

Would you like to defer more savings from tax?

As a result of the relatively recent passage of American Tax Payer Relief Act (ATRA) and the Affordable Care Act (ACA), taxes have increased, not only due to an increase in the top marginal tax rate, but also due to the Net Investment Income tax, and a personal exemption phase out. This has led many of our clients to ask what they can do to lower the amount of money that they hand over to the government each year. There are a number of planning opportunities that exist, but none of which are as attractive as having lower tax rates. One way to lower the overall tax burden is to reduce the amount of income that you receive. This sounds very unattractive at first glance, but is more common than you would assume. Owners and employees do this everyday through retirement plans. We are not suggesting that you make less money, only that you put it away before it is taxed, so that it may grow and compound tax-deferred and you can access a larger amount of money at a later date. We also believe that current tax rates are relatively high for modern times, especially in higher brackets, and there is the chance that when you access the money in the future, the effective tax rate may be lower.

What you may not realize about retirement plans is that there are a variety to choose from and while they are viewed primarily as a benefit to employees, they significantly benefit owners and highly compensated employees, which are usually the executives of the

company. We tend to focus on two types of retirement plans for our clients that are partners in medical practices and owners of businesses. Depending on the cash flow from the business and your income needs, we can work with a third-party administrator to establish the plan that is right for you.



Compounding a larger pre-tax amount leads to more after-tax money when distributed

Generally, the first plan that employers should look to implement is a defined contribution plan called a Profit Sharing Plan with a 401(k) option, more commonly known as a 401(k). If you would like to put away additional money on a pre-tax basis, you could then look to establish a Cash Balance Plan. This is what is known as a defined benefit pension plan. Each of these plans have different attributes, but both take pre-tax money that would

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otherwise be distributed and taxed through income or profit distributions, setting it aside and allowing it to grow, only to be taxed when withdrawn at a later time during retirement. In many cases, the combined top tax rate for



Business owners can contribute up to \$53,000 of pretax earnings to a 401(k) in 2015

our clients is above 50%. By putting away money on a pre-tax basis, you are doubling your after-tax contributions to your investible assets. So for example, an after-tax amount of \$50,000 would be more than \$100,000 to invest if taken out of pre-tax money. A 10% return on \$100,000 is \$10,000, where a 10% return on \$50,000 is \$5,000. Over time, at the same rates of return, the pre-tax money would grow exponentially compared to using after-tax money. Although taxes will be taken when

the money is withdrawn, this compounding effect results in more money for you in retirement, even if your effective tax rate remains the same.

A 401(k) is a qualified retirement plan that allows each employee to defer up to \$18,000 in pre-tax income for 2015. Plan participants over 50 may also put away an additional \$6,000 as a catch-up contribution. The amount eligible for deferral is subject to discrimination testing, so employers will generally make matching contributions or make a safe-harbor contribution in order to avoid testing. In addition to that contribution, the company may elect to share profits with employees. The profit-sharing component allows employers to share profits with employees in a rate that is scaled according to overall compensation, providing for the bulk of the profits shared to be allocated to the highly compensated employees and owners. The limit for total contributions for defined contribution plans in 2015 is \$53,000 per employee. Utilizing a profit sharing plan with a 401(k) option allows business owners and highly compensated employees the opportunity to not only reduce tax liability on their personal income, but the owners may deduct up to 25% of total employee compensation, with a \$265,000 maximum compensation amount per employee, from the earnings of the company as a business expense.

Actuarial testing is a large piece of the puzzle in keeping employer costs low with any retirement plan. While there are many

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benefits of employee sponsored plans to the employees, the motivating factor in implementing a retirement plan for many businesses is the ability to defer taxes and lower the annual tax liability for owners and highly compensated employees. One method for doing this with a defined contribution plan uses something called a New Comparability Plan, or a cross-tested plan. New Comparability Plans utilize formulas similar to defined benefit plans to allocate profits among all employees. These plans allow employees to be segregated into two or more classes based on certain similar factors for each class. Testing is required to make the determination on actual contribution allocations and to make sure that the allocations are non-discriminatory. Testing comes at a cost, however the overall result can be worthwhile in many cases.

While the ability to defer \$53,000 in 2015 from taxation is nice, for many of our clients, this is a small amount of their annual retirement savings. If you and your partners wish to defer additional money, we would be happy to explain the opportunities presented through a cash balance plan. A cash balance plan is considered a defined benefit plan, more commonly known as a pension. Pension plans have recently received negative treatment in the media and in politics, but that shouldn't scare you away from them. There is more uncertainty with a cash balance plan than with a profit sharing plan, but that uncertainty can be mitigated with the proper actuarial procedures and investment management.



Combining a 401(k) and a Cash Balance Plan allows a business owner to defer over \$150k of annual income from tax in many cases

A cash balance plan is funded by the employer in an amount necessary to pay out the promised benefits to all employees, including owners and executives. The amount needed for funding the plan on an annual basis is determined using the plan participants' individual and combined attributes, a pre-determined growth rate, and actual investment performance. The contribution necessary to fund the plan for non-owners and executives is far lower than the tax liability associated with the owners and executives taking that amount of money as income on an after-tax basis. The indexed maximum annual benefit from the plan for a participant is the lower of 100% of income or \$210,000 for 2015. This means that the plan must be set up to provide no more than \$210,000 per year to a plan participant during retirement.

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Depending on the participant's age and life expectancy, either more or less than the current maximum benefit amount may be contributed annually by the employer using pre-tax money. Employers are not required to fund to the maximum benefit, and may define a lower benefit amount. The money contributed is pooled among all employees and invested. Investment performance determines the annual contribution for a particular year, in order to satisfy the funding requirements. If investments perform poorly, a larger, tax-deferred contribution will be required in the following year, where if investments perform well, less money can be sheltered from taxation in the next year. A major difference with a cash balance plan from an ordinary defined benefit plan, is that the individual participant's theoretical account balance is broken out, instead of showing the defined monthly benefit. When the employee retires, he or she receives the account balance, which can then be rolled into the employee's IRA account and withdrawn over time. The benefit of this plan to participants is that they can see the account value as it accrues over time, and in many plans, they are allowed to roll it over to an IRA if they terminate their employment with that company prior to retirement.

By combining a defined contribution plan with a defined benefit plan, in many cases, you are able to defer upwards of \$150,000 in annual income, and thereby avoid taxes on that money in the current tax year, allowing it to grow on a pre-tax basis. We've included a sample study, which shows the amounts that

could be sheltered utilizing both a Profit Sharing Plan with a 401(k) option and a Cash Balance Plan, along with a theoretical example that illustrates how a Cash Balance plan can benefit a business owner in comparison to simply saving after-tax money.

Retirement plans can be very useful tools within your total wealth strategy, but there are many nuances. We invite you to contact us if you have any questions or would like more information about retirement plans and how you could utilize them within your particular circumstances.



John Schaffer joined Abundance in 2013 and oversees the firm's compliance program and advises clients on matters of personal wealth. His prior experience ranges from real estate and construction to criminal and civil law. John attended The Pennsylvania State University, where he majored in Marketing, and later returned to complete a joint degree in Law and a Masters of Business Administration. His graduate education focused on business, tax, and estate law. John is an active member of the Pennsylvania Bar.

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