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What is a Cash Balance Plan?

A Cash Balance Plan is a Defined Benefit Pension Plan: Retirement plans are classified either as a Defined Benefit Plans or a Defined Contribution Plans. In a Defined Contribution Plan, such as a 401(k) or Profit Sharing Plan, the contributions are defined at the establishment of the plan, and the participant is paid the fair market value of the accumulated contributions at their retirement age. Under a Defined Benefit Plan, a retiring employee will receive a guaranteed benefit. Each year, the employer contributes an amount necessary to fund for the payment of that benefit at some future date. Typically, the benefit is in the form of a monthly payment for the remaining life of the retiree; however, in a Cash Balance Plan, the guaranteed benefit is defined as a theoretical account balance (TAB). This balance consists of the accumulation of service credits and interest credits. Service credits may be defined as a percentage of pay, a flat dollar amount or a combination of the two, and are added to the TAB on the last day of the plan year. Interest credits apply to the TAB annually based on the plan's provisions. The plan promises to pay the TAB at retirement, regardless of the actual returns of the plan, similar to a traditional defined benefit plan. However, since the participant sees this Theoretical Account Balance, the Cash Balance Plan may be easier to understand as it looks more like a 401(k) or profit sharing plan, and may be more appreciated by the employees.

Vesting and Investments: Although the theoretical account balance is structured like a Defined Contribution Plan, there are key differences. For instance, participants must be vested after three years of service, in a "cliff" vesting schedule. The investments under the plan are pooled and Trustee directed; they may not be participant directed like so many 401(k) plans are.

Uses for a Cash Balance Plan: Cash Balance Plans may be especially useful in business where the Owners may be different ages, but they want the contributions to the retirement plan to be the same. The Service Credit can be defined as a flat dollar amount, for instance $100,000, where in a traditional Defined Benefit Plan, funding a monthly benefit at retirement would require a greater contribution for the older owners and a lesser contribution for the younger. Additionally, this type of plan design is often paired with a 401(k) or Profit Sharing Plan and tested together. By providing contributions to employees under the 401(k) plan, which may be vested over a longer period of time, the contributions to the employees under the Cash Balance may be reduced, but keeping the overall contributions to the owners consistent. An illustration of the differences between a traditional Defined Benefit and Cash Balance/401(k) Combination Plan is shown below.

Name	Age	Annual Salary	Traditional Defined Benefit Plan	Cash Balance Plan Allocation	401(k) Plan Deferral	401(k) Plan Employer Contribution	Total Under Cash Balance/401(k) Combination
Owner A	62	$305,000	$308,198	$278,000	$ 27,000	$ 12,200	$317,200
Owner B	61	$305,000	$308,198	$278,000	$ 27,000	$ 12,200	$317,200
Owner C	32	$305,000	$ 99,534	$ 60,000	$ 20,500	$ 12,200	$ 92,700
Employee D	27	$ 19,500	$ 4,986	$ 1,250			$ 1,250
Employee E	31	$ 17,500	$ 5,439	$ 1,250			$ 1,250
Employee F	53	$ 30,500	$ 27,729	$ 1,250			$ 1,250
Total			$754,085	$619,750	$61,500	$ 36,600	$717,850

PBGC Premiums May Apply: Since a Cash Balance Plan is a Defined Benefit Plan, the same rules regarding Pension Benefit Guarantee Corporation, or PBGC, apply. Most Corporate Defined Benefit Plan sponsors must pay annual insurance premiums. The PBGC pays monthly retirement benefits, up to a guaranteed maximum, for covered pension plans that cannot pay monthly promised benefits due to the bankruptcy or insolvency of the sponsoring organization.