BAIRD

Private Wealth Management

Cash Balance Plans

Cash balance plans are defined benefit plans. In contrast, 401(k) plans are a type of defined contribution plan. There are four major differences between typical cash balance plans and 401(k) plans.

The McCallum Group

248-723-7361

TheMcCallumGroup@rwbaird.com

HOW DO CASH BALANCE PLANS WORK?

In a typical cash balance plan, a participant's account is credited each year with a pay credit (such as 5 percent of compensation from his or her employer) and an interest credit (either a fixed rate or a variable rate that is linked to an index such as the one-year Treasury bill rate). Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. Thus, the investment risks and rewards on plan assets are borne solely by the employer.

When a participant becomes entitled to receive benefits under a cash balance plan, the benefits that are received are defined in terms of an account balance. For example, assume that a participant has an account balance of $100,000 when he or she reaches age 65. If the participant decides to retire at that time, he or she would have the right to an annuity. Such an annuity might be approximately $6,000 per year for life (subject to current age plus interest rates). In many cash balance plans, however, the participant could instead choose (with consent from his or her spouse) to take a lump sum benefit equal to the $100,000 account balance.

In addition to generally permitting participants to take their benefits as lump sum benefits at retirement, cash balance plans often permit vested participants to choose (with consent from their spouses) to receive their accrued benefits in lump sums if they terminate employment prior to retirement age.

If a participant receives a lump sum distribution, that distribution generally can be rolled over into an Individual Retirement Account (IRA) or to another employer's plan if that plan accepts rollovers.

CASH BALANCE PLANS VS. TRADITIONAL PENSION PLANS

While both traditional defined benefit plans and cash balance plans are required to offer payment of an employee’s benefit in the form of a series of payments for life, traditional defined benefit plans define an employee's benefit as a series of monthly payments for life to begin at retirement, but cash balance plans define the benefit in terms of a stated account balance. These accounts are often referred to as hypothetical accounts because they do not reflect actual contributions to an account or actual gains and losses allocable to the account.

CASH BALANCE PLANS VS. 401(K) PLANS

Cash balance plans are defined benefit plans. In contrast, 401(k) plans are a type of defined contribution plan. There are four major differences between typical cash balance plans and 401(k) plans.

	Typical Cash Balance Plans	401(k) Plans
Participation	Generally does not depend on the employees contributing part of their compensation to the plan.	Does depend, in whole or in part, on an employee choosing to make a contribution to the plan.
Investment Risks	The investments of cash balance plans are managed by the employer or an investment manager appointed by the employer. The employer bears the risks and rewards of the investments. Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants.	401(k) plans often permit participants to direct their own investments within certain categories. Under 401(k) plans, participants bear the risks and rewards of investment choices.
Life Annuities	Cash balance plans are required to offer employees the ability to receive their benefits in the form of lifetime annuities.	401(k) plans are not required to offer employees the ability to receive their benefits in the form of lifetime annuities.
Federal Guarantee	The benefits promised by cash balance plans are usually insured by a federal agency, the Pension Benefit Guaranty Corporation (PBGC). If a defined benefit plan is terminated with insufficient funds to pay all promised benefits, the PBGC has authority to assume trusteeship of the plan and to begin to pay pension benefits up to the limits set by law.	Defined contribution plans, including 401(k) plans, are not insured by the PBGC.