

Two Plans Are Better Than One

New Opportunities Lie Ahead

In the past, most companies had a choice of adopting either a Defined Contribution Plan, such as a 401(k) Profit Sharing Plan or a Defined Benefit Plan. Each of these types of plans has advantages and disadvantages to the employer and employees. This article will focus on the advantages and disadvantages of certain plans from the employer's perspective.

Combined plans have always been available to companies but few employers utilized a dual plan strategy because of the overall plan limitations. Section 404(a)(7) of the Internal Revenue Code limited the total contribution made to both plans to 25% of eligible payroll. This is the same limit that applies to a stand-alone Profit Sharing Plan. In other words, there was no incentive for companies to offer dual plans when they could achieve the same tax-deduction using one. Obviously, one plan requires less cost and time to administer and is less complex to communicate to employees. In addition, Profit Sharing Plans offer more flexibility than traditional pension plans.

The Pension Protection Act of 2006 amends Section 404(a)(7) of the code. This is where the opportunity lies. Under



How many eggs do you have in your basket?

the new rules, starting in 2007 the limitation for combined plans has been relaxed. In 2010, employers can fully fund a defined benefit plan, make salary deferrals to a 401(k) plan and fund their profit sharing plan up to 6% of compensation. Starting in 2008, the profit sharing portion can be funded up to the full government declared limitations at that time.

This means that companies no longer need to make trade-offs when choosing a retirement plan. They can take advantage of the large tax deductions afforded by a defined benefit plan and still keep the flexibility of a defined contribution plan. The cost of retirement and the investment risk is shared with employees in the 401(k)

profit sharing plan. The employer assumes the investment risk in the defined benefit plan. Most of the disadvantages of each plan standing alone are minimized when running a combined or paired plan. Interestingly, the benefits are maximized when running a paired plan.

A paired plan maximizes tax deductions to the owner, creates wealth working in a tax preferred environment, attracts, retains and rewards key employees. Furthermore, with proper planning, a paired plan can help the continuation of the business and can facilitate the transfer of the estate for the business owner (s).

Heritage Administrative Services LLC

What are your goals?

- Tax deductions?
- Wealth accumulation?
- Wealth Transfer?
- Attracting key employees?
- Rewarding and retaining key employees?
- Business succession planning?

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Defined Contribution Plans

Advantages

- ◆ Employer contributions are flexible and discretionary
- ◆ Employees can participate through salary deferral under a 401(k) feature
- ◆ Employees assume investment risk
- ◆ Investment options are vast
- ◆ No limit as to how much any one individual can accumulate under the plan

Disadvantages

- ◆ Employees are limited to receiving 25% of pay up to \$49,000 in any plan year (2011 plan limit)



How will you spend your retirement?

Defined Benefit Plans

Advantages

- ◆ High contribution limits
- ◆ Benefits are skewed towards older and higher paid participants

Disadvantages

- ◆ Employer contributions are mandatory
- ◆ Fully funded by employer
- ◆ Employer assumes the investment risk
- ◆ Plan investments are generally conservative since the Employer assumes the investment risk

A paired plan can maximize the benefits and minimize the shortcomings of each type of plan.

Paired Plan

Based on the above, it is easy to understand why over the past two decades so many defined benefit plans have been terminated and replaced by defined contribution plans.

When we run a paired plan we are able to maximize the benefits and minimize the shortcomings of each type of plan.

Some of the advantages of a paired plan include:

Higher Contribution Limits: An employer can take advantage of both the DC and DB Plan limits. These limits may allow highly compensated individuals to receive far in excess of the \$49,000 DC limit. All employer contributions to a qualified retirement plan are tax-deductible to the company and are non-taxable to the employee.

Cost of Retirement is Shared: Employees can take advantage of the tax-deductible salary deferral 401(k) contribution and the employer commits to funding the DB plan. In this way the burden of providing retirement benefits does not rest solely on the employer.

Investment Risk is Shared: Investments held in the 401(k) Profit Sharing Plan are employee directed. Each employee assumes the risk of his or her choices. They may be as conservative or as aggressive as the plan allows. The employer assumes the investment risk of the DB plan only.

Some Flexibility in Contribution: The defined contribution portion of a paired plan may change from year-to-year. The salary deferral portion is never required and if the non-discrimination testing allows, the employer contribution may be lowered as well.

An employer contribution to the defined benefit portion of a paired plan is required. However, we do have some flexibility as to when that contribution is made. The Pension Protection Act (PPA) of 2006 made it allowable for an employer to fund beyond the minimum contribution in any given year. Employers may fund their plan up to 150% of the accrued liability. These contributions are fully tax-deductible. In essence, the pension is accumulating a credit balance. Should the company have an “off-year” fiscally, the company can utilize the credit balance to meet its required contribution to the plan. The ability to overfund the plan in good years and carry a credit balance to use in bad years was a major gift of the PPA.

What Type Of Defined Benefit Plan Is Appropriate For Me?

There are many ways to design a defined benefit plan. No one plan design fits all client's tastes, needs or desires. At Heritage Administrative Services LLC, we will work with you to determine a plan design that is appropriate and maintainable for achieving your goals.

It is important to note that regardless of the type of defined benefit plan you choose, all defined benefit plans share common characteristics. First, all defined benefit plans do what the name implies. They are set up to deliver a promised benefit to employees at retirement. This benefit is usually expressed as a monthly benefit or a percentage of pay. The company is responsible for delivering on the promised benefit

The difference between the various types of plans lie in how the plan achieves the promised benefit. For instance, **412(e)(3) plans** are plans invested in conservative insurance contracts. When funding a plan under a 412(e)(3) design we must assume the guaranteed interest rate on the insurance contracts. These rates are relatively low. In order for the

employer to deliver the promised benefit in a lower rate environment, the plan generally requires larger contributions in the early years of participation. As time goes on, excess interest or dividends from the insurance contracts will decrease the required contributions. This type of design is attractive for a company looking to front-load their contributions and tax deductions.

Traditional Defined Benefit Plans work the opposite way. Traditional plans are usually based on three factors: your age, your salary and the number of years with the company. An employee's benefit grows slowly during the early years, then rises sharply as they grow older, earn more money and accumulate more years with the company. Traditional plan benefits are typically based on a **Final Average Pay** scale. In this type of plan design, contributions are rear-loaded.

A **Cash Balance Plan** is more evenly funded because it is based on a **Career Average Pay** scale. In this way sharp spikes in income that may occur as an employee approaches



Retirement is coming. Are you ready?

retirement will not have as big of an impact on the employer cost as it would under a traditional plan.

In a typical Cash Balance Plan, the company contributes a set amount of money— for example 5% of an employee's salary— to an account each year. The company will also guarantee that the account will grow at a certain rate every year. That rate may be either a fixed amount or a variable rate tied to a benchmark, such as the one-year Treasury bill.

The Cash Balance Advantage

For the past several years there has been some uncertainty in designing cash balance plans because there was little regulation from the IRS. What has changed is simple. The IRS concluded its cash balance research and through the Pension Protection Act has provided us with better guidance on how to design and administer these types of plans. They are also, once again, offering favorable letters of determination for **new** cash balance plans. We expect guidance in the near future regarding conversions of existing defined benefit plans.

Cash Balance Plans offer unique advan-

tages over traditional defined benefit plans. First, they look a lot like 401(k) plans. Employees receive an employer contribution equal to a set percentage of their pay to a hypothetical account. They are guaranteed a rate of return on this account. At year end, they receive a statement that shows a beginning balance, an employer contribution, a return on their account and an ending balance. The benefit is plain and simple to understand and is appreciated.

Another advantage that cash balance plans offer is the ability to equalize the contribution for partners. Under a tradi-

tional defined benefit plan one of the biggest factors in determining the cost of an employee's benefit is his/her age. Since partners are often of various ages, contributions are skewed toward the older partner (s). This may potentially create resentment from the younger partners and stop the plan design altogether. With a cash balance plan, we can create tiers of employees. As long as the nondiscrimination tests allow we can allocate different amounts of contribution to the various tiers of employees.



Case Study Cash Balance Plan

Here we will examine the economics of a cash balance plan for a small, closely held company. In this example, we are maximizing the contribution for the two owners. In order to pass our non-discrimination tests, the employees must receive 12.25% of their pay. In this example, the owners receive 90% of the total contribution.

<u>Name</u>	<u>Age</u>	<u>Compensation</u>	<u>CB Contribution</u>
Owner 1	55	\$245,000	\$145,000
Owner 2	50	245,000	85,000
Mgr 1	40	75,000	9,187
Clerical	36	40,000	4,900
Administration	38	31,000	3,797
Receptionist	27	31,000	3,797
Driver	24	27,000	3,307

Adding A DC Plan Can Enhance The Design

The Pension Protection Act enables employers to take advantage of a paired plan. In this example the company contributes 3% to a safe harbor Profit Sharing Plan, an additional 3% to the profit sharing plan and only 1.5 % for the employees to the cash balance plan. In return, the two owners are able to maximize their 401(k) contributions (including the catch-up provision) receive the total of 6% in the profit sharing plan and maximize their defined benefit plan. The owners, in this scenario receive 95% of all the money contributed toward the plan.

<u>Name</u>	<u>Age</u>	<u>Comp.</u>	<u>401(k)</u>	<u>Catch-up</u>	<u>NEC 3%</u>	<u>PS 3%</u>	<u>CB Plan</u>
Owner 1	55	\$245,000	\$16,500	\$5,500	\$7,350	\$7,350	\$145,000
Owner 2	50	245,000	16,500	5,500	7,350	7,350	85,000
Mgr 1	40	75,000			2,250	2,250	1,125
Clerical	36	40,000			1,200	1,200	600
Admin.	38	31,000			930	930	465
Recept.	27	31,000			930	930	465
Driver	24	27,000			810	810	405

Cash Balance Paired Plan With Equal Contributions For Partners

One of the greatest advantages of a cash balance plan is the ability to create tiers of employees. In this example, the two owners were placed in the same tier so that they would receive the same contribution towards their plan. This creates the equality that many partnerships desire. In this example, Owner One's contribution went down, but the required contribution for the employees also went down. The owners are still in receipt of 95% of the total contribution.

<u>Name</u>	<u>Age</u>	<u>Comp.</u>	<u>401(k)</u>	<u>Catch-up</u>	<u>NEC 3%</u>	<u>PS 3%</u>	<u>CB Plan</u>
Owner 1	55	\$245,000	\$16,500	\$5,500	\$7,350	\$7,350	\$85,000
Owner 2	50	245,000	16,500	5,500	7,350	7,350	85,000
Mgr 1	40	75,000			2,250	2,250	0
Clerical	36	40,000			1,200	1,200	0
Admin.	38	31,000			930	930	0
Recept.	27	31,000			930	930	0
Driver	24	27,000			810	810	200



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