QBI, LLC
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Defined Benefit Pension Plan Solution

Defined Benefit pension plans are powerful vehicles for benefit solutions and tax savings.

Defined benefit plans come in the form of a traditional defined benefit plan and a cash balance pension plan, also known as a hybrid pension plan.

So which plan is the right plan for the business sponsoring a pension plan? It depends. There are many aspects to consider.

Plan Documents

Up to this point, cash balance plan documents must be individually designed plans that require IRS approval that the plan document is qualified in form, while traditional defined benefit plans can be prepared on a pre-approved document that is already the subject of an approved IRS opinion letter.

However, as of the upcoming plan document restatements, cash balance plans will now be eligible to be updated as a pre-approved plan document as well.

Plan Contributions

Both defined benefit and cash balance plans enable business owners to make substantial pretax contributions on their behalf.

For example, each plan can enable an owner to receive a distribution in excess of $2.6 million upon attainment of age 62.

Both plans also enable flexibility regarding the owners' benefits, but cash balance plans make it easier to meet this goal by providing allocations equal to specific dollar amounts.

Pension Limits

Maximum pensions are equal to an annual benefit of $215,000 per year, prorated for years of participation under ten. Traditional defined benefit plans express benefits in the form of this annual benefit and thus it is easy to determine if a pension is approaching the maximum annuity. Whereas, in a cash balance plan, the benefit is expressed as an account balance and it is not readily clear as to whether the balance is approaching the maximum benefit, since the account balance must be converted to an equivalent annual benefit.

Distributions to rank and file employees

In a cash balance plan, the rank and file employees receive their cash balance account when they receive their pension in the form of a lump sum. However, in a defined benefit plan, there are statutory requirements as to the minimum present value of the employees' benefit. The present value is tied to prescribed interest rates and in a low interest rate environment (like experienced over the past ten years) the minimum distribution is relatively high. Thus, a traditional defined benefit plan has the risk of having to pay inflated lump sums to the rank and file employees.

Multiple Owners

For pension plans that include more than one owner, it is easier to allocate specific amounts for each owner under a cash balance plan as their accounts can be credited with a precise dollar amount or percentage of compensation. In a traditional defined benefit plan, if each owner is to receive an annuity equal to the same percentage of pay, the dollar value of their benefits can vary widely, thus making it more difficult to control precisely what each owner is to receive.

Investment Gains and Losses

In a traditional defined benefit plan, the participants do not share in the asset gains and losses. Thus they do not share in the investment risk. However, cash balance plans can be designed such that the participants' benefits can receive increases in accordance with market returns on assets. This approach enables some of the investment risk to be transferred from the employer to the employee. This method is generally used in larger plans, as opposed to plans sponsored by small closely held businesses. Small businesses can better control costs by adjusting the annual allocation credit to the participants; especially the owners.

Age of employees

In a traditional pension plan, the costs for employees increase as their pay increases and as they get older. That is, since an older employee has less time to retirement, there is less time to fund their benefit and thus a higher cost. And since benefits are based on highest average compensation, increasing compensation also increases costs for the employees. In a cash balance plan, it is feasible to set an employee cost as a fixed dollar amount or percent of current pay. This removes the added cost as an employee gets older.

Vesting

A traditional defined benefit plan can have vesting of accrued benefits increase on a graded scale, such as 20% per year beginning after two years, whereas a cash balance plan requires that accrued benefits fully vest after 3 years.

Conclusion

Bottom line is, the owners can control their costs and benefits in either a traditional defined benefit plan or cash balance plan and have substantial flexibility and the ability to receive large benefits (and deductions) in either type of plan.

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