Creative Plan Design Techniques for Small Businesses in 2015

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Session objectives

- Description - Small businesses and their owner(s) have different expectations and challenges to achieve a successful retirement plan. With today's limitations as well as options, you will look at combinations of plan design options for the small business owners to utilize in order to achieve different goals.
- L.O. 1 - Summarize the challenges faced by small business owners to achieve a successful retirement plan.
- L.O. 2 - Develop methodologies in order to determine the goals of the small business owner.
- L.O. 3 - Analyze retirement plan options and determine the most effect plan design.

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Considerations

- Deduction issues
  - DC only 25% of DC comp.
  - DC + DB 25% of comp. plus 6% of DC comp. OR
  - Max DB + 6% of DC comp OR
  - If PBGC covered max DB plus 25% DC comp
- Testing issues
  - 401(a)(4) / 410(b)
  - 401(a)(26) ; DB only
- Personnel issues

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Considerations

- Tax status
  - Self-employed – sole prop / partnership
    - Deductions for owners limited to earned income
  - Corp – S or C
  - S corp owners; need to be aware of 'basis' issues
  - S corp owners often want to minimize what is taken as compensation to lower PR taxes
  - Make sure accountant knows S pass through not comp!
  - Reasonable compensation issues

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Considerations

- Differing goals of various owners
- Creditor protection
- Top-heavy
  - Safe harbor and top-heavy exemption
  - Watch otherwise excludables in plan but excluded from SH
- Payroll taxes
- Additional Medicare tax of .9%
  - On wages and SE income above threshold amount
  - Threshold amt MFJ $250K; MFS $125K; others $200K

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Est. 415 Limits

- Approximate Cash balance/401(k) limits

– Age 30	$ 50,000	$53,000
– Age 35	$ 65,000	$53,000
– Age 40	$ 85,000	$53,000
– Age 45	$110,000	$53,000
– Age 50	$140,000	$59,000
– Age 55	$180,000	$59,000
– Age 60	$235,000	$59,000

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Setting expectations

- Retirement plan design should be driven by the client's goals and how best to achieve such goals
- So what is the client looking for in their plan?
  - Tax shelter?
    - Involve the accountant!
  - Least cost for employees?
    - Not always the case – ask!
    - Maybe they really want the plan to be an employee benefit!

Setting expectations

- Flexibility?
  - DB plans not always as flexible as clients desire
  - Don't let funding and other requirements be a surprise
  - Though they can be more flexible than folks might think
- Least amount of work internally?
  - At least set the expectations for amount of work
  - i.e., if there's to be a 401(k) make sure client realizes someone in their operation needs to be on top of things

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Setting expectations

- No/or limited commitment?
  - Is a SEP or a SIMPLE a better idea?
  - *Don't create plans that don't need to be created – good referral sources will remember and appreciate*
- *Always remember, you are offering a solution to a problem or helping the client achieve a goal*
  - If that results in you installing a plan or plans great
  - But don't look at process as "selling a plan"
  - Look at as process of helping the client achieve goal(s)

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The design process

- TAB is a company 100% owned by Trey
  - Begin by assuming no other employees
  - And for now assume Trey not c/u eligible
  - Wants to put $50K into retirement plan
  - Assume Trey is single
    - So additional .9% Medicare tax on any compensation over $200,000

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The design process

- TAB taxed as S corporation
  - So ability to take compensation "flexible"
  - I strongly suggest <u>advising</u> on <u>consequences</u> of level of comp. and <u>not</u> <u>suggesting</u> such level
  - This is the accountant's job!
- Assume we have $350K to use between compensation and retirement
  - Whatever not used here 'passed through'

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The design process

- Start with a SEP
  - Why?
    - No commitment to do anything if things change
    - Can stop making contributions at any time without 'permanence' issue
    - No plan document that needs to be amended and kept current
    - No 5500s irrespective of dollars accumulated

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The design process

- To get $50K into SEP needs compensation of $200K
  - SEP limit = 25% of compensation
  - Payroll tax cost = $20,494
    - » $200,000 * 2.9% = $5,800
    - » $118,500 * 12.4% = $14,694
  - No .9% additional as not over $200K

The design process

- Compare to solo 401(k) with PS
  - To get $50K into retirement only needs compensation of $128K
    - Deduction limit = 25% of compensation
    - 25% * $128K = $32K
    - Add deferral of $18K to get to $50K
    - Payroll tax cost = $18,408
      - » $128,000 * 2.9% = $3,712
      - » $118,500 * 12.4% = $14,694

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The design process

- Additional payroll taxes of ~$2K to get $50K to SEP v solo 401(k)
  - Also note employer half of payroll taxes deductible
  - Assuming 40% income tax rate net cost ~$1,600
- Again the compensation level should not be suggested by you as TPA
  - Instead show numbers and let CPA advise

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The design process

- Personally I'd be inclined to recommend SEP
  - For reasons stated above, <u>and</u>
  - Solo 401(k)s often end up being tended to less than they should as client's often don't want to pay the fees so they rely on investment company documents and CPA for the numbers
  - Documents may not be updated
  - 5500s may not be filed when $250K reached
  - Many came out of woodwork during recent IRS amnesty on EZ filings

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The design process

- What if Trey is c/u eligible?
- To get to $50K now need only $26K in PS if using solo k instead of SEP
- And compensation required only $104K
- Payroll taxes = $104K * .153 = $15,912
- Compared to SEP PR tax reduction = $4,582
- Considering deductibility of ½ PR taxes net difference $3,666 (assuming tax rate of 40%)
  - Enough to make qualified plan better idea?

The design process

- Additional advantage to SEP v solo 401(k)
- Hiring an employee means their entry into 401(k) after ~ a year
- With SEP can keep them out for as many as 2 more years
  - Recall SEP rules can require service in 3 of prior 5 years for entry

The design process

- Assume TAB formed in January 2015 with Trey as only employee
- Employee (Mike – age 21+) hired January 1, 2016
- With 401(k) Mike must enter January 1, 2017
  - Presumes 1,000 hours in 2016

The design process

- SEP could provide the following for entry
  - 2015 - no prior service required
  - 2016 – 1 year prior service required
  - 2017 – 2 years prior service required
  - 2018 – 3 years prior service required
  - i.e., can put off covering Mike until 2019
- Possibly adopt 401(k) in 2019
  - And could even start vesting at that point!

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The design process

- Now let's assume either we're in 2019 or that Mike's been around as long as Trey
- Further assume Trey and Mike both age 51
- Mike's comp. =$40K
- Again Trey has $350K available and wants $50K in retirement
- First look at SEP

The design process

- If Trey takes $200K in compensation he needs 25% to get to $50K
- This means Mike also gets 25% or $10K
- If Trey takes max compensation of $265K he needs 18.87% to get to $50K
- Mike would then get $7,548
- Save $2,452
- Payroll tax cost $65K * 3.8% = $2,470
  - ½ of 2.9% tax deductible
  - Over $200K of comp. so addt'l .9% applies

The design process

- So we save $2,452 in employee contribution by taking $65K more in compensation
- At a cost of $2,470 in PR taxes
- Said differently, to save $2,470 in PR taxes we have additional $2,452 in ee contribution
- Assuming combined income tax rate of 40% additional employee cost only $1,471
- Addt'l <u>net</u> payroll tax cost actually $2,093

The design process

- Of course SEP requires full and immediate vesting
- As well as inability to have elective deferrals
- So compare to safe harbor 401(k)
- Recall that Trey is c/u eligible
- So $24K of $50K in form of elective deferral
- Need $26K in employer dollars

Trey comp		101,025	120,000	150,000	150,000	200,000	200,000	200,000	265,000	265,000	265,000
Integration level	118,500	40,000	40,000	40,000	94,800	40,000	94,800	118,500	40,000	94,800	118,500
Excess		61,025	80,000	110,000	55,200	160,000	105,200	81,500	225,000	170,200	146,500
		4.30%	4.30%	4.30%	5.40%	4.30%	5.40%	5.70%	3.68%	4.15%	4.39%
PS on excess		2,624	3,440	4,730	2,981	6,880	5,681	4,646	8,280	7,063	6,431
PS on all		20,345	18,960	16,770	18,519	13,120	14,319	15,355	9,770	10,987	11,619
		20.14%	15.80%	11.18%	12.35%	6.56%	7.16%	7.68%	3.69%	4.15%	4.38%
Safe harbor		3,031	3,600	4,500	4,500	6,000	6,000	6,000	7,950	7,950	7,950
Total Trey PS/SH		26,000	26,000	26,000	26,000	26,000	26,000	26,000	26,000	26,000	26,000
Mike Comp		40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
PS/SH % to Mike		23.14%	18.80%	14.18%	15.35%	9.56%	10.16%	10.68%	6.69%	7.15%	7.38%
PS to Mike (include SH)		9,256	7,520	5,672	6,138	3,824	4,064	4,271	2,675	2,858	2,954
Net after tax	40%	5,553	4,512	3,403	3,683	2,294	2,438	2,563	1,605	1,715	1,772
Total Comp.		141,025	160,000	190,000	190,000	240,000	240,000	240,000	305,000	305,000	305,000
Deduction limit	25%	35,256	40,000	47,500	47,500	60,000	60,000	60,000	76,250	76,250	76,250
Trey and Mike		35,256	33,520	31,672	32,138	29,824	30,064	30,271	28,675	28,858	28,954
	12.40%	12,527	14,694	14,694	14,694	14,694	14,694	14,694	14,694	14,694	14,694
	2.90%	2,930	3,480	4,350	4,350	5,800	5,800	5,800	7,685	7,685	7,685
200,000	0.90%	-	-	-	-	-	-	-	585	585	585
PR tax cost		15,457	18,174	19,044	19,044	20,494	20,494	20,494	22,964	22,964	22,964
Deduction		7,728	9,087	9,522	9,522	10,247	10,247	10,247	11,190	11,190	11,190
Tax savings		3,091	3,635	3,809	3,809	4,099	4,099	4,099	4,476	4,476	4,476
Net payroll taxes		12,365	14,539	15,235	15,235	16,395	16,395	16,395	18,488	18,488	18,488
PR taxes plus Mike		17,919	19,051	18,638	18,918	18,690	18,834	18,958	20,093	20,203	20,260

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The design process

- Let's add two more employees
- Page and Jon
- Hired same time as Mike
- Ages 52 and 50, respectively
- Assume for now want to treat equally

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Trey comp			98,475	120,000	150,000	150,000	200,000	200,000	200,000	265,000	265,000	265,000
Integration level		118,500	40,000	40,000	40,000	94,800	40,000	94,800	118,500	40,000	94,800	118,500
Excess			58,475	80,000	110,000	55,200	160,000	105,200	81,500	225,000	170,200	146,500
			4.30%	4.30%	4.30%	5.40%	4.30%	5.40%	5.70%	3.68%	4.15%	4.39%
PS on excess			2,514	3,440	4,730	2,981	6,880	5,681	4,646	8,280	7,063	6,431
PS on all			20,531	18,960	16,770	18,519	13,120	14,319	15,355	9,770	10,987	11,619
			20.85%	15.80%	11.18%	12.35%	6.56%	7.16%	7.68%	3.69%	4.15%	4.38%
Safe harbor			2,954	3,600	4,500	4,500	6,000	6,000	6,000	7,950	7,950	7,950
Total Trey PS/SH			26,000	26,000	26,000	26,000	26,000	26,000	26,000	26,000	26,000	26,000
Mike/Page/Jon Comp each			40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
PS/SH % to Mike/Page/Jon			23.85%	18.80%	14.18%	15.35%	9.56%	10.16%	10.68%	6.69%	7.15%	7.38%
PS to Mike/Page/Jon (include SH)			9,540	7,520	5,672	6,138	3,824	4,064	4,271	2,675	2,858	2,954
	Times	3	28,619	22,560	17,016	18,415	11,472	12,192	12,813	8,024	8,575	8,861
Net after tax		40%	17,171	13,536	10,210	11,049	6,883	7,315	7,688	4,814	5,145	5,317
Total Comp.			218,475	240,000	270,000	270,000	320,000	320,000	320,000	385,000	385,000	385,000
Deduction limit		25%	54,619	60,000	67,500	67,500	80,000	80,000	80,000	96,250	96,250	96,250
Total PS/SH			54,619	48,560	43,016	44,415	37,472	38,192	38,813	34,024	34,575	34,861
		12.40%	12,211	14,694	14,694	14,694	14,694	14,694	14,694	14,694	14,694	14,694
		2.90%	2,856	3,480	4,350	4,350	5,800	5,800	5,800	7,685	7,685	7,685
	200,000	0.90%	-	-	-	-	-	-	-	585	585	585
PR tax cost			15,067	18,174	19,044	19,044	20,494	20,494	20,494	22,964	22,964	22,964
Deduction			7,533	9,087	9,522	9,522	10,247	10,247	10,247	11,190	11,190	11,190
Tax savings			3,013	3,635	3,809	3,809	4,099	4,099	4,099	4,476	4,476	4,476
Net payroll taxes			12,053	14,539	15,235	15,235	16,395	16,395	16,395	18,488	18,488	18,488
PR taxes plus EE cost			29,225	28,075	25,445	26,284	23,278	23,710	24,083	23,303	23,633	23,805

The design process

- Of course we don’t have to treat all 3 the same
- With rate group testing would need 2 of 3 in Trey’s rate group
- i.e. NHC concentration = 75%
- Safe harbor = 50% - (15*.75%) = 38.75%
- Unsafe harbor = 40% - (15*.75%) = 28.75%
- Midpoint = 33.75%
- 33.75% * 3 > 1 so need 2 in rate group
  - And would need to pass average benefits % test

PERMITTED DISPARITY ON ALLOCATION BASIS

A	Unadjusted allocation rate (w/o SH)	10.00%	7.68%	7.68%	0.00%
B	Plan Year comp.	200,000	40,000	40,000	40,000
C	TWB	118,500	118,500	118,500	118,500
D	Covered comp (lesser B/C)	118,500	40,000	40,000	40,000
E	PD rate (5.7%)	5.70%	5.70%	5.70%	5.70%
F	Max PD (lesser A/E)	5.70%	5.70%	5.70%	0.00%
G	Theoretical Disparity Allocation (F*D)	6,755	2,280	2,280	-
H	Imputed PD G/B	3.38%	5.70%	5.70%	0.00%
I	Adjusted allocation base (B - (.5*D))	140,750	20,000	20,000	20,000
J	Max adjusted allocation rate (A*B/I)	14.21%	15.35%	15.35%	0.00%
K	Safe harbor	3.00%	3.00%	3.00%	3.00%
L	Adjusted allocation rate (lesser A+H or J + K)	16.38%	16.38%	16.38%	3.00%
M	Average HCEs	16.38%			
N	Average NHCs				11.92%
	Average benefit percentage N / M				72.77%
	In dollars	26,000	4,271	4,271	1,200
	Total employee				9,742

The design process

- Do we dare rely on average benefits test in such a small plan?
- Recall class exclusions must be reasonable and based on objective business criterion and may not name names – or have effect of doing so
- Can we exclude drummers where there's only one drummer?
  – Does this have effect of excluding by name?

PERMITTED DISPARITY ON ALLOCATION BASIS - pass 410(b) with avg benefits test

A	Unadjusted allocation rate (w/o SH)	10.00%	8.50%	8.50%	0.00%
B	Plan Year comp.	200,000	40,000	40,000	40,000
C	TWB	118,500	118,500	118,500	118,500
D	Covered comp (lesser B/C)	118,500	40,000	40,000	40,000
E	PD rate (5.7%)	5.70%	5.70%	5.70%	5.70%
F	Max PD (lesser A/E)	5.70%	5.70%	5.70%	0.00%
G	Theoretical Disparity Allocation (F*D)	6,755	2,280	2,280	-
H	Imputed PD G/B	3.38%	5.70%	5.70%	0.00%
I	Adjusted allocation base (B - (.5*D))	140,750	20,000	20,000	20,000
J	Max adjusted allocation rate (A*B/I)	14.21%	17.00%	17.00%	0.00%
K	Safe harbor	3.00%	3.00%	3.00%	
L	Adjusted allocation rate (lesser A+H or J + K)	16.38%	17.20%	17.20%	0.00%
M	Average HCEs	16.38%			
N	Average NHCs				11.47%
	Average benefit percentage N / M				70.02%
	In dollars	26,000	4,600	4,600	-
	Total employee				9,200

The design process

- Let's go back to TAB being a one-person company and that's been around since 1984
- Trey has taken annual compensation of $100K
- Let's assume 2015 was very big year and Trey wants to get as much as possible in retirement
- If we create a DB plan with a benefit of $60 per month per year of service Trey's benefit at January 1, 2015 will be $1,750 (limited by 415)

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The design process

- At age 51 and assuming 5.5% and 2015 applicable table the cost at age 62 for such benefit will be $261,757 ($1,750 * 149.575)
- Discount 11 years at 2nd segment rate of 4.11% the 404 funding target = $168,066
- With the 50% cushion the maximum deduction in 2015 is $252,100

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The design process

- Assuming no amendments, at age 62 Trey's total benefit will be $60 * 42 = $2,520
- And the dollars needed to fund such benefit will be $2,520 * 149.575 = $367,955
- It will take a ROR of about 3.5% annually for the initial deposit to satisfy the entire liability

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The design process

- Could even limit credited years to say 35 and the dollars needed to fund such benefit will be ($35 * 60) - > $2,100 * 149.575 = $314,108
- It will take a ROR of about 2% annually for the initial deposit to satisfy the entire liability
- I've done this with an author with her first big seller as well as a lawyer with a big settlement

The design process

- Looking back at case with employees
- Assume Trey wants 'max' cash balance plus max DC for 2015 but wants to somewhat limit future requirements
  - But have flexibility to reach 2015 levels if future cash flow permits
- At age 51 max cash balance approx $150K
- Will ignore testing for now

The design process

- As previously discussed, as S Corp there is some flexibility to Trey's compensation
- However it's likely not our job to recommend levels, instead to demonstrate impact of different levels
- So assume Trey's 2015 comp = $250K
- 2015 cash balance would be 60% of comp.

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The design process

- Let's further assume that age demographic is such that required amount for employees to pass testing is 7% PS plus 3% in cash balance - Would likely provide
  - 3% non-elective 401(k) SH
  - 4% PS
  - 3% cash balance
  - This obviously allows Trey to defer $24K
  - As well as add $35K of PS (no SH to Trey)

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The design process

- Likely we'd be top-heavy - THM met in DC
  - Recall with combined plans one option is DC of 5% for those participating in both plans
- Make sure optional forms in cash balance limited to required annuities plus lump sum
  - Allows PS to not provide annuities
- Good practice to line up normal retirement ages
- 3-year cliff vesting required in cash balance
  - OK to leave PS at 2-20

The design process

- Some thoughts on limiting future obligations
- Document could provide Trey's cash balance as 60% of comp. in year 1 and same as employees (or some other low amount) in future years
- Of course this means that plan would need to be amended in future years to get Trey back up if goal in a future year is larger amount

The design process

- Again recall ‘flexibility’ on comp. in S corporation
  - Did I say not to ‘recommend’ but instead to demonstrate results to client and CPA?
- Anyway, what if cash balance formula for Trey is 4% of total comp plus 200% of comp. over $180K
  - 4% * $250K = $10K
  - 200% * ($250K - $180K) = $140K
  - $10K + $140K = $150K

The design process

- Can then manipulate level of comp. in future years to achieve desired level
- This will of course result in Trey earning benefit in future years such that top-heavy minimum will continue to be 5% in DC
  - Unlike DC, ANY level of cash balance pay credit for Trey would result in 5% THM needed
  - i.e., not limited to what key receives

The design process

- Perhaps make formula something like 200% of compensation in excess of $175K
  - With comp $175K or less no DB accrual for Trey
  - THM limited to that required in DC plan, if anything

The design process

- Note that if TAB is a C corp much less flexibility
- Closely held C corps tend to strip income out in form of compensation to avoid corporate level taxation
- In such case likely would need approach where cash balance credits lower percentage in future years and amend to higher levels if desired

The design process

- Similarly for sole prop or partnership where compensation is based on SE income which is much less easy to control
- In case of partnership (or LLC taxed as such) base on guaranteed payments?
  - And control level of such payments to meet funding goals in future years?
  - Again takes consultation with client and CPA