan's higher allowed contributions. Assuming the example above, a taxpayer in a combined marginal tax bracket for federal and state tax purposes of 45 percent would achieve tax savings of $199,620 for each contribution into the plan. The tax savings reinvested at a net rate of return of 6 percent would have an accumulated value of $2.78 million at the end of the 10-year period.[44] The following example illustrates how, by strategically arranging for an employee union, the owner of a professional services business can reap the benefits of a fully insured defined benefit plan at a reasonable cost to the business.

> ***Example:*** Dr. Ben Casey, age 55, is an orthopedic surgeon who practices on his own. He is married with four children. Dr. Casey has been very successful in his medical practice, consistently earning over a million dollars per year. However, having put four children through private school, college, and graduate school, along with paying high taxes, Dr. Casey is not where he thought

[43] See IRC §§ 412(e), 430.

[44] The calculation of the value of the tax savings was made using NumberCruncher 2014. The calculation is the future value of an annuity assuming annual tax savings of $199,620, a total contribution (defined benefit and defined contribution) of $443,600 annually, and a six percent investment return.

he might be with regard to his own retirement planning. Furthermore, he sees the writing on the wall with respect to the practice of medicine: his insurance reimbursements are declining as a result of Medicare, Medicaid, and the Affordable Care Act. He is finally in a position to contribute considerable amounts toward his own retirement planning, but he is troubled by the implications of the ERISA and tax law requirements as far as the cost of contributing for the employees of his medical practice is concerned.

The Casey Medical Group (CMG) has 10 employees not counting Dr. Casey or his wife, who functions as an office manager and bookkeeper. Dr. Casey would like to provide good benefits for his employees—but even better benefits for himself. He wants to maximize his own contributions for the next five to seven years for retirement planning purposes.

To achieve the doctor's goals, the Casey Medical Group enters into a collective bargaining agreement (CBA) with Local 999 of the AFL-CIO. Each employee will be a "card-carrying" member of Local 999, and will pay union dues of $35 per month. CMG will increase employees' salaries to compensate for the cost of union dues.

The CBA has several important provisions. First, the CBA prevents employees from striking. The CBA provides that the practice may fire any employee for just cause without restriction. In addition, the CBA allows the business owner, in the event he develops "cold feet," to terminate the CBA upon 90 days' notice to the Local 999. The CBA provides for a single coordinated annual visit by a representative from the union. The CBA outlines paid vacation days and holidays as well as vacation policy and overtime pay. (A point here: this type of information should be in writing anyhow!)

Employee benefits: The CBA memorializes the medical practice contributions to the Local 999 401(k) plan and Local 999 health care plan. The practice will make a 3 percent contribution to the 401(k) plan. Additionally, it will pay the full cost of employee healthcare in the union plan, which is a "Cadillac" plan.

The CBA arrangement excludes the employees from participating in any separate CMG benefit plans.

Owner benefits: CMG establishes a new defined benefit plan (New Plan) covering Dr. Casey and his wife, a fully insured plan option funded with life insurance and annuities. CMG (the sponsor) makes an annual New Plan contribution for Dr. Casey and his wife of $293,000 each, for a total contribution of $586,000 for the fully insured defined benefit plan. Each plan participant (keep in

mind, now the only participants are the doctor and his wife) has a pre-retirement death benefit of approximately $2.4 million. The level of funding in the defined benefit plan is almost five times the maximum that would allowed under a defined contribution plan arrangement.

In addition, Dr. Casey and his wife will each annually make full New Plan 401(k) contributions along with a catch-up contribution for a total of $23,000 each. Dr. Casey and his wife will each be able to make an additional contribution to a profit sharing plan. of 6 percent of their earned income up to $260,000 of compensation (which comes to $15,300 for each participant). Thus, together, Dr. and Mrs. Casey can annually contribute $76,600.

All together, Dr. Casey and his wife will be able to make pre-tax contributions of $662,600 into a combination of qualified retirement plans for the next five to seven years. The projected accumulated contribution in the defined contribution plan is $678,000 (assuming an 8 percent net return). The targeted annual retirement benefit for Dr. Casey and his wife collectively is $300,000. Alternatively, if they elect to roll over their accrued benefit in the company defined benefit plan, each will roll over approximately $2.5 million to their IRAs. Effectively, Dr. Casey and his wife have been able to funnel, on a pre-tax and tax deferred basis, in excess of $5 million over a seven-year period.

Costs: The additional expenses for the business related to the union arrangement are modest and are dramatically offset by the business owners' additional retirement benefits and pre-tax contributions to multiple pension plans.[45]

Summary

The proposed pension planning outlined in this article combines the power of defined benefit plans with an exemption to exclude employees covered under a collective bargaining agreement. All of this is spelled out in Section 410(b)(3)(A). Every pension plan document has referenced this exemption since the dawn of ERISA. The combination allows a business owner to maximize retirement plan contributions—defined benefit as well as defined contribution—while minimizing the costs of non-highly compensated employees.

The fully insured defined benefit plan under Section 412(e)(3) provides for the highest tax deductible contributions combined with guaranteed

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[45] An estimate of the costs associated with the collective bargaining arrangement is as follows: Union dues for 10 employees at $35 per month is $350/month and annually $4,200. The 3 percent contribution to the union collective bargaining agreement is $15,000 annually, based upon a payroll of $500,000.

retirement benefits. The larger contributions are the result of lower contractually guaranteed interest rates which provide for higher contributions into the plan.

As if that were not enough, using this strategy also allows a business owner to piggyback a defined contribution plan—a 401(k) and profit sharing plan—into the qualified plan mix, utilizing the collective bargaining exemption for a market-based retirement benefits.

Philosophically, the combination of tax savings and retirement benefits allows the business owner to treat his employees more generously through contributions to union-sponsored programs. For the majority of small businesses, an intelligent and reasoned partnership with a labor union can render a "win-win" result for owners and workers.

In the final analysis, retirement plans remain the principal avenue for tax reduction and deferral for business owners. No other statutory program provides the tax certainty and level of tax deductible contributions and benefits. Absent the utilization of techniques such as the one referenced in this article, workers and business owners will face a retirement age that is more likely to be the "earlier of age 95 or the participant's passing."

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