Defined benefit plans offer attractive option

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GREATER METROPLEX — Tax planning for small, closely held corporations, including those of physicians, architects, engineers and real estate brokers, creates unique problems for tax professionals.

Unlike large companies, which prefer retirement benefit programs with minimal funding costs, smaller entities focus on current tax savings and wealth accumulation for their owners.

To those ends, the government has authorized a variety of choices that are superior to IRAs and 401(k) plans. These include defined benefit pensions, profit sharing and money purchase plans. All can shelter a relatively large amount of income from current taxes while providing significant latitude for investing the tax-sheltered money until retirement.

Although a defined benefit pension plan can often provide the most benefits, it is perhaps the least-known retirement program. Yet, unlike popular defined contribution plans, which cap the maximum yearly contribution at the lesser of 25% of income or $35,000, individuals might be able to contribute more than 100% of salary into a defined benefit pension plan.

One of the most interesting aspects of a defined benefit pension plan is that the plan's trustee — usually the business's owner — targets a desired level of retirement income. An actuary then reports how much must be contributed each year to reach that goal. Annual contributions may change based on compensation levels and investment returns.

Defined benefit plans do not have a percentage limitation like profit sharing or money purchase plans. The contribution is actuarially computed to supply a fixed monthly benefit for life at retirement. For 2001 and 2002 the retirement benefit may be equal to 100% of current compensation up to a total retirement income of $140,000 and $160,000 respectively, if the social security normal retirement age is 65. In many cases, an earlier retirement is more beneficial, allowing the owner to retire sooner and take larger tax deductions from increased annual pension contributions. Retirement income is reduced for an age prior to 62 and increased if benefits commence after age 65.

Although a defined benefit plan can turbocharge retirement planning, it imposes more demands and costs on the business owner than more conventional plans.

For instance, defined benefit plans usually cost $1,000 to $1,500 annually to administer. That includes actuarial calculations using an average of the three highest consecutive years of pay, sex, age, life expectancy, years until retirement and a presumed annual investment return between 6% and 7%. There is also a yearly filing with the IRS and required reports to the Pension Benefit Guarantee Corporation if the company is not a professional service corporation.

Defined contribution plans could require fees between $450 to $750 annually to administer and $1,000 to set up. For companies with more than 10 employees, there could also be additional costs per employee. Mutual fund families sometimes offer defined contribution plans at no cost if you invest in their funds.

Starting in 2002, small employers with 100 or fewer employees will be eligible for a nonrefundable tax credit of up to $500 per year for each of a retirement plan's first three years to help offset plan start-up costs. The credit will be unavailable to any employer that maintained a plan for substantially the same employees during the previous three years.

Summary of plan attributes

Comparing profit sharing and defined benefit plans

	Profit sharing plans				Defined
Participant	Proportionate [illegible]	Integrated [illegible]	Age-Weighted	Comparability Allocation	Benefit
Tina	$25,318.00	$27,049.00	$34,323.00	$35,000.00	$117,060.00
Charles	$7,208.00	$6,179.00	$3,200.00	$1,452.00	$7,828.00
Ingrid	$4,915.00	$4,213.00	$818.00	$990.00	$2,874.00
Total $	$37,441.00	$37,441.00	$38,341.00	$37,442.00	$127,762.00
% of total compensation	15%	15%	15%	14.89%	69%
Who benefits?	All employees equally	Employees over the SS wage base	Older employees	Select class of employees	Older and higher compensated employees

Source: *The Pension Specialists Inc.*

Which plan is best?

Tina is a 57-year old entrepreneur who pays herself $170,000 annually and has a professional corporation with two employees, Charles and Ingrid. Thirty-seven-year-old Charles earns $48,400 while 28-year-old Ingrid earns $33,000. The corporation nets $150,000 per year after salaries. What is the best retirement plan for Tina and her company?

In the chart, Tina looks over her options using current salary levels. In each of the defined contribution plans — proportionate percentage formula, integrated with Social Security, age-weighted and comparability allocation by class — she is giving her employees between 7% to 32% of the total contribution. Under the defined benefit plan, she is giving her employees 8% of the total contribution.

Although our increasingly complex tax code virtually demands professional advice when evaluating and setting up a retirement plan, the most important thing is to start contributing as much as possible as soon as possible. That can make the difference between a relaxing retirement or a taxing one.

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