

Cash Balance Plans

More professional practices (and practice groups) should look into them.

In corporate America, pension plans are fading away: 59% of Fortune 500 companies offered them to new hires in 1998, but by 2015, only 20% did. In contrast, some legal, medical, accounting, and engineering firms are keeping the spirit of the traditional pension plan alive by adopting cash balance plans.¹

Owners and partners of these highly profitable businesses sometimes get a late start on retirement planning. Cash balance plans give them a chance to catch up. Contributions to these defined benefit plans are age dependent: the older you are, the more you can potentially sock away each year for retirement. In 2016, a 55-year-old could defer as much as \$180,000 a year into a cash balance plan; a 65-year-old, as much as \$245,000.²

These plans are not for every business as they demand consistent contributions from the plan sponsor. Yet, they may prove less expensive to a company than a classic pension plan, and offer significantly greater funding flexibility and employee benefits compared to a defined contribution plan, such as a 401(k).^{2,3,4,5}

How does a cash balance plan differ from a traditional pension plan? In a cash balance plan, a business or professional practice maintains an account for each employee with a hypothetical “balance” of pay credits (i.e., employer contributions) plus interest credits. There can be no discrimination in favor of partners, executives, or older employees; the owner(s) have to be able to make contributions for other employees as well. The plan pays out a pension-style monthly income stream to the participant at retirement – either a set dollar amount or a percentage of compensation. Lump-sum payouts are also an option.^{3,4}

Each year, a plan participant receives a pay credit equaling 5-8% of his or her compensation, augmented by an interest credit commonly linked to the performance of an equity index or the yield of the 30-year Treasury (the investment credit can be variable or fixed). Cash balance plans are commonly portable: the vested portion of the account balance can be paid out if an employee leaves before a retirement date.²

As an example of how credits are accrued, let’s say an employee named Joe Green earns \$75,000 annually at the XYZ Group. He participates in a cash balance plan that provides a 5% annual salary credit and a 5% annual interest credit once there is a balance. Joe’s first-year pay credit would be \$3,750 with no interest credit as there was no balance in his hypothetical account at the start of his first year of participation. For year two (assuming no raises), Joe would get another \$3,750 pay credit and an interest credit of $\$3,750 \times 5\% = \187.50 . So, at the end of two years of participation, his hypothetical account would have a balance of \$7,687.50.

An employer takes on considerable responsibility with a cash balance plan. It must make annual contributions to the plan, and an actuary must determine the minimum yearly

contribution to keep the plan appropriately funded. The employer effectively assumes the investment risk, not the employee. For example, if the plan says it will award participants a fixed 5% interest credit each year, and asset performance does not generate that large a credit, the employer may have to contribute more to the plan to fulfill its promise. The employer and the financial professional consulting the employer about the plan determine the investment choices, which usually lean conservative.^{2,4}

Employer contributions to the plan for a given tax year must be made by the federal income tax deadline for that year (plus extensions). Funding the plan before the end of a calendar year is fine; the employer just needs to understand that any overage will represent contributions not tax-deductible. The plan must cover at least 50 employees or 40% of the firm's workforce.⁴

Cash balance plans typically cost a company between \$2,000-5,000 to create and between \$2,000-10,000 per year to run. That may seem expensive, but a cash balance plan offers owners the potential to keep excess profits earned above the annual interest credit owed to employees. Another perk is that cash balance plans can be used in tandem with 401(k) plans.^{3,4,5}

These plans can be structured to reward owners appropriately. When a traditional defined benefit plan uses a safe harbor formula, rank-and-file employees may be rewarded more than owners and executives would prefer. Cash balance plan formulas can remedy this situation.⁵

Benefit allocations are based on career average pay, not just "the best years." In a traditional defined benefit plan, the eventual benefit is based on a 3- to 5-year average of peak employee compensation multiplied by years of service. In a cash balance plan, the benefit is determined using an average of all years of compensation.⁵

Cash balance plans are less sensitive to interest rates than old-school pension plans. As rates rise and fall, liabilities in a traditional pension plan fluctuate. This opens a door to either overfunding or underfunding (and underfunding is a major risk right now with such low interest rates). By contrast, a cash balance plan has relatively minor variations in liability valuation.⁵

A cash balance plan cannot be administered with any degree of absentmindedness. It must pass yearly non-discrimination tests; it must be submitted for IRS approval every five years instead of every six. Obviously, a plan document must be drawn up and periodically amended, and there are the usual annual reporting requirements.⁵

Ideally, a cash balance plan is run by highly compensated employees (HCEs) of a firm who are within their prime earning years. Regarding non-discrimination, a company should try to aim for at least a 5:1 ratio – there should at least be 1 HCE plan participant for every 5 other plan participants. In the best-case scenario for non-discrimination testing, the HCEs are 10-15 years older than half (or more) of the company's workers.^{4,5}

If a worst-case scenario occurs and a company founders, cash balance plan participants have a degree of protection for their balances. Their benefits are insured up to their maximum value by the Pension Benefit Guaranty Corporation (PBGC). If a cash balance plan is terminated, plan participants can receive their balances as a lump sum, roll the money over into an IRA, or request that the plan sponsor transfer its liability to an insurer (with the pension benefits paid to the plan participant via an insurance contract).^{3,4}

Cash balance plans have grown increasingly popular. Some businesses have even adopted dual profit-sharing and cash balance plans. Maybe it is time for your firm to look into this intriguing alternative to the traditional pension plan.

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Citations.

1 - [reuters.com/article/us-column-miller-pensions-idUSKCN10M12L](https://www.reuters.com/article/us-column-miller-pensions-idUSKCN10M12L) [8/11/16]

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3 - [investopedia.com/articles/financial-advisors/092315/cash-balance-pensions-pros-cons-small-biz.asp](https://www.investopedia.com/articles/financial-advisors/092315/cash-balance-pensions-pros-cons-small-biz.asp) [9/23/15]

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