

BENEFIT CONSULTANTS GROUP NEWLETTER

Fall 2007

IS A CASH BALANCE PLAN RIGHT FOR YOUR COMPANY?

Overview. The Pension protection Act of 2006 provided definitive rules for the operation of cash balance plans, making it likely that many more employers will choose to adopt these plans in the future. A cash balance plan is a defined benefit plan under which each employee's benefit is expressed as an account balance. The benefits provided by a cash balance plans are designed to be more easily understood by employees because they are expressed in terms of an account balance payable upon termination of employment. At the same time, because it is a defined benefit plan, in many cases the plan can be designed to provide deductible contributions for business owners and/or key employees well in excess of the maximum \$45,000 (in 2007) contribution limit that applies to 401(k) and profit sharing plans. In some cases, the maximum annual employer contribution for an individual could exceed \$100,000. Combining a cash balance plan with a 401(k) profit sharing plan can produce even higher contributions for owners and key employees while still controlling plan costs overall.

A cash balance plan is a form of defined benefit plan because individual accounts are not actually established. The account balance is hypothetical. A participant receives a benefit equal to the account balance promised by the plan regardless of the actual investment experience of the plan's trust. For this reason, participants' benefits are more predictable and secure than those provided under a defined contribution plan, assuming the plan is funded sufficiently. Employers like cash balance plans because the defined benefit nature of the plan enables the employer to choose an actuarial funding method and contribution level which best fits its financial situation (unlike less flexible defined contribution plans).

A participant's hypothetical account under a cash balance plan typically increases each year by a stated percentage or a dollar amount determined under a benefit formula. For instance, the plan might specify that a participant will have a hypothetical annual employer contribution of 2% of the participant's compensation, with earnings on the previous year's ending balance credited at a rate equal a rate specified in the plan or determined by a formula in the plan.

For employees, cash balance plans can be attractive because typically the interest on an account balance is guaranteed rather than dependent upon the investment performance of an actual account in a defined contribution plan's trust. Employees who tend to change jobs frequently benefit more from cash balance plans because benefits accrue faster than under most defined benefit plans. Unlike defined contribution plans, cash balance plans can more easily provide employees with benefit credit for past service without discrimination problems and can be used to provide subsidies for early retirement or early retirement window programs.

Because cash balance plans are defined benefit plans, they generally are covered by ERISA plan termination insurance and must make annual premium payments to the Pension Benefit Guaranty Corporation. Plans sponsored by professional firms with 25 or fewer employees are exempt from this requirement as are plans that only cover business owners.

Cash balance plans are most appropriate for:

- Companies that desire to enhance retirement benefits for their owners or key employees on a pre-tax basis (i.e., more than \$45,000 or \$50,000 for employees eligible for catch-up contributions) while obtaining a larger tax deduction.
- Medical, law, accounting and other professional firms of all sizes.
- Sole proprietors with substantial income who desire to defer more than \$45,000 or \$50,000 into pre-tax retirement savings.
- Older owners who have delayed saving for retirement.

Design. Cash balance plan designs vary, but often do not define benefits as a percentage of final or career average pay or as a flat dollar amount per year of service. Like 401(k) or profit sharing plans, cash balance plans often provide annual pay-related credits, determined in a manner similar to that for determining employer contributions to a defined contribution plan. Benefits are defined as a stated annual contribution allocated to an employee's account, with the contributions growing at a stated rate of interest each year.

Some cash balance plans provide for interest credits that accrue at the same time as the pay credit, where the interest credit may or may not be contingent on performance of future services. In general, the interest rate for interest credits in a cash balance plan is not linked to the actual investment performance of plan assets, and there is no minimum or maximum rate requirement.

Benefit Accrual. Cash balance plans must meet the Code's maximum limit on accrued benefits under defined benefit plans. The Code also prohibits a defined benefit plan from ceasing benefit accruals or reducing the rate of accruals because a participant has attained a particular age.

An employee's account in a cash balance plan can represent his/her accrued benefit. Cash balance plans are subject to the minimum funding standard and are funded under the same funding methods as traditional defined benefit plans. Thus, a cash balance plan affords the employer greater funding flexibility than a defined contribution plan, because actuarially based funding allows the employer to choose contributions within the IRS minimum and maximum deductible contribution limits.

Because a cash balance plan provides an accrual pattern similar to that of a defined contribution plan, cash balance plans are more beneficial to younger, shorter service employees than traditional defined benefit plans, and consequently these plans are relatively less valuable than traditional defined benefit plans to older employees or employees with shorter periods of service.

Traditional defined benefit plans skew benefits toward long-service employees because their benefits accrue on an age-related basis that allows older employees to earn benefits at a faster rate than younger employees. Further, many employees do not remain long enough to vest in their defined benefit plan benefits; others terminate employment, and their benefits are frozen and eroded by inflation. Cash balance plans can be structured to avoid these pitfalls.

Anti-Cutback Rule. The anti-cutback rule generally prohibits a qualified plan from

decreasing a participant's accrued benefit by a plan amendment. Thus, an employer must use caution when amending a traditional defined benefit plan to convert it into a cash balance plan because the cash balance plan must provide that a participant's level annuity will at least equal his or her accrued benefit under the traditional plan immediately before the amendment.

In addition, the cash balance plan must preserve any optional benefit forms that applied to the previously accrued defined benefit plan benefit.

Furthermore, if a cash balance plan conversion significantly reduces the rate of future benefit accruals, the plan administrator must provide a written notice on the reduction.

Vesting. Cash balance plans must satisfy the Code's minimum cliff vesting schedule that applies to defined contribution plans; that is, 100% vesting upon completion of 3 years of service.

Cash balance benefits generally vest in full should an employee die or become disabled. Following the model of the defined contribution plan, some cash balance plans pay out the entire account balance on death.

Nondiscrimination. Cash balance plans generally must satisfy the Code's general nondiscrimination test.

Distributions. Cash balance plan participants must receive benefits in annuity form, or, if the plan so provides, as a lump sum. Cash balance plans, therefore, are subject to the joint and survivor annuity and related consent requirements of ERISA. Actuarial assumptions used to convert the account balances to the various annuity forms of benefit must be set forth in the plan.

Most cash balance plans permit participants to elect to receive their benefits on termination of employment. Cash balance plans also are subject to the minimum required distribution rules.

Plan Administration. Plan administration for a cash balance plan is different for a defined contribution plan such as a 401(k) or profit sharing plan. In a cash balance plan, although allocations are made to individual accounts, the accounts are hypothetical and the actual pension assets are commingled in one fund so that the account balances only represent a bookkeeping device. Actuarial valuations and minimum funding calculations are required.

Further, unlike a defined contribution plan, employee contributions, investment options, and withdrawals are not available and, thus, do not have to be tracked. Cash balance plan benefits also tend to be more predictable than defined benefit plan benefits. Therefore, plan costs tend to be more predictable.

More Information. If you want to learn more about how a cash balance plan can help your company, contact the Benefit Consultants Group Implementation Department at 800-524-4015, option 3.