STIFEL

Retirement Plans Quarterly

Fourth Quarter 2014

IRS ANNOUNCES COST-OF-LIVING ADJUSTMENTS FOR 2015

On October 23, 2014, the Internal Revenue Service announced cost-of-living adjustments applicable to dollar limitations for plans and other items for tax year 2015. In general, many of the pension plan limitations will change because the cost-of-living index met the statutory thresholds that trigger their adjustment. However, other limitations will remain unchanged.

Annual Limit	2014	2015
Social Security Wage Base	$117,000	$118,500
Annual Compensation Limit	$260,000	$265,000
Key Employee Compensation Limit	$170,000	$170,000
HCE Compensation	$115,000	$120,000
Elective Deferral Limit (401(k), 403(b) & 457)	$17,500	$18,000
Catch-Up Contributions (401(k) & 403(b))	$5,500	$6,000
SEP Minimum Compensation	$550	$600
SIMPLE IRA Deferral Limit	$12,000	$12,500
Catch-Up Contributions (SIMPLE IRA)	$2,500	$3,000
Annual DB Benefit Limit	$210,000	$210,000
Annual DC Contribution Limit	$52,000	$53,000

IRA CONTRIBUTION LIMITS REMAIN UNCHANGED FOR 2015

According to IR-2014-99, the Traditional and Roth contribution limit remains unchanged at $5,500 for 2015. Taxpayers may contribute to either traditional and/or Roth IRAs up to a combined limit of $5,500 for tax year 2015.

Annual Limit	2014	2015
IRA/Roth Contribution Limit	$5,500	$5,500
IRA/Roth Catch-Up Contributions	$1,000	$1,000

IRA deductibility income limits have been raised to the following:

Traditional IRA Deductibility	Single Filer's AGI:	Married Filing Jointly AGI:
Full Contribution	< $61,000	< $98,000
Partial Contributions	$61,000–$71,000	$98,000–$118,000
Not Eligible	> $71,000	> $118,000

If one spouse is covered by an employer-sponsored plan: Maximum Joint Compensation for deductible contribution by non-covered spouse: $183,000–$193,000

Roth Eligibility	Single Filer's AGI:	Married Filing Jointly AGI:
Full Contribution	< $116,000	< $183,000
Partial Contributions	$116,000–$131,000	$183,000–$193,000
Not Eligible	> $131,000	> $193,000

ROLLOVERS OF AFTER-TAX DOLLARS

A Qualified Plan (QP) participant, upon a triggering event, is able to roll over assets into a traditional or Roth IRA. However, if a participant's plan balance includes both after-tax and pre-tax amounts, then each distribution from the account must include a pro rata share of both after-tax and pre-tax amounts. If the distribution is rolled into an IRA, the after-tax portion must be tracked for the life of the IRA. Historically a single distribution could not be split with the pre-tax amount going into a traditional and after-tax portion into a Roth IRA. This requirement has been a burden for plan participants for some time. Previous IRS guidance only allowed a few options to the participants taking a distribution of after-tax amounts:

1. Direct Rollover of pre- and after-tax dollars to a traditional IRA (Requires tracking of after-tax amount for life of IRA).
2. Distribution of entire QP balance (minus 20% mandatory tax withholding) to individual followed by an indirect rollover of pre-tax amounts to the IRA, (Effectively allowing the separation of pre- and after-tax amounts, however the 20% withheld amount must be paid out of pocket in order to complete the indirect rollover.)
3. Partial distribution of QP balance to the individual (Requires pro rata distribution. Does not allow the separation of pre- and after-tax amounts.)

Each of these methods contained steps that were required to be followed for accurate tracking of after-tax amounts rolling from a QP to a traditional or Roth IRA.

New Rules

The IRS recently released Notice 2014-54. Effective January 1, 2015, a plan participant may separate his or her pre-tax and after-tax dollars and direct them respectively into a traditional IRA and Roth IRA.

The following example from IRS Notice 2014-54 helps to illustrate this practice:

> *An employee's qualified plan balance consists of $200,000 of pre-tax amounts and $50,000 of after-tax amounts. The employee separates from service and requests a distribution of $100,000. The pre-tax amount of the distribution is $80,000 (four-fifths) and the after-tax amount of the distribution is $20,000 (one-fifth). The employee is permitted to allocate the $80,000 that consists entirely of pre-tax amounts to the traditional IRA so that the $20,000 rolled over to the Roth IRA consists entirely of after-tax amounts.*

Basically, this allows QP participants to isolate after-tax amounts and make tax free Roth IRA conversions directly from their plans, while directly rolling the pre-tax amounts to their traditional IRA according to language found in the notice:

> *If the direct rollover is to two or more plans, then the recipient can select how the pre-tax amount is allocated among these plans. To make this selection, the recipient must inform the plan administrator of the allocation prior to the time of the direct rollovers.*

As stated above, it is important for a QP participant to inform the administrator specifically how pre- and after-tax amounts are to be directly rolled. If the QP participant only indicates a total dollar amount, the administrator may proceed by utilizing a pro rata distribution of pre- and after-tax amounts.

Timing Is Everything

Another component of the guidance is the number of distributions from the plan. To achieve the separation of pre- and after-tax dollars, the rollovers must be initiated at the same time:

> *. . . all disbursements of benefits from the plan to the recipient that are scheduled to be made at the same time (disregarding differences due to reasonable delays to facilitate plan administration) are treated as a single distribution without regard to whether the recipient has directed that the disbursements be made to a single destination or multiple destinations.*

If a QP participant does not schedule the transfers to occur at the same time, he or she does not receive the benefit of the change in rules. The new guidance will not be applicable to the distribution.

This is good news for QP participants with after-tax dollars in their plans. Now instead of being stuck with a lifetime of pro rata tracking of after-tax dollars inside a traditional IRA, they have the ability to indicate where the pre- and after-tax dollars will roll if done properly.

IRS Notice 2014-54 can be found at the following web site: http://www.irs.gov/pub/irs-drop/n-14-54.pdf

THE ELEMENTS OF QUALIFIED RETIREMENT PLAN DESIGN

Start From the End

The first step in plan design is to determine the end result. Can the plan favor the employer, or will it be a true employee benefit plan where its economic value is based on attracting and retaining valued employees?

Favoring the Owner

If the ratio of owner(s) to employees is 1:5 or fewer, then a plan can often be implemented where the owner's tax savings can exceed his or her contribution to the employees.

For example, two partners make a contribution of $127,000 to their profit sharing plan (PSP), of which $25,000 is allocated to their employees. The owners' net tax savings (based on a 35% rate) is $19,450, calculated as follows: .35 x $127,000 = $44,450 - $25,000. If a tax deductible administrative cost of $1,500 is added to the mix, the plan remains very cost effective.

Once you are on the "favoring the owner" path, the next questions can determine which type of plan will work best. The questions for the owner(s) include: How much do you earn? How much do you want to contribute? Do you want flexibility in the amount of your contribution? How old are you?

Employee Benefits

When the ratio of employer to employees is 1:6 or greater, then it becomes increasingly difficult to skew the contribution to the owner's favor. The next questions for the employer on the "employee benefit" path include: Can you afford to make contributions to the employees and, if so, how much? Is

maximizing employee participation important? Is allowing the maximum Highly Compensated Employee* (HCE) deferral amount important? Do you want your contributions to favor the employees who make deferrals? Do you want flexibility in the amount and type of your contributions?

* *Highly Compensated Employees include: 1) a 5% owner of the employer, or 2) an employee earning > $115,000 (2014) in the prior year (and, if employer elects, in the top 20% of employees as ranked by pay). All other employees are considered Non-Highly Compensated.*

Defined Contribution (DC) Plans That Can Favor the Employer

Profit Sharing Plans are best suited to the employer who wants flexible contributions and also allows employer contributions that can be significantly skewed to favor the owner via cross-testing (explained below). Contributions may vary from 0% to 25% of eligible employee compensation (maximum of $260,000 in 2014) per year, but contributions must be "recurring and substantial." Therefore, the plan may not be utilized for a one-time contribution in a "wind-fall" year. Allocations to individuals may be up to the lesser of 100% of compensation or $52,000 (2014). PSPs may use a vesting schedule, requiring employees to attain six years of service to receive their full benefit. Forfeited (non-vested) amounts may be reallocated to remaining participants (or reduce future contributions), meaning the business owner can potentially recover some of their terminated participants' contributions.

401(k) Plans are generally PSPs with special features that allow for employee deferrals, matching contributions, etc., so all PSP features apply. However, in addition to deferrals, an employer may choose a 401(k) plan over a PSP for at least two reasons.

First, the availability of catch-up contributions (up to $5,500 for those ages 50 or more), increasing the maximum allocation to $57,500. Secondly, a Safe Harbor 401(k) can further skew contributions in the owner's favor. For example, if a 50-year-old employer's salary is $100,000 and she makes a 3% Safe Harbor contribution to her eligible employees, she can then defer the maximum of $23,000. In other words, she can make a 23% contribution to herself while making only a 3% contribution to her employees.

Money Purchase Plans and Target Benefit Plans offer the same tax deductions and contribution-skewing opportunities as PSPs but require employer contributions each year. Therefore, PSPs are almost always preferred for their flexibility.

Defined Benefit (DB) Plans That Can Favor the Employer

Defined Benefit Plans (DB) are best suited to highly successful employers who are at least age 40, do not need contribution flexibility, and want to maximize their tax deductions. With a DB, as the name suggests, the retirement benefit is defined, e.g., 100% of the average of the three highest years' compensation (up to a 2014 benefit cap of $210,000 per year). The annual contribution generally must be calculated by an actuary, which increases administration costs. There is no limit to the contribution amount as long as it is actuarially necessary to fund for future benefits. This allows DBs to potentially quadruple DC Plan tax deductions. Similar to cross-testing, a DB can skew benefits and the associated contributions to the owner's favor. Contributions are mandatory and the plan must generally be funded for at least three to five years before it can be terminated.

SEP IRA and SIMPLE IRA Alternatives

SEP and SIMPLE IRAs require no plan administration, so they can be less expensive than the plans noted above. However, they may not be so cost effective in other ways. A SEP IRA Plan offers the same tax deduction opportunities as a PSP but can be far less efficient in skewing contributions. The SEP has no cross-testing ability and contributions are generally allocated on a pro rata basis. Additionally, there is no vesting permitted, so there is no incentive for employees to remain with the employer, and there cannot be a return of forfeited amounts to the employer. However, unlike a PSP, a SEP can be funded to handle a "windfall" and then never be funded again.

A SIMPLE IRA Plan can be an alternative to a Safe Harbor 401(k), and, in addition to the lack of plan administration, can be more cost effective, since employer contributions can be a smaller percent of employee pay. However, the maximum possible allocation to the owner in a SIMPLE IRA is $29,000 compared to $57,500 for a 401(k).

Employee Benefit Plan Design Often Boils Down to the Following

Q: Is the employer willing and able to make contributions to the employees?

A: For an employer who will not or cannot make contributions, a 401(k) plan can still be an option. Employees can defer up to $17,500 ($23,000 if 50 or older), which is far more than the $5,500 ($6,500 if 50 or older) available outside of an employer-sponsored plan via an IRA. The only cost to the employer will be plan administration which can be paid from plan assets. For employers whose ability/desire to contribute may vary from year to year, contributions can be flexible in amount.

Q: Is maximizing employee participation and savings important?

A: "Auto-enrollment" helps employees save for retirement by automatically enrolling them in a 401(k) plan, usually deferring 3% of pay, unless they choose to opt out. Employees who, through ignorance or inertia, may not have enrolled can now benefit from retirement savings. Additionally, maximizing employee participation and savings often requires the employer to make matching contributions. The greater the matching contribution, the greater is the incentive for employees to defer their compensation. However, the matching contribution formula is also important. For example, with the same potential employer outlay, matching 50 cents on the dollar up to 8% of compensation can have a better result than matching dollar for dollar up to 4%. In addition, matching contributions can be a solution for employers who want to reward employees who save rather than making a contribution to all employees irrespective of their saving.

Q: Is maximizing the Highly Compensated Employee (HCE) deferrals important?

A: Maximizing HCE deferrals may mean adopting a Safe Harbor (SH) 401(k) plan, as it automatically passes the Actual Deferral

Percentage (ADP) Test. The ADP test generally limits the average HCE deferral to 2% more than the average Non-Highly Compensated Employee (NHCE) deferral. The SH 401(k) requires the employer to make a 100% vested contribution to the NHCEs of either a dollar-for-dollar match for up to 3% of salary plus 50 cents on the dollar on the next 2% of salary deferred, or 3% to all eligible employees.

Cross-Testing can skew an employer's profit sharing plan contributions to his or her favor. It is called "cross-testing" because, instead of the typical defined contribution non-discrimination consideration of contributions, projected benefits at retirement are tested like a defined benefit plan. Cross-testing recognizes that dollars contributed to a 25-year-old can be more valuable than dollars contributed to a 45-year-old due to the time value of money. In addition, not all, but only a certain percentage of the NHCEs need to have a benefit accrual rate that is equal to the HCEs. The chart below shows how efficiently cross-testing can get the two owners the maximum allocation of $52,000 vs. the same outlay of $111,950 using a standard allocation formula

Employee	Salary	Age	Standard Profit Sharing	Cross-Tested Allocation
Owner	$260,000	54	$47,022.62	$52,000.00
Owner	$200,000	53	$36,171.24	$52,000.00
Employee 1	$64,000	59	$11,574.80	$3,200.00
Employee 2	$45,000	43	$8,138.53	$2,250.00
Employee 3	$28,000	37	$5,063.97	$1,400.00
Employee 4	$22,000	31	$3,978.84	$1,100.00
Totals	$619,000		$111,950.00	$111.950.00
Owners			**74.31%**	**92.90%**

Plan design is to qualified retirement plans as "location" is to real estate. It can be the key in determining whether the plan can perform to the fullest advantage of the employer.

PLAN TERMINATION

Retirement plans must be created with the intent of continuing indefinitely. The IRS does not look favorably upon retirement plans being set up by business owners who contribute a year or two's excessive profits only to quickly terminate the plan. However, plans may be terminated for legitimate business reasons, such as filing for bankruptcy, closing a company division, or if the sponsoring employer wishes to open a different type of retirement plan. Sometimes a plan amendment may also accomplish the desired changes in the plan in lieu of plan termination and new plan setup. But if it is determined that a plan termination is necessary, these general steps must be followed:

1. Amend the plan document to do the following:
   a. Establish a termination date.
   b. Update the plan for law changes effective on or before the termination date.
   c. Cease plan contributions.
   d. Fully vest all employee account balances.
   e. Authorize the plan to distribute account balances.
2. Notify all participants and beneficiaries about the termination.
3. Distribute a rollover notice to all participants and beneficiaries.
4. Fund any outstanding required employer contributions.
5. Allocate any forfeitures to plan participants.
6. Fully vest any account balances regardless of employee status.
7. Distribute assets as soon as administratively feasible (generally within 12 months of termination date).
8. File a final Form 5500 after all assets have been distributed.
9. File an Application for Determination for Terminating Plan with the IRS to make a determination on the plan's qualification status. This step is optional.

The third-party administrator (TPA) and/or retirement plan vendor associated with the terminating plan will assist with most or all of the required steps. The TPA and retirement plan vendor will also have additional requirements for plan terminations, so it is best to inform both early on and document all actions taken.

Note: If the employer wishes to terminate a 401(k) plan and subsequently set up a new 401(k), money purchase, profit sharing, or other qualified defined contribution plan, the employer must wait 12 months after all assets have been distributed from the terminated plan before establishing the new plan. SEP IRAs, SIMPLE IRAs, 403(b) plans, and 457(b) plans can be set up without the 12-month wait period, however.

The information contained in this newsletter has been carefully compiled from sources believed to be reliable, but the accuracy of the information is not guaranteed. This newsletter is distributed with the understanding that the publisher is not engaging in any legal or accounting type of work such as practicing law or CPA services.

STIFEL
Investment Services Since 1890

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com
One Financial Plaza | 501 North Broadway | St. Louis, Missouri 63102