Defined Benefit Plan

A "Next Level" Retirement Plan

With the passage of the Pension Protection Act of 2006, (PPA '06), small businesses and self-employed individuals have even greater flexibility designing their pension plans. Unlike 401(k) and profit sharing plans, defined benefit plans are not subject to a $55,000* individual allocation limit, nor is the employer tax-deductible contribution limited to only 25 percent of the "eligible payroll."

A defined benefit plan is very different from a 401(k) or other defined contribution plan. That's because the retirement benefit is known (as selected by the employer), and the necessary contribution is calculated to fund that benefit at "normal retirement age." By contrast, the profit sharing contribution is known, but the future retirement benefit will vary with investment performance.

A traditional defined benefit plan may include a pre-retirement survivor benefit funded by life insurance. The funding rules under the PPA '06 create a flexible range of deductible contributions to fund both the retirement benefits and the death benefits. The plan also provides flexibility in the choice of funding vehicles that may be used, allowing risk-averse individuals to choose guaranteed life insurance and annuity products. Individuals who have a higher level of risk tolerance may choose from other products available for qualified plan investments.

Who Should Consider This Plan?

A Defined Benefit pension plan will reward high-income, mature participants (e.g., baby boomers will benefit far more than Generation X). In fact, age is more important than salary when calculating the anticipated annual cost for the benefit because older individuals have fewer years to reach the assumed retirement age and benefit.

Making a Commitment

Unlike a profit sharing plan, a defined benefit plan must be funded each year. This means that even in a "bad year," the pension plan contribution must be made because the benefit is promised by the employer. The employer must fund for benefits that have been earned. Benefits typically are earned when a participant works the requisite number of hours defined in the plan document.

The stability of the employer is an important consideration. Because a defined benefit plan is a fixed obligation and contributions are not discretionary, the sponsor should have both stable earnings and a relatively stable employee population so that future employee benefit expense does not become an issue.

To make sure that each employee is guaranteed to receive a benefit, the federal government requires most defined benefit plans to pay insurance premiums to the Pension Benefit Guaranty Corporation (PBGC).

The following example shows a sole owner, age 57, of an S-Corporation. He consistently earns more than the maximum IRS annual compensation limit of $275,000.*

Census Data			Contribution Amounts	
Position	Age	Salary Limit on Annual Compensation	Contribution	Survivor Benefit with Whole Life Insurance
Owner	57	$275,000	$163,664	$2,300,000

Retirement Benefits

The maximum benefit allowable in 2018 is 100 percent of pay, not to exceed $220,000 per year. This maximum amount is reduced if retirement occurs prior to age 62 or if the participant has fewer than ten years of participation in the plan. The maximum benefit increases if retirement occurs after age 65.

Generally, the benefit is expressed in terms of monthly income at normal retirement age (e.g., $18,333 each month for a maximum plan). However, most small-business plans will offer a lump-sum option in lieu of a monthly benefit. In our prior example, this benefit is converted to a little more than $1.8 million, which may then be rolled to an IRA or successor defined contribution plan. With all defined benefit plans, the lump sum limit is defined by IRC 415(b)(2).

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Enhanced Survivor Benefits

A Defined Benefit plan provides the plan sponsor flexibility in designing both the retirement and the pre-retirement survivor benefits. Whole life and universal life policies are permitted funding vehicles within the Defined Benefit plan.

IRS rules limit the amount of life insurance that can be purchased. The premium must be less than 66 2/3 percent of the theoretical contribution that would be required under the individual level-premium funding method to fund benefits under the plan. The premium for universal life insurance cannot exceed 33 1/3 percent of the theoretical contribution.

Plan Funding

Under the Pension Protection Act of 2006, the funding of defined benefit plans is determined by calculating the present value of benefits accrued up to the first day of the plan year (the funding target) plus the present value of benefits accrued throughout the plan year (the funding normal cost), plus the shortfall amortization charge, if any. The significant departure from pre-Pension Protection Act funding rules, which focused on funding toward projected benefits and not benefits accrued to date.

The addition of the life insurance to the plan creates a death benefit that is earned on the first day of the plan year and thus increases the plan's funding target.

Plan Administration

Before you can make contributions to a Defined Benefit plan, a Plan and Trust must be established. Security Administrators, Inc. (SAI), a wholly owned subsidiary of Security Mutual Life Insurance Company of New York, can provide assistance at a competitive price. The plan must be adopted by the last day of the employer's tax or fiscal year (e.g., December 31 if you have a calendar-year business).

A Defined Benefit plan will require an annual actuarial valuation to determine the cost of the promised benefits and IRS reporting, including an Enrolled Actuary's certification that the plan is funded properly. Administrative fees are generally deductible.

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*Limit for 2018