WELLS FARGO Advisors

Multiple retirement plans for a business

A strategy to help business owners achieve their objectives

Business owners are finding that having multiple retirement plans can help them address both key employees' and their own unique needs.

When determining the type of retirement plan to offer — a 401(k), defined benefit, SEP IRA, etc. — business owners often look for one that will allow them to maximize contributions for themselves and key employees while keeping contributions for other employees at a reasonable level. However, this can be difficult — especially for owners who are older than 45. In many cases, no single plan can satisfy this objective and pass IRS required nondiscrimination testing. When this is the case, the answer may be to have more than one retirement plan.

Keep in mind that the plan design we're going to discuss is complex and doesn't suit every business. However, if it works for yours, you may be able to make substantial contributions for your retirement and provide your business with a significant tax deduction.

To comprehend this advanced plan design, you first need to understand the components, beginning with its foundation: a cash balance plan.

What is a cash balance plan?

A cash balance plan is a hybrid plan with the features of both a traditional defined benefit plan and a defined contribution plan, such as a profit sharing plan. Each year, the business credits contributions to each participant's plan "account." These "accounts" exist strictly on paper — plan funds are actually pooled together, just like a defined benefit plan.

The contribution credit for each "account" is calculated based on:

- A percentage of the employee's compensation (usually called a "pay credit"), for example, 5%.
- Interest on the "account" balance (often referred to as an "interest credit") may be a fixed rate up to 6% or a variable rate such as the 30-year Treasury bond yield; or a market rate is available and can be based on a specific index such as the S&P 500 or an actual return on a diversified portfolio. The IRS dictates specific interest rates available. Interest rates outside the IRS list cannot be used.

Although the company credits the "accounts," it is up to an enrolled actuary to calculate the mandatory, tax-deductible contribution the company must make to the plan. The contribution will vary from year to year depending on a number of factors, including the plan's investment returns. If, for example, the investments have performed well, the contribution amount may be reduced. The amount the actuary calculates will be an approximation and will never exactly equal the total of the contribution credits for all of the "accounts."

Business owners can find cash balance plans attractive because they let owners create separate employee groups to receive different levels of benefits. For example, the business owner and his or her spouse are in one group and the remaining employees in another. This is where things can get tricky — the groupings must satisfy IRS nondiscrimination testing. This plan design is age-based, so the ages and compensation of the business owner, the spouse, and the remaining employees determine how well it will work for a particular business.

If the numbers work out, the owner will achieve his or her objectives and the plan will pass the nondiscrimination testing. The business owner may stop at this point and opt to implement a cash balance plan by itself. However, if the numbers don't add up, the owner may choose to either:

- Adjust his or her objectives to make the cash balance plan work by itself
- Determine whether his or her original objectives can be achieved with a complex plan design that includes a cash balance plan along with one or more other plans

What is a safe harbor 401(k)?

In many situations, a safe harbor 401(k) plan with a 3% nonmatching contribution[1] in addition to a cash balance plan will create a plan design that will pass the nondiscrimination testing.

A safe harbor 401(k) operates just like a traditional 401(k); however, the safe harbor rules eliminate certain nondiscrimination testing and allow highly compensated employees to maximize their salary deferral contributions, regardless of other employees' participation levels.[2] To satisfy these rules, a plan must meet certain contribution and notification requirements and the employer must make fully vested contributions.

In addition, annual employer contributions are required and can be structured as matching[3] or nonmatching.[4] An employer has the flexibility to make additional profit sharing contributions within the plan limits. These contributions may be subject to a vesting schedule.

If the combined plan design still doesn't pass the testing or the owner wants to make a larger employer contribution, he or she may choose to add a new comparability profit sharing contribution to the design.

What is new comparability?

New comparability refers to a profit sharing allocation method that allows an employer to designate different contribution percentages to favor certain groups of employees. Like a cash balance plan, the new comparability allocation is age-based. This allocation is used in the multiple-plan design to increase employer contributions to individuals other than the owners or key employees.

The hypothetical example below illustrates how each component — cash balance plan, safe harbor 401(k) plan, and new comparability contribution — works to create a plan design to help achieve the business owner's objectives of maximizing the business's contributions for the owner and his or her spouse.

Sample combined cash balance and safe harbor 401(k) with new comparability profit sharing allocation*

Cash balance plan contribution (pay) credit assumptions	
Group A: Owner	84.0% of W-2 earnings
Group B: Spouse	40% of W-2 earnings
Group C: Non-owners	2.5% of W-2 earnings

New comparability profit sharing contribution assumptions	
Group A: Owner	0.0% of W-2 earnings
Group B: Spouse	0.0% of W-2 earnings
Group C: Non-owners	4.8% of W-2 earnings

Sample combined cash balance and safe harbor 401(k) with new comparability profit sharing allocation* (continued)

Cash balance plan				Safe harbor 401(k) plan			
Name	Age at end of plan year	W-2 earnings	Estimated contribution	Employee elective deferrals	3% nonelective contribution	New comparability profit sharing contribution	Total contributed
Owner	58	$305,000	$256,200	$27,000	$9,150	$0	$292,350
Spouse	58	$50,000	$20,000	$10,000	$1,500	$0	$31,500
Employee 1	65	$20,000	$500	$400	$600	$960	$2,460
Employee 2	60	$20,000	$500	$400	$600	$960	$2,460
Employee 3	55	$20,000	$500	$400	$600	$960	$2,460
Employee 4	50	$20,000	$500	$400	$600	$960	$2,460
Employee 5	45	$20,000	$500	$400	$600	$960	$2,460
Employee 6	40	$20,000	$500	$400	$600	$960	$2,460
Employee 7	35	$20,000	$500	$400	$600	$960	$2,460
Employee 8	30	$20,000	$500	$400	$600	$960	$2,460
Total		$515,000	$280,200	$40,200	$15,450	$7,680	$343,530

*Prepared by July Business Services, Waco, TX

Keep in mind that this advanced plan design won't work for all businesses and:

- Because annual cash balance plan contributions are required and the safe harbor 3% nonmatching and profit sharing contributions are necessary to pass nondiscrimination tests, this combination is most suitable for businesses with stable, significant income. In general, this approach works best when the business owner has a W-2 or net Schedule C profit of at least $250,000.
- Cash balance and safe harbor 401(k) plan contributions will be required every year, including if the business loses money.
- Cash balance plans should only be considered with the intention of funding for a minimum of five years to meet the IRS permanency guidelines.
- A business owner's intent when offering a plan should be to provide a permanent, ongoing retirement savings program.
- Because the cash balance plan is a defined benefit plan, it and the safe harbor 401(k) plan would be subject to the deduction limit applicable to combination plans. In addition, the cash balance plan would have to satisfy the minimum participation rules by providing meaningful benefits to at least 40% of employees*. As with defined contribution plans, combination plans are subject to a special nondiscrimination test applicable when plans are being aggregated for testing purposes.

* When 40% of employees benefiting is less than two, a two-person minimum applies.

You can count on us

Your Financial Advisor can provide additional information on cash balance plans, safe harbor 401(k) plans, and new comparability. In addition, he or she can work with our Home Office retirement plan consultants to determine whether the approach discussed in this report may be right for your business or if other plan designs are better.

1. A matching safe harbor contribution will not help the combined plans pass nondiscrimination testing.
2. Nondiscrimination testing is eliminated only for the safe harbor 401(k) plan.
3. Basic match: dollar for dollar on first 3% of compensation; 50¢ on the dollar for the next 2% of compensation.
4. A nonmatching safe harbor contribution is 3% of each eligible employee's compensation.