Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues **May 2007**

New Life for Defined Benefit and Cash Balance Plans

The Pension Protection Act of 2006 (PPA) changed many of the rules affecting defined benefit and cash balance plans. Recent regulations have helped to make such plans more stable, and consequently more attractive to plan sponsors. New design opportunities now exist for these plans, individually and in combination with defined contribution plans. What follows is an overview of the new provisions along with some plan design illustrations.

Types of Retirement Plans

There are two basic types of qualified retirement plans: defined benefit and defined contribution. A defined benefit (DB) plan promises a specified benefit at retirement for each participant, usually in the form of a monthly annuity payable for the life of the participant (or the joint lives of the participant and a designated beneficiary). This benefit is often based on a participant's compensation and/or years of service. An actuary determines the amount that must be contributed each year in order to ensure that the funds are available at retirement age. DB plans are often funded entirely by employers, who bear the risk for investment gains or losses. Most DB plans are subject to insurance premiums of the Pension Benefit Guaranty Corporation (PBGC), a government agency that insures plan benefits. Plans that only cover owners or are sponsored by professional service companies with fewer than 25 employees are exempt from PBGC coverage.

In a defined contribution (DC) plan, benefits are provided from account balances that are funded by employer contributions, employee contributions (such as salary deferrals) or a combination of the two. These contributions along with actual investment earnings comprise the benefits at retirement.

Cash Balance Plan

A cash balance plan is a hybrid—a DB plan that in some ways resembles a DC plan. Each participant receives an annual contribution credit (usually a percentage of pay) and an interest credit based on a guaranteed rate that may change from year to year. The participant's "account balance" is the sum of all contribution and interest credits. These plans are also subject to PBGC coverage with the exceptions noted above.

As in a traditional DB plan, the employer in a cash balance plan bears the investment risk. An actuary determines the contribution to be made to the plan, which is the sum of the contribution credits for all participants plus the amortization of the difference between the guaranteed interest credits and the actual investment earnings (or losses). Participants appreciate this design because they can see their "accounts" grow but are still protected against fluctuations in the market.

In order to determine contribution and benefit limitations, the actuary converts the guaranteed interest and contribution credits to a monthly benefit at retirement age. Such benefit may not exceed 100% of pay or a specified dollar amount which is adjusted for inflation ($15,000/month as of 2007 for retirement age 62 or later). Contributions in a cash balance plan can be significantly higher for an older employee than the DC contribution limit ($50,000 as of 2007, including catch-up contributions).

Testing for Nondiscrimination

All plans must meet certain stringent guidelines or pass nondiscrimination tests. These rules are designed to ensure that plan benefits or contributions do not discriminate in favor of "highly compensated employees" (HCEs), generally defined as those who own more than 5% of the employer or earned more than a specified amount in the prior year ($100,000 in 2007). All others are considered "non-highly compensated employees" (NHCEs).

When performing nondiscrimination testing, either the benefit at retirement or the annual contribution is compared between HCEs and NHCEs. The type of testing selected need not coincide with the type of plan that is adopted. That is, a DB plan can be tested on a contribution basis and a DC plan can be tested on a projected benefits basis. Testing in this manner is referred to as "cross-testing."

DB Problems Prior to PPA

DB plans have fallen out of favor over the past several years. Legislative changes forced these plans to value lump sum payouts to terminated participants as much as two to three times higher than the amount accumulated for them under the plan, which led to funding deficiencies. Also, deduction limits did not allow employers to make extra contributions while the economy was strong. When the economy weakened, market losses increased underfunding and many sponsors were faced with rising costs at a time when corporate profits were lower than usual.

Cash balance plans were also affected by the lump sum payout rules. Once again, participants would receive far in excess of their "account balance," and the plan sponsor would have to amortize the difference. In addition, cash balance plans were plagued with legal problems as some courts found conversions from traditional DB plans to be age discriminatory.

DB Plans after PPA

Under PPA, the funding and lump sum payout rules are being brought into balance. Plan sponsors now have the option of making additional deductible contributions to fully fund the plan and even prefund future accruals. In addition, over a period of four years, new rules for lump sum payments will be phased in, resulting in lump sum distributions that are closer to the amount of benefits funded.

Cash balance plans are also provided relief, as long as they follow certain rules regarding interest rates. Lump sum distributions to participants will now equal their "account balances," without adjustment for various other published interest rates. In addition, PPA clarifies that cash balance plans that follow the new rules are not age discriminatory.

These changes significantly improve the outlook for DB plans by making them more practical and predictable in both costs and benefits. Employers can now take advantage of the unique design alternatives available to these plans. Following are some illustrations.

Cash Balance Plan Example

A cash balance plan can provide partners of different ages the same benefit, as illustrated below. The plan formula is 38.636% of pay for owners and 16% of pay for non-owners.

Employee	Age	Compensation	Contribution
Partner A	51	$220,000	$85,000
Partner B	58	$220,000	$85,000
NHCE	31	$25,000	$4,000

The contribution and interest credits are projected to normal retirement age for each participant and then converted into a monthly accrued benefit. The accrued benefits are compared for nondiscrimination testing. As a percentage of pay, the NHCE's benefit at retirement is greater than that of the two partners (who are HCEs), so the plan is not discriminatory.

Combined Plan Designs

In the past, an employer's maximum deduction to all plans for a fiscal year equaled the greater of the required contribution for the DB plan or 25% of total participants' eligible compensation. Under the new rules, as of 2006 an employer can contribute up to 6% of pay to a DC plan in addition to the required DB contribution, even if the resulting total exceeds the 25% limit. Employee deferrals do not count towards the 6% or the 25% limit. This new rule offers many opportunities for a combined plan approach.

DB + Safe Harbor 401(k) Combo

Shown at right is a DB plan for 2006 in which the contribution exceeds 25% of payroll. Under the new rules, the employer can also adopt a safe harbor 401(k) plan that meets the 401(k) nondiscrimination requirements by guaranteeing a 3% of pay contribution to all NHCE participants. The plan also allows discretionary profit sharing contributions. In this example the profit sharing contribution is allocated on a cross-tested basis, with a higher percentage going to the owner, who is older. The sum of the safe harbor and profit sharing contributions cannot exceed 6% of total participant compensation.

Employee	Age	Salary	DB Cost	Deferral	PS Contrib.*
Owner	52	$220,000	$133,518	$20,000	$14,250
Assistant	25	$35,000	$5,334	unknown	$1,050
Total		$255,000	$138,852	$20,000+	$15,300
*Profit sharing contribution includes the 3% safe harbor contribution.					

Prior to 2006, this sponsor would have only been able to deduct the DB contribution, and the owner's salary deferrals would have been limited based on what the assistant deferred. The addition of the safe harbor 401(k) profit sharing plan allows the owner to increase his own contribution by $34,250 with an additional contribution for the assistant of only $1,050. The assistant can further benefit by making pre-tax salary deferrals into the 401(k) plan.

Cash Balance + Safe Harbor 401(k) Combo

Here is an illustration of a cash balance plan with a safe harbor 401(k) profit sharing plan for 2006:

Employee	Age	Salary	Cash Balance Cost	Deferral	PS Contrib.
Owner 1	59	$220,000	$100,000	$20,000	$14,283
Owner 2	54	$220,000	$100,000	$20,000	$14,283
Other HCE	56	$120,000	$3,000	$6,600	$6,672
8 NHCEs	various	$372,470	$9,312	unknown	$20,710
Total		$932,470	$212,312	$46,600+	$55,948

Over 85% of the employer contribution is allocable to the owners and they can each defer $20,000 as well. The profit sharing contribution is allocated on a cross-tested basis, with different percentages going to the owners, the non-owner HCE and the NHCEs.

The plan design can go even further by excluding some employees from each plan and combining the plans for testing purposes. It can be useful if you have both older and younger HCEs. The younger HCEs can benefit under the DC plan while the older HCEs benefit under the DB plan.

Note that effective in 2008, DB plans covered by the PBGC will no longer count towards the 25% contribution deduction limit. As a result, sponsors of

PBGC insured plans will be able to fund a DC plan up to 25% of compensation in addition to their DB plan.

Other DB Plan Considerations

Employers interested in adopting a DB plan should be willing to commit to the contribution requirements of these plans over the long run. There is little flexibility in calculating required contributions. The plans also tend to be more expensive to administer and, if covered by the PBGC, will incur premium expenses. However, these costs may be far outweighed by the ability to fund significant amounts towards retirement.

The value to a particular employer of any of the plan designs outlined previously is highly dependent upon the ages of the participants. Each of these designs is subject to complicated nondiscrimination requirements which must be performed annually. Changes in the employee census can cause significant changes in the costs and allocations.

Conclusion

PPA has created new plan design opportunities that incorporate DB plans. Traditional DB plans are now less likely to become underfunded with distributions mirroring accumulated contributions with interest. A cash balance plan is a viable alternative to the traditional DB plan, offering a benefit more easily understood by participants. Cash balance plans also allow employers to equalize contributions for key employees of different ages.

Combining traditional DB or cash balance plans with DC plans can greatly expand contribution possibilities. These designs can be highly individualized to best match the census of the plan sponsor. Employers who are interested in increasing their annual contributions and are willing to commit to these contribution levels should seriously consider the alternatives that now exist.

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