



# YOUR MONEY:

## Defined Benefit Plans Offer Numerous Perks

September 2007, By Guy McPhail

**Consider a defined benefit plan if you'd like to alleviate some of your company's tax burden—and fuel retirement savings for yourself and your employees.**

Most small business owners would like to reward steadfast employees by offering a retirement plan as a benefit. And, of course, they are interested in socking away money to fund their own future financial independence. While defined contribution plans such as profit sharing, SEP IRAs and 401Ks have captured the spotlight in recent years, an alternative — the defined benefit plan — should not be overlooked.

Defined benefit plans, or “pension plans,” have been most commonly thought of as a perk for the employees of large corporations or union workers. But many small business owners fail to realize this plan type is an opportune vehicle for creating wealth for themselves and their employees — and reducing their company's tax burden.

### The ABCs of DBPs

Defined benefit plans are a great tool especially for the small business owner who wants to accelerate his or her retirement savings. These plans are typically best suited for owners who are older than their employees and are therefore closer to retirement, and who take home a significant percentage of the company's annual payroll. Defined benefit plans can be implemented regardless of the number of employees you may have, if any.

The contributions for defined benefit plans are usually calculated from a formula based on the ages of the owner and respective employees and their compensation. The older the employee and the greater their compensation (up to IRS compensation limits), the larger the contribution required for that person.

The amount you can contribute to a defined benefit plan is typically much higher than what can be contributed to a defined contribution plan. A defined contribution plan has lower set limits for allowable contribution amounts. How much lower? A defined benefit plan for a small business owner has the potential to allow contributions that are three to four times higher than what is allowable with a defined contribution plan. Additionally, contribution amounts to defined benefit plans are also adjusted each year to ensure the target goal is reached.

Let's take a look at a typical example of a small business owner's annual defined benefit plan investment scenario:

Employees	Ages	Annual Contribution	Annual DB Plan Contribution	Contribution as % of Total Compensation
Owner	59	\$220,000	\$150,000	89.8%
Employee 1	39	47,000	7,500	4.5%
Employee 2	34	42,000	4,700	2.8%
Employee 3	29	37,000	2,900	1.7%
Employee 4	24	32,000	1,900	1.2%
Total Contribution			\$167,000	100.0%

SUMMARY OF TAX SAVINGS		
Total Contribution for Small Business Owner		\$150,000
Total Contributions & Tax Deduction for the Business	\$167,000	
Less: <b>INCOME TAX SAVINGS</b> (Assuming a Federal and State Rate of 45%)	75,1500	
<b>Net Cash Paid Out</b>	\$91,850	\$91,850
<b>Portion Of The Owner's Net Contribution Funded by the TAX SAVINGS</b>		\$58,150

In this example your company is aggressively investing in retirement plans by contributing \$167,000 to the defined benefit plan of which you, the owner, are getting \$150,000 of the money or benefit added to your retirement plan savings. The \$167,000 is treated as an expense on your tax return, which can be deducted from revenues. If your business is a Partnership, LLC or S-Corporation which most small businesses are, and you are also in a high tax bracket the tax savings would be along the lines of what the above example shows.

Wouldn't you like the opportunity to put away \$150,000 in pension savings at a cost of only \$91,850? It's important to understand that because of the *additional* savings from your tax deduction the government is essentially funding the remaining \$58,150 of that annual contribution. Imagine how much revenue you'd have to generate to earn a \$58,150 profit — that's a lot of sales. Instead, you contributed \$58,150 toward your retirement without working any additional hours. In addition, you are contributing \$17,000 to your employees' pensions *without any cash outlay*.

Defined benefit plans generally reward long-service employees and can be a real loyalty builder. Workers don't "earn" the right to keep the entire balance of their plan until they have been with your business for a specific amount of time. Since the benefit value reaches its highest level as employees approach retirement, the plan minimizes payouts to workers who leave the company prior to retirement. For example, if an employee leaves after, say, two years, the vesting schedule may only allow him or her to receive 40% of the balance. Where does the other 60% go? It typically reverts back to the remaining plan participants, and is distributed according to their plan ownership ratios. Or, the small business owner has the option of applying those funds to future plan contributions. That means more cash in your pocket without additional outlay.

Ever wonder why OJ Simpson still lives a nice lifestyle when he reportedly lost everything in his civil suit? Well, an advisor was surely smart enough to put money away for him in a plan such as this because the monies are protected from lawsuits. For people in high-risk businesses such as construction this is an added benefit not be taken lightly.

### **Enlist the Pros**

I find that scenarios such as the above example surprise some prospective clients. They may have defined benefit plans, but their plan implementation isn't nearly as impressive. They are considering eliminating the program, and rightly so. Brokerage firms, insurance companies, investment advisory and even CPA firms frequently use "off-the-shelf" or prototype defined benefit plans, which have been adopted for general or mass use, and just "plug" in numbers without customizing the plan to the particular employer and his or her employees. Unfortunately, business owners don't realize their plan could be performing better, as my example above demonstrates. In these prototype plans I find the generic contribution levels are typically low — around the mid-five figures. Even more disturbing is the fact that many professionals utilizing such "off-the-shelf" plans don't understand them, or fail to recognize they are not serving their clients as well as they could with a customized defined benefit plan. In contrast, every plan that Zdenek Financial Planning recommends is approved individually by the IRS and by the plan administrator.

Unlike defined contribution plans, these plans can be somewhat complicated to set up and maintain. So, it's important to enlist the right pros. Use a great CPA who understands your current tax situation and can look ahead to your financial future. Hire an actuary to run calculations and valuations on a regular basis to ensure the required investments are being made and the promised benefits are adequately funded. And rely on an investment advisor who has a proven track record of providing acceptable investment returns to keep you and your employees on track. Your CPA can also make sure the Pension Benefit Guaranty Corporation (PBGC), a federal agency, insures the plan benefits, and makes sure all required paper work is handled and the annual premiums are paid. While these financial pros may sound costly, their fees can be minor compared to the wealth you can build quickly for yourself and your employees all while relieving a substantial tax burden for your business.

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