ROUND TABLE
WEALTH MANAGEMENT

CASH BALANCE PLANS

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Employer sponsored retirement plans are a great way for owners and employees to defer their income and save for retirement, whether with pre-tax dollars (Traditional) or after-tax contributions that receive tax-free growth (Roth). When deciding the type of plan to establish for the company and its employees, employers have the option to implement two types of plans: defined contribution plans and defined benefit plans.

A defined contribution plan is a type of retirement plan in which the employer, employee or both can make contributions on a regular basis. In a defined contribution plan, individual accounts are set up for participants and the benefits are based on the amounts credited to these accounts plus any investment earnings and the employee bears the investment risk. A 401(k) is the most used employer sponsored defined contribution plan.

A defined benefit plan or pension plan is a type of retirement plan in which an employer promises a specified benefit in the form of installment payments, lump-sum, or a combination of both upon retirement. These benefits are predetermined by an actuarial formula based on tenure, age, and the employee's earnings history. In the case of a defined benefit plan, the employer bears the investment risk.

A new concept is evolving in the pension world that combines both features of a traditional defined contribution and defined plan. A cash balance plan is sometimes referred to as a "hybrid" plan as it allows for the high contributions of a defined benefit plan, but with the look, feel and portability of a defined contribution plan. Like a defined benefit plan a cash balance plan defines the benefit to a participant, but the promised benefit is defined in terms of a stated account balance similar to a defined contribution plan.

This article:

- *Examines further what a cash balance plan is, the advantages, and key considerations; and*
- *Who might be a good candidate to establish this type of retirement plan.*

What is a Cash Balance Plan?

A cash balance plan is an IRS approved qualified employer sponsored retirement plan. They are utilized when somebody wants to contribute more than the annual defined contribution maximum limit (currently $61,000, $67,500 if age 50 or older). Like pension plans the contributions to a cash balance plan are dependent on numerous factors including age, compensation, and years of employment. Because of the numerous factors to consider it is important to work with a qualified Third-Party Administrator (TPA) or actuary that will help design a retirement plan, typically in conjunction with the 401(k) and profit-sharing, to maximize contributions, while meeting the cash flow objectives of the business. It is important to note that a 401(k) and profit-sharing plan are two separate defined contribution plans. A profit-sharing plan enables workers to share in their company profits and the key difference between a 401(k) and profit-sharing plan is that only employers contribute to a profit-sharing plan. The contributions made to profit-sharing plans are a key aspect in enabling business owners to maximize cash balance plan contributions and pass testing requirements.

Each eligible participant has a cash balance account that grows in two ways, a contribution credit and the interest crediting rate. The contribution credit is the amount that the employer contributes annually on behalf of the participants. This amount can either be a flat dollar value or a percentage of income. The third-party administrator or actuary will calculate the required contribution each year.

Cash balance plans are not set up to allow a business owner to decide year by year how much they would like to put away. Business owners should ensure they have stable, consistent cash flows, generally for a minimum of three years when deciding if a cash balance plan is appropriate or not. Shorter durations may create tax problems.

In addition to the annual employer contributions, a participant's cash balance account also grows by the earnings on those contributions referred to as the interest crediting rate. The interest crediting rate is the rate at which the plan assets are guaranteed to grow. The interest crediting rate cannot exceed a reasonable "market rate of return", and typically most actuaries will use between four and five percent. Because the assets of a cash balance plan are pooled and investments are directed by the trustee rather than each individual participant, the employer bears the investment risk of the plan being over or underfunded. It is therefore imperative to work with a financial professional that understands these plans and manages the investments to a target return that is consistent with the interest crediting rate. Lackluster investment returns may require an employer to add additional contributions at their expense.

Advantages of establishing a Cash Balance Plan

The primary benefit of establishing a cash balance plan is to super-charge your retirement savings, while providing significant tax deductions for high income earners.

For example:
Although contributions are dependent on several factors, a business owner who is 55 years old, may be able to contribute as much as $200,000 per year vs. the maximum 401(k)/profit-sharing contributions of $67,500. If we were to assume the top marginal tax bracket of 37%, a business owner could defer nearly $75,000 a year in federal taxes. State tax deductibility may vary from state to state, and you should always consult with a tax advisor.

As mentioned earlier, cash balance plans can be designed in conjunction with a 401(k)/profit-sharing plan. These contribution amounts would be in addition to the contributions being made to those plans, as well. Another benefit is the contribution limits can grow as you get older.

For business owners who may spend most of their earnings in the earlier part of their career investing back into the business, as the business matures a business owner could back end their contributions in later years to "catch up". The reason for this is the maximum permissible lump sum distribution from a cash balance plan is $3.15 million during 2022, so an older person has fewer years to save toward that maximum allowing for higher contributions. Younger business owners may still benefit, but to a lesser extent.

In addition to the flexible structure, which allows cash balance plans to be structured together with a 401(k)/profit-sharing plan, cash balance plans allow for a wide range of investment options. Most 401(k)s typically limit participants to choose from a plan line up that has a handful of funds chosen by the plan administrator or investment manager. A cash balance plan can open the universe of funds and investments that may not be available within a 401(k), such as individual stocks and bonds, however, don't forget the employer bears the investment risk.

Asset protection is another key benefit of cash balance plans. As is the case with all IRS qualified retirement plans, the assets in a cash balance plan are protected from creditors in the event of bankruptcy or many other lawsuits. Since business owners may be more vulnerable to lawsuits, it is very advantageous to maximize retirement savings in asset protected vehicles, such as qualified plans like a 401(k) or a cash balance plan.

Once you reach the retirement age defined by the plan, you are eligible to withdraw money in one of two ways. Like a traditional pension plan, you can opt to choose an annuity that makes systematic payments throughout your life, or you can opt to rollover your balance into an Individual Retirement Account (IRA). A rollover to an IRA account would not be a taxable event.

Considerations when establishing a Cash Balance Plan

Cash balance plans may seem intuitive to any business owner looking to take advantage of the tax benefits and high contribution limits, but they do come with risks that should be considered prior to establishing a plan. The most important consideration involves market value fluctuations and how it impacts future contributions required by the business. If the cash balance plan's investment results are below the stated returns in the plan (interest crediting rate), the shortfall will need to be made up with additional tax-deductible contributions by the company.

While these additional contributions may be amortized over 15 years, it increases the amount that has to be contributed to the plan and potentially less money that is available to re-invest into the business. Alternatively, if the plan's investment results are excellent, the future contribution requirements are decreased, in turn reducing the employer's tax deduction. In Figure 1 below, we show a numerical example on the impact of contributions and market fluctuations on a cash balance plan.

Hypothetical Example

Assumptions	
Contribution Credit	$100,000.00
Interest Crediting Rate (ICR)	5%

Scenario 1 - Strong Investment Performance		Scenario 2 - Poor Investment Performance	
Beginning Balance	$100,000.00	Beginning Balance	$100,000.00
Market Performance	15%	Market Performance	-15%
End of Year Balance	$115,000.00	End of Year Balance	$85,000.00
Balance to be considered fully funded*	$205,000.00	Balance to be considered fully funded*	$205,000.00
Contribution Required**	$ 90,000.00	Contribution Required**	$ 120,000.00
Reduction in Tax Deductible Contribution	**$ 10,000.00**	**Reduction in Tax Deductible Contribution**	**$ 20,000.00**

As seen in the example above, cash balance plans require an annual contribution credit and typically you will not have the ability to modify this credit year over year. These contribution credits are important when establishing a cash balance plan to ensure the business will be able to generate sufficient taxable income to benefit from the deduction and committing to that amount for a minimum of three years. If a business owner has volatile cash flows year over a year, a cash balance plan may not be suitable. Slow and steady is key.

In addition to the contribution requirements and cash flow planning, cash balance plans tend to be more administratively burdensome. Because of the complexity of the plan design, these plans require ongoing valuation analysis and discrimination testing which needs to be certified by an actuary each year. This will increase the costs of maintaining the plan. Since cash balance plans are defined benefit plans, Pension Benefit Guaranty Corporation (PBGC) premiums are also required, with the exception of professional service corporation plans with under 25 participants. These premiums add an additional expense to maintaining the plan.

Who are Great Candidates to Adopt Cash Balance Plans?

There are many pros and cons to establishing a cash balance plan for a small business. If you are a business owner and meet several of the following criteria, it may be wise to consult with a financial professional and begin the discussion to see if it is the right fit for you.

- Employers looking for contributions to key personnel that exceed the defined contribution limit, which is currently $61,000 ($67,500 if age 50 or older).
- Demographics such that key employees are older on average than the rest of the employees.
- Business consistently produces steady excess cash flow for at least 3-5 years.
- Company has fewer than 15 employees per one owner. Additional employees could greatly increase the overall cost to run such a plan and should be considered carefully.
- Already provide employees with an employer contribution or are interested in doing so. This could include a Profit-Sharing Plan or Safe Harbor 401(k).

Conclusion: Optimizing Your Cash Balance Plan

If you are considering alternative retirement plan options to maximize investment and tax savings through a cash balance plan, you should consult with a knowledgeable advisor that is focused on the tax and investment implications. The Wealth Advisors at Round Table Wealth Management have the experience managing cash balance plans from an investment perspective as well as the industry contacts and resources to ensure the plan design and cost structure is optimized for business executives to maximize their savings.

Contact us to learn more or to speak to an advisor.

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