THE WALL STREET JOURNAL. ONLINE
May 8, 2006
THE JOURNAL REPORT: SMALL BUSINESS

A Rapid Buildup

Traditional pension plans are disappearing.
So, why are they expanding among small firms?

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May 8, 2006; Page R4

Traditional pension plans may be going the way of the three-martini lunch at big companies, but they're increasingly popular for sole practitioners and small-business owners.

These plans -- which provide for a defined annual payout in retirement -- are especially attractive for high-earning baby boomers who have spent years funneling money back into their businesses at the expense of retirement savings. Depending on their age and circumstances, individuals can stow more than $150,000 annually in a pension plan -- all tax-deductible -- allowing them to catch up on their nest eggs in a hurry. In contrast, defined-contribution plans like a 401(k) allow a maximum contribution of $44,000 for this year, with an added $5,000 for those over age 50.

"It's ideal for sole practitioners that are doctors, attorneys, consultants, Realtors -- anyone that is a highly paid independent contractor or sole proprietor...who has capacity to put away more than $50,000 a year," says Joseph Birkofer, a certified financial planner and principal with Legacy Asset Management in Houston.

For small-business owners with many employees, pension plans can become too expensive to be practical, since the law requires all full-time employees to be included. But for those over the age of 45 with steady incomes and just a few employees -- especially younger, lower-paid workers, for whom the annual contributions to a pension plan can be much smaller -- these plans can still make sense.

Only the Beginning

"There has been an increase in small-business defined-benefit plans over the past few years, some of which has to do with changes made to the law in 2001 to make them more attractive," says Brian Graff, executive director of the American Society of Pension Professionals and Actuaries, a membership organization for the retirement-benefits industry in Arlington, Va. "We view this as a trend line that will continue, especially as you have small-business baby boomers that haven't saved for retirement."

To set up a pension plan, a small-business person needs to work with a pension actuary, either an independent at a plan-design firm or someone at one of the larger financial-services firms. The actuary calculates how much of a business's earnings should be funneled into a pension plan each year to achieve a certain benefit. For this year, the maximum contribution for each person in the plan is one that would be projected to yield an annual retirement benefit equal to the lesser of $175,000 or 100% of the participant's average compensation for the three highest consecutive years.

There are several variables that are baked into the defined-benefit formula: individuals' salary, current age, retirement age, mortality assumptions, and an estimated rate of return on investments before and during retirement, among other factors. Moreover, if investments in the portfolio decline, future funding obligations will increase, and vice versa.

The pension actuary often doubles as plan designer and administrator; however, experts say it's wise for a small-business person to engage his or her financial planner and/or accountant in the design process as well.

Pensions are particularly attractive for a business with few or no workers -- or a young, low-paid, transient staff -- since that lowers the contributions that must be made on behalf of anyone but the owner. Part-time workers who log fewer than 1,000 hours annually can be excluded from the plan. "As you add more employees, especially higher-paid, older staff, it dilutes the owner's benefits as a percentage of the total benefits in the plan," notes Lorraine Dorsa, president and actuary with Dorsa Consulting, a pension actuarial and retirement-plan design firm in Ponte Vedra Beach, Fla.

Pensions also can work well for family businesses, Ms. Dorsa says. Take a father-and-son team where the father needs to fund his retirement, but would like to pass his business on to his son. If the father sets up a pension plan, he can put aside the money he needs for retirement without eventually having to sell the business to an outsider or force his son to come up with the money to buy him out.

Before jumping in, individuals and small-business owners have to be sure they can sustain the plan for at least five years; short-lived plans are frowned upon by the Internal Revenue Service, pension experts say, and the deductibility of contributions could be challenged. Also, failure to make the minimum contribution the plan calls for each year will result in a tax penalty of 10% of the difference between the target contribution and the actual contribution, Ms. Dorsa says.

"You have to go in knowing you can afford this for a certain period of time," says Mark Sommers, who heads the defined-benefits practice at Invesmart Inc., a retirement financial-services company based in Pittsburgh.

When it comes time to retire, pension-plan participants can choose between the targeted annual payout or a lump-sum payment. For example, a 52-year-old doctor who can contribute about $88,000 a year to a pension plan might have a choice, upon retirement at age 65, of a monthly payout of $14,500 or a lump sum of about $2 million. Typically, small-business owners terminate these plans upon retirement, take a lump-sum payment and roll the money into an individual retirement account. That way they avoid the administrative costs of keeping the plan running.

Costs and Benefits

The costs of setting up and maintaining a plan will vary, depending on the plan size and complexity, as well as the plan provider. Experts say to expect setup expenses from $1,500 to $3,000 in most cases, plus administration expenses of about $1,000 to $2,500 a year. Charles Schwab Corp. offers an inexpensive plan for individuals -- it's $750 to set up and $750 a year to maintain; plans that include employees cost more.

Costs might be lower in cases where the plan providers are also making a commission on investment products sold inside the plan, says Allen Gorrelick, president of Gorrelick, Tievy & Associates Inc., an employee-benefits consulting firm in Rockville, Md. Investment decisions for the plan are made by a trustee, typically the business owner, who will often work with a financial planner or broker.

Keeping costs down shouldn't be the only goal, though, says Ian Weinberg, a certified financial planner and president of Family Wealth & Pension Management in Woodbury, N.Y. "It's worth the price of admission," he says, to have a plan that gives you features like "good withdrawal options, good loan provisions and good distribution options for your heirs."

--Ms. Bernard is a reporter for Dow Jones Newswires in Jersey City, N.J.

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