Benefit Insights

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PENSION CONSULTANTS

A non-technical review of qualified retirement plan legislative and administrative issues **July 2015**

The Right Combination for Your Retirement Plan

Although not a new design, there has been renewed interest in the "combo plan" as a way for higher income business owners to turbocharge their retirement savings. The term "combo plan" generally refers to the combination of a defined contribution plan (usually a 401(k) profit sharing plan) and a defined benefit plan (usually a cash balance plan). The combined benefits in both plans are tested together to allow certain owners or key individuals to receive significantly larger amounts without breaking the bank in contributions to the employees.

Sounds great, right? Sure, but there are several factors that are important to consider in determining whether the combo plan arrangement is right for you. Some of the concepts can be a little tricky, so we will take a look at them using an example.

Setting the Stage

Drs. Suffering, Pain, Agony and Misery have a medical practice—SPAM, PC. In addition to themselves, they have six employees and currently sponsor a cross-tested, safe harbor 401(k) profit sharing plan. Each of the doctors maximizes his or her deferrals. In addition to the 3% safe harbor contribution, the practice makes profit sharing contributions of 2% of pay to the employees (bringing the total to 5%) and enough for each of the doctors to reach the defined contribution plan maximum limit ($53,000 for 2015).

The SPAM doctors decide that they would like to contribute an additional $100,000 per year each, so they call their TPA/actuary to find out if that is possible. Enter the combo plan as the possible solution.

The Defined Benefit Component

As noted above, the defined benefit part of the equation is usually what is called a cash balance plan. It is important to remember that a cash balance plan is a defined benefit plan in every way. That means it is subject to all the regular defined benefit rules, including annual funding requirements, actuarial valuations, etc.

The key difference is in the way the benefit is expressed—in the form of a guaranteed

"hypothetical account" rather than what can be perceived as an esoteric formula based on years of service and average compensation. The hypothetical account is adjusted annually for guaranteed contribution credits and interest credits, both of which must be specified in the plan document.

Another reason cash balance plans have become the go-to is that they provide "age-neutral" benefits which reduces volatility. Older employees do not require higher contributions than younger employees which is one of the disadvantages of a traditional defined benefit plan.

Based on this information, our friends at SPAM decide to go with a cash balance plan. In addition to how the assets are invested, there are several critical decisions the doctors must make that will determine the levels of overall contributions:

- Who is eligible for/who will be covered by the plan?
- How will interest be credited to participants' hypothetical accounts?
- What benefit levels are desired and/or required to pass all the nondiscrimination tests?

Eligibility

All defined benefit plans are subject to a minimum participation test, which requires at least 40% of the eligible participants receive a "meaningful" benefit. There are two exceptions: no more than 50 participants have to receive it; and if there are at least two eligible participants, they both must receive it. Let's look at several examples:

- SPAM has 10 eligibles: At least 4 must receive meaningful benefits.
- Company B has 200 eligibles: At least 50 must receive meaningful benefits from the defined benefit or cash balance plan.
- Company C has 2 eligibles: Both employees must receive meaningful benefits.

Sometimes the cash balance plan is designed with various job classes excluded. For example, if SPAM excludes all job classes other than doctors, the plan would cover 40% of their eligible employees and pass the minimum participation test.

The challenge is that this can create volatility in small companies. Let's say the SPAM cash balance plan covers only the doctors, which obviously appeals to them. In year two, they increase their staff to 11 or 12, which means one additional employee must be brought into the cash balance plan. Now, one of the main selling features for the plan, that it only covers the doctors, has already fallen apart. It can also be difficult to explain to employees why some of them are covered in a second plan while others are not.

OK, by now you must be asking yourself, "So what's a meaningful benefit?" There is no formal guidance on this, but the IRS takes the position it is meaningful if it provides a **benefit at retirement** of at least 0.5% of compensation.

In a cash balance plan this does not mean a current contribution credit of 0.5% of compensation is meaningful! Rather, it must be accumulated to retirement and converted to a benefit for this test, so the amount it takes to be meaningful depends on the age and salary of the employee. For a young, lower-paid employee, a credit of $750 may be meaningful but for an older, very highly-paid employee it might take $10,000.

Crediting Interest

You will need to decide what interest crediting rate to select for the plan, which is an issue that warrants an entire article all on its own. In the interest of brevity, suffice it to say that it should tie into the trustees' investment policy, tolerance

for volatility and losses and understanding of some of the more advanced options available. Often in small combo plans like that of SPAM's, a low flat crediting rate of 3%–5% is used, and the trustees will invest the funds fairly conservatively to avoid the possibility of large losses.

Contributions

The SPAM doctors have decided the cash balance contribution credits will be $100,000 for each doctor and $1,000 to each of the other six participants. Sounds simple…what else is there to discuss? Lots, actually.

One of the first things to understand is that the cash balance plan will never be able to satisfy the nondiscrimination requirements on its own. It is part of a combo plan design, after all, so it will have to rely on contributions for the six employees in the profit sharing plan to pass.

The TPA/actuary accumulates the cash balance credits and the profit sharing allocations to retirement, converts them to benefits, compares them to salaries and tests them to confirm they are not discriminatory. That means those profit sharing contributions for the staff become required as long as the cash balance plan exists.

There is also a special "gateway" requirement that requires the staff to receive a minimum combined contribution of between 5%–7.5% of salary. In the typical combo plan the gateway usually translates to a required profit sharing contribution for the staff of about 6%–7% of pay. This only works if the staff, on average, is younger than the principals who are receiving the higher amounts.

Top Heavy Minimums

In most cases a combo plan for a small group will be top heavy (meaning that more than 60% of the combined benefits are for the owners and officers), and that triggers certain minimum contribution requirements. It is always best to provide this minimum in the profit sharing plan, which amounts to 5% of pay. Since the gateway amount already exceeds 5%, using this approach is a no-brainer as they say.

Limits on Tax Deductions

Another government agency, the Pension Benefit Guaranty Corporation, oversees certain aspects of defined benefit plans; however, plans sponsored by professional organizations like SPAM, who have fewer than 25 employees, are generally not subject to that oversight.

Plans covered by the Pension Benefit Guaranty Corporation do not have any additional limits on the tax deductions they can take for plan contributions, but those not covered are subject to a special combo plan deduction limit. It can get a bit complicated, but here is the gist:

- If the aggregate profit sharing contribution exceeds 6% of pay, then the combined cash balance and profit sharing contribution the company can deduct cannot exceed 31% of pay.
- If the profit sharing does not exceed 6%, there is no combined limit.

Back to SPAM. Given the size of the cash balance credits being provided to the four doctors, the design cannot work if constrained by the 31% deduction limit. That means the total profit sharing contribution cannot exceed 6% of pay. However, since the profit sharing contribution to the staff may be 7% of pay or more, the doctors must receive less than 6% in order to keep the aggregate amount at the overall 6% limit.

Because of this dynamic a combo plan design can only work if the profit sharing plan allows for different levels of allocations by group or by individual participant.

Flexibility

There are a couple of defined benefit myths that need to be dispelled:

- Once the plan is set up the contribution amount can't be changed.
- The plan must exist for at least five years or could be disqualified.

Both of these statements are incorrect. A defined benefit plan can be amended at any time (even in year two) to decrease or freeze the benefit. But as with any defined benefit plan, this amendment can only be made prospectively, before the credit has already been accrued for the year.

One of the requirements for any qualified plan is that the intention has to be that the plan is permanent at the time it is established. This does not mean a plan cannot be terminated within a few years if the business is sold, the principals get sick, the economy goes into recession, etc. It just means that when the plan is set up, the sponsor should intend for it to be permanent. This is why you will hear the mantra that the plan should exist for five years.

Funding Requirements

While there is flexibility to amend a defined benefit plan prospectively, you do not have discretion as to whether you make a contribution in a given year like you do with a stand-alone profit sharing plan. There will be a minimum amount that must be contributed each year. The actuary will calculate this amount, and failure to make the contribution timely results in some potentially expensive excise taxes payable to the IRS.

Conclusion

There are many different ways to design combo plans and not every client will be as straightforward as our friends at SPAM, PC. The important thing is to always convey your specific objectives to your TPA and then for them to design the simplest, most stable plan that meets those objectives.

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