It's Time to Rethink the Tax Advantages of a Retirement Plan for your Very Successful Smaller Clients / Prospects

Society of FSP Financial Service Professionals

Austin Chapter,
Society of Financial Service Professionals

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Why Now?

- Bush 2001 & 2003 Tax Cuts set to expire 2010
  - My opinion – Not likely to continue with current Deficit
- Marginal Income Tax Rates will Most Likely <u>Increase</u>

Before	**Now**	2010 Budget
15%	10%	15%
28%	15%	28%
31%	25%	31%
36%	28%	36%
39.6%	33%	39.6%

Why Now? (cont'd)

- Capital Gains Tax – in Proposed Budget
  - 15% now to 20%
    - Single taxpayer earning more than $200,000
    - Married taxpayer earning more than $250,000
- Estate Tax Increase – in Proposed Budget
  - $0 if die in 2010 :>) – any takers to save taxes?
  - 45% Tax Rate after exemption of $3.5 million for Individuals & $7 Million for a couple

Why Now? (cont'd)

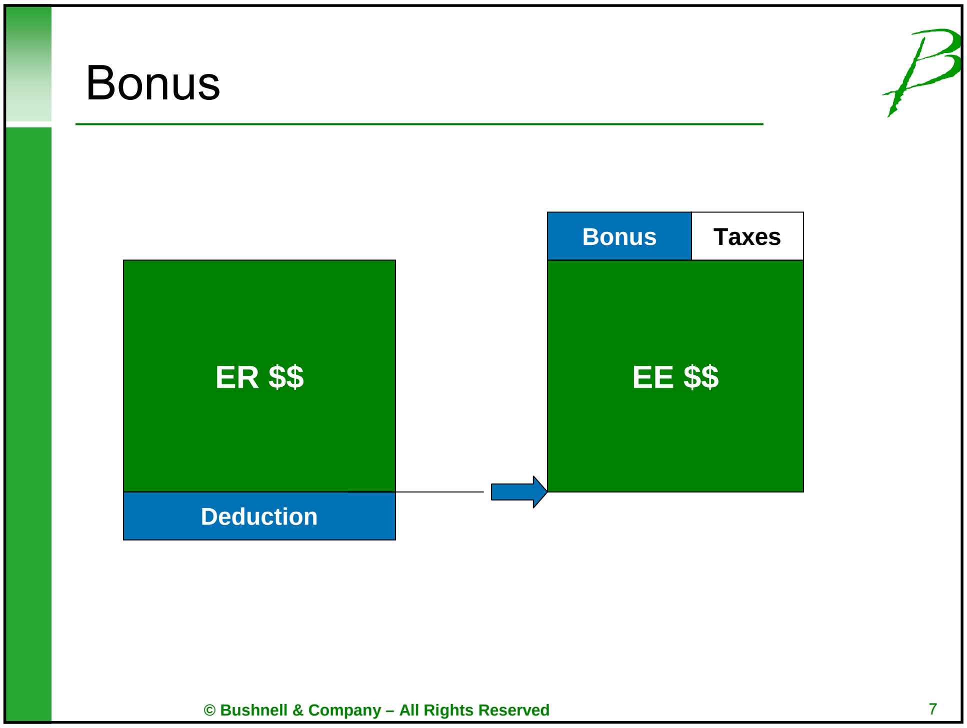
- Budget Deficit
  - FY Beg 2008 - $450 Billion + $750 Billion TARP – Bush
  - FY Beg 2009 - $1.3 Trillion – Obama
  - FY Beg 2010 - $1.6 Trillion - Obama
- National Debt
  - 6/30/72 - $427 Billion
  - 9/30/80 - $907 Billion
  - 9/30/91 - $3.7 Trillion
  - 9/30/00 - $5.7 Trillion
  - 9/30/08 - $10.0 Trillion
  - 2/04/10 - $14.3 Trillion

Maximize Tax Savings Now!

- 401(k) Plans became 201(k) plans or worse in the last few years.
- What does 50% mean?
  - 14,000 loses 50% = 7,000
  - 7,000 gains 50% = 10,500

Why a Retirement Plan?

- What are your choices to accomplish the following?
  1. Tax deductible by company now.
  2. Not taxable to employee now.
  3. Tax free deferral on earnings until later.


Bonus
Bonus
Taxes
ER $$
EE $$
Deduction
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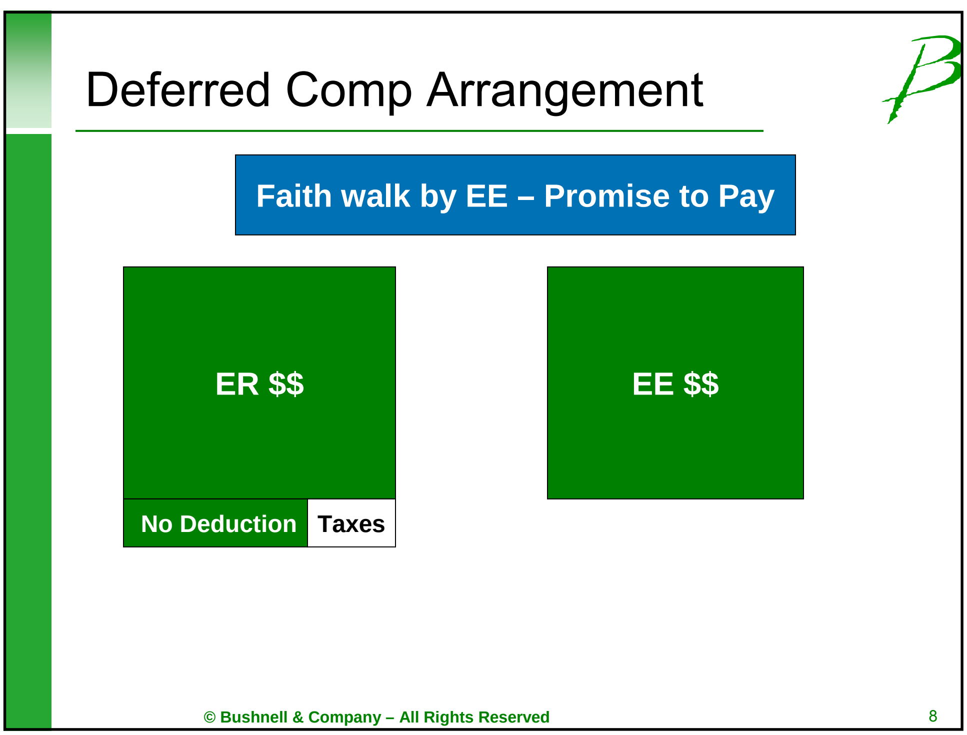
7


Deferred Comp Arrangement
Faith walk by EE – Promise to Pay
ER $$
EE $$
No Deduction
Taxes
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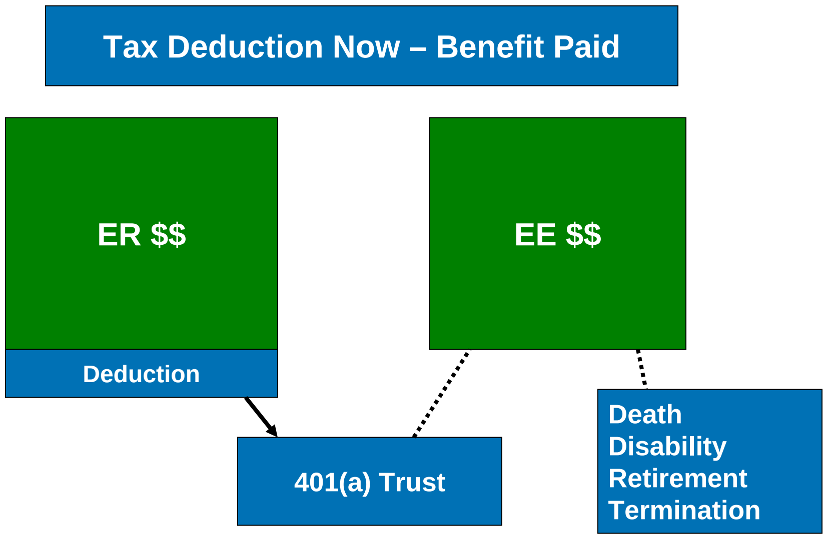
8

Qualified Retirement Plan



 9

Defined Benefit vs. Defined Contrib.

Limitation	2010
Defined Benefit Plans (benefit limitation)	$195,000
Defined Contribution Plans (contribution limitation)	$49,000
Annual Compensation Limit	$245,000
Highly Compensated Employee ("HCEs")	$110,000
Individual Retirement Accounts ("IRAs"), for individuals < age 50	$5,000
Individual Retirement Accounts ("IRAs"), for individuals > age 49	$6,000
Income Subject to Soc. Sec. Tax	$106,800

 10

Defined Contribution Plans

- Limits contributions for owners (up to $49,000)
- Benefits depend on fund earnings
- Historically, defined benefit fund earning higher
- Leaves investment choices to the discretion of employees
- Distributions are usually in lump sum – no protection during retirement
- Generally, higher overall fees
- Portability is a plus
- Ability to force employee savings is a plus

Defined Benefit Plans

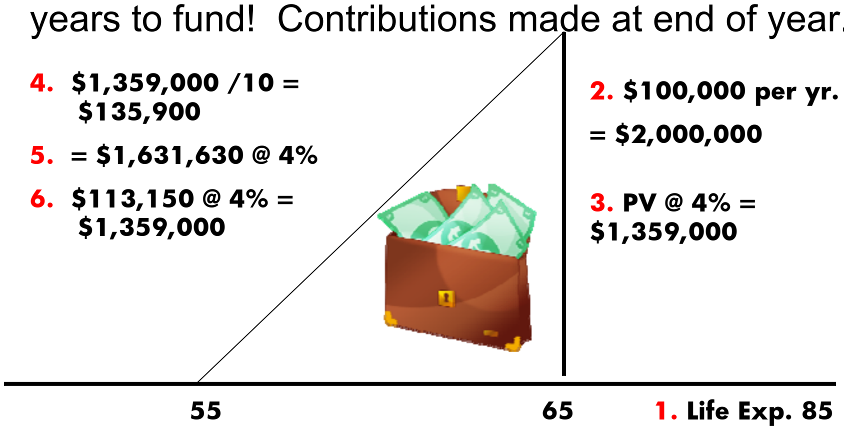
- Learning curve to understand.
- In very large plans, intergenerational cost sharing among participants – no correlation between cost of plan and benefit for an individual. Small ERs – Indiv. Level Premium
- Difficult to design formula that provides different levels of benefits for higher paid participants – uniform formula meant that all participants **over the pay cap** were "earning" equivalent benefits despite the wide range of compensation levels among the ownership group.
- Funding volatility & invest performance can be source of angst to the owners of the firm. Can also be a positive.
- On-going annuity payments force the firm to assume long term interest rate and mortality risks. Can buy an annuity.

Actuarial Valuation

- Understanding the variables
- How it works
- Impact on a small but very profitable company.

Actuarial Valuation

- Start with the end goal & work back to today – 10 years to fund! Contributions made at end of year.



Actuarial Valuation

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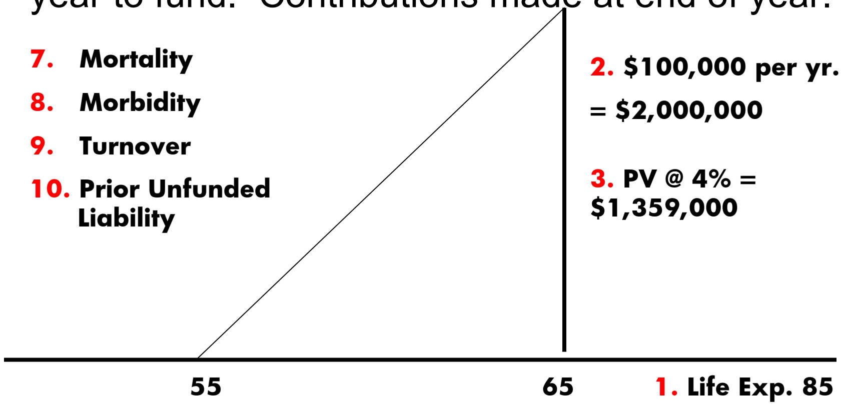

 15

Target Benefit Plans

- Similar to a defined benefit plan since contributions are based on projected retirement benefits. However, the benefits are based on the performance of the investments, and are therefore not guaranteed.
- Some similarity to a defined contribution Money Purchase plan as contributions are mandatory.
- Can allocate a larger proportion of total contributions to owners.
- Those employee/owners nearer retirement will benefit the most.
- Restricted to defined contribution limitations – 25% of total covered compensation.
- Maximum Annual Addition individual limitation $49,000.

 16

Cash Balance Plans

It's a Defined Benefit plan, but:

- Significant deferral beyond 401(k) and other DC plans – up to $199K (depending on participant's age).
- Flexibility around who is covered by the plan.
- Flexibility around the level of deferrals offered. However, notional contributions can only be changed by plan amendment.
- Easy to understand. Resembles a 401(k) plan.
- Equity among owners / principals / partners
  - participants pay for their own benefits.
- Contribution is a stated percentage of compensation

Cash Balance Plans (cont'd)

- Can be combined with a defined contribution plan.
- Works best for those owners that:
  - want to contribute more than $49,000
  - willing to contribute 5%-7.5% of pay for non-highly paid employees
  - Are generally over 40.

412(i) – What is it?

- A 412(i) Plan [now known as 412(e) plan] is a defined benefit retirement plan which can be exempt from the complex funding rules of Section 412 of the IRC.
- Fully Guaranteed Retirement Benefit MUST be funded with Insurance Contracts
- Typically generates largest possible tax deduction Defined Benefit
- Using Guaranteed Values as assumptions
- Deductible contributions well in excess of 25% of compensation.
- Ideal for the small employer (10 or less employees) who desires to put away a very large, tax deductible contribution

412(i) – What is it? (cont'd)

- Tax deductible 412(i) contributions reduce current taxable income and increases tax deductions.
- Additional protection for family and heirs may be provided with the addition of an insured death benefit to the plan. This also further reduces taxable income and increases tax deductions.

412(i) – How it Works

- The plan must be funded solely with individual or group life insurance and annuity contracts that are part of the same series and use same mortality tables and rate assumptions for all participants.
- Insurance 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.
- Plan benefits must be provided only by these contracts and be guaranteed by an insurance company.
- Participants may not take loans.

412(i) – How it Works (cont'd)

- These requirements are easily satisfied using IRS-approved prototype plans, funded by products designed specifically for this marketplace.
- When compared with other types of defined benefit plans, larger current contributions are required. Life insurance and annuity guaranteed assumptions are very conservative. A traditional defined benefit plan will have an interest rate assumption much higher than the guaranteed interest rate in a "fully insured" plan. The lower the plan assumptions, the higher the required contribution.

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412(i) – The Good News

- A "fully insured" plan can provide substantial retirement benefits.
- The accrued benefit for participants is simply the cash surrender value of all insurance contracts
- There can be no over-funding.
- There can be no under-funding.
- No actuarial certification required.
- No quarterly contributions are required

412(i) – The Bad News

- The 412(i) plan is not be the ideal plan for <u>all</u> situations and businesses.
- It works only when the business is established and highly profitable.
- May not work if too many employees < 10.
- May not be the best plan if the owner is younger than other EEs
- No policy loans can be outstanding at year end.
- No flexibility in investments. The plan must be funded exclusively through insurance contracts in order for all benefits to be guaranteed.

412(i) – The Ugly News

These are definitely no-nos for 412(i) plans. Having these traits may subject the employer to penalties, disqualification or IRS Listed Transaction Rules (possible $200,000 penalty).

- Different type of life policy on the principal(s) than on the rank-and-file
- Life insurance on the principal(s) and none on the rank-and-file
- A mix of policies from different carriers
- Life insurance coverage on participant(s) that exceeds the allowable payout under Revenue Ruling 74-307 or Revenue Ruling 2004-20?

 25

412(i) – The Ugly News (cont'd)

- Term Life Insurance
- Universal Life Insurance
- Exclude more than 30% of the Non-highly Compensated Employees yet include all of the Highly Compensated Employees
- Cover less than the greater of 2 participants or 40% of those employees

 26

Pension Protection Act of 2006

Pension Protection Act (PPA) added rules and clarification, much in favor of cash balance “hybrid” plans:

- Resolution of “whipsaw problem”- accrued benefit now equals notional account.
- Defined benefit plans can now comfortably be converted to cash balance plans.
- Cash balance plans are not inherently discriminatory.
- Interest rate crediting must be tied to market rates.
- Three year vesting minimum required.

PPA of 2006 (cont'd)

- Annual Market to Market of Assets
  - Old 10 – 15 year smoothing rules no longer exist
  - Volatility of Assets & Contributions
    - Choose investments wisely
    - Increase in contributions – Tax Deduction
    - Reduce Contributions – Excess Assets
      - Increase Benefits
      - Fund retiree Medical
- Funding
  - 100% of Annual Requirement
  - If < 80% funded – sanctions
  - If < 60% funded – Major Problems
    - Freeze benefit accruals, put money in plan, etc.

PPA of 2006 (cont'd)

- Non-highly Compensated EEs
  - Yes minimum contributions required – est. 6% of pay
- Exclude other Highly Compensated EEs
  - Permitted disparity
  - Still need to cover 40% of all eligible EEs

Summary of Highlights

- Not for all ERs
- Very successful, smaller & highly profitable
- Minimum contribution requirements
  - Fund the Plan
  - Non-highly compensated EEs
- Owner 45-50+ & going to sell or get out in 10 years
- You can sell product to fund if appropriate
- Help client leverage tax savings

Thank you!

- Questions