

GRAF & STIEBEL

TEN QUESTIONS ABOUT CASH BALANCE PLANS

1. What is a cash balance plan?

A cash balance plan is a defined benefit plan that looks and operates like a defined contribution plan (only with higher contribution limits). In a cash balance plan, the participant's accrued benefit is expressed in terms of a hypothetical account balance. Each year, the participant's hypothetical account receives an allocation (a "pay credit") and notional earnings (an "interest credit"). The pay credit is often a fixed dollar amount for highly compensated employees based upon age and a fixed percentage or dollar amount for non-highly compensated employees, regardless of age. For example, a participant may receive an annual pay credit of \$3,000 and an interest credit of 5%. To determine the appropriate formula for a cash balance plan, a census of employee data is required.

2. How is a cash balance plan different from a traditional defined benefit plan?

A traditional defined benefit plan typically provides a uniform benefit for all participants at normal retirement age. The only variable in such plans is the annual contribution required from the employer to provide the promised benefit at retirement. Because the benefit promised to participants is the same regardless of age, the employer is often required to make a larger contribution for older participants because they have less time to accumulate earnings.

In a cash balance plan, the annual contribution consisting of a pay credit and an interest credit is determined at the outset. The only variable in such plans is the benefit that accrues to each participant (expressed as a percentage of compensation). Thus, cash balance plans are able to leverage the additional time younger participants have to accrue earnings to reduce the employer's total contribution, just like a cross-tested defined contribution plan.

3. What problems have arisen with cash balance plans?

Cash balance plans have been plagued by two problems: age discrimination issues and the "whipsaw effect." Some federal courts have held that because younger participants in a cash balance plan accrue more interest credits than older participants (because they have more years to retirement), such plans are inherently age discriminatory. These decisions, along with an IRS moratorium on issuing cash balance determination letters, cast a cloud over the viability of cash balance plans. In addition, the previous IRS rules for calculating lump sum payments often resulted in distributions greater than the hypothetical account balance. Known as the "whipsaw effect," this anomaly made cash balance plans less attractive to certain employers.

4. Have these problems been corrected?

Yes. First, the Pension Protection Act of 2006 ("PPA") provides that a plan will not be treated as discriminatory if a participant's accrued benefit as determined as of any date under the plan is equal to or greater than that of any similarly situated, younger individual. Second, the PPA eliminates the whipsaw problem by allowing a lump sum distribution to equal the hypothetical account balance.

5. How is the interest credit determined?

Beginning in 2008, the PPA requires that a cash balance plan credit interest at no more than a “market rate of return.” The PPA does not define this term, and additional guidance from the IRS is expected. Congressional statements made during consideration of the PPA indicate that the term “market rate of return” will include a fixed rate of interest that is no greater than the yield on long-term, investment-grade corporate bonds.

6. What are the advantages of a cash balance plan?

- Easier for employees to understand because of the hypothetical account balance, which looks like the account in a typical defined contribution plan.
- Employer contributions are generally lower because a cash balance plan eliminates the disparity between older and younger employees.
- Direct tracking of contributions to benefits.
- More contributions can be made at lower cost to the owners.

7. What are the disadvantages of a cash balance plan?

- The allocation and interest credits are guaranteed each year regardless of profitability, so the employer bears the risk of loss.
- Accounts must be pooled for investment purposes.
- More expensive to maintain.
- Plan assets can become trapped if the plan is over-funded.
- Participants are fully vested after three years.

8. Who is a good candidate for a cash balance plan?

- Professional firms with two or more shareholders.
- Businesses with ten or more employees.
- Owners who are between the ages of 45 and 70 and employees that are, on average, at least 5-10 years younger.
- Owners who want to contribute more than \$50,000 per year and are willing to pool their accounts for investment purposes.
- Businesses with consistent cash flow.

9. Who is not a good candidate for a cash balance plan?

- Plans where discrimination testing depends on one or two younger employees.
- Employees are of a similar age as (or older than) the owners.
- Owners have not yet maximized a defined contribution plan.
- Businesses with inconsistent cash flow.

10. Do you have an example of a cash balance plan?

Below is an example of a 401(k) profit sharing plan combined with a supplemental cash balance plan. The calculations are based on the rules contained in the PPA that are effective for 2008. The employer in this example is a medical group consisting of six physicians and a staff of 20 employees. Because the plan is maintained by a professional group with more than 25 employees, it is covered by the PBGC and is not subject to the deduction limits applicable to employers that maintain both a profit sharing 401(k) plan and a defined benefit plan.

Owners	Age	Plan Comp.	401(k) Deferrals	Catch Up Deferral	Profit Sharing	Cash Balance Allocation	Total
1 Owner	62	\$230,000	\$15,500	\$5,000	\$30,500	\$181,600	\$232,600
2 Owner	57	\$230,000	\$15,500	\$5,000	\$30,500	\$132,700	\$183,700
3 Owner	53	\$230,000	\$15,500	\$5,000	\$30,500	\$96,200	\$147,200
4 Owner	49	\$230,000	\$15,500	\$0	\$30,500	\$77,700	\$123,700
5 Owner	47	\$230,000	\$15,500	\$0	\$30,500	\$66,200	\$112,200
6 Owner	45	\$230,000	\$15,500	\$0	\$30,500	\$56,300	\$102,300
Total for Owners		\$1,380,000	\$93,000	\$15,000	\$183,000	\$610,700	\$901,700
Total for Other Employees		\$1,030,000	\$0	\$0	\$82,400	\$20,600	\$103,000
TOTAL		\$2,410,000	\$93,000	\$15,000	\$265,400	\$631,300	\$1,004,700

Cash Balance Contribution	\$631,300
Profit Sharing Plan Contribution	\$265,400
Total Tax Deduction (Not including 401(k) deferrals)	\$896,700
Percentage for Owners	89.749%