

Defined Benefit Plans...An Overview

Description:

A defined benefit plan promises that a specific benefit will be paid at retirement. The promised retirement benefit can be either a flat dollar amount that is provided to all employees or, more commonly, a benefit that is determined according to a formula. The annual employer contributions required to provide the promised retirement benefits are then actuarially determined.

Benefit Formulas:

- **Flat Dollar Amount:** All plan participants receive the same flat dollar amount at retirement (e.g., \$300 per month for life).
- **Flat Percentage:** Each plan participant receives a fixed percentage of compensation as a retirement benefit (e.g., 20% of average compensation for the three consecutive highest paid years; someone with average compensation of \$75,000 would then receive a \$15,000 annual pension benefit).
- **Unit Benefit:** Each plan participant receives a flat dollar amount or a percentage of compensation for each completed year of service (e.g., a \$25 per month benefit for each completed year of service would pay a \$500 monthly pension benefit to someone with 20 years of service; alternatively 2% of monthly compensation for each completed year of service would result in a \$2,000 monthly pension benefit for someone making \$5,000 per month who had 20 years of service).

Advantages:

- If the business has older, higher paid employees, including owner-employees, a defined benefit plan makes it possible to shelter large amounts of current business income and provide meaningful retirement benefits to older employees, who are fewer years away from retirement.

Disadvantages:

- Administration of a defined benefit plan can be complex, requiring periodic actuarial review in order to determine how much the employer must contribute to provide the promised retirement benefits.
- The employer assumes the risk of investment performance. If plan investments perform below assumed rates of return, the employer may have to increase contributions in order to provide the promised retirement benefits.