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The new 401(k): Cash balance plans for fast recuperation and tax deferrals

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By Rob Hoxton

After the economy quickly demolished many retirement savings plans, business owners, executives, professionals and other high income individuals hope to regain the losses suffered in their retirement investments. Unfortunately, for your clients who are 401(k) and profit sharing plan participants, the maximum contribution amounts can be rapidly reached. With 401(k)s, participants are only allowed \$22,000 and profit sharing plans let employers contribute another \$32,500 (both dependent on age). Once the annual maximum is reached, no further contributions can be made on a pre-tax basis.

High income individuals, who earn \$200,000 or more per year are looking for retirement plan alternatives. Accelerating retirement savings that reduce tax liability is the best retirement plan alternative. As a result, a growing number of firms are opting for Cash Balance Plans, which allow as much as \$200,000 to be contributed annually on a pre-tax basis. This amount is in addition to the \$54,500 maximum available through 401(k) and profit sharing plan contributions, making the total amount of contributions of those who take advantage of all three plans over \$250,000 per year, depending on age.

In 1984, BankAmerica Corporation first introduced the cash balance plan to address a shift in the company's workforce. As a result of a change in the tax law in 2001, the contributions of cash balance plans were allowed to increase as much as 60 percent, making these plans much more attractive to successful businesses and professional firms. The Pension Protection Act of 2006 prompted a number of companies to adopt a cash balance plan, and currently over 120 cash balance plans exist in Maryland and over 5,500 in the United States, many in professional service businesses such as law firms and physician groups.

A cash balance plan has attributes of both defined benefit and defined contribution plans. The plan bears the investment risk and account balances can be paid out or rolled-over upon termination of employment. Similar to 401(k) plans, cash balance plans are "qualified plans," which means they offer tax deferral and creditor protection against bankruptcy.

Cash balance plans also allow a specific amount of contribution to be credited to each participant, which can be either a flat dollar amount or a percentage of pay, and based on those contributions, the plan credits interest at a guaranteed rate. Each participant has an individual account which resembles the accounts in a 401(k)/profit sharing plan.

The rate of return is guaranteed and is negotiated in the plan document. It is not dependent on the plan's investment performance. The rate of return changes each year and for many plans is equal to the yield on the 30-year Treasury bond, which is about 4.5 percent in recent years. Once participants terminate employment, they are eligible to receive the vested portion of their account balance, which is determined by the plan's vesting schedule.

Firms with one or more of the following characteristics may be good candidate for a cash balance plan:

1. *Owners who desire to contribute more than \$54,500 per year. Highly compensated individuals'*

contributions to 401(k) and profit sharing plans can reach the maximum amount very quickly, and executives or owners may want to make up recent financial losses promptly or may have neglected their personal retirement savings while investing in building their businesses. Profitable businesses sometimes need large tax deductions, and a cash balance plan allows for this in addition to accelerated savings.

- 2. Companies that have demonstrated dependable profit patterns. Because a cash balance plan is a defined benefit pension plan with required contributions, a reliable cash flow and steady profits are important. This makes stable companies with established profits ideal candidates for cash balance plans.*
- 3. Companies that contribute 3 percent or more to employees' accounts or are willing to do so. Although cash balance plans are often established for the benefit of owners and highly compensated employees, other employees may also benefit. Usually, plans provide a minimum contribution of five to seven percent of pay for the firm's staff.*

Cash balance plans need to be established by Dec. 31 to take advantage of 2010 benefits; however, they can be funded in 2011. Through cash balance plans, your high-income clients have the opportunity to defer taxable income while substantially increasing contributions to their qualified retirement plan.

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