Digging Deeper into Cash Balance Plans

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A cash balance plan is a type of defined benefit plan. Defined benefit (DB) plans, commonly known as traditional pension plans, offer a promised benefit—typically at retirement age—for eligible participants. For example, a DB plan may promise to pay participants a certain percentage of their annual salary each year in retirement.

Cash Balance Basics

The plan sponsor (employer) must then contribute enough to the plan to ensure that the promised obligations can be met. If the plan's investments do not yield enough return to meet these obligations, then the plan sponsor must contribute more to the plan to maintain adequate funding.

This "defined benefit" concept is much different from defined contribution (DC) plans. With defined contribution plans, plan sponsors and participants are limited to certain contribution amounts each year. Typically, participants get to choose how to invest their account assets. Then, the amount available at retirement is simply the amount contributed plus any investment earnings. The amount available to the participant depends on how much the investment choices have yielded over time. But irrespective of how these choices pan out, the employer is not required to make additional DC plan contributions to guarantee any particular benefit for participants.

Cash balance plans combine the defined benefit concept of a promised retirement nest egg with the defined contribution aspect of having a current balance, which gives participants a better sense of their progress toward a secure retirement. This balance, however, is called a "hypothetical balance" because cash balance plans are not individual account plans, as most defined contribution plans are. Rather, the plan administrator calculates the contributions made on behalf of the participant—along with the promised earnings amount—to arrive at the hypothetical account balance. So even though the balance is hypothetical in the sense that participants do not actually have individual accounts, such as 401(k) plans typically have, it has the look and feel of an individual account plan. And the balance is very much real; it accurately represents the amount that each participant is entitled to upon distribution.

Example: ABC Company's cash balance plan provides for an annual contribution of 5% of each eligible participant's compensation. In addition, it provides an interest credit that is linked to the one-year U.S. Treasury bill. At the end of each plan year, participants receive a statement showing their hypothetical balance, which represents the sum of annual employer contributions and interest credits.

What Types of Employers Benefit Most from Cash Balance Plans?

Cash balance plans have some remarkable advantages over DC plans (such as 401(k) plans), which make them particularly attractive for certain types of employers. Let's consider which businesses and employees may benefit the most from cash balance plans—and then look at other important factors in evaluating such plans.

There may be many factors that affect whether a cash balance plan—or some different plan or combination of plans—is right for a particular employer. Here are some of the best candidates.

- The business has consistent profits. Cash balance plans generally require substantial annual contributions, so a history of healthy profits is imperative.
- Owners (and other key employees) are older than rank-and-file employees. Those who are closer to retirement age are permitted to receive much larger annual contributions than those who are younger.
- Other types of plans do not provide enough benefit. SEP IRA plans or 401(k) plans, with strict annual contribution limits, simply may not allow sufficient contributions for some potential clients.
- The business is willing to make meaningful annual contributions to rank-and-file employees. Although cash balance plans allow disproportionately higher contributions to older, highly compensated employees, other employees will generally have to receive contributions that meet nondiscrimination requirements.
- The company has resources to make substantial overall contributions. Part of the beauty of a DB plan is the enormous contribution that can be made each year for certain employees. But the business must be able to afford it.

Which Employees Benefit the Most?

Generally, employees who are older and who have greater annual earnings than the rank-and-file employees will benefit the most from a DB plan. As a type of DB plan, the cash balance plan is no exception. Although sometimes complex actuarial calculations are involved when determining the precise amount that can be contributed to the plan each year, a quick look at the DB concept may help here.

Unlike a defined contribution plan, which limits the amount that may be contributed each year on behalf of any participant, a defined benefit plan limits the benefit that can be provided at retirement age. Because older employees have a shorter time until retirement, they are allowed to receive a greater current contribution—if the contribution doesn't result in a benefit, at retirement age, that exceeds the applicable limit. For instance, the 2024 IRS limitation on the annual benefit at age 62 is $275,000. This means that the participant could not receive an annuity from the DB plan that exceeds this amount for 2024. Expressed in terms of a lump sum distribution, however, this amount is approximately $3.5 million! Provided that the plan sponsor does not make contributions that would make the benefit at retirement age exceed these amounts, all is well.

An ideal candidate for a cash balance plan may be someone who has started a business in middle age or later. Perhaps they have substantial professional experience but have worked for someone else for most of their career. They may have had a 401(k) plan but may want to consider accumulating much more for retirement. Even if—or especially if—they don't have employees, they may now have an opportunity to jump-start their retirement savings with contributions that far exceed those allowed by defined contribution plans.

How Are Cash Benefit Plan Contributions Determined?

Required annual contributions for cash balance plans have two components: a "pay credit" and an "interest credit." The pay credit is either a fixed dollar amount or a percentage of salary (or a combination of both). For example, the plan formula could dictate a five percent contribution for all participants. Obviously, the higher compensated employees (e.g., the owners) would receive greater contributions based on their larger salaries. But perhaps more importantly, older participants can receive larger pay credits than their younger counterparts because they have less time until retirement. So based on actuarial calculations, they can receive contributions that enable them to reach a similar level of retirement benefit as those who have a longer investment time horizon.

The interest credit can be a reasonable fixed rate (e.g., five percent) or variable rate based on a market-related index such as the one-year or 10-year U.S. Treasury bill (which have been in the four-to-five percent range recently). If the plan's actual investments do not perform at least as well as the plan's promised interest credit, the plan administrator will have to make up for this difference when distributing benefits to a participant.

Determining the pay credit and interest credit formulas is an important decision. Because the promised contributions must be made each year, the formula may have a significant impact on the plan sponsor's financial picture. Clearly, an employer that adopts a cash balance plan (or any DB plan) usually does this to maximize contributions to a select portion of employees. But this should not be undertaken lightly, considering the long-term obligations that establishing such a plan entails.

How are Benefits Paid?

Any defined benefit plan distributions—including cash balance plan distributions—must be available as a life annuity. Plans will also typically offer various annuity options as well as a lump sum payment option (with spousal consent). As mentioned earlier, one of the advantages of cash balance plans for participants is that they can see their accumulated account balance as it grows. They don't have to speculate about how much their retirement benefit is worth. With a "traditional" DB plan, participants may know what they can expect if they work until their normal retirement age (e.g., 30 percent of their average annual salary after 30 years of service). But they don't know what the lump sum equivalent would be. And they certainly don't know how much is available if they leave the company before normal

retirement age. With a cash balance plan, participants know what they are entitled to—as a lump sum payment—during their entire course of employment.

Many DB plan participants choose to distribute their benefits in a lump sum, often rolling over these assets into an IRA. After all, they can always decide to later purchase an annuity with their IRA assets. But at least they preserve options by opting for a single-sum payout.

Additional Cash Balance Considerations

With all the cash balance plan benefits that we have discussed, it may seem like there are few downsides to adopting such plans. But any employer considering adopting a cash balance plan should approach this with their eyes open.

Cash Balance Plans are More Complex Than Defined Contribution Plans

All defined benefit plans have components that are less understandable to the average participant. Cash balance plans are no exception. Complex actuarial calculations are a part of every DB plan. And these calculations—which include longevity and mortality rates, employee attrition, the present value of future benefits, and many other factors—make such plans less than transparent for participants. But one

thing sets cash balance plan apart from its other DB cousins: at least the participants' account balances (even if "hypothetical") provide a valuable, common-sense benefit in advancing clearer understanding. Even if all the plan nuances still escape explanation for those in the plan, the promised benefits, expressed as a current account balance, make cash balance plans a bit more appealing.

Cash Balance Plans May be Subject to PBGC Premiums

Most employers that adopt cash balance plans have fewer than 100 employees, and many have fewer than 10. Plenty of adopting employers have no employees. But once an employer has more than 25 covered employees, it must generally pay premiums to the Pension Benefit Guaranty Corporation (PBGC) to insure against plan failure. Although these potential expenses may be a small price to pay (relative to other plan costs), they should still be factored in for businesses that grow beyond the 25-employee limit.

Evaluating Which Plan Is Best

DB plans, including cash balance plans, can provide retirement contributions that can potentially exceed 401(k) plan contributions three- or four-fold. For some employers, a DB plan is a perfect fit. But these plans are not for all businesses—for a variety of reasons. Pentegra has decades of working with DB and Cash Balance plans, and the depth of expertise to help employers evaluate which plan is right for their business. Contact us to learn more at solutions@pentegra.com or 855-549-6689.

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