

Counseling for Defined Contribution Plan Participants

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Key Differences
Between
DC & DB Plans

Different Types
of DC Plans

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DC vs. DB Plans: Key Differences

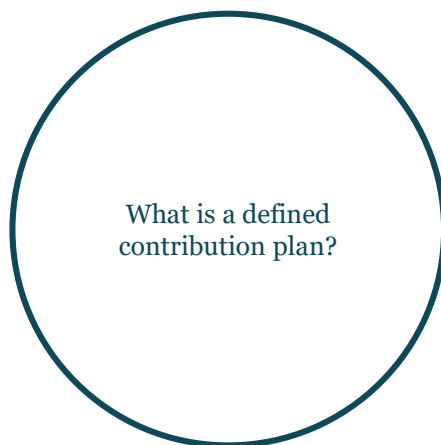


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DC vs. DB Plans



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DC vs. DB Plans



Defined Contribution Plan

- No promise to pay a particular benefit at a future time
- Only promise is to make current contributions
- Contributions are allocated to individual account
- Earnings on account are credited to account
- Benefit equals account balance at time of distribution
- That's legal definition of DC plan in ERISA § 3(34) and IRC § 414(i)

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DC vs. DB Plans



Defined Benefit Plan

- Legal definition of DB plan in ERISA § 3(35) and IRC § 414(j) is any plan *other than a DC plan*
- So if plan promises any benefit other than account balance on date of distribution, it's a DB plan
- Generally promises to pay a benefit at a future time or times
- Contributions are made to fund promised benefit
- But benefit is calculated independently of contributions

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DC vs. DB Plans

Key Distinctions between DC and DB Plans

Benefits directly linked to plan assets in DC plans

- Benefit = assets allocated to individual account
- Sum of account balances = plan assets

Benefits not directly linked to plan assets in DB plans

- Benefit = promised payments unrelated to plan assets
- Sum of value of DB benefits can be =, >, or < plan assets

Key differences in funding

- Unlike DC plans, DB plans can be over/under-funded
- DC accrued benefit is defined simply as account balance

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Different Types of DC Plans

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Different Types of DC Plans



Profit-Sharing Plan

- Non-pension defined contribution plan
- Types of contributions
 - *elective contributions*
 - *non-elective contributions*
 - *matching contributions*
- Employer is not required to have profits to contribute
- Employer contributions can be made pursuant to a specific formula or may be discretionary – but must be recurring and substantial
- Must have a definite allocation formula for contributions

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Different Types of DC Plans



Stock Bonus Plan

- Non-pension defined contribution plan
- Similar to a profit sharing plan, except that benefits must be distributable in employer stock (upon request)
- Commonly, invested in employer stock
- Same contribution and allocation formula options as a profit sharing plan

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Different Types of DC Plans

Money Purchase Pension Plan

- DC plan that is a pension plan subject to minimum funding requirements, spousal annuity, and 204(h) notice rules
- Must provide a specific contribution formula that is not subject to employer discretion
- Employer contributions may not be geared to profits
- Generally, may not have a 401(k) feature

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Different Types of DC Plans

Employee Stock Ownership Plan (ESOP)

- DC plan that is either a stock bonus plan or a money purchase pension plan that is designed to invest primarily in employer stock
- Lots of rules here that we're not going to go into, but stock bonus ESOPs are generally the preferred form of plan for providing benefits to employees in the form of employer stock
- Law provides a lot of advantages to ESOPs that are not available to other stock bonus plans
- Best example is the ability to do a leveraged ESOP in which
 - *a loan is taken out to permit ESOP to buy a large block of employer stock*
 - *the stock is held in a suspense account in the plan and is allocated ratably over time to participants' accounts as the loan is paid down*

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Different Types of DC Plans



Target Benefit Plan

- Type of money purchase pension plan that mimics a DB plan
- So, a DC plan that is trying to look and feel like a DB plan that pays a traditional annuity benefit
- Defines contributions by reference to annual amounts needed to fund hypothetical or “target” annuity benefit at retirement
- Promise is to make contributions that would be needed to fund the target benefit
- But, as a DC plan, the contributions are allocated to the participant’s individual account, where they gain or lose value based on the plan’s investment performance
- Accrued benefit still is just the participant’s account balance on the date of distribution

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Different Types of DC Plans



Cash Balance Plan

- Not a DC plan, but a DB plan that mimics a DC plan
- Defines hypothetical individual account
 - *hypothetical contributions or “pay credits”*
 - *hypothetical investment or “earnings credits”*
 - *hypothetical individual account or “cash balance”*
 - *benefits defined by reference to cash balance*
- Deemed contributions and earnings credited to the account
- Promise to pay benefit equal to account balance
- As DB plan, actual contributions/earnings generally irrelevant

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Different Types of DC Plans

401(k) Plan

- DC Plan That Includes a Cash or Deferred Arrangement (CODA)
 - *election to contribute part of compensation, pre-tax*
 - *choice between employer contribution and equal amount in cash*
- Technically, part of a qualified plan
 - *profit-sharing plan, stock bonus plan, or pre-ERISA money purchase pension plan that permits before-tax contributions*
 - *not a plan of its own*
- Matching Contributions Have Their Own Subsection
 - *IRC § 401(m)*
 - *they are an appendage, as it were, to a CODA, since matches are only permitted on elective contributions*

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Different Types of DC Plans

403(b) Plan

- An annuity contract plan offered by an insurance company
- Available to public education organizations, 501(c)(3) tax-exempt organizations, and churches
- Typically includes salary reduction arrangement similar to a 401(k), *i.e.*, a CODA

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Different Types of DC Plans



457 Plan

- Generally available only to state and local governments and certain tax-exempt employers
- Typically, has salary reduction arrangement similar to those in 401(k) and 403(b) plans
- Funding
 - *457 plans of state and local governments must be funded and their assets held in trust*
 - *457 plan of non-governmental tax-exempt organizations are prohibited from being funded*

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Common Legal Issues in DC Plans



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Common Legal Issues in DC Plans

How Plan
Structure
Influences
Claims

Maximizing
Retirement
Income

Common
Participant
Questions

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How Plan Structure Influences Claims

Participant
Discretion in
Investment
Selection

- Participant-directed investments in DC plans
- Typical in vast majority of DC plans today, and pretty much a constant feature in plans with elective contributions like 401(k), 403(b), and funded 457 plans
- Made possible by section 404(c) of ERISA, which relieves plan fiduciaries of responsibility for the consequences of participant investment elections
 - *provided that the plan offers a sufficiently varied selection of prudent investment alternatives and meets certain other requirements*
- Some traditional DC plans still exist under which all investment decisions are made by the plan fiduciaries and professional asset managers, and not by individual participants

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How Plan Structure Influences Claims

Participant-Directed Funding Vehicles

Mutual Funds	Exchange-Traded Funds (ETFs)
▪ Active vs. passive management ▪ Share classes generally based on plan size and can provide significant discounts on investment fees ▪ Mutual funds provide daily valuation based on the value of plan assets as of the close of business on days when markets are open	▪ Typically, passive management tracked to indices (but this is changing) ▪ Perceived as charging lower fees ▪ Typically update valuations throughout the day when markets are open, which poses a challenge to including ETFs in plan investment line-up

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How Plan Structure Influences Claims

More Participant-Directed Funding Vehicles

Collective Investment Trusts (CITs)	Separate Accounts
▪ Pooled investments of 401(k) plans and other institutional investors ▪ Not currently available to 403(b) plans ▪ Meaningful cost savings vs. mutual funds • Cost savings driven by different markets in which they serve ◦ Mutual funds: retail and institutional ◦ CITs: just institutional ▪ Typically, ERISA plan asset vehicles	▪ Custom investments ▪ Typically used by the largest plans ▪ Potential cost savings ▪ Typically, ERISA plan asset vehicles

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How Plan Structure Influences Claims

More Participant-Directed Funding Vehicles

- Variable Annuities
 - *offered by insurance companies*
 - *variable annuity contract “wrapped” around investment options*
 - *fee concerns raised by DOL in past*
- Stable Value Funds
- Individual Securities

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How Plan Structure Influences Claims

401(k) Investment Platforms

Traditional Investment Option Line-Up

- Plan recordkeeper such as Vanguard, Fidelity, State Street offers platform for investment options available to plan participants
- In case of variable annuity plans, the insurance company provides the platform
- Investment options selected by plan fiduciary
- Third-party fiduciary can manage/provide investment advice

Brokerage/Mutual Fund Window

- More investments but options typically not selected by a fiduciary (which presents an unsettled legal issue)
- Lower or no efficiencies of scale
- Challenges for individual to properly diversify
- Safer option is mutual fund window with limited number of funds selected by the plan fiduciary

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How Plan Structure Influences Claims

Common Claims

Plan Administration Fees

- Incurring excessive or unnecessary service fees
- Self-dealing and other prohibited transactions

Investment Selection and Monitoring

- Imprudent selection of investments, including
- Failure to make selections that maximize risk-adjusted returns
- Failure to provide a line-up of investment options that permit participants to construct an individually appropriate portfolio of investments
- Failure to monitor and re-visit investment selections

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Maximizing Retirement Income



Investment Selection

- Diversification
 - by third party (if available)
 - *investment advice/online asset allocation modeling*
 - *managed account*
 - by participant
 - *self-selection of investment funds*
 - *single investment options intended to provide diversification*
 - *target date funds*
 - *balanced funds*
 - cost considerations

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Maximizing Retirement Income

Distribution Options/ Considerations

- Lump sums, installments, purchase of annuities
- Ability to get in-service distributions in some plans
- Hardship withdrawals
- Loans from participant accounts
 - *far preferable to distributions*
 - *defaults and extraction of value through loans*
- Tax Considerations
 - *income tax generally due*
 - *10% additional tax on premature distributions*

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Maximizing Retirement Income

Rollovers and Plan-to-Plan Transfers

Rollovers to IRAs are common

- Long-standing fight over fiduciary responsibility for encouraging rollovers from ERISA plans to IRAs
- If ERISA plan is well run with good investments, rolling to an IRA where retail pricing applies can be disadvantageous to the participant
- Also, IRAs provide far fewer protections for participants and beneficiaries than ERISA plans (e.g., IRA accounts are subject to state escheatment)

Transfers from One Plan to Another

- Generally makes sense when participant changes jobs from one employer to another, assuming the new employer has a similar or better plan and permits rollovers into its plan
- Most often done by rollover, but can also be done in trust-to-trust transfer, e.g., when the job change is triggered by a sale of the employer or another corporate transaction

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Common Participant Questions

Timing of contributions and distributions

- When must an employer transfer elective deferrals to the trust?
 - *very strict rules apply here, with potential criminal liability*
 - *legal deadlines are quite short, usually one to two weeks maximum*
- When must an employer transfer employer contributions to the trust?
 - *must meet deadline for employer contributions set out in the plan document*
 - *if contribution is delayed too long, the employer may lose deduction for income tax purposes in current year*
- What can a participant do if the plan is taking a long time to make a distribution?
 - *participant can file a claim for benefits for excessive delay in making distributions due under the terms of the plan and applicable law*

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Common Participant Questions

Spousal Consent Requirements

- What types of distribution options are available to a surviving spouse?
 - *distribution options available under the plan, such as lump sum, installments, annuities, and rollovers to an ira or another qualified plan.*
 - *note that if the plan is a money purchase pension plan, or if it is a profit-sharing or stock bonus plan that fails to meet certain requirements, the required form of payment to the surviving spouse is a QJSA or QPSA, unless the spouse elects another form of payment.*
- Does a spouse have to consent to a loan or a hardship withdrawal?
 - *in a money purchase pension plan, yes.*
 - *in a profit-sharing or stock bonus plan, no, unless the plan fails to meet certain requirements.*
- What happens if the participant takes a hardship withdrawal or loan without involving the spouse (when consent was required), the money is gone, and then the participant dies?
 - *make a claim against the plan, the participant, or the participant's estate.*

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