



Cash Balance Plan Overview

Cash Balance Plans are **hybrid defined benefit plans** that combine the high contribution limits of a traditional pension plan with the flexibility and account-based structure of a defined contribution plan, like a 401(k). It is an attractive option for business owners, especially those with consistent cash flow, seeking to maximize retirement savings and tax deductions while providing competitive benefits for themselves and their employees.

Key Features of a Cash Balance Plan

Hybrid Design

A Cash Balance Plan is considered “hybrid” because it takes elements from both defined benefit and defined contribution plans. Each participant has a “hypothetical account balance” that grows annually through two components:

- › **Pay credits:** Contributions made by the employer. We typically use a fixed-dollar amount, for example, \$35,000.
- › **Interest credits:** Guaranteed annual growth on the account balance, usually tied to a fixed rate, for example, 3%.

Predictable Retirement Benefits

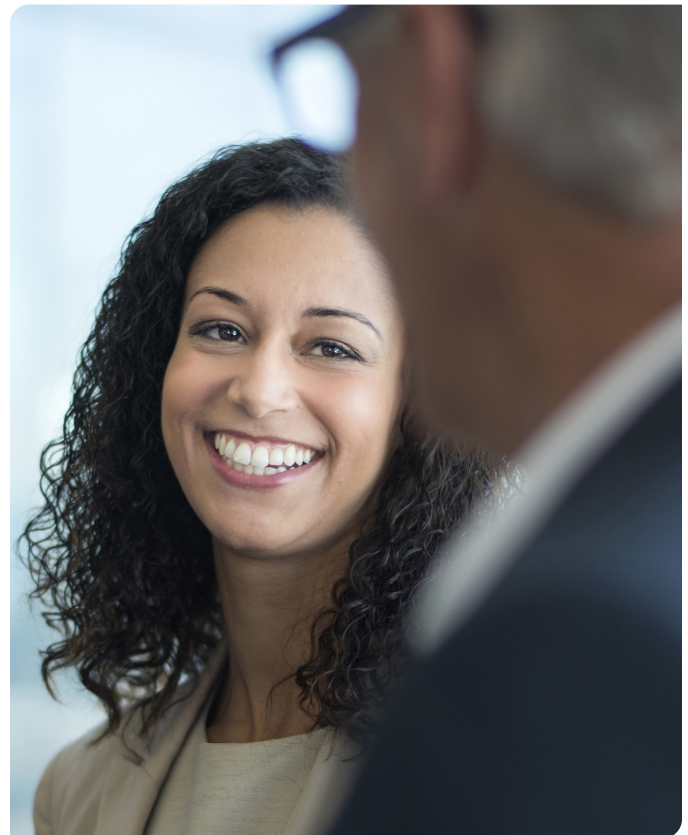
Unlike defined contribution plans like 401(k)s, where retirement benefits depend on investment performance, the employer bears the investment risk in a Cash Balance Plan. The plan sponsor must make sure plan assets are sufficient to fund the accrued benefits (the pay credits plus interest credits).

Higher Contribution Limits

One of the biggest advantages of a Cash Balance Plan is its contribution limits, which are significantly higher than those of 401(k) or profit-sharing plans.

Employee Understanding

The “account balance” structure makes it easier for employees to understand their benefits compared to traditional pension plans.



Cash Balance/401(k) Combination

Cash balance plans are often paired with 401(k) plans—this combination allows business owners to make large contributions through the cash balance plan and use the 401(k) to meet employee needs and nondiscrimination requirements.

Candidates for a Cash Balance Plan

Ideal Candidates	Less Optimal Candidates
High-Income Business Owners: Owners who seek to maximize tax-deferred retirement contributions beyond the standard 401(k) and profit-sharing limits. Businesses with Stable, Predictable Cash Flow: Companies that can commit to consistent annual contributions without significant risk to their financial stability. Older, Highly Compensated Employees: Business owners or key executives, typically aged 40 and older, who want to accelerate their retirement savings in a tax-efficient manner. Companies Seeking Larger Tax Deductions: Businesses looking for significant tax savings by making larger contributions to retirement plans. Owners Focused on Their Retirement Options: Entrepreneurs who want to create significant retirement savings opportunities for themselves while offering an attractive plan to employees.	Companies with Unpredictable Revenue: Businesses with cash flow volatility or inconsistent profits may struggle to meet the required contributions annually. Companies with Younger Owners: Firms where the owners are younger than employees may have difficulty setting up a plan that allows for large owner contributions and minimal employee contributions. Businesses with Short Time Horizon: Companies only looking for deductions/contributions for a short time aren't good candidates. Defined benefit plans should be in place for several years. Owners Satisfied with Standard 401(k) Contributions: Business owners content with current contribution limits might not feel the need for the additional benefits a cash balance plan offers.

Major Requirements of a Plan

Annual Contributions

Employers are required to contribute to the plan each year. Contributions must be sufficient to fund the promised benefits and maintain the plan's funded status according to actuarial calculations. This is different from 401(k) and profit-sharing plans, where contributions are generally discretionary.

Contribution Deadlines

Contributions for each plan year must be made by the employer's tax filing deadline, including extensions. This ensures that the plan remains fully funded and compliant with IRS requirements. In cases where contributions are made late, additional interest or penalties may apply.

Consistency and Longevity

A Cash Balance Plan should ideally be kept in place for at least five years. The IRS unfavorably views plans that

are terminated early unless there is a valid business reason, such as the sale of the company.

Steady Cash Flow

Since contributions are mandatory and can fluctuate based on the plan's investment returns and interest crediting rates, businesses need consistent cash flow to meet these funding obligations. The employer is responsible for covering any shortfall in the investment returns. Plan sponsor should choose pay credit amounts that allow for funding even if the company has a slow year—it is much better to be conservative.

Regulatory Compliance

As with other qualified retirement plans, Cash Balance Plans must comply with nondiscrimination rules to ensure they do not disproportionately favor highly compensated employees (HCEs). Annual compliance testing ensures that contributions and benefits are equitable across all employee levels.

Funding a Cash Balance Plan

Cash balance plans can be funded using a variety of assets, including life insurance, annuities and traditional investments like stocks and bonds.

- › **Whole Life Insurance:** Offers tax-deductible premiums, a pre-retirement death benefit, and cash value growth. It provides stability but requires compliance with IRS incidental benefit rules and can be costly.
- › **Annuities:** Fixed and indexed annuities offer guaranteed returns, reducing market risk. They provide stable, predictable growth, making them suitable for employers seeking certainty in funding. However, returns may be lower than other investments, especially during periods of low interest rates.
- › **Investments—Stocks, Bonds, Mutual Funds:** These offer higher growth potential, particularly over the long term. Bonds provide steady income with lower risk, while stocks and mutual funds allow for market appreciation. However, market volatility increases the employer's funding risk.
- › **Cash and Equivalents:** Offer liquidity and low risk but provide the lowest returns, which limits long-term growth.

Speak to your agent about the pluses and minuses of each approach, and which might be best for you depending on your needs.

Ongoing Administrative Responsibilities

Once a plan is installed there is still work to be done every year to ensure the plan remains compliant and operates effectively. To ensure this, there are certain ongoing obligations for the plan sponsor, as outlined below.

Standard Schedule for Calendar Year Plans:

- › **January:** Provide census and asset details in the Annual Valuation Data Sheet (AVDS) so we can prepare your annual valuation, conduct required compliance tests, including nondiscrimination testing, and to calculate the employer's annual contribution obligations.

- › **Contribution Deadline:** In general, plan contributions must be made by the earlier of the company's tax return due date or September 15.
- › **Funding Confirmation:** Once plan sponsor completes the funding, provide details of the amounts contributed and the funding dates to Lafayette Life Insurance Company (LLIC).
- › **Form 5500 Filing:** After confirming funding details with LLIC, we will prepare your Form 5500, which is due to the IRS by October 15. This filing is essential for maintaining the plan's tax-qualified status.

Life Insurance in a Qualified Plan

Life insurance can be integrated into a Cash Balance Plan to provide additional pre-retirement death benefits, offering financial protection for employees' families in case of an untimely death. Here are some important considerations:

Basics

Whole life insurance is the most common type of policy included in Cash Balance Plans. Upon an employee's death, the death benefit is paid to their beneficiaries. Typically, the policy's cash value at the time of death is considered a taxable distribution, while the excess amount (the difference between the face amount and the cash value) may be excludable as a life insurance death benefit.

IRS Rules:

- › **IRS Incidental Benefit Rule:** The IRS allows life insurance to be included in qualified plans under the "incidental benefit" rule, which limits the portion of contributions that can go toward life insurance premiums. Typically, no more than 50% of employer contributions can be used for life insurance in defined benefit plans.
- › **Nondiscrimination Testing:** If insurance is provided in the plan, it must be offered to all qualifying participants. Further, the insurance premium must be allocated proportionally to all participants (e.g., if one person gets 25% of the contribution in insurance premium, then so should everyone else).

Design Considerations:

- › **Funding Adequacy:** Cash balance plans require consistent annual funding. The plan sponsor must ensure that contributions cover both the retirement and life insurance components without jeopardizing the plan's solvency.
- › **Investment Risks:** Since employers bear the investment risk in a cash balance plan, incorporating life insurance must align with the plan's broader investment strategy.
- › **Flexibility vs. Obligation:** Unlike optional personal insurance, life insurance within a plan requires adherence to rigid funding schedules. This could strain cash flows during low profit years.

Ways to Take Insurance Out of the Plan

There are several ways that life insurance included in a defined benefit plan can be taken out of the plan when an employee leaves the company or retires:

- › **Transfer of Ownership:** The employee can take ownership of the life insurance policy by purchasing it from the plan. This requires the employee to pay the fair market value of the policy, minus any PS-58 costs (the cost of providing life insurance protection). Once the policy is purchased, the employee owns the policy and can maintain it outside of the plan.
- › **Distribution of the Policy as a Plan Benefit:** In some cases, the plan may allow for the life insurance policy to be distributed as part of the employee's retirement benefit. When this happens, the employee



assumes ownership of the policy, but the fair market value of the policy (minus the PS-58 cost) is treated as taxable income to the employee.

- › **Surrendering the Policy:** The employee or the plan may choose to surrender the life insurance policy, meaning the cash value of the policy is liquidated and added to the employee's account balance. This allows the employee to roll over the cash value into an IRA or take it as a lump sum distribution. However, surrendering the policy eliminates the life insurance coverage moving forward.
- › **Taking a Policy Loan:** If the employee wishes to keep the life insurance but does not want to pay the full market value to transfer the policy, they can take a policy loan. The plan can issue a loan against the cash value of the life insurance policy, and the proceeds from this loan can be rolled into the employee's retirement account, allowing them to retain the insurance coverage.

Want to learn more? Talk to your Lafayette Life financial professional today.

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