



ACTUARIAL



Single-Participant DB Plans: 4 Keys to Success

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Many problems in solo owner-participant defined benefit plans can be avoided by knowing what your client's funding objectives and projected cash flow are before you design the plan.

When a solo practitioner is looking for a way to defer taxes, often his or her advisor will recommend adopting a defined benefit plan. This can result in significant tax savings to the individual. However, if the design of the plan is flawed, it can create headaches for the advisor, the actuary and the owner as the plan matures. Even with a solid design at the onset, issues can still arise from a variety of areas. In this article we will identify four areas where we have seen issues that can lead to problems down the road:

- data issues;
- plan assets;
- deduction issues; and
- plan termination.

DATA ISSUES — IS THE COMPENSATION REPORTED CORRECT?

One of the keys to minimizing issues in a single-participant defined benefit plan is making sure the data you receive is accurate, not only when administering the plan on an annual basis, but also in the initial design of the plan. Many firms have gone to a web-based data collection process. While this may offer significant time savings, there is room for error depending on the knowledge of the individual entering the data. The entity type of the business determines how compensation is reported, as outlined in the following table.

REPORTING COMPENSATION

Entity Type		
Sole Proprietor	Earned Income (Form 1040, Schedule C)	
Corporation	W-2 (Generally Box 1)	
S-Corporation	W-2 (Generally Box 1)	The pass-through profits reported on a Schedule K-1 of Form 1120 are <i>not</i> considered compensation
Limited Liability Company	Depends on the structure Taxed as a Corporation Taxed as a Sole Proprietor	W-2 (Generally Box 1) Earned Income (Form 1040 Schedule C)

The best practice is to request copies of the Schedule C or W-2 to support the information reported.

PLAN ASSETS — ILLIQUID ASSETS

As actuaries, the authors do not give advice on how the plan's assets should be invested. However, the plan sponsor should have an understanding of the effects that a large asset loss or a large asset gain will have on the minimum and maximum contribution levels.

Since the plan is not subject to Title I of ERISA and an ERISA bond is not required, it is common to see illiquid assets as part of the asset portfolio. The plan sponsor should have an understanding the calculations are based on the fair market value of assets, and the burden of substantiating the value reported lies with them as the plan sponsor. If the plan is selected for audit by the IRS, the plan sponsor will need to provide documentation supporting the fair market values of the illiquid assets. If it is determined the assets were overstated, using the corrected lower value of assets could result in a higher minimum required contribution than what was initially reported. If the plan sponsor's contribution was not sufficient to cover the minimum required contribution, it would also be subject to excise taxes.

Alternatively, if it is determined that the assets were understated, this can result in the plan sponsor deducting more than the deductible limits allow. While this would result in a non-deductible contribution, Code Section 4972(c)(7) provides an

exception to the excise tax for defined benefit contributions if the employer makes an election for that tax year. There is no guidance on the form of the election.

When a decision is made to terminate the plan, not only does the issue of the fair market value of the asset arise, but how the asset can be distributed can be a factor as well. Can the investment be held in an individual retirement account, or will another qualified plan be established to hold the investment?

DEDUCTION ISSUES

A deduction on behalf of a sole proprietor is limited to that person's earned income under Code Section 404(a)(8)(C). The range between the minimum required contribution and the maximum deductible contribution increases as the plan matures due to the cushion calculation under Code Section 404(o)(3). With a large contribution range, the issue of limiting the maximum deductible contribution to earned income can be managed in the communication of the contribution levels beyond the results of the actuarial report.

However, if the minimum required contribution is greater than the sole proprietor's earned income, the minimum required contribution must still be contributed. Note that there is an exception to the excise tax on nondeductible contributions for amounts required by Code Section 412 but not deductible due to the earned income limitation under Code Section 4972(c)(4). Sometimes, this situation can be avoided based on

the initial design of the plan. If the participant had service prior to the establishment of the plan, the plan design could have a lower annual benefit formula by earning the benefit over years of service rather than years of participation.

The establishment of a past service benefit will result in a larger range between the minimum and the maximum initially. This range will narrow over time, since the goal is to contribute an amount greater than the benefit earned during the plan year. Alternatively, if there is no prior service, the interest rates under MAP-21 may create a contribution range where the plan sponsor can elect to create a prefunding balance to be used in subsequent years, as long as it was funded sufficiently.

PLAN TERMINATION

When a plan sponsor makes the decision to terminate the plan, a variety of difficulties can result if the termination is not carefully planned. While the owner-participant can elect to forgo a portion of his or her benefit to facilitate the plan termination, that election cannot be recognized for funding purposes.

Two key assumptions that actuaries make in their valuation are when the benefits will commence and how they will be paid. Many small plan actuaries design the plan with the underlying assumptions the participants will work until their normal retirement age and they will take their benefit in a lump sum.

Once the actuary is notified that the plan is terminating, how does

it affect those assumptions? If the valuation date is the end of the year, it is known as of the valuation date the plan is terminating. The assumptions need to reflect the actuary's best estimate of when the benefits will commence and how they will be paid based on the information known as of the valuation date.

In our view, if as of the valuation date, the plan has terminated, then the assumed distribution date is accelerated to the expected distribution date of the plan assets. This assumption can have a significant impact on the valuation results. In a traditional defined benefit plan, the liabilities are based on the plan rates or the annuity substitution rates, limited to the maximum distributable benefit. In a cash balance plan, the liability becomes the value of the cash balance account. These numbers may differ significantly from prior years based on the difference in the assumed

retirement ages and the underlying actuarial equivalent assumptions.

CONCLUSION

Many problems in solo owner-participant defined benefit plans can be avoided by having clear communication during your engagement with the client. Know what your client's funding objectives and projected cash flow are before you design the plan. Establish a relationship with the client or their advisors on the importance of communicating changes they foresee in their business so proper planning can be done and changes to the plan, if needed, can occur to meet their needs. Education at the onset of the engagement about the importance of keeping the plan funded to the plan's termination liability on an annual basis will avoid surprises when the client looks to wind down the plan.

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