Cash Balance Plans

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What is a Cash Balance Plan?

- A qualified retirement plan with (almost)no annual deduction limits
- Actually a Defined Benefit Plan in the eyes of IRS
- Not your (grand?)father’s defined benefit plan, which pays a monthly annuity for life
- A CB plan defines the benefit in terms of annual credits (pay-based or dollar based) which accumulate with a pre-determined interest rate that the CB plan (employer) guarantees
- The name says it all – “cash balance”, pays lump sums, easier to understand, fund and administer
- Much larger tax-deductible contributions compared to DC plans….typical hard dollar annual limits don’t apply

Similarities with DB Plan

- Annual minimum funding requirements
- Top Heavy contribution requirements (minimum benefits for ee's) if Key employees have more than 60% of benefits
- PBGC insurance coverage (unless PSC less than 25 ee's)
- Minimum participation (Lesser of 40% or 50 ee's)
- Joint & Survivor Annuity options must be offered
- GAAP/Accounting Standards Codification (ASC) reporting may apply in some cases

A CB Plan – Why Now?

- Reduce taxes on profitable businesses
- Efficient way to extract cash from the business
- Protects assets from potential creditors
- More attractive due to
  - high funding limits, liberalization of funding rules, deduction rules and combined plan rules
- Fastest growing plan type in the US – More press coverage than ever
- Flexibility – Tiered & variable benefit levels attractive to partnerships & professionals
- A potential tool to fund buy/sell arrangements

Myths about Cash Balance Plans

- They have to be in place for at least 3 to 5 years
- They are not flexible
- The IRS dislikes them
- They are really risky
- They require funding every year
- They cost large $$ in employee contributions
- They are like a jumbo profit-sharing plan
- They are too costly to administer

Pitfalls about Cash Balance Plans

- Poorly designed or maintained
- Plan sponsor not a good fit
  - fails to trust experts, doesn't understand the plan
  - volatile business conditions
  - not disciplined with cash flow
- PBGC premiums
- Poor communication between client and/or service providers
- Dramatic changes in census composition

Plan Design Process

- When is a CB plan most often a good fit?*
  - Relatively healthy, stable taxable profits
  - “Older” owners – at least age 40-45, with some younger employees (age disparity)
  - Already maxing out their 401(k) plan
  - Understand the importance of consultants/actuary
  - Willing to commit to funding each year
  - Looking for $80,000+ in annual deductions

*Can still work in many other situations

Plan Design Process

- **When is it <u>NOT A GOOD FIT</u>?**
  - Undisciplined with cash flow
  - Volatile profits and losses
  - Very young owners <u>and</u> older employees
  - No 401(k) plan in place yet
  - Unable/unwilling to take on any investment risk
  - Owners who are inattentive or can’t agree on things
  - Advisors who don’t understand them

Plan Design Process

- IRS allows greater % of pay allocations for older participants
- Advanced plan design applies “age-based testing” to control cost of benefits for staff (who are usually much younger than key employees)
- What is “age-based testing”?
  - Age-based testing looks at the current allocation and projects a benefit at retirement; then compare the projected benefit based as a % of current wages
  - Age based testing will direct a greater portion of overall contributions to older, higher paid individuals than a safe harbor design

Plan Design Process

- **Age-Based Testing Example**

  - 22-year old employee making $30,000 per year receives a $1,500 **PS** allocation = $6,000 annual annuity at age 65
  - $6,000 divided by $30,000 = 20.0% of pay annuity benefit

  - 57-year old employee making $250,000 per year receives a $200,000 **CB** allocation = $20,000 annual annuity at age 65
  - $20,000 divided by $250,000 = 8.0% of pay annuity benefit

  - The $1,500 allocation is more "valuable" than the $200,000
  - Yes, this is legal and IRS-approved

Plan Design Process

- Who will be eligible? Not all need to be
  - Can focus on “targeted” groups (almost like a NQ)
  - Must “cover” at least 40% of eligible employees
- Will this plan “stand alone” or be tested with a Profit Sharing Plan? 99% are paired with 401(k)/PS….called “Combo Plans”
- Must provide Gateway and Top Heavy minimum benefits (5-7.5% of pay)

Plan Design Process

- Generally, the annual allocation is going to be set by the owner/key employees
- Allocations can be different for different employee classifications, or none at all
- Must satisfy annual non-discrimination testing
- Annual allocation formula must generally be "permanent", but can be amended from time to time
- Can offset the benefits in the CB plan by the benefits provided in a PS plan (usually larger plans +30)

Cash Balance Funding

Two things drive the annual funding requirement:

1. The sum of the annual allocations
2. The investment performance (which determines if the plan is underfunded, fully funded or overfunded)

- Plan Sponsor will have a funding range each year
- Minimum required (tied to annual allocations), up to Maximum allowed
- Plan Sponsor is permitted to “overfund” the Plan (applies to all CB & DB plans) up to difference between 150% of liabilities and the Plan’s asset value
- “Overfunded” amounts can be applied toward future allocations and funding requirements

Funding & Benefit Limitations

- Funding levels can be consistent from year to year, or move up and down based upon allocations
- Cash Balance account (and thus funding) are limited by maximum benefit rules under IRS Code Section 415
- Cannot exceed the amount necessary to fund an annuity of $265,000 per year payable beginning at age 62
- Approximates to a lump sum of about $3.4 million at age 62
- Can play “catch up” in future years if not fully funded in earlier years

Maximum Annual CB Benefit Accruals

AGE	MAXIMUM
35	89,000
40	113,000
45	145,000
50	187,000
55	239,000
62	340,000
70	395,000

Benefits & Distributions

- All Cash Balance Plans must use a 3-year cliff vesting schedule
- Lump sums can be paid upon usual occurrences, but benefits can be held until a later date (5 years after term, age 65, etc.)
- Must offer annuity benefits and obtain spousal consent to waive annuity
- Can take in-service W/Ds at age 59.5 (American Miners Act) and roll to IRA or 401(k) Plan
- Loans also permitted, but not recommended

Cash Balance/401(k) "Combo" Plans

- One company can sponsor 2 retirement plans
- Creative & thoughtful plan design might put some employees into a CB plan and the rest into a DC plan
- Benefit levels within the plan(s) can vary

EXAMPLE:

- **Partners** – 100% of pay in CB plan
- **Directors** – 15% of pay in PS Plan
- **Managers** – 8% of pay in PS Plan
- **All others** – greater of $200 or 6% of pay in PS Plan

Typical Multi-Plan Arrangement

- **401(K) PROFIT SHARING PLAN**
  - 401(k) – All employees
  - PS – Non-Shareholders and Managers

- **CASH BALANCE PLAN** –
  - Shareholders and non-Managers
  - All other employees only receive PS benefits
  - Plans are tested together for non-discrimination

Brief Case Study

- 2 Partners age 55 with 7 staff employees
- Currently have a Safe Harbor 401(k) with required 3% non-elective contribution, plus provides 5% of pay in profit sharing
- Layer a Cash Balance plan on top of current 401(k)/PS Plan
- Only Partners and Admin personnel eligible for Cash Balance Plan

Brief Case Study

		CURRENT		NEW	
	Pay	PS/401(k)	PS/401(k)	Cash Balance	Total
Doctor	335,000	73,500	46,000	239,000	285,000
Doctor	335,000	73,500	46,000	239,000	285,000
Office Mgr	60,000	4,800	4,800	0	4,800
Nurse Prac	110,000	8,800	8,800	0	8,800
Aide	40,000	3,200	3,200	0	3,200
Aide	36,000	2,880	2,880	0	2,880
Aide	32,000	2,560	2,560	0	2,560
Clerical	28,000	2,240	2,240	1,400	3,640
Clerical	26,000	2,080	2,080	1,300	3,380
TOTAL	1,002,000	173,560	118,560	480,700	599,260

Brief Case Study

- **BEFORE:** Partners received $147,000
- **AFTER:** Partners receive $570,000 (can be less/unequal)
- Staff costs did not change materially
- Before PPA 2006, this could not be done
- Even higher deductions available after liabilities accumulate in CB plan (due to 150% funding allowance)

Cash Balance Plan Investments

- One pooled investment account(s) - Not a participant-directed type plan
- No special investment rules for CB Plans
- Investments should be prudent and easily-valued
- Will depend somewhat upon the age of the principals and the liabilities in the plan
- The younger the owner and the lower the liabilities, the greater the risk profile can be
- Investment goal should be approximately tied to annual interest crediting rate in the Plan

Cash Balance Plan Investments

- Regulations now permit market-based “interest crediting” (even losses!) on participant CB accounts which will mean that liabilities and assets can more closely track one another
  - But it does make testing much more difficult
  - Requires preservation of capital rule
- Asset volatility potentially means volatile funding results
- Cash Balance plans are intended to maximize deductions, and excess investment growth reduces deductions
- Underfunded Cash Balance plans can create great difficulty in paying out Owners/HCEs

FAQs about Cash Balance Plans

- **Can a Cash Balance Plan be frozen, and then unfrozen?**
  - Yes, in years when there is a valid business reason for freezing (ceasing) benefit accruals the Plan can be frozen and then unfrozen (restarted) when those reasons abate
- **What happens if the Cash Balance Plan shuts down and the assets are not enough to cover the liabilities?**
  - The business will need to fund the difference, or in many cases the majority business owner can “waive” off his/her benefits to reduce liabilities down to the asset values.

FAQs about Cash Balance Plans

- **Can a Cash Balance Plan invest in real estate?**
  - A Plan can invest in any asset that can be reasonably valued annually. However, it may not invest in an asset that the business or owner will directly benefit from. Real estate is often problematic and should be avoided for a number of reasons.
- **What if the business/owner had a DB or Cash Balance Plan in the past? Can they set up another one?**
  - Yes, but certain benefit limitations (including past amounts paid) must be closely monitored so that the business owner does not exceed them in total

CB Plans – *A Final Word*

- Cash Balance Plans are a powerful and effective tax deferral tool, though they must be well-maintained
- CB Plans work best when everyone is on the same page (client, CPA, investment advisor, actuary etc.)
- CB Plans are not for everyone; careful consideration should be given up front
- CB Plans are not forever – they can be amended, frozen or terminated based upon the needs of the Plan Sponsor (and within IRS/PBGC guidelines)