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THE END OF THE RAINBOW

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Cash Balance Plans Can Be an Extra Retirement Account

These pension-type plans are another tool in your savings arsenal

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by JAMES M. DAHLE, MD, FACEP

Question. ***I've heard that a cash balance plan can allow me to contribute more toward retirement and save on my current large tax bill. What do I need to know before using one of these?***

A. One of the biggest deficits in physicians' collective "financial fund of knowledge" is a lack of understanding of the various retirement accounts available to them. I have written before about using a health savings account as a "stealth IRA" and about how to contribute to a personal and spousal Roth IRA "through the backdoor." Another little known, but very useful, retirement account for physicians is a cash balance plan.

In fact, I think the standard retirement options made available to emergency physicians should include both a 401(k) with a profit-sharing component ($53,000 contribution limit for those under age 50, with an extra $6,000 catch-up contribution for those over 50) and a cash balance plan. Most physicians do have a 401(k), which, in 2015, allows an $18,000 annual employee contribution ($24,000 for those over 50), plus up to $35,000 of employer contributions. However, surprisingly few have access to a cash balance plan.

There are two broad categories of retirement plans: defined contribution and defined benefit. A 401(k) is an example of the first type. There is no guaranteed benefit when all is said and done. All that is defined is how much you can put into it as you go along. The amount of money you will have to spend in retirement depends entirely on how much you put into the account and the performance of your selected investments. A defined benefit retirement plan works differently. The classic example is the increasingly rare company pension. You work for a company or government entity for 20 or 30 years, and after you retire, the company pays you a defined benefit for the rest of your life. The company takes all the investment risk. If the investments do well, the company can get away with putting less money into the account. If the investments do poorly, the company must contribute more to the account.

A cash balance plan is technically a type of defined benefit plan, but it can act like a defined contribution plan in two important ways. The first is that, depending on how your plan is designed, you can actually change how much you can contribute each year to the plan. The second is that upon separation from the employer, or when the plan is closed for any reason, you can transfer the money into a 401(k) or IRA, just like most defined contribution plans. For most participants, the cash balance plan is essentially an extra retirement plan allowing for additional tax-deferred retirement contributions above and beyond those allowed in the 401(k).

How Cash Balance Plans Work

A cash balance plan seems complicated because, as a defined benefit plan, it must at least resemble a typical pension. That means the participants in the plan cannot select or manage investments in the plan. It also requires complicated actuarial calculations to determine the maximum contributions that can be made into the plan. The contributions also must technically come from the employer, not the employee. Due to these complications, fees on a cash balance plan are generally higher than those in a 401(k). This type of plan is not a do-it-yourself project; you will need to hire an experienced company to design and run the plan.

All contributions into the plan are pooled and invested together by the plan trustee. However, hypothetical individual accounts are tracked and credited with a certain amount of interest each year, depending on the performance of the underlying investments. If the investments perform well, that credited interest rate may be higher up to a certain point, such as 5–7 percent per year. If the investments perform very well, the additional earnings, above and beyond the 5–7 percent limit, are allocated to a surplus account where they can be used to make up for future shortfalls in investment performance or to reduce future required contributions. If the investments perform poorly, the owners of the company may be required to contribute additional money to the plan to make up the losses over a period of a few years. This aspect of defined contribution plans turns off many physicians (who are generally not only the participants in the plan but also the owners of the company). However, in reality, this mechanism is of significant benefit to the physician. Not only do you get to defer even more money into the plan, the make-up contributions are also deductible. You are essentially forced to buy low, boosting future market returns. Many emergency physician partnerships have incorporated both a 401(k)/profit-sharing plan and a cash balance plan into their practices. Independent contractors without employees can also use this combination of accounts. An individual 401(k) is relatively easy to set up. A personal defined benefit plan is a little more complicated but still widely available from a number of firms at a fair cost. Because you are both the trustee and the participant, you will have even more control over your investments.

Contribution limits to these plans vary based on a number of actuarial factors, such as the age of the participants. The older the participants, and the fewer years they will be in the plan prior to retirement, the more that can be contributed. Typical maximum contributions for emergency physicians range from $10,000 to more than $100,000 per year, all in addition to your 401(k) and IRA contributions.

Cash balance plans are a type of defined benefit plan that resembles a defined contribution plan. Emergency physicians interested in boosting retirement savings and minimizing their annual tax bill should give strong consideration to adding a cash balance plan on top of their existing 401(k) plan. A cash balance plan is a great option for those who wish to save for retirement and are already maxing out their 401(k)s and backdoor Roth IRAs.

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