PENSION TRENDS
BY INDEPENDENT ACTUARIES, INC.

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What Flavor Should You Choose? - A Primer

On Tuesday, April 30th, Independent Actuaries will host a presentation titled "What Flavor Should You Choose?" The presentation will cover different types of qualified retirement plan designs, and how the tax-savings objectives, structure, and employee demographics of a business can determine which retirement plan design is best suited to its situation. As a primer to the presentation, this is a 2019 update to the newsletters we issued in 2018 that highlight how qualified retirement plans can help business owners get a substantial tax deduction while saving for retirement.

Defined Contribution vs. Defined Benefit Plans

Qualified retirement plans fall into one of two main categories: defined contribution (DC) plans or defined benefit (DB) plans. In a DC plan, the IRS limits the contribution made to the plan each year; examples of DC plans include 401(k), profit sharing, SEP and SIMPLE plans. In a defined benefit plan, the IRS limits the benefit paid out at retirement. In many cases, this means an owner starting a retirement plan five to ten years before retirement can make much larger contributions to a defined benefit plan than they could to a defined contribution plan.

Let's take a look at the difference in how much a business owner can save by setting up each type of retirement plan. Jane owns a business with no employees, starts a 401(k) profit sharing plan at age 57, and would like to retire at age 62. Between deferrals and employer contributions, a business owner can contribute up to $62k a year ($56k for an owner under 50). If Jane contributes $62k each year, she will have approximately $340k in assets by age 62 (assuming a 5% rate of return on assets). If instead Jane had set up the plan at 52 and contributed $62k each year for 10 years, she would have $780k in assets at age 62.

Let's compare that to what Jane could save if she started a traditional DB plan at age 57. When a DB plan terminates, business owners typically take the lump sum value of their benefit as a tax-deferred rollover into an individual retirement account (IRA). Had Jane started a DB plan at age 57, she would be able to roll over up to $1.4 million at age 62 (assuming she meets certain pay and service requirements). That is about $1 million more than in the 401(k) profit sharing plan above. Assuming the plan assets earn 5% each year, the $1.4 million target translates to average annual contributions of roughly $260k per year over five years. If instead Jane had started the DB plan at 52, the maximum she could roll over at age 62 would be roughly $2.9 million. If the plan assets earn 5% each year, the $2.9 million target translates to average annual contributions of roughly $230k for 10 years.

Age When Plan Adopted	Age at Retirement	Number of Years Contribution is Made	Level Contribution Each Year 401(k) Profit Sharing Plan*	Lump Sum at Retirement Age 401(k) Profit Sharing Plan	Level Contribution Each Year Defined Benefit Plan	Lump Sum at Retirement Age Defined Benefit Plan*
57	62	5	$62,000	$340,000	$260,000	$1,440,000
52	62	10	$62,000	$780,000	$230,000	$2,890,000

*Based on 2019 IRS limits, and assuming a 5% rate of return.

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Cash Balance Plans

While the two examples above can work well for an owner-only business, for a partnership or a company with employees, other plan designs such as a cash balance plan may be more appropriate.

Cash balance plans are attractive because they share qualities of both DB plans and DC plans. Similar to a DC plan, the benefit in a cash balance plan is expressed as an account balance that grows over time with employer contributions and interest credits. However, because a cash balance plan is a type of DB plan, the employer can generally make larger contributions than allowed under a DC plan. As shown in the examples above, an owner can contribute up to $62k to a DC plan for 2019, assuming they are at least 50 by the end of the year. The same owner may contribute over $200k per year to a cash balance plan (depending on age, years of service, and number of years they will participate in the plan).

For a sole proprietor or husband-wife business, there would be no advantage to having a cash balance plan over a traditional DB plan. For a larger company, there are situations where a cash balance plan can be preferable. For example, with a partnership, a cash balance plan works well if the individual partners want to contribute different amounts. The annual contribution can be expressed as a set dollar amount or percent of pay, and can be changed as needed over the life of the plan.

For a company with employees that sponsors (or intends to sponsor) a DC plan, the addition of a cash balance plan can allow the business owners to contribute and deduct substantially more while still directing a majority of the total contribution to the owners.

Floor Offset Arrangements

The last example is another type of retirement plan arrangement that is not well known but can be an ideal retirement solution for many businesses. In this arrangement, a defined benefit plan is set up alongside a 401(k) profit sharing plan in a "floor offset" arrangement.

Similar to a cash balance plan, this type of arrangement allows the business owner to provide retirement income for their employees while maximizing the percentage of the total contribution that goes toward the owner's benefit.

Floor offset arrangements are advantageous for both the owner and the employees. In a typical arrangement, the employees receive an employer contribution to the 401(k) profit sharing plan (usually 6% to 10% of pay), while the owner receives the bulk of their benefit in the DB plan. Because the contribution limits are much higher in DB plans, the owner is able to contribute larger amounts for their own benefit.

In many cases, owners already have a 401(k) profit sharing plan where they are contributing 3% to 5% of pay to their employees. By adding a DB plan to work in a floor offset arrangement, owners can increase tax deductible contributions significantly while incurring a small additional employee expense. Adding a floor offset plan often allows the owner to make tax deductible contributions of $100k to $200k per year more for his or her own benefit.

Floor offset arrangements and cash balance plans work well in certain situations, especially if the owner wants to contribute more than the $62k individual limit in a 401(k) profit sharing plan. When considering which plan design will work best, the answer may depend on the number of business owners there are. For a business with employees and one business owner (or owners who are married), a floor offset arrangement often works best. In a situation with multiple business owners, a cash balance plan can work better.

With the regular tax season winding down, now is a great time to have IAI prepare a plan design study to show what the tax benefits of a qualified retirement plan can do for your business. In order to make a tax-deductible contribution for 2019, a plan document must be in place by December 31st, but we should be starting the conversation now. If you are interested in exploring a qualified retirement plan, please contact us at 503-520-0848 or at www.independentactuaries.com/contact.

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