

Could You Create Your Own Pension Plan?

SBOs are taking a new look at old-school defined benefit plans.

By Magda Perez

Contrary to popular belief, classic pension plans have not disappeared. Corporations have mostly jettisoned them, but highly profitable small businesses are giving them a second look. Why are small business owners deciding to adopt old-school, employer-funded retirement plans?

The tax breaks attached to a defined benefit plan may be substantial. In fact, if these plans are funded with insurance contracts or guaranteed insurance products, plan contributions made by the owner become tax-deductible for the business.¹

There is no cap on how much you can save. IRAs, 401(k)s, and SEPs all have annual contribution limits. Traditional employer-funded pension plans do not. Business owners have the potential to accumulate millions for the future through such a vehicle.

For the record, the IRS does limit the yearly retirement income that a participant in a defined benefit plan may receive. In 2017, the pension benefit resulting from such a plan may not exceed a) \$215,000 or b) 100% of the participant's average compensation across his or her three highest-paid consecutive years of service.²

If you are earning well into six figures and you are 45 or older, you may have entered the "sweet spot" when it comes to defined benefit plans. You will presumably be in your peak earning years, and yet you may need to accelerate retirement savings. A defined benefit plan offers you the possibility to do just that.

What are the downsides? Cost and complexity. Actuaries have to be involved (and paid) when you have one of these plans; you need an actuary to perform regular and annual calculations and valuations to see that the plan is being properly funded. In addition, the pension benefits need to be insured through the federal government's Pension Benefit Guaranty Corporation (PBGC), and in exchange for that service, the business must pay the PBGC annual premiums.^{2,3}

An actuary must determine the annual employer contribution amount needed to fund the plan (typically adjusted yearly in light of investment performance) and the actuarial formula used to make contributions per worker. The business must fund the plan annually, regardless of how well it is doing.⁴

What businesses are bad candidates for defined benefit plans? If you have a small firm with ten or more employees, or if most of your employees are older or high-salaried, these plans may be a poor choice. That is because the employer contributions could be very expensive, even if you opt for vesting.^{1,3,4}

What businesses are good candidates? Accounting, consulting, and medical practices are often good fits for these plans; seeing how many baby boomers have elected to continue working as consultants, you may see interest rising in them during the coming years.^{1,3,4}

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Citations.

1 - investopedia.com/terms/1/412i.asp [12/20/16]

2 - irs.gov/retirement-plans/plan-participant-employee/retirement-topics-defined-benefit-plan-benefit-limits [10/28/16]

3 - cfo.com/retirement-plans/2016/03/weighty-new-conundrum-pension-plan-sponsors/ [3/31/16]

4 - us.axa.com/axa-products/retirement-planning/articles/understanding-defined-benefit-plans.html [10/16]