MONEY MATTERS — Tax and financial planning strategies

Pension plans – A primer

By Jacob Ansel

> **A pension is a account that an employer maintains to provide a fixed payout for retirement. For most folks retirement is the farthest savings thought and that's a big mistake. It should be priority one.**

THERE ARE SEVERAL TYPES OF pension plans available to small and large businesses alike. Pension plans are designed to help employees and owners save for retirement. If you retire at 65, how much will you need in a pension plan to live the rest of your life without worrying about money? There's no easy answer to this, but with the value of the dollar and rising costs it makes sense to sock away as much as you can while you're still working.

Most folks start their working lives at 24 with an option to contribute to a company pension plan. Most don't. Many wait until their mid-30s with a house, children, and a dozen other obligations to start socking away money. The best thing to do is start contributing to a pension plan the moment you enter the workforce and never stop. Today, you can contribute $17,500 to a 401(k) plan. If you do this from 24 to 65, you'd amass $717,000, plus the earnings on the pension fund, easily a million bucks by retirement. Sounds like a lot, but if you live until 85 that's just $50,000 a year, before taxes.

There are several types of pension plans, each one has its own rules and contribution limits. It's best to seek a professional pension consultant to help design a plan to fit your needs. The five most popular plans are a traditional 401(k), Roth 401(k), profit sharing, defined benefit, and cash balance.

A 401(k) is designed as a salary reduction pension and normally reduces the taxable income reported to the IRS and the state. The limit on a 401(k) plan for 2013 is $17,500. The contribution usually goes into a self-directed investment allocation setup with a known brokerage firm able to take in 401(k) contributions and track the earnings tax deferred. Since the earnings are tax deferred taxes are paid when the money is withdrawn.

A Roth 401(k) doesn't reduce taxable income on a personal return so it's not tax deferred. But the earnings on the Roth are tax free with zero tax penalty when withdrawn. An analysis should be done to decide whether a Roth 401(k) or a traditional 401(k) works best for you.

A profit sharing plan is a company designed plan used to increase your contributions. It's generally the most flexible retirement plan. The general rule is 25% of your salary can go into a profit sharing plan with a maximum contribution of $33,500 when used in conjunction with a 401(k) plan. The contribution is normally allocated to plan participants in proportion to their compensation. If you take the maximum contributions for a 401(k) and a profit sharing plan, you can contribute a max of $51,000 yearly.

A defined benefit plan (DBP) is mostly used for highly compensated individuals at a company with few employees. The DBP aggregates the funds with the promise to pay a specific monthly benefit to an employee. This is a complicated plan – an actuary is used to calculate benefits – but the benefits are extraordinary. The more employees, the more you have to contribute. The ideal candidate for a DBP is an individual earning more than $255,000 a year with an S Corp or LLC and additional K-1 earnings. The maximum plan limitation is actuarially determined, based on age and other factors, so it varies from person to person, company to company.

A cash balance plan is a type of DBP that resembles a defined contribution plan. That's why these plans are called hybrid plans. A traditional DBP promises a fixed monthly benefit at retirement, usually based on a formula that includes the employee's compensation and years of service. A cash balance plan looks like a DBP because the employee's benefit is expressed as a hypothetical account balance instead of a monthly benefit. Employees appreciate this design because they can see their accounts grow, but are still protected against fluctuations in the market. In addition, a cash balance plan is more portable than a traditional DBP since all plans allow employees to take their cash balance and roll it into an IRA when they terminate employment or retire.

So the takeaways? Pay yourself before others. Set up a retirement plan and contribute the max every year no matter the plan. And it's never too early to start saving for retirement. ❑

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