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Structuring Cash Balance Pension Plans: Maximizing Tax Benefits and Limiting Risks

Designing the Cash Balance Benefit Formula, Managing the Interest Crediting Rate with Plan Investment Returns

TUESDAY, MARCH 21, 2017

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Today's faculty features:

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Structuring Cash Balance Pension Plans

Maximizing Tax Benefits & Limiting Risks

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Presented by Strafford

Today's Agenda

1. Retirement savings opportunities
2. Why Cash Balance?
3. Setting principal and interest credits
4. Plan investment issues
5. Distribution issues
6. DB Plan conversions

Retirement Savings Opportunity

- High-value retirement savings,
- For profitable, cash-generating businesses:
  - Professionals (e.g., law firms, physician groups)
  - Businesses with working owners
  - Partnerships (e.g., private equity)
- With need for additional savings:
  - On a tax-deferred basis, and
  - Above and beyond the usual savings vehicles...

Retirement Savings Vehicles

- Usual retirement savings vehicles:
  - IRA: $6,500 / yr limit
  - SIMPLE IRA: $15,500 / yr limit
  - 401(k) plan: $60,000 / yr limit
- Add a Pension Plan:
  - Pension plan: $250,000 / yr limit (roughly)
  - On top of 401(k) plan!
  - Both plans: $310,000 / yr (roughly)

Keys to Success

1. High-earning owners or principals
   - If top-earners below $200,000, may not be worth it
2. Available cash-flow
   - Large cash contributions required annually
   - If cash being conserved, may not be a good fit
3. Need for tax deferral
   - Large taxable income at business and individual levels makes for a good fit

Helpful Characteristics

a. Regular, steady annual income
   - High-value plans governed best when amended least
   - Businesses with variable income can still be good fit, but need to be careful
b. Retirement plan already in place (e.g., 401(k))
   - Some experience of tax-qualified plans
c. Some sophistication
   - Or the good sense to purchase it from advisors

Warnings Signs

1. Cash-strained business
   - Growth-oriented companies with heavy investing, like start-ups, may not have cash to fund savings
   - Non-qualified (unfunded) approach may be better
2. Reluctance to provide rank-and-file benefits
   - Compliance will require substantial, broad-based employee retirement contributions
   - Generally need at least 5% of pay contributions to cross-section of employees

Warnings Signs

3. Focus on business equity (e.g,. tech company)
   - Cash balance usually not involved in equity issues
   - Equity incentive programs may be better
4. Short-term horizon
   - Installation costs, and need to maintain High-Value Plans, may outweigh tax and savings advantages if only short-term
   - Design permanence is important to compliance
   - Should intend to keep stable plan for period of years

What are Pension Plans?

- Consider a 401(k) Plan:
  - 401(k) liability = account balances
  - 401(k) assets = account balances
  - No one ever thinks of them separately…
  - …because they are always equal to each other
- Consider a Pension Plan:
  - Liability = stated promise in a legal document
  - Assets = contributions + earnings in trust
  - They are almost NEVER equal

What is a Cash Balance Plan?

- Defined Benefit Plan
- Benefit = Notional Account
  - Assets are not divided into individual accounts
  - Account is on paper only
- Interest credit on Notional Account
  - E.g., 4% annual interest credit
- Interest credit may or may not match investment return on Plan assets

Cash Balance Example

- 1/1/2017 Account Balance: $100,000
- Annual principal credit: $25,000
- Annual interest credit:
  - 2017: $100,000 * 4% = <u>$4,000</u>
- 12/31/2017 Account Balance: $129,000

Need for Cash Balance Plan

Income	Income Replaced by 401(k) Plan
$200,000	57%
$300,000	26%
$500,000	20%
$800,000	12%
$1,000,000	10%
$1,500,000	6%

Need for Cash Balance Plan

- 401(k) Plan Not Sufficient
  - Other savings are needed
  - Culprit: contribution limit of $60,000 / year
- Cash Balance Plans:
  - Substantial additional savings
  - Discipline of forced annual savings
  - Tax-advantages
  - ERISA protection

Example of Cash Balance Plan

- Example: Small Law Firm

	401(k) Plan	CB Plan	Total
2 Partners	$70,000	$200,000	$270,000
1 Associate	-0-	-0-	-0-
3 Staff	$5,000	$2,000	$7,000

Amounts shown are annual contributions, excluding 401(k) deferrals.

Example of Cash Balance Plan

- Example: Mid-Sized Law Firm

	401(k) Plan	CB Plan	Total
30 Partners	$0.9m	$1.6m	$2.5m
30 Associates	-0-	-0-	-0-
70 Staff	$0.4m	$0.1m	$0.5m

Amounts shown are annual contributions, excluding 401(k) deferrals.

Example of Cash Balance Plan

- Example: Large Law Firm

	401(k) Plan	CB Plan	Total
450 Partners	$13m	$19m	$32m
600 Associates	$1m	-0-	$1m
1,100 Staff	$7m	-0-	$7m

Amounts shown are annual contributions, excluding 401(k) deferrals.

Tax Motivation for Plan

- Tax Consequences **FOR** Plans
  1. Contributions escape immediate taxation
     - Otherwise, immediate tax hit of 35% to 50%
  2. Investment earnings accumulate in tax-free trust
     - Accelerated growth of investment earnings, since no reduction for tax on the front-end
  3. Accumulated balance can be rolled over to IRA or another tax-favored plan at retirement
     - Tax deferral continues decades after retirement

Tax Motivation for Plan (con't)

- Tax Consequences **FOR** Plans (con't)
  4. Taxes apply only upon cash withdrawal
     - Ordinary income tax rates for the individual will likely be lower at that time
     - Even under minimum distribution schedules (4% to 9% per year), tax sheltering continues for many years

Tax Motivation for Plans

- Typical Arguments **AGAINST** Plans

1. Self-directed investing will outperform Plan investing
   - Counter: loss of 35% to 50% in immediate taxation usually too substantial to overcome with “superior” investing.
2. Plan asset allocation underperforms private savings, which would be more aggressive
   - Counter: Participants should reallocate outside investments to adjust for Plan’s conservativeness.

Tax Motivation for Plans (con't)

- Tax Arguments **AGAINST** Plan

  3. Given the national debt and entitlement problems in the US, income tax rates will likely be higher at retirement, so why avoid income tax now?

     - Counter: will likely future tax rates be sufficiently high to offset the tax-deferred investment build-up over decades, as well as the potential drop in tax rates at retirement?

Tax Motivation for Plans (con't)

- Tax Arguments **AGAINST** Plan
  4. Plan converts capital gains and dividends, taxed at lower rates, to ordinary income, which is taxed at higher rates
     - Counter: tax-deferred build-up on tax-deferred contributions could overwhelm this difference. Whether this happens relates to the length of time for which the monies are sheltered.

Tax Motivation for Plans (con't)

- Tax Arguments **AGAINST** Plan

    5. Republican tax-reform proposals include a 25% tax rate on income from pass-throughs. A professional service firm established as a partnership is a pass-through. If income were sheltered in the Cash Balance Plan against a 25% tax rate, and was later distributed as ordinary income taxed at the top 33% personal rate, the tax advantage would be impaired.

        - Counter: the devil is in the details, which are currently unavailable. Also, this does not consider state tax issues.

Exploring Cash Balance Plans

1. Benefit Levels for Principals
2. Benefit Levels for Rank-and-File
3. Interest Credits
4. Investments
5. Distributions
6. Conversions

Cash Balance Features

- Benefit Levels for Principals
  - Usually flat dollar annual contributions
    - Compensation capped at low level ($270,000)
    - Any link to compensation is complicated (circularity)
  - Usually varies by:
    - Ownership level
    - Age
  - Limited by IRS benefit maximum (next slide)
  - Limited by non-discrimination (more later)

IRS Benefit Maximum

- Limit on total Plan benefit paid
  - Unlike 401(k), which limits contributions
  - Once Plan benefit is limited, no more participation
- Limit is prorated Over 10 years
  - Based on Plan participation
- Limit is age-graded
  - Before age 62: reduced by at least 5% per year
  - After age 62: it varies…
- Limit is indexed to annual cost-of-living

IRS Benefit Maximum

Age	IRS Maximum (10 Years)	IRS Maximum (Annual)
45	$1,170,000	$117,000
50	$1,490,000	$149,000
55	$1,910,000	$191,000
60	$2,430,000	$243,000
65	$2,510,000	$251,000
70	$2,720,000	$272,000

IRS Benefit Maximum

- Sample Plan Design
  - Age 45 to 49: $100,000 per participant per year
  - Compliant with Benefit Max, which is $117,000+
  - But some participants will want less
    1. Differentiate by ownership
    2. Informal poll of principals, with formal differentiation decided by Plan sponsor
    3. Laterals & new principals: direct election

Rank-and-File Benefits

- Benefits for Rank-and-File Employees
  - Must be high enough to avoid “discrimination”
  - Sufficient number of non-highly-paid must have same benefit, as percent of pay, as highly-paid
  - Numerical test performed annually on Plan sponsor’s employees (including working owners)
    - Bright-line PASS or FAIL
    - If FAIL, corrective measures are available

Rank-and-File Benefits

- Challenge of Non-Discrimination
  - Show the following are EQUIVALENT in value:
    1. Rank-and-file: $2,000 contribution to 401(k) plan
    2. Principal: $250,000 cash balance contribution
  - In other words, how can giving 99% of the contribution dollars to the principal be non-discriminatory?

Rank-and-File Benefits

- Non-Discrimination: Why it Works

a. State benefits as percentage of pay
   - Now 100-to-5 (instead of 100-to-1)

b. Include assumed future investment returns
   - If 30-year age difference (age 25 vs age 55)
   - Now 100-to-60

c. IRS requires rosier assumptions for 401(k) plans
   - Now 100-to-100!

Rank-and-File Benefits

- Non-Discrimination: Keys for Success
  1. Principals <u>older</u> than many rank-and-file
  2. Rank-and-file benefits = non-elective contributions
     - 401(k) deferrals helpful, but not sufficient
     - Matching contributions <u>unhelpful</u>
       - Convert match to non-elective contribution
  3. Non-elective contribution <u>at least</u> 5% of pay
     - 7.5% of pay is the best

Rank-and-File Benefits

- Example: Law Firm

	401(k) Plan	CB Plan	Total
Partners	$36,000	$100,000	$136,000
Associates	None	None	None
Staff	5% - 9% of pay	None(*)	5% - 9% of pay

* It may be necessary to provide staff with CB benefits

Rank-and-File Benefits

- Cash Balance Coverage for Rank-and-File
  - Ideally, Cash Balance Plan covers ONLY principals
  - IRS required Cash Balance Plan coverage:
    - 2 actives: must cover both
    - 3 to 125: must cover 40% of actives
    - 125 or more: must cover 50 actives
  - For small to mid-sized businesses, usually must cover <u>some</u> rank-and-file employees in Cash Balance Plan

Interest Credits

- Available Types of Interest Credits:
  1. Fixed rate: e.g., 4.0%
     - Cannot exceed 6.0%
  2. Market yield rates:
     - Treasuries: terms up to 30 years
     - Corporates:
       - 1st, 2nd, or 3rd IRS segment rates
       - "MAP-21" or unadjusted

Interest Credits

- Available Types of Interest Credits (cont'):

3. Investment returns
   - Plan assets (more on this later)
   - Subset of plan assets
   - Broad-based mutual funds (e.g., Vanguard 500)
4. Others:
   - Annuity contract rates
   - Cost-of-living indices

Interest Credits

- Available Types of Interest Credits (cont'):

5. Anything not listed above, as long as it's capped
   - Cannot exceed "market rate of return"
   - Term defined exclusively by list above (1-4)
   - As long as interest crediting rate is capped by anything on the list above, it's compliant
   - Example: credit investment return on VICEX
     - Without cap: not broad-based RIC
     - Cap at 6.0%: compliance achieved!

Interest Credits

- Minimum rates permitted in some cases
  - 5% annual with Treasury yields
  - 4% annual with corporate bond rates
- Specific look-back rules for determining bond rates
- Investment-based rates must be based on returns for same period
- Participant-directed investment rates not currently addressed, but discouraged

Interest Credits

- Matching Liabilities to Assets

1. Align investment strategy with interest crediting rate
   - Difficult to invest with a yield rate, or a fixed rate, as target return
2. Best way to match:
   - Set interest credit = Plan asset return
   - Called "Market-Rate Cash Balance"
   - Absent restrictions and under/over-funding, Liabilities (account balances) = Plan assets

Interest Credits

- Issues with "Market-Rate"
  1. Must impose annual cap
     - Level of cap depends on demographics & design
     - Usual cap: 5% to 8%
  2. For rank-and-file, "Market Rate" less workable
     - Give staff a flat interest rate (e.g,. 3%)
     - Treasury/IRS have reservations about this

Interest Credits

- Issues with "Market-Rate"

  3. At distribution, cumulative return cannot be negative
     - May need to top-up balances, if persistently bad investment results
  4. Administration is more expensive
     - If small employer, may not be worth it
     - Use flat rate (e.g., 4%) instead?

Investments

- Investing Cash Balance Plan Assets
  - Invested singly in Plan’s trust
    - No self-direction of investments
    - Firm committee for oversight
    - Engage expert advisors
  - Investments governed by same ERISA requirements as other tax-qualified plans
    - Prudent person rule
    - Fiduciary duties

Investments

- Investing Cash Balance Plan Assets (cont')
  - Consider IRS Benefit Limit on Distributions
    - Distribution = contributions + investment gains
    - If investment gains maximized, contributions would be smaller
    - Smaller contributions means less tax deferral!
    - To extent IRS Benefit Limit is an issue, it's better to invest aggressively outside the Plan, and preserve future tax deferral inside the Plan

Investments

- Investing Cash Balance Plan Assets (cont')
  - Typical investment posture: conservative
    - Significant allocation to short- and medium-term fixed income investments
    - Modest allocation to equities and other riskier investments
  - Alternative view: why have a plan if we can't invest significantly in equities and other risky investments?
    - Likely reach the IRS benefit limits sooner

Investments

- Investing Cash Balance Plan Assets (cont’)
  - Some unhappiness among principals
    - Mandatory take-home-pay reductions
    - No self-direction of investments
    - Conservative asset allocation
  - *How long must my money be tied up in this thing?*

Distributions

- Timing of Distributions from Cash Balance Plan
  - Distributions typically available at:
    - Termination, death, disability
    - Normal retirement age, even if still in-service
    - Age 62 or older, even if still in-service
    - Plan termination
  - With data analysis, could try to lower distribution age down to as early as age 55
    - Only appropriate for larger employers
    - Due to cost of analysis

Distributions

- Timing of Distributions from Cash Balance Plan
  - Annual distributions to age 62+ active participants
    - Withdrawal of each year's remaining account
      - Typically equal to prior year's contribution
      - Although some plans have 1-2 year delay
    - Continual rollover of contributions
    - Investment self-direction starting at age 62...
      - ...because money has been moved to IRA or 401(k) plan

Distributions

- Timing of Distributions (con't)
  - Distributions also available at plan termination
    - Terminate existing plan, distribute assets, and start new Cash Balance Plan
  - Can terminate a retirement plan at any time
    - But if plan terminated shortly after inception, IRS may inquire as to permanence
    - Our experience: plans terminated after 7+ years are not an issue

Distribution Rules

- Distribution valuations
  - All distributions can be based on current account balance at time of distribution
  - Annuity options required, must use reasonable actuarial assumptions
- Late retirement benefit valuations
  - Suspension of benefit rules apply
  - Actuarial increases may be required if no notice

Converting Traditional DB Plan

- Traditional plan can be converted to cash balance design
- Strict anti-cutback and age discrimination requirements apply
- Generally requires an A+B approach to plan benefits (A = prior, frozen traditional benefit, B = future cash balance benefits)
- Alternative approach would be termination of old plan and establish new cash balance plan

Audit Target?

- Law Firm Cash Balance Plans:
  - May be subject to increased IRS audit activity
    - Two of Andrew’s law firm plans recently audited
    - In one audit, IRS reviewer stated that law firm cash balance plans are subject of current interest
    - Audits were deep dive into plan document, ongoing calculations, 415 limits, etc.
    - Both audits concluded favorably to sponsors

What's Next?

- Many Plans were established in early 2000's
  - Some principals have participated for 10 to 15 years
    - IRS Maximum Benefit Limit now applies
    - No further contributions or tax deferral
  - How to replace the lost tax deferral?
    - Nothing as good as Cash Balance
    - Some firms use non-qualified arrangements secured by overfunding the Cash Balance Plan
    - Insurance funding is in use

Summary

- Cash Balance Plans
  - Excellent opportunity for tax deferral
    - Significantly higher savings than 401(k) alone
  - Legal & regulatory structure is solid
    - One of the last great tax deferrals
  - "Industry standard" design has emerged
    - Cash Balance Plans common among professional service firms

Questions and Answers

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