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ClientAdvisor
APRIL 2022

Maximize tax-favored savings in specially designed qualified plans

Defined Benefit, Cash Balance, Profit Sharing, and Money Purchase plans are solutions beyond the traditional 401(k)

Doctors are not told how to maximize their eligible yearly tax-favored contributions to qualified plans. There are more opportunities than simply making contributions into their 401(k) plans and Individual Retirement Accounts (IRAs).

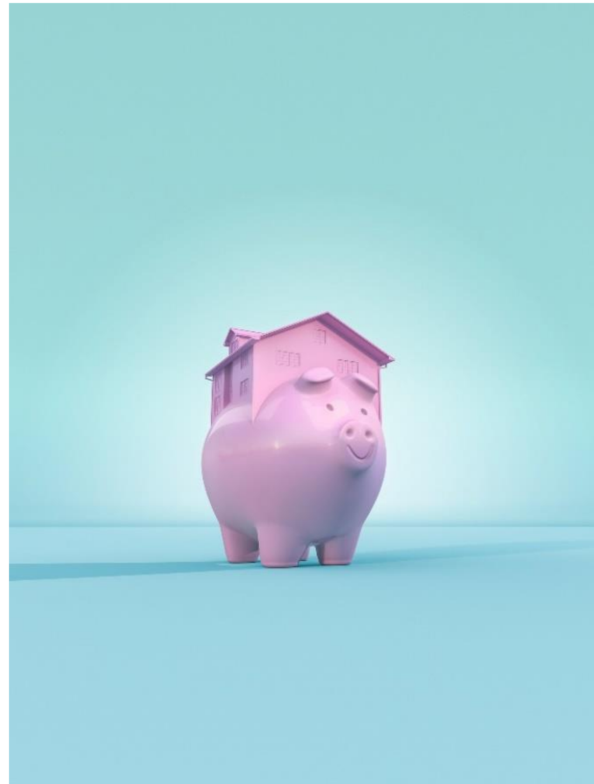
Congress has enacted legislation for plan designs in addition to 401(k) plans to incentivize taxpayers to maximize contributions to Qualified Plans.

Among these plans are **Defined Benefit Plans** (including 412(e)(3), **Cash Balance Plans, Profit Sharing Plans,** and **Money Purchase plans.**

Defined Benefit versus
Defined Contribution Plans

Qualified (tax-deferred) retirement plans are either **Defined Benefit**, promising a specific retirement benefit (e.g., fixed monthly income), or **Defined Contribution**, offering no specific result but access to accumulated savings (e.g., your 401k balance at retirement, subject to continued market fluctuations and your withdrawals).

There are additional DC and DB plans which increase the opportunity to make pre-tax contributions and manage the investment portfolio on a tax-favored (and asset protected) basis.



Defined Benefit Pension Plans

A Defined Benefit Plan is funded by employer contributions, with yearly benefits in retirement based on a formula that considers salary, tenure, and age. Successful Doctors who own or control their Practice are eligible to contribute as much as $300,000 or more each year (based on age and earnings history) to their plan on a pre-tax basis (possibly up to $500,000 in a 412(e)(3) plan).

Deferred Profit-Sharing Plan (DPSP)

A profit-sharing plan is a defined contribution plan that accepts discretionary employer contributions to give employees a share in the company's profits. The Board of Directors of the Plan Sponsor (The Practice) determine the contribution each year. Contributions to a profit-sharing plan are made by the employer. Contribution limits are 25% of W-2 income, subject to annual limits on income eligible for plan calculations and/or total defined contribution limits published each year by the Department of Labor and the IRS ($61,000 in 2022).

Money Purchase Plans

A money purchase plan requires a practice to contribute a specific percentage of an employee's salary each year, regardless of profitability. Contributions to a money purchase plan are fixed on an annual basis. The plan documents state the percentage of an employee's salary that the employer will contribute to the plan

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each year. Unlike a profit sharing plan, employer contributions don't change based on how profitable the company was throughout the year.

The Cash Balance "Hybrid"

Cash balance plans grant employees a set account balance at retirement or when they leave the company, instead of a set monthly benefit. For that reason, many people think of them as a hybrid between traditional pensions and 401(k)s. They do not guarantee indefinite benefit payments, but participants are guaranteed up to a certain cash balance.

Combination Plans: 401(k) Plan / Cash Balance

The Employee Benefits Security Administration of the Department of Labor is responsible for administering and enforcing the provisions of Employee Retirement Income Security Act. Those provisions include regulations which allow a Plan Sponsor to Implement both a 401(k) plan and a Cash Balance Plan. When designed by an actuary with a specialty in qualified plans, it is possible to maximize the tax favored contributions for the Doctors (or owners) and minimize the rank-and-file cost of providing retirement benefits.

How do I design a compliant qualified plan?

The Department of Labor requires specific "tests" for qualified plans to assure employees are receiving the benefits required by law. Those tests are based on the age and income of all the participants. To design an efficient and compliant plan, information about employees of the practice (a census), the ownership of the Practice (or the business), and the employer's budget for the benefits are provided to the actuary to craft a plan design.

Plan document, actuarial services, taxes, and service

All plans require a Plan Document which describes the operation of the plan. This document must be approved by the IRS. The Plan Sponsor (the Practice) selects a Third-Party Administrator (TPA)to provide the plan documents, conduct required testing, annual reporting, prepare plan tax returns and reporting to the plan

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participants. Further services are required to manage the plan investment portfolios, custody, and employee enrollments.

Timing

In 2022, the Secure Act allows a plan sponsor to establish and fund a plan for 2021 any time before the practice tax return is filed for 2021. With extensions, a plan can be adopted and funded as late as October 2022 for tax year 2021.

Conclusion

With the right plan in place, our doctors and other business owners can maximize pre-tax contributions to qualified plans allowing them to reach Financial Independence sooner.

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401k Contribution Limits

The maximum amount you can contribute to your 401(k) may be adjusted from year to year. For 2022, you can put up to $20,500 in a traditional 401(k), up $1,000 from 2021. The 50-and-over crowd is allowed an extra $6,500 as a "catch-up" contribution, for a total of $27,000. Employer contributions do not count toward these limits.

However, the IRS does limit the combined contributions made by employers and employees. For 2022, that limit is $61,000, and it's $67,500 for participants age 50 or older, reflecting the catch-up amount allowed.

For "SIMPLE 401(k)" plans, which small businesses might offer, there is a contribution limit of $14,000 for 2022. The catch-up amount is $3,000. Solo 401(k) plans — used by the self-employed with no employees except perhaps a spouse — come with the same contribution limits as traditional 401(k) plans.

The maximum annual compensation that can be used to determine contributions for most plans is $305,000 for the 2022 plan year.

The IRS requires that the employers contributing to your separate plans are unrelated. Keep in mind that you may qualify as one of your employers. To be considered unrelated, your employers must not be part of the same entity or controlled group that owns 80% or more of another business. That means they can't work for the same parent business an LLC, partnership, sole proprietor, etc. For a lot of docs, this will mean their W-2 income and the additional moonlighting income from another hospital will count as unrelated employers.

Highly Compensated Employees and Nondiscrimination Testing

A highly compensated employee (HCE) is, according to the Internal Revenue Service, anyone who has done one of the following:

Owned more than 5% of the interest in a business at any time during the year or the preceding year, regardless of how much compensation that person earned or received compensation from the business of more than $130,000 if the preceding year is 2021 (and more than $135,000 if the year is 2022), and if the employer so chooses, was in the top 20% of employees when ranked by compensation

Tax-deferred retirement plans such as 401(k) plans were implemented by the Internal Revenue Service (IRS) to offer equal benefits to all workers. Initially, all employees could contribute as much as they want, with total contribution matched by the employer up to $19,500 annually for 2021 and $20,500 for 2022.2

High earners could contribute much more than other employees and were thus likely to benefit more from qualified plan tax treatment. Seeing that not all employees were receiving equal benefits from retirement plans, the IRS set rules against high earners contributing over a certain limit based on the average contribution of the other employees.

The Internal Revenue Service (IRS) requires that all 401(k) plans take a nondiscrimination test every year. The test separates employees into two groups—non-highly compensated and highly compensated employees (HCE). By examining the contributions made by HCEs, the compliance test determines whether all employees are treated equally through the company's 401(k) plan.1

The non-discrimination stipulations are set in place so that employee retirement plans do not discriminate in favor of highly compensated employees. Defining highly compensated employees provided a way for the IRS to regulate deferred plans and ensure that companies were not just setting up retirement plans to benefit their executives.

The 5% threshold is based on voting power or the value of company shares. The interest owned by an individual also includes the interest attributed to their relatives such as spouse, parents, children, grandparents, but not grandchildren or siblings. An employee with exactly 5% ownership in the company is not considered a highly compensated employee, whereas one with a 5.01% interest in the company has the HCE status. For example, an employee with 3% holdings in the company will be considered an HCE if their spouse owns 2.2% interest in the same company. (Total interest is 5.2%)

Defined Benefit Pension Contribution Limits

Defined Benefit Plan Contribution Limits Although employees generally have little control over their benefits, there are still annual limits for defined benefit plans. In 2022, the annual benefit for an employee can't exceed the lesser of 100% of their average compensation for their highest earning three consecutive calendar years or $245,000. This is up from $230,000 in 2021 and 2020.

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Defined Benefit Plan Eligibility

Only employees are eligible to participate in a Defined Benefit Plan. Independent contractors are not eligible.

Employers may exclude any employee group but must be able to meet minimum participation, coverage and nondiscrimination requirements. However, some employee groups, such as certain union employees or nonresident aliens, may be excluded without it counting against the employer.

If the Plan document does not exclude an employee group, the employer may require a minimum age of 21 and a one year waiting period. Additionally, the employer may require the employee to have worked at least 1,000 in a year. The waiting period may be extended to two years if the benefit is fully vested when the employee enters the Plan. After the employee meets these requirements, the employer may further delay Plan entry until the following January 1st or July 1st (for a calendar year Plan).

Vesting of Defined Benefit Plans

An employee is vested in their Defined Benefit if all or a portion of their benefit is not forfeited when they separate from service.

For purposes of vesting, the employer may require a participant to work as many as 1,000 hours in a year to earn a year of vesting service. When the participant terminates, whether they are vested depends on how many years of vesting service they have.

In a Traditional Defined Benefit Plan, the employer may require the participant to earn up to five years of vesting service using a "cliff" schedule (i.e., 0% vesting for the first 4 years and 100% vesting at 5 years). Alternatively, the employer may require up to seven years of service for full vesting using a "graded" schedule (i.e., 20% after 3 years, 40% after 4 years,..., 100% vesting after 7 years).

On the other hand, for Cash Balance Plan benefits, the employer may require no more than three years of service for full vesting using a "cliff" schedule. Unlike their traditional counterparts, extending the vesting schedule using "graded" vesting is not permitted.

Regardless of years of service, the employer must provide full vesting once the participant reaches Normal Retirement Age, as defined in the Plan. Normal Retirement Age can be not exceed the later of age 65 and five years from when the employee participated in the Plan.

Defined Benefit Rules for Lump Sum Payments

In lieu of lifetime monthly payments in a Traditional Plan, employers may offer a single sum distribution equal to the actuarial present value of the monthly payments.

The conversion from a lifetime payment stream to a lump sum distribution is based on the Plan's definition of actuarial equivalence. However, the Defined Benefit Plan rules require that the payout be no less than the distribution calculated using the IRS' prescribed interest and mortality rates.

Note that Cash Balance Plans are not subject to this requirement because their benefit already is expressed as an account balance (i.e., no conversion is necessary).

Pension Accelerator Program Opportunity

The Pension Accelerator Program has been created from findings of the43 year Doctors Economic Research Project to help productive business owners prevent the loss of $1,000,000 of qualified retirement plan savings. Legislation enacted in 2001 (EGTRAA) tripled the maximum annual pre-tax earnings that could be allocated by productive business owners to defined benefit pension plans. The maximum retirement accumulation at a plan participant’s age 65 provided for by Internal Revenue Code section 415 was increased from $865,000 to $2,400,000. Allowable annual deductible contribution levels to defined benefit pension plans exceed the amount of surplus pre-tax earnings that are available to most business owners.

Findings of the Doctors Economic Research Project indicate that many business owners have limited earnings exceeding their lifestyle costs, and, as a result, they are unable to make annual contributions to their retirement plans that are large enough to accumulate sufficient retirement savings to finance their lifestyle costs through their life expectancies.

The Pension Accelerator Program enables business owners who have limited or no surplus business earnings to make significant additional annual contributions to their retirement plans that increase their retirement savings by$1,000,000 or more. Business owners who can qualify for a $250,000 Pension Accelerator credit line can prevent the loss of $1,000,000, or

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more of retirement savings by increasing their contributions of pre-tax earnings to their defined benefit pension plans by $90,000 per year for five years. Pension Accelerator Program credit lines enable productive business owners to accumulate retirement savings that would not otherwise exist.

How the Pension Accelerator Program Works

The loan proceeds of bank credit lines are allocated in equal annual increments over five years to pay a portion of the business owners annual lifestyle costs. The payment of lifestyle costs with loan proceeds enables business owners to receive less taxable compensation from their employers. The tax losses that would have resulted from their allocation as compensation are converted into additional annual contributions to defined benefit pension plans that would have not been possible. As a result, these increased annual savings and the tax-deferred growth on these savings accumulate over time in businessowners retirement plans instead of being lost to unnecessary income taxes.

Through the Pension Accelerator Program, business owners can also multiply non-productive residential equity that earns no annual income by indirectly and temporarily repositioning that equity into income producing retirement savings by using the residential equity as collateral for the credit line.

A business owner’s employer’s maximum contribution to a defined benefit pension plan to fund future monthly retirement benefits is generally limited to the difference between net employer earnings and the annual pre-tax earnings that the owner requires as salary to finance annual personal lifestyle costs. Many times, because of current living expense cycles (such as their children’s education costs), business owners have little or no surplus business earnings that exceed the compensation payments they must receive in order to fund their lifestyle costs. Business owners use $50,000 of a $250,000 credit line each year for five years to pay a portion of their annual lifestyle costs, which reduces their need for annual compensation from their businesses by approximately $90,000. The reduction in salary requirements enables their employers to fund $90,000 of additional annual contributions for five years to fund their future retirement benefits.

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