RESOURCE PARTNERS

QUALIFIED RETIREMENT PLANS
A SHORT EXPLANATION

Retirement Plans can be excellent vehicles for accumulating savings and reducing current income taxes. They are often referred to a qualified plans. The "qualified" relates to the fact that they are tax-qualified – the contributions are tax deductible. To be tax-qualified, the plans must meet specific rules outlined in the IRS regulations. The following are characteristics common to all qualified retirement plans.

(a) Deposits into the plan, known as contributions, are tax-deductible to the sponsoring company as a business expense.

(b) There is no current reportable income to any participant of the plan since the participant does not pay tax until the participant realizes the benefits of the plan when funds are distributed in the future.

(c) All earnings on investments within the plan grow on a tax-deferred basis.

(d) Funds are taxable as ordinary income when withdrawn from the plan. Only the funds actually distributed are taxed; remaining funds continue to grow on a tax-deferred basis.

(e) Unused funds can be left to the participant's beneficiary at death.

(f) Plans may provide an insured pre-retirement death benefit for participants. This insurance acts as a self-completion feature in case of a premature death. The premiums for this coverage are tax-deductible as part of the overall pension contribution. A small amount of current income is reportable representing the term insurance value of the life insurance protection. Net insurance proceeds above the cash value are received income tax-free by the beneficiaries at death. With proper planning, it may be possible to have the proceeds escape inclusion in the taxable estate as well.

Retirement plans fall into two broad categories – defined contribution and defined benefit plans.

DEFINED CONTRIBUTION PLANS

These plans define the amount of contribution that can be made for each participant and are typified by profit sharing and 401(k) plans. For example, a profit sharing plan defines the contribution by allowing contributions of up to 25% of the current compensation for the covered participants. IRS sets an absolute dollar limit ($53,000

in 2016) on the amount that may be contributed on behalf of any individual participant in any given year. This limit is periodically adjusted to reflect cost-of-living increases.

These plans focus and limit the contributions going into the plan. There is no way to accurately forecast the ultimate accumulation. The end result will be dependent on such factors as the contributions made, earnings on those contributions, forfeitures (money left behind by short-time employees), and how long the funds are left to accumulate. The known factor is on the front end, how much may go into the plan.

DEFINED BENEFIT PLANS

Defined benefit plans limit the amount that can be distributed from the plan. Unlike the defined contribution plan where the focus is on what goes into the plan, these plans focus on what can come out of the plan.

Current IRS regulations state that a defined benefit plan can provide a participant with a lifetime pension of up to 100% of his/her compensation, but not to exceed $210,000 beginning as early as age 62 (2016 limitation). A participant must have at least 10 years of service at normal retirement age as well as ten years of participation in the pension plan at retirement in order to be eligible for maximum benefits.

For example, an employee age 53 earning $210,000 could have a defined benefit plan that provides him with $210,000 of lifetime income beginning at age 62. To do this, he must accumulate a lump sum of approximately $2.74 million by age 62. This number comes from IRS actuarial tables that consider life expectancy and assumed earnings.

Assuming that the plan assets are invested and earn a reasonable rate of return (usually about 5%), this client can contribute approximately $217,000 per year into his defined benefit plan for the next ten years. The plan contributions are adjusted up or down annually to reflect plan earning that are different than the assumed rate, but the focus always remains on the lump sum goal at retirement required to provide the benefit. Generally, the closer an employee is to retirement, the larger the contribution to provide his retirement benefit. The deductible contribution can be significantly increased by adding a life insurance component as permitted under the law.

Note that in this example, this type of plan allows nearly ***FOUR TIMES*** the amount of contribution available in a defined contribution plan.

IF YOUR CLIENT WISHES TO SAVE MORE THAN $53,000 PER YEAR FOR RETIREMENT, A DEFINED BENEFIT BECOMES THE PLAN OF CHOICE.

There are many funding techniques available with defined benefit plans. The level annual method described above is most common. Other techniques can result in larger contributions in the early years followed by smaller contributions in future years.

412(e)(3) DEFINED BENEFIT PLANS

412(e)(3) plans are a special form of defined benefit plan that only permit investments in annuity and/or life insurance contracts. 412(e)(3) plans provide guaranteed benefits. These guarantees are backed by the issuing insurance carriers.

Because investments are limited to insurance contracts only, there is no need for an actuarial valuation each year. This simplifies the administration of these plans.

Funding for 412(e)(3) plans is based on the conservative guaranteed values built into the contracts. The amount of accumulation needed at retirement for a guaranteed pension can be 50% more than the amount determined by actuaries on a current basis. This is because the insurance company that is guaranteeing the benefits factors longevity when publishing their guaranteed figures. The guaranteed investment interest rate is often around 3%.

The result is that initial contributions to fund guaranteed benefits under a 412(e)(3) plan can be substantially larger than for comparable defined benefit plan based on IRS actuarial tables.

Note that if the plan is amended to allow for a lump sum rollover option, the IRS limitations on maximum accumulation will apply and ongoing funding is usually adjusted and reduced to avoid accumulating excess assets.

SUMMARY

Qualified Retirement plans offer your clients a cost-effective way to save for retirement. Congress recognizes the importance of encouraging employers to provide retirement benefits for their employees and has implemented several incentives (through tax deductibility) for companies to implement these plans.

Defined Contribution plans are excellent tools for companies where a contribution of no more than $53,000 or 25% of salary is desired. These plans tend to favor younger employees who have longer work horizons.

Defined Benefit plans are excellent tools for employees who are closer to retirement. The ability to contribute much more than 25% of current salary allows older employees the ability to provide a meaningful pension in a relatively short time.

Tax numbers based on 2016 IRS Tax Facts; numbers may vary based on the tax year.