Keeping the 'Lion's Share': The Appeal of Defined-Benefit Retirement Plans

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Qualified retirement plans are an excellent way to grow tax-deferred money for retirement and to protect assets from unjust lawsuits. In addition, contributions to qualified retirement plans generate tax deductions.

However, even those advantages can't motivate everybody—especially, say, closely held contractors running their own companies.

If the company is generating significant pre-tax income, for instance, a $20,000 deduction isn't necessarily going to motivate the busines owner to start a retirement plan for the family construction company. When there is no personal financial benefit for them, many affluent individuals give up on using these plans altogether.

Putting these two considerations together, business owners may find certain types of qualified retirement plans appealing. However, the ability of many such plans to deliver the value successful business owners are looking for—meaningfully lower taxes coupled with solid benefits for themselves—is sorely lacking. For example, it's not uncommon for 401(k) plans to be top-heavy, meaning successful business owners are unable to personally receive any significant real value.

Defined-Benefit Plans

Proving to be more appealing to business owners are defined-benefit plans. These often enable owners to make larger contributions, resulting in corresponding tax deductions. The most appealing type of defined-benefit plan is referred to as a benefit-focused plan.

The Pension Protection Act of 2006, which took effect in 2008, changed the rules for funding defined-benefit plans and, among other things, it brought to life the "benefit-focused plan." While many qualified plan types exist, most of them benefiting company employees, the new law has spawned something different through various mechanisms backed by IRS letters of determination and legal opinion.

In essence, it has created a new type of plan that for the first time offers benefits for business owners who might otherwise stay away. The changes have been little talked about, but even now some contractors are starting to take advantage, resulting in real, meaningful contributions and benefits to both owners and key personnel.

The benefit-focused plan enables key employees, principals and their families to benefit most from the invested money in the plan. Moreover, within governmental guidelines, these principals have the power to designate who participates in the plan at their companies, while maintaining safe-harbor profit-sharing and 401(k) plans for employees.

One of the most important aspects of the new plan is that it can as much as triple business contributions and the resulting deductions when compared to a traditional defined-benefit retirement plan, offering the closely held construction company owners larger potential contributions and resulting deductions than he or she could find in any other type of retirement plan. This can allow companies the highest possible deductible contribution amounts of all qualified retirement plans available, thus making it useful for income tax planning.

The benefit-focused plan also creates business planning and estate planning advantages. If owners die, the benefits can transfer to their spouses and heirs over their lifetimes due to the death benefit component in the plan.

In a benefit-focused retirement plan, the company-sponsored plan purchases life insurance as part of the funding mechanism for the plan structure. Not only does the owner then benefit by getting life insurance using pretax dollars, but the proceeds of the insurance when he dies are income tax free and can potentially be estate tax free. This benefit proves useful in succession and estate planning.

A benefit-focused plan enables business owners to make large contributions resulting in immediate tax deductions of any qualified retirement plan. Further, the benefit-focused plan also directs by plan design the vast proportion of the money contributed as future benefits to the business owner.

Construction Case Studies

To get a better understanding of the value successful business owners find in the benefit-focused plan, here are a few case studies to consider.

1. A 44-year-old heavy highway contractor was unhappy with his existing retirement plan because his contributions were declining annually since he started the plan, and he was earning a low rate of return on the fixed annuity used to fund his plan. He could only contribute about $112,000 each year. By taking into account his past service and the ability to restate his existing plan, the company was able to convert to a benefit-focused plan that would provide him a projected contribution and tax deduction in excess of $519,000 for the next 10 years. The owner would also derive benefit from significant account build-up available for future retirement benefits.
2. A family business doing commercial window installation with 11 employees wanted to fund the maximum 401(k) benefits for four key executives while minimizing contributions for the remaining seven. Integrating a traditional defined-benefit plan with the existing 401(k) plan would result in total contributions of about $725,000. Utilizing a benefit-focused plan with the 401(k) plan, the company was able to put away more than $1,554,000 annually with 92% of the contribution going toward the four key executives.
3. A 45-year-old owner of two drywall companies with 11 full-time employees and 25 part-time employees was making more money in his businesses and wanted to set aside funds for a retirement plan. Considering the transient nature of many of his employees, the owner was looking for a plan where he would be the most significant beneficiary. With a traditional defined-benefit plan, he could fund nearly $176,000 a year for himself and the 11 full-time employees. Instead, by choosing a benefit-focused plan, he was able to contribute and take a corresponding tax deduction of about $441,000 for the next 10 years with 89% going toward his future retirement benefits.
4. A demolition contractor with 22 employees was looking to implement a retirement plan. The company's advisors initially could not come up with a plan that was able to benefit the managing partners in any meaningful way. Using a benefit-focused plan, the newly company-sponsored retirement plan was able to generate a first-year contribution of $1,095,000 and corresponding tax deduction. The two managing partners will receive 85% of the future retirement benefits.
5. An electrical contractor with nine employees was looking to fund retirement benefits for the owner and founder of the company as well as his two key executives. Contributions to the existing plans were maxing out at about $230,000 per year. By restating the existing defined-benefit plan and converting it into a benefit-focused plan, the newly company-sponsored plan generated a level contribution of $678,000 per year with approximately 94% going to the founder and the two key project managers.

As the benefit-focused retirement plan is a qualified plan, the assets are protected from creditors and litigants. Furthermore, the insurance component can be used in a buy/sell agreement. So, if a business partner dies, the owner can use insurance proceeds to buy his equity interest in the company.

Qualified plans are one of the best ways to address the needs for providing future retirement benefits, mitigating taxes and creating tax deferred growth for the closely held business owners.

If the objectives of a successful business owner are to get the lion's share of the financial benefits for a select number of senior managers and owners, then a benefit-focused plan is an effective and powerful option. The major consideration for the successful construction company owner is their ability to personally benefit from any qualified retirement plan. CE

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