Cash Balance Plans

Should professional practices look into them?

Provided by DSA Financial Group

In corporate America, pension plans may be fading away. Only 14% of Fortune 500 companies offered them to full-time employees in 2019. In contrast, legal, medical, accounting, and engineering firms are keeping the spirit of the traditional pension plan alive by adopting cash balance plans.[1]

Owners and partners of these highly profitable businesses sometimes get a late start on retirement. Cash balance plans give them a chance to catch up since these defined benefit plans are age-weighted: the older you are, the more that can sock away each year, up to $336,000, depending on your age.[2]

How does a cash balance plan differ from a traditional pension plan? In a cash balance plan, a business or professional practice maintains an account for each employee with a hypothetical "balance" of pay credits (i.e., employer contributions) plus interest credits. The plan's objective is to pay out a pension-style monthly income stream to the participant at retirement – either a set dollar amount or a percentage of compensation. Lump-sum payouts are also a choice. Another important factor to keep in mind is that cash balance plans are commonly portable: the vested portion of the account balance can be paid out if an employee leaves before a retirement date.[3]

An employer takes on responsibility with a cash balance plan. The plan document states that annual contributions must be made—either in the form of a percentage of pay or a lump sum. An actuary needs to advise the employer, and help the business determine the yearly contribution needed to appropriately fund the plan. The employer effectively assumes the investment risk, not the employee.[3]

Cash balance plans must cover at least 50 employees or 40% of the firm's workforce, whichever is lesser. They can be used in tandem with 401(k) plans.[4]

Benefits are based on career average pay. In a traditional defined benefit plan, the eventual benefit is based on a 3- to 5-year average of peak employee compensation multiplied by years of service. In a cash balance plan, the benefit is determined using an average of all years of compensation.[3]

Cash balance plans can be less sensitive to interest rates than some pension plans. As rates rise and fall, liabilities in a traditional pension plan fluctuate. This may open the door to either overfunding or underfunding (and underfunding is a major risk right now with such low interest rates).

A cash balance plan cannot be administered with any degree of absentmindedness. It must pass yearly non-discrimination tests; it must be submitted for Internal Revenue Service approval every five years instead of every six. A plan document must be drawn up and periodically amended, and there are the usual annual reporting requirements.

Ideally, a cash balance plan is run by highly compensated employees (HCEs) of a firm who are within their prime earning years. In the ideal scenario for non-discrimination testing, the HCEs are 10-15 years older than half (or more) of the company's workers.

If trouble occurs and a company flounders, cash balance plan participants have a degree of protection for their balances. Their benefits are insured up to their maximum value by the Pension Benefit Guaranty Corporation (PBGC). If a cash balance plan is terminated, plan participants can receive their balances as a lump sum or request periodic payments.3

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