Retirement Plans: An Overlooked Benefit for Business Owners

Higher Contributions and Greater Flexibility

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Many CPAs ask if companies are still sponsoring defined benefit plans. They are usually surprised by how the current pension rules are "business-owner friendly."

The Pension Protection Act of 2006 (http://www.gpo.gov/fdsys/pkg/PLAW-109publ280/pdf/PLAW-109publ280.pdf) (PPA) made permanent the pension provisions of the Economic Growth Tax Relief Reconciliation Act of 2001 (https://www.congress.gov/bill/107th-congress/house-bill/1836) (EGTRRA), including higher dollar limits, an increase in the combined deduction limits brought about by eliminating IRC section 404(a)(7) (https://www.law.cornell.edu/uscode/text/26/404), and new rules for cash-balance pension plans.

The current dollar limits are as follows:

- The employer deduction limit for individual allocations applicable to profit-sharing plans is $53,000 (as indexed for 2015) or $59,000 for individuals over age 50, inclusive to 401(k) catch-up deferrals; the annual deductible contribution limit is 25% of participation payroll.

- The maximum annual 401(k) deferral limit for individuals is $18,000 (as indexed for 2015).

- Plan participants who are older than 50 are eligible for catch-up contributions up to $6,000 (as indexed for 2015) if the plan permits 401(k) deferrals.

- The maximum compensation limit used to calculate contributions or benefits for defined contribution plans and defined benefit plans is $265,000 (as indexed for 2015).

- The defined benefit maximum limit is $210,000 (as indexed for 2015) for benefit payment based on a single-life annuity with a retirement age of 62. This limit may be reduced if the participant has less than 10 years of participation.

Furthermore, 401(k) deferrals do not count towards the 25% annual addition limits. This can lower the profit-sharing formula and reduce the employee cost to owners.

Safe Harbor 401(k) Plans

If employee deferrals do not sufficiently satisfy the required actual deferral percentage (ADP) or actual contribution percentage (ACP) tests, it might force the return of excess deferrals; this, in turn, could result in taxable income to business owners or highly compensated employees. Safe harbor contributions allow business owners and highly compensated employees to defer the maximum permissible amount of $18,000 (as indexed for 2015), regardless of what other employees contribute, thus eliminating ADP or ACP testing.

This can be done in one of two ways. Under the first option, all eligible employees will receive a 3% non-elective contribution, regardless of whether they defer any part of their salary into the 401(k) plan. Under the second option, the employer can match 100% of an employee's deferrals up to 3%, and can match 50% of the next 2% of employee deferrals. This in effect, will cost the employer 4% of compensation, but only for those participants who defer more than 5% of their pay; if no eligible employees defer, then no employer contribution is required. Thus, the 4% safe harbor maximum matching contribution might be the preferable option when overall employee participation is low. Note that all safe harbor contributions are 100% vested at all times.

Contributions to Owners and Key Employees

An effective design commonly used for allocating a larger percentage of contribution to owners and key employees in a profit-sharing plan is the "new comparability" or "cross-testing" allocation formula. Depending upon the demographics of the business, the results might exceed those of plans using a permitted disparity design (also known as Social Security integration). Since the passage of PPA and the relaxation of IRC section 404(a)(7), companies are allowed to fully fund both a defined benefit plan and a profit-sharing plan if the business is subject to Pension Benefit Guaranty Corporation (PBGC) premiums.

Companies not subject to PBGC premiums are owner-only and owner-and-spouse companies that have no other employees, as well as professional services corporations that have fewer than 25 employees.

These companies are allowed to have both a defined benefit plan and a profit-sharing plan with 401(k) deferral, but the employer's profit-sharing contribution is limited to 6% of participation payroll. By funding both a profit-sharing and defined benefit plan, business owners have the ability to make larger tax-deductible contributions. Actuaries now also have a larger landscape in which to allocate employee costs, often resulting in a more efficient allocation of overall employee cost. Coverage rules under IRC sections 410(b) (https://www.law.cornell.edu/uscode/text/26/410) and 401(a)(26) (https://www.law.cornell.edu/uscode/text/26/401) must still be factored into the plan design.

Renewed Popularity of Defined Benefit Plans

In the past, plan sponsors might have been hesitant to convert an existing traditional defined benefit plan into a cash-balance plan because many courts had ruled that these plans were discriminatory on the basis of age; however, PPA provides legal certainty for employers and plan sponsors that establish a cash-balance pension plan by clarifying that such plans do not violate discrimination laws if certain conditions are met. Court approval of IBM'S conversion of its traditional defined benefit plan to a cash-balance defined benefit plan helped set this precedent in *Cooper v. IBM Personal Pension Plan* (http://caselaw.findlaw.com/us-7th-circuit/1162293.html). Unlike a traditional defined benefit plan, in which benefits are expressed as a monthly benefit payable at retirement, cash-balance plans show benefits as a hypothetical individual account balance, similar to a profit-sharing or 401(k) plan. A benefit expressed in this fashion is easier for most employees to understand.

Another profound change in PPA is the ability to fund up to 150% of a funding target, minus current assets. While this provision helps an underfunded plan's asset value catch up to the plan's accrued liabilities, it can help a new plan as well. Historically, defined benefit plans have been known for inflexible contribution requirements. Actuaries can now provide a range of contributions indicated by minimum and maximum funding amounts, providing greater flexibility for future contributions.

IRC Section 412(e)(3) Plans

Potential larger deductions are available under IRC section 412(e)(3) (https://www.law.cornell.edu/uscode/text/26/412). IRC section 412(e)(3) plans are funded exclusively with guaranteed annuities or with a guaranteed annuity and pension whole life insurance contracts. This design works well in those situations where a higher contribution and tax deduction is desired. Lower market volatility is another benefit. Contributions and tax deductions can be higher than those of a traditional defined benefit plan, due to lower guaranteed interest assumptions.

Life Insurance

In addition to creating a retirement nest egg, profit-sharing and defined benefit plans can accomplish other business and personal planning objectives, including buy-sell arrangements, succession planning, and deferred compensation benefits, as well as distribution and estate planning. They provide an available income of capital to fund life insurance premiums that otherwise might not be available for personal cash flow reasons. The leverage gained from the use of tax-deductible dollars makes plan assets a funding source for life insurance. With proper planning, the purchase of life insurance can provide substantial benefits to a plan participant and can meet personal and business planning needs.

A primary concern when purchasing life insurance with qualified plan funds is removing the policy from the plan at some future date. This would occur if the insured participant retired or terminated employment, or if the plan terminated. Distribution and purchase from the plan represent two methods of removing a policy from the plan. For a more in-depth discussion of options, see Kenneth A. Horowitz's "Exit Strategies for Life Insurance Policies in Qualified Plans," found here (http://www.slideshare.net/KennethHorowitzCLUCh/advisor-today-articleexit-strategies-of-life-insurance-in-retirement-plans).

In all cases, the availability of life insurance at a significantly lower cost while in the plan, plus the benefits of portability at retirement or plan termination, will usually offset the cost required to remove the insurance from the plan.

Overview of Benefits and Takeaways

Between EGTRRA and PPA, a multitude of benefits are available to business owners engaged in profit-sharing and defined benefit plans, including the following:

- Benefits range from more efficient, lower employee-cost plan designs, to maximizing owner contributions. Overall, annual contribution limits have been increased to the mid-six figures for individuals. The company also gets to deduct contributions made on behalf of all of the employees.

- Typically, percentages can range from 80% to 90% for owner and key employees. Therefore, employee costs are typically funded from tax savings.

- Plan document preparation and annual administration expenses have been lowered to a range of \$1,500 to \$2,500. A credit of \$500 is also available for the first three years of newly sponsored plans.

- Qualified plans can be a viable planning tool in order to save money on a tax-deductible basis.

- Other business and personal planning needs can be accomplished inside a pension or profit-sharing plan, such as funding buy-sell arrangements, deferring compensation, facilitating succession and estate planning, and meeting life insurance needs.

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