

H. C. FOSTER & COMPANY

Retirement and Welfare Plan Actuaries

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Employer Benefit Costs Should Be Zero (\$-0-) – Summer 2018

A Defined Benefit Pension Plan (DBPP) helps control labor costs under an efficient compensation design for the following reasons:

- A meaningful retirement plan reduces re-hiring and training costs by retaining employees invested in their benefits. Qualified job candidates for the 6.5 million unfilled job openings in the United States seek pension and employee welfare benefit plans in a highly competitive market.
- A portion of active working life taxable income is deferred through benefit plan funding to balance direct and indirect compensation sources. Older employees are allocated more valuable benefits in a DBPP to compensate them for their contribution to building a business, and they receive retirement income when active working life income replacement is needed.
- Benefit costs are controlled with plan amendments and increased contributions in higher profit years. DBPPs permit an unlimited range of plan designs. Employers can obtain the advantages of emerging conditions from year to year.
- Tax deferrals for business owners often exceed any costs for nonowner employees' funding.

Retirement and welfare plan costs do not add to an employer's total compensation costs under an efficient compensation design as illustrated below. Retirement income is a monthly life annuity projected to begin at age 65. For simplicity, no future salary increases are assumed. Rounding is internal.

		Employer's Net Total Compensation Costs						
Columns --->		A	B	C	D	E	F	G
<u>Ages</u>		Total	DBPP	Other	W-2 Wages	Employer Cost	Tax	Cost After
<u>Hire</u>	<u>Now</u>	<u>Comp.</u>	<u>Cost/yr.</u>	<u>Costs</u>	<u>A less B less C</u>	<u>for B and C</u>	<u>Savings</u>	<u>Tax Savings</u>
25	30	\$ 27,521	\$ 521	\$ 2,000	\$ 25,000	\$ -0-	\$ 5,779	\$ 21,742
35	45	43,388	2,138	3,750	37,500	-0-	9,111	34,277
40	50	47,605	2,805	4,800	40,000	-0-	9,997	37,608
45	50	61,283	4,283	7,000	50,000	-0-	12,870	48,414
50	60	95,374	8,374	12,000	75,000	-0-	20,029	75,345
Totals--->		<u>\$275,171</u>	<u>\$18,121</u>	<u>\$29,550</u>	<u>\$227,500</u>	<u>\$ -0-</u>	<u>\$57,786</u>	<u>\$217,386</u>

Column A - total compensation equals the employee's value of production

Column B – DBPP allocated funding cost for employee on level funding basis

Column C - Other Costs for benefit and administrative expenses range from 8.0% to 16% of Column D

Column D - Form W-2 Wages equal employee's total compensation less DBPP and Other Costs

Column E – employer's retirement and welfare benefit costs from an efficient compensation design

Column F – employer's net tax rate assumed at a 21% corporate rate to reduce net compensation expenses

Column G – employer's net total compensation cost after tax savings for these five employees

Notes:

1. The DBPP benefit formula for this example is 2.0% of high-5-year average compensation times Years of Service (YOS) to a maximum of thirty (30) YOS at age 65 offset by a portion of projected Social

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Security retirement benefits as permitted for Social Security integration under nondiscriminatory limitations; but, is not less than 2.0% of average compensation to a maximum of ten (10) YOS for Top-heavy minimums. A Floor-offset Plan arrangement is not assumed for replacement of DBPP liabilities by employer contributions to a defined contribution plan, and the plan requires no employee mandatory contributions that could further reduce benefit funding costs.

2. Values are discounted annually from age 65 under a long-term, 5.0% investment return assumption and a 2018 PPA '06 Mortality Table post-retirement. Current mandated interest rate assumptions under PPA '06 for DBPP funding are more conservative for older employees. A level funding method is applied with all past service liabilities assumed funded in the above example because the mandated PPA '06 funding method does not adequately represent pension funding costs. These values can vary dramatically for another employee group depending on several factors including investment returns, past contribution amounts, and the employee group's distribution of age, service, and compensations.
3. Total Compensations in column A are adjusted to fit a total compensation policy that represents each employee's value of production. Our Fall 2016 Newsletter entitled *Efficient Compensation Design* shows an example of how to align compensation with the value of an employee's production.
4. A partial replacement of Form W-2 Wages with retirement and other benefits can be phased in for existing employees, and begin immediately for new employees. The reduction in an employee's Social Security retirement income for reduced Form W-2 Wages will be recovered through the DBPP.
5. A successful compensation program includes communication of wage and benefit values to an employee group. Benefit statements list the components of the employee's direct and indirect compensation sources to illustrate that employees gain more from their benefit costs than the reduction in their taxable Form W-2 Wages.

During 2017, labor productivity declined in 54 of 86 manufacturing industries with unit labor costs increasing in 73 of 86 manufacturing industries; this, according to the Bureau of Labor Statistics' (BLS') website entitled *Productivity and Costs by Industry: Manufacturing and Mining Industries – 2017*, data published April 19, 2018. These measures compare “the amount of goods and services produced (output) with the number of hours worked to produce these goods and services.” See also BLS websites entitled *Labor Productivity and Cost* and *Multifactor Productivity Slowdown in U.S. Manufacturing*, data published July 2018, describing the slowdown in manufacturing labor productivity. An employer whose compensation costs exceed the value of its employees' production will not thrive.

Defined contribution plans do not permit plan designs that meaningfully reward older employees for age and service differences. Section 401(k) and IRA-type arrangements survive under false premises that include: (a) defined benefit plan funding is too expensive; (b) employees will receive real retirement benefits from account balance plans; and, (c) retirement plan costs are passed to employees. Ultimately, the employer must increase Form W-2 Wages to enable employee voluntary contributions in lieu of paying living expenses; then, most employees lack the discipline to voluntarily save for retirement.

Conversion to a defined contribution plan from a DBPP is often an emotional decision rather than a business decision. Defined benefit pension plans are the least-cost means to fund retirement benefits for each \$1 of retirement benefit provided.

Please call or e-mail any questions or comments.

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