Turbocharged 401k

Individual 401k Plans

Posted September 17, 2018

Oftentimes business owners want to put away a ton of money in individual 401k plans, but cannot due to inherit limitations within the plan. Or business owners want to keep most of the plan money for themselves, which is shocking yet natural. For example, to have the company make a 10% profit sharing contribution, every eligible employee will also receive a 10% contribution which is usually undesirable. You only thought having a staff was a pain because of drama and turnover. Add this dilemma to the list.

You work hard to make money, and you shouldn't have to work too hard to keep most of it. There are turbocharger kits you can add to your normally aspirated 401k plan. These usually work best with an underlying safe harbor 401k plan. Here we go-

- Age-Weighted / New Comparability Profit Sharing Plan, and
- Defined Benefits Pension / Cash Balance Plan

Age-Weighted

A profit sharing plan based on age allows older employees to receive more of the profits than younger employees (hence the tricky name of age-weighted). Another way to look at this is to consider those closer to retirement possibly needing the most assistance in saving for retirement. This also makes sense since older employees are usually more valuable, and therefore profit sharing plans can be used to discriminate in their favor.

New Comparability

The new comparability profit sharing formulas take age-weighted formulas one step further by grouping certain employees together such as officers, executives, clerical, etc. Officers are given a higher portion of the profit sharing, and within the officer group the older employees are given a higher portion. A double shot. For example, a crusty officer will have a much larger contribution than a new administrative assistant.

In a real life case that the Watson CPA Group worked on, a husband and wife business with over $600,000 in net profits were able to keep 75% of all plan contributions. Read more in Chapter 9 of our book on small business retirement including individual 401k plans here-

Turbo Charged 401k Plans

Defined Benefits Pension / Cash Balance Plan

If the age-weighted or new comparability profit sharing plans supercharge a 401k plan, the defined benefits pension and cash balance plan turbocharges it. We can hear gear heads moaning all over the country above turbo and super charging your engine. Regardless, the defined benefits pension and cash balance plan adds a ton of meat to your 401k platter. Here we go.

A defined benefit is in contrast to a 401k plan since a 401k plan is a defined contribution. A defined contribution plan specifies the amount going into the plan and has nothing to do with how much will be available when you start taking withdrawals. It could be $0 or millions. A defined benefit is a calculus where some future benefit is defined, and is usually a stream of payments similar to an annuity.

A cash balance plan is a form of a defined benefits pension, with one major difference. The participant can see his or her account balance grow over time similarly to an IRA or 401k plan. A cash balance plan can be considered a hybrid since it does not rely on formulas and salary histories although it falls under a defined benefits umbrella by definition.

Similar to age-weighted and new comparability profit sharing plans, cash balance plans use a person's age to determine the amount that can be contributed and use actuary consultation to defend the plan's discrimination.

Some quick examples- a 50 year old could put away $201,000 which saves about $90,450 in taxes. A 40 year old could do $136,000 and save over $61,200 in taxes. Here is the full 2017 table-

Age	401(k)	Cash Balance	Total	Tax Savings @ 45%
65	60,000	251,000	311,000	139,950
64	60,000	257,000	317,000	142,650
63	60,000	263,000	323,000	145,350
62	60,000	268,000	328,000	147,600
61	60,000	254,000	314,000	141,300
60	60,000	241,000	301,000	135,450
59	60,000	228,000	288,000	129,600
58	60,000	217,000	277,000	124,650
57	60,000	205,000	265,000	119,250
56	60,000	195,000	255,000	114,750
55	60,000	184,000	244,000	109,800
54	60,000	175,000	235,000	105,750
53	60,000	166,000	226,000	101,700
52	60,000	157,000	217,000	97,650
51	60,000	149,000	209,000	94,050
50	60,000	141,000	201,000	90,450
49	54,000	134,000	188,000	84,600

48	54,000	127,000	181,000	81,450
47	54,000	120,000	174,000	78,300
46	54,000	114,000	168,000	75,600
45	54,000	108,000	162,000	72,900
44	54,000	102,000	156,000	70,200
43	54,000	97,000	151,000	67,950
42	54,000	92,000	146,000	65,700
41	54,000	87,000	141,000	63,450
40	54,000	82,000	136,000	61,200
39	54,000	78,000	132,000	59,400
38	54,000	74,000	128,000	57,600
37	54,000	70,000	124,000	55,800
36	54,000	66,000	120,000	54,000
35	54,000	63,000	117,000	52,650

Before you lose your mind on the tax savings (which is assumed to be at 45% total), you need the cash to do so. To save $90,450 at age 50 you need to part ways with $201,000 in cash. And if your spouse is on the payroll, you can double it. There are data available for those under 40, we started there for simplicity.

In a recent case that the Watson CPA Group consulted on the owners were able to keep **92.5%** of the money contributed to the 401k and cash balance plans. That is ridiculously good! Total tax savings was 51% since this case was also in California, or about $92,000 combined for just the owners' portion. The annual cost to administer this in 2016 was $1,750 for the 401k plan portion and $4,300 for the cash balance plan. Cash balance plans are pricey since actuary consultants are used to defend the plan's discrimination. Worth every penny.

See the tables and more information which is reprinted in our book here-

Turbo Charged 401k Plans

Controlled Groups

Another concern is controlled groups. If you think you are clever and create a holding company to only offer retirement savings plans to certain employees (like your family), the IRS says No. There are controlled group rules where a holding company that controls another company must offer the same retirement programs for both companies.

Exotic Stuff

There are all kinds of exotic stuff out there. Be careful. If it sounds too good to be true, check it out. Do your research. Talk to us. Yes, there are several legitimate yet exotic plans out there. A lot of them use life insurance as the vehicle. Life insurance has many unknowns and can prove difficult to tease out the problems or issues. And with life insurance there must be an insurable interest by the policy owner and some of the life insurance-based plans cannot be used in a pass-thru entity such as S Corporations and disregarded entities such as single member LLCs.

Here are some things that might be a good fit for you and your business-

Employee Stock Ownership Plans

You can also set up an employee stock ownership plan (ESOP) where employees can purchase company stock over time, and the stock is held in trust. A cool feature is the tax deferral of this system- the employee-owned portion of the company profit's is added to the ESOP's overall asset balance, and is only taxed when the employee makes withdrawals similar to an IRA. Check out the National Center of Employee Ownership here-

NCEO ESOP Article

Section 79

Internal Revenue Code Section 79 offers huge deductions of policy premiums and instant tax savings. A Section 79 plan is where life insurance is offered as a group policy, but employees are able to obtain more benefits that are taxable as income. But, there is cash value to the policies that allow for borrowing in the future. There is one inherit problem- when a life insurance policy for a company under ten employees is underwritten, no medical exam is necessary which means the policy has high risk. And to balance that, the policy will have poor cash accumulation. Short-term gains, potentially long-term failures. Are all Section 79 plans bad? No. Just do your homework and ask those pointed questions.

Captive Insurance Company

If you have high property and casualty insurance needs, you can create another corporation that is essentially in the insurance business by collecting premiums from your primary company and investing those premiums into quality investments. The primary company gets a tax deduction since insurance premiums are an expense, and if the premiums are less than $1.2 million per year, the captive insurance company only has to pay taxes on the investment income. The captive insurance company might also be able to take out a key-person life insurance policy as well. As you can imagine, there a bunch of hoops to jump through and lots of due diligence, but a captive insurance company might prove worthwhile.

Controlled Executive Benefits and Endorsement Split-Dollar

These programs are similar in the sense that life insurance is used to retain key employees by controlling the access to the cash value. The tax deferral or tax savings might not be available with type of arrangement, and depending on how it is setup, the payout to the beneficiary might be taxable as well. This is very complicated, and your garden variety financial planner might not be comfortable with these. Your best bet is to speak directly to an advisor who works for a life insurance company such as Transamerica, Northwestern Mutual, New York Life, etc. Or at the very least get a second opinion.

Again, do you homework and ask around before jumping into a life insurance-based product. They have their place, and they can provide huge tax savings especially during high marginal rate tax years. But not all products and plans are the same.