DEFINED BENEFIT PLANS

DEFINITION

A defined benefit plan is an employer-sponsored retirement plan where employee benefits are determined based on a formula using factors such as salary history, age, and duration of employment. Investment risk and portfolio management are entirely under the discretion of the employer. There are also restrictions on when and how one can withdraw these funds without penalties.

HOW THEY WORK

ELIGIBILITY

Employees age 21 or older with one year of service must be eligible if employer contributions are subject to a vesting schedule. If employer contributions are immediately vested, a two-year eligibility period may be imposed.

WHO CONTRIBUTES

Generally, only employers contribute to a defined benefit plan; employee contributions are usually not allowed. All employees of a company are typically eligible to participate, depending on the required age and number of years of service with the employer. Defined benefit plans are subject to minimum vesting requirements.

BENEFITS

These plans differ from standard defined contribution accounts like IRAs and 401(k) plans because, as their name suggests, defined benefit plans provide a specified benefit upon retirement. Benefits may be specified as a dollar amount or a formula. The most common type of formula used is based on the employee's terminal earnings (final salary). Using this formula, benefits are based on a percentage of average earnings during a specified number of years at the end of an employee's career.

CONTRIBUTION AMOUNTS

Companies providing these plans make contributions to the plan based on assumptions determined by actuaries. Rather than contribute to separate accounts for each participant, contributions are paid into a general trust fund for all plan participants. The actual formulas on which benefits are based are fairly complex. The annual employer contribution to a defined benefit plan is determined each year by an actuary and these calculations directly affect the amount of the employer's required contribution. To be deductible by the employer, the contribution to the plan may not exceed the amount necessary to fund individual participant's benefits of up to the annual benefit limit; the lesser of $210,000 (for 2015), or 100% of compensation averaged over the three consecutive years of highest compensation. The actuary determines this "necessary amount."

FUNDED VS. UNFUNDED PLANS

Defined benefit plans can either funded or unfunded. With a funded plan, employer contributions, and in some cases, those from plan members, is invested in a fund towards meeting the plan benefits.

In contrast, in an unfunded plan, no assets are set aside and the benefits are paid for by the employer or other pension sponsor as they are incurred. This type of financing is known as the pay-as-you-go approach and cannot be used for defined benefit plans in the private sector.

TAX BENEFITS

Contributions to a defined benefit plan are deductible for the employer and excluded from income for the employee and earnings on the contributions grow tax-deferred. Because of the actuarial nature of these plans, they are fairly expensive to administer and require a significant amount of tax reporting.

USE OF THESE PLANS

Typically, large corporations offer defined benefit plans, though some small business may also adopt a defined plan. This plan makes sense for small businesses if:

- There are a small number of employees;
- The owner is relatively close to retirement (age 45 or older) and needs to set aside a significant amount of money for retirement over a short period of time (e.g., 10 years); and
- The business' income is fairly stable, so that it can support ongoing contributions to the plan year after year.

ADVANTAGES VS. DISADVANTAGES

For employees, the assurance of a specified benefit is a great advantage, but there is also the disadvantage of this being a much less portable plan compared to other employer-sponsored retirement plans. For employers, the advantages of a defined benefit plan are the ability to contribute a greater amount to retirement accounts for top-level employees, and the potential for increased employee loyalty. However, they are not without their disadvantages, as the plans are fairly expensive to administer and companies are at a great risk of having to provide a specified benefit, regardless of investment returns. Employers will need to take from company's earnings in the event that the returns from the plan's investments result in a funding shortfall.