Qualified Plans

Afternoon Session
Various Issues Related to Plans

Tax and Compensation Planning

- The Math of Qualified Deferred Compensation
- Distribution Issues

Math of Qualified Plans

- Two Key Techniques of Tax Planning
  - Tax Deferral
    - Move the payment of tax into the future
    - Time value of money concepts
      - $1 today worth more than $1 next year
      - Can invest the tax not paid and have the earnings on those funds
    - The longer the deferral the greater the benefit
  - Income Conversion
    - Changing the type of income from a "high tax" to a "low tax" type
    - Simple tax savings from this technique

Tax Deferral

- Primary benefit of a qualified plan
- No tax imposed on the participant when the funds go in
  - Have higher amount invested
  - Have larger amount to earn on
- No tax imposed on the earnings
- Have geometric growth (we hope) while only a percentage applied as tax—come out ahead

Example of Deferral

- Individual has $1,000 that can either be put in a qualified plan or invested outside the plan
- Will invest in a 20 year note paying 6%
- Will withdraw from the qualified plan the entire balance in year 20
- Result at end of year 20
  - Regular Investment: $1,215.60
  - Qualified Plan: $1,924.20
  - Has 58.29% more in pocket

Critique of Example

- Assumed would invest in investment with all earnings being taxable income each year
- Assumed would invest only generating ordinary income—no capital gain provision
- Assumed we would take the entire distribution at the end of the twenty year period—no stretch out
- Assumed would be in same marginal rate when we take funds out as when put in

Effect of Assumptions

- Change Assumption to Presume Invested in Capital Gain Property
  - Results at end:
    - Qualified Plan: $1,924.20
    - Outside Plan: $1,656.80
    - With plan have 16.14% more
  - Qualified plan still better—but not by nearly as much

Effect of Assumptions

- Change to Presume Invested in Nontaxable Dividends
  - Results
    - Qualified Plan: $1,924.20
    - Outside Plan: $1,921.00
    - Plan ends up with 0.17% more
  - At this point, is a dead heat after 20 years
  - Remember at this point the nontaxation of dividends is all proposed

Point of This?

- Assumptions are very important
- Don't accept uncritically any projection and be prepared to defend yours
- Long term tax projections are always subject to changes in the tax laws—and totally unexpected changes will occur
- Even with nontaxable dividends, plans will still be important for fixed income investments

Point of This?

- Always analyze projections into the future with two views
  - What's the very best case outcome?
  - What's the worst case outcome?

Income Conversion

- Qualified Plans are not big on this issue
- In fact, can serve to turn capital gains into ordinary income (trait shared with annuity products)
- Can be some conversion if are in lower bracket when funds come out
- However, my experience is that those with large retirement savings don't see their brackets drop

Income Conversion

- Remember examples in first part of this section
- Even with “reverse conversion” the qualified plan still came out ahead in all cases—the deferral beat the conversion
- However, if assumptions were changed some, the result could change

Getting at the Money

- Plan Loans
- Distributions prior to age 59 ½
- Required Distributions

Plan Loans

- Qualified plans can allow loans to be made
- Remember, the plan document itself must provide for loans
- No interest deduction for
  - Key employees
  - Loans secured by elective deferrals

Plan Loan Rules

- Found at IRC §72(p)
- Maximum Loan
  - $50,000 for all loans
    - One year "look back" rule
  - As well cannot be more than greater of ½ of present value of vested accrued benefit under plan or $10,000

Plan Loan Rules

- Repayment
  - Maximum five years
  - At least quarterly amortization
- Failure to meet terms
  - Generally considered a taxable distribution
  - Subject to penalties if a premature distribution
  - Generally still have to repay loan

Plan Loan Rules

- Generally do not recommend them in small plans or recommend that participants make use of them
- Are administratively complex to manage
- Create recordkeeping nightmare
- Normally have due on termination clause

Distributions Prior to 59½

- Normally considered premature distributions
- Certain exceptions available
  - Separation from service after attaining age 55
    - Separate during or after year turn 55
    - Note this only applies to qualified plans
    - If participants rolls this into an IRA, has to wait until age 59½
  - Death
  - Disability
  - Substantially equal payments

Distributions Prior to 59½

- Certain exceptions available (continued)
  - Dividends paid on ESOP shares
  - Made on account of a tax levy under §6331
  - Medical expenses in excess of 7.5% of adjusted gross income
  - Payments to an alternate payee under a qualified domestic relations order (QDRO)

Distributions Prior to 59½

- Exceptions only applicable to IRA Important to know because are *not* available directly from qualified plans
  - Medical insurance premiums for unemployed individuals
  - Higher education expenses
  - First time homebuyer
- Also, remember exceptions only remove the 10% tax—not the regular tax

Required Minimum Distributions

- Begin no later than April 1 of year after the later of the year in which either
  - Participant turned 70½
  - Participant separated from service
- Latter exception not available to certain key employees nor to beneficiaries of IRA accounts

Required Minimum Distributions

- Many changes in this area
- If you haven't looked in this area recently, you need to be updated
- Original proposed regulations released in 1987...and then they just sat there.
- In January of 2001, the IRS released a new set of proposed regulations
- In 2002, the IRS released the final regulations

Required Minimum Distributions

- 2001 proposed regulations
  - Far simpler than the 1987 regulations
  - Fewer opportunities for a participant to foul up (though still more than enough)
  - Eliminated the importance of having a designated beneficiary when minimum distributions began
- 2002 Final Regulations
  - Pretty close to 2001 regulations with some key changes

Required Minimum Distributions

- Now can only use the 2002 Final Regulations
  - For 2001 could use either 2001 or 1987 proposed regulations
  - For 2002 could use 2002 final regulations, or either set of proposed regulations
  - However, no option at this point
- Rules apply to both qualified plans and IRAs
  - Note that neither is *required* to allow as long a stretch-out as law allows
  - Need to check plan documents

Required Minimum Distributions

- Use a standard table for most participants
- Table is for employee's life expectancy and that of a ten year younger beneficiary, recalculated annually
- Only exception for person whose spouse is more than ten years younger—then can use spouse's actual life expectancy
- Used even if there is no beneficiary

Post Death Distributions

- A lot more flexibility here
- Will not cover here since normally more applicable to IRAs, though qualified plans are eligible to use them

Alternatives to Qualified Plans

- Nonqualified Deferred Compensation Arrangements
- Other Tax Advantaged Options

Nonqualified Deferred Compensation

- Can provide funding or benefits far beyond what is allowed under §415
- Can pick and choose who will receive the benefits—including giving all to the highly compensated
- Fewer reporting issues
- Rather “interesting” payroll tax issues

Nonqualified Deferred Compensation

- Income tax standpoint
  - Included in employee's income only when there is no substantial risk
  - So long as it remains an unsecured promise to pay and/or the funding mechanism is available to the entity's creditors
  - Normally structured to be taxable only when actually paid

Nonqualified Deferred Compensation

- Social security/Medicare Tax
  - Generally included when benefits vests at present value
  - Future earnings on account not subject to social security or Medicare tax
  - Since most often paid to high income individuals, actually helps insure only subject to Medicare tax

Nonqualified Deferred Compensation

- Problem—with above structure, the employer only gets a deduction when it is finally included in the employee's income
- Contrast with a qualified plan where the employer gets the deduction up front
- Additionally, qualified plan is very well protected from creditors, while the nonqualified plan must remain subject to those creditors (remember Andersen...)

Nonqualified Deferred Compensation

- Use when...
  - Need to compensate executives beyond what qualified plans will allow
  - Can use in a closely held entity to reduce value and therefore reduce cost of redemption while giving income to departing shareholders
  - Note that a qualified plan can also accomplish that, especially if younger highly compensated are not included in the plan

Other Tax Advantaged Options

- Invest in Capital Gain Property
- Life Insurance Polices
- Annuities

Capital Gain Property

- See earlier discussion
- Advantage is that get taxed at lower rate than the plan
- Also current year earnings not taxed so long as property not sold
- However, escaping current tax puts you in an investing straight-jacket

Life Insurance Policies

- Advantages
  - Provide death benefit
  - Funds can be withdrawn without triggering a current tax, either through withdrawals against basis or loans
  - It can be owned by a number of entities, unlike a qualified plan
  - Provides a shield from current taxation of investment component
  - Death proceeds income tax free

Life Insurance Policies

- Disadvantages
  - Cost of insurance, to extent death benefit "excessive" in order to provide shield
  - Incidents of ownership rules complicate accomplishing multiple goals with policy
  - Must carefully monitor policy
  - Tax disaster if plan overstretched and collapses with large loans outstanding
  - Because of need to keep in force, full value not available to client without triggering tax

Annuities

- Advantages
  - Same tax deferral on earnings as qualified plans
  - Insurance component can provide other types of protection beside a death benefit
  - Far more liberal distribution rules—no 70½ minimum distribution requirement
  - No limits on funding

Annuities

- Disadvantages
  - Cost of insurance if being used solely to provide a tax wrapper and not otherwise valued
  - No tax deduction for funding
  - Like qualified plan, converts ordinary income to capital gains
  - Like qualified plan, is IRD when it passes to heirs on death

Small Plan Audit Exception

- Old rules: plans with fewer than 100 participants were automatically exempt from the requirement to have their financial statements examined by an independent certified public accountant
- New rules: the exemption is only available if the plan clears certain hurdles. If it doesn't, a rather expensive audit will be required.
- DOL was concerned about certain frauds perpetrated on small plans

Small Plan Audit Exception

- Plan with less than 100 participants is exempt if it meets one of two requirements
  - 95% qualified asset test
  - Additional bonding requirement
- Also additional information required in Summary Annual Report

95% Qualified Asset Test

- As of beginning of plan year, 95% of the plan's assets were invested in qualified assets
- Qualified assets are
  - Qualified employer securities
  - Participant loans
  - Any asset held by
    - A bank or similar financial institution
    - An insurance company qualified under the laws of a state
    - An organization registered as a broker-dealer

95% Qualified Asset Test

- Qualified assets
  - Assets held by (continued)
    - Any organization authorized to act as a trustee for individual retirement accounts under Section 408 of the IRC
  - Mutual fund shares
  - Investment and insurance contracts
  - Individually directed accounts held by a financial institution if the individual is given a statement at least annually by the institution

Additional Bonding Requirement

- If plan fails 95% test, can still escape audit if
  - Have a bond on any person who handles assets that are not qualifying assets in at least the value of the nonqualified assets
  - Remember a 10% bond is normally required anyway

Reporting Addition to SAR

- Name of Institutions holding qualified assets (except for employer securities, participant loans and individually directed accounts) and amount of such assets held by the institution
- Surety company if using bond exception
- Notice participants can get evidence of bond and statements from institutions holding qualified assets
- Notice to contact DOL if they have problems getting information

Actions Required

- Must provide statements if requested

Consequences of Failing

- End up with standard audit requirement
- Plan audit both verifies the financial information reported and examines the plan's operations for compliance with law
- Is an expensive and time consuming operation
- If need one, need to contract for it early enough to receive it by the extended due date