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Re: **WHAT YOU SHOULD KNOW AS A SPONSOR OF A DEFINED BENEFIT PLAN**

All qualified retirement plans must meet the standards and regulations set forth in ERISA and regulated by the Internal Revenue Service and Department of Labor. Defined benefit plans bring with them some unique compliance and operational issues. The purpose of this writing is to outline those issues.

A Promise to Pay

A defined benefit (DB) plan promises to pay its participants benefits at retirement based on a predefined formula. In contrast, a defined contribution (DC) plan allocates money to its participant accounts on an on-going basis. A defined contribution plan participant ultimately receives a benefit that is dependent on the success of the investment return on his or her account.

Contributions Required

Contributions to a defined contribution plan are often discretionary while in a defined benefit plan they are required.

The required contributions to a defined benefit plan are calculated and certified annually by an Enrolled Actuary. If the plan's actual investment returns are greater than the interest assumption used in the actuarial valuation, future contributions may be reduced (or eliminated). Conversely, if the plan earns less than the actuarial assumption, future contributions may be higher than anticipated to compensate for this loss.

Contributions Can be Significantly Higher Than a Defined Contribution Plan

In a defined contribution plan, the maximum allocation to a participant is \$44,000 in 2006 plus a \$5,000 catch up contribution if the participant is over age 50 or older in 2006. The maximum deductions at the employer level are generally limited to 25% of "covered compensation" plus the 401(k) deferrals.

In a defined benefit plan, the maximum benefit that can be paid to a participant is generally limited to 100% of compensation not to exceed \$175,000 annually in 2006 for payments payable beginning at age 62. These limits are adjusted for the age at when the benefits begin (before age 62 or after 65), and by the periodic cost of living increases granted under ERISA. The employer tax-deductible contributions are actuarially determined and are not limited to 25% of "covered compensation". In some situations that can exceed the total compensation paid.

Types of Defined Benefit Plans

Two of the most common types of defined benefit plans are "traditional" and "cash balance". While they have some similarities, they also have some differences.

i) Traditional defined benefit plans normally describe the benefit based on a formula. The formula often defines the annual benefit accruals based on a percentage of average compensation (over 3 or 5 years) for each year of service and may incorporate a permitted disparity (formerly known as social security integration.)

It can be complicated to isolate the cost of each participant on an annual basis. Thus in professional firms or companies with multiple owners where the partners/owners are using the Defined Benefit plans as part of the overall compensation package, the traditional defined benefit plan has lost some of its appeal. Further, since traditional defined benefit plans focus on the output at retirement, it is optically more difficult to explain the program to staff employees who are used to a "401(k) style" of benefits.

ii) Cash Balance plans create a "hypothetical allocation" for each participant each year. That hypothetical allocation account is "credited" each year with an interest rate that is set forth in the plan document. Thus from a participant's perspective, a cash balance looks very similar to a defined contribution plan.

A participant's "hypothetical allocation" for a given year is then projected to the normal retirement age at the "crediting rate". That projected lump sum resulting from the current year's "hypothetical allocation" is then divided by an annuity factor to convert it into a "defined benefit". This account balance methodology is the reason that many of the Fortune 500 companies have converted their traditional defined benefit plans into cash balance plans.

The benefits and deductions can be just as high as a traditional defined benefit plan but they look and feel like a defined contribution plan to the plan participants.

Details

Some details you should know before setting up either a traditional or cash balance defined benefit plan are as follows:

Plan Design

(a)Cash or deferred arrangement. If a participant makes a choice to forego his/her compensation for a specific level of benefit from the plan, the IRS could construe this as having the “choice” of taking an increase in compensation or deferring it into the plan. The rules for “cash or deferred arrangements” have an exception to this rule for 401(k) plan elections. Because of this rule, we suggest that you discuss this with your attorney. While there is no basis in the law we recommend that the “hypothetical allocation” levels in cash balance plan remain in effect for a minimum of 3 years.

(b)Maximum benefit levels. Benefits from any other defined benefit plans of the same plan sponsor, even those that were previously terminated, are subtracted from the maximum benefit available in the current plan. It was very common in the 80’s for professional corporations to have their plans set up so that all the partners or principals had individual defined benefit plans while their staff was in a money purchase plan. Those benefits need to be communicated to your administrator so they can be taken into account in determining the current maximum benefits.

(c)Minimum participation rule. Unlike defined contribution plans, defined benefit plans have minimum participation requirements under Internal Revenue Code Section 401(a) (26). The Code states that a plan must provide an annual “meaningful benefit” accrual to a minimum of 40% of the otherwise eligible participants, or 50 people. In the event of an acquisition or some other circumstance that drastically changes the demographics of the company, you may find yourself in the position of having to cover additional participants in order to satisfy 401(a)(26). If this occurs, there will be an additional contribution with respect to the participants.

It is common in defined benefit plans to “carve out” individuals or groups of employees that will not participate in the plan. The minimum participation rule is 40% of those that would have been eligible had they not been in a “carved out” group of employees.

The “meaningful benefit” is fairly straight forward in a traditional defined benefit plan but more subtle in a cash balance plan. In a cash balance plan the benefit accrued each year must be “meaningful”. See Section I.D.ii. for a description of how to calculate the benefit in a cash balance plan.

Managing Annual Contributions

(a)Lowering or Eliminating Annual Contributions. A defined benefit plan contribution will be due on an annual basis regardless of corporate profitability. A plan can be amended to lower the formula or it can be frozen once 1,000 hours are worked by the plan participants. This means that any plan amendments to lower benefit levels or freeze the plan normally needs to be done before about 5 1/3 months into the plan year.

A frozen plan means that benefits will no longer continue to accrue to participants, but this does not mean that there will not be any required contributions. If the plan is underfunded there will be a contribution each year. If distributions are made to a terminated participant, this may cause an additional underfunding for which a contribution may be due.

Government prescribed notices known as “204(h) notices” must also be given to all participants 15 to 45 days before the amendment takes effect depending on size. If the plan has fewer than 100 participants, the notice must be sent at least 15 days prior to the effective date of the amendment. If the plan has 100 or more participants the “204(h) notices” must be sent 45 days prior to the effective date of the amendment.

Thus, it is good to review corporate profitability and goals early in the plan year and take appropriate actions to manage the contribution levels.

(b)Increasing Annual Contributions. Benefit levels in a defined benefit plan can be increased by plan amendment up to 2 ½ months following the end of the plan year.

(c)Watch out for Partners/Owners who terminate after completing 1,000 hours. A partner or principal in a cash balance plan who terminates after working 1,000 hours during a plan year will still have an obligation to fund the hypothetical employer contribution. This can be tricky, particularly if the split was acrimonious.

Investment Policy vs. Plan formulas and earnings assumptions

Coordinate plan investments with the plan benefits and assumptions. Actuarial valuations assume a particular interest rate on the assets; the plan sponsor bears the investment risk. This means that if the assets don't perform as expected, the losses will need to be made up in subsequent years in the form of increased plan contributions.

PBGC (Pension Benefit Guaranty Corporation)

Coverage required unless exempted. Regular corporations, sole proprietors with a non spouse employee, and professional corporations with more than 25 participants are subject to flat rate premiums due to the Pension Benefit Guaranty Corporation (PBGC) on an annual basis. Currently the flat rate premium is \$30 per participant. If the plan becomes underfunded (liabilities of the plan based on PBGC assumptions exceed assets), additional “variable rate premiums” and participant notices related to the underfunding may be due.

Care must be taken with regards to the PBGC in the event of an owner-only plan or a professional corporation with less than 25 participants if there is an increase in staff. Premiums which were never before required before may all of a sudden become mandatory.

Plan Termination

(a) Plan must be fully funded on termination. Generally, unless the plan sponsor is declaring bankruptcy, defined benefit plans cannot be terminated if there is a funding deficiency, i.e., not enough assets to cover the liabilities. In some circumstances the “major owners” may waive portions of their benefit to make up the underfunding but this would be a decision requiring some consideration.

(b) Excise tax if plan is over funded. If upon termination a plan has assets in excess of the maximum benefits owed to plan participants, the amount of the excess is reverted back to the plan sponsor and is both taxable to the sponsor and subject to a 50% excise tax. Since the excise tax and the income tax apply to the amount of the reversion, the combined tax can be in excess of 90%. Investments subject to a sound investment policy and annual monitoring can prevent an excess situation from occurring.

Communication/Culture

Required Communication vs. what works in your company. Some defined benefit plans are not easily understood by participants. This could cause some cultural or morale issues if care is not taken to fully explain how the plan works. The government mandated Summary Plan Descriptions are sometimes augmented with additional information to meet plan sponsor needs.

Cash Balance Plan Congressional Status

Hybrid Plans: Cash balance plans are part of a larger group of plans that the government is referred to as “hybrid plans”.

Prior to PPA cash balance plans had been viewed by some Federal circuits to be “age discriminatory”. The Cooper vs. IBM court case in the 7th Circuit (Illinois) was the landmark case making this ruling. In August of 2006 this case was reversed on appeal. PPA (signed into law on August 17, 2006) made most cash balance prospectively non age discriminatory on date of enactment.

PPA also allows for the conversion of traditional defined benefit plans to be converted to cash balance in 2008.

Distributions

(a)Distributions: a more complicated process. Distributions from a defined benefit plan are a bit more complicated than from a defined contribution plan. Many defined contribution plans require a lump sum as the method of distribution. A defined benefit plans must distribute the benefits in the form of a joint and survivor annuity to married participants unless the participant and his or her spouse waive that form of benefit in favor of, for example, a lump sum.

(b)Restrictions on distributing to the 25 most highly compensated employees. Lump sum distributions to the top 25 most Highly compensated Employees may be restricted if the plan is not funded at a high enough level (110% of the current liability as calculated using government imposed interest rates and mortality table). If the HCEs who are restricted wish to receive distributions, this can be accomplished by entering into an escrow agreement that secures repayment to the Plan of the lump sum into an escrow agreement that secures repayment to the Plan of the lump sum distribution in the event that the Plan is terminated with insufficient assets.

General Plan Operation

More Complex to administer. There are certain areas of compliance which must be tested for all plans. There are additional elements of administrative process and compliance; however, that effect defined benefit plans.

Thus, the cost to design and maintain a defined benefit plan is higher than the cost of a 401(k) or a profit sharing plan. The compliance work must be certified by an Enrolled Actuary who must sign the Schedule B attachment to the 5500 Form filing annually. Whether you have a traditional defined benefit plan or a cash balance plan, the level of complexity is far greater than a 401(k) or a profit sharing plan. The closing out of the plan year often entails coordination between the plan sponsor and ACI in entities that wish to anticipate the defined benefit plan contribution in determining its taxable profits for the year.

Combination Defined Contribution/Defined Benefit Plan Design

Defined benefit plans often do not exist by themselves. Many plan designs involve the same employees participating in both defined benefit and defined contribution plans. When this occurs additional complications are put in play.

Deduction Limit: If at least one employee participates in both the defined contribution and the defined benefit plans, the maximum deduction is limited to the **greater** of 25% of compensation, or the maximum defined benefit contribution **plus** an aggregate 6% contribution to a defined contribution. (Note: this does not need to be allocated in a uniform percentage to all participants.)

In addition to limit each participant can defer up to \$15,000 into a 401(k) element to the profit sharing plan (as long as it passes the 401(k) discrimination test) plus a catch-up contribution of \$5,000 if the participant is age 50 or older.

Gateway Contribution: Very often the defined contribution and defined benefit plans are tested together to determine that, in combination, they are not discriminatory in favor of highly compensated employees. This is calculated under the general discrimination rules of IRC section 401(a) (4) and is often referred to as “cross testing”. Regulations require that when a cross testing is utilized to prove that the plan is non-discriminatory, a “minimum gateway contribution” must be made with respect to the non-highly compensated employees. In a defined contribution plan, minimum gateway caps out at 5% of compensation. In a combination defined contribution/defined benefit plan, the minimum gateway caps out at 7.5% of compensation.

Top Heavy Minimum: When the key employees (generally owners) have more than 60% of the total benefits or account balances, the plans are considered top heavy. A top heavy plan requires that a top heavy minimum contribution be given to all non key employees (generally non owners). The contribution plan and 5% in a combination defined benefit/defined contribution plan.

Benefits, Rights and Features: When cross testing a combination defined contribution/defined benefit plan structure, there are certain non-numeric elements of the plan that must also be non discriminatory. Thus when a defined benefit plan is being added to an existing defined contribution plan the defined contribution plan normally has to be amended or restated to ensure that certain non numeric plan provisions such as the normal retirement date, distribution options etc. are in sync.

We hope that his material gives you a better understanding of the underbelly of defined benefit plans as contrasted to defined contribution plans.

IRS Circular 230 Disclosure

IRS regulations effective June 20, 2005, require us to notify you that this communication was not intended or written by this firm to be used, and cannot be used, by you as the taxpayer, for the purpose of avoiding penalties that the IRS might impose on you.