COMMON SENSE APPROACH TO CASH BALANCE PLANS

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Abraham Lincoln once posed this question, "If you call a tail a leg, how many legs would a dog have?" Abe's answer: "Four, because even if you call it a leg, it's still a tail."

When faced with truth we have two choices – adjust our beliefs and behavior to align with truth, or develop our "own truth," i.e., myth.

In our society today, many so-called "experts" say things that sound good on the surface but are really not true and do not stand up to scrutiny. This is true in so many fields and the pensions field certainly is no exception. As I move forward allow me to provide another thing these self-proclaimed experts leave out: history and context. Let me show you some background for the pension field and then discuss some areas where we are regularly helping our clients in overcoming myths.

Quick Pension History in America

Family (and related religious institutions) had historically formed the basis for retirement since individuals are not productive forever and governments can not be relied on to keep long term promises, since most politicians will not be around in twenty or more years.

With the coming of the industrial revolution many family-based farms and related small businesses were replaced with a significant portion of the population working in factories. This brought about the genesis of employer-based pension plans. With high marginal tax rates and the gradual development of pension law culminating in the passage of ERISA (Employee Retirement Income Security Act) in 1974, some of the societal assumptions about pensions and other qualified plans developed into:

1. Congressional Expectation – that employers, as with healthcare, will play a significant role in providing adequate pensions to their longer service employees. Shorter vesting schedules coming about in the last few decades recognized that more and more employees work for several different employers during their working lifetime
2. Since the early 1980s, with 401(k) Plans employees are encouraged to participate in their employer-based retirement. (Note that IRAs and other personal wealth building are personal and not employer-based).
3. The development of anti-discrimination regulations (starting around 25 years ago) have given great opportunity to skew a substantial portion to owners and other key individuals, but unfortunately have allowed for many longer service older employees to get a lower than adequate pension, since giving them an adequate pension would not help to "pass the test."

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So basically, we have government saying to employers "we will give you significant tax breaks, but we expect you to do your share in providing adequate retirement to your employees."

From the employer's point of view:

We, the employer, will go along with this platform as long as you (the government):

1. Don't overregulate us or play gotcha games.

2. Gives us flexibility in funding to match the ups and downs of our business profits and the ups and downs of the need to reinvest in our businesses.

In this environment TPAs (Third Party Administrators), actuaries, CPAs and investment advisors, etc., play a type of middleman role.

When pension rules and regulations develop many numerical rules to determine if a plan is acceptable, there is a temptation to act like passing a government test means a plan design is acceptable.

While it is necessary to comply with the myriads of rules, regulations, schedules, etc., this attitude and/or practice is not a replacement for good consulting. I have seen over the last forty plus years in many areas of the pension planning process (both initially and ongoing) that compliance-only approaches and other narrow “rules of thumb” do not produce the best results for the plan sponsor.

Consulting Opportunities and Pitfalls During the Life of a Plan

Here are six areas where good consulting makes a difference:

1. Funding Flexibility – For a minority of our clients this is not an issue since the sponsor’s income is high and their expenses do not vary much. But for most of our clients, in about 2-3 years of plan life out of 10, there is a need to contribute much less than usual or a desire to put in much more. If we as the actuary do not build in flexibility from the beginning the sponsor may be forced to contribute funds into the plan that are desperately needed in another part of the business. We find that sometimes the best thing a company can do for their plan is to contribute nothing in a given plan year, reinvest strategically in their business, and out of the increased profits make sizable contributions to their plans for several years in the future.

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2. Dynamic vs. Static Approach – It is important to look at these plans on a dynamic basis. Changes from one year to the next include:
   a. Employee population – new partner or doctor; a young participant needed to help pass testing leaves; employee population doubles; etc.
   b. Business – net income goes up or down; the need to reinvest a significant amount in business; a desire to reach a certain breakpoint to optimize tax deductions brought about by tax reform; the need to coordinate Cash Balance Plan with an exit strategy.
   c. Owner/Key – looking to optimize benefits accumulated in a combo plan by accumulating more in the different plans at a young age vs. an older age and the need to distribute funds at the right time. Also, there may be a need to navigate around the effect of large personal expenses at certain times.

3. Extra Money Concept – This concept is key to understanding design/funding strategy. The question that is rarely if ever asked is: “If an owner can get a better rate of return by investing in someone else’s business (after adjustment for tax benefits), why should he be in business for himself?” The best answer I have to this question is that money needed for normal business expenses, building up a business reserve, investment in business expansion (i.e., needed equipment, additional location, etc.) and/or unusual personal need of the owner should not take second place to money required to be contributed to the qualified plans. Hence, it is the extra

money that should be used for qualified plan contributions. Good plan design and funding strategy needs to take this in mind. The exception is when the business is so profitable that this is not an issue.

4. "Water Cooler Test" and Other Non-owner Participant Concerns – Let me cite a recent example we saw on a takeover case of a violation of what we call the "Water Cooler Test." A doctor with seven participants gives just enough benefit to the three youngest (and shortest service employees) to pass the "40%" meaningful benefit test (Code Section 401(a)(26)) and gives nothing to the four other participants. What happens when one of those excluded participants, an office manager who has been with the doctor for 15 years, is at the watercooler when one of the three benefiting younger employees asks the office manager a question about their Cash Balance Statement? This is, obviously, an employee relations nightmare.

   A second issue involves providing an adequate benefit to long service employees. Let's say Mary, a 62-year-old widow who has been a very loyal employee for thirty years, does not have enough resources to retire and is given the same Cash Balance accrual as all the other non-owners. The owner would have no problem giving Mary more but the actuary, in setting up the plan, never raised this question. Not only does that hurt Mary but it can have a demoralizing effect on many of the younger employees who "look up" to Mary.

5. Investing Cash Balance Fund – Financial Planning Approach vs Immunization Approach – Several times a year I am asked by an investment advisor, "What is the interest crediting rate?" My response is usually, "Wrong question." I have worked on cases back in the 1970s and 1980s when interest rates were much higher, and a mature company wanted to "immunize" the liability on retirees and vested terminees by matching up coupon payments of high yield bonds with benefit payments as a way to minimize risks. For Cash Balance Plans today in the small plan market there is no such risk since:
   a. The non-keys represent a small portion of the liability
   b. The owners can usually reduce their benefits at retirement to make sure everyone else is fully funded.

   Also, the Cash Balance account crediting rate may be higher because a floor is used to more easily pass the meaningful benefit test. Using such a floor can still be a good design decision whether the investments can match the higher rate of return.

6. Coordinating with Exit Strategy (and Age 62 Peak) – Other than setting up a Cash Balance Plan to avoid or delay taxes, the motivation and the longer-term focus is retirement and the business exit strategy. We have worked with several companies in the last year that have been involved in various exit strategies including outside sale, passing the business on to employees and/or children, shutting down the business with little residual value, and phasing down the owner/founder's participation in the business. Cash Balance Plans can be coordinated with each of these and other strategies, for example:
   a. Building up a large sum in Qualified money puts the owner seller in a stronger negotiating position in the case of an outside sale.
   b. The Cash Balance Plan can be used to shelter some of the funds that come about from the sale of a business.

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c. Younger employees taking over a business can help to pay the owner through tax deductible contributions to a qualified plan.

A second issue we address regularly is maximizing the lump sum payment at retirement for those owners that are near the legal (IRC Section 415(b)) limits. Actuaries may know but don't often communicate to their clients the fact that:

a. Maximum lump sum peaks at age 62
b. Then drops to age 65
c. Then goes back up again until it peaks again a few years later and then goes back down

This is the case for those that have more than ten years of participation (the amount needed to get the maximum benefit). For those with less than ten years there are also ups and downs but it is a little more complicated.

Our Approach

While it is obviously necessary to guide our clients to comply with the various rules and regulations associated with their qualified plans, it is vital to implement a dynamic strategy to optimize the wealth accumulation through the coordination of qualified plans with the business and sometimes personal life of the owner(s). Using such an approach has proven to benefit our clients significantly, sometimes to the tune of tens and even hundreds of thousands of dollars.

Our approach with clients encourages awareness of what is going on with their business so that we can be ahead of the curve in making sure the plan design and funding fits what is going on with the sponsor.

Some of the things we provide our clients are:

1. We do not time and expense bill. Not just because clients do not like to be "nickeled and dimed," but because we want to encourage our clients and their advisors to feel free to ask questions, and otherwise give us useful input.
2. We give them, with few exceptions, immediate answers to their questions such as:
   a. What is the effect of a potential hiring decision?
   b. How much or how little can I put in my plan next year?
   c. Should I terminate or just freeze my plan?
   d. My company is growing rapidly – is a Cash Balance Plan still feasible
   e. What is the potential effect of adding a family member to the payroll on the qualified plans?

Most successful business owners do not think about their pension plans every day, and understandably so. Therefore, when a client calls with a question we realize that they are busy and need their answer as soon as they can get it. So, we like to stop everything and give them due diligence and talk with them. Of course, we may qualify an answer by saying we will get back with them to confirm, but most times by looking at our recent reports and asking a few questions we can give them good answers that help them with the planning they are doing. And we do not subsequently charge for this time, so the client is encouraged to keep the lines of communication open.

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Finally, we strive to keep up with what is happening with our sponsors so we can cutback benefits (usually before 1000 hours in June) if they are struggling or increase benefits (before the end of the plan year) if they are looking to deduct more.

By keeping an eye, as it were, on our clients' plans and keeping the current financial situation of the business world in front of us, we are able to give our clients warnings about what may happen in the future if they do not take corrective action when good, honest, down to earth consulting indicates the necessity to do so.