The Perfect Last Minute Tax Planning Tool: Adopting a Qualified Retirement Plan

Historically, about one-third of the new qualified retirement plans we set up for our clients occur in the last two months of the year. Some of those plans are set up in the last two weeks and even on the last few days of the year. We have become so accustomed to our "end of the year rush" that our holidays are not impacted by the added time pressures. We recognize, as do many of our referral sources, that adopting a qualified retirement plan late in a year is one of the most effective, if not the most effective, tools for reducing the income tax obligation of a profitable business.

What else can the owner of a profitable business do late in a year that:

- Creates a tax deduction that is retroactive to the first day of the year
- Creates a tax deduction that, depending upon the demographics involved, can be worth as much as $200,000, or possibly even more
- Sets aside every dollar of the tax deduction in a tax-deferred, creditor protected trust fund that will hold the funds until retirement, and
- Allows for the funding of the tax deduction to occur as late as the extended due date for the business' federal return? For 2011 calendar year taxpayers, that could mean funding the plan as late as September 15 or October 15, 2012.

If that sounds too good to be true, it is not. As I said at the outset, it is something we have done many times every year for more than a decade. There is, however, one catch. Timing is critical. If a deadline is missed, so is the opportunity. Fortunately, many of those deadlines for 2011 actually occur in 2012, creating much more flexibility than many people realize.

Here, is a chronology of the steps involved and an explanation of the opportunities available to the employer who acts in a timely fashion. (These dates apply to calendar year taxpayers; for fiscal year entities, the dates will be different, but the chronology is the same.)

Between now and mid-December – Design the plan to optimize the tax benefits to the owner(s) of the business. Not all plan designs are equal. For example, a cash balance plan often works best for a firm of partners with differing retirement funding goals and capabilities. Provide us with some basic employee data and we can develop a recommended plan design. Every year we do a few very last minute plan designs, but if we can get a recommended plan design done by mid-December, there will be still be adequate time for any last minute design tweaks.

Before January 1, 2012 – Sign the documentation that creates the plan. In order to take a tax deduction for 2011, the liability for the contribution to the plan has to exist in 2011. The one exception to this rule is a SEP-IRA which can be adopted as late as April 15, 2012.

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Important Timing Change – Until the IRS adopted a recent revenue procedure, Rev. Proc. 2007-44, it was possible to amend a plan after January 1 but before March 15, 2012, and have that change apply to 2011. In other words, all that had to be done before January 1 was to adopt a plan. The specific plan provisions could be completed or modified after yearend as long as they were formally adopted by March 15, 2012. Not everyone believes the position taken by the IRS is supported by the law, but until this matter is settled, possibly through the courts, we are advising our clients that they should no longer rely upon this extended date to amend their plan. All modifications to a plan should be formally adopted before January 1, 2012.

A plan can still be set up to provide a modest benefit in 2011, then amended if desired in 2012; it's just that the amendment can't be reflected in the 2011 funding level. The 2011 deduction can still be material and the stage is set for 2012, so this approach is considerably preferable to having no plan at all. In fact, we are often able to achieve the desired contribution amount for the business, but there can be no guarantee that will happen.

By the due date, including extensions, for the business federal tax return – make the required contribution to the plan. For incorporated business, the due date for their federal tax return is March 15, 2012 or if extended, September 15, 2012. For unincorporated businesses, the corresponding dates are April 15, 2012 and October 15, 2012*. This extended due date applies to cash basis taxpayers as well as accrual basis taxpayers, one of the few tax deductions available to a cash basis taxpayer that do not require the expenditure of cash in the year of the deduction.

Before Everything Else! – contact IAI. Give us a chance to ask the right questions. It is possible that the business may have already funded its retirement plan for 2011 which could limit its options for 2011. For example, if a business has already funded a SEP-IRA plan in 2011, it may still be possible to adopt and fund a defined benefit plan with a substantially larger tax deduction, but to do so may result in taxes and/or penalties associated with the SEP-IRA. The better plan of action may be to wait to start the defined benefit plan in 2012, although we have found situations where the penalties were incidental to the benefit of the much larger tax deduction.

This issue of Pension Trends is being released in November. That leaves about two months until the end of the year, plenty of time for the profitable business owner interested in deferring taxes and adding to his/her retirement savings. If you or your client has any questions, please contact Steve Diess directly at (503) 601-0870 or steve@indact.com.

**Calendar year defined benefit plans have a separate September 15, 2012 minimum funding deadline. The sponsor of a defined benefit plan must complete the minimum required funding by then, but may make additional deductible contributions as late as October 15th.*

This article was written by Alan J. Stonewall, FSPA, EA, MAAA. Mr. Stonewall is a former president of the American Society of Pension Professionals & Actuaries and former chairman and board member of the Actuarial Standards Board.

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This newsletter has been published in order to share general information with our professional contacts. The information presented in this newsletter should not be acted upon without first seeking the advice of a CPA, attorney or other benefit professional.

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