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RETIREMENT PLANS

Cash Balance Plans

Overview

Retirement Plans have become extremely popular. Congress loves them, and so does everyone else. Even the IRS loves them if you follow the rules.

The IRS allows you to convert tax dollars into retirement benefits – you get to feel better about saving money and actually have some money to spend in retirement. With the tax-free (or tax-deferred) growth of the money in the account, coupled with up-front tax deductions, you end up with more retirement money than through any other savings vehicle.

Many times, your tax rate is lower in retirement. Even if the tax rate is higher, the value of the tax-free or tax-deferred growth eclipses every other form of savings and makes it worth setting the funds aside.

Across America, the only real cash savings of most families is their 401(k) account (and perhaps their primary residence). Their only real spendable wealth is the balance of their retirement account. No one has ever complained "Gosh, I saved too much for my retirement!" While the 401(k) Plan is the best known, it is only one of 24 different types of retirement plans, many of which you haven't heard of but are explained in the Tax Code.

Cash Balance Plans

Maximizing owner benefits under a retirement plan is an effective method of utilizing tax breaks and converting them into retirement savings, and a Cash Balance Plan is an innovative means of boosting owner contributions.

A Cash Balance Plan is a type of pension plan, but there are some differences:

- The benefits are paid in a "lump sum" which can be rolled over to your IRA
- The account statements are easier to understand than a regular pension plan
- Typically, different participants (or owners) have different levels of contribution
- The employer has contribution flexibility to fund little in lean years and a lot in good years

Good candidates for a cash balance plan include employers seeking deductions in excess of $55,000 for each owner, who have a reliable earnings stream to fund benefits, and are able to make small yearly employee contributions (if applicable).

Many medical firms have adopted Cash Balance Plans. These Plans are gaining popularity with professional service firms because of higher contribution limits and ease of understanding. Most Cash Balance Plans are paired with a 401(k) Profit Sharing Plan to increase deductions and reduce the cost of covering employees.

Additional Considerations

- Available to Corporations, Partnerships, Sole Proprietorships, Not For Profit Employers, etc.
- Employer bears investment risk
- No individual investment – all of the assets are "pooled"
- Investments must be conservative (non-aggressive)
- Plan must exist for five years, although contributions may cease anytime
- Can be coupled with a 401(k) plan to maximize benefits
- Must meet additional non-discrimination tests
- Requires actuarial valuation, individually designed plan document
- Demographic changes can have a significant impact
- Investments are pooled and the employer must make up for investment losses
- Some participants will not like "pooled" investment structure
- Limits are based on Defined Benefit limits
- Because it is a pension plan, it requires actuarial calculations, certifications, etc.
- Can have a more flexible contribution.
- The concept of a funding cushion" helps in bad years
- Contributions to younger staff members may be possible using certain non-discrimination tests
- Some participants will not like "pooled" investment structure

What About the Employees?

While owners want to have a Plan that excludes all other employees, that is not deductible. The government provides a large tax break, and in exchange they expect some of the contribution, in some amounts, to be allocated to some employees. Calculating "some of some of some," to become the lowest possible cost, is an esoteric skill. However, most "tailored" plans have 85% to 95% of all the money being allocated to the ownership or management group. In other words, the tax break is so huge that it is a "no-brainer" to install a Plan.

If this is the first Plan that is installed, and an employee is included in the Plan, there is a tax credit of $500 a year for three years on top of the deductions.

There is a demographic aspect to having the Plans work well. Typically, having both highly paid owners and some young workers will allow the costs to stay low.

Not a "Classic" Defined Benefit Plan

A Cash Balance plan is a defined benefit plan that specifies both the contribution to be credited to each participant and the investment earnings to be credited based on those contributions. Each participant has an account that resembles those in a 401(k) or profit sharing plan.

PARTICIPANT ACCOUNTS GROW ANNUALLY IN TWO WAYS

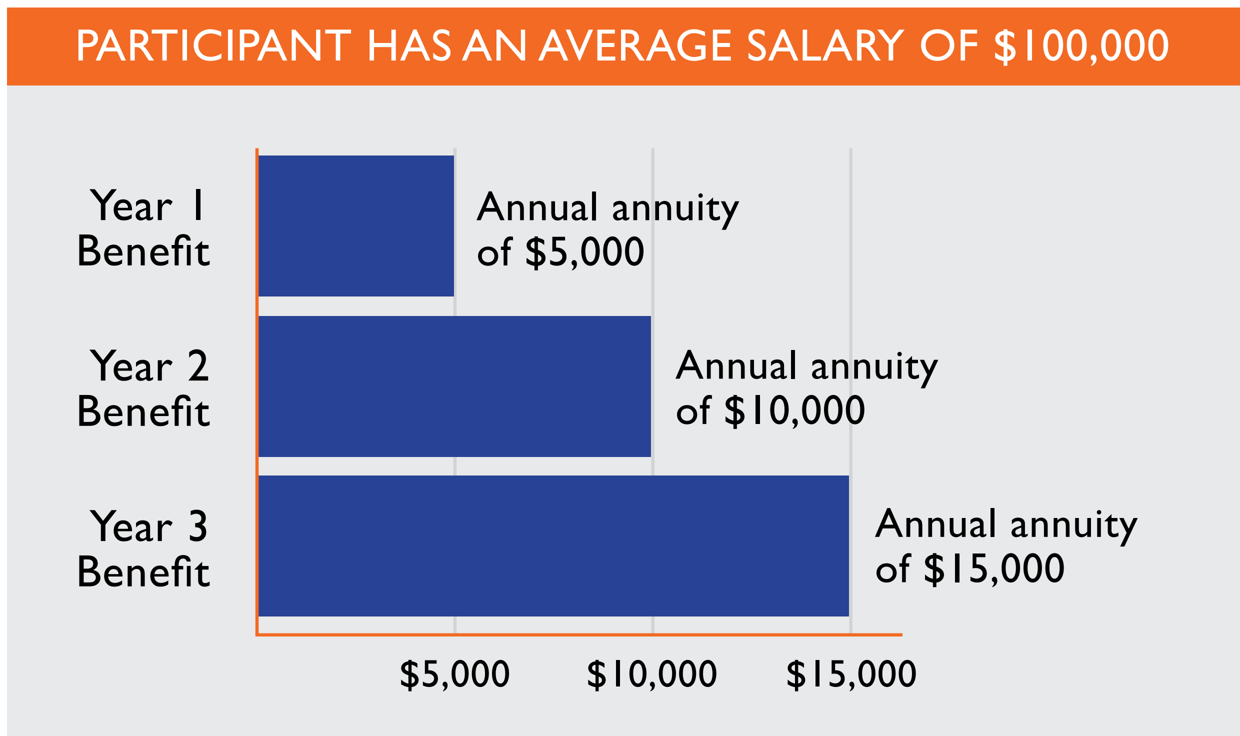
The company contribution. A percentage of pay or a flat dollar amount is determined by a formula specified in the plan document; and

An annual interest credit. The rate of return (generally 5%) is guaranteed and is independent of the plan's investment performance. The interest credit is not related to the actual performance of the Plans assets.

When participants terminate employment, they are eligible to receive the vested portion of their account balance.

Why a Cash Balance Plan and not a "classic" Defined Benefit Plan? A classic defined benefit is usually more difficult for participants to understand and appreciate. The plan will describe all benefits in terms of an annuity payment at retirement. For example: "You will receive an annuity starting at age 65 which is equal to 5% of your average compensation times the number of years of participation, not to exceed 20 years of participation."

On a year by year basis, a participant will be told what his benefit at retirement is. For example:



Although the exact amount of what this is worth today (as a balance) can be estimated, it is never a fixed amount and an actuary will not give you a fixed number that you can rely on. This is because the Plan will need to use interest rates applicable on the day that the lump sum is paid, and these rates change frequently.

With a Cash Balance Plan, however, you will receive a statement showing a solid number of what your balance really is.

Cash Balance Account
Beginning Balance: $100,000
Employer Contribution $50,000
Earnings Credit: $5,000
Ending Balance $155,000

How Much can I Contribute?

Cash Balance contributions are age-dependent. The older the participant, the higher the amount. The reason for this difference is that an older person has fewer years to save toward the approximate $2.6 million lump sum that is allowed in a Cash Balance Plan.

Subject to IRS limits, the actual contribution is determined by a formula specified in the plan document. It can be either a percentage of pay or a flat dollar amount. However, this is where the Defined Benefit rules can make a Cash Balance Plan far superior to any sort of 401(k), Profit Sharing, or Defined Contribution Plan

The maximum allocation to any individual under a Profit Sharing Plan is $55,000. Under a Cash Balance Plan, the maximum contribution is age dependent as follows:

Age at Plan Entry	Maximum Contribution Credit
35	$77,000
40	$98,000
45	$126,000
50	$179,000
55	$228,000
60	$237,000
65	$254,000

Profit Sharing Plans allow contributions to vary from year to year depending on profitability, but Cash Balance Plans must usually be amended in order to change contribution credits. However, special rules for Cash Balance Plans allow the credits to be "funded ahead"– in good years, the Plan sponsor can increase the cumulative contributions by up to 150%, allowing for an even greater range of contributions, and allowing the "maximum" to be much higher.

EMPLOYERS CAN DESIGNATE DIFFERENT CONTRIBUTION AMOUNTS FOR PARTICIPANTS

There is, however, a restriction on the frequency of amendments unless a valid economic reason exists

For example, if a firm's profits are not expected to support its Cash Balance Plan contribution, then the plan can be amended. Any reductions must be made before any employee works 1,000 hours during a plan year. For increases, the plan must be amended within two and a half months following the end of a plan year. In addition, a Cash Balance Pension Plan can also be frozen or terminated before an employee works 1,000 hours during a plan year.

Deductions and Allocations for Partners and Owners

Each Partner, Owner, and participant can have a different contribution amount. The amount can be a percentage of pay or a flat dollar amount. For Partnerships, tax deductions for contributions made on behalf of non-partner employees are taken on the partnership tax return. Tax deductions for contributions made on behalf of partners are taken on their personal or corporate tax returns.

To ensure that the amount deducted for tax purposes by a partner as shown on Schedule K-1 is the same as the amount contributed on behalf of the partner, the partnership agreement must permit this method of allocation. Most partnerships that adopt Cash Balance plans do not want the partners' contributions allocated like most other firm expenses, in proportion to ownership. Either the partnership agreement or internal policy should assure that each partner is allocated an appropriate share of the plan's cost.

Are You a Good Candidate For a Cash Balance Plan?

Many partners and professionals find Cash Balance an excellent way to increase contributions to their retirement accounts. The following are typically good candidates:

- *Partners or owners who desire to contribute more than $55,000 a year to their retirement accounts.* Many professionals and entrepreneurs neglect their personal retirement savings while they're building their practice or their 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 pre-tax contributions as high as $100,000 to $300,000, depending on their age.

- *Companies already contributing 3-7.5% to employees, or at least willing to do so.* While Cash Balance plans are often established for the benefit of key executives and other highly compensated employees, other employees benefit. The plan can use the existing employer contributions as a basic foundation on which owner benefits can then be enhanced.

- *Companies that have demonstrated consistent profit patterns.*

- *Partners or owners over 40 years of age 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 savings.

Top 10 Candidates

01 *Highly profitable companies of all types and sizes*

- Usually indicated by the owner's desire for a larger tax deduction
- Principals earning more than $270,000 per year

02 *Family businesses*

A Cash Balance Plan can be used as a component of succession planning

03 *Closely-held businesses*

Several owners want a greatly enhanced retirement plan

04 *Law firms of all sizes*

Tax deferral and asset protection are often very important to this profession, along with a highly competitive retirement package to attract and retain top talent

05 *Medical groups of all sizes*

Tax deferral and asset protection are often very important to this profession

06 *Professional firms of all types*

CPAs, engineers, architects, financial services firms, management consultants and others

07 *Older owners who have delayed saving for retirement*

They need to squeeze 20 years of savings into 10

08 *Those who highly value asset protection*

ERISA protects all qualified plan assets from creditors in the event of bankruptcy or lawsuit

09 *Those who want an enhanced benefits package for executives*

They want to attract and retain high caliber employees

10 *Sole proprietors with income exceeding $250,000 per year*

All entity-types apply

Creditor Protection and Qualified Plans

A Cash Balance plan is an "ERISA Qualified Plan", and contributions to qualified plans are deductible expenses.

ERISA Qualified Plan assets are protected from creditors in the event of bankruptcy or lawsuit. The anti-alienation provision of ERISA states that "each pension plan shall provide that benefits provided under the plan may not be assigned or alienated" – this means that the assets in a qualified plan are not available to creditors.

Since professionals and business owners often consider asset protection a premium, it is very advantageous to accrue retirement savings in an asset-protected vehicle, like a qualified plan. These plans provide a means for business owners and partners to move assets from their businesses to a pension plan. Once in the qualified plan, these assets are then protected from creditors as a "nest egg" for retirement or to pass on to heirs.