Cash Balance Corner:

Adding an Employee to Your Cash Balance Plan? You Should be Thinking This Article is "Just What I Needed"

Welcome back to DWC's Cash Balance Corner! If you're joining us for the first time, our Cash Balance Plans 101 is an FAQ that provides an overview. This and all subsequent editions of the Corner will use that as a foundation to build from. Where applicable, we include links for easy access to resources with additional information or explanation. If you are not familiar with cash balance plans (or if you would like a quick refresher), please check out that FAQ first. So, let's get started!

Sponsoring a retirement plan can provide significant benefits to a company (and its participants). But with great benefits comes great responsibility…responsibility to follow all of the various regulatory requirements. Since these plans provide hundreds of billions of dollars in tax deductions each year, Congress and the various agencies want to be sure everyone is playing by the rules.

In our last episode of the Cash Balance Corner, we reviewed many of the basic plan document and filing requirements, focusing mostly on those requirements that apply to all plans regardless of whether or not there are any employees other than the owner. This time, we want to introduce some new things that kick in when the company hires its first non-owner employee.

This discussion is kind of a set up for next time when we will discuss why we design plan documents for owner only plans with provisions that do not seem to apply.

ERISA Requirements

Congress enacted the Employee Retirement Income Security Act (ERISA) back in 1974 to protect benefits promised to employees. In a stroke of genius, the legislators at the time realized that there were certain requirements that did not need to pertain to owner-only plans since there are no employees in need of protection. However, now that Robert has gotten so famous (and busy), Robert Smith, Inc. has hired Simon as a full-time assistant. As a result, the cash balance plan will no longer be owner-only and will now be subject to ERISA's requirements.

Participant Notices

One activity added to Robert's list of duties is to provide Simon (as well as any other future employees who become eligible for the plan) with certain mandatory participant notices. He must provide all employees a Summary Plan Description when they are first eligible to join the plan. The SPD is a plain-language explanation of the plan's benefits and other important provisions.

Participants must receive either an Annual Funding Notice or Summary Annual Report (depending on whether the plan is covered by the PBGC – more on that later). If the plan is not funded to at least 80%, then additional notices may be required to inform participants that lump sum distributions are not available, or if less than 60%, that accruals are frozen. Finally, in cash balance plans, participants must be provided with a statement of benefits at least annually.

Form 5500

As soon as the first employee joins the plan, it must file an annual Form 5500 or 5500-SF. Unlike the Form 5500-EZ that owner-only plans must file when assets exceed $250,000, the 5500 and SF are required each year no matter what the asset levels are. The other main differences are that there are a few more questions to answer, a full reconciliation of trust assets to prepare, and the requirement to file the form electronically. There are even more filing requirements when a plan reaches 100 participants, but Robert has a little way to go before reaching that mark.

PBGC Coverage

We know that owner-only plans are not covered by the PBGC. Once there is another participant in the picture, PBGC coverage is dependent on the type of company the plan sponsor is. Professional services companies (think doctors and lawyers) are exempt from PBGC coverage until they have at least 25 participants in their plans. Musicians do not fall into that category, so Robert's plan will be subject to PBGC coverage as soon as Simon become eligible.

Once covered, the plan's main requirement is to pay PBGC premiums. This is done online, and for the most part, is quite easy. As long as the plan stays well-funded, the premium in most years is about $85 a participant. As mentioned above, PBGC plans have different participant reporting requirements. But again, it is not that big of a deal.

The biggest change when being covered by the PBGC is actually a benefit - the company can now take advantage of the maximum tax deduction limit in both its 401(k) plan and its cash balance plan without any other combined limits.

Things do get more involved when it comes time to terminate a PBGC-covered plan. For starters, there are some very detailed reporting requirements. Here is a quick list:

- Notice of Intent to Terminate: provide to participants between 60 and 90 days before the date of termination
- Notice of Plan Benefits: provide to participants before Form 500 is filed
- Form 500: file with the PBGC no later than 180 days following the date of termination
- Review by PBGC: within 60 days
- Benefit Payments: distribution of participants
- Form 501: file with PBGC no more than 60 days after the final distribution
- Then, if the plan sponsor is lucky, they get to participate in a post-termination audit by the PBGC.

AFTAPs

The rules for AFTAPs do not necessarily change when the plan covers its first non-owner participant, but the implications certainly do. Let me start off by saying that almost all of our cash balance clients are diligent at funding their plans, so the negative implications from AFTAPs never come into play. Most problems are the result of a plan sponsor's tardiness in providing necessary data and confirming contributions.

Let's consider an example. Let's assume that as of January 1, 2021, Robert's plan liabilities are $203,000, and the assets are $103,000. Once Robert makes the 2020 contribution of $110,000 (in 2021), the plan's assets for many purposes (including AFTAP) are well over the liabilities and the AFTAP is well over 100%. However, until the contribution is actually deposited, the AFTAP is 50.74% ($110,000 / $203,000).

The catch is that the actuary is not allowed to certify the final AFTAP until the plan sponsor provides confirmation the contribution has been deposited. If Robert Smith, Inc. extends the filing deadline for the 2020 company tax return, the funding deadline is not until September 15, 2021. The AFTAP deadline is two weeks later on September 30th, and the Form 5500 is due two weeks after that on October 15th. If the actuary is not provided with confirmation of the deposit until after September 30th (which sometimes happens), then the AFTAP is deemed below 60% and the plan is frozen until the later of actual certification or December 31, 2021.

That is a very long example. What is the point? I am glad you asked. The point is that if an owner-only plan has a deemed AFTAP under 60%, then there really isn't much practical impact. If there is an employee in the plan, however, he or she must receive a notice that states the plan is under-funded, which could create a PR problem (to say the least). Also, if the participant in this example terminates employment and requests a lump sum distribution, it cannot be paid out until 2022.

So, the bottom line is that with employees, not only are there more requirements, but the owner must pay greater attention to all those requirements as there is a huge difference between being a fiduciary to oneself vs. others.

What's Next?

Now that we know some of the additional complexities that come with hiring an employee, we are going to look at specific details and explain why we recommend provisions that assume employees will someday be hired – even if the client says "I will never, ever, ever hire an employer" – because too many times, they do!