

Owner-only DB Plans

Frequently Asked Questions

The following applies primarily to owner-only DB plans that qualify to file Form 5500-EZ. Answers to some questions may be different for plans that must file a full Form 5500.

General Defined Benefit FAQs

How long must I maintain the DB Plan?

Normally a DB Plan is expected to be “permanent” and should be maintained and funded for a minimum of five years in order to comply with this requirement.

However, if business conditions change such that the company can no longer afford to sponsor a DB Plan, a termination earlier than five years may be justifiable.

Are DB contributions required?

Yes. DB Plans have a required minimum contribution based on keeping pace with additional benefits accrued each year under the plan, investment performance, and other factors. If plan benefits are fully funded, this minimum may be \$0.

However, an employer considering adopting a DB Plan should assume that contributions close to the initial contribution target will be required each year, as this is the most realistic situation.

In many cases, a timely plan amendment may provide the ability to lower the amount of the required contribution (see “deadline for amendment” below). However, this ability depends on a number of factors, including benefit accruals for that year, the funding status of prior years, investment performance, changes in employee demographics, and others.

To maintain maximum plan amendment options, it is important to consult Benetech as early in the plan year as possible.

Can I amend the DB plan to increase or decrease contributions?

In most cases, the answer is “yes.” But be sure to consult Benetech as early in the plan year as possible to properly understand your options.

The timing of an amendment is very important. For maximum contribution flexibility in lowering contributions, an amendment must be executed prior to benefit accrual (generally, 1,000 hours of credited service in a plan year if this is specified in the plan document).

Amendments executed after benefit accrual cannot lower benefits already accrued for that year.

What is the deadline for amending a DB Plan?

Plan amendments can be made up to 2 ½ months after the end of the plan year.

Although benefits accrued for that year cannot be lowered after benefit accrual (usually, 1,000 hours of service), benefits may be increased up to 2 ½ months after the end of the plan year.

Can the contribution amount be changed each year?

Although in many cases the contribution target may be adjusted higher or lower, it is not recommended that a DB Plan be amended up and down on a regular basis as this could be a flag attracting the attention of the IRS. The IRS presumes that DB Plan benefit accruals should be relatively consistent. On audit, the IRS may challenge the reasons for frequent adjustments to a DB Plan.

What is the deadline for making DB contributions?

The deadline for making contributions to a DB Plan is the tax filing deadline of the plan sponsor, including extensions, but not later than 8 ½ months after the end of the plan year. For example, the latest date a contribution may be deposited for a calendar-year DB Plan is September 15 (assuming the fiscal year of the plan sponsor is the calendar year, and the sponsor is on business extension).

However, if the plan sponsor is not on extension, the contribution deadline is the first business tax filing deadline (e.g., 3/15 for a corporation with a 12/31 fiscal year end).

Are there penalties for not timely making required contributions?

Yes. There is a 10% excise tax for required minimum contributions not made by the proper deadline (IRS may levy a higher excise tax in certain situations). This excise tax is applicable in each subsequent year until the deficiency is funded.

For example, if \$100,000 is the minimum required contribution and only \$80,000 is deposited by the deadline, only \$80,000 may be deducted, and an excise tax of \$2,000 is owed to the IRS.

Further, the unfunded amount generally will increase the required contribution for the following year.

Should I make early contributions (during the plan year)?

We recommend that you do not make significant contributions to the DB Plan before Benetech has provided you with a formal contribution letter identifying the minimum required contribution, and the maximum allowable contribution for that plan year.

The reason for this is that contributions greater than the maximum allowable are not deductible, and are subject to a 10% excise tax. Since many factors work together in calculating DB contributions (including actual annual compensation and actual investment performance), it is possible that the maximum deductible contribution will be less than the company expected. If the full expected contribution had already been deposited during the year, the company would be subject to an excise tax on the difference between the actual deposit and the maximum allowable.

The IRS does expect that quarterly deposits be made during the plan year. However, if quarterly deposits are not made, IRS regulations are satisfied by making a simple interest adjustment. Since this modest amount of additional interest is deductible, it is usually most practical to wait until after the end of the plan year to deposit the contribution to avoid the possibility of an excise tax on earlier non-deductible contributions (please note that this applies only to plans eligible to file Form 5500-EZ; plans not eligible for Form 5500-EZ and covered by the PBGC may have additional PBGC reporting requirements).

If you would still prefer to make partial contributions during the plan year, please be sure to consult Benetech before making a contribution in order to determine an appropriate partial contribution amount based on a review of your expectations for the current year regarding the most relevant factors.

For the first year of a new DB Plan, when should the contribution be made?

To avoid possible excise taxes associated with incorrect funding of the DB Plan, first year contributions should be made **after** you have received a formal contribution letter from Benetech identifying the minimum required contribution and the maximum allowable contribution.

In no case should you make contributions based on a proposal illustration. Illustrations are just that: a *pro forma* illustration, and not a guarantee of contribution amounts.

A final DB valuation cannot be performed until the plan documents have been properly executed, and accurate company information and employee census information has been certified by the plan sponsor and delivered to Benetech.

In no case should you make contributions prior to executing the plan documents.

What types of contributions can be made to the Plan?

By law, only cash contributions can be made to a DB plan. Stocks or other types of investments are not allowed to be transferred to the plan.

Can the Plan's investment performance affect the Plan's contribution amount?

Yes. Investment performance is an important component of calculating contribution amounts each year. A simplified characterization of this effect is the following.

Each year an actuary calculates the expected benefits that will need to be paid at the plan's expected retirement age.

These benefits are converted to a lump sum amount (that is, the total dollars that will be necessary at retirement to fund those expected benefits given current interest rates, regulations, and other factors).

An actuary then calculates the amount necessary to contribute each year given a particular expected rate of return on Plan investments. The rate of return used must be within a range limited by regulations.

If the Plan's investments perform better than the expected rate of return, this will tend to reduce future contributions (assuming other Plan assumptions are accurate). Likewise, if performance is lower than assumed, this will tend to increase future contributions.

Can DB Plan assets be invested in something other than publically traded securities?

A DB Plan has no special investment restrictions.

So, in principle, a DB Plan can invest in anything that a DC Plan can invest in, including real estate and other hard-to-value or illiquid assets.

However, due to the nature of how annual contributions are calculated, as well as limitations on the amount that may be distributed for each participant, using non-traditional investment vehicles could result in a DB Plan that is greatly underfunded or overfunded, either of which could cause serious problems for the plan sponsor. Possible problems include unexpectedly high required contributions in future years, or a taxable reversion to the employer of excess assets at plan termination.

The lack of liquidity of a non-traditional investment could also cause problems when processing participant termination distributions, or properly distributing plan assets at plan termination.

Another factor weighing against these types of investments is that such investments are generally not considered "qualifying assets" as

defined by the IRS, and could trigger a costly independent audit or an increase in the amount of the plan's fidelity bond.

Taken together, these and other considerations make investing in publicly traded securities the most practical option for a DB Plan.

Should the DB Plan's investment style change over time?

Benetech cannot give advice in regard to the particulars of investing for retirement. However, it is safe to say that as the DB Plan approaches the expected Plan termination date (for example, the date the owner expects to retire), it is typically more prudent for the Plan's investment style to become more conservative than in the early years of the Plan.

For example, if in the final years of the Plan there are significant investment losses, only a limited number of years remain in which these losses can be recouped. This potentially could result in unexpectedly large contributions, just when a company may be least able to afford it (for example, business may be slowing down in anticipation of the owner's retirement).

Can I rollover funds from another plan into the DB Plan?

Yes, but it's probably not the best option. The investment style for assets rolled out of another qualified retirement plan or an IRA is usually more aggressive than the style appropriate for DB Plan assets. For this reason, it's usually more appropriate to roll assets into another DC Plan or a personal IRA.

In many cases, a DB Plan document does not allow rollovers into the plan. So be sure to check your plan document or consult Benetech prior to authorizing rollovers into the plan.

Can a DB plan be "frozen" to permanently cease required contributions?

No. Referring to a DB plan as "frozen" generally means that the plan's benefit formula has been reduced to zero so that participants are no longer accruing additional retirement benefits each year. In some cases, freezing benefit accrual may result in no additional required contributions for a number of years.

However, there are situations in which contributions may be required even when a DB Plan has been frozen for a number of years. The most common situation is when the trust investments have lost enough value to fall below the minimum amount needed to fund the benefits that had been previously accrued. For this reason, if a plan sponsor would like to cease contributions to a DB Plan altogether, they should consider terminating the Plan rather than freezing it.

What should I do when considering terminating a DB Plan?

To maximize your plan termination options, it is important to consult Benetech at the earliest opportunity. Adjustments to the plan may be required, and early action will maximize your Plan termination options.

This is particularly important if the DB Plan is to be terminated prior to the owner reaching the Plan's retirement age. In the early years of a DB Plan we may be "front loading" the Plan with contributions in excess of that required to fund benefits immediately accrued, with the expectation of leveling off contributions as the plan approaches the expected retirement ages of the participants with the highest benefits (e.g., the owners). If the Plan is terminated unexpectedly, some significant adjustments may need to be made to bring the assets and accrued benefits into sync.

How are plan assets distributed upon plan termination?

Participants accrue a monthly retirement benefit while they are covered by a DB Plan. Although participants have the right to a monthly annuity-like payment stream at retirement, most small DB Plans also allow a “lump sum” distribution of the present value of those annuity payments beginning at the plan’s retirement age. So, in most cases, when a participant in a DB Plan that allows lump sum distributions takes a distribution from the plan, they take it as a lump sum cash distribution. This lump sum may be rolled into an IRA, at which point it would be only subject to IRA rollover and distribution rules.

What is involved in terminating a DB Plan?

To properly terminate a DB plan, there must be sufficient assets in the plan’s investment account at the time of termination to fund the present value of the promised retirement benefits accrued under that plan.

Terminating DB Plans should file with the IRS, and this process may take from six to eighteen months.

When a DB Plan is terminated, what happens if the assets are greater than the benefits to be distributed?

Assets in excess of the amount needed to pay plan benefits generally revert to the employer. All of this reversion amount is subject to taxation at the plan sponsor’s tax rate, **and** all of the reversion is subject to a 50% excise tax. The result is that only a small fraction of the reversion is actually left with the plan sponsor.

To maintain as many options to a reversion as possible, it is important that you consult Benetech if you are considering Plan termination. There may be alternatives to reversion available, including increasing plan benefits (within regulatory limits), running the DB Plan for an additional period of time (to allow for additional benefit accruals), or transferring the excess assets to a “qualified replacement plan” to reduce the excise tax.

When a DB Plan is terminated, what happens if there are not enough assets to cover the benefits to be distributed?

When a DB Plan is terminated, the plan sponsor has the opportunity to contribute enough to the Plan to cover the accrued benefits to be distributed. Fully funding accrued benefits prior to termination is the preferred method of terminating a DB Plan.

Please note that if there is a required contribution in the year of plan termination, to avoid the 10% excise tax the required contribution must be made in full by the proper deadline.

DB FAQs Unique to Owner-only Plans

Why are Benetech’s fees for an Owner-only DB Plan lower than for a DB Plan with non-owner employees?

A business that has no employees other than an owner, or an owner and spouse, qualifies for using the shorter Form 5500-EZ, and has fewer reporting and other requirements than does a standard DB Plan that covers non-owner employees. For this reason, Benetech’s Owner-only DB Plan fees and services differ from the fees and services offered for DB Plans that cover common-law employees.

An explanation of what types of businesses qualify for the 5500-EZ can be found in the instructions to the form at <http://www.irs.gov> (type “5500-EZ” in the search box).

Businesses that do **not** qualify for Form 5500-EZ include companies that employ anyone other than an owner and spouse (this includes

children, parents, and other relatives of the owner), and corporations the owners of which are not married to one another.

Businesses that do not qualify to use Form 5500-EZ may still sponsor a DB Plan, but they must use the standard Form 5500, follow standard DB Plan reporting and other requirements, and are subject to Benetech’s standard DB Plan fee schedule. Although the reporting requirements of the standard DB Plan are more comprehensive than those of the Owner-only program, the contributions would be the same.

My spouse is my only employee. Why must my spouse be included in the Owner-only DB Plan?

DB Plans have an additional “minimum participation” requirement not found in DC Plans: a DB Plan must cover at least 40% of all employees, **but no fewer than two** (if there are two employees). This rule includes owners and relatives of owners. Since your business has two employees, both you and your spouse must participate in the plan.

My spouse has a business that is unrelated to mine and is that business’s only employee. I am the only employee of my business. Why must my spouse be included in my Owner-only DB Plan?

In most states that recognize community property in marriages, each spouse is attributed the other spouse’s ownership in a company. So, in effect, you would own 100% of your spouse’s business as well as 100% of your own business. This constitutes a “Controlled Group” of companies, which means that for plan purposes they are considered together as if there were only one company.

Since the two companies constitute a Controlled Group of companies, the minimum participation rule (in the previous question) applies. Therefore your DB Plan must include your spouse.

Please note that if you have minor children, or if the spouses participate in any way in each other’s businesses, the two companies constitute a Controlled Group no matter what state your business is in.

I am the 100% owner of my professional corporation (PC) and the corporation’s only employee. My PC is a 25% partner in a medical practice with employees. Much of the income to my PC is from services provided to patients seen at the medical practice. Can my PC sponsor an Owner-only DB Plan?

No. This type of arrangement is an “Affiliated Service Group” (ASG). Like a Controlled Group, the companies that form an ASG must be considered together as if there were only one company. For this reason, a DB Plan sponsored by your PC would be required to cover employees of the medical practice as if they were employees of your PC.

I am a 50% owner of a corporation, and the other 50% owner is not my spouse. We are the only employees. Why do we not qualify for an Owner-only DB Plan?

You do not qualify for the Owner-only DB Plan because your business does not qualify for using Form 5500-EZ.

However, your corporation **does** qualify for a standard DB Plan that will provide the same contribution levels as an Owner-only DB Plan.

I currently do not have any employees other than myself, and do not plan to hire employees in the future. I did have an employee earlier in the year, but he terminated after working about 700 hours. This employee had worked full-time for me for a number of years. Do I qualify for an Owner-only DB Plan?

No. Since the employee met the plans eligibility requirements he would be covered by the plan even though you adopted the DB Plan after the employee terminated.

Further, because he worked more than 500 hours, coverage rules require that he accrue a benefit for the current year, which would mean that the company would make a contribution to fund that benefit.

However, you may be eligible to start an Owner-only DB Plan the next year (that is, the year after the year in which the employee terminated).

I have one long time employee who currently works far less than 1,000 hours a year. However, there was a prior year in which the employee worked more than 1,000 hours. Is this employee eligible for the DB Plan?

Yes! If the employee has ever satisfied the DB Plan's eligibility requirements, he is eligible for plan entry. Since 1,000 hours in a year is the maximum a DB Plan can require for participant eligibility, the employee has already met this requirement. It does not matter that he met this requirement in a year prior to the first year of the new DB Plan.

I am the 100% owner of an S-corporation, and its only employee. I receive total annual W-2 wages of \$25,000, but I receive an additional \$500,000 of K-1 income from the S-corporation. Can I report \$525,000 as my total income for plan purposes?

No. Your total income for DB Plan purposes is the \$25,000 of W-2 wages that you pay yourself. You cannot consider the additional income as part of your plan compensation.

The only employees of my business are me and my son. Can I sponsor an Owner-only DB Plan?

No. Employing your son means that your company does not meet the requirements for using Form 5500-EZ. Therefore, you must sponsor a standard DB Plan.

My business is a sole proprietorship, and I use my Social Security Number for business tax reporting purposes. Can I continue to exclusively use my Social Security Number for DB Plan reporting purposes?

No. The IRS requires businesses that sponsor a qualified retirement plan to use an "Employer Identification Number" ("EIN") for DB Plan reporting purposes. You will need to get an EIN before Benetech can prepare your first 5500 filing form.

An EIN can be obtained from the IRS quite easily over the internet. To get an EIN (or for more information on obtaining an EIN), go to <http://www.irs.gov> and type "SS-4" in the search box (SS-4 is the form used to apply for an EIN, but the search should provide you with instructions for using the internet-based application process as well).

Once you receive your EIN, be sure to notify your CPA and Benetech of this new number for your business.

I do not directly employ anyone, but the business from which I rent office space allows me the use of their full-time receptionist to answer my phone and occasionally perform clerical work. I reimburse the business for the use of the receptionist. Can I sponsor an Owner-only DB Plan?

No. The IRS considers this to be a "shared employee" arrangement. Even though not on your payroll, you must consider the receptionist to be an employee for plan purposes.

Although you would not pick up 100% of the receptionist's compensation, you would be required to consider the total hours worked for the other business for plan eligibility and benefit accrual purposes. So, the receptionist is (or will be, depending on when he or she started providing services for you) eligible for your DB Plan.

I do not directly employ anyone, but I lease my office staff from a Professional Employment Organization (PEO). I am the only person directly employed by my business. Can I sponsor an Owner-only DB Plan?

No. The IRS considers leased employees, as described, to be your company's common-law employees. Therefore, they are considered your company's employees for DB Plan purposes.

Some leasing companies sponsor a multiple-employer 401(k) Plan for the employees they lease to other firms. However, this would not affect the fact that your DB Plan must consider them to be employees of your company.

The only type of retirement plan sponsored by a leasing company that may allow the ability to exclude leased employees from your plan is a Money Purchase Pension Plan with certain characteristics, such as immediate entry, a 10% of compensation contribution, and 100% vesting. This exception does not apply if more than 20% of your Non-Highly Compensated employees are leased.

What should I do if, in the future, I hire an employee or take on an additional owner?

If you are considering hiring an employee or adding an owner, consult Benetech at your earliest opportunity so that we can evaluate the effect on the plan of covering additional participants.