Cash Balance Plan Update

What is current and upcoming with the fastest growing retirement plan segment

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The Pension Design Group

Focused on minimizing tax liability and increasing retirement savings for business owners.

Full-service compliance firm providing customized plan design, administration, and actuarial services for Plan Sponsors in partnership with Financial Advisors

Provide compliance & administration to almost 1,000 qualified retirement plans

Great growth in Cash Balance Plans

- Double digit growth in number of CB Plans almost every year dating back to early 2000
- Cash Balance Plan assets now exceed $1 Trillion
- 94% of Cash Balance Plans have < than 100 participants
- 59% of Cash Balance Plans have < than 10 participants
- Healthcare, Professional Services, Finance/Insurance, and Construction represent 67% of all Cash Balance Plans

*Source – 2020 National Cash Balance Plan Research Report

Why are these popular again?

2001

EGTRRA – significant increase in combined plan deduction limit and increase in maximum DB benefit

2006

PPA – another increase in combined plan deduction limit

2010

IRS Cash Balance regulations – clarity and expanded options for Interest Crediting Rates

2014

Final IRS Cash Balance regulations – greater investment flexibility and option to use fixed rates up to 6%

2017

Tax Cuts and Jobs Act (Section 199A) – helps owners reduce their AGI to obtain additional 199A deduction

2020

Secure Act – permitted retroactive adoption of DC and CB plans. 50% tax credits for startup plans over first 3 years.

2022

Secure Act 2.0 – expanded tax credits to 100% over 3 years PLUS up to $1,000 credit for employer contributions.

What is a Cash Balance Plan?

- A type of a Defined Benefit Plan
- Provides for an annual allocation defined in Plan Document (usually as a % of compensation or a specific amount). Can have different allocation formulas for different employees or groups
- Provides for an annual interest credit defined in Plan document. Makes sense to use a fixed rate of interest
  - Does not make sense to use an interest rate greater than 5.50% as that results in a lower lump sum limit.

About Defined Benefit and Cash Balance Plans

- Subject to minimum funding requirements
- Annual contribution for a participant is not directly limited but maximum lump sum payable is limited based upon:
  - Compensation history
  - Plan participation history
  - Age
- Usually work backwards from maximum lump sum to determine maximum contribution on behalf of a participant
- Must offer annuity form of payment (rarely elected)

Why Cash Balance?

- Higher Contributions possible than in 401(k) or other Defined Contribution Plans
- Tax Deductible and ERISA creditor protection
- Value of tax deduction and deferral likely to increase considering potential higher income and investment tax rates
- Increase retirement benefits for employees (paid for by tax benefits to owners)

Why Cash Balance Instead of Traditional Defined Benefit?

- COMMUNICATION
  - Easy for participants to understand (benefit is a lump sum amount instead of monthly amount payable for life beginning in retirement)
- AGE NEUTRAL FOR STAFF
  - Can provide age neutral benefits (employees of different ages but same compensation can receive same allocation)
- INCREASED FLEXIBILITY
  - Increased flexibility if annual allocation is based upon current compensation.
- CONSISTENT BENEFIT GROWTH
  - Lump Sum amounts do not fluctuate based upon changes in Treasury or Corporate Bond yields

Cash Balance Plans make sense for

- Not everyone but are often a fit for:
  - Medical or Dental Groups
  - Sole Proprietors
  - Professional Firms (CPA, Attorney, Engineers, Architects, Investment Advisors)
  - Small closely held business
- Even starting to see governments looking to change from traditional DB to CB

2023 Sample Maximum Contributions

AGE	401(K) PROFIT SHARING ONLY	401(K) AND CASH BALANCE PLANS
40	66,000	180,000
50	73,500	261,500
60	73,500	382,500

*actual maximum may be lower if compensation is less than $330,000

Valued Client

A Combination 401(k)/ Profit Sharing/ Cash Balance Plan

For the Plan Year 01/01/2022 - 12/31/2022

CONTRIBUTION REPORT - DETAIL

								Cash Balance		401(k)	Profit Sharing		Total Contribution				
															Employer		% of
P	O	H	Class	Last Name	First Name	AA	RA	Considered Earnings	Amount	%	Deferral	Amount	%	Amount	%	Cost	%	Total
*	*	*	A	Owner		55	62	305,000	222,253	72.9	27,000	6,100	2.0	255,353	83.7	228,353	74.9	100.0

Legend: P- Principal, O- Owner, H- Highly Compensated Employee

CONTRIBUTION REPORT - SUMMARY

		Cash Balance		401(k)	Profit Sharing		Total Contribution				
									Employer		% of
	Considered Earnings	Amount	%	Deferral	Amount	%	Amount	%	Cost	%	Total
Principals	**305,000**	**222,253**	**72.9**	**27,000**	**6,100**	**2.0**	**255,353**	**83.7**	**228,353**	**74.9**	**100.0**
Grand Total	**305,000**	**222,253**	**72.9**	**27,000**	**6,100**	**2.0**	**255,353**	**83.7**	**228,353**	**74.9**	**100.0**

Benefit to Owner = $255,353

Total Deductible Contribution = $255,353

Est. Tax Savings (42%) = $107,248

Valued Client
A Combination 401(k)/ Profit Sharing/ Cash Balance Plan
For the Plan Year 01/01/2022 - 12/31/2022
CONTRIBUTION REPORT - DETAIL

									Cash Balance		401(k)	Profit Sharing		Total Contribution				
								Considered								Employer		% of
P	O	H	Class	Last Name	First Name	AA	RA	Earnings	Amount	%	Deferral	Amount	%	Amount	%	Cost	%	Total
*	*	*	A	Owner		55	62	305,000	426,450	139.8	27,000	18,300	6.0	471,750	154.7	444,750	145.8	100.0

Legend: P- Principal, O- Owner, H- Highly Compensated Employee

CONTRIBUTION REPORT - SUMMARY

		Cash Balance		401(k)	Profit Sharing		Total Contribution				
	Considered								Employer		% of
	Earnings	Amount	%	Deferral	Amount	%	Amount	%	Cost	%	Total
Principals	**305,000**	**426,450**	**139.8**	**27,000**	**18,300**	**6.0**	**471,750**	**154.7**	**444,750**	**145.8**	**100.0**
Grand Total	**305,000**	**426,450**	**139.8**	**27,000**	**18,300**	**6.0**	**471,750**	**154.7**	**444,750**	**145.8**	**100.0**

Note: Cash balance credit for 2022 assumes 1 year of pre-participation service and compensation for those years are at the 401(a)(17) maximum.

Note: Pre-funding contribution total $194,474 and the 2022 cash balance credit is $222,253.

Benefit to Owners = $471,750

Total Deductible Contribution = $471,750

Est. Tax Savings (42%) = $198,135

Benefit to Owners = $462,899
Total Deductible Contribution = $516,647
Est. Tax Savings (42%) = $216,991
Cost to Staff = $53,748
Est. Net Savings = $163,243

Valued Client - 2023 PLAN YEAR
A Combination 401(k)/ Profit Sharing/ Cash Balance Plan
For the Plan Year 01/01/2023 - 12/31/2023
CONTRIBUTION REPORT - DETAIL

P	O	H	Class	Last Name	First Name	AA	RA	Considered Earnings	Cash Balance Amount	Cash Balance %	401(k) Deferral	401(m) Match	Profit Sharing Amount	Profit Sharing %	Total Contribution Amount	Total Contribution %	Employer Cost	Employer %	% of Total
*	*	*	A	Owner		66	66	330,000	337,699	102.3	30,000	13,200	0	0.0	380,899	115.4	350,899	106.3	76.8
*		*	C	Spouse		62	65	50,000	50,000	100.0	30,000	2,000	0	0.0	82,000	164.0	52,000	104.0	11.4
			B	EE1		29	65	37,391	935	2.5	2,437	1,496	2,524	6.8	7,392	19.8	4,954	13.3	1.1
			B	EE2		54	65	66,375	1,659	2.5	788	788	4,480	6.8	7,715	11.6	6,927	10.4	1.5
			B	EE3		45	65	33,000	825	2.5	0	0	2,228	6.8	3,053	9.3	3,053	9.3	0.7
			B	EE4		42	65	44,662	1,117	2.5	0	0	3,015	6.8	4,131	9.3	4,131	9.3	0.9
			B	EE5		66	66	21,300	533	2.5	0	0	1,438	6.8	1,970	9.3	1,970	9.3	0.4
			B	EE6		30	65	29,901	748	2.5	1,495	1,196	2,018	6.8	5,457	18.3	3,962	13.2	0.9
			B	EE7		45	65	55,513	1,388	2.5	1,665	1,665	3,747	6.8	8,466	15.2	6,800	12.2	1.5
			B	EE8		46	65	45,922	1,148	2.5	2,265	1,821	3,100	6.8	8,334	18.1	6,069	13.2	1.3
			B	EE9		29	65	39,445	986	2.5	1,183	1,183	2,663	6.8	6,015	15.2	4,832	12.2	1.1
			B	EE10		55	65	32,733	818	2.5	0	0	2,209	6.8	3,028	9.3	3,028	9.3	0.7
			B	EE11		31	65	35,834	896	2.5	389	389	2,419	6.8	4,093	11.4	3,704	10.3	0.8
			B	EE12		58	65	46,685	1,167	2.5	0	0	3,151	6.8	4,318	9.3	4,318	9.3	0.9

Legend: P- Principal, O- Owner, H- Highly Compensated Employee

CONTRIBUTION REPORT - SUMMARY

	Considered Earnings	Cash Balance Amount	Cash Balance %	401(k) Deferral	401(m) Match	Profit Sharing Amount	Profit Sharing %	Total Contribution Amount	Total Contribution %	Employer Cost	Employer %	% of Total
Principals	380,000	387,699	102.0	60,000	15,200	0	0.0	462,899	121.8	402,899	106.0	88.2
Non-Principals	488,759	12,219	2.5	10,222	8,538	32,991	6.8	63,971	13.1	53,748	11.0	11.8
Grand Total	868,759	399,918	46.0	70,222	23,738	32,991	3.8	526,869	60.6	456,647	52.6	100.0

Interest Crediting Rates - History

- Before 2006, had to use 30-year treasury rate as interest crediting rate
- After PPA (2006), can use other interest crediting rates with treasury to define what is available
- 2010 Regulations, IRS started to define what rates are available and what is not acceptable

Interest Crediting Rates

- Can use a fixed rate up to 6%
- Can use a bond related index (including 30-year treasury bond yield)
- Can use an equity index or mutual fund return or return on plan assets (with some limitations)
- Cumulative interest credits cannot be negative

Interest Crediting Rates

- Lots of options but only a low fixed rate or low bond rate make sense for most plans
- Generally best plan design is a low fixed rate (between 3% and 5%)
  - Can't go too low for most plans without needing to increase staff benefits to satisfy minimum participation and meaningful benefits
  - Contribution cost for staff is predictable
  - Maximum lump sum benefits and maximum contributions are available
- 30-year treasury rate with a cap so that it doesn't go over 5.50% would be next best

Cash Balance Plan Designs - Future

- Online access to Cash Balance Plan benefits
  - Platforms that could show both 401(k) and CB plan benefits together
  - Or separate online access showing CB plan benefits
    - – Note that the participant interest in CB plan is in the benefits and is not tied directly to actual asset allocation
  - Caution – bells and whistles should not be chosen over solid plan design and expertise

- Tax reform and retirement crisis
  - – Both likely to continue to make CB plans attractive and popular
  - – Employee appreciation of pension benefit and annuity payout options likely to increase

Cash Balance Plan Statement Details

- Participant A
  - Beginning Cash Balance = $100,000
  - Interest Credit (4.50%) = $4,500
  - Cash Balance Allocation = $100,000
  - Ending Cash Balance = $204,500

- Participant B
  - Beginning Cash Balance = $1,000
  - Interest Credit (4.50%) = $45
  - Cash Balance Allocation = $1,000
  - Ending Cash Balance = $2,045

Cash Balance Accounts

- Cash Balance accounts are hypothetical accounts
- Plan investments are TRUSTEE DIRECTED and invested in a SINGLE ASSET POOL
- The value of Cash Balance accounts are usually not exactly equal to the value of Plan Assets

Cash Balance Account Values vs. Plan Asset Values

- If Plan Assets perform <u>better</u> than Cash Balance interest credit
  - Reduce future deposits or
  - Allocate additional assets to participants with amendment or
  - Make no current change

Cash Balance Account Values vs. Plan Asset Values

- If Plan Assets perform <u>worse</u> than Cash Balance interest credit
  - Increase future contributions or
  - Amend plan to reduce future allocations to allow plan assets to catch up or
  - Make no current change

Example of Cash Balance Plan Funding Management

- 2021
  - Cash Balance benefit values = $2.65mm
  - YE asset value = $2.60mm
  - 100% Funded amount = $50,000

- 2022
  - Cash Balance benefit values = $3mm
  - Market Loss = $450k
  - YE asset value = $2.2mm
  - 80% Minimum Funding Required = $200K (ending assets = $2.4mm)

Example of Cash Balance Plan Funding Management

- 2023 – Freeze Plan
  - Reduce Allocation to ZERO before 1000 hours
  - YE 2023 estimated CB benefit values = $3.12mm (4% interest credit)
  - 2023 funding goal (actual & market) = $720k
  - Projected 100% Funded

- 2023 – Amend Plan to increase allocation back to desired level (at any time before 3/15/2024)

Cash Balance Plan Contribution Range Communication

- Minimum Required Contribution = actuarially calculated amount needed to be contributed for year in order to avoid 10% excise tax on funding deficiency (calculated using IRS prescribed interest rates)
- 100% Funding Contribution = contribution amount that would bring plan assets = value of Cash Balance accounts
- Maximum Deductible Contribution =
  - If combined plan 31% limit applies…amount to bring total company contribution to this limit or
  - If combined plan limit does not apply = 150% value of benefits at beginning of year plus 100% value of benefits accruing during year less value of plan assets (calculated using IRS prescribed interest rates)

IRS Minimum Funding Calculation

- Amount that satisfies IRS minimum funding is always less than the amount that brings plan assets to 100% of Cash Balance benefit values
  - Due to amortization of shortfall over 7 years instead of 1 and
  - Value of benefits for IRS minimum funding purposes is less than real Cash Balance benefit values [due to difference between interest credit and IRS prescribed rates for funding (which are higher)]

What about Contribution Flexibility?

- Usually, a range from minimum required to maximum deductible
- Can always amend plan up until 2.5 months after year end to increase benefits (Section 412(c)(8) amendment) and consider in funding for year
- Can freeze plan or amend to lower allocation before 1000-hour point in year (i.e., can lower contribution requirement on a prospective basis only)
- Consider using Profit Sharing and 401(k) as flexible part of design

Managing Cash Balance Plan Funding

- Best way to manage funding is to focus on funding to 100% of Cash Balance benefit values when possible
- This will ensure the IRS minimum funding is met (and will build up a prefunding balance that could be used in bad years).

Cash Balance Plan Asset – Investment Allocation

- Proper investment allocation depends upon plan particulars but:
  - Very little downside to being always conservative and
  - Importance of conservative allocation increases as plan benefits grow compared to annual allocation / expected contribution
  - Potential downside risk to being too aggressive and little upside to aggressive allocation since ultimate maximum lump sum is limited

Cash Balance Plan – Interest Crediting Rate

- Older plans may use 30 year treasury yields as interest crediting rate
- Although contemplated by regulations and promoted by some, setting interest crediting rate equal to a market based or plan return based index does not make sense
  - Can cause severe reduction in maximum lump sum benefit limits
  - Severe Employee contribution cost fluctuation

Pairing 401(k) Profit Sharing Plans and Cash Balance Plans

- Usually works better (i.e., more cost effective) to have both 401(k) Profit Sharing Plan and Cash Balance Plan than stand-alone Cash Balance Plan (significant higher cost without combined testing)
- Usually tested together for non-discrimination (3% Safe Harbor, Profit Sharing and Cash Balance Plan benefits)

Pairing 401(k) Profit Sharing Plans and Cash Balance Plans

- 401(k) and Profit Sharing add to flexibility
- Common design for Staff is:
  - At least 5% of comp. in 401(k) Plan (Safe Harbor, Match, or Profit Sharing)
  - 2.50% of comp. in Cash Balance Plan
- Profit Sharing can be vested over 6 years / Cash Balance over 3 years

Combined Plan Deduction Limits

- If company 401(k) Plan contributions are more than 6% of total compensation, then maximum combined contribution deduction limited to 31% of compensation (25% plus 6%)
- If company 401(k) Plan contributions are less than 6% of total participant compensation, then combined plan limit (31%) does not apply
- Combined plan limit also does not apply if DB plan is covered by PBGC

Other Testing and Compliance Issues

- Top Heavy usually satisfied in DC Plan with 5% company contribution (less expensive than top heavy minimum DB benefit).
- Cash Balance or Defined Benefit Plan must provide meaningful benefits to at least 40% of non excludable employees
- Must satisfy minimum contribution gateway if testing DC / CB together on benefits basis (usually 7.5% combined between DC and CB Plan).

DB and CB Plan Annual Communication

- Actuarial Valuation Report and Participant Statements
- Combined Plan Allocation Summary
- PBGC Premium Filing (if applicable)
- Form 5500 and Schedule SB after all contribution deposits made
- Adjusted Funding Target Attainment Percentage (AFTAP) (prepared at same time as Schedule SB)
  - Required to be provided to Plan Sponsor by Pension Protection Act.

DB and CB Plan Annual Communication

- Plan Sponsor Elections for treatment of prefunding balances, funding interest rate choices (prepared at same time as Schedule SB
- Benefit Options Chart prepared for terminated participant (upon request)

Defined Benefit and Cash Balance Plan Benefit Options

- Must offer annuity forms of payment
  - Actuary calculates Lump Sum, Single life annuity, Joint life and 50% survivor annuity, Joint life and 75% survivor annuity, and Joint Life and 100% Survivor Annuity

- Extremely rare for participant to elect an annuity
  - If it happens, either pay monthly amount from plan or purchase single premium annuity from Insurance Company

Pension Benefit Guaranty Corporation (PBGC)

- May be subject to coverage by, premium payment to, and filing to Pension Benefit Guaranty Corporation (PBGC)

- Covered by PBGC if CB or DB Plans:
  - Cover non owners and
  - Are not professional service employers (i.e., not office of physicians, dentists, CPAs, attorneys, engineers, etc.) or
  - Are professional service employers but have more than 25 participants in plan

PBGC

- Fixed Rate Premium = $96 Per Participant Per Year plus
- Variable Rate Premium = 5.2% of excess of value of vested benefits over value of plan assets (it is unusual for the variable rate premium to apply to small plans or plans of professional service employers)
- Annual Filing is due 10 months after plan year ends (i.e., Filing for calendar year plans is due October 15th)

What to avoid

- Floor Offset Plan Designs – they are not what they are sold to be
- Fully Insured Plans (412(i) / 412(d)(3)) – If insurance is needed, Cash Balance Plans can include life insurance without the baggage and scrutiny that a fully insured plan brings
- Funding only minimum required
- Excluding employees

Who is a good candidate?

- Want more than $60K contribution for some physician(s) or owners(s) (and have cash flow)
- Can contribute at least 7.50% of compensation for staff
- Helps to have some employees that are younger than owners (Note that does not mean that all employees need be young)
- Staff payroll per physician or owner is not too high

Decision Making Process

- Does it make economic sense?
- Are key individuals receiving enough of the total contribution increase?
- Is Cash Flow significant for additional contributions (and relatively consistent)?
- Are owners okay with Trustee Directed Investments?

Thank you!

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