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Pensions Can Mean Big Tax Savings For Small Firms

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There's an ironic twist to the long-running decline of pension plans: They can be great tax-saving tools for small businesses.

The halcyon days of defined benefit plans, of course, have long since faded in America's rear-view mirror. For years, big and well-known companies have been freezing underfunded pension plans and leading a wholesale transition to an era in which workers bear the most responsibility for their lives after retirement.

But for small businesses with strong long-term cash flows, one kind of private pension, known as a cash balance plan, offers a way to set aside more tax-deferred earnings than traditional retirement accounts alone. Cash balance plans also shield assets from lawsuits against the sponsoring business, which is a key feature for doctors, lawyers and other professionals.

Cameron Short, a financial adviser with Stifel Financial Corp. (SF), says about 60% of his nationwide client base is composed of small medical practices, such as a partnership of five surgeons. Those types of clients typically want to set aside earnings for retirement beyond traditional IRS limits, while also making sure an unexpected malpractice lawsuit doesn't take a scalpel to their post-career income.

"This vehicle really fit the bill," said Short, who's based in Pittsburgh. Like many financial advisers, Short recommends contributing funds to a cash balance plan while also making maximum contributions to a traditional 401(k) retirement plan.

Cash balance pensions typically guarantee a defined lump sum (or cash balance) benefit at retirement, along with an option to convert that lump sum into a stream of income.

There are some important caveats, including a few extra administrative costs and a long-term commitment to setting aside funds. And unlike traditional 401(k) plans, in which employees bear the investment risk of their own account, employers bear the cost or benefits if a cash balance plan performs above or below expectations. And since the plans include actuarial accounting, the wrong mix of employee ages and tenures can make cash balance plans very costly.

They often make terrific sense for consistently profitable smaller companies whose owners want to save more money for retirement than is allowed under traditional defined-contribution plans, like a 401(k), while also providing key employees with an incentive to stick around in the future.

"Cash balance plans can provide a real retirement source for your most important employees, and in the meantime save very significant taxes," said Terry Siman, a tax attorney and president of Vantage Point Advisors Inc. in Lower Gwynedd, Pa. "When you start doing the math, it's overwhelming how much it can benefit the owner." In fact, Siman said, he uses a cash balance plan in his own financial planning.

Although cash balance plans are governed by rather complex regulations, including the Employee Retirement Income Security Act, financial advisers say administrative costs for standard cash balance plans have fallen sharply over the last decade as specialist providers have streamlined costs and services. What's more, the federal government recently laid down new rules that make it easier for employers to minimize their liability in funding a plan.

"If you have a profitable business, you'll be paying taxes," said Warren Ward, of advisory firm Warren Ward Associates in Columbus, Ind. "Would you rather give more to the government in taxes, or would you rather give a real benefit to the people who work for you?"

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