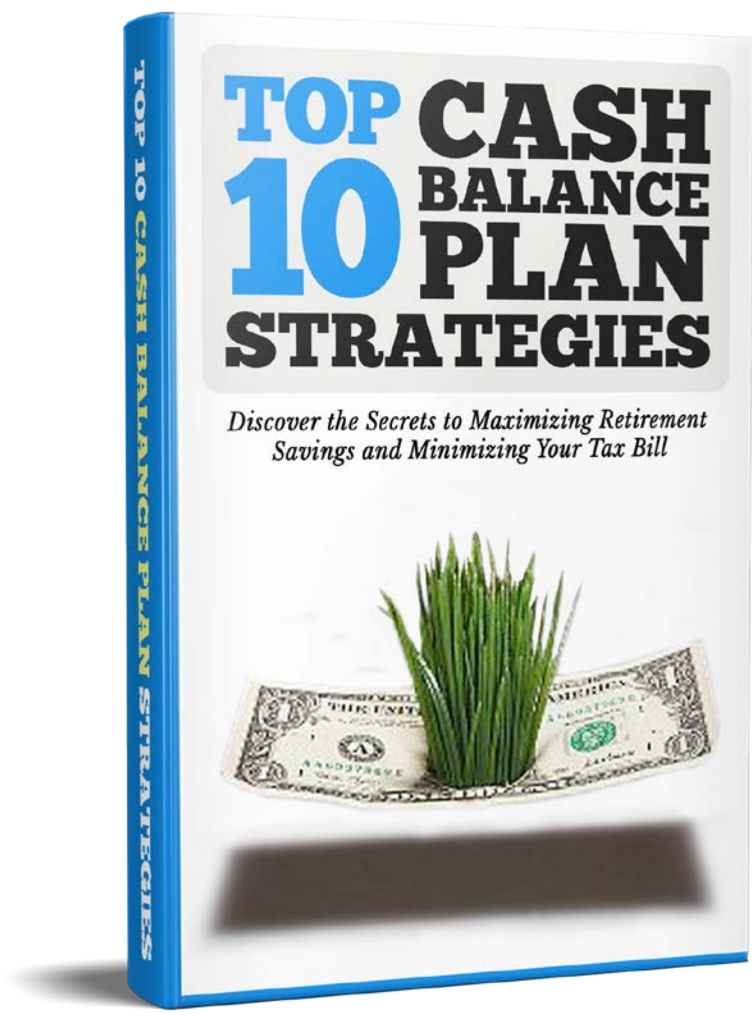
Top 10 Cash Balance Plan Strategies



Discover the strategies to maximize your retirement savings and minimize your tax bill

Table of Contents

Forward

The truth hurts. Retirement planning is something that most Americans fail at.

According to the Economic Policy Institute, for households between the ages of 50 and 55, the average savings balance is just under $125,000. But this number is a little skewed. As a result of a handful of big savers that bring the average up, the median savings amount for this age group is a meager $8,000.

Herein lies the problem. In your early employment years, you simply aren't making enough money to put much away. In your later and higher earning years, life gets in the way. You have child education expenses, vacation plans, etc. As a human being, you make every excuse possible.

But at some point, you need to get serious. When people think of contributing to a retirement plan, they often think first of 401(k) plans. These plans are definitely great options, but they do not allow participants to maximize contributions. As you know, it is often tough to catch up when you have fallen behind.

What if there was a retirement strategy that would allow business owners to supercharge their retirement? Well, there is. It is called a *cash balance plan* and it has been used by wealthy business owners for years.

So what is a cash balance plan?

When people think of retirement accounts, they often think first of a 401(k) plan. 401(k)s are certainly great options, but they come with contribution caps that could fall short of some participants' hopes. This is where a cash balance pension plan comes into the picture, because they have contribution limits that can top $200,000 annually, depending on your salary and age.

However, before we examine the cash balance plan, let's take a closer look at the two main types of pension plans: defined benefit plans and defined contribution plans.

In a typical cash balance plan, the participant's account is credited each year with a "pay credit" from the employer. For example, this could be 5% to 7% of compensation as specified by the employer. Also, the participant's account receives an "interest credit." The plan can be offered as either a fixed rate or a variable rate that links to an index such as a Treasury note.

Annual increases or decreases in the overall value of the plan's investments do not directly affect the benefit amounts promised to participants. ***So, if the actual rate of return on plan assets varies from the expected rate, the employer contributions will be adjusted.*** Accordingly, the investment risks are solely the responsibility of the employer.

When a plan participant becomes entitled to receive benefits, they are expressed in terms of an account balance. For example, let's assume that a participant has an account balance of $250,000 at age 65. Should the employee retire, he or she would have the right to an annuity based on that account balance. Such an annuity might be approximately $20,000 per year for life.

However, many cash balance pension plans allow the participant to choose to take a lump sum benefit instead equal to the account balance. If a retiree receives a lump sum, that distribution can typically be rolled over into an IRA or to another employer plan (if that plan accepts rollovers).

How are cash balance pension plans different from traditional pension plans?

Both traditional defined benefit plans (pensions) and cash balance plans are required to offer payment of an employee's benefit in the form of a series of payments for life (like an annuity). For traditional defined benefit plans, the payments would begin at retirement.

But cash balance plans define the benefit in terms of a stated account balance. These accounts are usually referred to as "hypothetical accounts," because they do not reflect the actual contributions to the account. They merely state an account balance pursuant to the plan document.

Cash balance plans are not just for large companies. In fact, they work great for owner-only businesses and small employers (fewer than 20 employees). However, they are a little more complex to establish. The plan needs to be set up by a third-party administrator and reviewed at least annually by an actuary.

Cash balance plans are great for: (1) companies with historically consistent profits; (2) professional service businesses (attorneys, physicians, etc.); (3) businesses interested in improving morale and employee retention; (4) owners who fell behind on retirement savings and are looking to “catch-up”; and (5) owners looking to maximize income tax deductions. If you think a cash balance pension plan is right for you, make sure that you review your situation with your CPA and a third-party administrator. Hopefully, the cash balance plan becomes a significant tool in your retirement arsenal.

Strategy #1: Forward Thinking

Cash balance plans are great retirement vehicles and, for many business owners, one of the best plans on the market. But they are not for everybody. There are some companies who are ideal candidates for cash balance plans.

The plans are technically defined benefit plans that define retirement benefits similar to a defined contribution plan. This is why they are often called hybrid plans.

But questions arise. Who are ideal candidates for cash balance plans? What professions make most sense for cash balance plans? Does a cash balance plan make sense for me?

The truth is that there are many companies and professionals who are ideal candidates for cash balance plans. The following are the top 5 ideal candidates for cash balance plans:

1. Companies with consistent profits (historically and forward looking)
2. Professional service businesses (doctors, lawyers, CPAs, etc)
3. Companies looking to improve morale and employee retention
4. Owners trying to "catch-up" on retirement savings
5. Owners looking to maximize tax deductions

Ideal Candidate #1: Consistently Profitable

The truth is that you don't have to have high profits for a cash balance plan to make sense for you. But of course it helps.

Companies who have consistent profits are great candidates. If your business is very cyclical in nature and subject to boom years as well as bust years it can be more challenging. In reality, even a company with inconsistent cash flows can do very well with cash balance plans, but it just becomes more difficult when times are challenged.

Ideally, consistently high cash flows and the expectation of solid cash flow over the foreseeable future makes the most sense. We have seen companies in manufacturing, distribution, real estate and a variety of service businesses. If a business owner makes in excess of $200,000 a year it might make sense to consider.

Ideal Candidate #2: Professional Service Businesses

While any business industry can be a good candidate, professional service firms can work great. Professional service firms tend to have less overhead and higher earnings power than many business types. That's why they are some of the best candidates.

Let's look at some professional service firms that could benefit from a cash balance plan:

- Attorneys and law firms
- Accountants and CPAs
- Engineers
- Physicians
- Actuaries
- Psychologists
- Dentists
- Chiropractors
- Architects

Law firms and medical groups have historically been large proponents of cash balance plans. Obviously, a large reason why are the consistent high incomes. But these practices are looking for a way to get more money into practitioner's retirement accounts.

Ideal Candidate #3: Improve Employee Retention

Finding quality employees can be a challenge for many business owners. Most cash balance plan sponsors would like to maximize the savings for owners or partners. But others are looking to improve employee morale and retention. Improving a company's retirement plan can be a great option.

If a company is willing to contribute 5-7.5% to employees then that is a good starting point. Motivating employees with a cash balance plan can be great for morale. In addition, the owner can consider vesting options that can still improve retention while offering deductions for the plan sponsor.

Ideal Candidate #4: Owners Behind on Retirement Savings

Let's face it. Most people are behind on retirement savings. As they age, they try to get as much as possible contributed. But the problem is that life gets in the way. Kids need money for college – vacation plans get in the way. As human beings we can also make every excuse possible to get behind on our retirement planning. Unfortunately, we need a plan to get more money contributed.

401k plans have maximum contribution limits of $60,000. This also assumes that the participant is over the age of 50. Owners and/or partners who want to contribute more than this are normally stuck. A cash balance plan can be a great fit for these people.

Ideal Candidate #5: Owners Looking to Maximize Tax Savings

Retirement savings is nice. But minimizing taxes is one of the best benefits and what drives the majority of business owners to cash balance plans. When combining the marginal federal tax rates (with state tax rates as well), it makes a cash balance plan a no-brainer for business owners looking for tax savings. Any cash balance contributions will come off at the owner's marginal tax rate.

Most clients should save at least 40% in taxes when you consider their marginal rates. But in states like California where the top marginal income tax rate is 13.3%, a cash balance plan can be especially appealing. With the top federal rate at 39.6%, even employers who reside in states with no (or little) state tax it can make a big difference.

Ideal Candidates for Cash Balance Plans?

The best candidates have a combination on all the characteristics noted above. But most importantly, they should be committed to the plan and all the benefits that come with it.

Strategy #2: Taking Advantage of the Deadline

Cash balance plans have critical deadlines and contribution limits. The most important is the funding of the plan. When is the cash balance plan contribution deadline? It depends on the structure of the company who adopted the plan. Let's take a closer look.

First, a plan must be set-up and approved by the end of the company's fiscal year to allow for contributions to be made for that year. However, contributions are not required by the end of the year. Contributions must be made by the deadline of the company's tax return (which includes extensions).

The contributions should then be accrued and deducted on the tax return. If the contribution deadline is missed, the contribution will be deducted on the subsequent year tax filing.

You must also state in writing to the plan administrator (or plan trustee) that contributions made subsequent to year-end represent contributions for the prior year. Alternatively, the company may simply deduct the contributions on the prior year tax return.

So for sole proprietorships and C-Corporations this deadline is April 15th and October 15th if an extension if filed. For partnerships and S-corporations, the deadline is March 15th and September 15th if an extension is filed.

So where are the contributions deducted?

Sole proprietors deduct these contributions on line 28 of Schedule C (on Form 1040), C-corporations deduct them on line 23 of form 1120 and S-Corporations deduct them on line 17 of form 1120-S.

Partnership rules are a little different. Contributions made by the partnership on your behalf are shown on Schedule K-1 of form 1065.

Unlike salary deferral made under a 401k plan, cash balance plan contributions will not show up as a salary reductions or in an information bow on form W2.

Make sure to work closely with your accountants so that the deadline is not missed.

So what if required contributions are not made by the deadline? The company will incur a 10% IRS excise tax as a penalty. Depending on the circumstance, the

IRS can increase this tax up to 100%. The excise is non-deductible by the company. This is certainly not a situation any company wants to find itself in.

Planning for a cash balance plan contribution deadline

Many business owners are aware of the contribution deadline and plan their tax payments and contributions accordingly. For example, let's assume an S-Corporation estimates that it will earn $500,000 for a given year before any cash balance contribution. Let's also assume that the company expects to make a $100,000 contribution to the plan and that the owner will have a $100,000 tax liability.

But what if the company (and the owner) does not have the $200,000 required to fund the cash balance contribution and the pay the tax liability? The owner can then make sure that an extension is filed for both the business and his or her personal return. The owner can then make a $100,000 extension tax payment before April 15th.

Since the business tax return is under extension, the owner can then take up to six months to save up the additional $100,000 required for the cash balance plan. Once the contribution is funded by the deadline, the owner can then file his or her personal return. Assuming the expected tax liability was accurate, the owner would have no late payment penalties or interest. This can be a win-win scenario.

So if you have examined the pros and cons of cash balance plans and decide one is right for you, take note of the cash balance plan contribution deadline.

You don't want to find yourself with penalties and even worse – the loss of the plan tax deduction.

Strategy #3: The Combo

The goal of a defined benefit plan, what most of us would call a pension, is to provide a specific benefit at retirement for eligible employees. This would typically be a monthly payout similar to Social Security. The amount of the benefit isn't reliant on the employee kicking in: It's a set amount usually based on the salary of participants during their final, usual top-earning, working years. Upon retirement age of at least age 59½, pension distributions are taxed at the recipient's ordinary tax rate. Presumably, this rate is substantially lower than the tax rate during the recipient's high-income employment years.

On the other hand, defined contribution plans, such as 401(k)s and 403(b)s, specify a contribution that can be made by the employee and employer. In a defined contribution plan, the amount of benefits employees get upon retirement depends on the cumulative amount of contributions made to the plan, along with investment gains or losses. For 2017, the combined 401(k) employee and employer contribution limits are $54,000. Employees age 50 and up are entitled to an additional contribution of $6,000, bringing the maximum contribution to $60,000.

A cash balance plan is a little different. It is a defined benefit plan, like a pension, with an employer contribution aspect, and the opportunity for an employee contribution and a payout that has the feel of a 401(k). Unlike with a pension, the amount of the payout is stated as an account balance rather than as a monthly income stream. This is why a cash balance pension plan is often called a "hybrid" plan. Just like pension distributions, cash balance distributions at retirement age are taxed at the taxpayer's ordinary tax rate.

Strategy #4: The IRA Rollover

Among the many questions often asked about qualified retirement vehicles is whether they can be rolled over into an IRA. With a cash balance plan, you can roll over your funds into a rollover IRA as seen fit.

Why would anyone want to do this? It is assumed that as circumstances change in one's life, potential job changes are going to happen. When one leaves his or her job position at a former employer who offered a cash balance plan, they need to have options on where to put it should they leave.

Keep in mind that when you roll over a Cash Balance Plan into an IRA, the funds rolled over will be taxed as ordinary income.

Strategy #5: Life Insurance

A significant advantage of qualified retirement plans is the fact that they can utilize life insurance for plan participants. The plan can use any current plan assets in additional to future retirement contributions to pay for the premiums. Accordingly, life insurance in a cash balance plan can be a great option.

Using this strategy, the plan can acquire life insurance coverage on plan participants using tax-deductible dollars. However, one important consideration is it has to be offered to *all* plan participants and cannot be only offered to key employees.

The qualified plan itself becomes the owner of the insurance policy and the participant becomes the insured party. In addition, the participant can name a beneficiary (often the spouse or the children of the plan participant).

There are many prospects who would consider life insurance-based qualified retirement plans. The following may be a good fit:

- Entrepreneurs and business owners who desire the benefits of life insurance and also desire the tax deduction;
- Individuals who would like to maximize retirement plan contributions (see discussion about 412(e)(3) plans below);
- Individuals who may not have the best rating and would like the tax deduction to offset the increased premium costs;
- Individuals who would like life insurance combined with a retirement plan and are on a limited cash budget;
- Business owners who would like to fund a buy/sell agreement and get a tax deduction. In this case, the surviving business owner would be the beneficiary on the policy which would provide the cash requirements to acquire the business interest from the estate of the deceased business owner.

Life Insurance in a Cash Balance Plan

Traditional defined benefit plans and cash balance plans do not place restrictions on the type of insurance policies that can be utilized. As such, universal or variable life policies can be utilized along with mutual funds and other investments. In a fully insured 412(e)(3) defined benefit plan, the plan is required to use whole life insurance along with a fixed annuity. The plan allows business owners to maximize retirement plan contributions, which may be especially beneficial if the owner is approaching retirement.

But there is a special rule that needs to be considered. The “50 percent test” will limit the life insurance premium to no more than 50 percent of contributions and forfeitures to an individual participant in 412(e)(3) defined benefit plans. The other 50 percent must be invested in a fixed annuity.

But there is another rule to consider. The "100-to-1 rule" will limit any death benefit to no more than 100 times the related plan participant's monthly retirement benefit.

Life Insurance in a Cash Balance Plan: So What About Taxes?

One of the advantages of a cash balance plan is the tax benefits it offers, both for employers and employees. Employers who wish to offer a cash balance plan can deduct any contributions from their taxable income, resulting in less taxes paid for any given year.

Employees likewise don't pay any taxes on the contributions until they reach retirement age and begin taking distributions. The growth of the funds within the account grow tax deferred, so no annual taxes are paid on the growth of the funds.

Because the life insurance premiums are paid with funds from the qualified plan, they are tax deductible by the company. But the addition of the life insurance can result in a tax liability to the plan participant based on the cost of the economic benefit (the insurance protection). The actual economic benefit is determined by utilizing IRS Table 2001. Generally, it is calculated by the TPA or the insurance company.

So what happens if the plan participant dies prior to retirement? The tax situation gets a little tricky. A portion of the insurance proceeds would likely be subject to taxation and the entire death benefit would be included in the insured's estate. The taxable amount would equal the cash value at the date of death. The tax-free amount is based on the "net amount at risk". This is calculated as the difference between the cash value and the death benefit amount.

So what happens when the participant retires? One popular option is to surrender the insurance policy and have all cash proceeds rolled over to an IRA. If the participant still needs insurance, the participant can purchase the policy itself from the plan. The purchase price of the policy is generally the cash surrender value.

Assuming the policy is acquired from the plan, it is subject to the same rules and tax treatment as any policy that was purchased with non-qualified funds. But one option is to have the policy purchased by an irrevocable life insurance trust. If structured correctly, this would avoid having any death benefit proceeds included in the participant's estate.

Life Insurance in a Cash Balance Plan: Other Considerations

There are many benefits to life insurance in a cash balance plan. But there are a few pitfalls. Make sure you consider the following:

- There must be adequate funds to make retirement contributions because the payment of insurance premiums is dependent on it.
- As the retirement plan is established primarily for the benefit of the participant, IRS code requires that the survivor's benefit is incidental to the retirement benefit and there is a cap on the total amount of life insurance that can be obtained.
- Again, if the participant dies prior to retirement, the policy is included in the estate. This could result in negative tax consequences including federal or state estate tax.
- An IRA is prohibited from owning life insurance. The insurance policy will be required to be surrendered, purchased, or distributed to the participant at retirement or at plan termination.
- The closer the participant is to retirement the higher the cash value will be and, accordingly, the higher the amount required to purchase the policy from the retirement plan.

Utilizing life insurance in a cash balance plan can be an excellent option. But it requires careful plan design and the proper coordination between the financial advisor, tax professional and TPA.

Strategy #6: The Benefits of Old Age

Why is a cash balance pension plan the ultimate tax and retirement strategy?

Simply put, it allows the plan participant to contribute a substantial amount into retirement and take a significant tax deduction. Contribution limits are indexed annually and are based on age. For 2017, participants who are ages 50 and 60 can contribute up to $141,000 and $241,000, respectively. This compares favorably to the $60,000 annual limitation of a 401(k) plan.

Let's look at an example. Assume a 55-year-old physician earns $500,000 a year and is looking to maximize a retirement contribution. Let's also assume, for the sake of simplicity, that the doctor has no qualifying full-time employees (if the doctor had employees they could be subject to small contributions under the plan).

Because of his age and compensation, this doctor could contribute approximately $220,000 into a cash balance plan in year one. If the cash balance plan combines with a solo 401(k) that has a profit-sharing component, the doctor can contribute an additional $37,000. (A 401(k) limit is normally $60,000, but when combined with a cash balance plan it is limited to the $24,000 employee deferral plus 6% of $220,000.) The physician now has a total of $257,000.

This contribution is fully deductible for income tax purposes. Also, substantially all of the contributions can be made up to the date the tax return is filed (including extensions). Assuming a tax rate of 40%, this is a tax saving of $102,000. Not too bad. This amount will grow tax deferred, but will be subject to taxation at his (presumably lower) tax rate in retirement.

Consider the above example of the physician. As you can see, there just are not many retirement options that will allow for such a significant contribution. A 401(k) plan will not come close in this situation.

Strategy #7: Don't Forget Taxes

As a CPA by trade, I enjoy tax planning with my clients. The goal is to deduct all legal tax deductions. But most importantly, my job is to educate my clients so that they are aware of all tax deductions they are legally entitled to. Let's look at the cash balance plan tax deduction.

Structuring retirement plans is no different. The goal is to maximize retirement savings and obtain tax deductions at the same time. When it comes to retirement plans it is even more important. The whole goal for a retirement plan is to boost your retirement see a savings and obtain tax deductions. That is the end result. Unless you were investing in a Roth.

One of the biggest benefits of a cash balance plan is the ability to defer taxes on the contributions each year. Tax deferral simply means you can elect to defer paying taxes on the amount you contribute to the plan.

While most retirement benefit plans have limits on how much you can contribute limiting the amount of tax deductions you can take, a cash balance plan has a relatively higher potential contribution limit. This allows you to defer taxes paid now until you are eligible to withdraw the funds.

Cash balance plans offer significant contributions like traditional defined benefit plans. However, they are presented as a "cash balance" which is easier for employees to understand. Transparency is greatly enhanced.

The cash balance plan tax deduction

Yes, they certainly are. Cash balance plans are considered "qualified" plans by the IRS. What this means is that it is specified in Section 401(a) of the Tax Code. This allows the contribution to be deductible by the self-employed as well as S-Corps, C-Corps and partnerships. A qualified CPA should have some insight into cash balance plans and where to deduct them on your tax return.

Qualified plans come in many different shapes and sizes. This includes 401(k) plans, defined benefit plans, profit sharing plans, SEPs, and SIMPLE plans. Contributions are tax deductible because a cash balance plan is technically a defined benefit plan.

So if you are looking for a retirement plan that will allow for significant contributions along with tax deductions, a cash balance plan may make sense.

Tax deduction benefits of using a cash balance plan

Cash balance plans have become increasingly popular, especially among small business owners and high-income earners. Why? One of the biggest strategies for saving money as a small business owner or high-income earner is through tax deductions. The more deductions an individual can claim, the less in taxes they are required to pay. The higher contribution limits allowed by a cash balance plan give high income earners and small business owners the ability to deduct more from their income, thus saving them in taxes.

In 2012, The American Taxpayer Relief Act (ATRA) was put into place, resulting in several tax increases for upcoming years. These tax increases affected mainly high-income earners for individuals earning over $400,000 and households earning over $450,000. Other increases resulting from the ATRA of 2012 were Medicare tax rate increases as well as a new tax surcharge on all portfolio income.

The tax laws put in force back in in 2012 have changed slightly in terms of high income earning households over the years. The newest tax laws passed in 2017 and effective on January 1, 2018 have raised the marginal income tax rate for households filing jointly up to $600,000. Rates on portfolio income and long-term capital gains have remained the same.

While these increases in high income tax rates are beneficial, they still have their limitations, causing high income earning individuals and families to turn to cash balance plans as a way of saving more money on taxes and heavily funding their retirement.

What are the tax benefits of a cash balance plan?

Like most defined benefit plans offered by employers, cash balance plans are considered tax deferred retirement vehicles. This means that all contributions to the plan are not taxed until withdrawn from the plan.

The problem with most other defined benefit plans, such as a 401(k) plan, is the contribution limits placed on them. Under a regular 401(k) plan, the maximum deductible contribution is limited to just $18,500 as of 2018.

The benefit of using a cash balance plan is the ability to contribute substantially more to a qualified retirement plan. Contribution limits are age dependent, allowing older aged employees to contribute more. These limits are defined in the plan documents provided by your employer and sponsored investment management firm.

Cash balance plans are unique in that they allow one to contribute to both their cash balance plan, and a 401(k) plan, thus taking advantage of the tax deduction benefits of both retirement vehicles. The annual contribution limits to a cash balance plan is also dependent upon the number of individual business owners, principals and/or key individuals of the company, offering tiered benefit levels. This makes the plan very attractive for businesses established as partnerships and companies with multiple levels of ownership and different compensation plans.

Contributions of the cash balance plan are deposited into a trustee-directed account and invested by a professional investment management firm. This leaves the responsibility of investment risk up to the plan sponsor, or the investment firm appointed by the small business wishing to offer a cash balance plan.

The contributions to a cash balance plan by the employer also include interest credits that are defined in the plan documents at a fixed rate. These interest credits are usually between 3% and 5% annually. Depending on how well investments in the plan perform, the minimum requirements concerning deductible contributions may vary each year.

The investment firm in charge of managing the plans investments is responsible for communicating the plan policy, the funding policy and actuarial policies to the sponsoring business so that these minimum requirements are planned well in advance.

Employers who may benefit most from cash balance plans include:

- Accountants, Financial services firms, engineers and consulting firms
- Companies with sustainable above average incomes
- Small business owners of older age and limited retirement funds
- Companies wishing to attract and retain key employees vital to company growth and operation
- High income earners looking to take advantage of tax deductions and retirement planning benefits

With the high taxes and retirement contribution restrictions placed on high income earners, Cash Balance Plans make for an attractive vehicle allowing you to pay less in taxes and save more for retirement.

Cash balance plan tax deduction: What are the deadlines?

There are a few deadlines of the cash balance plan you will want to keep in mind. For tax deduction purposes, any contributions to the cash balance plan must be made by the employer by the tax due date or by the extended due date of the employers tax return.

The required minimum funding contributions of a cash balance plan must be made at least within 8 ½ months following the plan year end. This cannot be any later than the last day of the tax year in order to qualify for a cash balance plan tax deduction.

Let's face it. The main reason someone is investing money into a cash balance plan is to take tax deductions. Cash balance plans have the ability to include contributions that are me several times greater than 401K plans. This is great for the self-employed.

Another advantage is that you have up to the date you file your tax return (including extensions) to get the money into the plan. But don't forget to share the details of your plan with your CPA. You don't want to miss out on the tax deduction.

Strategy #8: The Maximizer

We speak with both small and large business owners on how they can improve their retirement situation and save a bit on taxes. I strive to help them with both goals. So with that said – let's look at one cash balance plan example and the financial benefits.

When I look at retirement solutions, there is no one size fits all. There are many plans with different pros and cons. But one thing is for sure – the cash balance plan is an often overlooked solution. If a business owner has no employees (or just a few) then there are a couple great solutions.

Typically, I would do a 401k plan (with a basic profit sharing component) in addition to a cash balance plan. Most folks can grasp the details of the 401k, but the cash balance plan is a different animal. Let's examine a real life cash balance plan example.

The Contractor

This example is not that uncommon. The client is a 54 year old contractor with a thriving construction business. As I have said before, it doesn't really matter what business the client is in as long as the circumstances make sense.

He is married with two children in college. He has accumulated $425,000 in retirement, which is short of his needs based on his spending level and expected retirement age. Like a lot of self-employed folks, he lives a modest but comfortable lifestyle and understands that he needs to buckle down and start maximizing his retirement contributions.

The contractor had no full time employees since he acted as a general contractor and only used subcontractors. Since he was the only qualifying employee, the cash balance plan was a great solution. His business is structured as an S corporation and he was paid officer compensation of $180,000. He was already contributing to a solo 401k and his retirement holdings were divided between the 401k and a rollover IRA.

The cash balance plan example

There is no need to touch the solo 401k. Because he is over age 50, he can contribute up to $24,000 annually. With the profit sharing, he can contribute an additional 25% of his W2 income. The profit sharing will be limited to 6% though when combined with a cash balance plan. But in any case, I would just leave this in place as is.

So the goal was to supplement the solo 401k with the cash balance plan. You are allowed to have both plans in place, subject to the profit sharing contribution limitations previously discussed. One little known fact is that most cash balance plans have a 401k plan attached. Let's take a look at what the combined plans look like.

The hybrid plan

A cash balance plan is technically a defined benefit plan. But it acts somewhat like a defined contribution plan (i.e. 401k). This is why many refer to it as a hybrid plan.

A cash balance plan will create individual accounts for each employee and it will also specify a lump sum account balance. But for the owner, it allows for substantially higher contributions than any 401k plan.

This is a great benefit to many business owners who have either fallen behind in retirement contributions or have increased income and are looking for a tax deferral. Contribution limitations are based on income and age and can be in excess of $250,000 for certain highly compensated, older employees.

The result

Now let's get back to the example. We started off by contributing $24,000 into the 401k plan and an additional $10,800 as a profit sharing contribution. This part is straightforward, considering the 6% limitation on the profit sharing.

But that is just a start. We were then able to contribute $154,000 into the cash balance plan. The combined total for the two plans was $189,000. Assuming a combined federal and state tax rate of 40%, the result was $75,000 in tax savings. Good news for a business owner looking to maximize retirement contributions.

The contributions allowed in cash balance plans are great, but the tax savings are even better. When high income business owners are looking for a tax shelter this can be a great solution.

But this is only one cash balance plan example. Every client has different retirement needs and goals. But the end result is to listen carefully to your client and design a retirement strategy that fits.

Cash balance plan example: Understanding the details

There are a few deadlines of the cash balance plan you will want to keep in mind. For tax deduction purposes, any contributions to the cash balance plan must be made by the employer by the tax due date or by the extended due date of the employers tax return.

The required minimum funding contributions of a cash balance plan must be made at least within 8 ½ months following the plan year end. This cannot be any later than the last day of the tax year.

Can you rollover a cash balance plan? Yes. Cash balance plans can be rolled over into an IRA upon certain qualifications. The most common circumstance that this may happen will be changing jobs. Just like a 401(k), when you switch employers, you have the ability to rollover your plan balance into an IRA (Individual Retirement Account).

This example shows what can be done with cash balance plans. All it takes is a little planning and right team.

Strategy #9: The Alternative Asset

A cash balance plan can make traditional investments, such as stocks, bonds, certificates of deposit and mutual funds. But many have asked the question - what can a cash balance plan invest in? Well the answer is quite simple. It can also invest in non-traditional investments, such as real estate, notes and loans, gold, private business stock, commodities, crowdfunding, foreign currency, options, and much more.

A Solo 401(k) offers a self-employed business owner the ability to use his or her retirement funds to make virtually any type of investment on their own without requiring the consent of a custodian. The IRS only describes the type of investments that are prohibited, which are very few.

The following are some examples of types of investments that can be made with your cash balance plan:

1) Real Estate

Real estate of course is one of the most utilized alternative asset classes for cash balance plans. This includes all kinds of real estate, such as single family homes, multi-family residential, commercial and other forms.

2) Raw Land

Large purchases of real estate are often leveraged, so it can be more challenging in a cash balance plan. That is why raw land purchases can work so well in a cash balance plan.

3) Tax Liens

This has become an increasingly popular choice.

4) Gold, Silver and Precious Metals

Purchasing precious metals in a cash balance plan is gaining in popularity as a safeguard against inflation. But there are certain restrictions. In addition, cash balance plan plan participants need to be aware of the "physical holding requirement" for any precious metals held in a plan.

The account owner is considered a disqualified person. Therefore, the plan participant cannot have physical possession of the precious metals in the cash balance plan. The IRS has a requirement that precious metals must be held by a qualified financial institution. Precious metals, such as bars or gold coins, may be held in a safe deposit box at a bank. If strict storage requirements are not adhered to, it can be viewed as a distribution from the plan.

5) Real Estate Crowdfunding

Real estate crowdfunding has been very popular as of late. As such, many 401k participants have made large investments in this space.

6) Mortgage and Loan Originations

Many folks use their 401k to make hard money loans or even to buy non-performing loans. When non-performing loans are foreclosed upon, the investor can then acquire the real estate.

Strategy #10: 412 (E)(3) Plans

We all know about the advantages of cash balance plans. But what about other retirement plans for small business owners? Specifically, let's look at 412(e)(3) pension plans. They are little known but are a great solution for many business owners.

Not only are we going to examine some of the pros and cons of the plans but also take a look at the FAQs. Few investment advisors or tax advisors understand how they work, so we will try to break down the barrier.

What are 412(e)(3) plans?

A 412(e)(3) plan is a defined benefit pension plan. But rather than using the plan assets to invest in stocks, bonds, and mutual funds, the plan benefits are guaranteed with insurance contracts, including life insurance and life insurance. Some professionals refer to 412(e)(3) plans as fully insured defined benefit plans.

What is the difference between traditional defined benefit plans and 412(e)(3) plans?

412(e)(3) plans are only allowed to invest funds in annuity contracts and permanent life insurance. The plans will offer participants a guaranteed return. Defined benefit pension plans are allowed to invest in the same insurance contracts, but also can invest in traditional investments like stocks and mutual funds. Defined benefit plans can offer higher returns, but since 412(e)(3) plans offer guarantees they can protect against investment downside.

What are the advantages of 412(e)(3) plans?

There are many advantages of 412(e)(3) plans:

They offer stable investments returns without market fluctuations.

They provide flexibility and security based on the guaranteed insurance contracts.

Because of the assumed lower rate of return, companies can generally make substantially higher tax deductible contributions compared to traditional defined benefit plans.

They allow companies to fund larger contributions for older employees that will not increase contributions for younger employees.

Because they do not require an actuary, they will generally allow for lower administrative costs compared to traditional defined benefit plans.

What are the disadvantages of 412(e)(3) plans?

Some of the disadvantages include:

Since they use only insurance products, the investment returns tend to be lower.

They can require large contributions, especially in early years.

They do not allow loans.

The annual contributions are fixed, so there is no ability to increase or decrease based on circumstances.

While the plan is open, annual contributions are required and are not elective.

Even though administrative costs are lower than traditional defined benefit plans, they are higher than 401k plans.

How does a 412(e)(3) plan work?

The plan works as follows:

A qualified third party administrator is chosen and the plan is designed and drafted.

The plan is funded and acquires qualified annuities and possibly life insurance contracts.

On an annual basis, the third party administrator provides compliance and reporting services.

The company will level-fund the plan during the working life of each participant.

Upon retirement, the promised benefit based on the insurance annuity is utilized by the retiring participant.

What are the 412(e)(3) plan requirements?

The key to a 412(e)(3) plan is that it must be funded with guaranteed insurance products. This can be done with annuity contracts or a combination of life insurance and annuity contracts. In addition, the insurance products must allow for level funding until participant retirement. The employee benefit is guaranteed so long as the premiums are paid.

Can you borrow from a 412(e)(3) plan?

No. Loans are not allowed under the plan. The rights under the insurance contracts cannot be used as collateral. So, unfortunately, neither the company nor plan participants can borrow under the plan.

What is the maximum benefit under a 412(e)(3) plan?

The maximum benefit is adjusted typically annually. Currently, the maximum benefit for a retirement age of 62-65 is the lower of 100% of salary or $18,333 a month. This is then reduced by 1/10th for every year of plan participation less than 10 years.

How safe is a 412(e)(3) plan?

Very safe. Because participant benefits are guaranteed by the insurance provider, the plan essentially has no investment risk.

How are contributions determined?

The company will often determine a targeted retirement amount. Using the guaranteed interest rate and the number of years to normal retirement, the annual premium needed to reach the target is calculated.

How much can you contribute to a 412(e)(3) plan?

The company's contribution depends on a variety of factors, including primary the ages of its employees and the desired targeted benefit amount. Because of the conservative returns association with the insurance guarantees, companies can typically contribute substantially more to a 412(e)(3) plan than a defined benefit pension plan. 412(e)(3) contributions will far exceed any contributions allowed in a 401k or other defined contribution plan.

Are contributions to a 412(e)(3) plan tax deductible?

Yes they are. The plan is a qualified plan and, accordingly, the company can take a tax deduction for contributions made to the plan. Participants are not taxed until the receipt of the benefit.

Can the company take a tax deduction for plan set-up fees and annual administration costs?

Yes. The costs are tax deductible as ordinary business expenses.

Does the plan cost anything to participants?

No. Plan participants do not pay any costs associated with the plan. But if the plan provides a life insurance death benefit, an employee will have taxable income to the extent of current economic benefit. This is calculated using Table 2001.

Does an actuary sign off on the plan?

Review of the plan by an actuary is not required. Since the benefit is guaranteed by the insurance company, the plan cannot be under funded. As such, there is no need for annual certification by an actuary to state that funding is adequate and to determine annual contributions. This can decrease the cost of annual administration.

Can a 412(e)(3) plan be combined with other plans?

Yes. But you must take a close look at the structure of the current plans. The following rules apply:

- *401(k)*. Subsequent to January 1, 2002, a company is allowed to retain its 401(k) plan and also adopt a 412(e)(3) Plan.
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- *Profit Sharing Plan*. The company is allowed to have a profit sharing plan. However, the profit sharing contribution would typically be limited to 6% of compensation if the 412(e)(3) plan is not covered by the PBGC.
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- *Defined Benefit Plan*: Since a 412(e)(3) plan is a form of defined benefit plan, it is recommended that the company terminate any existing defined benefit plan. Any accrued benefit of the prior defined benefit plan would lower the maximum benefit of a new 412(e)(3) plan.

What type of companies can adopt a 412(e)(3) plan?

The plans are available to all business entities, including S-Corps, C-Corps, partnerships, and sole proprietors. Generally, the plans work best for small businesses with minimal employee. In addition, the older the owners the better in order to maximize contributions and take advantage of tax deductions.

Can a 412(e)(3) plan be structured to make contributions at a specified level?

Yes. Plan design is critical to success. Company contributions can be established at a rate that the company is comfortable with. Specific scenarios should be run that will allow for the required contribution level.

Is annual funding mandatory?

Yes. The plan is subject to annual funding requirements. But plans can be amended, frozen or terminated if circumstances dictate.

Who are qualifying employees under the plan?

Any full-time employees must be covered. Part-time employees who work less than 1,000 hours and union employees can be excluded. In addition, the company can exclude employees younger than age 20 1/2 or who have less than one year of service. Plans can be customized to exclude certain other employees, subject to additional coverage testing.

What happens when a participant retires?

The participant receives the targeted retirement benefit. Participants may also retain the life insurance benefit by taking the policy as a distribution. In this case, the policy's fair market value will be deemed taxable income assuming the policy is purchased from the plan. If the participant does not want the life insurance, the policy may be surrendered for its cash value.

Should the participant desire to maintain the life insurance, the policy will be individually owned. Assuming proper estate planning, proceeds may be excluded from estate tax.

Conclusion

412(e)(3) plans can be great plans for small business owners. Unfortunately, most advisors and financial planners are not familiar with them. We have examined many of the pros and cons and also many FAQs. Hopefully, you are now well versed on how the plans work and can determine if a plan is right for you.

Closing

Cash balance plans have been around for decades, but few financial planners and CPAs are aware of them. Simply put, they allow the plan participant to contribute a substantial amount into retirement and take a significant tax deduction.

You don't have to have high profits (or consistent profits) for a cash balance plan to make sense for you. But of course, it helps. If your business is very cyclical and subject to boom years as well as bust years, it can be more challenging. Ideally, consistently high cash flows and the expectation of decent cash flows over the foreseeable future make the most sense.

Saving for retirement is great. But reducing taxes is what drives many entrepreneurs to cash balance plans. When combining federal and state tax rates, it makes a cash balance plan a no-brainer for business owners looking for tax savings. This savings could exceed 40 percent in taxes, depending on state tax rates.

I have been using cash balance plans with clients for years with much success. There just are not many options available for entrepreneurs who seek significant contributions and large tax deductions.

A cash balance plan may not work for everybody. But for the right person, it can be a home run.