



DB PLANS



The Right Way to Sell A Cash Balance Plan

Just because a cash balance plan makes sense for a plan sponsor demographically doesn't mean it's in their best interest — but very few, if any, plan sponsors can make that decision on their own.

BY MAX WYMAN

The cash balance industry is booming right now. Plans are going in at a rate faster than the 401(k) industry. Every year more and more sponsors are shown these designs and more and more of these plans are put in place.

When they work, cash balance plans are a lean, mean tax-saving machine. When they don't, the sponsor is beyond frustrated, and this boils over to all other parties involved. The best way to prevent this very undesirable situation from happening is ensuring that during the sales process you make sure the sponsor understands the following basic concepts — and not just how much they're saving on their taxes every year.

IT IS A DEFINED BENEFIT PLAN

Cash balance plans are not profit sharing plans! Contributions are not discretionary, but are determined by an actuary and create an annual funding obligation to the plan. Current funding methods develop a wide range of allowable contributions after the first few years, but there will be a minimum amount of contribution required to avoid excise tax penalties.

In addition, if the pension program involves the combination of a cash balance plan with a defined contribution plan (*i.e.*, a profit sharing or 401(k) plan), the employer's contribution to the DC plan is no longer totally discretionary. There will normally be a minimum contribution amount required to the DC plan to cover the top heavy and minimum gateway requirements. In addition, people who previously did not qualify for a contribution due to a last-day or hours-of-service requirement may now be required to receive contributions.

This is not to say that the funding obligation is totally inflexible. Some methods of defining the pay credit

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will automatically adapt to lower compensation numbers in small plans. Utilizing the maximum contribution level allowed to prefund or maintain a 5-10% cushion (assets in excess of the hypothetical account balances) will allow lower contributions in bad investment years without jeopardizing benefits.

If a bad investment year occurs prior to establishing a cushion, it might be possible to amend the plan for the current year to reduce pay credits if participants have not worked the requisite number of hours. Another possibility would be to amend the pay credits for future years to allow the sponsor to improve the funding level back to 100% of the hypothetical account balances.

INTEREST CREDITING RATE

Cash balance plans provide monthly benefits at retirement that are the actuarial equivalent of a hypothetical account balance (although other forms of payment are normally allowed, including a lump sum which can be defined as the hypothetical account balance). The hypothetical account balance is the sum of pay and interest credits that are added to the beginning hypothetical account balance each year. Both of these must be defined in the plan document.

The pay credit is the percentage of compensation or flat dollar amount (as defined in the plan document) that each participant will receive. This is similar to a DC plan except that at least a portion of the pay credit must be earned as soon as the participant completes 1,000 hours in the plan year, even if he or she terminates prior to the end of the plan year.

The interest credit can be defined as any flat rate of return up to 6%, as a variable rate based on one of several indices or as the actual return on the plan's investments. However, a participant's aggregate return for all years of participation can never be less than zero. The choice of interest rates is at least as important as the choice of pay credits.

QUALIFYING TESTING

These plans normally require that they pass a number of tests that have to be performed annually. Like any defined benefit plan, they have to be tested to see if an adequate number of participants have received “meaningful benefits.” Currently, 40% of eligible employees, or if less, 50 employees, must receive an allocation each plan year that converts to a monthly benefit at retirement equal to 0.5% of compensation.

The math to this conversion includes projecting the account balance to the normal retirement age at the interest crediting rate. Therefore, lower interest rates will convert to lower benefit amounts which require higher formulas to meet the requirement. If a variable rate is used, then during a period of falling interest rates, the sponsor may have to amend the plan to provide for higher pay credits. Once adopted, it is always possible to reduce future pay credits when interest rates rise again (although this could create an HR issue). Finally, if using the plan's actual rate of return, the employee cost may become prohibitive if the plan fails to have a positive return.

Next, the plan must pass non-discrimination testing. This testing is very complicated. An oversimplification is that a small percentage of non-highly compensated employees must accrue monthly benefits, or receive current contributions, expressed as a percentage of pay equal or greater than each HCE. HCEs are defined as owners of more than 5% or having earnings in excess of a fixed threshold

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for the prior year. (This earnings threshold, which is subject to a COLA increase annually, is \$120,000 for 2015.)

The choice of interest rates will usually depend on whether the cash balance plan will be tested on its own or in combination with a DC plan. When testing the cash balance plan on its own, the choice of interest rates will not have the same impact on testing as when tested in combination with a DC plan. Since standard interest rates of 7.5–8.5% must be used when testing a DC plan, using a lower interest crediting rate in the cash balance plan which mainly benefits the HCEs should provide advantageous testing results.

FUNDING THE PLAN

Perhaps more important than the testing issues is how the cash balance plan's assets are invested. The question is whether the plan's investment policy and the market will provide investment returns sufficient to cover the interest crediting rate. Keep in mind that the interest credits to be added to the hypothetical account balances are defined in the plan document and are usually independent of the actual investment results. The normal goal that we recommend is that the assets be maintained at a level equal to 100–110% of the hypothetical account balances.

There are only two sources of money to maintain that level: employer contributions and actual investment earnings. If the pay credits

are designed to use the sponsor's full budget, then the investment earnings will have to cover the interest credit plus any investment and administration expenses paid by the plan. Use of a lower interest crediting rate takes some of the pressure off; alternatively, the plan could provide lower pay credits and allow the balance of the budgeted contribution to cover any shortfall.

If the sponsor is a professional practice with a number of partners/owners, how is the cost of the plan to be allocated between them? In most cases, each owner is responsible for the cost of the benefits they earn as well as their share of the cost of the employee benefits. How will their share of the cost be collected, and what happens if some of the owners leave the practice prior to funding their benefit for that year? What if they have funded part of their current year share but have not met the requirements to receive them? What happens if the plan has a surplus or deficit at the time they leave the practice? All of these issues should be discussed.

The solution may revolve around whether the sponsor wants to make contributions monthly or annually. If the former, it might be as simple as removing the hours requirement to earn an allocation and instead allocate a pay credit for each month that a participant completes. However, this does not solve the possibility that the plan is materially under- or over-funded at the time an owner leaves the practice.

It is important for the sponsor and each owner to understand how these issues will be resolved with respect to the plan. Some of these issues may require the input of an attorney and possibly the rewriting of partnership or employment agreements. This could delay the adoption of the plan.

PBGC

Plans that cover common law employees and are not sponsored by a professional business with fewer than 25 active participants are covered by the Pension Benefit Guaranty Corporation. Although this allows a much larger potential contribution in those situations where the cash balance plan is combined with a DC plan, the premium levels and filing deadlines should be understood since the premium amounts can be a substantial expense.

CONCLUSION

Just because demographically a cash balance plan makes sense for a plan sponsor does not mean it's in their best interest. Ultimately the only person/people who can make the determination whether this plan type is in the sponsor's best interest is the sponsor — but very few, if any, can make the decision on their own. They need proper consultation with advisors, lawyers, actuaries and the TPA so that they are fully aware of their obligation in the future and are aware of the effects that different situations will present down the road. If this consultation isn't done as part of the sales process and the plan is sold, it might be too late to make necessary changes. This is why it's crucial that these plans are sold the right way! **PC**



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