

CASH BALANCE PLANS: AN EFFECTIVE STRATEGY TO MAXIMIZE RETIREMENT SAVINGS FOR KEY EMPLOYEES

Competition for talent is fierce today, and many employers are searching for solid benefit strategies to attract and retain top employees. One approach that can accomplish these goals is the cash balance plan. These plans have been growing in popularity in recent years despite the fact that many in the benefits industry once considered cash balance plans to be nearly extinct.

Cash balance plans—also known as hybrid plans—are a type of defined benefit plan where employees see their accounts just like they would in a defined contribution plan. Unlike 401(k)s, however, employers—not employees—contribute to an account. These accounts are known as hypothetical accounts because cash balance plans are ongoing, not finite like a 401(k). Contributions to the accounts comprise two calculations: one that is based on a pay credit (which is typically based on a percentage of pay or a flat dollar amount) and the second is a fixed or variable rate interest credit.

Defined contribution plans are certainly eclipsing defined benefit plans in number and assets under management. But cash balance plans are bucking this larger trend. According to Kravitz's [2017 National Cash Balance Research Report](#), the number of new cash balance plans increased 17 percent, while 401(k) plans grew only 3 percent in 2015, the most recent year for which data are available. In addition, cash balance makes up more than a third (34 percent) of all defined benefit plans. Most of this growth has come from smaller companies; Kravitz's report shows that 92 percent of plans are found at companies with 100 or fewer employees.

Despite the growing popularity of cash balance plans, it's important for companies to analyze whether they are a good candidate to adopt these strategies. We find that cash balance plans work best in companies that have the following qualities:

- Consistent cash flow and/or profit margins
- Desire to give key employees the opportunity to accrue higher retirement savings than what would be expected with a 401(k) and/or profit sharing plan
- Desire to take advantage of significant tax savings to help fund other plans

Reliable Annual Cash Flow

It's important for a company that adopts a cash balance plan to have consistent cash flow because the plan sponsor is responsible for funding the plan annually. When investments do better than the guaranteed interest credit, the plan sponsor usually gets a reduced contribution rate. Conversely, if investments underperform, the plan sponsor has to make up the shortfall. In general, plan sponsors should expect to contribute between 5 percent and 7.5 percent of pay for staff employees for their retirement plan. In addition, companies generally should consider making a 3- to 5-year commitment to the cash balance plan before considering amending plan documents.

Key Retention and Funding Tool

Unlike many retirement plans today, cash balance plans are a powerful way to significantly boost retirement savings for key employees. This approach also creates considerable tax savings that can be used to fund other plans. In general, cash balance plans are typically used for top talent while a 401(k) or other type of defined contribution plan is offered to

all employees.

Employees who are included in the cash balance plan are allowed significantly higher contribution rates. Each participant is allowed to accumulate up to around \$2.5 to \$3.0 million under current law; the actual contribution limit each year depends upon the participant's age and progress toward accumulating that maximum amount. Beyond that, adding a cash balance plan can make a significant difference for key employees of all ages who are behind in saving for retirement, not just those who are age 50 or older, as is the case with 401(k) and profit sharing plans.

Listed below are the 2018 contribution limits allowed by the Internal Revenue Service for employees of various ages, along with the potential federal tax savings (assuming a 37 percent federal income tax rate for pass-through entities):

Age	401(k) only	401(k) w/Profit Sharing	Cash Balance	Total	Tax Savings
70	\$24,500	\$61,000	\$329,000	\$390,000	\$120,990
65	\$25,500	\$61,000	\$266,000	\$327,000	\$127,280
60	\$24,500	\$61,000	\$254,000	\$315,000	\$117,290
55	\$24,500	\$61,000	\$194,000	\$255,000	\$96,200
50	\$25,500	\$61,000	\$148,000	\$209,000	\$79,920
45	\$18,500	\$55,000	\$113,000	\$168,000	\$65,120
40	\$18,500	\$55,000	\$87,000	\$142,000	\$55,130

In many cases, the tax savings generated from employer contributions to a cash balance plan for key employees can help fund other retirement plans sponsored by the company. This is one of the primary benefits of the strategy and an important consideration. Assuming a 37 percent federal tax rate for pass-through entities, companies can realize tax savings ranging from \$55,130 to \$120,990 per employee for the age groups listed above. State and local tax savings may also apply. The tax savings alone from cash balance plans can easily pay for the employer contributions needed for 401(k) and profit sharing plans.

Another point to keep in mind is that IRS requires plan sponsors to retain an actuary to certify the funding of the plan. This can be done in-house or by a service provider.

Other Benefits

In addition to the tax savings and ability to provide significant retirement contributions to key employees, other benefits of cash balance plans include:

- **Portability.** Like 401(k)s, most cash balance plans are set up to allow employees to take their vested assets should they decide to leave the company. Those assets can be rolled into an Individual Retirement Account (IRA) or other qualified retirement plan, such as a 401(k).
- **Flexibility.** The plan sponsor can decide who to include in the plan as well as how much should be contributed to each hypothetical account. Of course, the plan needs to pass IRS non-discrimination testing rules, so employers need to cover a sufficient number of employees of the company and contribute at least 5 percent to 7.5 percent of pay for employees to achieve desired testing results.

- **Relatability.** Most employees have a general understanding of how 401(k) plans work, and this base of understanding helps them grasp cash balance plans. Cash balance plans' hypothetical accounts work quite similarly to 401(k) plans, so it's usually not overly difficult for sponsors to gain buy-in from employees when introducing a cash balance plan.
- **Protection.** Cash balance plans are qualified plans. That means that in a financially troubled business, the assets are protected from creditors.

Insight: Cash Balance Plans Are Worth a Look

While most employers assume that 401(k) plans should be the primary retirement benefit they offer employees, cash balance plans can add significant value to a company as well. In the race to attract and retain top talent, cash balance plans can be an important tool. In addition, the tax savings realized by implementing cash balance plans can help fund other company retirement plans. Contact an ERISA Compensation and Benefits team member to learn more about whether cash balance plans are right for your organization.