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Ask Kidder.®

How can you use your qualified plan to mitigate Healthcare Reform tax increases?

Many plan sponsors will turn to more sophisticated 401(k) and Cash Balance plan designs.

After months of political wrangling, the Patient Protection and Affordable Care Act (Patient Protection Act) was signed by President Obama on March 23. The Health Care and Education Reconciliation Act of 2010 (Reconciliation Act), which modified the Patient Protection Act, was signed by the President on March 30.

One of the biggest issues relating to this legislation is HOW it will be paid for. The answer, at least partially, is taxes.

Beginning in 2013, Medicare taxes will be increased in two ways for individuals with Adjusted Gross Income exceeding $200,000 and for joint filers with AGI of $250,000 or more. Also, net investment income will be included in the taxable base used to calculate an additional Medicare tax. Net investment income is defined as the sum of dividends, interest, annuities, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business), less deductions properly allocable to such gross income or net gain.

The increased "Medicare" tax will be 0.9% on earned income in excess of $200,000 (single) or $250,000 (joint). PLUS, if the taxpayer's AGI exceeds the respective thresholds, an additional 3.8% will be assessed on the lesser of a) the net investment income for the taxable year, or b) the excess of the modified AGI for such taxable year over the threshold amount.

Clearly, the key to minimizing the impact of these new taxes will be to reduce AGI. The question is how to do it. Your legal and tax advisors will be able to provide specific answers, but here are two options to consider.

1. Maximize your deductible 401(k) contributions including "catch up" opportunities.
2. For business owners and professionals, including S Corporations, LLCs, Partnerships, PCs and others, the use of tax-deductible profit sharing or pension contributions will reduce the amount of income passing through to the individual tax return and the calculation of AGI.

To optimize the impact of these options, a plan must be properly designed and take into account the critical tax cost/benefit relationship. For example, a standard 401(k) profit sharing plan with a traditional employer match may provide 50% to 60% of the benefit of the employer contributions to the owner and certain key employees. From an income tax perspective, that is about a wash. Under the Patient Protection Act as modified by the Reconciliation Act, it's possible that the marginal tax burden – including federal, state and FICA taxes, as well as new increased and add-on Medicare taxes -- will approach 60% for high wage earners. (Remember that non-elective employer contributions for pension or profit sharing are not subject to FICA taxes.)

If the owner and key employees receive $100,000 (50%) of a $200,000 employer contribution in their accounts, they save about $100,000 in taxes at a 50% tax rate ($200,000 times 50%). So, by saving $100,000 in taxes, the employee cost is provided at basically no after-tax cost.

But consider what happens when that same plan is redesigned under a compliant allocation formula that provides 75% to owners and key employees and 25% to employees. Under this formula, the total contribution might be increased to $400,000, with the owner and key employees receiving $300,000 and the employee cost maintained at $100,000. At the same 50% tax rate, they save $200,000 in taxes ($400,000 times 50%). In other words, the $300,000 placed in their qualified plan accounts cost only $200,000, including the $100,000 provided to employee

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participants! In addition, they potentially reduce their income by $200,000, which may help them fall below the $250,000 AGI threshold.

Many plan designs allow 90% or more of the employer contribution to be contributed to the owner and key employees while satisfying all IRS coverage and discrimination testing. So to carry this example one step further, $900,000 could be contributed to the owner and key employees and $100,000 to the remainder of the eligible staff. At a 50% tax rate, $500,000 in taxes could be saved at an employee cost of $100,000.

What types of qualified plans could be used in this scenario? Surprisingly, a modification to your existing 401(k) plan is often all that is needed. In some cases, combining a 401(k) plan and a Cash Balance plan provides the optimum structure. In either situation, using only the standard 401(k) profit sharing and employer match structure, while simple, does not provide the optimum tax benefit.

Just as there are specialists in the medical, legal and accounting fields, there are specialists and experts in the qualified plan field. Kidder is such an expert. Before bemoaning the increased taxes being imposed by this new legislation, examine your qualified plan design to determine how to optimize its tax benefits while maintaining the flexibility needed to operate your organization. This examination should be a team effort that includes not only you and Kidder, but also your tax and financial professionals.

Hidden within the Healthcare Bill: Changes to the Economic Substance Doctrine

Section 1409 of the Reconciliation Act contains provisions that amend Section 7701 of the Internal Revenue Code of 1986 to clarify the Economic Substance Doctrine, which is a judicial doctrine that has been used to deny tax benefits when the transaction generating those tax benefits lacks economic substance or a business purpose.

The goal of this legislative action is to have the Economic Substance Doctrine applied uniformly, and it requires the potential for a pre-tax profit in the transaction to determine economic substance. In layman's terms, this means that if the transaction produces no meaningful economic change (profit) to the taxpayer except to reduce taxes, and if the taxpayer had no purpose to enter the transaction other than to reduce taxes, there is no economic substance to the transaction.

Section 6662 of the Internal Revenue Code is amended to impose penalties for disallowed tax benefits at 20%. Non-disclosed or not adequately disclosed noneconomic substance transactions are penalized at 40%. Reasonable cause exceptions are not applicable to noneconomic substance transactions. Tax and legal professionals will be reviewing these changes closely, since they can impact many corporate transactions and tax shelters.

Form 5500 EFAST filing credentials update

All Kidder plan sponsors are receiving by email a PDF which shows, step-by-step, how to register for credentials as a signing filer for Form 5500. These credentials are required under new laws effective for plan years beginning after January 1, 2009. If you have not received the email, please contact your Kidder Primary Administrator. The PDF instructions can also be downloaded from the Home Page of our website at www.askkidder.com.

New disclosures required on Form 5500 Schedule C

Plan Sponsors will see additional information on this year's Form 5500 which is filed with the Department of Labor. The form's Schedule C now requires the disclosure of all compensation paid by the plan. The more detailed reporting includes both direct and indirect fees paid to plan service providers from plan assets or participant accounts. Direct fees or compensation are paid directly or debited from a plan account. Indirect fees are all fees or compensation (other than direct compensation) a vendor receives for services provided to a plan. There are many types of indirect compensation, and some are less transparent than others.

The purpose of this additional information is to help plan sponsors understand fees and make informed decisions regarding the plan. The additional disclosures coincide with the new 408(b)(2) regulations discussed in this newsletter.

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408(b)(2) Regulations are almost here.

In prior issues of this newsletter, we have discussed the impact of new regulations under section 408(b)(2) of ERISA, which cover fee disclosure, the fiduciary status of service providers and potential conflicts of interest among parties involved with the plan. At Kidder, we look forward to the implementation of these new regulations, as they are intended to provide plan fiduciaries with needed information to make informed decisions and satisfy their fiduciary governance obligations to the plan and its participants. The regulations were delayed when the Obama administration came to power, but they now appear to be ready for release in May or June. The effective date of the regulations is uncertain, though it is anticipated to be January 1, 2011, when new service engagement agreements, disclosures and additional documentation will be required.

Special Announcement

Kidder Benefits Consultants joins APAPA.

Kidder Benefits has become a charter member of the ASPPA Plan Administrators Policy Alliance (APAPA). APAPA is a unique membership division of the American Society of Pension Professionals and Actuaries (ASPPA) and is limited to Third Party Administration firms whose primary business is retirement plan design and administration. The purpose of APAPA is to provide an organization through which member firms can share common concerns, become more politically active in the preserving the private pension system and increase educational opportunities.