One of the Questions We Hear Today is…

"Are Defined Benefit Plans Good for Successful Small Businesses or Professionals?"

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In 2001 a major part of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was meant to encourage the establishment of small-business retirement plans. As an incentive to small-business owners, the tax-deductible dollar limit and the allowable compensation percentage for such plans has increased. In 2008, the efficiency of these plans was greatly enhanced by *The Worker, Retiree, and Employer Recovery Act* (WRERA), which was passed in Dec. of 2008. This brought positive changes to the qualified retirement plan landscape. Of great importance is IRC 404(a)(7). This new provision now allows business owners to <u>deduct contributions to both a defined benefit plan and a defined contribution plan</u> such as a DB plan and 401(k) and/or profit sharing plan. Previously, there were limits on the profit sharing contribution deduction if the plan was paired with a defined benefit plan. They also added a $500.00 tax credit for a newly set up plan (see IRS Form 8881).

Other recently-passed legislation, such as PPA 2006, has increased the complexity of the funding requirements for traditionally funded defined benefit plans. Finding a Third Party Administrator (TPA) or advisor that can help plan sponsors address the new requirements that must be met to take advantage of these new laws is not always easy, making it even more important that a plan sponsor find a qualified TPA.

In 2015 the maximum contribution limit for defined-contribution plans under IRC Sec. 415(c) (I) (A) is $52,000. Participants at age 50 or more are allowed an additional catch-up limit of $6,000. The next problem for the successful business owner or professional is that even with maximum contributions to a Profit Sharing plan and the maximum deferral in a 401(k) plan (Defined Contribution plans or DC plans) from age 50 to age 65, there is still not enough to retire on.

There is more to consider…

While Sec. 401(k) plans are common, they limit the professional or business owner's tax-deductible contributions. <u>One other seldom discussed issue with the 401(k) plan is that they are the most tax- inefficient retirement plan used today.</u> Why? Because elective deferrals are still subject to a Social Security and Medicare tax of 15.3%. Another seldom discussed fact is that they may in essence discriminate against the successful professional or business owner. Because of tax-law changes in the last decade or *so (provided by EGTRRA and the Pension Protection Act of 2006),* which amend the Employee Retirement Income Security Act by establishing new minimum pension funding standards, many of these successful professionals or owners of companies are eligible for a 401(k) plan, <u>**as well as**</u> a defined-benefit and profit-sharing plan combination. These provisions were permanently installed in the code with WRERA in

December of 2008. An advisor's awareness of these changes will enable him/her to provide new options to clients.

What is a Defined Benefit Plan?

A defined-benefit plan is a qualified plan where a pre-determined formula sets the amount of retirement income *(benefit)* received by a participant. With a traditional defined-benefit plan, the size of the tax-deductible contribution made to fund retirement income benefits under the plan are calculated annually. The rollercoaster of the investment market performance the last decade or so adds an element of risk to these plans.

The actual deductible contributions are determined by a complex set of mathematical calculations and regulatory requirements which must be performed by qualified actuaries (preferably enrolled actuaries). Depending on the age of the participants and benefit levels provided, a defined-benefit plan can achieve tax-deductible contributions well in excess of Sec. 415 limits.

The ability of these types of plans to allow significant contributions can also add to the complexity and reporting requirements. In traditionally funded plans annual contributions and deductions must be calculated each year and are affected by:

- Actual earnings or losses from investment of the trust assets
- And from actuarial assumptions
- And limitations imposed by the minimum funding standards and full funding limitations of IRC Sec. 412.
- They also expose plan sponsors to possible over funding and underfunding penalties as well as other compliance issues

As a result, administration costs tend to be higher for traditionally funded DB plans than for those with defined contribution plans.

The alternative to these higher cost plans is to use a Fully-Insured DB plan under Sec. 412(e)(3), referred to in the IRS regulations as an "insurance contract plan". These plans dramatically reduce the possibility of over funding and underfunding penalties as well as other compliance issues and are exempt from the funding requirements of IRC Sec. 412.

The Fully Insured Defined Benefit Plan under Sec. 412(e)(3), Solution may be the answer.

Fully-Insured or Sec. 412(e)(3) plans are exempt from the DB section's funding rules described above because the burden of providing the benefit is shifted from the ***employer to an insurance company and provides many guarantees not provided under the other plan choices***. They are referred to as "fully-insured defined benefit plans". Why….because the benefits are guaranteed by an insurance company (subject to the insurance companies' claims paying capacity).

Fully-insured defined benefit plans are unique in the retirement planning arena because they have a **higher tax deduction limit than most plans**. Moreover, plan contributions may be greater than those made to traditionally funded defined-benefit plans. They are funded using fixed annuity products and some guaranteed insurance contracts may also be included. Note: Death benefits are limited and must be incidental to the plan.

The interest-rate assumptions are much more conservative in these types of contracts than in traditionally funded defined-benefit plans. National Pension Partners based on their study done in 2009, said "The irony is that in the decade (1/1/1999 to 12/31/2008) these contracts would have outperformed the S&P 500 without the inherent risk of the stock market." Even with the market improvements we have seen in recent years, these plans may still rival the S&P 500. This not only helps reduce or eliminate the investment and compliance risks. By using fixed retirement annuities guaranteed by insurance companies there is less administration cost. It also allows for a greater tax-deduction. While contributions (which are based on *guaranteed interest* and mortality assumptions) to a fully-insured plan generally remain high, they can decrease over time if the insurance contracts used in the plan earn dividends or interest over and above the guaranteed levels. In this situation, these "extra" earnings must be used to offset future contributions.

The accrued benefit for a participant at retirement is a stated monthly pension, or simply the guaranteed cash values of the underlying annuities or policies. Business owners and professionals who would appreciate the ability to set aside large amounts of money each year for their retirement, while taking large tax deductions for doing so—as well as the *fully guaranteed* retirement benefits the plans provide--are the best candidates for these plans. When combined with a profit sharing plan and 401(k) in what is sometimes called a "custom carve out plan" or "combination plan," the professional or business owner can maximize the contributions for themselves and have the best of both a DB plan and a DC plan. Contributions under this "three silo" strategy can be as high as $350,000 in the FIDB/412 (e)(3) plan and $53,000 in all defined contribution plans including the profit sharing plan contribution, and $18,000 in the 401(k) plan, plus $6,000 in catchups. The bottom line is this strategy can optimize the tax deductions available.

The retirement payout is subject to the same IRS limits as all other defined-benefit retirement plans. For 2015, the maximum annual amount that can be received by each participant is generally the lesser of $210,000 or 100 percent of the participant's average up to $265,000 (2015 limits) of annual compensation for the highest three years of work with the same the same employer(s). Just like a traditionally funded defined-benefit plan, you have an alternative to taking periodic distributions from the fully insured plan; a participant at retirement may take a lump sum and roll the assets into an IRA.

Who Qualifies for a 412(e)(3) Plan?

By and large, 412(e)(3) plans are ideal for business owners with relatively few employees that can commit to making large regular contributions. The concept works best for businesses that are well-established, highly profitable and the owners are within 5 to 15 years of retirement.

The plan is equally suited to successful self-employed professionals or individuals who may have been unable to set money aside for retirement in their early years, due to education, family or other obligations, and now need to put away large amounts of money in a short amount of time to in essence "catch up".

- Individuals starting a second career are also good candidates for these plans
- Those who want to provide for family members and heirs should they die unexpectedly?
- They may also be used as part of a business succession strategy
- Many find them to be a more tax efficient alternative to a Solo 401(k)

Note that any life insurance contract transferred from a plan to the individual plan participant must be taxed at its fair-market value, and life insurance must be incidental to the plan so an employer may not buy excessive life insurance under a plan.

Also, Sec. 401(a) 4 discrimination testing could allow business owners to receive a substantial portion of the plan's benefit for themselves. As much as 90 plus percent of all contributions, especially if a "custom carve out" design is used. A first step in determining if a defined benefit plan is appropriate is a feasibility study. This should be performed by a qualified pension consultant to determine the right type of plan and its costs and benefits.

What about a 401k Plan?

In a 401k for example, you can elect to defer salary into the plan up to $18,000 in 2015. If you are over age 50, you may add another $6,000 for a total of $24,000. Many people do that, however **it is not tax efficient**.

Why?

The 401 (k) funds go from the company to an individual in the form of salary. They are then "deferred" into the 401(k). In this case, social security and Medicare taxes are paid on that income prior to the deferral to the 401(k). (*6.2% for social security and 1.45% for Medicare. In addition, the employer must match this contribution-6.2% social security and 1.45% Medicare making a grand total of 15.3%).* For example if you would have deferred $24,000 in the year 2014, $3,672 in payroll taxes would have been paid.

Why is the Fully-Insured Defined Benefit Plan / 412(e) (3) Plan More Tax Efficient?

The contributions come from your company into the plan. Contributions to the plan are not from salary deferral. If the company contributes $24,000 into the defined benefit (FIDB) plan, because it is not received as salary, then deferred, no social security and Medicare taxes are paid on the amount contributed to the Fully-Insured DB plan. Hence, the $24,000 goes to work immediately without incurring a "tax load ". The individual and the company saves about $3,672 in payroll taxes. This is why in some situations a "Solo Fully-Insured" DB plan may work better and provide more tax benefits than the same contributions made to a Solo 401(k) plan.

Small employers may also find a standalone or"Solo"412(e) (3) plan more attractive than traditional defined-benefit plans. For example, no enrolled actuary's certification is needed; there are no required quarterly contributions and there is no full funding limitation applied that might limit contributions. Also, administrative costs are generally lower. The risk of penalties for overfunding the plan, or for underfunding the plan as in traditional defined benefit plans, are tremendously reduced. Another popular feature includes protection of plan assets from lawsuits and creditors.

What are the next Steps?

Many Professionals and small-business owners with successful and mature businesses have higher incomes and assets than traditional wage earners. The problem is that this doesn't always translate into higher retirement savings. Many times they have spent years sacrificing to build a successful business or acquiring the education needed for success in their profession and because of this have not built a retirement plan for themselves. According to a 2004 study by The Public Policy Institute of the AARP, only 12 percent of self-employed individuals over age 50 have a pension or retirement plan. Worse still, based on several recent studies, the average retirement plan account balance is just $147,000 to $193,000. Professionals such as doctors, architects, lawyers, CPA's and individuals with second incomes may benefit from a fully-insured defined benefit plan or from the flexibility of a custom carve-out strategy. There is a set up cost that may be lower provided there are no common law employees but may be higher for larger groups. The business or you may receive a $500.00 tax credit for a newly set up plan (see IRS Form 8881).

We believe these tax law changes create opportunities for an advisor to help clients increase tax deductions through retirement plans, increase baby boomer retirement income and enhance the advisor's relationship with their clients. For a calendar tax year business, the new plan must be adopted by Dec. 31 and funded by the tax due date *(including extensions).* A third-party administrator (TPA) will establish the plan, which includes providing the plan and trust documents and providing the plan trustee with all documents and administrative forms that may be needed in the future. The administrator also provides annual processing of all IRS and Department of Labor forms, plan valuation and 5500 forms.

National Pension Partners, is an internet-based pension plan design and administration firm operating in 49 states. National Pension Partners has a staff of enrolled actuaries, CPAs, CFPs and tax attorneys who work to help plan sponsors with their retirement plan objectives and that their qualified plans are in compliance. CEO of National Pension Partners, Nicholas Paleveda, MBA J.D. LL.M. Nick has over 32 years' experience in law financial services and business and pension planning. Nick is an Adjunct Professor in the Graduate Tax Program at Northeastern University as well as a guest lecturer on pension law and taxation for several colleges and educational institutions across the country. Maxwell A. Coulliette, CFP, CLU, ChFC, is President of National Pension Partners, Max has over 32 years of experience in financial services and working with retirement plans. Max is a regular presenter of CPA/CPE, Insurance professional CE, CFP/CE and a regular speaker at various industry and education programs.

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