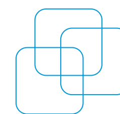
Morgan Stanley

Are Your Retirement Savings Getting the Most Tax Efficiency?

Defined Benefit Plans Create More Retirement Wealth Through Greater Tax Efficiency

When it comes to saving for retirement, many business owners and professionals are familiar with 401(k)-style, or "defined contribution," plans. However, not all of these owners and professionals are familiar with another type of retirement savings vehicle that could allow for greater tax efficiency for retirement dollars. Tax-deferred "defined benefit" plans may enable business owners to save large annual sums for retirement — potentially far more than 401(k) or SIMPLE plans, SEP IRAs, and other plans for business owners. Even better: Defined benefit plans can be combined with those plans to further boost annual retirement savings.



DEFINED BENEFIT PLANS CAN BE COMBINED WITH OTHER RETIREMENT PLANS TO FURTHER BOOST ANNUAL RETIREMENT SAVINGS.

Should You Adopt a Defined Benefit Plan?

To determine if a defined benefit plan is appropriate for you and your business, consider the following criteria:

- You want to accumulate the maximum amount of retirement assets in a short time frame.
- You have stable cash flow sufficient to fund mandatory annual contributions.
- You do not have employees, the employees are significantly younger than you or you are comfortable making additional retirement contributions on behalf of your employees.

WHAT IS A DEFINED BENEFIT PLAN?

A traditional defined benefit plan allows business owners to predetermine the amount of income they would like to receive during retirement and contribute amounts that will grow and sustain this income level.

Contributions are generally tax deductible and invested in a single tax-deferred account for the company's plan. At retirement, you can roll your plan assets into an IRA for continued tax deferral, or you may arrange for periodic payments.*

Annual contribution limits to defined benefit plans vary according to your age and other factors. But in 2020, you can generally save enough to generate an annual retirement benefit of as much as $230,000 per year for life, or an amount equal to the average of your three highest consecutive years of compensation if less.

MAKING YOUR WEALTH WORK HARDER

Not only is a defined benefit plan a vehicle for accumulating personal retirement assets, but the contributions your business makes to the plan are generally income tax deductible.

To defray the cost of starting a plan, a small business with common-law employees may be eligible for a tax credit of up to $5,000 per year for qualified startup costs for the first three years.[1] Additional plan expenses are considered normal business deductions.

WHAT IS A CASH BALANCE DEFINED BENEFIT PLAN?

A cash balance plan is a defined benefit plan that allocates a hypothetical percentage of pay, plus interest credits, to each eligible participant. The contribution credited each year may be a flat percentage of pay or a percentage of pay that varies based on age and/or service. This gives business owners a wide range of possibilities to construct a plan that meets their objectives, regardless of age, employment tenure or number of employees. Also, cash balance plan benefits are portable: A lump sum is typically available when the owner (or employee) departs or retires. Gains and losses within the plan's underlying investment portfolio would not directly affect a participant's benefits upon retirement or termination as they might in a profit-sharing or 401(k) plan.

Instead, the employer must adjust the company's annual funding contribution when actual investment results vary significantly from the plan's credited rate of return. Higher investment earnings would reduce employer contributions in some years, while lower earnings — or losses — would require additional employer contributions.

WHICH TYPE OF DEFINED BENEFIT PLAN SHOULD YOU ADOPT?

- **Businesses with employees.** Consider the cash balance defined benefit plan. If properly designed, it may allow you to receive a greater proportion of the total benefits under the plan.
- **Sole Proprietors.** If you are a sole proprietor or have partners and spouses who receive compensation, a traditional defined benefit plan may offer the highest contributions and retirement accumulations. A cash balance plan may also fit your planning needs.

ARE THERE WAYS TO BOOST CONTRIBUTIONS FOR BUSINESS OWNERS WHILE LIMITING MANDATORY CONTRIBUTIONS FOR EMPLOYEES?

Yes. Popular choices are to combine profit-sharing and 401(k) plans with a cash balance plan. Doing so may allow you to construct a retirement benefits program designed to meet your objectives.

WHAT IS THE DEADLINE FOR ESTABLISHING A DEFINED BENEFIT PLAN, INCLUDING A CASH BALANCE PLAN?

A defined benefit plan needs to be set up before your business' tax-filing deadline for the taxable year, plus extensions.

ARE THERE ANNUAL ADMINISTRATIVE REQUIREMENTS?

The complexity of administering a defined benefit plan, cash balance plan, or any combination plan with 401(k) and profit-sharing features may require the services of a professional plan administrator or service provider to properly administer the plan. A plan administrator will generally determine the required annual contributions using actuarial calculations and provide other required services, for a set annual fee. In addition, some plan administrators may be able to provide you with an IRS-approved defined benefit plan and trust documents, for a fee. Your Morgan Stanley Financial Advisor may work with any plan administrator you select, or may refer one to you.

[1] $5,000 maximum effective for tax years beginning after December 31, 2019. Previously limited to a maximum of up to $500.

What is the difference between a traditional defined benefit plan and a cash balance plan?

DEFINED BENEFIT PLANS promise a specific benefit at retirement—for example, $10,000 a month. This amount can be determined as a percentage of pay, such as 75% of average compensation, or using some other formula. Employer contributions and investment gains must be sufficient to fund promised benefits. Employees do not contribute to a defined benefit plan.

CASH BALANCE PLANS promise a benefit based on a hypothetical assessment, with theoretical contributions based on a formula, such as 7% of compensation per year, plus a credited rate of return applied to all contributions, such as 5% per year. This rate is frequently pegged to Treasury securities, but the credited interest does not depend on the plan's actual investment performance.

Sample Illustration—Owner and Spouse Plan

Allan and Barbara, both age 52, are not sure about retiring early, but would like to have the financial resources to do so if they wish at age 62—just 10 short years away. Their business has good cash flow, and their youngest child graduated from college a year ago. Their monthly expenses have dropped substantially; income previously earmarked for college expenses can now be invested for their retirement. But will this be enough? How much could a retirement plan realistically provide? Here's a sample of an owner-only cash balance plan with a profit-sharing plan illustration:

	AGE	INCOME	EMPLOYEE DEFERRALS[4] (INCLUDING CATCH-UP)	COMPANY PROFIT SHARING CONTRIBUTION (LIMITED TO 6% OF INCOME)	ANNUAL CASH BALANCE PLAN CONTRIBUTION	TOTAL CONTRIBUTION	ESTIMATED LUMP SUM AT AGE 62
Allan	52	$225,000	$25,000	$13,500	$193,913	$232,413	$3,196,000
Barbara	52	$50,000	$25,000	$3,000	$65,087	$93,087	$1,278,000
TOTAL					$259,000	$325,500	$4,474,000

Hypothetical Example.
Data: Morgan Stanley and Benetech. Assumes a retirement age of 62.
For illustrative purposes only.

Sample Illustration—Owner and Employee Plan

Combining a Cash Balance Plan with a Tiered Profit-Sharing Plan can increase the owner's contribution while reducing the cost of covering employees:

	AGE	INCOME	SALARY DEFERRALS[4] (ASSUMED 3% NHCES)[1]	SAFE HARBOR 3% NEC[2]	TIERED MANDATORY EMPLOYER PROFIT-SHARING CONTRIBUTION	ANNUAL CASH BALANCE PLAN CONTRIBUTION	TOTAL CONTRIBUTIONS TO PLANS	TOTAL ACCUMULATION AT DISTRIBUTION AGE	AGE AT DISTRIBUTION
Owner	55	$280,000	$25,000[3]	–	$13,568	$200,983	$239,551	$3,396,249	65
Employee 1	48	$60,000	$1,800	$1,800	$2,232	$1,516	$7,348	$100,898	58
Employee 2	41	$45,000	$1,350	$1,350	$1,674	$1,137	$5,511	$75,673	51
Employee 3	39	$32,500	$975	$975	$2,958	$821	$5,729	$77,752	49
Employee 4	32	$28,000	$840	$840	$1,042	$708	$3,430	$47,091	42

Hypothetical Example.
Data: Morgan Stanley and Benetech. Assumes a retirement age of 62.
For illustrative purposes only.

[1] Non-Highly Compensated Employee
[2] Non-Elective Contribution
[3] "Including catch-up"
[4] Based on 2019 IRS contribution and benefit limits

HOW WILL THE DEFINED BENEFIT PLAN BE INVESTED?

A defined benefit plan allows you, as the plan fiduciary, to choose from a wide range of investment options, such as stocks, bonds, cash, mutual funds, "alternative" investments, even insurance. Your Financial Advisor or Private Wealth Advisor can help you create an Investment Policy Statement, which outlines the underlying objectives and procedures for investment selection, as well as the ongoing monitoring of those investments.

IS A DEFINED BENEFIT PLAN PROTECTED FROM CREDITORS?

Yes. As a "qualified" plan, a defined benefit plan is protected in the event of bankruptcy, providing a way to shelter substantial assets from creditors.

WHAT HAPPENS TO MY BENEFIT IF I DIE?

Your plan terms will determine how your benefit is paid upon your death. If you are married, your spouse will generally receive your benefit, unless you choose another beneficiary with your spouse's consent. It is very important to check your plan forms and name both primary and contingent beneficiaries in case of premature death. The designations should be reviewed periodically to be sure they reflect your current wishes, and comply with current retirement regulations.

Also, your spouse or other beneficiary may be able to take a rollover of plan assets to an Inherited IRA, which can provide for better cash flow and investment selection, and preserves the tax-deferred status of the account.

HOW MORGAN STANLEY CAN HELP

It's important to take a holistic approach when managing your business and personal assets. Your Morgan Stanley Financial Advisor or Private Wealth Advisor can help you design a retirement plan for your business and yourself. Here's how:

- **Setting a retirement income goal.** Your Financial Advisor or Private Wealth Advisor will help you figure out how much you'll need to support your retirement lifestyle, how much to save in order to meet that goal and which plan can help you do so.
- **Recommending a plan.** We can help you design a plan that will reflect your current business profile and retirement goals.
- **Selecting investments.** Your Financial Advisor or Private Wealth Advisor knows you and knows the markets. He or she will apply this experience when helping you choose appropriate plan investments from Morgan Stanley's broad range of product offerings.
- **Reporting performance.** Morgan Stanley will report regularly on your plan's investment performance. Your Plan Administrator will provide annual benefit statements to each plan participant as well.

Points to Ponder …

- Defined benefit plan contributions are required and must be made every year. Underfunded plans may be subject to penalties or restrictions.
- Your required plan contributions can vary each year depending upon the investment performance of your plan assets. Contribution levels may also change for other reasons: more or fewer eligible employees, compensation changes or replacing younger employees with older employees.

*Typically, as a retirement plan participant who may be receiving an eligible rollover distribution from the plan, you have the following four options (and you may be able to engage in a combination of these options depending on your employment status and age and the availability of the particular option):

1. Cash out the account value and take a lump-sum distribution from the current plan subject to mandatory 20% federal tax withholding, as well as potential income taxes and a 10% additional federal tax,

OR continue tax-deferred growth potential by doing one of the following:

2. Leave the assets in your former employer's plan (if permitted),

3. Roll over the retirement savings into your new employer's qualified plan, if one is available and rollovers are permitted, or

4. Roll over the retirement savings into an IRA.

Each option offers advantages and disadvantages, depending on your particular facts and circumstances (including your financial needs and your particular goals and objectives). Some of the factors you should consider when making a rollover decision include (among other things) the differences in: (1) investment options, (2) fees and expenses, (3) services, (4) penalty-free withdrawals, (5) creditor protection in bankruptcy and from legal judgments, (6) Required Minimum Distributions or "RMDs," and (7) the tax treatment of employer stock if you hold such in your current plan.

The decision of which option to select is a complicated one and must take into consideration your total financial picture. To reach an informed decision, you should discuss the matter with your own independent legal and tax advisor and carefully consider and compare the differences in your options.

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