# Cash Balance Plans With Life Insurance

McHenry Advisers

**Scott R. McHenry, MSPA, MAAA**
**Consulting Actuary**
**McHenry Advisers, Inc.**
Phone/Fax: (800) 805-9538
Direct: (614) 656-1879
scott@mchenry-advisers.com

McHenry Advisers

# Agenda

- Cash Balance Plan Basics
- Good Candidates for a Cash Balance Plan
- Life Insurance inside of a Cash Balance Plan
- Plan Design Examples
- More Cash Balance Plan topics
  - flexibility, what's new, interest credit rate and plan investment topics
- Questions

## Cash Balance Plans - A Review

Cash Balance Plans are a type of tax – qualified Defined Benefit Pension Plan. They have increased in popularity in recent years for a number of reasons:

### Tax Benefits

Contributions to the Plan are Tax Deductible and investment return is tax deferred.

### Higher Contribution Limits

Cash Balance Plans permit larger annual tax deductible contributions and benefits than is possible with a 401(k) Profit Sharing Plan.

McHenry Advisers

# What is a Cash Balance Plan?

- Tax Qualified Defined Benefit Plan
- Follow some of the same rules as Defined Contribution Plans ***(eligibility, subject to coverage and nondiscrimination testing, timing of contribution for deduction, can rollover to IRA)***
- Require Actuary Certification
- Subject to minimum funding requirements

McHenry Advisers

# What is a Cash Balance Plan?

- A Defined Benefit Plan
- Each Participant has a hypothetical account balance
  - Annual allocation in Plan Document *(% of compensation or $ amount)*.
  - Can have different allocation formulas for different employees or groups
  - Interest Credit Rate defined in Plan document.

McHenry Advisers

# Why have a Cash Balance Plan?

- Higher tax deductible contributions than 401(k) alone
- Works well with a 401(k) Plan
- Value of current tax reduction and deferral
- Creditor Protection
- Increase retirement benefits for employees
  *(paid for by tax benefits to owners)*
- Can include incidental death benefits funded with life insurance in addition to retirement benefits

McHenry Advisers

# Why Cash Balance Instead of Traditional Defined Benefit?

- **Communication**
  - Easy for participants to understand *(benefit is a lump sum amount instead of monthly amount payable for life beginning in retirement)*
- **Age Neutral Staff**
  - Can provide age neutral benefits (employees of different ages but same compensation can receive same allocation)
- **Increased Flexibility**
  - Increased flexibility if annual allocation is based upon current compensation.
- **Consistent Benefit Growth**
  - Lump Sum amounts do not fluctuate based upon changes in Treasury or Corporate Bond yields
- **Easier to Target Specific Contribution**

# About Cash Balance Plans

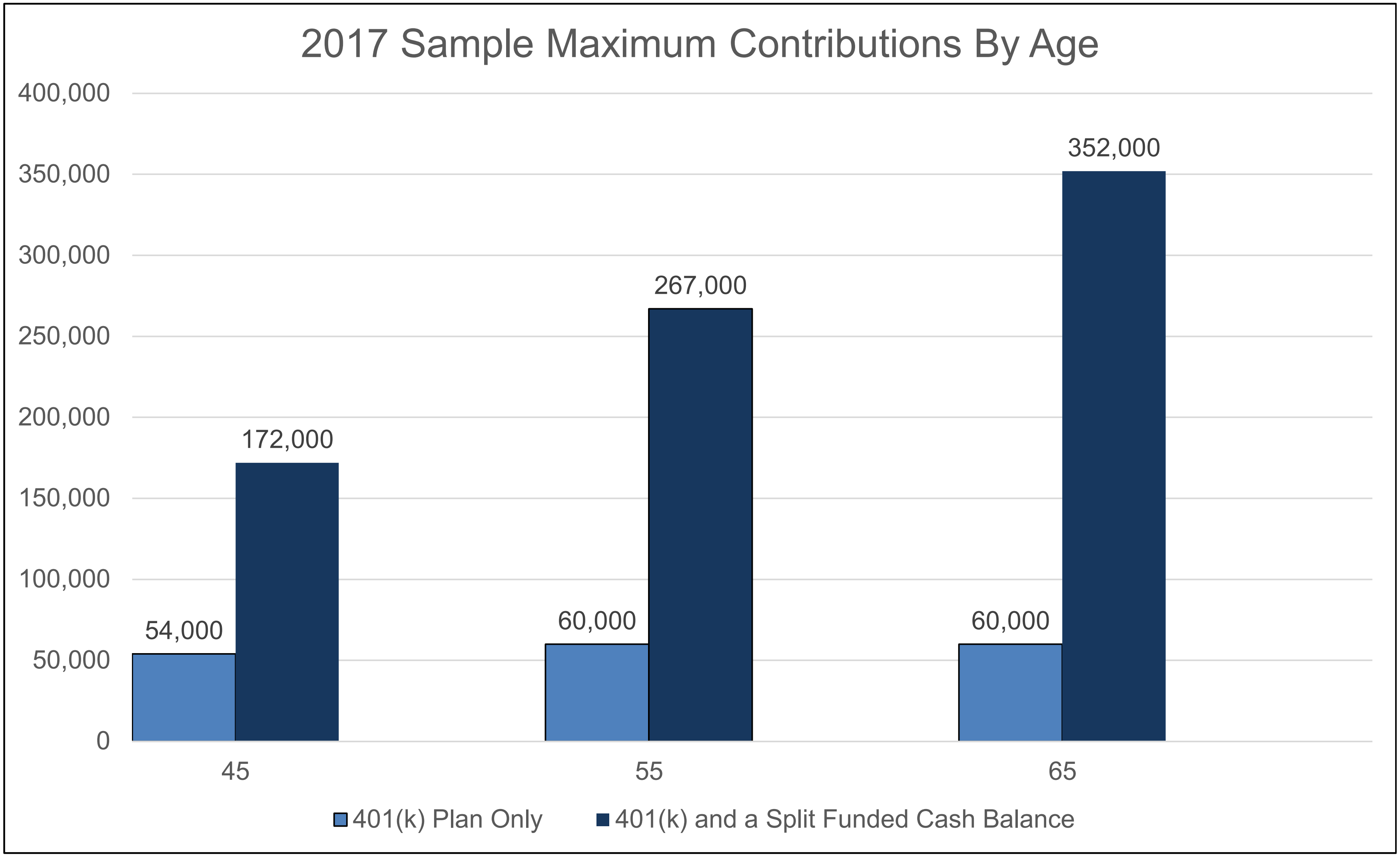
- Maximum benefit payable is limited based upon:
  - Compensation history
  - Plan participation history
  - Age
- Generally work backward from maximum lump sum to arrive at maximum contribution
- Must offer annuity form of payment

# Sample Maximum Lump Sum Benefit Limits (Code Section 415)

Assume 3 Years with at least $215K of W – 2 comp. and 10 Years of Cash Balance Plan Participation

| Age | Maximum Lump Sum Limit Code Section 415 |
| --- | --- |
| 62 | 2,688,000 |
| 55 | 1,896,000 |
| 45 | 1,153,000 |

***These are the maximum retirement benefit amounts that can be rolled over into an IRA. However, insured death benefits can be payable beyond these limits.***



2017 Sample Maximum Contributions By Age
400,000
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
54,000
172,000
60,000
267,000
60,000
352,000
45
55
65
401(k) Plan Only
401(k) and a Split Funded Cash Balance

McHenry Advisers

# Who is a good candidate?

- Not everyone but are often a fit for:
  - Medical or Dental Groups
  - Professional Firms (CPA, Attorney, Engineers, Architects, Investment Advisors)
  - Sole Proprietors
  - Small closely held business with not too many employees
  - Moonlight income
  - Larger Companies with specific goals and census

## Who is a good candidate?

- Want more than $50K contribution for some physician(s) or owners(s) (and have cash flow)
- Can contribute at least 5% of comp. for staff (exception for very large employers that will not be top heavy)
- Helps to have some employees that are younger than owners (Note that does not mean that all employees need to be young)
- Staff payroll per physician or owner is not too high

McHenry Advisers

# Including Life Insurance Inside Cash Balance Plan

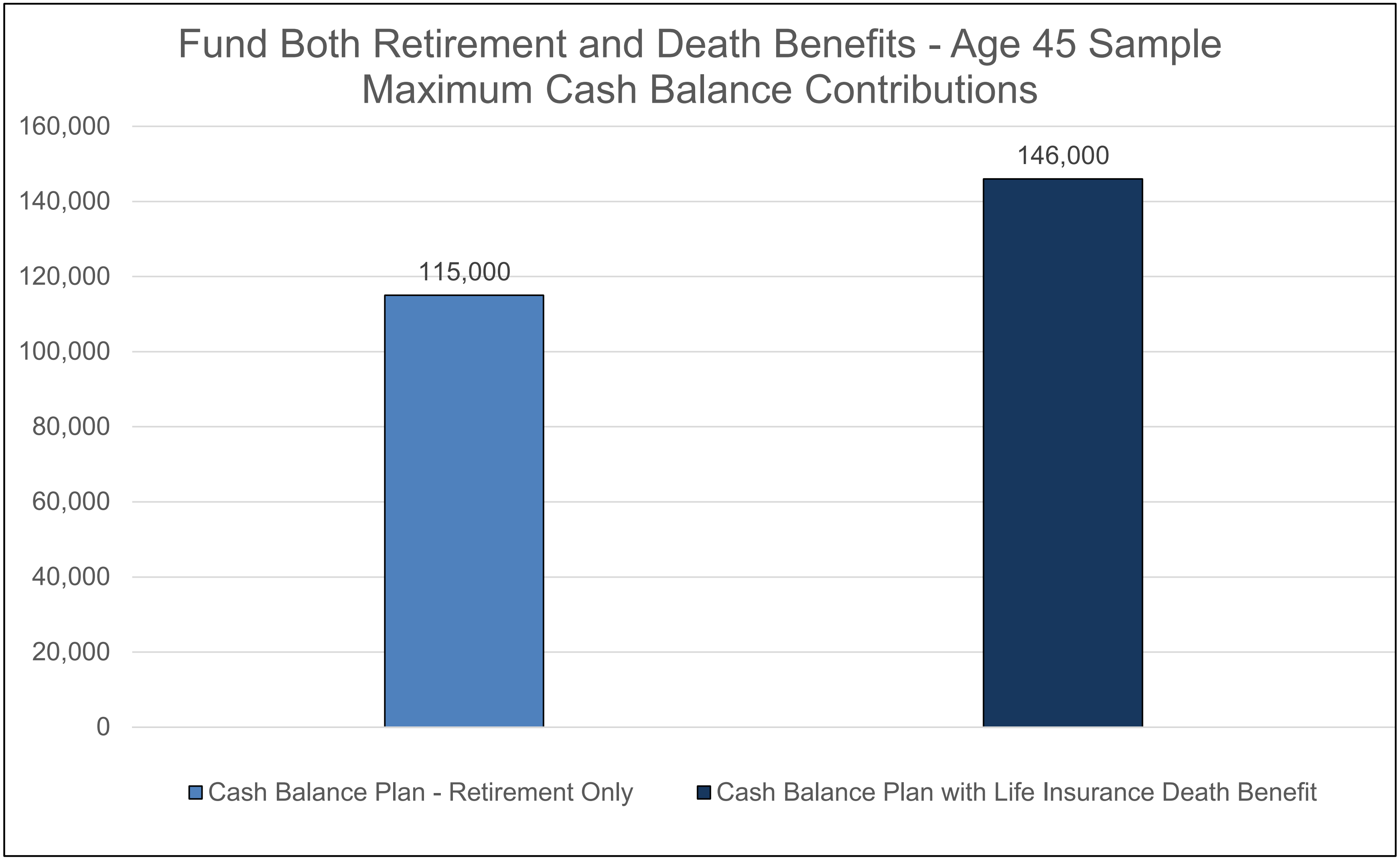
- Ancillary Benefit in addition to normal retirement benefit
- Higher total contributions available since funding retirement ***and*** death benefits
- ***Deductible premiums*** (small portion reportable economic benefit is taxable income to participant)
- Can help ***self complete*** family retirement planning in event of pre mature death
- A solution for an overfunded Cash Balance Plan

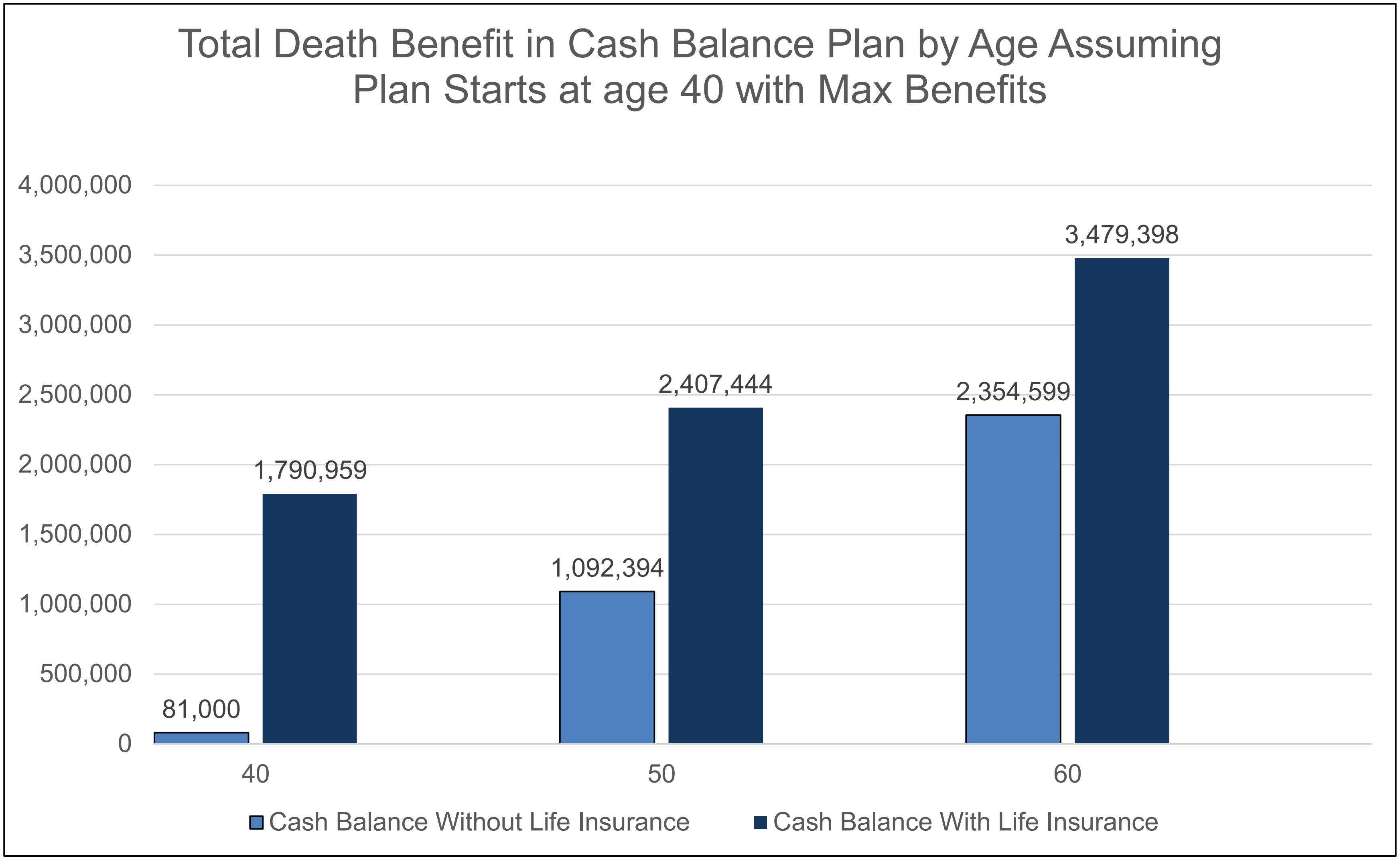
# Why include Life Insurance Inside Plan?

| Gross Income Used for Premium | Outside of Qualified Plan | Inside of Cash Balance Plan |
|---|---|---|
| Gross Income Used for Premium | 181,818 | 101,443 |
| Less State and Fed Tax on Income assuming 45% | (81,818) | (1,443) tax on reportable economic benefit only |
| Equals Available for Premium | 100,000 | 100,000 |

Costs 79% more to pay premiums outside of plan

McHenry Advisers





Total Death Benefit in Cash Balance Plan by Age Assuming
Plan Starts at age 40 with Max Benefits
4,000,000
3,500,000
3,000,000
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
81,000
1,790,959
1,092,394
2,407,444
2,354,599
3,479,398
40
50
60
Cash Balance Without Life Insurance
Cash Balance With Life Insurance

McHenry Advisers

# Including Life Insurance Inside Cash Balance Plan

- Tax-free insurance proceeds to beneficiary in case of death (Face less CSV is tax free, CSV plus other retirement funds can be rolled to IRA)
- Generally must provide to all participants (benefits, rights and features non discrimination testing).

McHenry Advisers

| Name | Nearest Age @ 12/31/17 | Projected Comp. (as limited) | Defined Contribution Plan: 401(k) | Defined Contribution Plan: Non Elect Safe Harbor | Defined Contribution Plan: Profit Sharing | Cash Balance Plan: CB Investment Account | Cash Balance Plan: CB Life Insurance Premium | Overall Total | | Life Insurance Death Benefit |
|---|---|---|---|---|---|---|---|---|---|---|
| Owner | 55 | 270,000 | 24,000 | 0 | 16,200 | 116,885 | 122,850 | 279,935 | | 1,893,788 |
| Owner | 45 | 270,000 | 18,000 | 0 | 16,200 | 70,983 | 74,750 | 179,933 | | 1,611,339 |
| *Highly Compensated Employee T* | | *540,000* | *42,000* | *0* | *32,400* | *187,868* | *197,600* | *459,868* | *97.8%* | *3,505,127* |
| Employee 1 | 45 | 50,000 | 0 | 1,500 | 1,325 | 692 | 650 | 4,167 | | 14,012 |
| Employee 2 | 35 | 35,000 | 0 | 1,050 | 928 | 692 | 650 | 3,320 | | 19,860 |
| Employee 3 | 25 | 25,000 | 0 | 750 | 663 | 692 | 650 | 2,755 | | 28,066 |
| *Employee Totals* | | *110,000* | *0* | *3,300* | *2,915* | *2,076* | *1,950* | *10,241* | | *61,938* |
| *Overall Allocation Totals* | | *650,000* | *42,000* | *3,300* | *35,315* | *189,944* | *199,550* | *470,109* | | *3,567,065* |

# Split-Funded CB Plan - Pre-Mature Death Example

- Assume age 50, started CB Plan at age 45
- Cash Balance retirement benefit – 792K
  - CSV 321K
  - Side Fund – 471K
- Death Benefit / Life Insurance Face – 1.611M
- Face less CSV transfers income tax free – 1.290M
- CSV plus Side Fund eligible for Rollover – 792K
  - 16K basis from accumulated reportable economic benefit

# Incidental Benefit Limits

- Insured Death Benefit must be incidental to normal retirement benefits
  - Can prove incidental by limiting the death benefit to 100 times the projected monthly retirement benefit
  - Can also be incidental based upon an actuarial calculation showing that the premium is less than 2/3 of the individual level premium normal cost (i.e. a prior method of during minimum funding of total plan benefits).
- Can normally provide for death benefit of at least 1.791M for a high income business owner.
- Sometimes can go higher

McHenry Advisers

# Simplified Underwriting / Guaranteed Issue

- Simplified Underwriting
  - Potential for no medical exams, needles, or fluids for highly compensated executives
- Guaranteed Issue Class
  - Issue Ages 20 to 65
  - Total Face Amounts >5K and <50K
  - Uses Standard rates
  - Must be part of a multi-life case, with an average total face amount >=50K
  - Total Face Amount of the policies using GI underwriting must not exceed 20% of the total case

McHenry Advisers

# Removing Policy From Plan

- May be necessary upon plan termination, retirement or termination of employment
- Optionally can be removed from plan at any point before (usually after all scheduled premium payments are made)
  - 8th Policy Year Exchange Right no additional underwriting
- Assuming survivorship and ultimate removal from Plan, policy can:
  - Provide tax free retirement income and tax bucket diversification
  - Be used as an estate planning tool
- Purchased from plan for fair market value by insured or ILIT
- Distributed from the Plan to participant (taxable income at fair market value less previous reportable economic benefit)
  - Plan could take policy loan before distribution

# DOL Fiduciary Rules Do Not Materially Change the sale of Life Insurance to a Cash Balance Plan

- Still covered by Prohibited Transaction Exemption (PTE) 84-24

# Cash Balance Benefit Accounts

- Hypothetical not actual accounts.
- Plan investments are TRUSTEE DIRECTED and invested in a SINGLE ASSET POOL
- The value of Cash Balance benefits are usually not equal to the value of Plan Assets

McHenry Advisers

# Cash Balance Account Values vs. Plan Asset Values

- Assets outperforms Interest Credit
  - Reduce future deposits; Amend plan to allocate additional assets to participants; or make no current change
- Interest Credit outperforms
  - Increase future contributions; Amend plan to reduce future allocations to allow plan assets to catch up; or make no current change
- Plan Termination True Up

McHenry Advisers

# Annual Available Funding Range

- Plan Sponsor can fund between:
  - Low - Minimum Required Contribution that avoids 10% excise tax; Actuarial calculated with some flexibility
  - Middle - Amount that brings total value of plan assets up to value of Cash Balance benefit values (100% funding contribution)
  - High – Maximum Deductible contribution

McHenry Advisers

# Managing Cash Balance Funding

- Best way to manage funding is to focus on funding to 100% of Cash Balance benefit values when possible
- Amend Plan benefit formula when needed

McHenry Advisers

# Contribution Flexibility

- Range from minimum required to maximum deductible
- Can ***amend*** plan to increase during year
- Can freeze plan or ***amend*** to lower allocation before 1000 hour point in year (i.e. can lower contribution requirement on a prospective basis only)
- Consider using Profit Sharing and 401(k) as flexible part of design

McHenry Advisers

# Plan Termination Flexibility

- No issue if over 10 plan years.
- Legitimate business reason for termination before 10 years
  - Any number of reasons qualify - Retirement of owner, Income Decline, Plan Costs
- Historic comfort zone 3 plan years
- Do not need to make contributions in all plan years
- If Life Insurance Policies – consider remaining premium payments

McHenry Advisers

# Interest Crediting Rates – Present Law

- Lot's of options now (Final Regs. 2004)
- Should be driven by plan design considerations (actuary) but
- Generally best options are
  - Low Fixed Interest Credit Rate (example 2%, 3% or 4%)
  - Actual Rate of Return with a floor and a cap (example actual rate of return with an annual floor of 0% and a cap of 5.50%) – requires closely following certain parameters on contribution timing.
- Plan Design Considerations
  - Section 415 Maximum Lump Sum Limits decline if ICR greater than 5.50%
  - Cash Balance Benefits for staff may need to increase if ICR too low (401(a)(26) meaningful benefits)
  - Profit Sharing for staff may need to increase if ICR too high (Cross Testing 401(a)(4)

# Cash Balance Plan Asset Investment Allocation

- Depends upon plan particulars
- Check with actuary
- Generally ok to be moderate to conservative
  - Importance of conservative allocation increases as plan benefits grow compared to annual allocation / expected contribution
  - Potential downside risk to being too aggressive and little upside to aggressive allocation since ultimate maximum lump sum is limited
- But ok for certain plans to be aggressive (if not close to maximum benefit limits)

# Too Much Wind in Your Sail:

## Being Too Aggressive with Your Client's Cash Balance Assets

Being up too high:

- Assets could grow more than maximum lump sum benefit limits of Code Section 415 leading to income and excise taxes.
- Upon plan termination, if plan assets are more than the lump sum benefit values, and assets that revert back to the plan sponsor are subject to income tax and a 50% excise tax.

Being down too low:

- Assets could lead to required contributions that are more than desired and potential excise tax.
- Asset drops could lead to a plan being underfunded and restricted from lump sum distribution to departing shareholders.

# Not Enough Wind in Your Sail:

## Lost Opportunity Cost

## Being Too Conservative With Your Client’s Cash Balance Assets

- Assets could lead to not growing to their potential and leaving money on the table.
- Proper Asset Allocations strengthens your relationship with your client.
- Not all Cash Balance Plan assets need to be allocated conservatively.

McHenry Advisers

# 401(k) / Cash Balance Combination

- Usually works better to have both 401(k) Profit Sharing Plan and Cash Balance Plan than Cash Balance Plan Only
- Usually tested together for non discrimination (3% Safe Harbor, Profit Sharing and Cash Balance Plan benefits)

McHenry Advisers

# 401(k) / Cash Balance Combination

- 401(k) and Profit Sharing add flexibility
- Common design for Staff is:
  - At least 5% of comp. in 401(k) Plan (Safe Harbor and Profit Sharing)
  - Nominal Benefit in Cash Balance Plan
  - Meets top heavy and cross testing gateway minimums
- Profit Sharing can be vested over 6 years / Cash Balance over 3 years

# A word about Excluding Employees

- Cash Balance or Defined Benefit Plan must provide meaningful benefits to at least 40% of non excludable employees [401(a)(26)]
  - Not often a significant cost savings to exclude any staff from CB Plan (may need more in Profit Sharing if excluded)
  - Exceptions are larger group to save on PBGC premiums or avoid required annual audit cost

McHenry Advisers

# Pension Benefit Guaranty Corporation (PBGC)

- May be subject to coverage by, premium payment to, and filing to Pension Benefit Guaranty Corporation (PBGC)
- Exempt from PBGC Coverage if CB or DB Plans:
  - Covers owners only or
  - Professional service employers (i.e. not office of physicians, dentists, CPAs, attorneys, engineers, etc.) with less than 25 active participants
- $69 Per Participant Flat Rate Premium
  - Additional Variable if underfunded

# Watch Out For:

- Make sure the numbers make sense before proceeding
- Keep it simple where possible
- Floor Offset plan designs
  - Recent IRS determination letter request positions and IRS agent continuing education materials
- Excluding Employees

McHenry Advisers

Cash Balance MANAGEMENT

McHenry Advisers, Inc.
Cash Balance Management, Inc.
134 East Main Street
New Albany, Ohio 43054

Phone and Fax: (800) 805-9538
Email: scott@mchenry-advisers.com

*www.mchenry-advisers.com*

Cash Balance INSURANCE SERVICES