To James B. Cassidy
1924–2004
Father, Husband, Brother, Soldier
## CONTENTS

<table>
<thead>
<tr>
<th>Acknowledgments</th>
<th>vii</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 1 Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Chapter 2 The Basics of Retirement Plans</td>
<td>5</td>
</tr>
<tr>
<td>Chapter 3 Administration</td>
<td>23</td>
</tr>
<tr>
<td>Chapter 4 Fiduciary Duty</td>
<td>33</td>
</tr>
<tr>
<td>Chapter 5 Financial</td>
<td>49</td>
</tr>
<tr>
<td>Chapter 6 Human Resources</td>
<td>79</td>
</tr>
<tr>
<td>Chapter 7 How to Hire the Right Consultants</td>
<td>107</td>
</tr>
<tr>
<td>Chapter 8 General Trends</td>
<td>119</td>
</tr>
<tr>
<td>Chapter 9 Where to Go for Help?</td>
<td>141</td>
</tr>
<tr>
<td>Appendix A Company ABC—Request for Proposal: 401(k) Savings Plan</td>
<td>147</td>
</tr>
<tr>
<td>Appendix B Sample Traditional Request for Proposal</td>
<td>151</td>
</tr>
<tr>
<td>Appendix C Sample Defined Contribution Plan Investment Policy Statement</td>
<td>167</td>
</tr>
<tr>
<td>Appendix D 401(k) Plan Investment Performance Review</td>
<td>181</td>
</tr>
<tr>
<td>Appendix E Replacement Ratio Study: A Measurement Tool for Retirement Planning</td>
<td>203</td>
</tr>
<tr>
<td>Appendix F Selecting a Default Fund for a Defined Contribution Plan</td>
<td>233</td>
</tr>
</tbody>
</table>
Appendix G  Argus Consulting Ltd NGO Retirement Plan Survey—2005 Results  255

Appendix H  Lessons from Behavioral Finance and the Autopilot 401(k) Plan  257

Index  275
This book would not have even begun without the pushing and prodding of Ron Lang, who serves on my firm’s board of advisers. It all started with Ron suggesting (but with Ron it sounding more like “ordering”) that I call his daughter Beth Lang Golub at Wiley. My virginal journey into book publishing began after a short conversation with Beth the following day. Thank you to both Ron and Beth for your faith and support during the entire process.

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And finally, to my wife Audrey, who continues to amaze me in managing our household while I run a business (and in the last months, write a book). My everlasting love.

Daniel P. Cassidy
www.arguscl.com
Managing retirement plans is an ongoing process. Regardless of the type of plan you manage—from profit sharing to traditional defined benefit program—you have to familiarize yourself with the rules of the plans as well other issues including investment risk and legal requirements (see Figure 1.1).

Managing retirement plans can be a difficult and daunting task for a number of reasons. Not only are the number and variety of plans ever increasing, but the day-to-day management itself is complex. This book will help you navigate the process, whether you are self-managing within your organization, outsourcing the total retirement plan management to outside vendors, or a combination of the two.

Overview of Retirement Plans

A retirement plan, in the employer model, is multifaceted:

- **Employee relations.** First and foremost, the employer is holding an asset of the employee—whether it is a 401(k) account balance or the accrued benefit in a defined benefit plan.

- **Asset management.** Employers must invest these assets in a productive manner. Specific rules regulate.

- **Retiree relations.** If your retirees and other inactive employees still participate in your plan, you must continue to take their needs into consideration as you manage the plan. These people no longer have a
HISTORY OF RETIREMENT PLANS

Retirement plans are a by-product of the Industrial Age. Kaiser Wilhelm was the first to enact a social insurance plan that would cover workers in turn-of-the-century Germany. Railroads were the first industry in the United States to embrace retirement plans. In both cases, the initial goals were identified as providing retirement income for workers after they have completed a useful working life.

Before the industrial age, there was no need for this “continued income” after retirement for the following reasons:

1. *Agrarian culture.* With the vast majority of the workers engaged in producing “food” for our society in a very wide distributed system, there was no central control/depository system to facilitate a savings vehicle.
2. *Mortality.* People did not live very long lives and however long they lived, they worked until they died. Medical science was not such that people lived past their useful working lifetime.
3. *Social structure.* Monarchy-based systems did not encourage personal asset accumulation; in fact, monarchies encouraged social welfare through noblesse oblige.
After the industrial revolution, larger businesses such as railroad companies or steel mills and others that encouraged the development of the middle class had the means to provide long-term security plans. Price controls during World War II also contributed to the increased use of retirement plans as a part of the overall compensation package as companies who were unable to increase direct pay looked to other means to attract qualified workers. Further social changes, including the increased power of unions, pushed retirement plans into the mainstream.

Many people point to the failure of the automobile manufacturer Studebaker’s pension plan in the mid-1960s as a pivotal moment in pension plan history. Directly out of this highly visible pension failure came federal action to regulate pension plans. In 1974, the watershed legislation called the Employee Retirement Income Security Act (ERISA) was passed and signed by President Gerald Ford in one of his first acts as president. From that point on, pension plans have been regulated on the federal level. Briefly, ERISA added significant provisions to protect workers and beneficiaries such as minimum vesting schedules, minimum funding standards, stringent fiduciary standards, and limitations on prohibited transactions. It also increased reporting requirements and established an insurance program for defined benefit plans (Pension Benefit Guaranty Corporation).

At the time of ERISA, defined benefit plans were the predominant retirement plan at larger employers; in fact, for most people, the term pension plan is synonymous with a traditional defined benefit pension plan. The number of defined benefit plans peaked in the mid-1980s with over 170,000 plans. However, due to many factors, including changes in legislation, the number of defined benefit plans has dropped to under 30,000. Now the vast majority of plans are defined contribution plans where the participants bear the investment risk.

Many critics point to two reasons for this sudden decline:

1. Pension plans were used in legislation to balance the federal budgets (increasing complexity with no real added value).
2. By limiting benefits to highly paid managers, this reduced the business owners’ incentive to continue sponsoring plans for their rank and file employees.

Finally, in the last several years with significant volatility in the equity markets and prolonged period of economic uncertainty/recession, we may be witnessing the last rites of the traditional pension plan.
direct tie with the employer, but an indirect one through the retirement plan.

- **Systems integration.** Payroll and plan management systems must communicate with each other in an effective manner. As employers make changes to one, the impact on others needs to be considered.

- **Legal and tax issues.** Our government encourages creation of retirement plans by providing substantial tax benefits both to the employer and employee. However, to continue to get these benefits, the employer must maintain the plan in compliance with an enormous amount of tax and legal requirements.

Whether the chief financial officer or vice president of human resources is managing the plan, he or she needs to keep all of these facets in mind.

As with any management task, there are several levers that a manager can use to apply pressure to get a desired result (see Figure 1.2).

In this book, we will examine the specifics of the plan in which managers can strategically affect the outcome of the retirement plans. You won’t become an expert in ERISA legislation, but as one of my clients said, the book will “give you the questions you need to ask.” Going further, our goal is to empower you by providing an explanation of the levers you can use to impact the real outcome of your plan. Only you know the right answers for you, your employer, and your employees. But first, you have to know what questions to ask.

![Figure 1.2 Retirement plan corporate governance tools](Source: Argus Consulting Ltd.)
Before digging deeper into the strategic management of retirement plans, it is worth taking a step back to review the fundamentals. As with most industries, the retirement plan community uses both technical language and nontechnical jargon. This can be very confusing to many managers as they work to understand their organization’s plans. Managers who have recently taken charge of their company’s retirement plans may feel like they are caught in the Talking Heads song “Once in a Lifetime” singing “And you may ask yourself—well . . . how did I get here?” The answer to this question is usually found in how previous managers evaluated the pros and cons of the various options available to them, which we will now discuss.

**Why Have Retirement Plans in the First Place?**

You may wonder why an organization goes through all the trouble of having a retirement plan. Boiled down to its core, the answer is that it is in the best interest of our society to promote private wealth accumulation in order to ensure that our citizens can avoid living in poverty after their useful working lifetime.

Before the United States set up the Social Security program in the 1930s, the overwhelming majority of our population over age 65 was dependent on either public/private assistance or had no income at all (see Table 2.1). Only a little more than one third were able to take care of their needs independently.
The U.S. social welfare structure has been shaped both by long-standing traditions and by changing economic and social conditions. In its early history, the United States was an expanding country with a vast frontier and a predominantly agricultural economy. Up to 1870, more than half of the country’s adult workers were farmers. In the years that followed, however, industry developed rapidly and the economy tended to be increasingly characterized by industrialization, specialization, and urbanization. The result was a nation of employees who were dependent on a continuing flow of income to provide for themselves and their families.

The first form of social insurance in the United States was workers’ compensation. Workers’ compensation made employers responsible for the costs of compensating workers and their families if the worker was killed or injured on the job. Later, the first retirement programs were developed in the late nineteenth century for government workers, including teachers, firefighters, and police officers. During the economic crisis of the Great Depression of the 1930s, the United States recognized the extreme poverty that many elderly citizens were living in, and created the Social Security system in 1935. Using current workers’ payroll taxes to finance the retirement of current retirees, over 70 years after the programs’ inception, the United States Social Security system is still providing income and reducing poverty for retirees.

With this goal of reducing poverty in old age, our government did two things:

1. Raised taxes to fund the new social security program (see boxed material).
2. Promoted the establishment of company-sponsored retirement plans by reducing taxes—or in the language of Washington, provided tax expenditures—thereby allowing companies to take tax deductions for contributions to pension plans. Pension plans that meet the requirements to receive the tax deduction are called “qualified plans.”

Table 2.1 Dependency of Senior Citizens in the U.S. in 1932

<table>
<thead>
<tr>
<th>Dependency status of population over age 65 in 1937</th>
<th>% of Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-dependent</td>
<td>35.1%</td>
</tr>
<tr>
<td>Dependent with public/private assistance</td>
<td>18.5%</td>
</tr>
<tr>
<td>Dependent with no income</td>
<td>47.5%</td>
</tr>
</tbody>
</table>

Source: Social Security Administration, “Historical Development,” 3.
Thus, from the employer’s standpoint, the first solution has no choice element involved—you must pay taxes—and in the case of social security taxes, these are shared equally between employee and employer. However, the second solution of promoting new retirement plans is completely voluntary; a company can choose to sponsor a plan or not—it is up to them. However, to answer the question posed in the Talking Heads song, we got here by jumping over the various hurdles required to get the government-approved tax deductions.

**Tax Overview**

To understand the full value of the government’s tax policy to promote company pensions, you need to understand some general tax policy issues. As you will see below, the tax advantages of a qualified retirement plan go far beyond just the initial company tax deduction.

First, the general rule for taxation for wages (and retirement plans are considered wages from a tax perspective) is the general tax rule: Timing of income to the employee is coordinated with the deduction to the employer. This general tax rule has a fancy name that is sometimes used in IRS and other publications: the Constructive Receipt Doctrine (CRD). Simply put, the company gets a tax deduction at the same time that the employee pays tax on the wage income. You can extend this general rule to the following corollary: If an employee is not taxed on the wage income, then the employer cannot take a tax deduction on the wages paid. However, the government, in order to promote qualified plans, has suspended the CRD in several areas.

**Suspension of the Constructive Receipt Doctrine**

There are three major areas in retirement plans where the CRD is suspended.

1. **Employer contributions.** Not many employers would find sponsor plans if the CRD were not suspended for qualified plans. If our government did not suspend the CRD for employer contributions, employers would be making contributions that would not be deductible immediately since the employees do not receive their benefits until years later in their retirement. So, clearly, it is in the government’s interest to allow employers to immediately deduct their contributions. Since the government does not want this tax deduction abused, it has placed limits on the amount of the deduction.

2. **Tax-deferred income.** Assets within a retirement plan trust are invested in the hope of earning future interest, dividends, and capital gains.
Normally, the CRD would call for the immediate taxation on interest and dividends paid as well as on any realized capital gains at the sale of the asset. However, retirement plan trusts do not pay any taxes on their income. Income taxes are only paid by participants when they ultimately receive their benefits. Again, this suspension of the CRD encourages employers to make contributions to retirement plans; in fact, it encourages them to make larger contributions earlier in an employee’s career in order to take full advantage of the trust’s tax-exempt status.

3. **Distributions favorably taxed.** This last area where the CRD is suspended is sometimes overlooked by participants and employers alike but it applies both when participants make a distribution choice and then when they receive payment of their benefits.

   • **Choice.** Applying normal tax policy with the CRD, if a person has a choice between two payment options, the IRS would tax the person on the most advantageous basis to the IRS. For example, in a retirement plan context and if the normal CRD were applied, if you had the choice between a single lump sum of say $1,000,000 or an annual annuity of $100,000, you would have to pay tax on the full $1,000,000 regardless of which option you chose. If you in fact did choose the annuity, you could get a tax bill from the IRS for $300,000, but only have a $100,000 annuity payment—so you would be in the hole $200,000 immediately. However, after year one, you would receive all $100,000 tax free, since you paid all the tax in year one. The IRS knew that this would not work for the vast majority of the plan participants, so they suspended the CRD for pension plans when there is choice involved.

   • **Timing.** In addition to suspending the CRD when choice is involved, the IRS went further and said that participants and beneficiaries will have to pay taxes once they receive their benefits. So, participants will only pay taxes on benefits received. This goes beyond the choice issue above and includes spouses. For example, if a participant selects an optional benefit form that continues to the spouse after the participant’s death, the spouse will only be taxed as he or she receives the benefit.

**Overview of Qualification Rules**

In order to take advantage of these rules, an employer must follow the specific regulations set out by the government. In the United States, two agencies have oversight responsibilities for retirement plans—the IRS as well as the Department of Labor (DOL). The IRS is clearly interested in making sure the tax regulations are followed since retirement plans
represent significant tax expenditures employee benefits; in fact, they represent the largest tax expenditure of the U.S. government in fiscal year 2006. Employer pension plans alone represent $99 billion in tax expenditure, according to the Office of Management and Budget.

The DOL, on the other hand, is focused on safeguarding employees' rights. Issues such as vesting, spousal rights, and fiduciary duty are clearly in the purview of the DOL.

The following is a brief summary of the major qualification issues that any manager should be familiar with.

I. Plan Document
   A. Plan must be written.
   B. Trust created and maintained in the United States.

II. Exclusive Benefit Rule
   A. Plan must be used for the exclusive benefit of employees and their beneficiaries.
   B. In general, trust assets must never revert back to the employer. In fact, if assets do revert back, the employer would pay income tax as well as an excise tax that can put the total tax rate at 90%—so it is very rare for employers to take a reversion since they only net about 10 cents on the dollar.

III. Minimum Age and Service Conditions
   A. Employers can limit who is eligible to enter the plan based on age and service. The predominant condition is age 21 and X years of service; however, other limits can be used for certain employers such as educational institutions.

IV. Minimum Vesting Standards
   A. Employee contributions, such as 401(k) salary deferrals, are always 100% vested.
   B. For employer contributions and benefits, a plan can specify a service-based schedule of vesting. Common vesting schedules include:
      1. 5-year cliff vesting—Participants have no vested benefit until they reach 5 years of service. After 5 years of service, they are 100% vested.
      2. Graded vested schedule—Participants vest in a portion of their benefit over a series of years (see Table 2.2).

V. Age Discrimination
   A. Not allowed to stop benefit accruals simply on the attainment of an age (for example age 65). Can stop accruals based on service.

VI. Alienation of Benefits
   A. In general, benefits may not be assigned or alienated such as a
wage garnishment. This is why you may hear that if someone files for personal bankruptcy, the debtors cannot force distribution from a qualified plan. However, there are several significant exceptions, including divorce and federal tax liens. In divorce, the parties can enter into an agreement to split the benefit in two. This is done through what is called a qualified domestic relations order.

VII. Benefit and Contributions Limits

A. The IRS imposes limitation on either the amount of benefits paid out of a defined benefit (DB) plan or the amount of contribution that goes into a defined contribution (DC) plan. These limits are indexed and can change annually. More information on this is included in the more specific discussion of each plan type.

VIII. Nondiscrimination of Benefits and Integration with Social Security

A. In general, the government would like all retirement plans to provide comparable benefits to all employees, regardless of their pay level. However, the government recognized that Social Security—financed through payroll taxes shared by employees and employers—is significantly skewed in the level of benefits provided to lower-paid employees. That is, lower-paid employees will contribute fewer dollars to the Social Security program, but receive about the same in benefits as higher-paid employees. This skewing of benefits to lower-paid employees was intentional and one of the major goals of Social Security. In order to encourage employers to sponsor private pension plans, the government allowed them to take into account this skewing. In fact, the government allows employers to “integrate” their plans with Social Security by providing higher benefits to higher-paid employees. There are limits to this and rules that employers must follow. In general, most private plans do take advantage of this integration. One small note: 401(k) plans (described later) cannot integrate matching benefits.

Table 2.2  Sample Graded Vesting Schedule

<table>
<thead>
<tr>
<th>Years</th>
<th>Vested</th>
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<tbody>
<tr>
<td>3</td>
<td>20%</td>
</tr>
<tr>
<td>4</td>
<td>40%</td>
</tr>
<tr>
<td>5</td>
<td>60%</td>
</tr>
<tr>
<td>6</td>
<td>80%</td>
</tr>
<tr>
<td>7</td>
<td>100%</td>
</tr>
</tbody>
</table>
B. Related to this issue is an area called “top-heavy” plans. These are plans that are typically due to employee turnover of non-vested benefit amounts result in the highly paid employees/owners receiving the vast majority (over 60%) of the benefits of the plan. This is typically an issue for small, closely held organizations. In these cases, the qualification rules call for minimum benefits as well as shorter vesting periods.

IX. Prohibited Transactions

A. Plans are not allowed to enter into prohibited transactions—basically self-dealing—with retirement plan assets. Prohibited transactions could include owners of a company using plan assets to buy a property from the cousin of the owners. There are some significant exemptions from these rules—including profit sharing plans investing in company stock, financial services firms using their own proprietary investment funds, etc.—but in general, plan sponsors should keep all transactions involving retirement plans at an arm’s length distance.

Overview of Plan Design Types

Even though there are hundreds of thousands of retirement plans in the United States, they basically come in two flavors: defined benefit or defined contribution. In simplest terms, the plan defines either one of two things:

1. Benefits that are actually paid out to participants after they leave employment—hence the name defined benefit.
2. Contributions into the plan while a participant is employed—hence the name defined contribution.

The plan defines either what goes into the plan or what comes out. Now we will describe each of these broad types in more detail and highlight why an employer would select one type versus another.

Defined Benefit Plan

Basic Structure

The focus of DB plans is on the benefits payable out of the retirement trust. These benefits are typically defined as an annuity—an annual payment of $X paid over the lifetime of the participant. The plan document (the legal document that spells out all the plan provisions) will include an operative sentence such as “The participant will receive an amount equal to . . .”
Funding

The key difference between DB and DC plans, beyond the difference of benefits paid versus contributions made, is who bears the investment risk. In the case of DB plans, the employer bears the investment risk. The employer must make all contributions and investment decisions for a DB plan. (Note that a few DB plans require employees to contribute to the plan, but these types of plans are not very common in the United States since the contributions are not tax deductible.) If there is a shortfall in assets, the company is wholly responsible for making up the difference. In practice, an actuary (see boxed material) is employed to calculate the value of the benefits promised by the DB plan. This liability value is then compared with the current asset value. If there is a shortfall, company contributions will be required and the actuary determines these in compliance with IRS rules. If there is a surplus, that is, assets are greater than liabilities, no employer contribution will be due at this time.

Pension Benefit Guaranty Corporation Insurance

Since DB plans can become underfunded, that is, where assets are less than liabilities, Congress recognized the need for an insurance program to cover this contingency—similar to the Federal Deposit Insurance Corporation (FDIC) for banks. It set up the Pension Benefit Guaranty Corporation (PBGC) to insure most DB plans. DB plans pay an annual premium into a fund that is based both on the number of participants as well as the level of funding in the plan. Plans in poor financial condition, that is, underfunded, pay a higher premium, and vice versa. The recent bankruptcies in the airline, automotive, and steel industries have put the PBGC system under tremendous strain. Currently, the PBGC itself has a deficit of over $20 billion. Serious concerns about this deficit has prompted Congress to consider raising premiums. However, the entire system itself may be in jeopardy as more and more DB plans terminate, reducing premium income and leaving the poorly funded plans all alone.

Sample Formulas

DB plans define the benefits paid using a formula, typically in one of three ways:

1. Formula based on compensation and service (most common). Example: Annual benefit paid will be equal to 1% of annual pay times years of service up to a maximum of 30 years.

2. Formulas based on service only (common with hourly/union workforce). Example: Annual benefit paid will be equal to $200 per year of service up to a maximum of 30 years.
ROLE OF THE ACTUARY

Many managers, once they become involved with a DB plan, immediately become aware of a business professional whom they had never encountered before—an actuary. Compared with other professions (over 400,000 attorneys, 300,000 CPAs), only 13,000 actuaries practice in the United States. With so few actuaries, misperceptions arise about what exactly is an actuary. This is highlighted in a funny joke about the definition of an actuary—that’s where they bury dead actors. All kidding aside, let’s describe what an actuary is and how he or she can help you manage your retirement plan.

What is an actuary? In general, an actuary is a business professional who analyzes the financial consequences of risk. Actuaries use mathematics, statistics, and financial theory to study uncertain future events, like those in pension programs. They evaluate the likelihood of those events, design creative ways to reduce the likelihood and decrease the impact of adverse events that actually do occur. Their work requires a combination of strong analytical skills, business knowledge, and understanding of human behavior to design and manage programs that control risk. This combination of skills—which is an amalgamation of legal, management, and statistical training—produces a professional with whom you should develop a close relationship to help you navigate through the complexity of running your plan.

Traditionally, actuaries have tended to focus solely on DB plans—helping to calculate the annual contribution requirements and annual pension expense, including the financials of the company, and so forth. However, as the marketplace has changed with the increase in DC plans, actuaries have retooled and broadened their scope of services to include all types and areas of retirement plans. Many clients now look to their actuaries for independent, professional advice on all issues surrounding their retirement plans.

3. Formula based on neither service nor compensation (rare). Example:
   Annual benefit will be equal to $10,000.

Since formula type number one is the most common, we will spend some more time describing the two major types of this formula. These types differ in what pay is used in the formula:

- Final average pay formula
  - Pay used—Pay during the last several years of a person’s career
  - Averaging period—Typically three or five year average
  - Example—1% of five-year average final pay times years of service
Career average pay formula

- Pay used—Pay during the entire career of a person, from hire to termination
- Averaging period—Entire career
- Example—1% of career average final pay times years of service

How Does a Plan Sponsor Choose Between a Career Average Pay Formula versus a Final Average Pay?

In simplest terms and ignoring any difference in administration (keeping track of an entire career of earnings compared to just the last five years), the two interconnected issues that plan sponsors need to deal with are inflation and “fast-track” employees.

Regarding inflation, if the goal of a retirement plan is to provide a certain level of retirement income—possibly enough to maintain an employee’s standard of living—then it could be difficult to design a career average pay plan to accomplish this. For example, during an extended high inflationary period, a person’s pay will be increasing significantly, but the retirement benefit will be calculated using significantly lower pay levels prior to the inflationary period.

Similarly, a fast-track employee who is hired and is promoted through the ranks to a higher pay level is difficult to adequately handle in a career pay environment. As with the inflation issue, fast-track employees will still have some of their benefits based on significantly lower pay levels and employers could have problems providing a comparable level of benefit to a person who was promoted at a more moderate pace throughout his or her career.

If these are your concerns, then a final average pay plan may be the right answer for your company. However, note that the final average pay plan, while doing a better job of meeting retirement goals during an inflationary period, will have significantly higher cost, since it is providing larger benefits.

Form of Payment

Most DB plans express the benefits paid as an annual annuity. That is a payment received periodically while a participant and/or beneficiary is alive. Also, participants can choose from a variety of options forms. These optional forms are “actuarial equivalents,” meaning that they have the same financial value to the participant and spouse, assuming their future life expectancies.

- Single life annuity. Payment is made while the participant is alive (no payments made after his or her death).
■ **Joint and survivor annuity.** Payment is made while the participant is alive, and then continues after his or her death. The amount continuing to the beneficiary can vary typically between 50% and 100%. For example, with a joint and 50% survivor annuity, the participant would receive $100 while alive and then the beneficiary would receive $50 after the participant’s death.

■ **Lump sum payment.** A single payment of the entire accrued benefit is made.

### Hybrid Plans

It is worthwhile now to mention hybrid plans. Examples of hybrid plans include cash balance, defined lump sum, and pension equity. These are DB plans that communicate the benefit in terms of a lump sum in order to facilitate employees’ understanding. As you can see in Figure 2.1, hybrid plans have become very popular, especially in the larger plan marketplace.

Instead of expressing the benefit as an annuity at normal retirement, hybrid plans describe the benefit as a lump sum—employees can then easily compare this value to, say, the account balance in their 401(k) plan. Even though these plans express the benefit as a lump sum and look and feel like a 401(k) plan, they are in fact DB plans, subject to all the same rules and regulations. In the vast majority of hybrid plan designs, the participants can in fact receive the entire lump sum value immediately. This

![Figure 2.1 Prevalence of hybrid plans in 2003 by plan size](source: Pension Benefit Guaranty Corporation. Pension Insurance Data Book 2004 (2005), 60.)
portability is greatly appreciated by employees who can then decide exactly what they want to do with the money, for example roll it over to an individual retirement account (IRA).

Most hybrid plans were not started up from scratch, but instead are just your typical DB plans that were amended to include the hybrid features. Most of these transitions took place during the 1980s and 1990s. Several high-profile hybrid transitions, for example, IBM’s change from a traditional final average pay plan to a cash balance plan, have been challenged in court on age discrimination charges. The courts have provided conflicting judgments, and the federal government has yet to publish definitive regulations and standards. So, due to this uncertainty, employers have recently shied away from transitioning to hybrid designs.

Timing of Payment

In addition to the form of payment, participants can also typically elect to commence their benefits before age 65. The plan will spell out how much the benefit will be reduced since the participant will be receiving it earlier than expected. Some employers use these early retirement provisions to achieve other human resources goals like reducing head counts. By providing enhanced early retirement benefits, this may just be the right incentive that allows people in their fifties and sixties to elect to retire.

IRS Limitations

With DB plans, the two operative limits are those on pay and benefits:

- **Pay.** Pay in excess of $220,000 (2006) cannot be used in the calculation of benefits.
- **Benefits.** The plan cannot pay out more than $175,000 (2006) per year to any participants or beneficiaries.

Defined Contribution Plan

Basic Structure

The focus of DC plans is on the contributions made into the retirement trust. These contributions are typically defined as a percentage of pay—an annual contribution of X% of pay will be made into the trust. The plan document will include an operative sentence such as “Each year the employer shall contribute to trust . . .” Contributions are made to the plan on behalf of employees. Individual accounts are set up and assets are invested on behalf of employees.
**Funding**

As mentioned earlier, the key difference between DB and DC plans, beyond the difference of benefits paid versus contributions made, is who bears the investment risk. In the case of DC plans, the employee bears the investment risk. The employer’s responsibility for funding stops after it makes the required contributions. The investment responsibility is now typically handed over to the participant; however, the employer is still responsible for selecting appropriate funds for the employees to choose from. There is a broader discussion later in the book.

Since the participant’s benefit is ultimately the account balance, a shortfall can never exist. If the assets have negative performance, then the participant’s balance will go down. The employer does not have to make up this shortfall. On the other hand, if the assets perform well, the participant’s balance will go up.

**PBGC Insurance**

Since the account balances are always 100% funded, there is no need for any PBGC insurance coverage.

**Sample Formulas**

DC plans define the contributions made to the plan and have a predetermined formula for allocating the dollars to participants. The employer contribution amount need not be based on any formula, such as X% of profits; however, the allocation method must be written down. Just like DB plans, there are a variety of DC plans to choose from. However, unlike DB plans, many DC plans contain more than one type and many times include an element of employee contributions. In a quirk of the U.S. tax code, employee contributions to DC plans can be made on a tax-deductible basis. Probably the most common is a 401(k) plan that includes employee salary deferral, company match, and a discretionary company profit sharing contribution.

- **401(k) plan**
  - Description—Employees can elect to contribute a percentage of the pay on a pretax basis. This is typically matched by the employer.
  - Example—Employees can elect to deduct up to 10% of pay. The employer will match the first 6% of employee pay.

- **Profit sharing plan**
  - Description—Employer will make a discretionary contribution to
the plan. Many times the level of contribution will be tied to profits, but there is no requirement to have it strictly based on profits.

- Example—The company will make a discretionary profit sharing contribution to the plan. Or, the company will contribute 10% of its pretax profits to the plan.

**Employee stock ownership plan (ESOP)**

- **Description**—A special type of profit sharing plan that invests primarily in employer stock. These plans have significant differences in operation, fiduciary, deductibility, and funding from profit sharing plans. In general, ESOPs are used to increase employee ownership in a company as well as to facilitate ownership changes in closely held firms.
- **Example**—The company will contribute X% of pay to the ESOP and invest in company stock.

**Allocation Methodologies**

For profit sharing plans, the allocation methodology can vary based on the employer’s goals and objectives. The simplest is to allocate equally based on pay. However, companies may choose to allocate based on age, or on age and service. Generally, if the company chooses one of these alternative allocations, the plan will need to be tested in order to prove that it does not discriminate in favor of highly paid employees (see nondiscrimination discussion above).

**Form of Payment**

Most DC plans pay the benefits as a single lump sum. Some plans allow other forms of payment, like level payment over 10 years or a single life annuity. However, these alternative payment forms are becoming rarer, with most participants selecting the lump sum and either taking the cash or rolling the account over to an IRA.

**Timing of Payment**

Since DC plans pay lump sums and the annual contributions to DC plans are limited, there is no ability to integrate an early retirement program like DB plans. This one disadvantage of DC plans is not viewed by plan sponsors as a problem. It is more of an advantage of a DB plan than a disadvantage of a DC plan.

**IRS Limitations**

For DC plans, the IRS imposes limits on pay and contributions.
Pay. Like DB plans, contributions cannot recognize pay in excess of $220,000 (2006).

Contributions. No more than $44,000 (2006) can be contributed on behalf of an employee in any one year (an additional $5,000 [2006] employee contribution is allowed for participants over age 50).

**Advantages and Disadvantages of Defined Benefit Plans and Defined Contribution Plans**

How to decide to sponsor one plan versus the other is an exercise in decision making and goal setting. It is hard to say one is better than the other. We have put together Table 2.3 to compare side by side how each type achieves certain objectives.

**Nonqualified Plans**

Our discussion so far has focused on qualified plans—those plans that seek to meet the qualifications rules in order to provide the tax benefits to both employees and employer. However, in many instances, the employer would like to provide benefits that specifically do not meet these qualification standards. For example, many employers want to provide benefits in excess of arbitrary limits set by the IRS capping pay at $220,000 (2006), contributions at $44,000 (2006), and benefits at $175,000 (2006).

In order to do so, an employer typically adopts a nonqualified plan, which is simply a contract between individual employees and the employer promising certain contributions and/or benefits. By moving beyond the qualification rules, the employer is then at liberty to adopt whatever plan provisions it wants. However, by not following the qualification rules, the employer and employee will not enjoy the significant tax advantages of being qualified.

<table>
<thead>
<tr>
<th>Table 2.3  Comparison of Typical Plan Features</th>
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<tbody>
<tr>
<td>Participation</td>
</tr>
<tr>
<td>Contributions</td>
</tr>
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<td>Investment risk</td>
</tr>
<tr>
<td>Disability coverage</td>
</tr>
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<td>Loans</td>
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<tr>
<td>Distribution form</td>
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<td>Benefit guaranty</td>
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Source: PBGC, Pension Benefit Guaranty Corporation.