Cash Balance Plans Surge. Will You Be Left Behind?

A Remarkable Opportunity for Small to Mid-sized Businesses

Popularity of cash balance plans continues to rise. A little over 25,000 cash balance plans now cover nearly 11 million employees and encompass over $1 trillion in assets. Notably, most of the growth in cash balance plans has occurred among small to mid-sized businesses (*2020 National Cash Balance Research Report*).

What is a cash balance plan? Why have business owners been increasingly turning to them? Is this type of plan right for your clients? Are there any unique considerations to take into account? Let's explore these and other important questions.

Cash balance plans have been around since the late 1980s. They are a part of the Internal Revenue Code, have passed the muster of the U.S. courts, and were one of the key topics written into the Pension Protection Act of 2006 (PPA '06) by Congress. These plans became especially attractive to small business owners after the passing of the Economic Growth & Tax Relief Reconciliation Act of 2001, which, among many things, expanded pension funding limits and created the opportunity to pair these plans with more familiar 401(k) programs. PPA '06 further solidified cash balance plan opportunities, in addition to providing clarification to questions and issues that plan sponsors and benefit professionals had posed since their early adoption. The 2017 Tax Cuts and Jobs Act, aka the 2017 tax reform, increased the popularity of these plans with small businesses even further.

What Is a Cash Balance Plan?

A cash balance plan is a flavor of defined benefit pension plan. The funding limits and rules that apply to pension plans are applicable to cash balance plans. However, unlike a traditional pension plan, a cash balance plan in some respects resembles a 401(k) plan—a retirement program that most have become accustomed to seeing in the workplace. While similar to a 401(k) on the surface, cash balance plans frequently allow contributions far exceeding the limits prescribed to 401(k)s. Depending on age and income, these plans can usually accommodate a contribution between $80,000 and $200,000+, making a positive impact on both retirement accumulation and reduction in current taxable income.

How Does a Cash Balance Plan Work?

Cash balance plans establish an internal account for every participant; all assets are pooled in a single trust and invested under the direction of plan trustee. Each account grows annually from two sources: a contribution credit and an earnings credit tied to a formula specified in the plan. For example, a cash balance plan may describe a retirement benefit as a lump sum amount based on a $1,000 contribution credit (made by the employer) and a four percent interest credit earned in the plan (guaranteed by the employer).

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How Is the Plan Funded?

Cash balance plan contributions are determined annually by the plan's actuary, who calculates the amount of funding based on the plan's crediting formula, performance of plan assets, and other actuarial factors.

Because cash balance plans are a type of defined benefit plan, if plan assets do not perform in line with the interest expectation in the plan document (crediting rate), the employer is responsible for making up the difference. Conversely, returns in excess of the plan's crediting rate will tend to reduce the required contribution.

For that reason, when considering implementing a cash balance plan, it is important to determine an acceptable funding range and to design an investment portfolio with a level of risk appropriate for the plan. Cash balance plan assets should be invested conservatively, so the investments measure up to liabilities of the plan as much as possible. This approach may be compensated by investing other assets (e.g., a 401(k) account) less conservatively, when appropriate. Working with a team of qualified pension design specialists, an actuary, and a knowledgeable financial professional then becomes an essential component of a successful cash balance retirement plan.

How Is the Money Distributed and When Is It Taxed?

A cash balance plan, especially in small business situations, typically allows a lump sum distribution at retirement, which can be annuitized or rolled over to an IRA to retain its tax-preferred status. Account balances then become subject to IRA distribution rules with ordinary income tax payable on amounts distributed. Distributions before age 59½ are subject to a 10 percent early withdrawal penalty, unless an exception applies.

The health care reform signed into law at the end of March 2010 imposed new Medicare. Individuals with earnings in excess of $200,000 and married taxpayers filing a joint return with earned income greater than $250,000 are required to pay additional payroll tax of 0.9 percent, and a new 3.8 percent tax on investment income.

Because employer contributions to retirement plans are not subject to payroll tax and the net investment income under this recent legislation does not include distributions from qualified retirement plans and IRAs, these new taxes do not apply to cash balance plan contributions or distributions. This makes cash balance plans appealing to those seeking to quickly build up their retirement savings in a tax-efficient environment, reduce current tax liability and manage income taxes on withdrawals.

What If Funding Goals of One Business Partner Differ from Those of the Other Partner?

One of the unique advantages of a cash balance plan is that it can elegantly accommodate the varying savings needs of business partners. For instance, if one is interested in increasing her contributions to $100,000, while her partner's funding objective falls within the limit applicable to a profit-sharing plan, a cash balance plan can be designed in a manner that will allow both business owners to reach their funding goals. If funding objectives change later, then the plan formula may be amended accordingly to match the needs. Such amendments, however, should not be frequent.

Considering Selling All or a Portion of a Business?

This may be yet another opportunity to utilize a cash balance plan with payments being directed to fund the seller's retirement and reduce the tax exposure both today and when ready to distribute plan assets. This strategy has been successfully utilized by organizations with varying ownership

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structures: from multiple senior partners transitioning their ownership shares to junior partners, to situations when ownership changes within a family business.

What If a Business Already Sponsors a Retirement Plan?

Each situation differs based on the unique characteristics of the plan sponsor, employee makeup and personal financial objectives. In many cases, however, establishing a cash balance plan alongside an existing 401(k) plan may prove more advantageous. For example, it may allow a business to significantly increase key employee contribution allocation while only marginally increasing benefit costs for non-key employees, and, in some instances, potentially reducing them.

What Are the Key Advantages of a Cash Balance Plan?

Cash balance plans work very well with businesses that have multiple owners; you can track contributions to specific participants more easily than in a traditional defined benefit plan. A business that installs a cash balance plan can design a cash balance contribution to its participants is either a dollar amount or a percentage of compensation, similar to a 401(k) plan. This makes cash balance plans easier to understand than traditional defined benefit plans which is helpful in planning and presenting to employees the additional benefits provided to them.

When is a Cash Balance Plan Worth a Closer Look?

Those who need to catch up on retirement savings or would like to increase their nest egg may find a cash balance plans desirable. Typical characteristics of a good candidate for a cash balance plan include:

- Ability to contribute more than $80,000 a year, including current retirement savings
- A consistent profit pattern and available surplus
- Key beneficiaries are in the 45-60 age range (for businesses without employees, age may be less of a factor) with the work force generally younger than the owner
- Ability to contribute five to eight percent of pay to the staff

For a successful business owner, cash balance plans may offer substantial advantages, including tax management, accelerated retirement savings in the tax-deferred environment, and asset protection.

To learn more, reach out to Retirement Plan Solutions consultants. Call 844.881.PLAN, send a message to retirementplans@cetera.com or click here to start a conversation.

NOTE: Individual results will vary based on plan design, census data, earnings history, actuarial calculations, and governing regulations. Because cash balance plan is a type of a defined benefit plan, minimum funding rules apply. Failure to meet minimum funding requirements leads to excise tax until funding requirements are met. The figures quoted are statutory maximums based on compensation as illustrated; lower compensation will result in lower contributions. IRS regulations limit the combined contribution to certain plans. The illustration provided is for informational and educational purposes. It is not intended to provide, and should not be construed as ERISA, tax, investment, legal or financial advice or guidance.

Distributions from traditional IRAs and employer sponsored retirement plans are taxed as ordinary income and, if taken prior to reaching age 59½, may be subject to an additional 10% IRS tax penalty.

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