
The Cash Balance Plan

A cash balance plan is a “hybrid” retirement plan that has the features of both a traditional defined benefit plan and a defined contribution plan.

What is a cash balance plan?

A cash balance plan is a defined benefit plan that defines the benefit in terms that are more characteristic of a defined contribution plan. In other words, a cash balance plan defines the promised benefit in terms of a stated account balance. A cash balance plan should only be put in place with the intention of funding for a minimum of five years to meet IRS permanency guidelines.

Like a traditional defined benefit plan, benefits under a cash balance plan must be definitely determinable; that is, the participant’s benefit at retirement age must be determined by the plan. This is accomplished by defining the contribution (pay) credits and interest credits in the plan document.

In a cash balance plan, the participant’s “account” is credited with:

- Pay credit (for example, 5% of compensation from the employer).
- Interest credit (may be either a fixed amount or a variable rate tied to a benchmark, such as the rate paid by Treasury bills).

These accounts are often referred to as “hypothetical accounts” because they do not reflect actual contributions to an account or actual gains and losses allocable to the account.

The cash balance plan provides employees with a guaranteed rate of return, regardless of the actual results of the plan. The employer is responsible for funding the plan to pay for benefits. This means that if the investment return on the plan is low, the employer will have to make larger contributions, and if the return is greater than the amount needed, the employer contribution will be reduced.

Since a cash balance plan is a defined benefit plan, the IRS maximum annual benefit for the cash balance plan is the lesser of 100% of the employee’s compensation or \$265,000 (2023) per year.

Key aspects of a cash balance plan

Vesting. The Employee Retirement Income Security Act of 1974 (ERISA) requires a qualified plan to give participants a vested right to benefits. Once a benefit is vested, the employer cannot take it away for any reason. A plan must provide a vesting schedule that provides the length of service an employee must complete to receive a benefit if his or her employment is terminated before the normal retirement age. If an employee is not fully vested at termination of employment, a forfeiture of the nonvested benefit will occur.

Forfeitures must be used to reduce employer contributions.

A cash balance plan must provide full vesting after no more than three years of service. This vesting requirement is consistent with a three-year cliff schedule, which states the employee is 100% vested once he or she is credited with three years of service.

Compensation. To determine contributions, compensation is typically defined as:

- W-2 wages for corporations
- Net profit from Schedule C (Form 1040) for sole proprietorships
- Self-employment earnings from Schedule K-1 (Form 1065) for partnerships

- Sole proprietorships and partnership income require an additional calculation to determine eligible compensation. Please consult your tax advisor or actuary to determine.

In 2023, the maximum compensation that can be used for these purposes is \$330,000.

Why choose a cash balance plan?

Familiarity

An important part of any retirement program is helping employees understand the plan's value. One of the ways a cash balance plan achieves this goal is by showing employees something they are already familiar with: an account balance. For example, employees who have participated in a defined contribution plan are used to seeing balances on participant statements.

Fairness

A cash balance plan gives employers the chance to equalize pay credits to participants who happen to be of different ages. A traditional defined benefit plan rewards participants with very different values simply because of the different ages of the participants. A cash balance plan can be used to equalize this disparity.

Deduction limit

Because a cash balance plan is a defined benefit plan, it is not subject to the \$66,000 (for 2023) defined contribution limit under Internal Revenue Code Section 415.

Normal retirement age

The plan document must specify a normal retirement age, which is the date when benefits begin. A normal retirement age cannot be later than the date when the participant attains either the age of 65 or the fifth anniversary of the date the employee began plan participation. A participant must be 100% vested at normal retirement age.

Contributions

Each year, an enrolled actuary performs a calculation to determine the amount the company must contribute to the plan. This amount will vary depending on the plan's investment return. The actuarial calculation for the contribution credit for each "account" is calculated based on:

- A percentage of the employee's compensation (usually called a "pay credit"), for example, 5%.
- Interest on the "account" balance (often referred to as an "interest credit"), may be a fixed rate up to 6%, a variable rate such as the 30-year Treasury bond yield, or can be based on a specific index such as the S&P 500 or an

actual return on a diversified portfolio. The IRS dictates specific interest rates that must be used.

Contributions to a cash balance plan must be made in cash.

Investment considerations

Cash balance plans are pooled plans, not individual accounts. This money is invested to provide benefits for the entire group. Plan investment options must be carefully established and reviewed. To create a more consistent contribution year after year, investments should be designed to meet the interest credit rate established by the Third-Party Administrator/Actuary for the plan.

Because benefits are ultimately provided from employer contributions and the investment earnings, the employer's annual contributions fluctuate based on investment performance. For example, if aggressive investments are used and a large loss occurs, the employer may have to increase contributions dramatically.

Minimum funding requirements

A cash balance plan must comply with minimum funding requirements. If an employer fails to make the legally required contributions by the deadline for its tax return, including extensions (but no later than 8½ months after the close of the plan year), the IRS can assess penalty taxes.

Minimum participation requirement

As a condition of qualification, a cash balance plan must benefit at least the lesser of the following:

- 50 employees; or
- The greater of 40% of all employees, or two employees

Employers may exclude employees who:

- Are younger than age 21
- Have less than one year of service (1,000 hours)

Distributions

When plan participants reach a "triggering event," they may be entitled to receive money from their retirement plans. The plan document will identify when participants may receive benefits from the plan. Triggering events include:

- Employment termination
- Plan termination (all participants become 100% vested)
- Divorce (Qualified Domestic Relations Order)
- Normal and early retirement
- Attainment of RMD age
- Disability and death

Cash balance plans, unlike defined contribution plans, are not required to offer a lump-sum distribution option. Instead, some plans may only permit an annuity payment option, which provides payments over either a set number of years or for life. If a lump-sum payment is available, the participant may elect to roll the distribution into an IRA or qualified plan, or pay ordinary income taxes on a cash distribution in the year it was received.

The role of the Pension Benefit Guaranty Corporation

The Pension Benefit Guaranty Corporation (PBGC), a federal corporation, administers the pension insurance program ERISA established. Although the PBGC insures most qualified cash balance plans, it does not cover the following:

- Plans established and maintained exclusively for substantial owners, where a substantial owner is a sole proprietor or partner who owns 10% or more of the capital or profit interest in a business entity. (In the case of a corporation, a substantial owner is an individual who owns 10% or more of the corporation's voting stock or total stock.)
- Professional service employer plans that have 25 or fewer active participants
- Government plans
- Church plans

Defined benefit plans covered by PBGC are required to pay PBGC yearly insurance premiums. There are two kinds of normal premiums: the flat rate premium, which applies to all plans, and the variable-rate premium, which applies to single employee plans.

Maintaining cash balance and defined contribution plans

Employers that maintain defined contribution and cash balance plans at the same time must apply the combined plan deductible limit [IRC 404(a)(7)], only to the extent that employer contributions to the defined contribution plan do not exceed 6% of compensation.

Defined benefit plans covered by PBGC are not taken into account when applying the combined plan deduction limit.

Certain defined contribution plans may not be funded concurrently with cash balance plan, including:

- SEPs established using the IRS Form 5305-SEP
- SIMPLE IRAs and SIMPLE 401(k)s

You can count on us

Although a cash balance plan offers many benefits, it is not right for every business. Wells Fargo Advisors offers a range of plans and can help you match the right plan with your needs and objectives. Your financial advisor can provide more information on employer retirement plans and help you evaluate the right type for your business.

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