Overview of U.S. Pension System

- Private pension are key to supplement Social Security benefits during a worker's retirement years.

- Why is this important? – Help workers receive an adequate level of income in retirement.

- Employment-based (employer-sponsored) retirement benefits are a very important source of income for many retirees.

- Our story begins in 1974, with the passage of the Employee Retirement Income Security Act of 1974 (ERISA). Actually begins earlier than that. Why would Congress need to pass a law regulating employee benefit plans?

Early Attempts at Pension Programs:

Railroad Plans – employer acting alone

1. *Why were they established*?
   - ✓ Large numbers of workers in hazardous jobs,
   - ✓ Mandatory retirements at age 70 for safety reasons,
   - ✓ Able to attract massive amounts of capital – pensions funded from current income.

2. *What did they promise*?
   - ✓ If you remain employed with this company throughout your productive lifetime,
   - ✓ If you do not die before the retirement age,
   - ✓ If you are not discharged or laid off for an extended period,
   - ✓ If you are not refused a benefit as a matter of discipline (join union, ask for a raise),
   - ✓ If the company continues in business, and

- ✓ If the company does not decide to abandon this plan,
- ✓ You will receive a pension subject to discontinuance or reduction.

3. *Why did they fail?*
   - ✓ Railroad revenues declined; no pension reserves,
   - ✓ Number of railroad workers expecting to be retired because of age or years of service was increasing,
   - ✓ Government bail-out, i.e., "substantial federal appropriations to cover immediate obligations"

Union Plans – union acting alone

1. *Why were they established*?
   - ✓ Safeguard against financial losses of their members,
   - ✓ Originally not for old-age concerns, but for wage replacement during strikes, permanent disability, death benefits, other concerns of their young male membership,
   - ✓ Helped build unions and conserve members.

2. *What did they promise*?
   - ✓ Benefits depending on the state of the union treasury.

3. *Why did they fail*?
   - ✓ Benefits paid for by assessments on union members,
   - ✓ As older workers increased, assessments had to increase Great Depression; other union priorities,
   - ✓ Negotiated Employer-Financed Plans – union used ability to strike,
   - ✓ Mine Workers' Plan, Steel Plans, Automobile Plans.

The force Behind Funded Plans – Employee Retirement Income Security Act (ERISA) - The Studebaker Story:

Studebaker Plant Closing A Pre-ERISA Funding Plan Failure

- ✓ December 1963 after a long period of losing money, Studebaker plant in South Bend, Indiana closed.
- ✓ Eventually laid off about 9,000 workers all members of the UAW.
- ✓ Covered under a single employer pension plan negotiated between the UAW and Studebaker.
- ✓ UAW and the company entered into an agreement to terminate the plan, which had about $24 million in assets.

They created priorities:

- ➢ 3,600 retirees and active workers over age 60 (permitted retirement age) - received full lifetime annuities $21.5 million;
- ➢ 4,000 workers aged 40 to 59 who had vested (10 years of service).
- ➢ Only $2.5 million left, so this group got lump sum payments equal to about 15% of their accrued benefits.
- ➢ 2,900 workers who were not vested - got nothing

Obviously, the plan was underfunded. How?

- ✓ Plan started in 1950;
- ✓ Gave prior service credits (for service before the plan was created), so immediate unfunded liability of $18 million; supposed to fund over 30 years.
- ✓ Kept increasing benefits in 1953, 1955, 1959 and 1961.
- ✓ Each time they increased benefits, additional unfunded liabilities for the past service credits (retrospective improvements in an ongoing plan) were granted.
- ✓ Had not funded the unfunded past service liabilities when the plant closed and the plan was terminated.

Why did this capture attention?

- ✓ Workers were laid off just before Christmas.

- ✓ Studebaker was the oldest major auto producer in the U.S.
- ✓ Plan covered almost 11,000 Studebaker employees.
- ✓ Those who got 15 cents on the dollar averaged age of 52 and average years of service of 23.

ERISA AND YOUR PENSION PLAN

- What is the purpose of the Employee Retirement Income Security Act?
- What does it cover and what is excluded from its coverage?
- ERISA tells which plans are exempt from the law and who administers the law.

The following questions are addressed:

- ➢ What is the Employee Retirement Income Security Act?
- ➢ What pension plans are covered by ERISA?
- ➢ How does the law protect a plan's assets?
- ➢ What are ESOPs and 401(k) plans?
- ➢ What are profit sharing plans, stock bonus plans, and SEPs?
- ➢ What is the role of Federal agencies?

What is ERISA?

T The Employee Retirement Income Security Act of 1974 (ERISA), a federal statute, delineates minimum standards for the administration of private industry's pension plans and establishes the impact that federal income taxes will have on transactions associated with management of such pension plans. The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for the administration of pension plans in private industry, and establishes the impact of federal income taxes will have on transactions associated with management of such pension plans. For example, if your employer maintains a pension plan, ERISA specifies:

- ➢ When you must be allowed to become a participant,

- How long you have to work before you have a non-forfeitable interest in your pension,
- How long you can be away from your job before it might affect your benefit, and
- Whether your spouse has a right to part of your pension in the event of your death.

The statute also creates causes of action for employee plan participants and their beneficiaries.

- ✓ Requiring the disclosure of financial and other information concerning the plan to beneficiaries;
- ✓ Establishing standards of conduct for plan fiduciaries;
- ✓ Providing for appropriate remedies and access to the federal courts

Effective: Most of the provisions of ERISA are effective for plan years beginning on or after January 1, 1975.

Note: ERISA does **not** require any employer to establish a pension plan. It only requires that those who establish plans must meet certain minimum standards.

The law generally does not specify how much money a participant must be paid as a benefit.

ERISA does the following:

- Requires plans to provide participants with information about the plan including important information about plan features and funding. The plan must furnish some information regularly and automatically. Some is available free of charge, some is not.
- Sets minimum standards for participation, vesting, benefit accrual and funding. The law defines how long a person may be required to work before becoming eligible to participate in a plan, to accumulate benefits, and to have a non-forfeitable right to those benefits.
- The law also establishes detailed funding rules that require plan sponsors to provide adequate funding for your plan.

- Requires accountability of plan fiduciaries. ERISA generally defines a fiduciary as anyone who exercises discretionary authority or control over a plan's management or assets, including anyone who provides investment advice to the plan. Fiduciaries who do not follow the principles of conduct may be held responsible for restoring losses to the plan.
- Gives participants the right to sue for benefits and breaches of fiduciary duty.
- Guarantees payment of certain benefits if a defined benefit plan is terminated, through a federally chartered corporation, known as the Pension Benefit Guaranty Corporation.

How ERISA is Administered?

ERISA is sometimes used to refer to the full body of laws that regulate employee benefit plans, which are mainly in the Internal Revenue Code and ERISA itself.

- ✓ Responsibility for interpretation and enforcement of ERISA is divided among the
  - ➢ Department of Labor,
  - ➢ the Department of the Treasury (particularly the Internal Revenue Service), and the
  - ➢ Pension Benefit Guaranty Corporation.

Ttile 1 – Protection of Employee Benefit Rights. Subtitles A & B. B further broken down into Parts 1 – 7.

Title IV – Plan Termination Insurance – Subtitle A – D.

Title II – Qualification requirements in Internal Revenue Code.

IMPORTANT: Here is the split under Title I of ERISA – you are either a "***welfare*** plan" or a "***pension*** plan". Welfare plans are not covered in this class.

ERISA section 3(2) – A "*pension plan*" either:

(1) Provides *retirement income*, or

(2) Results in a *deferral of income* by employees for periods *extending to the termination of covered employment or beyond*

Note: Under the Internal Revenue Code – you are either a "***pension plan***" (Defined Benefit Plan) or a "***profit sharing plan***" (Defined Contribution Plan).

IRS Reg section 1.401-1 "Qualified pension, profit-sharing and stock bonus plans"

- "*Pension Plan*" – to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. Determination of amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits.

- "*Profit sharing Plan*" – to provide for participation in profits by employees. Definite predetermined formula for allocating contributions and distributing funds accumulated under the plan after a fixed number of years, attainment of a stated age, or occurrence of some event such as layoff, illness, disability, retirement, death or severance of employment. Primarily a plan of deferred compensation.

Note: A "profit sharing plan" is an ERISA pension plan, but not an IRC pension plan.

Under "pension plans" in ERISA, there are two more splits:

ERISA section 3(34) – An "*individual account plan*" (or "defined contribution plan") means a pension plan providing for an individual account for each participant, and for benefits based solely upon the amount contributed, plus income, losses, forfeitures, etc.

ERISA section 3(35) – A "*defined benefit plan*" is a pension plan other than an individual account plan.

1. ***Defined Contribution Plans*** – "Individual Account Plans"

- Benefits are based on amount of contributions employer makes to plan – focus on the **input**. Example: 5% of his total earnings in the Plan Year.
- Held in a separate account and paid at retirement.
- Income/expenses and gains/losses are allocated to the account.
- Participant bears investment risk.
- Annual contributions may not be required, such as profit-sharing plans.
- Employees may be permitted to make contributions - pre-tax ("cash or deferred" 401(k) – instead of taxable compensation, employer makes contribution to the plan) or after-tax.
- May have employer matching contribution

2. ***Defined Benefit Plans –*** Other than DC plan

- Benefit is expressed as a certain amount to be paid at an employee's retirement – focus on the **output**.
- Investment risk is with the employer.
- Usually fixed monthly amount for the retiree's (and spouse's) life (annuity).
- Plan formula usually based on years of service and earnings (could be average of high 5 or high 3), multiplied by a percentage (could be 1-2%).
- Employer must fund with help of actuary – make sure there is enough money to pay the benefits when due. Actuary projects plan participation, future salary increases, rates of returns, etc.
- Pooled trust – no individual accounts.
- Can be "integrated" with Social Security – lower benefit accrual rate for lower amounts of compensation and higher benefit accrual rate for compensation above a certain level.

Formulas:

Unit benefit – specified unit of benefit for each year of service (for example percentage of compensation per year of service)

(1) 1.13% of the Participant's Average Compensation, times the number of Years of Credited Service not in excess of 35, plus (2) .40% of the Participant's Average Compensation in excess of monthly Covered Compensation times the number of Years of Credited Service not in excess of 35. [“unit credit” formula per 401(a)(4) regs].

Flat benefit –flat dollar amount regardless of salary or service, i.e. $250/month at retirement.

Fixed benefit – fixed percentage of compensation at retirement, i.e., 20% of compensation (but may be based on a threshold number of years of service). [Per 401(a)(4) regs, either same % of compensation or same $ amount for employees with minimum number of YOS at NRA. If 25 YOS at age 65, get 50% of compensation, pro rata reduction if less than 25 YOS.]

Variable or equity type benefit – adjusted periodically after retirement according to a recognized cost-of-living index.

3. Comparing Defined Benefit and Defined Contribution Plans

Advantages of Defined Benefit Plans

For employees:

- ✓ High degree of retirement security – guaranteed benefit.
- ✓ Pension Benefit Guaranty Corporation (PBGC) insures at least a portion of the benefit in the event of employer insolvency.
- ✓ Benefit often related to final pay – guard against inflation.

For employers:

- ✓ If investment return is good, required pension contributions will go down.
- ✓ Can more accurately integrate benefits with Social Security in reaching income replacement goals (although can integrate contributions to a defined contribution plan).

- ✓ Can reduce pension costs by not including a death benefit (other than a spousal QPSA).
- ✓ Bigger benefits for employees with longer service and higher pay – rewards lifetime contribution to the employer.

Disadvantages of Defined Benefit Plans

- ✓ Slowly accumulates retirement income – worse for short service employees.
- ✓ More complex and costly to maintain.
- ✓ Had been favored by unions, manufacturing, long-service employers – employment trends are away from this type of employment.

Advantages of Defined Contribution Plans

For employees:

- ✓ Quickly accumulate retirement income.
- ✓ Entire account balance generally payable upon death or disability

For employer:

- ✓ Lower cost to administer.
- ✓ No funding projections

Disadvantages of Defined Contribution Plans

- ✓ Benefits depend on investment return. Investments must outpace inflation.
- ✓ In certain plans, investments could primarily be in employer stock (stock bonus plans, ESOPs) – even more risk.
- ✓ Contributions based on current pay and investment return – can't predict with achieve income replacement goals.

Different Types of Defined Contribution Plans

1. ***Money Purchase Pension Plan*** – contributions must be fixed or determinable, typically a percentage of compensation. Contributions go into a separate account for each employee and are credited with

investment earnings (or losses!). Contributions are required. (This is an IRC “pension plan.”)

2. ***Target Benefit Plan*** – instead of defining contributions based on percentage of current pay, contributions are calculated more like a defined benefit plan. Contributions are meant to fund a target age 65 benefit level.

- ✓ Results in larger contributions for older employees.
- ✓ Doesn’t guarantee target. If investments are disappointing, retiree won’t get target benefit level. (This is an IRC “pension plan.”)

Example. The Company contribution shall equal the amount necessary to fund the applicable Target Benefit for the Plan Year with respect to a Participant, such amount to be determined each Plan Year as follows:

Step 1: Present Value of Target Retirement Benefit. Calculate the present value of the Participant's Target Benefit as follows:

1.1 Determine the Participant's Target Benefit (based upon Years of Service and Average Annual Compensation to date and projected future Years of Service to Normal Retirement Age).

1.2 Determine the present value of the Participant's Target Benefit by: (i) multiplying the Target Benefit by the appropriate Annuity Date factor determined by using a Mortality Table and an assumed interest rate and (ii) then multiplying the result by the appropriate present value factor using an assumed interest rate.

Step 2: *Theoretical Asset Accumulation*. Calculate the portion of the Participant's Target Benefit that has theoretically been funded to date (his "Theoretical Asset Accumulation"). For the Plan Year beginning July 1, 1991, the Theoretical Asset Accumulation is zero (0). For Plan years beginning July 1, 1992 and thereafter, the Theoretical Asset Accumulation equals the 2.1 value, as adjusted in 2.2 as follows:

2.1 Current Methodology Contributions to Date. Determine the actual annual contributions made by the Company for the Participant under this Section 3.01(b) for each Plan Year beginning on or after July 1,

1991 and continuing through the Plan Year preceding the current Plan Year.

2.2 Accumulation to Date. Accumulate the contributions described in 2.1 at interest from July 1, 1991 up through the last day of the current Plan Year by sequentially applying the actuarial assumptions in effect under the Plan for each such Plan Year to the accumulation in effect at the end of the preceding Plan Year.

Step 3: Target Benefit Still To Be Funded. Calculate the present value of the portion of the Participant's Target Retirement Benefit remaining to be funded by subtracting the Step 2 value from the Step 1 value.

Step 4: Current Annual Company Contribution. Calculate the Company contribution for the Participant for the current Plan Year by multiplying the Step 3 value by the appropriate amortization factor, using an assumed interest rate of 7.5% and the Participant's age on his or her nearest birthday (or, if the Participant has attained his or her Normal Retirement Age in the current or any prior Plan Year, by 1.0).

3. ***Profit Sharing Plans*** – doesn't include plans where share of profits given at end of each year (such as a bonus). *To be a retirement plan, must have a definite predetermined formula for allocating contributions and for distributing funds after a fixed number of years, attainment of a stated age, or upon the occurrence of layoff, illness, disability, death or severance of employment.* Typical allocation formula is in proportion to compensation.

- ✓ Used to need profits, but not anymore. Can say that company will determine contribution each year.

Questions: Why doesn't this work as a retirement plan? Why would an employer prefer this type of plan over a money purchase pension plan?

4. ***Stock Bonus Plan*** – Like a profit sharing plan, but the benefits are distributable in company stock. Contributions are made in stock, or made in cash and then the plan purchases the stock on the market.

5. ***401(k) Plan*** – Employee elects to have a portion of his or her cash compensation contributed to a retirement plan on the employee's behalf. Typically percentage of compensation, with option for a flat dollar amount. *Known as a "cash or deferred election" and the plan a CODA*.

- ✓ Might get to choose to receive a profit-sharing allocation in cash or have it contributed to the plan.
- ✓ May have an employer match, for example 100% on the first 3% of compensation contributed, or 50% on the first 6% of compensation.
- ✓ Originally supplementary plans; now offered more frequently as the only retirement plan (sometimes coupled with a discretionary match or profit sharing contribution).
- ✓ Many 401(k) plans offer investments in a range of mutual funds, or stock or bond portfolios, and even company stock. Employee gets to choose.

Multiemployer Plans (Union Pension Funds):

- Employers within a single industry contribute to the same plan pursuant to collective bargaining agreements.
- Governed by the Taft-Hartley Act, which requires equal number of union and employer representatives as plan trustees.
- Useful for industries with small employers or high mobility between employers (such as construction workers).
- Employer contribution is negotiated – usually cents per hour, but the benefit is a guaranteed defined benefit.
- To prevent the fund from collapsing if an employer stops contributing, withdrawal liability is imposed – statutory formulas – fund's actuaries determine the health of the fund and whether withdrawal liability will be imposed.

Cash Balance Plans – more discussion later – a Defined Benefit Pension plan that presents itself as having account balances (theoretical accounts with pension and interest credits).

A Look at tax-favored retirement savings vehicles:

"***Qualified plans***" – employer-sponsored pension, profit-sharing, or stock bonus plans that meets the requirements of Code section 401(a) – may be called "401(a) plans."

Benefits of a "qualified plan" – if you do it right –

Preferential tax benefits intended to be an incentive for employee's to save for retirement – under DB and DC plans.

- Employees only pay income tax when the amounts are distributed, not when the employer contributes the money to the trust.
- This is the case even though the employee may have a vested economic benefit (i.e., it's the employee's money at that point, but the taxation is deferred).
- Employers get a current income tax deduction.
- Trust is exempt from tax on its investment income. (So the contribution earns interest and the contribution + interest earns interest.
- Compounding of interest. No taxes are paid on the interest, so more is available for future compounding. Pre-tax compounding of interest. BUT this assumes investment gain, not loss.)

Fundamental Requirements

The private pension plan system is complex because employers offer a variety of plans to their employees, and sponsors must ensure that the design and operation of their plans satisfies a myriad of laws and regulations.

1. *Plan must be established by an employer*. Self-employed is okay – called "Keogh" plans or H.R. 10 plans. Used to have special rules. Now regulated mostly by the top-heavy rules – if too much of the plan is attributable to certain key employees, must provide a minimum benefit for non-key employees.

2. Plan must be for *the exclusive benefit* of employees/beneficiaries. Employer can receive incidental benefits like good will and enhanced productivity.

3. Plan *participants must be employees*. No independent contractors! Sole proprietors and partners may participate as owner employees. Employee may designate beneficiaries, but benefits paid to beneficiaries (i.e., death benefits) must be incidental.

[S. Ct ERISA case – Nationwide Mutual v. Darden – difference between employee and independent contractor. S. Ct settled on common law employee test – who controls the manner and means by which the product is accomplished.]

4. Plan must be *intended to be permanent*. If terminate within a few years, look for a legitimate business reason such as bankruptcy, sale of business, financial difficulty.

5. *No diversion of plan assets*. Held in trust and used solely to provide plan benefits to employees/beneficiaries or to pay admin or investment expenses. Limited exceptions for return of contributions or DB reversion after all liabilities have been satisfied.

Formal Requirements

1. *Plan must be in effect*. Formally adopted (Board resolutions) and any trust instruments executed by the end of the employer's taxable year for which the deduction is claimed (not the tax return due date). Initial contribution due by the due date for filing the employer's tax return (including extensions). Annuity contracts issued by an insurance company may be used by a plan, in lieu of a trust. [Note on annuity contracts – plans developed as insurance company products – surrender charge for premature termination]

2. *Written plan document*. Must include procedure for implementing funding policy, allocating fiduciary responsibilities, procedure for amending plan, identifying who may amend the plan, and the basis on which benefits are distributed.

3. *Communicated to employees*. ERISA requires a summary plan description (SPD) to be furnished to participants within 120 days after the plan is established (or 90 days after an individual become a participant).

Usually, employers send out a shorter piece announcing the plan because they are still working on the SPD.

Qualification Requirements

To encourage employers to establish and maintain pension plans for their workers, the Federal government provides preferential tax treatment under the Internal Revenue Code (IRC) for plans that meet certain requirements, i.e., Qualification requirements (Qualified plans).

Pension tax preferences are structured to strike a balance between:

(1) Providing incentives for employers to establish and maintain voluntary, tax qualified pension plans, and

(2) Ensuring participants receive an equitable share of the tax-favored benefits – 2015 – Revenue expenditures DB = $66.6 (billion); DC = $62.1 (billion); IRA = $18.4 (billion). 2016-2015 = $903 (billion).

To get the tax benefits, pension plans must meet certain requirements, i.e., obligations of sponsoring employer**.**

Internal Revenue Code §401(a) Qualification Requirements:

1. **401(a)(3)** – must satisfy minimum participation standards in §410 (age 21/1YOS).

2. **401(a)(4)-(5)** – contributions or benefits must not discriminate in favor of HCEs.

3. **401(a)(7)** – must comply with minimum vesting in §411, DB accrual standards in §411(b)

4. **401(a)(8)** – DB cannot use forfeitures to increase benefits

5. **401(a)(9) –** minimum required distributions (70-1/2 rules)

6. **401(a)(10)** – must comply with top-heavy rules in §416

7. **401(a)(11)** – must comply with QJSA and QPSA rules

8. **401(a)(12)** – no decreased benefits due to plan merger

9. **401(a)(13)** – no alienation except in limited circumstances (QDROs)

10. **401(a)(14)** – benefit must commence at latest of NRA, 10 years of participation, or termination of employment

11. **401(a)(16)** – must comply with the §415 limits on benefits/contributions

12. **401(a)(17)** – compensation for plan purposes cannot exceed $200,000 (adjusted for inflation)

And it keeps going – we are now up to 401(a)(37) – some are quite narrow, but here are some of the broader ones:

13. **401(a)(26)** - Additional participation requirements for DB plans

14. **401(a)(27)** - Contributions need not be based on profits

15. **401(a)(30)** – Must comply with the §402(g) limit on elective deferrals ($16,500 in 2010)

16. **401(a)(31)** - Direct rollovers to IRAs and other retirement plans

17. **401(a)(32)-(33)** - Rules to make sure DB plans are adequately funded

18. **401(a)(34)** - Benefits of missing DB participants can be transferred to PBGC

19. **401(a)(36)** - Distributions during working retirement (age 62)

20. **401(a)(37)** - Death benefits under USERRA-qualified active military service

Some of these provisions are identical to provisions in Title I of ERISA (the 200s). Only found in the Code are permanency, incidental death benefits, minimum coverage and nondiscrimination, full vesting upon plan termination, 415 limits, and top-heavy rules. These all justify the tax subsidy for 401(a) plans.

IRS has authority for minimum funding, coverage, and vesting. DOL has authority for fiduciary standards and some minimum participation standards (because responsible for regs defining HOS, YOS, BIS).

Pension Benefit Guaranty Corporation (PBGC) controls the DB plan termination insurance.

What is the current face of our retirement system?

In 1980 there were approximately 250,000 qualified Defined Benefit Pension plans covered by PBGC. As of 2011 only 10% of private employers offered a pension plan (not DC) accounting for 18% of employees in the private workforce.

The percentage of workers covered by a traditional DB pension plan (pays a lifetime annuity, often based on years of service and final salary) has been steadily declining over the past 25 years.

The percentage of workers covered by a Defined Contribution plan (an investment account established and often subsidized by employers but owned and controlled by employees) increased from 1980 to 2008 from 8% to 31%.

Note: Approximately 90% of employees in public sector are covered by a traditional pension plan compared to approximately 10% of workers in the private industry.

Recently, many employers have frozen their DB pension plans. Experts expect all DB pension plans will eventually be all frozen.

Under a typical DB plan freeze, current plan participants will receive retirement benefits based on their accruals up to date of the freeze but will not accumulate any additional benefits (hard freeze), and new employees are not covered under the plan.