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[1], or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA[2] or to another employer plan if that plan will accept such a rollover. Beginning in 2007, 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[3], 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[3] for the first ten years of service plus 5.2% of compensation[3] for all other years, but not to exceed a total of 33 years.
- **Service plan:** Example - The benefit is 2.5% of compensation[3] 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[4] 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.

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[1] 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.

[2] 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 will be taxable events, subject to the same requirements as a Roth conversion.

[3] 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 2007, $225,000 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.

[4] 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 $145,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded $150,000.

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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[1] 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 $180,000 per year (2007) 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

Many factors influence the annual contribution calculated by the plan actuary. The following table illustrates hypothetical first year contributions for an employee planning on retirement at age 55, or a minimum of 5 years of participation. In all instances, the employee's compensation is $180,000. The benefit is 100% of compensation on a life annuity basis.

Current Age	1st Year Contributions
30	$29,255
35	42,917
40	66,780
45	116,226
50	134,064
55	172,006
60	177,365

[1] 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.

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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.

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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 lump sum benefits valued at less than $5,000. If the lump sum value is more than $1,000, the plan must automatically roll the distribution 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.

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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.