

PART TWO
RETIREMENT BENEFITS

CHAPTER 5

RETIREMENT PLANS

Introduction

The first pension plan in the United States was established in 1759 to benefit widows and children of Presbyterian ministers. But it was more than a century later, in 1875, before the American Express Company established a formal corporate plan (Allen et al., 1993). During the next half century, some 400 plans were established, primarily in the railroad, banking, and public utility industries. The most significant growth has occurred since the mid-1940s. In 2005, private pension plans numbered 679,095 and covered 82,665,000 active participants¹ (U.S. Employee Benefits Security Administration, 2008).

The statutory tax treatment of pensions was formally legislated through the Revenue Act of 1921, which exempted interest income of stock bonus and profit-sharing plans from current taxation and deferred tax to employees until distribution. Statutes enacted since 1921 have permitted employers to deduct a reasonable amount in excess of the amount necessary to fund current pension liabilities (1928); made pension trusts irrevocable (1938); and established nondiscriminatory eligibility rules for pension coverage, contributions, and benefits (1942). These provisions were incorporated into the Internal Revenue Code (IRC) of 1954 and, along with major modifications made by the Employee Retirement Income Security Act of 1974 (ERISA), the Tax Reform Act of 1986 (TRA '86), the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the Pension Protection Act of 2006 (PPA), constitute the basic rules governing the tax qualification of pension plans.

The tax treatment accorded “qualified” plans (meaning qualified with the Internal Revenue Service for tax-favored treatment) provides incentives both for employers to establish such plans and for employees to participate in them. In general, a contribution to a qualified plan is immediately deductible in computing the employer’s taxes, but only becomes taxable to the employee on subsequent distribution from the plan. In the interim, investment earnings on the contributions are not subject to tax. This preferential tax

¹ Readers comparing this number to those that appeared in previous years should be aware that the definition of active participants as reported in the Department of Labor’s *Private Pension Plan Bulletin* has changed recently. Previously, this definition excluded the estimated number of participants in 401(k) plans who did not elect to receive employer contributions, and nonvested, separated employees who had not yet (at the time the 5500 was completed) incurred the break in service.

treatment is contingent on the employer's compliance with rules set out in the Employee Retirement Income Security Act of 1974 (ERISA) and administered by the U.S. Department of the Treasury (under the IRC) and the U.S. Department of Labor (under ERISA). Plans not meeting ERISA qualification requirements may also be used to provide retirement income, and such "non-qualified" plans are generally governed by trust law rather than the tax code.

Types of Plans

Defined Benefit Plans—In a traditional defined benefit plan (cash balance plans are covered in the chapter on cash balance plans and hybrids), the employer agrees to provide the employee a nominal benefit amount at retirement based on a specified formula. The formula is usually one of three general types: a flat-benefit formula, a career-average formula, or a final-pay formula.

Flat-Benefit Formulas—These formulas pay a flat dollar amount for each year of service recognized under the plan.

Career-Average Formulas—At retirement, the benefit equals a percentage of the career-average pay, multiplied by the participant's number of years of service.

Final-Pay Formulas—These plans base benefits on average earnings during a specified number of years at the end of a participant's career; this is presumably the time when earnings are highest. The benefit equals a percentage of the participant's final average earnings, multiplied by the number of years of service. This formula provides some degree of preretirement inflation protection to the participant but can represent a higher cost to the employer.²

Flat-benefit formulas are common in collectively bargained plans or plans covering hourly paid employees. Career-average and final-pay formulas are most common in plans covering nonunion employees. Under pay-related formulas, an employer has some discretion in defining pay for plan purposes provided the definition does not discriminate in favor of highly compensated employees (defined later in this chapter), subject to the statutory and regulatory definition of compensation used in testing for nondiscrimination. Under ERISA's minimum standards, there is also some leeway in determining what employment period will be recognized in the benefit formula. The benefit may reflect only the plan participation period or may be based on the entire employment period.

² Very few private-sector defined benefit plans provide post-retirement indexed benefits, compared with public-sector plans. (For more information on public-sector defined benefit pension plans, see chapter on the public-sector environment).

Defined Contribution Plans—In a defined contribution plan, the employer makes provision for contributions to an account established for each participating employee. The final retirement benefit reflects the total of employer contributions, any employee contributions, investment gains or losses, and withdrawals and unpaid loans. Sometimes the accumulated amount includes forfeitures resulting from employer contributions forfeited by employees who leave before becoming vested. As a result, the level of future retirement benefits cannot be calculated exactly in advance. Employer contributions to defined contribution plans are often based on a specific formula such as a percentage of participant salary or of company profits. The plans may be designed to include pretax or after-tax employee contributions, which may be voluntary or mandatory.

There are several types of defined contribution plans. In a *money purchase* plan, employer contributions are mandatory and are usually stated as a percentage of employee salary. In a *profit-sharing* plan, total contributions to be distributed are often derived from a portion of company profits and can vary or even be suspended year-to-year, depending on profits. *Stock-bonus* plans are similar to profit-sharing plans but usually make contributions and benefit payments in the form of company stock. A *target benefit* plan is a cross between a defined benefit plan and a money purchase plan—with a targeted benefit used to determine the level of contributions but with contributions allocated to accounts, as in a money purchase plan. A *thrift* or *savings* plan is essentially an employee savings account, often with employer matching contributions. In a *401(k)* arrangement, an employee can elect to contribute, on a pretax basis, a portion of current compensation to an individual account, thus deferring current income tax on the contribution and the investment income earned. In an *employee stock ownership* plan (ESOP), employer contributions to employee accounts must be primarily in company stock.

Minimum Standards and Other Qualified Plan Rules—ERISA sets specific standards for eligibility, coverage participation, vesting, benefit accrual, and funding of retirement plans. Most of these represent minimum requirements (thus the term *minimum standards*); employers may adopt plans with more liberal standards.

Plan Qualification Rules—Pension plans must satisfy a variety of rules to qualify for tax-favored treatment. These rules, created under ERISA, are designed to protect employee rights and to guarantee that pension benefits will be available for employees at retirement. The rules govern requirements for reporting and disclosure of plan information,³ fiduciary responsibilities,

³ A description of this topic is beyond the scope of this chapter. However, a detailed description may be found at www.dol.gov/ebsa/pdf/rdguide.pdf for the law prior to the enactment of the Pension Protection Act of 2006. Further information on the impact of the Pension Protec-

employee eligibility for plan participation, vesting of benefits, form of benefit payment, and funding. In addition, qualified plans must satisfy a set of nondiscrimination rules (under IRC Sec. 401(a)(4), Sec. 410(b), and in some cases Sec. 401(a)(26)) designed to insure that a plan does not discriminate in favor of highly compensated employees. The nondiscrimination rules are satisfied through a series of complex rules that must be tested annually to ensure that the classification of employees who are eligible for participation (i.e., covered) is nondiscriminatory, and the proportion of eligible employees who actually participate in a plan is nondiscriminatory. In addition, the level of contributions and benefits under the plan(s) is tested to ensure that it does not disproportionately accrue to the highly compensated. A highly compensated employee for a particular year is an employee who is a 5 percent owner (or who was a 5 percent owner in the preceding year), or any employee who in the prior year had compensation in excess of \$110,000 (in 2009, adjusted for changes in inflation) and who, if the employer elects to apply the top 20 percent rule, was in the top 20 percent of employees on the basis of compensation for the prior year.

General Eligibility—A pension plan may require that an employee meet an age and service requirement before becoming eligible for participation. However, the employer cannot require the employee to be over age 21 or to have completed more than one year of service with the employer, typically defined as at least 1,000 hours of work in a 12-month period. An exception is plans with immediate vesting; such plans may require completion of up to two years of service.

Coverage and Participation—An employer has some flexibility in determining who will be covered under the pension plan(s). For example, employee groups may be defined on the basis of pay (hourly vs. salaried), job location, or unionization. An employer may have one plan covering all these types of groups (and others), or separate plans. However, tax-qualified plan(s) must generally satisfy a set of nondiscrimination rules (under IRC Sec. 401(a)(4), 410(b), and, in some cases, 401(a)(26)) designed to ensure that the plan arrangement does not discriminate in favor of highly compensated employees in coverage, participation, and benefits provided.

Vesting—Participants generally attain nonforfeitable and irrevocable—vested—rights to pension benefits after satisfying specific service (or years of participation) or age and service requirements. Once vested, an employee's rights generally cannot be revoked. ERISA requires a single-employer⁴ defined benefit plan to adopt vesting standards for the employee's accrued benefit at least as liberal as one of the following two schedules: full vesting

tion Act on reporting and disclosure of plan information is available at www.dol.gov/ebsa/pensionreform.html

⁴ Vesting standards are described in chapter on multiemployer plans.

(100 percent) after five years of participation in the plan (with no vesting prior to that time, known as *cliff* vesting) or graded (*gradual*) vesting of 20 percent after three years of service and an additional 20 percent after each subsequent year of service until 100 percent vesting is reached at the end of seven years of service.

Faster vesting is required for employer contributions to single-employer defined contribution plans. The law requires that employer contributions vest under a vesting schedule that is at least as fast as a three-year “cliff” vesting schedule or a two- to six-year “graded” vesting schedule.

These rules apply to benefits attributable to employer contributions to a single-employer pension plan. Benefits attributable to employee contributions to either defined contribution or defined benefit plans and investment income earned on employee contributions to defined contribution plans are immediately vested.

Full vesting must also occur when a participant reaches the plan’s normal retirement age (commonly age 65, but sometimes earlier) or (to the extent the benefit is then funded) if the plan is terminated; some plans provide for full vesting on early retirement, death, or disability. Loss or suspension of benefits can occur in some situations, however. If a participant and spouse have both waived the preretirement survivor option (discussed later in this chapter), the spouse will not be entitled to any benefit based on employer promises or contributions in a qualified retirement plan should the participant die before retirement. Participants who take their own contributions out of the plan may—if they are not sufficiently vested—lose their rights to employer plan contributions, but must be permitted to buy back the forfeited benefits on repayment of contributions and interest.

In many cases, an employee who is not vested can have a break in service (temporary cessation of covered employment) without losing credit for previous years of service.⁵ Revised break-in-service rules were legislated under the Retirement Equity Act of 1984 and require prior service to be reinstated unless the number of consecutive one-year breaks in service is equal to, or exceeds, the greater of five years or the number of pre-break years of service. Benefit credit is further protected while an employee is on parental leave.

Benefit Accrual—ERISA requires that plans use one of three alternative formulas to determine the minimum speed at which defined benefit pension benefits accrue to participants. In general, benefit amounts in a defined

⁵ If an employee completes fewer than 1,000 hours of service within a computation period, credit need not be given for a year of service, and the employee need not be given any benefit accrual for the period in question. However, if the employee has completed at least 501 hours of service in the computation period, this will prevent the employee from incurring a “break in service.” Whether the employee has incurred a break in service is significant in terms of eligibility and vesting of benefits.

benefit plan accrue over the period of an employee's plan participation, but they do not have to accrue evenly over that time. The law focuses only on the rate of benefit accrual, generally forbidding benefits to accrue disproportionately at the end of an employee's career; it does not mandate any specific benefit levels. However, benefit accruals may not be reduced or discontinued because of age. Thus, employees who work beyond normal retirement age will continue to receive credit for time worked and contributions made to their plan, but the employer is allowed to restrict the number of years of benefit accrual.

Form of Benefit Payment—ERISA requires retirement plans that offer an annuity as a payment option to provide a qualified joint-and-survivor (J&S) annuity for married participants as the normal method of benefit payment. This provides the surviving spouse with a lifetime monthly income equal to at least one-half the amount of the employee's benefit. To pay for this protection, the employee's benefit is usually reduced. In order to select a pension paid over the duration of the participant's life only (or any other payment form), both the participant and the spouse must refuse the J&S option in writing. (The spouses' signatures must be notarized or made before a plan administrator.)

Plans may make additional death benefits available to vested participants in the form of a life insurance contract or a cash distribution as long as these benefits are incidental to the pension plan, which is defined explicitly by the IRS.

Most plans must also provide preretirement survivor benefits to the spouse of a vested participant who dies before retirement. The benefit is payable in the form of an annuity for the life of the surviving spouse beginning at what would have been the employee's normal retirement date or, at the election of the surviving spouse, as early as the employee's earliest retirement date or death, whichever is later.⁶ Unless both spouses waive this benefit option in writing, these benefits will be provided to the surviving spouse even if the participant had named someone else as his or her heir. The annuity must be equal to at least one-half of the participant's accrued benefit at the time of his or her death. To reflect the cost of providing survivor protection, employers are allowed to provide a lower benefit to the participant. Preretirement survivor benefits need not be provided unless the participant has been married at least one year.

Funding—Assets in qualified pension plans must be kept separate from the employer's general assets. A plan may be maintained through one of a number of vehicles. One method is to establish a trust agreement with a bank or similar institution. In this case, the trust holds the plan's money and

⁶ Profit-sharing plans may have different compliance requirements with respect to spousal provisions.

invests it, and the employer does not have access to the funds. A plan may also be maintained with an insurance company through allocated or unallocated accounts. If the allocated arrangement is used, separate accounts are established for each plan participant prior to retirement, and total contributions are divided among participants. Under an unallocated arrangement, a pool of funds is established and benefits are paid from it. Pension plans may also be maintained through individual policies issued on each participant's life. Sometimes both arrangements are used.

To ensure that pension plans have sufficient assets to pay benefits when participants retire, ERISA established minimum funding standards for defined benefit and some defined contribution plans. *Money purchase* and *target* benefit plans are covered under these requirements but not profit-sharing, stock bonus, or most employee stock ownership plans.⁷ For money purchase and target benefit plans, the minimum contribution is the amount set out in the plan formula. The funding rules for single-employer defined benefit plans are described in the chapter on defined benefit/defined contribution plans. The funding rules for multiemployer plans are somewhat different from those for single-employer plans; see chapter on Pension Benefit Guaranty Corp. (PBGC) and Plan Funding.

Assignment of Benefits—The assignment of benefits to another person (also called alienation) under a pension plan is prohibited, with certain exceptions, including: the assignment of up to 10 percent of a benefit that is in pay status; the use of an employee's vested benefit as collateral for a plan loan (if not a prohibited transaction); and payment pursuant to a qualified domestic relations order (QDRO). A QDRO assigns to an alternate payee (spouse, former spouse, or dependent) the right to receive all or a portion of the benefits payable to a participant (even where the participant is still employed).

Contributions and Benefits—ERISA also set maximum limits on annual contributions and benefits that qualified retirement plans may provide for each participant. The limits are known as Sec. 415 limits, referring to the IRC section that defines them. There are separate limits for defined benefit and defined contribution plans. (A detailed description is provided later in this chapter.)

Individual Participant Limits: ERISA originally set limits on the contribution and/or benefit amounts that retirement plans could provide to

⁷ In a money purchase plan, employer contributions are mandatory and are usually based on each participant's compensation. A stock bonus plan is similar to a profit-sharing plan but usually makes benefit payments in the form of company stock. A target benefit plan is a cross between a defined benefit plan and a money purchase plan, with an initial defined retirement benefit target, as in a defined benefit plan, but with contributions allocated similarly to a money purchase plan. An employee stock ownership plan must be invested primarily in employer stock.

individual participants on a tax-deductible basis under IRC Sec. 415. Under defined benefit plans, the original maximum annual benefit at age 65 was set by ERISA at the lesser of \$75,000 per year or 100 percent of the participant's average compensation over the three consecutive highest earning years. Under defined contribution plans, the maximum annual contribution (including a portion of employee contributions) was originally limited to the lesser of \$25,000 or 25 percent of compensation. These limits have been modified several times since 1974, most recently by EGTRRA. The dollar annual benefit limit under a defined benefit plan has been increased to \$195,000⁸ in 2009, adjusted for changes in inflation in \$5,000 increments. The annual dollar contribution limit for defined contribution plans is \$49,000 in 2009 and will also increase in \$1,000 increments in the future as inflation increases.⁹ However, the percentage limitation for defined contribution plans was increased from 25 percent to 100 percent of compensation beginning in 2002.

Employee Contributions: Both pretax and after-tax employee contributions are included in computing the above limits. Furthermore, each of these has its own separate limits. Employee pretax contributions are limited to \$16,500 in 2009 and then adjusted for inflation in \$500 increments for 401(k) arrangements and 403(b) tax-deferred annuities. After-tax contributions in practice may be limited by nondiscrimination rules under IRC Sec. 401(k) and 401(m). (For further discussion of employee contributions, see chapter on 401(k) and cash/deferred arrangements.) There is an overall limit of \$245,000 (in 2009, adjusted for changes in inflation) on annual compensation that can be considered for calculating benefit and contribution limits. This, too, is adjusted for changes in the cost of living.

Reduction for Defined Benefit Plan Participation or Service of Less Than 10 Years: In the case of an employee who has less than 10 years of participation in a defined benefit plan, the dollar limitation is multiplied by a fraction, the numerator of which is the number of years (or part thereof) of participation in the defined benefit plan of the employer, and the denominator of which is 10. A similar reduction will be provided for the percentage limitation except that the reduction is applied with respect to years of service with an employer rather than years of participation in a plan.

For example, assume an employee begins employment with a defined benefit sponsor at the age of 58. The employer maintains only a noncontributory defined benefit plan that provides for a straight life annuity beginning

⁸ The dollar limit is reduced if benefits begin before age 62 and increased for benefits beginning after age 65. IRC Secs. 415(b)(2)(C), 415(b)(2)(D).

⁹ Certain participants may make catch-up contributions under 401(k) plans, simplified employee pensions, SIMPLE plans, and tax-sheltered annuities. A catch-up contribution will not be subject to the annual addition limitation.

at age 65. The employee becomes a participant a year later and works until he is age 65. The employee's average compensation for his high three years of service is \$20,000. Furthermore, under the terms of the plan, the employee has only seven years of service with the employer. Therefore, because he has less than 10 years of service with the employer at the time he begins to receive benefits under the plan, the maximum permissible annual benefit payable with respect to the employee is only \$14,000 ($\$20,000 \times \frac{7}{10}$).¹⁰

Definition of Annual Benefit for Defined Benefit Plans: The term *annual benefit* means a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions are made. A straight life annuity (aka, single life annuity) is one in which payments will cease upon the death of the annuitant. If the benefit under the defined benefit plan is payable in any other form, the determination as to whether the limitation has been satisfied shall be made, in accordance with regulations, by adjusting such benefit so that it is equivalent to the benefit described. However, that portion of any joint-and-survivor annuity which constitutes a qualified joint-and-survivor annuity shall not be taken into account.

For example, assume a corporation maintains a defined benefit plan that provides a benefit in the form of a joint-and-100-percent-survivor annuity with a 10-year certain feature. A *period certain* feature will guarantee that payments will continue for at least as long as the period certain, even if the annuitant dies prior to that time.

The value of this benefit is equal to 126 percent of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable in the form of a joint-and-100-percent-survivor annuity, without a 10-year certain feature, its value would be equal to only 123 percent of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable with a 10-year certain feature, but without the joint-and-100-percent-survivor aspect, its value would equal 110 percent of the value of the same amount payable as a straight life annuity beginning on the same date. Thus, the value of the post-retirement death benefits that would be payable even if the annuity were not in the form of a joint-and-survivor annuity is 10 percent.

Therefore, the values which may be excluded for purposes of the adjustment are as follows: The value of the joint-and-survivor annuity provided by the plan (126 percent) to the extent that such value exceeds the sum of the value of the straight life annuity beginning on the same date (100 percent) and the value of the post-retirement death benefits (10 percent). Therefore, the value of the joint-and-survivor annuity provided by the plan exceeds the

¹⁰ Treas. Reg. Sec. 1.415-3.

value of the straight life annuity with the 10-year certain feature by 16 percent (126 percent–110 percent).

Although 16 percent of the excess benefit attributable to the annuity provided by this plan may, consequently, be ignored (because this represents the value added to the 10-year certain and life annuity benefit by the joint-and-survivor feature), 10 percent of such excess benefit (the value added to the straight life annuity benefit by the 10-year certain feature) must be taken into account for purposes of adjusting the benefit under the plan to an actuarially equivalent straight life annuity. Thus, for example, if ABC Corporation were to provide a benefit equal to 95 percent of a participant's compensation for the high three years of service, the Sec. 415 limitation would be exceeded because the benefit under the plan would be the actuarial equivalent of a straight life annuity equal to 105 percent of a participant's compensation for the high three years.¹¹

Top-Heavy Plans

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established a new category of plans known as *top-heavy* plans. A plan is top heavy if more than 60 percent of the accounts or accrued benefits under the plan are attributable to key employees. A key employee is defined as:

- An officer¹² of the employer having an annual compensation greater than \$160,000 (in 2009, adjusted for changes in inflation).
- A 5 percent owner of the employer.
- A 1 percent owner of the employer having an annual compensation from the employer of more than \$150,000.

A top-heavy plan must satisfy special requirements for vesting and for contributions and benefits. The required vesting schedules for a top-heavy plan are *three-year cliff* or *six-year graded*.

Top-heavy plans must also provide a minimum benefit (for defined benefit plans) or a minimum contribution (for defined contribution plans) to nonkey employees. Under a top-heavy defined benefit plan, the annual retirement benefit of a nonkey employee must not be less than his or her average compensation¹³ multiplied by the lesser of 2 percent times the

¹¹ Treas. Reg. Sec. 1.415-3.

¹² No more than 50 employees (or, if fewer, the greater of 3 percent or 10 percent of the employees) shall be treated as officers.

¹³ A participant's average compensation means the participant's average compensation averaged over a period of no more than five consecutive years during which the participant had the greatest aggregate compensation from the employer.

number of years of service¹⁴ or 20 percent. Under a top-heavy defined contribution plan, the employer's contribution for each nonkey employee must not be less than 3 percent of compensation. However, if the highest contribution percentage rate for a key employee is less than 3 percent of compensation, the 3 percent minimum contribution rate is reduced to the rate that applies to the key employee.

Integration

Social Security benefits replace a greater proportion of preretirement earnings for lower-paid employees than for higher-paid employees. This is caused by two factors. Social Security taxes and benefits are based on earnings up to the taxable wage base rather than on all earnings. In addition, the Social Security benefit formula produces higher benefits—relative to earnings—for lower-paid employees. Thus, to help compensate for the greater Social Security benefits received by lower-paid employees, employers are permitted to provide proportionately higher pension benefits to higher-paid employees. This benefit coordination is known as *integration*. (For further discussion of this issue, see chapter on integrating pensions with Social Security.)

Types of Distributions and Tax Treatment

Pension plans generally offer retiring participants a choice between two payment options: an *annuity*, in which the benefit is paid out in a stream of regular payments, usually monthly and usually over the life of the participant (or lives of the participant and spouse) but sometimes over some other specified period; or in a *lump sum*. The type of distribution and when it is taken determines the tax treatment.

Distributions in the Form of an Annuity—Benefits from a qualified plan payable in the form of an annuity are only included in the employee's income as payments are received. A portion of any after-tax employee contribution to the plan is considered a return of the contribution and therefore is not taxable.¹⁵ An individual computes the tax-free portion of each year's

¹⁴ However, the following years of service are not taken into account for determining the minimum annual retirement benefits: a year of service within which a plan year ends for which the defined benefit plan is not top heavy; and a year of service completed in a plan year beginning before 1984.

¹⁵ Technically, there are two other components that may be received tax free: loans from the qualified retirement plan to the participant that were treated as taxable distributions and PS-58 costs (the amount of a participant's current taxable income as a result of receiving life insurance protection under a company's qualified retirement plan).

distribution by dividing his or her contributions and other amounts previously taxed by a specified factor.

The rules apply to distributions from pension or 401(k) plans, as well as distributions from Sec. 403(b) arrangements.

Lump-Sum Distributions—A lump sum is commonly offered in defined contribution plans for distribution at retirement, death, or disability. Some defined contribution plans also provide an annuity option for their participants.

Distributions for Special Events—Most pension plans pay benefits when events other than normal retirement or separation from service occur. Most of the benefit distributions are not mandatory. The amount of such benefits is usually based on the participant's accrued benefit at the time of the event.

Early Retirement—Early retirement benefits are generally payable when a participant satisfies certain age and/or age and service requirements. The early retirement benefit is usually the accrued benefit reduced to reflect a participant's increased duration of benefit receipt. Sometimes, to encourage early retirement, subsidized early retirement benefits are paid until the participant is eligible for Social Security retirement benefits. This type of benefit may be limited to participants with long service or to those who are retiring because of a plant shutdown or staff reduction. The maximum benefit payable from a defined benefit plan under IRC Sec. 415 must be actuarially reduced for retirees who claim benefits before age 62.

Disability Benefits—Disability benefits may be tied to age and/or age and service requirements and are usually contingent on satisfying the plan's definition of disability. The definition of disability for plan purposes may be linked to the definition of disability under Social Security. (For further discussion of disability benefits, see chapter on Social Security.) The benefit may be a flat-dollar amount that continues until the participant's normal retirement date (assuming he or she remains disabled); then, at the normal retirement date, the normal retirement benefit would become payable. Or, the plan may pay the participant the unreduced, accrued benefit during the period before he or she reaches normal retirement age. Under yet a different method, the plan may reduce the participant's accrued benefit to reflect that benefits are paid before normal retirement. In some plans, disabled participants continue to accrue benefits from the time they become disabled through their normal retirement age. Where an employer also provides a long-term disability (LTD) plan, the pension plan benefit is usually postponed until the LTD benefit stops to avoid duplicate payments.

Late Retirement Benefits—Most pension plans specify age 65 as the normal retirement age for plan participants, but employers may not force employees to retire because of age. These plans must reflect how benefits will

be calculated for participants who remain employed beyond age 65. A plan must now recognize earnings and/or service after age 65 for pension contribution and benefit purposes.

Death Benefits Before Retirement—Some plans must provide a preretirement survivor benefit to the spouse of a vested participant who dies before retirement. The benefit is payable in the form of an annuity for the life of the surviving spouse, beginning at what would have been the employee's earliest retirement date, or death, whichever is later. The annuity must be equal to at least one-half of the participant's accrued benefit at the time of his or her death. To reflect the cost of providing survivor protection, the law permits employers to provide a lower benefit to the participant. Written spousal consent is needed to elect out of the coverage.

Death Benefits After Retirement—Retirement benefits must typically be paid to married persons as a joint-and-survivor (J&S) annuity (if an annuity is a payment option). This provides the surviving spouse with monthly income equal to at least one-half the amount of the participant's benefit. To reflect the cost of the survivor protection, the participant's benefit is usually reduced. Both the participant and the spouse must give written consent to waive the J&S annuity.

Premature (Early) Distributions—A 10 percent penalty tax is imposed on most pension plan distributions paid to individuals prior to age 59½. The penalty is designed to discourage the use of these funds prior to retirement. Distributions under certain conditions are exempt from the tax, including amounts rolled over to an individual retirement account (IRA) or other qualified plan, as are most distributions in the form of an annuity. See chapter on IRAs for specified exemptions.

The Unemployment Compensation Amendments Act of 1992 (UCAAA) affects qualified pension plan distributions by imposing a mandatory 20 percent income tax withholding on eligible rollover distributions that are not transferred as direct rollovers.

Loans—The availability of loans to participants is an exception to ERISA's general principle that transactions between a plan and parties in interest—such as participants—are prohibited because of potential abuse of funds earmarked for retirement. Plan loans are generally not treated as taxable distributions and are restricted to limited circumstances defined under IRC Sec. 72 and ERISA Sec. 408(b)(1).

A plan loan must be described in writing. The amount of a new loan plus the outstanding balance of any other plan loans cannot exceed the lesser of \$50,000 or the greater of one-half of the present value of the employee's nonforfeitable accrued benefit under the plan or \$10,000. The \$50,000 limit is reduced by the excess of the highest outstanding loan balance during the

one-year period ending on the day before the new loan is made, over the outstanding balance on the date of the loan.

Loans must be repaid within five years. A longer term is available only for loans used to acquire the participant's principal residence. The loan must require substantially level amortization payments, payable at least quarterly. The interest rate must reasonably reflect rates charged on comparable loans made on a commercial basis. The loan must be adequately secured so that, in the event of a default, the participant's retirement income is preserved and loss to the plan is prevented.

Rollovers—In general, lump-sum distributions from a qualified pension plan may be rolled over tax free into an IRA or another retirement plan. The transfer must be made within 60 days of the participant's receipt of the distribution to prevent current treatment as a taxable distribution.

Timing of Distributions—Distributions of qualified plan balances must generally begin by April 1 of the year following the later of (1) the year in which the individual attains age 70½ or (2) the year the employee retires from employment with the employer maintaining the plan. A minimum distribution is required to be paid out each year, loosely equal to the value of the individual's account divided by the individual's life expectancy, if the form of benefit payment is a lump sum. If the form of benefit is an annuity, the required distribution is the amount of the annual annuity payment. A 50 percent nondeductible excise tax is imposed on the individual in any taxable year on the difference between the amount required to be distributed and the amount actually distributed.

Defined Benefit Plan Termination Insurance

Although pension plans must be established with the intent that they will be permanent, employers are permitted to terminate their plans. If a defined benefit plan terminates with assets greater than the amount necessary to pay required benefits, the employer may recover the excess assets and use them for business or other purposes. A 50 percent excise tax is imposed on the amount recovered.¹⁶ ERISA established plan termination insurance to protect participants' benefits in the event a plan terminates with insufficient assets to pay benefits.

Title IV of ERISA established the PBGC to insure payment of certain pension plan benefits in the event a covered (i.e., private-sector defined benefit) plan terminates with insufficient funds to pay the benefits. Covered

¹⁶ This penalty is reduced to 20 percent if: (1) 25 percent of the otherwise recoverable reversion is transferred to another qualified retirement plan that covers at least 95 percent of the active participants of the terminated plan; (2) 20 percent of the otherwise recoverable reversion is used to provide pro rata increases in the benefits accrued by participants under the terminated plan; or (3) the employer is in Chapter 7 bankruptcy liquidation.

plans or their sponsors must pay annual premiums¹⁷ to PBGC to provide funds from which guaranteed benefits can be paid. Both single-employer and multiemployer plans are covered under Title IV, but under separate insurance programs. Coverage is mandatory if the employer is in interstate commerce or the plan has been determined to be qualified for tax-favored status. Certain plans are exempt, including defined contribution plans, government and church plans, plans established by fraternal societies to which no employer contributions are made, and plans established and maintained by a professional service employer with 25 or fewer participants in the plan. The contributing sponsor or plan administrator must pay the premiums imposed by the PBGC. If the contributing sponsor of any plan is a member of a controlled group, each member is jointly and severally liable for any premiums.

Termination Policy—Voluntary terminations of single-employer plans are restricted to two cases: a standard termination and a distress termination. (PBGC may, at its discretion, force a termination in certain situations. This is known as an involuntary termination.) A standard termination is permitted only if the plan has sufficient assets to pay all of the plan's benefit liabilities.

Underfunded single employer¹⁸ defined benefit plans may only terminate in a distress situation, which is allowed only if the entire corporate (controlled) group would not be able to pay its debts pursuant to a plan of reorganization without the termination or would be unable to continue business outside the Chapter 11 reorganization process. A distress termination is only possible with the approval of the bankruptcy court or PBGC.

Covered Plans and Benefits—PBGC guarantees certain nonforfeitable retirement benefits, and any death, survivor, or disability benefit either owed or in payment status at plan termination, under defined benefit plans covered by Title IV should such a plan terminate. Benefit guarantees are expressed in terms of life annuities, which are regular payments beginning at age 65 and made over the life of the beneficiary.

There are certain restrictions on the monthly benefit amount PBGC will pay. In general, payment of guaranteed benefits is limited to a maximum dollar amount that is adjusted annually to reflect increases in workers' wages. The maximum annual benefit in 2009 is \$54,000. The limit applies to a participant's total guaranteed benefit under all plans in which he or she is covered; it is not possible to receive separate insurance protection under several plans and, thus, to increase the total guaranteed benefit.

¹⁷ See chapters on defined benefit plans and multiemployer plans for a description of the premiums for single-employer defined benefit plans and for multiemployer plans.

¹⁸ See chapter on multiemployer plans for a description of the requirement.

Insurance on new benefit provisions (i.e., benefits resulting from newly established plans or recent plan amendments) is phased in at 20 percent per year (or \$20 per month if higher). Therefore, full insurance coverage may not apply to some benefits until they have been in effect for five years prior to plan termination. The guarantee pertains exclusively to benefits earned while the plan is qualified for favorable tax treatment. Additionally, benefits are guaranteed up to the stipulated maximum.¹⁹

Employer Liability to PBGC—If a plan terminates in a distress situation with insufficient assets to meet all benefit liabilities, the contributing plan sponsor and each member of the controlled group is jointly and severally liable to PBGC for the total amount of unfunded liabilities plus interest on such liabilities from the termination date. Different rules apply for multiemployer plans.²⁰

Fiduciary Requirements

Employers who sponsored retirement plans before ERISA²¹ were subject to one general fiduciary standard: plans had to be operated for the exclusive benefit of participants and beneficiaries. ERISA expanded this principle and applied it to almost all employee benefit plans. Fiduciaries are broadly defined as those who exercise control or discretion in managing plan assets; those who render investment advice²² to the plan for direct or indirect compensation or have authority to do so; and those who have discretionary authority in administering the plan. They may include individual employers and officers and will include trustees and plan administrators. Attorneys, actuaries, accountants, and consultants would generally not be considered fiduciaries when performing their normal professional services.

In fulfilling their responsibilities, fiduciaries must act in the exclusive interest of plan participants and plan beneficiaries, diversify the plan's

¹⁹ See chapter on multiemployer plans for a description of the guaranteed benefits.

²⁰ See chapter on multiemployer plans for a detailed description.

²¹ See chapter on Employee Benefits in the United States: An Introduction.

²² The Labor Department issued proposed rules in August 2008 that would make it easier for participants in 401(k)-type plans to get investment advice. The proposed rules would implement provisions of the Pension Protection Act of 2006. One of the ways in which investment advice may be given under the 401(k) proposal is through the use of a computer model certified as unbiased; the other is through an adviser compensated on a "level-fee" basis. Several other requirements also must be satisfied, including disclosure of fees the adviser is to receive. The regulation provides general guidance on the proposed requirements, including computer model certification, and includes a nonmandatory model form that advisers may use to satisfy fee disclosure provisions. To further the availability of advice, the department proposed permitting advisors to provide individualized advice to a worker after giving advice generated by use of a computer model.

assets to minimize risk of large losses, and act in accordance with documents that govern the plan.

Fiduciaries must act with the care, skill, prudence and diligence under the circumstances then prevailing that a “prudent man” acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. This standard is frequently referred to as ERISA’s *prudent man rule*. Because the performance standard is so high, the prudent man rule is often referred to as the *prudent expert* rule.

Fiduciaries must meet this test in performing any aspects of plan operation for which they are responsible—from selecting the individual or institution that will handle plan asset investment to setting investment objectives. A fiduciary who violates ERISA’s standards may be personally liable to cover any losses resulting from failure to meet responsibilities and may be required to return any personal profits realized from his or her actions. Additionally, fiduciaries may be liable for the misconduct in some circumstances, e.g., if they know about such misconduct and fail to take appropriate remedial action.

The Department of Labor (DOL) is responsible for enforcing these standards. In certain situations, DOL may bring suit on behalf of participants in plans that do not satisfy ERISA’s fiduciary standards. DOL may also assess a monetary penalty for any breach of fiduciary responsibility even with respect to a person other than a fiduciary who knowingly participates in the wrongdoing.

Certain transactions between a pension plan and parties in interest are prohibited. Parties in interest include, but are not limited to, a fiduciary, a person providing services to the plan, an employer whose employees are covered in the plan, an owner of 50 percent or more of the business, a relative of any of the above parties, or a company at least 50 percent owned by any individual noted above. Prohibited transactions include: the sale, exchange, or leasing of property; lending money or extending credit; furnishing goods, services, or facilities; use of plan assets; and acquisition of qualifying employer securities and real property in excess of allowable limits.²³

ERISA provides specific exemptions for certain circumstances as well as a process for applying to the DOL for an administrative exemption. ERISA prohibits anyone, including the employer, from discriminating against a participant to prevent the participant from obtaining benefit rights or for

²³ The Department of Labor provides the Voluntary Fiduciary Correction Program, which allows plan officials to identify and fully correct certain prohibited transactions. In 2006, the Program covers 19 specific transactions that could result in fiduciary breaches and prohibited transactions. For more details, see www.dol.gov/ebsa/newsroom/fs2006vfcp.html

the exercise of his or her benefit rights. If a participant is fired or otherwise discriminated against in violation of this provision, he or she may seek assistance from DOL or may file suit in federal court.

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