UNDERSTANDING
DEFINED BENEFIT PLANS

While defined benefit plans provide a stable retirement income, they are less common today as many employers have shifted to defined contribution plans due to the cost and complexity of managing pensions. Let us explore the details further.

What is a Defined Benefit Plan

A defined benefit (DB) retirement plan is a type of employer-sponsored retirement plan where the benefits an employee receives upon retirement are predetermined and guaranteed by the employer.

EXAMPLE:

Years of Service
× Multiplier
× **Final Average Salary**
BENEFIT

An employee with 30 years of service and a final average salary of $100,000 would receive:

30×1%×$100,000

=$30,000 per year in retirement benefits

These benefits are typically based on factors such as:

▶ **Salary History:** Usually the average of the employee's highest earnings over a specific period.

▶ **Years of Service:** Usually the number of years the employee worked for the company.

▶ **Age:** Age at retirement can influence the benefit amount.

Key Features of a Defined Benefit Plan

▶ **Guaranteed Payments:** The employer commits to paying a specific benefit amount, often as a lifetime annuity, regardless of the plan's investment performance.

▶ **Employer Responsibility:** The employer is responsible for funding the plan, managing the investments, and ensuring that there are enough funds to pay retirees.

▶ **Formula-Based:** Benefits are calculated using a fixed formula, such as: Benefit = {Years of Service} x {Multiplier of 1-2%} x {Final Average Salary}

▶ **No Direct Investment Risk for Employees:** Employees don't bear the investment risk; the employer assumes the risk of managing the plan's assets.Because of this, many organizations have shifted toward defined contribution plans, like 401(k)s, where employees bear investment risks, due to the rising costs of maintaining defined benefit plans.

Cash Balance Plans are Considered a DB Plan

A cash balance plan is a type of defined benefit plan that maintains hypothetical individual employee accounts, like a defined contribution plan. It looks like a defined contribution plan but it functions as a defined benefit plan.

Deadlines and Contributions

According to the SECURE Act of 2019, the plan must be set up by the due date of the employer's tax return (plus extensions). In order to take a deduction for the current tax year, contributions must be made by your business's tax filing deadline for the current tax year (plus extensions), but no later than September 15th.

The amount that can be contributed annually is based on factors such as a participant's age, income, length of time before retirement and rate of return of the investment portfolio. In 2024, the annual benefit payable at retirement can be as high as $275,000 per year and maximum lifetime of $3.5M.

Contributions can be leveraged to both owners and key employees. But keep in mind that your plan must pass the "General Non-discrimination"and "Top Heavy" tests.

▶ Top Heavy is when the owner and key employees' present value of accrued benefit exceeds 60 percent of the TOTAL present value of accrued benefits for all employees. Once a plan is Top Heavy, all non-keys receive 2% of average annual compensation for each year of service with the employer not to exceed 20 percent.

▶ The General Non-Discrimination Test ensures that contributions and benefits to highly compensated and non-highly compensated employees are proportional.

A minimum contribution is usually required each year. Unless the plan becomes significantly overfunded. Unlike defined contribution plans, the required minimum contribution is not discretionary.

If you can't make the contributionl planned on, then you have three options:
▶ amend
▶ freeze
▶ terminate the plan

By amending the plan, you can decrease the annual contributions that needs to be made. It may be viewed as abusive by the IRS if too many amendments are made. As a result, amendments should be infrequent. By freezing the plan, you can stop future benefit accruals. At any time the plan can become un-frozen by writing an amendment.

Eligibility for Defined Benefit Plans

☑ **Sole proprietorships**
☑ **S corps**
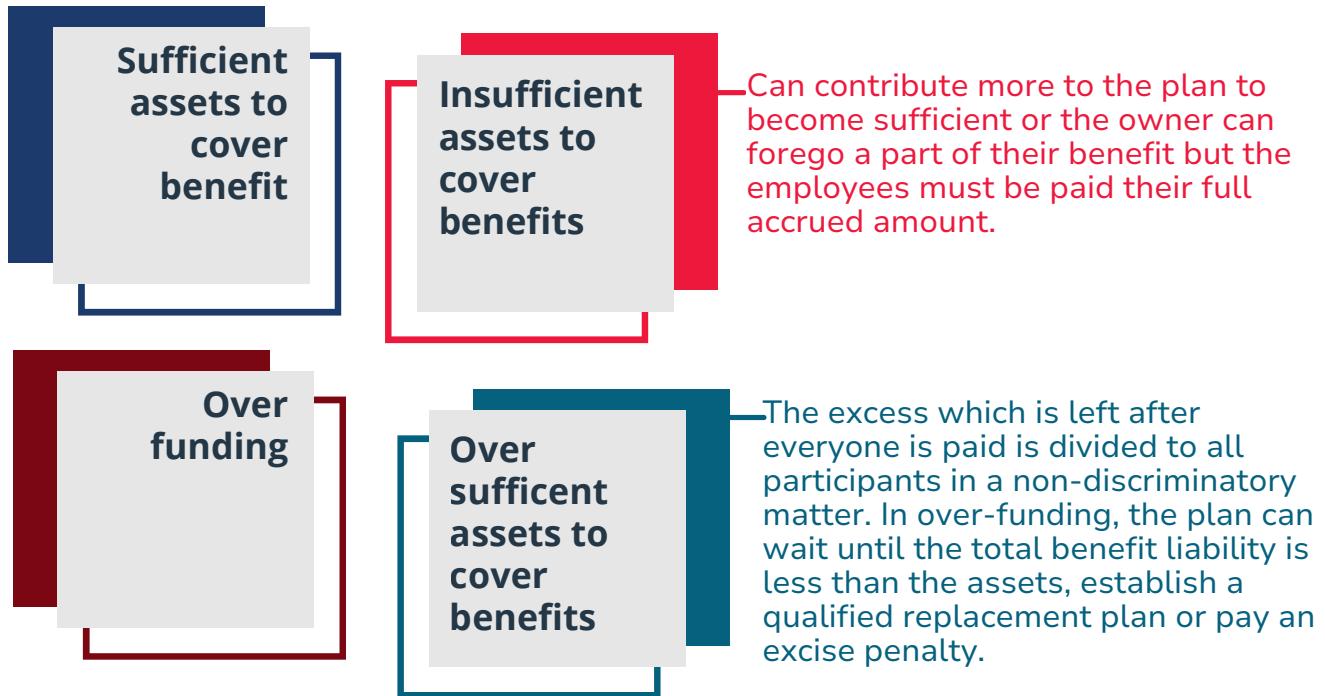☑ **C corporations**
☑ **LLCs and partnerships**

Keep in mind, if you are an owner of multiple businesses, you may need to include employees in both businesses since you may be considered a "controlled group" or an "affiliated service group".

A qualified plan has coverage requirements to ensure benefits do not overly benefit highly compensated employees at the exclusion of non-highly compensated employees. That simply means that an owner can not exclude all their employees from a DB plan. Also in defined benefit plan there is an additional layer of compliance to make sure that enough participants receive a meaningful benefit every year. If the requirements are not fulfilled, participant must be added back into the plan with a meaningful benefit until IRS requirements are met.

Terminating a Defined Benefit Plan

Generally the plan is designed to have a retirement age of 62 or age 65 and is expected to be maintained at least 5 years. You can terminate the plan prior to retirement date if your circumstances should change by preparing a resolution. When the plan is terminated the lump sum value can be rolled over to an IRA.

There are four types of DB plan terminations.

Sufficient assets to cover benefit

Insufficient assets to cover benefits — Can contribute more to the plan to become sufficient or the owner can forego a part of their benefit but the employees must be paid their full accrued amount.

Over funding

Over sufficent assets to cover benefits — The excess which is left after everyone is paid is divided to all participants in a non-discriminatory matter. In over-funding, the plan can wait until the total benefit liability is less than the assets, establish a qualified replacement plan or pay an excise penalty.

Loans and Hardship Withdrawals

Hardship withdrawals are not permitted. Participant loans are available, but not recommended. If you elect to include a loan have this feature when you adopt the plan, If you receive a loan from the plan, it may increase required minimum contributions. Loans are not permitted in a fully insured defined benefit plan.

Payment at Retirement

Defined Benefit plans are designed to pay a lifetime or joint and survivor annuity at retirement. The IRS, with additional funding restrictions, allows defined benefit plans to pay out lump sums, like a 401(k) or Profit Sharing plan. Lump Sums can be taken directly (taxable) or rolled over to an IRA (non-taxable) or another qualified plan (401(k)).

In the case that you are considered a "Top 25 highest paid" employee, a rollover to an IRA is not allowed at termination or retirement. The plan restricts lump sum distributions. The IRS requires that the distribution is less than 1% of the plan's liability AND that the plan be 110% funded after the distribution. If the restriction applies, a partial lump sum not greater than the straight life annuity may still be paid to the participants.

Add a 401(k) and Profit Sharing Plan to a Defined Benefit Plan

Adding a 401(k) and profit sharing plan can increase annual contributions and tax deductions. However, additional testing is required to ensure no discrimination towards non-highly compensated employees across both plans.

The Pension Benefit Guaranty Corporation (PBGC)

A PBGC is a quasi-governmental corporation that guarantees participants will receive a benefit up to specific level even if the plan terminates without sufficient assets. The PBGC covers plans that are over 25 participants or businesses that aren't considered to be a "licensed" business by the PBGC. Once covered, the sponsor must pay annual insurance premiums.

We Are Here to Help

Choosing the right plan design can be complex, and understanding your options should reflect your growing business needs. We can help you design and maintain a retirement plan that supports employees and serves as an asset for you and your business. We're here to make retirement planning straightforward and beneficial for you and your business.

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