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Turning What You Know About Defined Benefit Plans on Its Head

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Defined benefit plans which used to be the retirement plan of choice for private employers — covering more than 60% of all private employees* — have largely been replaced by 401(k)s.

But defined benefit (DB) plans are far from dead. Today they are becoming the retirement plan of choice for high-income individuals with self-employment income, as well as independent professionals and small business owners, such as doctors, consultants and even farmers. DB plans are an excellent tax strategy for these high-income individuals, particularly those aged 40+ because they will qualify for huge tax deferrals while quickly accumulating significant retirement wealth.

Today's DB plans receive very favorable tax treatment, and are streamlined so that they can be managed much more easily than in the past.

Let's look at the case of Kathy and Bob, a married couple and co-owners of a successful market research firm who pay themselves $275,000 each in W-2 income annually. They've done a great job building their business but haven't paid enough attention to their retirement. Now in their late-50s, they'd like to retire in five years but don't have enough saved to ensure that they will be able to maintain their current lifestyle.

By opening a DB plan, Kathy and Bob could contribute as much as a combined $454,000 per year, deferring $167,900 in taxes annually and accumulating a stunning $2.55 million in five years – enough to secure their retirement.

Though defined benefit plans have lost favor to defined contribution plans (such as 401(k)s) in large corporations, **micro** DB plans are growing in popularity. With Baby Boomers "retiring" but continuing to work and the number of small businesses and independent consultants on the rise, these plans are a fast-growing segment of retirement planning – think of them as the retirement plan of choice for your choice clients.

Large corporate defined benefit plans are positioned as an employee benefit - promising employees a guaranteed income stream in retirement. The primary reason small plan sponsors now establish a DB plan is to reduce their own taxes. DBs allow the highest IRS-approved deductible qualified plan contributions, and because the plan sponsor is the main or only participant, the higher the contribution, the better. What's more, even though it is labeled a "defined benefit" plan, it doesn't stay that way at retirement or plan termination. At that time, generally, the business owner will roll over the entire amount into an IRA, allowing assets to continue to grow tax deferred until withdrawn.

* Source: Employee Benefit Research Institute "Retirement Trends in the United States Over the Past Quarter-Century, 2007

In designing and setting up DB plans for the client, we start by getting an understanding of what amount the business owner will be comfortable contributing for the next 3-5 years. Taking into

account the age, income and years of service of the participants, the “defined benefit” formula is adjusted to reach the desired contribution amount. Since the passage of the Pension Protection Act of 2006, calculations in subsequent years provide a contribution range each year. On average, our clients contribute and deduct $130,000+ annually – often two to three times the amount that they could contribute to a SIMPLE, SEP-IRA, or 401(k).

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DB plans do require some paperwork to set up, as well as the services of a third-party administrator and actuary to perform the annual calculations to determine each year’s contribution and to ensure that the plan stays in compliance with the IRS code. But the amount of documentation is far from onerous and there are now providers, such as Dedicated Defined Benefit Services, that bundle all these services for low annual fees, relieving CPAs of any additional work.

Despite their advantages, a few misconceptions have made some clients hesitant to open DB plans. That’s a shame, because these plans are actually an effective way for small business owners and other self-employed high-income earners to quickly accumulate wealth later in their careers while at the same time reducing what would otherwise be big tax bills.

Here are some of the features of DB plans which have broadened the range of suitable clients in recent years:

- **IRS treatment:** In the past 15 years, Congressional action has resulted in DB regulations that make these plans much more attractive. The changes increased the amount of the retirement benefit, lowered normal retirement age to 62 thus increasing the potential to make larger tax-advantaged contributions earlier in one’s career. Plans now can be suitable for business owners as young as 40.

- **Maximum Contribution:** The calculated maximum annual amount the business owner can contribute is based on the annual retirement benefit defined by the plan. There are two separate limits on the benefit set by the IRS, either of which may apply: 100% of compensation, reduced pro rata for years of service less than 10; or $220,000 (in 2018), reduced pro rata for less than 10 years of participation in the plan. Currently, sponsors can accumulate a maximum of approximately $2.66 million in total, though this figure adjusts annually.

- **Required annual contributions:** Unlike defined contribution plans, DB plans must be funded annually. But there is a great deal of flexibility in the amount of contribution. This is particularly important to business owners whose incomes fluctuate, which is not uncommon for small business operators and other high-earning self-employed individuals.

- **Required length of the plan:** Business owners should be prepared to keep their plan active for a minimum of three-to-five years, both to accumulate enough wealth for retirement and to demonstrate its permanency to the IRS. This is not a legal requirement however – plans can be open for fewer years if unforeseen business circumstances necessitate plan termination.

- **Eligible earnings:** Only employment income can be used to calculate contributions to a DB plan [see Figure 1 for more specifics]. But this is not as big a limitation as it may sound at first, as many high earning individuals may have multiple sources of income. For instance, a professor with a university-sponsored retirement plan may also choose to open a DB plan if she receives significant income from outside endeavors, such as being on a corporate board of directors or doing consulting.

Figure 1 – Types of compensation used to calculate annual DB contributions

Type of Entity	Eligible Compensation
Corporation	W-2 income
S-Corporation	W-2 income only (no K-1 distributions)
Sole Proprietorship	Net-earned income (Sch. C line 31, or revenues minus expenses)
Partnership	Net-earned income (Sch. K-1 line 14a)
LLC	Depends on how the LLC is taxed (see sole proprietorship or corporation above)

- **Set-up:** New DB plans must be established by the end of the tax year – this is important to keep in mind, as it will be too late to make this recommendation when you are doing a client's taxes in the first quarter of the following year. But DB plans can be funded up to 8½ months after the end of the tax year, assuming the client has filed extensions.

- **Annual maintenance:** DB plans must be reviewed annually by the plan's administrator to establish that year's minimum and maximum contribution range. In the past, this has been a sticking point with some clients, largely due to the perceived cost – but this is another misconception. Firms such as Dedicated Defined Benefit Services, provide complete administration services, including all the actuarial and tax-related tasks necessary to maintain a plan, at a reasonable fixed annual cost. All the client has to do after providing updated information is decide how much to contribute within the calculated range, and how to invest the plan's assets.

- **Flexibility:** The leading misconception about DB plans is that they are inflexible once they are established. This is no longer true. Based on up-to-date information provided by the client annually, an annual contribution range is calculated for each plan. This allows the plan sponsor to vary what they contribute year by year. There are many strategies for designing in and maintaining contribution flexibility. Plans can be designed using past compensation to broaden the contribution ranges, they can be set up with a lower contribution amount and then paired with a 401(k) and they also can be amended. If the business owner needs a break from contributing, the plan can be frozen, or it can be terminated and the assets rolled into an IRA.

- **Suitable clients:** DB plans can be advantageous for sole practitioners, partnerships, and family businesses. Certain types of physicians are prime prospects – such as anesthesiologists, psychiatrists, audiologists, endodontists, and radiologists - since they are often high-earners with few or no employees. Other typical occupations include consultants, attorneys, contractors, entertainers, franchise owners, farmers, software engineers and real estate agents. In addition, these plans may be advantageous for working spouses of high-earners, or employees of large institutions who also earn a substantial side income (such as fees from sitting on boards of directors).

- **Covered employees:** Since these plans are sponsored by the business, they must cover all eligible employees. The benefit formula is the same for everyone but if the employee is younger or receiving lower income, the contribution for them will be significantly lower. Furthermore, sponsors can limit the number of covered employees by setting eligibility thresholds (such as one or two years of service or 1000 hours per year service requirement to prevent part-time or short-term employees from participating in the plan), or establishing a vesting schedule so that if employees leave before they are fully vested, the remaining assets stay in the plan trust.

Establishing a DB plan does not preclude a business owner from setting up a separate defined-contribution plan, such as a 401(k), and many clients choose to open both to maximize tax savings, accumulate wealth faster and build in additional flexibility.

For instance, take the case of Charles, a 52-year-old management consultant who earns $500,000 a year and wants to maximize his savings. For 2018, we calculate that Charles could contribute $197,300 to a DB plan and an additional $40,800 to his 401(k), for a total retirement contribution of $238,100. Assuming a combined federal and state marginal tax rate of 37%, Charles will defer a whopping $88,000 on his taxes in a single year. If he funds the plan for 10 years, Charles will accumulate $2.66 million in retirement savings (assuming an annual 5%-7% funding interest rate) in the DB plan alone. And, he has the option each year whether to fund the 401(k).

Suzanne, on the other hand, is a 60 year old software interface designer with fluctuating income. She averages $150,000 a year in net profit but in good years can make as much as $200,000. She sets up a DB plan with a $50,000 annual contribution and a 401(k). In high income years, she can contribute up to an additional $30,000 in her 401(k); in other years she will make her defined benefit plan contribution only.

Clearly, DB plans offer a remarkable opportunity for the right clients to both build retirement wealth and enjoy substantial tax savings. This is something every tax advisor and CPA should consider when inviting their small business and self-employed clients to a year-end tax planning conversation.

Karen Shapiro, Ph.D. heads Dedicated Defined Benefits Services, an Ascensus company which specializes in setting up and administering Defined Benefit plans for small business owners and other high-earning individuals. CPAs, financial advisors and individuals can find out if a DB plan is the right strategy by using Dedicated DB's online calculator at Dedicated-DB.com.

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