BY JOHN HIGGINS

Time for Small Businesses to Rethink Defined Benefit Plans?

Historically, the defined benefit plan was the standard type of employer-sponsored retirement plan. However, over the past decade, defined benefit plans have declined in popularity among many small business owners. Defined contribution plans, such as profit-sharing plans and 401(k)s, stole the spotlight, particularly during the booming 1990s.

But what is the best option for a business owner with 15 or fewer years until retirement who wants to accumulate a significant benefit in a relatively short period of time?

The dollar limits for defined contribution plans (the lesser of $42,000 or 100 percent of salary in 2005) may make it difficult for construction business owners interested in accelerating their retirement savings to reach their goals. Strong candidates for defined benefit plans include older owners of closely held businesses with few employees—in particular, owners who are older than their employee population and who take home a significant percentage of the payroll.

Defined benefit plans offer fixed retirement benefits that vary according to the specific plan, but are generally based on the participants' salaries and years of service. In contrast, defined contribution plans provide no specific benefit. Instead, retirement benefits are based on the amount contributed (an employee's elective deferrals plus employer contributions, if applicable) and the investment performance of the account.

Favorable changes to defined benefit plans began with the Small Business Job Protection Act of 1996, when a repeal of Section 415(e) allowed participants of both defined contribution plans and defined benefit plans to fully benefit from both for plan years beginning in 2000. This legislative reform also eliminated the provision that required married business owners to aggregate compensation.

In 1997, the Taxpayers Relief Act (TRA) repealed a 15 percent excise tax on excess distributions from qualified retirement plans. Coined the "success tax," it was levied on amounts of more than $160,000 and, when added to income taxes, could take a significant bite out of benefits.

More recently, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) lowered the possible age for funding full benefits to 62, and raised the maximum annual benefit limit, which is $170,000, in 2005. This figure will be adjusted annually, in $5,000 increments, according to inflation. Furthermore, this legislation boosted the amount of yearly compensation that may be considered for benefit purposes, with the 2005 limit set at $210,000. This amount also is indexed for inflation every year in $5,000 increments.

EGTRRA is currently scheduled to expire Dec. 31, 2010. Unless Congress takes additional action, all legislative changes will revert to their status prior to EGTRRA.

PROS

Given the regulatory changes, the characteristics that can make a defined benefit plan an attractive option for small business owners include:

- **Counting prior service allowance.** Unlike most other plans, a defined benefit plan can count prior service with the employer in determining the benefit. This allows business owners, who may have delayed setting up a retirement plan until late in their careers, to make up for lost time.
- **Higher contribution and deduction levels.** Unlike defined contribution plans—which limit annual contributions—an employer sponsoring a defined benefit plan generally can contribute and deduct the annual amount necessary to fund the projected benefit.
- **Higher benefit levels.** While EGTRRA gave a boost to both defined benefit and defined contribution plans, business owners may find that defined benefit plans offer a better opportunity to build a substantial retirement fund.

CONS

Some small business owners may still find defined benefit plans less attractive than defined contribution plans for the following reasons:

- **Complexity.** In general, a defined benefit plan is more complicated to administer. Actuarial calculations must be performed on a regular basis, and the benefit formulas and options can be complex.
- **Cost.** An actuary must be retained to perform annual calculations and valuations to help ensure the promised benefits are being adequately funded. Also, the Pension Benefit Guaranty Corporation (PBGC), a federal agency, must insure the plan benefits. Annual premiums must be paid to the PBGC.

So are defined benefit plans worth considering? For the small business owner who started late in preparing for retirement or who wants to save more, a defined benefit plan might be a viable option. A qualified professional can offer specific guidance.

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