TOPIC: Cash Balance Plans – The Basics.

MARKET TREND: With the concerns regarding retirement preparedness, certain employers are looking to a "hybrid" defined benefit form of retirement plan, the "cash balance plan," as a means of accumulating additional retirement assets for employees.

SYNOPSIS: Cash balance plans allow employers to provide defined benefit-type retirement plan deferrals while looking more like a defined contribution-type plan to ease employees' understanding. Cash balance plans are technically defined benefit pension plans under ERISA, but are allowed different benefit and funding requirements that are more flexible than traditional defined benefit plans. As ERISA pension plans, there are benefit limit, participation, and distribution requirements that apply.

TAKE AWAYS: Cash balance plans have become preferable to traditional defined benefit plans because of their greater predictability and enhanced employee understanding. These plans also can provide significant benefits to senior, more highly-compensated employees with less cost for other employees, as cash balance plans can allow for significant contributions for older, more highly-compensated employees. While many large employers have converted their traditional defined benefit plans to cash balance plans because of the greater cost predictability, these plans also can be exceptionally beneficial and cost-effective for small to mid-size employers and professional practices. A careful analysis of employee demographics, however, is necessary for an establishment determination and optimum design.

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WHAT ARE CASH BALANCE PLANS?

Cash balance plans are defined benefit pension plans under ERISA and are subject to the usual plan requirements:

- *Eligibility:* Immediate to two years of service.
- *Participation*: Percentage of employees required to benefit is a minimum of 40% or 50 employees, whichever is less.
- *Vesting:* Immediate to three years graduated; immediate for eligibility of more than one year.
- *Benefit / Contribution / Discrimination Limits:* Applicable.
- *Funding:* Funding minimums, actuary necessary.
- *Distribution*: Lump sums usual; annuities must be available.
- *Reporting*: Regular annual reporting.
- *Taxation*: Taxed when paid, unless rolled over.

WHY USE A CASH BALANCE PLAN?

Cash balance plans express benefits as cash balances instead of a monthly annuity for life, which makes them easier for employees to understand (annual participant statements showing a cash balance are provided). The benefits tend to be less expensive because the stated growth rate is usually less than traditional pension plans require. Also, a cash balance plan can be designed to provide a larger annual contribution to more senior employees and owners to accumulate greater benefits for those closer to retirement.

HOW DO CASH BALANCE PLANS WORK?

Overview. Cash balance plans are defined benefit pension plans that express benefits as a cash value instead of a monthly benefit amount. The benefit is reported as a "hypothetical" individual account that grows by adding contributions and interest, but the account is theoretical. Interest credits can: (1) be at a fixed rate; (2) be at a variable rate linked to an index (such as the one-year Treasury bill or a corporate bond index); or (3) vary with the actual investment returns of the plan's assets. The employer makes annual contributions to the plan to ensure that the assets will be sufficient to pay the promised benefits. The plan actuary must perform an annual "actuarial valuation" to estimate the cost of benefits accruing in the current year, as well as the value of plan assets. Assets are managed by plan fiduciaries as a pool, and the funding mechanism is the same as for defined benefit plans. Therefore, cash balance plans can have unfunded liabilities, just like traditional defined benefit pension plans.

Benefit Formula. Benefits paid under a cash balance formula are based on either: (1) the employee's entire career earnings; or (2) the employee's final years of service, when the employee's salary is usually at its highest level. For example, the following illustrates a simple cash balance plan that credits 4% of compensation per year with an interest credit of 5%.

Year	Compensation	Credit	Interest	Account Balance
1	$100,000	$4,000	$ 0	$ 4,000
2	$105,000	$4,200	$200	$ 8,400
3	$110,000	$4,400	$420	$13,220

A cash balance plan can be designed to increase the annual credit ("**contribution**") based on age or service. For example, contributions to accounts could be 4% of compensation per year for the first ten years of service and 6% per year of service after ten years, if statutory discrimination requirements are satisfied. A cash balance plan can be broken down into employee class allocation credits if desired. The maximum annual dollar amount that may be credited is related to the age of the participant. Assuming maximum compensation, the following table illustrates the maximum amounts that can be reasonably credited for the 2015 calendar year:

Age	Credit
40	$ 87,000
45	$112,000
50	$145,000
55	$184,000
60	$235,000

65 $250,000

Distributions. Upon retirement, and usually other terminations of employment, the hypothetical account balance can be converted to an annuity form of payment, but typically cash balance plans allow participants to elect distribution in a lump sum because they understand their benefit as a dollar amount. Plan sponsors prefer lump sums because it shifts two key risks – market volatility and longevity – from the employer to the employee.

HOW DO CASH BALANCE & DEFINED CONTRIBUTION PLANS COMPARE?

Cash Balance vs. Defined Contribution Amounts. The following compares maximum defined contribution plan contributions with maximum cash balance credits over a five-year period for a participant who is age 55 in 2015.

	Defined Contribution/Profit Sharing		Cash Balance	
Year	Contribution	Account	Credit	Account
1	$53,000	$ 53,000	$184,000	$ 184,000
2	$53,000	$108,650	$184,000	$ 377,200
3	$53,000	$167,083	$184,000	$ 580,060
4	$53,000	$228,437	$184,000	$ 793,063
5	***$53,000***	***$292,859***	***$184,000***	***$1,016,716***

Summary of Other Major Differences. The chart below summarizes some other notable differences between cash balance plans and defined contribution plans.

Plan Type	Cash Balance Plan (CB)	Defined Contribution (DC)
Amount of Benefit	Fixed; determined from plan accumulation formula; function of compensation and investment credits; compensation credits and investment credits correlate to contributions and investment earnings in DC plans	Benefit depends on accumulation of employer and employee contributions and investment earnings; employee usually makes investment decisions
Guaranteed Benefits by Employer	Employer obligated to provide accumulated balance of compensation and investment credits	Benefit is account balance
Form of Payment	Must offer monthly benefits, but most plans also offer lump sum	Lump sum benefits; also can offer monthly benefits
Amount of Contribution	Varies based on plan liabilities, actuarial assumptions and plan assets	Defined by plan; typically based on percentage of payroll
Minimum Funding Requirements Apply	Yes	No
Plan Termination Liability	Employer must provide accrued benefits (PBGC provides guarantee in event of bankruptcy)	None
Administrative Expenses	More costly due to benefit calculations	Least costly in terms of administrative expenses

Plan Type	Cash Balance Plan (CB)	Defined Contribution (DC)
PBGC Coverage	Required	Not required
Investment Risk	Employer bears risk	Employee bears risk
Separate Accounts for Each Employee	Recordkeeping accounts exist for each participant, but not reconciled directly to assets as in DC plans	Yes

HOW TO MAXIMIZE BENEFITS – PLAN COMBINATION

A combined profit sharing and cash balance plan program can be established to provide maximum benefits. These programs require general nondiscrimination testing and must follow several additional rules. If the goal is to maximize benefits for key personnel, in addition to other requirements, a gateway test must be passed that could require a contribution of as much as 7.5% of compensation for non-highly compensated employees. The gateway provides minimum benefits for non-highly compensated employees and is required to allow additional benefits for highly compensated employees under general nondiscrimination testing. Not every non-highly compensated employee must participate in the cash balance plan. There are minimum coverage and participation rules, requiring meaningful benefits for cash balance plans. For small employers, a change of one or two employees either leaving or joining the company could have a significant impact on the general nondiscrimination testing. Such employers must review their plans periodically and accommodate such changes in order to pass the nondiscrimination testing.

For a combined plan program, it may make sense to have the 401(k) plan be a safe harbor plan. A safe harbor 401(k) plan requires minimum employer contributions, such as 3% of compensation (or a minimum matching employer contribution) for non-highly compensated employees, and are therefore exempt from 401(k) nondiscrimination testing—allowing highly compensated employees to defer the maximum amount allowed without concern about the deferral rate of non-highly compensated employees. The employer contributions as a percentage of compensation for safe harbor purposes count toward top-heavy and gateway contribution requirements, as well as general nondiscrimination testing.

A cash balance plan design combined with a safe harbor 401(k) plan contribution would look as follows:

Participant	Age	Compensation	Cash Balance Credit	Profit Contribution	Profit Sharing as a % of compensation	401(k) Deferral	Total
Owner	55	$265,000	$184,000	$15,500	5.8%	$24,000	$223,500
Staff 1	40	50,000	5,000	3,750	7.5%	--	8,750
Staff 2	30	50,000	5,000	3,750	7.5%	--	8,750
Total		$365,000	$194,000	$23,000	6.3%	$24,000	$241,000

Example of Combined Program

Company A is a medical practice group with 11 doctors and 11 staff. Doctors A, B, C, D, and E are older and wish to set aside more income for retirement if possible. The remaining doctors are younger and are not currently interested in contributing as much, but may wish to later. The doctors and staff have varying compensation and ages.

Maximum Benefit

Name	Date of Birth	Eligible Plan Compensation	Defined Benefit Contribution	Profit Sharing Contribution	Maximum 401(k) Contributions	Total New Design Benefit
Dr. A	11/14/70	$260,000	$106,000	$8,200	$17,500	$131,700
Dr. B	8/26/67	260,000	125,000	8,200	17,500	150,700
Dr. C	10/23/50	260,000	248,000	8,200	23,000	279,200
Dr. D	7/01/64	260,000	146,000	8,200	23,000	177,200
Dr. E	10/19/50	260,000	248,000	8,200	23,000	279,200
Dr. F	2/23/74	260,000	90,000	8,200	17,500	115,700
Dr. G	3/01/64	260,000	148,000	8,200	23,000	179,200
Dr. H	2/06/79	260,000	71,000	8,200	17,500	96,700
Dr. I	5/17/68	260,000	121,000	8,200	17,500	146,700
Dr. J	7/15/68	260,000	120,000	8,200	17,500	145,700
Dr. K	8/01/59	260,000	187,000	8,200	23,000	218,200
Ee. A	11/10/60	33,280	-	9,360	-	9,360
Ee. B	9/12/47	29,602	-	4,507	-	4,507
Ee. C	11/05/49	23,046	-	3,993	-	3,993
Ee. D	10/07/66	31,740	-	11,700	-	11,700
Ee. E	10/15/60	27,539	-	2,765	-	2,765
Ee. F	4/17/65	17,000	-	13,500	-	13,500
Ee. G	10/02/59	14,339	-	3,304	-	3,304
Ee. H	3/01/59	78,000	-	10,000	-	10,000
Ee. I	12/18/48	37,564	-	8,500	-	8,500
Ee. J	1/20/62	26,769	-	3,212	-	3,212
Ee. K	1/17/79	26,083	-	5,300	-	5,300
Total - Physicians		$ 2,860,000	$1,610,000	$90,200	$220,000	$1,920,200
Total - Employees		$344,962	-	$76,143	-	$76,143
Grand Total		$ 3,204,962	$1,610,000	$166,343	$220,000	$1,996,343

TAKE AWAYS

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