

SUMMARY OF CASH BALANCE PENSION PLAN

1. Purpose of Cash Balance Plan. Contributions that can be allocated to a participant's account under a defined contribution plan (e.g., 401(k) profit sharing plan) are subject to an annual limit imposed by applicable tax law. For 2020, the limit is \$57,000 (or \$63,500, including 401(k) "catch-up" contributions, in the case of a participant who has attained age 50). Sometimes, professionals and other small business owners desire to contribute amounts in excess of the annual limit available under a defined contribution plan. In these cases, a supplemental cash balance pension plan can be used. The term "supplemental" is used because these plans typically do not replace, but are designed to supplement and work in conjunction with, an existing defined contribution plan.

2. Nature of Cash Balance Plan. Technically, a cash balance pension plan is a form of defined benefit pension plan, and this is the reason that amounts in excess of the annual defined contribution plan limit can be allocated to a participant. Although an "account" is maintained for each participant in the plan, this account is really just a hypothetical account balance maintained by the actuary for the plan; no separate investment account is maintained.

3. Cash Balance Projection. The additional benefits that can be funded through a cash balance plan depend on a variety of factors. For this reason, employers considering the potential adoption of a cash balance plan are encouraged to have a projection prepared by an actuary to illustrate the additional benefits available to owners, the cost of additional benefits for non-owner employees, etc. To prepare such a projection, the actuary needs employee census data for the business, including the following information for each employee (a) date of birth, (b) date of hire, (c) annual compensation, and (d) annual hours worked (if less than 1,000). Importantly, all business owners do not have to receive equal cash balance allocations. Since some limits are overall limits, the non-participation by an owner-employee can potentially increase the cash balance benefits available to other owners. Also, since the cash balance allocations depend to some extent on age, younger owners should understand that they might not be able to receive the same level of annual contributions as older owners. However, they can receive an equivalent benefit at Normal Retirement Age.

4. Interest on Cash Balance Plan Accounts. Unlike accounts in defined contribution plans, the amounts credited to cash balance accounts do not depend on the actual investment performance of the assets of the plan. Instead, interest is credited to each cash balance account on an annual basis, based on a specified rate or index (and subject to IRS rules) that is written into the plan document. For example, a fixed rate of 3% is now common in cash balance plans.

5. Cash Balance Plan Funding. Again, since interest credits to cash balance accounts do not depend on actual investment performance, any experienced rate of return in excess of the crediting rate dictated by the plan (e.g., 3%) will reduce ongoing contributions to fund the benefit, but will not affect the participant's account balance. In this case, the business would simply fund the lesser required amount and the owners of the business would presumably receive larger bonuses as taxable wages. Conversely, if the rate of actual investment return in the plan is less than the targeted rate, the contribution requirement to fund the same benefit may need to be increased (which while deductible may be a less desirable result).

6. Cash Balance Plan Funding Not Discretionary. Unlike employer contributions to most profit sharing plans, contributions to a cash balance plan are not discretionary. While future benefit accruals under a cash balance plan can always be reduced or discontinued prospectively (with a proper plan amendment and advance notice to participants), the employer remains responsible for funding any benefits accrued prior to the effective date of the "freeze." Therefore, an employer should only adopt a cash balance plan if it is comfortable with projected contribution levels for the foreseeable future.

7. Cash Balance Plan Investments. By definition, all assets in a cash balance plan must be invested as a single, pooled account; no individual participant direction of accounts is permitted. As in the case of investments under a defined contribution plan, assets in a cash balance plan should only be invested with the advice of a qualified investment advisor. Because of the fact that interest is credited to cash balance accounts at a particular rate, without regard to actual investment performance, the investment policy of the cash balance plan is typically weighted toward fixed income, as opposed to equity. To compensate for this, many cash balance plan participants maintain a stronger equity position in the defined contribution plan, to achieve overall balance.