COMPLIANCE

DB Plans for Young Owners?

The age of the owner of a small business should not be the deciding factor in deciding whether to sponsor a defined benefit plan.

BY JAKE LINNEY

Conventional wisdom says that the best time for a business owner to start a defined benefit (often a cash balance) plan is when the business owner is between the ages 52 and 55 because the business owner can maximize his/her annual tax break as he or she reaches normal retirement age. This article challenges that wisdom and instead contends that the age of the owner should not be a deciding factor for sponsoring a defined benefit plan. Advisors who frame this conversation as taking advantage of tax breaks to create wealth-building opportunities open up new discussions and opportunities with prospective clients.

THE BIG PICTURE

Defined benefit plans have limits on the amount of contributions that can be made to them each year that are based on the maximum amount of a single life annuity that an individual can receive over his/her lifetime. The annuity is converted to a maximum lump-sum amount using actuarial factors. Minimum and maximum contribution amounts are based on the plan's funding level and an estimate of future plan liabilities.

Rather than trying to predict future interest rates, tax rates and market experiences, I encourage my clients to focus on making decisions based on present facts and then build a flexible plan to handle whatever may happen in the future.

A business deciding to start a defined benefit plan today will need to ask: Is this the best use of capital? If the answer is "yes," the key reason is because of the tax breaks that a qualified plan offers the company, participants and trust:

- For the company, money contributed to the plan is tax deductible now.
- For participants, taxation on benefits is deferred until received as income.
- For the trust, earnings to the trust are tax free while they remain in the trust.

A recent paper "The 50% Rule: Keeping More Profit In Your Wallet," by Stuart E. Lucas of Wealth Strategist Partners, LLC suggests that retaining at least 50% of your earnings in an after-tax account is a good goal. This entails that wealth planning strategies using tax-deferred accounts over long periods of time are very compelling. Defined benefit plans allow employers to put more tax-deferred money away for employees than any other vehicle in the tax code.

MEASURING WEALTH ACCUMULATION

Suppose you are a 33-year-old business owner running a profitable business. One of the things you can do with some of your profits is start a defined benefit plan. However, if you start one now, you will limit the contributions you can make to a defined benefit plan in the future.[1]

Should you start a DB plan now, in 10 years when you are 43 or in 20 years when you are 53? Fig. 1 provides lump sum amounts after 10 years for three age brackets.

Okay, so maybe you should wait. But what if I posed the question to you differently: Would you rather have $1 million today or $2.5 million in 20 years?

> "Defined benefit plans allow employers to put more tax-deferred money away for employees than any other vehicle in the tax code. Why should the firm owner's age be a barrier?"

I would take the $1 million, and the answer should be based on what type of returns you can receive on that $1 million over the next 20 years. Fig. 2 shows the differences in returns in an IRA using four annual return assumptions.

So as long as you can expect at least 5% annual returns, you should start the plan now.

THE ANALYSIS FOR PROFESSIONALS (OR OWNER-ONLY BUSINESSES)

The above analysis does not take into account the entire situation of the owners of small professional practices or owner-only businesses. Businesses that sponsor defined benefit plans that are not covered by the Pension Benefit

FIG. 1: LUMP SUM PAYMENT AFTER 10 YEARS

Age	Age 33-42 DB Plan[2]	Age 43-52 DB Plan[2]	Age 53-62 DB Plan[2]
Lump Sum After 10 Years	$940,777	$1,546,528	$2,545,725

1 Defined benefit accruals are measured for all defined benefit plans for a single employer. So if a business owner sponsors a defined benefit plan from 2000-2009, and then wants to start another defined benefit plan in 2015, the benefit from the 2000-2009 plan would have to be considered when determining the benefit accruals in the 2015 plan.

2 Assumes a cash balance plan funded for 415 maximum lump sums using 2013 MAP rates.

FIG. 2: IRA RETURN AFTER RECEIVING A LUMP SUM

	Age 33-42 DB Plan Account Age at 62	Age 43-52 DB Plan Account Age at 62	Age 53-62 DB Plan Account Age at 62
5% Annual Return	$2,496,161	$2,519,131	$2,545,725
6% Annual Return	$3,017,199	$2,769,596	$2,545,725
7% Annual Return	$3,640,510	$3,042,255	$2,545,725
8% Annual Return	$4,384,921	$3,338,838	$2,545,725

FIG. 3: PLAN BALANCE DEPENDING ON RATE OF RETURN

Rate of Return	Balance at Age 62
5%	$3,454,820
6%	$4,111,025
7%	$4,911,960
8%	$5,890,726

Guaranty Corporation[3] are limited in their employer deductions to their 401(k) profit sharing plans. This changes our analysis, because *when* the defined benefit plan is sponsored will change the contribution level to the 401(k) profit sharing plan.

Suppose you are a 33-year-old business owner and you sponsor a 401(k) profit sharing plan. If you make consistent contributions of $52,000 a year and $57,500 a year after you are age 50, then Fig. 3 shows your plan balance depending on the rate of return you received over the life of the plan.

The rate of return of the defined benefit plan is far less important while the plan is in place because of the limits on lump sum distributions from defined benefit plans. Once the benefit is rolled into an IRA, however, the rate of return becomes very important.

If we assume that our return will be the same for both 401(k) accounts and rolled over IRA accounts, and the return of the defined benefit plan does not matter — only the lump sum does — then we can expand our chart as shown in Fig. 4.[4]

> "As consultants and advisors we are not in the fortune telling business, so it is vital to provide our clients with a sound framework for making good decisions."

It is very close, and when you look at the potential account balance ranges at age 62, you could make an argument that the more risk averse you are, the longer you should wait until you start a defined benefit plan. Of course, this is making a decision based on risk tolerance and not age.

Other Considerations

Increases to 415 Limits

There is no way to predict what the Section 415 limits will be in the future other than we suspect they will go up. On the other hand, there could be changes in the law that cut the 415 limits in half or put caps on tax-deferred accounts. It is impossible to include these considerations; all we can do is work within the framework we have now.

Changes to Interest Rates

Predicting future interest rates is difficult business — probably impossible. Yet we need to be able to make well-informed decisions now. A rise in interest rates will lower the lump sum limits in defined benefit plans; a decrease in rates will increase them. The ideal defined benefit plan should last 10 years so the owners

3 The following defined benefit plans are not covered by the PBGC: plans that only cover substantial owners, professional employer plans with less than 25 participants during the life of the plan, governmental plans and Indian tribal plans.

4 Assumes a $52,000 contribution to a defined contribution plan every year a defined benefit plan is not in existence, $33,100 contributions to a defined contribution plan every year that the defined benefit plan is in existence, plus $5,500 of catch-up contributions when the participant is at least 50 years old.

FIG. 4: IMPACT OF RISK ON LUMP SUM

Rate of Return on 401(k) and IRAs	DB Plan from 33-42 401(k) from 33-62	DB Plan from 43-52 401(k) from 33-62	DB Plan from 53-62 401(k) from 33-62
5%	$5,417,655	$5,684,148	$5,829,458
6%	$6,433,124	$6,538,342	$6,477,638
7%	$7,652,750	$7,551,305	$7,270,149
8%	$9,117,720	$8,756,683	$8,240,076

can reach their 415 limit maximum, which means that the lump sum distribution of a fully funded plan can be affected by interest rates 10 years out from the plan's start date.

CONCLUSION

As consultants and advisors we are not in the fortune telling business, so it is vital to provide our clients with a sound framework for making good decisions. The only point of this article is that the age of the owner in a small business should not be the deciding factor on whether to sponsor a defined benefit plan. If you have a client that can afford a defined benefit plan, bring up the conversation — it is a good one to have. Get your clients to think about their future and their strategic planning with *you*. Regardless of whether your client starts a defined benefit plan or not, these conversations open up new discussions and opportunities. PC

Jake Linney, QPA, QPFC, ERPA, is part of the Solutions Center at Pentegra Retirement Services, Inc. He designs qualified plans and consults with clients on a variety of plan topics. In addition, Jake is an advocate for pension education and has led education programs ranging from retirement plan fundamentals to advanced consulting practices.

CELEBRATING 20 YEARS OF PARTNERSHIP

In 2014, John Hancock celebrates the **20th Anniversary** of the **Plan Consultant Forum.**

We believe the team approach can provide the best possible service for a plan. It is through our partnership with Plan Consultants that we can help design and build retirement plans specifically suited to meet your clients' needs.

We work diligently to continuously improve our products and services in order to deliver comprehensive retirement options. This, along with our strong Plan Consultant relationships, forms the pillars of our success today and in the future.

As a partner who understands your business, John Hancock is committed to **making plans work** and being **easy to do business with.**

John Hancock
RETIREMENT PLAN SERVICES

Both John Hancock Life Insurance Company (U.S.A.) and John Hancock Life Insurance Company of New York do business under certain instances using the John Hancock Retirement Plan Services name. Group annuity contracts and recordkeeping agreements are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02210 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595. Product features and availability may differ by state. Plan administrative services may be provided by John Hancock Retirement Plan Services LLC or a plan consultant selected by the Plan. © 2013 All rights reserved.

NOT FDIC INSURED | MAY LOSE VALUE | NOT BANK GUARANTEED | NOT INSURED BY ANY GOVERNMENT AGENCY

For Third Party Administrators use only. Not for distribution with the public.