

# Traditional Defined Benefit Plan

**The basics:** Employer contributes an actuarially determined amount sufficient to pay each participant a fixed or defined benefit at his or her retirement.

## How It Works

- Employer contributes an actuarially determined amount each year to the plan.
- Employer contributions are tax deductible.
- Contributions are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging<sup>1</sup>, or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA<sup>2</sup> or to another employer plan if that plan will accept such a rollover. Federal law allows retirement distributions to employees who are at least age 62 even if they have not separated from employment at the time distributions begin.



## Methods of Defining the Benefit

- **Level percentage plan:** Example - The benefit is equal to 50% of compensation<sup>3</sup>, reduced by 1/25 for each year of participation less than 25 years.
- **Step rate service weighted for prior service:** Example - The benefit is equal to 8% of compensation<sup>3</sup> for the first ten years of service plus 5.2% of compensation<sup>3</sup> for all other years, but not to exceed a total of 33 years.
- **Service plan:** Example - The benefit is 2.5% of compensation<sup>3</sup> for each year of service. Younger participants – with a potentially longer working career – may also be favored if the benefit formula is service related.
- **Plan participation:** Example - The benefit is 5% of compensation per year of participation with a maximum of 20 years.
- **Top-heavy plans:** If the present value of the accrued benefits of “key” employees<sup>4</sup> is 60% or more of the total value of all accrued benefits, the plan is top heavy. In that instance, the plan must provide for a minimum level of benefits for “non-key” participants.

<sup>1</sup> Those born before 1936 may be able to elect 10-year averaging or capital gain treatment; these strategies are not available to those born after 1935.

<sup>2</sup> Beginning in 2008, distributions from qualified retirement plans, IRC Sec. 457 plans, and tax-sheltered annuities may be rolled directly into a Roth IRA. These rollover distributions are taxable events, subject to the same requirements as a Roth conversion.

<sup>3</sup> For those self-employed, compensation is limited to “net” self-employment income, e.g., gross income less the contribution and the deduction allowed for one-half of the self-employment tax. In 2008, \$230,000 is the maximum income that may be considered. In unusual circumstances, the required contribution may exceed the allowable deduction, which can trigger an excise tax.

<sup>4</sup> A “key” employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded \$150,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded \$150,000.

*Continued...*

# Traditional Defined Benefit Plan

## Additional Considerations

- **Investment of plan assets:** Investments must be diversified and prudent. Subject to plan provisions, plan assets can be invested in equity products like mutual funds, stocks and debt-free real estate; or in debt instruments like T-Bills and CDs. Insurance products like life insurance and annuity policies may also be used.
- **Social Security integration:** Since the employer already contributes to the employee's Social Security retirement benefit, these benefits can be integrated into the benefit formula of the plan.
- **Parties which are favored:** Usually favors older employees.

## Maximum Benefit

Maximum benefit under a defined benefit plan is measured in two ways:

- **Percentage:** The retirement benefit cannot exceed 100% of the average compensation<sup>1</sup> for the highest three consecutive years of employment. This is reduced by 10% for each year of service less than 10.
- **Dollar amount:** The maximum annual dollar benefit is indexed at \$185,000 per year (2008) for retirement at age 62. For retirement prior to age 62, this amount is actuarially reduced. Retirement at age 55 would typically produce a maximum annual benefit of approximately \$100,000, depending on the number of years of participation. The dollar amount will also be increased for retirement after age 65, subject to the percentage and dollar limitations. Lastly, if the individual has fewer than 10 years of participation at normal retirement age, the dollar amount is reduced proportionately.

## Contributions

The table below illustrates hypothetical first-year contributions for an employee retiring at age 62 with at least 5 years of plan participation. In all instances, the employee's compensation is \$185,000 or more. The benefit is 10% of compensation per year of plan participation, which provides the IRS maximum annual benefit per year.<sup>2</sup>

Current Age	1st Year Contributions
30	\$48,066
35	61,557
40	78,873
45	101,094
50	129,626
55	140,351
60	179,506

<sup>1</sup> For those self-employed, compensation is limited to "net" self-employment income, e.g., gross income less the contribution and one-half of the deduction allowed for the self-employment tax.

<sup>2</sup> The Pension Protection Act of 2006 permits a plan sponsor to contribute and deduct an additional amount, generally 50% of the plan's funding target, as advance funding for future plan years.

*Continued...*

# Traditional Defined Benefit Plan

## First-Year Contributions

A number of assumptions must be made in determining the amount of current contributions necessary to accumulate the future retirement benefit. The list below includes some of these assumptions.

- Death benefits
- Retirement age
- Form of annuity
- IRS Requirements
- Various government interest rates
- Interest rate on earnings
- Annuity rates at retirement
- Statutory requirements and limits
- Participants' current ages
- Compensation

## Annual Contributions

Year-to-year contributions will fluctuate based on the following items.

- Earnings on previous contributions
- Gains and losses on investments (realized and unrealized)
- Participants' actual compensation
- Death of participants before retirement
- Disability retirements
- Age mix of participants
- Turnover in participants
- Cost of annuities at retirement
- Rate of vesting
- Timing of contributions
- Assumptions mandated by IRS
- Funding limits and requirements of the Internal Revenue Code
- Legal/actuarial requirements
- The Pension Protection Act of 2006 mandates a new uniform method of calculating minimum required contributions effective in 2008.

*Continued...*

# Traditional Defined Benefit Plan

Annual funding is done on the assumption that each participant will retire. Accrued benefits are earned each year, and if the participant does not work until scheduled retirement, he or she will not be entitled to the entire benefit.

## Advantages to Employer

- A.** Contributions are tax deductible.
- B.** Can reward long-term employees with a substantial retirement benefit even though they are close to retirement age.
- C.** Larger contributions for older employees may reduce corporate tax problem; e.g., excess accumulated earnings, high tax bracket current earnings, etc.
- D.** Forfeitures of terminating employees will reduce future costs.
- E.** It can provide employees with permanent life insurance benefits that need not expire or require costly conversion at retirement age.
- F.** The employer directs investments.
- G.** If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than \$5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds \$1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than \$1,000.

## Advantages to Employees

- A.** Annual employer contributions are not taxed to the participant.
- B.** Earnings are not currently taxed.
- C.** Participants may also have a traditional, deductible IRA (subject to certain income level limitations), a traditional, nondeductible IRA, or a Roth IRA.
- D.** There is the ability to purchase significant permanent life insurance, which is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.
- E.** Employee is guaranteed a known retirement benefit.
- F.** Participant may borrow from the plan within certain guidelines if provided for in the plan documents.

*Continued...*

# Traditional Defined Benefit Plan

- G.** Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

## Disadvantages to Employer

- A.** In low profit years, the employer is often still obligated to make contributions.
- B.** Even if profits are low, there is less flexibility with the level of contribution than with some other types of plans.
- C.** Investment risks are on the employer.
- D.** Administration costs are usually higher because an actuary must certify as to the reasonableness of the contribution and deduction (unless it is a fully insured plan).
- E.** Participants often do not understand the defined benefit plan as easily as they do other types of plans.
- F.** If there are rank and file employees and the plan terminates, there may be insufficient assets to pay all accrued benefits. The shortfall must be made up by either the business making a contribution, or by the assets being reallocated from owner-participants to nonhighly compensated participants.
- G.** When a plan terminates, it may find that there are surplus assets which may not be distributed to participants. Any such surplus returned to the employer is subject to a 50% (20% in some instances) excise tax.
- H.** An employer with an older work force may find the cost of a defined benefit plan to be prohibitively expensive.
- I.** If a small defined benefit plan terminates with insufficient assets, the rank and file participants receive the full value of their benefits, while the business owners receive the remaining balance. If there are insufficient assets, the pension benefit guarantee corporation (PBGC) will guarantee some benefits

## Disadvantages to Employees

- A.** Younger employees will generally not receive as great of a benefit as they would under other types of plans.
- B.** The plan concept is more difficult to understand.

# How a Traditional Defined Benefit Plan Works



## Employer

- Employer contributes an actuarially-determined amount sufficient to pay each participant a fixed or defined benefit at retirement.
- Employer contributions are tax deductible.



## Employee

- Employee has a known retirement benefit.
- Maximum retirement benefit is the lesser of \$185,000 per year<sup>1</sup> or 100% of the individual's average compensation for the three highest consecutive years.<sup>2</sup>

## Traditional Defined Benefit Plan

- Employer contributions are not currently taxable to employee and earnings accumulate tax deferred.
- Investment risk remains on employer. Investments must be diversified and prudent. Both equity and debt investments may be used.
- Retirement benefit is typically defined as a percentage of compensation for each year of service or participation.

## Early Withdrawal

- A 10% penalty generally applies if withdrawals are made before age 59½.
- Some exceptions to 10% penalty are available.
- Employee may borrow from plan within certain guidelines if provided for in plan documents.

## Retirement

- Distributions must begin by specified date.<sup>3</sup>
- Funds may be distributed as lump sum or periodic payments.
- Distributions are generally taxed as ordinary income and may be eligible for 10-year income averaging or rolled over into an IRA.

## Death

- The PV of the accrued retirement benefit is usually included in owner's gross estate.
- Proceeds can pass to surviving spouse with payments made over survivor's lifetime.
- Income/estate taxes can severely reduce funds left to nonspousal heirs.

<sup>1</sup> These are 2008 limits. This amount is subject to indexing for inflation. Applies when retirement occurs at age 65 or the Social Security normal retirement age, if later.

<sup>2</sup> The 100% is reduced by 10% for each year of service less than 10.

<sup>3</sup> Except for more than 5% owners, distributions must begin by the later of (1) April 1 of the year following the year in which the participant reaches age 70½, or (2) the year following the year in which the participant retires.