Cash Balance Plans Retirement Planning Strategy for Closely Held Businesses | Ask the Experts Video Transcript

George Sparks, Director and Wealth Management Practice Leader
Kat Jenkins, Marketing Director

Kat Jenkins (00:06):

Hello, and welcome to Barnes Dennig Ask the Experts. I'm Kat Jenkins, Marketing Director at Barnes Dennig. Today I'm talking with Director and wealth management practice leader George Sparks about cash balance plans.

Kat Jenkins (00:19):

George, what is a cash balance plan?

George Sparks (00:21):

A cash balance plan is a defined benefit retirement plan, and it's used on top of other plans, typically your safe-harbor match or your 401(k), profit sharing plan as well, and it's meant to layer on top of those plans to give some added benefits to the closely-held business owner.

Kat Jenkins (00:39):

What types of companies should consider a cash balance plan?

George Sparks (00:43):

Generally what we would be looking for would be companies that are profitable, that can project to be profitable for about a five-year period. This isn't something that you can get in and out of with the IRS. You can't jump in one year and get out the next year. You have to be in it for a number of years, but the benefits are really worth it if it works out for you.

Kat Jenkins (01:02):

Is it a long-term strategy?

George Sparks (01:04):

Again, I think these plans are set up so that the main beneficiaries of the accounts are to accumulate about two and a half million dollars. So once you start getting close to that two and a half million dollars, you see that the amounts being allocated to the highly compensated or the shareholders start to diminish. And at that point you would look to cease the plan and make distributions out of it to other retirement plans. You can do a tax-free rollover into your IRA or your profit-sharing plans.

Kat Jenkins (01:37):

It sounds like there's a huge tax advantage to a cash balance plan. Why does the IRS allow that?

George Sparks (01:41):

I think what's important to note here is that it's not just the shareholders and their family members that are benefiting, or the highly compensated people. The typical retirement plan, there's a safe-harbor match, which is 3%. But in order to take advantage of a cash balance plan, the IRS says, "Hey, if we're going to give some additional benefits to the shareholders or highly compensated people, we want to make sure that the employees are being taken care of as well. The result of that is that by adding the additional plans, the employees generally get about a 7% contribution to their retirement plan. So again, you're more than doubling the amount that they receive on an annual basis.

Kat Jenkins (02:19):

I know you have an example you're going to walk us through. How does this work?

George Sparks (02:23):

The example I have before you is an actual company. This is a plan that we implemented in 2016. Again, what you see here is at the top line you see highly compensated employee totals and the names that are omitted from there, but the individuals inside there are the shareholder and the related family members. Throughout the illustration, I'll show you how all this comes to play.

George Sparks (02:48):

What typically happens is most plans have the 401(k) plan and they also have the non-elective safe-harbor plan, and that keeps the retirement plan from being top-heavy. But in order to enact the cash balance plan, in order to take advantage of the benefits to the shareholder and his related family members, we have to add the profit-sharing plan along with the cash balance plan to enhance the benefits that the employees receive.

George Sparks (03:16):

Remember under a safe-harbor plan, employees are generally only getting 3%. What makes this work from the IRS's perspective is that you become a very generous plan, not only to the shareholders, but to the employees. When we add the profit-sharing plan and the cash balance plan, employees generally end up with around 7% of their wages being contributed to the retirement plan overall.

George Sparks (03:40):

What we see here is in the company cost analysis column we see that the highly compensated employees using all three plans end up with about $254,000 worth of contributions to their retirement plans. And moving down that column we see that the total cost for the company, including the employees and the shareholder and its family members are $334,000. So when we look at that as a percentage, we say the $254,000 that's going to the shareholder and their related family members compared to the $334,000 for everyone, we see that 76% of the benefits from the retirement plan are going to the shareholder and their family members.

George Sparks (04:28):

What we see next though, is I want to show you that in the profit sharing column, and we're just going to focus on the employee totals, which are the costs outside the shareholder and the related family members, we see that the profit sharing requires an additional $22,000 worth of contributions to be made on behalf of the employees, and we see that in the cash balance column, there's a requirement of about $26,000 to be added to their accounts as well. Rounding that we'll just use the amount of $49,000 of additional contributions that have to go to employees.

George Sparks (05:04):

What we want to point out at this point is that the total cost, the total deduction that the company is getting is about $334,000. We take that $334,000 using an effective tax rate of 40% federal and state, and I think we're being conservative in that, would amount to about $100,000 worth of tax savings to the company. In order to get that $100,000 worth of tax savings, you had to shell out the $334,000 of employee contributions, and when I say employee at that point, it's shareholders and employees, but what we really put into our employees' pockets outside of the shareholder and related family members is just $49,000.

George Sparks (05:49):

So here we've generated $100,000 of cash inside of the company's operations by taking this deduction, and of that $100,000, we have to give our employees $49,000, which most employers are happy to do to give it their employees, instead of giving it to Uncle Sam. The remaining $51,000 is just cash flow that you get to keep in your business to work inside of your business versus giving it to Uncle Sam. That's the beauty of the cash balance plan.

Kat Jenkins (06:21):

That's fantastic. So if I'm the owner of a closely-held business, and I think that my business might be a candidate for a cash balance plan, what do I do?

George Sparks (06:29):

Well, you can pick up the phone and call me, George Sparks at Barnes Dennig, or you can reach out to your relationship director at Barnes Dennig. You can also learn more about this on our website at wwwbarnesdennig.com.