Cash Balance Add-On Plans —Plain and Simple

Answers to Ten Common Questions About Cash Balance Add-on Plans

John S. Agatston FSA, EA, MAAA, MSPA
John S. Agatston Actuarial Services

November 2005

Question One

What is a Cash Balance Plan?

A Cash Balance Plan is a Qualified Defined Benefit that looks more like a Profit Sharing Plan or Money Purchase Pension Plan. But, unlike a regular Defined Benefit Plan, benefits are expressed as account balances (lump sum amounts).

Question Two

How does it work?

As shown in exhibit 1 below, each year the participants gets credited with a "hypothetical" contribution (the contribution % times Pay), provided they work more than 1000 hours. This contribution is deemed to be made at the end of the plan year. In addition, each year, the beginning balance is credited with a year's interest using the 30 Year Treasury Equivalent interest rate.

Each year the plan sponsor funds the plan according to the Defined Benefit Funding rules. These funds are not assigned to anyone's specific account, but in total will generally be a little more than the total hypothetical balances. As with a regular Defined Benefit Plan it is possible to provide maximum/minimum funding flexibility.

Question Three

What is meant by the term "Add-On" when speaking of "Add-On Cash Balance Plans"?

Simply an "Add-On" plan is an additional plan added on to a Plan Sponsor's already existing Profit Sharing or Profit Sharing/401(k) Plan. **A Cash Balance Add-on Plan is not a conversion plan.** You are not converting one plan into another, you are simply adding one plan to another. Although there have been some issues raised with converting regular Defined Benefit Plans into a Cash Balance Plan (i.e. IBM), and that these issues have not been fully resolved, these are not the type of plans we are discussing here.

Question Four
Part 1

Why is the Add-On Cash Balance Plan such a powerful tool to optimize plan design and funding strategy?

We will answer this question in two parts. First, lets consider the three critical areas, regardless of whether you have a defined contribution plan or a defined benefit plan, that good plan design and funding strategy will effectively address:

Exhibit 1

Year	Pay	Contrib. %	Hypothetical Contribution	Int. Rate	Interest	Account Balance
2004	$20,000	4%	$800	5.31%	$0.00	$800.00
2005	$21,000	4%	$840	5.06%	$42.48	$1,682.48
2006	$22,000	4%	$880	4.46%	$85.13	$2,647.61

a. Maximizing Tax Deductible Contributions

b. Allocating contributions in the best way among owners, long service employees, favored groups and other employees. This includes limiting employer costs in part by having employees participate in a 401(k) Plan.

c. Allow for funding flexibility from year to year to help a sponsor to maximize contributions in an up year and limit contributions in a down year.

Question Four
Part 2

Now that we understand the basics to optimizing plan design and funding strategy, how does adding a Cash Balance Plan to a Profit Sharing/401(k) Plan specifically address these three critical areas?

- Owners and keys (i.e. Favored Employees) can have much more than $46,000 ($49,000 in 2006) contributed for them.

- Favored Employees can receive a much higher percent of the contribution than in either a New Comparability Profit Sharing Plan or a Defined Benefit Plan by itself.

- Long Service employees can receive higher contributions than other employees without the excessively high contributions in regular Defined Benefit Plans and 412(i) Plans.

- The risk and responsibilities are shared more with participants through the fact that there is a 401(k) Plan (i.e. employee contributions and responsibility for investment choices and results). Also, the investments on the Profit Sharing portion (whether trustee directed or participant directed) do not affect employee contributions as in the Defined Benefit Plan.

- The Cash Balances carry much less risk than a regular Defined Benefit Plan in that:

  1. It is a career average as opposed to a final average pay plan. This means that a spike in pay a few year before someone retires will have a much smaller effect on pension costs.
  2. A higher percent of the contribution goes for the owner or favored group. It is easier for the owner to cutback on his own benefit than for other employees.
  3. Usually there is no past service liability and small PBGC premium payments.
  4. Investments are usually more conservative since relatively more equity investments will be made in the Profit Sharing/401(k) side.
  5. Lump Sum payouts are not affected by fluctuations in the 417(e) interest rates.

- Cash Balance Plans are easier for participants and sponsor's to understand since all benefits can be expressed as account balances just as with Profit Sharing and 401(k)'s.

Question Five

What are the design and funding factors actuaries have to consider with dual plan situations?

It is imperative for the actuary to have clear communication with not only the plan sponsor, but also with the sponsor's other advisors. This will allow him to not only take advantage of dual plans strategies, but, also, multi-year strategies to maximize wealth accumulation for the owner. A good actuary has to balance and optimize among such factors as:

a. Benefit and Contribution Limits

b. Providing adequate benefits for long service employees while holding down costs for short service employees.

c. Decide the best way to handle Top Heavy minimums not just currently but as circumstances change in the future.

d. Participation and Coverage Tests

e. Discrimination Testing on benefits and contributions and related Gateways

f. Funding Flexibility within rules and standards as well as deal with the 25% combined plan deductible limit.

g. Changes in Sponsor's business, cash flow, goals and personnel.

Question Six

How do the administrative requirements for Cash Balance Plans differ from Defined Contribution Plans?

Unlike a Defined Contribution Plan, the yearly administrative requirements for a Cash Balance Plan require the actuary to produce an actuarially valuation, schedule B (with the IRS 5500 forms) and a PBGC-1. In addition, annual benefit statements are usually done after the end of the plan year (as stated earlier, these may be combined with the Profit Sharing and 401(k) Statement).

Question Seven

What are some of the Investment Considerations?

As a Defined Benefit Plan, Cash Balance Plans are trustee directed and normally call for more conservative, fixed income investments.

Question Eight

Does the actuary have to do the recordkeeping for both plans?

No, Profit Sharing/401(k) recordkeeping can stay where it is. But, as stated in question five, the actuary must have good communication and coordination with the other advisors and recordkeepers to do the necessary contribution determination, testing and combined benefit statements (if they are desired).

Question Nine

How do the fees for a Cash Balance Plan compare with those for a regular Defined Benefit Plan?

It is true that the fees for a Cash Balance Plan are a little higher (about 20%) then a regular Defined Benefit Plan. But, and this is a big but, those additional fees are usually minor in comparison to the cost savings from a fully optimized plan design. In fact, the cost savings is often many times the slight extra cost in administrative fees.

Question Ten

How easy is it to close down a cash balance plan?

Usually much less difficult than for a regular defined benefit because the assets track close to the hypothetical account balance amounts. Many times reducing accruals is an alternative if the problem is a short term cash flow shortage.

John S. Agatston has been an actuary for over 30 years and has owned his own firm, John S. Agatston Actuarial Services, for the past 22 years. If you you would like to contact John you can reach him or his staff at 412-661-6292 or email John direct at: johna@practicalactuary.com.

website: www.practicalactuary.com • fax: 412-774-1670 • 5704 Elgin St, Pittsburgh PA 15206