Cash Balance Plans for Professional Firms: Understanding a Hybrid Approach

A Safe Harbor from Rising Tides of Uncertainty

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Much has been written in today's retirement planning industry about the sheer growth of cash balance plans, a type of qualified defined benefit (DB) plan. Between 2011 and 2012, plan adoption surged to 22%, compared to only 1% for the ubiquitous 401(k) plan. Today, these make up roughly 25% of all U.S. defined benefit plans, compared to only 3% in 2001.

Among their many benefits, cash balance plans, as qualified DB plans, offer participants an account balance, the vested portion of which can be distributed as a lump sum upon retirement, or upon separation from a business. Employees may more readily understand and appreciate a benefit defined as an account balance, vs. a vaguely-defined monthly retirement benefit payable in the future—based upon average compensation and service. Further, pairing a cash balance plan with a 401(k) plan (a "hybrid" approach), and using techniques such as New Comparability, allow an employer to craft differing benefit levels for different participant groups, while still satisfying complex nondiscrimination requirements.

Sheer popularity of cash balance plans among successful professional firms such as physicians' offices may stem from a few reasons: a growing expectation that income taxes and health care expenses will continue to rise, as well as a desire for owners to protect assets from creditors, amid an increasingly litigious business climate. Today, this is especially timely, with the Congressional Budget Office (CBO)'s Aug. 2014 update, where individual income taxes as a percentage of GDP will continue to trend upward over the next decade, as a result of inflationary pressures.

In an increasingly unknowable and changing environment, professional firms like physicians' offices might consider the potential impact of such tax increases, as well as gain a better understanding of the many tax-sheltered savings benefits that cash balance plans offer; in particular – the aforementioned "hybrid" approach. Recently-released guidance by the IRS and Treasury Department in September 2014 on hybrid plans, has finalized the allowable interest crediting rate definitions that can be used in a cash balance plan to include a maximum fixed interest rate of 6%. Furthermore, the new regulation, effective Jan. 1, 2016, enables interest credit rate definitions that can help sponsors of cash balance plans reduce funding volatility and share risk with participants.

Aside from the rising tide in income taxes—perhaps among the most unknowable issues for those planning ahead for retirement is the continued rise of health care costs. Although difficult to quantify over the long-term, and largely dependent on various individual characteristics, such costs are expected to be significant. The Employee Benefits Research Institute projects that a married couple age 65 with median drug expenses is estimated to need approximately

$151,000 to have a 50% chance of meeting their retirement health care costs and approximately $255,000 to have a 90% chance.[i] Paired with a portable Health Savings Account, assets in qualified high deductible retirement health plans are likely the chief source to address these costs. Subsequently, the need for increased retirement savings is a very likely reality and a priority for owners of small to mid-sized, closely-held professional firms.

Benefits of a Hybrid Plan Approach

In general, companies that only offer a 401(k) plan typically provide employer contributions to participants averaging roughly 2.6% of pay. Conversely, using a hybrid approach, after adopting a cash balance plan alongside the §401(k), employer contributions tend to approach 6% of pay or more. When census demographics are ideal, it is not uncommon for an employer sponsoring a Cash Balance and §401(k) Plan combination arrangement to provide a substantially meaningful benefit for rank and file employees of between 7% - 10% of pay. Even more beneficial, the percentage of pay allocations for owners and key principals can often approach 70% or more.

This combination arrangement is particularly appealing to the middle-aged business owner, who after 20-30 years of pouring every available dollar back into the business, is now quickly approaching retirement, without sufficient savings to maintain a current standard of living. In a standalone 401(k) plan, owners can achieve allocations totaling only $52,000-$57,500 (as indexed for 2014). Adding the cash balance plan component, can allow potential total allocations of more than $160,000 for individuals age 45 and older. The chart below summarizes the maximum allowable allocations by age in a combination arrangement.

Age	Cash Balance Plan [ii]	§401(k) Profit Sharing Plan[iii]	Total Both Plans [iv]
45	$112,056	$52,000	$164,056
50	$143,680	$57,500	$201,180
55	$184,304	$57,500	$241,804
60	$236,495	$57,500	$293,995
65	$244,112	$57,500	$301,612

While cash balance plans broadly appeal to businesses of all sizes and types, they are not ideal for every employer. Before making a decision, business owners should consider the following questions:

- Do you want to greatly increase your tax-deductible retirement savings?
- Do you want to control the cost of benefits for employees?
- Are you and your key executives much older, on average, than your rank and file employees?
- Is your business's income and profitability consistently stable and high?
- Can you make a commitment to increase plan contributions for the foreseeable future?

The above are just a few of the key questions for business owners considering the many benefits of a hybrid approach. Risks in today's environment can potentially impact retirement savings as owners prepare for retirement. As a result, owners should consider retirement plan solutions that allow the flexibility of key benefits at both the employer and employee level.

For more information on cash balance plans, please contact Manning & Napier at: info@manning-napier.com.

[i] "Amount of Savings Needed for Health Expenses for People Eligible for Medicare: More Rare Good News", Employee Benefit Research Institute, Notes, October 2013.
[ii] This column illustrates the maximum amount that can be distributed as a lump sum to a participant that has earned income of $260,000, is fully vested and has one year of plan participation. It uses the 2014 Applicable Mortality Table at 5% for the monthly benefit and 5.5% for lump sum distributions; and a normal retirement age assumption of 65.
[iii] For 2014, the maximum defined contribution plan annual addition for an individual is the lesser of 100% of compensation or $52,000 ($57,500 if catch-up deferrals apply). A $5,500 catch-up deferral is allowed for any participant who attains age 50 during the plan year and either makes salary deferrals up to the maximum of $17,500 or reaches another regulatory or plan-imposed allocation limit. This amount assumes that maximum allowable salary deferrals have been made, and that the Cash balance plan is covered by the Pension Benefit Guaranty Corporation.
[iv] Required Minimum Distributions must be made by April 1 of the year following the year in which age 70½ is attained; unless still an active non-owner employee.
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James earned his BA in Mathematics from the State University of New York at Buffalo. He is a 10+ year member in good standing of the American Society of Pension Professionals and Actuaries (ASPPA), through which he holds the designation of Qualified Pension Administrator (QPA).