StatonWalsh

Financial Clarity Through Transparency

**Prepared for:**

**Prepared by:**

Ryan Staton, MBA, CFP, AIF, CeXP, CHFC
Managing Partner
StatonWalsh
Phone: 410-777-9487
Email: rstaton@statonwalsh.com
Website: www.statonwalsh.com
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# Target Benefit Plan


**The basics:** The target benefit plan has elements of both the defined benefit and defined contribution plans. The contributions are determined as if the plan were a defined benefit plan, while the defined contribution plan annual contribution percentage and dollar amount limitations apply to the actual contributions made on behalf of each participant. Target benefit plans are largely obsolete; a tiered/new-comparability plan would be used instead.

## How It Works

- Employer contributes an actuarially determined amount each year subject to percentage and dollar limitations to the plan.
- Employer contributions are tax deductible.
- Contributions not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging,[1] or, at retirement from the current employer, rolled over to a traditional or a Roth IRA, or to another employer plan if that plan will accept such a rollover. Federal law allows retirement distributions to employees who are at least age 59½ even if they have not separated from employment at the time distributions begin.[2]
- Except for more than 5% owners, required minimum distributions (RMDs) must begin by April 1 of the later of (a) the year following the year in which the participant reaches age 72, or (b) the year following the year in which the participant retires. More-than-5% owners must begin to receive distributions by April 1 of the year following the year they reach age 72.[3]

[1] Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

[2] If allowed by the plan; prior to 2020, federal law required employees to be at least age 62.

[3] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

## Methods of Defining the Benefit

- **Level percentage plan:** Example: The benefit is equal to 50% of compensation, [1] reduced by 1/25 for each year of participation less than 25.
- **Yearly accrual:** Example: The benefit is equal to 5.0% of compensation for each year of participation.
- **Top-heavy plan:** If more than 60% of the plan assets are allocated to key employees,[2] the employer must contribute at least as much for non-key participants as it does for key employees. This requirement applies only to a contribution of up to the first 3% of includable compensation (higher in some instances).

## Additional Considerations

- **Contribution limitations:** The employer contributes an amount actuarially determined, but not more than the lesser of 100% of includable compensation or $66,000 annually(2023 limit) for each participant.[1] If the plan is top heavy, minimum contributions are required.
- **Deduction limits:** Notwithstanding the individual allocation limits, the maximum employer deduction is limited to 25% of covered compensation.
- **Parties which are favored:** Older employees are favored. A company with principals and key workers older than the rank and file should consider a target plan.
- **Investment of plan assets:** Investments must be diversified and prudent. Subject to plan provisions, plan assets can be invested in equity products like mutual funds, stocks and debt free real estate; or in debt instruments like T-Bills and CDs. Insurance products like life insurance and annuity policies may also be used.

[1] For those self-employed, compensation is limited to net self-employment income, e.g., gross income less the contribution and the deduction allowed for one-half of the self-employment tax. For 2023, $330,000 is the maximum income that may be considered

[2] A "key" employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded $215,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

- **Social Security integration:** Since the employer already contributes to the employee's Social Security retirement benefit, these contributions can be integrated into the benefit formula of the plan.

## How Much Will There Be at Retirement?

This will depend upon three factors:

- The amount of contributions,
- The number of years until retirement, and
- The investment return.

The risk of poor investment returns rests upon the *employee*. However, if the investment results are favorable, the participant will have a larger fund at retirement age.

| An Example of What $10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax[1] | | | | |
|---|---|---|---|---|
| Years | 2.00% | 4.00% | 6.00% | 8.00% |
| 5 | $52,040 | $54,163 | $56,371 | $58,666 |
| 10 | $109,497 | $120,061 | $131,808 | $144,866 |
| 15 | $172,934 | $200,236 | $232,760 | $271,521 |
| 20 | $242,974 | $297,781 | $367,856 | $457,620 |
| 25 | $320,303 | $416,459 | $548,645 | $731,059 |
| 30 | $405,681 | $560,849 | $790,582 | $1,132,832 |
| 35 | $499,945 | $736,522 | $1,114,348 | $1,723,168 |

## Advantages to Employer

- Contributions are tax deductible.
- Contributions will rise as compensation rises, but they are controllable both by formula and absolute dollar amounts.
- Forfeitures of terminating employees may reduce future costs.

[1] The rates of return used in this illustration are not representative of any actual investment. Typically, an investment will not provide a consistent, unchanging rate of return year after year. Years with a rate of return higher or lower (even negative) than the hypothetical returns shown here can substantially affect the final results.

- It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- The employer usually directs investments.
- Often the advantages of a defined benefit plan can be obtained without its problems.
- If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than $5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds $1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than $1,000.

## Advantages to Employees

- Annual contributions are not currently taxed to the participant.
- Earnings on the account are not currently taxed.
- Participants may be given the right to direct investments. If participants are given the right to "self-direct," plan sponsors are required to provide certain standardized investment fee and performance data. This information is intended to aid participants in making better-informed investment choices.
- Federal law allows a qualified plan to establish an "eligible investment advice arrangement" under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.
- Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- If the plan allows, there is the ability to purchase significant permanent life insurance under the plan. Purchase of life insurance will generate taxable income to the employee.
- Participant may borrow from the plan within certain guidelines if provided for in the plan documents.
- ERISA and federal bankruptcy law provide significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

## Disadvantages to Employer

- In low profit years, the employer is still obligated to make contributions.
- There is no flexibility with the level of contributions.
- In some cases, the target benefit plan may not produce as large of a contribution and deduction for older employees as a defined benefit plan might.
- Since these plans are so rare, it may be difficult to find a plan administrator.
- If a plan gives participants the right to direct investments, plan sponsors are obligated to provide participants with standardized investment fee and performance information. Failure to comply with these ERISA requirements may result in a breach of fiduciary duty to plan participants, and the loss of ERISA Section 404(c) protection. In this situation, the plan fiduciaries could be held responsible for the results of the participants' own investment choices.

## Disadvantages to Employees

- There is no guarantee as to future benefits.
- Investment risks rest on the *participant*.
- Older participants may not receive as great of a benefit as with a defined benefit plan.
- Plan is not easily understood by participants.

## Coronavirus Aid, Relief, and Economic Security (CARES) Act

- **Coronavirus-related distribution (CRD):** One section of the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided for a "Coronavirus-related distribution," or CRD. A CRD – optional (not mandatory) for a qualified retirement plan sponsor – was a distribution made from January 1, 2020, through December 30, 2020, from an IRA or qualified retirement plan. A CRD could not exceed $100,000 in aggregate per individual, was exempt from the usual 20% mandatory federal income tax withholding, and must have been made to an individual (or spouse or dependent) who was diagnosed with SARS-CoV-2 or COVID-19, or who experienced an adverse financial consequence as a result of the COVID-19 pandemic. A CRD was exempt from any 10% early withdrawal penalty that may have applied and, unless the individual chose otherwise, the CRD could be included in taxable income ratably over a three-year period. A CRD may be re-paid, without regard to the normal contribution limits, over a three-year period.

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Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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