Defined Benefit Plans

For Solo Practitioners

When a solo practitioner is looking at retirement plans for a way to defer taxes, their choices are not limited to a Simplified Employer Plan (SEP) or other Defined Contribution plan. Often an advisor will recommend adopting a Defined Benefit (DB) plan. Depending on the age, the annual tax-deductible contribution they may make can be much larger than the $55,000 ($61,000) maximum allowed under the typical Profit Sharing Plan. This can result in significant tax savings to the individual while accumulating significant savings for retirement.

There is no maximum contribution that can be made to a DB plan per se. Rather, the DB plan defines the benefit that can be paid from the plan. The maximum annual benefit payable from a DB plan is the lesser of $220,000 payable at age 62 or the high three consecutive year average compensation. If the compensation average supports it, an individual with 10 years of participation in a DB plan can receive a $220,000 annual benefit, or an equivalent lump sum of approximately $2.8 million. Since the limit is determined when benefits are paid, the $220,000 benefit limit is actuarially adjusted for ages earlier than 62 and later than age 65; and further reduced pro rata for years of participation in the DB plan less than 10 years. The high three consecutive year average limit is reduced pro rata for years of service less than 10 years.

Age	Maximum Benefit Limit
55	$138,729
60	$192,102
62	$220,000
65	$220,000
67	$254,193

The compensation that can be recognized for plan purposes will depend on the entity type for the business. An entity that is taxed as a sole proprietor uses their Net Earned Income (line 31 from the Schedule C) minus the pension contributions (excluding 401(k) deferrals). An entity that is taxed as a corporation (including an S-Corporation) uses W-2 compensation for plan purposes. Pass through income on a Schedule K-1 for an S-Corporation is not recognized as compensation for plan purposes.

With a DB plan, the sole practitioner will need to work with their consultant, accountant and advisor to determine the annual contribution level. Once the contribution level is decided, the actuary will determine the benefit available at normal retirement. The calculations are based on their age, compensation, years to retirement and expected return on assets. The older you are, the larger the possible contribution is to a DB plan.

Example 1

A 52 year old sole proprietor, with net Schedule C compensation (after the DB contribution) well over the compensation limit ($275,000 for 2018) could count on depositing approximately $170,000 annually (depending on asset performance). This assumes Normal Retirement at age 62.

Example 2

A 60 year old sole proprietor, with net Schedule C compensation (after the DB contribution) well over the compensation limit ($275,000 for 2018) could count on depositing approximately $255,000 annually (depending on asset performance). This assumes Normal Retirement at age 65.

Once the contribution level is established, assuming reasonable returns on assets, the contribution will normally remain at roughly the same level over the ensuing years. If the business changes and the level of contributions need to be decreased, the plan benefits may be reduced or frozen. It is important to note that freezing benefit accruals does not mean there is no required contribution for the year. If the solo practitioner is unable to make the required contributions you may face penalties imposed by the federal government. If you have large fluctuations in income, this is something to discuss with your actuary. Additional planning is also needed if the entity type is taxed as a sole proprietor since the pension deduction cannot exceed the net earned income for the year.

Since the DB plan provides for a benefit at retirement, the actual investment returns can cause the required contribution to increase or decrease from year to year based on the return on assets. Since the annual contribution is determined based on the fair market value of the assets, the contributions should be invested in assets that have a fair market value readily determinable on an established market. When the decision is made to wind down the plan, the investments should be of the type that can easily be held in an individual retirement account or another qualified plan.

When establishing a DB plan, the IRS requires that the plan be “permanent”. Conventional wisdom is to plan on the solo practitioner maintaining the DB plan a minimum of 3-5 years. Changes in their business can impact the life of the DB plan. At Normal Retirement or some earlier date due to business reasons, the plan could be terminated. Advance planning needs to occur when terminating the plan as a contribution may be required in the year of termination. There is a maximum amount that can be distributed from the plan, which is dependent on their age, compensation average, years of participation and years of service. At the point of the termination and dissolution of the DB plan the proceeds can be rolled over to an IRA, deferring income tax until retirement.

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