How to Help Clients Defer Taxation in Their Working Years

(and Plan Their Exit Strategy)

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TYPES OF DEFERRAL PLANS

Qualified Plans

What Is a Qualified Plan?

- A qualified plan is the most efficient manner in which a company may provide retirement or termination benefits to its employees (or for business owners to save on a tax-favored basis)
  - HUGE tax benefits
  - HUGE requirements to meet

Tax Advantages

- Contributions are tax-deductible to the employer at the time deposited
- Contributions are <u>not</u> taxed to participants until taken from the plan (even if vested and payable upon request)
- Money is held in tax-exempt trust – no tax on earnings, so benefits grow faster
- Tax exemption continues after termination of employment through rollovers

One More Advantage

- Spendthrift Trust: benefits in the plan cannot be touched by creditors of the participant or the employer
  - Exceptions:
    - Former spouses (through court orders incident to marriage dissolution)
    - IRS tax liens
    - Certain benefits that are in pay status

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What Are the Requirements for a Qualified Plan?

- Too numerous to mention here, but generally:
  - Must be a broad-based plan that covers employees other than owners/executives
  - Benefits can discriminate in favor of highly paid employees … just not by too much
  - Must be a written plan that stays in compliance with the law
  - Lots of other nitpicky details (so the plan must be handled by someone with know-how)

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Defined Contribution Plans

- 401(k) Plans
  - Employee deferrals allowed
  - Employer contributions possible
    - Profit-sharing contribution
    - Matching contributions on the employee deferrals

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Defined Contribution Plans

- Defining Characteristic:

  Individual account balance maintained for each participant

- Deduction Limit:

  25% of compensation

Defined Contribution Plans

EXAMPLE 1

Facts: Dr. Izzy's earned income is $100,000 and pays 4 staff members $25,000 each. Thus, total compensation is $200,000.

Results: Maximum deductible is $50,000.

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Defined Contribution Plans

EXAMPLE 2

Facts: Total compensation is $200,000. Izzy awards profit-sharing contribution $5,000 per employee ($25,000). Matching contribution 5% per employee ($10,000).

Results: Of $50,000 deductible, used $35,000. For staff, $20,500. Izzy got $10,000. Max for Izzy would be $14,500.

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Defined Contribution Plans

- Profit Sharing Plans (most common DC plan)
- Money Purchase Pension Plans
- Stock Bonus Plans
- Target Benefit Pension Plan

Defined Contribution Plans

Type of Plan	Classification	Contribution & Deduction Rules	May Permit Elective Deferrals?	Other Features
Profit Sharing Plan	Nonpension-defined contribution	Contrib. stated or discretionary; have definite allocation formula; deduct. limited to 25% comp.	Yes	Most common defined contribution plan
Money Purchase Pension Plan	Pension-defined contribution	Have definitely determinable contrib. formula; subject to minimum funding; deduct. Limited to 25% comp.	No, unless pre-ERISA plan	Less popular since EGTRRA deduct. limits increased to 25% for profit sharing plans
Stock Bonus Plan	Nonpension-defined contribution	Contrib. stated or discretionary; have definite allocation formula; deduct. Limited to 25% comp.	Yes	Req'd to invest in ER securities & pay benefits in form of ER stock exception exists
Target Benefit Pension Plan	Pension-defined contribution	Contrib. determined actuarially by definitely determinable target benefit formula, but limited to DC §415 limits & 25% deduct. limit	No	Less popular since new comparability & cross-testing became available

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Defined Contribution Plans

New Comparability Plans

These plans use IRS rules for converting ER contributions into benefits at retirement age to pass nondiscrimination rules.

- Age-Weighted Profit-Sharing Plans
  - Use age (not compensation) to determine EE's allocation
- Cross-tested Plans
  - Use actuarial factors to convert benefit into single life annuity at retirement age

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Defined Contribution Plans

These plans work best for . . .

- Profit Sharing Plan
  - Use 401(k) feature to allow EEs to prepare for own retirement
  - Use matching contribution to encourage deferrals by rank-and-file so HCEs can defer more
  - Profit-sharing contributions provide general incentives for all EEs

Defined Contribution Plans

These plans work best for . . .

- Age-Weighted Plan
  – ERs where owners are older; rank-and-file are younger and high turnover rates (doctors)
- Cross-Tested Plan
  – Prof. ERs where owners benefit from combined high comp/age rates; other older EEs not too numerous (law firms)

Defined Benefit Plans

- Defining Characteristic

  Benefit provided is based on a formula in the plan, which determines the total benefit that will be paid out at normal retirement age

- Maximum permissible benefit
  - $195,000 annual payout starting at normal retirement age (NRA)
- No access to funds during working years
  - Exception for EEs who attained NRA

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Defined Benefit Plans

- Defined Benefit Pension Plan
  - Traditional pension plan where contributions fund benefit defined by formula chosen by employer
  - Benefit not based on contributions to plan but on benefit promised in plan at EEs retirement
  - ER assumes risk of investment and that funding in past years will be sufficient to pay out promised benefits

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Defined Benefit Plans

- Cash Balance Plans
  - Generally subject to same rules as traditional DB plans, but considered “hybrid” by IRS because they express EE‘s benefit as hypothetical account balance
  - ER still bears risk of investment; still directs investment of plan assets
  - Like DC plan, EE knows exactly the amount he will get in a current lump-sum payout

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Defined Benefit Plans

These plans work best for . . .

- DB Pension Plan
  - Great benefit for EEs, especially ERs where EE spends whole career there
    - Government ERs – teachers; public safety (police/fire)
    - Highly skilled workers – manufacturing; transportation
    - Organized labor
- Cash Balance Plan
  - Medical practices; partner trust is key

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NONQUALIFIED PLANS

Advantages of Qualification

- Employee: Deferral of tax
- Employer: Current deduction for contribution
- Tax advantaged distributions
- Protection from creditors

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Limitations of Qualification

- Statutory dollar Limits
  - Pension Plans reach "pay-out" maximum
    - Annual benefit at retirement of $195,000
  - DC Plans reach maximum annual contribution
    - $54,500 (for age 50+)
- Practical dollar Limits
- Must extend benefits to most employees

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ERISA Rules

- ERISA—Federal act governing retirement plans
  - Includes any plans providing retirement income or deferral of compensation to or after termination
- Retirement plans must meet bevy of rules:
  - Coverage—% workforce that must receive benefits
  - Eligibility—Who can you exclude?
  - Vesting—When can employee walk away w/ benefits?
  - Nondiscrimination—Limits on richer benefits to execs
  - Reporting to gov’t; disclosures to employees

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Advantages of Nonqualified Plans

- Flexibility
  - Usually only limited by imagination
- Fewer regulations
- Simplicity
- No annual discrimination testing

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Effects of Nonqualified Plans

- No ER deduction until EE recognizes income
- Earnings on funds taxable
  - If ER sets aside funds—ER taxable
  - Exception: Purchase insurance policy
- Takeaway:
  - ER can't zero out profits to avoid corp-level taxes
  - ER subsidizing EE by current income tax
    - ER giving up current deduction of business expense

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Key Requirements

- Timing of deferral elections
- Timing of payouts
- Limits on changing deferrals
- No acceleration of payouts
- Funding only in domestic “rabbi trusts”
- No transfers on change in ER’s financial health

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American Jobs Creation Act of 2004

- Exec abuses: Worldcom/Enron collapses
- Created IRC §409A
- Affects many (most?) Nonqualified Plans
- Applies to deferrals ≥ 1/1/2005
- Teeth: 20% penalty, immediate taxation, plus interest

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Nonqualified Plans

- Ensure 409A drafting/operational compliance
- More IRS oversight than 7 years ago
- Nonqualified plans still offer lot of flexibility
- Very useful for non-owner executives/talent
- May be only hope for young executives (~45)
- Not suited for closely held businesses

Examples of Nonqualified Plans

Generally, these are Nonqualified Plans:

- Employment agreements and offer letters
- Bonus programs
- Commission programs
- Stock awards and purchase programs
- Performance pay
- Incentive plans (long-term and short-term)
- Severance agreements and mass severance plans
- Change-in-control or "golden parachute" agreements
- Reimbursement arrangements
- Reimbursement for taxes or "tax gross-ups"
- Director's fee deferral arrangements
- Consulting agreements
- Split-dollar life insurance
- Post-retirement health or fringe benefits
- Plans providing deferrals or benefits in excess of those made to a qualified DB or DC plan
- "Top Hat" retirement plans reserved for management or select personnel

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GROWTH OF BUSINESS

How Growth Affects DC Plans

- May need to add more features to satisfy EEs, attract talent, pass annual testing
  - Matching contributions
  - Roth deferrals
- More difficult to afford profit-sharing contributions
- Aging or hiring of older, lower-paid workers or middle management can spoil cross-testing

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How Growth Affects DB Plans

- Unless business remains solely in businesses with highly skilled workers, more difficult to afford/justify rich DB benefits
- Branching into new industries may increase turnover, increasing administrative costs
- Cash Balance Plan may become too costly when hire more staff

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ACQUISITIONS & MERGERS

Advance Preparation

– Benefits issues can be a huge source of company liability
    - Benefits costs
    - Liability to participants who will terminate in connection with the transaction
    - Liability to participants who will change plans as a result of the transaction
    - Reporting and disclosure hoopla
– Many things can be done <u>before</u> the transaction that will save lots of money later

Advance Preparation

- To protect against being unable to warn your M&A executives about benefits concerns before it's too late, you need to educate them before an acquisition occurs
  - Employee reactions to transactions are better if they are managed early
  - Benefits transitions need advance planning
  - Don't promise what the law won't let us deliver
  - Early involvement by HR can save you money

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Advance Preparation

- Don't want employees to enter plan too quickly
  - Want employer to have time to think about it
  - Need to be able to enroll employees when eligible, or face liability for unpaid benefits, interest, and penalties
- Employers frequently buying other companies can set up plan that accommodates that and systems for handling the work
- Other employers need to buy time after the transaction to figure things out

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Advance Preparation

- Ensure plan permits ER to keep acquired EEs out of the plan until the first day of the *second* plan year that begins after the transaction
  - Can later amend to let EEs in sooner, if want

LET'S GO SHOPPING (FOR A NEW SUBSIDIARY)!

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The Deal Is On

- Retirement plans and other benefits should be part of the due diligence (examining books and records before deal)
- Risks: Liabilities for the seller's:
  - Poorly managed plan—fines and taxes
  - Unfunded benefits—funding obligations
  - Breach of fiduciary duties—DOL lawsuit
  - Failure to file government reports—penalties

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The Deal Is On

- Risk:
  - Buyer's plan may automatically include <u>seller's</u> Employees
- Some options are available only if action is taken before the transaction occurs
  - Seller's 401(k) plan usu. can't be terminated after acquisition if buyer already has a plan
  - But seller's plan can be terminated <u>before the deal</u> even if distributions occur later

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Good Ideas

- Someone with know-how should be in charge of due diligence
- Go to the right source—plan service providers
- Get as much data as possible
- Use experienced independent judgment
- Ensure deal makers consult with benefits staff if they change benefits or use as bargaining chips

Good Ideas

- If problems are discovered:
  - – Indemnifications only worth seller's ability to pay
  - – Liabilities can arise after indemnification periods
  - – May need to use government correction programs
    - Require seller to use *before* deal closes or pay costs

Good Ideas

- Acquisition Agreement should reflect how issues are being handled
  - Indemnifications (and whether a minimum or maximum amount to be indemnified applies)
  - Further assurances
  - Required pre-acquisition plan terminations or amendments
  - Representations about plan compliance
  - Agreed-to spinoffs

THE TRANSACTION

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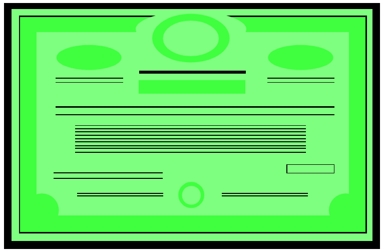
Stock Purchase



- Buyer purchases a majority of the shares of stock of the target
  - If the buyer is a company, target becomes a subsidiary
  - Transaction does not change which benefit plans are sponsored by the target (except to the extent that the target participates in the seller's plans)
    - To get rid of the target's plans, generally must terminate the plans

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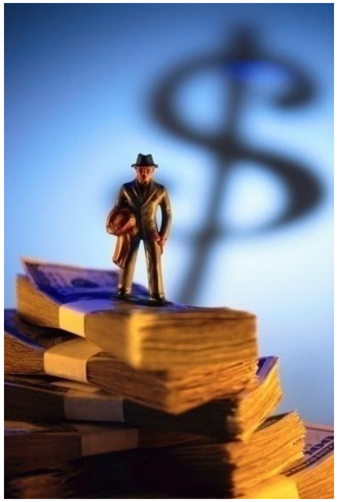
Asset Purchase



- Buyer purchases all or some of the target's assets and assumes all or some of the target's liabilities
  - Stock remains owned by the sellers: if all assets are sold, company is a shell with just the "consideration" for the transaction
  - Seller/target remains the sponsor of all plans unless buyer affirmatively adopts them
  - Employees are terminated by seller and hired by buyer (to the extent desired)

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Mergers

- Two companies combine and one of them – or a new company – survives the transaction
- The survivor owns and owes all of what either company owned or owed before the transaction – by operation of law
- The survivor sponsors all employee benefit plans sponsored by either company before the transaction – by operation of law

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Good Ideas

- Make sure to understand the trans-action and to communicate it to the various service providers
  - Be sure that service contracts survive the transaction
  - Be sure that everyone knows the new structure so that they can help you with the post-transaction transitions

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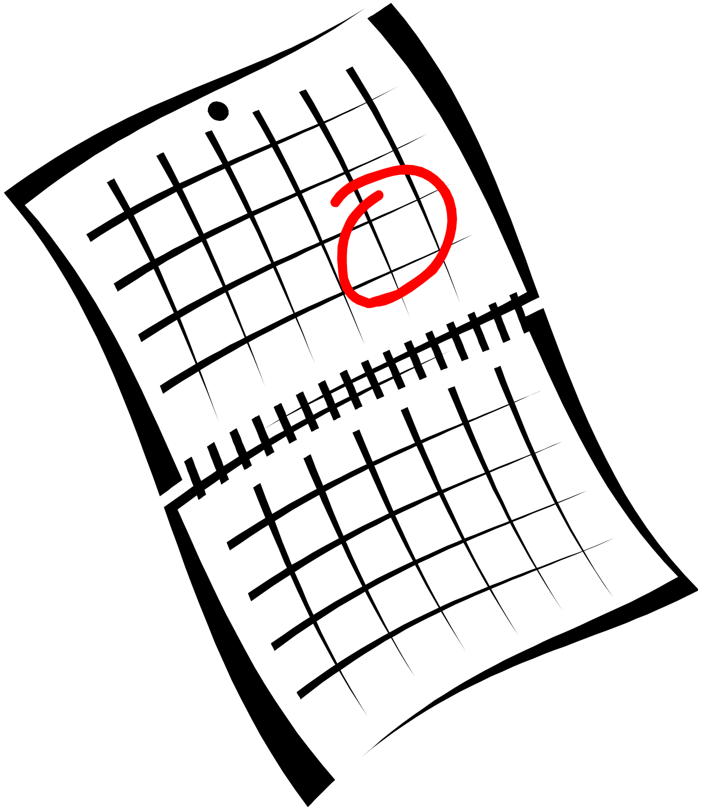

THE DAY AFTER

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The Day After

- Much of what has to happen after the transaction depends on the type of transaction
  - In a stock acquisition or merger, it is possible that the buyer now sponsors several more plans than it did before
  - In an asset acquisition, there’s a whole new workforce to integrate – the acquired group has changed employers

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Stock Purchase

- 401(k) Plans
  - Must have terminated seller's plan beforehand
  - If not, then buyer must do one of the following:
    - Maintain plan on ongoing basis,
    - Freeze the plan, or
    - Merge plan into buyer's plan

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Stock Purchase

- If acquired company maintains own plans:
  - Provides buyer window of time to make benefits decisions
  - Gives EEs “quiet time” to adjust to new ER before benefits are modified
- Buyer needs to get acquainted with acquired company’s service providers

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Good Ideas

- Stock Purchase
  - If plan terminated at or after purchase, make sure final Form 5500 filed
  - Final year is year all plan funds distributed
  - Unless final distribution matches up with end of plan year, *special deadline applies:*
    - Last day of 7th month after final distribution
    - Can use Form 5558 to extend additional 2½ months (if filed *before* deadline)
    - Generally can't use automatic filing extension

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Stock Purchase

- Plan Mergers
  - Common to have existing target plan merged into buyer's plan
  - Very important that the merger process is:
    - Well planned
      - Be sure to involve service providers for both plans in the process early
      - Common for fund holders to need several months advance notice
    - Well documented
    - Well supervised with post-transaction reconciliation

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Stock Purchase

- What if target had participated in the former parent's plan?
  - Need to make sure that participation in seller's plan is terminated concurrent with transaction
    - May require plan amendment
  - If 401(k) plan, seller's plan can pay out employees of sold subsidiary only under certain circumstances
  - Can spin off target's portion of seller's plan and merge with buyer's plan – need lots of cooperation between parties and service providers

Asset Purchase

- Acquired employees are "new" to buyer
  - Law does not currently require that prior service with seller be counted for retirement plans
    - Can make employees complete new eligibility requirements
    - Do not need to include for vesting
  - May need to amend plan to permit them to enter immediately, if so desired

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Asset Purchase

- Because of the way the rules work, none of the acquired employees in an asset acquisition will be an HCE in the year of the acquisition, unless s/he becomes a shareholder of the buyer
  - May be interesting opportunity to make these employees "whole" for perceived losses as a result of the transaction

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Asset Purchases

- Employees will generally be eligible for distributions from the seller's plan
  - Does buyer want to accept rollovers?
  - Can the movement of employees' money from seller's plan to buyer's be done for everyone automatically?
    - Plan spin-off and merger
    - Requires significant cooperation of the parties and service providers

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Mergers

- Benefits issues are quite similar to stock acquisitions
  - Beware terminating 401(k) plans if the survivor sponsors another plan
  - Beware of liabilities being assumed

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What Do We Suggest?

- Acknowledge that this is difficult stuff
  - Companies get into trouble because they try to deal with plan issues like they were easy
  - You need to:
    - Give yourself the time you need by planning ahead and understanding the issues
    - Coordinate among all your service providers
    - Have someone head up the process who understands the issues
    - Have a "to do" list and a timeline
    - Have all players "sign on" for the process

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What Do We Suggest?

- Be thorough
  - You will do the work now or later, and it will only be more expensive later
- Communicate with the employees
  - Particularly in this economy, people are scared, and scared people can't concentrate on their work
  - But, be very careful not to misrepresent: considered to be a fiduciary breach and can result in significant liability

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What Do We Suggest?

- Document for the ages
  - People will come and go, and you need to be able to understand what was done
- Be creative to solve your problems, but within the law
  - **<u>Always</u>** get professional advice if you are going to push the outside of the envelope

Other Concerns

- Sometimes the termination or merger of plans, or the change of service providers, will be prevented or impaired contractually
  – E.g., many fund holder contracts have back end loads – i.e., termination charges
  – E.g., most fund holders have a limit on the transfer of stable value fund balances to similar accounts at other financial institutions
  – E.g., some service provider contracts may be terminable on change in control

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WORKAROUNDS THAT DON'T WORK

Same Employer; Same Benefits

- Generally, members of controlled group must cover most employees (70%) and variation of benefits in limited range
- Exception for acquired <u>corporations</u> with distinct, independent operations
  - Won't work for a biz in the professional services
- Business owners gotten very creative, but Congress closed most desirable loopholes

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Workarounds That Don't Work

- Dividing companies into separate companies
- Dividing ownership among a few friends
- Dividing ownership among family members
- Putting interests in estates/trusts
- Dividing stock broadly; retaining voting shares
- Putting management in separate entity
- Prof. practice putting staff into separate entity

EXIT STRATEGY

Asset Sale

- Buyer may assume plan liabilities and adopt plan
  - Concerns: historical liability/fiduciary breaches
- If not, owner must terminate the plan
  - DB plans—must be able to fully fund (at least for all non-owners) to terminate plan
  - Owner-only plans not subject to PBGC rules, so cheaper/faster termination a year after all distributions made to Employees
  - DC plans only require some notices/amendments

Stock Sale

- Owner's accrued benefits in plan protected
- If owner stays with company
  - Just an EE with no plan responsibility
  - Buyer can change future benefits
- If owner stays behind
  - As terminated EE, can keep benefits in plan
  - Buyer can change investment choices, some distribution options
- Age 70½: minimum distributions must begin

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Estate Planning

- EE designates spouse as sole beneficiary
  - Usu. provides greatest income tax deferral
- Benefits left in plan will payout over spouse's life starting when EE would attain 70½
- Spouse can rollover benefit into IRA
  - Spouse's IRA
    - Can delay distributions until <u>spouse</u> is age 70½
    - Name own beneficiary for any remaining benefit
  - EE's IRA—
    - Only if EE designated spouse as IRA beneficiary

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Estate Planning

- If benefits paid in lump sum to spouse, benefits will qualify for marital deduction for federal estate tax purposes
  - Also qualify if spouse has right to w/d entire benefit at any time
- QTIP Trust as beneficiary
  - Provide for spouse during life; EE retains control over disposition after spouse dies; and
  - Defer estate taxes until spouse dies
- Involve a trusts/estate attorney for planning

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PROBLEM SOLVING

SAVING MONEY IN A RECESSION

Helpful Amendments

Amend the plan to use these provisions:

- Participant forfeitures shall be used to pay plan expenses, then to reduce ER contributions
- “Key EEs” don’t receive Top Heavy minimums
- Use cross-tested tiered allocation to get desired allocation for owners w/ minimum overall contributions

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Freezing the Plan

- Profit-Sharing Plans
  - If you freeze profit-sharing contributions, then plan is required to 100% vest all EEs
  - ER may have no choice, but they often don't like short-term EEs who quit to be able to take all those ER contributions
  - Also, important to remind ER to change all EEs vesting records immediately
  - Decision not to contribute in a lean year is not a freeze (but unclear when series of years is)

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Freezing the Plan

- 401(k) Plans
  - Vesting on freeze also applies to 401(k) plans
  - If you freeze all match and profit sharing contributions then it is <u>unclear</u> if that's a plan freeze should you continue to permit EE elective deferrals
  - Beware of the "deferral only death trap"—if plan is "Top Heavy" and ER can't afford the minimum contribution, then don't allow "key EEs" to defer

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Freezing the Plan

- Defined Benefit Plans (traditional pensions)
  - Don't need to fully vest EEs if plan not terminated
  - Must provide required notices at least 45 days before accruals can be stopped
    - ERs < 100 participants may provide 15 days in advance
  - Discuss the effects of amendments in advance with the plan's actuary
  - Owners can't just waive their benefits (except on plan termination)

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PLAN FAILURES

How To Stay Out Of Trouble

Common Sources of Problems

- No one minding the plan
  - Designate a person; give them resources
- Disorganization
  - Keep a plan binder; keep it handy; keep it updated
- Failing to adopt amendments
  - Read all mail from doc provider; sign/date all docs
- Failing to sign final documents
  - Ensure directors sign/date; annual binder check

Common Sources of Problems

- Changing operations, but not the document
- Organization changes w/o considering plans
  – M&A, staff changes, layoffs, ownership levels
- Pay/perks changes w/o considering plans
  – Bonuses, equity, fringe bens, incentives
- Operating the plan on the cheap
  – Dedicate a full-time EE to administer the plan, or hire an outside service provider to do it

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Service Providers Every ER Needs

- Third-Party Administrator
- Record Keeper
- Investment Provider (Fund Holder)
- Accountant
- Actuary (for Defined Benefit Plans)
- Auditor (100 or more people in plan)
- Benefits attorney

  * Investment advisers and benefits consultants are nice, but they're no substitute for any of the above.

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Service Providers Every ER Needs

If you can't afford this team,
you can't afford this plan.

Try a SEP or SIMPLE plan.

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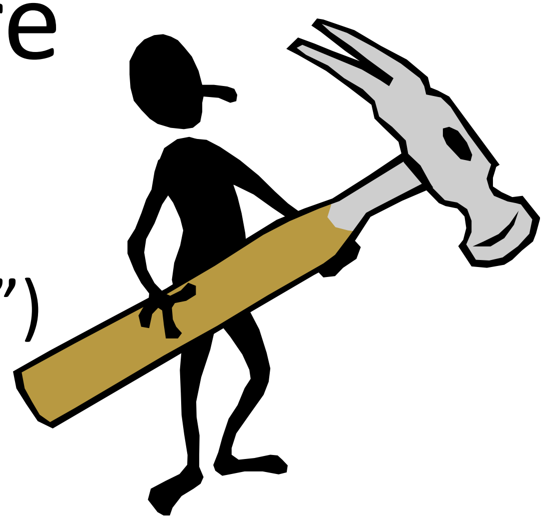
HOW TO FIX PROBLEMS

EPCRS Structure



- Three correction procedures:
  - Self correction procedure ("SCP")
    - Insignificant errors: anytime
    - Significant errors: time limited
  - Voluntary submissions to IRS ("VCP")
    - ***Regular submissions***
    - ***Appendix F submissions***
  - Audit Closing Agreement Program ("CAP")

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Self-Correction Procedure

- The "Do-It-Yourself" procedure
- For operational (and demographic) failures only

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Self-Correction Procedure: Insignificant Failures

- What is “insignificant”? Balancing of factors:
  - Have other failures occurred?
  - % of plan assets and contributions involved
  - Number of years affected
  - Number of participants affected (as % of total in plan and as % of those who could have been affected)
  - Was correction made within a reasonable time after discovery?
  - Why did the failure happen?

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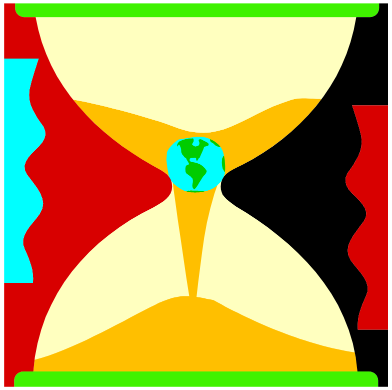
Self-Correction Procedure: Insignificant Failures

CORRECTION MAY BE MADE AT ANY TIME

(even if the plan is under audit by the IRS)



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Self-Correction Procedure: Significant Failures

- Defined: anything that is not insignificant
- Rule: must be substantially corrected during the "correction period"
  - Correction Period:
    - <u>General rule</u>: last day of 2nd plan year following year of occurrence
    - <u>ADP/ACP</u>: last day of 3rd plan year following year for which testing is failed

Self-Correction Procedure: Significant Failures

BUT -

The correction period <u>ends</u> if the plan comes under IRS audit

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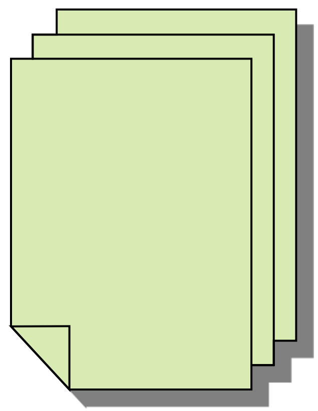
How to Correct

- The IRS's procedure:
  - Lists several errors and one or more permissible corrections for those errors
  - Lists correction "principles" to help practitioners formulate acceptable corrections
- Talk to an expert with experience if you have any questions

Correction by Plan Amendment

- Generally, self-correction by amendment to the plan is not available (must do in VCP or Audit CAP)



VCP

- Plan sponsor submits a plan to the IRS for coordinated correction process
  - Fee payable
  - Plan must be eligible for the program
  - No correction applies until after approval granted under VCP program (“correction letter”)

VCP

- When to use
  - Self-correction not available (too late)
  - Correction method is suspect
  - Failure is not operational
  - Want to correct by plan amendment
  - Involved in sale of company and buyer is squeamish

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Regular VCP User Fees

# of Participants	User Fee
20 or fewer	$750
21-50	$1,000
51-100	$2,500
101-500	$5,000
501-1,000	$8,000
1,001-5,000	$15,000
5,001-10,000	$20,000
More than 10,000	$25,000

But there may be streamlined submission options with lower fees

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WHEN TO BRING IN PLAN EXPERTS

Bring in Plan Experts

- Any changes to a nonqualified plan
- Any amendments of a qualified plan
- When qualified plans fail annual testing
- Reduction of any benefits
- Reductions in force/closures of locations/layoffs of 10% of location workforce
- Mergers, acquisitions, sales of operations
- Plan failures: late amendments/violate terms

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Questions?

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