Combining Defined Benefit and Defined Contribution Plans

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Creative plan design can help reduce expenses and achieve contribution goals for owners.

Many owners of small and mid-sized organizations face a dilemma as they prepare for retirement. They need to make larger contributions to their tax-qualified retirement plan to fund their future retirement objectives.

Traditional retirement plan designs seem unaffordable because higher contributions for owners result in higher contribution costs to cover other eligible employees. Fortunately, tax-qualified retirement plans can often use customized provisions that can help maximize contributions and benefits for owners, while seeking to control the cost of covering other eligible employees.

Successful Redesign of an Existing Retirement Plan

Let's look at a hypothetical example with the fictitious ABC Radiologists, a professional corporation owned by doctors Adams, Baker and Cox, to illustrate some of these plan design ideas. The practice comprises of three owner-doctors and 23 additional employees, ranging from ages 21 to 60. The doctors, ages 65, 55 and 45, each receive a base salary of $275,000. ABC Radiologists usually realizes a large profit at the end of the year, which can be used
for bonuses to the owners and for retirement plan contributions. Total annual compensation for the 23 staff members is $827,000.

ABC Radiologists Participant Demographics		
Strategy	Age	Compensation
Dr. Adams	65	$275,000
Dr. Baker	55	$275,000
Dr. Cox	45	$275,000
23 Staff	21-60	$827,000
		$1,652,000

For retirement plan purposes, each doctor's compensation is limited to a maximum amount set
by law - $275,000 in 2018. The three owner-doctors of ABC Radiologists had two key objectives with respect to their retirement plan contributions:

- First, they were interested in controlling the cost of contributions for their employees.

- Second, they were interested in increasing the amounts they could contribute for themselves each year.

Original Profit Sharing Plan

When the practice was first established, ABC Radiologists had set up a traditional profit sharing plan. Under the terms of this original plan design, the company decided annually what profit sharing amount, if any, to contribute to the plan. The employer profit sharing contribution was allocated among all eligible employees in proportion to their pay, so each participant received the same percent of pay contribution.

If the company had still been using this type of plan in 2015, ABC Radiologists would have contributed 20% of pay to the plan on behalf of the doctors and to the staff in order to give the three owners the maximum allowable contribution ($55,000 in 2018). This would have resulted in a total contribution of $165,000 for the doctors and $165,400 for the staff.

Adding 401(k) Provisions to the Original Profit Sharing Plan

Several years after establishing the original profit sharing plan, the doctors added 401(k) provisions to the plan. This change did not increase their maximum annual contributions, but now part of their annual contribution was made in the form of a 401(k) salary deferral, and the rest came from their share of the profit sharing contribution. If they still had this plan design in 2018, each doctor would have made a salary deferral contribution of $18,500 (or $24,500 for Adams and Baker because they had reached age 50) and would have received a profit sharing contribution of $36,500, for a total contribution of the maximum $55,000 (or $61,000 counting the extra catch-up salary deferral amount available at age 50).

The lower $36,500 profit sharing contribution would have been only 13.27% of pay contribution for each doctor, so the profit sharing contribution for the staff would also have been 13.27% of pay, or now $109,704. Compared to the 20% of pay profit sharing contribution they had been making for the staff under the original plan, the addition of 401(k) provisions resulted in a significant reduction in the cost of the contribution for the staff ($55,696 less using 2018 limits).

Changing to a Class-Based Allocation Method for the Profit Sharing Contribution

Although pleased with the reduction in contribution costs for the staff by the addition of 401(k) provisions, ABC Radiologists asked if further plan design changes could help them further control the contribution costs for their staff, without reducing the maximum amounts they could receive as annual retirement plan contributions. To achieve this goal, the plan was next amended to change the method of allocating the profit sharing contribution from a pro-rata allocation method, which results in a uniform percent of pay allocation for all eligible employees, to a class based allocation method that provides different contribution rates (as a percent of pay) for different groups or classes of employees. With this class based allocation method, the owner-doctors were in one allocation group, and all other eligible employees were in a second allocation group.

A plan using this type of profit sharing allocation method is called a class-based plan, a new comparability plan, or a cross-tested plan. This class based profit sharing allocation method works only with certain group demographics.

Highly compensated employees targeted for higher profit sharing contribution rates must be older, on average, than other eligible employees in order to pass non-discrimination testing on the non-uniform contribution rates.

The non-discrimination test is based on the projected benefits that will accumulate for each participant by retirement age, not on the contribution rates for each participant. If the projected benefits at retirement age do not discriminate in favor of highly compensated employees, then the contribution rates are deemed to be non-discriminatory.

In 2018, the demographics of ABC Radiologists would make it possible to provide the doctors with the maximum $55,000 annual contribution ($61,000 with age 50 catch-up salary deferral) through 401(k) salary deferrals and profit sharing contributions, while providing the staff with a 5% of pay profit sharing contribution, for a staff contribution cost of $41,350. This $41,350 staff contribution would represent a savings of $68,354 from the prior plan design, and a savings of $124,050 from the original plan design.

The staff contribution cost savings illustrated below shows the value of customizing a defined
contribution retirement plan to help meet a company's objectives. Although these design changes were effective in reducing staff contribution costs for ABC Radiologists, the changes did not increase the tax-deductible retirement plan contributions for the owners, which was their second key objective. We still had one plan design option available to help meet their second objective.

The chart below illustrates the reduction in contribution costs for staff through these two plan design changes, while maintaining maximum contributions for the owner-doctors.[1]

Employees	Traditional Profit Sharing Plan	% of Pay	Traditional Profit Sharing Plan with 401(k)[2]	% of Pay[2]	Class-Based Profit Sharing Plan and 401(k)[3]	% of Pay[3]
Dr. Adams	$55,000	20%	$61,000	20%	$61,000	20%
Dr. Baker	$55,000	20%	$61,000	20%	$61,000	20%
Dr. Cox	$55,000	20%	$55,000	20%	$55,000	20%
Doctor Total	$165,000		$177,000		$177,000	
Staff	$165,400	20%	$109,704	13.21%	$41,350	5%
Total	$330,400		$286,704		$218,350	

Increase Owners' Contributions by Adding a Cash Balance Pension Plan

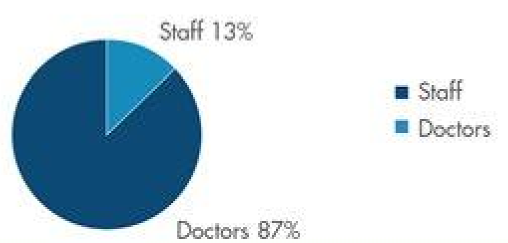
In order to increase the annual retirement plan contributions for the owners, ABC Radiologists could adopt a defined benefit (DB) pension plan in addition to maintaining the existing defined contribution (DC) plan (i.e. 401(k)/ profit sharing plan).

The chart below demonstrates the additional contributions/benefits for each doctor and for the staff. The maximum contribution is the cash balance plan for each owner-doctor is dependent on age, with higher contributions available for those closer to retirement age.

Employees	Cash Balance Plan	401 (k) Deferrals	Profit Sharing Plan	Total Contributions
Dr. Adams	$200,000	$24,500	$16,500	$241,000
Dr. Baker	$165,000	$24,500	$16,500	$206,000
Dr. Cox	$96,500	$18,500	$16,500	$131,500
Doctor Total	$461,500	$67,500	$49,500	$578,500
Staff	$24,810 (3% of pay)	Elective	$57,890 (7% of pay)	$82,700
Total	**$486,310**		**$107,390**	**$661,200**

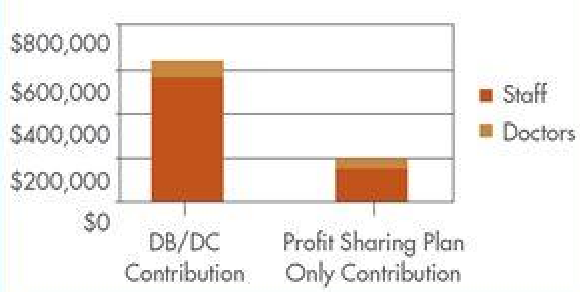
By adding the cash balance plan as a second plan and performing aggregated compliance testing on both plans, the contributions for the three owners would total $578,500, compared to $177,000 under the prior 401(k)/profit sharing plan. This CB/ DC combination plan design yields a contribution increase of $401,500 for the doctors. The cost of covering the staff in both plans would be 10% of staff payroll, or $82,700, which is an increase of $41,350 from the prior 401(k)/profit sharing plan.

Allocation of Contributions after Adding a Cash Balance Pension Plan

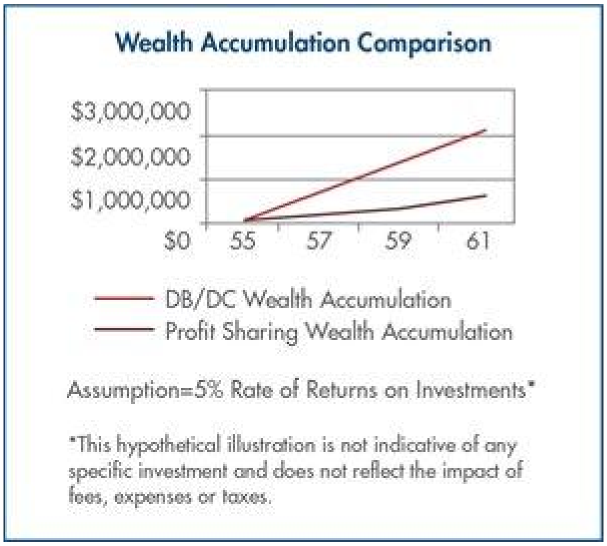


The tax savings on the additional contribution for the owners would more than offset the additional contribution cost for the staff. It is important to note that the contribution cost for the staff would still be 50% lower than the amount the doctors had been contributing for the staff under their original profit sharing plan.

Annual tax Deductible Contributions



The cash balance plan is structured to provide large retirement plan benefits limited to the allowable benefit at age 62, currently a life annuity of $220,000 payable each year. The benefit would be equivalent to a lump sum of about $2,619,000 at age 62. The doctors would continue to make 401(k) salary deferral contributions and would continue to receive a limited profit sharing contribution under the defined contribution plan.



The combination of a cash balance plan and a defined contribution plan, otherwise known as a CB/DC combination plan, would provide a significant increase in the maximum allowable contributions/benefits for the owner-doctors, with only modest additional contributions/benefits to all other staff members.

Understanding the DB/DC Combination Plan Requirements

IRS regulations for non-discrimination testing on a combination of a defined benefit plan and a
defined contribution plan require that contributions or benefits provided under the combined plans must not discriminate in favor of highly compensated employees. How did the ABC Radiologists CB/DC combination plan design pass the non-discrimination test? Let's review a few technical issues:

- The cash balance plan and the 401(k) profit sharing plan were tested on a combined basis as a single plan for purposes of determining that the plans did not discriminate in favor of the owner- doctors. The employer-provided profit sharing contribution and the employer-provided benefits under the cash balance pension plan were treated as though they were provided under a single retirement plan.

- The combined retirement plan was tested for non-discrimination on a benefits basis, not a contribution basis. Employer contributions under the profit sharing plan were converted into benefits payable at retirement age, similar to the testing method applied to the class-based profit sharing allocation method described above, and then combined with the benefits being provided under the defined benefit pension plan. If the combined benefits under the two plans did not discriminate in favor of highly compensated employees, then each plan would be deemed to be non-discriminatory.

- Regulations require that each staff employee receive a profit sharing contribution of at least 5% of pay per year under the defined contribution portions the combined plan.

- The cash balance pension plan standing on its own must provide meaningful benefits to the lesser of 50 employees or 40 percent of employees who satisfy the statutory minimum age and service requirements. In the ABC Radiologists example, the cash balance plan provided benefits to all staff members.

The Creative Plan Design Process

When the owners of a business or professional practice want to maximize their retirement plan contributions, the cost of covering the staff can be made affordable by using creative plan design techniques. Business owners who need tax-favored retirement contributions higher than the current annual limit under a 401(k) profit sharing plan, may consider adding a cash balance pension plan to their existing defined contribution plan.

Exploring the full range of creative retirement plan options gives business owners more opportunities to achieve financial security in later years. Newport Group will help you design a plan that aligns your contributions with your retirement savings goals while helping you control the cost of contributions covering your staff.

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