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Defined Benefit Plans

There are many different types of qualified retirement plans, and finding the right plan for the organization is the first step. The following is a brief description of various types of defined benefit plans.

Defined Benefit Plans

In a defined benefit plan, the plan formula defines the benefit that will be paid at retirement age (or earlier separation from employment). An actuary determines the amount that must be deposited into the plan on an annual basis to provide the benefits called for under the terms of the plan.

In addition to the benefits to be paid, the actuary takes into account an expected rate of return and other factors (e.g., mortality) when determining the required contribution each year. In an active plan, the investment results do not alter the benefit the employee receives, as the benefit the employee receives is determined solely by the benefit stated in the plan document. However, actual investment results can cause the required contribution to increase (decrease) from year to year based on whether or not they exceed (under-perform) the actuary's assumed returns.

An advantage to adopting a defined benefit plan is that the contribution for executives can be substantially higher in a defined benefit plan than in other types of retirement plans. Additionally, defined benefit plans tend to favor older, higher-paid employees.

The promised benefit must be provided to all participants regardless of the actual investment performance of the plan. Poor investment performance could result in increased contribution requirements. Because the employer is liable for providing the benefit, regardless of investment earnings, all investment risk is borne solely by the employer.

Traditional Defined Benefit Plan

Typically, traditional defined benefit plans will have a uniform retirement benefit formula that applies to all participants. A participant will receive a retirement benefit defined as some percentage of pay or some flat dollar amount at retirement age.

Cash Balance Plan

Many owners desire larger tax deductions and accelerated retirement savings. Implementing a cash balance plan may be the best solution for such owners. Recent legislature encourages more and more professionals and successful business owners to adopt this type of plan.

In a cash balance plan, a "theoretical" account balance (or "TAB") is maintained on behalf of each participant. Thus, each participant in the cash balance plan has a TAB that resembles those in a 401(k) or profit sharing plan (defined contribution "DC" plans).

On an annual basis the TAB is credited with a "compensation credit" and an "interest credit". The compensation credit can be a flat dollar amount or a percentage of pay and can vary by employee. The interest credit is determined by the plan document, and will typically be a fixed 6% rate or, alternatively, could be based on a conservative index, such as the rate on 30-year U.S. Treasury Securities.

Because the cash balance plan is communicated in terms of an "account balance", the benefits provided are more easily understood, and appreciated by employees. Cash balance plans take the mystery out of the employee benefit plan.

Finally, cash balance plans are more predictable than traditional defined benefit plans; a participant's account balance can be projected based on plan provisions to a future date with relative ease, no more special calculations or vague explanations.

Retirement Plan Design ▲ Administration ▲ Consulting ▲ Actuarial Services

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