Cash Balance Corner:

Anticipating a New Hire – You Might “Change Your Mind”

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!

In our last two entries of the Cash Balance Corner, we discussed certain plan sponsor responsibilities for owner-only plans and then for plans that also cover employees in addition to the owner. Not only are those responsibilities significantly different, there can also major differences in the provisions to include in the plan to begin with.

In this installment of The Corner, we will take a look at some of those plan provisions and explain why it is a good idea to design them with future employees in mind, even if you don’t have any intention of hiring any at present. We’ve seen quite a few “I will never have employees” owners change their minds for one reason or another!

The Big Three

There are three main provisions that have the largest impact on a cash balance plan:

- Eligibility,
- The allocation formula, and
- Vesting.

The eligibility provisions dictate when an employee actually joins the plan. The allocation formula describes the benefit a participant will receive each year. Vesting determines when a participant is entitled to keep any benefits already earned.

Eligibility

All qualified retirement plans must specify the criteria for an employee to become eligible to join. As a general rule, the maximum eligibility requirements are completion of one year of service (defined as working at least 1,000 hours in a 12-consecutive-month period) and attainment of age 21. It is possible to set the waiting period at two years of service, but we don’t see that very often.

It is tempting for owners without employees to forego these details and have eligibility be immediate. After all, if there won’t ever be any employees, why does it matter? Well, it matters when that owner decides to hire a friend’s high schooler to help out for a few hours a week during summer vacation. If the plan has immediate eligibility, that summer intern joins the plan the moment he or she begins working. Oops.

Most owner-only cash balance plans we set up are for individuals who have owned their business for many years (and they are certainly over age 21). As a result, the owner is eligible on the effective date of the plan even if there is a one-year "waiting period." That ensures that summer intern doesn't join the plan.

In the event a successful professional wants to establish a cash balance plan before the company has been around for a year, the plan can be written to still impose a one-year wait but to waive it for anyone who is employed on the initial effective date (which is usually just the owner). As an example, assume an owner starts a business in December 2020 and wants to adopt a cash balance plan effective January 1, 2021. The plan document can be written with a one year of service rule, but that rule can be ignored for all employees hired before January 1, 2021.

We will touch on the potential cost impact of immediate eligibility below, but the better bet is to avoid it altogether.

Allocation Formulas

The allocation formula in a cash balance plan has the greatest impact on the required contributions; it is also simple to define and control. For an owner only plan, with one participant, only one formula is necessary, correct? Anyone, anyone? You guessed it – go with more than one formula just in case.

Most cash balance plans set allocation formulas by group. Basic definitions might look something like this:

- Owners,
- Highly compensated employees who are not owners,
- Non-HCEs,
- Etc.

However, some allocation groups are more specific, like Owners named Robert Smith. The best way to protect the plan from the costs associated with unexpected future employees is to make sure there is always a group titled "Everyone Else" that provides a bare minimum allocation. Remember, the plan sponsor can always amend the plan to add additional groups or to increase allocations for certain participants, but once earned, allocations cannot be decreased.

One other provision to point out is the "year of service" allocation requirement. Most cash balance plans require participants to work at least 1,000 hours in a plan year to earn a benefit for that year. By including this provision in an owner-only plan, two protections come into play. First, if the plan is not amended during the new employee's first year of service, the 1,000-hour allocation requirement allows additional time to amend the plan before the benefit is earned.

The second protection applies to all plans – even those that truly do forever stay owner-only. Without a 1,000-hour requirement, the allocation is earned on the first day of the plan year. Remember, once a benefit is earned, it cannot be decreased – even for owners. With the 1,000-hour requirement, an owner can adjust his or her own allocation downward for the first approximately five months of the plan year. Remember, benefits can be increased (to the maximum) anytime during the plan year.

Vesting

That brings us to vesting, which has less of a potential impact but is still important to discuss. There are a couple of reasons to implement a vesting schedule for an owner only plan. The first is to control the cost for that future employee. The second reason is to limit potential required minimum distributions (RMD) for the owner.

Controlling the cost for the potential future employee is straight-forward. Cash balance plans can have a so-called "cliff" vesting schedule in which someone remains 0% vested until he or she completes three years of service. There is also an option that allows the plan to ignore all service prior to the effective date for vesting purposes. But wait, what if the owner closes the business before completing three years of vesting service? Good question. First, the owner can always amend the plan to reduce the number of years required to be fully vested. Second, if the business is closing, the plan will be terminated. Once a plan is terminated, all participants become immediately 100% vested.

When an owner with a vested benefit reaches age 72, the plan must begin paying required minimum distributions. We bet you can guess where this is going. It is fairly common for a business owner to be in his or her early 70s when establishing a cash balance plan. If a 73-year-old starts a plan with immediate vesting, then a portion of the benefit must be immediately distributed (and taxed). This reduces the plan's tax advantages and adds unnecessary administrative complexity. If that same owner goes with a three-year cliff vesting schedule that disregards prior service, the owner will have two years at 0% vesting, thus pushing out that first RMDs by those same two years.

Why not use a five-year vesting schedule? Or 10- year? Especially since the owner can always amend the plan to speed up the vesting. Anyone? Anyone? (Couldn't resist) Because Congress said so. By law, cash balance plans must provide for full vesting after no more than three years of service.

Robert's Plan

When originally setting up Robert's plan, it would have been simple to have immediate eligibility, immediate vesting, and one allocation group with no minimum number of required hours. However, by putting in a one-year eligibility requirement, three-year cliff vesting and two allocation groups with 1,000 hours required to earn the benefit, it protects Robert financially without negatively impact his benefit.

Without those protections, when Simon is hired, the cost of the plan increases dramatically. First, Simon would come into the plan immediately (one year sooner than necessary), would be 100% vested (three years sooner than necessary) with a benefit of 66.67% of salary (much higher than necessary). With a one-year window before Simon is eligible, there is plenty of time to run some projections to determine whether that bare minimum allocation for the "Everyone Else" group is sufficient to pass nondiscrimination testing. If not, Robert can amend the plan to add other allocation group.

In order to pass nondiscrimination…just kidding, I think we have covered more than enough ground for one installment. Next time, we will discuss some of the financial and demographic details that can impact nondiscrimination testing.