Fairhaven Whitepaper

Patient, enduring growth. | September 2021

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Cash Balance Plan

What is a Cash Balance Plan?

A Cash Balance Plan is an IRS-qualified Defined Benefit retirement plan that can help business owners realize tax deductions and savings rate up to 4x greater than a 401(k) plan alone. Cash balance plans are “qualified plans,” indicating their tax-favored status with the IRS.

A cash balance plan is a “hybrid retirement plan” that combines the best of retirement plan types. More-traditional benefit plans provide specific elements that combine for retirement savings, while cash balance plans act as a fund almost like a bank account or a 401(k) profit sharing plan. Employers contribute a fixed amount or percentage of compensation and align it to a defined interest rate each year. A company’s cash balance plan is maintained by a plan actuary, who generates annual participant statements.

Who does it work for?

If you own or run a professional group, such as a law or accounting firm or a doctor’s office, consider adding a cash balance plan to your benefit offerings. It can enhance your employees’ tax savings as well as improve their overall retirement outcomes.

- **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. These individuals 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 $260,000, depending on their age.

- **Companies already contributing 3-4% 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 as well. The plan normally provides a minimum contribution 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.** Because a cash balance plan is a pension plan with required annual contributions, consistent cash flow and profit is very important.

- **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.

Specific organizations that might benefit from a cash balance plan include:

- Law offices
- Doctors' offices
- Dentists' offices
- Engineering firms
- Architectural firms
- Accounting agencies
- Family-run businesses
- Sole proprietors
- Organizations that have already maximized contributions to their current defined contribution plans

What are the tax Benefits?

Contributions to cash balance plans have the same tax effect as a deduction that reduces ordinary income dollar for dollar. With combined federal and state income tax rates as high as 45%, the tax savings from the contributions and the subsequent earnings on these contributions can be very significant. The tax benefits of a cash balance plan often offset the administrative costs of running it.

Age	401(k) only		401(k) with profit-sharing		Cash balance	Total annual contributions	Potential employer tax savings*
60	**$26,000**		**$64,500**	**+**	**$265,000**	**$329,500**	**$127,470**
55	26,000		64,500	+	210,000	274,500	104,370
50	26,000	or	64,500	+	160,000	274,500	83,370
45	19,500		58,000	+	125,000	183,000	68,670
40	19,500		58,000	+	100,000	158,000	58,170
35	19,500		58,000	+	75,000	133,000	47,670

2021 contribution limits; estimated for cash balance plans. 401(k) limit includes annual catch-up contributions for participants ages 50 or older. Actual results may vary depending on the actual plan design, participant compensation, employee demographics and projected retirement age. Calculations courtesy of Shore Tompkins Actuarial Resources, LLC.

*Based on assumed combined federal and state tax rate of 42%. Calculation uses "Total annual contributions" excluding 401(k) contributions.

Key Considerations

- Cash balance plans grow each year in two ways:

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

    2. **An annual interest credit.** The rate of return is guaranteed and is independent of the plan's investment performance. That rate changes each year, but usually is equal to the yield on 30-year Treasury bonds, which has hovered around 5 percent in recent years.

- Generally, when participants terminate employment, they are eligible to receive the vested portion of their account balances.

- Potential employers should be confident that their cash flow and profitability will allow it to meet their funding requirement.

Cash Balance Benefits for employers

- Easy to understand
- Can contribute either a percentage or flat-dollar amount
- Work well when combined with a defined contribution plan
- Makes it easier to boost benefits for owners and other key employees, and to control the cost of benefits for others

Cash Balance Benefits for Plan Participants

- Easy to understand
- More portable than many defined benefits plans. For example, upon separation from service, cash benefits plans can be distributed or rolled into an IRA or another employer-sponsored plan
- Permits higher contribution limits for key employees and older participants
- Little or no investment risk

About Fairhaven

Fairhaven Wealth Management is an independent, privately owned investment and wealth management firm serving select families and small to mid-sized businesses. At Fairhaven, our commitment is simple – we exist to serve our clients…period. Our culture of service and accountability combined with prudent risk management and tax-efficiency are the cornerstones of our client commitment. www.fairhavenwealth.com

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