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Consulting Offices:
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Ask Kidder.®

Corporate and personal income taxes are going up.

How can your qualified plan help reduce taxes?

Commentary coming out of Washington D.C. suggests that personal, corporate and other taxes will soon be increasing. One question business owners and participants in qualified plans (like 401(k) plans) might ask is "How can we reduce the impact of these tax increases?" A second question might be "How can I use tax savings to optimize my plan?"

Under the current economic environment, some plan sponsors are looking at short-term solutions to reduce costs in their businesses and benefit programs. Some are terminating their 401k plans. Others are working to reduce plan administrative or investment costs. The key is to balance short-term solutions with long-term needs.

Ways to help save in the current environment

Look beyond administration costs to find significant additional savings, if desired. Focus on plan design or redesign to minimize or optimize all plan costs – including employer match, employer profit sharing, compliance and investment costs, as well as the costs of participant education. The Department of Labor allows plan costs to be either paid directly or deducted from participants' accounts. Some plan costs are directly billed because they are deductible business expenses. However, if a business has minimal or no profits, the deductible expense may not be needed. In that situation, the plan sponsor may choose to temporarily have those expenses deducted from plan assets.

Many plan sponsors have made plan amendments to reduce or eliminate larger costs, such as the employer match or profit sharing contributions. But a better choice might be, once again, to review the plan design. By using plan design techniques that include different employer contribution or matching amounts for different groups of employees, key employees or owner groups, it's often possible to satisfy budgetary constraints without reducing the desired economic and benefit impact for the employer. An advantage of working with Kidder is that we can tailor a plan to each employer's needs much more easily than providers using off-the-shelf plans.

Use plan design to help reduce corporate and personal income taxes

A qualified plan is one of the few flexible tax shelters remaining. For an individual in the 33 percent federal tax bracket, the state income liability is often around 5 percent to 10 percent. The combined liability is about 40 percent. In an S Corporation or Limited Liability Company, income passes through to the personal income tax return. Many high-income taxpayers have a combined tax liability exceeding 50 percent! Regular corporations can also reach a combined tax liability of 50 percent.

That's why it's important to remember that an employer contribution to a plan, such as a match or a profit sharing contribution, is a business deduction for income tax purposes (saving 40 percent to 50 percent). It is also free from FICA taxes (saving up to an additional 7.65 percent). The math is simple. Saving \$100 in a qualified plan saves can save nearly \$60 in taxes. You get to keep \$100 (plus growth) rather than \$40.

As taxes go up, the savings from your flexible, well designed tax shelter could be even greater.

Use plan allocation formulas to achieve greater tax savings

Many plan sponsors do not realize that different contribution amounts or formulas can be established for different employees, classifications of employees or divisions of companies. In other words, employers have the ability to tailor contributions to the participants that are producing the income for the employer.

To achieve optimum tax savings and provide greater benefits to specific key employees, plan sponsors should consider all types of qualified plans, including 401(k), profit sharing, Defined Benefit, Cash Balance, and ESOP plans. They should consider allocation formulas that allow the greatest flexibility, such as cross-tested or triple stack match. Having a tailor-made solution with flexible terms can produce optimum long-term results and satisfaction.

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A tailored plan can cost $500 to $1,000 more for administrative and compliance costs, but produce significantly superior tax results – with Uncle Sam picking up all or most of the employee costs, as shown in the following illustration..

Assumptions:
30 Employees
50% combined Federal & State Tax bracket
HCE = Highly Compensated Employee
NHCE = Non-highly Compensated Employee

	Generic Plan		Kidder Alternative #1		Kidder Alternative #2	
HCE	$50,000	50%	$50,000	80%	$80,000	80%
NHCE	$50,000	50%	$12,500	20%	$20,000	20%
ER Contribution	$100,000		$62,500		$100,000	
Tax Savings	$50,000		$31,250		$50,000	
Tax Savings Less NHCE Contribution	$0		$18,750		$30,000	
Administration Cost Estimate	$2,500		$3,100		$3,100	

Generic plan A provides 50% of the employer contribution to the HCEs and owners. The plan design produces $50,000 in tax savings, but the out of pocket is also $50,000. So it is essentially a breakeven for the employer.

Kidder Alternative #1 is a redesign of the plan in which the same contribution is made to the HCEs but the employer contribution for NHCEs is able to be reduced so that 80% of the employer contribution is made to the HCEs. There is a net positive $18,750 to the employer due to tax savings of $31,250 less the $12,500 contribution for NHCEs.

Kidder Alternative #2 is a redesign of the plan in which the contribution for the HCEs is increased while the contribution for the NHCEs is reduced. There is a net positive $30,000 to the employer.

In these situations, the tax savings from Uncle Sam more than cover any employee costs and additional administrative costs.

The response we often hear is “I didn’t know you could do that.” Not only are these types of options available, they are used more and more to allow plans to be even more flexible in changing and challenging economic times.

Recent Speaking Engagements:

PLANADVISER National Conference; Orlando, Florida
September 23-25, 2009
“Balancing Act” - Cash Balance Plan Opportunities
Keith J. Gredys, J.D., CTFA, AIF®

Iowa Society of CPAs Continuing Education Program
West Des Moines, Iowa
October 7, 2009
“Cash Balance Plans - Can They Work for You?”
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