A Primer on Cash Balance Pension Plans

What is a Cash Balance Pension Plan?

A Cash Balance plan is a type of defined benefit pension that operates in ways similar to a profit sharing plan by clearly showing the amount of contribution being credited to each participant and the value of each participant's account.

How does a Cash Balance Plan work?

Each participant has an individual account, similar to a 401(k). The account grows in two ways. First, a company contribution is determined by a formula specified in the plan document. It can be a percentage of pay or a flat dollar amount. Second, the account grows with an annual interest credit. The rate of return is typically guaranteed and not dependent on the plan's investment performance. The rate of return generally changes each year and is often equal to the yield on the 30-Year Treasury bond, which in recent years has been around 3% or less. When participants terminate employment, they will be eligible to receive the vested portion of their account balance. A participant's vested percentage is determined by the plan's vesting schedule.

Plan investment and contributions

Individual participants are not able to invest their account – plan assets are pooled and invested by the trustee or investment manager. For traditional cash balance plans, the accounts of the participants will be credited with interest at a set rate guaranteed by the plan regardless of the actual investment return.

If a traditional plan's investment earnings exceed the crediting rate, the excess will be used to reduce future employer contributions. This will not affect the amount that is credited to the participants' accounts. That is, the account will increase according to the plan's schedule and the increase will be funded partly from a reduced employer contribution and partly from the excess investment earnings.

If the plan's investment earnings are less than the 30-Year Treasury rate, then future employer contributions will be increased. This make-up is typically spread out over five years. The assets can be invested utilizing any asset allocation method, although most groups use a conservative allocation model.

Can a Cash Balance plan be offered in addition to 401(k), Profit Sharing or other plans?

Yes, the employer can offer qualified retirement plans in combination to produce a desired effect.

Distribution options

In general, the vested accounts in a Cash Balance plan can be paid as lump-sum distribution or rolled over to an IRA upon the participant's retirement or termination of service. In addition, an annuity form of benefit could be elected where the participant receives a set monthly pension.

Can Cash Balance contributions change? Increase or decrease?

Yes, but with restrictions. Cash Balance plan contributions cannot vary from year-to-year depending on profitability. When establishing the plan it must be the employer's intention to contribute to fund the plan benefit for the foreseeable future. However, Cash Balance plans can be amended from time to time to permit different contribution levels, with some restrictions. Specifically, any reductions must be made before an employee works 1,000 hours during a plan year. For most participants, 1,000 hours will be reached in June for a calendar plan year. In addition to amending the plan, it can also be frozen or terminated.

Must everyone participate equally in the Cash Balance plan?
No, within government limits employers can designate different contribution amounts for participants.

Tax deductions and allocation of plan contributions for partnerships
Tax deductions for contributions made on behalf of non-partner employees are taken on the partnership tax return. Tax deductions for contributions made on behalf of partners are taken on their personal or corporate tax returns. However, to be sure that the amount deducted for tax purposes by a partner as shown on Schedule K-1 is the same as the amount contributed on behalf of the partner, the partnership's agreement must permit this method of allocation.

Is the plan subject to IRS discrimination testing?
Yes, like any other qualified plan it is subject to discrimination testing. In addition, a plan sponsor should anticipate employer contributions in the range of 7.5% for staff if the owners or partners receive the maximum Cash Balance contribution, assuming the plan is paired with a cross tested profit sharing plan. The exact percentage required for staff employees depends on the results of discrimination testing.

How do design and administrative costs compare with 401(k) profit sharing plans?
It is more expensive to set-up and administer a Cash Balance plan than a 401(k) profit sharing plan because the plan is maintained annually by an actuary. Expenses will vary by size of plan and annual testing requirements.

Who are good candidates for a Cash Balance plan?
Good candidates have one or all of the following characteristics:

- Owners or partners who desire to contribute more than $57,000* per year.
- Companies which have demonstrated consistent profit patterns.
- Companies already contributing 3-4% or more to employees, or at least willing to do so.
- Owners or partners over 35 years of age who desire to "catch-up" on their pension savings.

Advantages of Cash Balance Pension Plans

- Much higher contribution amounts for pre-tax dollars
- Acceleration of retirement savings
- Combine nicely with 401(k) and/or Profit Sharing for some contribution flexibility and higher amounts
- Portable in the event of job-change or termination
- Assets protected from creditors in the event of bankruptcy
- More flexible than traditional Defined Benefit plans
- Many distribution options upon retirement: lump sum payout or rollover to IRA

Potential disadvantages versus some other retirement plan alternatives may include mandatory funding requirements, higher contributions for the rank-and-file employees and more complicated and costly plan

*Represents 2020 limit. This may be adjusted for inflation in future years.

Oppenheimer & Co. Inc.
85 Broad Street
New York, NY 10004
800-620-OPCO • 212-668-8000
www.opco.com

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