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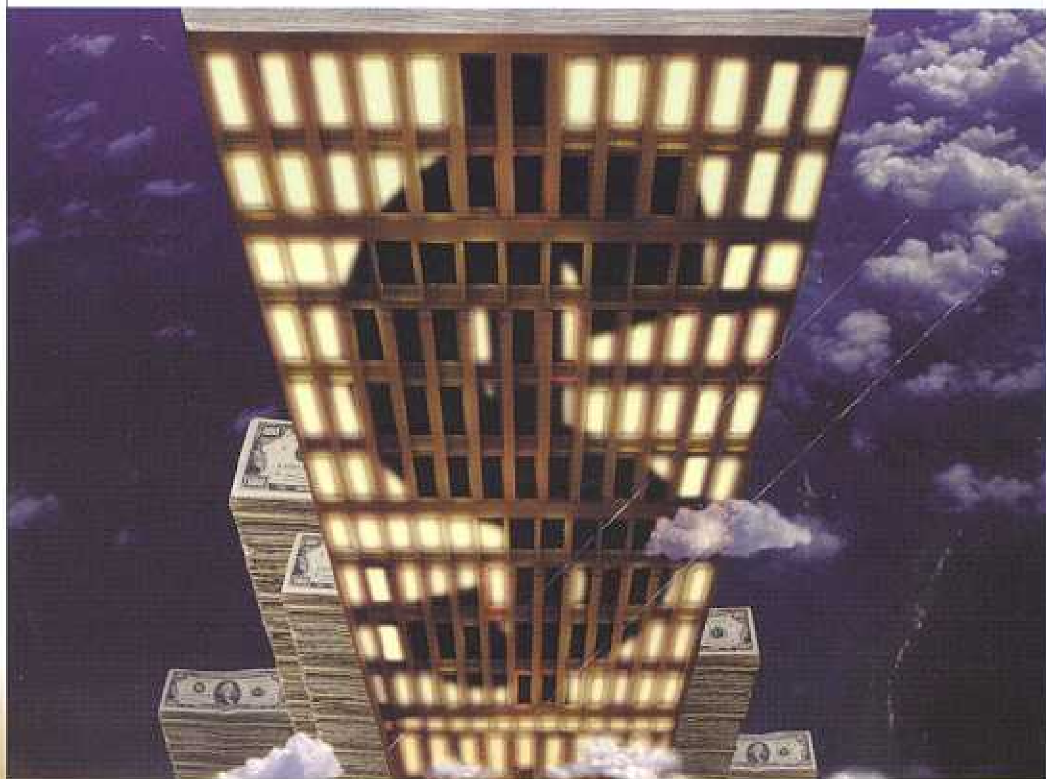

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Focus

Employee Benefits: A Balancing Act for Closely Held Businesses

by Jacqueline M. Quinn

Where do closely held business owners stand when it comes to the issue of employee benefits as we cross the millennium mark? How do they maximize benefits while still controlling employee costs? How do they attract or keep key employees in a tight labor market? How do they take advantage of law changes in qualified plans over the last few years? The timeliness of these and other questions that will confront closely held business owners is only further underscored by the projected growth in the number of people who will choose to be self-employed in the years to come.

The *Journal* took these questions to a number of benefit specialists and seasoned planners across the country. We felt the best way to get to the bottom of this issue was to see what planners' clients are doing, what they are considering, and what the experts view as opportunities as we move forward.

Recent Legislative Changes

"Over the last few years, dramatic legislative changes have given the owners of closely held businesses planning opportunities that never would have been thought possible," says retirement expert Bruce J. Temkin, author of the critically acclaimed *The Terrible Truth About Investing*. For example, effective January 1, 2000, as a result of the elimination of Section 415(e) of the Internal Revenue Code (IRC), there are no longer any limits on the amount an employer can contribute on behalf of an employee who participates in both of the employer's defined benefit and defined contribution plans. This will give many closely held business owners the opportunity to substantially increase contributions in qualified plans.

The government also recently changed laws pertaining to coverage. For example, when Section 401(a)(26) was eliminated, employers could reduce the percentage or the number of employees they would be required to cover in a qualified retirement plan. Temkin uses the following example to illustrate this point: A closely held business has four highly compensated individuals (generally earning $80,000 or more a year), one of them being the owner. It also has 16 non-highly compensated employees. It is now possible to cover only the owner from among the highly compensated and cover only 3 of the 16 non-highly compensated employees and still pass the coverage test.

In this example, only 4 of the 20 employees are covered in the plan. This is made possible since the law simply states that you take the percentage of highly compensated individuals (1 out of 4 employees or 25 percent) and multiply this percentage times 70 percent. Therefore, the employer would only have to cover 17.5 percent of the non-highly compensated employees (see Table 1). Temkin recommends that this be used as a supplemental plan rather than disturbing an existing 401(k) and profit-sharing plan.

Temkin also points out that many traditional profit-sharing plans can substantially increase contributions for owners and key employees without having to make any additional contributions for non-highly compensated staff employees. Many closely held businesses have, through the years, made contributions for all employees. Since profit-sharing plans favor younger employees, they actually discriminate against the owner, who generally is older than the staff. One could take a traditional profit-sharing plan, amend the plan and have a formula that states, for example, "All owner-employees shall have additional contributions of some percentage made in their behalf."

TABLE 1

An Example of Reduced Coverage in Light of Recent Legislative Changes

Employee	Job Classification	Coverage	Rule
HCE 1	Exec. Dir.	Covered	Calculate the percent of HCEs that are covered
HCE 2	Mgmt.		
HCE 3	Mgmt.		
HCE 4	Mgmt.		Here 1 out of 4 – 25%
Total HCEs		1	
NHCE 1	Staff		Must cover 70% of 25% (the covered HCE percent above) =
NHCE 2	Staff		
NHCE 3	Staff		
NHCE 4	Staff		70% of 25% – 17.5%
NHCE 5	Staff		17.5% of NHCE, or 17.5% of 16 employees must be covered =
NHCE 6	Staff		
NHCE 7	Staff		If 3 non-highly compensated employees participate, coverage test is passed.
NHCE 8	Staff		
NHCE 9	Staff		
NHCE 10	Staff		
NHCE 11	Staff		
NHCE 12	Staff		
NHCE 13	Staff		
NHCE 14	Staff	Covered	
NHCE 15	Staff	Covered	
NHCE 16	Staff	Covered	
Total NHCEs		3	

Bruce J. Temkin

"The irony is that if we carefully **examine plans,** we will find that a majority of them actually **discriminate against owners** or key employees."

How is this accomplished? It can be demonstrated under Section 401(a)(4) of the IRC that these additional contributions do not make the plan discriminatory. For example, a 37-year-old employee has 30 years until normal retirement at age 67. The government will allow the employee to take this projected account and assume it grows, hypothetically, at 8.5 percent over the next 30 years. An account with $1,500 would grow over this 30-year period to more than $17,000.

In turn, the government allows us to take the theoretical $17,000 account and use it to buy benefits starting at age 67. If the 50-year-old owner takes his account balance and projects it forward for 16 years to age 66, it can be demonstrated that by converting these theoretical account balances to benefits, that the younger nonowner-employee, as a percentage of earnings, actually is getting a higher benefit. Therefore, the government will allow the owner to make up the difference by having additional contributions made to the plan on his behalf.

Says Temkin: "The irony is that if we carefully examine plans, we will find that a majority of them actually discriminate against owners or key employees. Whereas large corporations may provide post-retirement medical and defined benefit plans or stock options to their employees, this is not the case for the closely held business owner, who has to pick up the tab in order to be afforded these opportunities. Plans have been underused, as perhaps the best way of grappling with the issues of financial security."

Why? It's in part because the markets have been so favorable for such a prolonged period. (According to Temkin, there's only been one negative year in the markets since the inception of the 401(k) plan in 1981.) "Many are dangerously vulnerable to being overconfident if they are experiencing continual growth in the value of their assets," says Temkin.

Moreover, the more familiar plans that are suitable for the larger corporations often are not what's right for the small, closely held business. Many small businesses simply are not attracted to the traditional 401(k) often embraced by larger companies. Their special needs require plans that take into consideration that, in small businesses, owners frequently want a bigger slice of the pie. By design, the classic 401(k) plan is too equitable and therefore often viewed by closely held business owners as an option with little benefit. What they need are plans that by their very nature are more flexible and permit them to reward select participants.

A Renaissance at Hand

"It's up to the financial planning community, as it better understands these new law changes, to get the message out to closely held business owners," says Bruce Temkin. "It's these new design opportunities that will move the employer into a 'renaissance' period." What's allowable today under the law will permit owners the freedom to push ahead with many innovative plan designs that were not available in the past. This is true whether it is the owners' desire to contribute more money for themselves, reward selected employees or control employee costs. "I've always thought of plan design like a good game of chess," says Temkin.

Most of the firms serviced by Mary Mahoney, CFP, of Financial Network Investment Corporation in Albuquerque, New Mexico, are closely held businesses. What's she seeing when it comes to employee benefits today?

"On our roster of clients is a small plumbing wholesale company that staffs about 15 employees, many of whom have been with the company for a long stretch. The father is retiring. The son is taking over the helm," says Mahoney. What they have decided to do to ensure little or no attrition at this critical juncture is to implement a SIMPLE IRA, after 20 years in business, she says.

As Mahoney sees it, the son intends to do what he can to retain a high morale among the employees who have been, in fact, requesting this benefit for some time. "Out of a total of 13 considered eligible to participate, 10 have already indicated—though they have yet to be formally introduced to the plan—that they will sign on," she says.

Sincere Interest in the Basics

"Generally speaking, my small-business clients are sincerely interested in provid-

Dave C. Grosjean, CLU, ChFC

"Our clients are very **cost conscious** and have a good idea of what they need. At this point, they're not always interested in adding fringes. They're just trying to **keep what's already in place**..."

ing the basic benefits of group health and group life insurance for their employees. Not all of them have dental, but more and more are opting to add this and group disability insurance," says Dave C. Grosjean, CLU, ChFC, and Mahoney's partner in the insurance brokerage firm of MGM Ltd. Company. "Our clients are very cost conscious and have a good idea of what they need. At this point, they're not always interested in adding fringes. They're just trying to keep what's already in place, primarily because of the dramatic increases in costs, particularly in health insurance."

"But we just completed implementing a disability insurance program for a small-business owner who already had health and dental insurance in place," says Grosjean. He's concerned about being able to attract laborers for an upcoming road construction project and wanted to add fringe benefits as opposed to giving raises: "That way, when it's time to hire quality people, he can say that he has something his competitors don't have."

Mahoney tells of another closely held business that recently instituted a 401(k) plan. The owner, emotionally connected to the employees, wanted them to be able to save for retirement. "Most go from paycheck to paycheck and don't have savings accounts," says Mahoney.

"The owner wanted to go ahead with the 401(k) plan because he needed to put some money away. But he also realized that if the employees signed up, it would force them to save," she says.

Malcolm Greenhill, CFP, principal of Sterling Wood Financial, specializes in working with closely held business owners from his offices in both San Mateo and San Francisco, California. They handle both the qualified and nonqualified sides of benefits.

On the qualified plan side, one option he finds many small business owners selecting as a benefit is an age-weighted profit-sharing plan. "The business owner is always trying to skew the benefits in his favor or toward the highly compensated people, and implementing an age-weighted plan can be one way to achieve this," says Greenhill.

Agreeing with Temkin, Greenhill offers that in situations where the bulk of the employees are quite young compared with the business owner and any key executives, age-weighted plans enable the older employees to sock away more than their younger colleagues. "Since individuals at age 55 have only 10 years left to make contributions, the federal government allows them to put away considerably more than, let's say, those at age 35. But from an actuarial point of view, it all works out to be equitable at age 65," stresses Greenhill.

The Allure of Nonqualified Plans

What does Greenhill see on the nonqualified plan side? "Nonqualified benefits can be attractive in a small business when you are aiming to slant benefits in favor of the highly compensated, desire some flexibility, and don't want to be tied into mandatory contributions."

Nonqualified benefits enable owners to do something for employees they view as key or essential to the company's success. Designed according to the specifications of the key executives, what's also a plus is that such benefits are a mechanism by which owners can "lock" into place those integral to the successful continuation of the firm.

For example, Greenhill points out that a small business owner might be interested in offering a performance incentive for a key executive salesperson. In that case, the owner might consider designing a nonqualified plan that's tied to the employee's sales targets. Referred to as deferred compensation plans, the key person only receives the compensation (and is therefore taxed on it) when he or she leaves the company.

Another example might be that of a key executive who's motivated by equity or the desire to walk away, when the time is right, with part of the value of the business. In

this case, putting together a phantom stock plan may be just the ticket. Although it's not real equity (the owner is not giving away any property rights), it is essentially a promise on the part of the company to pay the employee a specified percentage of the value of the business at a mutually agreed-upon time, according to Greenhill.

Yet another typical nonqualified deferred compensation arrangement is when individuals are coasting toward retirement and want to have a supplement to their retirement plan. When this is the case, the company can arrange to provide the employees, once they reach a certain age, with a flat benefit over an agreed-upon time frame. "And it's all totally confidential," says Greenhill.

Tax-Saving Benefits

Besides offering flexibility to key personnel, nonqualified deferred compensation plans offer tax-saving benefits to closely held businesses operating as C corporations under the Internal Revenue Code. How? The small business can defer to a future year the payout to the key players. It can pay the tax on the deferred amount at the lowest corporate tax rate of 15 percent, as well as take the deduction in the year of the actual payout (at a time when corporate tax rates may be higher).

"There are no ERISA requirements, no red tape with such plans," says Greenhill. There are no discrimination rules to pass, as with qualified plans, and while they should be blessed by the board of directors, unlike qualified plans, there's no need to obtain any governmental agency approval.

Long-Term Care Benefits

A pioneer in the development of long-term health care insurance in the nation, Gregory P. Seal is president of C-Hall Corporation and Seal Financial Services, a planning firm out of Denver, Colorado. C-Hall's purpose is to educate individuals about estate planning, primarily with regard to health care needs before and during retirement. Says Seal: "The issues of employee benefits and long-term care

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Mary Mahoney, CFP

"The owner wanted to go ahead with the **401(k) plan** because he needed to put some money away. But he also realized that if the employees signed up, **it would force them to save.**"

are hot topics for the closely held business. While long-term care is not as politically correct as child day care in the workplace, it's becoming more of an issue."

According to Seal, one of the difficult tasks for smaller employers centers on how they can support their employees financially as well as emotionally during times of care-giving crises, so they are able to function properly on the job and ultimately request less time off. This is particularly true of the baby boomers facing various, often long-distance, care-giving crises that come with aging parents, he says. "We're seeing an expansion of needs for family care-giving counseling."

The smaller firms are just starting to see the problems and the dynamics their employees, particularly employees in their fifties and sixties, are facing as their parents age. "Employers are going to have to respond to offer these benefits with unemployment as low as it is," says Seal.

He intends to target these smaller firms not only with the offer of long-term care plans, but also to educate their workers on health-care estate planning issues. Adds Seal, "The educational resource alone on such topics is a huge benefit families need, and one that will undoubtedly lower the anxiety threshold workers have to endure when such situations arise."

Bread-and-Butter Benefits

Wil Heupel, CFP, CLU, ChFC, principal of Minneapolis-based Accredited Investors, works with another partner to tend to a client base consisting largely of closely held businesses. When it comes to why small business owners are implementing certain benefit packages, he concurs with Malcolm Greenhill. "None of our employers are saying they need to put into place certain benefits in order to attract and keep employees, despite the tight labor market," he says.

Owners ask, for instance, how they can get benefits implemented for themselves on a before-tax basis. From there, the owners follow through on the decisions from a cost standpoint and examine what it will cost to make these benefits available to the employees.

Heupel suggests, "There are certain 'bread and butter' benefits most employees look for in a job search that need to be offered." Referring to them as the "three legs of the stool," Heupel lists health insurance, the traditional 401(k) or retirement plan, and disability insurance. Life insurance is not requested often. "And disability is really third on the list, if it's asked for," maintains Heupel.

But over and above that, Heupel agrees with Seal. A trend he sees on the upswing is that of implementing long-term care

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policies. "You can adopt corporate resolutions that allow the employer to make the benefit to select groups of employees, get the premiums paid on a before-tax basis, as well as get them on an accelerated pay schedule," says Heupel.

He offers an example of a closely held business owner who plans on retiring in ten years. "We can get the policy entirely paid off (on a before-tax basis) within that time for the owner and spouse, so they are not paying for the benefit when they go into retirement."

According to Seal, we're all familiar with the true group long-term care plans the larger firms offer. "But the wave of the future for the closely held business is to offer individual long-term care policies within a group environment," he says. Under this scenario, a select group of employees can be carved out and paid for by the corporation (offering a long-term care plan can be a fully discriminatory benefit for a C corporation), while the other employees can be offered the benefit on an employee-paid basis. And he adds, "A select group of long-term care providers not only will offer a group discount but simplified underwriting as well."

This carries with it the potential for being asked fewer in-depth questions by the insurance carrier during the underwriting process. Why? "The key is volume," says Heupel. "The volume of business from a particular group may make them more willing to make some allowances," he says.

"Practically speaking, there are only so many hats you can wear as a planner," says Seal, who testifies that, though questions surrounding long-term care and its ancillary issues (whether originating with the small-business owner or planner) are certainly becoming more prevalent, they have yet to move to the front burner.

In the end, however, benefit experts as well as planners agree that closely held businesses represent a significant, undeveloped market for the financial planning community. It's the planning community's responsibility to key in on, approach and deliver to closely held business owners the employee benefits that suit their own smaller operational needs. When a classic 401(k) is not appropriate, explore other qualified retirement plan designs. Discuss nonqualified plan options. That way, planners can remain confident they are outlining alternatives and rendering customized services that truly interest and assist the smaller, closely held firms.

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