Restoring retirement benefits for business owners and key employees

Retirement security is a critical concern of business owners and key employees. Tax law changes over the years have dramatically undercut the ability of qualified retirement plans to provide adequate retirement income to higher paid employees. This article examines that trend and looks at how supplemental executive retirement plans can effectively restore those benefits.

As the "baby boomer" generation reaches middle age, more and more Americans are thinking about their eventual retirement and assessing their financial ability to maintain their current life-style in retirement. This has created a very real concern for many, including business owners and executives, that their existing sources of retirement income are not adequate.

The focus of this article is on business owners and highly paid employees and on one important factor contributing to their concern. That factor is the long-term and still ongoing tax law changes preventing qualified plans from providing adequate retirement income for higher paid employees. We will highlight the tax law changes that illustrate that trend, including the most recent cutback in the eligible compensation limits in the 1993 Revenue Reconciliation Act, examine how those changes have drastically curtailed the benefits of qualified plans for higher paid employees, and look at the benefits to the employer and the employees of using a nonqualified supplemental retirement plan to restore those benefits.

THE CUTBACKS IN QUALIFIED PLANS FOR HIGHER PAID EMPLOYEES

The ability of qualified plans to provide appropriate levels of retirement income for executive level employees has been deteriorating for many years. The following discussion reviews the tax law changes that reflect that trend. Table I provides a tabular summary of retirement legislation since 1974.

ERISA (1974)

The passage of ERISA (the Employees' Retirement Income Security Act) in 1974 is an appropriate starting point. ERISA was designed to protect workers by imposing a much more strict regulatory regimen on employers in their providing retirement benefits to workers. ERISA imposed new minimum funding standards, as well as liberalized eligibility, participation, vesting and other rules, and also strict fiduciary requirements and prohibited transaction rules.

However laudable and necessary those reforms, they clearly imposed greater burdens on employers than ever before. Moreover, since the focus of ERISA was on protecting rank-and-file workers from perceived abuses relating to company retirement plans, ERISA adopted a general approach in which the interests of rank-and-file employees were favored over those of higher paid employees.

As far as contributions and benefits were concerned, the ERISA maximums were the lesser of 25% of compensation with a $25,000 dollar limit for annual additions to defined contribution plans and the lesser of 100% of compensation with a $75,000 dollar limit for the annual benefit under defined benefit plans. The combination plan rules used the so-called "1.4 rule."

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA)

The passage of TEFRA (the Tax Equity and Fiscal Responsibility Act) in 1982 is an important point of departure. Generally speaking, while certainly not favoring the higher paid employee, and not increasing contribution or benefit limits beyond cost-of-living adjustments, those changes liberalized various rules.
With the passage of TEFRA in 1982, however, the trend toward limiting the ability of private qualified plans to provide retirement benefits became clearly established.

Contribution and benefit limits were drastically reduced. For example, cost-of-living adjustments had brought the dollar limit for defined contribution plans to $45,475 through 1982. TEFRA cut back the dollar limit to $30,000. TEFRA's defined benefit plan dollar limit was reduced to $120,000 from $136,425.

In addition, TEFRA imposed special requirements on "top heavy" plans. These rules, including accelerated vesting schedules, minimum contribution requirements, includible compensation limits ($200,000) for members of the top-heavy group, and reduced combination plan rules for top-heavy group members, all basically made it harder and more expensive for plans to fully benefit higher paid employees.

Another benefit for higher-paid employees, the ability to take loans from qualified plans, was drastically reduced with new dollar limits and payback requirements.

Note: TEFRA did bring parity between Keogh plans (for unincorporated businesses) and corporate plans which was a liberalization of contribution and benefit limits for those types of plans.

TAX REFORM ACT OF 1984 (DEFRA)

DEFRA continued the trend to reduce the potential benefits of qualified plans. Among other changes, DEFRA (i) extended the freeze on cost-
Projected Defined Contribution Dollar Limit

<table>
<thead>
<tr>
<th>Year</th>
<th>Pre-TEFRA Rules (4% COLA)</th>
<th>TEFRA Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$45,475</td>
<td>$30,000</td>
</tr>
<tr>
<td>1983</td>
<td>47,294</td>
<td>$30,000</td>
</tr>
<tr>
<td>1984</td>
<td>49,186</td>
<td>$30,000</td>
</tr>
<tr>
<td>1985</td>
<td>51,153</td>
<td>$30,000</td>
</tr>
<tr>
<td>1986</td>
<td>53,199</td>
<td>$30,000</td>
</tr>
<tr>
<td>1987</td>
<td>55,327</td>
<td>$30,000</td>
</tr>
<tr>
<td>1988</td>
<td>57,540</td>
<td>$30,000</td>
</tr>
<tr>
<td>1989</td>
<td>59,842</td>
<td>$30,000</td>
</tr>
<tr>
<td>1990</td>
<td>62,236</td>
<td>$30,000</td>
</tr>
<tr>
<td>1991</td>
<td>64,725</td>
<td>$30,000</td>
</tr>
<tr>
<td>1992</td>
<td>67,314</td>
<td>$30,000</td>
</tr>
<tr>
<td>1993</td>
<td>70,007</td>
<td>$30,000</td>
</tr>
<tr>
<td>1994</td>
<td>72,807</td>
<td>$30,000</td>
</tr>
<tr>
<td>Total</td>
<td>$756,105</td>
<td>$390,000</td>
</tr>
</tbody>
</table>

Fig. 1. Projected defined contribution dollar limit.

of-living adjustments to the contribution/benefit limits until 1988; (ii) imposed pre-59-1/2 penalty taxes; and (iii) imposed minimum distribution rules beginning at age 70-1/2.

RETIREMENT EQUITY ACT OF 1984 (REA)

REA was enacted with the primary intention of protecting the spouses of workers from being unfairly deprived of retirement security through the unilateral action of the working spouse. Its provisions, however, continued the trend of favoring lower paid workers at the expense of higher paid workers.

For example, the minimum age and service requirements were reduced for participation and vesting purposes (generally from 25 to 21). Also the joint and survivor annuity rules were totally revised. And while those rules did not directly favor lower-paid employees, they did increase the administrative burdens imposed on qualified plans generally.

TAX REFORM ACT OF 1986

The 1986 Tax Reform Act involved a massive rewrite of the Internal Revenue Code, including in the area of qualified plans. The trend to restrict the benefits of qualified plans for higher paid employees clearly continued.

TRA 86 adopted the so-called “success” taxes under IRC Section 4980A. Distributions from qualified plans in excess of a threshold amount (generally $150,000 per year) became subject to a 15% excise tax and a complicated grandfathering system for benefits in excess of $562,500.

TRA 86 cut back defined benefit limits by requiring benefits to be calculated using the social security retirement age as the normal retirement age. Further restrictions on higher paid employees came from TRA 86's extending the $200,000 limit on includible compensation to all qualified plans rather than just top-hat plans and SEPs.

New integration rules under TRA 86 limited the ability of employers to use social security integration to reduce contributions for lower paid employees despite relatively higher percentage social security contributions for that group.

Section 401(k) plan rules are tightened and make those plans less favorable for higher paid employees. For example, TRA 86 imposed a $7,000 cap on elective deferrals. Also, TRA 86 imposed a stricter actual deferral percentage or ADP test under Section 401(k) plans.

REVENUE RECONCILIATION ACT OF 1993

Relatively minor changes took place in the Omnibus Reconciliation Act of 1987 (OBRA), the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and the Revenue Reconciliation Act of 1990.

The trend against higher pays in qualified plans continued in 1993, however, with the Revenue Reconciliation Act. That law reduced the includible compensation limit for qualified plans from $235,840 to $150,000. As we will see, this change further curtailed the ability of qualified plans to provide real retirement security to higher paid employees.

IMPACT OF THESE CUTBACKS ON QUALIFIED PLAN BENEFITS

There are many ways of illustrating the impact of these tax law changes on retirement planning for higher paid employees. Simply in terms of contribution limits, for example, one might compare the level of contributions permitted under the old and new rules.

Let's take the typical closely-held business owner or professional who regularly contributed the maximum dollar limit to his or her qualified plan each year. In 1982 that limit was $45,475 and was subject to an annual cost-of-living adjustment. TEFRA reduced the dollar limit to $30,000 and froze cost-of-living adjustments. Based on an assumed 4% annual cost-of-living increase, the following chart (Fig. 1) shows that the business own-
er's total contributions since 1982 would have been about $366,000 less as a result of the TEFRA dollar limit reduction.

THE IMPACT OF THE $150,000 INCLUDIBLE COMPENSATION LIMIT

The following case study illustrates how the 1993 rule reducing includible compensation to $150,000 can impact retirement planning for a closely-held business (Fig. 2).

Acme Manufacturing Company is a C corporation with four key owner-employees. Acme has a 10% money purchase pension plan. The following chart demonstrates that the reduction in the includible compensation limit drastically affects Acme's plan.

In 1993, with includible compensation at $235,840, we see that total plan contributions amounted to $187,168, of which $87,168 or 46.6% went to the four owners.

In 1994, with no changes in the plan or compensation or participation, but only a change in the tax law to reduce includible compensation to $150,000, the result is dramatic. The total contribution is reduced to $160,000 and the owners' contribution is reduced to $60,000 or 37.5%. Owners #1 and #2, for example, each face an $8,584 reduction in contributions.

In light of that change, the basic choices Acme faces (assuming it does not want to terminate the plan or completely restructure the plan through integration, age-weighted rules, etc., the result of which is uncertain and will depend on additional factors such as ages, etc.) are as follows:

One is to provide the 1993 contribution to Owners #1 and #2 by increasing the contribution formula under the plan. The $23,584 contribution for 1993 represents 15.7% of the $150,000 1994 includible compensation limit. Increasing the contribution formula to 15.7%, therefore, means that an additional $57,000 would have to be contributed for the rank-and-file.

Another choice is to leave the plan as is. Of course, doing so means that the retirement security of the owners is jeopardized. It means that they are setting aside fewer dollars than they probably need in order to assure themselves of the financial security they are going to need to retire in the lifestyle they have in mind for themselves.

A third choice, and one which appears to have a lot of advantages, is a supplemental retirement plan for the owners. Let us look at how that would work.

THE NONQUALIFIED ERISA RESTORATION PLAN

The basic idea is to take the dollars that would otherwise have been contributed to the qualified plan for the owners and use them as part of a nonqualified supplemental retirement plan exclusively for the owners. Acme would use those dollars to purchase life insurance on each of the owners and use those corporate-owned policies to informally fund supplemental retirement benefits. The policies provide tax-deferred cash value buildup that can be accessed by Acme to provide benefits at retirement. The policies can also offer pre-retirement death benefits and/or cost recovery for Acme.

Note: It should also be noted that an executive bonus plan or a split-dollar life insurance policy may also be used to provide supplemental benefits. In some cases, especially for personal service corporations, such plans may be as or more effective than a SERP.

The actual retirement benefits that can be provided under a supplemental retirement plan informally funded by Acme with life insurance on the lives of the owners will depend, of course, on numerous factors. These include (i) Acme's marginal income tax bracket, (ii) the owners' tax brack-
ets, (iii) whether Acme wishes to use the policy values to pay benefits, (iv) whether Acme wishes to have the insurance used to provide it full cost recovery, among other considerations. In most cases, however, a well designed plan, using only the “lost” qualified plan contributions ($8,584 for Owners #1 and #2 and $5,000 for Owners #3 and #4), can provide substantial supplemental retirement income. The age and insurability of each of the owners are obviously also key factors.

Note: The specialists in Connecticut Mutual's Advanced Sales & Marketing Resource Center can work with the company's advisors to help design a plan that meets the client's funding, benefit and other objectives.

Beyond the attractive retirement benefits that such a plan can provide, there are other design approaches that can be appealing from the employer's perspective.

For example, the plan can be limited to a select group of management or highly compensated employees. This means that there are no contributions required for the rank-and-file. In fact, in order to qualify for the “top hat” ERISA exemption for this type of plan, it is essential that no rank-and-file employees participate. This is a very effective way to make up for the apparent “reverse discrimination” against the higher paid employees now built into the qualified plan rules.

The plan can also be designed with creative vesting provisions that build an effective “golden handcuffs” element into the plan. Such a plan can reward loyalty and commitment by enhancing benefits for key employees who remain with the employer for an extended period. In this era of competition for skilled employees, such a plan can not only provide retirement security for the executive but security for the employer as well, knowing that the executive has a financial incentive to remain with the company.

SUMMARY OF ADVANTAGES OF NONQUALIFIED ERISA RESTORATION PLAN

In summary, there are numerous potential advantages to replacing qualified plan benefits lost to tax law cutbacks with a nonqualified supplemental retirement plan. Among the most significant are the following:

- The plan can be funded with dollars already budgeted for retirement benefits but cut back due to tax law changes.
- The plan can be limited to selected employees.
- The plan can cost effectively replace the retirement benefits that executives are losing from qualified plans.
- The plan can build loyalty and commitment from key employees.
- The plan can be designed to provide full cost recovery to the employer.
- The plan can avoid ERISA and IRS complications.

CONCLUSION

A well designed supplemental retirement plan can replace the benefits lost to tax law changes affecting qualified plans. It is a plan that employers need to consider as part of an overall benefits package for key employees.