SUMMIT

Benefit & Actuarial Services, Inc.

Defined Benefits Plans – Basics

- Unlike other types of plans, contributions are actuarially determined as the amount necessary to make sure that there is enough money to pay retirement benefits to each participant.

- Plan assets are *always* pooled and invested by the Trustees of the plan. *Participants cannot select investments*. Their benefits are not affected by the asset performance of the plan. If the assets do poorer than the actuary assumes then the contribution increases over time. If they do better than the actuary assumes, then the contribution decreases over time.

- A participant's interest in a Defined Benefit Pension Plan is based upon the plan's provisions, participant information and statutory limitations. It is never based on the performance of the plan assets.

- An enrolled actuary must certify the plan each year on Schedule SB, attached to Form 5500.

- Depending on the degree of overfunding or underfunding, there may be little funding flexibility (e.g., the ability to vary the amount of contribution from year to year). Plans can be *occasionally* amended if this is necessary, and as long as this is done early in the plan year, the amendment will change the required contribution for that year.

- Benefits are pre-set by the formula in the plan document:
  - Example: 50% of final average pay, reduced 1/25 for each year of service less than 25
  - Example: 1% of final average pay, multiplied by years of service (up to a maximum of 30 years)
  - Example: $1,000 a month for each year of participation to a maximum of 10 years for owners; Top Heavy minimum benefits for all other participants.

- There is no limit on the annual contribution. The limit is on the amount of the benefit that can be paid from the plan. Usually the contribution for higher paid employees is a lot more than the $58,000 defined contribution maximum. See contribution grid for the estimated maximum allowable contribution at different ages

- If the plan sponsor has both a defined benefit plan and another defined contribution plan, the deductible limit depends on how much is contributed to the defined contribution plan:
  - If more than 6% of payroll is contributed to the profit sharing plan, the limit is generally 31% of payroll;
  - If 6% of payroll or less is contributed to the profit sharing plan, then the minimum required contribution for the defined benefit plan is deductible if this is more than 31% of payroll;
  - If the defined benefit plan is subject to PBGC, there are generally no limits on deductibility.

- DB plans provide significant advantages over a defined contribution plan if the plan sponsor has surplus cash. Older business owners have the ability to save more rapidly for retirement:
  - Defined contribution plan: maximum contribution is $58,000 per year

- Defined benefit plan: maximum contribution is determined by the actuary – see contribution grid for the estimated maximum allowable contribution at different ages

- Sponsors need to make a commitment to the DB plan for minimum of five years. There is a permanency requirement for retirement plans. Exceptions: prove a valid business reason for early plan termination.

- An employer who maintains a Defined Benefit Pension Plan must pay annual premiums to the Pension Benefit Guaranty Corporation (PBGC), unless it is an owner and spouse plan, or a plan sponsored by a professional service corporation with less than 25 participants. The premiums are based on the number of participants in the plan and plan's funded status. The annual premiums are $86 for each participant covered under the plan. In subsequent years, the per participant premium may be greater than $86 depending on the plan's funded status.

- A Defined Benefit Pension Plan covered by the PBGC may not terminate unless all employees are paid what they are due under the plan. The employer may make additional contributions to fully fund benefits or 50% or more Shareholders may waive a portion of their benefits.

- If a Defined Benefit Pension Plan terminates with excess assets, and these assets are not, or cannot be allocated to the Participants as additional benefits, then these monies are refunded (reverted) to the sponsor with 20% or 50% excise taxes. The excess can be transferred without penalty into a successor defined contribution plan if the excess can be allocated within seven years.

- It is a process to terminate a Defined Benefit Plan that requires submission to the IRS and to the PBGC.

<u>Examples of Plan Design</u>

EXAMPLE. Kevin owns a small business with his wife and son. Kevin and Karen are in their early 60's and draw a combined salary of about $75,000 per year from the corporation. In addition, the corporation has about $300,000 in retained earnings that it needs to dispose of before they retire in four years. The spouses have income from other sources, and they can afford to reduce their combined salary from $75,000 down to $50,000. A defined benefit plan will allow the company to shelter approximately $100,000 per year. By contributing $75,000 of the retained earnings plus the $25,000 that would have been drawn in salary, the couple can accumulate a substantial retirement benefit. The combined monthly retirement benefit will be approximately $3,000. If they opt for a lump sum, approximately $425,000 can be rolled over to an IRA.

EXAMPLE. Sally, age 60, makes over $290,000 per year and has been contributing maximum amounts to a profit sharing plan for the last 15 years. Sally can set up a defined benefit plan funding a benefit of approximately $9,600 per month at age 65 at an annual contribution of approximately $241,200.