Hoarding Money Away for Retirement

One of my favorite calls from a client is when they tell me that their business is doing well and recovering from the economic downturn, however, they also realize that retirement is right around the corner and they need to be better prepared. Over the years, my client has taken my advice regarding putting away the maximum amount possible into their profit sharing/401(k) plan each year, but, it still may not be enough for retirement. “What do I do now?” is the question that typically comes next.

My bench mark question to the client is, “How much are you willing to hoard away each year?”

If the figure is in the neighborhood of $200,000, then we can discuss the possibility of adding a defined benefit retirement plan on top of their existing profit sharing 401(k) plan.

By adding a defined benefit plan, it may allow the business owner to put away an aggregate amount of $200,000 for themself with a relatively modest amount for the rest of the employees. This is assuming the demographics of their workforce (age and compensation of the workers) are suited for this arrangement.

It is important to understand some basic concepts surrounding a defined benefit plan. A defined benefit plan sets forth the amount of money a participant will have at some time in the future (retirement). Unlike a defined contribution or 401(k) where the employee benefits from the growth and bears the risk of decline in value of their account balance, the employer bears the risk of the rate of return of the assets under a defined benefit plan.

At times, the defined benefit plan can be confusing to understand, but a new form of plan has evolved that is much easier to understand called a “cash balance pension plan.”

A cash balance pension plan provides an annual benefit for each participant of either a fixed dollar amount or a percentage of compensation. An overly simplified example may make this easier to understand.

Let’s assume that there is only one participant in our cash balance pension plan (the “Plan”) and she earns $200,000 per year. The Plan provides for what is called a hypothetical allocation equal to 50% of the participant’s annual compensation each year. Therefore, the initial allocation for year one for our participant will be $100,000 (50% X $200,000.00). As I said before, a defined benefit plan sets forth the amount that someone will receive at retirement. The cash balance pension plan sets forth that this $100,000 hypothetical allocation will grow at a set interest amount each year until retirement. Let’s also assume for purposes of this calculation that our hypothetical interest factor is 5%. The employer makes a contribution of $100,000 at the end of year one.

In year two, our employee still earns $200,000. She will accrue another hypothetical allocation of $100,000 (50% X $200,000). The first $100,000 that was put in the Plan for year one is expected to grow to $105,000 (5% hypothetical interest X $100,000). Therefore, the hypothetical accrued balance at the end of year two is $205,000.

Since the employer bears the risk of having sufficient assets in the Plan as of the date of the participant’s retirement, the rate of return that the actual plan assets achieve will impact the amount of contribution that is required each year. In the event the Plan earns less than the hypothetical interest rate, then a larger contribution may be needed at year end. If the Plan exceeds expectations, a slightly smaller contribution may be required each year.

All of these concepts are great to discuss, but nothing speaks louder than some real world examples where the power of combining a cash balance pension plan with a profit sharing 401(k) plan drives the point home.

In this first example below, you have a single owner with 9 employees. Ninety-one percent of the total contribution benefits the owner and 9% of the total contribution benefits the other 9 employees.

NAME	AGE	ANNUAL COMP.	ASSUMED 401(k) DEFERRALS	401(k) SAFE HARBOR	PROFIT SHARING	CASH BALANCE	TOTAL AMOUNT
Owner	52	$260,000.00	$23,000.00	$0.00	$15,600.00	$145,000.00	$160,600.00
EE #1	50	$35,783.3	$0.00	$1,073.50	$715.67	$1,073.50	$2,862.67

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EE #2	62	$38,701.36	$0.00	$1,161.04	$774.03	$1,161.04	$3,096.11
EE #3	40	$18,525.10	$0.00	$555.75	$370.51	$555.75	$1,482.01
EE #4	35	$19,282.12	$0.00	$578.46	$385.65	$578.46	$1,542.57
EE #5	29	$17,146.57	$0.00	$514.40	$342.93	$514.40	$1,371.73
EE #6	51	$38,181.36	$0.00	$1,145.44	$763.63	$1,145.44	$3,054.51
EE #7	44	$27,135.45	$0.00	$814.06	$542.71	$814.06	$2,170.83
EE #8	30	$18,261.00	$0.00	$547.83	$365.22	$547.83	$1,460.88
EE #9	26	$17,501.00	$0.00	$525.03	$350.02	$525.03	$1,400.08
Owner’s	=	$260,000.00	$23,000.00	$0.00	$15,600.00	$145,000.00	$160,600.00
EE’S	=	$230,517.28	$0.00	$6,915.51	$4,610.37	$6,915.51	$18,441.39
TOTAL	=	$490,517.28	$23,000.00	$6,915.51	$20,210.37	$151,915.51	$179,041.39

In this second example, you have two owners with 8 employees. Ninety-six percent of the total contribution benefits the two owners and 4% of the total contribution benefits the other 8 employees.

NAME	**AGE**	**ANNUAL COMP.**	**ASSUMED DEFERRALS**	**SAFE HARBOR**	**PROFIT SHARING**	**CASH BALANCE**	**TOTAL AMOUNT**
Owner #1	52	$260,000.00	$23,000.00	$0.00	$16,562.00	$145,000.00	$161,562.00
Owner #2	50	$260,000.00	$23,000.00	$0.00	$16,562.00	$135,000.00	$151,562.00
EE #1	62	$38,701.36	$0.00	$1,161.04	$774.03	$1,064.29	$2,999.36
EE #2	40	$18,525.10	$0.00	$555.75	$370.51	$509.44	$1,435.70

EE #3	35	$19,282.12	$0.00	$578.46	$385.65	$530.26	$1,494.37
EE #4	29	$17,146.57	$0.00	$514.40	$342.93	$471.53	$1,328.86
EE #5	51	$38,181.36	$0.00	$1,145.44	$763.63	$1,049.99	$2,959.06
EE #6	44	$27,135.45	$0.00	$814.06	$542.71	$746.22	$2,102.99
EE #7	30	$18,261.00	$0.00	$547.83	$365.22	$502.18	$1,415.23
EE #8	26	$17,501.00	$0.00	$525.03	$350.02	$481.28	$1,356.33
Owners’	=	$520,000.00	$46,000.00	$0.00	$33,124.00	$280,000.00	$313,124.00
EE’S	=	$194,733.96	$0.00	$5,842.01	$3,894.70	$5,355.19	$15,091.90
TOTAL	=	$714,733.96	$46,000.00	$5,842.01	$37,018.70	$285,355.19	$328,215.90

The bottom line is that there are options available to help you effectively prepare for retirement, *no matter how soon it may be approaching*, but, knowing your options and preplanning are critical to achieving a successful retirement plan.