Cash Balance Plans for Greater Savings Potential

Lisa is a law firm partner who just turned 60 and is changing her perspective. Until now, she had invested mostly in her business and her family. Retirement wasn't the largest image on the radar. It's time for a change and a Cash Balance Plan could be part of the solution.

Over the years, Lisa contributed to the firm's retirement plan up to the amount matched. She figured that gave her an immediate boost from the tax savings and a 100% initial return through the company match. Over the last 30 years, her retirement account grew to about $2 million (invested 60/40 in stocks and bonds). She's heard that she could expect about 4%/year in retirement withdrawals. Between Social Security and this account, she's expecting close to $10,000/month in retirement income. The problem: this isn't enough to maintain her current lifestyle into retirement! How can she save even more to bridge this gap?

There are two main types of business retirement plans; Defined Contribution (DC) and Defined Benefit (DB) Plans. Lisa has so far used a DC plan to save for retirement. In these plans, there is a "defined" amount that is contributed by the employee or on the employee's behalf. The 401K is the most notable plan of this type.

In DB plans, it's the retirement benefit that is defined rather than the contribution. Based primarily on an employee's age and income, older highly-compensated employees may be able grow retirement assets more rapidly than in other types of plans. Often generally referred to as "pension" plans, DB plans are intended to provide predictable retirement income.

CASH BALANCE PLANS

Cash Balance Plans are a hybrid of DC and DB plans. Rather than provide retirement income, they build cash for plan participants. When paired with a profit-sharing plan, they can allow older, highly-compensated key personnel to build wealth rapidly.

When pitching the merits of the Cash Balance Plan to her partners, Lisa mentioned some notes of caution. The first consideration is that this type of plan is generally more expensive than a run-of-the-mill 401K. However, it is possible that much (or even all) of the increased expense may be offset by greater tax benefits to the business. Also, since the end benefit is defined, it should only be used in businesses with stable cash flow… annual contributions are set by an actuary and required.

Lisa calculates that she might save as much as $300,000/year if the firm offers a Cash Balance Plan in addition to the 401K! How does that work? Since she is over 50 years old, she can make "catch-up" contributions to the 401K which, when combined with firm contributions, help her max out at $60,000/yr. Additionally, at age 60, the firm could deposit as much as $245,000 to the Cash Balance Plan due to actuarial calculations. If the firm has an assumed tax rate of 45% (federal and state), it could see about $126,450 in potential tax savings from these contributions.

BENEFITS TO THE FIRM

For employers, the benefits of a Cash Balance plan include the flexibility to contribute either a percentage of pay or a flat dollar amount. It may be easier to boost benefits for owners and other key employees while controlling the cost of benefits to others. The firm maintains control over the investment strategy.

For plan participants, the Cash Balance plan is easier to understand than traditional DB plans. This plan is more portable than a DB plan since accounts can be distributed or rolled over to an IRA (or other employer-sponsored plan) at separation of service. It permits higher contribution limits for key employees and older participants. There is little or no investment risk to the participant, depending on plan design, as sponsors must guarantee each participant's payout will not be less than the sum of the employer's contributions to the plan.

If investment returns do not keep up with actuarial funding requirements, additional contributions will have to be made by the employer. Excess returns can be used to offset future contributions. Plan sponsors are responsible for the difference if the underlying investments, net of expenses, return less than the stated interest-crediting rate.

Cash Balance Plans are best suited to organizations with predictable cash flows and consistent profits. These could include professional groups (lawyers, doctors, dentists, engineers, accountants, et al), closely-held businesses, and organizations already maximizing contribution limits to their current DC plans. The potential benefits to both employers and employees certainly call for an exploration. This article is not tax advice. Please consult your tax advisor concerning a particular situation.

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