first allied

Rethinking Retirement Strategy

Retirement planning can be a difficult riddle to unravel as every client has a unique situation and faces different issues. The many retirement plans currently available may prove overwhelming to your clients, often leading them to select less-than-ideal plans for their specific circumstances. Is there one answer that can solve this retirement puzzle for everyone?

Problem Solved?

Saving the maximum in your 401(k) ($17,500 at the time of publication) for an extended period of time can make a significant impact: An average 8 percent rate of return over 40 years results in a retirement savings of about $4.8 million. This number is impressive even without consideration of catch-up contributions for those over age 50, cost of living adjustments or employer contributions. It seems that contributing the maximum amount to a 401(k) solves the retirement puzzle.

However, this is only useful if your client has 40 years until retirement, is able to contribute the maximum amount and can achieve the much-sought-after 8 percent annual return. What if your client is only 15 to 20 years away from retirement, was financially incapable of maxing out his or her 401(k) until recently, or needed funds for other endeavors? Or, what if your client is a small-business owner who must make contributions on behalf of his or her employees? This solution then becomes unfeasible.

For many, the search for an answer begins with identifying the amount of pre-tax surplus available for retirement savings. If your client wants to save $50,000 or less annually, a 401(k) profit-sharing plan can be a great solution, as it has maximum flexibility and low administration costs. Business owners with employees must make contributions for eligible plan participants, but key employees are often able to maximize their funding with a relatively small contribution.

Defined Benefit Plans

If your client would like to contribute in excess of $50,000 annually, in most cases a defined benefit plan is the appropriate solution. Although large pension plans are slowly fading into the past in favor of 401(k)s, defined benefit plans are still expanding in the small-business-owner marketplace. Depending on the age and income of the client, these plans can allow small-business owners to make annual contributions in excess of $200,000, making a positive impact on both retirement readiness and tax liability.

Clients are candidates for a defined benefit plan if:

- They are able to contribute more than $70,000 a year, including current retirement savings
- Their business has consistent profit patterns and available surplus, as defined benefit plan funding is not discretionary
- Their business employs about 10 employees per owner and the workforce is generally younger than the owners
- They are in the preferred age range of 40 to 70 years old (when the business has no employees other than owners, age becomes less of a deciding factor)
- They are willing to contribute 5 to 7 percent of their pay to the staff

Cash Balance Plans

There are many types of defined benefit plans that may be useful for your clients, but a cash balance plan is a particularly compelling option for a small-business owner. Cash balance plans have been around since 1985 when Bank of America first implemented them. In the following two decades, other corporations followed suit by including these plans in their employee benefit packages. However, controversy, due to alleged age discrimination, ensued after some businesses converted their traditional pension plans to the new cash balance variety. The Pension Protection Act of 2006, along with other court decisions that followed shortly thereafter, resolved the dispute and confirmed that cash balance plans are not age discriminatory in and of themselves.

You may use the following information to describe a cash balance plan to a client. A cash balance plan is:

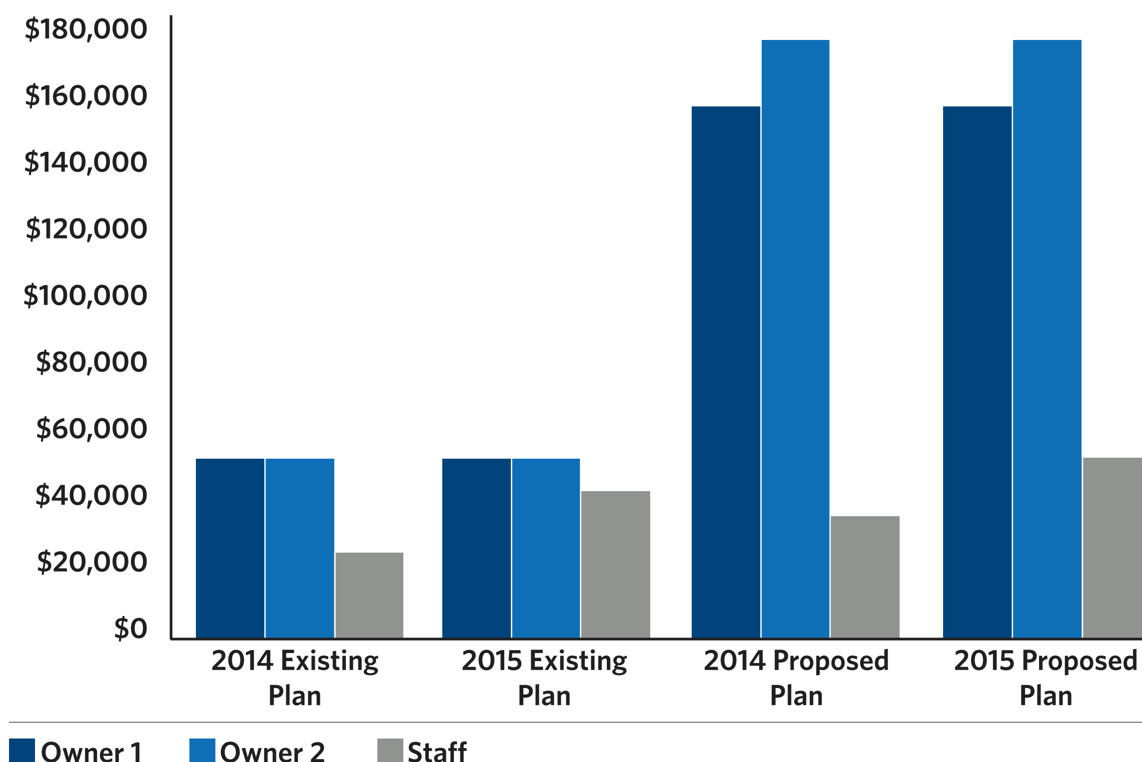
- A qualified plan that offers substantial tax benefits and asset protection similar to those available through ERISA plans.
- A type of defined benefit plan.
- A hybrid plan that uses the funding rules and limits available to defined benefit plans, but expresses those benefits as a hypothetical account balance for each participant similar to 401(k) plans, thus the term "cash balance."
- A plan where cash balances grow from annual contributions that are determined by a formula specified in the plan document (either a flat dollar amount or a percentage of pay).
- A plan that also grows from annual interest credit. Unlike 401(k) plans, where account value is tied to portfolio performance, the rate of return in a cash balance is guaranteed by the plan sponsor and is independent of the plan's investment performance.
- A plan that pays out an employee's vested account balance, which can be rolled over to an IRA or another retirement plan, upon retirement or termination of employment.

For clients who need to catch up on retirement savings or would like to increase their tax-favored nest egg, cash balance plans may be the most desirable option. However, there is another option that can prove even more profitable. Combining the client's existing profit-sharing 401(k) with a cash balance plan may allow him or her to significantly increase the contribution allocation while only marginally increasing the employee costs, and in some instances, lowering it.

A Winning Combination: A Case Study of a Customized Plan

Let's examine a case study involving a two-dentist partnership with 16 employees, seven of whom were eligible to participate in their 401(k) integrated profit-sharing plan. The plan required a corporate contribution of $23,000 on behalf of the non-owner participants. The partners, both over age 50, funded their plan with the maximum amount of $57,500 each, which

allocated to them 82 cents on every dollar they put into the plan. In 2015, with an additional seven employees becoming eligible to participate in the plan, the costs were projected to increase by $16,300, which would erode the plan's efficiency to 72 cents on the dollar.



	Existing 401(k) PSP				2014 Proposed Combo				2015 Proposed Combo			
Group	2014	% of TTL	2015	% of TTL	401(k)	Cash Bal.	Total	% of TTL	401(k)	Cash Bal.	Total	% of TTL
Owner 1	$57,500	41%	$57,500	37%	$20,500	$135,500	$155,500	44%	$20,500	$135,500	$155,500	41%
Owner 2	$57,500	41%	$57,500	37%	$20,500	$150,000	$170,500	48%	$20,500	$150,000	$170,500	45%
Staff	$25,000	41%	$41,300	26%	$16,900	$10,500	$27,400	8%	$28,950	$21,000	$49,950	13%

We first explored options for improving the existing profit-sharing plan design. Review of the census data and participant deferral information revealed that transitioning to a cross-tested profit-sharing plan formula would provide much-needed relief to the owners, reducing the employee funding obligation to $12,000 in 2014, while simultaneously cutting the 2015 contribution increase in half. The plan was optimized, giving 90 percent of the total funding to the owners in 2014, and 84 percent in 2015.

Secondly, we explored adding a cash balance defined benefit plan to the proposed 401(k) plan. Combining the two plans would allow the plan sponsors to achieve a very attractive outcome (see charts above).

This combined plan is a winning combination, and even more efficient than any of the other options. Despite covering twice as many employees, the efficiency of the proposed plan in 2015 is two times better than the 2014 numbers under the current 401(k) plan design.

The plan originally sponsored by these potential clients appeared to provide the desired result on the surface, but the coming year would have dramatically decreased its efficiency. Application of advanced plan design allowed the clients to optimize their plan and align their objectives. The owners increased their contributions threefold, while successfully mitigating an increase in the mandatory funding for their employees. Tripling their contributions and saving in excess of $50,000 in taxes each, net of employee costs, will allow them to take less investment risk to achieve their goals.

Do You Have Clients In Similar Situations?

As you meet with your clients to discuss retirement accumulation and tax planning, we invite you to introduce the concept of pairing a cash balance plan with a 401(k), or implementing a 401(k)/cash balance plan combination to those who sponsor an IRA-based plan, such as a SEP or SIMPLE. Since all qualified plans must be restated to include the language mandated by the Pension Protection Act of 2006, the timing is perfect to discuss review and optimization of the plan. Custom plan design can make all the difference to a client searching for the perfect solution to his or her retirement puzzle.

First Allied Retirement Services, your qualified retirement plan partner, is available to review your client's specific situation and work with you to identify an appropriate solution. We look forward to hearing from you by phone at 925-926-0600 or via email at retirement@firstallied.com.