

H. C. FOSTER & COMPANY

Retirement and Welfare Plan Actuaries

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Fallacies Debunked – Summer 2015

Tax deferrals enable business owners and employees at all compensation levels to retain control of income that is otherwise paid to IRS for its use. Assuming a 6.0% annually compounded discount rate, \$1 paid to a pension plan at age 40 rather than paid to IRS in taxes has a discounted value of \$.23 when taxed as a pension distribution at age 65 for an immediate \$.77 profit. Or, that \$1 pays \$4.29 of taxes on retirement income at age 65. This clearly debunks the notion that tax deferrals from a pension plan are of little or no value because taxes are ultimately paid on distributions at retirement.

Following is a demonstration of the magnitude of the tax deferral advantage for hypothetical employees (ees) and business owners (os), all expected to retire at age 65 with Form W-2 Wages after reduction for allocated pension costs to a defined benefit pension plan with all values annually:

Current Age/Status	Salary w/o Pension	Pension Cost	Form W-2 Wages	Tax Deferral	-----Accumulated Tax Deferrals at Ages-----				
					35	40	45	55	65
30/ee	\$ 20,374	\$ 374	\$ 20,000	\$ 75	\$ 423	\$ 989	\$1,746	\$ 4,115	\$ 8,358
35/ee	46,332	1,332	45,000	260	-	1,466	3,427	9,564	20,555
45/ee	96,932	6,932	90,000	2,083	-	-	-	27,456	76,624
50/o	311,865	51,865	260,000	20,746	-	-	-	116,947	482,883
55/o	350,618	90,618	260,000	36,247	-	-	-	-	477,764

Notes:

1. The tax advantage continues after retirement. The retiree has a pension asset he would not otherwise retain. Distributions of monthly benefits are taxed as ordinary income beginning as late as the April 1st immediately following the calendar year in which the employee or owner attains age 70½. The Accumulated Tax Deferrals at age 65 otherwise paid to IRS continue to accumulate with tax deferred earnings until monthly retirement income payments are withdrawn.
2. Actual allocated Pension Costs for each plan participant are not determinable from the current PPA '06 Funding Method procedures that are a form of the ERISA Accrued Benefit Funding Method, and do not fund benefits adequately under IRS' current round of "funding relief". The actuary can provide realistic estimates of the annual allocated Pension Cost for each plan participant.
3. Form W-2 Wages are net of allocated pension costs at year-ends based on the Social Security integrated formula shown in our Summer 2014 Newsletter with the same actuarial assumptions – 6.0% annually compounded investment returns with 2014 Mortality Table under PPA '06 applied post-retirement, no mortality or employee turnover assumed pre-retirement, and no Lump Sum Distributions exceeding \$5,000. A plan's actual cost to fund benefits is for participants who attain full vesting, and is reduced by the present values remaining from nonvested employee terminations.
4. Accumulations are without adjustments for compensation increases or losses of purchasing power due to monetary inflation; therefore, are in current dollar values. The tax advantage for a lower paid 30-year-old does not seem significant; however, a younger employee's Accumulated Tax Deferrals will increase with increases in his salary and age.

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5. Representative Tax Deferrals are at assumed bracket taxation rates plus employee and employer Social Security costs saved by reductions in direct compensation, and can vary dramatically for any salary rate depending on each person's situation. Allocated Pension Costs can vary dramatically with the participant's years of employment service, a plan's benefit formula, and a plan's funded status.
6. IRS confused matters a few years ago making it politically incorrect for tax advisors to issue tax advice without an apology titled IRS Circular 230 Disclosures saying tax advice can not be used for purposes of avoiding penalties, "...or promoting, marketing or recommending to another person any tax-related matter." The accountant's guidance in pension matters may be tax advice requiring a Circular 230 Disclosure. Factual presentations of plan values without marketing intent or recommendations are not tax advice. Higher paid business owners and employees need not feel guilty because they qualify for tax deferred pension contributions in lieu of direct compensation.

Other fallacies about pension plans include the following:

Derisking - "derisking" pension asset values is promoted by investment sales sources to sell life annuity contracts at retail costs, and obtain Lump Sum Distributions (LSDs) from participants to invest in their products. The idea is that if a plan is terminated or life annuity liabilities are settled as expensive LSDs, the pension plan avoids risk. This is akin to burning down the house to avoid the risk of fire, i.e., the value forfeited is significantly more than any expected losses from retaining the risk. True "derisking" retains the potential advantages of the risk within practicable bounds that include avoidance of hidden costs, potentially greater investment returns, and reduced or no sales commissions. Effective July 9, 2015 and afterwards, IRS Notice 2015-49 prohibits plans from converting retirees' life annuity benefits in payment status to LSDs.

Participant investment direction – promoters of Section 401(k) Plans tell their customers that transferring investment selection decisions to plan participants removes the employer from fiduciary liability for a plan's investments. This is not true because the employer selects the universe of investments from which participants choose their investments, and is required to monitor those investments for their quality with proper disclosures to participants to help them avoid uninformed decisions. See our Spring 2015 Newsletter on our website regarding recently enacted regulations to fully implement ERISA's investment fiduciary requirements. Fiduciary avoidance tactics are either impossible or impracticable for these plans.

Fiduciary risk with self-administration – a fashionable sales ploy following ERISA was to say employers should not self-administer their retirement plans because they were incapable of assuming the associated administrative and investment risk. Business owners, chief executive officers, and managers are not risk averse, or they would not be effective in those positions. ERISA clearly permits delegation of investment management responsibility by Plan Administrators to independent professional investment managers readily available through independent investment consulting services. Plan administration can be delegated within limits to Third Party Administrators as is common for collectively bargained plans. Defined benefit plans sponsored by closely held private employers typically hold little investment or administrative risk because most of the plan's assets accrue to the business owners leaving significant asset margins to cover non-owner accrued pension benefit present values.

Please e-mail any questions or comments.