I. Types of Retirement Plans

There are many types of retirement plans within two major categories:

Defined Benefit and Defined Contribution.

A. Examples of defined contribution plans are profit sharing, money purchase, stock bonus, employee stock ownership, target benefit, IRC §401 (k), IRC §403(b) and age-weighted profit sharing plans. A defined contribution plan is an individual account plan. Generally, the contribution amount is specified by the plan. In some cases, the allocation of contributions is specified, but the amount of contribution is determined by the employer within certain limits.

1. Most profit sharing plans do not have a required contribution. However, once a contribution has been made, it is allocated to the participants' accounts in accordance with the plan documents.

2. A money purchase pension plan has a required contribution that is set forth in the plan document. The contribution is allocated to the participants' accounts so that the required contribution for each participant is allocated to the individual's account.

3. Contributions to a target benefit plan are calculated using a defined benefit formula. The contributions are allocated to the participants' accounts, and the benefit paid at retirement is a participant's account balance.

4. The funds may be commingled in an investment pool so that the accounts are really a bookkeeping entry or each account may be separately invested depending on the terms of the plan.

5. The ultimate benefit the participant receives is based entirely on the participant's account balance. For this reason, the participant bears the risk of investment, since low investment returns will result in a smaller amount at retirement. The employer does not guarantee the benefits under the plan.

6. A defined contribution plan generally favors younger employees since money invested over a long period of time tends to accumulate to large amounts.

B. Examples of defined benefit plans are flat benefit, unit benefit, floor-offset, cash balance and fully insured IRC §412(i) plans. A defined benefit plan is defined as any plan that is not an individual account plan. Defined benefit plans can provide certain benefits other than retirement benefits. The typical plan provides a stated monthly benefit at retirement for as long as the participant lives and may even provide benefits to the participant's beneficiaries.

1. The benefit the participant receives is guaranteed by the employer. The participant does not bear the investment risk since the employer is required to make sufficient contributions to pay the benefits under the plan.

2. The normal retirement benefit is the amount the participant will receive if employed until the plan's normal retirement age.

3. If the participant leaves employment before reaching the normal retirement age the participant earns a portion of the retirement benefit. The benefit earned at any point in time is called the accrued benefit. This is an annuity amount (typically paid monthly for life) due at normal retirement age. To determine how much the participant would be entitled to receive in a single sum to replace the vested accrued benefit that is due at retirement, it is necessary to know the following:

a. Normal retirement age - Generally, the lower the retirement age, the more it costs to provide the benefit since it will be expected to be paid out over a longer period of time if the participant is younger when starting to receive benefits.

b. The normal form of benefit - The least expensive form of annuity benefit is a life annuity since it will stop on the death of the participant. Any extra guarantees such as payments guaranteed to be made for life but continued for a minimum of 10 years (10 years certain & life) will increase the cost of the benefit. If the benefit is provided on a joint and survivor basis that is for the life of the participant and for the life of the participant's survivor, the cost of the benefit will also increase.

c. The actuarial equivalence rates - Defined benefit plans typically allow distributions in many optional forms of benefit. In order to determine how much a benefit should be adjusted if it is paid in an optional form, the plan must provide rates or factors for determining equivalent benefits. Interest and mortality rates are used to convert the normal form of benefit into other forms of benefit. To determine a current lump sum amount, the annuity benefit at the plan's normal retirement age is first converted to a single sum at retirement. For a participant who has not reached normal retirement age, this single sum at retirement is then discounted to the participant's current age. This single sum present value replaces the monthly payment stream that would normally begin at normal retirement age.

d. The participant's current age - Generally, the younger the participant is when receiving a lump sum distribution (in lieu of the annuity at retirement age), the smaller the lump sum distribution. This is because the discount factor is operating over a longer period of time.

4. Unlike the defined contribution plan where the assets add up to the participants' account balances, the assets of a defined benefit plan may be more or less than the present value of the accrued benefit.

5. A defined benefit plan tends to favor older employees. Although the IRS places limits on the amount of benefits that can be provided in a defined benefit plan, the cost of the benefit may exceed the $41,000 annual additions limit on contributions that applies to defined contribution plans. A defined benefit plan can be a rapid way to accumulate meaningful benefits for an older employee.

C. There are various types of retirement benefit formulas that can be used in a defined benefit pension plan.

1. In a flat benefit plan, the formula is based on a flat dollar amount or a flat percentage of pay.

a. Flat dollar amount example - $100 a month beginning at age 65 and continuing for the life of the participant.

b. Flat percentage of pay formula (non-integrated) example - 50 percent of average monthly compensation shall be payable beginning at age 65 and will continue for the life of the participant.

c. A formula based on a flat percentage of pay may be integrated with Social Security. *(See Chapter* 6)

d. Compensation (a term for "pay" or "salary") is often averaged over a number of years, and the average is used for the calculation of benefits under the given formula. Average compensation will be defined in the plan document.

2. Under a unit benefit formula, the benefit is based on the number of years of service or participation of the participant.

a. Example of a unit benefit formula - The participant shall receive a monthly benefit payable at age 65 equal to $5 times years of service at retirement age. If a certain participant had 30 years of service, the benefit would be:

$5 x 30 = $150 per month.

b. A unit benefit formula may also be based on a percentage of compensation.

c. Another example of a unit benefit formula - The participant shall receive a monthly benefit payable at age 65 equal to 1 percent of average compensation times years of participation at normal retirement age.

If a certain participant's average monthly compensation was $1,000 and years of participation were 25, then the monthly benefit at retirement would be:

$1,000 x .01 x 25 = $250

d. A unit benefit formula can be integrated with Social Security.

II. Variations of Defined Benefit Plans

A. One variation of a defined benefit plan is a "floor-offset" plan .Under a floor-offset plan, the retirement benefit calculated under the defined benefit plan is offset by the benefits provided under another plan. For example, if the gross benefit under the defined benefit plan prior to applying the offset was equal to $250 per month, and the benefit for a participant being provided in a separate profit sharing plan was equivalent to $50 per month, then the "floor-offset" would require that the net benefit in the defined benefit plan be $200 ($250-$50=$200)

B.A cash balance plan is similar to a money purchase plan in that a specific contribution is credited to a hypothetical individual account of each participant. However, in a cash balance plan, the interest to be credited on these contributions is also specified by the plan and is not based on actual trust earnings. The sum of the hypothetical account balances will not be equal to the plan assets since this is not a true account balance plan. Instead, the hypothetical account balance is projected to retirement age and converted to a projected annuity benefit at retirement age. The actuary calculates the required contribution based on the projected retirement benefit and an actuarial funding method. The required contribution will not be the same as the amount credited to the hypothetical individual accounts.

C. An annuity plan is defined in Treasury regulations as "a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust."

D. An IRC§412 (i) plan is also known as a "fully insured plan”. A fully insured plan is a defined benefit plan under which all plan assets consist of life insurance policies. The cash surrender value of the policies at normal retirement age provides the retirement benefit specified in the plan.

III. Other Benefits Provided in Defined Benefit Plans

Other benefits that can be provided in defined benefit plans are known as "ancillary benefits," including

A. Death benefits;

B. Disability or medical benefits;

C. Early retirement benefits or early retirement "windows"; and

D. Termination benefits.

IV. Actuary

An actuary is the person who calculates the amount of money that a company should contribute to its qualified defined benefit plan. An enrolled actuary is an actuary who has satisfied testing and experience requirements set forth by the Joint Board for Enrollment of Actuaries, which is part of the United States Treasury Department. Certain government forms must be signed by an enrolled actuary as a certification that the required level of funding in a defined benefit plan has been maintained.

V. Actuarial Assumption

An "actuarial assumption" is an assumption an actuary makes about the future conditions of a defined benefit plan and its participants, taking into account predicted interest earnings, estimates of the future mortality, as well as other factors.

Funding a defined benefit plan means making a contribution to a trust fund set up by the plan sponsor in order to accumulate enough money to pay benefits as they arise under the plan.

VI. Funding a Defined Benefit Plan

A. "Pay-as-you-go" funding means that when a benefit becomes due, the plan sponsor would contribute only enough money to pay the current benefits.

B. "Terminal funding" means that the plan sponsor would contribute enough money to pay current and future benefits for a participant only when that participant begins receiving benefits.

C. "Prefunding" means that the plan sponsor would begin making contributions to a plan prior to any benefits becoming due. Prefunding is required by law due to the, enactment of ERISA in 1974. Prefunding requires smaller outlays of money over a longer period of time than the other two types of funding. Prefunding generally lowers the overall cost of the plan by taking advantage of the effect of compounding interest.

VII. Funding Method

A funding method is a set of calculations performed by the actuary in order to determine the amount of contribution to be deposited periodically to a defined benefit plan. There are a number of funding methods available for the actuary to use. Generally, the appropriate funding method is determined by the actuary.

VIII. Plan Design Plan

Plan design is an important phase of retirement planning. Prior to establishment or amendment of a pension plan, the plan sponsor must consider the reasons behind setting up the plan, who it wishes to benefit, and what the benefit level should be.

A. For a company whose essential employees are older than the majority of the employees, a defined benefit plan is usually designed for two reasons.

1. A defined contribution plan limits the amount of contribution a plan sponsor can make. Due to this contribution limit and the age of the employees, there may not be sufficient time to accumulate the desired pension benefit using a defined contribution plan.

2. Since contributions are not limited in a defined benefit plan, and the amount contributed is calculated actuarially to accumulate to the desired benefit, a defined benefit plan allows for accumulation of sufficient funds for retirement, even for older participants.

B. In plan design, the type of formula considered should be based on how the plan sponsor wishes to benefit certain individuals.

1. If it is important to the plan sponsor to benefit employees with long service, then a unit benefit plan is best.

2. If the plan sponsor wishes to benefit employees based on compensation level, then the formula should be a percentage of pay instead of a flat dollar amount.

C. The plan sponsor should also consider the amount of money it can afford to contribute to a plan each year. A high dollar amount or percentage of pay formula may require a contribution over and above what the plan sponsor can afford. The plan formula should be designed with a budget in mind.