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THE NEW MILLENNIUM - A RENAISSANCE FOR DEFINED BENEFIT PLANS?

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Gradually over the last few years, some baby boomers are learning that growing older has advantages other than the discounts available from their AARP membership. Advancing age may give them an ability to contribute more dollars toward their retirement through adoption of a defined benefit pension plan.

What is a Defined Benefit Plan?

A defined benefit plan is a "traditional" pension plan designed to provide an employee with a lifetime stream of income after retirement. The level of retirement income will vary depending on an employee's length of service and/or compensation history. Optional forms of benefit, including a lump sum payment, are often available. All other types of retirement plans, e.g., profit sharing, 401(k), money purchase pension, etc., are called defined contribution plans.

An employer sponsor is required to contribute to a defined benefit plan at certain prescribed rates to ensure a sufficient accumulation of funds to provide the promised benefits. These amounts are calculated each year by an enrolled actuary, who projects the funds needed by making his best estimate of future employee compensation, turnover, life expectancy, and the investment return on plan assets.

Limitation on Benefits

The maximum benefit payable to a participant from a defined benefit plan is the lesser of (i) 100% of his pre-retirement average compensation or (ii) $130,000. This is an annual amount payable over the life of the participant or over the joint lives of the participant and his/her spouse. The $130,000 limit is adjusted for distribution ages less than or greater than the participant's social security retirement age and for optional forms of benefit distribution.

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The $130,000 maximum is also subject to a possible annual adjustment due to inflation, rounded down to the next lowest multiple of $5,000. The limit started at $90,000 in 1989 and is scheduled to increase to $135,000 in 2000. For an individual retiring at age 65, the $130,000 maximum annual benefit equates to a lump sum accumulation of around $1,300,000. If an individual first becomes a participant in a defined benefit plan at age 55, the initial annual contribution required to fund the maximum benefit is around $97,000. This may be contrasted with the maximum limit for a defined contribution plan which is the lesser of (i) 25% of current compensation or (ii) $30,000.

Repeal of IRC Section 415(e)

The Small Business Job Protection Act of 1996 (SBJPA) repeals Internal Revenue Code section 415(e) for plan limitation years beginning after December 31, 1999. Section 415(e) is an additional limit imposed on individuals who participate (or have participated) in more than one type of qualified retirement plan of the same employer.

The additional limit is a combination of utilization factors: the defined contribution fraction and the defined benefit fraction. The defined contribution fraction compares the annual additions (contributions and forfeitures) received by a participant in any defined contribution plan over his entire period of employment to the maximum amount he could have received under the plan in each of those years. The defined benefit fraction compares the projected benefit of a participant in any defined benefit plan to the maximum permissible benefit. Certain adjustments may apply to the denominator of each fraction, but added together, the fractions cannot exceed 1.0.

The plans need not be in existence at the same time for the limit to apply. Therefore, there are many individuals who have participated in a defined contribution plan for a number of years who are precluded from participating in a defined benefit plan (or can only participate at a reduced level) even if the defined contribution plan terminated. Likewise, there are individuals who cannot participate (or can only participate at a reduced level) in a defined contribution plan even if their defined benefit plan terminated.

Contributions without Section 415(e)

Example 1: Employee Smith is currently age 55. Smith participated in a defined contribution plan for 25 years and received maximum annual additions. With IRC section 415(e) in effect, Smith can accumulate approximately $374,000 in a defined benefit plan over 10 years. Without the restrictions of the combined plan limit, Smith can accumulate approximately $1,300,000 in a defined benefit plan over 10 years. This difference results in a projected annual contribution deduction of approximately $97,000 or an increased deduction of approximately $70,000.

Example 2: Employee Brown is currently age 55 and participated in a defined benefit plan for 10 years and accrued maximum benefits. With IRC section 415(e) in effect, Brown can receive only small allocations in a defined contribution plan. Without the restrictions of the combined plan limit, Brown can receive annual allocations up to $30,000. Over 10 years, Brown can accumulate an additional $435,000 in a defined contribution plan (based on 8% annual earnings).

Overall Tax Deduction

While the repeal of the combined benefit limitation will enhance the contribution ability of many individuals, if a defined contribution plan and a defined benefit plan are maintained at the **same** time, they are still subject to an overall deduction limit. The total amount deductible is the greater of (i) 25% of compensation paid during the taxable year or (ii) the amount required under the defined benefit plan to meet minimum funding requirements. This is an aggregate plan limit and not an individual participant limit.

Retirement Plan Alternatives

The repeal of the combined benefit limitation offers opportunity for additional retirement benefit accumulations for highly paid employees and company owners. For individuals who are age 45 or older, a defined benefit plan generally produces greater annual deductible contributions and greater benefit accumulations. Other retirement plan alternatives include money purchase pension plans, traditional profit sharing plans, age-weighted profit sharing plans, cross-tested defined contribution plans, salary savings or 401(k) plans, and cash balance plans.

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If you want specific information on any of these plan alternatives, call our office. We would be pleased to assist you in planning for your retirement needs.

2000 Cost-of-Living Adjustments

The IRS has announced the following year 2000 cost-of-living adjustments for various dollar amounts that affect qualified retirement plans:

Purpose	**1999 Limit**	**2000 Limit**
Defined Benefit Limit	$130,000	$135,000
Defined Contribution Limit	$30,000	$30,000
Compensation	$160,000	$170,000
Highly Compensated Employee	$80,000	$85,000
Social Security Taxable Wage Base	$72,600	$76,200
401(k) Elective Deferral	$10,000	$10,500
SIMPLE Elective Deferral	$6,000	$6,000
457 Compensation Deferral	$8,000	$8,000

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