Defined Benefit Plans

Explained in Plain English

Defined benefit retirement plans enable successful business owners to significantly increase their retirement savings, while lowering their current income tax liability. Defined benefit plans allow for substantially higher annual contributions for business owners, as compared to other types of retirement plans.

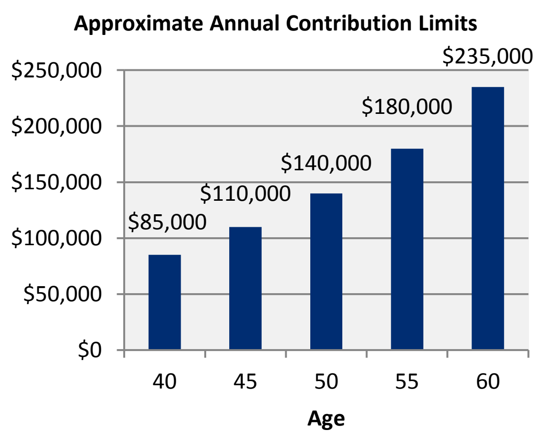
Traditional Defined Benefit Plans

In a traditional defined benefit (or "DB") plan, the plan defines the benefit that will be paid at retirement age (or earlier separation from employment). An actuary determines the annual amount that must be deposited into the DB plan on an annual basis to provide the benefit called for under the terms of the plan. In addition to the benefits to be paid, the actuary takes into account an expected rate of return and other factors (e.g., mortality) when determining the required contribution each year. The actual investment results can serve to cause the required contribution to increase or decrease from year to year based on whether or not they exceed projected returns. The investment results do not alter the benefit the employee receives.

In a traditional DB plan, a participant will receive a retirement benefit defined as some percentage of pay or some flat dollar amount. For example, a DB plan may provide that each participant will receive a monthly retirement benefit of 2% of average pay for each year of service with the employer. A participant with 30 years of service and average pay of $50,000 would then receive an annual retirement benefit of $30,000.

As a general rule, traditional DB plans will have a uniform retirement benefit formula that applies to all participants. Thus, traditional DB plans are an exceptional solution for firms that employ only owners, as the firm does not need to provide a uniform benefit formula to any employees.

Successful business owners often use DB plans to "maximize" their annual pre-tax contributions to the plan and then take a tax deduction for the contribution. There is no maximum contribution that can be made to a DB plan per se. Instead, the retirement benefit that can be paid from a defined benefit plan is limited. Under the law, an employee with 10 years of participation in a DB plan can receive a benefit up to $210,000 per year beginning at age 62, or an equivalent lump sum of approximately $2.6 million. Accordingly, over the employees' working life, the plan can accept contributions necessary to pay this benefit. The chart on the right gives an idea of the maximum permissible annual defined benefit plan contributions.



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