

H. C. FOSTER & COMPANY

Retirement and Welfare Plan Actuaries

P.O. Box 99, Belle Rive, Illinois 62810 ■ (618) 244-1850
hcfoster@mvn.net ■ www.hcfoster.com ■ Deliveries to 8252 North Program Lane

Efficient Compensation Design – Fall 2016

The decline of the private pension system in the United States results from mismanagement of total compensation costs rather than from the benefit plans. Insufficient employer resources remain after Form W-2 direct compensation costs to fund pension and welfare benefits. Our past Newsletters illustrate how to design an efficient compensation program, summarized as follows:

Step I – determine the total compensation cost for each employee compared to Bureau of Labor Statistics (BLS) norms via completion of the Compensation Expenses Worksheet updated with our Winter 2015 and 2016 Newsletter, and appearing on the Internet under “Measuring Compensation Expenses”.

Step II – replace all IRA-type arrangements with an uncomplicated, self-administered tax-qualified Profit Sharing Plan (PSP) that may or may not include Section 401(k) provisions. SIMPLE IRA plan termination notices are due to employees no later than November 2, 2016 to avoid mandatory contributions for the 2017 calendar year. IRS’ website shows a model employee termination notice for SIMPLE IRA plans.

Step III – review all investment sources for existing tax qualified retirement and welfare plans to remove hidden investment and administrative charges, and self administer retirement plan investments through an independent money manager free of product affiliations or a discount investment brokerage source.

Step IV – clarify company objectives: (a) who should benefit the most; (b) cost restraints; and, (c) profit objective per \$1 of total employee compensation costs that include direct and indirect employee costs.

Step V – modify or adopt defined benefit plan provisions that: (a) include cost savings features such as Social Security Integration and Floor-offsets for employer contributions to a tax qualified PSP; (b) add a mandatory employee “Contributory” requirement; and, (c) add benefit cut down and retirement age service requirements reflecting longer service employees within nondiscrimination limitations.

Step VI – avoid prototype plan document arrangements with investment sources in favor of individually designed plan documents available through independent benefit and law firms that do not maintain investment product affiliations to gain maximum control over plan provisions.

Following is simplified example of an efficient compensation design for an employee named “Joe” whose annual work product retails for \$90,000. Footnotes begin on page 2.

Compensation Component	Employer Costs		Cost/ (Savings)	Influencing Factors
	Before	After		
Form W-2 wages	\$50,000	\$45,000	(\$5,000)	FMV for job prospects and BLS statistics ¹
PSP/401(k)	3,000	1,500	(1,500)	PSP with 3.0% employer contribution w/FOP ²
Defined benefit plan	6,800	2,400	(4,400)	Plan re-design reducing cost ³
Ee and Er tax cost	(1,500)	(1,000)	500	Allocated tax costs, employees and employer ⁴
Welfare plan costs	1,800	1,800	-0-	Exclusive of ACA costs, plan redesign no effect ⁵
Regulatory costs	<u>5,000</u>	<u>4,600</u>	<u>(400)</u>	Social Security matching and other costs ⁶
Totals:	<u>\$65,100</u>	<u>\$54,300</u> ⁷	<u>\$10,800</u>	Joe’s total compensation cost reduces 16.6%

Continued, next page.

Footnotes:

1. Joe's skill level and work ethic would not command an annual salary of more than a \$45,000 on the open job market. 2. Does not include cost savings for replacement of IRA-type plan by a self-administered PSP with no Section 401(k) employer matching. Annual 3.0% employer contributions to the PSP would offset defined benefit plan funding costs and past service liabilities. 3. Existing defined benefit plan amended to include design features in Step V above and conversion to self administration under Steps III and VI above. The previous plan design provided employer-paid retirement benefits with Social Security exceeding 70% of Joe's expected age 65 salary. 4. Tax deferrals for owners' personal returns and business expense deductions can exceed pension funding costs for non-owners in a small plan; and, recover estate taxes \$1 for \$1 on death benefits through beneficiaries' itemized deductions. Aggregate tax deferrals for owners and employees in any sized plan can fund a significant portion of pension funding costs. 5. Varies with the levels of welfare plan coverages and the frequency of bidding for more cost-effective group insurance coverages. Employers' approaches to ACA costs vary widely. 6. Regulatory costs are consistent for most employers. The non-pension costs reflect BLS results and the decrease in Joe's Form W-2 wages. 7. The bottom line test is whether or not Joe's total compensation cost of \$54,300 produces a sufficient profit for the employer.

For our example, Joe's compensation expense returns about 18.4% of pre-tax income to his employer assuming an employer profit of \$10,000 after reduction of all other expenses from \$90,000 of gross revenues he generates. Joe's economic value to his employer will increase or decrease with the market value of his work product that varies with economic conditions and his ability to maintain his skills in a changing work environment. Profit measurements for employees who produce no marketable work products are allocated proportionately to each product producing employee's profit contribution.

We are not advising employees' compensations be abruptly reduced or increased to fit the results of the above analysis, but phased-in over future years. Joe's value to his employer may be more or less than his value on the open job market. His replacement costs for training and other new employee costs may negate the advantages of reducing his direct compensation costs; but, in any event, his indirect compensations costs for retirement and welfare benefits costs can most likely be reduced through a few simple steps:

- Avoid all retail, consumer oriented financial products to minimize employer costs to the extent not passed to employees and maximize benefits for employees.
- For Section 401(k) plans, avoid participant investment direction options, participant loan provisions, Roth IRA options, and employer matching contributions. These features add administrative costs and do not necessarily benefit the most productive workers.
- Prepare a written compensation policy to clarify how much dollar-wise and percentage-wise to commit to retirement and welfare benefits funding in addition to Form W-2 Wages. The employee skills required to meet production objectives and the need to avoid collective bargaining threats are significant factors in the evaluation of a compensation policy.
- Prepare to gradually align employees' total compensation packages to reflect their profit-return to the company and fit industry norms under BLS measurements for each job category after benefit plan objectives are implemented.

See our recent Newsletters at www.benefitslink.com, or via key words "H. C. Foster & Company" under an Internet search engine. Please e-mail any questions or comments through our website.