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Retirement Plan Administrators, Consultants, Actuaries

Defined Benefit Plans

New interest in traditional pensions

Defined benefit plans are making a comeback for small business owners! In recent years the advantages of defined benefit plans – often described as traditional pension plans – have been over shadowed by the popularity of defined contribution plans such as 401(k) and profit sharing. But a defined benefit plan may be just the answer for a small business owner concerned about adequate retirement planning.

What has generated this new interest in defined benefit plans?

1. The aging of the baby boomer generation has led to a heightened awareness of the need for adequate savings at retirement.
2. An increase in the maximum benefits allowable for defined benefit plans has increased the amount of contributions that can be made to the plans to fund those benefits, and
3. New legislation (effective for plan years beginning in 2000) repealing what is known as “combined plan limits” will mean more retirement planning flexibility and substantially increased benefits and contributions.

What is a defined benefit plan?

A defined benefit plan promises the participant a specific benefit at retirement – a “defined benefit”. The two most common forms of benefits are ***flat benefits*** and ***unit benefits***.

Flat benefit example: At age 65, the participant will receive an annual retirement benefit equal to 50% of the participant’s average compensation. If the participant’s average compensation is \$50,000, the participant would receive retirement payments of \$25,000 a year.

Unit benefit example: At age 65, the participant will receive an annual retirement benefit equal to 2% of average compensation for each year of service. If the participant’s average compensation is \$50,000, and the participant has 20 years of ser-

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vice with the employer, the annual retirement payment would be \$20,000. If the same participant has only 15 years of service, the annual retirement payment would be \$15,000.

How do defined benefit and defined contribution plans differ?

Defined benefit plans promise a certain benefit at retirement, but defined contribution plans make no promises about the amount of retirement benefits. In defined contribution plans, retirement benefits are the accumulation of contributions, investment gains *or losses* and, in some plans, forfeitures.

Also, defined benefit plan contributions are made to a general fund which is used to provide the promised benefits for all plan participants. In a defined contribution plan, however, contributions are allocated to participants' individual accounts.

Why are defined benefit plans becoming so attractive for an aging generation?

For an aging business owner who has had a little chance to save for retirement, a defined benefit plan is an excellent way to make up for lost time. Because a defined benefit plan promises a specific benefit, that benefit must be funded over the available time. For an older participant who has fewer years until retirement, there are fewer years to amass the needed funds. This can mean significantly larger contributions for an older participant over a relatively short period of time. *And because a defined benefit plan is a qualified plan, the contributions are tax deductible to the employer.*

Here is a simple example:

XYZ, Inc.'s owner and president, Tom, age 55, earns \$150,000 per year. He started the company 15 years ago when he was 40, and he wants to retire in 10 years at age 65. XYZ, Inc. has only two other employees: Ann, age 40 who earns \$35,000 per year and Jim, age 25, who earns \$27,500.

XYZ, Inc. hasn't had any type of retirement plan, but business is excellent, and Tom is feeling increasingly anxious about having adequate funds for retirement. He would like for the company to be able to contribute as much as possible to a retirement plan for himself and his employees.

Look at how XYZ, Inc.'s contributions would compare for maximum defined benefit and defined contribution plans:

	Defined Benefit Plan	Defined Contribution Plan
Tom	82,717	30,000
Ann	5,962	8,750
Jim	1,661	6,875
Total	90,340	45,625

Under the defined benefit plan, Tom will receive annual retirement payments of \$116,667 at age 65. Under the defined contribution plan, Tom's retirement benefits will depend on the amount of his account balance at retirement.

Although the defined plan's contributions may vary from year to year, 92% of the defined benefit plan's costs are for Tom's benefit instead of 66% of the contributions to the defined contribution plan.

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How are contributions calculated for defined benefit plans?

An actuary annually calculates how much money must be contributed for the plan to meet its future obligations. The actuary's calculations depend on many factors including:

- The ages of the plan participants,
- the normal retirement ages specified by the plan (e.g., 65,62,60),
- the manner in which benefits will be paid at retirement (e.g., lump sums or various forms of annuities),
- the amount of forfeitures left in the plan by partially vested, terminated participants,
- the actual performance of the plan's investment portfolio, and
- certain actuarial assumptions.

What are actuarial assumptions?

Actuarial assumptions are educated guesses as to such factors as mortality (how long the participants are expected to live), interest rates (the rate at which assets are expected to grow), turnover (how many participants can be expected to leave the plan each year) and salary scale (how salaries might be expected to increase).

Is there a maximum annual retirement benefit that the plan can promise?

Yes. Subject to an employee's years of service and "Social Security Retirement Age", the maximum annual benefit that may be paid is the lesser of (1) \$130,000 or (2) 100% of the participant's high three-year average compensation. In other words, an employee who has compensation of \$160,000 would be limited by the dollar amount to a maximum retirement benefit of

\$130,000; an employee who has average compensation of \$100,000 would be limited by the percentage amount to a maximum retirement benefit of \$100,000.

The dollar limitation is adjusted for cost-of-living increases and has gone from a limit of \$90,000 in 1987 to the current level of \$130,000.

What is the Social Security Retirement Age?

Social Security Retirement Age means the age used as the retirement age under the Social Security Act and is determined by the employee's years of birth. To qualify for the maximum dollar or percentage benefit, an employee must reach Social Security Retirement Age. For example, an employee born in 1937 will reach Social Security Retirement Age at age 65, but an employee born in 1947 will reach Social Security Retirement Age at age 66.

Year of Birth	Social Security Retirement Age
Before 1938	65
After 1937 but before 1955	66
After 1954	67

Will years of service limit the maximum benefit?

Yes, it is possible that both an employee's years of service with the employer and years of actual plan participation may limit the dollar and percentage maximums.

Dollar limitation: To qualify for the maximum dollar benefit of \$125,000, a participant must have at least 10 years of participation in the plan.

Percentage limitation: To qualify for the

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maximum 100% of compensation benefit, a participant must have at least 10 years of employment with the plan sponsor.

Nondiscrimination requirements: To reduce the potential differences in the rates at which benefits accrue between older and younger employees, a flat benefit plan may require that the maximum plan benefit must accrue over at least 25 years.

How will repeal of the “combined plan limits” benefit a small business owner?

The repeal of the complex combined plan limitations under Code §415(e), effective in the year 2000, will allow a small business owner who is nearing retirement to sponsor a defined benefit plan without reduction of benefit limits because of participation in a defined contribution plan.

Under current law, participants in both an employer’s defined benefit and defined contribution plans are prohibited from receiving the maximum allowable benefits under both plans, *even if one of the plans has been terminated many years before*. Beginning in the year 2000, participants will be able to participate fully in each plan.

Is it too soon to get excited about the repeal of the combined plan limitations?

Not at all! Although maximum benefits may be limited under current law, 10 years of plan participation are required to qualify for the maximum dollar benefit of \$125,000. So for a participant nearing retirement age, early plan participation can mean a greater potential retirement benefit.

Are there any special administrative requirements for defined benefit plans?

Yes. Because defined benefit plans provide significantly greater tax shelters to small businesses, the IRS and Congress have setup intense regulatory requirements for their administration. As a result, competent, expert, professional guidance is a must for effective plan design and operation. Two of the more important administrative considerations are (1) the role of the actuary and (2) coverage by the Pension Benefit Guaranty Corporation (PBGC).

- (1) An enrolled actuary – an actuary licensed to practice in the area of defined benefit plans – certifies the amount the employer must contribute to meet the plan’s current and future obligations.
- (2) The PBGC – a non-profit government insurance company – insures the retirement benefits of certain defined benefit plans and charges plan sponsors annual insurance premiums for the coverage.

Would a defined benefit plan make sense for you and your business?

We think these plans offer an exciting opportunity to build a tax-deferred retirement fund, to enhance retirement benefits and to maximize contributions made on the business owner’s behalf. Whether in designing and administering a new plan or in improving an existing plan to better meet your needs and objectives, we can help. We hope you’ll call.