RETIREMENT PLANNING

FOR THE

SMALL BUSINESS

II. INCOME AND TRANSFER TAX CONSIDERATIONS

A. <u>During Participant's Lifetime</u>

1. Prior to Distribution

   Income tax on earnings on plan assets are deferred until distribution. Therefore, the amount that would have been paid in income tax will continue to be invested and grow itself.

2. Upon Distribution

   Distributions are taxed as ordinary income.

B. <u>After Participant's Death</u>

1. Federal Estate Tax – Plan assets are included in the participant's gross estate for federal estate tax purposes, thereby generating an estate tax.

2. State Death Tax - Payments under pension and other retirement plans are exempt to the extent that one of the following exists:

   a. the payments are exempt from the federal estate tax.

   b. the payment would be exempt for federal estate tax purposes if it had not been made in a lump-sum or other non-exempt form of payment and the payment is made in a lump sum or other nonexempt form of payment.

   c. the decedent, prior to his death, did not have the right to possess, enjoy, assign, or anticipate the payments made. (The right to designate a beneficiary or to receive monthly payments, does not constitute one of these enumerated rights and will not subject the plan to inheritance tax.)

   d. rights under a plan which **would** subject the plan's payments to the tax include, but are not limited to:

(1) the right to withdraw benefits including the right to withdraw only upon payment of a penalty or additional tax if the penalty or tax is smaller than 10% of the withdrawal. (A withdrawal from an IRA before reaching age 59 1/2 would subject the taxpayer to a 10% income tax penalty under IRC §72(t), therefore, such an account would be exempt from inheritance tax if decedent was not yet 59 1/2.)

(2) the right to borrow money from the plan.

(3) the right to assign the benefits of the employment benefit plan.

(4) the right to pledge the plan or its benefits.

(5) the right to anticipate the benefits of the employment benefit plan other than in regular monthly installments.

(6) the right by contract or otherwise, to materially alter the employment benefit plan.

3. Generation-Skipping Transfer Tax – If a retirement plan beneficiary is two or more generations removed from the participant (usually a grandchild), the amount left to the grandchild (outright or in trust) may be subject to an extra generation-skipping transfer tax of 48%. Every individual may give up to $1,500,000 (in 2004, and thereafter will equal the applicable credit amount) to remote generations with incurring the additional 48% generation-skipping transfer tax.

a. GST exemption cannot be allocated during participant's lifetime

b. If the grandchild is a designated beneficiary, tax-free build up for a longer period of time

c. If segregate a separate IRA for grandchildren, it should be monitored so that assets do not exceed the GST exemption amount.

4. Income Tax – Most retirement plan and IRA assets are subject to income tax when distributed. The recipient may claim an income tax deduction from the incremental federal estate tax paid on the IRD.

FEDERAL ESTATE TAX RATES

Year	Maximum Marginal Tax Rate
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%
2010	estate tax repealed
2011	55%

APPLICABLE CREDIT AMOUNT

Year	Lifetime Credit	Deathtime Credit
2004	$1 million	$1.5 million
2005	$1 million	$1.5 million
2006	$1 million	$2 million
2007	$1 million	$2 million
2008	$1 million	$2 million
2009	$1 million	$3.5 million
2010	estate tax repealed	
2011	$1 million	$1 million

III. ADDITIONAL TAXES

A. Required Minimum Distributions

1. Distributions must begin at a participant's Required Beginning Date

   a. A participant's Required Beginning Date is the April 1 of the calendar year following the calendar year in which the participant attains the age of 70 ½.

   b. Payment of the participant's benefit must be:

      (1) Lump sum;

      (2) In installments as determined by IRS Table (Table is joint life expectancies of the participant and someone 10 years longer)

      (3) Exception: If spouse is designated beneficiary and spouse is more than ten years younger than participant, then distributions are made over the joint life expectancies of the participant and spouse's actual life expectancy.

   c. The benefit used to determine the required minimum distribution is the account balance as of the last valuation date in the calendar year immediately preceding the distribution calendar year. Contributions that are allocated to the account balance as of dates in the valuation calendar year after the valuation date may be excluded.

2. Each annual distribution must be distributed before the end of the distribution calendar year.

   a. The first required minimum distribution, which is for the year in which the participant reaches age 70 ½ can be delayed until the following April 1.

b. The calendar year during which the Required Beginning Date occurs may have two required distributions, one for the year in which the participant reaches age 70 ½ and one for the following year.

3. A 50% penalty tax is imposed on the amount of a required distribution that is not actually distributed.

B. Premature Distributions

1. If a participant receives a distribution prematurely, the income tax for the year in which the distributions was made will include the tax on the distribution and an additional amount equal to 10% of the distribution.

2. Premature distributions consist of those distributions made before the participant reaches age 59 ½, unless one of the following exceptions applies.

a. Periodic Distribution – Part of a series of substantially equal periodic (at least annual) payments made for the life expectancy of the participant or the joint life expectancies of the participant and a designated beneficiary.

b. Distributions after the death or disability of the participant.

c. Distribution that is rolled into an IRA or qualified plan.

d. Distribution to an alternate payee pursuant to a QDRO.

3. Distribution after a participant separates from service after reaching age 55.

IV. BENEFICIARY DESIGNATIONS

A. Distribution Rules

1. Lifetime Distributions

a. Distributions will be made over the joint life expectancies of the participant and a mythical designated beneficiary 10 years younger (IRS Table), unless spouse is more than 10 years younger and the designated beneficiary.

b. If the designated beneficiary is the participant's spouse, his or her actual life expectancy is used in the calculation of required minimum distributions if the spouse is more than 10 years younger than the participant.

2. After-Death Distributions

a. Participant Dies Prior to Required Beginning Date

(1) If the participant's spouse is the designated beneficiary, distributions to spouse will begin at the participant's Required Beginning Date and will be made over the remaining life expectancy of the spouse. The spouse's life expectancy is calculated using his or her age in the year following the year of the participant's death, reduced by one for each subsequent year. Therefore, if the spouse dies with funds remaining in the IRA, distributions will continue over the spouse's life expectancy to his or her beneficiary.

(2) If someone other than the participant's spouse is the designated beneficiary, distribution will begin by December 31 of the calendar year after the participant's death and will be made over the remaining life expectancy of the designated beneficiary. The

beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the participant's death, reduced by one for each subsequent year.

(3) If no designated beneficiary is named, distributions must be made within 5 years following the participant's death, regardless of who or what entity receives the distributions.

b. Participant Dies After Required Beginning Date

(1) If the participant's spouse is the designated beneficiary, distributions to spouse will continue to be made over the remaining life expectancy of the spouse. The spouse's life expectancy is recalculated each year so that actual life expectancy is used. After the death of the spouse, his or her life expectancy is calculated using his or her age in the year following death, reduced by one for each subsequent year. Therefore, if the spouse dies with funds remaining in the plan or IRA, distributions will continue over the spouse's life expectancy to his or her beneficiary.

(2) If someone other than the participant's spouse is the designated beneficiary, distributions will begin by December 31 of the calendar year after the participant's death and will be made over the remaining life expectancy of the designated beneficiary. The beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the participant's death, reduced by one for each subsequent year.

(3) If the participant's life expectancy is longer, then the participant's life expectancy, rather than that of the designated beneficiary, is used to calculate distributions.

(4) If no designated beneficiary is named, distributions will begin by December 31 of the calendar year after the participant's death and will be made over the participant's remaining life expectancy, each year subtracting 1 from the participant's life expectancy at the time of his or her death.

B. Designated Beneficiary Rules

1. Who is the Designated Beneficiary

a. A designated beneficiary is an individual who is designated as the beneficiary by an affirmative election by the participant or by the terms of the plan.

b. Only individuals may be designated beneficiaries. If a person other than an individual is designated as a beneficiary, the participant will be treated as having no designated beneficiary for purposes of calculating distributions. Non-individual beneficiaries include charities and the participant's estate.

c. There is one exception to the "individual only" rule of designated beneficiaries. If a trust is designated as a beneficiary, the life expectancies of the trust beneficiaries will be used in calculating required minimum distributions if the trust satisfies the following requirements.

(1) Trust is valid under state law;

(2) Trust is irrevocable, or by its terms will become irrevocable upon the participant's death;

(3) The beneficiaries with respect to the trust's interest in the plan must be "identifiable from the trust instrument"; they may be members of a class (e.g. children) if it is possible at the applicable time to determine the class member with the shortest life expectancy; and

(4) The plan administrator is provided with trust or list of beneficiaries and participant certifies that changes will be provided.

The IRS has ruled that a testamentary trust will satisfy these requirements.

2. When is the Designated Beneficiary Determined

a. The participant's designated beneficiary will be determined on September 30 of the calendar year following the calendar year of the participant's death.

(1) Consequently, any person who was a beneficiary as of the date of the participant's death, but is not a beneficiary as of the end of the year following death (usually due to a disclaimer), is not taken into account in determining the participant's designated beneficiary for the purposes of calculating required minimum distributions.

(2) If a beneficiary named as beneficiary dies before September 30 of the year following the participant's death without disclaiming, the deceased beneficiary continues to be treated as a beneficiary without regard to the identity of the successor beneficiary who is

entitled to distributions as the beneficiary of the deceased beneficiary.

b. If there are multiple beneficiaries named, the life expectancy used will be that of the oldest beneficiary (shortest life expectancy).

(1) If a beneficiary's entitlement to benefit is contingent only upon the participant's death or the death of another beneficiary, then such a beneficiary's life expectancy is not considered. Even if a beneficiary's entitlement to benefit is contingent on the death of the participant or the death of another beneficiary, such contingent beneficiary is considered to be a designated beneficiary for purposes of determining which designated beneficiary has the shortest life expectancy. Unless such beneficiary is a "successor beneficiary."

(2) If one of multiple beneficiaries is not an individual, the participant will be deemed to have no designated beneficiary.

C. <u>Who is the Best Designated Beneficiary?</u>

1. Spouse

a. During the participant's lifetime, the actual life expectancy of the spouse can be used for required minimum distribution calculations if the spouse is more than 10 years younger than the participant.

b. Spouse can rollover decedent's plan assets to his or her own IRA and designate a new beneficiary, thus enabling distributions to be over the joint life expectancy table.

(1) If the surviving spouse is age 70 ½ or older, he or she must take the required minimum distribution in the calendar year of the rollover. However, if the spouse rolls the balance over in the year of the IRA owner's death, the spouse is not required to take a required minimum distribution as the IRA owner for that calendar year. Instead the spouse is required to take a required minimum distribution determined with respect to the deceased IRA owner to the extent the required minimum distribution was not made to the IRA owner before death.

(2) A rollover must occur within 60 days of receipt of property from a qualified plan or IRA.

2. QTIP Trust

a. A trust designated as a beneficiary will qualify as a QTIP and receive the marital deduction against death taxes if it satisfies these requirements:

(1) The surviving spouse can compel the trustee to withdraw from the plan an amount equal to all the income earned on the plan assets at least annually and to distribute that amount to the spouse (the QTIP need not require that all income be distributed to the surviving spouse in order to qualify for a marital deduction);

(2) No person has a power to appoint any part of the QTIP to any person other than the spouse;

(3) Trustee and spouse have right to require plan or IRA trustee to convert low income producing assets into income producing assets; and

(4) List IRA on Schedule M of Form 706.

b. Advantages

(1) Trustee can manage funds for spouse

(2) Participant, not the spouse, gets to name the ultimate beneficiaries.

c. Remember -

(1) A QTIP trust is not the spouse. Rollover ability is lost. May not be able to postpone distribution until spouse's Required Beginning Date.

(2) Spousal consent is necessary for qualified plans.

3. Credit Shelter Trust

a. An individual can transfer up to the "applicable credit amount" by lifetime or after-death gifts to anyone without gift or estate tax. It is important for each spouse to take advantage of his or her applicable credit amount. Upon the death of the first spouse to die, it is common practice for a trust to be set up with an amount equal to such spouse's then existing applicable credit amount. The trust typically would be for the lifetime benefit of the surviving spouse, with any trust assets remaining at the death of the surviving spouse to pass under the terms of the first spouse's Will. The assets filling this "Credit Shelter Trust" would escape estate taxation upon both spouses' deaths.

b. If plan or IRA assets make up a large part of a participant's assets, it may become necessary for participant's estate to use plan or IRA assets to fill the credit shelter trust.

c. More wealth will escape taxation if non-IRD assets are allocated to the Credit Shelter Trust.

d. Beware of using retirement assets to satisfy a pecuniary marital bequest under a Will or trust. This will trigger income taxation on such income in respect of a decedent even before distribution from the plan.

e. Spouse can disclaim, or partially disclaim, plan assets within nine months of participant's death. The participant's Will may be drafted to direct disclaimed assets into a trust for the benefit of the surviving spouse, escaping taxation upon the death of participant and spouse.

f. Lose rollover ability (ability to name another designated beneficiary).

4. Charity

a. If a participant is inclined to make charitable donations, using retirement plan assets to fund a charitable bequest has tax benefits.

(1) The value of the plan assets will be deductible for federal, and usually state, death tax purposes.

(2) Because a charitable organization generally is exempt from taxation, the distribution of the assets to the charitable organization will escape income taxation.

(3) Taxes would reduce the amount received by a noncharitable beneficiary, and therefore, the foregone legacy to a family from

making a charitable bequest of plan assets is less than the face amount of the bequest.

(4) Charitable Remainderman

(a) General Rule - If non-individual is one of several beneficiaries there will be deemed to be no designated beneficiary. Charitable remainderman will be treated as beneficiary.

b. Exception exists if charity is "successor beneficiary."

b. Combine with QTIP (Charitable Remainder Trust)

(1) A QTIP can be created for the life of the surviving spouse with a charity as the contingent beneficiary. Income could be paid to the surviving spouse during his or her lifetime. Any remaining benefit would be included in the spouse's estate.

(2) The QTIP would receive the full marital deduction, and upon the death of the surviving spouse, the full charitable deduction would be available, to that there would be no estate tax due to inclusion of these assets in spouse's estate.

c. Remember –

(1) If a charity is the designated beneficiary, or one of several designated beneficiaries, there will be deemed to be no designated beneficiary. If only part of the benefits from a plan are to be paid to a charity, a separate account should be established to permit life expectancies of other beneficiaries to be used for determining the

payout period and distribution amounts for the balance of the plan benefit.

(2) May need spousal consent.

I. RETIREMENT PLANS FOR SMALL BUSINESSES

	SEP-IRA
Plan Documents	Most employers use IRS Form 5305-SEP to establish the SEP, but it can be individually designed or the employer can adopt a prototype (most prototypes are sponsored by financial institutions). Individual employee IRAs usually established with IRS Form 5305 or 5305-A.
Eligible Employers	No restrictions. Any employer can sponsor a SEP-IRA. If the employer establishes the SEP with Form 5305-SEP, the employer may not maintain any other "qualified retirement plan."
Eligible Employees	Only excludable employees are employees who (i) are less than age 21, (ii) have not performed services for the employer in at least 3 of the 5 preceding plan years, (iii) do not earn in excess of $450 (2004, indexed) in compensation for the plan year, (iv) are collectively bargained, and (v) are nonresident aliens receiving no U.S.-source earned income from the employer.
Employee Contributio	Maximum IRA contribution is the lesser of $3,000 (for 2004) or 100% of compensation plus a catch-up contribution of up to $500 (for 2004) for individuals age 50 or older.
Employer Contributio ns and Allocations	Nondiscriminatory contributions up to 25% of each employee's compensation. Contributions must bear a uniform relationship to the total compensation of each employee. (Integration with social security and limited disparity permitted.) The Code Section 401(a)(17) compensation limit ($205,000 for 2004, indexed) applies if the employer establishes the SEP-IRA using IRS Form 5305-SEP.
Applicabilit of Code Section 415	Applicable—Annual additions under all defined contribution plans, including SEP-IRA contributions, may not exceed the lesser of $41,000 (for 2004, indexed) or 100% of compensation.
Tax Effect t Employee of Employee Contributio	IRA contributions, including catch-up contributions, may be deductible. Since the employee is a participant in an employer-sponsored retirement plan, the maximum deduction phases out (i) for single employees earning $45,000 or more (for 2004) and (ii) for married employees filing jointly with combined earnings of $65,000 or more (for 2004). The maximum deduction is phased out to zero at $55,000 and $75,000, respectively (for 2004).

Tax Effect to Employee of Employer Contribution	Excludable from gross income.
Tax Effect to Employer	Contributions are generally deductible
Vesting	100% vesting at all times.
Top-Heavy Rules	N/A
Withdrawal and Distribution	Contributions may be withdrawn at any time subject to 10% excise tax for most withdrawals prior to age 59-1/2. Employer cannot prevent withdrawal of employer contributions. Minimum distributions required at age 70-1/2. Withdrawals of non-deductible employee contributions not taxable, withdrawals of deductible contributions, employer contributions and earnings on contributions are taxable ordinary income.

Reporting and Disclosure	SEP established with Form 5305-SEP generally need not file Form 5500 annual report. Limited disclosure; further disclosure not required if Form 5305-SEP furnished to employees.

	SIMPLE IRA
Plan Documents	Most employers use Form 5305-SIMPLE to establish the SIMPLE IRA, but it can be individually designed or the employer can adopt a prototype (most prototypes are sponsored by financial institutions). Individual employee IRAs will usually be established with IRS Form 5305-S or 5305-SA.
Eligible Employers	Employers who employ 100 or fewer employees with at least $5,000 in compensation during the preceding plan year and who do not maintain any other retirement plan. Two-year grace period applies to employers who establish a SIMPLE IRA and later have more than 100 employees.
Eligible Employees	All employees who received at least $5,000 during any two prior plan years and who reasonably are expected to receive at least $5,000 in compensation during the current plan year. Employee elections to participate are restricted to the 60-day period before the first day of the plan year.

Employee Contributio	$9,000 maximum contribution for 2004 through pre-tax salary reduction plus a catch-up contribution of up to $1,500 (for 2004) for individuals age 50 or older. There is no discrimination testing of employee contributions (i.e., there is no need to run the so-called ADP and ACP tests associated with traditional 401(k) plans).
Employer Contributio and Allocations	Employer may either (i) match employee contributions up to 3% of compensation (subject to an election no more than twice in any five-year period to match employee contributions up to a maximum of between 1% and 3% of compensation), or (ii) contribute, on behalf of each employee who earns at least $5,000 compensation in the plan year, 2% of each employee's compensation for the plan year. The Code Section 401(a)(17) compensation limit applies to the nonelective contribution, but not to the matching contribution.
Applicabilit of Code Section 415	N/A

Tax Effect t Employee of Employee Contributio	All employee contributions are pre-tax.

Tax Effect to Employee of Employer Contribution	Excludable from gross income.
Tax Effect to Employer	Contributions are generally deductible.
Vesting	100% vesting at all times.
Top-Heavy Rules	N/A
Withdrawal and Distribution	Contributions may be withdrawn at any time subject to 10% excise tax for most withdrawals prior to age 59-1/2. 25% excise tax applies to withdrawals made during the first two years of participation. Employer cannot prevent withdrawal of employer contributions. Minimum distributions required at age 70-1/2. Withdrawals of employee and employer contributions and earnings on contributions are taxable ordinary income.

Reporting and Disclosure	Annual Notice of right to participate and summary description required. Summary description generally satisfied by furnishing copy of Form 5305-SIMPLE, if that form is used. No Form 5500 Annual Reports filed.

	SIMPLE 401(k)
Plan Documents	No IRS form is available. The plan must be individually designed or the employer must adopt a prototype (most are sponsored by financial institutions).
Eligible Employers	Employers who employ 100 or fewer employees with at least $5,000 in compensation during the preceding plan year and who do not maintain any other retirement plan. Two-year grace period applies to employers who establish a SIMPLE Plan and later have more than 100 employees.
Eligible Employees	General qualified plan rules under Section 410(b) apply. As a result, selected groups of employees may be excluded from participation so long as the plan does not benefit a disproportionately highly compensated group of employees.
Employee Contributio	$9,000 maximum contribution for 2004 through pre-tax salary reduction plus a catch-up contribution of up to $1,500 (for 2004) for individuals age 50 or older. There is no discrimination testing of employee contributions (i.e., there is no need to run the so-called ADP and ACP tests associated with traditional 401(k) plans).
Employer Contributio and Allocations	Employer may either (i) match employee contributions up to 3% of compensation (subject to an election no more than twice in any five-year period to match employee contributions up to a maximum of between 1% and 3% of compensation), or (ii) contribute, on behalf of each employee who earns at least $5,000 compensation in the plan year, 2% of each employee's compensation for the plan year. The Code Section 401(a)(17) compensation limit applies to all contributions.
Applicabilit of Code Section 415	N/A
Tax Effect t Employee of Employee Contributio	All employee contributions are pre-tax.
Tax Effect t Employee of Employer	Excludable from gross income.

Contributio	
Tax Effect t Employer	Contributions are generally deductible.
Vesting	100% vesting at all times.
Top-Heavy Rules	N/A
Withdrawal and Distribution	General withdrawal and distribution rules applicable to qualified plans. Generally, withdrawals of employee contributions can be made by active employees only on the basis of hardship. Loans are permitted. Generally, distributions are subject to ordinary federal income tax and distributions prior to age 59-1/2 (age 55 after separation from service) are subject to a 10% excise tax.

Reporting and Disclosure	General reporting and disclosure rules applicable to qualified plans.

	SAFE HARBOR 401(k)
Plan Documents	No IRS form is available. The plan must be individually designed or the employer must adopt a prototype (most are sponsored by financial institutions).
Eligible Employers	No limitations.
Eligible Employees	General qualified plan rules under Section 410(b) apply. As a result, selected groups of employees may be excluded from participation so long as the plan does not benefit a disproportionately highly compensated group of employees.

Employee Contributio	$13,000 maximum contribution for 2004 through pre-tax salary reduction plus a catch-up contribution of up to $3,000 (for 2004) for individuals age 50 or older. There is no discrimination testing of employee contributions (i.e., there is no need to run the so-called ADP and ACP tests associated with traditional 401(k) plans).
Employer Contributio and Allocations	Employer may either (i) make a non-elective contribution equal to 3% of annual compensation or (ii) match 100% of elective deferrals up to 3% of annual compensation plus 50% of elective deferrals between 3% and 5% of annual compensation. The Code Section 401(a)(17) compensation limit applies to all contributions.
Applicabilit of Code Section 415	Applicable—Annual additions under all defined contribution plans, including Safe Harbor 401(k) contributions, may not exceed the lesser of $41,000 (for 2004, indexed) or 100% of compensation.

Tax Effect t Employee of Employee Contributio	All employee contributions are pre-tax.
Tax Effect t Employee of Employer Contributio	Excludable from gross income.
Tax Effect t Employer	Contributions are generally deductible.
Vesting	100% vesting at all times.

Top-Heavy Rules	N/A
Withdrawal and Distribution	General withdrawal and distribution rules applicable to qualified plans. Generally, withdrawals of employee contributions can be made by active employees only on the basis of hardship. Loans are permitted. Generally, distributions are subject to ordinary federal income tax and distributions prior to age 59-1/2 (age 55 after separation from service are subject to a 10% excise tax.

Reporting and Disclosure	General reporting and disclosure rules applicable to qualified plans. Annual notice of right to participate required.