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retirement plan actuaries and consultants

Cash Balance Pension Plans

When professionals and other small business owners desire to contribute amounts in excess of the annual limit imposed by tax laws, a supplemental cash balance pension plan can be designed to work in conjunction with an existing defined contribution plan.

A cash balance pension plan is a form of defined benefit plan. An “account” is maintained for each participant in the plan, but the account is really just a bookkeeping entry maintained by the actuary for the plan. No separate investment account is maintained.

CASH BALANCE PROJECTIONS AND BENEFITS

The additional benefits that can be funded through a cash balance plan depend on a variety of factors. For this reason, employers considering the potential adoption of a cash balance plan are encouraged to have a projection prepared by an actuary to illustrate the additional benefits available to owners, the cost of additional benefits for non-owner employees, etc. To prepare such a projection, the actuary needs employee census data for the business, including the following information for each employee (a) date of birth, (b) date of hire, (c) annual compensation, and (d) annual hours worked (if less than 1,000). Absent special circumstances (e.g., significant revisions to data), these projections are typically prepared by the actuary at no charge. Importantly, all business owners do not have to receive equal cash balance allocations, and since some limits are overall limits, the non-participation by an owner-employee can potentially increase the cash balance benefits available to other owners. Also, since the cash balance benefits available to an employee depend to some extent on age, younger owners should understand that they might not be able to receive the full benefits enjoyed by other owners.

INTEREST ON CASH BALANCE PLAN ACCOUNTS

Unlike accounts in defined contribution plans, the amounts credited to cash balance accounts do not depend on the actual investment performance of the assets of the plan. Instead, interest is credited to each cash balance account on an annual basis, based on a specified rate or index (and subject to IRS rules). For example, a fixed rate of 5% is now common in cash balance plans.

CASH BALANCE PLAN FUNDING

Again, since interest credits to cash balance accounts do not depend on actual investment performance, any experienced rate of return in excess of the crediting rate dictated by the plan (e.g., 5%) will reduce ongoing contributions to fund the benefit, but will not affect the participant’s account balance. In this case, the business would simply fund the lesser required amount and the owners of the business would presumably receive larger bonuses as taxable wages. Conversely, if the rate of actual investment return in the plan is less than the targeted rate, the contribution requirement to fund the same benefit may need to be increased (which while deductible may be a less desirable result).

CASH BALANCE BENEFIT EXAMPLE

Employee A enters a cash balance plan effective January 1, 2018. Her compensation for 2018 was $25,000. Under the plan's formula, 4% of her compensation was credited to her cash balance account as of December 31, 2018. For 2019, Employee A also has compensation of $25,000. As of December 31, 2019, she is credited with a "Compensation Credit" and an "Interest Credit".

Cash Balance Account at January 1, 2018: $0
Credit to Account for 2018: ($25,000 x 4%) = $1,000

Cash Balance Account at December 31, 2018: $1,000
Compensation Credit for 2019: ($25,000 x 4%) = $1,000
Interest Credit for 2019: ($1,000 x 5%) = $50

Cash Balance Account at December 31, 2019: $2,050

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CASH BALANCE PLAN FUNDING NOT DISCRETIONARY

Unlike employer contributions to most profit sharing plans, contributions to a cash balance plan are not discretionary. While future benefit accruals under a cash balance plan can always be reduced or discontinued prospectively (with a proper plan amendment and advance notice to participants), the employer remains responsible for funding any benefits accrued prior to the effective date of the "freeze." Therefore, an employer should only adopt a cash balance plan if it is comfortable with projected contribution levels for the foreseeable future.

CASH BALANCE PLAN INVESTMENTS

By definition, all assets in a cash balance plan must be invested as a single, pooled account; no individual participant direction of accounts is permitted. As in the case of investments under a defined contribution plan, assets in a cash balance plan should only be invested with the advice of a qualified investment advisor. Because of the fact that interest is credited to cash balance accounts at a particular rate, without regard to actual investment performance, the investment policy of the cash balance plan is typically weighted toward fixed income, as opposed to equity. To compensate for this, many cash balance plan participants maintain a stronger equity position in the defined contribution plan, to achieve overall balance.

SAMPLE 401(k) AND CASH BALANCE COMBO

Professional Service Organization

Maximum Compensation (2019): $280,000
Total Plan Compensation: $666,500
Maximum DC Deductible Limit: $39,990 ($666,500 x 6.00%)

	Profit Sharing Safe Harbor 401(k) Plan	Cash Balance Defined Benefit Plan Allocation	Combined Plan Contribution Cost
2 Owners (Compensation - $560,000)			
Total **Employer** Contribution (as a % of Compensation)	$30,800 (5.50%)	$473,200 (84.50%)	**$504,000 (98.17%)**
Total **Employee** Contribution	$42,000	N/A	
5 Employees (Compensation - $106,500)			
Total **Employer** Contribution (as a % of Compensation)	$7,242 (6.80%)	$2,130 (2.00%)	**$9,372 (1.83%)**
Total **Employee** Contribution	$0	N/A	

SAMPLE 401(k) AND CASH BALANCE COMBO

50/50 Business Owners (2 Owners / 2 Spouses) with Staff

Maximum Compensation (2019): $280,000
Total Plan Compensation: $1,228,400
Maximum DC Deductible Limit: $307,100 ($1,228,400 x 25.00%)
No combined plan deduction limit since not a professional service organization and PBGC covered.

	Profit Sharing Safe Harbor 401(k) Plan	Cash Balance Defined Benefit Plan Allocation	Combined Plan Contribution Cost
4 Owners (Compensation - $630,000)			
Total **Employer** Contribution (as a % of Compensation)	$78,690 (12.49%)	$448,000 (71.11%)	**$526,690 (91.00%)**
Total **Employee** Contribution	$100,000	N/A	
17 Employees (Compensation - $598,400)			
Total **Employer** Contribution (as a % of Compensation)	$40,093 (6.70%)	$11,968 (2.00%)	**$52,061 (9.00%)**
Total **Employee** Contribution	$0	N/A	

MAXIMIZE YOUR CONTRIBUTIONS

If your existing defined contribution plan is limiting the amount you would like to contribute, contact us to find out more about adding a cash balance retirement plan to maximize your deductions.

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