What is a Defined Benefit Plan? How Does It Work?

The biggest difference between Defined Benefit plans and all other types of pension plans (collectively referred to as Defined Contribution plans) is that the maximum limits on Defined Benefit plans are on how much can be accumulated over your working lifetime, and the maximum limits on Defined Contribution plans are on how much you can contribute each year. Historically, Defined Benefit plans have been used by large companies to ensure that their employees would not outlive their retirement savings. Under the terms of a Defined Benefit plan, a retiree would be entitled to a monthly benefit for the rest of his life, based on how long he worked for the company, how much he earned while employed, and how old he was when he retired. Since the federal government was mostly concerned about there being enough money in the company pension fund to ensure all retirees would collect what they were promised, the required annual contribution was not limited to a specified percentage of total wages.

Fortunately, for business owners with no employees, there's no restriction on how small a business can be in order to take advantage of a Defined Benefit plan. Thus, even though most large companies don't provide benefits anywhere near as large as the maximum permissible benefits, many small businesses do. In part, the reason the government allows small businesses this option is because many small business owners can't afford to save for their retirement during the early years of their businesses, and miss out on the opportunity that most employees in a large company take advantage of throughout their careers. A Defined Benefit plan was the only type of qualified pension plan that allows a business owner to significantly make-up for contributions that they couldn't afford to make in earlier years.

Specifically, the maximum amount you can accumulate in a Defined Benefit plan is enough to replace 100% of your annual pre-retirement income, during your retirement, for as long as you're expected to live. Further, "pre-retirement income" is defined by the government as the highest 3-consecutive-years of earned income from your business (or your predecessor business). Thus, once you've established a high 3-year average, you do not need to sustain high levels of earned income in order to maintain maximum annual Defined Benefit plan contributions. However, "pre-retirement income" is also limited by the government to a specific dollar amount, which is increased annually by a cost-of-living index. Lastly, this specified dollar amount is phased-in over the 10 year period during which you maintain your Defined Benefit plan.

Thus, for example, since the dollar limit for someone turning age 62 and retiring in 2018 is $220,000, if the Defined Benefit plan has only been if effect for 7 years, then the maximum annual benefit earned by 2018 is $154,000, or 70% of $220,000. The "present value" of this $154,000 annual benefit translates to a maximum plan accumulation of roughly $1,980,000 for this 62-year-old.

Unlike in a large company, where the plan continues during the employees' retirement, when you retire, you'll likely terminate your Defined Benefit plan and roll the assets over to an IRA.

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The key to a successful Defined Benefit Plan is to ensure that the business owner can contribute the maximum amount possible, without exceeding the maximum accumulation, and with enough flexibility to permit a lower contribution than the maximum, if desired. By keeping effective lines of communication open between the business owner, the accountant, the financial advisor and myself, by not being overly-aggressive in trying to maximize contributions every year, and by closely monitoring the plan's assets (especially as the owner approaches retirement age), all of the needs can be met to ensure a successful Defined Benefit plan.