Adding Layers

Insulating Clients from Increased Tax Liability and Underfunded Retirement

When used in the same sentence, the words "change" and "tax code" are seldom associated with good news. Yet, every so often, changes in the tax code create opportunities for innovative design that take retirement plans to a whole new level. The Pension Protection Act (PPA) and subsequent regulations brought about new opportunities to effectively combine cash balance defined benefit plans and defined contribution plans, building a compelling solution to help insulate clients from the risk of an underfunded retirement and increased tax burdens.

Background

Retirement plans fall into two basic categories: *defined benefit* and *defined contribution*. Defined benefit plans contain a promise of specific benefits upon retirement; cash balance plans promise a lump sum payment, which is a product of annual contribution credits and interest credits allocated to a participant's hypothetical account (read more on cash balance plans here). Employers are responsible for funding defined benefit plans adequately, so the earned benefits can be paid to retirees. Defined contribution plans, on the other hand, do not offer any guarantees. They are generally funded with employee salary deferrals, employer contributions, and provide a lump sum payout made up from contributions and earnings.

For a company offering a cash balance defined benefit plan and a defined contribution plan, prior to the passing of the PPA, the maximum deductible employer contribution to all plans for a fiscal year was the greater of the required defined benefit plan contribution or 25% of participants' eligible compensation. A paired plan would not increase the employer's deduction.

The PPA changed the rules to allow employers to deduct contributions to a defined contribution plan in addition to the required defined-benefit contribution, even if the resulting total exceeds 25% of participants' eligible compensation (subject to certain limits). Subsequent regulations expanded and clarified how these plans may be designed and operated, further increasing their appeal for closely held businesses.

Who's an Ideal Combination Plan Prospect?

Ideal candidates for a combination plan are business owners who seek to save substantially more than a defined contribution plan, such as a 401(k) or profit-sharing plan, would allow on its own. Given the added cost and complexity of these arrangements, typically a $85,000 per year contribution goal is when it makes sense to explore this plan option. The business sponsoring a plan should be consistently profitable. The business owner should plan to work at least three years before retiring, and, ideally, there should be a substantive difference in the owner's age and income compared to the non-owner employees.

Building the Layers: Start with a 401(k)

A 401(k) plan allows eligible employees to save a portion of their current compensation for retirement and receive immediate tax benefit, while allowing the money to grow and compound on a tax-deferred basis.

A Roth 401(k) alternative trades the current deferral of taxation for tax-free growth and distribution in retirement.

For plans that cover non-owner employees, the employer will often make a special safe harbor contribution to eligible participants. In doing so, the employer guarantees that deferrals of the highly compensated employees do not violate 401(k) non-discrimination tests (no need to return those contributions to key staff), helps fulfill the plan's top heavy requirements (most small business plans are top heavy, i.e. 60%+ of plan assets are attributed to owner-employees), and—in some cases—can count this contribution as a part of the profit-sharing contribution used to satisfy the non-discrimination testing. So, safe harbor contribution really plays a triple duty.

Add Profit Sharing

The remaining deduction is typically allocated to participants by way of a profit-sharing plan. Typically, new comparability design is used in this case. This approach allows allocation of the bulk of the profit-sharing dollars to key contributors without violating non-discrimination requirements outlined by the IRS.

Top It Off with a Cash Balance Plan

The final layer of a combination plan is a cash balance plan. Contributions to these plans require a complex calculation that encompasses age, compensation, the length of time until retirement, the promised benefit, the assumed growth of plan assets and a variety of actuarial factors. The annual funding requirement is recalculated each year to account for the actual performance of plan assets and any changes to the plan's liabilities. In general, the higher the earnings and the fewer years to retirement, the greater is the contribution required to fund the benefit promised under the plan. The end result is a robust plan that helps manage current taxable income and meet the retirement savings objectives. Here is a snapshot of contribution opportunities in a multilayered retirement plan.

Contribution and Tax Savings Opportunity in a Layered Plan[1]

Age on 12/31/22	Retirement Age	Plan Compensation[1]	401(k) Deferral	Profit Sharing	Cash Balance	Total	Est. Tax Savings
35	62	305,000	20,500	18,300	75,000	113,800	42,106
40	62	305,000	20,500	18,300	96,000	134,800	49,876
45	62	305,000	20,500	18,300	124,000	162,800	60,236
50	62	305,000	27,000	18,300	160,000	205,300	75,961
55	62	305,000	27,000	18,300	208,000	253,300	93,721

60	65	305,000	27,000	18,300	268,000	313,300	115,921
65	70	305,000	27,000	18,300	296,000	341,300	126,281
70	75	305,000	27,000	18,300	349,000	394,300	145,891

[1] Assumes that the top dollar is taxed at the 37% marginal rate. Plan compensation for sole proprietors is defined as net Schedule C income less the contribution amount and 1/2 of the self-employment tax. The numbers illustrated assume the participant can establish a high three-year salary to support the benefit, will fund the plan to their retirement age, and meets certain other criteria. This chart is intended to be used for informational purposes only and may not reflect the contributions actually available for a particular client. Assumed form of distribution is a lump sum at normal retirement age. The costs represent the target Normal Cost as generated using PPA funding methods. Individual results may vary.

Setup and Funding Deadlines

Generally, for a plan to be effective in the current year (or for another layer to be added), the plan document needs to be signed or amended by the last day of the employer's tax year. For most small businesses, their tax year coincides with the calendar year, making December 31 the deadline for current year plan implementation. Employer contributions, however, are not due until the following year. As long as they are deposited before the employer's tax filing deadline, including extensions, they are deductible for the preceding tax year.

SECURE extended the new plan adoption deadline from the last day of plan year up to the tax return due date of the employer, including extensions (similar to the well-known rule previously available only for SEP IRAs). This rule applies only to employer contributions; salary deferral provisions still have to be in place before a plan can accept salary deferral contributions.

From practical point of view, defined benefit plans, including cash balance, need to be set up before the minimum funding deadline applicable to pension plans, which is eight and a half months after the plan's year end, i.e. September 15 for calendar year plans. As announced on Aug. 6, 2021 in the IRS Employee Plans News, employers who retroactively adopted retirement plans for 2020 received a free pass from having to file a Form 5500 for that year. Instead, these employers will file their first Form 5500 for the 2021 plan year with a checkmark indicating retroactive adoption of the plan in 2021. Defined benefit and cash balance plan are required to include 2020 and 2021 Schedule SBs (actuarial certification) in such cases. While this announcement only concerned the plans retroactively adopted during the 2021 tax year, it is expected that similar treatment will apply to plans adopted in 2022 retroactive to 2021.

As always, Retirement Plan Solutions consultants at Cetera are ready to help. Please call 844.881.PLAN, email retirementplans@cetera.com or start a conversation here.

NOTE: Individual results will vary based on plan design, census data, earnings history, actuarial calculations, and governing regulations. Because cash balance plan is a type of a defined benefit plan, minimum funding rules apply. Failure to meet minimum funding requirements leads to excise tax until funding requirements are met. The figures quoted are statutory maximums based on compensation as illustrated; lower compensation will result in lower contributions. IRS regulations limit the combined contribution to certain plans. The illustration provided is for informational and educational purposes. It is not intended to provide, and should not be construed as ERISA, tax, investment, legal or financial advice or guidance.

Distributions from traditional IRAs and employer sponsored retirement plans are taxed as ordinary income and, if taken prior to reaching age 59½, may be subject to an additional 10% IRS tax penalty.

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