Aim Low

Cash Balance Plan Investment Strategies

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Goals for Today

- Review features of defined benefit, defined contribution and hybrid retirement plans
- Discuss investment risk/reward balance in cash balance plans
- Examine interest crediting rate options
- Work through examples
- Finish in one hour

DC vs. DB Plans

- It’s all in the <u>name</u>
- Defined <u>Contribution</u> plans
  - The contribution is the defined element
    - E.g. – Employer contributes 5% of pay for participants each year
  - Amount of savings at retirement is uncertain
  - E.g. – 401(k) plans, profit sharing plans, money purchase plans, SEPs, SIMPLEs

DC vs. DB Plans

- Defined Benefit plans
  - The benefit at retirement is the defined element
    - E.g. – Participant will get a benefit equal in value to $800 per month beginning at age 62, payable for life
  - Annual contributions needed to fund that benefit are uncertain

Hybrid Plans

- DB plans that have certain aspects of a DC plan
  - More predictable contributions and financial reporting
  - Understood and appreciated by employees
  - Higher contribution limits of a DB plan
- Often paired with a DC plan
  - Can keep existing DC plan, if any
  - Adds flexibility
  - Spreads investment risk
  - Maximizes contribution for business owner

Hybrid Plans

- Examples include
  - **Cash balance plans**
  - Floor offset arrangements
  - Pension equity plans (PEPs)
  - Adjustable pension plans

Cash Balance Plan Dynamics

- CB plans look and feel a lot like profit sharing plans
- Each participant has a "hypothetical account balance" that grows with
  - Pay Credits
  - Interest Credits
- Both Pay Credits and Interest Credits are defined in the plan document

Cash Balance Plan Dynamics

- Account balances are "hypothetical" since plan assets are pooled, and actual invested assets may not mirror hypothetical balances
- From the participant's standpoint there's nothing hypothetical about it
  - If they leave the company and are vested they're entitled to their entire balance

Cash Balance Plan Dynamics

- Example
  - Amy and Bob own ABC Inc. and have one employee, Carol, whom they pay $50,000 per year
  - ABC Inc. adopts a CB plan effective 1/1/2023
  - Amy gets Pay Credits equal to $100,000 per year, Bob $50,000 per year, and Carol equal to 5% of pay each year
    - Pairing with a 401(k) profit sharing plan keeps this arrangement nondiscriminatory
  - Interest Credits are 4% per year

Cash Balance Plan Dynamics

- Example (cont.)

	Amy	Bob	Carol	Total
1/1/23 Balance	**$0**	**$0**	**$0**	**$0**
2023 Int. Credit	$0	$0	$0	$0
2023 Pay Credit	$100,000	$50,000	$2,000	$152,000
1/1/24 Balance	**$100,000**	**$50,000**	**$2,000**	**$152,000**
2024 Int. Credit	$4,000	$2,000	$80	$6,080
2024 Pay Credit	$100,000	$50,000	$2,000	$152,000
1/1/25 Balance	**$204,000**	**$102,000**	**$4,080**	**$310,080**

Cash Balance Plan Dynamics

- Example (cont.)

	Total Hyp. Acct.			Actual Assets
1/1/23 Balance	**$0**		**1/1/23 Balance**	**$0**
2023 Int. Credit	$0		2023 Earnings	$0
2023 Pay Credit	$152,000		2023 Contribution	$152,000
1/1/24 Balance	**$152,000**		**1/1/24 Balance**	**$152,000**
2024 Int. Credit	$6,080		2024 Earnings	-$15,200
2024 Pay Credit	$152,000		2024 Contribution	$152,000
1/1/25 Balance	**$310,080**		**1/1/25 Balance**	**$288,800**

Cash Balance Plan Dynamics

- Example (cont.)
  - So, in this example hypothetical account balances are about $21k underfunded as of 1/1/2025
    - Not a big deal from the IRS' standpoint – Can "let it ride"
  - But what happens if Bob leaves the practice in early 2025?
    - He walks away with his full hypothetical balance ($102,000), even thought that's greater than his "share" of the invested assets
    - Amy is potentially left holding the bag

Cash Balance Plan Dynamics

- Example (cont.)
  - Potential solution
    - Adjust contributions each year to “true up” account balances
    - Total 2024 contribution (deposited in early 2025) would be $173,280 rather than $152,000
      - Of this amount, $114,000 would be for Amy’s benefit, $57,000 for Bob’s, and $2,280 for Carol’s
    - This solution gets difficult to manage with larger account balances and/or bigger investment return swings

Cash Balance Plan Dynamics

- Example (cont.)
  - “True up” strategy can also work if investment returns exceed the interest crediting rate
    - Owner group may be more inclined to “let it ride” in this situation
      - Excess assets can be used to offset any future investment shortfalls
      - Gives partners a bit of extra incentive not to leave

Benefit Limits

- The IRS limits the amount that participants can roll out of DB plans (including cash balance plans) and into IRAs upon plan termination
  - Maximum amount depends on participant’s age, years of plan participation, and IRS limits in effect that year
  - Plan assets grow through a combination of deductible contributions and investment returns
    - High investment returns ultimately limit what can be contributed in future years
    - Think of these plans as tax savings vehicles rather than investment vehicles

Interest Crediting Options

- The interest crediting rate in a cash balance plan can be defined in one of three ways:
  - As a flat percentage (e.g. – 4% per year)
  - Tied to a published index (e.g. – 10-year Treasury rates plus 100 basis points)
  - The actual return on plan assets
    - This one was a surprise when the IRS published cash balance plan regulations in 2010
    - Can be an attractive option, but comes with caveats – See next slide

Interest Crediting Options (cont.)

- Setting the interest crediting rate equal to the actual return on plan assets
  - In years the return is very low
    - Can cause minimum participation issues
    - Balances can’t fall lower than the cumulative amount of Pay Credits
  - In years the return is very high
    - Can cause nondiscrimination testing issues
    - Can trigger IRS benefit limitations

Interest Crediting Options (cont.)

- Setting the interest crediting rate equal to the actual return on plan assets
  - Potential solution to large investment swings
    - Limit interest crediting rate to a corridor
    - E.g. – Actual return on plan assets, but no less than 0% and no greater than 6% in any given year

Key Takeaways

- Many of the dynamics we've discussed apply to all types of DB plans
  - Just more obvious in the case of cash balance plans
- Consider options carefully before defining the interest crediting rate
- Investment strategy should strive to mirror the interest crediting rate as closely as possible
  - May mean that additional equity exposure in other parts of the investment portfolio is advisable
- Think of these as tax savings vehicles rather than as investment vehicles