United Retirement Plan Consultants

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Defined Benefit and Cash Balance Plans

Breathe new life into your retirement savings strategy. The Pension Protection Act of 2006 (PPA) created alternate design opportunities for defined benefit (DB) and cash balance (CB) plans both individually and combined with defined contribution (DC) plans. DB plans provide a specific benefit at retirement for each eligible employee, while DC plans specify the employer contribution toward each employee's retirement account. CB plans are the hybrid—a DB plan that defines the benefit in terms of an account balance.

Plan Types

DB plans promise a specified benefit at retirement for each participant, usually in a monthly annuity payable for the life of the participant. This benefit is often based on a participant's compensation and/or years of service.

CB plans are legally DB plans; however, they resemble DC plans. Each participant receives an annual contribution credit (usually a percentage of pay) and an interest credit based on a guaranteed rate that may change from year to year. Within the pooled trust account, each participant has a hypothetical account balance, which is the sum of contribution and interest credits. If investment returns closely track the guaranteed interest crediting rate, it is usually possible to have the required contribution closely track the sum of the contribution credits for all participants. Participants can see their "accounts" grow but are still protected against fluctuations in the market.

For both, an actuary determines the annual contribution needed to ensure that sufficient funds are available to pay benefits to plan participants at retirement age. Plans are often funded entirely by employers, who bear the risk of investment gains or losses. Most plans with non-owner participants are subject to insurance premiums of the Pension Benefit Guaranty Corporation (PBGC).

Funding DB and CB Plans

Required and deductible contributions are determined based on the monthly benefit provided at retirement. Such benefit may not exceed 100% of average pay or a specified dollar amount, which is adjusted for inflation *($17,916/month as of 2017 for retirement age 62 to 65)*. For an older employee, DB/CB contributions can be significantly higher than the DC contributions limit.

Nondiscrimination Testing DB and CB Plans

Stringent plan guidelines ensure that plan benefits or contributions do not discriminate significantly in favor of highly compensation employees (HCEs). When performing nondiscrimination testing, either the benefit at retirement or the annual contribution is compared between HCEs and non-HCEs.

CB Plans after PPA

Lump sum distributions to participants equal their account balances without adjustment for other published interest rates. PPA clarified that CB plans that follow the new rules are not age discriminatory. PPA made these plans more practical and predictable in costs and benefits. Take advantage of the unique design alternatives available to these plans.

Combined Plan Designs

In the past, employers' maximum deduction to all plans for a fiscal year equaled the greater of the required contribution for the DB or CB plan or 25% of the total participants' eligible compensation. PPA created new rules for combined plans. Now, if a DB/CB plan is not subject to PBGC coverage, the maximum allowable deduction is generally the greater of the DB/CB contribution plus a DC plan contribution of up to 6% of pay or 31% of pay total contribution between all plans. For plans subject to PBGC coverage, the maximum allowable deduction is 25% of pay to the DC plan in addition to the DB/CB maximum contribution. This offers many opportunities for a combined plan approach.

Other DB and CB Plan Considerations

Employers interested in adopting a DB or CB plan must be willing to commit to required annual contributions. Although DB and CB plans have required annual contributions, these plans can be amended to target desired contribution objectives as they change over time. If the amendments are timely executed, their effect can be reflected in the current year's contribution requirement. Otherwise, the effect of the amendment will be reflected in future years. Since the contribution credit is defined in the CB plan, they generally have a more predictable contribution pattern than traditional DB plans, which makes them often favored. Sponsors should know that even though there is usually flexibility in funding a profit sharing contribution, it may be lost if the contribution to the profit sharing plan for NHCEs is supporting the nondiscrimination test for the DB plan. Although these plans tend to be more expensive to administer and will incur a premium if covered by PBGC, these costs may be far outweighed by the ability to fund significant amounts towards retirement.

Plan assets must be combined into a single investment pool. Individual self-direction of a CB account is not permitted. Investment gains and losses impact the employer's contribution requirement, not the participants' benefits. Be mindful when determining the investment strategy for the DB/CB portion of the retirement plan assets. The value to a particular employer is dependent upon the ages of the participants. Changes in the employee census can cause significant changes in the cost and allocations.

Example

CB plans can provide partners of different ages the same benefit. The formula is 37% of pay for owners and 16% of pay for non-owners.

Employee	Age	Compensation	Contribution
Partner A	51	$270,000	$99,900
Partner B	58	$270,000	$99,900
NHCE	31	$25,000	$4,000

Contribution and interest credits are projected to normal retirement age for each participant then converted to a monthly accrued benefit. The accrued benefits are compared for nondiscrimination testing. As a percentage of pay, the NHCE's benefit at retirement is greater than that of the partners (HCEs), so the plan is not discriminatory —as long as the NHCEs receive the gateway minimum contribution.

Conclusion

PPA created new plan design opportunities that incorporate DB and CB plans. Traditional DB plans are now less likely to become under-funded with distributions mirroring accumulated contributions with interest.

A CB plan is a viable alternative to DB plans, offering a benefit more easily understood by participants. CB plans also allow employers to equalize contributions for key employees of different ages.

Combining traditional DB or CB plans with DC plans can greatly expand contribution possibilities. These designs can be highly individualized to best match the census of the plan sponsor. Employers who are interested in increasing their annual contributions and are willing to commit to these contribution levels should seriously consider the alternatives that now exist.

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