

Cash Balance Plans

The 2001 change in law (EGTRRA) made defined benefit plans much more attractive to business owners and key executives. The amounts that can be contributed to these plans were increased by as much as 60%. One form of defined benefit plan that we have found to be particularly useful in meeting our clients' business objectives is the "cash balance pension plan."

A cash balance plan is a pension plan with individual accounts. This is very important in situations where each executive needs to know how much is being contributed on his behalf and the value of his "account" if he leaves.

How They Work

Simply speaking, a cash balance plan is like a profit sharing plan that credits a specified rate of return to participants' accounts.

An account is established for each participant. Contributions are made to these accounts in accordance with a formula specified in the plan. Nondiscrimination tests must be passed to assure that contributions do not "discriminate" in favor of highly compensated employees. An actuary determines the annual contribution required for non-key employees, which is usually expressed as a percentage of pay.

The plan provides that each participant's account will be credited with a specified rate of interest. When a participant terminates employment, he takes his vested account balance with him, just as in a defined contribution plan. He can transfer his account balance to an IRA or another qualified plan to defer taxes. All plan assets are invested together so there are no individual investment choices as in 401(k) plans

The following table shows the maximum annual contributions available for participants of varying ages.

<u>Age</u>	<u>Annual Contribution</u>	
	Cash Balance Limit	Defined Contribution Limit
35	35,800	40,000
45	61,000	40,000
55	104,000	40,000
65	177,400	40,000

Keep in mind that a company can have both a cash balance plan and a defined contribution plan, such as a 401(k) profit sharing plan.

Example 1 – Small Business

The following exhibit shows how contributions could be allocated in a small business with two owners and 12 other employees. The owners receive the maximum amount allowable while the other employees receive contributions of 10.0% of pay.

	<u>Age</u>	<u>Pay</u>	<u>Cash Balance Contribution</u>
Owner A	45	\$200,000	\$61,000
Owner B	55	<u>200,000</u>	<u>104,000</u>
Subtotal		\$400,000	\$165,000
12 Other Employees		<u>\$384,000</u>	<u>\$38,400</u>
Total		\$784,000	\$203,400
% to Owners			81.1%

Example 2 - Law Firm

This example illustrates a law firm with two plans, a cash balance plan and a profit sharing/401(k) plan.

- ✓ The cash balance plan was designed to benefit only partners age 50 and older.
- ✓ All partners can receive up to \$40,000 under the profit sharing/401(k) plan.
- ✓ Staff employees receive profit sharing contributions equal to 7.5% of pay. Associate attorneys do not receive a firm contribution.

	<u>Cash Balance</u>	<u>Profit Sharing</u>	<u>401(k)</u>	<u>Total</u>
1. Partners Over Age 50				
1	\$ 53,000	\$ 29,000	\$ 11,000	\$ 93,000
2	50,000	29,000	11,000	90,000
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15	<u>20,000</u>	<u>29,000</u>	<u>11,000</u>	<u>60,000</u>
Subtotal	\$506,000	\$435,000	\$165,000	\$1,106,000
2. Partners Under Age 50				
16	\$ 1,000	\$ 29,000	\$ 11,000	\$ 41,000
17	1,000	29,000	11,000	41,000
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50	<u>1,000</u>	<u>29,000</u>	<u>11,000</u>	<u>41,000</u>
Subtotal	\$ 35,000	\$ 1,015,000	\$385,000	\$1,435,000
3. Partner Total	\$541,000	\$1,450,000	\$550,000	\$2,541,000
4. 38 Associate Attorneys	0	0	N/A*	0
5. 98 Other Employees	0	279,000	N/A*	279,000
6. Total	\$541,000	\$1,729,000	\$550,000	\$2,820,000
7. Percent to Partners				90.0%

*This exhibit shows only the cost to the firm. Staff employees and associate attorneys pay for their own 401(k) contributions.

Although cash balance plans are somewhat more complex to operate than traditional defined contribution plans, they can be a very useful method of accumulating funds for retirement. If you would like to see if a cash balance plan could be of benefit to your company, we would be delighted to help you.

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