Cash Balance Plan

A "3rd Generation" Defined Benefit Plan

When it comes to defined benefit plans, the Pension Protection Act of 2006 changed the playing field. One significant change was the validation of cash balance plans. Another change was the relaxation of the dual plan deduction limit that applies when both a 401(k) and defined benefit plan are sponsored. For the successful business, these changes provide a wide array of opportunities.

For owner/employees age 40 and older, cash balance plans, or 401(k) and cash balance combinations offer significant contribution and benefit flexibility.
Illustration I below summarizes potential contributions at various ages using the Plan limits currently in effect.

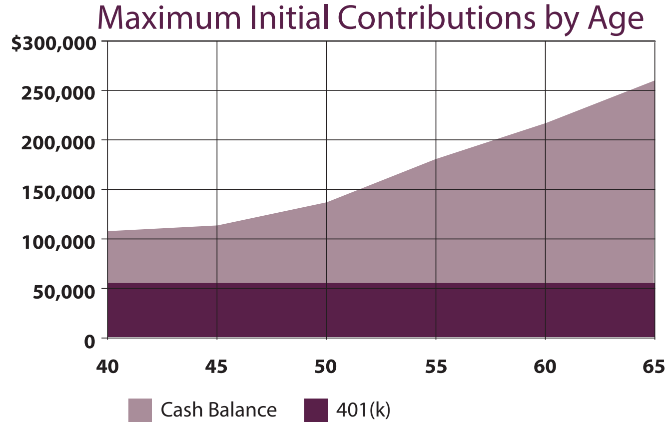
A cash balance or "statutory hybrid" plan is a defined benefit plan that mimics, in many respects, the operation of a money purchase pension plan. This "3rd Generation" defined benefit plan offers some compelling advantages, including:

- Deductible contributions that may exceed 100 percent of pay.
- Unparalleled design flexibility to favor select groups of participants while controlling overall Plan cost.
- Guaranteed benefits to all participants.
- Perfect companion to a 401(k) or profit sharing plan.
- Optional survivor benefits at a relatively modest marginal cost.
- Easy to understand and communicate.

Although a "3rd Generation" defined benefit plan has broad appeal among many sizes and types of businesses, it is not ideal for everybody. Before you look into whether or not a cash balance plan or a combination of plans is right for you, we suggest you consider the following options:

- Would you like to increase your tax-deductible retirement savings?
- Are you concerned with controlling the cost of employee benefits?
- Are you and other *preferred participants* at least 40 years of age?
- Would you consider adding substantial survivor benefits for your beneficiaries for a modest additional cost?
- Is your income or profitability stable and predictable?
- Can you make a commitment to increased savings for the foreseeable future?

Illustration I
Maximum Initial Contributions by Age



What is a Cash Balance Plan?

A cash balance plan is a "hybrid" defined benefit plan that provides guaranteed benefits for employees. It is similar to a defined contribution plan because it provides benefits to employees by referring to a hypothetical account balance. Contributions to the hypothetical account are typically based on a percentage of compensation. The hypothetical account is credited with interest each year based on some objective index or other amount as defined in the plan document.

Although similar to defined contribution plans, it is important to note that these plans are significantly different from the employer's standpoint. For example, a cash balance plan is like a defined benefit plan because the participants' hypothetical account balances do not sum to the actual assets in the plan. The sponsor usually grants a defined interest credit, but plan assets are often invested in a mix of securities that may gain or lose value in any given year.

Unlike other defined benefit plans, a cash balance plan may be designed to better control the cost of the employee benefits. Plans may be designed to optimize each owner's contribution or to levelize the owner contributions despite wide differences in age.

Our "Combo Plan" uses an innovative allocation method to provide comparable benefits to the owners when compared to the average benefit awarded to the employees. Comparable need not be equal. This method makes cash balance plans work in many situations where a classic defined benefit plan would be too costly. **Illustration II** illustrates the benefit of a cash balance "Combo Plan" to the owner.

Some Advantages

Unlike traditional defined benefit plans that are often under-appreciated, a cash balance plan awards each participant a specific contribution, and the plan guarantees it will grow at a fixed rate specified by law. The retirement benefit may simply be: the cash balance.

Cash balance plans provide guaranteed retirement and survivor benefits. They often require larger deductible plan contributions that can be more predictable year-by-year if the investment rate of return matches the cash balance rate. Contributions for owners or partners can be made equal, even if they are of different ages. Combining a cash balance plan with a 401(k) plan can provide even more flexibility for contributions. One advantage that deserves special note is that participant benefits receive protection from the claims of creditors. While true for all qualified plans, professionals may find this creditor protection particularly appealing.

Funding Your Plan

Although a cash balance plan appears to each participant to operate like a defined contribution plan, it is important to reiterate that a cash balance plan is not a defined contribution plan. The plan sponsor (owners) must define and then guarantee the benefit, regardless of the actual performance of the underlying investments.

If the trust assets outperform the hypothetical cash balance rate, future contributions will decrease. Likewise, if the plan assets under perform the cash balance rate, contributions will need to increase. That's why plan funding is best accomplished by using a guaranteed interest fund whose investment yield supports the promises made.

Auxiliary Funds

Security Mutual Life offers pension Auxiliary Fund* contracts that are ideal for cash balance plans. These contracts can guarantee the accumulations for up to five years while providing benefit-sensitive withdrawals to pay plan benefits without penalty. Each contract features:

- No Loads or Fees
- Guaranteed Interest for Either a Two-Year or Five-Year Term
- Benefit-Sensitive Withdrawals to Pay Retirement Benefits
- Withdrawals to Pay Premiums on Associated Security Mutual Life life insurance policies

Your Cash Balance Promise:

"X dollars will be placed in your account and will be credited with Y percent interest. Your benefit will be paid to you when due, and survivor benefits will be paid if called for in the Plan Document."

* IO-4149 – 2 Year Auxiliary Fund Agreement
IO-4150 – 5 Year Auxiliary Fund Agreement

Illustration 2

401(k) & Cash Balance "Combo Plan"*									
Census Data			401(k) Plan			Cash Balance		COMBO
Position	Age	Compensation	Salary Deferral	Employer Contribution	% Pay	Employer Contribution	% Pay	Plan Totals**
Owner A	55	$280,000	$25,000	$28,000	10.00	$190,400	68.00	$243,400
Owner B	50	280,000	25,000	28,000	10.00	148,400	53.00	201,400
Staff 1	44	75,000	0	5,250	7.00	1,500	2.00	6,750
Staff 2	51	60,000	0	4,200	7.00	1,200	2.00	5,400
Staff 3	43	45,000	0	3,150	7.00	900	2.00	4,050
Staff 4	35	40,000	0	2,800	7.00	800	2.00	3,600
Staff 5	50	35,000	0	2,450	7.00	700	2.00	3,150
Staff 6	28	30,000	0	2,100	7.00	600	2.00	2,700
Staff 7	27	25,000	0	1,750	7.00	500	2.00	2,250
Staff 8	30	20,000	0	1,400	7.00	400	2.00	1,800
Totals Percent to Owners				$79,100 82%		$345,400 98%		$474,500 94%

** Based on 2019 IRS Limits*
***Includes Salary Deferrals by Owners*

Adding Survivor Benefits

A cash balance plan must pass the non-discrimination test as a stand-alone plan if life insurance is used. To maximize the available benefits of a cash balance plan, life insurance will typically be used to enhance the pre-retirement survivor benefits" offered by the plan. The plan sponsor also has the choice to add life insurance to the 401(k)/Profit Sharing portion of the "Combo Plan", this option allows the Cash Balance plan to still be cross-tested.

Generally, a defined benefit plan can provide no more than 100 times the projected monthly retirement income as a pre-retirement survivor benefit. An alternative under Rev. Rul. 74-307 allows up to 33 1/3 of the "theoretical level premium" to be used to purchase universal life insurance policies within a defined benefit plan.

The life insurance premium used to fund survivor benefits adds a marginal cost to the overall plan contribution, particularly at younger ages. But participant's retirement benefits are not altered.

Security Mutual Life offers a broad portfolio of life insurance products that can be used in a cash balance plan. We make applying for this coverage easy by offering underwriting programs that feature:

1. No blood or urine specimens for face amounts up to $500,000.*
2. A simplified application* that minimizes our agent's time at your workplace.
3. No added policy loads or fees.

*Issuance of a policy or payment of benefits will depend upon the answers given in the application and the truthfulness thereof. Amounts in excess of $500,000 are subject to normal Company underwriting standards/requirements.

Establishing a Plan

We provide comprehensive service to allow the smooth implementation of a plan through Security Administrators, Inc. (SAI), a wholly owned subsidiary of Security Mutual Life. SAI can be retained by the plan sponsor to install the plan and provide the necessary annual service to help keep the plan tax qualified. SAI can (if retained) also conduct a thorough review of the initial plan design to help ensure the accuracy of data and initial cost estimates.

It is important to understand that the initial design study provided by your advisor is an estimate based on the initial information provided.

The Implementation Process:

1. **SAI Service Agreement.** The installation team at SAI will review all necessary information, verify the design and prepare installation documents once they receive a Service Authorization Agreement and Installation Fee.

2. **Establish the Plan in Writing.** The plan must be established prior to the last day of the client's tax year (to "establish" a plan you must execute the Plan Documents).

3. **Adopt the Plan by Executing the Plan Document.**

4. **Provide a Summary Plan Description (SPD) to Each Participant.**

5. **Fund the Plan.** The plan must be funded by the tax filing date, including extensions, assuming the plan year and the fiscal year are the same.

Comprehensive Administration

Each year required contributions for the plan must be recalculated and required reporting performed. An outline of the process that SAI uses is as follows:

- **Annual Information Request.** Each year, SAI sends a request to the plan sponsor to update census and other important information.
- **Annual Valuation.** SAI will check with the insurance company and record the value of the Auxiliary Funds and life insurance policies and determine the interest earned or dividends paid.
- **Current Cost Calculated.** The cost for the current year's benefit accruals is calculated by comparing the census and plan data to the policy valuation.
- **Actuarial Review.** The plan's actuary will review the cost calculations and plan experience and make changes to ensure that the plan operates smoothly and meets the funding standards of ERISA.
- **Fund the Plan.** Once the current cost is calculated, the plan must be funded by the tax filing date (including extensions, assuming the plan year and the fiscal year are the same). You can send payments through SAI so that they are properly recorded before being sent to Security Mutual Life.
- **Required Reporting.** Each year the plan is required to file an Annual Return/ Report of Employee Benefit Plan (IRS Form 5500 series).

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Any benefits and payments due under the auxiliary fund or life insurance policies are backed by the claims-paying ability of Security Mutual Life Insurance Company of New York. Such benefits and payments are subject to the financial condition of the insurance company.

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