Deferred Compensation

An Introduction to Retirement Savings Plans

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Overview

- Value of Retirement Plans
- Plan typology
  - Defined Contribution v. Defined Benefit
  - Pension v. Profit-Sharing
  - Qualified v. Non-qualified
  - ERISA v. Exempt or Partly Exempt
  - Multiemployer v. Single Employer
- History of Retirement Plans and Their Regulation

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Future Basics Sessions

- ERISA Fiduciary Law
- Vesting and Accrual Standards
- Spousal Rights and QDROs
- ERISA Claims Procedure and Litigation
- Searching for Plans and Documents
- Most Common Issues

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Value of Qualified Retirement Plans

- To employees:
  - tax-favored vehicle to save for retirement
  - forced and regular retirement savings
  - employer performs agency function for employees
  - most attractive to affluent employees
    - why?
      - would save in any event
      - more sensitive to tax deferral

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Value of Qualified Retirement Plans

- To employers:
  - an important part of compensation package
  - can be used to attract employees
  - can be used to advance personnel policies
    - retain employees/engender loyalty
    - encourage employees to retire when productivity ends
  - "right thing to do"
  - in some cases, can be a source of capital for the employer
    - ESOPs

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Value of Qualified Retirement Plans

- To society/government
  - create a large store of investment capital
    - economists disagree whether net increase in savings is greater than tax expenditure
  - mitigate burden on government to support elderly
  - give workers a stake in the economy
  - supplement Social Security

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Five binary pairs of retirement plan varieties

- Defined contribution v. Defined Benefit Plan
- Pension v. Profit-Sharing Plans
- Qualified v. Non-qualified Plan
- ERISA v. ERISA exempt plans
- Multi-employer v. single employer plans

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Defined Contribution v. Defined Benefit Plan

- Defined Contribution Plan
  - Plan defines the contribution made by the employer (and/or the employee)

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Defined Contribution v. Defined Benefit Plan

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    - 401(k) plan is the most common type of defined contribution plan

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    - 401(k) plan is the most common type of defined contribution plan
  - Benefit is the account balance
  - Investment risk is on employees
  - Employees bear risk of outliving assets

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Defined Contribution v. Defined Benefit Plan

- Defined Contribution Plan
  - Generally value of annual addition to a defined contribution plan is age-neutral, a percentage of compensation
    - but older employees have more saved and thus larger investment returns than their younger colleagues
    - Can “age-weight” contributions in some some defined contribution plans

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Defined Contribution v. Defined Benefit Plan

- Defined Contribution Plan
  - Prior to ERISA, most defined contribution plans had a professionally managed investment pool, with each participant having a fractional share of the pool
  - Today, most defined contribution plans require employees to make investment choices for their accounts

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Defined Contribution v. Defined Benefit Plan

- Defined Benefit Plan
  - The plan defines the benefit the employee will receive at retirement rather than the annual contribution to an employee account

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Defined Contribution v. Defined Benefit Plan

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  - The plan defines the benefit the employee will receive at retirement rather than the annual contribution to an employee account
    - Examples of formulas
      - $10 per month, multiplied by years of service

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      - 1% of final pay, multiplied by years of service
    - Plan does not have individual accounts

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    - Examples of formulas
      - $10 per month, multiplied by years of service
      - 1% of average pay over career, multiplied by years of service
      - 1% of final pay, multiplied by years of service
    - Plan does not have actual individual accounts
    - Investment risk and mortality risk is assumed by the employer

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Defined Contribution v. Defined Benefit Plan

- Defined Benefit Plan
  - Employer must fund defined benefit plan—ERISA plans are subject to minimum funding obligations

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Defined Contribution v. Defined Benefit Plan

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  - Benefit in most qualified defined plans are guaranteed by the PBGC

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Defined Contribution v. Defined Benefit Plan

- Defined Benefit Plan
  - Employer must fund defined benefit plan—ERISA plans are subject to minimum funding obligations
  - Benefit in most qualified defined plans are guaranteed by the PBGC
  - Benefits in traditional defined benefit plans are ”backloaded”

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Back-loading of Benefits in DB Plans

- Reasons for backloading
  - Time value of money
    - If plan promises you a benefit worth $1,000 payable at age 65 and you are age 65, the cost of that benefit to the employer (and the value to the employee) is $1,000

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Back-loading of Benefits in DB Plans

- Reasons
  - Time value of money
    - If plan promises you a benefit worth $1,000 payable at age 65 and you are age 65, the cost of that benefit to the employer (and the value to the employee) is $1,000
    - If the plan promises the same benefit to a 21-year old and we assume that the plan will earn an 8% return on investment, the employer will only need to contribute $33.84, which will grow to $1,000 by time employee attains age 65

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Back-loading of Benefits in DB Plans

- Reasons
  - Seniority in Final Pay Plans
    - Each year in which employee gets pay raise increases all prior benefit accruals

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Back-loading of Benefits in DB Plans

- Reasons
  - Seniority in Final Pay Plans
    - Each year in which employee gets pay raise increases all prior benefit accruals
    - Example: retirement annuity equal to 1% of final pay plan multiplied by years of service
      - Year one, participant earns $50,000, has earned a $500 retirement annuity
      - Year two, participant earns $100,000, how has earned a benefit of $2,000
        - » Benefit increased between year 1 and year 2 by $1,500

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Benefit Forms

- Normal form of benefit:
  - Life annuity commencing at retirement age (typically 65), or for married participants,
  - Joint-and-survivor annuity
- Benefit alternatives if plan permits
  - Early retirement benefits
  - Social Security bridge benefits
  - Lump sum
  - Non spousal survivor benefits

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Benefit Forms

- Subsidized Benefits
  - Some benefits might receive a subsidy over a single-life annuity,

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Benefit Forms

- Subsidized Benefits
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Benefit Forms

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    - Early retirement benefit

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Benefit Forms

- Subsidized Benefits
  - Some benefits might receive a subsidy over a single-life annuity, most commonly
    - Early retirement benefit
    - Joint-and-survivor annuity

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Benefit Forms

- Subsidized Benefits
  - Some benefits might receive a subsidy over a single-life annuity, most commonly
    - Early retirement benefit
    - Joint-and-survivor annuity
  - Plan must inform participants of most valuable benefit

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Hybrid Plans

- Plans that combine traditional aspects of defined benefit and defined contribution plans
- Much of this is driven by employers not wanting to absorb all risk of defined benefit plans but policymakers and employers wanting to provide employees with some advantages of the db form
  - Advantages of DB form for employees
    - Generally funded by employer
    - No individual investment choice, no investment loss
    - Life annuity rather than lump sum
  - But some defined benefit plans today offer participants a lump sum option

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Hybrid Plans

- Some types of hybrid defined benefit plans
  - Cash-balance plan
    - defined benefit plan in which benefit is stated as a cash amount rather than as an annuity
      - Pay credits and interest credits added to account each year
      - But no genuine accounts—only nominal accounts
      - Normal form of benefit is annuity but most plans provide a cash option

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Hybrid Plans

- Some types of hybrid defined benefit plans
  - Two tier defined benefit plans—only a minimum benefit is guaranteed—benefit in excess of the minimum depends on plan’s investment performance

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Hybrid Plans

- Some types of hybrid defined benefit plans
  - Variable benefit plan—benefit can vary depending on plan investment performance

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Pension v. Profit-Sharing Plans

- Pension plans—plans designed to provide periodic retirement income
  - Employer is obligated to fund plan each year
  - Plan does not pay until retirement (or sometimes earlier separation from service)
  - All defined benefit plans are pension plans
  - Some defined contribution plans can be pension plans (money purchase pension plans, target benefit plans)

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Pension v. Profit-Sharing Plans

- Profit—Sharing Plans are designed to share profits with employees on a deferred basis
  - All profit-sharing plans are defined contribution plans
  - Historically, contributions had to be made from profits, so in a loss year for employer, no contributions
  - Some profit-sharing plans provide X% of profits, divided among employees relative to salary
  - Other profit-sharing plans leave it to employers each year to decide % of profits to contribute (discretionary profit-sharing plans)

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Pension v. Profit-Sharing Plans

- Legal differences
  - Profit-sharing plans permitted to make distributions before employee retired (but penalty tax and 401(k) restrictions)
  - Most profit-sharing plans permitted employer discretion on how much to contribute each year
  - Pension plans have stronger statutory spousal survivor protections
  - Lower deductibility limits for profit-sharing plans than for other defined contribution plans (now eliminated)
    - Combined profit-sharing/money purchase pension plan
  - Employers could make contributions only out of profits (now eliminated)

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Qualified v. Non-qualified Plans

- Qualified plans comply with section 401(a) of the Internal Revenue Code
  - Employer gets deduction for contributions
  - Employee has no income until benefits are paid
  - Plan itself pays no tax on investment income
  - Tax benefits: tax deferral; possibly lower tax rates in retirement
- Non-qualified plans can sometimes roughly approximate qualified tax treatment

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Qualified v. Non-qualified Plans

- ERISA changed qualification rules, but the changes did not apply to government plans or church plans, so today they are subject to pre-ERISA (pre-1974) qualification law
- New ERISA qualification limits include: required minimum distributions, limits on benefits (in defined benefit plans) and contributions.

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Qualified v. Non-qualified Plans

- Important tax-only rules
  - (not too much, not to early and not too late
    - ***maximum benefit and contributions*** (section 415 of Internal Revenue Code—figures as of 2024)
      - defined benefit plans: $275,000 annual benefit (as early as age 62)
      - defined contribution plans: $69,000 annual contribution (plus extra $7,500 for those 50 or older)
    - ***benefit timing rules***
      - minimum distribution rules
      - pre-retirement distributions
  - Non-discrimination rules
    - Non-discrimination in coverage/participation
    - Non-discrimination in benefits/contributions
    - Social Security Integration

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ERISA v. Non-ERISA Plans

- ERISA, enacted in 1974, imposed new requirements on all plans, even non-qualified plans
- Basic requirements:
  - vesting
  - insurance for defined benefit plans
  - fiduciary standards
  - spousal protections
  - Minimum funding rules for defined benefit plans
  - Federalization and regulation of dispute resolution
  - Enhanced reporting and disclosure requirements
  - PBGC protection for defined benefit plans

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ERISA v. Non-ERISA Plans

- Some of the rules were put in both tax code and labor section of ERISA—tax rules only apply to qualified plans, but all plans must comply with requirements in ERISA unless exempt from ERISA

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ERISA v. Non-ERISA Plans

- ERISA created broad federal preemption of state law
  - Participants in ERISA plans cannot generally rely on state laws in enforcing rights under ERISA
- Federalization of dispute resolution in ERISA
  - Courts have interpreted parts of ERISA jurisdiction to make it more difficult for participants to obtain relief
  - Courts note tension between protecting participants and the costs of such protections, which might discourage employers from adopting plans
  - Some obstacles in ERISA actions
    - Plan venue provisions
    - Plan limitations periods
    - Standard of review in benefit denial cases—Firestone v. Bruch
    - Limits on ERISA remedies
    - No jury trials
    - Arbitration?

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ERISA v. Non-ERISA Plans

- ERISA Fiduciary Rules
  - Creation of ERISA "fiduciary"
    - named fiduciary and functional fiduciary
    - must administer plan
      - for exclusive benefit of participants and their beneficiaries
      - subject to a prudence standard
      - diversification
    - settlor/fiduciary distinction
    - relief in civil actions generally must be equitable or run in favor of plan
  - Prohibited Transaction Rules

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ERISA Exempt Plans (main types)

- Church plans
- Government plans
- Top-hat plans (only partly exempt—state laws are preempted for such plans; ERISA dispute resolution obstacles exist for such plans)
- Union dues plans

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Multiemployer v. Single Employer Plans

- Single Employer—one employer sets up plan
- Multiemployer plans
  - union negotiated plans
  - more than one employer contributes
  - employee benefits based on aggregate service to participating employers
    - multiemployer plans are common in industries with many employers and employee mobility
  - looser funding rules than single-employer plans
  - lower PBGC guarantees
  - funding problems with multiemployer plans and the Butch Lewis Act
  - generally subject to Taft-Hartley Act
- Multiple Employer Plans
    - plans that include more than one employer, but not collectively bargained

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Multiemployer v. Single Employer Plans

- Union dues plans—plans funded by union only for members
  - Exempt from ERISA vesting and funding standards
  - Not covered by the PBGC
  - Union dues plans predated ERISA; only a handful still exist

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Private-sector pension plans began in last quarter of 19th century
  - Many were pay-as-you go and many ultimately failed
  - Why did employers set plans up?
    - To provide retirement income so older, less productive employees could leave employment (personnel theory of pensions); paternalism.
  - Union plans
- Enactment of income tax created issues on how such plans should be taxed
  - early development of current tax treatment, probably first by regulation, then by statute
  - deduction to employer, no income to funding vehicle (if separate from the employer), employee taxed when benefits paid by plan
  - Many plans not prefunded, so employers would set up accounting reserves—deduction questions
  - But some plans set up trusts, or purchased deferred annuity contracts

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Early tax issues
  - Plans that covered only highly paid employees
    - More tax shelter than true retirement plan
    - High tax rates incentivized such plans
  - Plan termination and employer reversions
  - Employers taking deductions for accounting reserves without actually making contributions
  - limits on non-employees (partners, self-employed persons) participating in retirement savings plans

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Weak state law protection of employee rights
  - weasel clauses in defined benefit plans
  - generally no state-law vesting standards
  - no meaningful funding rules for defined benefit plans
  - weak fiduciary standards
  - corruption, particularly in multiemployer plans

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Passage of Social Security and Pensions
  - Personnel theory of pensions (replacement of human capital) as reason for employer to sponsor pension plan reduced in importance
  - Employers contributing to Social Security for retirement benefits—private plans provided duplication of benefits (and costs)
  - Integrated plans

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Expansion of Plans
- More plans with more people in 1940s
  - Why?
    - Higher tax rates, plans became better tax shelters
    - Wage/price controls
    - Union interest/recognition of pensions as mandatory subject of bargaining
    - Enactment of Social Security emphasized importance of preparing for retirement

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Federal Response
  - Taft-Hartley plans—1947
    - Taft Hartley was federal legislation limiting power of unions
    - After TH, union plans had to have both union and management-appointed trustees
    - exclusive benefit rule—courts allowed participants could sue plans for arbitrary behavior of trustees as structural violation of exclusive benefit rule—but Local 144 Nursing Home Pension Fund v. Demisay, 508 U.S. 581 (1993) held that no such private right of action exists.

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Federal Response
  - Studebaker
  - Merton Bernstein critique of private pension system (The Future of Private Pensions)
  - Creation (1962) and subsequent report (1965) of "Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs," a cabinet level task force—
    - recommended vesting standards; funding standards for defined benefit plans; termination insurance; limits on contributions
    - but limited fiduciary regulation (only limited investment in employer stock)
  - McClellan hearings—corruption in pension plans
  - An ERISA first proposed in 1967 by Jacob Javits, final version signed into law on Labor Day, 1974

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Primary Pre-ERISA Issues
  - DB plans
    - Funding and insurance
    - Insurance
  - Vesting and Accrual
  - Portability
  - Controlling Tax Costs, Limits on Maximum Benefits
  - Fiduciary Concerns

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Support for and Opposition to Reform
  - Business interests and most labor unions opposed major federal statutory intervention in pensions
  - Some labor unions (in auto industry especially) supported pension insurance
  - Some on the Hill believed reform was needed and would be a politically popular issue
  - White House opposition/ambivalence
    - offered a more limited bill, with IRAs, increased savings for self-employed, and limited minimum vesting
  - Jacob Javits and Harrison Williams team up
- Jurisdictional Issues on Hill and Among Agencies
  - Senate Finance Committee

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Jurisdictional Issues on Hill and Among Agencies

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Developing Grass Roots Support
  - Studebaker
  - Field Hearings on Horror Stories
  - NBC Documentary The Broken Promise

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Significant ERISA Changes
- vesting and accrual rules
- limits on benefits and contributions
- funding rules for defined benefit plans
- pension insurance, creation of the Pension Benefit Guaranty Corporation
- fiduciary rules
- changes in non-discrimination rules
- spousal protections
- preemption
- federalization of dispute resolution
- covered health and other welfare plans but no substantive standards
- tax on premature distributions
- requirement that distributions begin after participant attains age 70.5
- preemption of state law

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Unresolved Issues and New Problems
  - Exempt plans (governmental and church plans)
  - Portability
  - Preemption
  - Investment Advice
  - Pension Risk Transfer
  - Multi financial issues

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History of Retirement Plans and Federal Regulation of Retirement Plans

- Federal Response
  - Post-ERISA changes
    - better (but still arguably inadequate) spousal protections
    - QDROs
    - periodic modification of funding rules
    - improvements in vesting rules
    - limits on pension plan terminations for surplus
    - changes in non-discrimination rules
    - changes to PBGC insurance program
    - changes to encourage expansion of retirement plan coverage in population
    - changes allowing multiemployer plans to reduce benefits and passage of Butch Lewis financial support for multiemployer plans

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Self-Directed 401(k) Plans and Decline of DB Plans

- History of 401(k) plans
- History of self-directed plans
- Why employers like them
- Why employees like them
- Why did DB plans decline?

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Some Individual Financial Advice

- Contribute to 401(k) plans early
- Contribute at least enough to get full employer match
- Invest in index funds, target date funds
- Pay attention to fees and diversification
- Take on investment risk when young, become more conservative as you get closer to retirement and in retirement
- Limit retirement plan investments in employer stock
- Consider annuitizing part of your account balance if possible

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