

CASH BALANCE PLANS

A look at why small businesses and professional practices like this option.

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In 1985, there were 114,000 defined benefit plans in America. By 2011, that number had shrunk to 38,000. Since 1985, some businesses have elected to replace a traditional pension plan with an alternative: a cash balance plan.¹

Cash balance plans offer partners and owners of highly profitable businesses an option to ramp up their retirement savings through large pre-tax contributions. Contributions to these plans are age-dependent, so the older you are, the more you can potentially sock away for retirement.²

How does this differ from a traditional defined benefit plan? In a cash balance plan, a business or professional practice maintains a hypothetical account balance for each employee. Employees get periodic statements showing their "balances".

Every year an employee participates in the plan, he or she collects pay credits and interest credits. (The interest rate for a cash balance plan is commonly linked to the 30-year Treasury.) When the employee retires, the plan pays out either a lump sum or a pension-style income. Cash balance plans are portable: the vested portion of the account balance can also be paid out if an employee leaves before retirement.³

As an example of how credits are accrued, let's say an employee named Joe Green earns \$75,000 annually at the XYZ Company. 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.

Per Internal Revenue Code Section 412, an employer must make annual contributions to a cash balance plan. Each year, an actuary must make valuations to determine the current value of a participant's accrued benefit and the minimum yearly contribution.

Designing the plans. Cash balance plans have to meet some basic tests.

- They must be non-discriminatory (they can't be structured to favor executives).
- Allocations to plan participants must meet IRC Section 415 standards.
- Allocation formulas must be in line with the IRC's top-heavy required minimum contribution (if relevant).
- Plan contributions must be in amounts deductible by the business per IRC Section 415.⁴

Assuming those tests are met, there are some compelling reasons to adopt a cash balance plan in place of a traditional defined benefit plan.

Two major advantages. A cash balance plan can give business owners the chance to keep any excess profits earned above the annual interest credit owed to employees. Additionally, the

company has a consistent payment stream to direct to its retired employees, plus designated hypothetical accounts set up for that purpose.³

An alternative to the safe harbor formula. A safe harbor formula can help a traditional defined benefit plan avoid charges of age discrimination, yet it has a downside: it tilts greater amounts of money to a company's longest-tenured workers, leaving less for owners. In cash balance plans, the oldest and youngest employees simply collect credits that represent either a percentage of pay or a flat dollar amount.^{5,6}

Benefit allocations 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 a career average pay formula - an average of all years of compensation.⁶

Less sensitivity to interest rates. When rates rise and fall, liabilities in a traditional pension plan fluctuate, opening 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.⁶

Are there any demerits to these plans? Well, they often have greater administration costs than traditional defined benefit plans. The IRS terms these plans "individually designed", so you have to submit them for IRS approval every five years instead of every six. They also require annual non-discrimination testing.⁶

Still, cash balance plans have grown increasingly popular. Some businesses have even adopted dual profit-sharing and cash balance plans. Maybe it is time your business looked into this intriguing alternative to the traditional pension plan.

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Citations.

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