CASH BALANCE PLAN PRIMER

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The Pension Source Overview

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- The Pension Source is a high-quality provider of qualified retirement plan[1] consulting, administration, and compliance services. We are often referred to as a retirement plan Third Party Administrator, or TPA
- We were founded in 1979 and have never strayed from our core mission of serving small-to-medium sized business owners and their retirement plan needs. We have one business line and do not provide investment advice or sell insurance products of any kind
- Pension Source is headquartered in Stuart, FL and serves clients across the continental U.S.
- Pension Source's history and reputation for concierge-level service, customized plan design, and ability to solve for a business owner's most pressing retirement challenges has resulted in 800+ (and growing) plans under administration
- Throughout our history, we have adopted the latest technology to ensure a seamless experience for clients while always maintaining our personal touch
- Our team includes several members that are credentialed from the American Society of Pension Professionals and Actuaries (ASPPA) and the American Society of Enrolled Actuaries (ASEA)

(1) "Qualified" retirement plan refers to employer sponsored retirement plans that satisfy (i.e. qualify) requirements in the Internal Revenue Code and Employee Retirement Income Security Act of 1974 to receive preferential tax treatment. Tax benefits include deductions for employer and employee contributions and tax deferral of investment gains.

Cash Balance Plan Background

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- Qualified Retirement Plans come in two general types: defined benefit and defined contribution. Cash balance plans (CBs) are a mix of both, as they are technically defined benefit plans but have several characteristics of a defined contribution plan
- Cash balance plans combine the potentially high contribution amounts of a defined benefit plan with the "feel" of a defined contribution plan given participants have an individual, portable retirement account
- An experienced Third-Party Administrator (TPA), such as The Pension Source, will design a well-structured, highly personalized plan by understanding a company's projected income, demographics, retirement goals, and employee benefit needs
- For successful small businesses and professional practices, cash balance plans can offer significant advantages versus a standard 401(k) Plan or saving outside of a qualified plan, including but not limited to:
  - Business owners can contribute up to three or four times the dollar limits of other types of qualified retirement plans, accelerating the business owner's retirement readiness
  - Plan contributions are 100% tax deductible, which can significantly reduce tax liabilities during the plan's existence(1)
  - In a competitive labor market, a well-structured cash balance plan can distinguish an employer when hiring high quality talent
- As a result, cash balance plans have grown in popularity in recent years, with more than 22,000 plans covering 9 million participants and $1.2 trillion in assets(2)
  - The 2006 Pension Protection Act and regulations issued in the early 2010s have made CBs more flexible and easier to administer, also contributing to their increased popularity
- Lastly, a cash balance plan is often combined with a 401(k) plan (a "combination plan") to give business owners the best bang for their buck when deciding which qualified plan to set up for their business

(1) There are instances where qualified plan contributions are not fully deductible by the employer; However, a well-designed plan and close communication with your TPA can avoid this scenario
(2) Form 5500 filings, Judy Diamond Associates, Department of Labor, IRS

How Does a Cash Balance Plan Work?

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- The starting point of any Cash Balance Plan is a consultation between the business owner and their retirement plan third-party administrator. As a first step, a business owner must provide a company census that includes owner and employee demographic information.
- After the TPA reviews the census information and understands the business owner's needs, the TPA will creatively structure and design a cash balance plan to help them meet their retirement goals.
- Of note, the plan design stage will allow a business owner to answer several important questions:
  - **Who will participate in the Cash Balance Plan**? Everyone does not need to participate equally, and some people can be excluded from the plan if all nondiscrimination testing is met.
  - **What will the business contribute annually**? Annual contribution amounts can be set for each participant as a percentage of pay, a flat dollar amount, or a combination of the two for each employee (note, these are referred to as pay credits). Also, participants do not need to have equal pay credits.
  - **What will each employee's account balance grow by each year**? Cash balance participant accounts grow by employer contributions (pay credits) and an interest crediting rate (ICR), which is essentially the rate of return for each participant's account. For example, many cash balance plan documents include 5% as the ICR.
- Once these decisions are made, a plan document will be created to govern the plan going forward, and an investment account will be opened in the name of the plan's trust.
- Each year, the employer will provide the TPA with annual census data to determine required contributions, conduct nondiscrimination testing, and ensure all government reporting forms are processed correctly. During this process, the employer will make its annual contribution into the plan's trust.
  - Additionally, a high-quality TPA will remain in close contact with the business owner to amend and update the plan as the company's demographics and income change.

How Much Can You Contribute in a Cash Balance Plan?

- One of the main reasons that businesses adopt cash balance plans is that contribution limits are significantly higher than other types of qualified plans
- Cash balance plans are structured to target an allowable maximum income at retirement, which is defined as the actuarial equivalent of a lifetime income of $265,000 at age 62 or a lump sum balance of $3.4 million
- Cash Balance contributions are determined annually with the goal of achieving the maximum lump sum balance at retirement. Thus, contribution amounts change each year based on items such as a participants age, income, years to retirement, and investment performance of plan assets, among other variables
- Older individuals are allowed higher contributions because there is less time to accumulate the maximum lump sum balance prior to retirement. As a result, older business owners with high taxable incomes are oftentimes the best candidates for a combination 401(k) & cash balance plan

Age	401(k) with Profit Sharing(1)	Cash Balance	Total Contributions	Tax Savings(2)
66-70	$76,500	$376,000	$452,500	$203,600
60-65	$76,500	$336,000	$412,500	$185,600
55-59	$76,500	$274,000	$350,500	$157,700
50-54	$76,500	$214,000	$290,500	$130,700
45-49	$69,000	$167,000	$236,000	$106,200
40-44	$69,000	$130,000	$199,000	$89,500
35-39	$69,000	$101,000	$170,000	$76,500
30-34	$69,000	$79,000	$148,000	$66,600

(1) Assumes 401(k) deferrals of $23,000, $7,500 catch-up contributions, and $46,000 in Profit Sharing; (2) Assuming 45% tax rate for federal and state taxes; Taxes are deferred
Maximum 401(k) with Profit Sharing amounts may be reduced if compensation is lower than the IRS maximum compensation limit of $345,000 and other deduction limits may apply. Maximum Cash Balance amounts assume a three-year average compensation of at least $275,000 and prior service. Lower three-year average compensation or service history may reduce amounts shown.

Key Advantages of Cash Balance Plans

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1. **Reduce tax liabilities throughout the plan's existence**
   - Funds contributed to a cash balance plan are tax-deductible for the year of contribution, and the earnings grow tax-deferred until the funds are withdrawn by the participant. The compounding effect is enormous and can have a dramatic impact on savings accumulation.
   - Increasing tax rates are a virtual certainty given persistent federal government deficits and an aging population. It has never been more important to find valuable pre-tax savings vehicles, especially for business owners in their highest income earning years.
2. **Significantly accelerate a business owners' retirement funds**
   - Cash balance plans allow for three to four times the annual contribution limits of other qualified plans. This is especially important for business owners who have only recently begun to generate significant income and do not have multiple decades until they retire.
   - Deferral limits for 401(k) plans are so low that they're of limited value to high income earners.
3. **Diversify personal net worth**
   - For most business owners, most of their personal net worth is tied up in their business. Many believe that re-investing all income back into the business is the most prudent path. However, they also run the risk of tying up all their assets in their company.
   - A cash balance gives business owners a viable, tax-advantaged way to diversify their nest egg and protect against volatile economic conditions.
4. **Provides an extra boost to a prudent investing strategy, which alone cannot solve the problem of retirement readiness**
   - After-tax saving is an inefficient way of achieving any retirement goal. A well-structured cash balance plan allows an advisor to help his/her client save a significant money over a relatively short period of time.
5. **Better predictability and ease of understanding vs. traditional defined benefit pension plans**
   - Cash balance participant statements are familiar to employees given the similarity to 401(k) plan account balances
   - A business owner can point to a "number on a page" when demonstrating the significance of the money that is being contributed on behalf of their employees.
   - Removes interest-rate risk that leads to constantly changing value of liabilities in a traditional DB plan (which is impacted by 417(e) rates)
   - Allows for more consistent contributions to the owners, as plan design can incorporate a flat Cash Credit formula
6. **Protects valuable assets from creditors**
   - Assets in a cash balance plan are protected from creditors in the event of a bankruptcy or lawsuit.

Cash Balance Case Study: Engineering Firm

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- Situation: Owner of a local engineering firm has spent years building his practice and is beginning to generate significant amounts of income, with expectations for increasing income into the future
- Owner is age 60, while his staff is considerably younger and works hourly as needed. The owner wanted to quickly increase his retirement assets and defer taxes, and provide a nice benefit to his two long-tenured non-family member employees
- **Pension Source designed a Cash Balance & Profit-Sharing plan to allow a contribution of ~$300K to the business owner.**

Contribution Source			Employer	Employer	
Name	**Classification**	**Total Compensation**	**Profit Sharing Contribution**	**Cash Balance Contribution**	**Total Contributions**
Highly Compensated Employees (HCEs)					
Business Owner	Owner	$165,000.00	$100.00	$299,500.00	$299,600.00
Empoyee #1	Family Attribution	$14,000.00	$50.00	$500.00	$550.00
Sub-Total: HCEs		**$179,000.00**	**$150.00**	**$300,000.00**	**$300,150.00**
Non-Highly Compensated Employees (NHCEs)					
Employee #2	NHCE	$14,000.00	$8,000.00	$0.00	$8,000.00
Employee #3	NHCE	$36,000.00	$3,500.00	$0.00	$3,500.00
Sub-Total NHCEs		**$50,000.00**	**$11,500.00**	**$0.00**	**$11,500.00**
Total		**$229,000.00**	**$11,650.00**	**$300,000.00**	**$311,650.00**

- Owner receives $0.96 of every $1 contributed to plan

How Are Cash Balance Plan Assets Invested?

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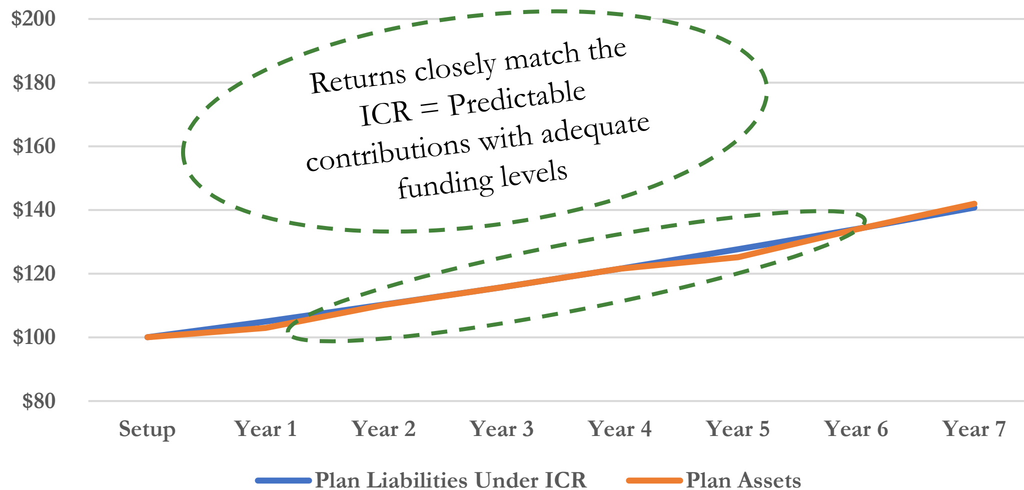
- Cash Balance assets are pooled, meaning there is one account for the plan rather than different accounts for each individual participant. Note, the TPA keeps track of individual hypothetical account balances each year and provides annual participant statements (see page 11).
- Plan assets are invested by the trustee or financial advisor, with the goal of meeting the interest crediting rate (ICR) per the plan document.
- If the Plan's investment earnings exceed the ICR, the excess return will be used to reduce future employer contributions.
- On the other hand, if the Plan's investment earnings are less than the ICR, then the future employer contributions must make up for the shortfall. This make-up contribution can be spread over seven years, although that does introduce additional complexity into administering the plan.
- **The goal of cash balance plan investment performance is to match the ICR**. Volatile returns can lead to negative consequences such as reduced employer contributions, high minimum required contributions at unfavorable times, excise taxes, and more

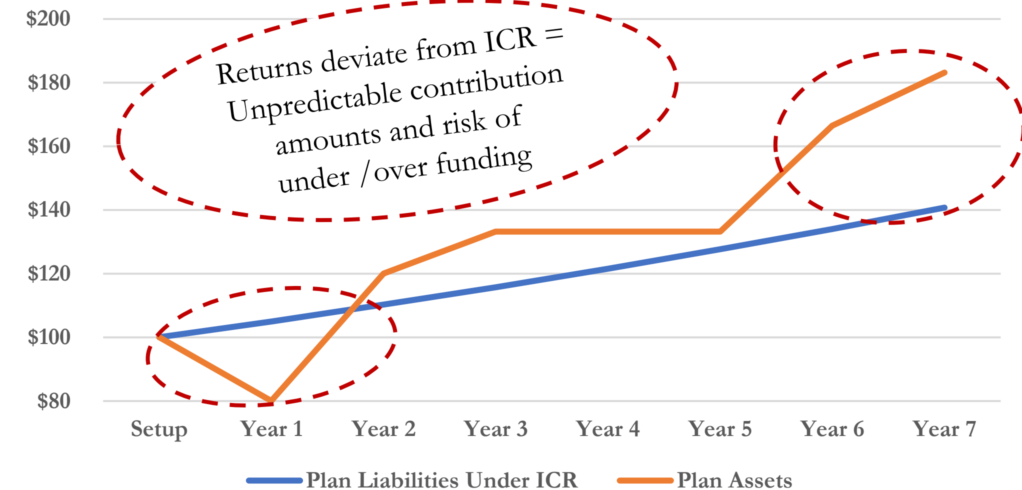
Stable Investment Performance That Tracks ICR



% growth

ICR	5%	5%	5%	5%	5%	5%	5%
Earnings	3%	7%	5%	5%	3%	7%	6%

Volatile Investment Performance That Deviates From ICR



% growth

ICR	5%	5%	5%	5%	5%	5%	5%
Earnings	-20%	50%	11%	0%	0%	25%	10%

Who Is a great Cash Balance Candidate?

Cash balance plans are an excellent tool for high-income business owners to significantly reduce their current tax liability. However, these plans work best for only certain types of clients.

Key Criteria

- ✓ Business owners who are already maximizing the current limits under their 401(k) and profit sharing plans, and desire to contribute more than $73,500 per year to their plan
- ✓ Business owners who are making $200,000+ per year in income and/or have significant pass-through income
- ✓ Highly profitable businesses with consistent earnings patterns
- ✓ Older business owners relative to their employees
- ✓ Businesses that are committed to investing in their retirement plan for at least 3-5 years
- ✓ *Note, 1 person companies ("owner only") can be fantastic candidates for cash balance plans. Do not think you have to have employees to set up a plan!*

Company Types Where Cash Balance is a Great Fit

- Professional service firms
    - CPAs, lawyers, architects, etc.
- Physician groups
- Successful family businesses and other closely held businesses
- High income solo practitioners

Company Types Where Cash Balance Might Not Work

- Unpredictable earnings patterns, or earnings that are significantly impacted by factors outside of their own control
- Company ownership is looking for a short-term tax reduction and is not committed to operating their plan each year
- Younger owner relative to the employee base

Key Considerations for Business Owners

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With great contribution potential comes great responsibility. Business owners should not make the decision lightly to adopt a plan, and must ensure they only work with experienced advisors.

1. **Expertise On Staff**: Cash balance plans should not be administered by people who only dabble in this line of work. These plans are complex and constantly evolving. Many TPAs don't consult on enough of these plans to have an actuary on staff, so they outsource / sub-contract the work to a 3rd party.
2. **Cost**: Cash balance plans require actuarial support and have more robust administrative duties versus defined contribution plans. The administration costs of a cash balance plan are typically double that of a 401(k) plan. Remember though, even after administrative fees, the net reduction in tax liabilities can be significant if the plan is well-designed.
3. **Required contributions**: Business owners should expect to contribute each year to their plan.
   - Certainly, economic and market conditions change and there may be years where a business does not have the funds to contribute. This is OK and we can design accordingly.
   - Plan sponsors must not assume that cash balance plans can be easily turned on and off each year
4. **Length of time commitment**: The IRS does not have a clear rule on how long a cash balance plan must stay open for. However, their "rules of permanency" are typically understood to mean that a business should owner commit to at least 5 years when operating their plan.
   - It is important to note that years of service are crucial when participants want to receive the maximum lump sum benefit available at retirement. In almost every case, the longer the plan is open, the better.
5. **Required involvement**: Although TPAs such as The Pension Source take on a lot of the administrative burden related to these plans, there is still more required involvement on the part of the employer versus a standard 401(k) plan.

Example Cash Balance Participant Statement

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Participant Account Statement

Bob Smith

For the plan year 01/01/2022 through 12/31/2022

Date of Birth	1/1/1969	
Date of Employment	1/1/2010	
Date of Participant	1/1/2021	
Date of Retiremnet	7/1/2031	

- Key demographic information per each participant

Hypothetical Account Summary

Beginning Balance	$200,000	A
Interest Credit	$10,000	B
Pay Credit	$200,000	C
Adjustment	–	
Distribution	–	
Ending Balance	**$410,000**	
Vesting Percentage	100%	D
Total Account Balance	$410,000	
Total Vested Amount	$410,000	

- (A) Reflects the ending balance of the prior year
- (B) This year's interest credit rate; in this case it is 5%
- (C) This year's Pay Credit, or the portion of the employer contribution that has been allocated to the participant
- (D) Cash Balance Plans allow vesting schedules

- Account balance similar to a defined contribution plan

Frequently Asked Questions

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What is my contribution amount going to be every year?
Cash balance plans are structured to target an allowable maximum income at retirement. Currently, participants can build their hypothetical account balance to the actuarial equivalent of a lifetime income of $275,000 per year, or roughly $3.5 million translated into a lump sum. As a result, annual contribution amounts are set to ultimately target that limit when the participant reaches retirement age.

What is my contribution amount going to be every year?
Each year, our actuarial team calculates a contribution range, that consists of a Required Minimum Contribution (RMC), a recommended contribution, and the maximum allowable funding amount. These contribution ranges will fluctuate each year, in part due to deviations in the plan's asset returns vs. the plan's interest crediting rate (ICR). If the plan's asset returns equal the ICR, then all else equal the recommended contribution amount will equal the plan's pay credits.

What if I can't make the required minimum contributions?
If a plan sponsor does not make the required minimums, they risk an excise tax of 10% of the value of the RMC, which then gets added to next year's contribution amount. However, there are several steps we can take as your TPA to help if your business income suddenly changes and you are unable to contribute. That is why it is imperative you contact us as early as possible, and we can potentially amend and/or freeze the plan to deal with your new circumstances.

I can't predict my business income 5 years from now and can't be certain I'll
During the plan design phase, we can craft your plan's formula (which dictates future contributions) to be for a defined period of time. For example, we can design the formula to be 3 years in length before being reduced to 0. At that time, we will perform an actuarial study taking into the plan's assets, your company's latest demographics, and your expectations for future income when amending the formula.

Frequently Asked Questions

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Can I contribute the maximum amount every single year?
You will likely be able to contribute the maximum amount for several years. However, at a certain point, you will reach the plan's limits (as set by the IRS) and your ability to contribute will be reduced or eliminated altogether. This is why it is imperative for you to remain in contact with us, and you can plan accordingly for any reduced contribution amounts in the future.

Who is required to receive a benefit in a cash balance plan?
You do not need to cover every employee in the cash balance plan. A cash balance plan must provide a "meaningful" benefit to the lesser of: (a) 40% of non-excludable employees, or (b) 50 participants. If the cash balance plan does not cover the employer's entire population, then it is typically paired with a 401(k)/profit-sharing plan that can satisfy nondiscrimination testing requirements.

Can I access the money in the plan before I retire?
For most cash balance plans, the document will state that the assets are only available for in-service distributions after the age of 62.

How do distributions work when I do reach retirement age?
For most of our clients, they will choose to convert their actuarial equivalent of lifetime income at retirement into a lump sum balance and roll the funds to an IRA. The funds will then continue to grow tax deferred until they are distributed. If desired, the participant also purchase an annuity at retirement instead of rolling the lump sum balance into their IRA.

Frequently Asked Questions

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How long do I have to keep the cash balance plan open for?
A cash balance plan needs to follow the IRS rules of permanency. Although there is not an explicit number of years, we recommend that clients expect to keep the plan open for at least 5 years. However, there are exceptions if there is a legitimate business reason for freezing or terminating the plan (such as bankruptcy or a business sale).

Is there a vesting schedule for cash balance contributions?
Cash balance plans typically use a 3 year "cliff" vesting schedule whereby participants do not vest in years 1 and 2 of service but are then 100% vested after 3 years. This means that if the employer contributes on behalf of an employee who leaves during their second year of service, that contribution amount is forfeited back to the plan. This forfeiture money can then be used to offset future required contributions into the plan.

Do employees defer anything out of their paychecks in a cash balance plan?
No, employees are not deferring out of their paycheck as they do in a 401(k) plan. The cash balance plan is contributed entirely by the employer to the plan's participants.

What is the deadline to establish a cash balance plan?
A cash balance plan can be established up until the earlier of: (a) the entity's tax filing date, or (b) 8.5 months after plan year end. However, it can take several weeks to set up the plan's documents, design a plan, and calculate and fund year 1's contributions, so we recommend reaching out at least 1-2 months before your entity tax filing date if you wish to establish a plan.

Disclosures

The Pension Source, LLC does not provide tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any financial transactions. The Pension Source, LLC provides qualified retirement plan design, administration, and compliance services, and is not a broker-dealer, investment advisor, licensed attorney or accountant.