

Cash Balance Plans Become the New 401(k) for Law Firms

Dan Kravitz*

With an increasing number of attorneys bumping up against their maximum contributions for 401(k) and profit sharing plans, more law firms are turning to cash balance plans to help shareholders/partners increase their pre-tax contributions.

The Employee Retirement Income Security Act of 1974 and subsequent amendments, known as ERISA, established minimum standards for private industry pension plans. ERISA paved the way for the Internal Revenue Code to add Section 401(k) in 1978, which caused an explosion in pension plans that were less expensive to maintain than a plan for each retired worker. As defined contribution plans, 401(k)s created a predictable cost for employers, while the cost of their forerunners, defined benefit plans, could vary from year to year. While a defined contribution plan sets an expected contribution level, a defined benefit plan establishes the benefit level, which may be for the lifetime of the employee with estimates based on economic and financial assumptions—variables that could swell the employer's costs.

As the fastest-growing retirement plan in the United States, 401(k) plans are oftentimes the first qualified retirement plan that a firm adopts. In years with strong profits, employers can make matching or profit sharing contributions and reduce or eliminate them in bad years. Employers pay plan administration costs if they elect not to match employee contributions or make profit sharing contributions. In addition, some or all of the plan administration costs can be passed on to plan participants. All of these factors make 401(k) plans very attractive to employers.

Eligible 401(k) plan participants can contribute up to \$20,500, depending on the participant's age. A profit-sharing plan allows employers to contribute another \$30,500 on behalf of the participant. However, once the annual maximum contribution has been reached (\$51,000 for those 50 years of age and over, or \$46,000 for those under 50 years of age for plan years ending in 2008), then no further contributions can be made for that participant on a pre-tax basis.

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As retirees are living longer and need more funds to sustain their lifestyles, a pension plan known as the cash balance plan is the answer to building additional retirement monies. A cash balance plan contribution can be as much as \$200,000 per year. For individuals making in excess of \$250,000 per year and who have a need for additional tax deductions, a cash balance plan provides a welcome respite from the lower retirement plan contribution levels available through a 401(k) and/or profit sharing plan.

As a hybrid plan, a cash balance plan combines the features of defined benefit and defined contribution plans. Treated as a defined benefit plan for tax, accounting, and regulatory purposes, the investment risk is borne by the plan sponsor. As with defined contribution plans, cash balance plan participants have account balances that can be paid out or rolled-over upon termination of employment.

A cash balance plan specifies both the contribution to be credited annually to each participant and the interest rate to be credited annually based on those contributions. Each participant has an account that resembles those in a 401(k) or profit sharing plan. The accounts are maintained by the plan actuary, who generates annual participant statements. Similar to 401(k) plans, cash balance plans are qualified plans in that the plans “qualify” for tax deferral and creditor protection under ERISA. Qualified plan assets are protected from creditors in the event of bankruptcy.

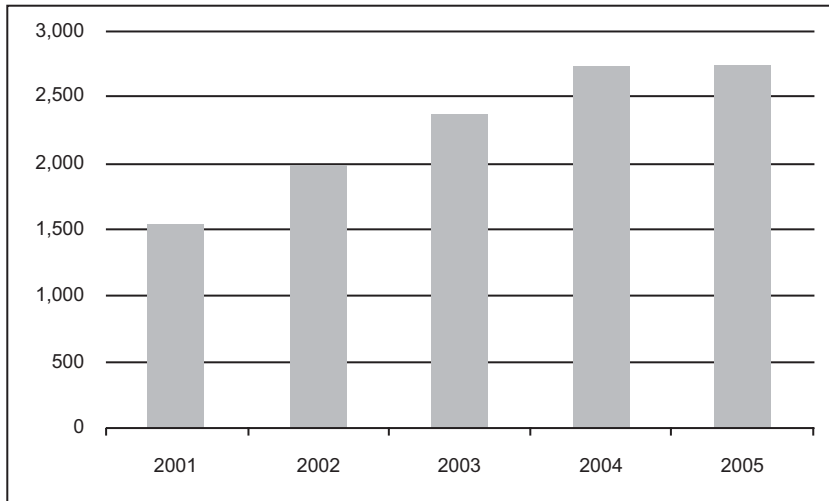
Since 1985 when BankAmerica Corporation implemented the first cash balance plan, thousands of companies have followed suit. Citing predictability and ease of administration, firms originally opted for cash balance plans because of their portability, which was used to attract employees, especially the young mobile workforce in high-turnover industries.

Initially, large corporations with more than 10,000 employees, such as AT&T, Bell Atlantic and IBM, converted their traditional defined benefit plans into cash balance plans. However, a change in the tax law in 2001 allowed contributions to increase by as much as 60%, making cash balance plans much more attractive to successful businesses and professional service firms. The Pension Protection Act of 2006 further cemented the future of cash balance plans by allowing for substantial increases in contributions and tax savings.¹ The law also set new cash balance plans apart from the initial cash balance conversions of the larger companies such as IBM by acknowledging that cash balance plans are not inherently age-discriminatory.

As of 2005 when the latest statistics are available, nearly 3,000 cash balance plans cover over 10 million participants with nearly \$500 billion in assets (See Figure 1: Number of Total Cash Balance Plans by Year).

¹ PL 109-280 (August 17, 2006).

Figure 1: Number of Total Cash Balance Plans by Year (courtesy of Judy Diamond & Associates)



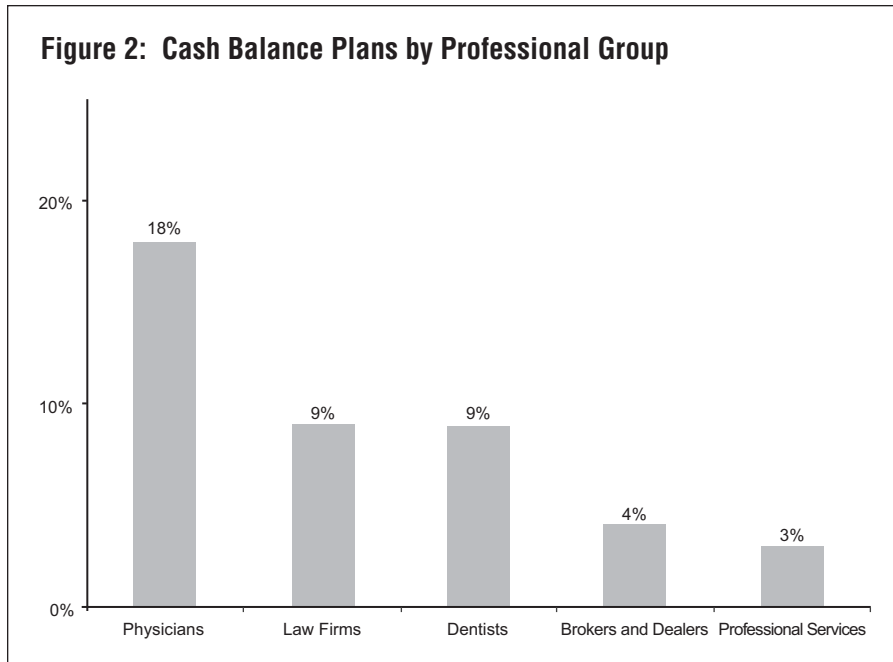
The types of businesses that are candidates for cash balance plans include professional service businesses such as CPA and law firms, medical groups, and family or closely-held businesses where there are a number of owners who are at their 401(k) and profit sharing contribution limits.

Law Firms Are One of the Cash Balance Plan Leaders

Over 40% of cash balance plans are in physician, law, dental, broker/dealer and professional service firms with law firms representing nine percent of all cash balance plans in the United States as of 2005 (see Figure 2: Cash Balance Plans By Professional Group).

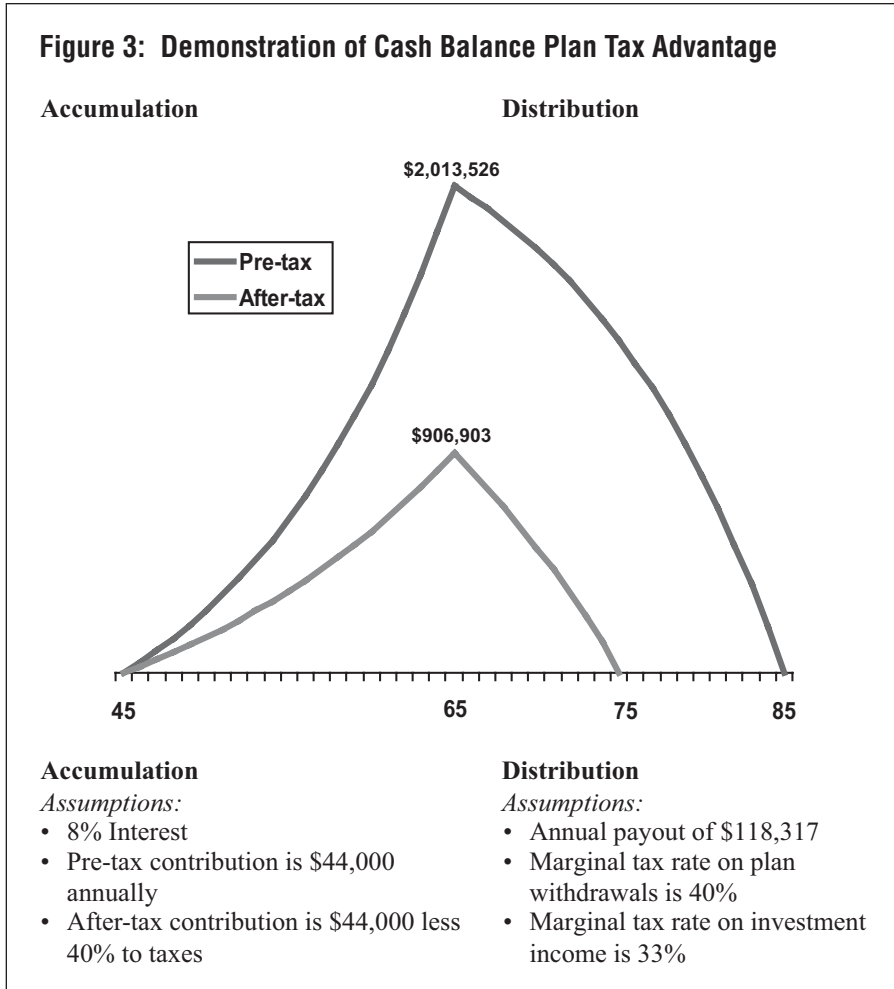
Law firms that are good candidates for cash balance plans have one or more of the following characteristics:

1. *Shareholders/partners who desire to contribute more than \$46,000 per year (participants 50 years or older can contribute \$51,000 per year).* Owners may neglect their personal pension plans while they are building their businesses. Consequently, they need to catch up on their retirement savings. In addition, many profitable firms need tax deductions and \$46,000 from the 401(k) and profit sharing plans is not enough. A cash balance plan allows for both an acceleration of savings and a large tax deduction.



2. *Shareholders/partners over 40 years of age who desire increased tax deductions or wish to catch up on their pension savings.* The maximum contributions allowed in cash balance plans are age dependent. Therefore, the older the participants, the faster they can accelerate their savings.
3. *Firms that are already contributing 3% or more to employees' accounts or are at least willing to do so.* While cash balance plans are often established for the benefit of shareholders/partners, employees also benefit. The plan normally provides a minimum contribution of 5% to 7% of pay for the firm's staff.
4. *Firms that have demonstrated consistent profit patterns.* Because a cash balance plan is a defined benefit plan with required contributions, a consistent cash flow and profit is important. Hence, cash balance plans may not be right for every firm, since they require a commitment to specific contribution levels for two to three years. It is important that a firm display consistent profit patterns in order to consider a cash balance plan.

One of the most attractive benefits of the cash balance plan is the tax advantage. Contributions are not taxed when they go into the plan. Interest on the investment is not taxed as it is earned. Only when a distribution is made is the money taxed. Hence, the investments grow tax-deferred. (See Figure 3: Demonstration of Cash Balance Plan Tax Advantage.)



Comparison Chart (with Retirement Plan)

Age	Beginning Balance	Contribution/ Distribution	Earnings	Ending Balance
45	0	44,000	0	44,000
46	44,000	44,000	3,520	91,520
47	91,520	44,000	7,322	142,842
48	142,842	44,000	11,427	198,269
49	198,269	44,000	15,862	258,130
50	258,130	44,000	20,650	322,781

(continued)

Comparison Chart (with Retirement Plan) (continued)				
Age	Beginning Balance	Contribution/ Distribution	Earnings	Ending Balance
51	322,781	44,000	25,822	392,603
52	392,603	44,000	31,408	468,012
53	468,012	44,000	37,441	549,453
54	549,453	44,000	43,956	637,409
55	637,409	44,000	50,993	732,401
56	732,401	44,000	58,592	834,994
57	834,994	44,000	66,799	945,793
58	945,793	44,000	75,663	1,065,456
59	1,065,456	44,000	85,237	1,194,693
60	1,194,693	44,000	95,575	1,334,268
61	1,334,268	44,000	106,741	1,485,010
62	1,485,010	44,000	118,801	1,647,811
63	1,647,811	44,000	131,825	1,823,636
64	1,823,636	44,000	145,891	2,013,526
65	2,013,526	-189,891	145,891	1,969,526
66	1,969,526	-189,891	142,371	1,922,006
67	1,922,006	-189,891	138,569	1,870,685
68	1,870,685	-189,891	134,464	1,815,258
69	1,815,258	-189,891	130,029	1,755,396
70	1,755,396	-189,891	125,240	1,690,746
71	1,690,746	-189,891	120,068	1,620,923
72	1,620,923	-189,891	114,483	1,545,515
73	1,545,515	-189,891	108,450	1,464,074
74	1,464,074	-189,891	101,935	1,376,118
75	1,376,118	-189,891	94,898	1,281,125
76	1,281,125	-189,891	87,299	1,178,533
77	1,178,533	-189,891	79,091	1,067,733
78	1,067,733	-189,891	70,227	948,070

Comparison Chart (with Retirement Plan) (continued)				
Age	Beginning Balance	Contribution/ Distribution	Earnings	Ending Balance
79	948,070	-189,891	60,654	818,833
80	818,833	-189,891	50,315	679,258
81	679,258	-189,891	39,149	528,516
82	528,516	-189,891	27,090	365,716
83	365,716	-189,891	14,066	189,891
84	189,891	-189,891	0	0
85	0	0	0	0

Comparison Chart (without Retirement Plan)				
Age	Beginning Balance	Deposit/ Withdrawal	Earnings	Ending Balance
45	0	26,400	0	26,400
46	26,400	26,400	1,415	54,215
47	54,215	26,400	2,906	83,521
48	83,521	26,400	4,477	114,398
49	114,398	26,400	6,132	146,929
50	146,929	26,400	7,875	181,205
51	181,205	26,400	9,713	217,317
52	217,317	26,400	11,648	255,366
53	255,366	26,400	13,688	295,453
54	295,453	26,400	15,836	337,690
55	337,690	26,400	18,100	382,190
56	382,190	26,400	20,485	429,075
57	429,075	26,400	22,998	478,473
58	478,473	26,400	25,646	530,520
59	530,520	26,400	28,436	585,355
60	585,355	26,400	31,375	643,131

(continued)

Comparison Chart (without Retirement Plan) (continued)				
Age	Beginning Balance	Deposit/ Withdrawal	Earnings	Ending Balance
61	643,131	26,400	34,472	704,002
62	704,002	26,400	37,735	768,137
63	768,137	26,400	41,172	835,709
64	835,709	26,400	44,794	906,903
65	906,903	-113,935	42,503	835,472
66	835,472	-113,935	38,674	760,211
67	760,211	-113,935	34,640	680,917
68	680,917	-113,935	30,390	597,373
69	597,373	-113,935	25,912	509,351
70	509,351	-113,935	21,194	416,611
71	416,611	-113,935	16,223	318,900
72	318,900	-113,935	10,986	215,951
73	215,951	-113,935	5,468	107,485
74	107,485	-107,485	0	0
75	0	0	0	0
76	0	0	0	0
77	0	0	0	0
78	0	0	0	0
79	0	0	0	0
80	0	0	0	0
81	0	0	0	0
82	0	0	0	0
83	0	0	0	0
84	0	0	0	0
85	0	0	0	0

Tax deductions for contributions to cash balance plans are similar to other tax qualified retirement plans. Contributions by a partnership to a cash balance plan are allocated like other firm expenses (in proportion to ownership) unless the partnership agreement provides otherwise. Partnership agreements may need to be amended so that the contribution is allocated in proportion to each partner's plan benefit.

Another advantage of the cash balance plan over the traditional defined benefit plan is that shareholders/partners know what is going into the plan on their behalf and what will come out when they leave. When shareholders/partners reduce their compensation to contribute to a retirement plan, it is imperative that they feel assured that when they leave the firm what they put into the plan will come out along with interest.

Because they are not profit sharing plans under which contributions can vary year to year depending upon profitability, cash balance plans have to be amended in order to change contribution levels. Firms can designate different contribution amounts for various participants. However, the frequency of amendments to change benefits may be restricted in the absence of a valid business reason. For example, if a firm's profit is not expected to support the cash balance plan contribution, the plan can be amended. A cash balance plan can also be frozen or terminated.

The cash balance plan document specifies the amount of contribution to be credited to each participant. The contribution can be either a flat dollar amount or a percentage of pay. The plan credits interest on those contributions at a guaranteed rate. Each participant's individual account is maintained by the plan actuary who generates annual participant statements. Once participants terminate employment, they are eligible to receive the vested portion of their account balance, which is determined by the plan's vesting schedule.

The guaranteed rate of return is spelled out in the plan document and is not dependent on the plan's investment performance. The rate of return changes each year as a floating benchmark and for many plans is equal to the yield on the 30-year Treasury bond, which in recent years has been around five percent.

The investment strategy for a cash balance plan is different from other types of retirement plans. The cash balance plan investment portfolio is established with a risk and reward equilibrium appropriate for firm and participant characteristics. However, by the very nature of the cash balance plan, the risk and reward balance mandates changes as the portfolio matures. As the assets in the cash balance plan portfolio grow, the greater the impact the investment returns have on future contributions. For example, if investment returns exceed the guaranteed interest credit rate, contributions in the following year are reduced. (There are exceptions to this rule, but only when the plan assets have become substantial and the investment

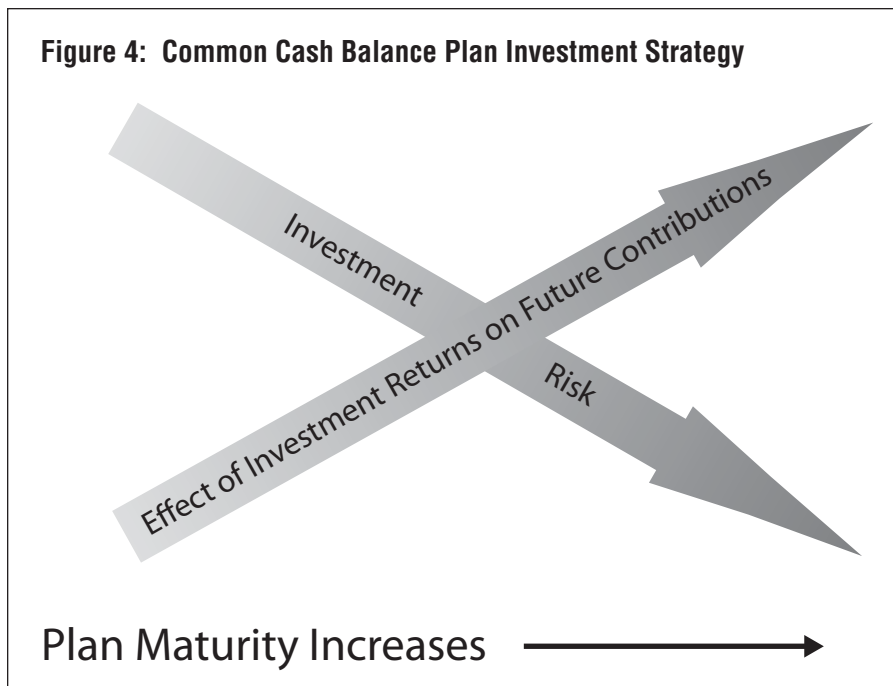
returns lead to dollar values that are actually greater than next year's entire contribution.)

If investment returns are below the interest credit rate (i.e. 30-year Treasury bond), future contributions are increased to make the difference. Shortfalls are typically amortized over seven years. For shareholders/partners, this can be a double edged sword; they receive a larger tax deduction and put in more money for themselves, but they also must put in more money for the other participants, as well.

Second, if another shareholder/partner leaves during a period where the plan is underfunded, that leaving person still receives his or her full benefit. However, that person will not make the extra contributions that are required due to the underfunding over the next seven years. The remaining shareholders/partners are responsible for making up the difference.

To avoid the ramifications of under and over investment returns, risk should be reduced over time. Although most cash balance plan portfolio strategies are for the life of the plan, innovative investment advisors have created specific portfolios to address the changing issues of a maturing cash balance plan. (See Figure 4: Common Cash Balance Plan Investment Strategy)

As the cash balance plan investment portfolio becomes increasingly conservative as the portfolio matures, the investment strategy should strive to hit the interest credit rate plus fees with as little risk as possible. During a



period where the plan is less mature and the added incremental risk can be tolerated by the cash balance plan, the investment strategy could be focused on surpassing the interest crediting rate.

Major variables in deciding on the portfolio investment strategy include the following:

Plan Interest Credit Rate. There are seven different interest crediting rates outlined in IRS proposed regulations available for use by cash balance plan sponsors.² All seven are tied to the yield on a fixed income instrument, for example the 30-year U.S. Treasury Bond.³ This number is expected to increase with the inclusion of interest credit rates that have an equity component. The development of an investment strategy for a cash balance plan must factor in which interest credit rate is being used inside a cash balance plan.

Risk Tolerance. After determining the amount of risk that plan sponsors can bear and targeting a specific standard deviation, the portfolio construction changes.

Plan Maturity. Investment returns have a greater impact on future contributions as the plan matures.

² Under Prop. Reg. 1.411(b)(5)-1(d)(1)(ii):

For purposes of this paragraph (d), a plan’s interest crediting rate means the rate by which a participant’s benefit is increased under the ongoing terms of the plan to the extent the amount of the increase is not conditioned on current service, regardless of how the amount of that increase is calculated. The amount of such an increase is an interest credit. Thus, whether the amount is an interest credit for this purpose is determined without regard to whether the amount is calculated by reference to a rate of interest, a rate of return, an index, or otherwise.

72 Fed. Reg. 73680 (December 28, 2007).

³ Safe harbors under Prop. Reg. 1.411(b)(5)-1(d)(5) deem an interest crediting rate to be not in excess of a market rate of return if the rate is adjusted at least annually and is equal to the sum of any of the following rates of interest for Treasury bonds and the associated margin for that interest rate:

Treasury bond interest rates	Associated margin
Discount rate on 3-month Treasury bills	175 basis points
Discount rate on 12-month or shorter Treasury bills	150 basis points
Yield on 1-year Treasury Constant Maturities	100 basis points
Yield on 3-year or shorter Treasury bonds	50 basis points
Yield on 7-year or shorter Treasury bonds	25 basis points
Yield on 30-year or shorter Treasury bonds	0 basis points

Liquidity Events. When participants leave the firm or retire, the plan has to pay the participants their vested amounts, so the portfolio needs to change to support these types of events.

Employee Turnover. Similarly, if employee turnover is high, the plan will experience increased distributions, so the portfolio may need to have a more conservative investment strategy to insure specific returns.

Cash Flow Generation. Cash balance plans are not profit sharing plans where annual contributions are discretionary. If the plan sponsor's business is cyclical or the economy is heading into a recession, then the cash balance investment portfolio may need to be more conservative. A more aggressive portfolio may lead to larger underperformance during an adverse market. This would result in higher future contributions during a period of time where it may be difficult for the plan sponsor. On the other hand, if the firm is very profitable, then the portfolio can take more risk.

These major variables, and others, fuel the asset allocation computer models that determine the timing as the cash balance plan investments migrate across maturity portfolios that differ in their risk and reward relationship.

For law firms with shareholders/partners who are interested in increasing their pre-tax contributions to pension plans, the cash balance plan is an excellent vehicle. Figure 5 provides estimated amounts that individuals can contribute to a 401(k) plan, profit sharing plan, and cash balance plan in 2008.⁴

401(k), Profit Sharing & Cash Balance Plans				
Age	401(k) only	401(k) with Profit Sharing	Cash Balance	TOTAL
65	\$20,500	\$51,000	\$188,000	\$239,000
64	\$20,500	\$51,000	\$193,000	\$244,000
63	\$20,500	\$51,000	\$197,000	\$248,000
62	\$20,500	\$51,000	\$202,000	\$253,000
61	\$20,500	\$51,000	\$191,000	\$242,000

(continued)

⁴ The limits are estimates based on rules for 2007. Rules for 2008 had not been finalized as of this writing.

Figure 5: 2008 Estimated Plan Contribution Limits* (continued)

401(k), Profit Sharing & Cash Balance Plans

Age	401(k) only	401(k) with Profit Sharing	Cash Balance	TOTAL
60	\$20,500	\$51,000	\$181,000	\$232,000
59	\$20,500	\$51,000	\$172,000	\$223,000
58	\$20,500	\$51,000	\$163,000	\$214,000
57	\$20,500	\$51,000	\$154,000	\$205,000
56	\$20,500	\$51,000	\$146,000	\$197,000
55	\$20,500	\$51,000	\$138,000	\$189,000
54	\$20,500	\$51,000	\$131,000	\$182,000
53	\$20,500	\$51,000	\$124,000	\$175,000
52	\$20,500	\$51,000	\$118,000	\$169,000
51	\$20,500	\$51,000	\$112,000	\$163,000
50	\$20,500	\$51,000	\$106,000	\$157,000
49	\$15,500	\$46,000	\$100,000	\$146,000
48	\$15,500	\$46,000	\$95,000	\$141,000
47	\$15,500	\$46,000	\$90,000	\$136,000
46	\$15,500	\$46,000	\$85,000	\$131,000
45	\$15,500	\$46,000	\$81,000	\$127,000
44	\$15,500	\$46,000	\$77,000	\$123,000
43	\$15,500	\$46,000	\$73,000	\$119,000
42	\$15,500	\$46,000	\$69,000	\$115,000
41	\$15,500	\$46,000	\$65,000	\$111,000
40	\$15,500	\$46,000	\$62,000	\$108,000
39	\$15,500	\$46,000	\$59,000	\$105,000
38	\$15,500	\$46,000	\$56,000	\$102,000
37	\$15,500	\$46,000	\$53,000	\$99,000
36	\$15,500	\$46,000	\$50,000	\$96,000
35	\$15,500	\$46,000	\$47,000	\$93,000
34	\$15,500	\$46,000	\$45,000	\$91,000

(continued)

Figure 5: 2008 Estimated Plan Contribution Limits* (continued)				
401(k), Profit Sharing & Cash Balance Plans				
Age	401(k) only	401(k) with Profit Sharing	Cash Balance	TOTAL
33	\$15,500	\$46,000	\$43,000	\$89,000
32	\$15,500	\$46,000	\$40,000	\$86,000
31	\$15,500	\$46,000	\$38,000	\$84,000

* These limits are estimates based on the rules that were in effect for 2007. The rules for 2008 have not yet been finalized.