

DEFINED BENEFIT PLAN EXECUTIVE SUMMARY

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1. What is a defined benefit plan?

Put simply, a defined benefit (DB) plan (commonly referred to as a “pension”) promises to pay an eligible employee a specified monthly benefit at retirement. The plan may state this promised benefit as an exact dollar amount, such as \$100 per month, or a percentage of compensation, such as 50% of average monthly compensation. Often, the plan may calculate a benefit using a plan formula that considers such factors as service and salary.

2. What are the tax benefits of a defined benefit plan?

Like other qualified plans, a DB plan offers tax-incentives to both the employer and their employees. Employer contributions are tax-deductible to the employer and tax-deferred until retirement distributions are made to the employee. Depending on a participant’s age and compensation amount, this type of plan can allow for employer contributions that exceed the limitations of defined contribution plans (such as a 401(k) or profit sharing plan). In addition to enhanced benefits, a DB plan may be combined with a 401(k) or profit sharing plan to allow for even larger contributions.

3. How are retirement benefits calculated?

As mentioned above, retirement benefits under a DB plan are based on a formula. When designing a DB plan, the consultant takes into account the age and compensation demographics of an employer’s workforce and the desired funding level that the client would like to achieve. Based on this information, a benefit formula(s) is developed.

For many plans, an employee’s retirement benefit is calculated by averaging the employee’s earnings over a period of time, whether a stated period such as the average of 3 consecutive years, or his or her entire career.

The “cost,” or contributions necessary to fund these calculated benefits, are not easily calculated and require application of actuarial science.

4. How are contributions determined?

Each year, the plan will employ a pension actuary to calculate the current and future benefits that are projected to be paid from the plan and, ultimately, determine what amount needs to be contributed to the plan to fund those projected benefit payouts.

Contributions are actuarially determined by taking into consideration the employee’s life expectancy, normal retirement age, possible changes to interest rates, the annual retirement benefit amount, and, for larger employers, the potential for employee turnover.

5. Who funds a defined benefit plan?

Almost all DB plans are funded exclusively by employer contributions and, unlike 401(k) plans, contributions are pooled. In other words, individual accounts are not allowed. Typically, assets are invested by the plan trustees with the assistance of financial professionals.

Participants have no discretion to direct their investments. The investment risk is borne by the employer. If assets increase above the assumed actuarial interest rate, the employer will fund less into the plan. The reverse is also true - if assets underperform the assumed actuarial interest rate, the employer is responsible for funding the shortfall.

6. What is the maximum amount the employer may contribute to a defined benefit plan?

DB plans do not have (defined) **contribution** limits. The contributions are a function of a participant's age and compensation, along with the application of the benefit formula. For example, younger, lower paid participants will generate lower contributions. Conversely, older employees, and especially older, highly-compensated employees (HCEs), will generate larger contributions.

There are **benefit** limitations defined by the IRS. These limitations are stated as an annual benefit payable at normal retirement age. Such a maximum can be as high as \$200,000. Again this is a maximum annual benefit not a maximum annual contribution.

7. When must the employer deposit contributions into the plan?

Contributions to a DB plan can be deducted for a taxable year if the contribution is deposited to the plan's assets **no later than the due date for filing the tax return for that taxable year** (including extensions). To meet the minimum funding requirements, the plan must be funded **no later than 8½ months following the plan year end**. For example, a December 31 plan year end would require funding no later than September 15th.

8. How and when will retirement benefits be paid?

Benefits under the plan are paid upon the occurrence of a distributable event. Such events may include:

- Reaching Normal Retirement Age
- Death
- Disability
- Termination of Employment

A DB plan allows different payment options, including:

- **Single life annuity** – a life-long, fixed monthly benefit.
- **Qualified joint and survivor annuity** – a life-long, fixed monthly benefit. Upon the employee's death, the employee's surviving spouse will continue to receive benefits in an amount equal to at least 50% of the employee's benefit until their own death.
- **Lump sum payment** – a payment of the entire present value of an employee's accrued benefit.

Each employer's plan design will determine what options are available to employees.

Typically, employees will be offered the option of purchasing an annuity or taking a lump sum distribution equal to the present value of the accrued benefit accumulated at the time of the participant's distribution.

9. How much must be paid to a terminated employee?

The plan actuary will determine each employee's accrued benefit and the present value of that benefit. In addition, the plan's vesting schedule will be applied to that benefit. Employees are always entitled to their vested, accrued benefit earned to date. However, the plan design will determine how and when an employee is entitled to payment.

Accrued Benefits

The concept of an accrued benefit can be difficult to understand. Below is a simple example of how an actuary begins the calculation of an accrued benefit.

Example:

Let's say we have an employee who is age 55 and earns \$1,000 per month. Our retirement plan has a normal retirement age (NRA) of 65 and a benefit formula of 100% of compensation (remember, this is a simple example). The plan also has a graduated vesting schedule where an employee will vest 20% per year starting in the second year of service and vesting 100% after the sixth year of service.

If the benefit to be received in 10 years (NRA is 65, starting age is 55, so $65 - 55 = 10$) is \$1,000, then the employee earns $1/10^{\text{th}}$ of the benefit each year. Thus, after year 1 the employee has earned the right to \$100 ($1/10 \times \$1,000$), year 2 = \$200, and so forth. If the employee terminates in year 2, he/she would have an accrued monthly benefit of \$200. We would then apply the vesting schedule (20% at year 2) resulting in a benefit of \$40. This benefit would be paid to the participant on a monthly basis once the participant attains the NRA of 65.

Most non-governmental, non-union DB plans offer employees a lump sum payment upon termination of employment. This being the case, the plan actuary would calculate the present value of receiving a benefit of \$40 per month at age 65 for this participant. The participant would be eligible to take this lump sum equivalent and roll it into an IRA or take the funds as a taxable distribution.

10. What are the filing requirements?

Like most qualified retirement plans, filing Form 5500 is required. In addition, a DB plan requires certification by an enrolled actuary and preparation of a Schedule B attachment. Other filings and forms may be required depending on the scope and size of the plan.

11. Are participant loans and in-service withdrawals permitted?

Loans

At the option of the employer, the plan may be designed to offer participant loans with the same limitations and restrictions found in defined contribution plans such as 401(k) plans.

In-Service Withdrawals

Participants who have reached the plan's retirement age (must be at least age 62) may be eligible for in-service withdrawals if the plan document allows for them.

12. What are the advantages and disadvantages of a defined benefit plan?

This type of plan is suited for businesses with consistent, positive cash flow, and highly-compensated owners and employees in their peak earning years. It is important to consider the advantages and disadvantages of these plans.

ADVANTAGES:

Guaranteed Benefits

- Plan provides a predictable benefit
- Benefit accumulations at retirement have the potential to exceed \$2 million

Tax Savings

- Employers are allowed to contribute more than they would be allowed to contribute under other types of retirement plans
- Employer contributions are tax-deductible
- Employer contributions are tax-deferred until retirement distributions are made

Flexibility

- A wide range of investment choices are available
- Can be combined with other tax-qualified retirement plans
- Distributions may be rolled to an IRA
- Eligibility requirements may be established
- Vesting can be immediate or graduated
- Forfeitures are used to reduce future employer contributions
- Any business entity of any size can sponsor a DB plan

DISADVANTAGES:

Restrictions

- Annual contributions are required - an excise tax applies if the minimum requirement is not satisfied
- Assets are pooled- and trustee-directed - there are no individually-directed accounts
- Benefits cannot be retroactively decreased

Administrative Complexity

- Distributions are based on actuarial assumptions, not account balances
- Trust fund earnings directly impact future employer contributions

Investment Risk/Reward

- The employer bears the investment risk/reward

13. If an employer has no other employees, will a defined benefit plan work?

Yes. Whether self-employed or an employee of a one-person corporation, a DB plan is available to help fund retirement benefits. If the employer/employee is a high-income earner and approaching middle-age or above (45+), a solo DB plan alone or paired with a 401(k) plan can help provide significant retirement savings.

The employer will make annual deductible contributions to the DB account in amounts calculated to be sufficient to fund the targeted level of retirement benefits. Of course, the larger the targeted benefit, the larger the allowable employer contribution.

14. What might an employer's contributions look like for the first year of a plan?

Example #1

Joe is a 49-year-old consultant who has formed a C-corporation. He anticipates total income to his corporation of about \$285,000 and needs \$155,000 to pay his corporate bills. He doesn't need the additional \$130,000 in income and has no other expenses looming. Therefore, Joe will pay himself \$155,000 in W-2 income and can anticipate contributing approximately \$99,436 (of the \$130,000) to a DB plan.

In addition, if Joe wanted to save more for retirement, a single-person 401(k) could be set up allowing Joe to contribute \$17,000 as a 401(k) deferral and, if circumstances allow, an additional 6% of compensation as a profit sharing contribution.

Name	Compensation	DB Contribution	401(k)	Profit sharing	Total Retirement Contributions
Joe	\$155,000	\$99,436	\$17,000	\$9,300	\$125,736

Example #2

Susan, a 54-year-old attorney practicing alone, currently pays herself \$45,000 in W-2 wages. Prior to incorporating as a Sub-S Corporation, Susan operated as a sole-proprietor filing a Schedule C. By averaging Susan's prior high 3 years of compensation (an average net Schedule C of \$156,000), we can disregard her current compensation and use her **average compensation of \$156,000**. Based on this higher compensation average, Susan can look forward to funding \$194,237 to her DB plan.

Name	Compensation	DB Contribution
Susan	\$45,000	\$194,237

Example #3

David is 60 and retired from practice as a physician. David works part-time filling in for vacationing physicians. Last year he earned \$151,000 in self-employment income (after subtracting half of his Self Employment Tax). David would be able to contribute \$101,000 to a DB plan leaving only \$50,000 as taxable, self-employment income.

Name	Schedule C	DB Contribution	Taxable Schedule C
David	\$151,000	\$101,000	\$50,000

15. Must all employees be eligible to participate?

As with most qualified retirement plans, a DB plan may establish eligibility criteria such as the option to exclude employees who have not attained the age of 21 and, if a vesting schedule is in place, the option to exclude employees who have not completed 1 year of service working at the rate of 1,000 hours per year. The plan may also be designed with a 2-year waiting period; however, an immediate 100% vesting schedule would be required.

For larger employers, combining DB plans with defined contribution plans may allow the DB plan to carve out, or exclude, up to 60% of the otherwise eligible employees and benefit those employees under a defined contribution plan.

DB plans may also be tiered (“cross-tested”), providing different benefit levels to different employees, as long as the plan passes all required nondiscrimination testing.

16. What is a cash balance plan?

Cash balance plans are DB plans that define the benefit in terms that are more characteristic of defined contribution plans. For this reason, a cash balance plan is sometimes referred to as a “hybrid” plan.

Statements look like a 401(k)	Contributions look like a defined benefit
Beginning balance	Contributions far exceed \$50,000 limit
Contribution credits	Assets are NOT divided into individual accounts
Interest credits	Contributions are actuarially determined
Ending balance	

Like a Defined Contribution Plan

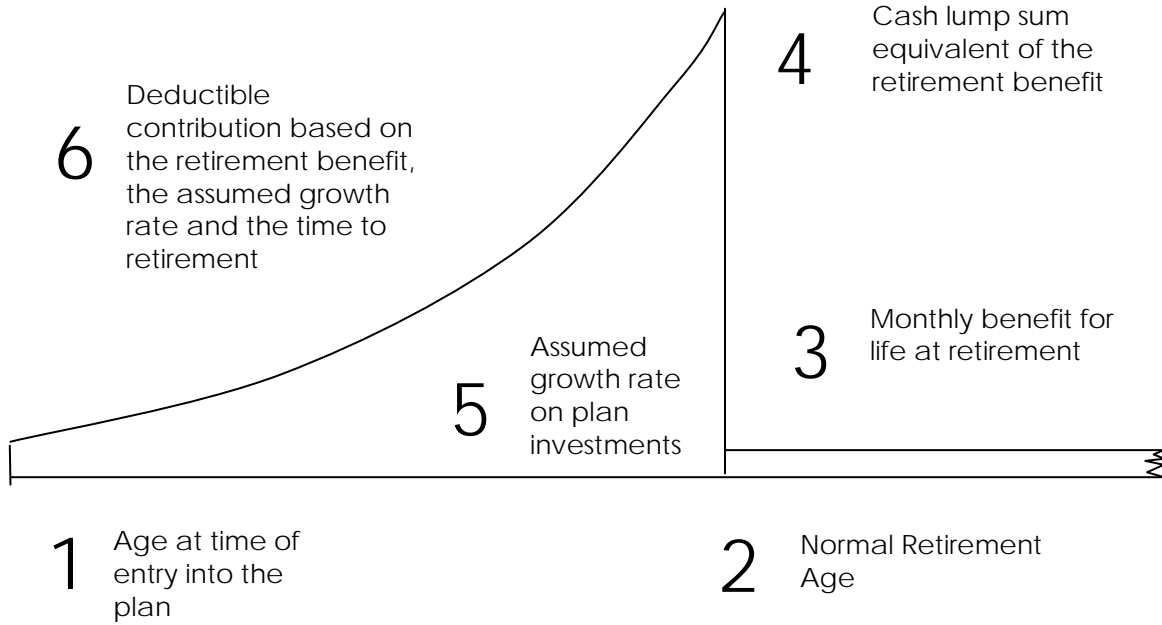
In a typical cash balance plan, a participant’s account (hypothetical account) is credited each year with a “contribution credit” that is based on a plan formula similar to a defined contribution formula, such as a percentage of the participant’s compensation (i.e. 5% of compensation) or a flat dollar amount plus an “interest credit” (either a fixed rate or a variable rate that is linked to an index such as the one-year Treasury Bill rate). Like a defined contribution plan, retirement funds accumulate in an individual account, although in this case the account is hypothetical. This account balance is guaranteed and not dependent on the actual investment performance of the trust assets.

Still a Defined Benefit Plan

Increases and decreases in the value of the plan’s investments do not directly affect the benefit promised to participants. Thus, the investment risks and rewards on plan assets are borne solely by the employer. Like DB plans, the employer is obligated to pay the employee a specified amount at retirement, and may be insured by the federal government.

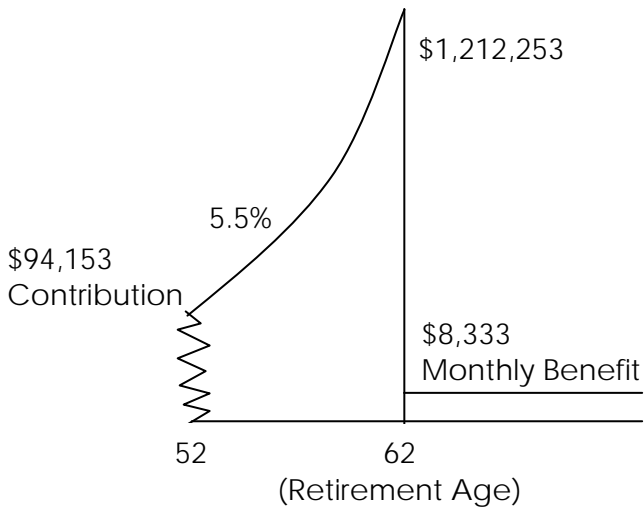
EXHIBIT 1

How Defined Benefit Plans Work



Employee A

\$100,000 Annual Pay (\$8,333 Monthly)



Employee B

\$50,000 Annual Pay (\$4,166 Monthly)

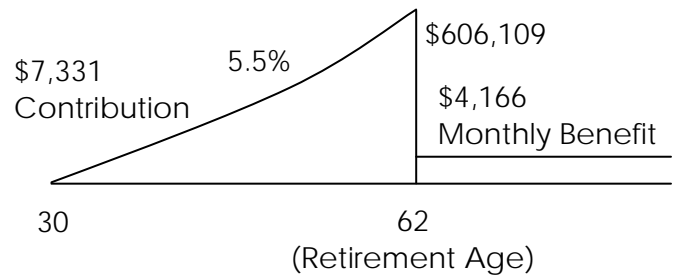


EXHIBIT 2

Comparison of Defined Benefit Plan Designs

Participant	Compensation	Traditional DB Contribution	Tiered DB With Carve-Out	Tiered DB With Out Carve-Out
Principal	\$130,000	\$144,926	\$112,828	\$112,828
Daughter	\$52,000	\$14,359	\$0	\$0
Employee 1	\$33,102	\$9,438	\$3,615	\$3,615
Employee 2	\$36,470	\$11,944	\$4,500	\$4,500
Employee 3	\$35,115	\$21,632	\$0	\$1,955
Employee 4	\$27,384	\$8,362	\$3,178	\$3,178
Employee 5	\$34,076	\$31,201	\$0	\$2,553
Employee 6	\$22,463	\$5,988	\$2,311	\$2,311
Employee 7	\$43,242	\$49,241	\$0	\$4,146
Employee 8	\$35,559	\$38,245	\$0	\$4,495
Employee 9	\$33,965	\$34,394	\$0	\$6,879
Employee 10	\$34,832	\$23,525	\$0	\$2,083
Employee 11	\$31,164	\$16,145	\$0	\$1,510
Employee 12	\$36,192	\$10,319	\$3,953	\$3,953
Totals	\$585,564	\$419,719	\$130,385	\$154,006

EXHIBIT 3

Owner-Focused Solution

Owner-Focused Defined Benefit Plan			
Participant	Age	Compensation	Annual Contribution
Owner	62	\$250,000	\$197,760
Owner's Spouse	62	\$27,500	\$0
Employee 1	59	\$182,371	\$0
Employee 2	60	\$90,000	\$0
Employee 3	31	\$71,395	\$0
Employee 4	31	\$42,429	\$479
Employee 5	47	\$40,634	\$0
Employee 6	28	\$34,750	\$325
Employee 7	25	\$21,467	\$167
Employee 8	24	\$17,200	\$0
Employee 9	25	\$16,500	\$129
Totals		\$794,246	\$198,860

Tiered Safe Harbor 401(k) Profit Sharing Plan			
Deferral	4% Safe Harbor Contribution	Tiered Profit Sharing Contribution	Total
\$22,500	\$0	\$0	\$22,500
\$22,500	\$0	\$0	\$22,500
\$22,500	\$7,295	\$5,471	\$35,266
\$22,500	\$3,600	\$6,750	\$32,850
\$1,436	\$1,436	\$5,355	\$8,227
\$827	\$827	\$3,182	\$4,836
\$1,625	\$1,625	\$3,048	\$6,298
\$1,390	\$1,390	\$2,606	\$5,386
\$859	\$859	\$1,610	3,328
\$0	\$0	\$0	\$0
\$0	\$0	\$1,238	\$1,238
\$96,137	\$17,032	\$29,260	\$142,429

Total Contributions to Owner and Spouse: **\$197,760**

Total Employer Contributions to Employees: \$47,392

Defined Benefit: \$1,100 | Safe Harbor: \$17,032 | Profit Sharing: \$29,260

(Minimum profit sharing for combination with DB 7.5% of compensation to pass compliance testing)