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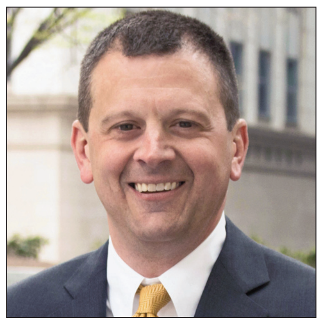
How a cash balance plan can help business owners boost retirement savings

By Daniel Tatomir



Daniel Tatomir

Many employers offer a retirement plan as a part of an overall benefits package to help attract and retain key employees. This is especially important in an increasingly competitive labor market. Plans such as a 401(k) or a 403(b) are popular choices to allow employees to defer salary in a tax advantaged manner and allow the company to help its employees save for the future. These types of plans are not only a great benefit to employees, but it can also allow business owners and key personnel to save up to $61,000 in 2022 on a tax deferred basis ($67,500 for those over age 50). For those that might want to save beyond the limits of a 401(k) plan, a cash balance plan could be a consideration.

What is a cash balance plan?

A cash balance plan is a qualified retirement plan that has some similar features to that of a 401(k) plan but also some important differences. These plans are a form of a defined benefit plan, while a 401(k) is a defined contribution plan. The company makes contributions on behalf of employees; individual employees do not contribute to a cash balance plan. These contributions are tax deductible to the company and any growth in the plan is tax deferred until withdrawal. The contribution limits of a cash balance plan increase with age and are much higher than a 401(k). As an example, a 58-year-old may be able to contribute up to $258,000 in 2022 and a 62-year-old up to $315,000 depending on the design of the plan. A cash balance plan can be a stand-alone plan or set up in conjunction with a 401(k) plan to allow plan sponsors to really maximize the benefits of both plans.

What are the considerations of a cash balance plan?

The tax savings and higher saving ability of a cash balance plan are attractive, but all aspects of a plan should be fully understood before deciding to start a plan. Unlike a 401(k) plan where the investment risk is born by each participant, the risk of a cash balance plan is born by the employer. Contributions grow at a predetermined rate – remember with a cash balance plan, the benefit is defined. Often this is set at 4% or 5% annually. Plan assets are pooled together and invested with the goal of working towards that rate of return. Generally, contributions are required each year, although there is some flexibility in the amount you contribute each year. Costs of a cash balance plan are usually higher than 401(k) plans due to the complexities in set up and to the annual testing and reporting that is required.

What type of company is a cash balance plan appropriate for?

The usual candidate for a cash balance plan is an employer looking to maximize the tax benefits and retirement savings ability above the limits of a 401(k) plan. Medical groups and law firms have historically been frequent sponsors of cash balance plans, but any company with sustainable income looking to increase retirement funding can open a plan. They work well for small employers. In 2020, 94% of cash balance plans were sponsored by companies with less than 100 employees and 59% had 10 or fewer employees. Cash balance plans can potentially be an attractive option for self-employed individuals who are looking to maximize retirement savings.

If you would like to discuss the possibility of implementing a cash balance plan for your company or would like to review your current retirement plan to maximize its benefits to the company and employees, our dedicated retirement plan department at Fragasso Financial Advisors will always welcome the conversation. ■

Daniel Tatomir is Vice President, Manager of Retirement Plan Advisors at Fragasso Financial Advisors. Investment advice offered by investment advisor representatives through Fragasso Financial Advisors, a registered investment advisor.