InFRE® Retirement Plan Administrator Series

Fundamentals of Retirement Plan Design

Part 2

Introduction to Qualified Retirement Plans

Presenter
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Webinar Agenda

- Text Book Chapters
  5. Defined Benefit Plans
  6. Defined Contribution Plans - Part 1
  7. Defined Contribution Plans – Part 2
  8. Hybrid Plans

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Chapter 5

Defined Benefit Plans

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Why Consider a DB Plan?

- Retain skilled employees
- Reward longer-term employees
- Motivate employee behavior – e.g., early retirement window
- Potential to lower employer contributions through favorable investment performance

1/5-6

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Background

- Single employer, multiemployer, multiple employer plan
- Pension Benefit Guarantee Corporation insures private sector DB benefits
- Public sector benefit guarantees are normally found in state statutes or constitution
- DB plans decreasing in private sector; public sector continuing to retain as primary benefit

1/5-4

DB Plan Attributes

- Income replacement plans that provide a predictable and secure benefit for life
- Employer must contribute a sufficient amount to fund current and future benefits
- Contributions must be held in trust for the exclusive benefit of participants and beneficiaries
- Employer bears investment risk

1/5-5

IRC Qualified Plan Rules Cover

- Minimum age & service eligibility requirements
- Trust and fiduciary responsibilities
- Vesting schedules
- Nondiscrimination rules
- Written plan documents
- Disclosure & communication
- Reporting requirements

Retirement Age Rules

- Normal retirement age (NRA) is the age a participant receives an unreduced benefit
- Cannot be later than age 65 or the fifth anniversary of date employee became a participant
- Can be as early as age 50 for a system covering qualified public safety employees

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Early Retirement Age

- Generally subject to minimum age and service requirement
- Produces a reduced benefit because
  - Full value of benefit has not yet accrued
  - Duration of benefits will be longer based on the earlier age

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Benefit Calculation

Compensation categories used in DB formulas

- Final pay
  - Average earnings over a predefined period
  - i.e. Last three or five years immediately prior to retirement or producing greatest income
- Career pay
  - Average earnings over entire employment period

1/5-10-12

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Benefit Formulas

- Unit benefit or unit credit plan
  - Percentage of earnings per year of service
  - Considered most equitable approach as based on both earnings and service
- Flat benefit plan
  - Flat percentage of earnings / flat amount per year of service
  - Considers either earnings or service in formula, not both
- Flat amount formula (fixed benefit plan)
  - Benefit is not based on employee earnings or number of years of service

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Permissive Service Credit

- Employees are permitted to buy additional years of service considered in benefit calculation
- Service that can be purchased includes:
  - Qualified: attributed to military service, service performed for other governmental employers, certain leave periods where no service was granted
  - Nonqualified: “airtime”, service used in calculation of benefits from another employer

1/5-13

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Death and Disability Benefits

- Ancillary benefits are optional, but typically part of a DB plan design
- Benefits are funded through the DB plan trust
- Death benefits must be incidental to the plan's primary purpose of providing retirement benefits
- Disability benefits are normally provided on a self-funded basis

1/5-14, 15

DB Plan Funding

- Trustee is responsible for:
  - Administration & investment of trust assets
  - Investment earnings
  - Payment of benefits
- Employer contributions are required to fund the benefit
- Employees also may be responsible for a portion of the required contribution

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Actuarial Assumptions

- Actuarial analysis determines rate of contributions to fund promised benefits
- Assumptions have a direct impact on contributions
  - Employee demographics
  - Benefit assumptions
  - Interest rate applied on trust assets
  - Current and future employee earnings

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Actuarial Cost Methods

- Method determines the contribution required to meet funding standards
- Accrued benefit cost method
  - Used primarily for unit benefit formula
  - Assumes portion of benefit accrues every year
- Projected benefit cost method
  - Characterized as level cost method

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Deferred Retirement Option Plan

- Provides flexibility to employees as they reach retirement age
- Encourages continued employment beyond retirement age
- Additional costs to fund benefits may be difficult to determine
- Advantages and disadvantages need to be closely examined

1/5-24-26

DROP Features

- Employer has considerable flexibility
- Benefit is calculated when DROP begins
- Value recorded in ledger account during DROP period
- At end of DROP period, balance paid in lump sum or value used to increase DB annuity

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Chapters 6 and 7

Defined Contribution Plans

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Cash or Deferred Arrangements

- Generally referred to as 401(k) plans
- Established in 1978 to encourage more private sector employers to offer retirement benefits
- IRC final regulations issued in 2004
- Corporate and tax exempt employers may offer
- State and local government employers that adopted a plan before May 6, 1986 are grandfathered

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General Requirements

- Contributions can made via
  - Pre-tax employee elective deferrals
  - After-tax employee contributions
  - Employer matching contributions
  - Non-elective contributions
- Individual accounts are established for each participant

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Eligibility

- Minimum requirements can be established for employee eligibility
- Employees enter into a salary reduction agreement to elect participation in the plan
- Automatic enrollment arrangement can be established to improve employee participation

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Salary Reduction Agreements

- Agreement between employee and employer to defer pay into the plan
- Constructive receipt rule requires
  - Agreement must be entered into before earnings are "available"
- Automatic enrollment meets the constructive receipt doctrine

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Crediting Contributions

- Section 415(c) annual addition limitation applies
  - Employee pre and post tax contributions
  - Employer contributions
  - Any forfeitures credited to accounts
- Elective deferrals limited by Sec. 402(g) and must be coordinated with other plans except 457(b) plans
- Contribution and benefit limits updated by the IRS each year and can be found at www.irs.gov ww.irs.gov

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Crediting Contributions

- Participants can make an additional contribution at age 50 and up
  - Not considered in 415(c) limits
- Excess contributions must be included in employees taxable income for that calendar year
- Failure to return contributions by April 15 results in double taxation to participant

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Vesting

- Employees must always be 100% vested in their own contributions
- Matching or employer discretionary contributions may be subject to vesting requirements
  - Cliff vesting
  - Graded vesting
- Only vested amounts can be considered in non-discrimination testing

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Non-Discrimination Testing

- Only applies to employers subject to ERISA
- Must be met to ensure highly compensated employees do not have disproportionate amount of plan benefits
- Certain safe harbor provisions can be adopted to satisfy nondiscrimination rules without complicated testing

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Investments

- Compliance with ERISA 404(c) is mandatory to transfer liability for investment decisions to participants
- Public sector plans generally follow as best practice guidance
- Requirements include:
  - Broad range of investments must be available
  - Opportunity to redirect investment decisions must be provided
  - Sufficient information must be provided

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Distributions

- Distribution rules under IRC Section 401(a)(9) applies
- Distributable event includes
  - Age 59½
  - Severance of employment, retirement, death or disability
  - Plan terminations
- Hardship withdrawals and plan loans are permitted

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Hardship Withdrawals

- Immediate and heavy financial need of the employee, spouse or dependent must be demonstrated
- Participant must have no other reasonable resources
- Certain types of expenses are deemed to meet the need requirement
- Distribution cannot exceed the amount of need
- Deferrals must be suspended for six months after hardship distribution

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Loans

- Procedures and requirements must be included in the plan document
- Loans must be made available to all participants and beneficiaries on a reasonably equivalent basis
- The plan's loan policy cannot be discriminatory
- Loans must be assessed a reasonable interest rate and adequately secured

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Designated Roth 401(k)

- Permits after-tax contributions with earnings accumulating tax-free
- Aggregate of Roth and traditional contributions cannot exceed annual limits
- Roth contributions and earnings must be maintained in separate account
- Employer match can be based on total contributions but must be contributed to traditional account

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Private Sector DC Plans

- Profit Sharing Plan
- Stock Bonus Plan
- Employee Stock Ownership Plan
- Savings Incentive Match Plan for Employees (SIMPLE)

Profit Sharing Plan Requirements

- Subject to IRC and ERISA requirements for qualified DC plans
- Tax advantages apply to employers and employees
- Goals of a profit sharing plan includes
  - Motivate employee performance
  - Enhance employee benefit package
  - Permit flexibility in determining contributions

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Profit Sharing Plan Requirements

- Must be maintained for exclusive benefit of employees and beneficiaries
- Cannot discriminate in favor of highly compensated employees
- Typically less restrictive eligibility requirements than other plan types

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Contributions

- Employers can vary contributions from year to year
- Contributions must be recurring and substantial or risk plan termination
- Annual employer contributions may either be determined by formula or a discretionary approach
- Sec. 415 annual addition limit applies

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Profit Sharing Plan Features

- Distributions are typically more flexible than other qualified plans (i.e., after fixed number of years, minimum age, layoffs)
- Distributions are taxed as ordinary income in the year received
- May purchase life, health, and accident insurance as part of its benefits, but must be considered incidental to the plan

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Stock Bonus Plans

- It's assumed that plans will invest exclusively in employer stock
- Participants must be given the choice of benefits either in cash or employer securities
- This plan is a necessary component of an employee stock ownership plan (ESOP)
  - A profit sharing plan cannot be an ESOP

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Specific Requirements

- Purpose of the trust is to buy and hold employer stock
- Voting rights for shares of employer securities must be passed through to plan participants, referred to as pass-through voting
- Participants must be given the right to receive benefits in the form of employer securities

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Employee Stock Ownership Plan

- Employees are owners of company stock
- Employers receive tax deduction for dividend payments
- Employers can borrow to purchase securities
- Benefits are directly tied to company's performance
- Must allow certain employees the option to diversify

1/6-12-14

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Savings Incentive Match Plan for Employees (SIMPLE)

- Less complex and costly to administer than other qualified plans
- Employers eligible to offer a SIMPLE must
  - Have 100 or less employees
  - Not offer any other retirement benefit
- All employees with $5000 for a two year period and expected to earn $5000 in the next year must be eligible to participate

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SIMPLE Structure

- Not subject to nondiscrimination testing if certain requirements are met
- IRC contribution limits are lower to a SIMPLE than other qualified plans
- Structure of plan can either be a
  - SIMPLE IRA
  - SIMPLE 401(k)

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Recent Developments – DC Plans

- Department of Labor Regulations
  - Auto enrollment
  - Investment advice
  - Fee transparency and disclosure

Auto Enrollment

- Employees automatically enrolled in the plan unless they opt out
- Proven to improve employee participation in elective deferral plans
- IRC and ERISA provide guidance on this plan design
- Participants who are automatically enrolled have 90 days after first deferral to receive a refund of deferrals

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Automatic Deferral Requirements

- DOL published guidance for qualified automatic contribution arrangement
- Minimum deferral with auto escalation
- Requirements on employer matching contributions
- Employer contributions must vest within two years
- Certain notices and disclosures are required

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Default Investment Option

- DOL established requirements for a qualified default investment alternative
- Default must be one of the following
  - Target date or lifecycle fund
  - Balanced fund
  - Managed account
- Although safe harbor does not apply to public sector, typically considered best practice guidance

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Challenges for Public Sector

- State law changes may be needed
- Payroll and enrollment process may need to be automated which can be difficult in large, governmental employers with decentralized payroll systems
- Defined benefit often requires employee contributions and auto enrollment seen as another mandatory contribution

1/7-7, 8

Investment Advice

- 2006 Pension Protection Act addressed investment advice in defined contribution plans subject to ERISA
- Defined a qualified fiduciary adviser as
  - A registered investment adviser
  - A bank or similar financial institution
  - An insurance company qualified to do business under State law.
  - A registered broker or dealer

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Investment Advice Rules

- Fee-Leveling Advice
  - Fees cannot vary based on recommendations
  - Must be based on generally accepted investment theories
  - Take into account fees and expenses
  - Specific participant information must be considered
- Computer Model Advice must follow above and
  - Cannot be designed to favor certain investments
  - Must consider all investment options
  - Must be certified by independent investment expert

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Disclosure of Fees and Costs

- DOL regulations have been released to require:
  - Disclosures to plan sponsors from providers prior to contracting
  - Itemized fee and cost disclosures to participants
- Legislation previously proposed to mandate certain fee disclosures to plan sponsors and participants

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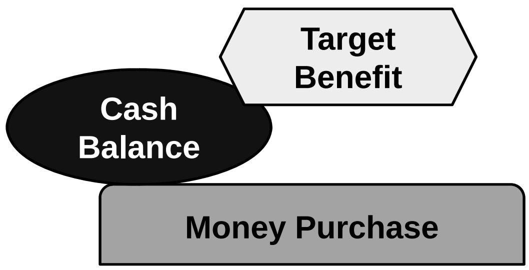
Chapter 8

Hybrid Retirement Plans



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Hybrid Plan Explanation

Certain provisions of a retirement plan are stated, defined and clearly definite within the plan document – IRC calls these "definitely determinable" because they are not subject to variability from year to year.

- In defined benefit plans, the *benefit* is definitely determinable.
- In defined contribution plans, the *contribution* formula is definitely determinable.
- Hybrid plans generally fall into one of these categories.

1/8-4

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Types of Hybrid Plans

- Cash Balance Plans
  - Typically categorized as DB as they provide a guaranteed benefit.
  - But also maintain individual accounts like a DC plan
- Money Purchase and Target Benefit Plans
  - Fundamentally DC plans that are subject to most DC plan qualification requirements
  - But also provide definitely determinable benefits like DB plans

1/8-4

Cash Balance Plan

- Most common type of hybrid plan
- Categorized as a DB plan but looks like a DC plan
- Hypothetical participant accounts are established
- Benefits are based on hypothetical account balance at termination

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Cash Balance Plan Design

- Employer annual credits typically based on
  - A percentage of earnings or a specified dollar amount determined in benefit formula
- Actual employer contributions are based on actuarial valuations
  - May be more or less than amount credited to hypothetical accounts
- Interest may be based on specified amount or index; not actual trust investment performance
  - Cannot be greater than a market rate of return

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Cash Balance Plan Advantages

- A more predictable and stable benefit than a DC plan
  - Employer bears investment risk
- Easier to communicate to participants
  - Value is clearly identified in hypothetical accounts
- Employer has control over contributions and earnings credited to accounts, therefore has more ability to control costs

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General Requirements

- Future benefits are determined through a formula established in the plan
- Participant contributions are typically not required
- The sponsor is responsible for investment decisions and subject to investment risk
- Benefits must be available as an annuity
- Joint and survivor annuity and related IRC consent rules apply

1/8-7

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Plan Administration

- Annual additions to account balance includes
  - Employer sponsored annual credit
  - Interest or earnings credit
- Participants must be 100% vested upon completion of three years of service
- Participant statements typically show
  - Value of account
  - Projection of benefit at retirement age

1/8-7, 8

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Distribution Requirements

- Annuity and lump sum options are permitted
- Annuity is based on the actuarial equivalent of hypothetical account balance
  - Joint survivor options must be available
- Lump sum distributions can be rolled to another eligible plan or IRA

1/8-8, 9

Money Purchase Plan

- Generally categorized as a DC plan
- Individual accounts are established with employer and employee contributions
- Investment risk borne by participants
- Accounts subject to the annual addition limits of 415(c)
- Benefits are based on vested account balance
- Plans must comply with qualified plan requirements

1/8-14

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Contributions and Earnings

- Like DB plans: subject to minimum funding requirements
- Like DC plans: contribution is set through an allocation formula, typically % of pay
- Contributions must be stated in plan document and can only be changed through amendment
- Employer contributions are mandatory
- Employees may be required to contribute via after-tax earnings only

1/8-15, 16

Investments

- Investments are typically handled by trustee, investment committee or investment manager
  - Gains/losses credited to participant accounts on a pro rata basis
- Employer may allow participants to make their own investment decisions
  - Individual gains/losses would be applied against the participant account balance

1/8-15, 16

Distributions

- Must be offered in the form of annuity
- Joint survivor and consent rules apply
- Alternate distribution forms, including lump sum options are also permitted
- Distributed assets can be rolled to other eligible plans and IRAs

1/8-15

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Target Benefit Plan

- A form of money purchase plan that is designed to provide a "target" benefit at retirement
- Individual accounts are established; credited with contributions/actual investment experience
- Benefit level "goals" are established and contributions are actuarially determined
- If contributions/earnings insufficient to reach goal, benefit will be lower; if greater than needed to reach goal, benefit will be higher

1/8-17

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Contributions and Benefits

- Required contribution is the amount necessary to fund target benefit
- Target benefit may be specified as
  - Income replacement ratio
  - Specific dollar amount to be paid annually
- Actuarial assumptions used to determine employer contributions, which must be made annually
- Benefits based on account balance and may be more or less than target

1/8-18

Additional Hybrid Plans

- DB(k) plan: combines features of DB & 401(k)
- Age-weighted profit sharing plan: combines employees' age with employer profitability to set contributions
- Pension equity plan: combines portability with the security of traditional DB plan
- Lifecycle pension plan: benefits generally based on years of service and salary immediately preceding retirement

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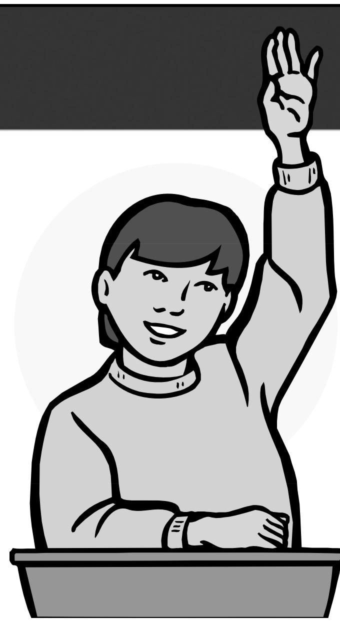
Questions?



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