Bloomberg BNA

Pension & Benefits Daily ™

Cash Balance and Comparability Plans: What They Are and When You Should Consider Using Them

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This article examines the characteristics of qualified retirement plans, including the advantages and disadvantages of using cash balance and comparability plans.

Qualified retirement plans generally fall into two broad categories: defined contribution (DC) plans and defined benefit (DB) plans. DC plans specify the amount of contributions the employer will make toward an employee's retirement account, while DB plans define a specific benefit that each eligible employee will receive at retirement and may be stated either as a percent of the employee's compensation or as a fixed dollar amount based on the employee's years of service.

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All qualified plans must meet the following requirements:[1]

- The plan and trust must be a definite written program that sets forth all the provisions necessary for qualification;
- The plan must be communicated to the employees;
- The plan must be permanent; [2]
- The plan must be for the exclusive benefit of employees and their beneficiaries;
- Contributions or benefits provided must not discriminate in favor of the highly compensated employees (HCEs);
- The plan must satisfy the minimum vesting rules;
- The plan must satisfy minimum participation and coverage requirements;
- Pension plans and profit sharing plans that receive rollovers from pension plans must provide automatic survivor benefits;
- The plan must provide that, in the event of partial or total termination, the employee's rights to benefits or contributions accrued will become 100 percent vested;
- The plan must provide that benefits may not be assigned or alienated;
- Assumptions used to determine an employee's benefits in a DB plan must be specified in the plan to prevent employer discretion;
- A DB plan may not use forfeitures to increase an employee's benefits; and
- The plan must provide that only the first $265,000 (for 2015 adjusted annually for inflation) of an employ-

[1] Internal Revenue Code (IRC) § 401(a)

[2] Stephen J. Krass, *The 2008 Pension Answer Book,* (Aspen Publishers, Inc. 2008).

ee's compensation may be taken into account to determine contributions or benefits.[3]

Some of the advantages for the employer in sponsoring a qualified retirement plan include the sponsoring company being allowed an immediate tax deduction for the amount contributed to the plan for a particular year[4] and the investments grow tax deferred. Participants pay no current income tax on amounts contributed by the company on their behalf,[5] and earnings of the plan are tax exempt, permitting tax free accumulation of income and gains on investments.[6] Income taxes on certain types of distributions may be deferred by rolling over the distribution to an IRA or to another eligible retirement plan.[7] Income taxes on certain types of distributions to a deceased participant's spouse may be deferred by rolling over the distribution to an IRA or to an eligible plan in which the surviving spouse participates.[8]

DC Plans

Three major consequences result when a retirement plan is classified as a DC plan:

- Plan contributions are determined by formula and not by actuarial requirements;
- Plan earnings and losses are allocated to each participant's account and do not affect the company's retirement plan costs; and
- Plan benefits are not insured by the Pension Benefit Guaranty Corporation.

DC plans must provide a valuation of investments held by the plan at least once a year, on a specified date, in accordance with a method consistently followed and uniformly applied. The fair market value on such date must be used for this purpose, and the respective accounts of participants must be adjusted in accordance with the valuation. A plan provision allowing interim valuations at the plan administrator's discretion, in addition to a consistent annual valuation, doesn't qualify the plan as long as the use of the interim valuations doesn't result in prohibited discrimination.

To maintain plan compliance, shortly after the plan's year end, the following must be provided to the third-party administrator:

- Company sponsor information;
- Financial information about plan assets, including gains and losses, income, contributions, distributions and description of plan assets; and
- Employee information, including dates of birth, hire, and termination, hours worked, job description and compensation.

DB Plans

In a DB plan, a retirement benefit, usually in the form of monthly income, is determined by the plan's benefit formula. A reserve is then calculated based on the life expectancy of the participant at retirement age and the expected return on investment sufficient to pay the employee's retirement benefit under the plan's benefit formula for life. The employer then makes a contribution each year for the participant until retirement age, with the contributions plus investment earnings accumulating to the reserve. Contributions must be made, on an estimated basis, at least quarterly. [9] Each year the employer's contribution is adjusted based on the actual changes in the operation of the plan, including employees' salaries, actual rate of return of plan investments, and employee turnover.

The Pension Protection Act of 2006 made extensive changes to the funding calculations for DB plans. Rather than fund the reserve necessary to pay the promised benefit over future service, the benefit earned each year is funded in that year. The required contribution under the new rules is the total of two separate calculations. The first is the funding of the benefit accrued (earned) in each year, and the second is the amortization of the difference between the value of the benefits earned to date for all participants, less the value of plan assets over seven years. This funding approach also allows for a cushion, i.e., additional funding over and above the two parts. The result of these rules provides a range of contributions each year from a minimum required amount to a maximum allowable amount. If the contribution for a given year is made at the high end, all else being equal, both the minimum and maximum for the next year are likely to be lower.[10]

Differences Between DC and DB Pension Plans

There are many differences between DC and DB pension plans:

- Funding for a DC plan is based on a formula in the plan document and may be discretionary; however funding of a DB plan is based on an actuarial determination of amounts needed to fund anticipated retirement benefits.
- The benefit at retirement for DC plans is the accumulation in the account balance whereas the benefit for DB plans is based on a formula in the plan.
- The maximum contribution for a DC plan is the lesser of $53,000[11] (for 2015) or 25 percent of compensation and for a DB plan the amount necessary to fund an annuity benefit is the lesser of $265,000 (for 2015) per year or 100 percent of compensation.
- The employer has an annual funding obligation for a DC plan with no guarantee of benefit BNA Suggestion: insert ''for the employee'' at retirement; however a DB plan's funding may not be required if assets are sufficient to meet benefit obligations.
- Employee contributions for DC plans are pre-tax contributions permitted in a 401(k) plan, though after-

[3] Louis Richey, Stephen Abramson, Deborah Miner, John Phelan & Bruce Tannahill, *2015 Retirement Plan Facts*, (The National Underwriter Company 2015).
[4] IRC § 404.
[5] IRC § 402 and § 403.
[6] IRC § 401.
[7] IRC § 401(a)(31), § 402(c), § 403(a)(4), and § 403(a)(5).
[8] IRC § 402(c)(9).
[9] Internal Revenue Code (IRC) § 430(j).
[10] Louis Richey, Stephen Abramson, Deborah Miner, John Phelan & Bruce Tannahill, *2015 Retirement Plan Facts*, (The National Underwriter Company 2015).
[11] IRC § 415(c)(1)(A).

tax contributions may also be permitted in the plan. However, in a DB plan, pre-tax employee contributions are not permitted and after-tax contributions may be required for the annual accrual of benefits.

■ Preretirement benefits for a DC plan are the value of the participant's account, yet the value of preretirement benefits for a DB plan varies.

In addition to the many differences among the two categories of plans, there is also a wide array of DC and DB plans available. Two plans that have become increasingly popular are cash balance plans and comparability plans.

Cash Balance Plans

A cash balance plan is a DB plan that defines benefits for each participant by reference to that employee's stated account balance, or ''cash balance.'' These accounts are often referred to as ''hypothetical accounts,'' because they are established based on contribution and interest credits as provided in the plan document, not actual investment experience. The contribution credits must satisfy the same nondiscrimination requirements that a DC plan would be required to satisfy, i.e., the same percentage of compensation for each participant or the same dollar amount for each participant. Furthermore, the contribution credit may take permitted disparity into consideration in determining the contribution credits.[12] There is no separate account and the amount credited to the account is based on a provision in the plan document. With no separate account, there is no directed investing available. Similar to other types of DB plans, the employer sustains both the risk and reward of the plan's investment performance. Thus, if the plan's investments incur losses, additional employer funding is generally required.[13]

In a safe harbor cash balance plan, the plan is an accumulation plan—a DB plan under which each employee's benefit for the plan year is separately determined using plan year compensation calculated for the plan year rather than projecting benefits. The employee's total accrued benefit, as of the end of a plan year, is the sum of the separately determined benefits for the year and all earlier years. The hypothetical allocation for the plan year must be determined with one of two formulas: one that would satisfy the safe harbor for a DC plan with a uniform allocation formula, or one that would satisfy the general test for nondiscrimination in the amount of contributions.[14] Interest adjustments to the hypothetical accounts must be made at least annually until normal retirement age and the interest rate must be the same for all employees for all plan years.[15] As of 2012, the interest credit for any plan year must be at a rate that is not greater than a market rate of return.[16]

As in a traditional DB plan, the actual funding of the cash balance plan is based on the projected benefit. In some cases, companies converting their plan offer additional contribution credits for older participants to make up for the lower benefits in the cash balance plan. A cash balance plan reports benefits to employees in the form of a theoretical account balance, something the employee already understands if he or she is participating in a 401(k) plan.

In a typical cash balance plan, the employee's benefit accrues evenly over his or her years of service, with annual pay credits to a hypothetical account. These pay credits usually are a fixed percentage of pay that is stated in the plan document, such as 4 percent, 30 percent, etc. However, the actual amount that must be contributed is determined by an actuary ensuring that the plan has sufficient funds to provide the promised benefits. Benefits in cash balance plans must be 100 percent vested after three years of service.

Advantages/Disadvantages of Cash Balance Plans

One advantage of a cash balance plan is that most provide a pay credit ranging from 3-7 percent of compensation and an interest credit. To the extent that the earnings generated by the plan assets exceed the interest credit, the employer may use those additional earnings to offset the costs of the plan.

The switch from a DB plan to a cash balance plan isn't advantageous to older, longer-service employees. A cash balance plan is a career average pay plan under which an employee receives a fixed percent of pay for each year he or she is a participant in the plan. Under a DB plan, an employee's pension is generally based on final average pay, which may be as much as 40 percent higher than the employee's career average. An employee who is five to ten years away from retirement may lose a big percent of that expected retirement benefit in a cash balance plan.

Compared to a traditional DB plan, cash balance plans are easier for employees to understand and appreciate; because with a hypothetical account, employees always know their balances. The hypothetical account balances are maintained by the employer and, upon termination, employees may take their pensions with them.

Comparability Plans

A comparability plan is generally a qualified profit-sharing plan in which the contribution percentage formula for one category of participants is greater than the contribution percentage for other categories of participants.[17]

A comparability plan is another option for DC plans to satisfy the ''nondiscriminatory in amount'' requirement. This approach projects contributions with interest to retirement age and then converts that accumulated sum to accrual rates (annuity payments). It then uses the accrual rates in place of allocation rates following the rules for the general nondiscrimination test to compare rate groups.[18] To maintain their qualified status, comparability plans must pass the general nondiscrimination test each year. Discrimination testing is done by analyzing the projected benefits at retirement

[12] Treas. Reg. § 1.401(a)(4)-8.
[13] Robert Bloink & William Byrnes, *2015 Tax Facts on Insurance & Employee Benefits*, (The National Underwriter Company 2015).
[14] IRC § 401(a)(4).
[15] Treas. Reg. § 1.401(a)(4)-12.
[16] Treas. Reg. § 1.411(b)(5)-1(d).
[17] Stephen J. Krass, *The 2008 Pension Answer Book,* (Aspen Publishers, Inc. 2008).
[18] Treas. Reg. § 1.401(a)(4)-8.

for a given participant, as contrasted to the traditional plan approach of analyzing the contributions allocated to a participant's account each year.

The comparability approach to designing DC plans results in plans that are markedly favorable to HCEs. For a comparability plan to satisfy the nondiscrimination rules, the following two approaches must be followed.[19]

- Each eligible non-highly compensated employee (NHCE) receives an allocation of at least 5 percent of compensation.

- Even if the allocation rate for any NHCE is less than 5 percent, the nondiscrimination requirements are still met if the minimum allocation rate for any NHCE is at least one-third of the highest allocation rate for any HCE.

If the plan offers "broadly available" allocation rates, nondiscrimination testing may be satisfied by following either mathematical test available under the proposed regulations.

In a typical new comparability plan, the employer will determine the amount to be contributed on behalf of each of the different groups specified in the plan. For example, if a plan has two specified groups of participants—owners and all other participants—the company can decide to contribute an amount equal to 10 percent of compensation for the owners and an amount equal to 4 percent of compensation for all other participants.

Under the comparability approach, top-heavy minimum benefits are determined by converting the account balance in the DC plan to a benefit and adding it to the accrued benefit in the DB plan. If the sum of the two benefits is greater than the top-heavy minimum requirement, additional benefits must accrue in the DB plan.[20]

Comparability plans are most appropriate for companies that want to reward key employees with higher contributions and for companies that don't want to be committed to a specific contribution amount each year. These plans also minimize contributions to lower paid employees and work well as a supplement to an existing 401(k) plan already established for the benefit of the owner and the owner's employees, something an age-weighted plan can't do.

Comparability plans (also called cross-tested plans), are designed to take advantage of cross-testing where contributions are tested on the basis of benefits at retirement rather than on the basis of amounts contributed. The plan is tested for nondiscrimination on the basis of benefits rather than contributions, thus permitting considerable flexibility in plan design.

In the event that the new comparability plan fails the nondiscrimination rules as originally structured, the plan should have provisions to reallocate or shift employer contributions from the HCEs to the NHCEs.

The comparability plan must be in place by the last day of the business's taxable year for which contributions will be made. Startup expenses and annual servicing expenses are usually higher than other plans; however those additional costs are often out-weighed by the enhanced benefits to key employees in the business.

A new comparability plan may provide a minimum allocation of less than 5 percent, provided the minimum allocation rate is not less than one-third of the highest allocation rate under the plan. If the new comparability plan is combined with a 401(k) plan, and HCEs defer under the 401(k) plan, the highest allocation rate for HCEs may be lower than otherwise possible. This, in turn, will reduce the minimum required allocation for NHCEs. This planning advantage is very important when the new comparability plan is used as a supplement to an existing 401(k) plan to increase contributions to the plan on behalf of HCEs.

Advantages/Disadvantages of Comparability Plans

Comparability plans are advantageous, because they allow employers to maximize contributions to targeted groups. This option can stand alone or be used in conjunction with other plan designs. The concept is to demonstrate that a specific group of employees is achieving comparable benefits to those achieved by another group by testing on the basis of benefits at retirement rather than current contributions. There can be as few as two groups (i.e., HCEs and NHCEs) and certain minimum contributions are required for all benefiting employees in order for such a plan to meet nondiscrimination requirements. Companies with owners and key employees who are older than a significant portion of their employees are good candidates for a new comparability plan, because HCEs can receive the maximum benefit with less total cost to the company.

Another advantage of a new comparability plan is that, unlike traditional profit-sharing plans, the participant's age, service, and level of compensation may separately, or in the aggregate, be taken into account when determining the allocation of plan contributions. Accordingly, under the plan, the percentage of contributions allocated to the owner and other HCEs may be much higher than under a traditional profit-sharing plan. However, this is the result only if the owners and HCEs are older, on average, than the NHCEs and have been employed longer.

Some of the disadvantages for the employer include additional costs associated with adopting the plan and monitoring compliance and additional administrative responsibilities.[21] The earnings of the plan may be taxable if the earnings are unrelated business taxable income.

Another disadvantage of a comparability plan is that even a small demographic shift can cause the coverage test of a rate group to fail. A new comparability plan requires annual attention and fine-tuning, as well as a thorough knowledge of nondiscrimination testing. And, even if a plan conversion is done in accordance with the rules, an employee may still choose to litigate rather than accept the change.

Conclusion

Cash balance plans and comparability plans are just two of the types of retirement plans available. There are several advantages and disadvantages of both types of plans depending on the specific retirement benefit ob-

[19] Treas. Reg. § 1.401(a)(4)-8(b).
[20] Treas. Reg. § 1.416-1.

[21] Louis Richey, Stephen Abramson, Deborah Miner, John Phelan & Bruce Tannahill, *2015 Retirement Plan Facts*, (The National Underwriter Company 2015).

jectives, and it is essential for employers to understand the differences between cash balance plans and comparability plans in order to choose the best plan to meet their goals.