CLARITY IN NUMBERS, LLC

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A CLARITY WHITEPAPER:

How Can Business Owners Fight Their 2013 Tax Increases?

Invest in a Cash Balance Plan.

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Introduction:

For more than two decades, cash balance plans have been a powerful tax-deduction tool for plan sponsors. Recent IRS legislation has not only confirmed cash balance plans as legitimate retirement vehicles, but has made them even more flexible, resulting in a surge of new plan adoptions.

The American Taxpayer Relief Act of 2012 (ATRA) is now law. Compromises have been made. However, with higher taxes on income over $400,000 ($450,000 for joint filers), and new levies on capital gains, high earners will owe more to the government in 2013 unless action is taken.

This whitepaper will outline how a Clarity Cash Balance™ can help reduce a plan sponsor's tax liability in this new world, and even discuss how in certain cases, the increase in taxes due to ATRA can be eliminated altogether.

Over the next 10 years, some high-income plan sponsors can put over $150,000 back in their pockets.

Now that the initial phase of the "fiscal cliff" panic has subsided, many high-earning business owners are feeling a mix of relief and bitterness given the changes ahead for 2013. With tax rates increasing, it is even more critical these owners take a closer look at a Clarity Cash Balance™.

What taxes have increased?: The American Taxpayer Relief Act of 2012 (ATRA) allowed taxes to increase on several levels. While some may focus on President Obama's compromise in raising the income threshold on the tax rate rollback (up from $200,000 on individuals/$250,000 for families, to $400,000/$450,000), they may not realize several other increases took effect on January 1, 2013 as scheduled.

Federal Income Tax

As most are aware, tax rates assessed by the federal government increased from 35% to 39.6% on income over the $400,000/$450,000 level for all Americans.

Medicare Tax and Surcharge

Those over the original income threshold levels of $200,000 for individuals and $250,000 for families will still be forced to pay more into Medicare starting in 2013. This assessment comes in two forms:

Higher Medicare Tax Rate

Individuals and families will pay an additional 0.9% on earnings above these thresholds. There is no cap on the earnings subject to this tax. As an example, an individual earning $1,000,000 will see their Medicare HI tax increase from $14,500 to $21,700.

Medicare Surcharge on Capital Gains

There will be a new, 3.8% additional surcharge on all capital gains for taxpayers over the $200,000/ $250,000 earnings level. This tax was never assessed before this year.

Capital Gains Tax

For individual filers with earnings over $400,000 and families over $450,000, the tax rate on capital gains increases from 15% to 20%. This increase applies to ALL capital gains starting from the first dollar. This is also on top of the 3.8% Medicare surcharge. Therefore, taxpayers above these thresholds will see their capital gains tax rate increase from 15% to 23.8%, while taxpayers between the $200,000/ $250,000 level and the $400,000/$450,000 level will go from 15% to 18.8%.

How does a Clarity Cash Balance™ Plan help?

Cash Balance Plans have long been an effective tool for mitigating tax liability. Given the unique mix of added taxes and surcharges under ATRA, business owners can use the following strategies to minimize the impact:

1. Adopt a Clarity Cash Balance™ or increase existing pension formulas

   Even without the higher tax rates, adopting these plans or maximizing existing contributions makes sound fiscal sense. But now that taxes have increased on income and capital gains, it may also be time to investigate whether there is room for increasing any existing benefit formulas. Maximum pension payments have increased from $195,000 per year to $205,000 per year since 2010. So for those who implemented plans more than 2 years ago, now may be a time to consider a redesign.

2. Reduce income to avoid threshold triggers

   Tax deductions from a Clarity Cash Balance™ can be used to reduce income below the key thresholds, and prevent the tax rate increases from triggering. For example, if a business owner with a net income of $300,000 adopts a Cash Balance Plan with an annual contribution of $120,000, he/she falls below the $200,000 breakpoint, and avoids all of the above tax hikes.

3. Put money in your Plan instead of outside investments

   Investment income within a Clarity Cash Balance™ is not subject to capital gains taxes until it's distributed, which is typically after retirement while at lower income levels. As a result, not only are the capital gains tax hikes on these investments deferred by investing in the Plan, they may be completely avoided altogether when paid. Those over the $400,000/$450,000 breakpoint not only escape the 20% capital gains tax rate on money earned from these deposits, but the 3.8% Medicare surcharge as well.

   *Case studies**:

   Lisa, a 50-year-old business owner earning $500,000 per year, decides to deposit $140,000 each year (approximate maximum allowed) in a Cash Balance Plan instead of outside capital investments. She maintains the plan for 10 years.

   Result: Lisa reduces her income to under the $400K threshold and avoids the federal tax increase allowed by ATRA. Future earnings on these deposits are removed from consideration for capital gains tax, and the Medicare surcharge.

   The ATRA-induced **tax increases are reduced by approximately $110,000 over the 10 year period**

   Richard, a 55-year old managing partner at a mid-sized law firm, earns $750,000 per year. He works with an actuarial consulting team to design a max-benefit Cash Balance Plan for himself and his partners. His annual deposit is $175,000 (approximate maximum allowed), and decides it would be best to invest in his retirement plan rather than in outside capital funds. He plans to retire from the firm at age 65, in 10 years.

Result: While Richard will remain above the $400K threshold, he drastically mitigates the tax increases allowed by ATRA.

By reducing his capital gains by moving these deposits to the Plan, and by drastically reducing his taxable income, **Richard will effectively eliminate $150,000 of the new taxes during 10 years** the Plan is in place.

William, 60, is the sole owner of a very profitable, family-run service business. Due to landing a new account, he will net $1,000,000/year for the foreseeable future. His advisor recommends a cash balance plan for his company. His personal contribution will be $200,000/year.

Result: In 10 years of steady earnings and a shift in investments, **Steve is able to put over $170,000 of the ATRA-induced tax increases right back in his pocket.**

*All examples assume 5% ROA.

With Higher Rates, Cash Balance Plans Even More Compelling

Accumulation of 10 Years Worth of Taxation Effects

	$500,000 Income Level		$1,000,000 Income Level	
	No CB Plan	With CB Plan	No CB Plan	With CB Plan
(1) Pre-ATRA Federal Income Tax	1,510,000	910,000	3,260,000	2,650,000
+Federal Tax Increase	50,000	0	280,000	200,000
+)Medicare Tax Increase	50,000	30,000	90,000	70,000
+Capital Gains Increase*	30,000	0	30,000	0
+Medicare Surcharge*	20,000	0	20,000	0
(2) ATRA "Additional Tax"	**150,000**	**30,000**	**420,000**	**270,000**
(3) Total Tax (1) + (2)	1,660,000	940,000	3,680,000	2,920,000
SAVINGS on (2) "Additional Tax" Clarity Cash Balance™		$120,000		$150,000
GRAND TOTAL SAVINGS on (3) Total Tax Clarity Cash Balance™		$720,000		$760,000

* Effect of moving annual capital investments of $175,000 into a Cash Balance Plan

SUMMARY

The American Taxpayer Relief Act of 2012 unleashed significant changes in tax for high net worth individuals. Those changes increase their annual taxes each year such that the magnitude over a longer time frame will create significant financial impact. Clarity Cash BalanceTM creates the best approach to mitigate the impacts.

Firm Background

Clarity is a national actuarial consulting firm that provides custom solutions to private, not-for-profits, governments, and publicly-traded employers who offer retirement, healthcare, and other benefits to employees. We call ourselves "Clarity" because we guide clients step by step through the complexities of managing their compensation and benefit plans.

About the Author

Alex G. Kuhel, ASA, EA, MSPA leads the cash balance and tax strategies practices of the national actuarial consulting firm Clarity In Numbers, LLC. Alex consults with closely-held business owners to help them create and maintain customized retirement programs including cash balance, traditional defined benefit, and defined-contribution/defined-benefit combo plans. He has diverse experience providing actuarial valuation and consulting services for clients of all sizes, ranging from sole proprietorships to national corporations with thousands of participants. Prior to joining Clarity in Numbers, LLC, Alex managed books of business and had major roles on client teams at JP Morgan, Towers Perrin, and PricewaterhouseCoopers.

This whitepaper is meant to detail options for consideration and should in no way represent Clarity opinion or recommendations for specific plan sponsors, employers, employees, or other related parties. Please contact us if you would like us to review your plan in detail.

ABOUT CLARITY

Clarity is a national actuarial consulting practice that provides custom solutions to private, not-for-profits, governments, and publicly-traded employers who offer retirement, healthcare and other benefits to employees. We call ourselves “Clarity” because we guide clients step by step through the complexities of managing their compensation and benefit plans. We know that when the numbers make sense and the options are clear, your confidence grows in the decisions you make on behalf of your employees.

OUR TEAM

We are proud to present our team of seasoned, credentialed actuarial professionals who spent much of their careers at large consulting and accounting firms. We formed Clarity to work in ways that we see as better serving our clients. Working for groups starting with sole-proprietorships all the way to large corporations, we find we can better leverage our extensive experience for the client and make customized recommendations. Our rates are lower and our responsiveness higher.

That’s Clarity.

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