Defined Benefit Plans

Most people are familiar with 401(k) plans and profit sharing plans; however, plans like these account for only 60% of qualified retirement plan assets. The remaining 40% is found within defined benefit plans, despite the fact that only 7% of qualified retirement plans are defined benefit plans[1]. Defined benefit plans can be a powerful alternative or addition to a 401(k)/profit sharing arrangement, enabling employers to turn tax dollars into retirement benefits.

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A. Defined Contribution Plans

401(k) plans and profit sharing plans are a form of defined contribution (or “DC”) plan. A DC plan is a plan where the plan does not define the benefit at retirement. Instead, the benefit at retirement is determined by the annual contributions and the actual investment earnings/losses realized by those contributions. In other words, the contribution is defined, not the benefit.

In a DC plan, a separate accounting is maintained for each employee and each year the account is credited with the actual contribution and actual earnings. The maximum contribution that can be made on behalf of any individual in a DC plan is $54,000 for years ending in 2017 (with an additional “catch-up” contribution of $6,000 available if the participant is at least 50 years of age at calendar year-end and a 401(k) plan is maintained).

B. Defined Benefit Plans

In a defined benefit (or “DB”) plan, the plan defines the benefit that will be paid at retirement age (or earlier separation from employment). An actuary determines the annual amount that must be deposited into the DB plan on an annual basis to provide the benefit called for under the terms of the plan. In addition to the benefits to be paid, the actuary takes into account an expected rate of return and other factors (e.g., mortality) when determining the required contribution each year. The actual investment results can serve to cause the required contribution to increase or decrease from year to year based on whether or not they exceed projected returns. The investment results do not alter the benefit the employee receives.

1. Traditional DB Plans

As a general rule, traditional DB plans will have a uniform retirement benefit formula that applies to all participants. Typically, that means two employees with similar participation and similar compensation will have earned the same amount of benefit. But because a younger employee will have many more years before retirement than an older employee, the annual cost to cover an older employee will be greater (sometimes much greater) than the younger employee's cost.

In a traditional DB plan, a participant will receive a retirement benefit defined as some percentage of pay or some flat dollar amount. For example, a DB plan may provide that each participant will receive a monthly retirement benefit of 2% of average pay for each year of service with the employer. A participant with 30 years of service and average pay of $50,000 would then receive an annual retirement benefit of $30,000.

There is no maximum contribution that can be made to a DB plan per se. Instead, the retirement benefit that can be paid from a defined benefit plan is limited. Under the law, an employee with 10 years of participation in a DB plan can receive a benefit up to $215,000 per year beginning at age 62, or an equivalent lump sum of approximately $2.6 million. Accordingly, over the employees’ working life, the plan can accept contributions necessary to pay this benefit.

2. Cash Balance Plans

A cash balance plan is a hybrid between a DC plan and a DB plan. It is a DB plan that looks like a DC plan. Legally it is a DB plan. Therefore the DB limits apply – i.e. the annual contribution on behalf of any participant is *not* limited to $54,000.

Instead, the ultimate retirement benefit cannot exceed the DB limit indicated above (i.e., the lump sum amount cannot exceed approximately $2.6 million at age 62).

[1]Source: dol.gov

Defined Benefit Plans

In a cash balance plan a "theoretical" account balance (or "TAB") is maintained on behalf of each participant. On an annual basis the TAB is credited with a "pay credit" and an "interest credit." The pay credit can be a flat dollar amount or a percentage of pay and can vary by employee (again, the pay credit is not limited to the annual DC limit). The maximum pay credit is a function of age. For example, a 35 year old may receive a pay credit of up to $70,000 while a 55 year-old's pay credit can be as high as $185,000. The interest credit is often based on an index of U.S. Treasury Securities, a fixed rate in the 4% - 5% range, or some other factor allowable under IRS Regulations.

The plan is a DB plan because the pay credit and the interest credit are guaranteed to the employee. That is, the amount that the employee will receive from the plan is defined. If the plan earns more or less than the interest credit, future contributions are either increased or decreased to reflect the positive or negative, but the participants' TABs are not affected.

<u>The ultimate benefit paid to an employee from a cash balance plan is equivalent to the balance in their theoretical account – i.e. the accumulation of pay credits and interest credits - at the time of distribution.</u>

It should be emphasized that the benefit to be paid from a DB plan (whether traditional or cash balance) comes from a single pool of assets. Therefore, the investments in a DB plan may not be tracked separately for any one participant. That is, separate investment accounts for each participant where the participant is entitled to the results of that account may <u>not</u> be maintained.

Disparate levels of cash balance benefit and employer DC plan contributions may be provided on behalf of the principals, compared to what are provided for the other employees, as a result of language in the IRS nondiscrimination regulations. Basically the two plans (i.e. the DC plan and the DB plan) are treated as a single plan. It is then shown that the **benefit levels** the principals will receive at retirement are not discriminatory when compared to those the other employees will receive. There are very complex calculations that are performed to prove this lack of discrimination; this is another factor that dictates just how large a benefit (and, therefore, how large a tax deductible contribution) can be provided.

C. Other Factors to Consider

1. Long-Term Plan

Any employer that adopts a defined benefit pension plan should do so with the intent of funding the plan for a moderate (but not necessarily indefinite) period of time. Generally, the IRS considers a 5-year time period sufficient to meet this rule. Of course, if business conditions change such that one cannot fund the plan without suffering adverse financial consequences, changes to the plan can be made to reduce (or eliminate) future funding obligations. Absent such an event however, the funding of a pension plan should be considered an annual obligation.

Additionally, the profit sharing contribution for the employees is what allows the disparate defined benefit levels for the shareholders. Accordingly, to a large extent, the discretionary nature of the profit sharing contribution, at least for the employees, is eliminated.

2. Employer Bears Investment Risk

Also, bear in mind that because the plan defines the benefit, it is the employer's responsibility to contribute enough funds to pay each employee's benefit. While investment results that exceed the interest crediting rate can reduce the size of future required contributions, poor returns can increase future required contributions. Consideration should be given to these and other factors when developing an investment strategy for the plan.

3. Payments to Partners/Shareholders

A related issue revolves around the lump sum payment to be made from a DB plan to a departing employee or partner/shareholder. In a <u>traditional</u> defined benefit plan, the actual amount to be distributed in a lump sum will depend on

Defined Benefit Plans

the interest rates the law requires the actuary to use when determining the present value of the future retirement income stream earned under the plan. As rates fluctuate, so does the amount of the present value of the earned benefit. This occurs even though the earned benefit (which, in a traditional defined benefit plan, is phrased as a periodic benefit beginning at retirement age) stays the same. For example, the amount to be paid out as a lump sum will be larger where rates are at 4.5% than if rates are at 6.0%.

Compare this to a cash balance defined benefit plan. There, the benefit is already phrased as a lump sum balance. Irrespective of interest rates at the time of distribution, the lump sum will be the exact amount reflected in the participant's TAB. In other words, in a well-designed cash balance defined benefit plan, fluctuating interest rates will not alter the amount of the lump sum benefit from the amount showing in the participant's statement.

Having said that, it should be pointed out that there may be a difference between what a partner/shareholder receives as a lump sum (i.e., his/her TAB) and the sum of the amounts contributed for the partner/shareholder plus the actual investment results on those contributions. If there is more distributed than what was contributed for him/her (plus actual plan earnings), the plan effectively suffers a "loss." Conversely, if the partner/shareholder receives less than the aggregate contributions made (plus actual plan earnings), the plan experiences a "gain." In some practices this gain or loss is taken into account by adjusting what the departing shareholder otherwise receives in his/her termination settlement.

This can be demonstrated by a simple example. There are two doctors in a cash balance plan, Dr. X and Dr. Y. Each year the plan receives contributions of $50,000 for each doctor. After 3 years the plan has received a total of $300,000 for the doctors. With annual interest credits of 5%, each Drs' TAB is $157,625. Dr. X is leaving and will receive a distribution of his $157,625. If the plan earned exactly 5% each year there would be $315,250 of plan assets and Dr. X would simply receive half of the assets. Presume however that the plan earned 5% in each of the first two years, but had a large gain in year 3 such that there is now $400,000 in the plan. Dr. X would still be entitled to his $157,625, leaving $242,375 in the plan for Dr. Y. As previously indicated, the practice would effectively inure to this gain, either in the form of reduced future contributions, or by increasing benefits for Dr. Y. In such a case it is not uncommon for there to be an adjustment to Dr. X's buyout from the practice.

Finally, the law imposes limits on distributions from under-funded defined benefit plans. Under such rules, plans that do not meet certain funding levels are prohibited from paying lump sums until the plan is adequately funded. Departing employees continue to receive interest credits until distribution can take place.

Takeaways

Ensuring that your firm has a positive retirement plan experience starts with a solid understanding of the options. A defined benefit plan for the right company can offer significant retirement benefits, beyond those available in a 401(k)/profit sharing plan.

About the Author

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