



Independent Actuaries, Inc. is a defined benefit plan expert. Unlike most firms providing retirement plan services, we specialize in this type of retirement plan. Defined benefit plans have been around for a long time, but are often overlooked. There are many cases, though, where a defined benefit plan is the best choice a business owner or company can make to achieve retirement planning objectives.

What is a defined benefit (DB) plan?

A defined benefit retirement plan (or "DB plan") is one of two general types of qualified retirement plans. A qualified retirement plan is one that satisfies certain provisions of the Internal Revenue Code, and in return for doing so, enjoys certain tax benefits. These tax benefits include deduction of contributions to the plan, exemption from tax for the investment earnings on plan investments and deferral of taxation to participating employees until benefits are distributed.

The other type of qualified retirement plan is called a defined contribution plan. Included in this plan type are 401(k) and profit sharing plans.

How do defined benefit and defined contribution plans differ?

There are four main differences:

- In a defined benefit plan, the employer bears the investment risk. This means that good returns lower the employer's cost and bad returns increase it. The employee's benefit is not affected. In a defined contribution plan, employees bear the investment risk. Good returns increase their accounts and bad returns decrease them. The employer's cost is not affected.
- The IRS limits both types of plans. For a defined benefit plan, the limit applies to the benefit paid out. For a defined contribution plan, the limit applies to the contribution going in.
- Benefits in a defined benefit plan may be insured by a government agency called the Pension Benefit Guaranty Corporation (PBGC). If a business goes bankrupt, the PBGC will cover unfunded benefits for participants of covered plans. Plans that are covered pay annual premiums to the PBGC.
- Defined benefit plans are subject to minimum funding requirements while most defined contribution plans are not. However, these requirements are NOT beyond the plan sponsor's control. See [myths about defined benefit plans](#) below.

Independent Actuaries, Inc.

Telephone: 503.520.0848
Toll-free: 888.643.5179

Mailing Address:
15725 SW Greystone Court
Suite 102
Beaverton OR 97006-6016

Web: www.independentactuaries.com
Email: info@independentactuaries.com
Fax: 503.520.1147



What are the advantages of DB plans?

The [differences](#) between a defined contribution plan and a defined benefit plan (see above) result in three key advantages of a defined benefit plan:

- Because it promises a benefit at retirement that is not a function of investment results, a defined benefit plan is the most efficient way to provide a guaranteed level of retirement benefit for employees. The plan can be designed to manage the work force by encouraging early or later retirement, and the employer cost can be reduced by favorable investment returns.
- Because the IRS limits benefits, not contributions, and the plan promises benefits at a specific age, a defined benefit plan can provide for a much larger tax deduction and accumulation of retirement funds on a tax favored basis for the older business owner or key employee.
- If business conditions permit, investment losses can be “made up” through increased tax deductible contributions.

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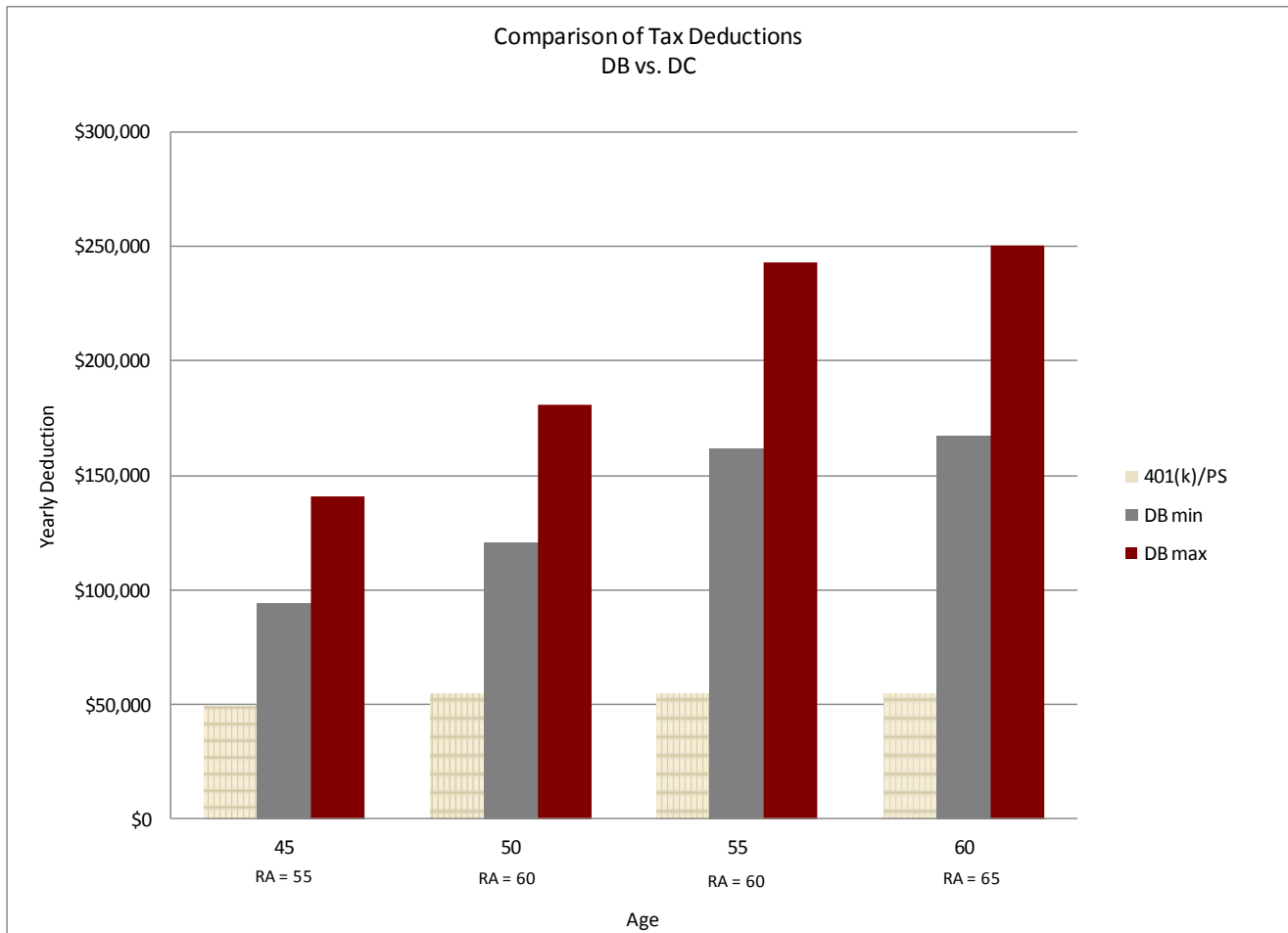
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Comparison of deductions under different types of retirement plans

The chart below illustrates the differences between annual funding levels that can be achieved in Defined Contribution (DC) and Defined Benefit (DB) plans. In a DC plan there is no minimum and, except for catch up contributions at or after age 50, the maximum is independent of current age or retirement age. In a DB plan, there is typically a range between the minimum and maximum contributions and both levels are sensitive to age. The older a participant is and the closer he is to retirement, the higher the contributions.



The chart above illustrates funding for calendar year 2009 based on a single participant making at least \$245,000 and a DB plan providing the maximum benefit permitted under IRC 415, valued using a 4 month look back yield curve.

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Can an employer have both a defined benefit and a defined contribution plan?

Absolutely. In fact one way that we have found to be particularly advantageous is what is called a **Floor Offset** plan combination.

The employer sponsors both types of plans. The defined contribution plan is typically a profit sharing plan and often includes 401(k) elective deferrals. The defined benefit plan provides a minimum, or "**floor**" benefit for the two plans combined. Each participant in both plans gets the greater of this minimum or whatever the account balance from employer contributions in the profit sharing plan will provide. The benefit provided by the defined benefit plan is "**offset**" by the profit sharing account. In many cases, the plans can be structured so that the entire benefit for everyone except the business owner is provided solely by the profit sharing plan and the defined benefit plan functions as a plan that benefits only the business owner. In order to be able to function this way, there is a minimum level of employer contribution to the profit sharing plan (typically 5% to 7.5% of pay) and the plan must pass non-discrimination testing each year based on the demographics of plan participants.

When should a small business owner consider a DB plan?

Any small business owner or professional who is at least 45 years old and wishes to contribute and deduct more than about \$50,000 (or 25% of pay) per year to a qualified retirement plan should consider a defined benefit plan. Please [contact us](#) for more information on how a DB plan can work for you.

What other advantages does a defined benefit plan have for the small business owner?

- Benefits may recognize prior service. Typically, this is to the benefit of the business owner.
- The older a participant is, the more valuable the plan benefits are for that participant. This is also typically an advantage for the business owner.
- Contributions and deductions are not dependent on compensation in the current year. The benefit, and IRS limits on the benefit, may be based on compensation in prior years. Under some circumstances, the business owner may make a substantial contribution without any current taxable compensation.

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Myths about defined benefit plans

- **Only corporations can sponsor a DB plan. NOT TRUE.** A sole proprietorship, partnership or limited liability corporation can sponsor a defined benefit plan on essentially the same basis as a corporation.
- **Plan sponsors cannot control the level of contribution. NOT TRUE.** While DB plans do have funding requirements, these requirements are dependent on the benefits the plan promises. The plan sponsor can control the contribution by amending the plan to change the benefit to be provided. All you need is a good actuary, like IAI, to guide you.
- **Defined benefit plans are expensive to operate. NOT AT INDEPENDENT ACTUARIES!** Give us a call at 888.643.5179 or 503.520.0848, or [email us](#) to request further information.

Sponsoring a DB plan

How the plan works

Each year, an actuary determines the minimum contribution the plan sponsor must contribute. The calculation is based on plan provisions (such as the normal retirement age, the benefit formula, the normal form of payment and the actuarial equivalence stated in the plan document), the participant data (dates of birth, hire participation and termination, expected retirement age and annual compensation), the plan's assets and assumptions about future events. We will ask you for employee data and plan asset information each year.

Based on the above factors and assumptions about future events, the actuary determines how much should be deposited each year, so that as participants reach their retirement ages, there is enough money in the plan to pay benefits.

Adding new participants, increases in compensation, amending the plan's benefit formula to increase benefits, a decrease in interest rates and/or poor investment returns will generally increase the required contributions. More participants than expected terminating their service, an increase in interest rates, good investment returns and/or amending the plan's benefit formula to decrease future benefits will generally decrease the required contributions.

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Designing the plan

Before a plan is set up, a study is generally done to determine the plan design that best meets the employer's objectives. These objectives may include rewarding older, long-term employees or owners, or maximizing the required contributions. Defined benefit plans are generally more beneficial to older, long-term and more highly-compensated employees. We will ask questions of you to help design the plan that best meets your need and budget.

Adopting the plan

Once you have decided upon the DB plan provisions, we or your attorney will draft a plan document with the desired provisions. You will need to adopt (sign) the plan document and notify the plan participants no later than the last day of the first plan year. If your plan contains language that has not been pre-approved by the IRS, you will also have to file your plan with the IRS for a favorable determination letter. The favorable determination letter states that the IRS has found your plan to be a qualified plan. Therefore, you are entitled to the tax deductions necessary to fund the plan. We can assist you with all the paperwork to complete the adoption of the plan. However, because your plan is a legal document, we always request that you have the plan reviewed by legal counsel before adoption.

Benefits and accruals

The projected benefit at retirement is the monthly benefit that a participant is expected to have earned at retirement, assuming the participant will continue to work until retirement age and earn at least the same compensation as in the last year. When a participant retires, he or she will be able to receive the monthly benefit (a life annuity) or may choose (in most plans) to receive a lump sum payment in lieu of the monthly benefit.

The accrued benefit is the portion of the projected benefit that has been earned by the participant as of a particular date. The exact calculation is dependent on the plan's provisions.

The amount of any participant's benefit is NOT directly affected by investment earnings or the amount of plan assets.

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Distributions to plan participants

When a participant terminates employment or reaches retirement age, he or she will be entitled to a benefit from the plan. This monthly benefit is payable as an annuity at the normal retirement age. But you don't have to keep track of all the participants you have in your plan until they reach retirement age. When an employee terminates you may distribute the benefit in a lump sum payment form, assuming the plan allows lump sums. This is the monthly benefit converted into a single payment of equivalent value. This is not the same as the accumulated value of the contributions deposited in to the plan. The lump sum value is essentially the amount of money that should be placed in an interest-bearing account so that when the participant reaches retirement age, the amount of money in the account would buy an annuity equal to the monthly accrued benefit.

Restriction on accrual or payment of plan benefits

Defined benefit plans may have the accrual or payment of certain forms of benefit (such as lump sums) restricted if the asset value falls below certain levels relative to the value of benefits earned. Plans that are sufficiently funded are not subject to these restrictions.

Terminating the plan

The process of terminating a plan involves notifying participants, and for plans covered by the PBGC (see below), filing the termination for review with the PBGC. You will also have the option of having the plan termination reviewed by the IRS. Essentially, you are asking the IRS to do a "mini-audit" of your plan to make sure that your plan remains qualified through the plan termination.

The length of the termination process depends on whether the plan is covered by the PBGC and whether the termination is filed with the IRS for review. Plans not covered by the PBGC may be terminated in as little as 15 days, while plans covered by the PBGC will require at least 60 days. However, in practice it generally takes a little longer than that. If the plan termination is submitted to the IRS for review, the process may be extended for several months or more.

IRS reporting

All qualified plans must file annual returns with the IRS. (There is a limited exception for plans with assets below a certain threshold). As part of your annual administration, we complete those forms and send them to you so that you may file the forms with the IRS.

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The role of the Pension Benefit Guaranty Corporation ([PBGC](#))

Many defined benefit plans are also subject to PBGC coverage. However, plans that include only the business owner (and spouse) and plans sponsored by smaller professional services employers are not covered.

The PBGC is a quasi-governmental agency that guarantees a certain level of benefits that are payable from DB plans. In exchange for this guarantee, the plan sponsor must pay an insurance premium each year. The base premium is a per-participant charge. A variable premium based on the funded status of the plan may also apply. We will calculate the premiums for you and prepare the necessary electronic filing forms. The PBGC also reviews the plan termination to make sure participants receive all the benefits to which they are entitled.

Controlling required contribution amounts

The required contributions are based on the plan's provisions, participant data, funding assumptions and the plan's assets. If the contributions become too large, the plan's benefit formula can be amended or frozen to help contain costs. However, changes in the plan's benefits to increase contributions must be adopted no later than 2½ months after the plan year end, and changes in the plan's benefits to decrease contributions typically should be made during the first half of the year. Ideally, such changes should not be a yearly occurrence. You should contact us as soon as possible if this situation occurs.

Special types of plans

There are three types of specialized defined benefit plans that deserve special comments.

Floor offset plans

A floor offset plan is the defined benefit part of pair of plans whose benefits are coordinated. The other plan is a defined contribution plan (usually a profit sharing plan, sometimes with a 401(k) feature). The floor offset plan provides a minimum guaranteed benefit (or "floor" benefit) from both plans combined. A total benefit based on compensation and service is described in the floor offset plan that is then reduced (or "offset") by a benefit that is equivalent to the account accumulated as a result of employer contributions to the defined contribution plan. After this reduction, the floor offset plan pays what is left and the total benefit from both plans adds back up to the total benefit described in the floor offset plan.

In some cases the benefit equivalent to the defined contribution account is larger than the minimum benefit guaranteed. In this case no benefit is paid by the floor offset plan, but the total benefit (in the form of the defined contribution account) is equivalent to more than this minimum.

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In many cases floor offset plans can be designed so that only the business owner and other favored employees receive any benefit from the floor offset plan. This happens because the defined contribution account fully offsets the minimum benefit for everyone else and the plans are combined to pass non-discrimination requirements of the Internal Revenue Code. In order for this to work, the non-favored employees must be, in general, younger than the owner and other favored employees and the non-favored employees must receive a minimum contribution to the defined contribution (generally between 5% and 7% of pay).

Because the floor offset plan is a defined benefit plan and is subject to defined benefit plan limits on benefits, it can provide much larger benefits and annual deductible contributions than a defined contribution plan alone for an older business owner.

Cash balance plans

A cash balance plan is a defined benefit plan that looks like a defined contribution plan. The benefit in a cash balance plan grows like an account in a defined contribution plan – each year an employer contribution (the contribution credit) is added to a participant’s account balance and the account balance grows with interest (the interest credit). The interest credit isn’t tied to the actual investment return for the plan; it is specified in the plan document. The account balance never loses value so the investment risk and reward are absorbed by the employer, not the participant.

Because a cash balance plan is a defined benefit plan, the contribution for a participant (the contribution credit) can be substantially larger than the maximum contribution to a defined contribution plan – depending upon the age of the participant as much as three or four times larger. A cash balance plan can be designed so that, unlike a traditional defined benefit plan, key employees or business partners with the same pay and service receive the same contribution and benefit payout from the plan regardless of differences in their ages.

Fully insured plans

These plans used to be known as 412(i) plans. In these plans all contributions are invested in life insurance and/or annuity contracts. The annual contribution is whatever is required under these contracts to guarantee the retirement benefit promised by the plan. At any time before retirement, the “accrued benefit” is the cash value of the underlying contracts. Many of the more complex factors for determining the required contribution or the value of benefits do not apply to these plans. There are times when a fully insured plan may be more suitable than a traditional defined benefit plan.

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Requirements and limits

The Internal Revenue Code (IRC) specifies procedures for calculating both a minimum required and a maximum deductible contribution for a defined benefit plan. Both contributions are based on the monthly pension accrued to date, the additional monthly pension expected to be earned during the year, and a prescribed set of interest and mortality assumptions that are updated each year as interest rates change and mortality improves (i.e., people live longer). There is generally a wide range between the minimum and maximum.

In addition to calculating the minimum and maximum, we typically also calculate a recommended contribution which is a "level amortization" of the amount necessary to pay benefits already earned and expected to be earned as they become due. Often, this recommended contribution falls between the statutory minimum and maximum.

The calculations of contribution amounts are based on the ages, compensation, and length of service of the participants in the plan, the value of the assets already in the plan and assumptions about future events. At retirement (or termination of employment), the participant is entitled to a monthly benefit. For purposes of payment, the monthly benefit may be "converted" into a lump sum payment. The lump sum payment is based on the monthly accrued benefit and the age of the participant at the time of the distribution -- not how much money is in the plan.

Contribution requirements

The employer is required to make contributions to fund a defined benefit plan.

The plan may be amended in order to reduce the required contribution. Failure to contribute the required amount may result in an excise tax. Contributions for a plan year can be deposited up to 8½ months after the end of the plan year.

Contribution/deduction limits

The employer deduction limit for a DB plan is a function of the contribution calculation, not a percentage of compensation. There is usually a wide range between the minimum required amount and the maximum deductible amount. The employer can deposit an amount anywhere within that range.



Where the DB plan is not covered by the PBGC, the annual employer deduction limit for an employer with a combination of DB and DC plans is 25% of eligible compensation or the minimum required contribution to the defined benefit plan, if greater. However, even if the minimum required contribution for the DB plan is over 25% of eligible compensation, an employer may still make a deductible contribution up to 6% of eligible compensation into a DC plan. Salary deferrals do not count toward this limit.

The 25% of pay limit does not apply if the DB plan is covered by the PBGC.

Individual contribution and benefit limits

Since the contribution to a defined benefit plan is not allocated to individuals, there is no individual contribution limit for a DB plan. Instead, there are annual benefit limits.

In a DB plan, the benefit for each participant is limited to the average of the highest three consecutive years of his or her eligible compensation. This may include years before the plan was established. This limit is further reduced if the participant has less than 10 years of service with the plan sponsor. For very highly compensated employees, the benefit is also limited by a monthly dollar limit, which is reduced for a retirement age less than 62 and for less than 10 years of participation in the plan. This limit generally affects only owners and very highly compensated employees.

This limit applies to the monthly pension benefit at retirement. The maximum lump sum payable by the plan is the present value of this limit.

About Independent Actuaries, Inc.

IAI is the largest local actuarial firm in the Pacific Northwest. While many actuarial firms offer similar services to IAI's, we are a unique organization. The depth and experience level of our staff set us apart from other independent actuarial consulting firms. The size of our staff allows all work to be reviewed by experienced consultants to assure the highest level of quality. Our local firm service and fee commitments set us apart from the national actuarial firms. As a local firm, we must rely on our reputation to attract and retain our clients. We believe strongly in the importance of customer service and work hard to meet or exceed client expectations. We do not have the overhead costs of many larger firms, which results in significantly lower hourly rates.

We offer our clients the best of both worlds — national actuarial firm caliber services with local firm service and fee commitments.

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