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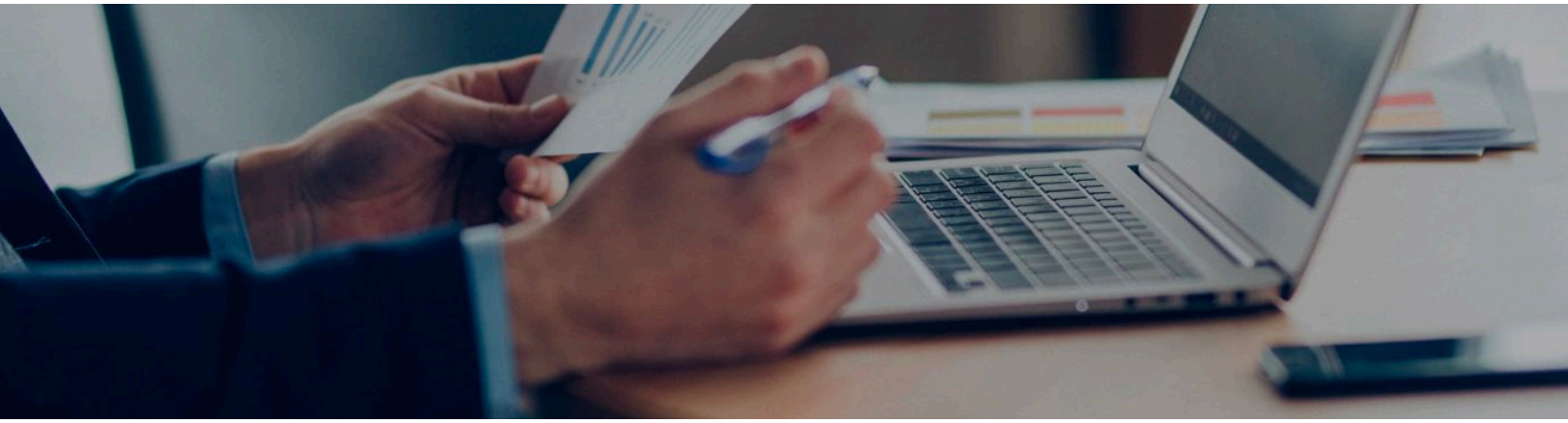

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Employer sponsored retirement plans: Key differences

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Contact Us
993 North 3rd Street, Abilene, TX 79601
Tel: (325) 677-6251 | Fax: (325) 677-0006
info@condley.com

Employer sponsored retirement plans: Key differences

Prepared by:

Mary Chiodo, Supvervisor, RSM US Wealth Management LLC
Jason Linder, Supvervisor, RSM US Wealth Management LLC

January 2020

Employers have a variety of options when considering what type of qualified retirement plan to offer employees. While most Americans view Social Security as the biggest source of their retirement income, the retirement plan offered through an employer is a critical retirement resource. There are two main categories of employer-sponsored retirement plans that provide supplementary income: defined benefit plans and defined contribution plans.

In years past, retirees relied on defined benefit plans, commonly referred to as pensions, sponsored by large companies to provide supplemental income. Over the past 30 years, however, defined contribution plans have become more common than defined benefit plans. In fact, according to the Bureau of Labor Statistics, 64% of private industry workers had access to defined contribution retirement plans through their employer in 2019 while only 16% of private industry workers had access to defined benefit retirement plans.

Retirement plans can be complicated and expensive to administer. Selecting the best plan for your organization involves a thorough consideration of a company's goals and objectives.

Defined benefit plans—pensions

With a defined benefit plan, the plan defines a specified payment amount (or benefit) paid to employees in retirement. What is available to a participant for retirement depends on the benefits determined by a formula in the plan. A defined contribution plan, on the other hand, is defined in the sense that the employee and employer contributions are defined and known in advance, while the benefits that are paid out are not known in advance.

Defined benefit plans provide employees a specified pension payment, lump sum or combination thereof that is funded by the employer or plan sponsor. The amount specified as a pension payment is predetermined by a formula based on the employee's earning history, length of service and age. Since the employer makes a promise to pay future payments, employers are required to make contributions to the plan every year. However, generally businesses can contribute and deduct more each year than defined contribution plans.

These types of plans are more complex and costly to administer than other types of plans. An enrolled actuary is required to determine the funding levels and sign the Schedule B which is an attachment to the annual Form 5500. All of the assets in the plan are held in a pool rather than in individual employee accounts. Since the employees do not make any investment decisions, it is the employer who bears the risk of fluctuations of the plan's investment pool.

Because employers are legally required to make sure there is enough money in the plan to pay guaranteed benefits, the federal government can step in if a company fails to meet its obligations. The Pension Benefit Guarantee Corporation (PBGC) insures defined benefit plans and will take over benefit payments if a company is covered and the company goes bust.

Businesses of any size can offer a defined benefit plan. For smaller companies with one owner and younger employees, the business owner most likely receives a higher percentage of the benefits.

Pension benefit formulas
There are three main methods of calculating pension benefits in defined benefit plans:

1) **Flat benefit formula:** Participants receive an annual benefit based on their years of service with a company.

   Example: A defined benefit plan may provide $1,200 for every year of service worked for a company. For an employee with 25 years of service, the annual benefit would be calculated as follows:

   25 x $1,200 = $30,000

2) **Unit benefit formula:** Participants receive a benefit based on their length of service as well as their salary.

   Example: A defined benefit plan may provide a benefit of 3% of the average compensation of the 10 highest consecutive years, or a $100 monthly retirement benefit. If an employee had an average salary of $84,000 and 25 years of service, the annual benefit would be calculated as follows:

   25 x $84,000 x .03 = $63,000

3) **Variable benefit formula:** With this formula, participant benefits are adjusted up or down based on investment returns. The assumed rate of return is called the hurdle rate, which typically between 4% and 6%, determines whether benefits rise or fall on a plan-year basis.

Cash balance plans
Cash balance plans are defined benefit plans. However, they "look" like a defined contribution plan because benefits are defined and guaranteed by the plan sponsor. Participants get an annual statement showing exactly what their balance is in the plan and how it changes from year to year. A cash balance plan looks like a profit sharing plan with a guaranteed rate of return.

There used to be a cost advantage to having a defined benefit plan in lieu of a cash balance plan. Now, there really is no difference in administration cost, and both require actuaries to be involved.

The most important difference is that the value of the liabilities in a traditional defined benefit plan fluctuates dramatically with interest rates, whereas the liabilities in a cash balance plan only move slightly when interest rates change. With defined benefit plans, interest rates are required by the government and set by the free market. Cash balance plans mitigate these risks by using more common credit rates such as the yield on a 30-year treasury bond, which has historically experienced less volatility. In other words, the cash balance plans are relatively predictable as you always know the value of the assets and liabilities and how much belongs to each person. This makes it easier to take on partners, have partners retire, or change contribution levels.

Defined contribution plans

With defined contribution plans, employees and employers "define" their contributions. What is available for retirement will depend on the contributions actually made and the earnings on those contributions.

There are many defined contribution plan options, but they generally fall into three general categories: profit sharing plans, 401(k) and 403(b) plans, and money purchase pension plans.

Profit sharing plans
Profit sharing plans allow employers the flexibility to change their plan contribution each year, how much to contribute (with the limits placed on these plans by the tax code), or even decide not to make a contribution in certain years. Contribution eligibility requirements can be established which employees must meet to receive a contribution.

Within the profit sharing category, there are a number of contribution allocation options:

Traditional profit sharing — In traditional profit sharing plans, everyone receives the same percentage of pay as a contribution. This is otherwise known as a pro-rata allocation formula.

Integrated profit sharing — In an integrated profit sharing plan, those employees earning over the Social Security wage base receive a higher percentage of the plan contribution than those earning under the Social Security wage base. This plan is appropriate if owners are younger than most of their employees but earn a higher salary. This is also known as a permitted disparity contribution formula.

Age-weighted profit sharing — In these types of plans, the majority of the contribution goes to those older employees who are closer to retirement. This plan is appropriate if you are older than your employees or if you want to favor older, long-time employees.

New comparability — A new-comparability plan allows you to place employees in different "groupings," allowing you to allocate a higher amount of the contribution to yourself and a lower amount to employees. This plan is appropriate if you are five to 10 years older than the average age of your employees.

Employee stock ownership plans — An ESOP is a retirement plan in which a company contributes stock (or money to buy its stock) to employees. Since employees become shareholders, many companies feel this type of plan helps keep employees focused on their performance as they have a direct stake in the profitability of the company as well as opportunities to participate in decision-making processes. In addition, ESOPs offer owners a method of succession planning and tax benefits.

401(k) plans

401(k) plans allow employees to set aside (or defer) money for their retirement by authorizing contribution deductions from their paychecks. Employee contributions (salary deferral contributions) may be made pre-tax, Roth, after-tax or a combination. Employees have flexibility in how much they contribute up to certain limits set by the IRS and adjusted annually. In addition, employers may choose to match some of the employees' contributions. Within the category of 401(k) plans, there are a number of plan options:

1) **Traditional 401(k) —** In addition to allowing employee contributions, employers may or may not choose to make matching contributions in a traditional 401(k) plan. The Employee Retirement Income Security Act (ERISA) requires several tests each year to prove 401(k) plans do not discriminate in favor of highly compensated employees. Subsequently, traditional 401(k) plans could limit how much participants defer.

2) **Safe harbor 401(k) —** Safe harbor plans require employers to make either a matching or nonelective contribution. Subsequently, employers avoid most annual compliance tests and employees are able to defer the maximum allowed by law. Safe harbor contributions can be set up one of three ways:

    1. Nonelective safe harbor contribution — Employers make a contribution to all eligible employees of 3% of their compensation. Employees receive the contribution whether or not they participate and their contributions are 100% vested.

    2. Basic safe harbor match — Employers make a matching contribution of 100% of the first 3% of each employee's contribution and 50% of the next 2%. Employees are required to contribute to get the match and their contributions are 100% vested.

    3. Enhanced safe harbor match — Employers make a matching contribuiton of 100% of the first 4% of each employee's contribution. Employees are required to contribute to get the match and their contributions are 100% vested.

Automatic enrollment 401(k) — Employees are automatically enrolled in these plans and make salary reduction contributions specified by the employer, unless they elect otherwise. This type of plan is ideal for employers who want a high level of participation and who have highly compensated employees whose contributions might be limited under a traditional 401(k) plan as they can increase plan participation. Plans are more likely to pass compliance tests required under a traditional 401(k) plan.

There are three types of automatic enrollment plans with the automatic contribution arrangement (ACA) being the most popular:

1) **ACA —** This is the most basic type of auto enrollment plan that most employers use. It is the only type of auto enrollment plan that allows plan sponsors to enroll only new hires.

2) **Eligible automatic contribution arrangement (EACA) —** This type of auto enrollment plan allows participants to withdraw their automatic contributions, including earnings, within 90 days of the date their first automatic contribution was made. Plan sponsors must auto-enroll all of their employees (as opposed to just new hires).

3) **Qualified automatic contribution arrangement (QACA) —** This type of auto enrollment plan allows plan sponsors to avoid (ADP) and (ACP) nondiscrimination testing through "safe harbor" contributions. Safe harbor contributions are required contributions and must be one of the following:

   - A nonelective contribution of 3% of compensation to all participants' nonelective contributions

   - A matching contribution of 100% of an employee's contribution up to 1% of his or her compensation plus 50% matching contribution for an employee's contributions above 1% and up to 6%

403(b) plans
A 403(b) plan is a tax-sheltered annuity plan for employees of public schools or tax-exempt organizations. It is considered a type of qualified defined contribution plan. A 403(b) plan allows employees to contribute some of their salary to the plan. Employers can also contribute to the plan for employees. These plans work very similar to a 401(k) plan in terms of tax treatment and contributions.

Money purchase pension plans
Money purchase pension plans are defined contribution plans in which employers are required to make a contribution to the plan each year for participants. The amount of the contribution is fixed and is stated in the plan.

A money purchase plan differs from a profit sharing plan in that the employer can decide on what to contribute in a profit sharing plan. For example, if an employer decides to contribute $50,000, then depending on the plan's allocation formula (i.e., pro-rata, integrated), $50,000 is "allocated" to the accounts of participants.

On the other hand, for example, if a money purchase plan states a contribution of 6%, then the employer is required to contribute 6% of each eligible employee's pay to their account.

Simplified employee pension individual retirement accounts
A SEP IRA is a retirement plan that typically small businesses or self-employed individuals can set up. Both employers and employees can contribute on a discretionary basis. These plans have higher contribution limits than IRAs, and employer contributions are 100% vested immediately.

Savings incentive match plan for employees
A SIMPLE 401(k) can also be established by small businesses or self-employed individuals. To qualify for a SIMPLE plan, an employer must have no more than 100 employees. Employers are required to contribute either a 3% match of employee contributions or 2% of each employee's compensation. Because of the required employer contributions, these plans are not subject to complex discrimination testing.

Final thoughts

Consultants, advisors, retirement plan specialists and certified public accountants can be valuable partners in helping select the right plan for your company's unique circumstances. It's important that you and your company's management team understand how these plans can help attract, retain and benefit your employees.

+1 800 274 3978
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