

Cash Balance Retirement Plan

Could This be the Solution We've Been Hoping For?

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Recent changes in pension plan law have paved the way for companies to adopt cash balance pension plans, which allow individuals to quickly accumulate benefits for retirement and express the value of benefits as an account balance. The Pension Protection Act of 2006 (PPA) includes the long-awaited guidance that cash balance plans are not inherently age-discriminatory. This legislation is expected to result in the continuation of the trend in conversions of traditional Defined Benefit (DB) plans to cash balance plans and the creation of new cash balance plans. In addition, PPA provides regulatory authority for an employer to establish a single plan containing both DB and 401(k) features. The DB feature can be a traditional DB plan or a hybrid DB plan, such as a cash balance plan. This article focuses on the cash balance DB plan, which defines each participant's benefit as an account balance, similar to the 401(k) plan.

Solution for Smaller Companies

For smaller companies, combining a cash balance plan with a profit sharing/ 401(k) plan may be the retirement plan solution that maximizes the ability to provide larger contributions to company owners and other highly compensated employees (HCEs). Since benefits under a cash balance plan accrue faster than they do with a traditional DB plan, these plans can provide greater benefits to younger HCEs than would traditional DB plans. Also, under a Defined Contribution-only (DC) plan, the annual contribution to an employee is limited to \$45,000. With the combination DB/DC plan, the annual contribution can be well in excess of \$100,000. These contributions are tax-deductible to the employer or employee (through 401(k) deferrals) at the time they are made, and they accumulate on a tax-deferred basis inside a qualified trust.

A partial example of total annual contributions allocated to participants from the cash balance plan and profit sharing / 401(k) plan is seen in the following table:

Highly Compensated Employees		
Age	Service	Total Contributions
60	30	\$125,000
50	15	110,000
40	5	55,000

Non-Highly Compensated Employees		
Age	Service	Total Contributions
60	30	\$10,000
55	20	8,000
30	5	2,000
25	1	1,000

In this example, annual contributions total \$605,000 with 88% allocated to HCEs.

Solution for Larger Companies

For larger companies, the combination DB/DC plan allows employers the benefit of offering a competitive matching 401(k) plan to attract younger employees, with the security of a DB plan to retain experienced workers. This combination also has the appealing diversity of investment risk, with the employee accepting the investment risk under the DC plan and the employer under the DB plan. When employers analyze the merits of maintaining either a DB or DC plan, many recognize the advantage of offering a DB plan because it:

- provides larger benefits at lower costs. This is because the average investment return of employer-directed retirement assets is higher than the average investment return of the individual 401(k) investor participant.
- allows better management of the employer's workforce. DB plans encourage retention and orderly retirement.

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- pools investment and mortality risk across groups of employees to help lessen the risks and provide better retirement security.

While the traditional DB plan achieves all of the above objectives, the cash balance pension plan provides an alternative that also satisfies these objectives while communicating the benefit as an account balance. This leads to a much higher appreciation of the cash balance plan, especially among younger employees.

PPA also provides the much needed ability for employers to manage their DB plan contribution volatility risk. In general, plans must be maintained at a 100% funded level with amortization of any shortfalls. However, PPA has greatly increased the deductible contribution limit so companies can now fund their DB plans up to 150% of target liability. This provides the opportunity for sufficient margin against experience losses such as investment loss and decreased interest rates and the ability to fund more in good business cycles and less during leaner years.