CB and DB Plans: Who, When, and Why Plus a Bit of What and How

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Cash balance plans are quite the trendy option and defined benefit plans have a lot going for them. For the right client, they are powerful ways to boost tax-qualified retirement savings and accumulate significant amounts at retirement. Cash balance plans offer the additional benefit of easy customization and coordination with the client's existing defined contribution plans.

This webcast is for anyone with an interest in how cash balance and defined benefit plans can work for closely held businesses in today's environment and when and how to present them. It will be real-world and practical, not actuarial nor techie.

Why DB/CB?

For Plan Sponsors

- Larger $ for owners, principals, and favored employees
- Can be combined with 401k PS for even larger $

For TPAs and Advisers

- New pool of prospective clients
- Less reason for current clients to leave you
- More services = larger billings

Types of Plans

Defined Contribution (401k, profit sharing, etc.)

- Contributions are determined by formula/method/procedure
- Contributions may be made by employer and/or the employee
- Employee bears investment risk

Defined benefit (traditional DB, cash balance)

- Retirement benefit/method is defined by formula
- Contribution = amount needed to fund retirement benefit
- Contributions are required and made by employer
- Employer bears investment risk

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Traditional Defined Benefit Plan

Retirement benefit: Monthly benefit payable at retirement age (often percentage of average compensation multiplied by years of service or years of participation)

Actual contribution: Computed by plan actuary (following IRS rules)

Investment risk: Lower earnings = higher future cost
Higher earnings = lower future cost

Works well for owner-only plans

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AEGIS SAMPLE DEFINED BENEFIT
For the Plan Year 01/01/2017 - 12/31/2017
CONTRIBUTION REPORT - DETAIL

P	O	H	Last Name	First Name	AA	RA	Considered Earnings	Monthly Benefit at RA	Annual Contribution	% of Total
*	*	*	OWNER	OWNER	52	62	270,000	17,917	220,000	94.2
			STAFF	1	35	62	40,000	3,333	10,000	4.3
			STAFF	2	25	62	25,000	2,083	3,500	1.5

Legend: P- Principal, O- Owner, H- Highly Compensated Employee

CONTRIBUTION REPORT - SUMMARY

	Considered Earnings		Annual Contributio n	% of Total
Principals	**270,000**		**220,000**	**94.2**
Non-Principals	**65,000**		**13,500**	**5.8**
Grand Total	**335,000**		**233,500**	**100.0**

BENEFIT: 8% X MONTHLY COMPENSATION X YRS OF SERVICE (MAXIMUM 1 PAST YEAR

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DB Plan Basics

Funding requirements

Contributions are required, not discretionary

Actuarial valuation/certification required

Basic funding equation: B = C + i

Low returns = higher future contributions

High returns = lower future contributions

Plan may be designed so that annual funding contribution is expected to be a certain level but no guarantee

DB Plan Basics

Minimum/Maximum/Recommended Contributions

- Minimum required
  - Minimum amount that satisfies IRS funding requirements
  - (adjusted with interest to date of deposit)
- Maximum deductible contribution
  - Allows a "cushion"
  - (essentially advance contribution for future years)
- Recommended contribution = just right!

DB Plan Basics

Benefit defined in plan
- Usually as monthly benefit payable at NRA

415 limits
- Defined in terms of annual benefit payable at NRA
  - $ limit = $200,000 (as indexed), reduced 1/10 for YOP
  - % limit = 100% of three-year average compensation, reduced for YOS
  - Adjustments apply to NRA other than 62, etc.

Limits apply to the participant's career/entire benefit; not on year-by-year basis

DB Plan Basics

Minimum Participation - IRC 401(a)26)

Minimum benefit is equivalent of annuity of one-half percent of compensation, commencing at NRA

Lesser of 40 percent of all non-excludable employees (minimum two) or 50 employees must receive minimum benefit

To maximize leverage of non-discrimination testing and 415 rules, contributions to HCEs are generally focused on the DB or CB plan and contributions to NHCEs on the DC plan

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DB Plan Basics

PBGC coverage

Exemptions: Plans covering only owners

Plans of professional service ERs with LT 26 active participants

Good news/bad news

Exempt: No PBGC premiums/requirements

Combined plan deduction limit of IRC 404(a)(7) applies

Not exempt: PBGC premiums/requirements

No combined plan deduction limit

IRC 404(a)(7) generally limits DC deduction to six percent or combined deduction to 31 percent

DB Administration Process

Basic administration process is the same as DC plans

- Collect data
- Run valuation report and participant statement
- Prepare/submit Form 5500

But additional steps/items specific to DB/CB Plans:

- Actuarial valuation
- AFTAP certification
- Schedule SB
- PBGC premium filings (if applicable)
- Benefit restriction calculations, timing, and notices (if applicable)

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Cash Balance Plan

Retirement benefit:	Sum of contribution credits and interest credits over period of participation (as defined in the plan; not discretionary)
Actual contribution:	Computed by plan actuary (following IRS rules)
Investment risk:	Lower earnings = higher future cost Higher earnings = lower future cost

Works with employees, multiple partners, different benefit levels
Combines well with a DC plan

SAMPLE PROFESSIONAL PRACTICE
A Combination 401(k)/ Profit Sharing/ Cash Balance Plan
For the Plan Year 01/01/2017 - 12/31/2017
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*	*	*	C	OWNER	DOCTOR	52	62	270,000	162,000	60.0	24,000	8,100	6,750	2.5	200,850	74.4	176,850	65.5	27.4
		*	H	NONOWNER	DOCTOR	47	62	150,000	0	0.0	12,000	4,500	0	0.0	16,500	11.0	4,500	3.0	0.7
			M	SR. STAFF	MANAGER	46	62	90,000	1,800	2.0	5,400	2,700	3,600	4.0	13,500	15.0	8,100	9.0	1.3
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			N	STAFF	MEDICAL	63	67	55,000	0	0.0	2,750	1,650	2,475	4.5	6,875	12.5	4,125	7.5	0.6
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			N	STAFF	MEDICAL	42	62	50,000	0	0.0	2,500	1,500	2,250	4.5	6,250	12.5	3,750	7.5	0.6
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Non-Principals	665,000	4,700	0.7	34,100	19,950	22,000	3.3	80,750	12.1	46,650	7.0	7.2
Grand Total	1,475,000	558,200	37.8	106,100	44,250	42,250	2.9	750,800	50.9	644,700	43.7	100.0

CB Plan Basics

Hybrid plan

- Is really a DB plan subject to DB rules but looks like a DC plan
- Minimum vesting = 100 percent vesting after three years

Contributions are required

- Not just a pumped-up profit-sharing plan!
- Not appropriate for client who cannot commit to make the required contribution each year

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CB Plan Basics

Cash Balance Accounts

Benefits are defined in terms of a hypothetical account balance

Beginning Balance + Contribution Credits + Interest Credits
= Ending Balance

Hypothetical account balance is a bookkeeping device and does not reflect an actual account or call on specific plan monies

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CB Plan Basics

Contribution credits (pay credits; employer credits)

Based on the plan's benefit formula, which must be "definitely determinable"

Generally a percentage of compensation or flat dollar amount

May be different for different classes

- Classes must be clearly defined in the plan document to meet the definitely determinable requirement
- Usually defined in terms of ownership, job title, or similar criteria

CB Plan Basics

Interest credits

Part of plan’s benefit formula, *NOT* simply asset return

“Market rate of return” within certain defined parameters

Safe harbors

- Fixed rate (up to six percent; five percent most common)
- Bond related or equity related
- Capital-preservation rule
- Market rate of return

CB Plan Basics

Assets do not automatically equal the sum of the account balances

In a perfect world, they would match perfectly

Can you make them match perfectly?

Is it worth trying to make them match perfectly?

Should you even care?

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Comments on Interest Crediting Rate

Most small plans use a fixed interest crediting rate, usually five percent

Some brokers/advisers want to use the actual return on plan assets so plan asset = sum of CB account balances, but this may cause problems re: funding levels and non-discrimination testing

Using other than fixed rates (actual return or indices) increases volatility of non-discrimination testing results

- Small plans are extremely sensitive to changes demographics and thus fluctuating contribution levels
- Adding changing interest crediting rates only increases the likelihood of unplanned (and probably unbudgeted) changes
  - May fail 401(a)(26) minimum participation
  - May require larger PS contributions to pass 401(a)(4) combo testing

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CB Design Considerations

Combo designs look like cross-tested plans

- Different contribution levels to different classes

But…CB benefits must be "definitely determinable"

- Classes must be defined
- Contribution to each class must be defined

…Higher gateways apply

- 5 percent, 6 percent, 7 percent, 7.5 percent

Non-Discrimination Testing Considerations

Most small business CB plans are aggregated with 401k/PS

Correction options when aggregated

> Must provide CB contribution credits per plan formula
>
> May only limit non-SH PS contributions to NHCEs
>
> Must provide sufficient contributions to NHCEs to pass aggregated testing, which effectively makes PS contributions to NHCEs required

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Non-Discrimination Testing Considerations

Perfect world

- Everything happens as planned
- Stable demographics
- Stable contributions and investment return

Not-so-perfect real world – stuff happens!

- Change in client's ability to fund
- Changing demographics and design/testing failures

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SAMPLE SMALL BUSINESS

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	Earnings	Amount	%	Deferral	Harbor	Amount	%	Amount	%	Cost	%	Total
Principals	340,000	114,300	33.6	26,700	0	40,500	11.9	181,500	53.4	154,800	45.5	82.5
Non-Principals	415,000	2,400	0.6	14,950	12,450	18,075	4.4	47,875	11.5	32,925	7.9	17.5
Grand Total	755,000	116,700	15.5	41,650	12,450	58,575	7.8	229,375	30.4	187,725	24.9	100.0

Should Our Firm Offer DB/CB Plans?

Are you willing to make the commitment? It's more than just adding another line to the list of services offered.

To be successful, a TPA will need to invest time, effort, and be willing to bear the expense of adding processes and procedures, training staff, and hiring or developing a relationship with an actuary.

How Do We Do This?

Become educated about cash balance plans, how they work, and when they are appropriate

- Industry conferences and meetings
- Educational materials published by professional societies and others
- Examples and illustrations available from presentations like this one

Learn what is required to properly maintain a cash balance plan, both what the TPA and other service providers can do and what the client must do

How Do We Do This?

Have the necessary services, such as the services of an actuary, in place whether in-house or outsourced

- Some firms may have an actuary on staff
- Others may choose to partner with an actuary to provide services on an outsourced basis

Learn how to identify prospects and how to present DB/CB plans to them

- Overlaps with becoming educated about DB/CB plans but involves a more client-focused outlook

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TPA Challenges

Adjusting procedures to accommodate DB/CB plans

Middle-man between actuary/client/broker

Additional consulting time needed (more complexity)

Staff training

Resources/commitment

Who Is a Prospect for a DB/CB Plan?

Employers already maxed out in the 401(k) profit-sharing plan

Businesses looking for accelerated retirement savings and tax deductions

Businesses with consistent cash flow and ability to budget for significant annual contributions

Who Is a Prospect for a DB/CB Plan?

Likely prospects

- Professionals such as doctors, dentists, attorneys
- Family businesses
- Businesses with high cash flow/retained earnings
- Multi-partner practices with partners with different goals
- Closely held businesses with age 45+ owner(s)
- Consultants
- Baby boomers

How Do I Find Prospects?

Mine your client base!

Reach out to current referral sources and introduce yourself to prospective referral sources with an expanded portfolio of services

- CPAs
- Financial advisers
- Attorneys
- Clients (often a forgotten source of referrals)
- Local business organizations, service groups, and other personal contacts

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When to Propose a DB/CB?

Most DB/CB plans are installed October-December

- Employer has just filed extended tax returns for prior year
- Tax planning for current year-end is in progress
- Plans can be adopted with retroactive effective date to BOY

Prime DB/CB proposal time is August-November

- It is a big commitment – need time for careful consideration
- Once holiday season starts, everyone is distracted
- Plan documents to be drafted and signed before end of year

How to Propose a DB/CB?

Ask (and ask again) about the prospect's goals, needs, cash-flow projections, commitment to funding, and anything else that might impact the plan over its lifetime

Explain how DB/CBs work and show generic examples

Obtain census and information re: current plans so you can prepare a custom design illustration

Review custom design with prospect and fine-tune if necessary

Then (and only then), get client go-ahead

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Questions?

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