Developments

RECENT DEVELOPMENTS IN EMPLOYEE BENEFITS

Designing a Retirement Program for Professional Firms—the Fundamentals

by The BPS&M Cash Balance Practice Group

Many employers in today's environment view a retirement program as a necessary evil—a costly means to attract and retain qualified employees. On the other hand, many professional firm employers see a retirement program as an opportunity to:

- Defer significant income for the owners/partners
- Design an appropriate balance between cash compensation and benefits for nonowner professionals
- Provide important retirement income for the nonprofessional staff

How does a retirement plan accomplish this? The critical element is that the program be composed of one or more *qualified* retirement plans. Under U.S. tax law, a qualified plan offers a tax deferral benefit that is not available in other arrangements. In general terms, an employer can contribute money to a qualified plan, take an immediate tax deduction for the contribution, and no one pays tax on the contribution (or the related investment earnings) until the money is distributed to the plan participant. This tax deferral is even more powerful when the employer is a tax pass-through entity, such as a partnership, S-corporation, or Professional Service Corporation (PSC), where earnings are taxed at an owner's personal tax level. The tradeoff for this significant tax advantage is a plethora of complex regulations that govern whom the plan covers, how much the covered individuals can contribute to the plan, and how much they can receive from the plan.

> A stand-alone 401(k) plan may not achieve all of a professional firm employer's retirement plan goals

A stand-alone 401(k) plan may not achieve all of a professional firm employer's retirement plan goals; however, Internal Revenue Service (IRS) regulations permit groups of highly paid professionals to convert or establish a next-generation cash balance plan to use in conjunction with a 401(k) plan. This approach may allow for significantly more tax-deductible contributions than can be made through a 401(k) plan alone.

Comparing cash balance and 401(k) plans

Qualified retirement plans are divided into two basic camps: defined benefit (DB) plans and defined contribution (DC) plans. Cash balance plans are the most common DB design among professional firms, while 401(k) plans are the most common DC plan design.

Cash balance plans are often referred to as hybrid retirement plans. A cash balance plan is structured to look like a DC plan with each participant having a notional account to which employer contributions and interest credits are added. It is important to note, however, that the actual investment return of the underlying assets in a cash balance plan can differ from the interest credits added to participants' accounts. Additionally, participants can elect annuity distributions from the plan. Because the employer assumes the risks for investment performance and participant longevity, by definition, the cash balance plan is a DB plan. As a DB plan, tax law limits the benefits that can accrue to the participant (as an annuity) rather than limiting the contributions allocated to the participant's notional account.

Dollars in

Highly paid professionals can build a significant retirement account through a 401(k) plan. They have the personal flexibility to defer individually up to $18,000 annually, plus $6,000 in catch-up contributions if they are age 50 or older, for a total of $24,000 (based on limits in effect for 2015). A substantial percentage of the combined (employee and employer) $53,000 annual limit ($59,000 including the catch-up contribution) is the professional's personal decision to save, while the remainder is *group discretionary* (i.e., the professional group can make the decision each year to contribute, but once the group decides, generally all participating employees of the group must share in the contribution). For late career professionals with substantial savings needs, this annual limit may be inadequate to meet their savings goals.

Cash balance plan *pay credits* appear as contributions in a participant's account statement and can be far greater than the $53,000/$59,000 combined DC contribution limit. The plan can be designed so that individual participant pay credits may vary, but the pay credit formula is defined within the plan document and is not discretionary. Contributions are required each year by the group, and each participating professional must share in those contributions.

401(k) Plans (based on 2015 limits)	Cash Balance Plans
Up to $18,000 in annual employee deferrals can be made	Contributions can be far greater than current 401(k) limits, depending upon a highly paid employee's current age
An extra $6,000 in catch-up contributions made by the employee if at least age 50	The cash balance account is guaranteed
Up to $53,000 ($59,000 including catch-up contributions) in annual employer contributions (including employee deferrals)	Additions to the cash balance account are based on pay credit and interest rate factors defined in the plan document
The employer contributions (match and profit sharing) are usually discretionary	Employer contributions are required

Dollars invested

Most 401(k) plans give the plan participant the ability to personally decide how his or her account is invested, whether in a target date fund, allocated among funds in the plan's fund lineup, or fully directed through a self-directed brokerage window.

It is at this point that the fundamental character of the cash balance plan as a defined benefit plan begins to reveal itself. Trust assets are invested as a pool and there is no individual investment control and direction. It is now possible for the participants' cash balance accounts to reflect the actual performance of the portfolio, which allows the employer to mitigate the investment risk that is typically inherent in DB plans; however, participants' accounts are not allowed to fall below the accumulated amount of the pay credits defined by the plan.

Dollars out

Within the 401(k) plan, the money is available for distribution for hardship, at age 59½, and at retirement. Lump-sum distributions can be rolled to an Individual Retirement Account (IRA), if desired. Loans are also available and are a common feature.

Within the cash balance plan, in-service distributions are available at or after age 62, at retirement, or upon termination if vested. Loans can also be made available under the plan but are not a common feature.

401(k) Plans	Cash Balance Plans
Participants typically direct investment of their account	Trust assets are invested as a pool—no active individual investment direction
Distributions for hardship, age 59½, and retirement	In-service distributions are allowable at or after age 62
Lump-sum distributions can be rolled over to an IRA	The account value is based on pay credits contributed and the investment return allocated to the account as defined by the plan
Account value is based on contributions and investment returns	Loans are permitted but seldom used
Loans are permitted and often used	

Common features

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

- Contributions made to 401(k) plans and cash balance plans are tax-deductible.
- Trust earnings for both plans are tax-deferred.
- Trust assets for both plans are protected from the claims of creditors.
- If lump sum distributions are made, both plans provide the ability to roll the distribution to a successor plan or an IRA.

- Distributions from either plan are not subject to FICA or FUTA tax.

Who bears retirement risks within each plan?

A fundamental difference between the 401(k) and DB plans is the responsibility for retirement risks such as the rate of return on plan investments and the lifespan of the plan participants. For DB plans where benefits are generally paid as a monthly annuity, these risks are the responsibility of the employer; for DC plans, the employee bears all risks while their account balance accumulates prior to retirement. Under DB or DC plans, if benefits are distributed as a lump sum, the employee bears these risks in retirement. DB and DC plans each have their own set of limits and testing requirements. As the names suggest, the ultimate amount of retirement benefits provided is the basis for DB plan limits and testing, while the amount of contributions added to participant accounts during a year is the basis for DC plan limits and testing.

These differences in how limits are set—and how nondiscrimination testing is performed—provide design opportunities, particularly for professional firms. The reason for this is that the age of the participant plays a role in DB plans but is not a factor in DC plans. Table 1 shows the amount of monthly retirement income, commencing at age 65, which can be attributed to a single $10,000 contribution made at various ages. Therefore, when testing for benefit limits and discrimination, an identical contribution is considered to have over three times greater value to a 35 year-old than to a 55 year-old.

Table 1: Approximate monthly retirement income attributable to a single $10,000 contribution

Age at which the $10,000 contribution is made	Approximate monthly life income attributable to the contribution
25	$820
35	$455
45	$255
55	$140
65	$75

Now, to illustrate the plan design consideration and current rules applicable in the plan design concept, we'll use a case study example of a hypothetical professional firm we'll call Washington, Adams & Jefferson (WA&J).

Washington, Adams & Jefferson: a case study

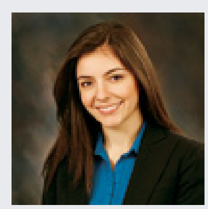
WA&J is a partnership and could be any group of professionals, e.g., accountants, doctors, lawyers, etc. The three named individuals are the only partners in the enterprise, each owning one-third of the practice. The firm has a number of associate-level professionals (Associates), who may or may not be on a track to become partners in the firm. There are also paraprofessionals (Paraprofessionals) and administrative (Staff) positions. The partners in WA&J have two primary goals for a retirement program:

1. Maintain equity among the partners—that is, no partner wants to subsidize the retirement benefit of the other partners.
2. Accommodate the retirement savings (and tax deferral) objectives of the partners and satisfy the firm's objectives for providing different levels of retirement benefits to the various categories of employees.

Tax law restrictions typically stand in the way of fully satisfying these two goals, but by working through the various required discrimination tests, a plan design that accomplishes a majority of the objectives can be determined.

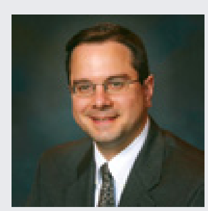
Before choosing an appropriate design for the retirement program, we must know more about WA&J's objectives for their different employment groups. It is important, however, to first understand the basic tenet of

CONSULTANTS *in the* LIMELIGHT



Bojana Zivak

Bojana Zivak has earned the Qualified 401(k) Administrator (QKA) credential. A minimum of two years experience in retirement plan related matters is required along with completion of ASPPA's QKA examination series. Bojana is located in our Nashville, TN office.



Wes Wickenheiser

Wes Wickenheiser spoke at the Kentucky CPA Society Annual Employee Benefits Conference on May 13th on the subject of Defined Benefit Risk Transfer. Wes also spoke on May 18th to Taylor County, KY High School junior and senior math students who are considering an actuarial career. Wes is located in our Louisville, KY office.

For more information about our consultants, please visit www.bpsm.com.

discrimination within qualified retirement plans. The golden rule is that a qualified plan may not discriminate in favor of highly compensated employees (HCEs). An HCE is generally any 5% owner of the plan sponsor or any individual with annual compensation above an annually adjusted dollar threshold ($120,000 in 2015, $115,000 for 2014). The three partners are HCEs; additionally, about half of WA&J Associates are HCEs because their compensation exceeds the required threshold.

The circumstances of, and objectives for, the four employee classifications are as follows:

- **Partners** – Washington (age 60) and Adams (age 55) would like to maximize their retirement savings but within the constraint of maintaining equity between the partners. Jefferson (age 45) already has significant real estate holdings and is less inclined to save for retirement.
- **Associates** – the Associates range in age from 30 to 45. From WA&J's perspective, Associates are primarily interested in current compensation rather than retirement benefits. The partners believe their Associates are reasonably paid within the marketplace and are also fairly mobile. Therefore, WA&J's objective is to minimize retirement plan contributions to this group.
- **Paraprofessionals** – these employees range in age from early 20s to mid-50s. WA&J uses their Paraprofessionals effectively and efficiently and places great emphasis on hiring and retaining strong individuals in this category. Therefore, WA&J wants to provide a significant retirement benefit to this group.
- **Staff** – WA&J hires relatively young Staff and is comfortable with a 20% turnover rate within this category. WA&J recognizes the need to offer a market-competitive level of retirement benefits to attract Staff employees.

Of course, WA&J could just provide a 401(k) plan with a simple match and perhaps an additional profit sharing contribution. This would maintain perfect equity among the founding partners; however, the DC plan limits will keep the three partners from deferring as much money into a retirement program as they would like. Furthermore, nondiscrimination testing may restrict their ability to earmark contributions to certain classes of employees. By adding a cash balance plan, WA&J will overcome these obstacles and meet all its objectives for the retirement program.

Cash Balance Plans

While a cash balance plan cannot remove all potential equity issues among the partners, legislation adopted in 2006 can greatly reduce the risk of inequity. This legislation allows for interest credits to the cash balance notional accounts to closely mirror the investment return on the underlying plan assets; thus, investment risk is substantially mitigated (preservation of capital is required). In addition, the benefit provided to a participant upon termination of employment at any age can now equal the balance in the notional account, eliminating the risk associated with difference between assumed date of termination or retirement and actual termination date. While longevity risk is still a potential issue, cash balance plan benefits are typically stated in terms of a lump sum account balance, and at least historically, most cash balance plan participants elect a lump sum rather than annuity payments. Table 2 sets forth the pros and cons for including a cash balance program with a 401(k) plan.

Table 2: Pros and Cons of Adding a Cash Balance Plan

Pros	Cons
Increased contribution amounts, especially for older individuals Ability to provide different levels of benefits by employment category and maintain contribution consistency within a category (as long as nondiscrimination tests are satisfied) Gains and losses are minimized resulting in greater equity among partners Relatively easy for employees to understand	Additional administrative costs, associated with a second plan, including a required actuarial certification More difficult to fully maximize contributions than in a traditional DB plan PBGC premium expense in some situations; however, PBGC coverage can result in additional deductible contributions Investment risk can be minimized but not eliminated Funding levels must be monitored to avoid certain benefit restrictions

Tables 3A and 3B demonstrate the employer contributions provided under the combination of 401(k) and cash balance plans established by WA&J. Each participant is also eligible to make salary deferral contributions up to the limits placed on those contributions (including additional catch-up contributions for individuals age 50 and over) in the 401(k) plan.

Table 3A: Annual Contribution amounts for WA&J Partners

	Eligible Pay	Salary Deferrals	Employer 401(k) Contribution	Employer Cash Balance Contribution	Total Employer Contribution	Total Retirement Contribution
Washington	$265,000	$24,000	$13,250	$79,500	$92,750	$116,750
Adams	265,000	24,000	13,250	79,500	92,750	116,750
Jefferson	265,000	18,000	13,250	21,200	34,450	52,450

Table 3B: Annual employer contributions, as a percentage of eligible pay, by employment category

	Employer 401(k) Contribution	Employer Cash Balance Contribution	Total Employer Contribution
Partners			
Washington	5%	30%	35%
Adams	5%	30%	35%
Jefferson	5%	8%	13%
Associates	0%	0%	0%
Paraprofessionals	5%	7%	12%
Staff	5%	4%	9%

Plan design notes: The example above assumes that WA&J sponsors two 401(k) plans, one safe harbor 401(k) plan that uses a 3% qualified nonelective contribution to satisfy the safe harbor requirements, plus an additional 2% to satisfy WA&J's top-heavy contribution requirements for the combination of their 401(k) and cash balance plan. This 401(k) plan covers all non-Associate eligible employees: Partners, Paraprofessionals and Staff. Associates are covered by a separate 401(k) plan that allows them to make employee 401(k) deferrals; no employer contributions are provided. Each plan defines plan compensation using a 415 definition of compensation.

WA&J also implements a cash balance plan covering the Partners, Paraprofessionals and Staff. The cash balance plan design shown requires a nondiscrimination testing technique known as *cross-testing,* where contributions and pay credits are converted to their equivalent benefits at a future retirement age, in this example age 65. The nondiscrimination testing requires that nonhighly compensated employees receive a minimum contribution *gateway* amount in addition to providing comparable equivalent benefits. In this example, we are assuming that the lowest contribution rate (the 9% total employer contribution for Staff) divided between the 401(k) and cash balance plans, is sufficient to meet the gateway minimum contribution requirements. Finally, we are assuming that these plans pass all other coverage, nondiscrimination, and minimum participation testing.

How well does this retirement program accomplish WA&J's objectives?

- **Partners** – The primary objective is to maintain full equity so no partner will have to subsidize the benefit of another. Assuming that all three partners elect a lump sum benefit from the cash balance plan, this objective is fully satisfied. In addition, Washington and Adams are able to receive contributions of (and defer tax on) approximately $116,750 each year. Jefferson accomplishes his goal by having a meaningful, but significantly lower contribution amount of $52,450 per year with flexibility to contribute more or less through the 401(k) plan.
- **Associates** – WA&J wants to minimize the contributions to the Associates while maintaining safe harbor 401(k) status for all Partners, Paraprofessionals, and Staff. This is accomplished by providing a separate, employee deferral only 401(k) plan for Associates and excluding the Associates from participating in the cash balance plan.
- **Paraprofessionals and Staff** – WA&J wants to offer a strong benefit to this group in order to attract and retain individuals in this category. The plan design provides employer contributions of 12% of pay for Paraprofessionals and 9% of pay for Staff, plus employee 401(k) salary deferrals and catch-up contributions if they are at least age 50.

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In Summary

The combination of a 401(k) plan with a cash balance plan for Partners, Paraprofessionals and Staff is frequently the optimal solution for a professional firm wishing to provide greater contributions to key individuals than are available under a 401(k) alone, as it is not unusual to see a combined plan design that allows key employees to be the beneficiaries of contributions that are multiples of what would be available under a stand-alone 401(k) plan. Establishing a separate plan for Associates is a common technique to enhance the cost-efficiency of the overall retirement program.

This combination of plans is easy to understand, and can provide surprising flexibility along with increased contribution limits. **The combined plan design shows the retirement accumulation potential of implementing a cash balance plan. More cost-effective plan designs are generally available; for more information, please contact your BPS&M consultant.**

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IRS Announces 2016 HDHP and HSA Limits

In Revenue Procedure 2015-30, the IRS announced the calendar year 2016 changes to the annual limits for health savings accounts (HSAs) and their linked high deductible health plans (HDHPs). The changes reflect a cost-of-living adjustment and rounding rules under Internal Revenue Code §223.

	2015 Limits	2016 Limits
HDHP minimum deductible	Self-only: $1,300 Family: $2,600	Self-only: $1,300 (unchanged) Family: $2,600 (unchanged)
HDHP maximum out-of-pocket expenses [1]	Self-only: $6,450 Family: $12,900	Self-only: $6,550 Family: $13,100
HSA contribution limit (employee + employer)	Self-only: $3,350 Family: $6,650	Self-only: $3,350 (unchanged) Family: $6,750
HSA catch-up contributions (age 55 or older) [2]	$1,000	$1,000

[1] *Out-of-pocket expenses include deductibles, copayments, and other amounts, but exclude premiums.*
[2] *The HSA catch-up contribution amount is not indexed, and an increase would require a statutory change.*

The BPS&M Pension Liability Index

Updated as of May 31, 2015

by Jeffrey Thornton, ASA, EA, MAAA

Interest rates are arguably the primary driver of the volatility in pension plan liabilities. BPS&M has established a set of liabilities and applied the yield curves to those liabilities in order to create the indices used to demonstrate the effect of interest rates on plan liabilities. The BPS&M Pension Liability Index tracks the percentage change in liabilities for a typical defined benefit plan under the following four interest rate standards, which are in general use:

1. The Full Yield Curve published by the IRS for minimum funding purposes under IRS Code §430.
2. The 24-month Averaged Yield Curve published by the IRS for minimum funding purposes under IRS Code §430.
3. The Adjusted Average Yield Curve reflects the impact of the Moving Ahead for Progress in the 21st Century Act (MAP-21) and the Highway and Transportation Funding Act of 2014 (HATFA). HATFA extended the funding relief, which was introduced by MAP-21 in 2012. Originally, under MAP-21, the funding relief began to diminish in 2013. HATFA extends the funding relief, such that it does not begin to diminish until 2018.

4. A Corporate Financial Yield Curve used for financial statement pension liability determinations. Prior to January 1, 2014, this was measured using the Citigroup Pension Discount Curve; now it is measured using the Wells Fargo Pension Discount Curve (AA-rated or higher). For more information about the Wells Fargo Pension Discount Curve, please read the article titled "Introducing the Wells Fargo Pension Discount Curves" in the Jan/Feb 2014 issue of Developments.

The BPS&M Pension Liability Index uses a hypothetical plan for benchmarking purposes based on "typical" pension plan features. The duration of the liabilities under this hypothetical plan is 15 years. The benchmark period for the Index starts with the effective date of the Pension Protection Act (January 2008), and the graph shows the rise and fall in liabilities due to changes in interest rates relative to that date. All other factors remain constant throughout the benchmarking period; ergo, the change in liabilities is due solely to the interest rate environment.

The trends demonstrated in the graph will generally hold true for most pension plans, but the magnitude of the percentage changes will vary depending on a given plan's demographics and benefit accrual patterns.

The table below shows the percentage changes in the indices over various periods.

Indices Changes

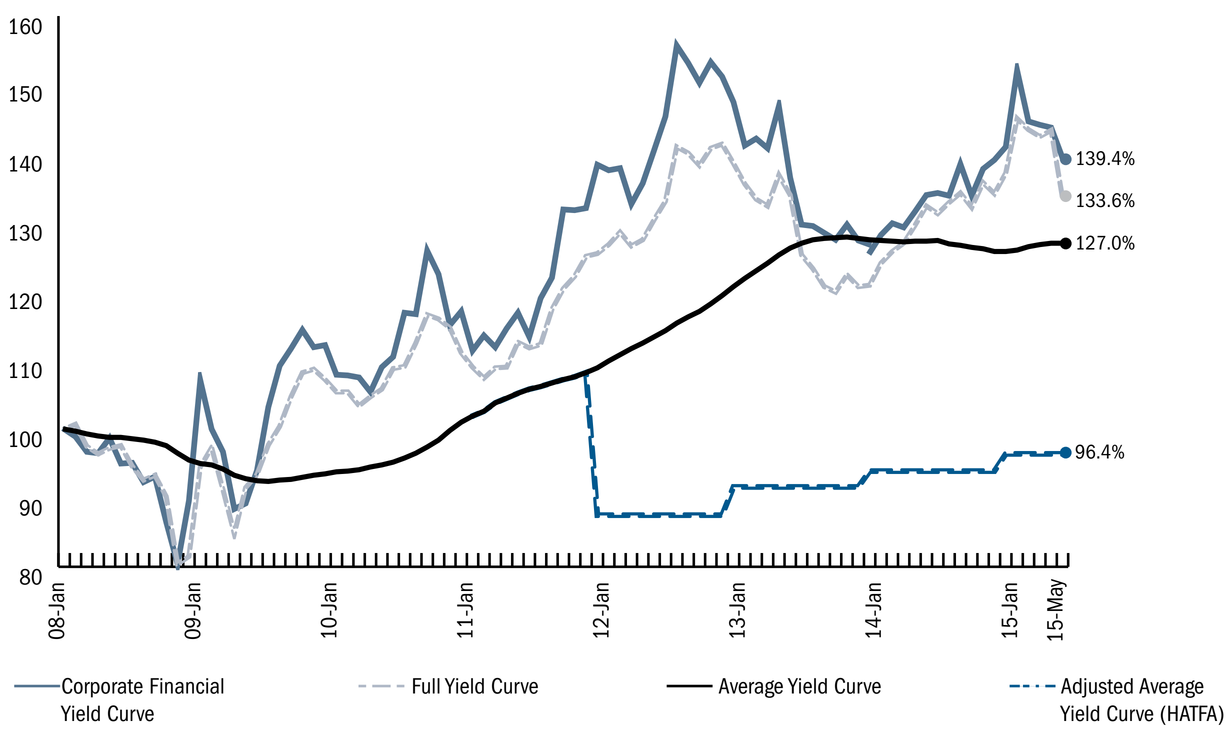
Indices	*Since Inception (1/1/08)*	*2015 Year to Date*	*Last 12 months*
Full Yield Curve	+33.6%	-2.6%	+0.9%
Averaged Yield Curve	+27.0%	+1.0%	-0.2%
Adjusted Average Yield Curve	-3.6%	0.0%	+2.7%
Corporate Financial Yield Curve	+39.4%	-1.1%	+4.0 %

The BPS&M Pension Liability Index is updated regularly. If you have questions or comments concerning the BPS&M Pension Liability Index, please contact your BPS&M consultant or jeffrey.p.thornton@bpsm.com.

Jeffrey Thornton, ASA, EA, MAAA

Jeff has 10 years of actuarial experience in defined benefit plan administration. He specializes in liability studies and has provided plan-specific analyses for clients of various sizes and diverse industries. Jeff is a consulting actuary in our Louisville, KY office.

BPS&M Pension Liability Index since inception



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IMPORTANT News

SCOTUS rules on King v. Burwell
Thursday, June 25, 2015: By a vote of 6-3, the Supreme Court has ruled that federal subsidies will remain available for individuals who enroll in a healthcare plan through the federal marketplace.

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About BPS&M

Bryan, Pendleton, Swats & McAllister, LLC has been providing actuarial and benefit consulting services to clients since 1971.

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