Not All Pension Plans are Created Equal: The Good News For Professionals and Business Owners

By R. Terry Sabom, Looper Reed & McGraw

As a series of high-profile states, cities, and large corporations across the country are being forced to shut down their traditional pension plans, the opposite trend is occurring in retirement plans for professionals and business owners. Thanks to a series of favorable ERISA law changes described below, baby boomers in their prime earning years can significantly increase the amounts they can set aside for retirement over the next five to 10 years. Even better, these super-charged pension plans can be designed to be cost-effective, to be flexible insofar as employer contributions are concerned, to be comprehensible to the sponsor, to his employees, and to his third party administrator, and to be bullet-proof to any challenge from the IRS.

From a retirement plan perspective, the only way a senior worker can "catch-up" to provide for his retirement needs is through a so-called defined benefit plan. These plans allow an employer to provide an annual retirement benefit stated as a percentage of the employee's income and to fund it over a time period based on the remaining years to retirement. So, the higher the compensation, the higher the retirement benefit; and the fewer years to retirement, the higher the allowable annual contributions.

Until recently, the upside potential of these defined benefit plans was limited by several factors, namely:

- an overall limit on the annual contributions that melded the defined (profit sharing) contribution limit with the defined benefit limit,
- a relatively low dollar limit on the benefit regardless of a person's income,
- a minimum retirement age of 65,
- and a limit on annual funding equal to 100% of the defined benefit plan's current liability.

Today, in contrast, ERISA law has changed and the minimum retirement age has been lowered to 62; the maximum annual benefit has been increased from $140,000 to $195,000; the combined limitation has been repealed; and the employer can fund annually up to 150% of a defined benefit plan's current liability. The first three changes significantly increase the amount that can be funded annually, and the last change gives employers flexibility to over-fund a defined benefit plan in good years and pay in less in other years. And, defined benefit plans have always been able to legally favor highly paid employees using a social security benefit "offset", thus increasing the efficiency of a defined benefit plan over that of a defined contribution plan that is required to contribute the same percentage of pay to each employee.

There's more. New IRS regulations enable employers to adopt so-called combo plans (a defined benefit plan plus a defined contribution plan) and benefit even further from the law change in 2007 that permits employers to contribute defined contribution amounts in addition to the maximum defined benefit contribution.

In addition, there is a new defined benefit plan on the block – the cash balance plan. These plans benefit from all of the foregoing changes but are even more employee-friendly. Cash balance plans promise an actuarially determined retirement annuity benefit, but look like defined contribution plans in that employees have account balances. The account balances are "notional" only in that they measure the employee's defined retirement benefit but do not necessarily reflect the underlying assets of the plan. Therefore, like a traditional pension plan, the employer bears the investment risk. Benefits are portable and can be paid in the form of a life annuity or a lump sum.

Pension Plans

So, what does all of this mean? A hypothetical 58-year old business owner or professional earning $225,000.00 has several retirement contribution options as follows:

- 401(k) plan – maximum annual deferral of $22,500, including catch-up; or
- Profit sharing plan – maximum annual contribution of $49,000; or
- Defined benefit plan – maximum annual contribution of approximately $250,000*; or
- Combo plan (401k deferral, profit sharing, defined benefit) – maximum annual contribution of approximately $285,000*.

*Actual maximum defined benefit contribution amounts depend on variables specific to the demographics of the employer and employees.

The set-up and annual expenses for the defined benefit plan and combo plan are higher than those of the other two defined contribution plans because of the need for tailored plan documents and an annual actuarial evaluation. However, the ratio of (i) the defined and combo benefits accruing to the highly paid employee, to (ii) the amounts going to non-highly paid employees and plan expenses, is considerably higher in the defined benefit and combo plans.

With these law changes, Congress addressed what it saw as a need for more retirement savings. In so doing, it created some very attractive options for highly paid professionals and business owners.

> About the Author

Terry uses his experience as an outside counsel (17 years) and as in-house counsel (15 years) to help business owners who would like to sell their business outright, transition ownership of the business to family or management, or expand the existing business. Most if not all of these transactions first require the grooming of the company, financially and operationally, and the raising of outside capital. Terry can accomplish these tasks, guide the owner through the legal documentation phase and the closing of the transaction, and fill the general counsel role for the surviving entity.

> About Looper Reed & McGraw

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