

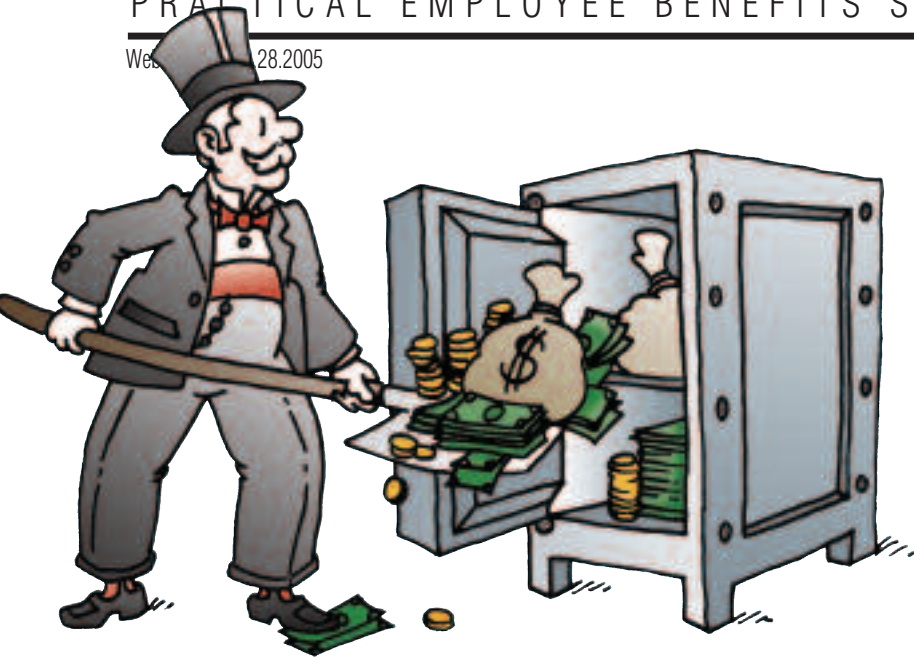
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Professionals Can “Cash-In” With A New Cash Balance Plan

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This article explains the unique characteristics of a cash balance pension plan and its suitability for use by professional groups where the owner-professionals are already maxing out their contributions under a defined contribution plan.

Although cash balance plans have received a considerable amount of negative publicity in recent years in connection with a number of “conversions” of traditional pension plans into cash balance arrangements by large corporations, this type of defined benefit pension plan has a number of features that may make it particularly attractive to successful and maturing professional groups (e.g., doctors, lawyers, accountants, dentists, and architects). This article briefly explains why such groups may want to add a cash balance plan as part of their overall retirement strategy, what a cash balance plan is, how it works and some of the issues that need to be addressed with these arrangements.

Why Should A Professional Group Adopt A Cash Balance Plan?

Many professional groups have designed and are funding their 401(k) profit sharing plans in a way that the owner-professionals are “maxed out” at the defined contribution plan limits. Under such a plan, the Code limits the compensation that each participant may defer for a year (i.e., \$14,000 for 2005) as well as the overall contributions (elective deferrals and employer contributions) and forfeitures that may be

allocated to a participant’s account for a year (i.e., \$42,000 for 2005). A plan can allow additional elective deferrals for a participant who is at least age 50 that do not count against these limits (e.g., an additional \$4,000 for 2005).

Under a defined benefit plan, however, the limits are described in terms of the benefits that may be paid by the plan at normal retirement age. Generally speaking, the maximum benefit that

may be paid upon retirement (usually age 65) to a professional would be the value of a life annuity in the amount of \$170,000 per year (for 2005). This dollar amount is indexed for inflation and will increase in the future. The dollar limit is reduced if the normal retirement age under the plan is less than 62 or if the participant does not have at least 10 years of participation in the plan.

Because the maximum benefit under a cash balance plan is described in terms of the

maximum amounts of money that can be taken out of the plan at normal retirement age, rather than the amounts of money that must be contributed to fund that benefit, it is possible to design the cash balance plan so that the annual “cost” per participant of funding the plan far exceeds the \$42,000

... a defined benefit plan (including a cash balance plan) is designed to provide a “guaranteed benefit” to each participant.

Editors Note: We did the best we could to make sure that the information and advice in this article were current as of the date shown above. Since the laws and the government’s rules are changing all the time, you should check with us if you are unsure whether this material is still current. Of course, none of our articles are meant to be specific legal advice to you. If you would like that, just send us an email at contactus@seethebenefits.com or give us a call at (916) 357-5660.

annual contribution limit for a defined contribution plan. It is even possible for an employee to participate in a defined contribution plan up to the maximum \$42,000 level and participate in a cash balance plan at the maximum benefit level. (Note, however, that the limits on an employer's tax-deductible contributions where the employer maintains both types of plans may preclude such an arrangement.)

Depending on the demographics of the group (*i.e.*, the ages, compensation levels, and number of owner-professionals, other highly-paid professionals and the non-professional support staff), it may be possible to design a cash balance plan that provides for very high levels of "contributions" to each participant's cash balance account or for different levels of such "contributions" for different participants. For example, it may be possible to establish "contribution" levels such as: \$10,000, \$25,000, \$40,000, \$60,000, and \$70,000.

What Is A Cash Balance Plan And How Does It Work?

A cash balance plan is a type of defined benefit plan that, to some extent, mimics the features of a defined contribution plan. Under a cash balance plan, a "hypothetical account" is established for each participant and the value of this hypothetical account determines the benefit that the participant will receive from the plan. In most cases, two types of credits are added to the hypothetical account balance:

- Hypothetical pay credits – usually expressed as a percentage of annual compensation or as a fixed dollar amount (*i.e.*, the "contributions" mentioned above); and
- Hypothetical interest credits – expressed as an annual percentage of the hypothetical account balance.

In order to understand how a cash balance plan works, it is helpful to compare it with the type of plan that most professional groups already maintain – a 401(k) profit sharing plan. A 401(k) profit sharing plan is a type of defined contribution plan. Under such a plan, an individual account is actually established for each participant and that account is credited with a combination of employer contributions (and in the case of 401(k) plans, employee salary deferrals), forfeitures, and investment earnings and losses. Most, but not all, defined contribution plans provide for participant-directed investments of these accounts. (See *Plan Investing – Participant Directed Investment and Participant-Directed Accounts . . . The Truth & Nothing But The Truth* on our website). Because each participant's benefit under this type of plan is equal to the vested portion of the participant's account balance, the participant bears the risk of the plan's investments. In other words, if the investments attributable to a participant's account cause it to lose money, the participant's benefit will become correspondingly smaller – the employer is **not** guaranteeing any portion of the participant's benefit.

On the other hand, a defined benefit plan

(including a cash balance plan) is designed to provide a "guaranteed benefit" to each participant. Generally speaking, a participant's benefit under a defined benefit plan is expressed in terms of an annuity, or a stream of income, for the life of the participant. In the case of a cash balance plan, the participant's hypothetical account balance must be convertible to an annuity. Assuming that the plan is properly funded and the participant continues to work until normal retirement age, the participant will be eligible to receive the promised annuity or, in most cases, a single sum payment that is equal to the participant's hypothetical account balance.

The benefit payable from a defined benefit or cash balance plan is not dependent on whether the plan's investments experience a particular rate of earnings. The benefit payable under the plan is "guaranteed" by the employer (by making sure that the plan is adequately funded) and the employer bears the risk of the plan's investments. For this reason, the plan assets may not be invested on a participant-directed basis and are instead invested as a single, commingled pool. If the plan's investment results are better than the actuarial assumptions, the plan will have an "investment gain" and, over time, the employer may contribute less to the plan in order to fund the promised benefits. However, if the plan experiences rates of return that are lower than the actuarial assumptions, the employer will, at some point, have to contribute additional amounts to the plan in order to fund the promised benefits.

In order to make sure that the amount of a participant's single sum benefit under a cash balance plan is equal to his or her hypothetical account balance under the plan, it is necessary to set the rate of hypothetical interest credits under the plan equal to the rate that the IRS publishes and monitors under Code section 417(e). Essentially, this rate of interest is equal to the rate of return on 30-year Treasury securities.

For more information about cash balance plans in general, see *Cash Balance Plans . . . Another Way To Go* on our website.

What Issues Will The Group Face With A New Cash Balance Plan?

Like any other tax-favored or "qualified" retirement plan, a group's new cash balance plan will be subject to certain minimum coverage, participation, and nondiscrimination rules. In order to satisfy the minimum participation rule, a cash balance plan must benefit at least the lesser of 40% of the group's nonexcludable employees or 50 employees. Because of this requirement, cash balance plans are particularly useful in larger professional firms that have at least 50 owner-professionals or 50 high-paid professionals. Assuming that the group also maintains a profit sharing plan, to which it makes regular contributions on behalf of the non-owner staff and which can be tested together with the new cash balance plan, participation in the new cash balance plan often can be limited to 50 owner-professionals or 50 high-paid professionals.

One of the most important issues with regard to cash balance plans is: Who pays for the cash

balance plan? In order to understand this issue, let's first take a look at who pays for the existing 401(k) profit sharing plan. Under that plan, employee elective deferrals come directly out of each employee's paycheck pursuant to his or her salary reduction elections. Employer matching contributions (if any) and employer profit sharing contributions are paid into the plan by the group. Although the group is responsible for making the employer matching contributions and employer profit sharing contributions to that plan, it is possible and permissible for the group to charge each owner-professional with his or her share of those employer contributions. As a result, each owner-professional is essentially paying for his or her total contributions under the plan as well as some share of the employer contributions for the non-owner participants in the plan.

Under the new cash balance plan, the employer must make all contributions to the plan. However, we believe that it is possible and permissible for the group to agree with each owner-professional (as part of their employment arrangements) to adjust his or level of compensation that would have been received in the absence of the new cash balance plan to reflect each owner-professional's share of the total employer contribution to the plan each year. **Please note, however, that due to important restrictions on so-called "cash or deferred arrangements," the overall effect of the cash balance plan and this expense allocation cannot be so flexible as to become an illegal "super-401(k) plan."** If it were to be treated as such by the IRS, all of the tax advantages of the new plan would be lost to the participants. It is for these reasons that the group must adopt restrictions that limit flexibility in changing levels of or participation within the new plan.

One of the advantages of a cash balance plan is that it can be designed to offer levels of "contributions" that vary among professionals. The problem with this approach is that many professionals also want the flexibility to move from one level to another or even to ignore their commitment to share in the costs of the plan at a particular level. In order to avoid problems with the IRS pertaining to a disguised cash or deferred arrangement, each owner-professional who participates in the plan must commit to bearing a share of the contribution for a significant period of time or until the group as a whole decides to amend the plan and change participation within each of the levels. Because of this commitment, each of the plan's levels and who participates in each of the levels must be considered very carefully by the group and its owner-professionals.

Although a cash balance plan describes a participant's benefit in terms of a hypothetical account balance, it is very important for each participant in the plan to understand that he or she does not actually have or control an account balance under this type of plan. The hypothetical account balance does not vary with the actual investment experience of the plan. Therefore, a key design and operational challenge with these plans is to make sure the value of what a professional gets out of the plan is close to what he or she has put into it. This is usually accomplished by coordinating the actual investments of

the plan with the interest rate that is used for the hypothetical interest credits under the plan.


What About The Negative Media Reports?

As you may have read, cash balance plans in general and certain cash balance plans in particular have been the subject of a fair amount of controversial press and lawsuits between participants and their employers. Basically, the negative press and the lawsuits have centered on a number of so-called cash balance plan "conversions" where large companies, like IBM and Xerox, converted their traditional defined benefit pension plans into cash balance plans. Due to the consequences of these conversions and the impact on certain older employees, a number of participants sued their employers alleging that the conversions violated the Age Discrimination in Employment Act (ADEA). To date, there have been rulings both in favor of these conversions and against some of these conversions as well. Furthermore, certain members of Congress have publicly stated that they believe cash balance plan conversions are particularly evil and have vowed to prevent the IRS from adopting any rules that would permit the use of the conversion technique.

Unfortunately, even a new cash balance plan of the type that we have described above is caught up in all of this controversy and uncertainty. Due to the controversy, the IRS has been unable to issue important guidance clarifying exactly how these types of plans should operate in order to satisfy ADEA and the various benefit accrual and nondiscrimination rules under the Code.

Despite all of the controversy, it is still possible to adopt a new cash balance plan and obtain a favorable determination letter from the IRS that states that the plan is indeed a qualified retirement plan under the applicable rules. Submitting any new cash balance plan adopted by a group to IRS scrutiny is absolutely essential.

What To Do?

If your professional group is interested in investigating the feasibility of adopting a new cash balance plan, you need to contact a team of pension professionals to analyze your situation and advise you on whether such a plan would be appropriate for you. At a minimum, the team should consist of an actuary, a third party administrator, the consultants that you use for your existing profit sharing plan, and an employee benefits attorney. 

For further information or developments on the issues raised in this article, call our office; or e-mail us at: contactus@seethebenefits.com or visit us at: www.seethebenefits.com



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