YEAR END PENSION PLAN STRATEGIES

—in Light of Pending Pension Legislation

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by John S. Agatston FSA, EA, MAAA, MSPA

It's the month of December, the time of year in which many small to medium size companies look to establish a pension plan, in part to enjoy the significant tax deductions that are one of the benefits of implementing a pension plan. With news of pending pension legislation and related talk of under funded plans, some employers may shy away from doing what is in their own best interest due to unnecessary fears.

Our firms analysis has determined that there is a real advantage for almost *all* smaller to medium size companies (i.e. 1 to 200 lives) if the pending legislation, as it presently stands, is put into law (it already has gone through the Senate by a 97-2 vote—see our website for complete article www.practicalactuary.com). The legislation, which to a large part is designed to encourage larger plans to properly fund their pension plans, would also allow smaller companies to make significantly larger deductions starting in 2006.

We will look at some of the more significant provisions as they apply to smaller plan design and funding. In addition, we will also offer a possible plan design idea that will work well within the guidelines of the new pension legislation. The provisions that we will focus on are based on taking the least favorable provisions of both the Senate and House versions of the present legislation. The scope of this article will ignore some provisions, such as new combination Defined Benefit 401(k) plan (DB/K), that would not be effective until a later date.

The Five Advantages

To keep our focus, since the pending legislation is so broad in scope and effect, we will consider a company, currently maintaining a pension plan, but not saddled by a big unfunded liability. The owner of the company wants to know that their pension plan is serving the overall purposes of their business as much as any "essential" department such as sales, marketing, customer service etc. There are 5 areas of the pending legislation that we believe are very advantageous to our business owner.

1. The ability to "over fund" the Defined Benefit plans in good years. In a way the pending legislation allows a deductible "rainy day"

Related Articles

These articles can be viewed on our website **www.practicalactuary.com** (see page 4 of this article for sample extracts)

Cash Balance Add-on Plans—Plain and Simple. Answers to Ten Common Questions About Cash Balance Add-on Plans.

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Cash Balance Dual Plan Set-ups—Perhaps the Best Kept Secret in the Pension Industry.

cushion within the Defined Benefit Plan. The level of the surplus will probably be between 80% (Senate version) and 50% (House version) above a what the legislation calls a Targeted Liability. The targeted liability, while calculated differently from the currently used termination liability, will usually be approximately equal. Simply put, the new legislation would allow the accumulation of 50% to 80% over funding of a plan, using typical measures of funded status.

2. The simplification of actuarial numbers needed to determine costs. Up to now the number of different actuarial values, amortizations periods etc. to determine minimum funding and maximum deductible amounts have become quite complicated. This "actuarial-speak" associated with these values has meant that most users of actuarial reports do not understand them, and therefore, are not able to ask the right questions to make the right decisions. The new legislation allows a simplified actuarial approach and will free up the actuary and the plan sponsor to talk on a more practical basis about the level of funding in a plan.

3. The interest rate(s) used to determine a lump sum can expected to be a little higher. This will lower the lump sum value used to payout terminated employees (particularly younger and shorter participants) thereby leaving more money for longer service and key participants.

4. The proposed legislation allows for Cash Balance conversions (i.e. regular Defined Benefit Plans becoming Cash Balance plans) but with some much needed safeguards. There has been some thought that Cash Balance Plans age discriminate, which if true, would mean by the same logic, that every profit sharing plan does also. Hopefully the recent court victory for Cash Balance Plans in the PNC case, as well as this pending legislation, will remove any remaining undeserved "cloud" over cash balance plans, both new and converted.

5. Finally, the combined plan 25% deductible limit is eliminated for most situations—particularly where the average profit sharing contribution is less then 6% of eligible compensation. This change will greatly enhance dual plan design (Cash Balance add-ons to 401(k)/Profit Sharing Plans). It will allow the sponsor to fund the extra cushion in the Cash Balance Plan, while also having a safe harbor provision in the 401(k)/Profit Sharing Plan, and thereby allowing the favored group to maximize their contribution in a 401(k) Plan.

For years, pension law has made it difficult to build a comfortable cushion in many pension plans, particularly where the owner was less than 10 years from retirement. The pending legislation has gone in the other direction. There finally seems to be a rational shifting of focus away from concern about high pension deductions and more towards the much bigger problem of under funded plans.

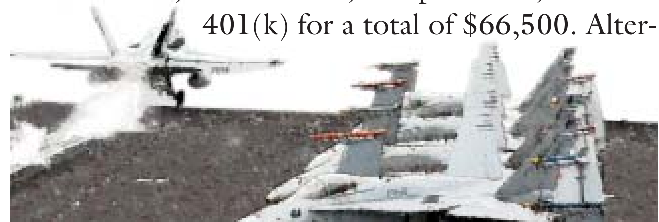
What These Changes will Mean In Practice—Now & In The Future

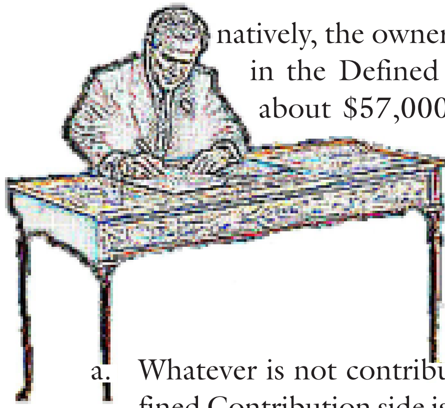
Now, lets consider some scenarios pertaining to the approximate amount that can be deducted by an individual, whether they are part of a one person plan or a group, depending on their age. We will also look at how a Cash Balance Add-On Plan works, and how it will get even better under the pending legislation becomes law.

The Maximum and Minimum Tax Deductible Contributions Available at Age 35, 45 & 55

These scenarios assume a dual plan of a traditional Defined Benefit and 401(k) with the individual at the $210,000 pay limit for 2005 (and $220,000 for 2006.

1. Age 35—For 2005
   Can easily contributed and deduct 25% of $210,000 for $52,500 plus $14,000 in a 401(k) for a total of $66,500. Alter-





natively, the owner maximizes first in the Defined Benefit Plan at about $57,000 and then adds the $14,000 in the 401(k) you get $71,000. There are three things to remember here:

a. Whatever is not contributed on the Defined Contribution side is lost—so for the largest long term accumulation it may make sense to maximize the Profit Sharing contribution first and then use the Defined Benefit Plan.
b. Maximizing 401(k) is not a problem for a one person situation, but once Non-Highly Compensated Employees (NHCE's) are added you have to make sure you pass the ADP test.
c. If you do add other participants who get less then 25% employer money, there is extra room to contribute more for the favored owner.

Age 35—For 2006
It looks like the contribution can go over $100,000 for the owner.

2. Age 45—For 2005
   Just over $100,000.

   Age 45—For 2006
   Probably over $150,000

3. Age 55—for 2005
   Around $195,000.

   Age 55—For 2006
   Over $250,000 (Defined Benefit plus Profit Sharing plus 401(k).

Cash Balance Add-On—A good thing can get even better.

The following is a quick summary of why we believe Cash Balance Add-on plans are a viable alternative in many circumstances. Obviously there are many good alternatives when considering pension plan design, and good pension plan design must consider each clients particular circumstances and needs. For a more complete understanding on Cash Balance Plans, and why we like this design alternative for many people you can go to our website, www.practicalactuary.com for our articles.

- Cash Balance Plans allows a large percentage of the contribution (after the contributions have been made to the Profit Sharing Plan) to go to the favored individuals. Also, this individual does not have to be the oldest.

- On a funding basis Cash Balance Plans present much lower risk than a final average pay Defined Benefit Plan. Also, lump sum payouts are not subject to the up and down swings that you can experience in a regular Defined Benefit Plan when the applicable interest rate (usually 30 year treasuries) changes. For example, in a regular Defined Benefit Plan, a 1% decrease in the interest rate will increase the lump sum payout on a 35 year old by over 50%.

- The investment risk and responsibility is spread more evenly, with the Cash Balance usually having more conservative investments. The profit sharing will generally have (whether the plan is participant and/or trustee directed) more equity investments with the downside risk not directly increasing employer costs.

- Since benefits are stated in account form, as opposed to a future pension annuity, it is easier to communicate value, especially through a dual benefit statement, to the participants.

If the pending legislation becomes law

1. Cash Balance Plans, like all defined benefit plans, can receive the substantial extra "cushion" deductible contribution.

2. It will be easier for an owner and their family to maximize their 401(k) contributions since safe harbor 401(k) plans can be set-up without violating the current IRC section 404(a)(7) combined plan deduction limit.

3. It will be "officially" legal to convert current Defined Benefit Plans to Cash Balance Plans as long as certain transitional rules are followed.

4. The business owner will have much funding flexibility by having the capability each year to decide where to direct a substantial amount their contribution:
   a. To "over fund" the Cash Balance Plan
   b. To put more into the profit sharing plan under several allocation choices.
   c. To personally put more or less in their 401(k) account
   d. To use the extra money to re-invest in the business with the promise of a higher rate of return, and therefore, a higher contribution in the future.

Some things to remember when setting up a new pension plan at year end:

There are two key elements that need to be remembered when decide to adopt a new pension plan at year end.

1. The document needs to be signed by the end of the year.

2. Contributions are due by the time the tax return is filed (with extensions).

Sample Extracts

Below are extracts from our other related articles on Cash Balance Plans. If you would like to view the entire article just go to our website, **www.practicalactuary.com**

Cash Balance Add-on Plans—Plain and Simple:
Answers to Ten Common Questions About Cash Balance Add-on Plans.
by John Agatston, FSA, EA, MAAA, MSPA

Question One
What is a Cash Balance Plan?
A Cash Balance Plan is a Qualified Defined Benefit that looks more like a Profit Sharing Plan or Money Purchase Pension Plan. But, unlike. . . .

Why Adding-on a Cash Balance Plan to 401(k) Profit Sharing Plans Not Only Makes Sense—But is Good National Pension Policy!
by John Agatston, FSA, EA, MAAA, MSPA

While designing a pension program for a client some time ago, I considered my options in balancing the various factors in the design process, including 401(a)(4), 25% dual plan deductible limits, Top Heavy, Gateway, 401(a)(26) and meaningful benefits. I stepped back for a minute and realized that adding a Cash Balance Plan onto a 401(k) Profit Sharing Plan was not only a viable pension design, but it also made good pension policy. Looking over my experiences and observations from my 30 years in the pension industry I formulated several key observations:. . . .

Add-on Cash Balance Plans-Perhaps the Best Kept Secret in the Pension Industry
by John Agatston, FSA, EA, MAAA, MSPA

If you have ever been frustrated by the contribution limits that a 401(k)/Profit Sharing Plan present, but are nervous about the risks that a traditional Defined Benefit Plan pose, then perhaps the solution you have been seeking is a Cash Balance Plan add-on to your present 401(k)/Profit Sharing Plan. . . .

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