



How Can We Create More Flexibility in our Cash Balance Plan Contributions?

Facts

We are considering adopting a new cash balance plan. We really like the higher contribution amounts, but we keep hearing that the contributions are fairly rigid and inflexible.

Question

Is there a way to design the contributions to be a little more flexible and, if so, what factors should we consider?

Answer

You are not alone in asking that question. It's true that cash balance plans do have a certain amount of rigidity. There is required funding, the plan must be permanent (more on what that means in a future QOTW), etc., and any way to build in some flexibility would help during years when your cash flow might take a temporary dip. Also, you may know exactly what you want to put as a set amount each year, regardless of your compensation (as long as it fits within IRS limits).

As with most plan provisions, the formula used to determine contribution credits in a cash balance plan must be defined in the plan document. That formula can be a flat dollar amount, a percentage of plan compensation, or a combination of the two. For example, assume your contribution formula says that a participant receives the lesser of \$100,000 or 50% of plan compensation. If your plan compensation is \$200,000 or greater, you will receive a contribution credit of \$100,000. However, in a year where your compensation is less than \$200,000 (for example, \$150,000), your contribution credit would be lower (\$75,000).

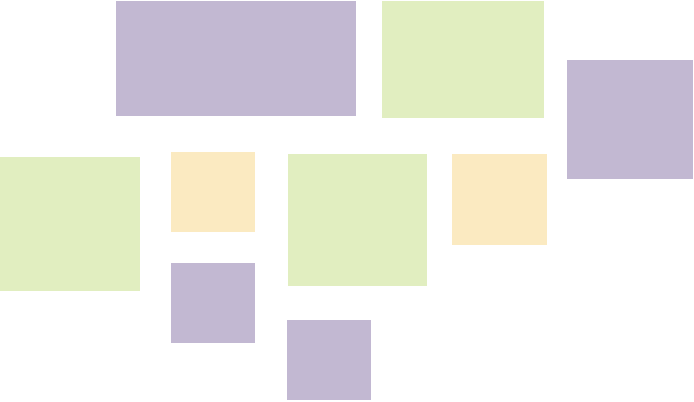
Amending Contribution Credits

If you find that you want to change your contribution formula, you can do so via a plan amendment. Although there are no set guidelines from the IRS as to how often a cash balance formula can be amended, a generally accepted rule of thumb is to limit it to no more than one change every three years. Of course, you can always amend your plan as is necessary to pass nondiscrimination testing (corrective amendments), when changes are necessary due to significant adverse business situations, and/or to update your plan document for new laws or regulations.

We should note that changes to the contribution formula can generally only be made on a prospective basis. Many plans require a participant to complete at least 1,000 hours in the year to accrue a benefit for that year, so any amendment must be adopted before any participant satisfies any such accrual requirements. That typically translates to sometime around late May or early June for a full-time employee.

Flexibility in Timing of Deposits

You also have some flexibility in terms of when you deposit your contribution to the plan. In order to deduct the contribution, you must make the deposit no later than the due date of the company tax return (with extensions); however, the outside deadline to meet IRS funding requirements and avoid benefit restrictions is 8 ½ months following the close of the year (September 15th for a calendar year plan).



Combining that with the ability to amend your formula provides a bit of a cushion in the event that cash is tight. For example, assume you determine in August that you need to amend the plan to reduce your contribution formula. Since it is late in the year, chances are good that participants have already accrued benefits for that year, meaning that the earliest your change can take effect is the first of the next year. However, since you have until as late as September 15th of the following year to fund the current contribution, you can minimize future obligations while taking more than a year to fund the current amount.

Limits on Compensation

There are several items we should note about which [compensation](#) counts for these purposes. For starters, the IRS caps the amount of pay that can be considered for a single participant in a given year. The limit - \$285,000 for 2020 - is indexed for inflation in \$5,000 increments. That means if you have a participant with \$400,000 in compensation and a 50% of pay formula, the contribution credit for that individual would be \$142,500 (50% of compensation capped at the \$285,000 limit).

Another item that we often see overlooked has to do with shareholders of S Corporations (or entities taxed as S Corps). In these situations, only W-2 compensation paid to the shareholders is considered plan compensation. Distributions of profits do not count. That means if an S-Corp shareholder has W-2 pay of \$120,000 and distributions of another \$200,000 (for total comp of \$320,000), the plan can only consider the \$120,000 for purposes of determining contribution credits. This can be a negative if it catches you off-guard, but when aware of it, this nuance can provide added flexibility in that the company can adjust the allocation between W-2 and distributions.

Last but not least, it is also important to keep in mind that if you are a sole proprietor or partner in a partnership (or a member of an LLC that is taxed as a partnership), your plan compensation is reduced by all qualified plan contributions made by you as the employer. Since a cash balance plan is a defined benefit plan, actual contribution amounts won't be exactly equal to the contribution credit. This all creates a bit of a [circular calculation](#) that we won't bore you with here. Suffice it to say one way to alleviate this discrepancy is to set the contribution credit as a flat dollar amount.

So, yes, cash balance plans are not quite as flexible as profit sharing plans. But also, yes, with careful planning, it is possible to design the contribution formula in ways that provide some extra wiggle room when needed. For assistance with that careful planning, give us a call.

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■ [Are There Risks to Contributing More Than the Minimum to a Cash Balance Plan?](#)



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