Pension Plans —Types and Characteristics

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If you are participating in any type of employer-sponsored retirement plan, congratulations! According to the Bureau of Labor Statistics in March 2012, 84% of state and local government workers participated in employer-sponsored retirement benefits, compared with 48% of private industry workers.[1] In these times, when we are living longer, healthcare costs are rising, and the future of Social Security is uncertain, it is imperative that people are aware of all of their options. The first step is having a clear understanding of your employer's plan.

There are qualified and non-qualified retirement plans. A qualified retirement plan is for the exclusive benefit of employees or their beneficiaries and must be non-discriminatory. This means that highly compensated employees (those being paid $115,000 or more in 2013) cannot benefit more than others. As such, every qualified retirement plan is required to have a "plan document" which serves as a blueprint for how it is operated, defining such things as eligibility requirements, funding, distributions, etc. Employer-sponsored qualified plans are governed by ERISA (Employee Retirement Income Security Act of 1974); they must satisfy specific IRS requirements and ever-evolving regulations to enjoy certain tax benefits and ensure employee protection. As a result of changing times and regulations, qualified retirement plans are dynamic entities.

In contrast, a non-qualified retirement plan does not have to adhere to all ERISA guidelines, and does not have to be made available to all employees. Such plans are often used to provide additional compensation to executives or specific employees. The employer will enjoy a tax benefit only when the participant receives payment. At that time, the participant must pay taxes at their regular income tax rate. Unlike most qualified retirement plans, payments cannot be rolled over to IRAs.

[1] *www.bls.gov/news.release/pdf/ebs2.pdf*

Following is a brief summary of each qualified retirement plan type:

Defined Benefit

In the United States, a handful of employers offered pensions to employees in the late 1800s. As time went on, more employers were able to offer pensions as a result of insurance companies offering group annuity contracts. However, the real growth in plans did not occur until WWII, Korea, and beyond. During the war years, the government imposed price and wage stabilization programs. By offering a pension, companies had a way of rewarding their employees without giving them a raise. After the war, the government provided tax incentives to companies offering pensions.

The result was a defined benefit plan; i.e., it defines the benefit that the employee will receive in retirement. The employer or plan sponsor provides all of the funding and assumes all of the risk. Once the benefit has been determined, the employer or plan sponsor makes investments that are professionally managed to achieve a specific rate of return. If those investments fall short, additional funding is required to make up the difference. If the investments outperform, the funding can be cut back. Should the employer go out of business or no longer support the plan, participants enjoy a limited guarantee of their benefits through the Pension Benefit Guaranty Corporation (PBGC), a federal agency created by ERISA to protect pension benefits in the private sector.

There is no single method of defining the retiree benefit for all pensions. Each plan has its own plan document which contains the formulas for calculating the benefit. These formulas can be simple or complex, taking into consideration compensation, age, and years of service.

Defined benefit plan payments are usually paid to the retiree monthly in the form of an annuity, beginning at normal retirement age, typically defined as 65. The retiree will be presented with several options on how they can be paid:

- **Life Annuity**, during which payments cease at the participant's death. In most cases, this is the highest monthly amount;
- **Life Annuity with Ten Years Certain**, meaning that if the participant passes away before ten years of benefits have been paid, their beneficiaries will receive the benefit for the remaining period. The retiree receives less each month than the first option, but has the comfort of knowing their beneficiaries will receive something for an additional number of years;

- **Joint and Survivor Annuity**, which not only pays the retiree, but continues to pay a surviving spouse at a prescribed rate until their death. This option usually provides lower monthly payments than the first and second options, but furnishes peace of mind knowing the spouse will be taken care of to an extent; and
- **Lump sum**, which can be reinvested into an IRA. It should be kept in mind that if the proceeds from a defined benefit plan are not reinvested into an IRA, they are subject to Federal Income Tax.

Defined Contribution

A defined contribution plan also does exactly what it says: defines the contribution to the retirement plan, while leaving the benefit to be determined by a variety of factors. The contribution can be made by the participant, the employer, or both. (Prior to 1978, defined contribution plans took the form of Cash or Deferred Arrangements (CODA), with limited oversight by the IRS.)

There are several kinds of defined contribution plans, each governed by their own set of regulations. Often, the adoption of a defined contribution plan shifts the funding responsibility and the risk from the employer or plan sponsor to the participant. It is incumbent upon the participant to make a lot of decisions, the first being whether or not to participate! If yes, the participant must select investments from a prescribed menu and determine their relative allocations.

Following are brief descriptions of the various types of defined contribution retirement plans:

- **401(k) Plan** – The Revenue Act of 1978 contained a provision that later went on to become Internal Revenue Code Sec. 401(k), and the 401(k) plan was born. This legislation provided for tax deferral treatment of the salary deductions used to fund the 401(k) plans. This is the type of retirement plan with which most people are familiar. Basically, eligible participants can have contributions deducted from their paycheck and deposited into their individual 401(k) account. The contributions are tax deferred and provide an income tax deduction. When distributed, the participant's normal tax rate is applied.

  A 401(k) lends itself to a high degree of customization. Participants should consult the plan document which outlines the features of the particular plan, including eligibility requirements, employer matching, the existence of a profit sharing feature, the availability of loans and hardship distributions, etc.

- **403(b) Plan** – 403(b) plans are also salary deferral plans, developed primarily for schools and healthcare facilities. They are very similar to a 401(k), but operate under some slightly different rules. Efforts are being made to shaping them closer to the 401(k) model.
- **SEP and Simple IRAs** – SEP and SIMPLE IRAs are plan designs that have historically been used by small businesses. They use documents that have been pre-approved by the IRS and have very little room for customization. As a result, administration costs are minimal. Only sponsors can contribute to SEP IRAs. The SIMPLE IRA allows for contributions by both the employer and the participant.
- **Profit Sharing Plan** – A profit sharing plan is one in which the employer allocates a contribution to eligible employees which may, or may not, come from the profits of the business. The employer is not required to make a contribution each year, however, if he does, he can set the amount up to 25% of the total compensation of all eligible participants. A variation of this is an ESOP (Employee Stock Ownership Plan) in which the profit sharing contribution is used to purchase company stock. (In order to qualify as an ESOP, 50% or more of the assets in the plan must be in company stock.)
- **Money Purchase Plan** – Money Purchase Plans are very similar to profit sharing plans with two notable exceptions: the percentage of the contribution is fixed, and the contribution must be made each year. Before 2002, tax law stated that the profit sharing contribution could not be more than 15%, and the total employer contribution could not be more than 25 percent of total compensation. Many employers, to reach the 25% upper limit would have an additional money purchase plan at 10 percent. When the profit sharing contribution limit was raised to 25% in 2002, many money purchase plans were terminated.

Cash Balance Plan

A cash balance plan is essentially a hybrid between a defined benefit and a defined contribution plan. It resembles a defined contribution plan, creating individual participant accounts into which the employer makes annual contributions defined by the plan document. Upon retirement, the participant has the option of taking either a lump sum or an annuity. The risk and funding responsibility belongs solely to the plan sponsor. Participants in cash balance plans also have limited protection with the PBGC.

In summary, all of the above plans (with the exception of the SEP and SIMPLE IRAS) offer a lot of options to the employer or plan sponsor to truly design a plan to fit their particular circumstances and culture. Since all retirement plans are essentially unique, how does a participant learn about the nuts and bolts of their particular plan? The best place to start is with the Summary Plan Description (SPD) which the employer/plan sponsor must provide to you, particularly any time a change is made to the plan. Participants do have the right to request a copy of the entire plan document from the plan sponsor. If you need additional clarification, consult your human resources department.

But what happens if my employer does not sponsor a retirement plan? The Employment Retirement Income Security Act of 1974 (ERISA) also addressed this situation by creating the Individual Retirement Account (IRA). The passage of the Tax Payer Relief Act in 1997 introduced the Roth IRA. The details of these types of accounts will be addressed in the next edition of the Muhlenkamp Memorandum.

Note:

When you extend the range of a life annuity by continuing payments to a second person ("Joint and Survivor" annuity) or for a guaranteed minimum period of time ("Period Certain" annuity), the extra coverage may reduce the monthly payment by about 5% to 15 percent. Several situations where these "extended" forms of annuity would be most suitable are: (1) when the income needs to be guaranteed over the lifetimes of a husband and wife ("Joint and Survivor" annuity); (2) when payments must continue for a specified period (e.g. 5 or 10 years or more) to a designated beneficiary ("Certain and Continuous" annuity); or (3) when the annuitant wants to make sure that, if he should die before his full investment has been distributed in monthly payments, an amount equal to the balance of the deposit continues to a named beneficiary ("Installment Refund" annuity).

The comments made in this commentary are opinions and are not intended to be investment advice or a forecast of future returns. Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Investors must consult their tax adviser or legal counsel for advice and information concerning their particular situation.

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