



Palais Royale Building
146 2nd Street North, Suite 104
St. Petersburg, FL 33701
727-867-1000, 727-867-2786 fax
www.hchcompanies.com
contactus@hchcompanies.com

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What's New at HCH:

- HCH becomes Registered Investment Advisor
- HCH is going daily on the internet—check out our website.
- HCH continues to add more investment opportunities—exceptional funds, lower fund fees, revenue sharing to offset expenses



Our Philosophy:

HCH Companies, Inc. is a benefits consulting firm that subscribes to the bundled/unbundled approach to qualified plan services. This approach recognizes the one-stop shopping benefits of a bundled product but avoids the pitfall of insufficient expertise of one company performing all functions for a client's retirement plan. Instead it emphasizes expertise in each aspect of a client's retirement plan. HCH forms alliances with these expert providers and comes up with a package that works for our client.

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JURASSIC PARK



By Rich Martin, A.S.A., M.A.A.A., M.S.P.A.

The title of this article was inspired by Steven Spielberg's famous movie in which once-extinct dinosaurs are being bred for fun and profit. Similarly, the defined benefit pension plan, which once ruled the small business world as the savings vehicle of choice, have virtually become dinosaurs and for several years have been nearly extinct. How-

ever, due to the factors discussed in this article, they are slowly but surely making a comeback. For the owner of a small business looking to secure his retirement over the next decade or so, they have a very significant role to play. They may not be much fun. They will, however, work to his profit.

A long time ago in a galaxy far, far away, small businesses loved the defined benefit plan. As a tool for reducing corporate taxes and providing for employees' retirement, its effectiveness was unexcelled. To be sure, it was somewhat inflexible and more than a little bit complicated.

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Let's look at what happened...

Section 401(k) and the Single Participant

By Rich Martin, A.S.A., M.A.A.A., M.S.P.A.

“The opportunity arises when a business owner is the only employee of his business and he desires to put away the maximum tax deductible amount for his retirement.”

Perhaps the most frequently overlooked opportunity for tax savings is the single-participant 401(k) plan. The opportunity arises when a business owner is the only employee of his business and he desires to put away the maximum tax deductible amount for his retirement.

The concept gained a great deal of viability as a result of the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The changes which brought the idea to life were:

1. Increases in the maximum **Elective Deferrals** under Code §402(g). The maximum amount which an individual may defer in 2004 is \$13,000. This amount is scheduled to increase to \$14,000 in 2005 and to \$15,000 in 2006. Further increases due to cost of living adjustments may occur after 2006.
2. Establishment of the **“Catch-Up” Contribution**. These are additional Elective Deferrals which may be made by any plan participant who has attained age fifty. These contributions do not count against any other applicable limitation. The maximum “Catch-Up” in 2004 is \$3,000. This amount is scheduled to increase to \$4,000 in 2005 and to \$5,000 in 2006. Further increases due to cost of living adjustments may occur after 2006.
3. Increases in the **Annual Additions Limit** under Code §415. This amount

is the lesser of 100% of compensation or \$41,000 in 2004 and is subject to future cost of living increases. Regretfully, Elective Deferrals are counted against this limitation; however, “Catch-Up” contributions are not. This means that a fifty-year old owner can potentially get contributions of as much as \$44,000 in 2004.

4. Increase in the **deduction limit** to 25% of compensation. Making matters even better, Elective Deferrals (including the “Catch-Up”) are considered compensation for purposes of this calculation. Making matters better still, Elective Deferrals and “Catch-Up” Deferrals are not counted against this limit.

Putting it all together, let's consider the fifty year old owner of a C-Corporation who would otherwise have \$140,000 of taxable income in 2004. With a traditional [not 401(k)] profit sharing plan he could pay himself compensation of \$112,000 and contribute \$28,000 to the plan. This consumes the maximum 25% of compensation deduction limit (25% of \$112,000 is \$28,000).

With a single-participant 401(k) plan he may also elect to defer the maximum \$13,000 as a contribution to the plan. Since he has attained age 50 (*i.e.*, he was born in 1954 or earlier) he may also defer \$3,000 as a “Catch-Up” contribution.

With this type of plan, the owner has gained a tax deductible contribution for himself of \$44,000 (\$28,000 plus \$13,000 plus \$3,000 equals \$44,000) and has

reduced his taxable income from \$140,000 to \$96,000. (It must be noted that social security tax is calculated on the \$112,000 compensation.)

Payment of compensation in excess of the \$112,000 illustrated will not allow an increase in the amount of contributions inasmuch as the amounts shown are the maximums available.

The analysis is only slightly more complex in the case of a sole proprietor or in the case of an S-Corporation inasmuch as the impact of Social Security tax must be considered. The concept is the same, however.

When the owner's compensation is lower, the concept works on a smaller scale. At the extreme, it may be possible to contribute nearly 100% of compensation. For example, when the owner's compensation is \$24,000, the employer contribution may be \$6,000 (25% of \$24,000). In addition, the \$16,000 elective deferral is available. The total contribution is \$22,000, leaving \$2,000 available to pay the owner's social security tax or for other purposes. Such an opportunity for tax savings is useful in situations where the business income is not needed for the owner's living expenses.

As can be seen from the figures, the single-participant 401(k) plan is far superior to the “cookie-cutter” simplified arrangements when it comes to delivering tax savings.

There is still time to take advantage of this opportunity for 2004. Contact us now to find out more about this wonderful tax advantage.



401(k) Plans and Late Deposits of Deferrals

Following are excerpts from a Corbel technical update regarding the Department of Labor's views on late deposits to a 401(k) Plan. A good rule of thumb to follow is that you should deposit deferrals into your 401(k) Plan as frequently as payroll. Contact us if you have any questions regarding your deferral deposits into your 401(k) Plan.

"DOL Ratchets Up Pressure on Late Deposits of 401(k) Elective Deferrals (1/26/2004)

The Department of Labor (DOL) has added language to the 2003 Form 5500 instructions to require plan auditors to review deposits of participant contributions (e.g., 401(k) plan elective deferrals) and to confirm that the employer has deposited the contributions timely. Enlisting the plan auditors to assist in enforcing this regulatory requirement will place greater pressure on employers to comply with the requirement and to correct any late deposits. Furthermore, with recent accounting scandals, employers probably should anticipate strict interpretation of the rules on the part of the auditors.

Over the past several years, the DOL has devoted more resources to enforcing the rule regarding the timing of the deposit of 401(k) elective deferrals. One of the methods the DOL uses to regulate this requirement is the Form 5500. Question 4a on Sched-

ules H and I inquires as to whether the employer has failed to deposit participant contributions in accordance with time period prescribed by the regulations. The regulations require an employer to deposit the contributions on the earliest date the employer can reasonably segregate the contributions from its general assets, but in no event later than the 15th business day of the month following the month in which the employer withheld the contributions from employee's paycheck. Unfortunately, many employers and practitioners have erroneously interpreted the regulation to permit them to have until the 15th business day of the following month to deposit the participant contributions, even if they could have segregated the funds sooner....

The DOL now has added language to the 2003 Schedule H and I instructions requiring a plan auditor to confirm the accuracy of the employer's response to question 4a.... Small plans that qualify for the audit waiver under line 4k do not have to be concerned with the plan auditor review, but of course the employer still must respond truthfully....

If an employer corrects the late deposit of participant contributions by filing under the Voluntary Fiduciary Correction Program (VFCP) and complying with the requirements of Prohibited Transaction Exemption 2002-51, the employer does not have to pay the prohibited transaction excise tax. Even if the employer qualifies for the excise tax exemption, the employer must report the

late deposit on question 4a (i.e., answering question 4a with a "yes").

Since the excise tax is nominal, most employers correct using the methodology of the VFCP but do not file under the program. We recommend if employers deposit participant contributions late, they should: (1) correct using the principles of VFCP, (2) pay the excise tax, and (3) footnote the Schedule H or I to indicate to the DOL that the correction has taken place."



"Over the past several years, the DOL has devoted more resources to enforcing the rule regarding the timing of the deposit of 401(k) elective deferrals."





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Palais Royale Building
146 2nd Street North, Suite 104
St. Petersburg, FL 33701

Phone: 727-867-1000
Fax: 727-867-2786
Email: contactus@hchcompanies.com

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However, the bottom line was impressive. Profit sharing and money purchase plans were unable to match the available savings. Neither could the "new kid on the block", the 401(k) plan.

Reagan-era tax policy changed all that. Seeking to "reduce tax expenditures" (i.e., raise taxes), Congress slashed the maximum benefit limit, raised retirement ages and imposed a new full funding limitation. The Internal Revenue Service, not to be denied an activist role, embarked on a Small Plan Audit Program aimed at curbing abuses (real or imagined) of the tax code. The Service also took a minor change in the language of the tax code governing nondiscrimination and expanded it into a thorough overhaul of the regulations affecting plan design.

The audit program was mercifully laid to rest by the Tax Court (Final Score: Taxpayers 8, IRS 0). However, the damage was done. Lower benefits, tougher nondiscrimination rules and higher interest assumptions eliminated the defined benefit plan's edge over its defined contribution cousins. For practical purposes, they became extinct (at least for small business).

Over the past few years, conditions for a comeback slowly developed. The more onerous provisions of the eighties' tax legislation were repealed. Benefit limits were increased to reasonable levels (less than in the good old days, but reasonable). Interest rates declined. Business owners who were foregoing the benefit of a retirement plan realized that

the time left before retirement was growing short.

In addition, the weaknesses of defined contribution arrangements were underscored by the losses many of them incurred during 2000-2002.

The problem: business owners, now in their fifties, grasp the need for retirement savings in excess of what's available in a 401(k) plan.

The solution: The Defined Benefit Plan.

Let's look at some numbers... A defined benefit plan is regulated by limiting the amount which may be distributed to a participant at retirement. This amount is at its maximum value at age 62, when it is approximately \$2,000,000. For a fifty year old owner, this translates to a tax deductible contribution of more than \$100,000 annually. For owners who are slightly older, the available deduction increases.

On the other hand, a defined contribution plan is regulated by limiting the annual contribution which may be made and deducted. The limit is currently \$41,000 [\$44,000 for a 50-year old in a 401(k) plan].

For a fifty-year old owner, saving the maximum \$44,000 per year under a 401(k) plan, to accumulate \$2,000,000 by age 62, he would have to consistently earn about 19% per year on his investments.

In a defined benefit plan, the sponsor adjusts his contribution upwards or downwards in response to investment results which vary

from the somewhat conservative actuarial assumption. In a defined contribution plan, this capability is denied.

If his defined benefit plan investments perform at a high level, the contributions will decline as the plan becomes overfunded. In this event, a new defined contribution plan may be considered to supplement the defined benefit plan.

If the investments fail to perform, the defined benefit plan sponsor may be able to make additional contributions to make up the loss. The 401(k) plan sponsor has no such "second chance".

The foregoing analysis has, of course, been greatly simplified to allow the reader to visualize the defined benefit plan's potential for delivering both immediate tax savings and eventual retirement security for an aging businessman. The superiority of the concept compared to defined contribution arrangements is apparent.

They're not for everyone, however, and one size certainly does not fit all. Each plan must be custom designed to suit the needs of a particular sponsor. The presence of other employees in the business makes the decision more complex. Depending on their ages they could be relatively expensive or inexpensive. The options available and the associated cost should be reviewed before a decision to sponsor a plan is made.

Contact us now to see if this plan design will be fit your retirement objectives.