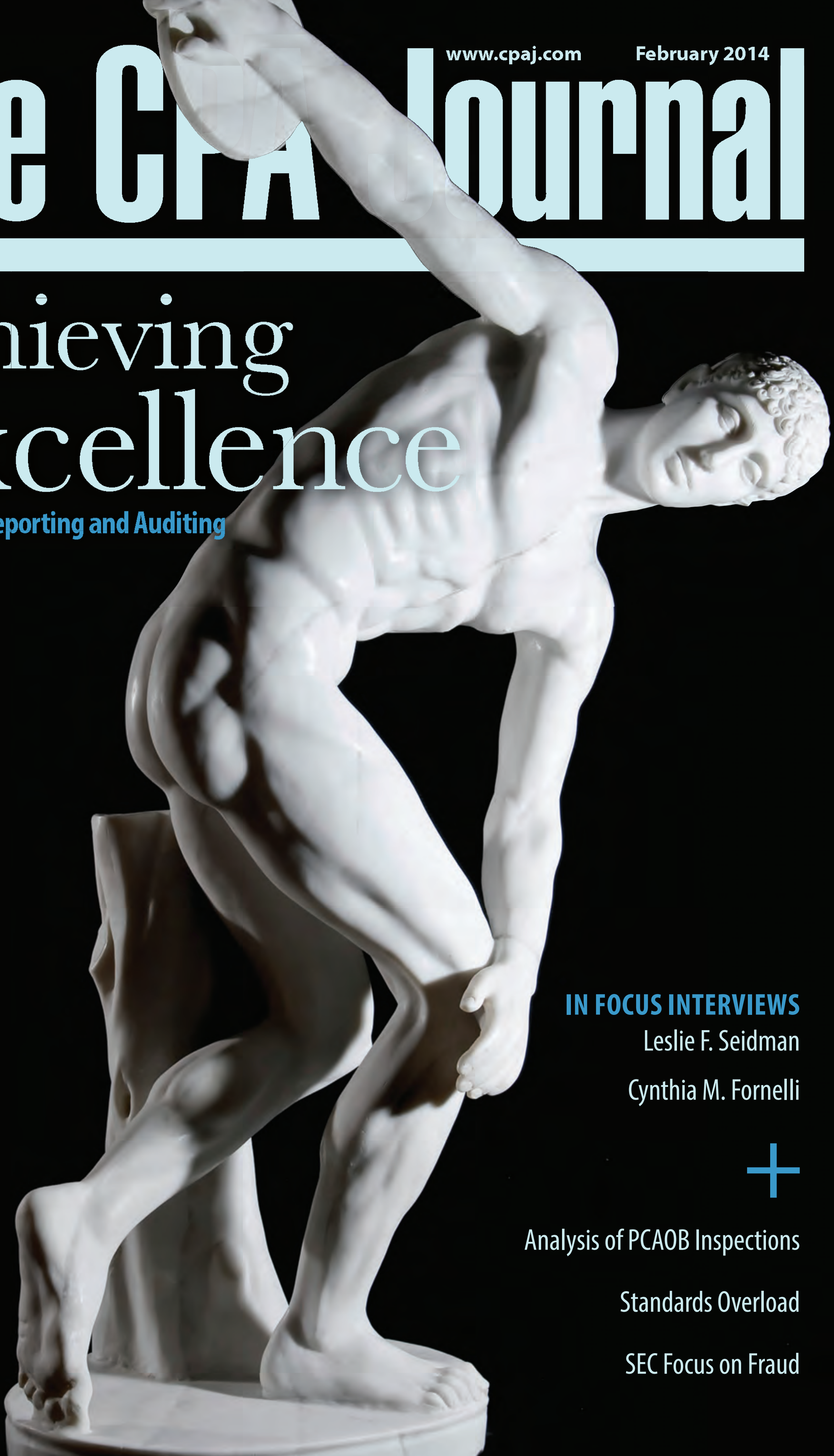
www.cpaj.com February 2014

The CPA Journal



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Leslie F. Seidman

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Analysis of PCAOB Inspections

Standards Overload

SEC Focus on Fraud

Developing Strategic Partnerships with Small Businesses in Retirement Planning

A Review of Recent Changes and Plan Design Opportunities

By Matthew Gaglio and Fely J. Cieza

A generation ago, CPAs and other financial advisors played an integral role in helping small business owners create retirement plans for themselves and their employees. Accountants, in particular, were instrumental in developing the strategy behind the plan and tailoring the design to meet each owner's unique goals and objectives. Once the small business implemented the plan, a CPA remained actively involved in pension management in order to ensure that the tax benefits associated with offering a company retirement plan were fully realized.

The Tax Reform Act of 1986 changed this. It eliminated much of the incentive for small businesses to provide pension plans. Over time, companies replaced traditional pension plans with one-size-fits-all assets under management plans, such as 401(k) plans and individual retirement accounts (IRA); these were managed by large brokerage companies that focused on rate of return. In essence, company-sponsored retirement plans became commoditized and focused more on the product than on thoughtful strategy and design. As a result, financial advisors largely removed themselves from the process altogether.

Recently, emphasis has started to shift back toward strategic, customized plan design. Because certain provisions in the tax code under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the Pension Protection Act (PPA) of 2006, and the American Tax Payer Relief Act (ATRA) of 2012 have been made permanent, pension plans are reemerging in the form of qualified plans, including defined-benefit and defined-contribution plans. When designed well, such plans might enable small business owners to shelter more money than has been possible in the last 30 years.

Recent legislation opens the door for CPAs to play a more strategic role in retirement planning for small businesses, which could further strengthen their relationships and potentially bring in more business if the CPA offers value-added services. Because many CPAs do not have expertise in pension and retirement planning, they may need to establish working partnerships with specialists in the field to capitalize on the opportunities afforded by the changes and new plan designs. They should also review the recent legislative changes and the various types of plans discussed in the following sections.

Key Highlights of the PPA

Once seen as highly inflexible, qualified plans can easily be tailored today, due to key changes brought about by the PPA. It made permanent several EGTRRA provisions set to expire in 2010; these included higher contribution and benefit limitations for qualified plans, as shown in the *Exhibit,* as well as increased IRA and 401(k) deferral limits and higher compensation limits.

The maximum 401(k) deferral for 2014 is $17,500 ($23,000 for those who are 50 years and older). The deduction limit for defined-contribution plans is 25% of eligible compensation, which is equal to the total compensation paid to all employees eligible to participate, with an individual compensation limit of $260,000 for 2014. Pensionable compensation includes W-2 income, as well as net Schedule C compensation and partnership net K-1 income after the appropriate deductions. (Note that K-1 income from an S corporation is not pensionable.)

The PPA and ATRA also made permanent a variety of Roth 401(k) provisions and allowed for catch-up contributions. In addition, Internal Revenue Code (IRC) section 404(a)(7) enables employers sponsoring a defined-benefit plan covered by the Pension Benefit Guaranty Corporation (PBGC) to also sponsor a defined-contribution plan without having to combine the two plans for deduction-limitation purposes.

Qualified Plan Design Opportunities

There are several plan designs that can benefit small businesses, but the three most significant are cross-tested plans, 401(k) safe harbor plans, and defined-benefit and defined-contribution plans.

Cross-tested plans. Typically, profit-sharing plans are structured so that eligible employees receive a contribution based on a certain percentage of their salary. The percentage is the same for each employee, regardless of compensation. For example, if the contribution is set at 3%, a plan participant earning $50,000 is eligible for a $1,500 contribution, whereas a participant earning $75,000 will receive a contribution of $2,250. In some cases, an integrated or permitted disparity allocation formula is used so that employees earning more than the Social Security taxable wage base ($117,000 for 2014) may receive an additional contribution of up to 5.7%. The maximum contribution to a profit-sharing plan for 2014 is $52,000. (If the plan is a 401(k) and the participant is 50 years or older, another $5,500 is permitted.) But a traditional profit-sharing allocation based on compensation would result in contributions of as much as 25% of compensation for other employees as well.

With a cross-tested formula, small businesses can allocate distinct contribution rates for different groups of eligible employees. This plan's design gives employers the flexibility to provide significantly larger contributions for highly compensated employees, making it an attractive option for rewarding and retaining key staff. This new structure is possible as a result of IRC section 401(a)(4),

Recent legislation opens the door for CPAs to play a more strategic role in retirement planning for small businesses.

which allows employers to divide plan participants into classes and make disparate contributions to the plan for each class. A numerical formula based on an analysis of projected benefits at retirement age is given in order to illustrate whether the benefits provided to highly compensated and non–highly compensated employees are comparable; if they are, the allocation is considered nondiscriminatory and is permitted. The result is that the contributions for employees can be significantly lower than would be the case in a traditionally allocated profit-sharing plan—often at the level of between 3% and 5% of compensation, depending upon employee demographics.

401(k) safe harbor plans. As of 2001, a new 401(k) safe harbor plan became available that offers automatic passage of the average deferral percentage (ADP) test and may satisfy the top-heavy minimum contribution requirement. The ADP test generally limits the amount that highly compensated employees can defer to 1.5 times the *average* deferral as a percentage of compensation of the non–highly compensated employees. The top-heavy minimum contribution generally requires an employer to contribute at least 3% of compensation for all employees eligible to make an elective deferral. If a 401(k) safe harbor contribution is made, highly compensated employees can defer the maximum 401(k) deferral ($17,500 for 2014, plus an additional $5,500 for those 50 years and older). If the 3% safe harbor contribution is made, the top-heavy requirements mandating minimum contributions for employees who are not owners or officers are deemed satisfied.

Two types of 401(k) safe harbor contributions exist. In the first, each eligible participant receives an employer contribution equal to 3% of compensation (which will usually satisfy the top-heavy minimum requirements for the plan). In the second, eligible participants who make a salary deferral election receive a dollar-for-dollar matching contribution on the first 3% of their deferral and an additional $0.50 per $1.00 for the next 2%. Regardless of which option is used, contributions are 100% vested immediately; however, highly compensated employees have the ability to make the maximum deferral, even if no

EXHIBIT
Maximum Benefit Limitation for Defined Benefit Plans, 2014

Retirement Age	Annual Life Annuity	Single Sum*
62	$210,000	$2,600,000
65	$210,000	$2,400,000

*Actuarially computed on the basis of 5.5% interest and the 2013 Internal Revenue Code (IRC) 417(e)(3) applicable mortality table. In addition, 10 years of plan participation is needed to accrue the maximum benefit.

non–highly compensated employees make a deferral.

Defined-benefit or defined-contribution plans with a carve-out design. A carve-out design essentially allows plans to exclude certain employees who might have otherwise met the normal eligibility requirements from participating in the plan. IRC section 410(b) allows an employer to divide employees into separate groups, as long as each group includes a certain percentage of non–highly compensated employees. As a result, it might be possible to exclude a significant number of non–highly compensated employees, depending upon the percentage of highly compensated employees included in the plan. By carving out a smaller group of employees and establishing a defined-benefit plan only for this group, employers have more flexibility in allocating the plan's benefits.

Along with the coverage requirements of IRC section 410(b), IRC section 401(a)(25) requires that most defined-benefit plans benefit a minimum number of eligible employees (both highly compensated and non–highly compensated); this requirement must be considered when the plan is designed. Defined-benefit plans require a greater commitment and mandated funding that must be recognized when such a plan is established; however, because defined-benefit plans generally permit higher contributions and higher accumulations than most other types of plans (especially for older employees), they can provide a higher degree of retirement income security than profit-sharing or 401(k) plans.

When properly structured, retirement plans can—and should—benefit the business itself through various tax advantages for owners, partners, and key employees.

Qualified Plan Design: A Team Effort

Perhaps the biggest misconception to arise during the last two decades is that company retirement plans are solely for employees. When properly structured, retirement plans can—and should—also benefit the business itself through various tax advantages for the owners, partners, and other key employees. Qualified plans provide a solid strategy for realizing this goal.

The real problem today is that many small businesses have plan designs in place that contribute more toward employee retirement plans than legally required or do not fully leverage the financial and tax advantages. This is, in large part, because retirement planning has traditionally focused on asset allocation, 401(k) platforms, and funds and products—not on truly designing a plan to fit the needs of the organization and its employees. The EGTRRA regulations made permanent by the PPA and ATRA have changed this, making qualified plans highly designable again for their ability to maximize benefits for both employers and their employees. Few small business owners, however, realize how much they could be saving, because their financial advisors might not be familiar with the changes, especially if they have not been in the field for very long.

It is important for financial planners to refresh themselves on these changes in order to best aid small business owners and employees. They should fully understand the nuances of the new tax provisions and should be able to perform a feasibility study for small businesses. The goal is to uncover whether the business is contributing more than required or paying more taxes than needed, as well as whether there are any additional tax shelter opportunities for the business. In the authors' experience, it's not uncommon to find that a well-designed qualified plan could substantially reduce taxes.

This is why financial advisors, particularly CPAs, must get back into the business of being strategic partners with small businesses when it comes to plan design. (See the sidebar, *Building a Retirement Planning Team*, for other important parties that can be included in the retirement planning process.) In this way, CPAs can create new opportunities for their practice, as well as for the small businesses they work with. The opportunity to meet with a small business owner and participate in the design of a retirement program can lead to other business opportunities for a CPA, especially if the CPA provides some form of investment tracking service or estate planning assistance. ❑

BUILDING A RETIREMENT PLANNING TEAM

Several parties can become involved in the retirement planning process:

- An attorney responsible for setting up a pension trust
- An accountant working with an insurance professional to design the plan, determining contributions, cash flow, and overall budget
- An actuary puting the design to the test using an actuarial algorithmic formula based on benefits earned at retirement and the aggregated percentage of compensation
- Finally, a broker investing money as defined by the specific plan design.

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