RETIREMENT PLAN SPONSOR'S GUIDE TO

CASH BALANCE PLANS

OVERVIEW OF CASH BALANCE PLANS

Back in the 1970's, companies that maintained qualified retirement programs were just as likely to have a defined benefit plan as a defined contribution (i.e. profit sharing) plan. The reason for this was that defined benefit plans provided larger benefits for older owners and executives and smaller benefits for younger employees than profit sharing plans could provide.

Beginning in 1980, however, an unbroken string of attacks by Congress hit defined benefit plans until by the early 1990's, they had virtually disappeared as a useful tool for providing retirement benefits. Among those disasters were the imposition of costly top-heavy rules, increasingly complicated and less flexible funding rules, new minimum lump sum rules and drastic reductions in the maximum benefit for owners and Highly Compensated Employees. Add to this the growth in popularity of 401(k) plans and the advent of New Comparability Plans which allowed for the skewing of contributions toward older employees within a Profit Sharing plan and it is easy to see why Defined Benefit plans were on the verge of extinction.

Over the past few years, however, the tide has begun to turn as new laws simplifying funding, increasing maximum benefits, and easing the top-heavy requirements have been passed. Like the Phoenix, defined benefit plans have risen from the ashes and the primary vehicle for this resurgence is the Cash Balance Plan. The reasons why this type of plan has proven to be so popular are discussed throughout this booklet but the best way to summarize their popularity is to say that except for slightly higher administrative expenses, the Cash Balance design is, in every way, equal to or better than the Standard Defined Benefit plan.

Also of importance is that various legal considerations involving cash balance plans have been resolved by the 2006 Pension Protection Act. The law unfortunately left the fate of certain older cash balance plans in the hands of the courts but new plans have clear "safe harbor" guidance.

Of course, Cash Balance plans are not for everyone. Most of the same laws that apply to Standard Defined Benefit plans also apply to Cash Balance Plans. In particular, companies should not adopt a Cash Balance Plan unless they anticipate a stable income for at least the near future. In addition, it is important to note that constant communication with the actuary must be maintained. Changes in employee population can have a major impact on plan design and, as a result, changes should be communicated to the actuary as they happen, not just at the end of the year.

The bottom line though, is that the Cash Balance design provides a dynamic option for achieving the savings objectives for your key employees and should be carefully considered when the standard 401(k) / profit sharing program is not enough.

STEPS IN DESIGNING A CASH BALANCE PLAN

1) **The “Wish List”:** The employer sets an overall budget, divides all employees into groups, and sets a desired level of contributions, either as a dollar amount or as a percentage of pay, for each group. This is known as the Wish List.

2) **Testing the Wish List:** Various tests are performed on the Wish List to make sure that all requirements of the Internal Revenue Code are met. If necessary, the Wish List is adjusted to conform to these requirements. The key requirements are as follows:

    a) **Non-discrimination (Internal Revenue Code Section 401(a)(4)):** The law requires that the benefits under a retirement program not discriminate in favor of Highly Compensated Employees. The test is very complex and, the results are somewhat unpredictable. Frequently, a retirement program which combines a 401(k) profit sharing plan with a Cash Balance plan can obtain very favorable results on the non-discrimination test.

    b) **Minimum Participation (IRC Section 401(a)(26)):** All defined benefit plans, including Cash Balance plans must cover a minimum number or percentage of the company’s employees. The minimum is the lesser of 50 employees or 40% of the employees who have at least 1 year of service.

    c) **Limit on Tax Deduction: (IRC Section 404):** Companies contributing to both a Cash Balance and a defined contribution plan (profit sharing or 401(k) matching) that are not covered by the Pension Guaranty Corporation typically cannot take a tax deduction of more than 31% of covered payroll. This limit is waived, however, if the profit sharing contribution is kept to 6% of payor less.

    d) **Individual Maximum Benefits (IRC Section 415):** This section limits the benefit that an individual can receive from the plan which, in turn, limits the contribution which can be made on behalf of that participant. Age plays a major role in determining that limit.

    e) **Minimum Funding Requirements (IRC Section 430):** This section requires all defined benefit plans to contribute at least a certain amount each year in order to achieve proper plan funding. While this amount is generally lower than the desired Pay Credits for the first year, it could in certain circumstances require that a higher amount be contributed.

3) **Final adjustments:** Once the Wish List has been modified to pass all applicable laws, a final proposal is prepared and, if approved, becomes the basis of the plan document.

CASH BALANCE PLAN FUNDING CONSIDERATIONS

1) DETERMINATION OF CASH BALANCE ACCOUNT

Each participant's account balance is determined according to the following formula:

a) **Account Balance at Beginning of Year.** For the first year of the plan, this amount is generally zero: plus

b) **Interest** on the beginning of year balance at either a fixed rate or a rate tied to a common market index (smaller companies typically use the fixed rate approach); plus

c) **The "Theoretical Contribution" or "Pay Credit"**, which is the amount set by the Plan document. This amount can be set at different amounts for different categories (set by the employer). That amount will normally be a fixed amount or a percentage of current year pay.

2) DETERMINATION OF ANNUAL CONTRIBUTION

Cash Balance plans must satisfy the same minimum funding requirements and maximum deductibility limits as all defined benefit plans. With recent changes in the funding rules, quite often a contribution of the total amount of the Pay Credits for the year will fall between the minimum required and the maximum tax-deductible limit. But that is not always the case.

3) FLEXIBILITY

It is critical that plan sponsors understand that cash balance plans, like all defined benefit plans, have a statutory minimum contribution requirement each year which must be determined by the plan actuary. That requirement can be adjusted, within limits, by amending the plan. Certain design techniques can also add some flexibility. For example, by defining a business owner's Pay Credit as a percentage of compensation rather than as a fixed dollar amount each year, the funding requirements will be reduced in years where compensation is lower and will again increase when compensation goes back up. In extreme cases, contributions can be significantly reduced, and possibly eliminated, by "freezing" plan benefits.

WHAT ELSE SHOULD A PLAN SPONSOR KNOW ABOUT CASH BALANCE PLANS

1) **Pension Benefit Guaranty Corporation (PBGC):** AIf the plan is subject to coverage by the PBGC, premiums must be paid each year to the PBGC**.** This amount is adjusted each year for the cost-of-living. If the plan becomes underfunded, an additional "variable rate" premium is charged. The PBGC is charged with making sure that participants receive the benefits that have been promised to them. **(Note that professional service corporations with less than 25 employees and plans covering only "substantial owners" are exempt from this coverage.)**

2) **Investment of Plan Assets:** All assets are invested on a "pooled" basis and cannot be individually directed. In general, investment gains reduce and investment losses increase the required contribution.

3) **Distributions from the Plan:** Participants may receive a distribution of their full account balance upon the earliest of termination of employment or, if the plan allows as early as age 59-1/2, provided that the plan is not underfunded as defined by law at the time of the distribution. The plan's funded percentage determines which, if any, restrictions on lump sum payouts might apply.

4) **Termination of Plan:** The plan will likely need to be fully funded when it terminates. Therefore, if investments do not meet the assumed rate of return, the company will be required to make up the difference. Another option is for "Substantial Owners" to waive enough of their benefits so that the plan has enough money to pay all remaining benefits. Owners with less than 50% ownership do not qualify as "Substantial Owners" under plans subject to PBGC coverage. Plans not covered by PBGC do not have this restriction.

5) **IRS Submission:** Because Cash Balance plans had been considered to be "individually designed", it was recommended, though not required, that they be submitted to IRS for approval. There was a separate IRS user fee required, in addition to the added expense of preparation of the submission. This is no longer required as Cash Balance Plans are now permitted to use pre-approved plan documents.

CASH BALANCE VS. STANDARD DEFINED BENEFIT

Maximum Benefit: While there is no specific limit on the amount that can be contributed to a defined benefit plan, there is a limit on the amount which can be paid to a participant. The limit is based on average compensation, age, and number of years of service and participation in a defined benefit plan. The limit on benefits is the same for Standard Defined Benefit plans and for Cash Balance plans. **ADVANTAGE: NONE**

Employee Cost: A qualified retirement plan is prohibited by law from discriminating in favor of Highly Compensated Employees. Standard Defined Benefit plans traditionally have met this requirement by giving all employees equal benefits. The result is that contributions required to provide these benefits are substantially higher for older employees than they are for younger employees. Cash Balance plans meet the non-discrimination requirements through a more complex set of rules which look at the average benefit that each group is receiving. Under this approach, the employee cost, especially for older employees, is generally much lower under the Cash Balance plan. **ADVANTAGE: CASH BALANCE**

Employee Communications: Employees in a Standard Defined Benefit plan receive an annual statement telling them about their projected benefit at their retirement age. Employees in a Cash Balance Plan receive an annual statement telling them how much is in their account today, similar to 401(k) or other "defined contribution" plans. Employees clearly understand how their benefit accumulate vs the complex formulas used in defined benefit plans. While some employees approaching retirement might be more interested in knowing their projected benefit, the great majority are far more interested in knowing how much they have today. Employers also like this because it allows them to let employees know how much the company is contributing on their behalf. **ADVANTAGE: CASH BALANCE**

Funding: Both plan types require that funds be accumulated to provide the benefits promised to employees. Accordingly, an actuarial calculation must be performed each year comparing plan assets to projected and accumulated plan liabilities to produce a minimum required and maximum tax-deductible contribution. In both plan designs contributions can fluctuate as plan assets increase but fluctuations tend to be greater in a Standard Defined Benefit plan as there are many more variables. **ADVANTAGE: CASH BALANCE**

Equalizing Contributions Between Partners: Benefits under a Standard Defined Benefit Plan formula are based on Salary, Years of Service, and age. It is therefore almost impossible to equalize contributions and benefits between partners of different ages. One of the key advantages of the Cash Balance Plan design is that Cash Balance accounts for partners can be kept equal even if the partners are different ages. Equal benefits allow for equal contributions. In fact, Cash Balance Plans can be designed to keep contributions between partners in any desired proportion. For example, the contributions could be set up to go 50% to Partner A, 30% to Partner B, and 20% to Partner C. When the plan ultimately terminates, the benefits payable from the plan will match up exactly with this 50/30/20 ratio. This type of planning with Partners of different ages is impossible in a Standard Defined Benefit Plan. This would apply to other employer-defined groups as well. **ADVANTAGE: CASH BALANCE**

CASH BALANCE VS. STANDARD DEFINED BENEFIT

Termination Liability: Cash Balance formulas are written so that upon termination, employees are entitled to a benefit equal to their Cash Balance account. Not so with Standard Defined Benefit plans where fluctuations in interest rates can cause large swings in the lump sum benefits to which employees are entitled. In fact, the recent decline in interest rates has contributed greatly to many Standard Defined Benefit plans becoming underfunded. As stated above, a plan that becomes underfunded cannot terminate unless either a) it is made whole, or b) the owners waive a portion of their benefits. So, many plan sponsors of Standard Defined Benefit plans have been saddled with liabilities they did not bargain for when the plan was established and can't even terminate the plan until the liabilities for all employees are fully funded. Cash Balance plans and Standard Defined Benefit plans can also become underfunded if plan assets do not meet the assumed rate of return. The nature of the formula in Cash Balance plans makes them immune to the fluctuations in liabilities which can have such a devastating impact on Standard Defined Benefit plans. Plan sponsors, therefore, have far more control over the costs and benefits in a Cash Balance plan than they do over the costs and benefits in a Standard Defined Benefit plan. **ADVANTAGE: CASH BALANCE**

Administrative Costs: In addition to the regular actuarial valuation required under both plan designs, Cash Balance also require that the complex non-discrimination test be performed annually. As a result, administrative fees tend to be higher under the Cash Balance plan design, but with the savings in employee cost the additional expense is often more than recovered. **ADVANTAGE: STANDARD DEFINED BENEFIT**

PBGC Premiums: Both plan designs are subject to paying annual premiums to the PBGC if the plan meets the PBGC coverage requirements. PBGC premiums increase based on the amount of the plan's unfunded liabilities. Standard Defined Benefit plans commonly grant credit for periods of service worked for the company prior to the plan's effective date in order to maximize benefits to the owners. Cash Balance Plans typically do not grant any credit for prior years and start with a $0 initial balance for all employees. As a result, Standard Defined Benefit plans often have large unfunded liabilities, especially in the early years of the plan. Cash Balance Plans do not have these initial liabilities and the plan balances are often fully funded on an ongoing basis. This results in much lower premium payments for PBGC coverage.
ADVANTAGE: CASH BALANCE

This Guide is intended as a brief overview and introduction to cash balance pension plans and is not to be considered as a fully comprehensive discussion of the topic. Please contact our office if you have any questions or require additional information.