WRMarketplace
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TOPIC: The "Old School" Retirement Plan – Defined Benefit Plan Basics.

MARKET TREND: *The topic of workers' preparedness for retirement is the subject of widespread discussion. A significant percentage of these individuals' retirement income comes from employer-sponsored retirement plans, with some employers still promising a specified level of benefit to be paid out at retirement.*

SYNOPSIS: *Defined benefit plans promise a specified amount to be paid to a participant upon retirement, usually in the form of an annuity. The major considerations for these plans include the following: (1) the employer must establish a formula for calculating the amount payable at retirement; (2) the Internal Revenue Code ("Code") limits the maximum amount that can be paid to a participant in any year; (3) the participants must vest in their accrued benefits within specified time periods; (4) the plans cannot discriminate in favor of highly compensated employees; (5) employers must satisfy, annually, minimum funding standards set under the Code; (6) benefits must be provided in specific annuity forms, unless consented to otherwise by the participant (and spouse); and (7) benefits generally are taxed to participants when distributed.*

TAKE AWAYS: *Defined benefit plans can offer very valuable benefits to employees, since they provide for a stream of lifetime income throughout retirement. Correspondingly, this can generate significant employee loyalty and retention for the employer, as the plan provider. Many employers, however, find that having to bear the full risk of the plan's investment performance and the burden of ensuring adequate funding for the plan far outweighs the potential employee retention benefits. As a result, defined benefit plans are continuing to decrease in popularity for larger companies, although there has been some interest in these plans for very small companies and one- or two-person firms.*

WHAT IS A DEFINED BENEFIT PLAN?

A defined benefit plan, or traditional "pension plan," is an employer-sponsored retirement plan that pays out a pension to the participant in a specified amount. Each year, the employer sponsoring the plan contributes at least the amount that is determined by the plan's actuaries as being sufficient to meet the funding obligations applicable to the plan under the Code. These funding requirements are intended to ensure that the plan contains assets sufficient to pay benefit obligations as they become due.

A defined benefit plan contrasts with a "defined contribution plan," under which the plan specifies the amount that will be contributed each year by the employer and/or employees, and the amount ultimately payable to the participant is the aggregate amount of those contributions adjusted for earnings or losses.

HOW IS THE AMOUNT OF A PARTICIPANT'S PENSION DETERMINED?

The amount of a participant's pension is determined by applying a formula set forth in the plan document. The most typical formula provides for a pension payable at normal retirement age equal to a specified percentage of the participant's compensation for each year of service performed for the plan sponsor by the participant. For example, a common pension formula is 1.5 percent (1.5%) of compensation times years of service. Thus, a participant who works for his employer for 30 years would be entitled to a pension equal to 45% (i.e., 1.5% * 30 years) of the participant's compensation. Some plans provide for the percentage multiplier to be applied to the compensation earned each year; other plans provide for the multiplier to be applied to the participant's average compensation over his final three or five years of service. This latter formula generally yields a higher pension amount.

Another popular formula, though most commonly found in plans maintained for union employees, is a flat dollar amount per year of service. Thus, if the plan provided a monthly pension equal to $50 per year of service, a participant with 30 years of service would be entitled to a pension of $1,500 per month (i.e., $50 * 30 years).

ARE THERE LIMITS ON THE ANNUAL AMOUNT PAYABLE TO A PARTICIPANT?

Yes. Under Code § 415, the maximum amount that can be paid to a participant under a defined benefit plan is equal to the lesser of (1) 100 percent of his average compensation for his high three years, and (2) a specified dollar amount. That specified amount for 2015 and 2016 is **$210,000**. This limit is adjusted in the event that the benefit is paid to the participant in a form other than a single life annuity or a joint and survivor annuity with the participant's spouse as the contingent annuitant. (Forms of pension payment are discussed in greater detail below.)

Pensions are often calculated as a percentage of a participant's compensation. The Code limits the amount of compensation that can be taken into account in any year in calculating the participant's pension accrual for that year. For 2015 and 2016, this limit is **$265,000**.

DOES A PARTICIPANT VEST IN HIS OR HER ACCRUED BENEFIT?

Yes. A participant vests in his or her plan accrued benefit (i.e., the participant's rights to amounts accrued as of any date under the plan's pension formula) in accordance with the schedule set forth in the plan document. The limits of these schedules are established under the Code, which allows slower vesting as compared to what is required for defined contribution plans. Specifically, if a "cliff" vesting schedule is used, the defined benefit plan's vesting

schedule cannot delay vesting beyond the participant's completion of five years of service. If a "graded" vesting schedule is used, a participant must become vested in his or her accrued benefit at least as rapidly as the following:

Graded Vesting Schedule	
Years of Service	**Non-forfeitable Percentage**
3	20%
4	40%
5	60%
6	80%
7 or more	100%

DO NONDISCRIMINATION RULES AFFECT ANNUAL ACCRUALS OF PARTICIPANT BENEFITS?

Yes. For a plan to maintain its tax-qualified status, it must not discriminate in favor of "highly compensated employees" in terms of the benefit accrued by participants. Generally, defined benefit plans satisfy this requirement through the formula used to calculate participants' benefits. As long as similarly situated participants (i.e., those with the same amount of service taken into account under the plan) have benefits that are equal in proportion to their compensation, the plan will not be discriminatory. Thus, by defining participants' accrued benefits as a percentage of compensation per year of service, the plan sponsor ensures that the benefits are not discriminatory. If a flat dollar amount per year of service is used, the plan will also not be discriminatory, because the flat dollar amount will represent a smaller percentage of a highly compensated participant's compensation than it will of a less highly paid participant.

DO EARNINGS OR LOSSES WITH RESPECT TO PLAN ASSETS AFFECT THE PLAN?

No. Unlike a defined contribution plan, under which assets of the plan are invested and investment gains and losses affect the amount ultimately payable to the participant, earnings and losses in a defined benefit plan do not affect the amount payable to a participant. That amount is determined solely by reference to the plan's benefit formula. Instead, earnings and losses affect the amount the employer is required to contribute to ensure that the plan is adequately funded.

WHEN ARE AMOUNTS DISTRIBUTED TO PLAN PARTICIPANTS?

Pension payments are generally made at the election of the participant. All plans provide for benefits to be able to begin when the participant reaches normal retirement age, although some plans provide for an early retirement age. The most common normal retirement age is

65, though some plans have a younger normal retirement age. Early retirement ages frequently are as young as age 55, but many plans require that the participant complete a specified amount of service as well to be able to commence his or her benefit early. Typically, the amount of a participant's benefit is reduced if it commences at an early retirement age, to reflect the fact that benefits will be distributed over a longer period than if they began at normal retirement age.

If a participant has terminated employment but has not begun taking distributions of his or her accrued benefit by the time the participant attains age 70½, the plan must begin making distributions by the April 1 following the date on which the participant attains age 70½. If the participant remains employed beyond that point, distributions must begin following the participant's termination of employment. Failure to make these distributions can result in a **50% penalty tax on the undistributed amount**.

Distributions also may be made following the death of a participant. In such a case, pension payments usually begin at the time the participant would have achieved his or her earliest retirement age under the plan and are made to the participant's designated beneficiary. This beneficiary must be the participant's spouse if the participant is married, unless the spouse consented in writing to the designation of another beneficiary or waived his or her right in writing to a pre-retirement death benefit. A defined benefit plan does not have to provide a death benefit on behalf of an unmarried participant, but it is common practice for a plan to allow an unmarried participant to designate a beneficiary to receive benefits following the participant's death.

IN WHAT FORM ARE DISTRIBUTIONS MADE TO PLAN PARTICIPANTS?

Unless properly elected otherwise, a benefit to an unmarried participant must be paid in the form of a single life annuity, and a benefit to a married participant must be paid in the form of a joint-and-50%-survivor annuity with the spouse as the designated beneficiary of the contingent annuity. Numerous other forms of annuities – such as joint-and-survivor annuities with different survivor percentages, life-and-period-certain annuities, social-security leveling annuities, etc. – are made available under defined benefit plans, but any such annuity can only be elected if the participant's spouse consents to the different form after being provided with extensive disclosure that includes disclosure of the relative value of the various distribution options available. If an optional form of benefit is elected, the amount payable to the participant and his or her contingent annuitant, if any, is adjusted to make the value of the benefit payment actuarially equivalent to the value of the single life annuity or the qualified joint-and-survivor annuity. Lump-sum distributions are rarely offered because they represent a significant potential drain on plan assets.[1]

HOW ARE PARTICIPANTS IN A DEFINED BENEFIT PLAN TAXED?

Participants' benefits under defined benefit plans are not taxed as they accrue under the plan but are taxable when paid from the plan. These distributions, however, are **not** taxed if they

are rolled over to an IRA or another employer's tax-qualified plan, although such rollovers are not typical because defined benefit distributions generally are made in annuity form.

WHERE ARE DEFINED BENEFIT PLANS SEEN TODAY?

While defined benefit plans used to be common with large businesses, their popularity has shrunk, with a relatively small percentage of large private companies offering these plans as their only retirement benefit, and a somewhat larger (but still low) percentage offering them with a combination of a defined contribution plan (see discussion of defined contribution plans in WRMarketplace No. 15-35). Still, there has been some renewed interest in these plans for owners of very small businesses as a way to maximize savings for retirement. With a defined benefit plan, the small business owner can make larger annual contributions than to a defined contribution plan, and can combine the defined benefit plan with other retirement savings options, such as an individual 401(k). So if a small business owner has not previously planned for retirement, wants to save a significant amount, and has the funds available, a defined benefit plan may be a way to jumpstart the retirement plan process.

However, there are several practical costs and considerations associated with defined benefit plans. For example, the defined benefit plan will apply to the entire business, so if there are more than a couple of employees, the funding requirements and other costs could likely be prohibitive (just as they have become for larger companies). Further, minimum funding requirements will still apply and must be determined each year by an actuary for each participant, so there are potentially significant administrative costs. And the minimum funding requirements must be met annually, so the business needs to ensure it will have sufficient annual cash flow to satisfy those obligations.

TAKE AWAYS

Defined benefit plans can offer very valuable benefits to employees, since they provide for a stream of lifetime income throughout retirement. Correspondingly, this can generate significant employee loyalty and retention for the employer, as the plan provider. Many employers, however, find that having to bear the full risk of the plan's investment performance and the burden of ensuring adequate funding for the plan far outweighs the potential employee retention benefits. As a result, defined benefit plans are continuing to decrease in popularity for larger companies, although there has been some interest in these plans for very small companies and one- or two-person firms.

NOTES

[1] Often, if a lump-sum option is made available, it is limited to participants whose benefits have a present value not in excess of a specified threshold, such as $25,000.