

WHY ADDING-ON A CASH BALANCE PLAN TO 401(K) PROFIT SHARING PLANS NOT ONLY MAKES SENSE, —BUT IS GOOD NATIONAL PENSION POLICY

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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:

- The goal of a National Pension Policy is for Americans who reach retirement age to have an adequate pension
- An adequate pension is achieved through the “Three Legged Stool”—the Social Security System, personal savings, and private pension plans.
- With private pension Plans the federal government has “outsourced” the third leg of the “stool” to the private sector, where it is assumed the goals of a national retirement policy are synchronous with the goals of the entrepreneur, and thus can be achieved more effectively.
- Plans do not help provide for adequate retirement benefits for long service employees. This happens when a plan is designed that allows the key employees to maximize their benefits/contributions while not providing adequate benefit amounts for other longer service employees. This can also happen because there are enough younger, lower paid employees to pass the various discrimination and other tests.



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So our National Pension Policy, far too often, leaves us with either no plans or worse yet, wrong plans! A good National Pension Policy needs to be outfitted with laws that give adequate financial incentives to plan sponsors while limiting their risks related to run-away costs by sharing some of the re-

Unfortunately, National Pension Policy, in regards to the private sector all too often fails. We could debate as to all the exact causes for this but two primary reasons are:

- There is a decrease in the number of private sector plans. This happens when there are not sufficient incentives for private companies to install or maintain plans. A prime example of this was with the great decrease in the number of Defined Benefit Plans in the late 1980's. This was occasioned by reductions to the maximum benefit limits and attacks on the funding levels due in part to the small plan actuarial audits along with the availability of participant funded 401(k) plans.

sponsibilities with employee participants. Pension laws must encourage self-correction and not penalize (even with small penalties) for non-intentional mistakes that are being corrected.

Good National Pension Policy also needs consultants and Third Party Administrators (TPAs) who properly design, and where necessary, re-design plans. Plan Design should go beyond finding enough young low-paid employees to maximize owner benefits. Plan design must provide adequate benefits for long-service employees and for the “sponsor's share” of adequate benefits for older employee's that have worked at more than one employer. Such plan de-

sign is not only good National Pension Policy, but is usually good for the employer. It may be important to provide incentives for certain non-HCE employees. For example, an office manager age 42 with 15 years of service being paid \$50,000 a year might be given a higher level of benefits/contributions than a 50 year old with 2 years of service.

The problem that I run into far too often is that those of us who design plans have hidden our professional laziness behind what I call “the greedy employer excuse.” This excuse goes something like this, “The owner just wants to maximize for himself and only contribute the minimum amount to stay out of trouble.” While it is the owner’s money, and he is responsible for maintaining the plan, it is our responsibility to present a proper range of options and related implications that goes beyond the me, me, me mentality.

EXAMPLE

The ABC Company has 20 employees who are mostly young. The owner is age 62, and he also employs a 60 year old executive secretary with 30 years of service, a 50 year old office manager with 20 years of service and a 40 year old IT person with 5 years of experience who holds everything together and would be very hard to replace.

A good consultant should present to the owner the effect alternative plan designs will have on these three individuals. The owner may say that the older secretary comes from a wealthy family and does not need the extra money but that he does want to do something extra for the other two individuals.

Obviously, the owner ultimately will make their decision, but it is incumbent on us as consultants to present the options, and dare I say, forcefully! I have seen too many cases in which it is clear this has not been done. Recently I was asked to look at, and make a proposal, on two cases that were originally designed by a prominent firm. What I saw was appalling, and, in my opinion, ethically corrupt. Lower paid, short service, younger employees were getting higher absolute dollar amounts than longer service older employees for the sole purpose of passing testing. This kind of sloppy plan design, unfortunately

something that happens far too often, gives our industry a bad name and causes congressmen to jump up and down. You would think that having to produce separate SPD’s (an employee relations powder keg) would deter this. The irony is that the same maximum contributions for the owner could have been achieved at a reasonable cost in a design that made good employee relations and incentive sense!

In many cases, adding a Cash Balance Plan to a 401(k) Profit Sharing Plan not only benefits the sponsor, the consultants, and the ones investing the funds, but is good National Pension Policy. In the typical case a Cash Balance Plan is added to a pre-existing Profit Sharing/401(k) Plan in order to maximize the contribution for a key or favored class and to help provide a more adequate pension to longer service/older employees.

Let’s look at this strategy from four angles:

1. Maximizing Benefits for Key People.

Since Cash Balance Plans are defined benefit plans, the benefit limits are the Section 415(b) limits for Defined Benefit Plans. For key employees over age 40 this means contribution equivalents are well over the Profit Sharing limit of \$42,000 (\$46,000 with 401(k) catch-up for over age 50). Also, Defined Benefit Plans allow for a certain level of pre-funding through the use of actuarial methods and assumptions. Currently, the only hang up is the 25% combined plan funding limit which applies in the smaller (generally under 20 lives) cases unless a “split” can be safely used. Hopefully, the current proposed legislation to ignore the 25% limit if at most 6% is contributed to the profit sharing (i.e. defined contribution side), will solve this.

2. Providing Adequate Benefits as Strategy for Passing Gateway and Meaningful Benefit Tests.

If you are familiar with the 7.5% dual plan Gateway Tests you know that the Defined Benefit Portion is an average for all the non-Highly Compensated Employees. The effect of the conversion of a hypothetical cash balance contribution to an accrued benefit is at the current 417(e) rate, which is now below 5%, and an EBAR calculated with an interest rate between 7.5% and 8.5%. This means a 1% hypothetical contribution, for a 25

year old, counts as only .25% toward the test. For a 60 year old the 1% only reduced to about .65%. This means providing higher contribution percentages to older employees helps in passing the Gateway Test. Similarly, the .5% benefit accrual considered by the Treasury to be necessary for a benefit to be meaningful, means about a .8% hypothetical contribution for a 25 year old, and a 4.6% contribution for a 60 year old.

3. Reduced Risks.

When Cash Balance Plans are added to a pre-existing Profit Sharing/401(k) Plan there are several reduced risks as compared to a regular Defined Benefit Pension Plan.

- a. The Cash Balance Plan is a Career Average Plan—this means that increases in pay do not have the same leveraging effect as with a Final Average Pay Defined Benefit Plan.
- b. A much larger portion of the Cash Balance liability is for the Owner and/or favored group. This eliminates the concern with many Defined Benefit Plans of “run-away” employee costs.
- c. The investment risk is shared with employees, assuming the profit sharing and 401(k) monies are participant directed. If the owner has money in both plans, more of the profit sharing and 401(k) monies can be invested in equities, and the cash balance monies can be invested in safer more fixed income investments. This greatly eliminates the investment risk associated with regular Defined Benefit Plans.
- d. Because a Cash Balance Plan is a Defined Benefit Plan, the use of actuarial methods and assumptions can provide for some pre-funding of the plan’s liabilities. This will allow for some funding flexibility to help an employer through a business cycle. I have noticed some actuaries using the 417(e) and the unit credit method



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for the funding assumptions. While it is easy to explain a plan in which the funding and accrual are the same I believe it adds an unnecessary inflexibility to the plan funding.

4. Industry Compatibility.

Currently, there are many more 401(k) Plans than Defined Benefit Plans. A whole industry is in place and there is increased interest in Cash Balanced plans in the 401(k) industry.

While there are more changes I would like to see in pension law and regulations, the government has outfitted us with many good tools that enable us to design qualified plans that reflect good National Pension Policy. It is our job to find a way to maximize a contribution for an owner, limit costs for everyone else, but have a pension plan do what it is suppose to do, allow people to retire comfortably. We need to present a full range of options to owners and decision makers on the effect of different plan designs on different classes of employees. We need to ask owner’s questions like; would they like to see their long service employee, who is making \$3000 per month, someone who has helped them succeed in business, retire on \$400 per month? While ultimately, decisions on plan design will be made by the plan sponsor, our contribution to setting good National Pension Policy must include our responsibility to present various options and explain the related consequences.

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