Cash Balance Wisdom in Uncertain Times

For a little over a decade Cash Balance Pension Plans, particularly when added to a 401(k)/Profit Sharing Plan (i.e. Combo Plan) have become the Qualified Plan of choice for very successful small business owners. Unfortunately, much of the literature available for Plan Sponsors (business owners) and their advisors is written on a static basis only and does not address a dynamic approach to plan design and funding strategy.

Advantages of Add-On Cash Balance Plans

There are many factors that contribute to the success of this type of plan design whether looked at from a static or dynamic approach. Cash Balance add-ons:

1. Allow for higher deductions,
2. Skew more of the contributions to favored individuals,
3. Are easier for the small business owner to understand,
4. Limit runaway costs - particularly with shorter service older participants,
5. Changes (especially lowering) of interest rates don't cause unexpected increase in costs.

Uncertainties

However, business, like life, is not always static. In addition to these five items, we need to respond to many uncertainties:

1. Changes in business income, cash flow, tax situation, etc.,
2. Extra needs - either personal or reinvesting in the business,
3. Changes in employee demographics that can affect discrimination testing,
4. Changes in investments and/or interest rates,
5. Changes in tax law.

All these situations can be handled successfully but it takes a dynamic approach. Without a dynamic approach, a business owner may face some undesirable situations. For example:

1. Being forced to put $100,000 into the plan, of which 95% is for the owner, in a year when he desperately needs the money to invest in some much-needed equipment,
2. Having to put an extra $25,000 into the profit sharing plan to pass testing because of lack of planning and then having the relational problem of whether to go back to the old level of contributions the next year and risk disappointing employees.

Successfully Navigating Uncertainties

Being able to determine the best path when unexpected "surprises" arise is dependent on having the right mindset. Three things we find that are vital to the formation of the right mindset are:

1. Clarifying the reason (goal) behind establishing a plan as well as any changes in goals along the way. Also, not all goals need to be met through the qualified plan. For example, taking a great offer to sell a business for $3,000,000 quickly changes how a Cash Balance Plan is viewed that was set up to provide retirement income for the owner. For many plan sponsors, the reason for setting up a plan can be described by one or all of the following statements:

A. “I don’t want to pay that much in taxes”
B. “I want to retire in 4 years”
C. “I want to hold on to some key employees”
D. “I want to diversify my assets before I try to sell the business”

Our role as actuaries is not just to help the business owner meet his or her stated goal but to anticipate any needs that may arise in future years such as greatly lowering a contribution due to business expansion or the development of an unusual personal need. Our approach is to be there to help our clients realize when their goals are changing, for instance when selling the business.

2. Thinking through the implications of investing in other people’s businesses (mutual funds, etc.) through a tax favored qualified plan and investing in one’s own business on a non-tax favored basis.

    a. As we explain in our YouTube presentation, “Cash Balance Plans for Business Owners,” one could categorize the use of business income into five distinct areas:

        i. Normal business expenses,
        ii. Owner’s pay and other income distributions (i.e. dividends),
        iii. Funds reinvested in the business,
        iv. Money held in reserve to balance business ups and downs,
        v. What we term, “Left Over Money” – what’s left after the revenues are reduced by the above items.

It is interesting to note that the current proposed Tax Reform handling of different tax rates for “business income” as opposed to “personal income” makes this type of distinction and may make it easier to contribute to these plans.

3. Understanding that the liability of participant promises (“hypothetical balances”) and the assets to back up the promises are almost never going to be the same and the differences can be strategically managed. Related to this is the ability to accrue more of a benefit than is funded one year and yet fund extra (above the accrual) in another year. We take a multi-plan and multi-year approach where:

    a. Contributions each year do not have to equal accruals. Some years may have higher contributions than accruals and other years higher accruals than contributions,
    b. Determining the optimization of contributions going into the 401(k)/Profit Sharing Plan vs. the Cash Balance Plan.

Conclusion

The above can be safely accomplished utilizing dynamic planning, which demands well thought out pre-planning. This concept pre-supposes a high level of communication with our client. From the first phone call, to quick initial proposal over the phone, to the final payout after the plan terminates years later, anticipating different possible scenarios and having plans to cope with them is key.

Specifically, we help our clients focus on a well thought out budget amount of their choosing. After the budget amount is set in place we work with our client to build extra flexibility in funding over a two to three-year period. In this way, they are prepared for unexpected ups or downs in money available for the qualified plans. In addition, as stated earlier, we encourage early communication on changes in such things as level of business, special cash flow needs and changes in employee census that can affect testing.

In conclusion, uncertainty is a given that exists in everything we do; in this case it is a given that can be successfully overcome.