CASH BALANCE PLANS

3 Steps to Success

By: Walker Phillips, CFP®, CIMA®

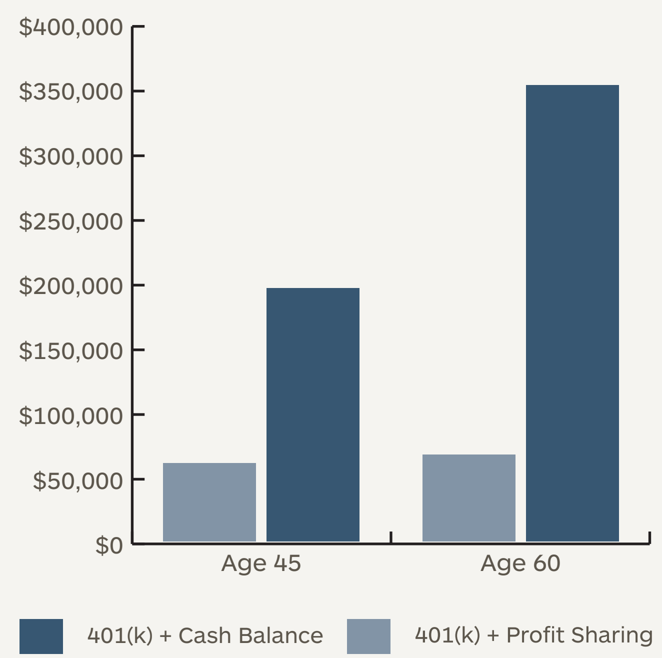
Business owners have long relied on retirement plans as a means of reducing taxes, attracting talent, and helping employees save for retirement. For businesses with consistent cash flows, a cash balance plan can enhance these benefits beyond the typical 401(k) or profit-sharing plan.

What is a Cash Balance Plan?

Cash balance plans operate much like traditional pensions in that they're designed to create an income stream in retirement. An employer pays in a percentage of an employee's wage. Each year, then, interest is credited to the employee's balance in the plan at a predefined rate. Formulaic contributions and interest add up to a set amount at retirement, paid either as a lump sum or via a lifetime annuity. Firms ranging in size from one owner to more than 50 employees have deployed cash balance plans to accelerate retirement savings for themselves and valued colleagues.

In providing a defined benefit for employees, business owners realize retirement savings well beyond what a 401(k) with profit sharing allows. For example, a 45-year-old business owner reaches the max 401(k) and profit-sharing contribution at $61,000 in 2022. However, pairing a cash balance plan with the 401(k) allows for a total contribution as high as $196,000 this year. Similarly, a 60-year old's 401(k) contribution is capped at $67,500, but the same business owner can contribute as much as $352,500 by adding a cash balance plan.[1]

2022 Max Retirement Savings



[1] https://www.cashbalancedesign.com/resources/contribution-limits/

How to Get the Most out of a Cash Balance Plan?

This high level of savings isn't without risks. To successfully realize the benefits a cash balance plan offers, business owners must clearly understand the pitfalls. Taking the following precautions will help ensure the plan is properly managed.

1. **COMMIT TO FUNDING THE PLAN FOR AT LEAST FIVE YEARS**

   As a qualified pension, a cash balance plan must intend to provide payment of "definitely determinable" benefits for employees throughout their retirement. In addition to contributing to employees based on their age and income, employees are credited a set rate of return, say 5%, at the end of each year. To assure a set return, the business invests the funds and contributes as needed to satisfy the plan's obligations.

   Absent a major business interruption such as bankruptcy or death of an owner, terminating a plan within the first five years may draw unwanted scrutiny from the IRS. The rules that provide prolific tax savings for business owners stipulate a "permanent" rather than "temporary" retirement benefit for employees. Therefore, unlike a 401(k), a cash balance plan requires annual contributions to sustain the benefit it promises, even if the market takes a punch or the business's cash flow hits a rough patch.

2. **UNDERSTAND HOW INVESTMENT RETURNS AFFECT THE PLAN**

There's no question about what rate of return participating employees receive each year on their cash balance plan assets. Taking responsibility for providing a set benefit to employees, the business owner assumes the risk in investing plan contributions to match the promised returns as closely as possible. Exceeding the employees' return reduces the amount the business owner can deduct from income taxes. Underperforming, on the other hand, can force the owner to contribute more of the company's cash flow than intended to make up the shortfall.

Example:

- If a plan with $1 million in assets credits employees 5% per year but the plan's underlying investments return 15%, the amount the business owner can defer is reduced by $100,000 [(5%-{+15%}) x$1,000,000 = -$100,000].
- Conversely, if the underlying investments lose 5%, the business owner must contribute $100,000 more of the business's cash flow to the plan to make up the shortfall [(5%-{-5%}) x$1,000,000 = $100,000].
- Providing a 5% return on average may not seem too tall a task; however, even with interest rates rising off historic lows, a 5% return for every one-year period is hardly a risk-free assumption.
- Understanding that negative returns are always a possibility, the best solution seeks to err on the conservative side, carefully managing duration with laddered bond maturities and using equities only as needed in proportion to return expectations. While equaling the rate credited to employees is ideal, falling a few percent short is better than risking the burden of a significant negative return to the business's cash flow.

3. **CONTROL COSTS**

Earning a flat 5% return over a one-year time horizon year after year is an improbable feat in and of itself. If, to generate a 5% net return, a business owner must also overcome the hurdle of investment expenses and advisor fees, the actual gross return necessary may be as high as 7%. While these costs won't affect the returns to employees, minimizing expenses lowers the bar for achieving the optimal return for business owners. Such expenses as paying an advisor, custodian, and administrator outside of plan assets helps the business defer as many dollars as possible. Likewise, using low-cost investments and individual securities aids in preventing internal expenses from weighing against the target return.

Conclusion

Committing to annual contributions for at least five years, understanding how investment performance affects contributions, and controlling the costs of a cash balance plan helps make sure both employees and business owners enjoy its benefits. As of 2020, only 15% of private sector employees enjoyed the stability and certainty of pension-style benefits.[2] For owners of businesses with consistently strong cash flow, the ability to defer income for retirement at three or even four times the rate of a 401(k) is an attractive consideration.

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If you have an interest in learning more about how you or your organization might benefit from a cash balance plan, please contact us for a free consultation with one of our Retirement Plan Consultants.

Contact Us

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[2] https://sgp.fas.org/crs/misc/R43439.pdf