INSIGHTS

Is a Cash Balance Plan Right for Your Company?

by Don Boetger, EA, and
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Cash balance plans, a type of a defined benefit (DB) plan, came onto the retirement stage more than two decades ago. These plans work well for both small- and large-sized companies, with the common denominator being the company is successful with stable and predictable income.

The cash balance plans Definiti services are typically used by small-sized companies, where the plan is paired with a 401(k). Using the two plans side by side allows a plan sponsor to take advantage of flexible plan design — both for the cash balance and 401(k) plan — and make higher participant contributions while enjoying a tax-sheltered strategy.

DB Plan vs. Cash Balance Plan

A traditional DB plan defines an employee's benefit as a series of monthly payments for life to begin at retirement. A cash balance plan defines the benefit in terms more characteristic of a defined contribution (DC) plan. When a participant becomes entitled to receive benefits from a cash balance plan, those benefits are defined in terms of an account balance but will also include monthly benefit payment options offered by the plan.

The similarities between a traditional DB plan and a cash balance plan.

- The company makes a promise to provide the benefit to its employees;
- The employee does not contribute to the plan;
- The investments are in a pooled account where the plan's trustee, with the help of an investment advisor, defines what funds are in the managed account;
- The company bears the ownership of all profits and losses in the plan's portfolio; and
- The employee can receive the benefit when they have a distributable event (i.e., terminate employment or reach retirement age or because of a disability or death).

Where Cash Balance Plans Shine

Cash balance plans can work well for companies in any industry. We often see them used by professional firms, such as a physician's office or legal practice, and at companies with older and higher-income owners when compared to their staff.

A cash balance plan is advantageous when the company's owners or its targeted employees:

- Are age 40 or older and are generally older than other staff;
- Need to maximize tax-deductible contributions beyond the scope of a DC plan;
- Are behind on retirement savings goals and need to accumulate funds more rapidly; and
- Can afford to make larger contributions based on their age and compensation.

Plan Administrator's Role

Definiti delivers ongoing administrative support of cash balance plans for plan sponsors, including the plan set-up, actuarial calculations, annual nondiscrimination testing and signature-ready government filings.

Before we design the plan, we seek to understand the employer's goals for it and their plan population. We will gather the employees' ages and life expectancies and build individual contributions for different employees or, more commonly, for groups of individuals.

Our design team will best satisfy the employer objectives for the plan while also considering a series of complex nondiscrimination requirements imposed by ERISA. We'll also consider the regulations that include requirements for minimum participation, average benefits, required gateways, and rate group testing.

Annually, an actuary from our team will prepare a valuation of the plan, where we recommend contribution amounts that keep the plan on track and meet the company's stated targets. We also calculate the minimum required contribution and the maximum tax-deductible contribution and complete the annual nondiscrimination testing.

Ultimately, the employer decides how much to contribute to the cash balance plan based on their tax situation and whether they want to build a reserve by prefunding future benefits within allowable limitations.

Cash Balance Plan Take-Aways

If you're new to the world of cash balance plans, they can be a lot to take in — so, here are a few points to keep in mind.

- Employee demographics are at the heart of a cash balance plan. Changes in a company's workforce or compensation can impact plan design. In general, it is better to have age disparities in the plan with those you want to favor being older and more highly compensated.
- Regularly monitor the plan's funded status. It's wise to keep the plan well-funded on a plan termination basis. In other words, try to maintain plan investments that are equivalent to the value of the promises made by the plan. Pay attention to market fluctuations that can impact your future contributions. Be careful of excess assets. When the value of the trust account is in excess of the value of the benefit promises and the plan is discontinued, the excess funds are returned to the employer and are included in taxable income and subject to excise taxes. (We deploy several techniques to minimize this potential.)
- Remember that it's a DB plan. With a cash balance plan, you make a promise to your employees that they will receive the benefit. When it comes time for them to do so, most employees elect a lump sum, but they will also have the option of receiving a monthly payment. The benefit may be paid from plan assets, but in certain situations an annuity purchase makes more sense.
- Once set up, the cash balance plan needs to remain in place. The nature of an employer's retirement plan is that it's permanent — however, "permanent" isn't always feasible. The general rule of thumb is to maintain a cash balance plan for at least three years. Five years is even better.
- Your financial advisor plays a pivotal role. The advisor recommends the investments for the plan that will enable you to fund the benefits for you and your employees. We will want to work closely with your financial advisor to control investment volatility as your plan increases in size and you approach retirement.

Interested in a Cash Balance Plan?

If you would like to explore the addition of a cash balance plan for your employee benefits program, reach out to Definiti and we will:

- Ask you to share objectives for maximizing a cash balance plan and gather employee census information;
- Talk through how much flexibility you have with W-2 compensation and earned income;
- Propose a plan design that can meet your retirement savings needs; and
- Implement the cash balance plan and administer it for you.

Our cash balance team looks forward to helping you build a benefits program that works for your company and employees.

We're Here to Help

If you'd like to continue the conversation about cash balance plans, call Definiti at 1-888-912-3653 or email sales@definiti-llc.com.

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Don Boetger is a consulting actuary in Definiti's cash balance and actuarial team. He joined the firm in July 2020 when Definiti acquired Don's Erie, PA-based firm, Boetger Retirement Plan Services. Don and his team of actuaries and actuarial consultants service more than 800 cash balance and 401(k) combination plans nationwide.

Don is an Enrolled Actuary (EA), a Fellow of the American Society of Pension Professionals and Actuaries (FSPA), and a member of the American Academy of Actuaries (MAAA).

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Leah Johnson is the manager of the cash balance team and responsible for the overall management, workflow and service standards for the cash balance team, consisting of several actuaries, pension analysts and retirement plan consultants. Leah has 20 years of experience in the retirement plan industry and earned several credentials with the American Society of Pension Professionals and Actuaries, including ERPA, QPA, QKC and QKA.