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Plan Design in the Balance

Weighing the pros and cons of cash balance plans

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Is your company interested in additional tax deductions and increased retirement savings? Does your company desire deductible contributions greater than the annual additional maximum per person of \$49,000 for a defined contribution plan, at least for key personnel? If so, you should consider whether a cash balance plan is right for your company.

A cash balance plan is considered a defined benefit plan and must follow the rules relating to those plans. However, a cash balance plan looks like a defined contribution plan to the participant. A hypothetical account is maintained for each participant, the company makes annual notional contributions, and interest is credited on the account. The contribution to the account is either a flat dollar amount or a percentage of compensation. The interest credited is either a fixed rate (for example, 5%) or tied to an index, such as the 30-year Treasury bond rate. Like any defined benefit plan, benefits are based on the plan's formula and not on the actual investment earnings on plan assets. Actual investment earnings of the plan assets also do not affect the account balance. Thus, the company rather than the employee bears the investment risk. This is in contrast to a money purchase type of plan where there are actual individual accounts for which the plan sponsor must also make annual contributions. However, a money purchase plan is a defined contribution plan and the plan participant, not the plan sponsor, bears the investment risk.

As a defined benefit plan, annual actuarial valuations must be performed. The valuation determines the required minimum contribution and the maximum tax-deductible contribution. Since the contributions are determined actuarially recognizing actual asset values and future plan demographic experience, the required contribution will not match the sum of the contributions to the hypothetical participant accounts. If assets perform better than expected, required and deductible contributions by the employer will decrease. Conversely, if assets perform worse than expected, employer contributions will increase. Assets are invested in a commingled account to provide benefits for all participants; no actual individual accounts are created. Participants, therefore, cannot direct the plan's investments.

ADVANTAGES AND DISADVANTAGES

Advantages to plan participants include the following:

- Employer pays the entire cost.
- Easy to understand.
- No investment decisions or investment risk.
- Portable account balance.
- Benefit protection provided by the Pension Benefit Guaranty Corporation (PBGC).
- Compared to traditional defined benefit plans, more attractive to younger, mobile workers.

Advantages to company (plan sponsor):

- Recruitment and retention tool, especially given the fact that the plan is relatively easy for job candidates and current employees to understand.

- Often may cost less than a traditional defined benefit plan.
- If designed appropriately and assets invested properly, fluctuations in cash contributions and financial statement impact may be minimized.
- Greater funding flexibility than defined contribution plans with the ability to fund more in years with good company financial results.
- Opportunity to provide significantly greater or additional benefits than a defined contribution plan. Contributions for older executives can easily exceed \$100,000. Benefits can approach a lump sum payout, depending upon age, of nearly \$2 million per executive.

Disadvantages to company (plan sponsor):

- As a qualified plan, the plan sponsor must follow all qualified plan rules, including the requirement to maintain a plan document and make periodic amendments, administer the plan in accordance with the plan document and IRS rules and regulations, and fulfill various annual plan reporting requirements
- The plan sponsor must be prepared to make annual required contributions. Ideally, the plan sponsor's income will be steady or have peaks where additional contributions can be made to lessen the requirements during down times.
- As a defined benefit plan, annual actuarial valuations are required, along with required minimum contributions and PBGC premiums, and consulting fees.

Plan design and an appropriate investment and funding strategy can significantly counter some of these disadvantages. Since the passage of the Pension Protection Act of 2006 (PPA), it is even more important than in the past to keep the plan fully funded.

Despite some past technical difficulties that have been largely resolved, adoption of cash balance plans has continued. According to a Louis Kravitz & Associates study, 571 new cash balance plans were adopted from 1997 to 2001. The pace accelerated as 1,755 new cash balance plans were adopted from 2002 through 2006. The PPA became law in 2006 and "blessed" cash balance plans as nondiscriminatory. Therefore, it is expected more will be adopted in the future.

DETAILS OF CASH BALANCE PLANS

Exhibit 1 provides an example of a straightforward cash balance plan that credits 4% of compensation per year with an interest credit of 5%.

Year	Compensation	Credit	Interest	Account Balance
1	\$100,000	\$4,000	\$ 0	\$ 4,000
2	\$105,000	\$4,200	\$200	\$ 8,400
3	\$110,000	\$4,400	\$420	\$13,220

A cash balance plan, like any defined benefit plan, must provide an annuity benefit at retirement. In lieu of the annuity benefit, however, the account balance can be paid as a lump sum.

In addition, plans can be, within limits, designed to increase the annual credit ("contribution") based on age or service. For example, contributions to accounts could be 4% of compensation per year for the first 10 years of service and 6% per year of service after 10 years.

Cash balance plans can provide significant deductions, and a participant can accumulate nearly \$2 million in his or her account. The maximum annual dollar amount that may be credited is related to the age of the participant. Assuming maximum compensation, the following table illustrates the maximum amounts that can be reasonably credited:

Age	Credit
40	\$ 66,000
45	\$ 86,000
50	\$111,000
55	\$144,000
60	\$187,000
65	\$196,000

Exhibit 2 compares maximum profit sharing plan contributions with maximum cash balance credits over a five-year period for a participant who is 55.

Exhibit 2 Maximum Contribution Comparison for 55-Year-Old Participant

Year	Profit Sharing		Cash Balance	
	Contribution	Account	Credit	Account
1	\$49,000	\$ 49,000	\$144,000	\$144,000
2	\$49,000	\$100,450	\$144,000	\$295,200
3	\$49,000	\$154,473	\$144,000	\$453,960
4	\$49,000	\$211,197	\$144,000	\$620,658
5	\$49,000	\$270,757	\$144,000	\$795,691

Note: The table assumes a maximum contribution credit for each plan and 5% interest crediting rate.

In addition to accumulating significantly more dollars than a profit sharing plan, depending upon demographics, a cash balance plan can have class allocation credits, similar to profit sharing plans. This plan design requires annual nondiscrimination testing in addition to actuarial valuations. For example, a cash balance plan could have annual credits per participant as shown in Exhibit 3.

Exhibit 3 Sample Cash Balance Class Allocation Credits

Class	Cash Balance	
	Age Range	Credit
Owner	55	\$60,000
Highly Compensated Employees	40-50	\$17,500
Staff	25-35	\$ 2,000

For firms with more than 25 active participants that are, therefore, subject to PBGC coverage, the combined plan deductible limit (for organizations that sponsor both defined benefit and defined contribution plans) does not apply starting with the 2008 plan year. Therefore, maximum benefits can be provided under both the profit sharing and defined benefit plans.

One example of combined plans with the goal of maximizing benefits to key personnel and also maximizing the key personnel's share of the company's total retirement plans contributions is referred to as a defined benefit/defined contribution (DB/DC) combo plan. These plans require general nondiscrimination testing and must follow several additional rules. If the goal is to maximize benefits for key personnel, in addition to other requirements, a gateway test must be passed that could require a contribution of up to 7.5% of compensation for nonhighly compensated employees as defined by the Internal Revenue Code. The gateway provides minimum benefits for nonhighly compensated employees and is required to allow additional benefits for highly compensated employees under general nondiscrimination testing.

Although dependent upon demographics, not every nonhighly compensated employee must participate in the cash balance plan. There are minimum coverage and participation rules, requiring meaningful benefits for any defined benefit plan, including cash balance plans.

For small employers, a change of one or two employees either leaving or joining the company could have a significant impact on the general nondiscrimination testing. Such employers must be prepared to tweak the plans periodically to accommodate such changes in demographics to pass the nondiscrimination testing, or they should not adopt the DB/DC approach.

For DB/DC combo plans it generally makes sense to have the 401(k) profit sharing plan be a safe harbor plan. A safe harbor 401(k) plan requires minimum employer contributions such as 3% of compensation (or a minimum matching employer contribution) for nonhighly compensated employees. Safe harbor plans are exempt from the specific 401(k) nondiscrimination (actual deferral percentage/actual contribution percentage tests) testing and allow highly compensated employees to defer the maximum amount allowed without concern about the deferral rate among the nonhighly compensated employees. The employer contributions as a percentage of compensation for safe harbor purposes count toward top-heavy and gateway contribution requirements as well as general nondiscrimination testing. Exhibit 4 illustrates a possible cash balance plan design combined with a safe harbor 401(k) profit sharing plan.

If assets are properly invested, fluctuations in the annual required contribution can be significantly minimized and more closely match the sum of individual account credits plus interest. However, due to the PPA's funding rules, it may be advisable to fund at a higher level.

This is an overview of the rules. Additional details apply. Be certain your company receives advice from a qualified consultant and actuary before proceeding. However, for a company that is looking for additional tax deductions or another retention tool, a cash balance plan may be the solution. ♦

AICPA RESOURCES

JofA articles

"Managed Accounts," Aug. 07, page 32

"Time to Rethink Your 401(k) Plan?," May 07, page 50

Conference

AICPA National Conference on Employee Benefits Plans, May 18–20, Orlando, Fla.

CPE

Employee Benefit Plans Audit and Accounting Essentials, a CPE self-study course (Text #733002, DVD/Manual #183002).

For more information or to order or register, visit www.cpa2biz.com or call the Institute at 888-777-7077.

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For more information and resources for members in business, industry and government, please visit the Financial Management Center at www.aicpa.org/fmcenter.

EXECUTIVE SUMMARY

■ **A cash balance plan is considered a defined benefit plan and must follow the rules relating to those plans.** However, a cash balance plan looks like a defined contribution plan to the participant.

■ **Advantages to plan participants include:** employer pays the entire cost; easy to understand; no investment decisions or investment risk; portable account balance; benefit protection provided by the Pension Benefit Guaranty Corporation (PBGC); compared to traditional defined benefit plans, more attractive to younger, mobile workers.

■ **Advantages to company (plan sponsor) include:** recruitment and retention tool; often less costly than traditional defined benefit plan; greater funding flexibility than defined contribution plans; opportunity to provide significantly greater or additional benefits than a defined contribution plan; contributions for older executives can easily exceed \$100,000; benefits can approach a lump sum payout, depending upon age, of nearly \$2 million per executive.

■ **Disadvantages to company (plan sponsor) include:** the plan sponsor must follow all qualified plan rules; the plan sponsor must be prepared to make annual required contributions; as a defined benefit plan, annual actuarial valuations are required, along with required minimum contributions and PBGC premiums and consulting fees.

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