Tired of Taxes?

A Cash-balance Plan May Be the Answer to the Problem

By CHARLES EPSTEIN, CLU, ChFC, AIF

What can successful business and professional entrepreneurs do to reduce rising taxes and create greater wealth for themselves? A cash-balance plan may just be what the doctor ordered.

High-net-worth individuals have a constant need to maximize the bottom line. In addition, many have their retirement future locked up in the value of their company, with the hope of one day unleashing that value with the sale of the business.

One effective way to accomplish the goals of reducing taxes and maximizing the value of your business on an ongoing basis is to generate higher tax deductions by accelerating contributions to your company-sponsored retirement plan. Now may be just the time to re-evaluate your current retirement plan design to achieve both outcomes.

Most small and medium-sized business and professional practices today are more than familiar with defined-contribution plans. These are 401(k)/profit-sharing plans that typically allow the owners to make annual contributions of $49,000 to $54,500 per year.

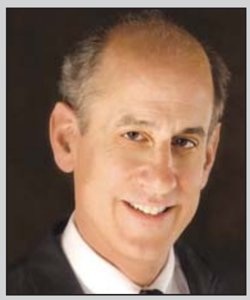
A defined benefit (DB) can enable you, the successful business owner or professional, the opportunity to dramatically increase these annual contribution levels. Here's how it works.

First, a defined-benefit plan promises a specified monthly benefit at retirement for life. The plan might state this promised benefit as an exact dollar amount, such as $1,000 per month at retirement. The annual benefit is defined as an accrual of a monthly benefit payable at retirement age, based on current and/or past compensation history.

The maximum benefit is based on an annual benefit payable every year for life starting at age 62. That maximum is currently $195,000 (indexed).

The maximum contributions depend on the age and compensation of an individual, with annual contributions for one individual as high as $220,000. The older the individual, the younger the assumed retirement age and the higher the potential limit. The ultimate benefit is totally dictated by the plan terms, with the employer responsible for all investment contributions and returns.

Now here is where the tax-saving and wealth-accumulation potential of a DB plan should get your attention — and make the IRS agent crazy. The maximum benefit limit of $195,000 at age 62 has an equivalent lump-sum value of more than $2.4 million. This means a sole proprietor, or business owner or professional, earning $500,000 at age 62, who currently may be funding only $54,500 annually to their 401(k) profit-sharing plan, could significantly increase their annual deductions and retirement benefit by funding $220,000 per year.



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Cash-balance Plans

The 2011 National Cash-balance Research Report, released by Dan Kravitz and Associates, one of the largest cash-balance plan-design firms, notes a 20% average annual increase in new cash-balance plans since 2001, compared with the 3% average annual growth rate in 401(k) plans.

One reason is increased flexibility, and another is enhanced plan-design flexibility. But, perhaps more than any other reason, the rise in cash-balance-plan creation has been caused by a desire by business owners and professionals to reduce taxes and accelerate retirement savings and greater wealth accumulation. Those in that camp can choose to do one of three things — work longer, spend less, or magnify their tax savings and retirement contributions.

For the owner of a successful business or practice with two or more employees, a cash-balance plan can allow the owner to pay less in overall pension benefits to the rank-and-file employees, while increasing their own retirement savings and obtaining higher tax deductions. Cash-balance plans have several attractive features for small businesses: contribution limits can be higher than a DB plan, the benefit formula for owners can be substantially higher than for non-owners (but only if non-discrimination testing is satisfied), and the owner can maximize discrimination and funding by pairing a cash-balance plan with their existing 401(k)/profit-sharing plan.

A cash-balance plan is a defined-benefit plan with an unusual feature. It is used in cases where the owner wishes to benefit key employees, and where the owner desires to have deductible contributions in an amount greater than that of traditional retirement plans. While a cash-balance plan is classified as a defined-benefit plan, it resembles your defined-contribution profit-sharing plan from the perspective of a participant. In this regard, although the plan assets are commingled to provide benefits to all participants, a hypothetical account is maintained for each participant, the plan sponsor makes annual contributions, and interest is credited to each account.

The fictional contribution to the account is either a percentage of a participant's compensation or a flat dollar amount. The interest credited is either a fixed rate (e.g. 5%) or tied to an index (e.g. the 30-year treasury bond rate). Since a cash-balance plan is a defined-benefit plan, its benefits are based on the plan's benefits formula as opposed to the actual investment earnings on plan assets. In addition, the actual investment earnings of the plan assets do not affect the amount of the balances in plan accounts. That's why the plan sponsor, not the participants, bear all the investment risk.

Who is a good candidate for cash-balance plans?

• Partners or owners who desire to contribute more than $50,000 a year to their retirement accounts. Many professionals and entrepreneurs neglect their personal retirement savings while building their practice or company. They often have a need to catch up on years of retirement savings. Adding a cash-balance plan allows them to rapidly accelerate savings with large pre-tax contributions as high as $100,000 to over $220,000, depending on their age.

• Family-owned businesses where mom and dad have not saved for their retirement and the kids are looking for a method of funding their retirement as a buyout strategy using corporate dollars on a tax-favorable, tax-deductible basis.

• Companies already contributing 3% to 4% in employee-matching contributions to a safe-harbor 401(k) profit-sharing plan, or at least willing to do so. While cash-balance plans often are established for the benefit of owners and/or key employees or other highly compensated employees, the rank and file will benefit. The plan normally provides a minimum contribution of between 5% and 7.5% of pay for staff in the cash-balance plan or a separate profit-sharing/ 401(k) plan.

• Companies that have demonstrated consistent profit patterns. This is important because a cash-balance plan is a pension plan with required annual contributions; thus, a consistent cash flow and profit are important.

• Partners or owners older than 40 who desire to catch up, or accelerate their pension savings. Maximum amounts allowed in cash-balance plans are age-dependent. The older the participant, the faster they can accelerate their wealth creation and tax savings.

At a minimum, it may be worth your time to re-examine your current retirement-plan design and see if it still fits your own personal and business tax and wealth-creation objectives. An experienced third-party administrator, actuary, or retirement-plan advisor can gather your census information and run various pension-maximization scenarios to show you the various advantages and disadvantages which are a function of the amount of contributions you wish to make or the benefit you want to target for yourself at retirement.

Doing so will go a long way to increase the amount of taxes you can save each year and increase the odds that your retirement years will be fruitful. ■

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