Retirement Planning

Partnerships and LLCs Beware! Qualified Retirement Plan Traps

If you are a partner of a partnership or a member of a limited liability company ("LLC") taxed as a partnership, there are certain little-known rules you need to know that may affect your company's qualified plan and the deductibility of those plan contributions.

Does the following situation sound familiar? You own a business with two other owners in a partnership or an LLC taxed as a partnership (for purposes of this memo, we'll use the term "partners" to represent owners of both types of business entities). Each partner is a different age and may be paying themselves either the same or different amounts in income. Additionally, each partner has different goals for saving for retirement. If your company's qualified plan is *other than* a Profit Sharing/401(k) plan, watch out. Even if your company sponsors a Profit Sharing/401(k) plan, you need to be careful. Here's why:

Generally, a partnership is permitted to maintain a cash or deferred arrangement under Internal Revenue Code ("Code) Section 401(k). This is the arrangement that allows employees to defer a portion of their compensation into a 401(k) plan. Additionally, individual partners are permitted to make cash or deferred elections with respect to compensation attributable to services performed for the entity, under the same rules that apply to their employees. For example, any contributions made on behalf of an individual partner pursuant to a cash or deferred arrangement of a partnership are elective contributions unless they are designated or treated as after-tax employee contributions.

However, pursuant to the rules applicable to cash or deferred arrangements for self-employed individuals,* Treasury Regulation §1.401(k)-1(a)(6) clearly states that "in the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf. Consistent with §1.402(a)-1(d), the elective contributions under such an arrangement are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement (i.e., the requirements of section 401(k) and this section are satisfied)."

This means that if your business maintains a qualified plan, such as a defined benefit plan, and you want different benefit formulas for each partner, or you have a partner that does not want to participate in the plan while the others do, this could automatically eliminate the deductibility of plan contributions entirely or at the very least, inadvertently convert the plan to become a 401(k) plan and be subject to the limits of 401(k) plan elective deferrals which is $17,500 for 2014.

Also, even if the arrangement is a qualified cash or deferred arrangement (i.e., a 401(k) arrangement), the deferrals are includible in gross income and are not deductible under Code Section 404(a) to the extent they exceed the applicable limit under Code Section 402(g), which is $17,500 (as indexed for 2014).

There are two solutions to this problem. First, this rule only applies to partnerships. If the business entity is changed to any type of corporation (S corporation, C corporation, Professional Corporation, or an LLC taxed as a corporation) this rule becomes a non-issue.

Second, the Treasury Regulations provide for a partner to make a one-time irrevocable election made no later than the partner's first becoming eligible under the plan or any other plan or arrangement of the employer to have contributions equal to a specified amount or percentage of their compensation (including no amount of

compensation) made by the employer on the partner's behalf to the plan and a specified amount or percentage of the partner's compensation (including no amount of compensation) divided among all other plans or arrangements of the employer (including plans or arrangements not yet established). This election must remain in effect for the duration of the partner's employment with the employer, or in the case of a defined benefit plan, to receive accruals or other benefits (including no benefits) under such plans.

*Pursuant to partnership law, partners of a partnership, and members of a LLC taxed as a partnership, are considered to be self-employed.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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GEAR #2013-14389 Expiration: 12/31/2014

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