Cash Balance Plans

A defined benefit option for retirement planning

Standard Retirement Services, Inc.

Popular defined benefit solutions

Cash balance plans represent an attractive solution for employers looking to provide an easily understood defined benefit plan to employees. In addition, they can be part of a leveraged plan design that maximizes contributions for highly compensated employees. Interest in these plans is growing as employers learn more about the unique advantages a cash balance plan can offer.

What is a cash balance plan?

A cash balance plan is a hybrid. It follows the rules of a defined benefit plan, but it looks like a defined contribution plan to employees. A participant's account grows with employer contributions and credited interest, similar to an account in a profit sharing plan. Contributions qualify for tax advantages and creditor protection under the Employee Retirement Income Security Act of 1974 or ERISA. But unlike a profit sharing plan, the account is hypothetical and participants make no investment decisions and take no investment risk.[1]

How does a cash balance plan work?

Each cash balance participant is assigned a hypothetical account. The account balance grows in two ways: through specified employer contributions in either a flat dollar amount or a percentage of compensation, and through annual interest credits. Interest may be either fixed or tied to an index, most commonly the 30-year Treasury bond. Plans can be designed to increase annual contributions according to a participant's age and years of service.

1 Assets are actually pooled and invested by the employer as allowed under the Pension Protection Act of 2006; plans should be designed with appropriate investment and funding strategies to keep the plans fully funded.

How are benefit payments calculated?

As a defined benefit plan, actual benefit payments are based on the plan formula, not on investment performance.

Integral to the formula is the relationship between return on assets and the guaranteed annual interest credit. When asset returns are:

- Greater than the interest credit, the employer contribution can be lower
- Lower than the interest credit, the employer contribution must make up the difference. The employer must absorb any investment losses and maintain sufficient funds to pay benefits

Because employers bear both the risks and the rewards of the plan's investments, the company's revenues ideally will be steady or have peaks during which higher contributions can be made to offset down times.

A cash balance plan specifies a retirement age and makes benefits available in the form of an annuity or a lump sum at retirement. If a participant is vested and chooses to leave the company prior to reaching retirement, cash balance assets may be portable.[2]

How are distributions handled?

Cash balance distributions are subject to the same taxation rules as other qualified plans, including federal and possibly state income tax. In addition, withdrawals prior to age 59½ may be subject to a 10 percent federal income tax penalty. To avoid a potential tax penalty for taking a distribution prior to age 59½, participants can roll over the assets to an Individual Retirement Account or another qualified plan.

Cash balance advantages

For employers:

- Can be used as a recruitment and retention tool:
  - High earners can accumulate high balances for annuity or lump-sum payouts, and benefit from tax savings
  - Younger workers find the portability and simplicity attractive
- May be less costly than a comparable profit sharing plan if investment returns are higher than the credited interest rate
- Greater funding flexibility than defined contribution plans

For employees:

- Plan is funded 100 percent by the employer
- All plan costs are paid by the employer
- Plans are straightforward and easy to understand
- Employees make no investment decisions and take no investment risk
- Account balance is portable[2]
- Benefits may be federally insured by the Pension Benefit Guaranty Corporation (PBGC)

2 For lump-sum distribution options only. Lump-sum distribution options may also be subject to additional plan requirements.

Sample leveraged plan scenarios

Below are a couple of hypothetical examples to illustrate how a leveraged plan design solution works when an employer wants to focus contributions on a few older, highly compensated employees in a work environment that includes primarily younger, non-highly compensated employees.

Scenario 1

A business with two owners, ages 42 and 50, had three employees between the ages of 25 and 45. One way to help them get the most out of their plan was to combine a cash balance plan with their current defined contribution plan to create a leveraged plan design. This allows them to not only provide their employees with a hybrid retirement plan solution, but also allows for 90 percent of annual contributions for the two owners.

Even if the employee group is larger, a leveraged plan can still provide significant contributions and tax savings to highly compensated employees through alternative plan design techniques.

Scenario 2

A business owner in his 40's was contributing the maximum to his 401(k) and was seeking more substantial opportunities to make tax-deferred contributions toward his retirement. His staff included his wife and eight other people, ranging in ages from 30 to 65. After collaboration with the business owner's advisor, a plan design was created that provided 84 percent of annual contributions for him and his wife without sacrificing what he contributed for his employees.

Leveraged plans

Cash balance plans and defined contribution plans are designed to work together

Using cash balance and defined contribution plans, an employer can create a leveraged plan design. The defined contribution plan allows all employees to save with the tax incentives and investment compounding typically offered in defined contribution plans. The cash balance plan maximizes contributions in excess of the defined contribution limit for older workers — which is often most advantageous for high-earning employees. Lower earners also benefit from the cash balance plan, but often to a lesser degree. Leveraged plans are tested on an aggregate basis and are designed to pass all nondiscrimination testing.

Cash balance plans may be more expensive to administer than profit sharing plans since they require actuarial calculations and reporting and may require PBGC premiums. However, the tax benefits of a leveraged plan approach may outweigh the costs. In addition, the cash balance plan could be less expensive than a profit sharing plan if the employer can earn a greater return on assets than the cash balance interest crediting rate.

An actuarial analysis can be performed to illustrate hypothetical cost/benefit projections based on different variables.

For a plan to succeed, it needs ongoing attention and care. Cash balance plans, like most retirement plans, are subject to evolving legislation and an ever-changing economy and workforce.

How The Standard can help

Employers and their plan advisors may be informed by The Standard's retirement plan consultants, actuaries, ERISA attorneys and other specialists who can review plan design and funding strategies. However, by law, it is the responsibility of the plan sponsor to identify tax deduction opportunities and to fulfill compliance and reporting requirements.

Compliance and reporting assistance to simplify your administrative responsibilities

After the cash balance plan is designed and the plan document is written and approved, it must remain in compliance with applicable regulations. The Standard's compliance testing and reporting services simplify an employer's fiduciary responsibilities and help keep the plan on track.

We'll conduct annual testing to assure plan compliance with Internal Revenue Code provisions and prepare the entire annual Form 5500 government report and its associated schedules. We'll also provide required annual PBGC forms and prepare:

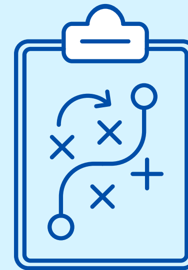
- The annual Funding Notice
- An annual actuarial report
- Participant statements
- Financial Accounting Standards reporting, if required

Next steps

Employers and their plan advisors can partner with The Standard to explore the potential financial benefits of a cash balance plan. Together, we'll make sure it is the right fit for the employer's organization and determine how to maximize the potential benefits.

To get started, employers need to submit the plan's census data to The Standard. We'll provide specifics on the type and format of the data and work with the plan advisor to help make this an easy process for the employer.

After running an actuarial illustration to show the potential benefits and tax savings to the organization, we'll consult on how to interpret the information and offer alternative scenarios that might be considered.



Frequently asked questions

What is the main difference between a traditional defined benefit plan and a cash balance plan?

A traditional defined benefit plan states the participant's benefit in terms of an annuitized monthly payment over a lifetime. A cash balance plan states the benefit in terms of a projected account balance, which makes it easier for employees to appreciate the value of the benefit.

Also, traditional defined benefit plans tend to provide low accruals for younger employees and high accruals for older employers. With a cash balance plan, it's easier to allocate the plan accruals to specific groups of employees.

Are cash balance plan benefits protected under federal law?

Yes, cash balance plan benefits are protected under ERISA and the Age Discrimination in Employment Act. These employee protections include requirements relating to fiduciary responsibility, reporting and disclosure and age discrimination. Employees' benefits under cash balance plans may also be federally guaranteed by the Pension Benefit Guaranty Corporation.

What are the tax benefits of cash balance plans?

Cash balance plans provide tax benefits in two ways. First, since cash balance plans are qualified plans, contributions made on behalf of employees are a fully deductible expense for the employer. Second, employees are not taxed on the contributions or on any interest earned on the contributions, until withdrawn. Employees receive the full benefit of tax-deferred compounding.

Are cash balance plans portable?

If a participant is vested and chooses to leave the company prior to reaching retirement, cash balance plans may be portable.[3] As noted on Page 3, cash balance distributions are subject to the same taxation rules as other qualified plans. Distributions will be subject to federal and possibly state income tax. In addition, withdrawals prior to age 59½ may be subject to a 10 percent federal income tax penalty. To avoid a potential tax penalty for taking a distribution prior to age 59½, participants can roll over the assets to an IRA or another qualified plan.

3 Lump-sum distributions may be subject to additional plan provisions.

Who are the best candidates for a leveraged plan design?

Leveraged plan designs are attractive to employers with highly compensated employees/owners who want to defer income for tax purposes. The following employers may especially benefit from having a leveraged plan design:

- Highly profitable companies of all types and sizes
- Family businesses
- Closely held businesses
- Law firms, medical groups and professional firms
- Older owners who have delayed saving for retirement
- Employers who want enhanced benefits for executives

Contact Us

To learn more about The Standard's cash balance plans and how we can help design a program for you and your employees, please call a retirement plan consultant at 844.239.3561.

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Employers and plan participants should carefully consider the investment objectives, risks, charges and expenses of the investment options offered under the retirement plan before investing. Investments are subject to market risk and fluctuate in value.

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