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Ask Kidder.

Will a Cash Balance Plan Work for Me?

In our September newsletter, a link was included to Doug Lane's article "Maintaining DB Plan Viability via Cash Balance Plans" published in the Summer 2013 issue of ASPPA's *Plan Consultant* magazine. The article considers three factors that influenced the decline in active defined benefit plans, including declining interests rates, volatile asset returns, and liability/asset mismatches. **To reduce the factors stated, the solution provided is a Cash Balance plan**. As reported by government sources, Cash Balance plans have increased by over 500% in the last ten years, from 1,337 plans in 2001 to 7,926 plans in 2011. This article expands on that discussion regarding the opportunities with Cash Balance plans.

What is a Cash Balance plan?

A Cash Balance plan is a defined benefit plan with the look and feel of a defined contribution plan. Defined benefit plans generally define the retirement benefit as a monthly annuity payable at retirement age. In contrast, a Cash Balance plan defines the retirement benefit as a balance (a lump sum). The balance is the sum of contribution credits plus interest credits – as defined by the plan. The interest credit may be a fixed rate, such as 5% per year, or an indexed rate, such as the yield on the 30-year Treasury bill.

How does a Cash Balance plan differ from a traditional defined benefit plan?

The lump sum benefit at retirement age in a Cash Balance plan (the account balance) is predictable and stable, increasing with contribution credits and interest credits. In contrast, a traditional defined benefit plan promises a monthly payment at retirement – much like social security, but pre-funded. The current lump sum value of that promised benefit will rise and fall with interest rate changes.

For example, suppose a traditional defined benefit plan promises a lifetime payment of $100 per month starting at age 62 to an employee who is now age 52. If interest rates are 4%, the plan must have about $17,200 set aside at age 62. Discounting this at 4% to age 52 provides a current lump sum value of $11,600. But if interest rates are 8%, the lump sum at age 52 is now only $5,600. Thus, the lump sum liability in a traditional defined benefit plan will increase when interest rates decline and decrease when interest rates rise.

Can Cash Balance plans be designed differently?

Cash Balance plans provide flexibility in that they can be structured as an overall employee benefit plan for all employees or structured to provide a large tax sheltering opportunity for owners and key employees. New Cash Balance plans are primarily built for the latter option. In the tax sheltering type of plan, the contribution credit to employees may equal 2% of pay per year while the owner may receive 50% of pay per year (or more) as long as non-discrimination tests are passed. To pass these tests, Cash Balance plans are normally offered in combination with a 401(k) plan or profit sharing plan. Tax deductible contributions, as determined by the plan's actuary, can easily exceed $150,000 per year for each owner and for other key employees.

How are Cash Balance plans invested?

Like defined benefit plans, the investments of a Cash Balance plan are not directed by the participants. Investment risk is solely borne by the plan sponsor. Plan assets are pooled for providing benefits for all participants. Thus, increases and decreases in plan investments do not directly affect the benefit amounts promised to participants. As a result, the value of the benefits promised by the plan may not be equal to the value of the plan's assets. An appropriate investment policy and strategy is critical to the success of the Cash Balance plan.

Must an employer commit to a contribution level for a minimum number of years?

No. As with all pension plans, including defined benefit plans, this is a common question. While plans are intended to be permanent, legitimate business conditions allow employers to amend their plans as needed. Keep in mind that a benefit already earned for a year cannot be retroactively decreased. IRC Section 411(d)(6) prevents cutbacks in benefits, but does not prevent employers from prospectively changing benefit formulas, freezing benefits, or terminating the plan.

Who should consider a Cash Balance plan?

- Owners who have not saved enough for retirement and want to catch-up
- Employers who want to provide key employees with larger tax advantaged benefits
- Large employers needing an enhanced retirement package
- Professional service employers or a closely held business seeking greater tax sheltering opportunities than a 401(k)
- Owners seeking to sell a business in a tax efficient manner

Cash Balance plans have provided additional flexibility and tax advantaged opportunities for plan sponsors in designing qualified plan programs to satisfy their strategic and tactical business needs. For more information please visit www.askkidder.com and www.kidderlane.com. Or contact us with our toll free number at (800)300-3086.