DEFINED BENEFIT PLANS: FAQ'S

1. **What is a Defined Benefit Plan?**
   A defined benefit plan is a qualified retirement plan that promises to pay an eligible employee a specific monthly benefit at retirement. Generally, the benefit is expressed as a certain percentage of compensation.

2. **Who are the candidates for a Defined Benefit Plan?**
   The contributions for the specified defined benefit plan are based on the time from entering the plan until the specified retirement age. The older the participant with a shorter time to retirement, the greater the needed annual contribution. Thus, the older business owner with few or no employees is usually the best candidate. This plan can require contributions far in excess of the limitations of defined contribution plans such as 401K or profit sharing plans. Generally, this will be attractive to older small business owners that have $200,000 or more of compensation and wish to contribute $100,000 or more for their own retirement.

3. **What if there is already an existing 401K or profit sharing plan in effect?**
   A defined benefit plan with its enhanced benefits and contributions for older highly paid executives may be used in addition to an existing 401K or profit sharing plan. In setting up the defined benefit plan, it may be necessary to adjust the existing 401K/profit sharing plan. This is determined on an individual case basis.

4. **Is the employer forced to pay a level plan cost each year?**
   The IRS allows the employer to contribute and deduct more than the level required amount in good earnings years and less in other years. If an employer deducts more in one year or more, and earnings and compensation stay constant, some of the future contributions will need to be reduced so the excess can be "drawn against" in later years. The plan actuary that is part of the necessary defined benefit plan administration will advise the minimum and maximum contributions for each year as well as the level contribution needed. Where the employer "front loads" the contract, the pension actuary must do careful monitoring to keep the plan on track.

5. **Can life insurance be included as part of the funding vehicles for a defined benefit plan?**
   Yes. As long as the life insurance death benefit is incidental, life insurance may be part of the funding choices for a defined benefit plan. When life insurance is used, it is called a split funded defined benefit plan.

6. **Is there a cost to the employee for the life insurance?**
   Yes, since the insured is receiving an immediate benefit in the form of life insurance protection. There is an "economic benefit" for the pure death benefit coverage (death benefit minus cash value) taxable to the insured each year. The benefit reported is determined using IRS Table 2001 or, if the insurance company that issues the policy meets requirements defined by the IRS, that company's own term rates at the insured's then attained age.

7. **How is the incidental face amount of the life insurance policy determined?**
   Life insurance inside a qualified defined benefit plan must be based on unisex rates and the death benefit must be incidental. There are two tests allowed by the IRS:
   - The death benefit can be no more than 100 times the anticipated monthly retirement income OR
   - Premiums for life insurance may be up to 66 2/3% of the "Theoretical Uninsured Cost" if whole life insurance is used or 33 1/3% of the "Theoretical Uninsured Cost" if universal life is used.

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Continued

The "Theoretical Uninsured Cost" is determined by the Pension Actuary used for plan administration. Typically, whole life insurance is used for defined benefit plans. The actual amount of insurance that may be provided depends on the type of whole life policy used and can vary greatly from product to product. While up to 66 2/3% of the level funding cost can be used towards whole life premium, as a practice Senex, who does our feasibility studies, generally limit the premium amount to about 50% of the level funding amount. They feel that year to year profitability tends to fluctuate quite a bit in their work with small business owners. Being more conservative serves the business well when there is a down business year. Senex tends to look for products that offer attractive options in the event that the client has a bad year and is unable to pay the full whole life premium.

8. May a long term care or critical care rider be included in the life insurance policy?
No. These riders would not be considered "incidental" to the retirement benefits.

9. Who is beneficiary of the life insurance policy?
The owner and beneficiary of the insurance is the plan. Since the life insurance policy is an asset of the plan, any funds generated by said policy must be credited back to the plan. The participant will be given a beneficiary election form for the plan and that is where the personal beneficiary is named. In case of death, the death benefit proceeds will be paid to the plan and then the plan will pay out the named beneficiary.

10. What is the tax treatment of life insurance benefits when death occurs prior to retirement?
Assuming the insured has included the costs of life insurance protection each year for income tax purposes, the pure amount of death benefit (face amount less cash value) will be received income tax free. In addition, a portion the benefits received from the policy equal to the total cost of life insurance reported by the insured over the years will be treated as basis in the plan and can be recovered income tax free. The balance of the cash surrender value will be treated as a taxable distribution of plan assets and treated as income in respect of a decedent (IRD).

11. What happens to the life insurance policy at retirement?

- If the insured does not need or want the life insurance policy, the policy is surrendered for its cash value. The cash value plus the other accumulated cash can provide the entire defined benefit or the full lump sum can be rolled over into an IRA
- If the insured wants to continue coverage, they can transfer the policy out of the plan through a purchase of the policy. The purchase price replaces the cash value and is combined with the other funds to provide the entire defined benefit or provide a lump sum that can be rolled over to an IRA. In some cases, the purchase of the policy may be done a number of years prior to retirement depending on the circumstances. This option is described in the personalized feasibility report
- If the insured does not have the liquidity to purchase the policy at retirement, they can take the policy out of the plan at retirement as a taxable distribution of its cash value and pay income tax. If necessary they can borrow from the cash values of the policy to generate money to pay the taxes. The balance of the pension fund can be rolled over into an IRA which could be used, if desired, to provide a defined monthly pension for a lesser amount. (Life insurance cannot be rolled over into an IRA)

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