Sound Financial Bites 092 - Michael Fennessy

Episode Transcription

Michael Fennessy: What I'm noticing is that the 401(k) plan, in many ways, is becoming a conduit where a business owner, an entrepreneur can work with a financial firm like Sound Financial Group and create these systems where, at retirement, the business owner has significant sums of tax-free money, and there's a variety of ways to accomplish that on an individual strategy.

Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across America, our host, Paul Adams, now brings directly to you.

"We have studies that prove that even by offering a retirement plan in a company, no matter what size you are…they're ability to succeed in retirement…goes from about 40% to above 60% just by offering a benefit."

Paul Adams: Hello, and welcome to Sound Financial Bites. I'm Paul Adams, your host, and I'm so glad you could be with us today. You are out running, you're at the gym, you're doing dishes, or perhaps you're in the middle of a super-boring conversation with your spouse, and you've just got earbuds in and you're pretending to listen right now, nodding, saying, "Yes, dear." Just kidding, that's probably not happening. But, I think I'm going to throw in some funny stuff at the beginning of these just to see if you all are always paying attention.

Today, I'm excited about our guest and what you're going to be able to get from today, the title of today's podcast being "Confessions of a 401(k) Freak", and what we're going to be doing is teaching you about strategy regarding your retirement plan, but it's more than the investments. That's where everybody defaults to is that when you're investing in your 401(k), the most important thing you do is the way you choose investments, but it also matters how you flow money into these retirement plans and how you take money out. Now, this is especially going to be important for those of you that are business owners and entrepreneurs. It's because you have the greatest amount of control over your plan, how you put money into it, how you take money out of it, and how you put money in for everybody else and how that impacts how much money you can put in.

Now, our guest today is Michael Fennessy. Now, Michael Fennessy is the regional sales director for Ameritas, and they're a set of consultants and a product offering that we will bring to our clients on a periodic basis. But, he has a unique claim to fame, and that is that he literally used to sell 401(k) plans to corporations that were bigger than the actual 401(k) company that he works for now. Why this is key is he spent a lot of time going really deep into the tax law and a set of regulations called ERISA. They give you the ability to understand how you might best be able to defer money in a 401(k), how you can get money out, and how you have to treat the entire population of your employees as an entrepreneur.

Now, if you are high income earning executive listening to the podcast today, this one could still be valuable for you and here's why. One, you are likely a key influencer inside your organization. As a result, you're going to have the ability to move the needle inside your company so that what you'll have the ability to do is get HR to look at certain provisions in the plan that are going to help you in particular, because we're going to talk about what you can do inside the company as an employee to set yourself up to have the best possible distribution outcomes when you arrive either at retirement or when you ultimately leave the company you're with today. So, Michael, welcome to Sound Financial Bites.

"Once you make the employee base aware that Roth is available, more people start deferring. "

Michael: Hey, Paul. Good afternoon.

Paul: In your time, just to give people a little bit of bio on you, you've been doing this how long, background, all that?

Michael: Sure, I'm happy to share that with you. I started working in financial services right at Y2K. So, I entered the labor force January 4th, 2000. They were going to hire me for the 2nd, but we were all worried about a technology issue that never occurred. So, I did basic investments for a couple years and eventually met a girl and needed to move to the West Coast in order to continue my relationship and courting of that woman who became my wife.

Over the time, I just got introduced to trying to find a job on the West Coast and wound up doing 401(k) plans and just loved the opportunity to start collaborating with business owners and inspiring them and their employees to save money for retirement. Pretty much, over the past 14 years, I've helped a variety of companies from small business owners, to medical groups, to Fortune 500 companies, to some publicly-traded tech companies, and I've brought on about a little over 800 individual corporations of clients, probably somewhere between a billion and 1.5 billion of total assets, and a lot of that was really just working on employee benefits.

We have studies that prove that, even by offering a retirement plan in a company, no matter what size you are, even if you offer that benefit to your employees, their ability to succeed in retirement, and my definition, "success", is making sure they maintain their standard of living in retirement. It goes from about 40% to above 60% just by offering a benefit. So, in many ways, the work we do is inspiring everyday Americans to save their own money.

Over the past four years though, there's been some significant tax law changes on a personal side that are really taking what many would be estate planning concepts and they're applying them into a 401(k) plan. That really focuses on the nature of the dollar that one spends in their retirement, and the way I look at this is there's really three dollars we're going to have access to in retirement. We're going to have taxable dollars, which are liquid, but if we invest them, they're going to be subject to things like capital gains, and they're going to be subject to distributions and things along those lines.

Paul: That's the stuff that's going to be outside of retirement plans. You're just titled in your name or you and your spouse's name.

Michael: Correct. You are just investing outside of any sort of retirement plan. Then, within retirement plans, what most people do is they are deferring their taxes. So, they use a traditional 401(k), they put whatever contributions they can afford, and I think some of the work we really have to do is teaching people how much money they need to save. But, how a traditional 401(k) plan was set up was that I would reduce my salary, I would get a deduction in this year, and if I deferred a dollar, I would be taxed upon that dollar when I took it out hopefully to pay for my retirement.

Now, the challenge with that, though, is that we are uncertain what our tax rates are going to be in retirement. So, even though I know I may be saving 30, 40, 50 cents, whatever it is on any dollar I save in my 401(k) plan today, I don't know what that tax rate's going to be when I need that money. I have found, in collaboration with financial planning firms like Sound Financial, is that you have employees who really aren't at a lower tax bracket in retirement, and often, in the worst case scenario, they're winding up in a higher tax bracket because they're taking money out, which is bumping them up a bracket.

Really the work I've been focused on over the past four years is how do we create a situation where we have tax-free money at retirement, and these are the strategies I'm really excited to share with your podcast listeners, again particular those who are the business owners and entrepreneurs, because I think if we can enact some certain strategies within their retirement plans, we can give them a conduit and vehicle where they'll have a lot of tax-free money at retirement.

"If you offer benefits to 100% of your highly compensated, everyone else is a non-highly compensated, you only have to offer benefits to 70% of that population."

Paul: One thing that occurs to me that would be widely applicable to everybody here is let's just talk about the tax-free money, getting money inside that tax-exempt environment, being able to pull it out in our old age without the taxes versus the tax-deferred money, and that tax-deferred money is like a sweet juice. It just feels good this year that if I can get 15,000 in, 18,000 in, or in some entrepreneurs' cases, they might already be maximizing a little bit to put more money aside, and maybe they're getting 40, 50 thousand dollars put away.

But, that feels real sweet to "have saved taxes" on that money when all we did was we're going to pay the taxes later. There's an old saying in the South that goes something to the effect of, "If you don't deal with something now, it's going to come back later with more hair on it," and certainly, tax bills can do that. So, there's this component that people can participate in called the Roth. Inside their 401(k), they put the money in. They have to pay taxes on it just like they would any other income, but it goes in and stays Roth and stays tax-free for the entirety.

Michael: That is correct, Paul. So, there was some very significant legal legislation that was passed called the Pension Protection Act of 2006, and as one of those parts of the Pension Protection Act of 2006, that allowed for a 401(k) plan to offer the ability to the participants and a participant in plan to personally decide to defer their own money into a Roth bucket.

Now, here is one of the more frustrating aspects of my career. That required that plan sponsor to amend their plan document. So, at its basis, a 401(k) plan is a trust, and the employer sponsors that trust for the benefit of their participants. But, in order to make changes to that trust, you have to amend the legal documents associated with that plan. So, what was necessary was that in 2007, a business owner had to amend their trust documentation so that, beginning in 2008, an employee could personally decide to save however much money. So, for 2018, if you're listening to this, that will be 18,500 you could save on a post-tax, after tax basis.

To this day, I still run into plan sponsors that have no idea that they could access a Roth benefit for themselves and their employees. I was visiting with one just last week. Because, that required this document change, and unfortunately, in my industry, the IRS, every four to five years, requires every retirement plan to amend language for new things that are being added. Certain revisions have been added.

"The way coverage works in a cash balance plan is you have to offer benefits to 40% of your population or 50 people."

For example, if we add servicemen and women returning back from active duty overseas and they need help getting up and running back here in America, we've allowed them to access their money without a penalty. We just had brand new legislation that's being required to be added to plan. If you were a victim of Hurricane Harvey, or Irma, or any of those moments, you can access money to get your life back up and running without penalties. In this situation, you're allowed to spread those taxes over.

But, the point I'm trying to make is there's been three moments the IRS told every employer, "You need to redo your plan documents." That would have been an outstanding time for a pension consultant to sit with that employer and say, "Hey, we should talk about the benefits of Roth."

Paul: This is not something they amend themselves. They had to go to the third-party administer, or the TPA, get it redone, they paid for that. You and I worked with a client earlier this year that didn't have it, but they had to actually get it revisited this many times.

Michael: They were mandated by law by the IRS to have three times their documents they've had to redone. So, they've paid a fee. Oftentimes, it was $1,500 as an average. So, I look at that, an employer has almost paid $5,000 to a third-party administrator or to their 401(k) service provider, and yet no one said, "Hey, you and your employees can now access tax-free dollars in your retirement." It's not subject to your AGI or how much money you're making. You can make millions of dollars and still do your deferral on a tax-free basis into the 401(k) plan.

Paul: If you're listening right now and you currently work for an employer and you have any level of influence, and you do not have Roth as an option in your plan, this is like reason number 1 to make sure that you go to HR and tell them they should listen to this podcast. You don't need to be the bad guy, you don't need to beat anyone up. It's like, "I don't understand why we don't have it," because they may want to know what's going, like, "Why did the TPA not tell us about this and make it a possibility?"

Michael: It's a very, very misunderstood topic, and I will tell you one of the struggles we all deal with is encouraging Americans to save their own money for retirements. Retirement is a cash flow issue. You need to make sure you have enough money to maintain your standard of living. Anecdotally, I've just noticed, over the course of setting up all these retirement plans that once you make the employee base aware that Roth is available, more people start deferring. It is just a phrase and a word that has some cache to it which inspires the employee to save their own money. Now, I will confess, they may not understand the exact specifics on why they find Roth so attractive. They just know, "Oh, I can do Roth in my 401(k). I thought I can only do that in my IRA, but maybe I made too much money to put the money into my IRA." So, I have spent, now, almost a decade trying to educate people on how they could have been accessing Roth dollars, or again, classifying them as tax-free dollars within their retirement plan.

Paul: For us, we run into very much the same thing where people won't know. There's something that we're going to cover in another podcast with the idea that even if you're a high-income earner, you can actually still put money into Roth through an indirect provision called a backdoor Roth IRA a lot of people are not familiar with. If you need more information on that, just email us at info@sfgwa.com and we'll get you info on that, but they phase out. So, for most of our clients, they're making over 186,000 a year, which is where the phase-out starts. It's done at 196. You can't put any more money into Roth, but you could still, inside your employer's 401(k), put 18 -- not 5,500 in an IRA, $18,000 a year directly to Roth with your portion.

Michael: Paul, for those people that are getting closer to retirement, those that retain the age of 50, you're also allowed to catch our provision in your 401(k) plan, which essentially enables you another $6,000 of deferral. That catch-up can also be Roth, so someone who's close to retirement, above the age of 50, could actually be deferring $24,000 a year into their Roth 401(k) component.

Paul: Now, I often refer to you as the 401(k) ninja, but if any of this sounds new to you guys as you're listening here, I want you to know we're not at ninja level yet. This is the basic capacity by simply adding Roth. The second thing that I think of, though, is we've got the Roth provision that ought to be there, but there needs to be another provision, because if your employer's putting money in, that all happens pre-tax. Now, no mystery. Your employer actually wants to deduct the money they put in for you, so that money has to be taxed when you retire because it hasn't been taxed yet. So, you have like two accounts side by side. But, the employer could still make the mistake, or if you are the employer, your TPA could have made the mistake and not left the provision in for an in-claim conversion. Is that right?

"To this day, I still run into plan sponsors that have no idea that they can access a Roth benefit for themselves and their employees.

Michael: Thank you, Paul, for bringing that up, because in 2014, obviously, currently, in the state of America, our country runs at a deficit. So, a tax law was proposed by the treasury and accepted that would allow an individual to convert their pre-taxed dollars within their 401(k) plan until Roth. But, as you're highlighting, it requires the plan document to permit it. I have found, since 2014, when this law was permitted, almost no plan documents permit for an in-plan Roth conversion. Some of that is because investment providers haven't built a form to allow for it.

But, the piece that you're touching on right now, this concept of an in-plan Roth conversion is going to take us now from a place where we're talking about employee benefits, and for those of you that are business owners, I'm sure, along the way, you have set up a 401(k) plan because you thought you needed to. You needed one to attract people to come work for you, and you're probably putting some sort of employer contribution, most likely a match in the plan, or maybe some of you are profit-sharing from a tax strategy basis.

But, we're going to sort of now put that employee benefit piece into a box because the second area that we're going to spend the rest of our time talking about today is more about how to use this retirement plan as more of a personal planning tool. Because if the thesis is at retirement, we want to have as many tax-free dollars at retirement. We can use not only this tax law change in 2014 that allows you to move from pre-tax to Roth, but accept if this is all going to be about tax estate and wealth transfer for you personally, we can now have a conversation about how do we target significant employer dollars to an owner or to a handful of key employees, we can take advantage of some rules under ERISA, under Code 410B, which shows that we're allowed to not have to offer contributions to every employee, and in fact, exclude the majority of those employees, and create a targeted contribution that, really, with great financial planning teams like Sound Financial Group, can then be converted from pre-tax because Paul, as you've highlighted, all employer dollars start pre-tax because the corporation's recognizing a tax deduction that tax year.

But, we now can look at converting those pre-tax dollar to Roth dollar internal to the plan. Now, obviously, the government will want to be paid those taxes they are due, so that is a taxable event. But, imagine a world where you can take that and then layer another tax strategy on top of that, and maybe another tax strategy on top of that. So, what I'm noticing is that the 401(k) plan, in many ways, is becoming a conduit where a business owner, an entrepreneur can work with a financial planning firm like Sound Financial Group and create these systems where, at retirement, the business owner has significant sums of tax-free money, and there's a variety of ways to accomplish that on an individual strategy.

Paul: Before we get to some of the ninja level stuff, I want to make sure that our listeners understand this one piece of the in-plan conversion. So, part one, if you don't have the Roth provision, you're going to want that. Now, we have a special giveaway today that's been super-generous of Michael for our audience that if you go to 401kfreak.sfgwa.com, that's the landing page for this episode, 401kfreak.sfgwa.com, you can actually put in, if it's your company and you own it, of course, or if you're an employee for a company, Michael has access to a scorecard system that benchmarks, because there's a, believe it or not, great deal of public information about every single 401(k) out there, and each of these 401(k)s have a rating, and as a result of this rating that they get, it's like a grade in different areas about how the 401(k) is doing, and that has to do with not so much the tax strategies we're going to go into in a moment, but it does have to do with the fundamental mechanics of the 401(k) and how well is it taking care of the employees. So, that's going to be huge.

Now, when we come back from commercial break here, we're going to talk a little bit about those key components that need to be in the 401(k) and we're going to branch over into these advanced tax strategies for the business owner and entrepreneur that they can implement, because the only way any of us are going to have financial freedom is if we convert the dollars that are business dollars on the business balance sheet onto our personal balance sheet. All financial independence are going to happen on the personal balance sheet, not the business balance sheet.

Cory Shepherd: At Sound Financial Group, we are committed to continuing to bring you Sound Financial Bites. Hello, my name is Cory Shepherd, president of Sound Financial Group. If you are finding value in these weekly podcasts, and they are making a difference in the way you think about money, then think about what kind of a difference could be made if you engaged one of our advisors to help you look at your personal finances.

So, what would the next step be? Send an email to info@sfgwa.com with "philosophy" in the subject line, and we will coordinate with you to have a conversation with Paul, myself, or one of our other advisors to share with you our philosophy of money. No one is going to close you on that call. No one is going to make you an offer to become a client. The only thing we allow our advisors to do in that call is teach, and the only thing we allow you to do is ask for an application.

While we don't accept everyone who applies to work with us, we are committed that any Sound Financial Bites listener who wants to go deeper has the chance to expand their thinking and walk away with new education and resources around money. So, even if we find out we aren't right to work together, our team will absolutely take care of you in that call and make sure that you have access to resources that might be of help to you.

Paul: Welcome back, and before we went to break, we talked a bit about the fact that we've got to add certain provisions to a 401(k) for some of the advanced things to happen. We need to make sure the Roth 401(k) provision is in there that people can make contributions. We have to have access to the in-plan conversion. What that means is if some of your employer dollars, your employer matches are in there, whether you are the entrepreneur or owner, or you're an executive, when you convert, say, $10,000 from pre-tax that the employer put in to Roth, what's going to happen is you're going to pick up that much in taxable income this year, but now the growth will remain tax-free on the Roth side of that plan. What we're after next is how do we set up strategies so that the business owner can extract the maximum value from the business balance sheet and get it on their personal balance sheet.

Now, everything here we're going to talk about is going to be business owner-related, but I don't want you to forget if you are a high-income earning executive, you have the same problem, and here's what I mean. When you work for a major company, and let's say you're even a publicly-traded company, you have stock options, whatever it is, you've got whatever income you have coming in from that business. You still, even though it's not your business, your objective in working there is making sure that you're driving enough money to your personal balance sheet so that you have financial independence. As you're working, especially if you're listening to this podcast and thinking about, "How do I become more efficient?" etcetera, this is what I want to have sitting there for you, you have to be efficient or you're wasting your time. Here's what I mean.

I want you to imagine if you were to work from now until, let's say, age 65. At age 65, imagine somebody came to you who had been following you your entire career and every financial decision you made, and then they looked at everywhere that you invested, and just tax-wise, or fee-wise, it was inefficient, and it cost you 10%. You would have had 10% more wealth over that period of years, which by the way, for the inefficiencies that we normally see in people's lives, 10% is an under-estimate. You're going to hear us talking about this a lot more.

If you're inefficient, then you wasted time. If you travel for work, if you have to go away to see customers, if you're building your business and you're staying up all night, you're missing kid tee ball practice, you're not able to participate in taekwondo, whatever it is, what if somebody got there and said, "You're 20% inefficient," which means 20% of the time, when you miss something important in your life, it was unnecessary because you weren't a good enough steward with the money that was on your balance sheet. That's why we keep pointing back to efficiency, and we never really gotten into this piece of it before.

But, given, especially if you're an entrepreneur or a business owner, and some of these things have never been floated to you before that we're about to talk about, what that means is, maybe, you're wasting your time, and you might be able to look and go, "Holy mackerel. If there's 20% more that could have been generated and I didn't know about," or, "If I could have put a bunch of money in tax-free accounts, maybe I didn't have to work as hard. Maybe I didn't have to be gone as much. Maybe I could have been there for that major life event, whatever it was," and I think one thing I'm super-thankful for, having had the opportunity -- well, last week as of the time of the recording, I was able to be at my dad's bedside when he passed because we worked to be efficient enough in the business and efficient enough in our personal finances that I was able to just be gone and be

100% there for him and for my mom, for my children, the rest of the family so that he had a great experience passing on and going to heaven, which wouldn't have been possible if it weren't for efficiency. If you feel like you've ever been missing things, it could be something as simple as having not been efficient.

I didn't mean that to be so heavy, but that's why this is important. This is not a dollar-and-cents game that we're playing. When we say that we're helping clients design and build a good life, we mean that. We mean that the more efficient you are, the better stewards you are, maybe the more of your life you can have back. Alright, Michael, with that as context, can you give us an example of where people have used some more of these ninja-level tax strategies to extract value from a business, get it on their personal balance sheet?

Michael: First, Paul, let's start on a basic, very easy that almost any person can implement strategy. I have the manage a 401(k) plan for a business owner who is a very forward-thinking financial planning firm and CPA, and unfortunately in 2015, this gentleman, they were building a dream home and they just ran out of the finances possible to build this dream home, which resulted in having to sell this - this is important - non-primary residence at a loss. So, just to keep our math easy, let's say they locked in a $200,000 loss on this property, which again, was not a primary residence. So, from a tax-planning perspective, that is what's called a passive loss. Well, this family had several hundred thousand dollars in their 401(k) profit sharing plan, and their CPA was fortuitous enough to say, "Hey, I remember this guy showing me, at a seminar one time, that we can take dollars in your 401(k) plan, and because of a new tax law change, convert them from pre-tax to Roth. But, however, that's going to create a tax bill." Well, this family was able to use this loss they locked in to offset any tax bill generated from the conversion of their 401(k) and profit sharing dollars from pre-tax to Roth. Now, tax advisory really played a significant role in figuring this out, but this family was able to convert approximately $300,000 from tax deferred to tax-free.

Paul: I say it a different way. Guaranteed taxable someday at an unknown rate to tax-free.

Michael: Exactly. They knew what the taxable -- but, the beauty of this transaction was that this family now has $300,000 of tax-free money they didn't have, they're only in their mid-40s. So, that money still has a long time to grow tax-free so that when they need their retirement, they're not worried about bumping up against a tax bill. There's another issue we haven't talked about again we should bring to the forefront is that, obviously, the IRS and our government want to get paid taxes even if you are deferring them. So, what happens is upon attaining the age of 70 and a half, the IRS mandates something called a "required minimum distribution".

Paul: Right before you explain what a required minimum distribution is, this is key, I want to make sure people don't mishear it, if you don't take this distribution at 70 and a half, that's required, what's the penalty?

Michael: I know there is a penalty. I'm pretty sure it's almost like half of what you were supposed to take, but I will have to defer to more of a professional financial planning situation.

Paul: 50%, 5-0, not 15, 50%, if you don't follow this rule. So, when we talk about you're going to build the money up in the retirement plan and how long people are living now -- when they put in required minimum distribution, it's like, "Well, in the odd chance somebody makes it past 70 and a half," but now that's the norm and people are paying this all the time. We have clients dealing with it right now. So, please continue.

Michael: Again, we're talking more about estate planning concept, and this is going to be a theme that, all of a sudden, we're taking estate planning concepts and bringing them into a retirement plan. But, if you continue to live from 70 to 75 to 80, our government and our IRS want to be paid those taxes. So, the older you get, the larger a percentage they have you take out of your tax-deferred account.

Paul: Forcing taxable money onto your balance sheet from one part of your balance sheet to another, said a different way, and you have no options.

Michael: Correct, and what happens, oftentimes, in a personal planning situation, it's all of a sudden, you're being ratcheted up a tax bracket because of this required minimum distributions.

Paul: If I can, I think, oftentimes, people, because they're earning money every year, it's obvious if they're making $450,000 a year that the checks they get are something less than that, the IRS gets some, sometimes they write a check, sometimes they get a refund: very clean, very simple. When you retire, and I'm just going to use an easy round one: $100,000 a year. So, you get to retiring, you say, "I'm going to take $100,000 out of my traditional IRA. It was the 401(k), I rolled it over, I'm taking $100,000 out. I'm going to live off that for a while." When you get to doing your taxes the next year, the CPA says, "Well, you owe taxes on the IRA," and you go, "Oh, no big deal. How much do I owe," and he says, "Well, because of where we're located, depending on the state of where you are when you're listening to this, you're going to owe about 35%." Alright, well I'll pay 35% because you've got other income, there's other assets still generating income. If you're doing a good job, the money and the IRA is not the only thing that you have. So, you say, "Okay, no big deal. I'll just take $35,000 out of the IRA to pay the tax," and he says, "No, no, no, you need to take enough out to pay the $35,000 so this doesn't happen again next year and to pay the tax on the $35,000."

Now, how much do I got to take out? Well, it takes a little bit of math, but suddenly it's like $65,000. That's what I'm doing in my head, the math. Something like that to net enough to pay the taxes and then to make sure you're paying the taxes on the money you had to pull out to pay the taxes. So, the first time somebody does that at age 65 like, "Wait a second. I had to take out $165,000 to enjoy $100,000. That's awful," and then they don't take money out anymore, and that's why people get surprised by the required minimum distributions because it's so painful to pay that tax bill when they first retire that they then try to leave the money in there, maybe even making the problem worse. How is that treated on Roth?

Michael: Paul, I'm happy to tell you that there is no required minimum distribution on Roth dollars.

Paul: Now, I'm going to ask this question. I know the answer, but this is the thing that I think people could be shocked by. You mean I can position money, high-income earner in my 30s, drive it into a tax-exempt environment, allow that tax-free snowball to continue to roll, invest it however I choose to invest it, and then at age 65, I don't have to take it, and I might even be able to let that snowball continue to roll and compound out into my 80s.

Michael: Correct.

Paul: So, I may have a tax-free investment vehicle that when positioned money into it, I might have it positioned there for 50 or 60 years?

Michael: Yes, and it can be a wonderful strategic planning tool. For purposes of time, I would encourage everyone to take a look at Mark Zuckerberg's Roth IRA and his Roth 401(k).

Paul: We will send, we will make a link to that as a part of our giveaways when you guys hit 401kfreak.sfgwa.com. Let's talk about some of these situations where you've had owners, Michael, that have told you, "Hey, listen, I just do it for the employees. I can't really put that much money in," and they've just kind of been remiss. Maybe they're getting 25 or 30 thousand dollars a year into their 401(k), and you've shocked them, some of them telling me they can put away hundreds of thousands of dollars a year from their business balance sheet to their personal balance sheet.

Michael: Correct, Paul, and I think -- the one thing I work on a lot with clients is not being initially focused on what subsection of IRS code we're using to qualify for reduction or retirement plan. My meeting before coming to visit with you today to do this podcast, I was showing a single employer, he's just a freelance software engineer, but he's 48 years old and his wife is 46, and I just asked a simple question, "How much money do you want to save?" and he said, "I don't know. I can do like 18 grand in a 401(k)." I was like, "That's true but --"

Paul: How much do you want?

Michael: "How much do you want to save?" and the conversation quickly turned to, "Well, how much money can I save?" and the answer is $268,000.

Paul: In that case, he is his only employee --

Michael: He and his spouse.

Paul: Yep, and they're able to put away nearly $300,000 a year every year that they can -- and we'll talk about this before we're done is the idea that, in high-income years, they can put it inside the plan tax-deferred, and in lower-income years, they could use that valve.

Michael: Correct. So, the story I told you about the family that had to sell that non-primary residence lock and passive, that's the concept I want to understand is that there's the ability to convert a dollar from tax-deferred to tax-free.

Paul: That's the in-plan conversion that we oftentimes see is not in people's 401(k).

Michael: Correct. Now, I'm going to take on another concept, which is most people don't understand that they can save upwards, sometimes, like -- depending upon our age, now we're getting to actuarial science. But, most people don't realize that they can be doing contributions for themselves sometimes in excess of a quarter of a million dollars a year. So, now we have these two theses. Because, when I start explaining to business owners, "Well, wait a second. I can get access to tax-free money, I can do a lot of money, and for firms like Sound Financial Group that are so focused on extracting value out of this business into the personal balance sheet in a very tax-efficient manner, now we're creating retirement plan contributions," and let's just use an easy number. It's $200,000 a year. Now, we're pulling that $200,000 out of this business and we're moving it into the retirement plan of this business owner.

Paul: Personal balance sheet.

Michael: Personal balance sheets. So, now we've got the in-plan world, we've got the large contribution, and here's the third pro I'm about to throw at this. Under ERISA code 410B --

Paul: Told you guys he was a 401(k) freak.

Michael: This is an important one though. This relates to coverage. Who do I have to really offer this benefit to? And one of the things you're going to take from this podcast --

Paul: Wait, I want to make sure this is what he's saying right here is for those of you who have said, "Well, I can't put that much money away because I have 35, 40 employees," what he's about to say is the keys to the kingdom about how you can still defer a ton just like that solopreneur example that you can still do that, you may still be able to do that inside a larger company with 40, 50, or more employees.

Michael: I'll touch on a larger case in a second, but I want to get the theses together. So, the thesis under 410B is that if I offer benefits to 100% of my highly-compensated employees, and highly compensated is someone who made more than $120,000 in the prior tax year, and that gets adjusted every now and then by the IRS as incomes continue to inflate, they are greater than 5% owner, or they are the spouse, child, or parent of that greater than 5% owner, they're a highly-compensated person.

But, what ERISA code 410B will tell you is that if you offer benefits to 100% of your highly compensated, everyone else is a non-highly-compensated, you only have to offer benefits to 70% of that population, or if you read it in inverse, you're allowed to exclude 30% of your employees by job classification. At this point, each employee's going into their own job classification. But, think of that thesis now. We've covered 100% of our highly-compensated. So, let's just make it easy. It's owner and spouse, and spouse although is not being paid an excess of 120,000, they are still highly compensated by virtue of being spouse. If I take the spouse out of the employer contributions - this is profit sharing and things along those lines, or maybe define benefit or cash balance - I'm now offering benefits to half of my highly compensated, and the math works in ratio.

Now, I only have to offer benefits to half of 70%, or 35% of my employee base. So, we just set up a plan which is commonly called a cash balance plan, and this is a mid-sized law firm, there is a multitude of partners, but the total population is over 200 employees, and the two owners of this practice were very focused on current year deductions, and they looked at their financial planner and said, "What's the most we can put in this thing?" and she spoke with an actuary, and the number was determined that, for two brothers who are on this practice, they could save, together, $500,000 annually. Now, cash balance plans are a little different, but the way coverage works in a cash balance plan is you have to offer benefits to 40% of your population or 50 people. So, an actuary is always trying to maximize the contributions to the owners - and this is the estate planning part, this is no longer employee benefit - minimize the contribution to the employees.

Paul: For clarity, that doesn't mean no contribution to the employees. It just means the business owner wants to take more of the money they've built and the enterprise value they've built in their company and put it aside in a 401(k) for themselves.

Michael: Correct, so these employees, all 200 members of this firm, still have a 401(k) plan. They still get to save their own money whether that's on a traditional basis or a Roth basis. There is still a match to every single employee because matches really encourage people to save their own money, and that's our goal of our 401(k) plan. We want to encourage people to save their own plan. But, this cash balance plan, again, is a tax estate and personal wealth strategy for ownership. Well, again, under those laws, we can only offer this benefit to 50 of those 200 people. So, again, an actuary, though, is going to maximize the contribution to the employer, which we began to confirm as half a million dollars total, 250 each, and minimize that contribution.

Paul: Because, the business could never do it if they had to give that kind of ratio to everybody, hence these exclusionary rules.

Michael: Correct. On average, make a cash balance plan work. It's a minimum of 7% of salary to the employee. So, if you had to give 7% of salary to all 200 employees, it would not make sense from a tax strategy percentage. But, if we just offer it to 48 employees, and those 48 employees happen to be some of the lower-wage earners -- so, an example, in a law firm, these are your document imagers. In this particular situation, it was calculated that for an employee cost, what you have to give these 48 employees, these document imagers, if you give them 117,000 total across these 48 people, that passed all of the IRS rules and regulations of a qualified plan so that the two senior partners could save half a million.

Paul: Those folks that are in those roles, they're not leaving for anything. That's actually a level of match -- in most cases, I think 401(k)s don't retain people, but that's a level of match that keeps their attention.

Michael: These 48 people are all getting 7% of their salary. So, this law firm is essentially going to write a check for $620,000 a year, but the two main partners are getting half a million that in their own account. So, on a percentage basis, they're getting about 81 to 82 cents out of every dollar they are putting into this benefit plan. The entire contribution is current year tax deductible, so it's a strategy where they really can begin to start extracting significant value out of, in this situation, this law firm and bring it into their personal balance sheets, and they have still maintained all their required laws and revision of ERISA and the IRS by having these 48 other employees of their practice receive the contribution.

Paul: The kinds of things, and this applies to our executives too, and I think this will kind of land us in a solid closing, because we've covered a lot. This has been one of our more analytical-type podcasts, but I want you to consider this. That valve that we have, that in-plan conversion, now, in that example for the law firm, if they have losses somewhere else on their personal balance sheet those years, they can dial it and let some money flow from the tax-deferred side to the tax-free side because they've got the losses. If they just have a bad year in the law firm and they were making a million dollars a year and they have a year where they make 400,000, that might be a year to open the valve. If they make a large charitable gift, they might be able to open the valve and let the money flow between the two and get more money to the tax-free realm.

By the way, imagine if what they did every year -- as I said, forget it, at the end of the year, I don't care what the taxes are. I'm getting this money tax-free, and they would be positioning between the two brothers, half a million dollars a year into a tax-free environment. That's not being taught at your typical basics in finance class. It's not being taught by most advisors, and as you've heard me talk about in the past podcast, it's oftentimes not talked about because the financial institutions love being able to manage wherever they can both your money and the IRS's money. The money is more sticky, it's less likely to be distributed when you're over age 64. They call that stickiness of assets that people don't withdraw the money. For you, it works really, really well to have the Roth component, but it may not work as well for the institution because you don't typically put aside enough money. In these cases where Michael is really teaching us how you can take money, lots of it, get it inside the tax deductible environment as a path to tax-free, which is about as far as you could imagine the path would be to get to tax-free is that you would actually make it fully taxable later to make it tax-free.

Too often, like we often see, people polarize in the financial world, like every radio host, or whatever, they will say, "Tax-deductible is better," or, "Roth is better," and it's an argument of that, but they're not talking about -- much like for those of you that have been familiar with the backdoor Roth IRA that you can do on a personal balance sheet, we're actually using one vehicle to get to the other vehicle, but people are not being taught how to do that math. Michael, what is it that when somebody's thinking about doing this, just your own experience, what do you think is the biggest reason it stops business owners from exploring being more creative in their 401(k) strategies?

Michael: Lack of awareness and education on these strategies, Paul. I sit with CPAs on a weekly basis who look at this and say, "I never knew I could do all this stuff for my clients," and they almost feel shameful of themselves that they're not aware of it. The one thing I'd probably have your audience take away is, much like tax advisory, not all actuarial science firms, or actuaries, look at data the same exact way. I really haven't found many people on the West Coast, where we reside, that are even aware that they can do these sorts of items, and it really is eye-opening particularly to the business owner who's saying, "Well, how come my current advisor didn't tell me about this when the tax law change happened for Roth in 2008?" and then he's looking at his CPA saying, "And how come you didn't tell me about the tax law change in 2014, where I can be converting these dollars from pre-tax to Roth?"

It's complicated. Much like all sort of tax thesis and retirement plan thesis is, it's hard sometimes, but we have just found that introducing these concepts, and in many ways, we're taking different concepts and intertwining them to one presentation. But, we're not finding the people to add the conversion to the Roth strategy to the ability to exclude employees from these large employer contributions. No one's really putting this elixir all together in such a way to really significantly benefit this business owner for their own personal long-term estate planning.

Paul: Right on. Well, Michael, I'm so thankful you could be here today, and I'm super-thankful for your giveaway that you'd be willing to open up that scorecard service to our clients and our listeners. All you have to do is go to 401kfreak.sfgwa.com and you're going to put in your company's name, where you're located, which is all they need, most of the time, to find the information, good contact information for you - email, phone, all that - and then we're going to drop this report to you. It will take three or four days to turn around, or we may have another question like, "Hey, there's two companies with similar names," but we will make sure that that gets to you, and that, again, is not going to deal with these highly-compensated, super-complex strategies, but I almost guarantee that every time we've seen a plan that the scorecard is low, almost never have they taken care of some of the really basic provisions of something like Roth, and we've seen some big companies, who will go unnamed, that our clients work at that don't have the Roth provision inside the 401(k), and it's really a missing thing.

So, if you're influential in a company that doesn't have Roth in their 401(k), we would love to support you in having that conversation with your human resource team and getting them to do that. But, you can move the needle by simply telling them, "Why would we give up the ability to put money away on a tax-free basis?" and if you've got a plan, the other takeaway would be you need to call your HR department and see if you have in-plan conversions from IRA to Roth, because everybody has a reason to periodically have tax losses on their personal balance sheet, large charitable gifts that would give you the ability to move money from one side to the other, and it's not an opportunity you want taken away from you simply because your employer doesn't have the provision. So, I'm so glad you guys could be with us today. I look forward to having you join us again next week, and we just hope that this has been a contribution to you being able to design and build a good life.

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