

Cash Balance Pension Plans

If your goal is a large deduction for your business and a secure retirement benefit for yourself, the special characteristics of a cash balance defined benefit plan are worth exploring.



A “Hybrid” Plan

A Cash Balance Pension Plan can be described as a “hybrid” plan because it has both defined benefit and defined contribution features. This type of plan can be the best of both worlds – higher defined benefit limits plus the flexibility to allow higher contributions to the business owner.



Defined Benefit Characteristics Include

- Benefits must be definitely determinable and stated in the plan document
- Contributions are required annually at the stated level
- The plan sponsor assumes the investment risk (no participant direction)
- Defined benefit 415 limits apply (i.e. no \$66,000 limit)
- Not limited to the 25% of payroll which allows for a much higher deduction and greater benefit accumulations

Defined Contribution Characteristics Include

- Participant's have an account balance
- Contributions and interest are added to the account annually
- Contributions can be skewed by class to favor owners and key employees
- May be adopted as late as the due date of the employer's tax return

There are some special features to be considered when it comes to a Cash Balance Plan:

- The contribution and the interest credited to participants' accounts must be guaranteed by the plan.
- Participants do not get to direct investments in their accounts, unlike a 401(k) plan.
- If the plan's investments earn less than the promised rate the employer must make up the difference because the plan sponsor must guarantee the interest credit to the accounts.
- If the plan earns greater than the promised rate the excess amount would reduce the employer's future required contributions.

In a cash balance plan, you can create classes of employees and skew contributions in favor of the owner, similar to a new comparability plan. This means that the defined benefit contribution limit can be used for the owner rather than the \$66,000 defined contribution limit.

The classes allows one to create an “efficient” plan design by providing the maximum contribution for the owner while making lower contributions for the other employees. From a contribution standpoint, a cash balance plan can be looked at as a new comparability plan without the \$66,000 contribution limit for the owner class.

The following contribution comparison chart shows how the owner of a small business with four employees benefits from a cash balance plan design over a new comparability profit sharing plan.

| | Age | Salary | New Comp. | Cash Balance* |
|----------------------|-----|------------------|-----------------|------------------|
| Owner | 62 | \$330,000 | \$66,000 | \$320,100 |
| EE 1 | 40 | \$41,000 | \$3,075 | \$770 |
| EE 2 | 31 | \$31,000 | \$2,325 | \$375 |
| EE 3 | 28 | \$29,000 | \$2,175 | \$303 |
| EE 4 | 24 | \$24,000 | \$1,800 | \$207 |
| Total | | \$455,000 | \$75,375 | \$321,755 |
| Owner's Share | | | 88% | 99% |

*Contributions are dependent on the specific ages of the employees in the firm. The allowable contributions necessary to meet the nondiscrimination requirements will vary by firm.

The higher cash balance contribution allowed for the owner requires a higher contribution for the employees.

Another unique feature of a cash balance design is that a business is allowed to make the exact same

contribution amount for all of the members of the “owner” class of employees. This means if there are different age owners they can still receive the same contribution amount. That is often not possible in most other plan designs but is most often what the small business owner is looking for.

The next chart illustrates the benefit of a cash balance plan design for a business with two different aged owners.

| | Age | Salary | Contribution | % of Salary |
|----------------------|-----|------------------|------------------|-------------|
| Owner 1 | 61 | \$250,000 | \$132,500 | 53% |
| Owner 2 | 51 | \$250,000 | \$132,500 | 53% |
| EE 1 | 40 | \$44,000 | \$7,040 | 16% |
| EE 2 | 30 | \$31,000 | \$4,960 | 16% |
| EE 3 | 30 | \$30,000 | \$4,800 | 16% |
| EE 4 | 27 | \$26,000 | \$4,160 | 16% |
| Total | | \$631,000 | \$285,960 | |
| Owner's Share | | | 93% | |

Again, a higher contribution amount is required for the employees than we’ve seen in the past with new comparability, but the two owners are both getting an equal contribution that is more than two times the \$66,000 defined contribution limit and together they receive 93% of the total plan contribution. The cost of benefits for the employees should be more than paid for by the tax savings the business receives for this substantially higher contribution.

American National would be happy to provide you with a complimentary review of a cash balance plan designed specifically for your business.

Since cash balance is considered a defined benefit plan, this means that an employer who is looking to fully maximize deduction potential could fund a 401(k)/profit sharing plan along with a cash balance plan.

If the employer contributions to the 401(k)/profit sharing plan do not exceed 6% of the compensation of the participants (for plans not covered by Pension Benefit Guarantee Corporation [PBGC]), then the contributions to both that plan and the companion cash balance plan are deductible. Additionally, if the cash balance/defined benefit plan is PBGC covered, the full 25% defined contribution deduction limit is allowed along with the full cash balance/defined benefit contribution.

Neither American National Insurance Company nor its agents give legal or tax advice. Clients should contact their attorney or tax advisor on their specific situation.

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