



PEBA

Introduction to Qualified Defined Benefit and Defined Contribution Plans

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This document is incomplete without the accompanying discussion.

Overview of Retirement Plans

The Basics

- Employer-sponsored employee benefit plans are of two main types
 - Health and welfare (“H&W”, or “welfare”) plans
 - Plans that provide employees with benefits relating to medical and hospital coverage, life insurance, income continuation (such as short- and long-term disability insurance), and other benefits typically used while employed
 - E.g., group medical and dental plans, group-term life insurance, “cafeteria” plans
 - Retirement plans
 - Plans that provide employees with income replacement after employees retire or otherwise stop working
 - May be provided on a “defined benefit” (“DB”) basis or a “defined contribution” (“DC”) basis
 - DB plans come in two forms: “traditional” and “hybrid”
 - Traditional: plan that provides an annual or monthly benefit at retirement, often determined using a multiple of “final average pay” and accumulated service with the employer
 - Hybrid: plan that communicates the future benefit in terms of a current lump sum amount (“cash balance” plan is the most common example)
 - DC plans come in numerous forms as well
 - E.g., profit-sharing plans, 401(k) plans, ESOPs, 403(b) plans

Regulation of Employee Benefit Plans

- Benefit plans are administered on the basis of a 12-month period referred to as the “plan year”, and compliance with legal requirements is, for many purposes, determined on the same basis
 - The plan year can be any 12-month period, and is separately determined for each benefit plan
 - The plan year for any benefit plan does not have to be the same 12-month period as the plan sponsor’s fiscal/tax year, although often they are the same for reasons of administrative and accounting convenience
- Employer-sponsored employee benefit plans are primarily regulated by federal law, as opposed to the laws of individual states
 - This preeminence of federal law is referred to as “preemption”
 - There are some exceptions to preemption that allow state laws to occasionally impact retirement plans
 - E.g., in the case of a “qualified domestic relations order”, or “QDRO”
- Two federal laws do most of the regulating
 - The Employee Retirement Income Security Act of 1974 (“ERISA”)
 - The Internal Revenue Code (the “IRC” or the “Code”)

Regulation of Employee Benefit Plans

- ERISA protects plan participants and beneficiaries with respect to their rights to benefits by imposing requirements on plan sponsors, such as
 - Plan sponsors must submit certain reports to the federal government, often on an annual basis, that provide information regarding the operation and administration of benefit plans
 - Plan sponsors must supply participants — and, in some situations, beneficiaries — with certain information regarding plan provisions, their rights to benefits, amounts of benefit entitlement, and related information
 - Retirement plans must be specific as to the benefits promised and the way that benefits will be funded, and must hold plan assets in trust outside the reach of the plan sponsor
 - The plan sponsor and individuals who oversee benefit plans are held to a high standard of care as fiduciaries
 - ERISA is interpreted and enforced by the U.S. Department of Labor (“DOL”) and, with respect to DB plans, the Pension Benefit Guaranty Corporation (“PBGC”) as well
 - In this role, the DOL and PBGC audit plans/plan sponsors for compliance with ERISA and issue regulatory guidance
 - ERISA also provides plan participants (and beneficiaries in some cases) with certain legal remedies
 - E.g., rights to compel disclosure of information, rights to enforce the terms of the plan, right to recover benefits

Regulation of Employee Benefit Plans

- The IRC's focus with respect to employee benefits is to determine the federal income tax effect of contributions made to benefit plans, investment growth on benefit plan trust fund assets, and the utilization/receipt of benefits by plan participants and/or beneficiaries
- In the retirement plan context, the IRC contains rules that, if satisfied, allow a retirement plan to become "qualified" for favorable tax treatment (i.e., to become a "qualified plan")
 - This favorable tax treatment generally applies to the plan sponsor, plan participants, and beneficiaries
 - Plans that do not satisfy these "qualification" rules do not qualify for favorable tax treatment and are generically referred to as "nonqualified plans"
- The IRC is primarily interpreted and enforced by the Internal Revenue Service ("IRS"), an element of the U.S. Department of the Treasury

Regulation of Employee Benefit Plans

- Although ERISA and the IRC are the primary federal laws that regulate employee benefit plans, other federal laws come into play on occasion, for example
 - H&W plans
 - Consolidated Omnibus Budget Reconciliation Act of 1986 (“COBRA”)
 - Health Insurance Portability and Accountability Act of 1996 (“HIPAA”)
 - Qualified retirement plans
 - Certain federal securities laws (primarily in the context of DC plans)
 - Age Discrimination in Employment Act of 1967 (“ADEA”)
 - Both H&W and qualified retirement plans
 - Family and Medical Leave Act of 1993 (“FMLA”)
 - Uniformed Services Employment and Reemployment Rights Act of 1994 (“USERRA”)
 - Pension Protection Act of 2006 (“PPA”)

“Defined Benefit” vs. “Defined Contribution” Plans

- DB plans: key features and characteristics
 - Plan provides a definitely determinable benefit at the plan’s “normal retirement age” through the use of one or more benefit formula(s)
 - Historically, most DB plans used (and still use) a formula that produces a benefit expressed as a percentage of a participant’s average pay earned during the latter portion of his or her career with the plan sponsor, multiplied by service with the plan sponsor
 - In the last 20 years or so some DB plans (i.e., “hybrid” plans, the most common of which is the “cash balance” plan) instead grant an annual “contribution credit” to participants equal to a certain percentage of compensation, as well as some level of “interest credit” on accumulated contributions
 - The employer bears the investment risks relative to plan assets
 - Benefits are typically payable at retirement in the form of an annuity, as opposed to a single sum
 - Single sums are permitted, but DB plans are required to offer certain annuity forms
 - Employer contributions to fund benefit obligations are determined actuarially, via an annual “valuation” process
 - DB benefits up to a certain amount are insured by the federal government through the aforementioned PBGC, should the plan sponsor become insolvent and benefits are not fully funded

“Defined Benefit” vs. “Defined Contribution” Plans

- DC plans: key characteristics
 - Rather than define a benefit to be paid from the plan, DC plans define the types of and conditions for annual contributions that may be made to the plan by the plan sponsor, participants, or both
 - Employees bear the investment risks relative to plan assets
 - Participants typically direct the investment of their accounts
 - Plan must provide for an individual account for each participant, composed of contributions to the account, (whether made by the employer, employee, or both) and income, expenses, gains or losses allocated to the account
 - Distribution is typically after employment termination in the form of a single sum, not an annuity
 - Most DC plans take advantage of an exception to the annuity requirements applicable to DB plans
 - In-service distributions (and participant loans) are common
 - Actuarial valuations are not required
 - PBGC insurance is not available

“Qualified” Plans vs. “Nonqualified” Plans

- Qualified plans
 - Plans designed to satisfy IRC “qualification” requirements, primarily those in IRC section 401(a), and is therefore eligible for favorable tax treatment
 - Generally, all or a majority of the rules in ERISA also apply to qualified plans
 - Several of these rules require that qualified plans be available to and provide benefits for a broad base of employees, not just the highly-paid (i.e., the “coverage” and “nondiscrimination” rules)
 - If a qualified plan fails to satisfy any of the relevant qualification rules, the plan technically loses its qualified status and the associated favorable tax treatment (i.e., becomes a “disqualified” plan)
- Nonqualified plans
 - Plans intentionally designed so as to not satisfy applicable qualification rules, and therefore ineligible for favorable tax treatment
 - Instead, nonqualified plans of most organizations must generally meet the requirements in IRC section 409A
 - This section was added by the Congress via the American Jobs Creation Act of 2004 (“AJCA”), generally effective post-2004
 - To avoid regulation by the majority of ERISA, nonqualified plans typically cover only highly-paid individuals (unlike qualified plans)

Some Key Qualification Requirements for Retirement Plans (IRC section 401(a))

- Plan must be administered according to a written plan document that is complete and up-to-date
- Plan assets must be held and used for the exclusive benefit of plan participants and beneficiaries
- Plan must not be designed or operated in a manner that discriminates in favor of highly-compensated employees
- Plan must satisfy certain requirements regarding plan coverage, eligibility, vesting, and benefit accrual
- Plan must satisfy certain requirements regarding the form and timing of distributions, including the provision of certain information regarding benefits and distributions to participants and/or beneficiaries
- Plan must, in general, prohibit the assignment or alienation of a participant's benefits to a non-beneficiary third party without the participant's consent
 - Certain exceptions to this rule are provided, including one for "qualified domestic relations orders", or "QDROs"
- Contributions made to, benefits paid from, and compensation recognized by a qualified plan must satisfy certain restrictions or limits
- Plans must permit "rollovers" of eligible amounts by participants and beneficiaries

Federal Tax Treatment of Qualified Plans

- As long as the qualification requirements are satisfied, a qualified plan experiences the following favorable tax treatment
 - Deductibility of employer contributions – if applicable, the plan sponsor may deduct plan contributions (up to certain limits) for the tax year for which the contributions are made
 - Tax deferral on employer contributions – at the time contributions are made, participants do not include the contributions in income, even if such contributions are nonforfeitable (vested)
 - Tax-deferred growth of trust fund assets – until distributed, trust fund assets are free from taxation
 - Favorable tax treatment upon distribution – distributions to participants are included in ordinary income for the year when received, but favorable tax treatment may still apply, such as the ability to roll over a distribution to another tax-deferred vehicle

Funding and Accounting of Qualified Plans

- DB plans: funding and accounting
 - Unlike the Social Security system, benefits in private DB plans must be funded in advance of benefit commencement
 - Level of employer contributions required to satisfy funding requirements is determined annually through the actuarial “valuation” process
 - Various actuarial assumptions are used as part of the valuation process, such as interest rate, mortality, salary growth (in pay-related plans), and employee turnover
 - At the highest level, the valuation results in the determination of two quantities as of the “valuation date” (typically, the first day of the plan year)
 - Plan benefit liabilities
 - Plan assets
 - Relationship between these two quantities determines whether and in what amount employer contributions are required for the plan year that is the subject of the valuation
 - Funding requirements have been “toughened up” as a result of the PPA of 2006
 - Funding levels also influence amount of PBGC premiums
 - Funding levels, required contributions and related information must be certified annually by an “enrolled actuary” on the Schedule B to Form 5500
 - Beginning with 2008 plan years, the Schedule B is replaced by, for single-employer plans, the “SB” and, for multiemployer plans, the “MB”

Funding and Accounting of Qualified Plans

- DB plans: funding and accounting, cont'd.
 - Actuary's calculations in the valuation typically produce a range of employer contributions for the year: a minimum contribution and a maximum contribution
 - The minimum reflects the smallest contribution that will satisfy ERISA and IRC funding requirements for the year
 - The maximum reflects the highest contribution amount that may be contributed and taken as a tax deduction by the employer for the current tax year
 - Sometimes the minimum is \$0 (no contribution required)
 - Sometimes the maximum is \$0 (no contribution permitted without penalty)
 - A similar type of valuation is performed to determine how the plan's liabilities and contributions are reflected on the employer's financial statements, specifically, the income statement (i.e., "P&L" statement) and the balance sheet
 - This valuation follows a somewhat different set of rules established by the accounting profession (e.g., via Financial Accounting Statement ("FAS") 87)
- DC plans: funding and accounting
 - Funding and accounting of DC plans is much simpler than with DB plans
 - Cash contributions go on the income statement
 - Because assets always equal benefits in a DC plan, DC plans are always by definition fully funded, and there is therefore no impact on the balance sheet

Fiduciary Responsibility

- Generally, a “fiduciary” is anyone with legal responsibility for another’s property and/or rights to property
 - E.g., a “trustee” of a trust fund
- Fiduciaries are legally held to a very high standard of conduct
- ERISA applies the concept of the fiduciary to benefit plans
 - Benefit plan fiduciaries are identified
 - Duties and standards of performance are required
 - Consequences are prescribed for a fiduciary’s failure to fulfill his/her duties under ERISA
- ERISA’s fiduciary rules apply to both H&W plans and qualified retirement plans
 - “Nonqualified” retirement plans are usually exempt from these rules

Fiduciary Responsibility

- ERISA describes two types of fiduciaries
 - “Named” fiduciary (ERISA section 402(a))
 - Fiduciary by virtue of having been named as such in the plan document (or by the employer pursuant to a procedure in the plan document)
 - Named fiduciaries have general authority under ERISA to control and manage plan operation and administration
 - Each benefit plan covered by ERISA must designate at least one named fiduciary
 - “Deemed” fiduciary
 - Fiduciary by virtue of satisfying the “functional” definition in ERISA section 3(21)(A)
 - “A person is a fiduciary with respect to a plan to the extent he [or she]
 - Exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control over management or disposition of its assets
 - Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
 - Has any discretionary authority or discretionary responsibility in the administration of such plan.”

Fiduciary Responsibility

- ERISA standards of performance (duties) for fiduciaries (ERISA section 404(a))
 - Loyalty
 - “...a fiduciary shall discharge his duties with respect to a plan solely in the interest of plan participants and beneficiaries...”
 - Exclusive purpose
 - “...for the exclusive purpose of providing benefits to participants and their beneficiaries, and defraying reasonable expenses of administering the plan...”
 - Prudence
 - “...with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims...”
 - Courts generally focus on the decision-making process fiduciaries followed, not the actual result (referred to as “procedural prudence”)
 - Courts have held that fiduciaries are not “guarantors” of good results, and that the prudence requirement includes an ongoing “duty to monitor”
 - Documentation of decision-making and monitoring is essential

Fiduciary Responsibility

- Standards of performance (duties) for fiduciaries, cont'd.
 - Diversification
 - “...by diversifying the investments of the plan so as to minimize the risk of large losses, unless...it is clearly prudent not to do so...”
 - Follow plan documents
 - “...in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with [ERISA].”

Fiduciary Responsibility

- Fiduciary status carries the risk of civil and, in certain cases, criminal liability
 - Civil liability
 - Exposure of plan sponsor, benefit committees and individual fiduciaries for plan losses and/or profits made as a result of the breach
 - “Equitable” remedies, such as removal as fiduciary
 - Penalty equal to 20% of amount recovered in DOL-initiated court action or settlement with DOL
 - Criminal liability (partial list)
 - \$100,000 fine and/or 10 years imprisonment for “willful violation” of reporting/disclosure requirements
 - Penalties and/or imprisonment for theft, embezzlement, mail fraud, wire fraud
 - Co-fiduciary liability
 - A fiduciary may be liable for the breach of another fiduciary under certain circumstances (next overhead)

Primary Compliance Requirements of Qualified Plans

Plan Documentation, Reporting and Disclosure

- Both ERISA and the IRC require benefit plans to be administered according to a written document, and to satisfy certain reporting and disclosure requirements
- Plan documents
 - Must contain certain content, depending upon the type of plan (e.g., retirement vs. H&W, DB vs. DC)
 - Detailed DOL regulations spell out required content per type of plan
 - Must be kept up to date with changes in relevant law as well as plan design changes
 - Changes in the law: e.g., the PPA
 - Changes in plan design: e.g., change of benefit formula in a DB, addition of participant loans in a DC
 - Most qualified retirement plans periodically submit the document to the IRS for a determination that the plan's content meets requirements
 - IRS issues the plan sponsor a ruling referred to as a "Determination Letter"
 - Current IRS procedure is for plans to submit for determination letters, in general, every five years

Plan Documentation, Reporting and Disclosure

- Reporting and disclosure
 - This is a very detailed and complex set of requirements imposed by ERISA and the IRC
 - Goal is to keep both regulators and plan participants informed regarding plan operation and, with respect to plan participants, to provide necessary information to make benefit-related decisions
- In general, “reporting” means communicating with the federal government and “disclosing” means communicating with plan participants and, in some cases, beneficiaries
- Ensuring compliance with the myriad reporting and disclosure requirements is technically the responsibility of the “plan administrator” (so named in the IRC, called simply the “administrator” in ERISA)
 - IRC and ERISA define the plan administrator as the party designated as such per a procedure in the plan document or, in the absence of such a procedure, the employer/plan sponsor
- Failure to meet reporting requirements usually results in a penalty in the form of specific dollar amount, usually based on the number of days that the reporting requirement is late
- Failure to meet disclosure requirements usually does not result in a specific dollar penalty, but instead can result in lawsuits by participants and/or the DOL, as well as other government regulatory action

Plan Documentation, Reporting and Disclosure

- Examples of reporting requirements
 - Form 5500
 - Filed with the DOL, who then circulates portions to the IRS and, if a DB plan, the PBGC
 - Initially due within 7 months after plan year end
 - Two different extensions are available: 1½ months or 2½ months
 - PBGC premium payment forms
 - Used to submit premium payments for DB plans
 - One form is used early in the plan year to pay an estimated premium for the year based on the prior year's participant count
 - Due by the end of the second month of the plan year
 - One and possible two other forms are used later in the year to true up the estimated premium amount and pay any additional premiums
 - Due by the 15th day of the 10th month of the plan year
 - Form 11-K
 - Applies only to DC plans sponsored by publicly-traded companies where the plan holds employer stock as an investment
 - Filed with the SEC (Securities and Exchange Commission)
 - Due within 180 days after plan year end

Plan Documentation, Reporting and Disclosure

- Examples of disclosure requirements
 - Summary plan description (“SPD”)
 - A summary of key provisions of the plan
 - Due to newly eligible participants within 90 days after date of eligibility, and an updated version is due to all participants every five years
 - Summary of material modification (“SMM”)
 - A summary of change(s) to the plan
 - Due within 210 days after the end of the plan year in which the change occurred
 - Summary annual report (“SAR”)
 - A summary of certain financial and demographic information from the latest Form 5500
 - Due within two months after the final filing deadline for Form 5500
 - PPA funding notice
 - Replaces the SAR for DB plans beginning with the 2008 plan year
 - Due within 120 days after plan year end
 - Benefit statements
 - DC plans: due within 45 days after each calendar quarter
 - DB plans: generally due every three years (or an annual notice may be provided stating that a statement is available)

Plan Documentation, Reporting and Disclosure

- Examples of disclosure requirements, cont'd.
 - DC plan-unique disclosures
 - Notice of opportunity to diversify employer stock investments
 - Notice regarding default investments
 - Notices relative to automatic enrollment
 - ERISA section 404(c) information
 - Distribution-related disclosures
 - Qualified joint and survivor annuity (“QJSA”) notice/election/spousal consent
 - In DB plans, also includes “relative value” disclosures
 - Notice/consent to distribution of an amount in excess of \$5,000 (or such lower amount as designated under the plan)
 - For rolloverable distributions (e.g., single sums), the “402(f)” notice (also referred to by other terms, such as the “rollover” notice or “Special Tax Notice”)
 - For non-rolloverable distributions (e.g., life annuities), a notice and election to waive/change amount of tax withholding from each payment (the “3405” notice/election)

Plan Coverage and Eligibility

- Plans may cover fewer than all employees, but must cover (technically, “benefit”) a group of employees that satisfies the coverage requirements of IRC section 410(b)
- In general, these rules require that the plan benefit a group of nonhighly compensated employees (“NHCEs”) that is at least 70% of the number of highly compensated employees (“HCEs”) benefiting under the plan
 - Determined by performing a numerical test called the “ratio percentage test”
 - “Benefiting means, in general, being eligible for contributions in a DC plan and actually accruing a benefit for the year in a DB plan
- An employee is an HCE for a given plan year if the employee satisfies either of two “tests”
 - The “earnings test”: the employee earned more than \$80,000 (as periodically indexed by the IRS) in the previous plan year
 - For 2007 the threshold is \$100,000 and for 2008 the threshold is \$105,000, meaning that employees who earn more than \$100,000 in 2007 are HCEs for 2008 and those who earn more than \$105,000 in 2008 are HCEs for 2009
 - Plan sponsors may elect to limit the size of the HCE group under this test to the top 20% of employees ranked by compensation
 - The “ownership test”: the employee owns more than 5% of the employer in either the current or previous plan year
- Employees who are not HCEs are NHCEs

Plan Coverage and Eligibility

- Plans may impose one or more conditions on plan eligibility
 - Employee must be part of the “eligible class” (e.g., salaried and non-union hourly)
 - Employee must attain a certain age
 - Maximum permitted by ERISA and the IRC is generally age 21
 - Employee must complete a period of service with the employer
 - Maximum service requirement is generally one year with 1,000 hours
 - Service with all members of the employers “controlled group” generally counts for this purpose
- Once employee satisfies plan’s eligibility requirements, employee must be treated as a participant not later than the earlier of
 - Six months after satisfying eligibility criteria, or
 - The 1st day of the first plan year following the plan year in which the employee satisfies eligibility criteria

Benefit/Contribution Limitations

- Limitations on DB plan benefits (IRC section 415(b))
 - Annual benefit between ages 62 – 65 cannot exceed the lesser of
 - 100% of the average of a participant’s highest three-year (consecutive) compensation, or
 - \$160,000, as periodically adjusted for inflation by the IRS
 - \$180,000 for 2007 commencements, \$185,000 for 2008 commencements
 - This dollar limit is reduced or increased for benefit commencements before age 62 or after age 65, respectively
- Limitations on DC plan contributions
 - IRC 402(g)(1) annual limit on the sum of employee pre-tax contributions and Roth 401(k)/403(b) contributions
 - \$15,000 as adjusted by the IRS (for 2007 and 2008, \$15,500)
 - IRC 414(v)(2)(B)(i) annual limit on “age-50 catch-up contributions”
 - \$5,000 as adjusted by the IRS (for 2007 and 2008, \$5,000)
 - IRC 415(c) annual limit on total contributions and forfeitures allocated to a participant’s account (except age 50 catch-ups)
 - Lesser of
 - 100% of compensation, or
 - \$40,000 as adjusted by the IRS (\$45,000 in 2007, \$46,000 in 2008)

Benefit/Contribution Limitations

- Other limitations that can affect the level of DB benefits or DC contributions
 - DB and DC plans
 - IRC section 401(a)(17) limit on the amount of participant compensation that may be recognized by a qualified plan
 - \$200,000, as adjusted by the IRS (\$225,000 in 2007, \$230,000 in 2008)
 - “Governmental” plans (qualified plans maintained by state or local governments) may have a much higher limit
 - DC plans permitting employee contributions
 - IRC section 401(k) and section 401(m) discrimination tests
 - If these tests fail, the usual method of correction is to distribute excess contributions to HCEs, thereby limiting the amount of contribution HCEs were permitted to receive in a given year

Nondiscrimination

- Qualified plans are subject to rules that prohibit discrimination in favor of highly compensated employees (“HCEs”)
 - Overall requirements are found in IRC sections 401(a)(4) and (5) as well as in very detailed IRS regulations
- What the requirement of nondiscrimination really means is that a plan may discriminate in favor of HCEs, just not too much
 - How much discrimination is “too much” depends upon the particular nondiscrimination requirement
 - Demonstrating compliance is accomplished via use of “safe harbor” plan design elements or numerical testing, again depending upon the specific requirement
- The prohibition against discrimination applies to various design and operational aspects of qualified plans, such as
 - Amount of
 - Benefit from a DB plan
 - Contribution to a DC plan
 - Other benefits, rights and features of a plan
 - E.g., distribution options, rates of matching contributions
 - Timing of plan amendments and plan terminations

Nondiscrimination

- Demonstrating nondiscrimination in amount of DB benefits or DC contributions
 - DB plans
 - Safe harbor design
 - Numerical testing generally every three years (the “general” test)
 - DC plans
 - Employer nonelective contributions
 - Safe harbor design
 - Numerical testing generally every three years (the “general” test)
 - Employee pre-tax contributions and Roth 401(k)/403(b) contributions
 - Safe harbor designs
 - One for plans using “traditional” enrollment
 - A different one for plans using “automatic” enrollment
 - Numerical testing every year (the “actual deferral percentage” or “ADP” test)
 - Employee “traditional” after-tax contributions and employer matching contributions
 - Safe harbor designs (same two choices as for pre-tax/Roth contributions)
 - Numerical testing every year (the “actual contribution percentage” or “ACP” test)

Nondiscrimination

- ADP test
 - Testing population is all employees who were eligible to make elective contributions at any time during the plan year
 - Year from which data for the testing population is drawn may be different for HCEs and NHCEs
 - If plan is being tested on a “prior year” basis
 - HCE data is taken from the testing year (e.g., 2007)
 - NHCE data is taken from the plan year that precedes the testing year (e.g., 2006)
 - If plan is being tested on a “current year” basis
 - Data for both HCEs and NHCEs is taken from the testing year
 - The plan document specify the method being used, whether prior year or current year

Nondiscrimination

- ADP test, cont'd.
 - Testing procedure
 - Divide testing population into HCEs and NHCEs
 - Calculate an individual fraction (“actual deferral ratio”, or “ADR”) for each eligible participant by using the following data drawn from the correct plan year (depending upon whether the plan is using the prior year or current year method)
 - Numerator: dollar amount of pre-tax elective contributions plus Roth 401(k) contributions made during the plan year (even if \$0), capped at the IRC section 402(g) limit for the year (e.g., \$15,500 for 2007)
 - If a participant’s numerator exceeds the applicable 402(g) limit, this is a compliance violation and must be addressed
 - Denominator: dollar amount of “testing” compensation for the plan year being tested, limited to the applicable IRC section 401(a)(17) limit on plan compensation for the year (e.g., \$225,000 for 2007)
 - Testing compensation must generally satisfy one of the “safe harbor” compensation definitions under IRC section 414(s)
 - Average individual fractions of each group (HCEs and NHCEs)
 - Compare the HCE group average to the NHCE group average

Nondiscrimination

- ADP test, cont'd.
 - Test passage
 - If NHCE group average is equal to or higher than HCE group average (not likely), test passes
 - Otherwise, test passes if HCE group average does not exceed the NHCE group average by greater of
 - NHCE average x 1.25, or
 - Lesser of NHCE group average plus 2 percentage points or NHCE group average x 2
- ACP test
 - Testing population, procedures and passing ranges are generally the same as for the ADP test
 - Individual fraction is “actual contribution ratio” or “ACR”
 - Numerator is dollar amount of employer matching contributions plus employee “traditional” after-tax contributions
 - Denominator is testing compensation (may be the same definition as that used for the ADP test, but does not have to be)

Nondiscrimination

- Correction of ADP and/or ACP test failure: methods
 - “Drop the top”: two alternatives
 - Distribute excess contribution amounts plus proportionate share of earnings to certain HCEs
 - Distribution is taxable and not rolloverable, but is exempt from the 10% penalty on pre-age 59½ distributions
 - For the 2006 and 2007 testing years, distribution must also include earnings for the “gap” period (the period between the end of the testing year and the date of the distribution, less seven days)
 - Beginning with 2008 testing years, the requirement to distribute gap period earnings is eliminated
 - ADP test failure: recharacterize excess pre-tax amounts as after-tax and test in ACP test
 - HCE is taxed but does not receive a distribution
 - Plan must provide for post-tax contributions
 - “Lift the bottom”: two alternatives
 - Make additional employer contributions to accounts of eligible NHCEs
 - “Qualified nonelective contributions” (QNECs”) and/or “qualified matching contributions” (QMACs”)
 - ACP test failure: “swing” amounts from passing ADP to failing ACP

Nondiscrimination

- Correction of ADP and/or ACP test failure: timing
 - Drop the top
 - Distribution method has two deadlines
 - First deadline: within 2½ months after plan year end
 - Through 2007 plan years, HCE must include the distribution as income for the year of test failure
 - Second deadline: after 2½ months but within 12 months after plan year end
 - HCE must include the distribution as income for the year distributed
 - Employer is assessed a 10% IRS penalty on the amount of distribution (on excess amount only, not the earnings component)
 - Beginning with the 2008 plan year, two changes occur
 - In automatic enrollment plans, corrective distributions may be made within 6 months after the end of the plan year without the employer incurring a 10% excise tax
 - For all plans, corrective distributions will always be taxed for the year distributed, regardless of whether distribution occurred within the 2½-month/6-month deadlines
 - Recharacterization method: within 2½ months after plan year end

Nondiscrimination

- Correction of ADP and/or ACP test failure: timing
 - Lift the bottom
 - QNECs/QMACs
 - Generally, within 12 months after plan year end
 - However, if plan is testing on the prior year method, QNEC/QMAC must be made by last day of testing year
 - Swinging: virtually anytime before testing is finalized

Vesting: Minimum ERISA/IRC Requirements

- Employee contributions (pre-tax, traditional post-tax and Roth)
 - Must be 100% vested immediately
- Employer-funded benefits (DB plans)
 - “Traditional” DB plans (e.g., final average pay formulas)
 - May use either of two maximum vesting schedules
 - Five-year cliff
 - Less than five years of service: 0%
 - Five or more years of service: 100%
 - Seven-year graded
 - Less than three years of service: 0%
 - Three years of service: 20%
 - Four years of service: 40%
 - Five years of service: 60%
 - Six years of service: 80%
 - Seven or more years of service: 100%
 - “Hybrid” DB plans (e.g., cash balance)
 - As a result of the PPA, all accrued benefits must be vested over a three-year cliff schedule

Vesting: Minimum ERISA/IRC Requirements

- Employer contributions (DC plans)
 - Traditional matching contributions
 - Pre-2002 contributions: either five-year cliff or seven-year graded
 - Post-2001 contributions: maximum schedules are either a three-year cliff or a six-year graded (works the same as seven year graded except each vesting breakpoint is one year earlier)
 - Traditional nonelective contributions
 - Pre-2007 contributions: either five-year cliff or seven-year graded
 - Post-2006 contributions: either a three-year cliff or a six-year graded
 - QNECs, QMACs, and “safe harbor” QNECs and QMACs made to all plans through 2007 and, post-2007, to plans that are not using automatic enrollment
 - Must be 100% vested immediately
 - Post-2007 safe harbor QNECs or QMACs made to plans using automatic enrollment
 - May impose a two-year cliff schedule

Distributions: Overview

- In general, distributions from qualified plans are triggered by either of two scenarios
 - An event that represents a severing of a plan participant's employment relationship with the plan sponsor, such as
 - Retirement
 - Employment termination
 - Death
 - Disability (typically, when an employee is out on LTD long enough he or she is terminated)
 - An event that occurs while the employee is still employed (referred to as an "in-service" distribution or withdrawal), such as
 - Attainment of a particular age, e.g., 59½
 - Financial hardship
- Whatever the circumstances triggering a distribution, the IRC and ERISA have rules regarding
 - The form which distributions may – and in some cases, must – take
 - The timing of the distribution
- Also, under the IRC distributions are subject to federal income taxation, generally for the year of receipt, although there are a variety of exceptions and special rules

Distributions: Form

- At a minimum, DB plans must provide for distribution in the form of certain types of annuities
 - The particular mandatory annuity form is determined by
 - Whether the participant survives until his or her “annuity starting date” (i.e., the earliest date the benefit is payable to the participant), AND
 - The participant’s marital status at benefit commencement
 - Mandatory forms
 - Participants who survive to their annuity starting date must be offered a “qualified joint and survivor annuity” (“QJSA”)
 - For unmarried participants, the QJSA is a single life annuity
 - For married participants, the QJSA is a actuarially equivalent joint and survivor annuity with a survivor percentage of at least 50% but no more than 100%
 - The surviving spouses of married, vested participants who die prior to their annuity starting date must be offered a preretirement form of the QJSA referred to as the “qualified preretirement survivor annuity” (“QPSA”)
 - Beginning in 2008, the PPA generally requires plans to offer an additional annuity option: the “qualified optional survivor annuity” (“QOSA”)
 - The required survivor percentage of the QOSA depends on the designated survivor percentage of the plan’s QJSA for married participants

Distributions: Form

- Plan can provide that the mandatory annuity rules for married participants only apply to participants married at least one year
- In addition to the mandatory forms, plans may offer optional forms of distribution
 - E.g., 5- and 10-year term certain annuities, “level income options”, single life annuities for married participants, joint and survivor annuities for unmarried participants, single sums
 - However, if a married participant selects a form of distribution other than the QJSA, the spouse must consent in writing (witnessed by a notary) to the election
- If the aggregate amount of a participant’s benefit is “small”, the amount may be distributed as a single sum instead of as an annuity, regardless of the participant’s marital status
 - This process is referred to as a “mandatory cash-out”
 - “Small” is defined as a total benefit amount that does not exceed U.S.\$5,000 (the plan may choose a lower value)
 - For distributable amounts that exceed \$1,000 but do not exceed \$5,000, the IRC requires the plan sponsor to automatically roll over the amount to an IRA of the plan sponsor’s choosing if the participant does not make an affirmative election to take the distribution within the plan’s time frames (e.g., 30 days)

Distributions: Form

- The mandatory annuity rules that always apply to DB plans also apply to money purchase pension DC plans, and theoretically to all other types of DC plans as well, but the law permits non-money purchase DC plans (e.g., 401(k), ESOPs) to avoid paying annuities if
 - Plan provides that the full amount of a participant's vested benefit is payable
 - If married, to his or her surviving spouse
 - Spouse can waive this right in writing (witnessed by a notary)
 - If unmarried, to his or her designated beneficiary
 - Participant does not choose to take benefit in the form of a life annuity (if offered by the plan)
- This results in the majority of DC plans offering either or both of two forms of distribution
 - Single (“lump”) sums
 - Installment payments over a fixed number of years (e.g., annual installments over 10 years)

Distributions: Timing

- Earliest
 - DB plans and money purchase pension DC plans
 - Generally no earlier than employment termination or “retirement” as defined by the plan, although the PPA now permits plans to allow benefit commencement @ age 62 even if still employed
 - All other DC plans
 - Upon termination of employment regardless of age, but in-service distributions are permitted and offered widely by plans
- Latest
 - All qualified plans must require distribution to a participant of at least a minimum annual amount per year, beginning no later than the April 1st following the plan year in which the participant attains age 70½
 - A plan may provide that minimum distributions begin by the April 1st following the year the participant retires, if later than age 70½
 - These requirements are referred to as the “required minimum distribution” (“RMD”) rules
 - Minimum amount that must be distributed each year is generally the participant’s total benefit divided by a life expectancy factor
 - Complex IRS rules determine when, how much and for how long minimum benefits must be distributed

Distributions: Taxation

- Although qualified plan distributions are generally taxable to recipients in the tax year of receipt, the “rollover” is a technique to delay the tax effect of certain distributions
- Rollovers
 - Generally, a direct transfer from a qualified plan to certain eligible vehicles
 - But not all forms of distribution may be rolled over
 - OK to roll over: single sum distributions, installment payments paid over 10 or fewer years
 - Not OK to roll over: most types of annuities, hardship distributions, required minimum distributions
 - Eligible vehicles that may accept a rollover
 - Qualified DB or DC plan, 403(b) plan or governmental 457(b) plan
 - Individual retirement account (IRA)
 - IRC section 401(a)(31)(B) generally requires plan sponsors to roll over a participant’s amount to an IRA on the participant’s behalf, if the amount exceeds \$1,000 but does not exceed \$5,000 and the participant fails to provide instructions
 - Plan sponsor must select the IRA vendor and investment vehicle
 - DOL regulations provide guidance on acceptable vendors and investments
 - If DOL requirements are satisfied, employer is “off the hook” as an ERISA fiduciary once the money is transferred to the IRA

Distributions: Taxation

- In addition to federal income taxation, distributions may trigger potential additional penalty taxes in two situations
 - Distribution is “too early”, that is, prior to age 59½
 - Penalty: 10% of the distribution amount that is received into a participant’s income
 - Some exceptions
 - Distributions due to participant’s death or disability
 - Distributions made over participant’s life (or life expectancy) or over the joint lives (or life expectancies) of the participant and designated beneficiary
 - Distributions made after separation from service during the year the participant attains age 55
 - “Corrective” distributions (e.g., because of a failed nondiscrimination test)
 - Distribution of dividends paid on employer stock held in an ESOP
 - Distribution is “too little or too late”, meaning that the required minimum distribution (RMD) rules were not satisfied
 - Amount of the penalty is 50% of the “shortfall” (the amount by which the actual distribution is less than the RMD)