



Cash Balance Contributions as a Business Expense: How to Allocate Costs Among Multiple Owners

Understanding what is possible and preparing for the worst will add significant value to your consulting practice and alleviate potential issues before they arise.

BY JOHN FRISVOLD AND JEFF CAIRNS

Cash balance retirement plans offer many benefits for a business owner. Generally, cash balance plans are established by successful privately held small businesses. A consultant introduces the concept and follows up with a plan design; often the client is smitten and ready to move forward.

A cash balance plan has a lot of appeal to business owners because they can put significant amounts away on a pre-tax basis and better prepare themselves and their staffs for retirement. But while cash balance plans are very attractive to business owners, they are complex — meaning that soon the client will be asking some tough questions. Typically, this is when consultants talk

about the indefinite duration of the plan, the investment risk falling on the sponsor and not the employees, and the importance of keeping the plan fully funded. However, there is an important issue most consultants don't discuss with the client: How is the plan expense (contributions and administrative costs) handled from a business standpoint?

In the retirement plan industry, plan expenses is definitely not a topic that is overlooked very often. Even when “it's not about expenses,” at some point it becomes at least somewhat about expenses. Often, very little is discussed about how defined benefit retirement plan contributions are handled from an accounting perspective. Most consultants will direct the client to “ask your accountant, that's their job.” A client

asking their CPA about basic plan design is fine. However, when it gets more complicated, such as new comparability profit sharing plans and especially cash balance plans, it takes collaboration among the consultant, the client and the plan sponsor's attorney to make sure the contribution is handled properly within the business structure so that all the business owners are treated fairly.

What is "fair" depends upon the circumstances, so let's use a simple example to illustrate. (A request for my actuary friends: Be nice about the numbers; it's just to discuss the concept.)

Typical Company has met with all parties involved and decided to establish a cash balance plan. Typical Company has two owners: Dick, age 55, and Jane, age 35. Each owns 50% of the business. Because of their ages, they have decided to have different pay credits allocated to the plan each year for their benefit. To keep things simple, they will always fund the plan so that balances equal assets. Dick's pay credit, or annual hypothetical allocation, will be \$150,000 each year; Jane's will be \$50,000 each year. Their staff, consisting of five non-highly compensated employees (NHCEs), will receive pay credits each year totaling \$25,000.

ALLOCATION ISSUES

Here's our first dilemma: How is the annual contribution that accounts for the pay credit handled? The business treats the annual contribution as \$225,000; like most expenses, this would be simply allocated. Dick and Jane would both have their partnership or S corporation income reduced by \$112,500. The issue here is that the pay credit does not match the business expense allocation. They each pay \$112,500 of business expense, but the contribution is \$150,000 for Dick and \$50,000 for Jane, with \$25,000 going to the staff.

The accounting for this disparity will depend upon the business

“It takes collaboration among the consultant, the client and the plan sponsor’s attorney to make sure the contribution is handled properly and all the business owners are treated fairly.”

structure. The solution is relatively straightforward for partnerships and LLCs taxed as partnerships. The final payout that each owner receives from the profits is simply adjusted (under the partnership or LLC governing documents) to take into account this discrepancy. In a partnership, ownership payouts do not need to reflect ownership percentages.

However, this is not the case for S corporations. In an S corporation, the owners' compensation is made up of two parts: W-2 compensation

and distributions/dividends. (For simplicity, the combination of distributions and dividends will be referred to as "distributions" for the rest of this article.) The distribution in an S corporation must be paid out on a pro rata basis to owners based on their ownership percentage. Therefore, adjusting the W-2 pay is the solution for addressing any contribution disparity. W-2 compensation has a number of legal requirements, so this definitely needs to be discussed and reviewed by a CPA or tax professional prior to any adjustments being made. Also, any adjustment must not have the appearance or operate as an "elective deferral" of income, which will violate the 401(k) regulations by, in most cases, exceeding the annual limits under those rules.

DISPARITY CONCERNS

Let's build on our example of Typical Company. Dick receives \$150,000 a year; Jane receives \$50,000 a year; and the staff receives \$25,000 a year. The cash balance plan has now been in place for 10 years. The interest crediting rate on this plan is 4% per year; over the first 10 years of the plan's life, the plan has earned exactly 4% (we are simplifying reality in this example to demonstrate a concept). An approximate breakdown of the cash balance plan's hypothetical accounts is illustrated in Fig. 1.

Now the plan experiences a loss of 20%. The actuary for the following year recommends a contribution of \$765,275. This amount is comprised of the \$225,000 pay credit plus 20% of the \$2,701,374 balance to keep the

FIG. 1: DISPARITY CONCERNS

	Balances	Percent of Total
Dick	\$1,800,916	67%
Jane	600,305	22
Staff	300,153	11
Total	2,701,374	100

plan fully funded. For simplicity's sake, we are going to assume that the plan will be fully funded at all times. ERISA rules permit a plan's shortfall to be deferred for up to seven years; however, for the purpose of this example we will assume that the shortfall is funded in the year of occurrence. (A discussion of deferring the shortfall adds a layer of complexity when dealing with owners who might either join or leave the organization. Accordingly, amortizing a shortfall and dealing with adjustments to accommodate new or departing owners is a topic for a future article.)

Dick and Jane now need to decide how much they owe. When this is not specifically spelled out in the entity's operating agreement, often one owner will argue that the shortfall is a business expense and needs to be handled pro rata to the ownership percentage. The other owner will contend that each person is benefiting differently from the total, so splitting the cost based on an ownership percentage is unfair.

Unfortunately, this dilemma is rarely addressed on the front end, and can lead to problems later on. Businesses that do not have a clear answer to this problem often will freeze and/or terminate the cash balance plan, leading to internal conflict between the owners. In extreme circumstances this has led to businesses being split or dissolved and lawsuits being filed between business partners. This situation can be avoided but, as with most good ERISA consulting, it's best to address it before things actually happen. Disparity concerns need to be addressed in the business's operating agreement/bylaws/shareholder agreement, so there is no room for argument when circumstances change. Importantly, this kind of contractual work needs to meet the requirements of business law, the tax code and ERISA, so it is imperative to have revisions to the business operating agreement drafted and

reviewed by both a business attorney and an ERISA attorney.

MAKING THE ALLOCATION RECOMMENDATION

So back to the question, who owes what? There are three parts to the recommendation that each owner needs to account for:

- 1st portion: Their own pay credit (\$150,000 for Dick and \$50,000 for Jane)
- 2nd portion: The staff's pay credit (\$25,000)
- 3rd portion: The shortfall/surplus created by the investment loss/gain (\$540,275)

The first portion of the recommendation is easy: Each owner should be responsible for his or her own pay credit. Dick would pay \$150,000 and Jane would pay \$50,000.

The second portion of the recommendation is best apportioned by the ownership percentage of the business, like a traditional business cost. Dick and Jane both own equal shares in the business so they should share that amount equally — Dick and Jane would each pay \$12,500 for the staff's pay credit out of their share of operating income.

The final portion of the recommendation is based on investment gain/loss on existing balances. The accrued benefits owed to participants in the plan will not change. However, the plan will either have a surplus or a shortfall. Typically a surplus belongs to the plan sponsor (the business) and it can decide how to deal with it at the time of plan termination — *i.e.*, either transfer to a

defined contribution plan or revert back to the company (with a steep excise tax due).

DEALING WITH A SHORTFALL

A shortfall has unique issues, however. If the plan is terminated, the owners would need to contribute additional funds to provide the promised benefits. If the business is in financial difficulty, it may be possible for the owners to waive a portion of their accrued benefit to make the plan fully funded. In either case, how is the additional funding amount or the waiver to be applied among the business owners? The plan documents rarely address this. Neither do typical partnership or shareholder agreements. Some alternatives:

- pro rata based on ownership;
- pro rata based on the present value of each owner's accrued benefit; or
- pro rata based on cumulative contributions on behalf of each owner.

There is no right or wrong answer to this question. A cash balance is a defined benefit plan and therefore a pooled investment vehicle. The pooled investments pay for each participant's (owners included) benefit and everyone is going to get paid at the end of the day (unless majority owners waive a portion of their benefit, as referenced above). This is where a discussion needs to occur and a decision made on how these expenses will be allocated before a cash balance plan is ever set up.

For the sake of simplicity, let's assume that the owners decide on the easiest calculation method. The owners decide that losses/gains are

FIG. 2: RECOMMENDED ALLOCATIONS

Recommended Contribution	Dick	Jane	Total
1st Portion	150,000	50,000	200,000
2nd Portion	12,500	12,500	25,000
3rd Portion	391,699	148,576	540,275
Total	554,199	211,076	765,275

going to be allocated on a pro rata basis from all accounts. Under this scenario, 11% of the balances belong to the staff. Therefore 5.5% of the loss needs to be covered by each owner. Sixty-seven percent of the balance already belongs to Dick. Therefore, Dick needs to cover any unallocated loss at his 67% rate. Additionally, 22% of the balance belongs to Jane, and therefore she needs to cover any unallocated loss at her 22% rate. In aggregate, Dick needs to cover 72.5% of the loss and Jane needs to cover 27.5% of the loss. In our example involving Typical Company, the loss equals \$540,275. Allocated according to the aforementioned percentages and added to the two other portions of the recommendation, Fig. 2 provides a breakdown of the \$765,275

recommended contribution.

With this clearly defined method in place, Dick and Jane can focus on more important things — like running their business. While ideally this is a concern that a cash balance plan will not encounter, understanding that it is possible and preparing for the worst will add significant value to your consulting practice and alleviate potential issues before they arise. **PC**



John Frisvold is a regional VP with Trademark Capital Management, a boutique investment firm specializing in protecting investors from large losses during inevitable periods of risk. Trademark incorporates this idea in

products such as a target date fund series, cash balance investment solution and separately managed accounts.



Jeff Cairns is a partner with the law firm Stinson Leonard Street LLP in Minneapolis.

He advises employers on ERISA and employee benefit matters, including qualified and nonqualified pension and profit sharing plans, ESOPs, welfare and fringe benefit plans.

» ERISA's Bond Requirement – An Overview (continued from page 11)

and employees) and then externally (e.g., at investment managers, plan administrators and other service providers). ERISA bonds have historically been inexpensive and it has been comparatively easy to obtain a bond covering all “inside” persons. Third party service providers have differing approaches to ERISA bonds. Some service providers maintain their own ERISA bonds; others ask that the plan add the service provider to the plan’s bond. Although compliance with ERISA’s bond requirement is a fiduciary matter, maintaining and paying for the bond is often negotiated.

The consequences of failing to have a bond will vary from having to obtain a bond to a court order to pay the plan for losses resulting from failing to have a bond. An obvious factor affecting the scope of relief is the scope of the violation (i.e., from a plan having no bond, to having a bond that does not cover all of the required persons, to having a bond that covers all required persons but

“The consequences of failing to have a bond will vary from having to obtain a bond to a court order to pay the plan for losses resulting from failing to have a bond.”

that is not in the correct amount). However, the most important factor is whether the plan has suffered a loss. Because an ERISA bond pays only in the event of theft or fraud, a plan suffers a loss only if a bonded person

has committed theft or fraud (or other bad acts) and the plan would have recovered had a bond been in place. But even if the plan has a loss from a bond failure, that loss can never be more than \$500,000 (or \$1 million, if the plan holds employer securities).

This is not to suggest that the bond requirement should be taken lightly. The bond requirement provides some protection from criminal and near-criminal conduct. A fiduciary’s failure to maintain a bond is a violation of ERISA in and of itself but it may also be used to argue that the fiduciary acted imprudently. **PC**

This article is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. ©David Pickle, 2015. Used by permission.

David Pickle is a partner at K&L Gates in Washington, D.C.