



I NEED A BIG YEAR END TAX DEDUCTION BUT IS A CASH BALANCE PLAN WISE?

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In this short article, let's look at how much money can be deducted using a Cash Balance Plan in combination with a 401(k)/Profit Sharing Plan. We will take a look at related non-key costs, risks involved, ongoing responsibilities, mechanics, and other practical issues in setting up a Cash Balance Plan. The goal of this article is to inform entrepreneurs who might consider this opportunity, but who at this time either do not have enough information, or have the wrong information to make an educated decision. We also want to identify those entrepreneurs who should implement a Cash Balance Plan, and also address the timeframes for those who should sponsor a plan, specifically, whether they should start the plan for this year or wait until the next. Having consulted on hundreds of plans over several decades we realize the importance of fitting the right client to the right plan design as it relates to each business.

How Much Can Be Deducted with Cash Balance Add-On Plans Along Side 401(k)/Profit Sharing Plans

Let's look at an example of a young, very successful couple in their mid 30's with a non-owner lower paid clerical employee.

SUCCESSFUL YOUNG COUPLE SCENARIO

	Age	Eligible Pay	Cash Balance Contribution	Profit Sharing Contribution	Total
Husband	35	245,000	55,000	49,000	104,000
Wife	35	245,000	55,000	49,000	104,000
Clerical	22	20,000	400	2,600	3,000
Deductible Pre-Funding			50,000		50,000
Total			160,400	100,600	261,000

The contributions for each owner are approximately \$55,000 in the Cash Balance Plan, and \$49,000 in the 401(k)/Profit Sharing Plan. This gives us a total combined contribution of \$104,000 for each owner, or \$208,000 for the husband and wife combined. Assuming the non-related third person is a 22 year-old making \$20,000, the cost to fund the plan for them is approximately \$3,000 between both plans. After the initial plan year an additional prefunding contribution (\$50,000 in our example) can be

made and deducted to the Cash Balance Plan. Without the third non-owner employee, the total contribution limit would be smaller, approximately \$150,000 instead of the \$208,000. After 2007, a combined plan deduction limit only applies to owner-only plans and professional firms with less than 26 participants. For the owner-only or small professional plan, there is either a 31% of pay dual plan limit or no Cash Balance (or other Defined Benefit) Plan limit if the aggregate employer contribution to the Profit Sharing portion of the 401(k)/Profit Sharing Plan is under 6%.

The following table gives you some idea of how much can be put away for one individual by age:

DEFINED BENEFITS/ CASH BALANCE PLANS DUAL PLAN LIMITS BY AGE *

Age	Plans Subject to PBGC			Owner Only/Professional Firms	
	Cash Balance Contribution	401(k) Profit Sharing	Total	401(k) Profit Sharing	Total
30	42,614	49,000	91,614	33,336	75,950
35	55,694	49,000	104,694	20,256	75,950
40	72,790	49,000	121,790	14,700	87,490
45	95,134	49,000	144,134	14,700	109,834
50	124,337	54,500	178,837	20,200	144,537
55	162,503	54,500	217,003	20,200	182,703
60	168,795	54,500	223,295	20,200	188,995
65	216,652	54,500	271,152	20,200	236,852
70	278,096	54,500	332,596	20,200	298,296

*Note: These are general limits that are affected by form of benefit, percent of pay limits, and other factors. They ignore any Cushion Funding and effects of dual plan limits with more than one participant.

Employee Costs

While there are many factors that affect the cost for the non-favored/owner/key group, the costs usually range from 6% to 9% of pay. This generally means for a plan with few non-key participants the cost is small. For plans with more participants where the sponsor wants to provide for an adequate pension, or where the sponsor is already generous, the marginal additional cost is small. However, in a case where there are a lot of non-key participants with good pay and the sponsor is contributing a relatively small amount (such as a 25% match on the first 6% of pay deferred to the 401(k)) the cost to provide a high contribution level for the key is usually prohibitive, or requires additional consideration.

Risks

Let's review each of the risks involved in adding a plan, which include costs, cash flow, investments, and future legislation.

1. Costs: Historically, there has been a concern with Defined Benefit Plans, of which Cash Balance Plans are a type, of runaway costs. This is due to usually three contingencies:
 - a. Frequently, older and longer service participants receive higher than planned increases in pay. Runaway costs result from the higher resulting average salary application to all years of

service. In a Cash Balance Plan, whose formula is pay related, this increase is applied to only the current year. In the case in which the owner or key employee benefit is a dollar amount, the increase is negligible.

- b. The concentration of the plan's liability in older, longer service non-key participants contributes to concerns of high costs. Since our typical design puts most of the contribution for non-keys in the profit sharing plan, this risk is all but eliminated.
 - c. The lump sum payouts on regular final average pay Defined Benefit plans have gone up with lower prescribed interest rates. However, Cash Balance Plan lump sum payouts, which are equal to the participant's balance, are unaffected by changes in the prescribed rates.
2. Cash Flow: A good pension plan design and funding strategy should prepare for the situation that the sponsor needs to make a contribution either when the sponsor does not have the funds or has to make an important investment in the business and consequently cannot make the annual recommended contribution. Over many years, we have successfully avoided this unpleasant situation by:
- a. Designing plans that limit non-owner/non-key benefit promises.
 - b. Promising less and funding more thereby building up a cushion that can lower or eliminate contributions in a slow business cycle.
 - c. Cutting back accruals on the owner/keys before they accrue a benefit in a year (usually after 1000 hours - June in a calendar year) if business is slow.
3. Investment: To minimize investment risk, we supply you and your advisor with certain dynamic benchmarks so that the fund takes appropriate risk. On the low side, you may not want a loss that either causes legally required benefit restrictions or increases minimum required contributions to a level that is not affordable. On the high side, it may be possible to go above the maximum allowed contribution and either allocates the excess to other participants or pay a 50% overfunding penalty. Finally, it is important to coordinate the asset allocation with your other non Cash Balance Plan investments, including taking into account how different asset types are taxed in different vehicles. Please note, that even though each person's balance is credited with a set rate (such as 30 year treasuries) a gain will be used to either reduce costs or eventually increase benefits.
4. Future Legislation: The good news is that routinely any changes in the law that would reduce benefits are not retroactive. Secondly, as it stands there is nothing in any current legislation that would negatively affect Defined Benefit Plans in general and Cash Balance Plans, specifically. In fact, future legislation is directed either toward more 401(k) or easing funding requirements for larger Defined Benefit Plans.

Implementing a Plan

To implement a Cash Balance Plan, documents need to be signed by the end of the fiscal year in which you want a deduction (i.e. December 31, 2009 if your fiscal year is calendar 2009). To be able to deduct your contributions they need to be made by the time you file your tax return with extensions, but generally by eight and one-half months after the end of the year.

If there is a concern about the need for downside flexibility the initial coordination of the design and funding strategy should be decided on before the documents are implemented. The investment strategy, which should coordinate with the plan's funding and design, can, obviously wait until the first significant contributions are made.

As we implement the plan, we provide a compliance calendar to help track the routine notices and filings throughout the year

Decision-making Steps

In working with clients we usually go through a four step process:

1. We interview the prospective plan sponsor and their advisor (usually in less than ten minutes by phone) and give a preliminary "quick and dirty" design such as "you can put away another \$100,000 of which about \$94,000 will be for the owner." If the numbers make sense for the owner we request an employee census (Name, date of birth, date of hire, recent pay, estimated annual hours, ownership and owner's relatives) and if readily available an annual report on the 401(k)/Profit Sharing Plan.
2. Then we prepare a proposal worksheet showing contributions to both the current and new Cash Balance add on plan. We make sure these proposed contributions meet applicable tests and limits.
3. If the sponsor likes these numbers we then, sometimes, arrange for a meeting with the sponsor's advisors. We find online software, such as GoToMeeting, is a convenient way to have the meeting. If after that meeting the client wants to proceed with a plan, we ask for the additional information required to prepare the plan documents.
4. We draft a plan document, related adoption agreement and the other necessary paperwork to adopt the plan. If we have revised the proposal spreadsheet based on a previous discussion or part of our due diligence process we will include it in the package. This is electronically sent to the sponsor and any advisors the sponsor wishes. This gives everyone an opportunity to review the document before we send out a notebook with all the documents including the necessary Summary Plan Descriptions. The Plan can be executed by either printing out and signing the electronic copy or waiting to sign the hard copy.

Conclusion

John S. Agatston Actuarial Services strives to work with entrepreneurs in a way they can optimize their retirement planning while ensuring their safety in regards to government regulations and rules. We start with a short phone feasibility analysis. After that, we will proceed with a proposal worksheet. The next step is a draft of legal documents, and, when the entrepreneur is comfortable executes the forms. Each year we work with the entrepreneur to collect the necessary census data and prepare necessary reports, notices, and filings. However, the most important activity is the communication with the business owner and his advisors to handle changes in business, pension plan investments, workforce, etc., to regularly make the wisest decisions with regard to how it affects their long term goals.

If you are interested in scheduling a free Phone Feasibility Analysis please call us at 412-967-6240 or email us at proposal@practicalactuary.com