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Cash Balance Plan Basics

Common questions and answers from our experts



Who bears the investment risk?

In a cash balance plan, the employer bears the investment risk. Participants have no investment choice; the trustee pools all assets and directs them.

What are the main benefits of cash balance plans?

- Career average benefit pattern – avoids the heavy weighting of benefits to the final years of work.
- Employees have a much better understanding of their benefits
- Lump sum payments are not subject to IRC §417(e) rates
- Direct tracking of contributions made to benefits that are ultimately distributed
- Age-neutral contributions for employees

What interest crediting rate can be used for the accounts?

- **Fixed rate:** Up to 6%. A lower rate may help reduce the risk of investment losses that the employer must make up.
- **Treasury yield:** Based on a Treasury rate, such as the 30-year Treasury bond.
- **Actual rate of return:** The trust's actual return is capped at 5%. This can reduce employer investment risk, stranded costs, and testing fluctuations, but adds complexity and is generally best suited for plans with multiple shareholders. It does not increase plan benefits.

What is a cash balance plan?

A cash balance plan is a "hybrid" plan in that it is fundamentally a defined benefit plan but expresses benefits as an account balance (like a defined contribution plan) rather than as an annuity benefit at retirement. It has the following features:

Employer investment risk:
Like a defined benefit plan, the employer assumes the investment risk.

Benefit limits:
Maximum benefits follow rules similar to those for defined benefit plans.

Annual credits:
The plan defines each participant's annual pay credit and interest credit.

Clear account values:
Participants receive statements showing the value of their account.

Note: The trust's investment strategy should be coordinated with the plan's crediting rate to avoid losses.

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What defined benefit plan rules must cash balance plans follow?

- A schedule of credits that all shareholders can live with must be created (for example, an equal credit for everyone, or a percentage of salary, or an amount from a table based on age are safe approaches). Allowing each shareholder to "choose" a different credit amount may fall afoul of the requirements.
- A shareholder can be named out of the document, and the plan can be amended at a later time to allow the person in at the specified credit.
- The plan can only be amended prospectively and infrequently!
- Once someone has worked 1,000 hours, they have earned a credit for that year, and the contribution must be made. So, if you leave during a year and you have worked 1,000 hours, there will be a required contribution on your behalf.

How long should the cash balance plan be maintained?

- The IRS has a permanency requirement. Although there is no objective standard, five years appears to be a sufficient time to satisfy the permanency requirement.
- Within these five years, the cash balance plan can be amended to adjust the annual credits, but such an amendment must be made early in the year before the annual credits are accrued.
- In the event of a significant business event (e.g., sale of the business, severe financial downturn, loss of primary contract, etc), the plan could be terminated.
- At the time the plan is terminated, a favorable determination letter should be sought from the IRS to ensure that the permanency requirement is satisfied.

What happens when a Highly Compensated Employee ("HCE") terminates employment or retires?

- Upon termination of employment, an eligible participant has the option to receive a lump sum distribution or an immediate/ deferred annuity
- The annuity is the default option and, if chosen, the plan would purchase an annuity for the benefit of the plan participant
- In the event of a significant business event (e.g., sale of the business, severe financial downturn, loss of primary contract, etc), the plan could be terminated.
- At the time the plan is terminated, a favorable determination letter should be sought from the IRS to ensure that the permanency requirement is satisfied.
- If a lump sum distribution is chosen, the participant's spouse (if any) must consent to the distribution in writing
- Lump sums may be directly rolled over into an IRA
- Due to IRS restrictions, an HCE may not be able to receive an immediate lump-sum distribution if the plan's remaining assets would be less than 110% of its remaining liabilities after the distribution. This may occur if plan assets decline due to a market downturn. In this case, the HCE may:
  - **Leave funds in the plan,** where the balance continues earning interest at the plan's crediting rate until the 110% threshold is met.
  - **Begin monthly benefit payments** from the plan.
  - **Roll the lump sum to an IRA,** provided the IRA trustee signs a collateral agreement to repay funds to the plan if it terminates with insufficient assets.

Have more questions about cash balance plans? Contact Blue Ridge Associates to learn how a cash balance plan could support a business's retirement goals.

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