Case 9

The Edwards Case

A RETIREMENT AND EMPLOYEE BENEFITS MINI-CASE

Nick Edwards owns a used car dealership. He is age 60, has worked in the business for 30 years, and earns $110,000 per year. He has several employees with varying years of experience and tenure at the dealership. As the owner of the company, Nick has come to you for advice regarding the establishment of a retirement plan. He is also interested in learning more about employee benefits as a tool to help him recruit and retain good salespersons.

Over the course of several weeks of meetings with Nick you have compiled a list of attributes he would like to see in a retirement plan:

- He wants his employees to contribute to the plan.
- He is willing to match employee contributions if necessary.
- He wants the plan to be an incentive to increase productivity.
- He is willing to pay all of the plan's administrative costs.
- He would prefer not to assume any investment risk on the part of employees.
- He would be happy with a payroll deduction for his firm of 10% to 15% per year.
- Although he is willing to match contributions, he would prefer to maintain flexibility so that in low-profit years he could skip matching if needed.
- He does not want 100% immediate vesting for employees.
- He has no opinion regarding the ability of employees to make in-service withdrawals.

- He would like to maximize his own benefits, but not at the expense of running afoul of IRS highly compensated employee rules.

You have learned that, in addition to retirement benefits, Nick offers a mix of employee benefits, including life, health, and disability insurance for his employees. Information about these plans is summarized below:

- Group term life insurance equal to two times annual earnings.
  - Table VI.15 shows the cost per $1,000 of life insurance protection offered through an employer on a monthly basis for tax purposes
- Group health insurance benefits
  - Traditional plan with a $500 annual deductible and 80/20 coinsurance provision
  - Out-of-pocket maximum equal to $5,000 annually
  - Lifetime limit of $750,000
  - Benefit coverage includes employee and spouse only
  - Financed 100% through the dealership
- Group short-term disability insurance
  - Benefit equal to 50% of salary for six months
  - 30-day waiting period

Table VI.15 Cost per $1,000 of Employer-provided Life Insurance Protection

Attained Age on Last Day of Employee's Tax Year	Cost Per $1,000 of Protection for One-month Period
Under 25	$.05
25–29	.06
30–34	.08
35–39	.09
40–44	.10
45–49	.15
50–54	.23
55 – 59	.43
6 –64	.66
65–69	1.27
70 and above	2.06

Nick's best employee is Emily James. Emily has worked at the dealership full-time for seven years. She is 56 years old and makes $74,000 per year. Other employees' relevant data are shown in Table VI.16.

Table VI.16 Relevant Employee Data

Name	Salary	Years w/Firm	Age	Status
Kate	$36,000	6	28	Full-time employee
Mark	$32,000	4	47	Full-time employee
Joyce	$32,000	4	34	Full-time employee
Bill	$30,000	2	36	Full-time employee
Jack	$15,000	3	20	Part-time employee (< 1,000 hours/year)
Andy	$12,000	2	17	Part-time employee (< 1,000 hours/year)
Mary	$6,000	1	19	Part-time employee (< 1,000 hours/year)

Use this information to answer the following questions.

Case Questions

1. How much must Emily James report in yearly § 79 income (rounded) for tax purposes, assuming she stays employed for the year?

   a. $42

   b. $98

   c. $506

   d. $6,000

2. Nick purchased a $100,000 participating whole-life insurance policy on his life. To date, he has paid $50,000 in total premiums and received $10,000 in dividends. The policy currently has a net cash value of $15,000 and is subject to a $30,000 outstanding loan. If Nick decides to surrender the policy, he would realize a gain of

   a. $0

   b. $5,000

   c. $10,000

   d. $15,000

3. Currently, Nick's brother Tommy owns an auto repair shop across town. Tommy owns the shop as a sole proprietorship. Nick has suggested that Tommy think about converting the shop to a corporation. Advantages for incorporating the repair shop into a C corporation include which of the following?

   I. Allowing the flow-through of corporate profits to shareholders that could be taxed at each owner's marginal tax bracket.

   II. Withdrawing accumulated profits at capital gain rates.

   III. Providing tax-favored fringe benefits to employee shareholders.

   IV. Changing the form of business with ease once a corporation has been formed.

   a. II only

   b. III only

   c. I and III only

   d. I and IV only

4. Assuming that Nick is most interested in implementing a retirement plan that offers flexibility, low costs, and limited paperwork and regulation, he should consider establishing a:

   a. Cash balance plan

   b. 401(k) plan

   c. Roth 401(k) plan

   d. SIMPLE plan

   e. Stock bonus plan

5. Based on Nick's desires, as outlined in the list you developed, which of the following plans would meet his needs?

   I. A 403(b) plan

   II. A profit sharing plan

   III. A stock bonus plan

   IV. A defined benefit plan

   a. I and IV only

   b. II and IV only

   c. II and III only

d. I, II, and III only

e. II, III, and IV only

6. Using the most restrictive vesting schedule and participation rules available, Nick can exclude which of the following employees from participating in a qualified defined contribution plan?

   I. Bill

   II. Jack

   III. Andy

   IV. Mary

a. I and II only

b. II and III only

c. I and IV only

d. I, II, and III only

e. II, III, and IV only

7. Nick is concerned about how he will fund contributions to a defined contribution plan. You recommend that he use a unit formula based on employee compensation and years of service. The formula is calculated using one unit of credit for each year of service and one unit of credit for each $10,000 in earnings. If Nick is willing to allocate $30,000 in total contributions in any given year, using a total allocation of 80 units (and disregarding any key employee or top-heavy restrictions), what is the maximum amount that will be contributed to Nick's account?

a. $9,675

b. $13,225

c. $15,375

d. $22,750

8. Nick's daughter, who is hoping one day to take over ownership of the dealership, is interested in your discussion with her father. She would like her father to receive the maximum plan benefit available before and after retirement. She would also like to establish a plan that guarantees her father a steady source of income during retirement. If you follow the daughter's desires, which of the following plans would be most appropriate?

a. A SIMPLE plan

b. A money purchase plan

c. A stock bonus plan

d. A defined benefit plan

e. A target benefit plan

9. *Nick is intrigued by his daughter's idea. However, he is still adamant about providing the* best possible benefits to his employees, in addition to himself. The thought of maximizing tax deductions for contributions is something he would like to consider. Assuming that the dealership has steady to increasing levels of cash flow, which of the following plan(s) would be most appropriate?

   I. A defined benefit plan.

   II. A target benefit plan.

   III. A 401(k) plan.

   IV. A stock bonus plan.

   V. A Roth 401(k) plan.

   a. I and V only

   b. I and II only

   c. IV and V only

   d. II, III, and IV only

   e. I, II, III, and V only

10. Joyce, one of Nick's employees, has come to you for advice. She would like guidance on choosing between contributing to a defined contribution plan and a Roth IRA. Assuming that Nick establishes a 401(k) plan, which of the following statements is true for Joyce?

   a. If Nick's firm matches contributions to the 401(k) plan, she should contribute to the plan at least to the point of obtaining the match.

   b. Under no circumstances will the 401(k) plan provide a better after-tax return than the Roth IRA.

   c. If Joyce believes that tax rates in retirement will be higher than rates today, she should contribute to the 401(k) plan rather than the Roth IRA.

   d. Regardless of employer matching, Joyce should maximize her contribution to the Roth IRA before contributing to the defined contribution plan.