Paying Too Much in Taxes? Consider a Cash Balance Plan

The retirement plan landscape has undergone a series of radical changes in recent decades. For a long time, the traditional pension plan was dominant. Under these plans, employers put money into funds that pay retired workers, and sometimes their survivors, a regular income for the remainder of their lives. However, traditional defined benefit pension plans began to lose ground among businesses of all sizes in the 1990s due to their high operational costs, regulatory complexity, and potential for expanding liabilities. According to the U.S. Bureau of Labor Statistics, only 17% of workers in private industry have a traditional pension plan, significantly lower than was the case three decades ago. As the number of employees with access to pension plans fell, the number of workers who could participate in a defined contribution plan, such as a 401(k) plan, grew significantly.

However, some owners of professional practices and other small businesses found the limits on how much they could contribute to their defined contribution plans to be much too restrictive. For example, a sole proprietor or partner age 50 or older may contribute a maximum of only $62,000 to a 401(k) plan in 2019, including elective deferrals, catch-up contributions, employer matches, and profit sharing contributions. In reviewing the range of available retirement alternatives, business owners have been discovering cash balance retirement plans. According to a recent study of cash balance plans*:

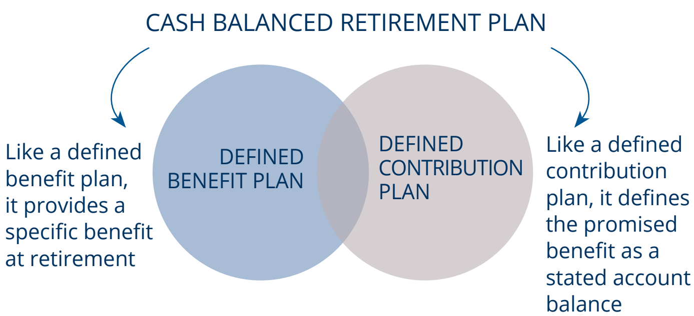
In 2016
total assets in cash balance plans
$1.03 trillion

92%
of plans in place are at firms with
fewer than 100 employees.

*2018 National Cash Balance Research Report, Kravitz, Inc.

A Hybrid Plan

Cash balance retirement plans are considered "hybrid" retirement plans since they use a combination of features from both defined benefit and defined contribution plans. Like a traditional defined benefit plan, a cash balance plan provides a specific benefit at retirement for each eligible employee. However, a cash balance plan defines the promised benefit in terms of a stated account balance, much like a defined contribution plan.



For regulatory purposes, a cash balance plan is a defined benefit pension plan. That means that the plan's funding limits, funding requirements, and investment risk are based on defined-benefit requirements and the benefits promised by the plan are usually insured by the Pension Benefit Guaranty Corporation, a federal agency. The employer assumes the risk of any trust fund earnings shortfall or losses that are in excess of the actuarially determined amount required to fund the plan.

How Cash Balance Plans Work

The employer is responsible for making all contributions to the plan. The plan's assets are commingled in the plan trust for investment purposes, but separate notional (or "hypothetical") accounts are created for each covered employee. Typically, the employer credits the participant's account each year with a set percentage of his or her annual compensation (a pay credit) plus interest (an interest credit). In order to determine the participant's accrued benefit at any particular time, the hypothetical account balance is projected, with interest, to normal retirement age. This projected lump-sum amount is then converted to an annuity by dividing the amount by the annuity purchase rate specified under the plan.

Cash balance plans are usually set up to pay lump-sum benefits equal to the hypothetical account balance at any point in time. The benefit formula, or the Hypothetical Allocation Formula, must be stated in the plan.

Who Benefits Most From Cash Balance Plans?

Cash balance plans are particularly **attractive to small employers and professional groups,** such as physicians or lawyers. The contributions for cash balance plans are calculated based on the employees' ages, compensation, and employee classification. Because the plan provides generous benefits for the owner or key employee, it is typically set up in combination with a 401(k) plan so that together they can satisfy the tax law's nondiscrimination requirements.

A combination plan can provide participants with a larger amount of retirement savings than would be possible through a stand-alone 401(k) plan. However, the owners of the business derive the greatest benefit from a cash balance plan inasmuch as they can make significant contributions for themselves every year.

Example

A two-lawyer practice earns $1 million in profit in 2019. Lawyer A takes a salary of $250,000. The cash balance plan can be designed so that Lawyer A takes the other $250,000 of his profit for 2019 as his contribution to the plan for that year. Lawyer B's share of the plan contribution is $100,000 and he takes the remaining $400,000 of his share of the profits as salary. The practice's net taxable income is zero.

What's Required of Employers

A cash balance plan could require one annual fixed contribution for owners and a different fixed contribution for other eligible employees, within limits specified by the IRS. While the possibility of making large annual contributions and the potential tax deductions are attractive features of cash balance plans, business owners should be aware that a cash balance plan requires them to make a commitment to contribute each year that the plan is active (unless the plan is currently overfunded).

Employers are obligated to fund the plan in the amounts and according to the schedule they specified when they created the plan. That means that the owner will have to contribute to the plan irrespective of how much or how little profit the business earns in a given year. Moreover, the business may add or terminate employees or it may undergo other changes over time. When changes of this nature occur, it may be necessary to revisit aspects of the cash balance plan to ensure it continues to meet IRS regulations.

ERISA

The inclusion of non-owner participants in a cash balance plan means the plan must have an ERISA fidelity bond so that the plan is protected from loss due to fraudulent or dishonest activities by those individuals who handle funds or other property of the plan. Generally, the bond must be for at least 10% of the value of the plan's assets.

Interest Credits — Different Options

FIXED RETURNS

A cash balance plan's interest crediting rate can be a fixed rate, such as 5.25%, or a variable rate, such as the yield on the 30-year U.S. Treasury bond. The variable interest rate must be locked in on a given date in the plan year and the same interest rate, based on the variable, must be applied to all participants' accounts in a uniform manner. The interest rate of the cash balance plan is guaranteed and is independent of the plan's investment performance. Essentially, each account earns the interest credit annually irrespective of the plan's actual investment performance.

MARKET RETURNS

Another design option involves crediting interest based on market returns. In other words, interest is credited based on the actual investment returns of assets that are specified under the plan, including the plan's own assets, a designated portion of the plan's assets, or on one or more specified outside funds, such as mutual funds.

When interest credits are based on market returns, plan assets and liabilities (account balances) may frequently move in unison. This unified movement produces a volatility similar to that of a defined contribution plan. The tradeoff for participants for assuming this financial volatility is that they may earn higher returns than those from other interest crediting rate designs and potentially accumulate larger retirement benefits over time.

Payout Options

Participants can be given a choice as to how they receive their payouts from a cash balance plan. The plan may provide for the payment of a lump sum equal to the participant's vested hypothetical account balance. Subject to IRS rules, upon retirement or plan termination, participants electing a lump sum payout would have the option to roll plan assets over into an individual retirement account (IRA) or another qualified retirement plan and continue to defer taxes until funds are withdrawn. Alternatively, participants could elect to receive guaranteed monthly payouts in the form of a life annuity.

Additional Tax Benefits

The Tax Cuts and Jobs Act of 2017 created a new tax deduction for 20% of qualified business income from "pass-through" entities, such as S corporations, partnerships, and sole proprietorships. However, income limitations may prevent some professionals from benefiting from this tax break. The tax deduction available for contributions to a cash balance plan might allow owners to reduce their adjusted gross income (AGI) enough to qualify for the full 20% deduction of qualified business income.

Investment Strategy

Since the cash balance plan is different than a 401(k), can be complex, and is also covered by ERISA law, the best practice is for the plan sponsor to engage an independent financial advisor who will partner with the owner as a co-fiduciary for the plan. Given the complexity, the plan sponsor should also make sure that the engaged professional is experienced with cash balance plans. Developing an investment strategy for a cash balance plan requires an approach that's different from what is generally applied in the defined contribution plan context. The portfolio must be structured to enable the plan to satisfy a guaranteed rate of return. The plan's interest crediting rate, the degree of turnover in the business, company demographics, the predictability of cash flow, and the owners' capacity to handle investment risk are all factors that should be considered in devising a portfolio of investments for the plan.

The cash balance plan's assets can be invested in any marketable securities, including bonds and funds. The investment risk is borne by the business owner/plan sponsor. That can mean that on those occasions when investment performance is stronger than assumed, the required annual contribution would decrease. Of course, the opposite can occur: The required annual contribution could increase over time if the investment portfolio fails to perform as expected. Should the plan become underfunded, the sponsor would have to make additional contributions.

Portability

Traditional pension plans do not allow participants to take their vested accrued benefits with them when they leave to work for another employer. Instead, participants must wait until they reach their normal retirement age to receive a payout from their pension plan. A cash balance plan, on the other hand, generally allows participants to take the vested portion of their account balance with them when they change jobs and invest it on their own.

Cost and Expenses

As with any qualified retirement plan, a cash balance plan involves costs for setup fees, annual administrative fees, and investment management fees. In addition, an actuary must be engaged to assess the plan's funded status and to determine the amount of contributions necessary to properly fund the benefits payable from the plan.

Is It Right for Your Business?

Not every business will benefit from having a cash balance plan. You can determine whether setting up a cash balance plan for your business makes sense by working closely with a trusted financial advisor.

Call (844) PROCYON today

Do you need alternative options for your retirement plan? Contact Christopher E. Foster at Procyon Partners for more information on cash balance retirement plans and whether they are right for your organization.

Christopher E. Foster, CIMA, CRPS

Partner
Managing Director

Chris has over 10 years of industry experience and prior to co-founding Procyon Partners, Chris served as a Senior Wealth Strategist, Institutional Analyst, and Senior Retirement Plan Consultant for the FDG Group at UBS Financial Services. He was also a member of the firm's Institutional and Retirement Plan Consulting Groups. As a Partner at Procyon, he leads the firm's investment analyst group while helping clients understand how analytics, retirement plan design and fiduciary best practices can help improve employee retirement outcomes and mitigate organizational risk. Chris is a graduate of the University of Connecticut and holds a B.S. degree in Finance and a B.A. degree in Political Science.

He has earned designations as a Certified Investment Management Analyst (CIMA®) through the University of Pennsylvania's Wharton School of Business and a Certified Retirement Plans Specialist (CRPS®) through the College for Financial Planning.℠ He works with both qualified and non- qualified plans sponsored by many of the nation's top companies, who leverage his expertise in portfolio construction, investment manager research, and fiduciary governance. Chris was recognized by the National Association of Plan Advisors (NAPA) as one of their Top 50 Advisors Under 40 (a.k.a. "young guns") in 2016, by Barron's as one of their Top 30 Institutional Consultants in 2017, 2016 and 2015, and also by plansponsor magazine as a member of their 2011 Retirement Plan Advisory Team of the Year.

Chris is also a member of the Investments and Wealth Institute, a national industry association responsible for establishing and enforcing high fiduciary standards for Investment Consultants. He enjoys traveling, skiing and playing golf, and currently resides in Wallingford, Connecticut with his wife Lauren and their French Bulldog named Gus.

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One Corporate Drive • Suite 225 • Shelton, CT 06484 | (844) PROCYON | www.procyonpartners.net