Quick Reference

Cash Balance Plans

A cash balance plan is a type of defined benefit pension plan which has the appearance and feel of a defined contribution plan. The Treasury regulations refer to cash balance plans as "hybrid" plans. The benefit in a cash balance plan is generally expressed as a "hypothetical account." This account consists of the sum of "pay credits" and "interest credits." A pay credit can be a flat dollar amount or be expressed as a percentage of compensation. An interest credit is typically a fixed rate of interest (other options exist but may not be practical in the typical situation).

For example, consider a plan which provides for a pay credit equal to 30% of compensation for eligible employees who receive credit for 1,000 hours of service during the year. The plan also provides for an annual interest credit equal to 4% of the hypothetical balance, as of the beginning of the year. Interest credits are earned each quarter.

Example: Sarah has satisfied the eligibility requirements of the plan and enters on January 1, 2019. Her compensation for 2019 is $150,000. She works more than 1,000 hours each year. As of January 1, 2019, Sarah has a hypothetical account of zero. As of December 31, 2019, she has a hypothetical balance of $45,000 (30% of $150,000). She does not receive an interest credit in 2019 because she did not have a hypothetical balance as of January 1, 2019.

She begins 2020 with a hypothetical balance of $45,000. As of December 31, 2020, she receives another pay credit of $45,000. She also receives an interest credit of $1,800 (4% of $45,000). Her hypothetical balance as of December 31, 2020 is $91,800 ($45,000 X 2 + 4% X $45,000).

Despite appearing like a supersized defined contribution plan, cash balance plans are treated as defined benefit pension plans for the following reasons:

- These types of plans are almost always intended to serve as wealth accumulations vehicles, where a participant elects to receive the hypothetical balance in a lump sum (eligible for rollover). However, the plan does guarantee a periodic lifetime benefit at retirement based on the hypothetical balance and actuarial assumptions stated in the plan.
- The employer generally bears the investment risk. In other words, if over the life of the plan it earns an average of 3% per year, and the interest crediting rate is 4% per year, the employer must fund the shortfall.
- The employer bears the cost of annuity risk. If a participant elects an annuity and the cost to purchase that annuity from an insurance company exceeds the hypothetical balance, the employer must fund the difference. In practice, most participants in a cash balance maintained by a small business do not elect an annuity. The intended use of the vast majority of cash balance plans established by small businesses and professional practices, is to accumulate wealth, and not to provide a periodic benefit.

An employer might choose to adopt a cash balance plan rather than just a defined contribution plan because the deduction limitations in the cash balance are the same that apply to defined benefit plans. In general, for participants over age 40, these plans can provide much larger deductions and retirement accumulations than typical defined contribution plans. The actual range of deductible amounts each year can vary widely. The amounts are dependent on complex actuarial calculations. However, if we view the deductible amounts as the maximum value that can be accrued in a year, the list below shows some examples:

- Age 40- $88,000
- Age 45- $115,000
- Age 50- $151,000
- Age 55- $198,000
- Age 60- $258,000
- Age 65- $269,000

The employer can also set up a 401(k) profit sharing plan alongside the cash balance plan. In addition to the cash balance deductions, deferrals can be made to the 401(k) plan, as well as varying amounts of employer profit sharing contributions.

Cash balance plans can offer several distinct advantages over traditional defined benefit plans:

- Cash balance plans permit distribution of the hypothetical balance as the lump sum benefit. In a traditional defined benefit plan, the lump sum benefit is the actuarial present value of the accrued benefit. This concept is non-intuitive. In addition, the actuarial factors used to make this calculation vary over time resulting unanticipated increases or decreases in the lump sum value. The cash balance plan eliminates this complexity. The lump sum benefit is simply the hypothetical balance. In order to obtain this special treatment, a cash balance plan must offer 3 year cliff vesting for benefits (or better) and credit not more than a “market” rate of interest. Many pages of regulations are devoted to the latter requirement and a discussion is beyond the scope of this summary.
- In situations where the employer desires to provide the same benefit to owners of differing ages, the cash balance plan offers a distinct advantage over the traditional defined benefit plan. Consider a traditional defined plan which provides for an annual accrual of $1,000 per month for each partner. When calculating the lump sum equivalent of this amount, a partner who is older will have a greater value than a partner who is younger. The solution in the past was to have a different benefit formula for each partner, in order to equate their lump sum values. Not only was this cumbersome, it became imprecise, as the years passed. The cash balance plan simply provides the same pay credit to each partner, thus easily and intuitively solving the problem.
- Cash balance plans level the cost of benefits over the employee’s working life. Take an employee who works from the ages of 45 to 65 at a company that maintains a traditional defined benefit plan. Assume the employee accrues an additional benefit of $200 per month, for each year of service. The value (and therefore the cost) of that accrual at age 45 is much lower than the cost at age 64. In other words, the cost of funding the same incremental benefit increases over time due to increasing present values. In the cash balance plan, the cost of a level pay credit, remains level each year.
- The value of the hypothetical account is much more intuitive than that of a pension benefit.
- Other more subtle advantages such as ease of projection and sensitivity of funding to changes in compensation (in some cases).

In small companies and professional practices, cash balance plans are almost always paired with 401(k) profit sharing plans. The typical pattern is for the principals to receive a far greater share of the cash balance benefits than other employees. The other employees will receive significant profit sharing contributions. As plans increase in size, the pattern of contributions within each plan can become very complex. This occurs because the nature of the actuarial non-discrimination testing (highly compensated employees versus others), puts a premium on the value of amounts contributed to profit sharing. Therefore, by providing most of what non-highly compensated employees receive through profit sharing, costs for employees get reduced, relative to what they would be if the cash balance were the only plan.

Cash balance plans that cover employees other than owners, or professional practices that have ever covered more than 25 participants, are subject to the jurisdiction of the Pension Benefit Guaranty Corporation (PBGC). Plans subject to the PBGC are required to pay annual premiums to the PBGC. These premiums are usually small relative to the plan contributions. However, in absolute amounts, they can be significant.

The PBGC guaranties a certain portion of benefits, should the plan be unable to provide benefits and the company is unable to make the necessary funding. This is generally a rare occurrence in the realm of single employer pensions. In addition, the types of companies that seek to adopt cash balance plans usually have good cash flow. It is highly unlikely PBGC guarantees will be triggered. Nevertheless, covered plans have to pay these premiums. The current PBGC premium is $83/participant in 2020. In addition, unfunded benefits (calculated using special PBGC factors) are 4.5% of the unfunded amount. There are special mitigating rules for plans with up to 25 participants.

Ironically, a plan that is covered by the PBGC is subject to larger profit sharing deductions, assuming the actuarial non-discrimination testing supports them.

The Tax Cuts and Jobs Act created new Code Section 199A, first effective in 2018. This section provides for a deduction of up to 20% of Qualified Business Income (QBI). In general, QBI is pass through income such as S Corporation dividends, partner K1 income, or proprietorship Schedule C income. The rules are somewhat complex. Final regulations were issued at the end of 2018. A detailed discussion of these rules is beyond the scope of this summary. However, it should be noted that it is possible for cash balance plans to have 3 types of impacts on the QBI deduction. These outcomes are based on the fact that qualified plan deductions reduce taxable income, but also reduce pass through income subject to the deduction (for affected entities):

- Individual is not eligible for the QBI deduction so the qualified plan deduction does not impact the QBI deduction.
- Individual is eligible for the QBI deduction and has income below the phase-out range. In this case the qualified plan deduction reduces the QBI deduction. It may still be advantageous to contribute to a qualified plan, but an analysis should be performed.
- Individual has income above the phase-out range. However, a large deduction, such as that available under a cash balance plan could reduce taxable income to a level within, or below the phase-out range. In this case adding the cash balance plan provides an enhanced deduction because it recaptures at least some of the QBI deduction in additional the cash balance deduction.

In conclusion, cash balance plans constitute a more intuitive type of defined type plan. Companies and professional practices with large cash flow that want to reduce taxable income, while saving for retirement, may want to consider a cash balance plan. In evaluating the viability of a cash balance plan in a particular situation, it is important to discuss your objectives with a plan service provider or actuary. There is no substitute for a thorough discussion which considers all relevant factors. In addition, we recommend that any prospective adopter review any recommendations with their own tax professional.