FINDLEY *perspective*

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# Retirement Savings Opportunities for High Earning Owners and Professionals

Overview: For successful small businesses, a 401(k) plan combined with a cash balance plan can provide opportunities to:

- Build wealth and retirement savings for the owners/ professionals with much greater contributions than through a 401(k) plan alone
- Save on federal, state, and local taxes through higher deductible contributions
- Protect substantial assets from creditors or legal action
- Provide attractive retirement benefits for nonowner
- Attract and retain talented employees
- Enhance financial well-being and retirement readiness for all participants

The Tax Cuts and Jobs Act substantially reduced corporate tax rates for C corporations, and added a complex set of rules on deductions for pass-through entities such as partnerships, LLCs, and S corporations. Fundamentally, tax reform enacted a slightly lower individual tax rate (top brackets reduced from 39.6 percent to 37 percent) for high-earning owners, which means that these plans are still tax effective, while the substantial long-term benefits remain unchanged. Business owners who are currently sponsoring or planning to set up a 401(k) plan and cash balance plan should talk with their tax advisor and actuary, to see if any changes to plan design or their business structure are desirable.

## Impact of the Tax Cuts and Jobs Act

A lot has been written and said about the Tax Cuts and Jobs Act and the tax rule changes that affect businesses. In this article, we focus on the very fundamental aspects of these changes.

C corporations now have a flat 21 percent income tax rate and pass-through entities now have a 20 percent deduction on qualified business income. This 20 percent deduction is limited or phased-out based on the type of business and business income through very complex rules. For taxpayers in the top individual income tax bracket of 37 percent, this 20 percent deduction can be viewed as a 7.4 percent (20 percent of 37 percent top individual income tax rate) rate reduction.

### Why choose a Cash Balance Plan?

- Build wealth and retirement savings
- Much greater contributions than through a 401(k) plan alone
- Save on federal, state, and local taxes
- Protect substantial assets from creditors or legal action
- Provide attractive benefits for non-owners
- Attract and retain talented employees
- Ability to roll over lump sum distributions to an IRA or succcessor plan

Thus for most high-earning owners and professionals, the evaluation of the tax effectiveness of their 401(k) and cash balance plan will involve only a change in tax rate from 39.6 percent to 37 percent. We've seen that this may cause subtle changes in design and contribution levels, but it does not change fundamental decisions on whether to adopt one or both plan types.

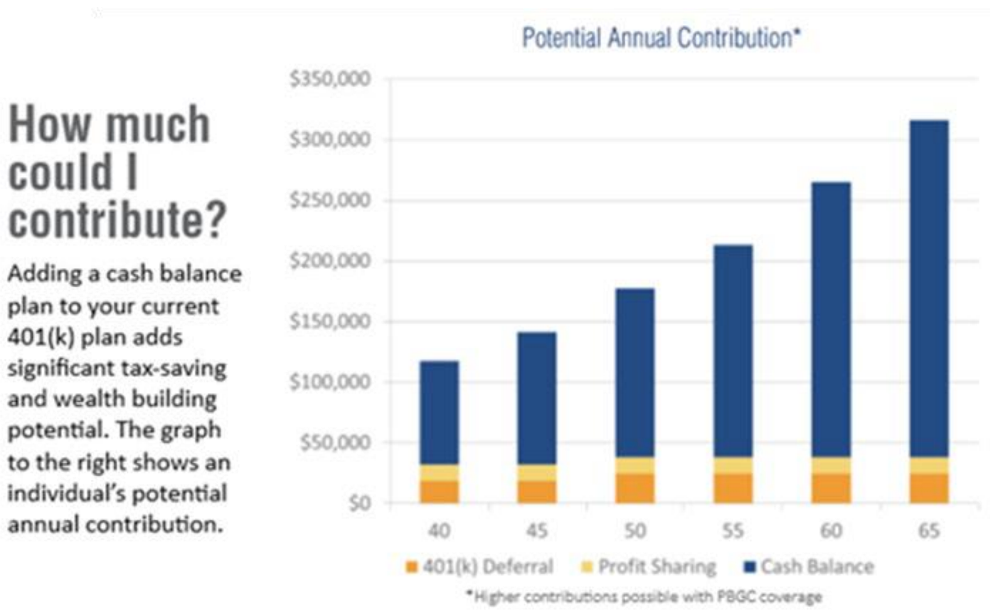
To illustrate how the combination of a 401(k) and cash balance plan can be used, let's look at a case study of a professional firm we'll call ABC Services.

## Case Study: ABC Services

ABC Services is a partnership of any type of business professionals such as accountants, doctors, or lawyers. There are three partners in the business, each owning one-third of the practice. The firm has a number of nonowner professionals we'll call associates. The firm employs other staff as well.

The partners at ABC have these goals for their retirement program:

- **Partners** – Adam and Bill (both age 55) would like to maximize their retirement savings. Carol (age 45) needs more current income and less saving for retirement. No partner wants to subsidize the retirement benefit of the other partners.
- **Associates** – the associates are ages 30 to 45. Associates prefer current compensation over future retirement benefits. ABC wants to minimize retirement plan contributions to this group.
- **Staff** – ABC hires relatively young staff and experiences moderate turnover among this group. ABC wants to offer a market-competitive level of retirement benefits to attract staff employees.



Tables 1A and 1B show the employer contributions provided under the 401(k) and cash balance plans established by ABC. Each participant can make salary deferral contributions to the 401(k) plan up to the IRS limits, including additional catch-up contributions for individuals age 50 and older.

### Table 1A: Annual contribution amounts for ABC partners

| | Eligible Pay | Salary Deferrals | Employer 401(k) Contributions | Employer Cash Balance Contributions | Total Employer Contributions | Total Retirement Contributions |
|---|---|---|---|---|---|---|
| Adam | $280,000 | $25,000 | $14,000 | $140,000 | $154,000 | $179,000 |
| Bill | $280,000 | $25,000 | $14,000 | $140,000 | $154,000 | $179,000 |
| Carol | $280,000 | $19,000 | $14,000 | $35,000 | $49,000 | $68,000 |

*Subject to IRS limits*

### Table 1B: Annual employer contributions, as a percentage of eligible pay, by employment category

| | Employer 401(k) Contribution | Employer Cash Balance Contribution | Total Employer Contribution |
|---|---|---|---|
| **Partners** | | | |
| Adam | 5% | 50.0% | 55.0% |
| Bill | 5% | 50.0% | 55.0% |
| Carol | 5% | 12.5% | 17.5% |
| **Associates** | 0% | 0% | 0% |
| **Staff** | 5% | 2.5% | 7.5% |

How well does this retirement program accomplish ABC's objectives?

- **Partners** – Adam and Bill are able to receive contributions of (and defer tax on) $179,000 each year. Carol accomplishes her goal by having a meaningful, but significantly lower, contribution amount of $68,000 per year with flexibility to change her contribution amounts through the 401(k) plan.
- **Associates** – ABC minimizes retirement contributions for associates by providing a separate, employee deferral only 401(k) plan for associates, and excluding the associates from the cash balance plan.
- **Staff** – ABC offers a strong benefit to this group in order to attract and retain staff employees. The plan design provides employer contributions of 7.5 percent of pay for staff, plus employee 401(k) salary deferrals and catch-up contributions if the employee is at least age 50.

## What Types of Employers Should Consider a 401(k) Cash Balance Plan?

We've noted that any successful business can consider implementing a 401(k) and a cash balance plan. We find, however, that businesses with the following characteristics are the most likely to see the benefits of implementing these plans together:

- The business owners are age 40–64
- The business has had consistent cash flow and profitability
- The future of the business looks good, with positive cash flow and profitability over the next five years
- The ratio of nonowner employees to owner employees is relatively low
- The business has a 401(k) plan in place and is making employer contributions currently

Also, we frequently hear these goals in discussions with owners of successful businesses:

- We want (or need) to save more for retirement than the current IRS annual limit imposed on the 401(k) plan
- We want to reduce our current taxes
- We need protection of assets from creditors, or in the event of a lawsuit
- We want to recognize and reward key staff
- We want to attract and retain the best employees

By implementing a 401(k) plan and cash balance plan with advanced plan designs, successful businesses can meet their owners' goals for wealth building and retirement savings and offer an attractive and cost-effective retirement program to their employees.

## Looking Closer at Cash Balance and 401(k) Plans

Qualified retirement plans are divided into two categories: defined benefit (DB) plans and defined contribution (DC) plans. Cash balance plans are a typical DB design for small businesses and professional firms, while 401(k) plans are a common DC plan design.

A cash balance plan is structured to look like a DC plan with each participant having a recordkeeping account that receives employer contributions and interest credits. These interest credits are often defined and guaranteed by the plan.

### Common Features

Since both 401(k) and cash balance plans are types of qualified retirement plans, they share a number of common features that are important for employers and participants:

- Contributions are tax-deductible
- Trust earnings are tax-deferred
- Trust assets are protected from the claims of creditors
- Distributions are usually immediately available after termination, retirement, death or disability
- Lump sum distributions may be rolled over to a successor plan or another tax-advantaged plan
- Distributions are not subject to FICA or FUTA tax

### Key Differences

Table 2 highlights the key differences between 401(k) and cash balance plans:

| 401(k) Plans | Cash Balance Plans |
| --- | --- |
| **Contributions (based on 2019 limits)** | **Contributions** |
| • Participants can save up to $19,000 in before tax or Roth (after tax) employee savings<br>• Participants age 50 or older can save an extra $6,000 in catch-up contributions<br>• The employer and employee contributions can be up to $56,000 ($62,000 including catch-up contributions)<br>• Employer contributions (match and profit sharing) are usually discretionary | • Contributions can be far greater than current 401(k) limits, depending on the owner's/professional's current age<br>• The cash balance account is guaranteed<br>• Additions to the cash balance account are based on pay credit and interest rate factors defined in the plan document<br>• Employer contributions are required |
| **Investments** | **Investments** |
| • Participants usually direct the investments in their 401(k) account<br>• The participant chooses their investment strategy and bears the investment risk | • Assets are invested in a pool for all participants in the plan, usually with a conservative investment strategy<br>• Plans are allowed to credit the actual performance of the portfolio to participants' cash balance accounts (certain restrictions apply)<br>• The employer sets investment strategy and often bears all the investment risk |

| 401(k) Plans | Cash Balance Plans |
|---|---|
| Accounts | Benefits |
| • The participant's account value is based on contributions and actual investment returns (or losses) | • The participant's account has guarantees; the account is based on contributions, interest credits as defined by the plan, and minimum guarantees required by law |
| Distribution | Distribution |
| • In-service distributions are allowable for hardship or upon reaching age 59½<br>• Distributions are usually as a lump sum, some plans allow for installments or purchase of an annuity<br>• Participant loans are often available through the plan | • In-service distributions are allowable at or after age 62<br>• Distributions are usually made as a lump sum, annuity options are available through the plan<br>• Loans are usually not offered |

## Other Considerations

With examples showing the benefits of implementing a 401(k) plan and cash balance plan to owners and their employees, the natural question is: why not implement these plans?

Business owners considering these plans should also discuss these issues with their actuary, tax advisor, and plan consultants:

- Higher contributions for nonowner employees will likely be required
- There will be higher administrative costs for a second plan, including hiring an actuary to certify the minimum funding required of the cash balance plan
- There may be PBGC premium expense for certain plans and employers; however, PBGC coverage can result in additional deductible contributions
- There are annual required minimum contributions for the cash balance plan
- Volatility in the investments held by the cash balance plan can lead to volatility in the required minimum contributions
- Funding levels must be managed to avoid certain restrictions on distributions

## In Summary

The combination of a 401(k) plan and a cash balance plan is often the best solution for a successful business wishing to provide substantial tax-deferred savings for key individuals. This combination of plans is easy to understand and can provide surprising flexibility along with increased contribution limits.

The case study shown in this article shows the retirement accumulation potential of implementing a 401(k) and cash balance plan. Other cost-effective plan designs are generally available; for more information, please contact your Findley consultant.