Cash Balance Plans- Another Retirement Plan for Professionals

The single best tax break available to you is maximizing your retirement plan contributions. Most self-employed or partnered doctors already have a defined contribution/profit-sharing plan (SEP-IRA or 401K) available to them into which they can contribute $50K a year ($55K if you're over 50.) If your federal and state marginal income tax rate is 40%, you just knocked $20K off your tax bill. But what if you want to save more of your money toward retirement? You can use a backdoor Roth IRA or even a taxable account, but neither of those reduces your tax bill this year. One option you should consider is using a cash balance plan.

A Hybrid Retirement Plan

A cash balance plan is a type of defined benefit plan (pension) that acts like a defined contribution plan (401K). When private companies were trying to get rid of their expensive pension plans, many of them converted their pension plans into cash balance plans, since they cost the company less. Employees didn't like this, as their benefits were often lower, but it does provide an option for a physician or similar professional to shelter some more money from Uncle Sam. Here's how it works:

How It Works

Every year your company (i.e. you if you're the owner or a partner) makes a contribution toward the cash balance plan, usually at the end of the year on your behalf. That money is invested by your company's chosen investment manager (you don't choose the investments like in a 401K). At the end of the next year, your "account" (which legally is not technically yours, but the company's) is credited with a certain interest rate, often fixed at something like 5% or a variable rate tied to the IRS treasury interest rate (3.88% currently), and another contribution is made by the company. That 5% comes from the investments the company made. If the investments did better than that, the company puts them toward future years in a reserve account. If they did worse, the company pulls from the reserve account so it can still credit you with 5%. If the plan has a big loss, the company may have to make a larger contribution the next year, but if the reserve account starts getting too large, the company can amend the plan and make an additional distribution to the "individual accounts" within the plan. In essence, the company is taking the investment risk, not you. Of course, for many doctors, you are the company, so you're taking it either way.

My cash balance plan, with MedAmerica, set up defined benefit cash balance plan for our partnership a little differently. The Pension Protection Act of 2008 now allows the plan to pay the participants the actual returns of the plan instead of the IRS Treasury Rate, with the caveat that the return can't be less than zero. The plan also decided to cap the return at 6.5%, with extra earnings (if they occur) going toward a reserve account to be drawn upon in the event of market losses. The money is invested across 8 mutual funds, in a 54%/46% stock/bond ratio.   Each year an investment committee (made up predominantly of physicians in the plan) decides how much interest to credit the participants. In the event the investments have little to no return, participants don't get an interest payment. In the event of a high return, the

interest is capped at 6.5% and the rest goes into the reserve account. In the event of a really low return, the company has to make an extra contribution to the account to make up some of the losses. While that sucks to have to do in an economic downturn, especially when you'd rather be buying low yourself in your personal accounts, at least by doing so the plan is buying low, which should improve future returns. When you retire or leave the company, you don't get any share of that reserve account even if there have been recent high returns in the plan, but nor are you required to make an extra contribution if the plan has a significant loss the year you separate from the company or partnership.

How much more could you have to contribute in the event of a severe market downturn? In 2008 the MedAmerica plan lost 22.8%. First the reserve account was applied, reducing the net loss to about 15%. By law that loss is spread over 5 years, so it is divided by 5. The "company" (i.e. the partners in the plan) had to make their regular annual contribution, plus 3% of what they had in their "individual account" in the plan at the beginning of 2008. So if you started 2008 with $100K in the account, and your annual contribution was $10K, the contribution due at the end of 2008 was $10K + 3%*$100K, or $13K. Of course, that entire $13K is tax-deductible. There was also a much smaller contribution due in 2009, but investment gains have the plan now back into a surplus.

Like in a 401K, the money grows in a tax-deferred manner, and you can't access it before age 59 1/2, except for some limited circumstances, without paying a 10% penalty (plus the taxes due).

When you retire or separate from the company, you can either annuitize your "account balance" or you can take it as a lump sum, either in cash or by rolling it over into an IRA or

another retirement plan.

How Much Can You Contribute?

That's, unfortunately, a really complicated question. It depends on how much is in there and how old you are. There's a law that only let's you accumulate up to ~$2.5 Million into the cash balance plan. So the older you are, and the less you have in there, the more you can contribute. In general, you contribute either a percentage of salary or a flat sum (such as $5,000 or $40,000) each year. Of course, if you have employees, non-discrimination testing must be done and you should plan on contributing 5-7.5% of their salary for each of them. Maximum contributions may range from $50K for a 35 year old to $200K for a 65 year old. But many plans, due to actuarial restrictions and top-heavy testing, limit you to much less. Mine, for instance, currently limits partners to $15K per year (which knocks about $5K off my federal tax bill and another $750 off my state tax bill.)

Watch Expenses

Expenses for these plans can be considerably higher than for a 401K plan, because they have to be run by an actuary. My plan charges 0.6% of plan assets per year, in addition to the expense ratios on the funds used in the investments (which range from 0.07% to 1.26%).

A Good Option for Partnerships

According to a presentation put together by KravitzInc.com, 28% of cash balance plans are run by/for physician partnerships, another 9% by dentists, and a further 9% by attorneys. Despite the additional expense, the immense tax break available, as well as the asset protection (generally fully protected from creditors, just like a 401K) make them particularly attractive to these professionals. The flexibility available through the plans is also a huge

benefit. Partners can make different contributions, the plan can often be made physician-only, liability between partners can be managed, and you can scale back on contributions or even amend or terminate the plan relatively easily if cash flows decrease.

A cash balance plan is a far better option for additional tax savings than purchasing a variable annuity or cash value life insurance since it not only grows in a tax-deferred manner, but it also gives you an upfront tax break and lower expenses than most life insurance products.

What are the downsides?

It's possible the investments perform poorly for a long period of time and you have to make up the interest payments out of your cash flow. That doesn't seem like a big deal if you have to make up a 5% payment on a $50,000 balance ($2500), but coming up with $50K could be a huge issue if you have a $1 Million balance. If you're not already saving $50K into a 401K (and probably maxing out backdoor Roths for you and your spouse), then you're unlikely to benefit from a cash balance plan especially given the decreased flexibility and higher expenses which drag on returns. The average physician (making $200K) probably doesn't need one of these plans simply because she doesn't make enough money to really benefit from them.

Although the money in the plan technically belongs to the company, not you, the assets must be managed for your benefit and are not subject to the company's creditors. The pension is also usually insured by the Pension Benefit Guaranty Corporation, a government entity. Your company generally pays $35 per year per participant for this insurance, but may be exempt if there are fewer than 25 employees.

Also, if you're required to make significant contributions for your employees, this can be an additional practice expense, eliminating the personal benefit to you, the owner.