



March 2010 Qualified Plan Corner: Combination Cash Balance/401(k) Profit Sharing Plans For Smaller Firms

Over the past three decades, usage of traditional defined benefit plans (which promise a specified monthly retirement benefit to participants) has declined in favor of defined contribution plans, most prominently the 401(k) plan with a profit sharing component. This development can be largely explained by the desire and ability of employers to shift investment risk to participants and better control required funding and administrative costs through the use of defined contribution plans.

However, the tradeoff for using a 401(k) profit sharing plan in lieu of a defined benefit plan is that annual contributions for the benefit of an individual participant are limited. The limit for 2010 is \$49,000 (or \$54,500 for participants at least age 50). The contribution limits for defined benefit plans are a function of a number of variables which include the promised benefit and the age of the participant. Generally speaking, older participants with substantial compensation can receive a much larger annual contribution under a defined benefit plan than under a 401(k) plan.

For smaller firms whose principal(s) earn substantial compensation and desire to reduce taxable income while aggressively funding their retirement accounts as their target date approaches, an annual contribution of \$54,500 may not be enough. Is there an approach for such firms?

Impact of the Pension Protection Act

The Pension Protection Act (PPA) of 2006, provided a real boost in the small plan market for combination plans incorporating a defined benefit plan with a 401(k) plan with a profit sharing component.

PPA provided that employers utilizing combination plans could make deductible contributions up to 6% of eligible compensation in the profit sharing component of the 401(k) plan. Previously, the deductible amount was zero.

The result is that combination plans are now viable vehicles for small firms with favorable demographics and cash flow (more on that below) to provide for substantial contributions to principals while controlling funding costs to non-principals.

Favorable Demographics and Cash Flow

Combination plans can be appropriate for firms who desire to fund principals' contributions in amounts that vastly exceed the annual additions limit (\$54,500 for 2010) in defined



contribution plans. To do so, of course, requires financial ability. , e.g. substantial and stable cash flow. As discussed below, contributions to the defined benefit component are not discretionary. They must be made each year the plan is retained absent amendment of the defined benefit.

Additionally, demographics of the participant population impact the extent to which employer funding costs to non-principals are controlled. Favorable demographics include:

- Compensation disparity in favor of principals relative to staff
- Principals are older relative to staff members
- Low ratio of staff members to principals
- Multiple principals

Interestingly, the above demographics may also contribute to the efficiency of a new comparability profit sharing allocation, commonly used in stand-alone 401(k) profit sharing plans for small firms. In the context of a combination plan, the degree to which their presence helps control costs can be magnified, as is the degree to which their absence may hinder cost control.

Typical Combination Plan Design

The typical combination design is:

1. 401(k) with employer funded 3% non-elective safe harbor contribution and profit sharing components
2. A hybrid form of defined benefit plan known as a Cash Balance Plan

What's a Cash Balance Plan and Why Use It Instead of a Traditional Defined Benefit Plan?

A cash balance plan is a hybrid form of a traditional defined benefit plan. It can be best described as a defined benefit plan that looks like a defined contribution plan. Participant benefits are expressed as a current balance just like in a defined contribution plan. Funding of individual participant benefits are expressed as dollar credits which can be thought of as the contribution for a participant. Cash balance plans provide for a pre-determined annual interest credit to participants' account values. Thus, cash balance plans may be easier for participants to understand than a traditional defined benefit plan which expresses benefits as a monthly annuity to be received at a future point in time.

And as illustrated in the example below, cash balance plans can provide for "age neutral" contributions which helps leverage total contributions in favor of the preferred group (e.g. Principals) while still passing non-discrimination testing.



Example with Very Favorable Demographics

The example below identifies the contribution components of a typical combination design with very favorable participant demographics as described above.

	Age	Compensation	Cash Balance Credit	3% Nonelective Safe Harbor	Profit Sharing	401(k) Deferral	Total Employer Contribution	% of Total Employer Contribution
Principal A	56	\$ 245,000	\$ 180,000	\$ 7,350	\$ 13,965	\$ 22,000	\$ 223,315	52.64%
Principal B	50	\$ 245,000	\$ 140,000	\$ 7,350	\$ 13,965	\$ 22,000	\$ 183,315	43.21%
Subtotal		\$ 490,000	\$ 320,000	\$ 14,700	\$ 27,930	\$ 44,000	\$ 406,630	95.85%
Staff 1	40	\$ 50,000	\$ 1,200	\$ 1,500	\$ 3,500	N/A	\$ 6,200	1.46%
Staff 2	25	\$ 50,000	\$ 1,200	\$ 1,500	\$ 3,500	N/A	\$ 6,200	1.46%
Staff 3	28	\$ 40,000	\$ 1,200	\$ 1,200	\$ 2,800	N/A	\$ 5,200	1.23%
Subtotal		\$ 140,000	\$ 3,600	\$ 4,200	\$ 9,800	N/A	\$ 17,600	4.15%
Grand Total		\$ 630,000	\$ 323,600	\$ 18,900	\$ 37,730	\$ 44,000	\$ 424,230	100.00%

This example illustrates strong leverage in favor of the Principals group with almost 96% of contributions for their benefit.

However, it also illustrates a substantial annual financial commitment to create that result: over \$424,000 of annual employer contributions. Combination plans such as this offer limited employer discretion in the amount of annual contributions because (1) The Cash Balance Credit is fixed (unless and until the plan’s benefit structure is amended) and necessary to create the leverage in favor of Principals, and (2) The Safe Harbor and Profit Sharing contributions to Staff are necessary for the combination plan to pass non-discrimination testing (which is why PPA’s provision for deductible employer profit sharing contributions is so important).

Therefore, combination plans may be appropriate for:

- Firms with substantial and stable cash flow as well as favorable participant demographics.
- Firms with the desire and means to fund Principals’ benefits far in excess of the annual additions limit for defined contribution plans (\$54,500 for 2010).



Cautionary Comments

Even where the firm's participant demographics, cash flow, and objectives are suitable for a combination plan, there are other less favorable aspects to take into consideration.

Participants in a cash balance plan do not control how their balances or contribution credits are invested. Investment responsibility and, therefore, investment risk is borne by the employer. The same holds for traditional forms of defined benefit plans.

Therefore, it is prudent to select a conservative interest credit for participants' account balances. According to Dan Kravitz, President of Kravitz, Inc, approximately 90% of cash balance plans in existence utilize the yield on 30-year Treasury bonds as the interest credit.

Therefore, it is important to understand that the bulk of participants' retirement accounts may be earning T-bond-yield returns. Heavy weighting of the participant portfolio to bonds to the exclusion of equities may not be the ideal asset allocation for a given participant.

Furthermore, cash balance plans are more expensive to establish and administer than defined contribution plans. Eventually, the cash balance plan will be terminated, potentially resulting in significant additional fees relative to a defined contribution plan termination.

Finally, it can be tempting to poll the firm's Principals periodically to determine how much of their compensation they desire to defer through the cash balance plan. Doing so could result in the plan being deemed a cash or deferral arrangement with the tax deduction for the employer contribution disallowed.

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