OPTIONS FOR RETIREMENT BENEFITS

Charles M. Lax

Maddin Hauser Roth & Heller PC
attorneys and counselors

Maddin Hauser Roth & Heller, P.C. - maddinhauser.com
28400 Northwestern Hwy., Southfield, MI 48034 | p (248) 354-4030 | f (248) 354-1422

INTRODUCTION

- Your Name
- Your Company
- Your Position
- Your Companies’ Retirement Plan(s)

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

- Tax Benefits
  - Income tax deferred (except Roth contributions)
  - Tax free accumulation
  - Ability to roll over tax free
  - Employer gets a current deduction

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

- Limitations on Compensation/Contributions/Benefits
  - Maximum amount of compensation that may be considered is $265,000 for 2016
  - 401k plan deferrals - $18,000 (plus $6,000 catch up for 2016)
  - $53,000 for defined contribution plans (plus $6,000 catch up if a 401k plan for 2016)
  - $210,000 benefit for defined benefit plans for 2016
  - Each limit is indexed

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

- Non-Discrimination Rules
  - May not discriminate in favor of highly compensated employees (HCEs)
  - HCEs are generally 5% owners and others earning more than $120,000 for 2016

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

- Non-discrimination rules apply to such things as:
  - Contributions
  - Benefits
  - Eligibility requirements
  - Investment options
- If discriminatory, plan loses its tax qualified status

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

- Fiduciary Obligations
  - Who are the fiduciaries?
    - Persons named in the plan (trustees and plan administrator)
    - Persons who provide investment advice for a fee
    - Persons who have discretionary authority over the administration of the plan
    - Persons who either have the authority or exercise the authority over management of plan assets, investment options or distribution options

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

- What are their duties?
  - Must discharge their duties for exclusive purpose of providing benefits
  - Must act with the skill, care and diligence, under the circumstances, of a prudent person ("Prudent Man Rule")
  - Must diversify investments to minimize risk of loss
  - Must act in accordance with plan's governance documents

WHAT'S COMMON IN MOST QUALIFIED RETIREMENT PLANS?

– What happens if they breach their duty?
  - Make the plan whole for losses
  - Restore to the plan any profits they made through their use of plan assets
  - The plan may lose its tax qualified status

QUALIFIED PLAN ALTERNATIVES

- Simplified Employee Pension Plan (SEP)
  - Features
    - Employer contributes directly into an IRA for each participant
    - The contribution rate must be the same for each participant
    - The maximum contribution is the lesser of 25% of compensation or $53,000
    - Employees who have worked in any part of 3 of the last 5 years and attained the age of 21 must be included

QUALIFIED PLAN ALTERNATIVES

– Advantages
  - Contributions are completely discretionary
  - SEP plan documents are simple to deal with and are usually provided at no cost by institutions providing the IRAs
  - No annual reports are required with IRS or DOL

QUALIFIED PLAN ALTERNATIVES

- Disadvantages
  - Employees are always fully vested in their employer's contributions
  - Loans are not permitted
  - The employee can withdraw funds at any time, subject to a 10% income tax penalty, if applicable

QUALIFIED PLAN ALTERNATIVES

- Profit Sharing/Discretionary Contribution Plan
  - Features
    - Contributions by the employer are discretionary
    - Various methods may be used to allocate the contributions (pro rata, cross-tested, integrated with social security)
    - Participants' accounts may be self directed or invested by the trustees
    - Participants bear the investment risk
    - Generally favors younger employees

QUALIFIED PLAN ALTERNATIVES

- Advantages
  - Greatest flexibility for the employer among plan alternatives
  - Non-vested account balances can be used to reduce employer contributions or reduce administrative costs

QUALIFIED PLAN ALTERNATIVES

- Disadvantage
  - Employer bears the entire cost (unless paired with a 401k component)

QUALIFIED PLAN ALTERNATIVES

- Traditional 401k Plan
  - Features
    - Employees permitted to make pre-tax contributions
    - The maximum deferral permitted in 2016 is $18,000, with individuals who are age 50 or older permitted to make an additional "catch up" contribution of $6,000
    - The plans are subject to non-discrimination testing to assure that HCEs (those earning more than $120,000 in 2016) do not defer disproportionately large contributions relative to the non-HCEs

QUALIFIED PLAN ALTERNATIVES

- Advantages
  - Plan mostly funded through employee deferrals
  - Employer contributions are discretionary
  - Employees can reduce current taxable income and save for retirement
  - Loans and hardship distributions are available
  - Employer may make matching contributions to encourage participation in the plan
  - Often combined with a profit sharing feature

QUALIFIED PLAN ALTERNATIVES

- Disadvantages
  - Actual Deferral Percentage (ADP) Test can limit deferrals of HCEs
  - Administration can be more complicated than other types of plans

QUALIFIED PLAN ALTERNATIVES

- Roth 401k Plan
  - Features
    - Limits, distribution rules and ADP testing identical to traditional 401k plan
    - Deferrals are made after tax as opposed to before tax
    - In most instances, distributions are made tax free
    - May be used in conjunction with a traditional 401(k) plan

QUALIFIED PLAN ALTERNATIVES

- Advantages
  - Distributions are tax free, if qualified
  - Distributions may be rolled into a Roth IRA and distributions postponed after age 70-1/2
  - Can be used as a terrific “death benefit” for younger beneficiaries
- Disadvantages
  - No current tax incentive to save through this vehicle

QUALIFIED PLAN ALTERNATIVES

- Defined Benefit Plan
  - Features
    - Instead of an account balance, a participant earns a retirement benefit, generally starting at their retirement date and continuing for life
    - The benefit is often related to a participant's compensation and/or years of service
    - Contributions are actuarially determined each year and are subject to rules that require plans to be "adequately funded"
    - The maximum benefit that may be provided is generally $210,00 per year

QUALIFIED PLAN ALTERNATIVES

– Advantages
  - Tends to favor older employees
  - Contribution levels can be much higher than in other types of plans
  - Participants have certainty of what will be their monthly or annual retirement amount
  - Amount forfeited by terminated employees will automatically reduce future contributions

QUALIFIED PLAN ALTERNATIVES

- Disadvantages
  - The employer needs sufficient cash flow to meet minimum funding to avoid penalties
  - Insurance premiums must be paid to the Pension Benefit Guaranty Corporation each year (unless exempt as a professional corporation with less than 25 participants)
  - The employer bears the investment risk if the plan does not meet assumed performance
  - In-service distributions not permitted prior to age 62
  - Generally, a more expensive plan to operate

QUALIFIED PLAN ALTERNATIVES

- Cash Balance Plan
  - Features
    - The plan is a "hybrid" plan having features of both a defined benefit plan and a defined contribution plan
    - The participant's benefits are described in the form of a hypothetical account. Each year the participant receives a hypothetical contribution to the account (i.e., 2% of compensation, or $1,000 plus a specified rate of return on investment (i.e., 5%)
    - When the participant's benefit is paid, they are paid the value of the hypothetical account
    - Because it is a pension plan, the employer bears the investment risk but also enjoys the investment gains

QUALIFIED PLAN ALTERNATIVES

- Advantages
  - For many participants, describing their benefit in a lump sum rather than a monthly benefit at their retirement date is preferential
  - Often used today as a “tax shelter plan” for business owners
- Disadvantages
  - Same as other defined benefit plans

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- Safe Harbor 401k Plan
  - 401k plans that fail the ADP test must either return deferrals to HCEs or make additional contributions for the non-HCEs
  - "Safe Harbor Plans" automatically pass the ADP test

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

– Required contribution options
  - A contribution of 3% of eligible participants' compensation
  - A matching contribution equal to 100% of a participant's first 3% deferral and 50% of the participant's next 2% deferral

– Participants must be notified before the plan year of the contribution methodology

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- Age Weighted, Cross-Tested or New Comparability Plan
  - A discretionary contribution plan (a “Profit Sharing Plan”)
  - Different contribution rates determined for each participant
  - Contribution rates may appear to be discriminatory on their face

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- Instead of testing contributions, you test the benefits that would be produced by the contributions
- Older employees require greater contributions because of their proximity to retirement
- See Case Study #1

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- “Stacking Plans” – Use of 2 or More Plans
  - Often a defined benefit plan replaces a defined contribution plan or is “stacked” on top of an existing profit sharing or 401k plan
  - The 2 or more plans can be combined for discrimination testing purposes

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- For example, the added defined benefit plan may appear to be discriminatory, but when tested together with second plan, it passes
- See Case Studies #2 and #3

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- Non-qualified Deferred Compensation
  - Much more flexible than a qualified retirement plan
    - Can be discriminatory in terms of eligibility, benefits, etc.
    - Can be funded or unfunded
    - Benefits can be taken away under specific circumstances

INCREASING CONTRIBUTIONS OR BENEFITS FOR OWNERS AND KEY EXECUTIVES

- Most of the tax benefits of a qualified plan are lost
  - Either the employer gets no current deduction or the employee has current income tax
  - Generally, does not grow tax free
  - Distributions may not be rolled over tax free

PLAN ENHANCEMENTS/SOLVING ISSUES

- ADP Failures in 401k Plans
  - Add or increase employer matches
  - Extend matches or use escalating match rates.
    If the plan provides for 100% match on the first 2% of deferred, consider:
    - 50% of the first 4% deferred, or
    - 25% of the first 4% deferred, plus 50% of the next 2% deferred

PLAN ENHANCEMENTS/SOLVING ISSUES

- Provide for automatic enrollment (i.e., deferrals of 3% will begin automatically). This requires a participant to make an affirmative election to not participate or defer another percentage
- Give the participants access to their accounts
  - Plan loans
  - Hardship distributions
  - In-service distributions after age 59-1/2

PLAN ENHANCEMENTS/SOLVING ISSUES

- Regular employee meetings
- Increasing the opportunities to change deferral elections or investment choice

PLAN ENHANCEMENTS/SOLVING ISSUES

- Adding Roth Provisions
  - Can be really beneficial to:
    - Younger participants
    - Older participants for estate planning purposes
  - Allow for “In-Plan Roth Conversions” on:
    - Elective deferrals
    - Vested matching contributions
    - Vested non-elective employer contributions
    - Rollover contributions
    - Earnings on any of the above accounts

PLAN ENHANCEMENTS/SOLVING ISSUES

- Shifting the Economic Burden from the Plan Sponsor
  - Relying on contributory plans and getting "the most bang for the buck"
  - Many plan expenses can be charged to the plan and allocated pro rata among all participants (legal, accounting, investment and administrative fees)

PLAN ENHANCEMENTS/SOLVING ISSUES

- Other expenses can be allocated directly to the participant who benefits from the expense (loans, QDRO reviews, distribution packages, etc.)
- Forfeitures in some plans can be used to pay administrative costs instead of increasing benefits
- Certain financial service providers may offer to subsidize administrative expenses depending on the size of the plan