

H. C. FOSTER & COMPANY

Retirement and Welfare Plan Actuaries

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Accumulating Tax Deferrals – Fall 2017

Business owners and other highly-paid wage earners easily forfeit 35% to 45% of their top-dollar earnings for Federal and State taxes, Social Security, and other costs tied to personal incomes. This means \$1 of ordinary income reported on Form W-2 is reduced to 60¢ at a 40% reduction rate. That 40¢ is lost forever, never to be recovered. Each \$1 of a business' earnings redirected from wages to a properly designed tax qualified retirement plan accomplishes several goals:

- Each 40¢ of business profits contributed on behalf of the business owners can easily exceed non-owner employees' pension funding costs depending on several factors.
- At 7.0% annual investment earnings net of expenses, 40¢ grows to nearly 80¢ in ten years.
- The retirement plan accumulates investment earnings at full value because accumulations are not treated as income to plan participants until received as retirement income.
- Business owners and employees accumulate retirement benefits to supplement Social Security and personal assets to achieve 70% of pre-retirement age wage levels needed to maintain their life styles.
- Assets removed from the owner's estate can reduce exposure to estate taxation if managed properly.
- Compensation distributed through allocated pension contributions justifies reductions in Form W-2 Wages to reduce total compensation costs to levels with no retirement plan funding costs.

The illustration below shows how contributions to a defined benefit pension plan produce a net financial gain for the business owners with conditions that typically apply for a closely held business. Annual compensations, funding costs, the covered employee group, investment returns, and other factors are held constant for simplicity. The employer administers the plan and its investment functions with assistance from its advisors only as needed for cost efficiency. The employee group consists of two owners, both age 50s, with 10 non-owner employees having a wide range of compensations, past service, ages, and other factors.

Plan Year	Contributions	Annual Minimum Funding Costs		Costs Accumulated at IRR to 12/31/16		Savings Accumulated at IRR to 12/31/16	
		Owners	Employees	Owners	Employees	Owners	Employees
2011	\$125,000	\$100,000	\$ 25,000	\$137,779	\$ 34,445	\$ 55,112	\$13,778
2012	125,000	100,000	25,000	129,980	32,495	51,992	12,998
2013	125,000	100,000	25,000	122,623	30,656	49,049	12,262
2014	125,000	100,000	25,000	115,682	28,920	46,273	11,568
2015	125,000	100,000	25,000	109,134	27,283	43,653	10,913
2016	125,000	100,000	25,000	102,956	25,739	41,183	10,296
Totals:		<u>\$600,000</u>	<u>\$150,000</u>	<u>\$718,153</u>	<u>\$179,538</u>	<u>\$287,261</u>	<u>\$71,815</u>

The Net Gain from the Plan for the owners is derived as follows for minimum funding costs under a 40% reduction factor for owners' taxation and other salary related costs:

A. Accumulated savings on contributions for owners at 40% of contributions	\$287,261
B. Investment earnings from accrued benefits for owners, \$718,153 <u>less</u> \$600,000	118,153
C. Investment earnings from accrued benefits for non-owners, \$179,538 <u>less</u> \$150,000 .	29,538
D. Accumulated savings for non-owners, 40% <u>times</u> \$179,538	71,815
E. Accumulated net cost for non-owners, 60% <u>times</u> \$179,538	<u>107,723</u>
F. Total Net Gain from plan costs, A. <u>plus</u> B. <u>plus</u> C. <u>plus</u> D. <u>less</u> E.	<u>\$399,044</u>

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Employer and employee groups vary greatly, and each must be reviewed in detail to determine a plan design that meets the employer's objectives at the least cost to the employer for non-owner employees. The conditions applied for the above illustration include the following:

- A 6.0% Internal Rate of (Investment) Return (IRR) per annum is assumed on plan assets, net of expenses. Increases in the IRR increase the Net Gain and decrease benefit costs.
- Maximum annual compensation and benefit limitations under IRS regulations apply each year.
- The business owners each have 30 or more Years of Service (YOS). Their projected YOS at the plan's Normal Retirement Age (NRA) exceeds 35 Years.
- The plan's NRA is the later of age 60 or completion of 30 YOS, but not later than the later of age 65 and the fifth anniversary date of plan entry as required under IRS regulations.
- A costly Lump Sum Distribution option is not available, restricting benefit payments having present values exceeding \$5,000 to a single life annuity or its actuarial equivalent beginning at NRA.
- A YOS Social Security integrated benefit formula reduces benefit accruals to recognize the employer pays a greater percentage of a lower paid employee's Wages for Social Security costs.
- The plan meets the nondiscrimination requirements of the IRC Section 401(a)(4) General Test for Nondiscrimination, i.e., benefit accrual rates for non-owners are sufficient to be nondiscriminatory.

The business owners hold \$399,044 that otherwise would have been taken from their Form W-2 Wages or Earned Incomes had they not diverted these amounts through a tax qualified defined benefit pension plan; and, they retain an extra \$125,000 each year to fund pension benefits for the employee group including the owners. The range of the Net Gain for minimum funding cost would be from \$345,685 for an otherwise 35% Wage reduction, to \$453,417 for an otherwise 45% Wage reduction.

If this employer had contributed \$200,000 per year within the PPA '06 contribution limitations, his excess contributions of \$75,000 would have retained \$30,000 per year in the plan at an otherwise 40% reduction rate to generate investment earnings in the pension trust. The additional accumulated savings would be \$221,815 for a total savings of \$399,044 plus 221,815, or \$620,859. Additional savings could have been achieved from employer contributions to a deferred Profit Sharing Plan for non-owners to reduce their benefit accruals on a favorable actuarially equivalent basis under a Floor-offset Arrangement.

This example is not unusual for a profitable closely held business where the highly-paid owners are older with longer past service, and the younger non-owner employees are lower-paid with shorter employment service. The ratio of owners to total employees in the example is 2 to 12, or 16.7%. A 50 employee business can easily have the same concentration of owners and key employees to total employees with the longer service, key employees having contributed significantly to building the business, but with higher pension funding costs depending on when the plan began and their ages.

But, the older, longer-service employees will be concerned about their emerging retirement income security, and may voluntarily exchange current ordinary income for benefit accruals in a retirement plan. This is accomplished through individual Salary Withholding Agreements with the employer. The salary withholding amount each year is the estimated funding cost with a settlement at retirement for the difference in the accumulated amounts withheld and the single sum value of retirement benefits determined from a valuation interest rate bench mark. Larger employers may have smaller concentrations of owners working in the business and key employees in management positions, but have more options for diverting Form W-2 Wages from ordinary income to compensate key employees.

Please call or e-mail any questions or comments.

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