POLLARD
& Associates
A Strongpoint Partner

A. One North Park Drive, Suite 104
Hunt Valley, MD 21030

T. 410.771.3035 / F. 410.771.3036

pollardpensions.com

Cash Balance Plan Overview

A Cash Balance Plan is a type of qualified retirement plan that is a "hybrid" between a traditional Defined Contribution Plan and a traditional Defined Benefit Plan. Like traditional retirement plans, Cash Balance Plans qualify for tax deferral and creditor protection under the federal pension law known as ERISA.

Cash Balance Plans are particularly effective for small business owners who are looking for larger tax deductions and/or accelerated retirement savings. Employers can combine Cash Balance Plans with 401(k) Profit Sharing Plans to maximize tax-deductible contributions.

In a Cash Balance Plan, each participant has a theoretical account that resembles those in a 401(k) or profit sharing plan, but is not actually maintained in individual accounts. The plan maintains one commingled trust account for all plan participants and hypothetical individual accounts are maintained by the plan's actuary/third party administrator, who generates annual participant statements. Each participant's account grows annually in two ways:

i) ***A benefit credit***. The benefit credit is a percentage of pay or flat dollar amount that is specified in the plan document. The credit is often class-based (e.g., higher dollar or percentage amount to owners/partners or other targeted groups; lower dollar or percentage amounts to staff).

ii) ***An interest credit***. The interest credit is a guaranteed rate of return specified in the plan document, and is typically tied to federal long-term rates or set at a fixed rate between 4% to 5%. The interest credit is not dependent on the plan's actual investment performance, but the plan's investment portfolio should be structured to attempt to perform in-line with the anticipated crediting rate.

When participants terminate employment, they are eligible to receive the vested portion of their theoretical account balance.

Cash Balance Plan Benefits

What types of companies or business owners benefit from a Cash Balance Plan?

- ***Business owners or partners who want to contribute & deduct more than $72,000 per year in retirement savings.*** Many highly-compensated individuals are finding that contributions made to their 401(k) and profit sharing accounts have reached the maximum allowable amounts (currently $72,000, or $80,000 if age 50 or older). Maximum annual contributions to a Cash Balance Plan are significantly greater than what is allowable through a Defined Contribution Plan. With a Cash Balance Plan, tax deductible contributions of an additional $50,000 - $350,000 per year may be obtained depending on the age and income levels of plan participants. Cash Balance Plans are generally designed using a Class-based benefit formula, which allows different benefit credits for different classes of employees. This means that owners/shareholders can often receive higher benefits than other classes, similar to the differences permitted in Class-based profit sharing plans. These types of plans are subject to what is known as "general testing" under IRS rules.

- ***Business owners or partners who want to "catch-up" on retirement savings.*** Cash Balance Plans provide a means to catch-up on retirement savings, particularly for individuals over age 40. Maximum annual contributions to a Cash Balance plan are age-dependent, so the older the participant, the faster they can accelerate their savings. This is because older participants have fewer years to save toward the approximate $3.6 million lump-sum that may be allowed to accumulate in a Cash Balance Plan.

Sample Plan Benefits for 10-Year Plan Starting at Age 52

Age	CBP Maximum Annual Benefit Credit	CBP Plan Accumulation*
52	226,000	226,000
53	237,000	474,300
54	249,000	747,015
55	262,000	1,046,366
56	275,000	1,373,684
57	289,000	1,731,368
58	304,000	2,121,937
59	320,000	2,548,033
60	336,000	3,011,435
61	353,000	3,515,007
62	29,970	3,720,727

**5% ICR, NRA 62, 26AMT*

- ***Companies already contributing 3% or more to employees, or companies willing to do so.*** While Cash Balance Plans are often established for the benefit of owners or key executives, broad-based employees will also benefit. A minimum contribution of 7% to 8% of pay is typically provided for staff in a combined arrangement with a Cash Balance Plan, providing as little as 2% of pay benefits for Non-HCEs, plus 5% to 6% of pay in the Profit Sharing Plan.
- ***Companies that have relatively stable earnings.*** Stable cash flow and profit is important because Cash Balance Plans require minimum annual contributions to maintain plan funding. Cash Balance plans require a commitment to a relatively stable contribution level for three years or more to establish the IRS requirement of plan "permanency."

Comparison to Other Qualified Plans

What are the advantages of Cash Balance Plans over traditional Defined Benefit Plans?

Traditional Defined Benefit Plans promise a specified monthly benefit amount at retirement (e.g., 2% of pay per year of service payable at retirement age of 65). Because Cash Balance Plans define benefits in the form of an account balance, rather than a deferred monthly annuity, employees always understand what they are entitled to under the Plan. Owners and employees both know what is going into the plan on their behalf, and what will come out when they leave.

How are Cash Balance Plans Similar to a Defined Benefit Plans?

Cash Balance Plans must comply with the same funding and reporting requirements as traditional Defined Benefit Plans. Minimum funding standards apply, i.e. there is a minimum annual Employer contribution that is reported on the Schedule SB (an attachment to the Plan's Form 5500 filing). An actuary is required to calculate this contribution amount using a reasonable actuarial funding method and actuarial assumptions specified by the IRS. There is some contribution variability from year-to-year, particularly with plan asset fluctuation and participant salary increases. The employer can decide to contribute an amount between the minimum funding requirement and the maximum permitted deduction, but should attempt to fund to the actuary's recommended contribution level in order to meet the plan's current benefit liability.

How is a Cash Balance Plan Different from a 401(k) Plan?

- ***Participation*.** Participation in a Cash Balance Plan does not depend on employees contributing part of their compensation to the plan. Contributions by employees are not permitted in a Cash Balance Plan.
- ***Investment risks*.** The investment of assets in Cash Balance Plans is managed by the employer or an investment advisor appointed by the employer. The employer bears the risk and reward of the investment returns. Increases or decreases in the value of the plan's investments do not directly affect the benefit amount promised to participants. Increases in plan assets over the benefit liabilities will decrease future contribution requirements of the employer; decreases in plan assets will increase future contribution requirements.
- ***Social Security and Medicare taxes.*** Unlike payroll deducted 401(k) contributions, contributions to a Cash Balance Plan are not subject to Social Security and Medicare taxes (7.65% for both the employer and employee) for plans sponsored by employers which maintain corporate entities. Self-Employment tax is still applied to net Schedule C or K-1 income for pass-through entities, which would include the amount contributed to the plan.
- ***Life annuities*.** Cash Balance Plans are required to offer employees the ability to receive their benefits in the form of annuities payable for life, or for the joint lives of the participant and his/her spouse, but can provide and typically do provide for other options, including the ability to rollover lump-sum amounts to IRAs or other qualified plans.

How do design and administrative costs compare to those for 401(k) Profit Sharing Plans?

It is more costly to establish and administer a Cash Balance Plan than a 401(k) Profit Sharing Plan because the plan's funding must be certified by an actuary each year. However, the tax benefits of the Cash Balance Plan will often significantly exceed the additional cost. Expenses will vary by plan size and annual testing requirements.

Contributions to the Plan

How are minimum required contributions determined each year?

Because plan assets fluctuate with investment gain/loss, the theoretical participant accounts will not necessarily equal the actual plan assets. Annual deposits may be more or less than the total of the participants' benefit credits for the year and the Plan, at any point in time, can be over or under-funded. Generally, the plan's actuary and administrator will provide three contribution amounts to the Employer each year: the minimum required, the maximum deductible and the recommended amount to bring the plan asset balance equal to the benefit liabilities.

The minimum required contribution for all participants is the amount determined under the plan's actuarial cost method each year. The contribution is not at the discretion of the employer nor is it a percentage of revenue.

If the plan's actual investment growth is comparable to the interest crediting rate, the minimum required contribution will be close to the sum of the participants' benefit credits. When the actual annual return on investments is less than the interest credited under the plan, it increases the minimum required contribution. It is not a direct make-up of the deficiency, but instead is spread over future service time of the participants. When the actual annual return is greater than the interest crediting rate, future minimum contributions will be reduced.

How frequently may contribution levels be changed?

Profit Sharing Plans allow contributions to vary from year to year at the employer's discretion, but Cash Balance Plans must generally be amended to change contribution levels. Plan amendments to change contribution credits can be made from time-to-time, but should not take on the appearance that increases or decreases are tied to profits or to the income of one or more partners from year-to-year. During the plan design stage, employers can set different contribution amounts for various participants or classes of employees.

Must contributions to a Cash Balance Plan be equal?

No. Each participant can have a different contribution amount, specified as a percentage of pay or a flat dollar amount.

How are the annual interest credits determined?

Interest credits are defined in the plan document and are typically tied to federal long-term rates or set at a fixed rate between 4% to 5%% so that the hypothetical account will not result in a benefit in excess of the maximum DB limits.

Tax Deductions

What are the benefits of tax-deductions?

Contributions to Cash Balance Plans are tax-deductible in the same way as they are in a Profit Sharing Plan. Contributions directly reduce the employer's ordinary income dollar for dollar. Investment income on plan assets is tax-deferred until distributions are made from the plan, unless rolled over into another tax-qualified account (e.g. IRA). With combined Federal and State income tax rates as high as 45%, the tax savings from the contributions and subsequent investment earnings can be very significant.

How are tax deductions allocated for partnerships?

Tax deductions for contributions made on behalf of non-partner employees are taken on the partnership tax return. Tax deductions for contributions made on behalf of individual partners are taken on their personal or corporate tax returns. To ensure that the amount deducted for tax purposes by a partner as shown on the Schedule K-1 is the same as the amount contributed on behalf of the partner, the partnership agreement must permit this method of allocation.

Distributions from the Plan

What are the distribution options at retirement or termination?

Cash Balance assets are portable. When a participant terminates employment or retires, they become eligible to receive the vested portion of their account balance, as determined by the plan's vesting schedule. A payment election is made by the participant at the time benefits are available for distribution (upon retirement, termination of employment, death or disability).

Benefits in the form of a monthly annuity must be the "normal" form of benefit payment under Cash Balance Plans, even though the benefits under the plan are expressed in the form of a hypothetical account. The monthly annuity payment may be waived by a notarized election by the participant and his/her spouse. Once waived, a lump-sum payment or installment payments are available. Lump-sum payments can be rolled over to an IRA or another qualified retirement plan. Actuarial assumptions and life expectancy tables are used by the plan's actuary to convert the retirement benefit from one form of payment to another.

Miscellaneous

Are benefits protected?

A Cash Balance Plan is covered under the Pension Benefit Guaranty Corporation (PBGC) insurance program, except when the plan covers only substantial owners or is sponsored by a professional service corporation with less than 25 employees. Therefore, benefits are protected, but with an annual premium per-head cost to the Employer. In the event of distress plan termination where the plan sponsor does not have sufficient funds to pay all benefits, the PBGC will make certain guaranteed benefit payments.

Can a Cash Balance Plan be frozen or terminated?

Yes, Cash Balance Plans can be frozen or terminated, but contributions for benefits accrued during the plan year must still be made for staff employees. Benefits for partners or owners can be waived but only in order to terminate the plan with assets sufficient to pay all benefit liabilities.