Two Plans Are Better Than One

Traditionally, companies have had the option 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 some of 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 may offer more flexibility than traditional pension plans.

The Pension Protection Act (PPA) of 2006 amended Section 404(a)(7) of the code. With this revision, opportunities were now created. Under the new rules, the limitation for combined plans has been relaxed. In 2023, 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.[1] 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 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. Disadvantages of stand-alone plans are minimized when running a combined or paired plan. As a result, the benefits are maximized when combining a paired plan.

A paired plan maximizes tax deductions to the owner, while also creating wealth working in a tax preferred environment. The plan also serves to attract, retain and reward key employees. Furthermore, with proper planning, a paired plan can help the continuation of the business and facilitate the transfer of the estate for the business owner.

Defined Contribution Plans

Advantages:

- Employer contributions are flexible and discretionary
- Employees can participate through salary deferral under a 401(k)
- 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 $66,000 in the 2023 plan year

1: Section 404(a)(7) of the Internal Revenue Code as amended by PPA.

All References to IRS Codes can be found at: https://www.irs.gov/tax-professionals/tax-code-regulations-and-official-guidance

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 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.

Paired 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 more than the $66,000 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:

Employees 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 over-fund 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, 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 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.

Traditional Defined Benefit Plans

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.

How will you spend retirement?

The Cash Balance Advantage

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

Cash Balance Plans offer unique advantages over traditional defined benefit plans. First, they "look" very similar to 401(k) plans. Employees receive an employer contribution equal to a set percentage of their pay deposited into a pooled account.

Employees are guaranteed a set rate of return on this account as dictated by the plan. At year end, they will 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 traditional 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 partners.

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 passes, we can allocate different amounts of contribution to the various tiers of employees.

Not every employee must benefit under a Cash Balance and Profit Sharing plan. Under IRS rules, there is an objective test that compares the percentage of Non-Highly Compensated Employees (NHCEs) covered under the Plans to the percentage of Highly Compensated Employees (HCES) covered under the Plan. If the "70% ratio test" is satisfied, then the Plan passes the coverage requirements.

A Highly Compensated Employee (HCE) for 2023 is an employee who owns more than 5% of the company, is a family member of a more than 5% owner, or an employee who earned more than $135,000 in 2022[2]. When you have many employees, who earn more than $135,000, and you exclude them from the plan, it becomes much easier to pass the ratio test and maximize deductions to the owners.

Combination plans can work for many types of businesses both large and small. For companies already sponsoring a 401(k) plan, a Cash Balance Add-on may be the perfect solution to their retirement and tax planning goals.

2: Section 414 (q)(1)(b) of the Internal Revenue Code

All References to IRS Codes can be found at: https://www.irs.gov/tax-professionals/tax-code-regulations-and-official-guidance

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 17% of their pay. In this example, the owners receive over 90% of the total contribution.

Name	Age	Compensation	CB Contribution
Mr. Smith	48	$330,000	$165,000
Mr. Jones	57	$330,000	$255,000
Manager	35	$135,005	$2,700
Supervisor	28	$25,000	$5,500
Sectrectary	35	$30,000	$6,600
Assistant	39	$22,000	$4,840

Adding A Defined Contribution Plan Can Enhance the Design

Name	Age	Compensation	401(k)	Catch-up	SH / NEC	PS	CB Contribution	Combined Total
Mr. Smith	48	$330,000	$22,500	$0	$0	$9,900	$165,000	$197,400
Mr. Jones	57	$330,000	$22,500	$7,500	$0	$9,900	$255,000	$294,900
Manager	35	$135,005			$0	$4,050	$0	$4,050
Supervisor	28	$25,000			$750	$1,250	$500	$2,500
Secretary	35	$30,000			$900	$1,500	$600	$3,000
Assistant	39	$22,000			$660	$1,100	$440	$2,200

The Pension Protection Act enables employers to take advantage of a paired plan. In this example the company contributes a 3% safe harbor contribution, an additional 5% to the profit-sharing plan and only 2% for the employees to the cash balance plan. In return, the two owners can maximize their 401(k) contributions (including the catch-up provision), receive the total of 3% in the profit-sharing plan & safe harbor and maximize their defined benefit plan. In order to pass our non-discrimination tests, the employees must receive 10% of their pay. The owners, in this scenario receive 97% of all the money contributed toward the plan.

Conclusion:

Small businesses that are consistently profitable and wish to make a large tax-deductible contribution should explore adding cash balance plan as a company benefit when the cash balance plan is paired with a well-designed 401(k) profit sharing plan it gives a tremendous boost to small business owners who want to maximize their retirement benefits.

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