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Tax Law Provides Business Owners Options Using Retirement Plans

A significant goal in personal financial planning is saving for retirement. We are living longer with an average lifespan of almost 80, and an average retirement age of 62 – spending an average of 18 years in retirement. Compare this to when Social Security was formed in 1935 when the male life expectancy was 58 and female was 62. Social security didn't begin to pay out until age 65, so it was clear then that Social Security only paid benefits to a relative few. At the current birth rate, our average population age is 38 and growing by 0.2 years annually. Social Security benefits in the future will have to be significantly reduced or the program will collapse.

Fortunately, employees of most companies here in Orange County are offered a 401(k) plan, and some employees still enjoy a traditional pension plan. Not so fortunate for the average small business owner who faces unique challenges in saving for his or her own retirement:

- They often get a late start saving because they have invested every cent they have into their business.
- The IRS maximum contribution limits on 401(k) plans are too low to accumulate sufficient funds to provide adequate retirement income ($24,000 per year, assuming an owner age 50 or above).
- They may not be able to sell their business when they are ready to retire.
- As income rises, Social Security replaces a smaller percentage of income, and is capped at about $32,000 per year at full retirement age. Visit socialsecurity.gov/estimator to view your benefits estimate at various retirement ages.

A business owner is last in line when cash is short, he or she must borrow to purchase equipment and pay taxes on the company's profit each year and leave all earnings in the business for working capital. At age 50-60, after 20 plus years of hard work, the business is consistently profitable. Now they are only able to contribute into a 401(k) up to $24,000 per year. At age 65, they may have accumulated $160,000-$550,000. At a 4% withdrawal rate per year, this might replace 3-10% of the pre-retirement earnings.

The tax code offers companies the opportunity to establish a tax deductible Cash Balance Pension Plan. These plans allow business owners to accumulate up to $2.7 million through age 62, with tax deductible contributions, as well as tax-deferred investment earnings, just like 401(k) plans. The Cash Balance Pension Plan plus a 401(k) could replace up to 40-50% of pre-retirement earnings.

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In addition to replacing company income, these tax-qualified plans provide other significant benefits to a company and its owners:

- Diversification – for most business owners, their company is their single largest asset. A pension plan allows the business owner to contribute profits from the business with a tax deduction and invest it in other assets for a rainy day.
- The ability to retire – many business owners say they will never retire but things change. About 45% of people retire earlier than planned often due to illness.
- Succession planning – owners with a well-funded retirement are not necessarily forced to sell the business at an inopportune time; they can afford to wait for the right buyer and get a better price.
- Creditor protection – Cash Balance Pension and 401(k) retirement plan assets are fully protected under both federal labor and bankruptcy laws. Even if your business were to collapse and you had to file for bankruptcy, your retirement account would be safe and secure.
- Employee retention – Employees will remain loyal since they most likely will have vesting requirements up to six years. This can be one of the best tools for retaining and rewarding hard-working employees.

In summary, setting up the right retirement plan is critical to enabling many business owners to retire in the style they are accustomed to.

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