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The Beauty of a Cash Balance Buy-Out Tool

(AUGUST 10, 2010)
BY STEPHEN J. BUTLER

Today many businesses, including accounting firms, have a sobering problem when it comes to

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It can be difficult to negotiate a sale of an owner's interest, and finding a way to pay for it is an even greater challenge.

A unique retirement plan variation can grease the skids of an exit strategy and leave all parties in a win-win situation. This involves the creative use of a special retirement hybrid known as a cash balance plan. In the context of a partnership buy-out, a cash balance plan can be incorporated as an overlay to a existing 401(k) plan and create the opportunity for massive retirement plan contributions for older people in their 60s. By massive, I mean something in the neighborhood of $150,000 p year for many business owners approaching retirement.

The typical dilemma for younger owners of a professional practice stems from their need to come up with after-tax dollars to buy out a retiring partner. This means that a payment of $500,000 will cost $1 million in pre-tax dollars. Then, the dollars are taxed at capital gains rates to the departing partner who, if an original founder of the business, probably has a cost basis of zero. Therefore, the entire amount of the sale proceeds will be taxed at capital gains rates. In simple terms, over half of all the money required at the start of the transaction wil be paid in taxes by a combination of the buyer and seller.

The beauty of incorporating a cash balance plan into the mix is that the contributions are a tax- deductible expense for the firm and its remaining younger business owners. For the sell the deposits are tax-free — or at least tax-deferred — until the retiring seller starts spending the money years later in retirement. Moreover, the money in the plan can be invested and compound on a tax -deferred basis over the years.

In an actual example of a small firm with an owner and a handful of employees, we can start by calculating a yearly "service credit" for each year the firm's owner has worked. In an act recent case, this turned out to be $25,000 a year for the 25 years this professional had been self-employed — a total of $600,000 becomes the "opening balance." ("Opening balance" i another way of saying that this is what he should have had by now if he had started saving years ago.)

Since he wants to retire in five years, we extend the $25,000 annual service credit out for that length of time compounded at 6 percent per year. We also compound the $600,000 open balance out for five more years at 6 percent. The total of the two numbers is just under $1 million.

Now, we work backwards to determine how much money has to be contributed over the next five years to accumulate the $1 million lump sum funding level we have just calculated. Ar annual tax-deductible contribution of $175,000 earning 6 percent for the next five years will do the trick. Fortunately, with the business (at least) in its prime of life, this owner could affo to make those tax-deductible contributions.

Meanwhile, what about other employees in this small firm? Well, the typical turnover at small firms generally means that not many folks have worked long enough to have accumulated much in the way of an "opening balance." This reduces the lump sum to be funded for them. Also, their younger ages as a group allow us to use a much lower service credit. The servic credit for the business owner was 12.5 percent of current salary.

The other employees had 2 percent of their current salary service credit, because hypothetically, they had the advantage of about thirty years until retirement. This meant that the business owner contributed about $15,000 for a handful of younger employees as a cost for the right to contribute $175,000 into his own account. A further advantage is that each employee has his or her own specific account. They can actually see their money as opposed to just a vague promise of an "accrued benefit" that may or may not be adequately funde

The cash balance plan, in this small company environment, offers a tremendous advantage for older business owners or professionals. This example was extreme, to illustrate the poir but this vehicle can be incorporated as an overlay to existing 401(k) plans to "supercharge" the contribution levels and accomplish more for senior owner/employees who find themselv "behind the retirement eight-ball." Employers view their contributions for employees (required of only the lowest-paid half of the non-owner employees) as a good bargain. The thought process says, "I'm just giving to my associates a portion of what I otherwise would have paid in taxes."

This example above is small and simple to illustrate the mechanism. When the tool is used to fund the business interest buyout of a senior partner, younger partners are treating the substantial retirement plan contribution as installment payments for his or her ownership interest.

People selling business interests later in life too often assume the value of their stock amounts to what they have calculated as that final nut to fund their retirement lifestyle — and the sales price in their mind's eye has been "grossed up" to cover what the estimated capital gains tax on the sales proceeds. Either that, or the sellers have some round number in their heads like $1 million. The nicest people in the world can rationalize what's in their self-interest. Buyers, of course, only care about what the business can support financially and remain going concern. Emotional benchmarks mean little or nothing, and this disparity in priorities can bring negotiations to a standstill.

Judicious use of the cash balance plan — before it gets too late — begins the process of eating the elephant one bite at a time. Practiced over a number of years as part of the sales process, it relieves the pressure of having to come to terms with a single, final, large number.

Steve Butler is the founder and president of Pension Dynamics Corporation, a retirement plan consulting and administration company, in business since 1980. He can be contacted at ***sbutler@pensiondynamics.com*** *or* ***http://www.pensiondynamics.com****.*