The Appeal Of Benefit-Focused Retirement Plans

WITH THE POTENTIAL FOR TAX INCREASES LOOMING IN THE future, tax mitigation activities take on increased importance. At the same time, there's a growing belief that the goal of attaining financial security in retirement is going to fall squarely on the shoulders of the individual, as certain governmental programs may not be able to deliver as promised.

Putting these two considerations together, business owners may find certain types of qualified retirement plans appealing. However, the ability of many such plans to deliver the value successful business owners are looking for—meaningfully lower taxes coupled with solid benefits for themselves—is sorely lacking. For example, it's not uncommon for 401(k) plans to be top-heavy, meaning successful business owners are unable to personally receive any real value.

What is proving more valuable and consequently more appealing to business owners are defined-benefit plans. These often enable business owners to make larger contributions, resulting in larger tax deductions. The most appealing type of defined-benefit plan is referred to as a benefit-focused plan.

The Pension Protection Act of 2006, which took effect in 2008, brought to life something we have dubbed the "benefit-focused plan.

The benefit-focused plan enables key employees, principals and their families to benefit most from the invested money in the plan. Moreover, within governmental guidelines, these principals have the power to designate who participates in the plan at their companies. It allows them to further derive the largest corporate tax benefit of any qualified retirement plan.

But one of the most important aspects of the new plan is that it can as much as triple corporate tax deductions when compared to a traditional defined benefit retirement plan, offering the wealthy individual who owns the company larger potential deductions than he or she could find in any other type of retirement setup. This can allow companies the highest possible deduction amounts of all qualified retirement plans out there, making it very useful in adroit income tax planning.

The benefit-focused plan also creates great business planning and estate planning advantages. If the owners die, the benefits can transfer to their spouses and heirs over their lifetime. And part of the reason is the life insurance component in the plan.

In a benefit-focused retirement plan, the owner purchases life insurance as part of the funding mechanism for the plan structure. Not only does he then benefit by getting life insurance using pretax dollars, but the proceeds of the insurance when he dies are income tax free and can even be estate tax free. This benefit proves useful in succession and estate planning.

A benefit-focused plan enables business owners to take the largest tax deductions of any qualified retirement plan. Further, the benefit-focused plan also returns the vast proportion of the money contributed and the returns to the business owner. While there are a number of other advantages to the benefit-focused plan, these two are often at the top of the list.

Case Studies

To get a better understanding of the value successful business owners find in the benefit-focused plan, let's consider a few case studies.

Surgeon: A 44-year-old surgeon was unhappy with his 412(e) defined-benefit plan because his tax-deductible contributions were declining annually since he started the plan. He was also not satisfied with the low rate of return he was earning on the fixed annuity used to fund his plan.

He could only contribute about $312,000 each year. By taking into account his past service and the ability to restate his existing plan, we were able to convert his plan to a benefit-focused retirement plan. The new plan would provide him a projected contribution and tax deduction in excess of $519,000 for the next 10 years.

Commercial window installation company: A family business with 11 employees wanted to fund the maximum 401(k) benefits for four key executives while minimizing contributions for the remaining seven.

Integrating a traditional defined-benefit plan with the existing 401(k) plan would result in total contributions of about $725,000. Utilizing a benefit-focused plan with the 401(k) plan, the company was able to put away more than $1,554,000 annually with 92% of the contribution going toward the four key executives.

Restaurateur: A 45-year-old owner of two restaurants with 11 full-time employees and 25 part-time employees is making a lot of money in his businesses and his accountant prompted him to set up a retirement plan. Considering the transient nature of many of his employees, the restaurant owner was looking for a plan where he would be the most significant beneficiary.

He first considered a traditional defined-benefit plan. He found he could fund nearly $176,000 a year for himself and the 11 full-time employees. Instead, by choosing a benefit-focused plan, he is able to contribute and take a tax deduction of about $441,000 for the next 10 years with 89% going toward his retirement benefits.

Hedge fund partners: A hedge fund with 22 employees was looking to implement a retirement plan. The fund's tax advisors initially could not come up with a plan that was able to benefit the managing partners in any meaningful way until they were introduced to the benefit-focused plan.

Using the benefit-focused plan, we were able to give them a first year pre-tax contribution of $1,095,000. Aside from this significant tax deduction, the two managing partners receive 85% of the retirement benefits.

Accountant: An accounting firm with nine employees was looking to fund retirement benefits for the owner and founder of the firm as well as his two key executives. The firm already had a defined-benefit plan along with a 401(k) profit-sharing plan.

Contributions to the plans were maxing out at about $230,000 per year. This was proving insufficient as they determined they needed additional funds to meet their planning goals. By restating the existing defined-benefit plan and converting it into a benefit-focused plan, we were able to give them a projected level contribution of $678,000 per year with 94% going to the founder and the two key CPA's.

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Implications

Qualified retirement plans are one of the best ways to address the needs of mitigating taxes and creating tax-free growth for business owners. Considering the potential for future increases in taxes, the appeal of qualified plans is inclined to rise. However, please note that some types of qualified retirement plans are better for successful business owners than others.

If the objectives of a successful business owner are to make the largest contributions with the accompanying tax deductions possible *and* get the lion's share of the financial benefits for a select number of senior managers and owners, then a benefit-focused retirement plan needs to be considered. With these goals in mind, the benefit-focused plan is an effective and powerful qualified retirement plan.

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