Cash balance pension plans

How to determine if a cash balance pension plan is right for your company **Interviewed by Lisa Murton Beets**

Companies that have maxed out their 401(k) plans but still have discretionary income and steady cash flow available for retirement benefits may want to consider a cash balance pension plan.

"A cash balance pension plan is technically a defined benefit pension plan which has features that resemble a defined contribution plan," explains Tom Sigmund, firm director and chair of the Employee Benefits & ERISA practice at Kegler, Brown, Hill & Ritter. "Like a traditional defined benefit pension plan, the employer bears all responsibility for funding and investing, and the value of the assets do not impact the promised benefit. However, the benefits are depicted as an account balance."

Sigmund says that a cash balance pension plan is an especially popular tool for professional practices.

"If they have not maxed out their 401(k) plan, we recommend that they do so prior to establishing the cash balance pension plan. In combination, these two plans can enable the organization to cost effectively meet a variety of goals relative to the principles of the practice."

Smart Business asked Sigmund to further describe cash balance pension plans and how they might benefit an organization.

What is the difference between a cash balance pension plan and a defined contribution plan?

The cash balance plan is technically a defined benefit pension plan subject to benefit limitations. However, the plan defines the promised benefit as an account balance that grows based on a defined rate of return. It is then up to the employer to fund the plan and invest the plan assets so as to have enough to pay the promised benefits. Whereas with a defined contribution plan, contributions are limited. Contributions are defined and actually made to the accounts of the plan participants and the actual rate of return on plan investments directly impacts the benefits provided to the plan participant.

How is it structured?

The plan specifies a dollar amount or percentage of pay per year to be credited to the participant's account, along with a hypothetical rate of return. The interest rate might be a variable indexed rate, such as one geared to 30-year treasury bonds or it could be a fixed rate. An actuary determines how the company will meet its commitments. You can be very flexible with how you structure the plan, subject to discrimination laws. For example, you can have two individuals who are the same age and earning the same salary getting different benefits. Or you may have two individuals of different ages getting the same benefits. For example, a medical practice with two partners of different ages who both want to contribute $50,000 per year may have their respective benefits defined as $50,000 per year plus a 5 percent rate of return.

Tom Sigmund
Director
Kegler, Brown, Hill & Ritter

Are there contribution limits?

There are no contribution limits per se, but there are benefit limits — which you can control — that drive the funding. The benefit limit for 2012 is a life annuity of $200,000 per year commencing at age 62. This translates to a lump sum distribution of more than $2.3 million.

Why would a company wish to sponsor such a plan?

A typical scenario that plays out well is when a company sponsors a 401(k) that is maxed out but still has more discretionary income available. Or perhaps there are participants in their 50s who are getting a late start on retirement savings — even with the catch-up allowances, a 401(k) plan could not produce as much retirement savings as a cash balance pension plan with its $2.2 million lump sum benefit limit. A cash balance pension plan can also be a very effective way for a younger partner to indirectly buy out an older partner who wishes to exit.

What are some things to consider when investing the assets of these plans?

As with any defined benefit pension plan, having enough assets in the plan to cover the promised benefits is critical. The targeted rate of return on plan investments should be the defined interest crediting rate. Poor investment performance will require more contributions and investment returns in excess of the interest crediting rate will not impact benefits but may, in fact, give rise to an excise tax when the excess assets are returned to the employer upon plan termination. The interest crediting rate drives the benefits. According to the IRS rules, the interest crediting rate must be a 'market rate of return,' which essentially translates to a moderate rate of return.

Are there any proposed regulations that would change the way these plans are structured?

The IRS has issued proposed regulations which would allow cash balance pension plans to define the interest crediting rate as the actual rate of return on the plan investments. The hypothetical contribution amount or the percentage of pay that is promised each year must however be preserved. A plan structured in this manner would look more like a defined contribution plan than ever. It is not likely that these proposed rules will become final any earlier than January of 2013.

Are the workings of these plans very complex and, if so, would that be a deterrent to a company seeking to establish one?

They are complex in the background, but that's why you hire experts — an attorney, third-party administrator and good investment advisors who understand these types of plans. Once established, the plan and its promised benefits are as simple to understand as a 401(k) plan. <<

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