

The following is the Table of Contents for the April 2011 rewrite of Chapter 6 of Hugh Forcier's GUIDE TO CASH BALANCE PLANS (Aspen, 2003, as previously supplemented). The rewritten Chapter 6 will be provided to attendees at April 28, 2011 presentation.

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Use of hybrid defined benefit plans by professional service practices.

Professional service practices use hybrid defined benefit plans very differently than large corporations do. Therefore, professional service practices must deal with very different design and compliance issues. This chapter discusses those types of issues.

PART ONE: INTRODUCTION.

- ¶6.1 Tax-qualified hybrid defined benefit plans are used by professional service practices to enable the partners / shareholders to increase their pre-tax contributions to tax-qualified plans.
 - 6.1[a] The maximum increase in the pre-tax contributions that can be achieved by adding a hybrid defined benefit plan is driven by the 415(b) limit – and is quite high, particularly for older partners / shareholders.
 - 6.1[b] From the perspective of a partner / shareholder: An expectation of more spendable retirement income.
 - 6.1[c] From the perspective of the management of the professional service practice: Larger retirement accumulations can make succession planning easier.

- ¶6.2 Tax-qualified plans sponsored by professional service practices must demonstrate that they do not discriminate in favor of the “highly compensated”.
 - 6.2[a] The general nondiscrimination test.
 - 6.2 [b] The minimum aggregate allocation gateway.
 - 6.2[c] The 401(a)(26) minimum coverage requirement.

- ¶6.3 A primer on the types of hybrid defined benefit plans used by professional practices:
- 6.3[a] Cash balance plans.
 - 6.3[b] Variable annuity plans.
- ¶6.4 A core objective of almost all professional service practices: Each partner / shareholder is to pay the cost of the benefit that will ultimately be paid to him / her. This requires the professional service practice to use what is called a “special allocations program”:
- 6.4[a] Using a special allocations program to allocate the regularly scheduled contribution of each partner / shareholder.
 - 6.4[b] Using a special allocations program to allocate plan-level shortfalls and surpluses attributable to the accumulating benefit of a partner / shareholder.
 - 6.4[c] Why some professional service practices do not use special allocations programs to allocate plan-level shortfalls and surpluses.
 - 6.4[d] Why some professional service practices do not apply special allocations programs to allocate plan-level shortfalls and surpluses to terminated partners / shareholders.
 - 6.4[e] The mechanics of a special allocations program are different depending upon whether the professional services practice is taxed as a partnership or a professional corporation.
- ¶6.5 A partner / shareholder is unlikely to want to participate in a hybrid defined benefit plan unless he / she can reasonably expect that by doing so he / she will have more spendable retirement income than he / she would have by making equal-effort, after-tax contributions to a different type of account – such as a regular taxable account or an account under a non-qualified variable annuity insurance company contract.
- 6.5[a] Spendable retirement income calculations:
 - 6.5[a](1) Spendable Retirement Income Percents.
 - 6.5[a](2) Spendable Retirement Income Indexes.
 - 6.5[b] Variables that materially impact spendable retirement income calculations.

PART TWO: REGULARLY SCHEDULED CONTRIBUTIONS

- ¶6.6 The preferences of individual partners / shareholders to participate in a hybrid defined benefit plan (and the level of their participation) are almost always “random” – meaning the preferences are unrelated to age or job-related factors.

- ¶6.7 It is a widespread practice to accommodate the random preferences of individual partners / shareholders – at least to some extent.
- ¶6.8 Accommodating the random preferences of individual partners / shareholders presents a tax-qualification issue under the “Cash Or Deferred Arrangement” rule.
- ¶6.9 Accommodating the random preferences of individual partners / shareholders also presents a tax-qualification issue under the “Similarly Situated” rule.

PART THREE: INVESTING THE PLAN ASSETS.

- ¶6.10 In-service rollouts to an IRA or to a defined contribution plan (to obtain individual investment control) are no longer permitted prior to age 62.
- ¶6.11 The Treasury and the IRS have not yet expressed a view on whether investment options can be provided within a hybrid defined benefit plan. As a result, very few professional practices provide investment options within a hybrid defined benefit plan. If investment options are not provided, plan assets attributable to the contributions of all participants who are under age 62 are invested in a single pooled fund.
- ¶6.12 The return on a single pooled fund determines the return on partner / shareholder contributions prior to an IRA rollover – in turn, impacting the spendable retirement income that can be expected to be produced by the plan.
 - 6.12[a] Is it better to i) invest a single pooled fund to produce a higher expected return even if that return would lower the level of contributions to the plan or ii) invest to produce a lower expected return to avoid lowering the level of contributions to the plan?
 - 6.12[b] If the equity component used for a single pooled fund under the plan is lower than a partner / shareholder would choose to use for an equal-effort, after-tax account, can the partner / shareholder reasonably expect to be able to increase the equity component in his / her other retirement accounts to be able to achieve his / her equity allocation goals on an overall (or “aggregate”) basis?
 - 6.12[c] If the fixed income component used for a single pooled fund under the plan is expected to produce a lower return than the return a partner / shareholder would expect from the fixed income component that the partner / shareholder would choose to use for an equal-effort, after-tax account, can the partner / shareholder nevertheless reasonably expect to have more spendable retirement income by making contributions to the hybrid plan? ¶

¶6.13 How the leadership of a professional service practice will decide to invest a single pooled fund is driven by two key decisions it will make: i) What type of hybrid plan will it use – a variable annuity plan or a cash balance plan? ii) If the leadership decides to use a cash balance plan, will it use a special allocations program with respect to plan-level shortfalls? The answers to these questions are primarily driven by compliance considerations.

6.13[a] Variable annuity plans: The hoped-for advantage of using a variable annuity plan is that it does not produce the type of shortfalls produced by a cash balance plan. If there are no such shortfalls, the leadership of a professional service practice can choose to use a less conservative investment strategy for a variable annuity plan than it would choose to use for a cash balance plan. However, whether a variable annuity plan can achieve this hoped-for advantage under the federal tax laws is a question now pending before Treasury and the IRS. Their answer is expected before the end of 2011.

6.13[a](1) If the IRS confirms that the hoped-for advantage of variable annuity plans (over cash balance plans) is achievable, many professional service practices will choose to use variable annuity plans (rather than cash balance plans.)

6.13[b] Cash balance plans: If (for whatever reason) the leadership of a professional service practice decides to use a cash balance plan, the investment strategy it chooses will be primarily driven by whether it will decide to use a special allocations program with respect to shortfalls produced by the plan.

6.13[b](1) If the leadership of the professional service practice is concerned about how the 401(a)(26) issue will be resolved, it will invest the plan assets using a very conservative investment strategy.

6.13[b](2) If the leadership of the professional service practice is not concerned about how the 401(a)(26) issue will be resolved, it will invest the plan assets using an investment strategy that is less conservative than if it were concerned about how the issue will be resolved – but one that may still be considerably more conservative than if it used a variable annuity plan.

¶6.14 If the leadership of a professional service practice decides to use a cash balance plan:

6.14[a] It will likely use some type of market rate cash balance plan.

6.14[b] It should consider using atypical design features that will lower the minimum interest crediting rate required under the 133-1/3% accrual rule.

6.14[c] If it will not use a special allocations program with respect to shortfalls, it should consider the use of some atypical distribution provisions to lessen the risk of adverse selection.

PART FOUR: THE HYBRID PLAN PROJECTION ISSUES – EXPECTED TO BE ADDRESSED BY THE IRS PRIOR TO THE END OF 2011.

¶6.15 The cash balance plan projection issues:

6.15[a] The impacts of the projection issue under cash balance plans.

¶6.16 The variable annuity plan projection issues:

6.16[a] The impacts of the projection issue under variable annuity plans.

PART FIVE: THE 401(a)(26) MANDATORY DISAGGREGATION RULE ISSUE.

¶6.17 The types of shortfalls and surpluses that may be allocated under a special allocations program:

6.17[a] Plan-level shortfalls and surpluses under a cash balance plan based on the differences between the interest crediting rates and the investment returns.

6.17[b] Plan-level surpluses under a variable annuity plan based on the 415(b) limit.

6.17[c] Plan-level funding whipsaws.

6.17[d] Annuity purchase rate shortfalls.

¶6.18 The pending request by a large law firm for a Private Letter Ruling involving its cash balance plan.

¶6.19 Senior IRS officials have made unofficial comments (both in public and in private) that indicate the IRS is likely to adopt an adverse position.

¶6.20 Why the IRS is concerned about the use of special allocations with respect to shortfalls and surpluses.

¶6.21 The leadership of each professional service practice must evaluate the issue in the context of its risk tolerance with respect to tax-qualified plans that cover its partners / shareholders.

6.21[a] An “if litigated” analysis: How likely is it that the courts would reverse an adverse IRS position?

6.21[b] A “political” analysis: How likely is it that the IRS would reverse an initially adverse position – because so many large law firms use special allocations programs with respect to shortfalls and surpluses?

6.21[c] A “duration of uncertainty” analysis: How does the leadership evaluate the practical problems that may be encountered if the issue takes a long time to resolve – even if it ultimately is resolved favorably?

PART SIX: RESTRICTIONS ON LUMP SUMS PAID TO THE 25-TOP-PAID.

¶6.22 A general explanation of the rule that can operate to impose restrictions on lump sums paid to the 25-top-paid.

¶6.23 Does the rule apply to hybrid defined benefit plans covering only individuals who are “highly compensated” under the nondiscrimination test?

¶6.24 Will the IRS adopt changes that will eliminate the ability of many professional service practice plans to avoid the restrictions on lump sums paid to the 25-top-paid?