

Create your own pension plan

Classic retirement plans are an intriguing option for shielding small-business income from the IRS.

By [Jeanne Lee](#)

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(FORTUNE Small Business) -- Like many successful business owners, Bob Johnson, founder and CEO of [Johnson Insurance & Financial](#) in McKinney, Texas, was hungry for juicy tax breaks. He found some - more than \$200,000 in just three years - in an unlikely place: the old-fashioned defined-benefit pension plan.

"It's amazing how much you can save, and it gives you a great tax deduction," he says.

Johnson, 65, has been running a thriving financial services business for 35 years, generating net income of about \$500,000 a year. He faithfully maxed out annual contributions to his SEP retirement plan, but three years ago he looked at his tax bill and wondered if there wasn't a better way.

"If you're making \$500,000 a year and contributing \$40,000 to a SEP [the maximum in 2004], you still have \$460,000 of net income on which you have to pay 35% tax," says Johnson.

It was another financial advisor who pointed him to a defined-benefit pension plan. These classic pensions have long been associated with large corporations - and in the age of 401(k)s they have become an increasingly rare perk. But recent regulatory changes have made them much friendlier for the small-business owner.

And here's the kicker: High earners who are 45 and older are often able to sock away much larger sums than with defined-contribution plans such as IRAs, SEPs, or solo 401(k)s.

Unlike defined-contribution plans, a traditional pension plan does not put a cap on how much you can save each year. Instead, you start with the amount you want to receive annually in retirement. The older you are and the closer to retirement, the bigger the annual contribution. What is capped is your annual retirement income, currently at \$180,000. That means the maximum pot you can legally accumulate - based on an actuarial formula - is a little more than \$2 million.

Because defined-benefit plans are not widely understood, the small-business market is barely developed. But financial advisors have started to pay attention. [Dedicated Defined Benefit Services](#) of San Francisco offers a streamlined defined-benefit plan specifically for companies of one to six people. The company provides a two-page plan agreement, as opposed to the 50-page document you'd get if you went through a tax attorney. Dedicated Defined Benefit offers its own plan, called [OnePersonPlus](#), and also has a co-branded product through the Hartford Group ([HIG, Fortune 500](#)), Oppenheimer, and Pioneer. (Setup costs vary by provider - OnePersonPlus costs \$1,200 to establish, plus \$50 a year for each eligible plan participant.)

Johnson opened a defined-benefit plan three years ago and contributes \$200,000 each year. By his reckoning, he has shaved more than \$200,000 from his tax bills while accumulating more than \$700,000, including gains, in his plan. (Of course, when he withdraws that money, he will have to pay taxes on it.)

By law he has to make contributions based on the same actuarial formula for each of his employees - who in this case happen to be his wife and his daughter, both of whom are younger and earn less than Johnson does. He puts in \$10,000 a year for his wife, who is in her 50s, and \$12,000 for his daughter, who is 40.

"It's fantastic for a family business," he says, "because all the money is going to family members."

The latest rule changes, introduced with the Pension Protection Act of 2006, make these plans even better. Business owners with fluctuating income are now allowed to combine a defined-benefit plan with a solo 401(k) plan, which does not require a contribution every year.

That is a boon for Johnson, who is currently investing in new office space and a marketing campaign, which he thinks could double his income next year. If he succeeds, he will maximize his tax deduction by opening a solo 401(k) plan and contributing the maximum in addition to the \$200,000 contribution to the pension plan.

"If I have a windfall next year - which I might with the new business - I can put an additional \$34,000 into a solo 401(k) plan. Together with my wife, we can put in \$68,000," says Johnson. In a bad year, he's not obliged to add anything to the 401(k).

Defined-benefit plans do not fit all small businesses. If you have many employees, lots of older workers, or a number of high earners, your required contributions could be prohibitively expensive. (You can use a vesting schedule to legally exclude some employees - for example, by requiring 1,000 hours of service to qualify for the plan.)

"These plans offer a particular advantage if you, as the owner of the company, are older than your work force - for example, a doctor who employs physician's assistants," says Heather Hutchinson of [Hutchinson & Ziegler Financial Advisors](#) in San Rafael, Calif., who has set up defined-benefit plans for small-business clients.

When you open a defined-benefit plan, you must be able to fund it for at least three years. However, thanks to the Pension Protection Act, you now have the option to front-load the plan: If you design it with contributions of \$100,000 for three years, say, you can put in \$150,000 one year and the remainder in years two and three.

Whatever formula you choose, a defined-benefit plan can leave you with more and the taxman with less. ■