Cash Balance Defined Benefit Plans

A Cash Balance Plan is a defined benefit plan with characteristics similar to a defined contribution plan (profit-sharing plan). Contributions are made by the employer to a participant's "hypothetical" account based on a predefined formula in the plan. The hypothetical account grows based on annual interest credit and future contributions.

The allocation formula, or the amount of contribution to each participant, is based on groupings of participants. This offers the potential to have a different allocation or contribution rate for different groups of employees depending on the goals of the employer. The scope of the different allocation or contribution rates in each group is strongly dependent on the demographics of the company (ages of employees) due to required non-discrimination testing. Allocation or contribution rates are most commonly stated as a percentage of salary, or a flat dollar amount, and are not based on years of service with the company.

Cash Balance Plans are used by businesses looking for maximum tax deductions and large retirement funding for owners, partners and key employees. Since a Cash Balance Plan is a Defined Benefit Plan, deduction limits are based on actuarial funding rather than a fixed dollar limitation. This allows the employer to make larger contributions and receive increased deductions in comparison to a Defined Contribution Plan such as a profit-sharing or 401(k) plan.

CASH BALANCE ALLOCATIONS AND HYPOTHETICAL ACCOUNT BALANCES

According to the plan's design, an annual contribution is made to each participant's hypothetical account. A hypothetical account is a term used to describe each participant's benefit in the plan. Allocations to this hypothetical account are credited with interest each year. This may be a fixed interest rate or a commonly used indexed interest rate, such as a 30-year Treasury rate. This rate is defined in the Plan Document.

YEAR	CONTRIBUTION	HYPOTHETICAL ACCOUNT BALANCE
1	$1,000	$6,000
2	$50 interest credit + *$1,000*	$1,050 *$2,050*
3	$102.50 interest credit + *$1,000*	$2,152.50 *$3,152.50*
▼	▼	▼
15	**$1,000**	**$21,579***

Upon retirement in 15 years, this participant will receive $21,579

PLAN FUNDING

Cash Balance Plans are fully funded by the employer. No employee contributions are permitted in the plan. The amount of the actual contributions are determined by the actuary based on allocations to employees' hypothetical accounts less any funding credits or plus any funding shortfalls. A funding credit occurs when the plan's assets exceed the total value of all employees' hypothetical accounts. A shortfall occurs when the plan's assets are less than the total value of all employees' hypothetical accounts.

The employer assumes all investment risk. Participants' hypothetical account balances are not affected by gains or losses in the plan's assets. This may initially sound discouraging to some employers, though for several reasons it should not be.

First, many Cash Balance Plans are designed to allocate most of the dollars contributed to the owners, partners and key employees. Those same people are often the plan's investment decision-makers. Therefore, investment policies can be created according to the risk tolerances of those with the largest account balances. These individuals can do this while keeping in focus the plan's health and the company's objectives.

Second, if losses do occur (a loss is considered any return less than the credited interest rate on a cumulative basis), an additional contribution is made to help make up for them. In this case the actual contribution to the plan may be higher than the dollars allocated to participant's accounts. This additional contribution is **tax-deductible**.

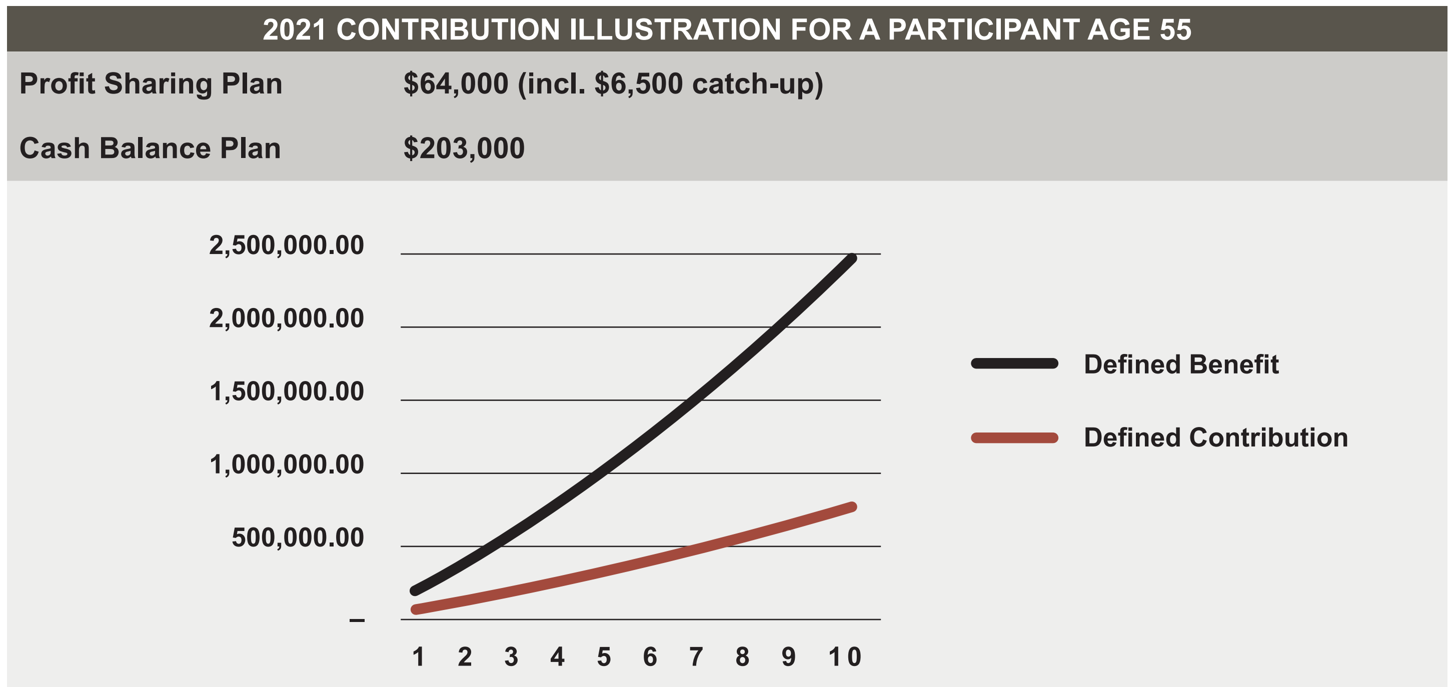
Compare this to a profit-sharing or a 401(k) plan that has fixed annual maximum contribution limits. When accounts in these plans decrease in value, the subsequent year's contribution is limited to the maximum contribution and does not allow a make-up contribution for the shortfall due to decreased account balances. Unlike the fixed contribution limits of profit-sharing and 401(k) plans, a Cash Balance Plan has the unique feature of allowing tax-deductible employer contributions to make up for any losses that occur in the plan's assets. Again, with the highly compensated employees' or owners' accounts being the largest, this allows them to make up for losses on a tax-deductible basis.

Finally, funding of a Cash Balance Plan is much more predictable than a traditional Defined Benefit Plan. With allocation or contribution rates and the credited interest rate stated in the plan's document, liabilities are consistent and transparent. An investment strategy can be developed to meet or exceed these liabilities. Over time, a plan's assets can exceed the value necessary to fund all the liabilities or hypothetical account balances in the plan. In that situation, the actual annual contribution may be lower than the total allocations to participant's hypothetical accounts. For example, a participant's hypothetical account may be credited with 4% of salary, but in actual deductible contribution dollars it may only cost the employer 3.5% of the participant's salary.

There is a common concern regarding credited interest. The concern is that a participant's hypothetical account is only credited with a fixed, usually conservative, rate of return. This is of particular interest to the owners, partners and key employees as their accounts are the largest.

The nature of funding in a Cash Balance Plan answers this concern. As the actual return on assets continually exceeds the plan's interest credit, the required contribution also goes down, thus fewer contributions are required to have the same hypothetical account balance at retirement.

For example: A hypothetical account balance is expected to be $1,000,000 at retirement based on an annual allocation or contribution of 20% of a participant's salary. When the earnings on the plan's assets exceed the credited interest rate, then only a 12% annual allocation or contribution may be needed to achieve $1,000,000 at retirement. The excess return translates into a savings of 8% of a participant's salary.



2021 CONTRIBUTION ILLUSTRATION FOR A PARTICIPANT AGE 55	
Profit Sharing Plan	**$64,000 (incl. $6,500 catch-up)**
Cash Balance Plan	**$203,000**

Growth over 10 years with a return or credited interest of 5% annually

PLAN DESIGN

Cash Balance Plans differ from traditional Defined Benefit Plans in several ways. One of the most important and a distinct difference is design flexibility.

For example, three partners wish to have contributions made on their behalves to a Cash Balance Plan; one would like to contribute 50% of his salary, the other 30% of her salary and the third wants to receive nothing. This can easily be done in a Cash Balance Plan.

The plan design options are heavily influenced by the demographics of the company and the goals of the employer. There are numerous options and customizations, including aggregating with a new comparability (cross-tested) plan and utilizing 401(k) features. Combining two plans allows employers to use the best features of both while adding some flexibility to the overall plan design.

Cash Balance Plans are typically utilized by companies from three to several hundred employees. Even in very large groups, there is the ability to target certain employees. This makes a Cash Balance Plan a very attractive tool in plan designs.

COMMON QUESTIONS

Q: Can I change my contribution level every year?

A: Generally, no. An amendment is required to change contribution levels. Though with many combination plan designs, a range of contribution levels is available without amendments. There can be flexibility with the proper plan design.

Q: Is my Cash Balance benefit protected from creditors?

A: Yes, as qualified plan assets under ERISA.

Q: Is a Cash Balance Plan required to be covered under the PBGC (Pension Benefit Guarantee Corporation)?

A: Yes, a Cash Balance Plan is a Defined Benefit Plan with a promised benefit. Exceptions do apply for certain types of employers, such as a professional service corporation.

Q: Is a Cash Balance Plan legal?

A: Yes. The Pension Protection Act of 2006 specifically addresses Cash Balance Plans and makes it clear that they do not violate federal age-discrimination laws.

Q: What happens to my current 401(k) Plan?

A: Nothing. In many cases, existing plans are used in conjunction with a Cash Balance Plan to create the best overall plan design. An example is the Combination Plan on the following page.

CASH BALANCE PLAN				
	Age	Pay	Cash Balance Contribution	% of Total
Owner	50	280,000	158,000	90%
HCE 1	53	280,000	0	
NHCE1	37	52,300	6,974	
NHCE2	29	18,800	5,452	
NHCE3	34	28,600	3,490	
			173,916	

HCE = highly compensated employee

NHCE = non-highly compensated employee

HCE1 can receive a contribution as well, but this is an example of an extreme shift to the owner.

COMBINATION PLAN							
	Age	Pay	401(k) Contribution	Profit Sharing	Cash Balance	Total	% of Total
Owner	50	280,000	25,000	17,640	158,000	200,640	96%
HCE 1	53	280,000	0	0	0	0	
NHCE1	37	52,300	0	2,615	1,569	4,184	
NHCE2	29	18,800	0	940	564	1,504	
NHCE3	34	28,600	0	1,430	858	2,288	
						208,616	

A Combination Plan is actually two plans. A New Comparability Safe Harbor 401(k) Plan and a Cash Balance Plan. The plans are aggregated for testing. Because the plan is Safe Harbor, it does not hurt the plan if employees elect not to participate in the 401(k).

NOTES

Additional information can be found on the Department of Labor's web site at the following address:

www.dol.gov/ebsa/publications/cb_pension_plans.html