

QUALIFIED PLAN STRATEGIES

OCTOBER, 2007

Cash Balance Defined Benefit Plans

Cash Balance Defined Benefit Plans have been around for a number of years, but there had been considerable uncertainty about their legality.

The *Pension Protection Act* (“PPA”), passed in August of 2006, included provisions that removed this uncertainty for new Cash Balance Plans.

Prior to this legislation there were conflicting court decisions, but the general view was that Cash Balance Plans inherently discriminated against older employees, and therefore violated the *Age Discrimination in Employment Act*.

PPA stipulated that if a new Cash Balance Plan meets certain conditions, the plan would not be subject to possible disqualification due to age discrimination.

The Appeal of Cash Balance Plans to Small Business Owners

Traditional Defined Benefit Plans (“DB Plans”) have always been appealing to owners of successful small businesses due to their ability to allow contributions that may be far in excess of those available under a Profit Sharing or 401(k) Plan.

A *Cash Balance* Defined Benefit Plan has some features that increase the appeal of a DB Plan for small business owners.

More Equitable Benefit Accruals for Owners

Since accruals to owners participating in a Cash Balance Plan can be defined as a percentage of compensation (or a flat dollar amount), two owners can

accrue benefits at the same rate, even if their ages are quite different. This may seem trivial, but it is quite difficult to accomplish with a traditional DB Plan.

Maximize Contributions to Owners while Keeping Employee Contribution Costs Low

A Cash Balance arrangement uses special testing procedures to show that anti-discrimination rules are satisfied. This allows a “Tiered” formula to be used with the potential for the owners to be allocated up to the DB maximum (as high as \$200,000 each, depending on age and compensation), in exchange for a modest contribution to other employees (usually between 7.5% and 10% of compensation).

Add a Cash Balance Plan to an Existing 401(k)

A Cash Balance Plan works best when it is combined with a Tiered 401(k) Plan. So, a company that currently sponsors a 401(k) Plan can simply add a new Cash Balance Plan to their existing retirement program, without disrupting employee deferrals.

Employee Benefits are Easier to Understand

Cash Balance Plan participant statements have a beginning and ending dollar-value balance. This allows participants to have a clear understanding of the current value of their benefit under the plan.

Traditional DB Plan participant statements usually specify a monthly retirement benefit. The current dollar value of this future payment stream is not clear, so participants tend to not fully appreciate what the company is contributing on their behalf.

Example 1

Company contributions for owners total \$209,250, while contributions to other employees total \$19,302 (92% to owners). When combined with their deferrals, the owners set aside a total of \$250,250.

	Age	Salary	Deferrals	Contributions
Owner 1	51	\$225,000	\$20,500	\$104,625
Owner 2	53	\$225,000	\$20,500	\$104,625
9 Employees		\$257,362	n/a	\$19,302
Total Company Contributions:				\$228,552
Total to Owners (including deferrals):				\$250,250

Ideal Candidate for a Cash Balance Plan

Because a Cash Balance Plan requires a commitment to high annual contributions, a good candidate generally would have certain characteristics:

- **The business has stable income.** Although future contribution targets may be changed by amending the plan, a company considering a Cash Balance Plan should expect sufficient income in future years to make required minimum contributions.
- **Owner age 50 or older.** Age is important because the older the owner is, the less each dollar contributed adds to the owner's benefit at retirement (everything else being equal), thus lowering the owner's benefit accrual rate. A low benefit accrual rate for the owner increases the likelihood of satisfying anti-discrimination rules.
- **Contribution goal for each owner is \$100,000 or more.** A Cash Balance Plan is most appealing if the owner wants contributions that are substantially higher than the maximum available with a Profit Sharing or 401(k) Plan (\$45,000 in 2007, indexed).
- **Owner's W-2 wages are \$225,000 or more.** Discrimination testing is based on benefits accrued as a percentage of compensation. So, it is important that the owner receive compensation at or above the maximum that may be considered for plan purposes (\$225,000 in 2007, indexed). This higher compensation is more effective when testing the plan for discrimination.
- **50 or fewer total eligible employees.** A Cash Balance Plan may be successful with more employees, but its maximum effectiveness as a tax-planning tool for the owner will be for companies with 50 or fewer employees.

Example 2

Company contributions for owners total \$416,550, while contributions to other employees total \$11,250 (97% to owners). When combined with their deferrals, the owners set aside a total of \$457,550.

	Age	Salary	Deferrals	Contributions
Owner 1	60	\$225,000	\$20,500	\$208,275
Owner 2	61	\$225,000	\$20,500	\$208,275
3 Employees		\$100,000	n/a	\$11,250
Total Company Contributions:				\$427,800
Total to Owners (including deferrals):				\$457,550

Evaluating Options

The first step for a company considering a Cash Balance Plan is to discuss their objectives with a Benetech Consultant, and request a free plan design study. This study illustrates contributions and benefits under a combined Cash Balance Defined Benefit Plan and Tiered 401(k) Plan.

To generate such an illustration your Benetech Consultant would need:

- **Basic information about the company** (for example, company name, form of the business, fiscal year end, are there any other related companies, etc.).
- **Employee census information** (for example, name, date of birth, date of hire, total annual compensation, etc.).
- **Contribution objective.** The contribution could be as high as 25% of covered payroll. If the contribution objective is lower than this, then the target amount should be specified.
- **Is there an existing retirement plan?** If so, we would need to gather some details about the plan, such as: plan type (e.g., 401(k) Plan), plan year end, eligibility requirements, participant entry dates, types of contributions, profit sharing allocation method, benefit accrual requirements, safe harbor provisions (if a 401k), etc. Providing Benetech with a copy of the plan's current adoption agreement is quite helpful as it specifies most of the relevant information.

For more information about Cash Balance Plans or our free contribution illustration service, please contact your local Benetech Consultant, or call our Consulting Department at 800-925-7526.

What follows is some important information about Cash Balance Defined Benefit Plans. The information is general in nature, and is not intended to be taken as a comprehensive description of the regulations covering such plans.

Why DB Plans Favor Older Participants

A Defined Benefit Plan favors older participants because the plan promises to pay each participant a specific benefit at retirement. This benefit at retirement has a “lump sum” value. The expected lump sum at retirement is a fixed amount regardless of the participant’s current age (assuming the same compensation and years of participation in the plan at retirement).

Older participants have fewer years for annual contributions to be made to build the required lump sum. So, the closer to retirement the participant is, the greater the annual contributions needed to accumulate the required lump sum.

Further, younger participants have more time for compound interest to work in their favor. Consider two persons with \$100 each invested in a retirement account at 10% interest: one is age 55 and the other is age 25. At age 65, the first person’s investment is worth \$259. But, as a result of 40 years of compound interest, at age 65 the younger person’s investment is worth \$4,526!

These two factors allow older participants to achieve greatly accelerated retirement accumulations when compared to any other option.

The Basics of Defined Benefit Plans

Since a Cash Balance Plan is a type of Defined Benefit Plan, it’s a good idea to begin an overview with the basics of DB Plans.

A “Defined Benefit” Plan is well named: it is a plan that promises to pay a specific benefit at retirement.

Each year an actuarial valuation is performed to determine the contribution amount necessary to fund the promised retirement benefits. Since the annual contribution is determined by the need to fund future retirement benefits, the contribution amount can be much higher than that allowed by Defined Contribution Plans (“DC Plans”), such as a Profit Sharing Plan.

When the plan is terminated, the distributed amount for each participant is the present value at that time of the promised benefit at retirement. Generally, the participant rolls this lump sum amount into an IRA, at which point the rollover amount is subject only to IRA rules.

Some of the more important aspects of a DB Plan include the following:

Benefit Formula

Determining annual contributions to a DB Plan begins with the benefit formula in the plan document. The benefit formula usually considers years of participation in the plan and compensation. The formula defines a

monthly amount to be paid to the participant beginning at the retirement age specified in the plan.

The maximum benefit at retirement cannot be higher than 100% of a participant’s highest consecutive 3 year average compensation, with a maximum limit of \$180,000 per year (2007 limit, indexed).

Actuarial Valuation

Because a DB Plan promises to pay future retirement benefits, each year an actuarial valuation is performed to, first, determine the plan’s liabilities (the retirement benefits it will pay in the future), and second, to determine how much needs to be contributed to the plan each year to build the required lump sum to fund this expected stream of payments. This valuation takes into consideration the current plan assets as well as a number of assumptions, including a particular rate of investment earnings, a rate of salary appreciation, mortality expectations, and other factors.

The set of facts, actuarial assumptions and the valuation method used by the actuary become the basis for making a valuation of the DB Plan. The contribution level that is reflected in this computation is determined by the actuary in accordance with IRS rules and regulations.

Each year, an actuarial valuation is again performed to make sure the plan stays on track to fund the expected retirement benefits promised by the plan.

The plan assumes a rate of return on investments, so the investment risk in a DB Plan is assumed by the employer. If the actual investment earnings are greater than the earnings assumed in the actuarial valuation, then the employer’s cost to fund the plan would tend to decrease. Likewise, if the earnings are less than those assumed in the actuarial valuation, the employer’s costs would tend to increase.

Annual actuarial valuations are used to adjust contributions based on actual plan experience. For this reason, actual experience (investment performance, actual rate of salary increases, change in demographics of plan participants, etc.) will affect future valuations and future contributions. As a result, required contributions will tend to vary from year to year.

Required Contributions

Each year the actuarial valuation calculates contributions to the DB Plan necessary for funding expected retirement benefits under the plan. Unless the DB Plan document is amended by certain deadlines, this contribution is required to be made by the employer.

The contribution deposit is due by the employer’s deadline for filing its business tax return, including extensions (though not later than 8 ½ months after the end of the plan year). Any amount of a required

contribution that is not deposited by the appropriate deadline is subject to a 10% excise tax.

Contribution Flexibility

Although annual contributions are determined by an actuarial valuation, a DB Plan has a certain amount of flexibility. If plan benefit or contribution objectives change, the plan may be amended to meet the new objectives. For maximum flexibility, a DB Plan should be amended very early in the plan year.

However, a DB Plan may be amended up to 2 ½ months after the end of the plan year. While benefits accrued for that plan year cannot be lowered after the end of the plan year, the plan may be amended to lower future accruals which could lower the contribution for the current year (the amount the contribution may be lowered depends on many factors, and can only be determined on a case-by-case basis).

Please note that for plan years beginning in 2008, recent tax law changes may restrict some of the flexibility to lower contributions after the plan's benefit accrual requirements have been met for that year.

Plan Distributions

Normal distributions of a participant's account may occur when the participant terminates employment with the company, retires, or becomes disabled.

Generally, participants may "roll" all of the distribution into an Individual Retirement Account (IRA) and continue tax-deferred earnings, or they may elect to take a lump-sum distribution and pay the tax required. Any taxable distribution before age 59 ½ (or age 55, with separation of service) may be subject to an additional 10% excise tax.

Limitations on Certain Distributions

In certain situations, distributions to a participant who is a Highly Compensated Employee may be subject to limitations or a requirement that some of the distribution be collateralized.

Plans Covered by PBGC

The PBGC is an entity within the Department of Labor that provides insurance coverage to certain DB Plans. The purpose of this insurance is to ensure that promised benefit payments are made.

DB Plans sponsored by most U.S. businesses are required to be covered by the PBGC, with the exception of:

- DB Plans sponsored by "professional service employers" (as defined by the PBGC) that have never had more than 25 active participants.
- DB Plans sponsored by companies with no employees other than substantial owners (or owners and their spouses).

DB Plans covered by the PBGC are required to make annual premium payments to the PBGC. Premiums are based on a number of factors including number of participants and funding status. PBGC premiums are payable to the PBGC, and are independent of administrative and actuarial fees.

Cash Balance Defined Benefit Plans

A "Cash Balance" Plan is a type of Defined Benefit Plan that in many respects resembles a DC Plan (such as a Profit Sharing Plan). However, it is fundamentally still a DB Plan in that it requires an annual actuarial valuation, allows substantially higher contributions, and retains other important underlying features.

How is a Cash Balance Plan like a DC Plan?

One of the principal differences between a traditional DB Plan and a Cash Balance Plan is that the Cash Balance Plan appears to participants to be very similar to a DC Plan.

For example, contributions to a Cash Balance Plan are credited to a "hypothetical account" for each participant, and a specific interest rate is credited to that account.

Participant statements are structured like statements for a DC Plan, and include the following items:

- Beginning balance
- Contribution credits
- Interest credits
- Ending balance

"Contribution credits" are usually defined as either a percentage of that year's compensation, or a flat dollar amount.

"Interest credits" are based on an index or an amount defined in the plan (but must conform to IRS regulations).

Distributions generally agree with the participant's hypothetical account balance at the time of distribution. This allows participants to have a better understanding of the value of their retirement account than with a traditional DB Plan.

How is a Cash Balance Plan like a Traditional DB Plan?

Even though participant statements may appear similar to those of a DC Plan, a Cash Balance Plan remains a type of Defined Benefit Plan.

The participants do not have an actual account under the plan: it is merely a "hypothetical" account. For this reason, participant-directed investment accounts cannot be allowed.

The investment risk is still born by the plan sponsor. The “interest credit” is applied to each hypothetical account without regard to the actual performance of the plan investments. For this reason, investment performance greater than the interest crediting rate would tend to lower annual contributions; likewise, investment performance less than that rate would tend to require higher annual contributions.

Most traditional DB Plan rules still apply to Cash Balance Plans. For example, limits on maximum distributions, minimum accrual requirements, and Top Heavy contribution requirements are the same for a Cash Balance Plan as for a traditional Defined Benefit Plans.

It is important to note that even though Cash Balance Plan contributions can be defined as a percentage of a participants compensation, additional contributions may be required in order to satisfy anti-discrimination rules.

Vesting Schedule

The Pension Protection Act clarified many aspects of Cash Balance Plans. However, it also introduced a more restrictive vesting schedule for Cash Balance Plans than is required for other types of qualified retirement plans.

All Cash Balance Plan participants must be 100% vested after 3 years of service. For this reason, most Cash Balance Plans are setup with a 3-year “cliff” vesting schedule: 0% vested until the third year of service is accrued, at which time the participant becomes 100% vested.

Combining a Tiered Safe Harbor 401(k) Plan & a Cash Balance Defined Benefit Plan

Cash Balance Plans are usually combined with a Defined Contribution Plan (such as a Profit Sharing Plan or 401(k) Plan). This combination results in more favorable testing than if plan contributions were made to a stand-alone Cash Balance Plan. As a result, a “two plan” approach is much more favorable to the plan sponsor.

A two plan approach usually combines a Tiered Safe Harbor 401(k) Plan and a Tiered Cash Balance Plan. The basic contributions under the program begin with the following:

- **The Tiered Profit Sharing Contribution:**
 - **Owners** are generally allocated up to the \$45,000 maximum (less salary deferred by the owner).
 - **Non-targeted participants** are generally allocated at least 7.5% of compensation.
- **Tiered Cash Balance Plan:**
 - **Owners** accrue up to the DB maximum benefit accrual.
 - **Non-targeted participants** generally accrue a 0.5% minimum retirement benefit.

The plan contributions are subject to special discrimination testing, so the actual formulas will depend on company demographics: in some cases the allocation to the non-targeted employees may be higher.

In most cases, the total company contribution to this program is subject to the DC Plan’s deduction limit of 25% of covered compensation. Therefore, this design is not optimal for many “micro” employers (e.g., one owner and 2 other employees).

Generally, the Tiered 401(k) Plan will use the Safe Harbor 3% “Non-Elective Contribution” (“NEC”) provision. Unlike a Safe Harbor Match, the 3% NEC can be included as part of the 7.5% profit sharing contribution discussed above. This serves to help minimize the total company contribution to the plan.

The Safe Harbor 3% NEC provision allows each owner to defer an additional \$15,500 of salary into the retirement program (\$20,500 if age 50 or older).

The Next Step

The next step for a company that might benefit from a Cash Balance Plan is to discuss their objectives with a Benetech Consultant and request a free plan design study. This study illustrates contributions and benefits under a combined Cash Balance Defined Benefit Plan and Tiered 401(k) Plan.

For more information about Cash Balance Plans or our free contribution illustration service, please contact your local Benetech Consultant, or call our Consulting Department at 800-925-7526.

Benetech, Inc. does not provide tax or legal advice. The above overview of Cash Balance Defined Benefit Plans is provided for general information purposes only, and should not be construed as advice regarding legal or tax issues. Plan sponsors should consult their legal or tax advisors prior to adopting or modifying a qualified retirement plan.