Why are cash balance plans used to supplement 401(k) plans for higher-paid employees?

Understanding the benefits and advantages of cash balance plans

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Introduction

Employers offer retirement benefits for many important reasons, with retirement security being paramount. However, 401(k)s (and similar plans such as 403(b), 401(a), and 457) often fall short for higher-paid employees because of IRS limits designed with the average American in mind. Cash balance plans bridge this gap, providing a powerful supplement to 401(k) plans and an effective solution for long-term financial security.

Why 401(k)-only retirement programs may not be enough for high-paid employees

401(k) plans provide a strong foundation for retirement savings. For average earners, Social Security benefits along with employer and employee contributions to a 401(k) plan may be sufficient for a secure retirement. But for high earners, both Social Security and 401(k) plans have considerable limitations, and a significant gap may remain.

CHALLENGES FACED BY HIGHER-PAID EMPLOYEES

High earners need stronger retirement strategies to maintain their standard of living. Several factors make a 401(k)-only approach insufficient:

- **Shorter savings window:** Many high earners, such as doctors and lawyers, enter the workforce later and may retire earlier, reducing their accumulation period.
- **Higher tax burden:** As income rises, so do taxes. High earners need tax-efficient strategies to defer income and maximize savings.
- **Social Security gap:** For high earners, Social Security replaces only a small fraction of pre-retirement income, increasing the need for employer-sponsored savings options like 401(k)s and cash balance plans.
- **Regulatory limits:** In 2025, total 401(k) contributions are capped at $70,000, with only $350,000 of salary eligible for employer contributions—limiting tax-advantaged savings.

ANNUAL SAVINGS POTENTIAL: MAKING MORE? SAVING LESS?

The table below illustrates how IRS contribution limits impact the percentage of salary that high-paid employees can save in a 401(k) plan compared to lower-paid employees.

	SAVINGS RATE	LOWER PAID	HIGHER PAID
Salary		$50,000	$500,000
Employee savings	10% (limited to $23,500)	$5,000	$23,500
Employer contribution	5% (on salary up to $350,000)	$2,500	$17,500
	Total savings	$7,500	$41,000
	Savings rate (% of salary)	15.0%	8.2%

Both employees attempt to contribute 10% of their salary, but only one gets the full benefit. An employee earning $50,000 saves 15% of their salary, including the employer contribution, while an employee earning $500,000 saves only 8.2% due to IRS limitations on employee deferrals and income.

The illustration shows an employer contribution of 5% up to the pay limit ($350,000), which could come from either a nonelective contribution or a matching contribution that results in the same amount.

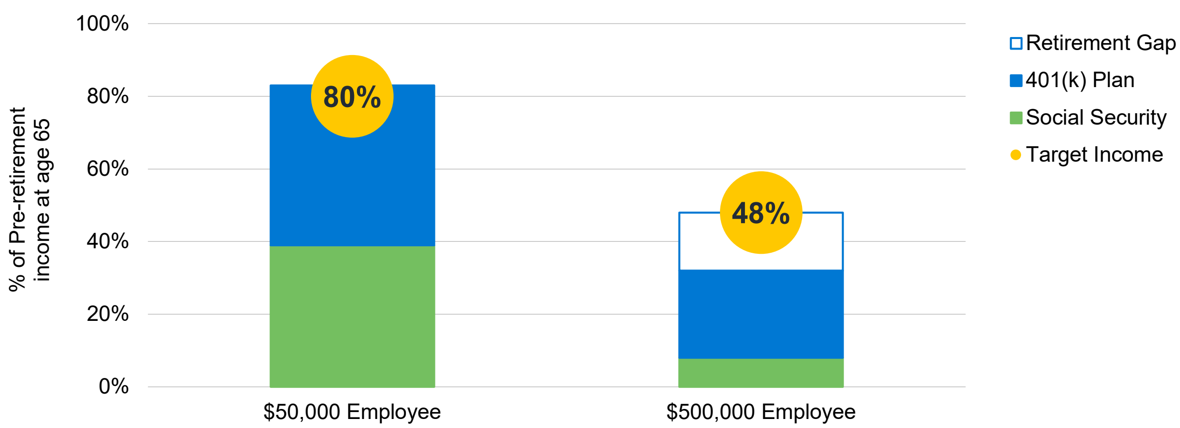
Retirement security divide: High vs. low earner

Over the long term, higher-paid individuals accumulate less on a relative basis due to their lower effective savings rate. IRS restrictions add up. Moreover, Social Security is designed to replace a smaller share of income for higher-paid workers.

While higher-paid workers don't have to replace as large a share of pre-retirement income as an average worker—generally they may target 45% to 50% of pre-retirement income rather than the 80% an average worker may aim for—this target may still be difficult to achieve if relying on just a 401(k) plan and Social Security.

Continuing the example from above, the following chart estimates the share of retirement income replaced for each of our two hypothetical employees by the 401(k) plan and by Social Security.[1]

FIGURE 1: SOURCES OF RETIREMENT INCOME FOR TWO SAMPLE EMPLOYEES COMPARED TO TARGET REPLACEMENT INCOME



The retirement replacement:

- **Lower-income employee:** ~80% of pre-retirement income (at target)
- **Higher-income employee:** ~32% of pre-retirement income (16% below target)

While this is a simplified example, it highlights a critical issue: Higher earners may need additional income strategies to close the gap.

1. The illustration assumes an accumulation period starting in 2025 from age 40 through age 65 based on a 10% employee savings rate and the employer match contribution as described (as restricted by projected IRS limits). 401(k) investment earnings are assumed to be 6% prior to age 65 and 5% thereafter. Annual salary increases by 3.5%, while inflation for IRS pay limits is assumed at 2.4% per year.

Introducing cash balance plans

A cash balance plan can supplement a 401(k) program and bridge the retirement income gap.

Cash balance plans represent a modern evolution of the traditional defined benefit (DB) plan, offering a hybrid solution that combines the features of 401(k) and DB plans. It provides a retirement benefit, where each participant's benefit is communicated in terms of an account balance, which mimics the look and feel of a 401(k) plan from the participant's perspective, while still following DB plan rules.

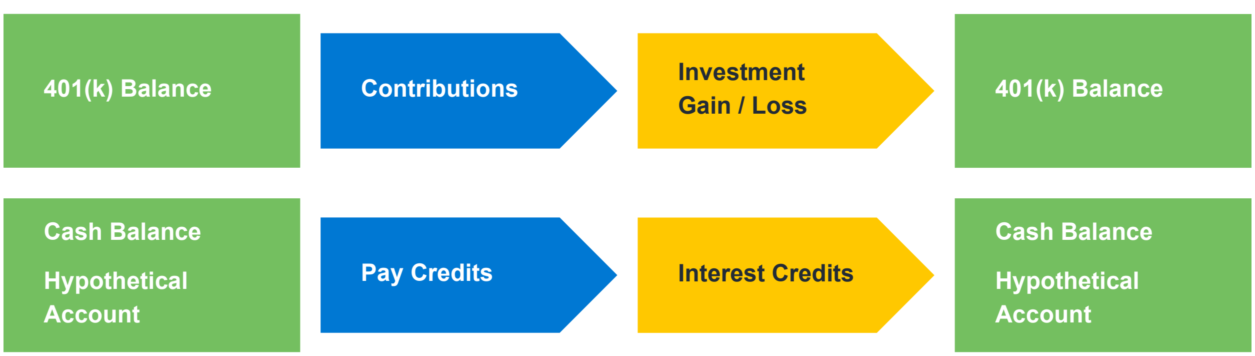
WHAT IS A CASH BALANCE PLAN?

A cash balance plan is structured like an individual account similar to a 401(k) plan but operates as a DB plan in terms of funding and benefit determination. Here's how it works:

- **Account-based approach:** Each participant has a hypothetical account that grows annually, receiving pay credits (e.g., a percentage of salary) and interest credits, which can be fixed or variable.
  - **Pay credits** are generally calculated as a percentage of salary, although they can also be specified as a fixed dollar amount. The structure of pay credits may vary based on factors such as age, length of service, or job classification.
  - **Interest credits** can be a fixed rate or a variable rate. In a 401(k) plan this would be equivalent to the investment earnings or losses. Plan sponsors can choose among several allowable methods for defining the interest credits. There are three principal options:
    1. **Fixed:** A fixed interest crediting rate up to 6% per year.
    2. **Variable:** A menu of allowable variable rates that link to inflation experience, bond yields, mutual funds, exchange-traded funds (ETFs), and collective investment trusts (CITs).
    3. **Market-based:** The actual rate of return on trust assets. Such a plan is referred to as a market-based cash balance plan (MBCBP).
- **Defined formula:** The plan follows a defined formula to calculate future benefits, ensuring predictability and security for employees.
- **Paying benefits:** At retirement a participant in a cash balance plan may either take their account balance as a lump sum or may elect an annuity payment based on the terms of the plan. If taking a lump sum, participants can roll over their distribution into another tax-qualified retirement account, allowing them the assets as part of a holistic tax-planning and retirement spenddown strategy.

Please see this illustration for how a cash balance plan works compared to the commonly understood 401(k) plan.

FIGURE 2: HOW A CASH BALANCE PLAN GROWS FROM ONE YEAR TO THE NEXT



ADVANTAGES FOR EMPLOYEES

Cash balance plans offer several key benefits that make them especially attractive for higher-paid employees:

- ☑ **Tax-protected compensation:** Employees can go beyond 401(k) limits to accumulate more retirement assets in a tax-efficient manner. For example, as you will see in Figure 3, the cash balance plan covers the 16% retirement gap, which translates to $2,300,000 of additional tax-advantaged retirement savings at age 65.
- ☑ **Simple and familiar:** A cash balance plan is account-based and feels like an additional 401(k), making it easy to incorporate into retirement savings and spending strategies.
- ☑ **Retiree choice:** Participants can choose a lump sum or guaranteed lifetime annuity—allowing options to meet individualized financial objectives.
- ☑ **Flexibility and control:** Similar to 401(k) plans, cash balance plans may be rolled over to an IRA at retirement, which allows retirees to have flexibility over when they pay taxes on the benefit. In addition, as with any IRA, the retiree controls how much they take out of the account each year in retirement.
- ☑ **Professional asset management:** A professional investment advisor helps manage plan assets, which typically leads to higher risk-adjusted returns on average than if employees invested individually. Due to the plan's pooled investment fund, employees benefit from economies of scale in asset management and lower fees.

In short, cash balance plans can let high earners save more, pay less taxes, and retire more confidently.

BENEFITS FOR EMPLOYERS

Employers also gain significant advantages by offering cash balance plans:

- ☑ **Recruiting and retention:** These plans help attract and retain top talent, especially in competitive labor markets. Employers offering a cash balance plan can proudly say they provide a company pension and demonstrate the tax-protected compensation.
- ☑ **Funding flexibility:** Cash balance plans provide funding flexibility, allowing employers to adjust contributions based on business performance.
- ☑ **Tax deductions:** Employers may benefit from permanent FICA tax savings, enhancing the economics of the benefits offered.
- ☑ **Employee morale:** Securing an employee's retirement future can boost employee satisfaction, morale, and loyalty.
- ☑ **The ability to retire:** Many employees delay retirement due to financial concerns. A well-structured retirement plan gives them the security to retire confidently and transition to their next phase of life.

Cash balance plans may have a compelling business case for many organizations, helping employers stay competitive while controlling costs and risk exposure.

Addressing common DB challenges

Market-based cash balance plans (MBCBPs) in particular are a distinct and modern design, solving many issues associated with traditional DB plans while offering key advantages:

- ☑ **Lower risk:** Employers reduce their risk since investment returns determine the plan's interest credits, shifting most of the volatility (and rewards) toward participants, like a 401(k).
- ☑ **Predictable funding:** MBCBPs provide more predictable contributions than traditional DB plans, reducing financial uncertainty for employers.
- ☑ **Increased employee engagement and transparency:** MBCBPs provide transparency with account-style benefit statements, making benefits easier to understand, track, and appreciate.

Cash balance plans as a supplement to 401(k) plans

When integrated with 401(k) plans, cash balance plans can significantly enhance retirement security for higher-paid employees. Here are some key points to consider:

- ☑ **Significant tax-deferral benefits:** Cash balance plans let employees accumulate far more for retirement than a 401(k) alone, reducing taxable income and maximizing tax-deferred growth.
- ☑ **Scalability:** Employers can tailor benefit levels based on the needs of the employer and employees, including adjustments for job classification.
- ☑ **Balanced retirement portfolio:** MBCBPs are often invested in a conservative portfolio, providing a steady foundation for overall asset allocation, potentially freeing up 401(k) assets for riskier investments for employees seeking higher-growth potential.

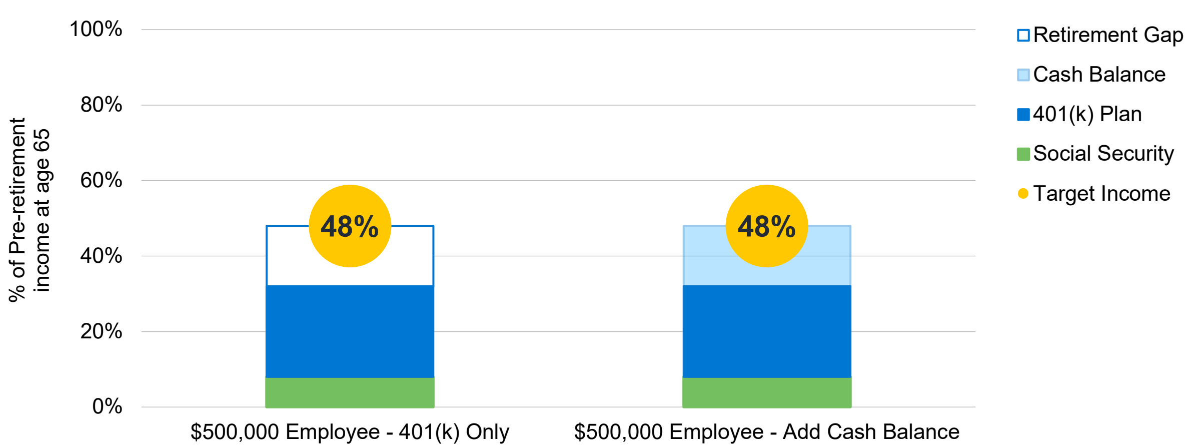
Bridging the gap

Extending the simple illustration above, we see how a cash balance plan can help reduce the retirement gap for higher-paid individuals.

Adding a cash balance plan benefit with an 11% pay credit (up to the IRS salary limit) and a 5% interest crediting rate could increase the replacement ratio from 32% to 48% of pre-retirement income, filling the gap between their retirement income target and the value they are able to receive from Social Security and their 401(k) plan. The 11% pay credit would translate to $38,500 per year of additional retirement savings for an employee earning at or above the IRS salary limit of $350,000.

Unlike traditional pensions, this benefit is transparent and participant-friendly. And unlike simply adding more employer contributions to the 401(k) plan, it does not run into the contribution limitations that apply to a 401(k) plan or crowd out the potential for employee savings. It allows for more pre-tax savings and greater compounded growth, which a high-paid workforce will appreciate and actively seek.

FIGURE 3: EFFECT OF USING A CASH BALANCE PLAN TO ACHIEVE TARGET RETIREMENT INCOME FOR A HIGH-EARNING EMPLOYEE



Conclusion

Cash balance plans are powerful tools for addressing the retirement gaps faced by higher-paid employees. By supplementing the IRS limits on 401(k) plans, they serve as a valuable addition to a comprehensive retirement program, enhancing both employee security and employer appeal. At the same time, their flexibility and risk management features make them a more sustainable alternative to traditional DB plans of the past.

Organizations considering cash balance plans should evaluate their benefits and consult with financial and legal advisors for proper implementation. Many employers have already adopted these plans to improve retirement security, enhance talent retention, and gain a competitive edge—a growing trend in industries with highly compensated workforces.

In short, cash balance plans bridge the retirement savings gap left when employers offer only a 401(k), offering a strategic solution for high earners. Employers who adopt them can attract top talent, strengthen retirement benefits, and promote long-term financial security for their workforce.

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