

**RETIREMENT PLANNING & EMPLOYEE BENEFITS FOR FINANCIAL PLANNERS
4TH EDITION UPDATES**

CHAPTER 12

Example 12.1, page 572

Consider the following employer data from Meyer Group.

QUALIFIED SAVINGS AS A PERCENTAGE OF GROSS PAY FOR 2008

Person	Current Compensation	Covered Compensation	Contribution to Qualified Plan (Limit)	Savings Rate (As a % of Gross Compensation)
Al	\$400,000	<u>\$230,000</u>	<u>\$46,000</u>	<u>11.5%</u>
John	<u>\$230,000</u>	<u>\$230,000</u>	<u>\$46,000</u>	20.00%
Kelly	\$40,000	\$40,000	\$20,000*	50.0%

** Kelly could have a larger contribution under IRC 415(c) under certain scenarios.*

Each employee's final compensation can be projected using a 3.5 percent assumed wage rate increase and assuming that each employee is 20 years from retirement.

PROJECTED FUTURE COMPENSATION

Person	Current Compensation	Compensation 20 Years from Today (Assume 3.5% Raises)
Al	\$400,000	\$795,916
John	<u>\$230,000</u>	<u>\$457,651</u>
Kelly	\$40,000	\$79,592

Assuming that each employee saves the stated contribution amount each year at year end and the funds earn eight percent per year, determine the accumulated account balance and the dollar size of a 20-year annuity paid in arrears on an annual basis.

PROJECTED ACCUMULATION AT RETIREMENT AND A 20-YEAR ANNUITY

Person	Savings from Qualified Plan Today	Future Accumulated Balance at 8% in 20 Years	Accumulation 20-Year Annuity
Al	<u>\$46,000</u>	<u>\$2,105,050</u>	<u>\$214,404</u>
John	<u>\$46,000</u>	<u>\$2,105,050</u>	<u>\$214,404</u>
Kelly	\$20,000	\$915,239	\$93,219

The wage replacement ratio that the annuity provides can then be calculated as a fraction of each employee's final pre retirement compensation

WAGE REPLACEMENT RATIO

Person	Wage Replacement (Annuity/Future Compensation)	
Al	<u>26.94%</u>	$(\$214,404 \div \$795,916)$
John	<u>46.85%</u>	$(\$214,404 \div \$457,651)$
Kelly	<u>117.12%</u>	$(\$93,219 \div \$79,592)$

As illustrated, Al saves 11.5 percent of his gross compensation in the qualified plan, resulting in a wage replacement ratio from that qualified plan at retirement of 26.94 percent. This amount is substantially less than the 70-80 percent recommended wage replacement ratio that he will need.

The qualified plan restricted Al to this wage replacement ratio of 26.94 percent because the maximum contribution to the plan each year was limited (\$46,000 for 2008).

Example 12.6, page 588

Rob, age 50 (president), and Joe, age 50 (vice-president), are the top two executives in AFA, Inc. Joe's compensation is \$230,000 and Rob's is \$400,000. Joe is expected to receive \$120,000 per year in retirement from AFA's qualified plan, thus achieving a wage replacement ratio of 52.2% ($\$120,000 / \$230,000$). Unfortunately for Rob, he will also receive the same \$120,000 from the qualified plan, thus producing a WRR of 30% ($\$120,000 / \$400,000$). To make their retirement WRRs equal, AFA might use a NQDC arrangement to pay Rob an additional \$88,800 per year in retirement [$(\$120,000 + \$88,800) / 400,000 = 52.2\%$]. This is an example of an excess benefits plan.

Multiple Choice #10, page 613

10. Arnie, the CEO of The Producers Inc., was awarded the following stock options from The Producers Inc.

Option	Grant Date	Type	Exercise Price	FMV	Number of Shares
1	1/1/ <u>2006</u>	NQSO	\$15	\$15	1,000
2	1/1/ <u>2008</u>	NQSO	\$25	\$25	1,000

During 2008 Arnie had the following transactions regarding the above options.

Option	Date	Action	Number of Options (O)/ Shares (S)	Market Price on Date
1	2/1/ <u>2008</u>	Exercised	1,000 (O)	\$27
1	2/1/ <u>2008</u>	Sold	1,000 (S)	\$27
2	12/12/ <u>2008</u>	Exercised	1,000 (O)	\$36

Which of the following is correct?

- a. Arnie has \$11,000 of W-2 income and a \$12,000 capital gain.
- b. Arnie has \$23,000 of W-2 income.
- c. Arnie has capital gain of \$12,000.
- d. Arnie has \$66,000 of W-2 income.

The correct answer is b.

At the exercise of an NQSO, Arnie will have W-2 income equal to the excess of the fair market value over the exercise price. In this problem, Arnie has \$12,000 $[(\$27-\$15)\times 1,000]$ of W-2 income related to the 1/1/2006 options and \$11,000 $[(\$36-\$25)\times 1,000]$ of W-2 income related to the 1/1/2008 options.

Multiple Choice #13, page 614

13. In 2008, Chip, an accomplished professional race car driver, is to receive a signing bonus for agreeing to drive for Hot-Lap International, a racing team. Hot-Lap agrees to establish a NQDC agreement with Chip to defer the bonus beyond Chip's peak income producing years. Hot-Lap transfers the bonuses to an escrow agent who invests the funds in securities acting as a hedge against inflation. The bonus is deferred until 2015 and is then paid to Chip in years 2015-2024. When is the income deductible by the employer and includible by Chip?

Option	Employer Deduction	Employee Inclusion
A	<u>2008</u>	<u>2008</u>
B	<u>2015</u>	<u>2015</u>
C	<u>2015-2024</u>	<u>2015</u>
D	<u>2015-2024</u>	<u>2015-2024</u>

The correct answer is d.

The income is only deductible when includible by Chip in 2015-2024.

Multiple Choice #14, page 615

14. On July 31, 2003, B Corp sold 1,000 shares of its stock to Mike, an employee, for \$12 per share. At the time of the sale, B stock was trading for \$30 per share. The stock was to vest in 4 years on July 31, 2007. This restriction was stamped on the certificates. On July 31, 2007, the B stock was trading for \$125 per share. Mike sold the stock in 2008 for \$125 per share. Assuming no special elections, how much must Mike include in income and in what year?

Option	Year	Amount
A	<u>2003</u>	\$18,000
B	<u>2003 - 2007</u>	\$18,000 ratably
C	<u>2007</u>	\$113,000
D	<u>2008</u>	\$113,000

The correct answer is c.

When the substantial risk of forfeiture expires on July 31, 2007, Mike has income of \$125,000 less the basis of \$12,000, or \$113,000.