

**Lanny D. Levin Agency, Inc
The Guardian Life Insurance Company of America
Continuing Education Seminar (3 Hrs)**

**Defined Benefit Pension Plans:
“What’s Old Is New Again” And Better than Ever!**

**August 5, 2008
Oakton College
Business Conference Center
Des Plaines, Illinois**

Defined Benefit Pension Plans



**What's Old is New Again
&
Better Than Ever**

**Presented by:
Jerry Kalish
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**Fleetwood Mac is going back on tour
in 2009, and Defined Benefit Pension
Plans are back too!**



A group of five people, three men and two women, are standing together in professional attire. The man in the center is wearing a dark top hat and a dark pinstriped suit jacket over a white shirt. To his right is a man in a dark suit jacket and a white shirt. In the foreground, there are two women: one with blonde hair wearing a dark, patterned blazer, and another with blonde hair wearing a light-colored, patterned blazer. On the far left, a man in a light blue shirt is partially visible. The background is plain white.

Our Agenda

- 1. What employers need to know**
- 2. How defined benefit plans work**
- 3. How they fit with other plans**

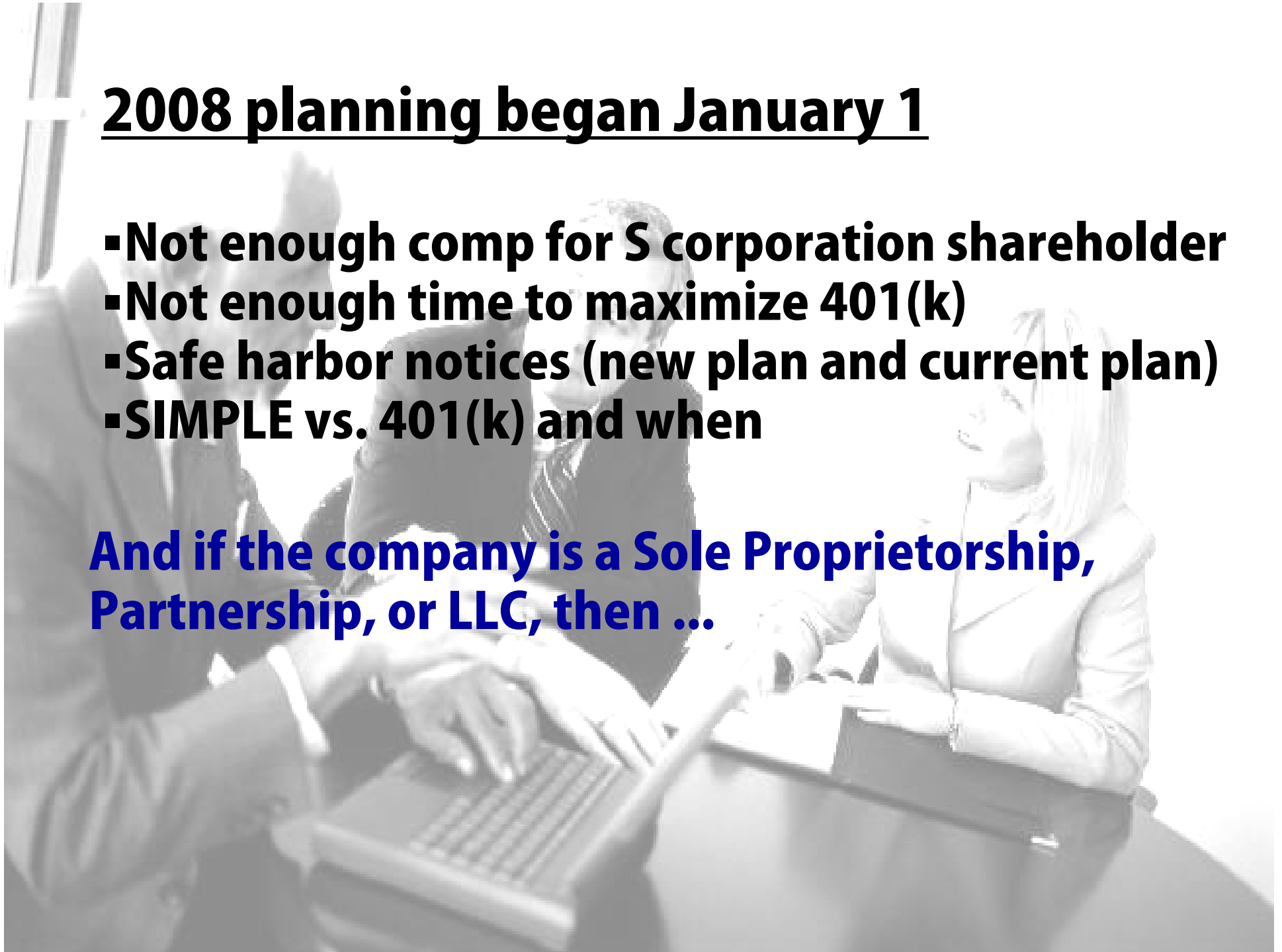


**What's New?
What employers need to
know**

2008 planning began January 1

- Not enough comp for S corporation shareholder
- Not enough time to maximize 401(k)
- Safe harbor notices (new plan and current plan)
- SIMPLE vs. 401(k) and when

**And if the company is a Sole Proprietorship,
Partnership, or LLC, then ...**





April 30, 2010: the next major deadline

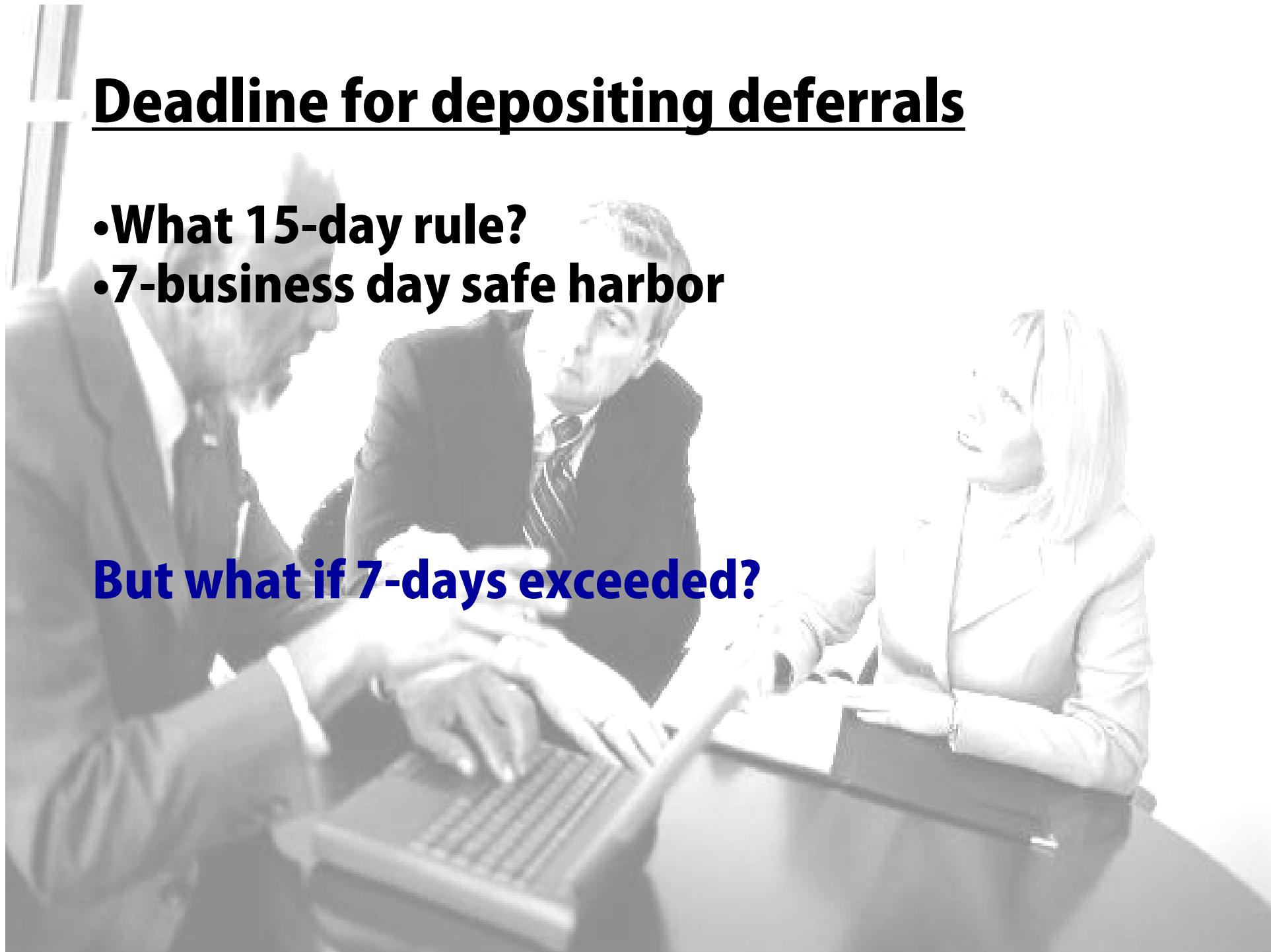
- **Restatement for EGTRRA changes since 2004 by employers using prototype and volume submitter defined contribution plan**
- **Form 8905?**
- **Good Faith Amendments?**
- **Operate in accordance with Pension Protection Act of 2006**

It's an opportunity for a plan sponsor to review the plan to see if can be improved.

Deadline for depositing deferrals

- **What 15-day rule?**
- **7-business day safe harbor**

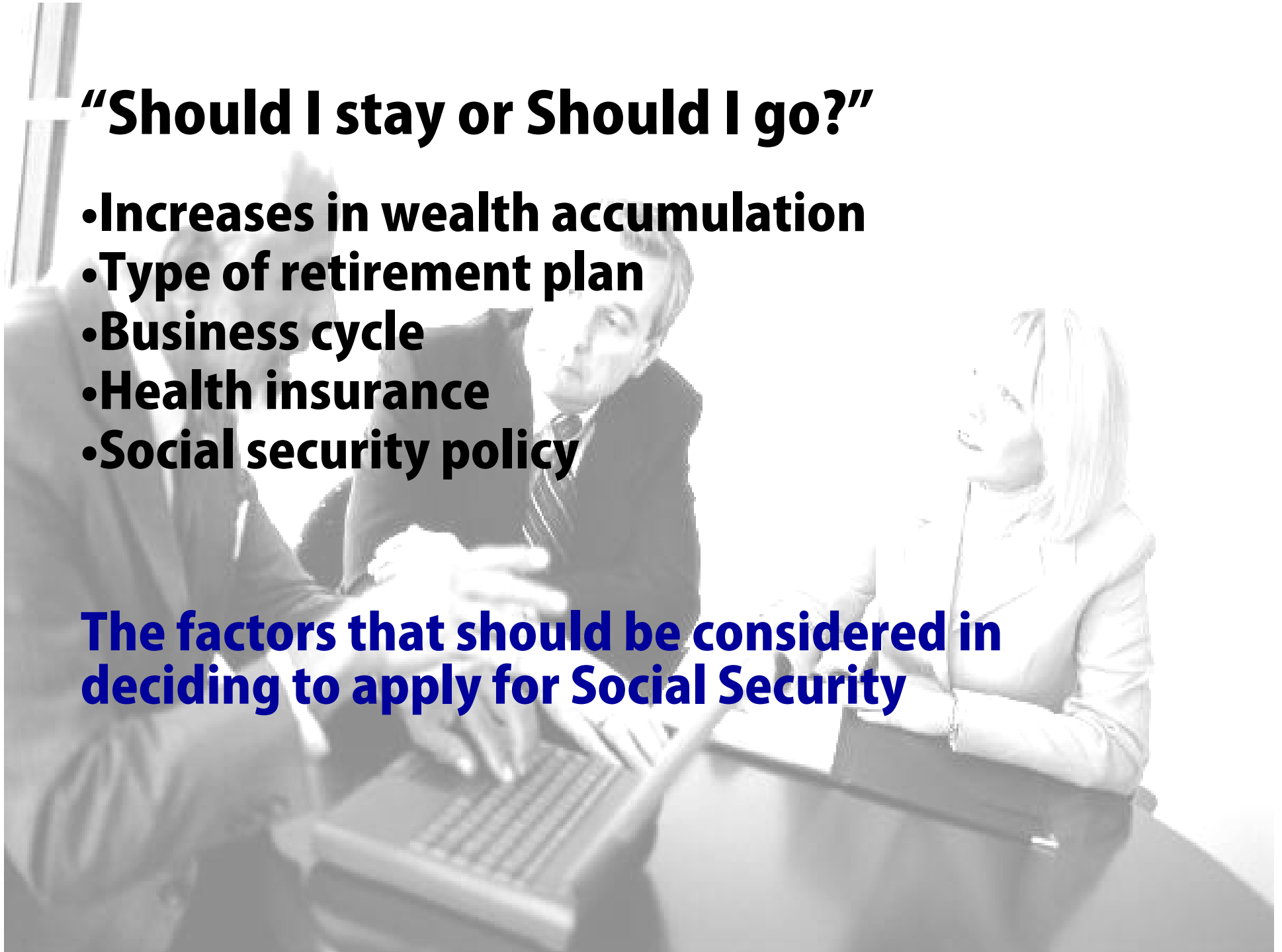
But what if 7-days exceeded?



“Should I stay or Should I go?”

- **Increases in wealth accumulation**
- **Type of retirement plan**
- **Business cycle**
- **Health insurance**
- **Social security policy**

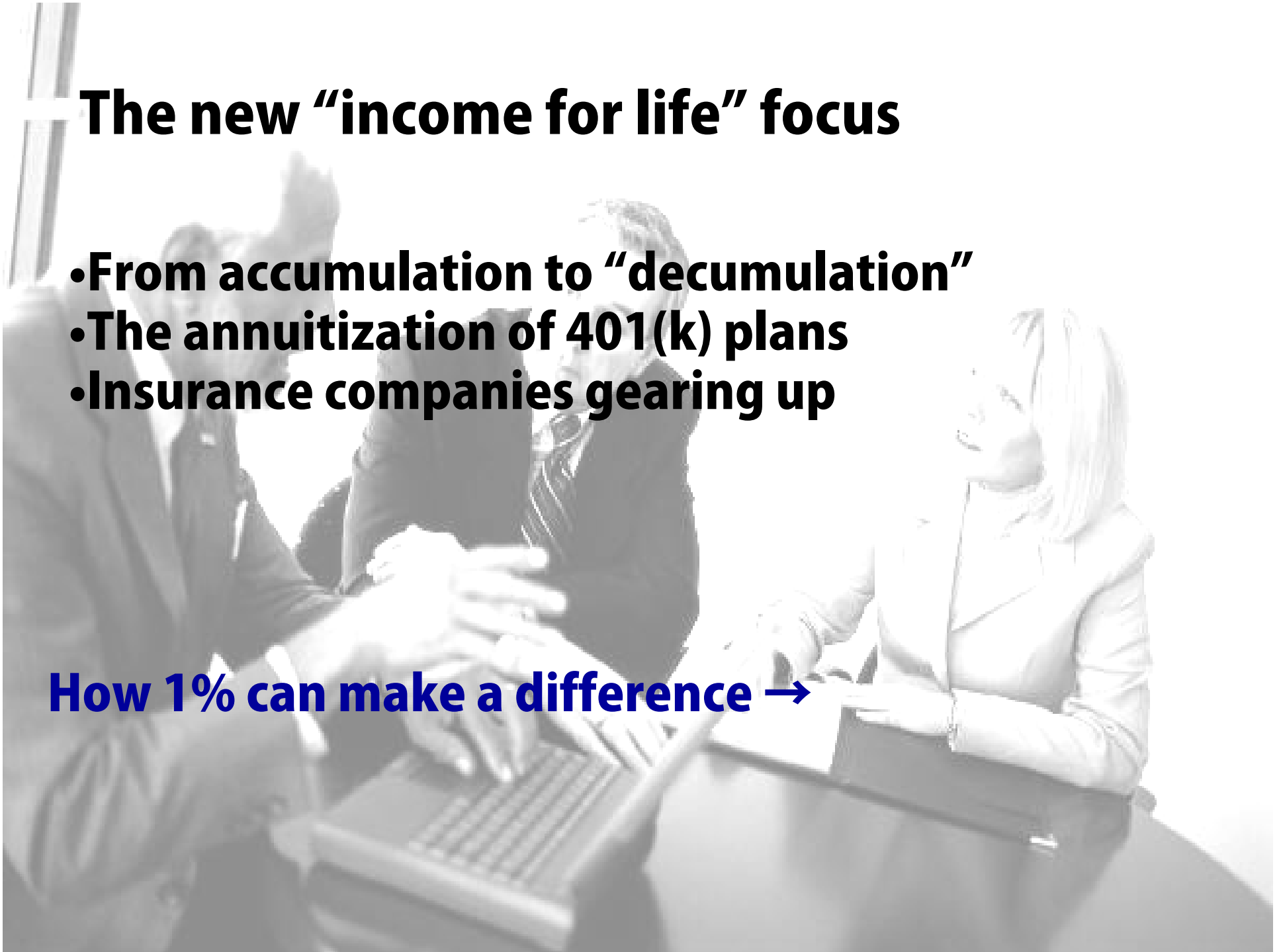
The factors that should be considered in deciding to apply for Social Security



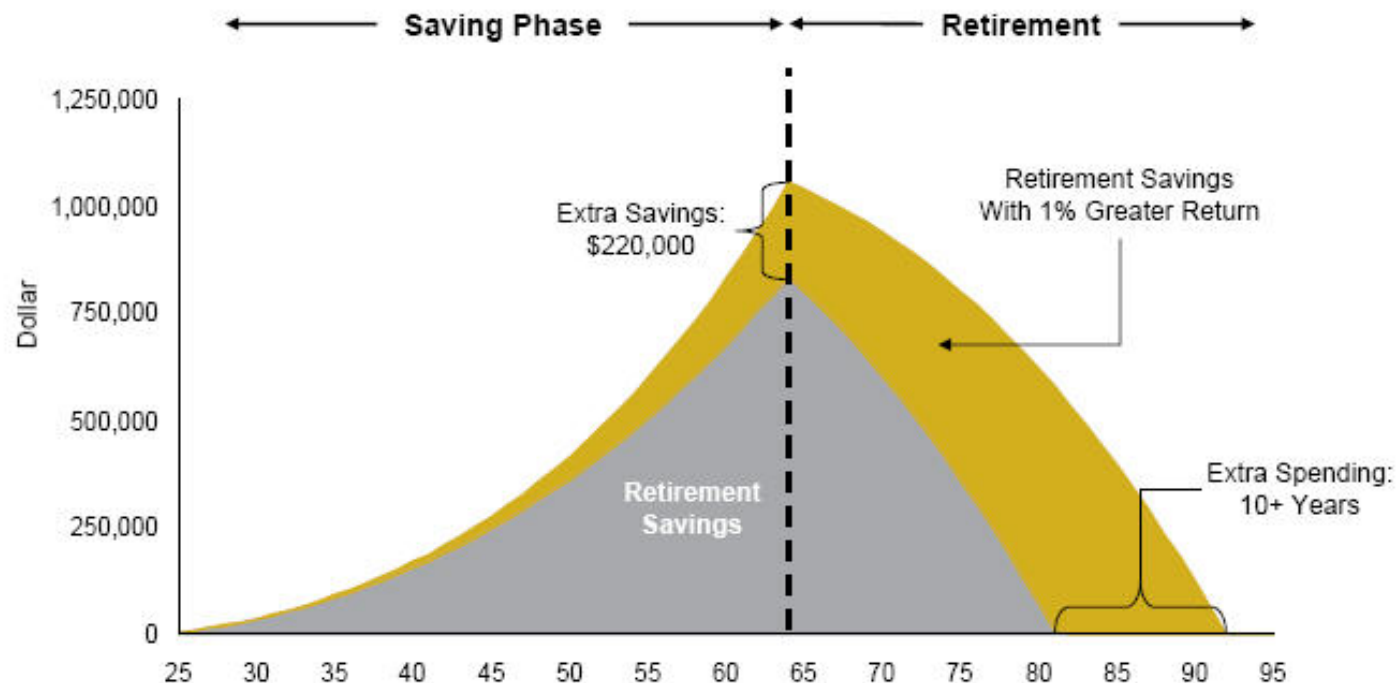
The new “income for life” focus

- **From accumulation to “decumulation”**
- **The annuitization of 401(k) plans**
- **Insurance companies gearing up**

How 1% can make a difference →



1% Greater Return Can Mean 10 Extra Years of Spending



*Results are simulated. This is a hypothetical illustration only and its results are not indicative of any specific investment, including any AllianceBernstein mutual fund. The savings phase simulates a defined contribution participant salary of \$45,000 at age 25, linearly increasing to \$85,000 by age 65, making yearly contributions of 6% of salary at age 25 increasing by 0.5% per year to a maximum 10% with a 50% company matching contribution up to the first 6% of salary. In the spending phase, \$63,750 (75% of final salary) is deducted at the beginning of each year. A yearly investment return of 9% is assumed at age 25, linearly decreasing to 6% at age 80 and remaining constant thereafter. In the "1% Greater Return Scenario" a yearly investment return of 10% is assumed at age 25, linearly decreasing to 7% at age 85 and remaining constant thereafter. Inflation is assumed to be a constant 3% and dollar values are expressed in real purchasing power terms.

Source: AllianceBernstein

The new focus on fees

- **New disclosures effective in 2009**
- **More detailed than ever before**
- **Surprises!**

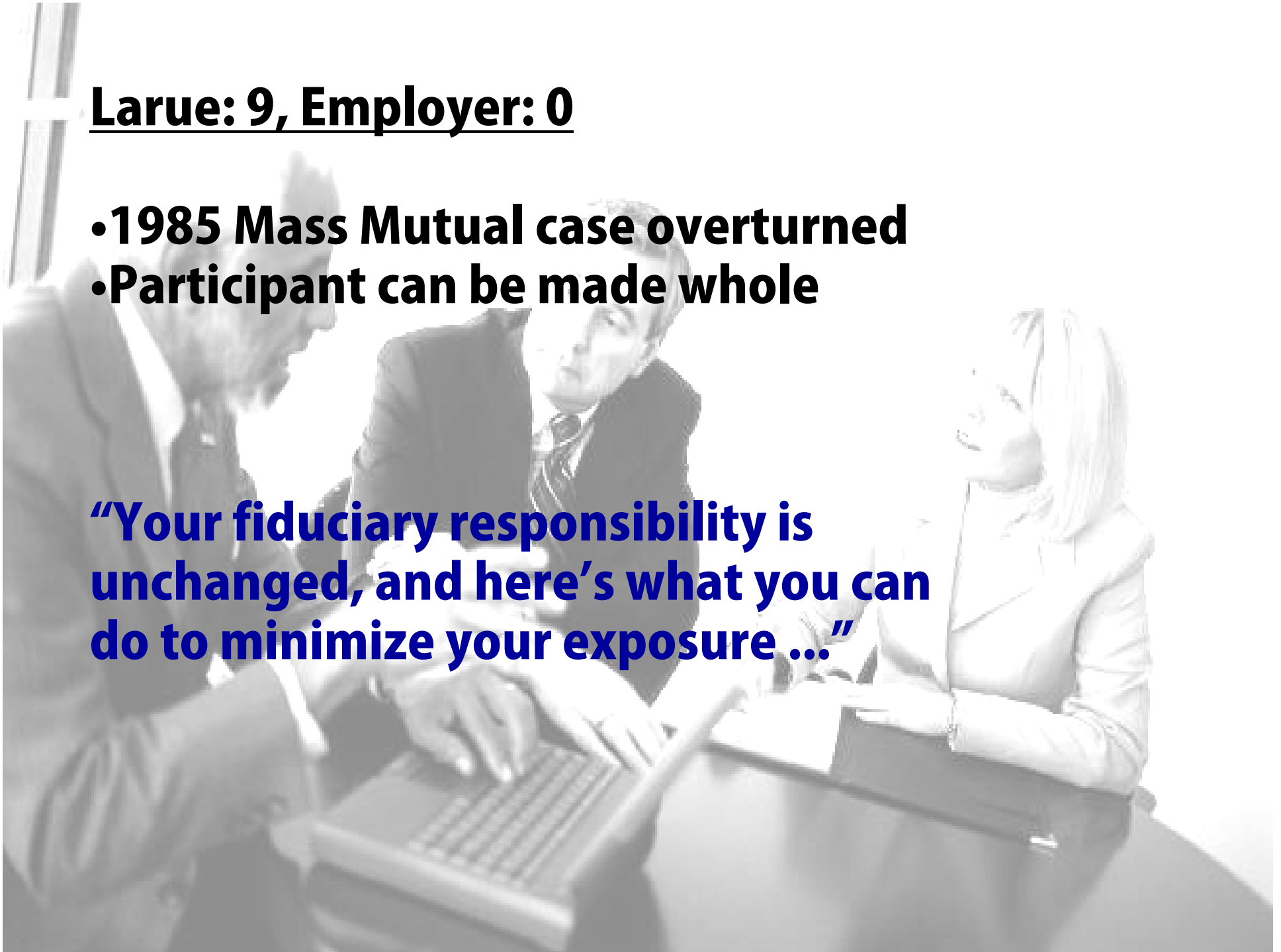
Are fees competitive? Inquiring employees will want to know.



Larue: 9, Employer: 0

- 1985 Mass Mutual case overturned
- Participant can be made whole

“Your fiduciary responsibility is unchanged, and here’s what you can do to minimize your exposure ...”





How defined benefit plans work

How DB differs from DC

- **Only qualified plan to provide guaranteed benefit**
- **Fund for monthly benefit at retirement based on annual compensation, years of participation, over lifetime of participant**
- **Normal form is annuity: life-only if single, 50% J&S if married**
- **Tax deduction based on funding requirements**

The basic pension plan formula

Benefits actually paid

+

Expenses actually incurred

-

Investment income actually earned

=

The actual long term cost

Valuation is just a budgeting tool

- **Actuarial assumptions**
- **Funding method**

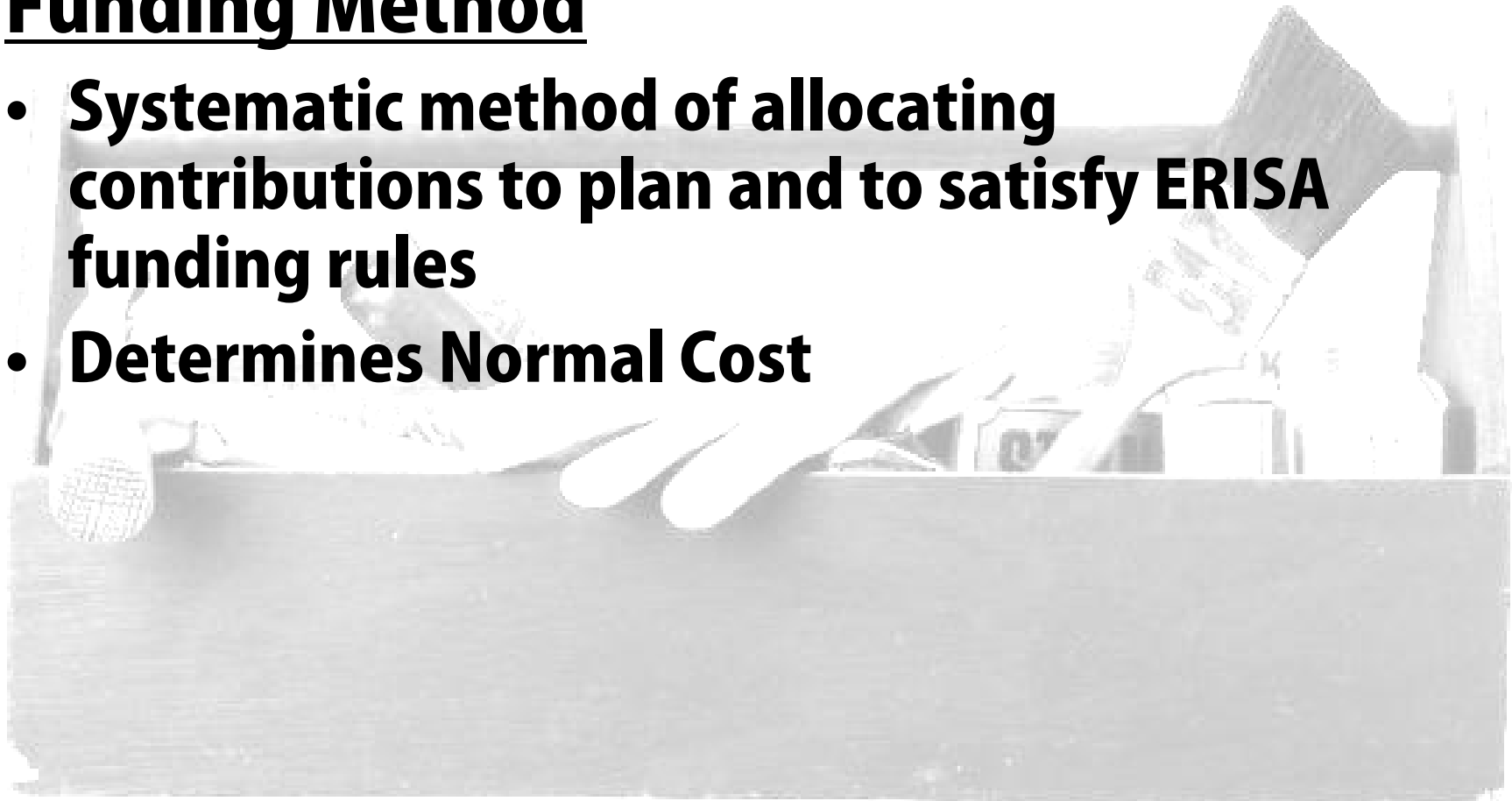


Actuarial assumptions

- **Probabilities: salary increases, turnover, mortality**
- **Estimates: annual earnings**
- **Annuity purchase rate (cost of providing \$1 per month of income at NRA): e.g., \$120.43 at age 65**

Funding Method

- **Systematic method of allocating contributions to plan and to satisfy ERISA funding rules**
- **Determines Normal Cost**



Funded status of a pension plan

- **On-going funding uses Plan interest and mortality rates**
- **Accounting disclosures use IRS interest and mortality rates**
- **Lump sum distribution uses IRS interest and mortality rates**

What happens when a DB plan terminates

- Plan assets *must* equal benefit commitments valued at IRS rates not plan rates
- What if plan overfunded?
- What if plan underfunded?

Pension plan generations

- **1st (pre-ERISA (1974): 412(i) fully insured**
- **2nd: (post-ERISA): “traditional” (insurance plus side fund or investment only)**
- **Déjà vu all over again (aging Boomers): 412(i) fully insured**
- **3G (Pension Protection Act of 2006): Cash balance pension plans**

412(i) now 412(e)(3) revisited

- **Special type of pension plan which if qualifies is exempt from funding rules**
- **Must be funded by insurance contracts: life insurance plus annuity or just annuity**
- **Accrued benefit based on policy values**
- **Usually generates largest possible tax deduction**
- **Still viable despite class action suits**

Traditional DB plan

- **Actuarially funded**
- **Subject to ERISA funding rules**
- **Can include pre-retirement death benefit using insurance**
- **Accrued benefit difficult to understand (and explain)**
- **May be subject to Pension Benefit Guaranty Corporation**

Which one is better?

- **Depends on facts and circumstances**
- **But either works only if business is stable, highly profitable, and has consistent cash flow**

But now we have another choice: Cash Balance plans

Cash Balance (“CB”) Plans pre-PPA

- **Form of defined benefit plan**
- **Called a “hybrid” because it looks like DC but operates as DB**
- **Age discrimination issues when DB converted to Cash Balance**
- **IRS not issuing determination letters**

CB plans now “legal”

- **Court cases resolved ADEA issues**
- **Specifically mentioned in PPA**
- **Plan documents now available (individually designed)**
- **IRS now issuing letters**

How CB plans work

- **DB plan that specifies the amount of the contribution credited to each participants account and guarantees the investment earnings**
- **Each participant has individual account like DC plan**

How the account grows

- **Employer contribution determined by formula specified in document (% of pay or \$ amount)**
- **Annual interest credit spelled out in document and not dependent on actual return, e.g., 5%**
- **Actual earnings only impact future contributions like traditional DB and 412(i)**

How the contributions are invested

- **Assets invested in pooled account**
- **Usually use asset allocation method or target-maturity approach**



CB usually maintained with PS/401(k)

- **Can be tested together**
- **Normally provides minimum contribution of 5% - 7% of pay for NHCEs if owners receive maximum CB contribution**

Here are some maximum contributions

Age 60-65: \$180,000

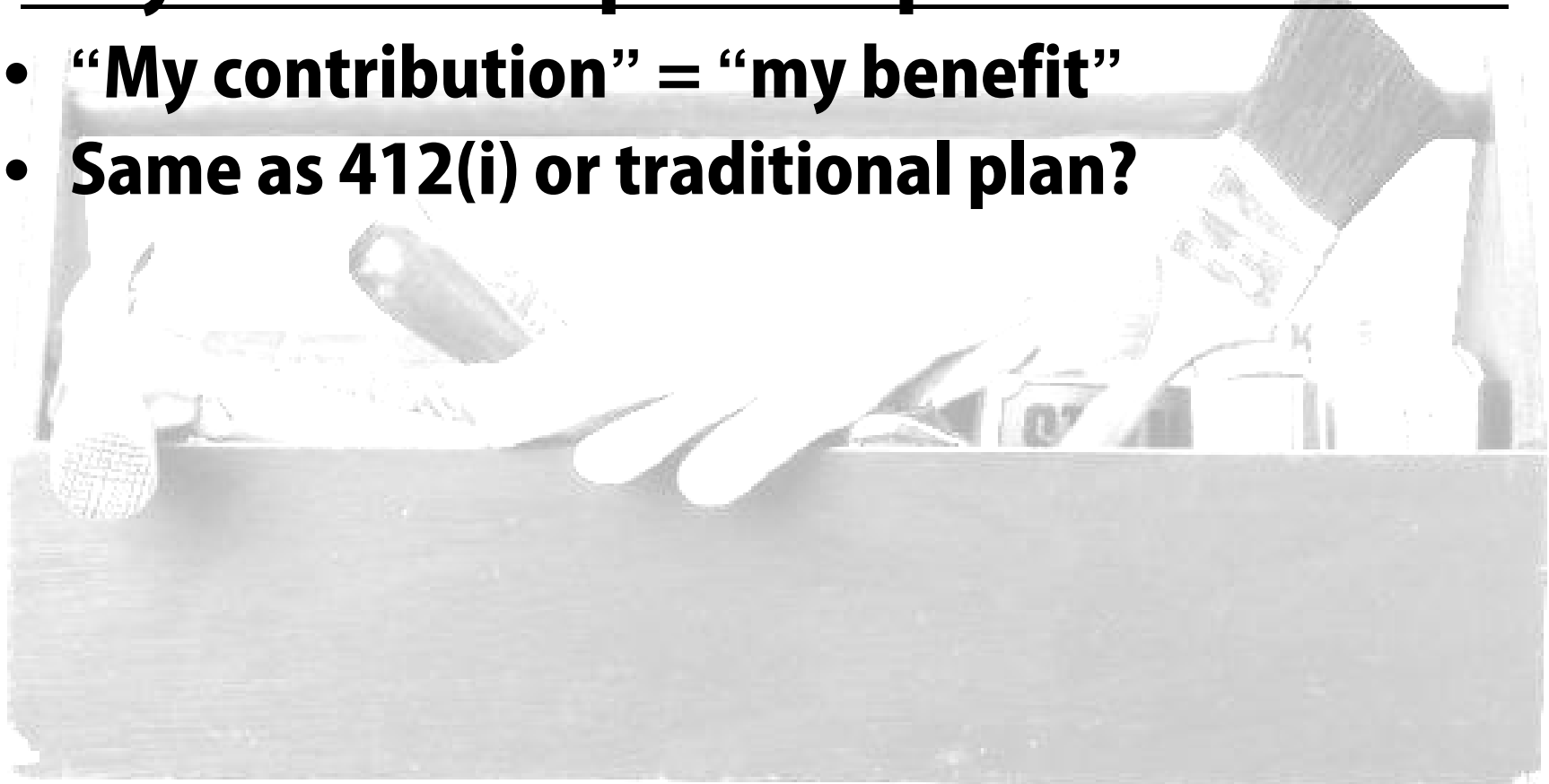
Age 45-49: \$80,000

Age 35-39: \$45,000

**Actuary determines annual contribution
which is subject to ERISA funding rules and
may be covered by PBGC**

Why CB best DB plan for professional firm

- **“My contribution” = “my benefit”**
- **Same as 412(i) or traditional plan?**





Putting the Pieces Together

How recent tax legislation encourages DB plans for business owners

- **DB limit has COLA adjustment: \$185,000/yr beginning at age 62 (2008)**
- **DB and DC benefit limits uncoupled (Section 415)**
- **401(k) doesn't count against 25% deduction limit (Section 404)**
- **25% combined plan deduction limit removed**
 - **Extra 6% of pay for DC if not subject to PBGC**
 - **25% to DC + cost to fund DB if subject to PBGC**



For the self-employed who receives income from sources other than primary employment

- **Board members**
- **University professors with consulting income**
- **Writers with royalties or licensing income**



Earned income = compensation for retirement plan purposes

- **Income from trade or business - not passive income**
- **Used for sole proprietor, partner, or member of LLC**
- **Calculated by subtracting trade or business expenses from total self-employment income**
- **Not known until after year end**

How does that affect PS/401(k) plans?

Here's an example:

| | |
|--|--------------|
| Net Earnings Before Qualified Plan Deduction | \$220,000.00 |
| Calculate 1402(a)(12) Deduction | \$203,170.00 |
| Calculate Medicare and FICA | \$18,539.93 |
| 1/2 of Self-Employment Tax | \$9,269.97 |
| Self-Employment Income | \$210,730.04 |

And here's the maximum contribution to one plan:

| | |
|-------------------------------------|---------------------|
| Maximum Profit Sharing Contribution | \$42,146.01 |
| Maximum 401(k) Contribution | \$15,500.00 |
| Maximum 401(k) Catchup | \$5,000.00 |
| Maximum Contribution | \$62,646.01 |
| Annual DC Limit Under Section 415 | \$51,000.00 |
| | |
| Maximum SIMPLE | \$16,637.77 |
| Maximum SIMPLE Catch-Up | <u>\$2,500.00</u> |
| Total Maximum SIMPLE | \$19,137.77 |
| | |
| Maximum SEP | \$42,146.01 |
| | |
| Maximum DB | \$154,274.34 |



And here's the maximum contribution to both DB and DC using new rules

| | |
|-------------------------|---------------------|
| Maximum DB | \$154,274.34 |
| Maximum 401(k) | \$15,500 |
| 401(k) Catch-Up | \$5,000 |
| New 6% DC Rule | \$12,643.80 |
| Total Both Plans | \$187,418.14 |

Adding a cash balance to existing PS/401(k)

| | 2007 PS/401(k) | | 2008 Combined Plans | | | | Increase | |
|-------------------|----------------|---------|---------------------|--------------|--------------|---------|--------------|---------|
| | Allocation | % | PS/401(k) | Cash Balance | Total | % | \$ | % |
| Owners | | | | | | | | |
| 1 | \$45,000.00 | | \$46,000.00 | \$75,000.00 | \$121,000.00 | | \$76,000.00 | |
| 2 | \$50,000.00 | | \$51,000.00 | \$125,000.00 | \$176,000.00 | | \$126,000.00 | |
| | \$95,000.00 | 61.59% | \$97,000.00 | \$200,000.00 | \$297,000.00 | 72.44% | \$202,000.00 | 78.98% |
| Non-Owners | | | | | | | | |
| 35 | \$59,250.00 | 38.41% | \$78,000.00 | \$35,000.00 | \$113,000.00 | 27.56% | \$53,750.00 | 21.02% |
| Total | \$154,250.00 | 100.00% | \$175,000.00 | \$235,000.00 | \$410,000.00 | 100.00% | \$255,750.00 | 100.00% |

And our attorney wants me to remind you

This presentation is provided for general discussion purposes only and should not be considered tax or legal advice. Always check with a qualified tax adviser to determine the application of the tax laws and rules to your specific situation.

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Will Form 5500s reveal outdated fidelity bonds or retirement plans without bonds at all

July 31st, is of course, the due date (unless extended) for calendar year retirement plans required to file Form 5500 for the 2007 plan year. And, as in the past, there will be a number of plan sponsors who have to indicate on the 5500 that they have outdated fidelity bonds or none at all.



07 | 26 | 2008
Posted By Jerry Kalish

One of my 2006 posts, [It's Bond. Fidelity Bond](#), discussed the then requirements. My attempt at humor aside, it is a serious matter. There's still time for plan sponsors who aren't in compliance to do so before filing.

Here's a link to our [Briefing](#) in Q & A format (PDF) on fidelity bond requirements updated for the Pension Protection Act of 2006.

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