Defined-benefit and 401(k) plans could spell tax savings

While the word is that defined-benefit plans are no longer in favor, they can still provide a tax savings for the right client.

“A lot of the press would lead you to believe that defined-benefit plans are on the way out,” said Karen Shapiro, chief executive of Dedicated DB, a San Mateo, Calif.-based provider of such plans. “But for some small-business owners, it’s a terrific tax strategy.”

“With a defined-benefit plan, the owner funds the plan. One of the reasons they’ve faller out of favor with large corporations is that they have moved to 401 (k) plans, where they get individual employees to contribute, and sometimes, but not always, the company does a match,” she said. “Since the owner makes the contribution, he gets the deduction.”

The strategy works best with a one-to-five person business, explained Shapiro. “A one-person owner gets 100 percent of the benefit, and can still get 90 percent of the benefit for themselves if they have a few employees,” she said. “People who are opening these plans are going it for the tax advantage. That money, instead of going to the IRS, is going into their retirement plan.”

Shapiro identified a number of situations where there is a good fit for such a plan. “It has to be someone who can have an advantage in sheltering a lot of money, which means they’re earning a lot of money,” she said. “For example, people who, if they’re working, may be a highly paid executive in the company but have income on the side, such as being on a board of directors, or having royalties from a book or getting consulting income.”

Another situation is where a husband and wife are in business together, explained Shapiro. “Together they can accumulate a huge amount money in one of these plans funded for five to 10 years. Or, where one is employed by a corporation making a large salary, while the spouse has a home business making $60,000, and they don’t need that second income. The entire amount can go into a defined plan, and that’s sheltered from tax.”

Dentist, doctors and other small business owners who have offices with just a few support staff also fit the profile of those likely to benefit, Shapiro noted that the strategy works with any type of business entity, including sole proprietorships, S corporations, limited liability companies and others.

However, Salim Omar, a Matawan, N.J.-based CPA, warned that compliance and testing are important factors to consider with any plan. “Sometimes on the administrative side, the work and cost don’t pay. Some of our clients offer DB plans and 401(k) plans, but up to now we have more [Simplified Employee Pension] and [Savings Incentive Match Plans for Employees] plans, because of their low cost,” he said. “But in a competitive environment, they are important to offer to clients, and they do help shelter and defer tax.”

The typical owner keeps the plan open for eight years, said Shapiro. “The IRS want to be sure that they’re not doing it as a scam, by setting the plan in the year they have a windfall and then closing it the next year,” she said. “We say they generally should keep it open for at least three to five years.”

While the plain is open, they are obligated to contribute to it every year, she noted. “That’s unlike a 401(k) plan, where you don’t have to contribute if you don’t want to. When the plan is closed, participants can roll it over to an IRA without any tax consequences until they start withdrawing."

"To compare this with a single-person 401(k) or SEP, think of someone 52 years old who'll work for another 10 years," she said. "If they're making $200,000 a year, the maximum they could put in a SEP would be $45,000 a year. For a 401(k), they could put in $50,000. For a DB plan, they could put in $169,000, and it also reduces the tax bracket because the contribution is a deduction from earnings."

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One reason that these plans have been growing is that there have been a series of statutory changes over the past seven years that have made them more flexible, noted Shapiro.

"The Pension Protection Act in 2006 added some additional flexibility to it," she said. "For example, if you can contribute $120,000 to the plan this year but aren't sure if you will be able to continue making contributions at that rate for five years, you can set up the plan for $80,000 and add $40,000 to a 401(k) that you contribute to only in good years. Another aspect is that you can do some front-loading. If the first year is really good, you can contribute up to 150 percent, which means that later on you can contribute less. This works well if you're not sure what your financial position will look like later."

The reason that defined benefit plans have fallen out of favors is that they become a liability of the company, observed Mark Gutrich, president of ePlan Services, a Denver-based DB consultant and services provider. "They put a lot of companies out of business because the pension liabilities were too great," he said. "For a 55-year-old who intends to retire at 62, the defined benefit plan still exists and still has to be funded. It puts a damper on acquiring the business for a potential buyer."

"Although it's no panacea, the Pension Protection Act eliminated much of the liability that small business owners feared about offering 401(k) plans,' said Gutrich, whose company sells and services such plans.

He added that, under the new rules, participants have to work for two years before they become fully vested. "It's now a vehicle to retain as well as attract workers," he said.

A provision of the PPA makes it easier for employers to automatically enroll employees into a 401(k) plan by giving nondiscrimination protection for these enrollments if they meet certain requirements, according to Gutrich.

In addition, it protects them from liability where the employees fail to make an election on their own on where to invest their assets. "The Qualified Default Investment Alternative protects the employer from fiduciary liability if the fund doesn't perform up to par," said Gutrich. "It allows the employer to name a default investment option that won't be subject to attack."