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Defined Benefit Plans: A Tax Strategy for High-Income Baby Boomers

While the press decries the demise of large corporations' defined benefit (DB) plans, the opposite trend is occurring in DB plans for small businesses. For many baby boomers now in prime earning years, a DB plan can significantly increase annual tax deductions, add $1 to $2 million in retirement assets over the next 5 to 10 years, and even accelerate the date of retirement.

Over the past seven years Congress has passed a series of laws that increase the flexibility and power of DB plans for high-income baby boomers. These changes raise annual benefit amounts, broaden the range of suitable participants, and increase flexibility. For clients who are self-employed, small business owners, or professionals looking for higher deductions and a way to build significant retirement savings over the last decade of their careers, DB plans are more appealing than ever before.

Starting Over

In the late 1990s, Congress recognized that many Baby Boomers were inadequately prepared for retirement and that a DB plan could be the most effective way to provide them retirement benefits.

DB plans allow an individual to select an annual benefit—the amount that will be paid out annually in retirement—taking into account the individual 's age, income, and years to retirement. The individual commits to make tax deductible contributions to the plan annually, generally for 5 to 15 years, to accumulate enough to pay out that benefit over his or her lifetime. These plans are particularly attractive to the self employed and to owners of 1- to 5- person companies, aged 45 to 70, who can contribute and deduct from taxes $100,000 or more annually, often 3 to 4 times the amount that they could contribute to other retirement plans.

To revive DB plans, effective January 1, 2000 Congress repealed IRC Section 415(e), which limited the maximum annual amount highly compensated individuals could receive at retirement (annual benefit) to 100% (the 1.0 Rule) of the combined benefits under defined contribution (DC) and DB plans.

Section 415(e)'s repeal gave these individuals a fresh start. Even if they had funded a DC plan for 30 years, they could open a DB plan during their last ten career years and fund to the maximum benefit. Assuming the maximum annual benefit under a DB plan is $90,000 and a normal retirement age is 65, the maximum contribution under the law climbed from less than $20,000 to over $79,000 after repeal.

Higher Benefits at an Earlier Age

The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) further enhanced the appeal of DB plans by raising the maximum benefit from $140,000 to $160,000 per year and lowering to 62 the Social Security retirement age when a maximum benefit is payable. The lower retirement age and increased benefits mean that more money is necessary to provide the promised benefits, thus increasing the plan contribution and accompanying tax deduction amounts.

Example: Dr. Jane, age 52, has always earned enough and been able to afford to contribute enough to provide for the maximum benefit. With a Social Security retirement age of 65, a maximum benefit of $140,000, and an assumed 5.5% rate of return (the lowest rate currently allowed by the IRS), Dr. Jane's annual contribution to a DB plan was approximately $86,000. Because the EGTRRA increased the maximum benefit to $160,000 and lowered the retirement age to 62, Dr. Jane could now contribute in excess of $150,000. The $20,000 increase in benefits and the 3-year lowering of the retirement age raised her annual tax deductible contribution by over $60,000—an almost 75% increase.

2007—Maximum Benefit Increases Again

The law also provides that these limits be adjusted for increases in the Cost of Living Index, which raised the 2007 maximum annual benefit to $180,000. Today, Dr. Jane could contribute and deduct more than $169,000, approximately $83,000 more than she could just 7 years ago.

Adding Flexibility Broadens the Fit

Because DB plans obligate individuals to contribute each year, many qualified individuals, particularly those with fluctuating incomes, have been reluctant to establish a plan. Changes introduced under the Pension Protection Act of 2006 (PPA) now give individuals flexibility in addition to the larger tax deductions available under DB plans.

Pay More in Good Years

The PPA amended IRC Section 404(a)(1)(D) to permit individuals to contribute and deduct up to 150% of the plan's "current unfunded liability." This feature allows individuals to contribute more in good years and less in other years.

If plan assets are zero (for a new plan) and the Year 1 plan liability is $150,000, the unfunded current liability (the excess of benefits owed today over the assets available today) is $150,000. In this case the individual could contribute from $150,000 to $225,000 (150% of $150,000) and deduct the full contribution. By contributing $225,000,

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the individual could create a credit balance to be "drawn against" in subsequent years.

Example: Charles, a patent attorney, establishes a DB plan at age 52. His unfunded current liability is $150,000, and in Year 1 he contributes $225,000. In Year 2, his income is not as high and he cannot afford to contribute the full required amount of $150,000. He can elect to draw against the plan's credit balance and contribute anywhere between $75,000 and $150,000.

The IRS limits the maximum contribution to the DB plan to 100%— not 150%—of the current unfunded liability if the individual has made a contribution of any amount to a DC plan. Also, front loading of contributions during the plan's early years might reduce or eliminate the future contributions permitted. Since front loading could result in an over-funded plan and a taxable reversion if the plan is terminated early, the plan actuary must carefully monitor the plan to keep it on track.

Consider a "Combo"

Pairing a 401(k) plan and a DB plan has been a standard tool to provide flexibility and to increase contributions since passage of the EGTRRA. However, contributions to combined DB and DC plans prior to the PPA were limited to the greater of 25% of annual compensation (up to the IRS compensation ceiling of $225,000) or the DB plan contribution amount. Since the DB plan contribution is generally well in excess of 25% of compensation, individuals who wanted the large contribution allowed in a DB couldn't also use a DC.

The PPA exempts the first 6% of the DC contribution from the combined plan limits. A business owner with income that fluctuates now has the flexibility to set up a DB plan at a lower amount and contribute to a DC in higher income years.

Example: Jack, aged 55, the only employee of his S corporation, receives an annual salary of $200,000. Jack could establish a DB plan with a maximum contribution of $184,766.

If Jack is hesitant to commit to an annual contribution of $184,766, he could set up his DB plan with a lower contribution, say $150,000. When combined with a 401(k) plan that allows discretionary salary deferrals up to $20,500, plus an additional $12,000 DC contribution, Jack's total allowable contribution is $182,500, but he is only obligated to contribute $150,000. Jack has built-in a flexibility factor of 22% of the DB contribution.

Summary

Thanks to the latest regulatory changes, DB plans are a potent source of tax savings and future retirement benefits for the growing number of high-income baby boomers who are self-employed, small business owners, or professionals. To take advantage of the tax deduction for 2007, DB plans must be opened by the fiscal year's end, December 31 for most companies.

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