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Cash Balance Plans: Best Practices and Key Considerations for Retirement Advisors

Chris Anderson
Regional Director

Ted Watt
Regional Director

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Joe Nichols is a Partner and the Director of Actuarial Services at DWC-The 401(k) Experts. He is also the President of the American Retirement Association, one of the nation's premier nonprofit retirement organizations. At DWC, Joe is responsible for streamlining defined benefit plan processes, ensuring the accuracy of his firm's actuarial work, and facilitating effective communication between his clients and other interested parties. In his 30+ years of experience in the industry, Joe has worked with both national and regional actuarial firms. He has also helped design and implement hundreds of new cash balance plans over the last decade.

Cash balance plans, which blend features of both defined benefit and defined contribution plans, are the fastest-growing sector in the US retirement plan marketplace.[1] Since 2001 the number of cash balance plans has climbed 17-fold, and assets in such plans now exceed $1 trillion. Given these encouraging trends, should advisors looking to build a robust and diverse service offering explore a cash balance plan component for their practice?

To find out, Dimensional connected with Joe Nichols, a Partner and the Director of Actuarial Services at DWC-The 401(k) Experts. Here, Nichols shares some insights he has gained from his many years of experience with cash balance plans, including key elements of the implementation process and what advisors should be aware of when considering this solution for clients

DIMENSIONAL: Should advisors consider integrating cash balance plans into their service offering? If so, what are the main challenges of offering these plans to their clients?
JOE NICHOLS: Cash balance plans (CBP) can complement an advisor's practice because they work well with high-income earners, often business owners and partners, who want to defer more money than the limits of a 401(k) or SEP plan allow. By including CBPs as part of their service offering, advisors create a value-added service and an additional tax management tool for a very important group of clients and prospects.

While positioning the potential tax deferral benefit and increased contribution limits to clients is straightforward, the main challenge is explaining to the client the sometimes-complex rules of these plans. For example, the benefit of higher deferrals comes with more stringent funding requirements. Additionally, if there are employees in the plan (besides owners or partners), the issues become exponentially more complex.

Is there a target market or ideal client profile for CBPs? Alternatively, what types of clients are CBPs not a good fit for?
NICHOLS: Plans that have participants with the desire and cash flow to fund amounts in excess of the $64,500 per year limit on 401(k) contributions (for 2021) are the best fit. Most ideal plan clients are high earners, but not all of them. For example, plan sponsors that have owners with annual income of $50,000 but who have annual savings budget goals well over $150,000—using a combination of contributions from their own wages, the company's 401(k)/profit sharing plan, and the CBP—could very well be good candidates (See **Exhibit 1**).

Exhibit 1
The Employee Benefit: Contribution Advantage

CASE STUDY

- Owner/Participant Occupation: Farmer
- Current Age: 50
- Retirement Age Goal: 60
- Annual Compensation: $50,000
- Annual Savings Budget Goal: $150,000+

Retirement Vehicle Options and Maximum Contribution Limits				
SEP[2]	401(k) only	401(k) with Profit Sharing[3]	Cash Balance Plan[4]	401(k), PSP, and CBP Total[5]
$12,500	$26,000	$38,500	$162,000	$191,000

KEY TAKEAWAY

Using a cash balance plan in conjunction with a 401(k) profit sharing plan can result in significant contribution and tax advantages for business owners and partners.

Another factor for advisors to consider is the predictability of business revenue. Clients with more variable revenue typically are not a good fit as down years can inhibit the firm's ability to contribute and fund the plan properly. The involvement and expertise of the client are also important. Some clients only want to know when to make contributions and when to complete required compliance tasks. Others may prefer to be much more involved and have full transparency into the process. Some of the more challenging clients are the ones who claim they want to know all the details of a cash balance plan but then fail to fully understand and retain the necessary information. It's important to know your audience and be able to adapt to different client types and needs.

What steps need to be taken for a successful and efficient CBP onboarding process? Are the dynamics different for owners and partners vs. regular employees?
NICHOLS: Onboarding a CBP is rather simple as the assets are in a pooled account. Once the plan design is finalized and the plan document is created, contributions can be made and assets can be invested at the trustee's direction. The employees then receive a summary of the plan and fill out a beneficiary form, but they have no other enrollment tasks. The biggest challenge going from an owner-only structure to a partnership is making sure everyone knows the assets are pooled. As joint trustees, the partners must agree on how to invest the trust assets. If a partner leaves the plan and the plan is

underfunded, the remaining partners typically must make contributions to offset the deficit; however, partnership agreements can be written to mitigate this effect.

The opposite happens as well. If investments outperform expectations and the plan becomes overfunded, the surplus stays in the plan and lowers future contribution requirements. Once employees are included, the only additional work for onboarding is to make sure all required employee notifications are distributed.

How should advisors think about the investment options within the interest credit portion of CBPs?
NICHOLS: Investments in a CBP tend to favor minimizing volatility over maximizing returns. Since a CBP is a defined-benefit plan, any asset losses must be made up through additional contributions. Wide fluctuations in the cash balance assets can result in more variability of employer contribution amounts. Many actuaries use a fixed interest credit. For example, at DWC, we use a 3% interest crediting rate, which provides stability in the non-discrimination testing. Some firms allow for actual rates of return (with gates on the top and bottom). However, even though the range is small, it still creates some volatility in the testing and required contribution amounts, which in turn can greatly affect the cost of the plan.

The selection and monitoring of the investments used to achieve the targeted interest crediting rate is usually a key responsibility of the advisor. This is an opportunity for the advisor to take the lead and add value by designing and maintaining an investment strategy ideally suited to the needs of the plan. A general best practice is to select an interest crediting rate aligned with a realistic target investment return (accounting for external factors, such as interest rate environment, inflation, etc.), while aiming for minimum volatility. An appropriate interest crediting rate should strike a balance between supplementing a participant’s retirement goals and being mindful of the firm’s financial capital should the rate not be met, meaning additional contributions are needed in a given year.

What happens if investment returns don’t meet the targeted interest crediting rate —or exceed the rate?
NICHOLS: If the actual investment returns do not meet the targeted interest crediting rate, additional contributions from the business will be necessary. Business owners and plan sponsors have options as to how to make up for these shortfalls. They can be addressed as a lump sum over the next year or if necessary, amortized over a 15-year period for added flexibility. If persistent investment losses create a cash flow strain on the business, the cash balance plan terms and conditions can be amended to lower the annual contribution credits to ease the burden on the plan sponsor. Partner attrition and turnover are other factors to consider, especially during underfunded years, as the business’s changing headcount can also dictate the method by which plan sponsors choose to address shortfalls.

If the actual investment returns exceed the targeted interest crediting rate, future contributions can be, and usually are, lower. If the plan’s payout is not currently at the maximum limit, set by the Internal Revenue Code’s Section 415 (100% of the participant's highest average compensation for a period of three consecutive years or $225,000, whichever is less), the formula can be amended to increase benefit payouts to the participants. This would keep the contribution level stable. However, if the benefits are already at the Section 415 limit maximum, future contributions must be decreased,

potentially freeing up capital to be deployed elsewhere in the company.

What differentiates successful CBP offerings from the rest of the field?
NICHOLS: Experience is the key factor. In practice, CBPs are pretty simple to establish and maintain. However, when unique situations arise, small issues can be exacerbated by lack of experience. Being prepared for the unique situations minimizes the likelihood of difficult discussions between the provider, the advisor, and the client.

The first that comes to mind is when the advisor does not fully understand the permanency created by the CBP—not only the permanent required funding but also the required funding placed on otherwise discretionary profit-sharing allocations. The CBP allocations are typically heavily favored toward the owners. In order to pass non-discrimination testing, once the cash balance benefit is earned, a profit-sharing allocation is required.

Another potential situation, often overlooked, is coming up with a funding strategy that protects the plan sponsor during both the below-average and above-average revenue years. Prefunding not only accelerates tax deferrals but also creates a funding cushion for a year when cash flow might be limited. However, a CBP should not get into a situation where it must terminate with surplus assets. Coming up with the right balance is not overly complicated, but it takes some experience to design the strategy to be client-specific.

What are some common mistakes you see advisors make with regard to CBP management?
NICHOLS: The most common mistake is that many do not understand what they are promising the client. Not fully understanding the various dynamics of CBPs can get advisors into challenging scenarios, as outlined above, and can result in a poor experience for the client. In addition, the plan sponsor must understand that, by offering both 401(k) and cash balance plans, the complexity of these plans and the time required for administration can sometimes more than double. The impact of ownership changes, mergers, and employee demographic changes are exacerbated with the additional funding requirements. Working with an experienced third-party administrator (TPA) well-versed in CBP nuances can help alleviate these potential setbacks as well as mitigate those risks for the advisor. In the end, it is important to not over-complicate the service offering and to remember that the advisor's main role is to manage the assets in a pooled account.

When might a cash balance plan be attractive to a plan sponsor and when might it not?
NICHOLS: The most attractive feature to plan sponsors is the additional flexibility of tax deferrals. If the client wants to defer more than the amount permitted in their 401(k) or SEP, the cash balance plan will be attractive. A CBP will become less attractive when there are many employees and the total cost of employer contributions for participants outweighs the tax savings. (See **Exhibit 2** for an example of the dynamics to consider.)

Exhibit 2

The Employer Benefit: Economics of Implementation

CASE STUDY

- Effective Tax Rate: 40%
- Employer/Owner Deferral Amount: $200,000
- Non-Owner Employee Cost: 10% of salary
- Non-Owner Employee Salaries: $250,000

Employer's Deferral Amount	Non-Owner Salaries	Employee Cost[6]	Tax Savings[7]	Net Tax Benefit to Employer[8]
$200,000	$250,000	$25,000	$90,000	+$65,000

KEY TAKEAWAY

Advisors should consider the economics of employee contribution costs vs. potential tax savings in addition to the overall retirement benefits provided to all participants.

For advisors just getting into the CBP space, how can they best leverage service providers to help grow their practice and what should an advisor look for in these providers?

NICHOLS: Advisors should be prepared to learn all they can about the basics of CBPs and leverage experienced partners to cover the more difficult, technical questions. Service providers with actuaries on staff are a key attribute for advisory firms that successfully develop and maintain a cash balance plan offering. Additionally, the actuaries should be members the American Society of Enrolled Actuaries for enhanced credibility and quality of service.

In a challenging financial year for a plan sponsor, what tools or plan design features can they use to mitigate potential challenges?

NICHOLS: There are a couple of ways we prepare clients for challenging years. First, the plan document can be written such that the cash balance plan formula is a percentage of the current salary. That way, in an off year, if the owner's salary is lower, the cash balance contribution can be lower. It is also best for clients to keep their plans well-funded. Ideally, the plan assets will cover the contribution in an off year. Plans should not become too overfunded; a one-year buffer is the best practice. In addition, plans should maintain their current structure for at least three to five years before making any major changes. Amendments and enhancements can be made occasionally but should not be implemented every year, as frequent plan changes can be costly and undercut the experience for participants, owners, and plan sponsors.

What are your top five best pieces of advice for advisors considering implementing a CBP solution?

NICHOLS:

- Learn the basics.
- Make sure the client is sophisticated enough to handle a complex plan or is really good at following directions!
- Find an experienced actuary to work with, preferably a member of the American Society of Enrolled Actuaries.
- Explain the non-discretionary nature of a cash balance plan to the client, and make sure they have a basic understanding.
- Maintain a disciplined and thoughtful investment philosophy using the appropriate strategies to accurately target the plan's interest crediting rate.

1. "2020 National Cash Balance Research Report: 11th Annual Edition," Kravitz, part of FuturePlan by Ascensus. Analysis uses data from IRS Form 5500 filings via the Judy Diamond Associates, Inc. database.
2. Simplified Employee Pension (SEP-IRA) contribution maximum is 25% of annual net earnings, up to $58,000 for 2021. In our example, 25% of owner's $50,000 earnings = $12,500.
3. $19,500 standard maximum contribution plus $6,500 catchup allowed for participants age 50+, plus $12,500 profit sharing maximum (lesser of 25% of annual compensation or $58,000).
4. Cash balance contribution is estimated maximum for 50-year-old participant in 2021. Actual cash balance maximums are not only age-based but can also depend on current and past compensation and past service.
5. When combined with a cash balance plan, profit sharing allocation is limited to 6% of annual compensation—$19,500 standard maximum contribution plus $6,500 catchup allowed for participants age 50+, plus $3,000 profit sharing maximum (lesser of 6% of annual compensation or $58,000), plus $162,000 cash balance plan contribution.
6. Non-owner salary multiplied by employee cost ($250,000 x 10%).
7. Employer deferral amount plus employee cost multiplied by effective tax rate (($200,00 +$25,000) x 40%).
8. Tax savings minus employee cost ($90,000 –$25,000).

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