Qualified Retirement Plans

Brief Overview

- This material is meant as a very brief overview of some of the things most clients have NOT looked at when it comes to the qualified plan.
- Most clients have SIMPLE or SEP IRAs or have traditional 401(k)/profit sharing plans.
- If your goal as a small business owner is to put the maximum amount away for yourself and the minimum amount away into a qualified plan for your employees, then it is VITAL that you work with a consultant who knows the tools of the trade.

What tools?

- Solo 401(k)
- New Comparability Plans (where each employee is tested as his/her own class.
- The Double Advantage Safe Harbor Plan
- Defined Benefit and 412(i) DB planning the right way (which few advisors know how to do).
- Carve out Planning

What will follow

- Instead of going into chapter and verse on qualified plans which would take nearly 100 slides, we have chosen just to give you some examples of how a small employer could save money by working with advisors who know how to legally skew the contribution amounts in your favor.

Different testing for <u>Profit Sharing Plans</u> (PSP)

Employee Name	Age	Current Salary	Traditional	Integrated w/SS	Age-Weighted	New-Comparability
Owner (key)	**55**	**$210,000**	**$42,000**	**$42,000**	**$42,000**	**$42,000**
% of Pay			**20%**	**20%**	**20%**	**20%**
Key Employee	45	$100,000	$20,000	$17,463	$15,701	$10,000
% of Pay			20%	17.50%	15.70%	10%
Employee 1	30	$40,000	$8,000	$6,735	$1,847	$2,000
% of Pay			20%	16.80%	4.62%	5%
Employee 2	35	$35,000	$7,000	$5,893	$2,431	$1,750
% of Pay			20%	16.80%	6.95%	5%
Employee 3	30	$25,000	5000	$4,209	$768	$1,250
% of Pay			20%	16.80%	3.10%	5%
			$23,750	$141,804		$165,554
Total			**$82,000**	**$76,300**	**$56,771**	**$57,000**
% to Owner			**51%**	**55%**	**74%**	**74%**

New Way to Test PSP

- Each employee is treated as their own "class" of employees.
- One problem with New Comparability Plans is that the are a bit rigid.
- Once the classes are chosen, there is not ability to change that until the following year.
- Therefore, on December 31, the class is set even though the owner employees have not decided how much they would like to put into the PSP.
- The lack of inflexibility can cost the ERs a lot of extra contributions for certain classes of employees.

Example

- Assume that the business has two key owners (highly compensated) ages 36 and 35 and nine (9) employees who’s ages range from 30-63 years old.
- Assume the total payroll of the non-owner employees is $443,116 and that the owner’s compensation is $185,000 and $165,000 respectively.

Continued (New Comp. continued)

	Integrated with Social Security		New Comparability Two Tier		**Individual Testing With 401(k)**	
		% of Total		% of Total		% of Total
Owner allocation	$82,000	56.16%	$82,000	64.02%	$82,000	**81.82%**
EE allocation	$64,012	43.84%	$46,091	35.98%	$18,226	18.18%

- What type of PSP do you have?
- Simple PSP with integration?
- New Comparability Plan?
- Individual employee tested New Comp Plan?
- Which one of the above would you prefer?

Double Advantage Safe Harbor 401(k) plan (DASH 401(k))

- Essentially, <u>**if**</u> the preferred employees are older than the average age of the non-preferred employees, this design can dramatically skew benefits to the older groups.
- A DASH 401(k) plan combines the a “safe harbor” 401(k) plan with a new comparability profit sharing feature. The results are often dramatic, and compelling.

Employee Name	Age	Current Salary	Salary Deferral	3% Safe Harbor	New Comparability	Total Contribution
Owner (key)	**55**	**$210,000**	**$18,000**	**6,300**	**21,700**	**$46,000**
% of Pay			**8.60%**	**3.00%**	**10.30%**	**22%**
Key Employee	**45**	**$100,000**	**14,000**	**3,000**	**5,000**	**22,000**
% of Pay			**14%**	**3.00%**	**5.00%**	**22%**
Employee 1	30	$40,000	?	1,200	600	1,800
% of Pay				3.00%	1.50%	4.50%
Employee 2	35	$35,000	?	1,050	525	1,575
% of Pay				3.00%	1.50%	4.50%
Employee 3	30	$25,000	?	750	375	1,125
% of Pay				3.00%	1.50%	4.50%
Total				**12,300**	**28,200**	**72,500**
% to Key				**75.60%**	**94.60%**	**93.80%**

Micro (k) (Also known as solo 401(k))

- Another plan that should be considered in lieu of a SIMPLE or SEP-IRA is what we call the “Micro(k).”
- A 401(k) salary employee deferral can now be added on-top of the employer profit sharing contribution until the participant reaches the 100% of pay not to exceed $44,000 indexed defined contribution limit (for 2006).
- *Those participants who turn age **50 or older** during the current year may also make “**catch-up**” contributions even if they exceed the $44,000 limit. Thus, a 50-year-old may have up to $48,000 between the employer contribution and salary deferral in 2006, as long as he/she is deferring the maximum allowed under the law or the plan.*

Continued

- Let’s compare a Micro(k) to a SEP-IRA for the following participant, age 50:

	SEP-IRA	Micro-K
W2 Salary	$100,000	$100,000
Owner Contribution	$25,000	$25,000
Salary Deferral	-	$15,000
Catch-Up	-	$5,000
TOTAL	$25,000	$45,000

Defined Benefit Plans

- Many small-business owners and professionals put off saving for retirement to invest money in their business or practice, pay for their children's education and enjoy their working years.
- Now, with stable and growing income (profits), they look to catch up in a fairly short period of time.
- This can not be done in a PSP or 401(k) plan.

The Solution

- Consider the following: a 50-year-old small business owner who earns $170,000 or more in salary and plans to retire at age 62 can select from the following plans, with an assumed 5.5% investment yield:

	Annual Accumulation	Accumulation At age 62*
Profit Sharing	$42,000	$688,195
Defined Benefit	$125,852	$2,062,154

How do DB plans work

- Unlike a defined contribution plan, a defined benefit plan (other than a 412(i) “Fully Insured” plan) does not have participant accounts.
- Rather, the sponsor gives the required contribution to the plan trustee who then invests all of the trust assets into the plan.
- Benefits are then paid from the plan as employees become eligible and are vested.
- Most 401(k)/PSPs have individual accounts that are self directed.

Carve out DB Planning

- “Carve-out” retirement plans are fairly new to the pension industry.
- If you asked 10 small employers what their ultimate pension plan would look like, the employers would say they would like to put away as much money as possible for the owner/employees and as little away for the rank and file employees.
- Carve out planning seems to be the next generation of planning to help small business owners create plans skew the contribution amounts to key employees.
- Carve out planning is complicated and for this initial view of the topic we will explain it through examples.

Dr. McIntire

- Dr. McIntire's goals are to receive the maximum retirement benefit allowed by law and to retire by age 62. However, he wants to make sure his employee benefit costs do not get out of control.
- He can commit up to $200,000 a year to his tax-deductible plan and is pleased to know that assets within his retirement plan are protected from the claims of creditors and potential litigants.

- the cost of Dr. McIntire's **traditional** defined benefit plan is **more than triple** his SEP-IRA contribution, while the attributable cost for his Generation X employees is actually lower. Although he and his wife, Rita, receive the majority of the benefits, he is troubled by the benefit cost attributed to his baby boomer employee: Linda Booker.

Employee Name	Age	Current Salary	Current Plan SEP-IRA	Traditional Defined Benefit Plan
McIntire, DMD(K)	**50**	**$210,000**	**$42,000**	**$125,852**
McIntire, R (K)	50	$40,000	$8,000	$27,634
Booker, L	55	$45,000	$9,000	$33,538
Clerk, A	30	$35,000	$7,000	$6,582
Clerk, B	25	$25,000	$5,000	$3,738
Nurse, N (Part Time)	45	$10,000	$0	$0
			$71,000	$197,344
% to Key (K)			**70%**	**78%**
Projected Benefit for McIntire DMD (K) @62			**$4,728**	**$14,167**
Projected Accumulation for DMD (K) @62			**688,195**	**$2,062,154**

Continued (with carve-out)

- What about the excluded employees? Because the **"carve-out"** group will often contain family members and other highly paid employees who are important to the business, it is recommended that they be included in a separate plan. **It is important to make sure that absolutely no employee participates in both plans**, since this may cause some employer contributions to be non-deductible.

Employee Name	Age	Current Salary	Profit-Sharing	""Carve-Out"" Defined Benefit Plan	Total Plans
McIntire, DMD(K)	**50**	**$210,000**	**$0**	**$125,852**	**$125,852**
McIntire, R (K)	50	$40,000	$10,000	$0	$10,000
Booker, L	55	$45,000	$11,250	$0	$11,250
Clerk, A	30	$35,000		$6,582	$6,582
Clerk, B	25	$25,000		$3,738	$3,738
Nurse, N (Part Time)	45	$10,000	$2,500	$0	$2,500
			$23,750	$136,172	$159,922
% to Key (K)					**85%**
Projected Benefit for McIntire DMD (K) @62					**$14,167**
Projected Accumulation for DMD (K) @62					**$2,062,154**

Advanced Carve-Out

- Dr. McIntire likes the defined benefit plan idea but is concerned with the added expense and potential confusion of operating two plans for two different groups of employees. He would like to pursue a “Next Level” alternative using one plan, if possible.
- How?
- By integrating a “New Comparability” profit sharing plan with the DB plan.

Advanced Carve-out with New Comparability Plan

- A “New Comparability Plan” allows clients to craft a plan specifically to meet their retirement goals and business needs. By creating non-discriminatory classes of employees and placing them in various groups, clients can accomplish their objectives, while still providing meaningful benefits to everyone eligible.

Employee Name	Age	Current Salary	Current Plan SEP-IRA	Traditional DB Plan	““New Comparability”” Defined Benefit Plan
McIntire, DMD(K)	**50**	**$210,000**	**$42,000**	**$125,852**	**$125,852**
McIntire, R (K)	50	$40,000	$8,000	$27,634	$8,275
Booker, L	55	$45,000	$9,000	$33,538	$10,042
Clerk, A	30	$35,000	$7,000	$6,582	$3,942
Clerk, B	25	$25,000	$5,000	$3,738	$2,238
Nurse, N (Part Time)	45	$10,000	$0	$0	$0
			$71,000	$197,344	$150,349
% to Key (K)			**70%**	**78%**	**89%**
Projected Benefit for McIntire DMD (K) @62				**$14,167**	**$14,167**
Projected Accumulation for DMD (K) @62				**2,062,154**	**2,062,154**

412(i) Defined Benefit Plans

- A 412(i) plan is a defined benefit pension plan, the funding requirements of which fall under Internal Revenue Code (IRC) §412(i). If a plan meets the requirements of this subsection, it is exempt from the complex funding rules of §412 of the Internal Revenue Code applicable to all other defined benefit plans.
- "**Fully insured**" 412(i) plans have been around since ERISA '74 and may be an attractive option for very small, successful businesses and professionals. They offer:

  -**No market risk**

  -**Maximum current contributions**

  -**Guaranteed retirement benefits**

  -**Simplicity**

Ideal Sponsor Profile:

- -Age 40 and above;
- -Fewer than five employees;
- -Employees are younger than the owner;
- -Stable, predictable income;
- -Desires more than $50,000 contribution;
- -**Risk averse** (to market losses); or
- -Seeks added safe money diversification

Example (annuity only)

- Participant Age 55 with $165,000 Salary, Normal Retirement Age (NRA) 65.
- Higher contributions with the annuity only 412(i) because of the lower assumed rates of return in the annuity.

	Classic **Defined Benefit Plan**	**412(i)** **“Annuity Only” Plan**
First Year Contribution	$144,902	$187,997
Monthly Benefit @ NRA 65	$13,750	$13,750
Accumulation @ NRA 65	$1,865,672	$2,155,172

Summary on Qualified Plans

- For many clients (especially high income small business owners) reducing income taxes and funding for retirement are the most important topics the clients deal with on an annual basis.
- If you are a potential client looking to reduce your taxes, while you might not have understood everything in this powerpoint presentation, it should illustrate that there are many ways you can skew the numbers in favor of the highly compensated employee/owner’s.
- The **key is working with advisor who know all the rules and options**. If you would like help reviewing your current plan or with putting in a new qualified plan, please contact our office.