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# About Defined Benefit Pension Plans



A Defined Benefit Pension Plan (“DB Plan”) allows an employer to make retirement plan contributions that are eligible for special tax treatment. Tax advantages of plan sponsorship are similar to those of a Defined Contribution Plan (“DC Plan”), and include:

- Employer contributions to the plan are tax deductible to the company.
- Contributions to the plan are not currently taxable to the employees.
- Investment earnings within the trust are not currently taxable (that is, they accumulate tax deferred).

A DB Plan does not have the direct contribution limits associated with a DC Plan (such as Profit Sharing Plan). So, the DB Plan is an excellent option for a company that wants to make annual contributions greater than 25% of covered compensation, without the individual limit of 100% of compensation or \$45,000 (2007 limit).

A DB Plan generally favors older participants. Since owners of small businesses tend to be older than most of their employees, this is the plan of choice for many owners of successful small businesses who want to make large deductible contributions to a retirement program.

What follows is some important information about DB Plans. The information is general in nature, and is not intended to be taken as a comprehensive description of the regulations covering qualified plan sponsorship.

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## Types of DB Plans

There are a number of DB Plan design options available. Some of the options include:

- **Traditional DB Plan.** This is generally the best option for a small company with one owner (or owner and spouse) as the targeted employee.
- **Cash Balance Defined Benefit Plan.** This plan is similar to the traditional DB Plan except that participant statements reflect a “hypothetical account balance.” This is a good option when a company has multiple owners who are unrelated, because the benefit accruals under the plan are more understandable to the owners than a traditional DB Plan.
- **Tiered Cash Balance Plan combined with a Tiered Profit Sharing Plan.** This powerful combination is an excellent option when there are some participants who are older than the owners, and the objective is to set

aside the highest percentage of annual contributions for the retirement benefits of the owners.

- **DB Plan combined with a 401(k) Plan.** Recent tax law changes make it even easier for a successful small company to combine a 401(k) with a Defined Benefit Plan (traditional or Cash Balance).

Additional information on each of these options is included below.

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## Why DB Plans Favor Older Participants

A DB Plan favors older participants because the plan promises to pay each participant a specific benefit at retirement. This benefit at retirement has a “lump sum” value. The expected lump sum at retirement is a fixed amount regardless of the participant’s current age (assuming the same compensation and years of participation in the plan at retirement).

Older participants have fewer years for annual contributions to be made to build the required lump sum. So, the closer to retirement the participant is, the greater the annual contributions needed to accumulate the required lump sum.

Further, younger participants have more time for compound interest to work in their favor. Consider two persons with \$100 each invested in a retirement account at 10% interest: one is age 55 and the other is age 25. At age 65, the first person’s investment is worth \$259. But, with 40 years of compound interest working for him, at age 65 the younger person’s investment is worth \$4,526!

These two factors combine to allow older participants to achieve greatly accelerate retirement accumulations when compared to any other option.

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## DB Plan Basics

A “Defined Benefit” Plan is well named: it is a plan that promises to pay a specific benefit at retirement.

Each year an actuarial valuation is performed to determine the contribution amount necessary to fund the promised retirement benefits. Since the annual contribution is determined by the need to fund future retirement benefits, the contribution amount can be much higher than that allowed by DC Plans.

When the plan is terminated, the distributed amount for each participant is the present value at that time of the promised benefit at retirement. Generally, the participant rolls this amount into an IRA, at which point the rollover amount is subject only to IRA rules.

Some of the more important aspects of a DB Plan include the following:

### Benefit Formula

Determining annual contributions to a DB Plan begins with the benefit formula in the plan document. The benefit formula usually takes into consideration years of participation in the plan and compensation, and defines a

monthly amount to be paid to the participant beginning at the retirement age specified in the plan.

The maximum benefit at retirement cannot be higher than 100% of a participant's highest consecutive 3 year average compensation, with a maximum limit of \$180,000 per year (2007 limit).

### **Actuarial Valuation**

Because a DB Plan promises to pay future retirement benefits, each year an actuarial valuation is performed to, first, determine the plan's liabilities (the retirement benefits it will pay in the future), and second, to determine how much needs to be contributed to the plan each year to build the required lump sum to fund this expected stream of payments. This valuation takes into consideration the current plan assets as well as a number of assumptions, including: a particular rate of investment earnings, a rate of salary appreciation, mortality expectations, and other factors.

The set of facts, actuarial assumptions and the valuation method used by the actuary become the basis for making a valuation of the DB Plan. The contribution level that is reflected in this computation is determined by the actuary in accordance with IRS rules and regulations.

Each year, an actuarial valuation is again performed to make sure the plan stays on track to fund the expected retirement benefits promised by the plan.

The plan assumes a rate of return on investments, so the investment risk in a DB Plan is assumed by the employer. If the actual investment earnings are greater than the earnings assumed in the actuarial valuation, then the employer's cost to fund the plan would tend to decrease. Likewise, if the earnings are less than those assumed in the actuarial valuation, the employer's costs would tend to increase.

Annual actuarial valuations are used to adjust contributions based on actual plan experience. For this reason, actual experience (investment performance, actual rate of salary increases, change in demographics of plan participants, etc.) will affect future valuations and future contributions (that is, required contributions will tend to vary from year to year).

### **Required Contributions**

Each year the actuarial valuation calculates contributions to the DB Plan necessary for funding expected retirement benefits under the plan. Unless the DB Plan document is amended timely, this contribution is required to be made by the employer.

The contribution deposit is due by the employer's deadline for filing its business tax return, including extensions (though not later than 8 ½ months after the end of the plan year end). Any amount of a required contribution that is not deposited by the appropriate deadline is subject to a 10% excise tax.

### **Contribution Flexibility**

Although annual contributions are determined by an actuarial valuation, a DB Plan has a certain amount of

flexibility. If plan benefit or contribution objectives change, the plan may be amended to meet the new objectives. For maximum flexibility, a DB Plan should be amended very early in the plan year.

However, a DB Plan may be amended up to 2 ½ months **after** the end of the plan year. While benefits accrued for that plan year cannot be lowered after the end of the plan year, the plan may be amended to lower future accruals which, in many cases, could lower the contribution for the current year (the amount the contribution may be lowered depends on many factors, and can only be determined on a case-by-case basis).

Please note that for plan years beginning in 2008, recent tax law changes may restrict some of the flexibility to lower contributions after the plan's benefit accrual requirements have been met for that year.

### **Plan Distributions**

Normal distributions of a participant's account may occur when the participant terminates employment with the company, retires, or becomes disabled. Generally, participants may "roll" all of the distribution into an Individual Retirement Account (IRA) and continue tax-deferred earnings, or they may elect to take a lump-sum distribution and pay the tax required. Any taxable distribution before age 59 ½ (or age 55, with separation of service) may be subject to an additional 10% excise tax.

### **Limitations on Certain Distributions**

In certain situations, distributions to a participant who is a *Highly Compensated Employee* may be subject to limitations on distributions or a requirement that a part of the distribution be collateralized.

### **Plans Covered by PBGC**

The PBGC is an entity within the Department of Labor the principle purpose of which is to provide insurance coverage to certain DB Plans. The purpose of this insurance is to make sure that promised benefit payments are made.

DB Plans sponsored by most U.S. businesses are required to be covered by the PBGC, with the exception of:

- DB Plans sponsored by "professional service employers" (as defined by the PBGC) that have never had more than 25 active participants.
- DB Plans sponsored by companies with no employees other than substantial owners (or owners and their spouses).

DB Plans covered by the PBGC are required to make annual premium payments to the PBGC. Premiums are based on various factors including number of participants and funding status. PBGC premiums are payable to the PBGC, and are independent of Benetech's fees.

## ***Cash Balance Defined Benefit Plans***

A "Cash Balance" Plan is a type of Defined Benefit Plan that appears to participants in many respects to be similar to

a DC Plan (such as a Profit Sharing Plan). However, it is fundamentally still a DB Plan in that it requires an annual actuarial valuation, allows substantially higher contributions, and retains other important underlying features.

### **How is a Cash Balance Plan like a DC Plan?**

One of the principle differences between a traditional DB Plan and a Cash Balance Plan is that the Cash Balance Plan appears to participants to be very similar to a DC Plan (such as a Profit Sharing Plan).

For a Cash Balance Plan, annual contributions are credited to a “hypothetical account” for each participant, and a specific interest rate is credited to that account.

Participant statements are structured like statements for a DC Plan, and include the following items:

- Beginning balance
- Contribution credits
- Interest credits
- Ending balance

“Contribution credits” are usually defined as either a percentage of that year’s compensation, or a flat dollar amount.

“Interest credits” are based on an index or an amount defined in the plan (but must conform to IRS regulations).

Distributions generally agree with the participant’s hypothetical account balance at the time of distribution. This allows participants to have a better understanding of the value of their retirement account than with a traditional DB Plan.

### **How is a Cash Balance Plan like a Traditional DB Plan?**

Even though participant statements may appear similar to those of a DC Plan, a Cash Balance Plan is still a type of Defined Benefit Plan.

The participants do not have an actual account under the plan: it is merely a “hypothetical” account. For this reason, participant-directed investment accounts cannot be allowed.

The investment risk is still born by the plan sponsor. The “interest credit” is applied to each hypothetical account without regard to the actual performance of the plan investments. For this reason, investment performance greater than the interest crediting rate would tend to lower annual contributions; likewise, investment performance less than that rate would tend to require higher annual contributions.

Most traditional DB Plan rules still apply to Cash Balance Plans. These affect such things as limits on maximum distributions, minimum accrual requirements, Top Heavy contribution requirements, and other factors.

### **Vesting Schedule**

Recent tax law changes clarified many aspects of Cash Balance Plans. However, they also introduced a more

restrictive vesting schedule for Cash Balance Plans than is required for other types of qualified retirement plans.

All Cash Balance Plan participants must be 100% vested after 3 years of service. For this reason, most Cash Balance Plans are setup with a 3-year “cliff” vesting schedule: 0% vested until the third year of service is accrued, at which time the participant is 100% vested.

### **Cash Balance Plan Combined with a DC Plan**

Cash Balance Plans are usually combined with a Defined Contribution Plan (such as a Profit Sharing Plan or 401(k) Plan). This is done because contributions to the DC plan result in more favorable testing than if they were made to a stand-alone Cash Balance Plan. Because of this, the “two plan” approach is much more favorable to the plan sponsor.

## ***Combining a Tiered Profit Sharing Plan & a Tiered Cash Balance Plan***

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A stand-alone DB Plan (whether traditional or Cash Balance) works best when the owner (and other targeted employees, if any) is substantially older than the rest of the plan participants.

However, for companies with a few older non-targeted employees, it’s often possible to design a combined Tiered program that minimizes the impact of those older employees, thus maintaining a high percentage of the annual contributions funding the retirement benefits of the targeted employees.

This program combines a Tiered Profit Sharing Plan and a Tiered Cash Balance Plan. The basic contributions under the program begin with the following:

- The Tiered Profit Sharing Plan generally allocates a minimum of 7.5% of compensation to the non-targeted employees, and up to the \$45,000 maximum to the owners.
- Non-targeted participants under the Tiered Cash Balance Plan Plan accrue a 0.5% minimum retirement benefit, and up to the DB maximum benefit accrual for the owners.

The plan contributions are subject to special discrimination testing, so the actual formulas will depend on company demographics: in some cases the allocation to the non-targeted employees may be higher.

The total company contribution to this program is subject to the DC Plan’s deduction limit of 25% of covered compensation. So, this design is not optimal for many “micro” employers (e.g., one owner and 2 other employees).

Since the individual limit of \$45,000 does **not** apply to the accruals under the Cash Balance Plan part of this program, it is an excellent program for many successful small employers who want to set aside more than this amount for their retirement.

## **Combining a 401(k) Plan & a DB Plan**

The Pension Protection Act of 2006 included provisions that make it even easier for a successful small company to combine a 401(k) with a Defined Benefit Plan (traditional or Cash Balance).

A couple of key items to keep in mind when combining a 401(k) Plan and a DB Plan are:

- An owner's salary deferrals under a 401(k) Plan do **not** affect the DB Plan's deduction limit. This could effectively increase the amount the owner could contribute by \$15,500 (or \$20,500 if age 50 or older) in a properly designed plan.
- Company contributions of up to 6% of covered compensation may be made to a DC Plan without affecting the DB Plan's deduction limit. This PPA '06 change makes it possible to add a Safe Harbor 401(k) Plan to a traditional DB Plan, even for the micro employer.

There are a number of different configurations of this type of program. Below are a couple of options.

### **DB Plan combined with a Safe Harbor 401(k) Plan**

On this program, a basic Safe Harbor 401(k) is added to a DB Plan, increasing the owners ability to save for retirement by at least 15,500 (or \$20,500 if age 50 or older).

Since the employer contribution to the 401(k) Plan is less than 6% of covered compensation, the 401(k) contributions do not impact the contributions to the DB Plan.

### **Tiered Cash Balance Plan combined with Tiered Safe Harbor 401(k) Plan**

Any employer who is a candidate for the Tiered Profit Sharing Plan combined with the Tiered Cash Balance Plan should consider this option.

Company contributions to this program are the same as the non-401(k) options, but the Safe Harbor 401(k) provisions increase the owners ability to save for retirement by 15,500 (or \$20,500 if age 50 or older) in most cases.