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Cash Balance Pension Plans: The Changing Landscape of Retirement Planning

A recent study by Willis Towers Watson highlighted that more than ever before, Americans are planning to retire after reaching age 65. As the baby boomer generation ages, the media has focused on that age group's inability to successfully prepare for retirement. Approximately 10,000 people in the United States turn 65 each day. However, the average amount saved for retirement for 55 to 64 year olds was only $104,000.

Business owners and entrepreneurs suffered serious financial setbacks during the 2008 financial crisis. Eight years later, many have recovered and are now looking for ways to improve their financial security and are focusing on maximizing their retirement plan savings.

Cash balance pension plans have changed the landscape of retirement planning for many business owners, allowing them to maximize or catch-up on retirement savings, reduce taxable income, and take advantage of asset and creditor protection strategies.

What is a Cash Balance Plan?

First introduced in the mid-1980s, these plans were used sparingly and didn't catch on until certain legal issues were clarified in the 2006 Pension Protection Act, 2010 IRS Cash Balance regulations and 2014 Final IRS Cash Balance regulations. According to the Kravitz 2017 National Cash Balance Research Report, from 2014 to 2015, the number of new cash balance plans grew by 17%, versus 3% growth in new 401(k) plans. Over a slightly longer time frame, between 2010 and 2015 there was a 152% increase in the number of new cash balance plans. Their combined value was $1.1 trillion by the end of 2015, including more than $29 billion of annual contributions in 2015 alone—and they represented more than 34% of all defined benefit plans, up from only 3% in 2001.

Cash balance pension plans are employer-sponsored retirement plans that incorporate elements from traditional defined benefit plans along with the flexible characteristics of defined contribution plans (401k). These hybrid plans provide the ability for high income business owners and partners in professional service firms to save upwards of $261,000 annually based upon demographics and plan design.

Similar to traditional defined benefit plans, employers make contributions for the benefit of each employee. However, instead of using an actuarial rate of return, the employer makes two contributions for each employee. The first is a pay credit, which is either a fixed amount or a percentage of annual compensation. The second contribution is an interest credit rate (ICR) which is typically set to equal the actual rate of return of the portfolio, thereby reducing the investment risk of market volatility and the possibility of having an underfunded plan.

Another defining difference is that a hypothetical account is maintained for each employee. Contributions are recorded into these accounts, providing the employee with the ability to understand their benefit as a hypothetical account balance, similar to a 401(k) account, instead of a specific monthly benefit upon retirement.

Benefits of Cash Balance Pension Plans

» **Not all participants are equal** – plans can be designed to maximize benefits to owners, while minimizing contributions to other employees. Since contributions are age-based, older business owners may be able to contribute as much as $261,000 annually and reap upwards of 90% of the benefits of the plan.

Cash balance plans are ideally suited for businesses that have consistent cash flow and are highly profitable.

- **Income tax reduction strategies** – contributions to retirement plans reduce your taxable income dollar for dollar. With a 39.6% maximum Federal tax bracket, along with additional taxes on earned income over $200,000 ($250,000 married, filing jointly) for Medicare and Obamacare surcharges, the income tax savings for high income earners could be significant

- **Asset protection** – all qualified pension plans are protected under the Employee Retirement Income Security Act of 1974 (ERISA). The ability to accumulate large sums makes these plans particularly attractive to doctors, lawyers and entrepreneurs.

- **Eliminate the potential of an underfunded pension liability** – regulatory revisions allow the plan's ICR to equal the plan's actual rate of return, thereby eliminating a plan's ability to be underfunded due to market declines. The plan's assets must be adequately diversified.

- **Federal guarantee** – as with all pension plans, cash balance plans can be guaranteed by the Pension Benefit Guaranty Corporation for a nominal fee.

- **Portability and value** – IRS regulation allows for a maximum accumulation of $2.5 million. After a 3-year vesting period, account values can be rolled over to an Individual Retirement Account (IRA) or a lifetime annuity can be purchased. Knowing the market value of your retirement benefit makes planning more meaningful and easier to understand.

Is a Cash Balance Plan Right for You?

While some Fortune 500 companies have converted their traditional pension plans to cash balance, small and medium-sized businesses have contributed most to the recent popularity of these plans. More than half of cash balance plan sponsors have fewer than 10 employees, and companies with 100 employees or less now represent 92% of all cash balance pension plans. The largest growth segment in recent years has been with businesses employing less than 25 people.

Cash balance plans are ideally suited for businesses that have consistent cash flow and are highly profitable. Based on the 2017 Kravitz report, more than half of all plans are represented by doctors/dentists (37%), lawyers (9%) and accountants and financial services firms (10%). A variety of other businesses make up the remaining percentage.

About the Author

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Sources: Willis Towers Watson; U.S. Department of Health and Human Services – Administration on Aging (AoA); U.S. Government Accountability Office; Kravitz 2017 National Cash Balance Research Report

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