The Defined Benefit Plan Solution For Small Businesses

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About IAI

Independent Actuaries, Inc. (IAI)

- IAI is the largest independently-owned actuarial consulting firm in the Pacific Northwest. We provide customized retirement plan design, valuation, administrative and consulting services to a wide array of clients, including small business owners, large corporations, and public sector employers.
- We have 14 professional credentialed consultants on staff, including 12 credentialed actuaries.
- We specialize in defined benefit plans (both pension and retiree medical) and the majority of our clients are small businesses.
- For additional information and resources, visit our website at:

www.independentactuaries.com

The Defined Benefit Plan Solution

A Defined Benefit Plan (DB Plan) can be a unique but underutilized solution for a number of challenges affecting closely-held business owners.

The goal for today is to help you identify when and how a DB Plan might be a solution for your client.

Agenda

- Differences between defined contribution (DC) and defined benefit (DB) retirement plans
- Pros and cons of each type
- Situations / challenges where a DB plan could be a solution
- Details, examples and case studies
- Questions / discussion

Why are These Plans so Underutilized?

- Bad press. Generally reported from a large or public plan perspective
- Not well understood (so mistrusted)
- Hard to find actuarial firms that specialize in small businesses
- Lack of quality ongoing consulting

Defined Contribution vs. Defined Benefit Plans

Defined Contribution plans (401k, profit sharing, money purchase, SEP, SIMPLE)

- The contribution is the *defined* element
  - E.g. – Employer contributes 5% of pay for participants each year
- Annual contribution limited to $62,000 (2019)
- Deduction limited to 25% of covered payroll
- Amount of savings at retirement is uncertain: depends on investment return and annual contributions
- Investment risk borne by employee

Defined Contribution vs. Defined Benefit Plans

Defined Benefit plans (DB, pension, Cash Balance, Floor Offset)

- The benefit at retirement is the *defined* element
  - E.g. – Benefit defined as an annuity equal to 5% times average compensation for each year of benefit service. Benefit is payable for life beginning at age 62
- *Benefits* are subject to maximum limits:
  - Annual annuity of $225,000 (2019) if payable between age 62 and 65
  - Smaller if paid at an earlier age, larger if paid at a later age
  - Further limited to highest 3 consecutive year average compensation
  - Phased in over ten years of participation
- Maximum benefit payable converts to a lump sum value of about $2.9 million at age 62

Defined Contribution vs. Defined Benefit Plans

Defined Benefit plans (continued)

- Annual contributions needed to fund the benefit are uncertain (determined annually by the actuary)
- Investment risk borne by the employer
- The closer to retirement, the larger the contribution
- Contribution range:
  - Minimum required contributions
  - Maximum deductible contributions
- Maximum deductible contribution can be greater than covered payroll

Profit Sharing / 401(k) Plans

Principal Advantages

- Appreciated by employees
- Easy to understand
- Extremely flexible
- Contributions are generally discretionary.

Principal Disadvantages

- Low contribution limits
- Not designed to be a plan primarily for owners
- Difficult to build sufficient retirement savings in short period of time
- Need high current compensation to maximize contribution

Defined Benefit Plans

Principal Advantages

- Substantially higher contribution limits
- Greater assurance of achieving retirement goal
- Generally higher benefits for owners relative to rank and file employees
- Wide range of allowable contribution provides some flexibility
- *Current* salary not necessary to make a contribution

Principal Disadvantages

- More complicated / less understood
- Underappreciated by employees
- Minimum employer contributions are required

DB Plans Work Best for:

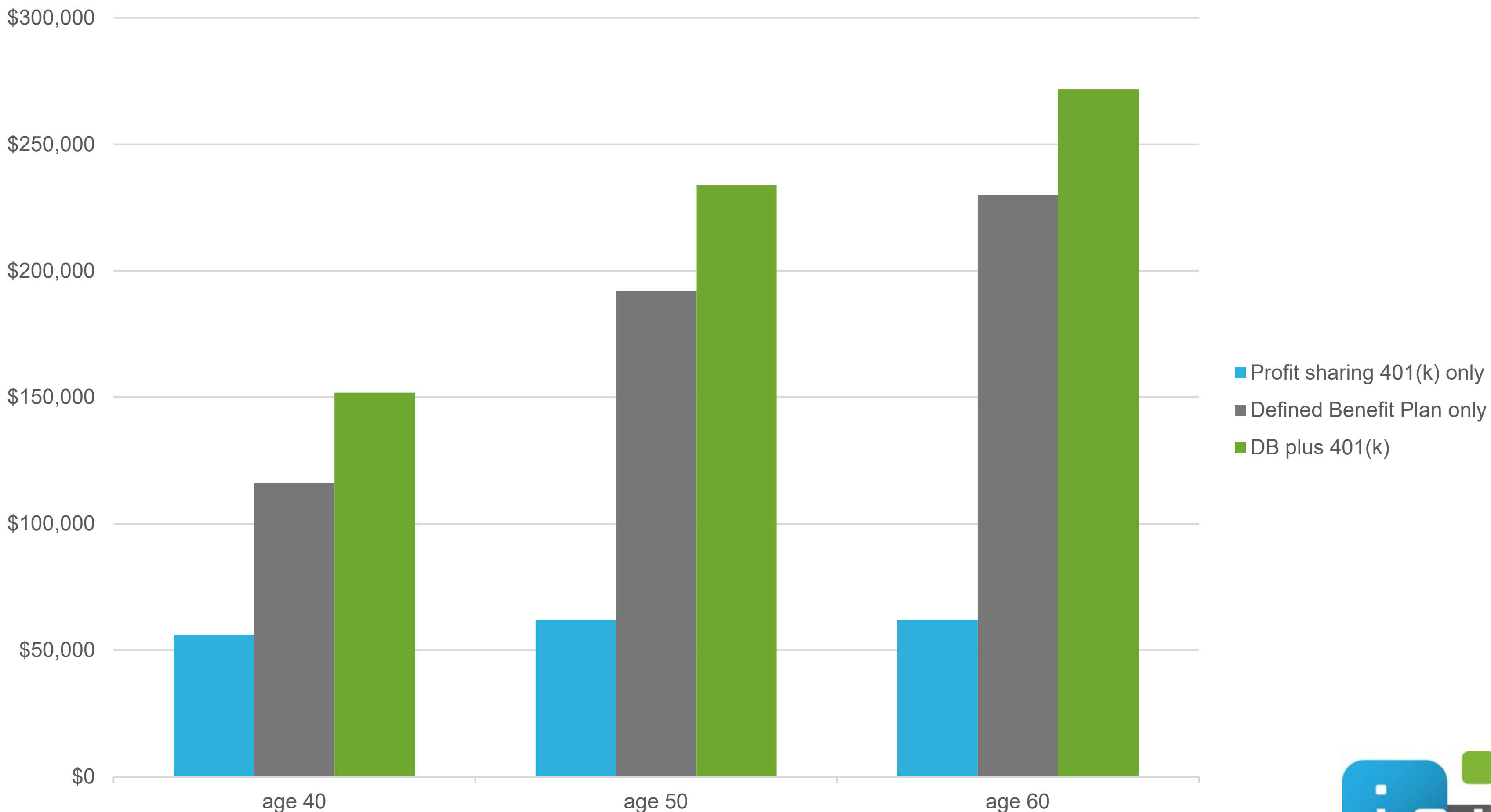
The business owner who:

- is over age 40,
- has historical compensation in the six figure range,
- has no employees or the employees are younger and lower paid than the owner

Challenge #1 where a DB Plan is a potential solution

- The business owner is looking for larger tax deductions and retirement benefits than a 401(k) plan can provide

Contribution Comparison for Owner Only – Over a 10-year period (2019 limits)



Challenges #2 and #3

- The business owner who wants to accumulate a lot of money toward retirement in a short period of time
- The business owner who wants to achieve a specific level of retirement income

Large Contributions and Retirement Fund Accumulation

Set up retirement plan at age 52 and retire at 62

- Assume annual investment return of 6%
- Profit Sharing / 401(k) plan –
  - Maximum annual contribution: $62,000
  - Accumulated value at retirement: $820,000 (will vary based on investment return)
- Defined Benefit plan –
  - Maximum accumulated value at retirement: $2.9 million
  - Average annual contribution: $212,000 (will vary based on investment return)

Challenge #4

- The business owner who wants larger deductions, but still needs flexibility in contribution amounts

Contribution flexibility example

Scenario:

- Owner only participant, age 64, average compensation of $175,000
- Plan set up to target a $250,000 per year contribution
- Fell short first few years then made up in later years

Plan Year	Allowable Contribution Range	Actual Contribution	Notes
2015	$40,000 - $400,000	$170,000	First year
2016	$140,000 - $375,000	$170,000	
2017	$40,000 - $500,000	$40,000	Accruals frozen
2018	$30,000 - $450,000	$350,000	
2019	?	$350,000	Restore accruals?

Challenge #5

- The business owner who wants to provide retirement income for employees, but relatively more for themselves

DB / DC "Combo" Example

Sample Company

Cash Balance Study for 2017 Plan Year

Tiered CB Plan Contributions for Owners

Employee Name	Current Age	Estimated Comp.	Profit Sharing Contribution	CB Plan Contribution	Total Employer Contribution	Employee 401k Contribution	Total Contribution with 401k
Owner #1	55	200,000	6,000	120,000	126,000	24,000	150,000
Owner #2	62	200,000	6,000	120,000	126,000	24,000	150,000
Owner #3	43	200,000	6,000	56,000	62,000	18,000	80,000
Owner #4	44	200,000	6,000	56,000	62,000	18,000	80,000
Employee #1	41	40,000	3,400	600	4,000	0	4,000
Employee #2	56	45,000	3,825	675	4,500	0	4,500
Employee #3	57	39,000	3,315	585	3,900	0	3,900
Employee #4	34	86,000	7,310	1,290	8,600	0	8,600
Employee #5	41	36,000	3,060	540	3,600	0	3,600
Employee #6	42	104,000	8,840	1,560	10,400	8,100	18,500
Employee #7	35	35,000	2,975	525	3,500	0	3,500
Employee #8	36	36,000	3,060	540	3,600	0	3,600
Employee #9	29	16,000	1,360	240	1,600	0	1,600
Employee #10	43	34,000	2,890	510	3,400	0	3,400

Totals	1,271,000	64,035	359,065	423,100	92,100	515,200
Totals for Owners	800,000	24,000	352,000	376,000	84,000	460,000
Totals for Other Employees	471,000	40,035	7,065	47,100	8,100	55,200
% of total to Owners	62.94%	37.48%	98.03%	88.87%	91.21%	89.29%

Challenge #6

- The business owner looking to take full advantage of deductions under the Tax Cuts and Jobs Act

"Supercharged" Deductions

- Creation of deduction for certain pass-through income (Code Section 199A)
- Applies to companies that are NOT C Corps
- Provides for a deduction of up to 20% of qualified business income (QBI)
- Deduction may be limited by the business owner's taxable income minus capital gain income
- If the business owner's taxable income is too high to take advantage of the QBI deduction, a large pension contribution can drop it below the applicable threshold
- The details of how this works are extremely complex and beyond the scope of this presentation

Supercharged Deduction Example

- Eligibility for QBI deduction based on taxable income
  - Married filing jointly get full deduction if <$315k taxable income, but no deduction if >= $415k taxable income
  - Pension contributions reduce taxable income
- Example
  - S-corp owner has $500k taxable income
    - Ineligible for QBI deduction
  - Add a DB plan allowing for $250k annual contributions
    - Gets deduction for the contribution, as well as full QBI deduction
    - Supercharged!

Challenge #7

- The business owner looking to facilitate selling their business while reducing the tax impact

Utilizing a DB Plan in a Business Sale

- Can be utilized in either an asset or a stock sale, but there are very different considerations for each type
- Works best if sale proceeds are made in installments
- Sale proceeds are all or partially deducted as pension plan contributions
- Owner receives sale proceeds as tax deferred income
- Tax advantages may allow for more flexibility in the sales price
- Putting proceeds from a sale into a DB plan may provide protection from creditors that would not otherwise be available

Simple business sale illustration

- Joe is the only employee
- He is age 54 in 2015
- His compensation is $200,000 / year
- He has had a DC plan and has been making the maximum contributions
- In 2015 he sets up a DB plan
- In 2018 he sells the business (asset sale) for annual payments of $250,000 for three years
- In 2022 he terminates the plan and rolls a lump sum benefit of approximately $2,000,000 into an IRA

Simple business sale illustration (continued)

	Year	Compensation	Plan Contribution
DC Plan	2012	200,000	49,000
	2013	200,000	50,000
	2014	200,000	50,000
DB Plan	2015	50,000	250,000
	2016	50,000	250,000
	2017	50,000	250,000
Sale	2018	0	250,000
	2019	0	250,000
	2020	0	250,000
	2021	0	0-?
	2022	0	0-?

Utilizing a DB Plan in a Business Stock Sale

- Works best when the sale is to family member(s) or current employee(s)

- Usually a longer term strategy – owner is generally still working when process is started

- DB is set up primarily to benefit owner with minimal benefits to other employees

Utilizing a DB Plan in a Business Stock Sale

- A benefit with a lump sum value equivalent to all or part of the sale price is provided as retirement income
- Allows buyer to purchase company with tax-deductible contributions
- Owner receives sale proceeds as tax deferred income
- Consider the fact that some sale proceeds are taxed at capital gains rates and retirement income is taxed at ordinary income rates

Case Study #2

	No DB Plan	With DB Plan	Comparison
Value of business	$1,500,000	$1,500,000	
Cost to Buyer			
Cash Down Payment	$500,000	$500,000	
PV of after-tax principal payments over 10 years	$1,000,000		
PV of tax-deductible Pension Payments		$1,000,000	
	$1,500,000	$1,500,000	
Annual P&I payment at 5.5% interest	$126,000		
Annual pension contribution over 10 years		$126,000	
Deductible amount @ 50%	-$13,000	-$63,000	
Average annual after-tax cost @ 50%	$113,000	$63,000	
Total cost to buyer over 10 years	$1,130,000	$630,000	($500,000)
Proceeds to Seller			
Down payment at capital gains tax @ 30%	$350,000	$350,000	
After-tax sale proceeds - Interest @ 50%	$130,000		
After-tax sale Proceeds - principal @ 30%	$700,000		
Accumulated value of proceeds at 5.5% @ 30%	$198,000		
Single sum value of pension benefit (rolled into an IRA)		$1,712,000	
Total proceeds *available* to Seller at end of 10 years	$1,378,000	$2,062,000	$684,000
Single sum value of pension benefit (paid directly to seller @ 50%)		$856,000	
Total After-tax Proceeds to Seller	$1,378,000	$1,206,000	($172,000)

Stock Sale with Outside Buyer

- Can work with outside buyer, but is more complex:
  - Seller sets up a separate business (consulting?)
  - Avoid Controlled Group or Affiliated Service Group relationships
  - Need some service and salary in the new business
  - Sale proceeds are paid to new business
  - Especially important to get good legal and tax advice in this situation

Comments, Caveats and Cautions

- There are many things that go into setting up a DB plan. It is important that all legal and tax as well as actuarial issues are considered. The actuary setting up the plan will want to consult with the business' attorney and CPA as well as the plan sponsor to make sure all bases are covered.

- The case studies shown in this presentation are for illustration and discussion purposes only. In the interest of clarity, they have been simplified and generalized and do not necessarily represent any real-life situations.

When is a DB plan not likely to be a good solution for your client?

- If the business owner is generally younger than the workforce.
- If a maximum contribution of up to $60k is acceptable to the owner.
- Like all qualified retirement plans, a DB plan must cover a cross-section of employees. Sometimes the cost to cover employees outweighs the other financial advantages.

Other Considerations

- DB plans are flexible, but not as flexible as a 401(k) plan. The business owner needs to be prepared for minimum required contributions and other rules and regulations that come with sponsoring DB plans.
- There are costs to set up and administer a DB plan. The more complex the plan design, the higher the cost. This needs to be weighed against the benefits.
- Can “front load” the contributions but may require the plan continue for a period with no contributions.

Conclusion

- A defined benefit plan can be a valuable tool to help your clients achieve retirement goals and manage tax liability, but they don’t work for everybody. Hopefully, you leave today with some idea of when a DB plan could solve a problem for a client (and make you look good in the process!). If you aren’t sure, call us! We want you to consider us your resource for any DB or other retirement plan questions.

How to contact us

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