CASH BALANCE PLANS AN ATTRACTIVE ALTERNATIVE FOR MANY SMALL BUSINESSES

Overview

As we have pointed out in previous newsletters, employers who wish to provide maximum retirement benefits to older members of their work force frequently decide to adopt some form of a defined benefit plan. While defined contribution plans face statutory limits on employer contributions and on allocations to individuals, the same is not true for defined benefit plans. Instead, defined benefit plans limit the amount of the annual income the plan can provide, currently $210,000 after 10 years in the plan. The employer must contribute an actuarially determined minimum contribution and may make larger deductible contributions in many cases.

When examining the potential benefits and contributions, the most that a defined contribution plan can offer is a $53,000 annual individual allocated contribution that does not exceed 100% of the participant's compensation. In addition, aggregate plan contributions cannot exceed 25% of annual aggregate participant compensation with an individual's compensation limited to $265,000. Individuals age 50 and over are permitted an additional $6,000 "catch up" salary deferral under a 401(k) salary deferral arrangement, bringing the total annual maximum to $59,000. Employer contributions to defined benefit plans can be three times as large as this on an annual basis, or more. However, this is not apparent in a typical defined benefit plan where the annual benefit is expressed by a mathematical formula such as "2% of compensation multiplied by total years of service with the employer."

Cash balance plans represent "hybrid plans" because, while they are defined benefit plans under tax law, they base benefits on a hypothetical account. This account receives hypothetical contributions, is credited with a stated interest rate or formula, and is reduced by any distributions. Upon retirement or other termination of employment, participants may receive their hypothetical accounts in a single sum, instead of a lifetime income. These plans are becoming very popular with smaller businesses that are able to make a commitment to fund necessary annual amounts into the plan. Substantial flexibility is provided because different individuals (such as different owners) can have different hypothetical contributions. For example, the founder of a business might have a $175,000 annual hypothetical contribution, while a junior partner might receive $100,000. Non-owners may have specific dollar amounts as hypothetical contributions, or may receive a uniform percentage of compensation each year.

The hypothetical interest need not be

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related to the actual investment performance of the underlying trust fund. Since it is a defined benefit plan, the actuarially calculated contribution will increase if hypothetical interest credits are below trust earnings, and vice versa. This is one of the reasons that an enrolled actuary is necessary to monitor plan funding. Additionally, the Pension Benefit Guaranty Corporation may be required to insure cash balance plan benefits unless the plan meets an ERISA exemption.

SEE Page 3 for Cash Balance Illustration (under the 2016 law)

Cash Balance – other advantages:

Cash balance plans, in addition to being flexible and offering the option of high deductible contributions, have several other advantages over traditional defined benefit plans:

- **Simplicity –** Instead of expressing benefits as a lifetime income that depends upon age of retirement, income continuation after the participant's death, and a complicated benefit formula usually based on compensation and length of employment, a cash balance plan simply provides a statement of account each year, similar to a profit sharing or 401(k) benefit statement.

- **Portability –** Since benefits are normally paid as a lump sum equal to the participant's account balance, benefits can be easily rolled over to a new employer's plan or to an Individual Retirement Account (IRA).

- **Employer controlled liability –** Benefits expressed and paid as a single sum benefit are not dependent upon market interest rates. If interest rates decline, smaller lifetime benefits will be available per dollar of single sum benefit, but the plan liability for participants will not increase.

- **Employers control plan asset investments –** If the cash balance plan credits participant accounts with a fixed rate of interest, the employer may choose investments that will approximate that rate of return and may reduce future rates as required.

- **Cost predictability –** Since hypothetical contributions are stated in advance and controlled by the employer, plan costs are much more predictable than traditional defined benefit plans. This is particularly true to the extent that contributions are expressed as a flat dollar amount, instead of a percentage of compensation.

Because of the above advantages, it is not surprising that cash balance plans are the fastest growing segment of the defined benefit retirement plan marketplace.

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CASH BALANCE ILLUSTRATION (UNDER THE 2016 LAW)

ABC, INC.
CASH BALANCE / 401(K) PLAN

Name	Age	Compensation	Cash Balance Contribution	401(k) Deferral & Catch-Up	Safe Harbor Profit Sharing Contribution	Additional Profit Sharing	Total
Owners							
Owner 1	54	$265,000.00	$175,953.00	$24,000.00	$0.00	$100.00	$200,053.00
Owner 2	49	$265,000.00	$137,144.00	$18,000.00	$0.00	$100.00	$155,244.00
TOTAL		$530,000.00	$313,097.00	$42,000.00	$0.00	$200.00	$355,297.00
Non-Owners							
Employee 1	59	$30,000.00	$750.00	$0.00	$900.00	$912.00	$2,562.00
Employee 2	52	$30,000.00	$750.00	$0.00	$900.00	$912.00	$2,562.00
Employee 3	34	$30,000.00	$750.00	$0.00	$900.00	$912.00	$2,562.00
Employee 4	25	$30,000.00	$750.00	$0.00	$900.00	$912.00	$2,562.00
TOTAL		$120,000.00	$3,000.00	$0.00	$3,600.00	$3,648.00	$10,248.00
		Total Employer Contribution to Owners		Total Employer Contribution to Non-Owners		Total Employer Contribution to Owners and Non-Owners	
		$313,297.00		$10,248.00		$323,545.00	
		96.83%		3.17%		100.00%	

Please Note: The above numbers are approximations. Actual results will vary based on actual census data, plan assumptions and plan experience. Above results reflect 2016 tax law.

IT'S NOT TOO LATE TO START A 2016 SAFE HARBOR 401(K) PLAN

When considering 401(k) plan options, one popular feature is a safe harbor plan. A safe harbor plan is a plan that makes prescribed employer contributions, avoids nondiscrimination testing, and generally allows the eligible highly compensated employees to contribute the maximum deferral amount. Safe harbor plans face a much shorter time frame due to requirements found in the 401(k) regulations. Employers who are interested in starting a new safe harbor 401(k) plan for calendar year 2016 must act quickly. Employers have until October 1, 2016 to design, communicate, and administer a new, safe harbor 401(k) plan. Also, if the employee deferrals are to be invested with a financial services provider, one must be selected and the administrative mechanics of receiving and investing plan money must be established and operational when the employee deferral contributions begin. In addition, all of the detailed plan provisions must be described in a formal Plan document and communicated to participants. NRS is here to assist you!

REMINDERS FOR SEPTEMBER 2016

- **September 15 –** Minimum funding requirements for Defined Benefit, Money Purchase, and Target Benefit plan years ended 12/31/15 must be met by September 15 in order to avoid excise taxes. An electronic transfer must be completed or a check mailed by this date.

- **September 15 –** Retirement plan employer contributions are due in order to be deducted on employer tax returns due to be filed September 15, 2016.

- **September 15 –** Forms 5500 Series/8955-SSA – Forms that are on extension are due for the Plan Year ended 11/30/15.

- **September 30 –** Forms 5500 Series/8955-SSA – Forms are due for the Plan Year ended February 29, 2016 for plans that are not on extension.

And don't forget that calendar year 2017 safe harbor notices for 401(k) plans with safe harbor provisions and automatic enrollment notices for auto enrollment plans are required to be distributed during the months of October or November.

For more information or to request a proposal, please visit our website at www.NRServices.com, or for sales support, please contact:

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