WELLS FARGO Advisors

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The Defined Benefit Plan

Important information regarding Defined Benefit plans

The plan provides a specific benefit at retirement for each eligible employee through contributions funded exclusively by the employer.

What is a defined benefit plan?

When you establish a defined benefit plan, you promise each participant a specified monthly benefit at retirement. This type of plan lets you select the desired level of benefits and then provide those benefits to eligible employees.

On the other hand, a defined contribution plan, such as a 401(k), differs because you determine the level of contributions—not the level of benefits. With these plans, employees receive different levels of retirement benefits based on how many years they participated in the plan, the return on plan assets, and other factors.

With a defined benefit plan, the monthly benefit is usually determined by the employee's compensation and years of service or plan participation. The amounts are expressed in terms of a monthly benefit payable for life, beginning at what is called the "normal retirement age." The benefit defined by the plan is called the "normal form of benefit." In many cases, participants choose to receive their benefit payments in a manner other than the normal form, which may include a lump sum distribution.

Normal retirement age

For a plan to define the benefits payable at retirement, a "normal retirement age"—the date when benefits begin—must be specified in the plan document. Normal retirement age cannot be later than the date when the participant attains age 65 or the fifth anniversary of the date the employee began plan participation. A participant must be 100% vested at normal retirement age.

When is a defined benefit plan appropriate?

Your intent when offering a defined benefit plan should be to offer a permanent, ongoing retirement savings program rather than a temporary incentive to attract and retain quality employees. The defined benefit plan should be established with the intent to contribute to the plan for at least five years to meet the IRS permanency guidelines.

A defined benefit plan is more complex to administer than a defined contribution plan, and it requires using the services of an enrolled actuary. However, this type of plan may generate a much larger tax-deductible contribution for you than a defined contribution plan. In fact, the annual tax savings on contributions often exceed the administrative costs involved with establishing and maintaining the plan.

You may consider a defined benefit plan to help address your retirement needs if you are approaching retirement age and have not saved enough to achieve your financial goals. In general, you must be aged 40 or older for a defined benefit plan to offer larger deductions for funding retirement than a defined contribution plan can provide. In such situations, a defined benefit plan can be a good tax-planning and wealth-accumulation tool.

Eligibility requirements

When establishing a defined benefit plan, you must include all of its eligible employees. You may exclude employees who:

- Are younger than age 21
- Have less than one year of service (1,000 hours), unless using full vesting, which lets the employer require two years of service
- Are covered by a collective bargaining agreement

Minimum participation requirements. As a condition of qualification, a defined benefit plan must benefit at least the lesser of the following:

- 50 employees; or
- The greater of 40% of all employees, or two employees

Vesting

The Employee Retirement Income Security Act of 1974 (ERISA) requires a qualified plan to give participants a vested right to benefits. A benefit is vested when it becomes nonforfeitable—meaning the employer cannot take it away. In addition, a plan must provide a vesting schedule showing the length of service required for an employee to receive a benefit if his or her employment is terminated before normal retirement age.

There are several vesting schedules available for defined benefit plans, but certain criteria mandate specific vesting schedules. For example, if more than one year is required for eligibility, the employer contributions must be 100% immediately vested. The IRS has developed other requirements and plan designs that could alter the structure of the vesting schedule. The maximum statutory vesting schedules are:

- **Three-year cliff.** No vesting is provided until the employee is credited with three years of service, at which time he or she becomes fully vested.
- **Six-year graded.** An employee must be 20% vested after completing two years of service, with vesting increasing in 20% increments until the employee is 100% vested after six years of service.

If an employee is not fully vested at the time of termination of employment, a forfeiture of the unvested benefit will occur. Forfeitures under a defined benefit plan cannot be used to increase the benefits other employees would otherwise receive. Forfeitures must be used instead to reduce employer contributions.

Compensation

To determine contributions and benefits, compensation is typically defined as follows:

- W-2 wages for corporations
- Net profit from Schedule C (Form 1040) for sole proprietorships
- Self-employment earnings from Schedule K-1 (Form 1065) for partnerships

There is an additional calculation that must be done to determine "eligible compensation" for sole proprietorships and partnership income. Please consult your tax advisor or actuary to determine.

In 2021, the maximum compensation that can be used for these purposes is $290,000.

Contributions

Each year, an enrolled actuary performs a calculation to determine the mandatory, tax-deductible amount you must contribute to the plan to provide the retirement benefit specified in the plan formula.

Factors that affect the contribution necessary for a participating employee include the current value of assets in the plan, the employee's age, date of hire, and compensation. For example, a participating employee with a large projected benefit and few years to normal retirement age may require a large contribution because there is little time to accumulate the needed value. The Supreme Court has ruled that an in-kind contribution to a pension plan is a prohibited transaction. Therefore, contributions to a defined benefit plan must be made in cash.

In 2021, the maximum benefit for this plan type is the lesser of 100% of the employee's compensation or $230,000 per year.

Minimum funding requirements

To ensure the plan will have enough assets to pay the promised benefits, a defined benefit plan must comply with minimum funding requirements.

When calculating the contribution, the enrolled actuary must make reasonable assumptions about mortality (i.e., how long participants are expected to live) and interest (i.e., the rate at which plan assets will grow). If you fail to make the legally required contributions by the deadline for the business's tax return, including extensions (but no later than

8½ months after the close of the plan year), the IRS can assess penalty taxes.

Investment considerations

Defined benefit plans are "pooled" plans—instead of individual accounts, a pool of money is invested to provide benefits for the entire group. Plan investment alternatives must be carefully established and reviewed.

Because benefits are ultimately provided from your contributions and investment earnings, your annual contributions fluctuate based on investment performance. For example, if aggressive investments are used and a large loss occurs, you may have to increase contributions dramatically to help ensure funding is available to pay the retirement benefit. To create a more consistent contribution year after year, investments should be designed to meet the assumed interest rate established by the Third Party Administrator/Actuary for the plan.

Adopting a written plan

A defined benefit plan must be in writing and communicated to employees through a summary plan description. To be eligible for a tax deduction for a contribution, you must sign the plan document before the last day of the tax year (December 31 for companies operating on a calendar fiscal year).

Distributions

When plan participants reach a "triggering event," they may be entitled to receive money from their retirement plans. The plan document will identify when participants may receive benefits from the plan. Triggering events include:

- Employment termination
- Plan termination (all participants become 100% vested)
- Divorce (qualified domestic-relations order)
- Normal and early retirement
- Attainment of age 72
- Disability and death

Defined benefit plans, unlike defined contribution plans, are not required to offer a lump-sum distribution option. Instead, some plans only permit an annuity payment option, which provides payments over either a set number of years or for life. If a lump-sum payment is available, the participant will have the option to roll the distribution into an IRA or pay ordinary income taxes on the distribution for the year it was received.

The normal and automatic form of benefit for married participants is a Qualified Joint and Survivor Annuity. The normal form of benefit for a single participant is a Single-Life annuity. To waive either of these benefit forms, the participant must waive the automatic form of payment, and if the participant is married, the participant's spouse must consent to the participant's election.

Pension Benefit Guaranty Corporation Insurance

The Pension Benefit Guaranty Corporation (PBGC) is the federal corporation that administers the pension-insurance program ERISA established. Although the PBGC insures most qualified defined benefit plans, it does not cover the following:

- Plans established and maintained exclusively for substantial owners, where a substantial owner is a sole proprietor or partner who owns 10% or more of the capital or profit interest in a business entity. (In the case of a corporation, a substantial owner is an individual who owns 10% or more of the voting stock or total stock of the corporation.)
- Government plans.
- Church plans.
- Plans of professional-service employers that have 25 or fewer active participants.

Defined benefit plans covered by the PBGC are required to pay PBGC yearly insurance premiums. There are two kinds of normal premiums: the flat rate premium, which applies to all plans, and the variable-rate premium, which applies only to single-employee plans.

Maintenance of defined benefit and defined contribution plans

The combined plan deductible limit [IRC 404(a)(7)] for employers that maintain defined contribution and defined benefit plans applies only to the extent employer contributions to the defined contribution plan (excluding elective deferrals) exceed 6% of compensation.

Certain defined contribution plans may not be funded in addition to the defined benefit plan. These plans include:

- SEPs established using IRS Form 5305-SEP
- SIMPLE IRAs and SIMPLE 401(k)s

You can count on us

Call your Financial Advisor for more information about defined benefit plans or other business retirement plans. Wells Fargo Advisors offers a range of plans and can help you match the right plan with your needs and objectives.

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