FUNDAMENTALS OF QUALIFIED RETIREMENT PLANS
SESSION 1

January 18, 2018

Presented by:
John P. Griffin, J.D., LL.M.
ASC Institute, LLC
Littleton, CO
www.asc-net.com

Session 1 Topics

- Introduction to Qualified Plans
- Participation, Coverage and Vesting
- Controlled and Affiliated Service Groups
- Leased Employees
- Plan Types and Categories
- Contributions and Allocations
- Defined Benefit Plan Formulas and Accrual Rules

Session 2 Topics

- Limitations on Contributions and Benefits
- Compensation Definitions
- Definition of Highly Compensated Employee
- General Nondiscrimination Testing (Code §401(a)(4))
- ADP/ACP Testing
- Safe Harbor and Automatic Enrollment Plans

Session 3 Topics

- Top-Heavy Plans
- Deduction Rules
- Plan Distributions
- Spousal Distribution Rights
- Taxation of Distributions
- Rollovers
- Required Minimum Distributions

Session 4 Topics

- Participant Loans
- Qualified Domestic Relations Orders (QDROs)
- Death Benefits
- Plan Termination
- Fiduciary Responsibility
- Prohibited Transactions

Session 5 Topics

- Plan Documents
- Plan Communications
- IRS/DOL Audits
- Plan Correction Programs
- Government Filings

What is a Qualified Plan?

- A qualified plan is a retirement plan that satisfies §401(a) of the Internal Revenue Code
- Plan must satisfy these requirements both in form and in operation
  - Form – plan document contains language sufficient to document compliance with Code §401(a)
  - Operation – all requirements of Code §401(a) satisfied in the actual administration of the plan

Why Adopt a Qualified Plan?

- Assets accumulate on a tax deferred basis
- Employees do not recognize income until benefits are actually distributed
- Tax-favored distributions (e.g., rollover to qualified plan or IRA)
- Employer gets current tax deduction for contributions
- Trust earnings are tax-exempt

Establishing a Qualified Plan

- Plan must satisfy all Code requirements for tax qualification under §401(a)
- Plan must be established by an employer
- Employer must execute written plan document and plan must be communicated to employees
- Must have trust to hold plan assets
- Employer must adopt a new plan by end of employer's tax year
- Plan must be for the exclusive benefit of employees and beneficiaries

Plan Participation and Eligibility

- Under Code §410(a), a qualified plan must specify which employees can participate and when an employee becomes eligible to participate under the plan
- A employee generally becomes a participant upon satisfying the minimum age and service requirements, unless otherwise excluded under the terms of the plan

Minimum Age and Service

- Written terms of plan control
  - Plan must satisfy the minimum age and service requirements of Code §410(a)
- Plan may have different eligibility requirements for different contributions

Minimum Age and Service

- Age 21 requirement
- One year of service requirement
  - Special rule
  - 2-year eligibility with immediate vesting
    - Not available for elective deferrals under a 401(k) plan
- Imposition of both age and service requirements

Measuring a Year of Service

- No more than 1,000 hours of service during Eligibility Computation Period (ECP)
  - Calculating hours – actual, equivalency or elapsed time methods
- ECP must be a 12-consecutive month period
  - Initial ECP begins on employee's employment commencement date
  - Subsequent ECPs may be based on plan years or anniversary years
- Plan may use more liberal entry rules

Example

- Wayne is hired on March 15, 2017.

  a) What is Wayne's initial Eligibility Computation Period (ECP)?

  3/15/17 – 3/14/18

  b) If Wayne does not complete 1,000 hours of service during first ECP, what period should plan use to measure subsequent ECP's under anniversary year method?

  3/15/18 – 3/14/19

  c) What period should plan use to measure subsequent ECP's under plan year method?

  1/1/18 – 12/31/18

Crediting Year of Service

- Year of service is credited at end of Eligibility Computation Period
- No requirement for continuous employment
- Employee does not have to be employed on last day of Eligibility Computation Period
- Generally, all service with employer counts toward eligibility

Plan Entry Dates

- Employee enters plan on appropriate entry date after satisfaction of eligibility conditions
- Entry date may not be later than earlier of:
  - first day of next plan year; or
  - 6 months following satisfaction of eligibility conditions
- Common entry dates -- semi-annual (January 1 and July 1 for calendar year plan), quarterly, monthly
- Plan may require employment on entry date

Plan Entry Dates

- Wayne is hired on March 15, 2017
  - Wayne completes 1,000 hours of service on 9/24/17. When does Wayne earn a year of service?

    3/14/18

  - Assuming plan uses semi-annual entry dates, when will Wayne enter the plan?

    7/1/18

  - When would Wayne participate if plan uses quarterly entry dates?

    4/1/18

Plan Entry Dates

- Assume Wayne was born February 14, 1997 and has worked full-time since March 15, 2015. The plan requires employees to attain age 21 and have a year of service to participate in the plan. Plan uses semi-annual entry dates. When will Wayne enter the plan?
  - Wayne is credited with a Year of Service on March 14, 2016, but does not attain age 21 until February 14, 2018. Wayne will enter the plan on July 1, 2018, the first entry date following completion of age and service requirements.

Break in Service Rules

- One-year break in service rule
- Rule of parity break in service rule
- Two-year eligibility break in service rule

Break in Service

- Employee incurs break in service if completes 500 or fewer hours of service in Eligibility Computation Period
- Service must be credited for certain leaves of absence solely to prevent a break in service
- Termination from employment not necessary
- Service may be disregarded if employee has a sufficient break in service

One-Year Break in Service Rule

- "Temporary" disregard of service
- Year of Service after re-employment determined in the same manner as under the normal eligibility rules
- Disregarded service must be restored retroactively if employee completes a Year of Service following Break in Service

Other Break in Service Rules

- Rule of parity
  - Permanent disregard of service - treated as new employee
  - Must be a participant
  - Participant must incur 5 consecutive Breaks in Service (or the participant's YOS, if greater)
  - Must be totally nonvested
- Two-year eligibility break in service
  - If employee incurs a BIS before satisfying two-year requirement, must start over as if new employee

Exclusion for Other Reasons

- May exclude employees for reasons other than age and service
  - Hourly / salaried
  - Job title / location
- Plan must be able to satisfy coverage
- Exclusion may not relate to age or service
  - Part-time employees
  - Seasonal employees

Coverage Testing

- Limits extent to which plans can be designed in favor of highly compensated employees
- Plan must pass coverage test every plan year
- Coverage measures relative coverage of HCEs and NHCEs
- Two coverage tests - only need satisfy one test
  - Ratio percentage test
  - Average benefits test

Special Rules

- Coverage testing options
  - Daily
  - Quarterly
  - Annual
- Special rules for 401(k) plans - must perform separate coverage test for each separate source
  - Elective deferrals
  - Matching contributions
  - Employer contributions

Special Rules

- Plans deemed to satisfy or exempt from coverage requirements
  - Governmental plans
  - Nonelecting church plans
    - Subject to Pre-ERISA requirements
  - Plan benefiting no highly compensated employees
  - Plan sponsored by an employer with ONLY highly compensated employees
  - Collectively-bargained plans

Ratio Percentage Test

- $$\frac{\text{NHCE ratio}}{\text{HCE ratio}} \geq 70\%$$
- $$\text{NHCE ratio} = \frac{\text{NHCEs benefiting}}{\text{total NHCEs}}$$
- $$\text{HCE ratio} = \frac{\text{HCEs benefiting}}{\text{total HCEs}}$$
- Only include "nonexcludable" employees in ratio percentage test = may exclude certain "excludable" employees from coverage tests

Nonexcludable Employees

- Nonexcludable employees - total workforce reduced by "excludable" employees
- Excludable employees - do not affect coverage test results
  - Minimum age and service
  - Collectively-bargained employees
  - Nonresident aliens with no U.S. source income
  - Certain airline pilots
  - Terminated employees with 500 or fewer hours
- All other employees are included in coverage test, even if excluded for other reasons

Benefiting Group

- Once you know nonexcludable employee group, need to determine which employees are "benefiting" under the plan
- Benefiting under plan
  - Defined contribution plan (employer contribution) - employees who *receive* allocation of contribution or forfeiture
  - 401(k) plan - employees who are *eligible* to defer
  - 401(m) plan - employees who are *eligible* to make after-tax employee contributions or to receive match if defer
  - Defined benefit plan - employees accrued benefit increases in the plan year

Benefiting Group

- Plan may exclude employees for other reasons (e.g., job classification, salary type, location) – not considered benefiting
- Plan may contain allocation conditions – not considered benefiting
- Different levels of contributions or benefits not important in ratio percentage test

Example

- Total workforce - 35
- Excludable employees – 9
- Total nonexcludable employees – 26
- Total nonexcludable employees who are NHCEs – 22
- Total nonexcludable employees who are HCEs – 4
  - NHCE benefiting – 16
  - HCEs benefiting – 4
  - NHCE ratio – 16/22 = 72.73%
  - HCE ratio – 4/4 = 100%
    - Ratio percentage = 72.73%/100% = 72.73%

Average Benefits Test

- Alternative to ratio percentage test
- Two parts to average benefits test - must satisfy both parts to pass test
  - Nondiscriminatory classification test
  - Average benefit percentage test

Minimum Participation Test

- Code §401(a)(26) requires plan to benefit a minimum number of employees
  - The minimum number is the lesser of 50 employees or 40% of the employees of the employer
- Applies only to defined benefit plans
- 40% test not satisfied unless at least two employees benefit under the plan
- Excludable employees and "benefiting" are the same as under coverage tests
- Aggregation of plan not permitted

Minimum Vesting Requirements

- Minimum vesting rules contained in Code §411
- Vesting – participant has nonforfeitable right to account balance or accrued benefit
- Plan must meet specified vesting schedules
- Vesting schedule depends on total years of service based on vesting computation period

Minimum Vesting Requirements

- Permitted schedules for defined contribution plans
  - 3-year cliff = 100% after 3 years
  - 6-year graded
    - 0 – 1 YOS 0%
    - 2 YOS 20%
    - 3 YOS 40%
    - 4 YOS 60%
    - 5 YOS 80%
    - 6 YOS 100%

Minimum Vesting Requirements

- Permitted schedules for defined benefit plans
  - 5-year cliff = 100% after 5 years
  - 7-year graded
    - 0 – 2 YOS 0%
    - 3 YOS 20%
    - 4 YOS 40%
    - 5 YOS 60%
    - 6 YOS 80%
    - 7 YOS 100%
- Top-heavy defined benefit plans must satisfy either the three-year cliff or 6-year graded schedule

Special Vesting Rules

- Full vesting always required at NRA - often age 65
- 100% immediate vesting for:
  - Elective deferrals under 401(k) plan (including Roth deferrals)
  - After-tax Employee contributions
  - QMACs and QNECs
  - Certain matching and employer contributions to a Safe Harbor 401(k) plan or a Qualified Automatic Contribution Arrangement

Year of Service (Vesting)

- No more than 1,000 hours of service during Vesting Computation Period (VCP)
- VCP must be a 12-consecutive month period
  - Plan can designate any 12-month period
  - Most common VCP is plan year
- Plan uses full VCP even if employee is hired during VCP

Crediting Year of Service

- Generally, all service with employer counts
- Certain years may be excluded
  - Service earned prior to date the plan (or a predecessor plan) is first effective
  - Service prior to age 18
  - Certain service under the break in service rules

Vesting Example

- XYZ Corp. maintains a profit sharing plan with a plan year Vesting Computation Period (VCP). Bob is hired July 7, 2017.
  - What is Bob's initial VCP?

    1/1/17 – 12/31/17

  - If Bob works 200 hours per month, how many years of service will Bob have for vesting as of 12/31/18?

    2 years of service

  - If Bob works 100 hours per month, how many years of service will Bob have for vesting as of 12/31/18?

    1 year of service

Amendments to Vesting Schedule

- Protection of vesting percentage
  - IRS Position – vesting percentage at the time of amendment must not be reduced, even with respect to benefits accrued after the amendment
- Right to remain on old schedule for participants with 3 years of service
  - "Best of both worlds" eliminates election

Break in Service Rules

- Employee incurs BIS if completes 500 or fewer hours of service in vesting computation period
  - Termination of employment not necessary
- Break in service rules - vesting
  - One–year break in service rule
  - Rule of parity break in service rule
  - 5-year break in service rule

Break in Service Rules

- One-year break in service rule
  - "Temporary" disregard of service
  - Does not affect vested benefits accrued prior to break in service

Break in Service Rules

- Rule of parity - nonvested break in service rule
  - Permanent disregard of service - treated as new EE
  - Requirements –
    - Employee must be participant when break in service period begins;
    - Employee must incur a minimum of five consecutive breaks in service; and
    - Employee must be totally nonvested in his accrued benefit under the plan

Break in Service Rules

- 5-year break in service rule
  - Must have 5-consecutive breaks in service
  - Post-break service is ignored for pre-break accruals
  - Permits permanent forfeiture of nonvested account balance

Forfeitures

- Forfeiture events
  - 5-year forfeiture break in service
  - Cash-out distribution
- Termination of employment is not a forfeiture event!
- Forfeiture under 5-year break in service rule– forfeiture of nonvested benefit occurs at the end of the 5-year break in service period

Cash-Out Distribution

- Accelerates recognition of forfeiture
  - Immediate forfeiture upon cash-out
- Vested benefit must be distributed
- Employee must consent if vested benefit exceeds $5,000
- Employee may "buy back" forfeited benefit if rehired prior to a 5-year BIS
  - Plan may require repayment within 5 years of reemployment

Allocation of Forfeitures

- Plan may designate allocation of forfeitures under any of the following methods:
  - Reduction of future employer contributions
  - Reallocation to other participants in accordance with plan's allocation formula
  - Payment of plan expenses
- Forfeitures generally are allocated under same method as employer contributions

Treatment of Forfeitures

- A defined benefit plan may NOT use forfeitures to increase the benefits payable to other participants
- Forfeitures only affect the employer's contribution under the plan's funding method
- Generally, forfeitures in a defined benefit plan will reduce the employer contributions needed to fund the benefits promised by the plan

Related Employers

- Controlled group of businesses
  - Parent - Subsidiary Group
  - Brother-Sister Group
- Affiliated Service Group

Qualification Rules

- Eligibility
- Vesting
- Section 415 limits
- Highly compensated employee determination
- Top heavy determination
- Coverage
- Nondiscrimination

Controlled Group of Businesses

- Parent – subsidiary relationship
- Brother-sister relationship

Parent-Subsidiary Group

- 80% ownership
- Ownership by another company
- More common with larger employers

Brother-Sister Group

- Same 5 or fewer individuals ("common owners")
  - 80% ownership
  - 50% identical ownership
- More common for smaller businesses

Brother-Sister Group

- 80% common ownership test
  - Must have same five or fewer individuals owning at least 80% of each entity - only look at the combined ownership of the common owners in each business
  - To be counted in the combined ownership percentage, the common owners must have at least some ownership in each entity
- 50% identical ownership test
  - The combined identical ownership of the common owners is more than 50%
  - Use same common owners as in 80% test

Affiliated Service Groups

- Organizations have such a close relationship that the IRS believes that they should be treated as a single employer for qualified plan purposes
- Common fields - health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting and insurance

Leased Employees

- Leased employee treated as an employee of the recipient employer under Code §414(n)
- Definition
  - Services provided for a fee
  - Substantially full-time for at least one year
  - Primary direction or control by the recipient employer
- Treatment as an employee

Categorizing Qualified Plans

- Defined contribution plan vs. defined benefit plan
- Pension plan vs. non-pension plan

DC Plan vs. DB Plan

- Defined contribution plan
  - Individual account plan
  - Sum of the account balances generally equals the value of the trust
  - Participants bear the investment risk
  - Various types of defined contribution plans subject to different rules
    - Profit sharing plans / 401(k) plans
    - Money purchase plans
    - Stock bonus plans / ESOPs
    - Target benefit plans

DC Plan vs. DB Plan

- Defined benefit plan
  - Promised benefit (e.g. life annuity) at normal retirement age
  - Participant accrues benefit under a formula
  - Employer contributes amount necessary to fund promised benefit
    - Contribution depends on gain or loss on plan assets
    - Need actuary to determine funding obligation
  - Employer bears the investment risk

Pension vs. Non-Pension Plans

- **Pension plans**
  - **Must have definitely determinable benefits**
  - **Benefits based on formula under the plan**
  - **All defined benefit plans are pension plans**
  - **Money purchase plans and target benefit plans are pension plans**
  - **Contributions generally must be made each year**

Pension vs. Non-Pension Plans

- **Non-pension plans**
  - **Plans do not have definitely determinable benefits**
  - **May provide for discretionary contribution**
  - **Profit sharing plans, 401(k) plans, stock bonus plans, and ESOPs are all non-pension plans**
  - **Must provide a definite allocation formula**

Pension vs. Non-Pension Plans

- Only pension plans comply with minimum funding rules
- Permissible distribution events are restricted in pension plans
- Pension plans must comply with QJSA rules
- Only non-pension plans can include a 401(k) arrangement

Profit Sharing Plans

- Most popular type of plan
  - Can have 401(k) feature
- Discretionary or fixed contribution formula
- “Profits” are not required
- Designation as profit sharing plan required
- Recurring and substantial contributions
- Must have definite allocation formula

Profit Sharing Plans

- Common allocation formulas
  - Pro rata allocation formula
  - Permitted disparity allocation formula

Pro Rata Allocation

Total Employer Contribution

X

<u>Participant's compensation</u>
Total Participant Compensation

=

Participant's Allocation

Pro Rata Allocation

EE	Comp.	Allocation	Allocation %
Dr. 1	$200,000	$20,000	10%
Dr. 2	$100,000	$10,000	10%
NHCE 1	$50,000	$5,000	10%
NHCE 2	$30,000	$3,000	10%
NHCE 3	$20,000	$2,000	10%
Totals	$400,000	$40,000	

Permitted Disparity Formula

- Takes into account contributions to Social Security system to determine employer contributions
  - *"Integrated Plan"*
- Allocates more as a percentage of compensation to higher compensated employees than to lower compensated employees
- Additional allocation is made for compensation above the integration level (e.g., taxable wage base)

Permitted Disparity Formula

EE	Base Comp	Excess Comp.	Alloc. on Excess Comp	Pro rata Alloc.	Total Alloc.	Alloc. %
EE 1	$200,000	$71,600	$4,081	$16,735	$20,816	10.41%
EE 2	$30,000	0	0	$2,510	$2,510	8.37%
EE 3	$20,000	0	0	$1,674	$1,674	8.37%
	$250,000	$71,600	$4,081	$20,919	$25,000	10%

- Based on 2018 taxable wage base of $128,400

- Permitted disparity allocated on 5.7% of Excess Compensation

Profit Sharing Plans

- **Other allocation formulas**
  - **Points**
  - **Tiered**
  - **Age-weighted**
  - **New comparability (cross-tested) plans**

Money Purchase Plans

- Money purchase plan is a pension plan
  - Must have a fixed contribution formula and definitely determinable benefits
  - No employer discretion
  - Amendment needed to change formula
- Types of contribution formulas
  - Uniform percentage of compensation (10% of plan compensation)
  - Permitted disparity
  - Unit, age-weighted and tiered formulas

Money Purchase Plans

- Designation of type of plan is required
- Allocation formulas
  - Generally, allocation formula mirrors the contribution formula
  - Rarely, the allocation formula differs from the contribution formula
    - Contribution formula sets the amount
    - Allocation formula determines how that amount is allocated to participant's accounts

Money Purchase Plans

- Qualified joint and survivor annuity required
- Minimum funding rules apply
- Why establish a money purchase plan?
  - Disciplined approach
  - Assures employees of employer's commitment to the plan
  - No longer the deduction limit

401(k) Plans

- Profit sharing or stock bonus plan can include a 401(k) feature
- Money purchase plan may not be used
- Cash or deferred arrangement
  - Choice between cash and an employer contribution to a qualified retirement plan
  - Generally, participants avoid current taxation on elective deferrals made to plan

401(k) Plans

- Plan may provide for any of the following contributions
  - Elective deferrals (including catch-up and Roth deferrals)
  - Matching contributions
  - Employer nonelective contributions
- Elective deferrals are based on employee's salary deferral election
  - Salary deferral election must be entered into before compensation is currently available
  - Plan must be established before deferrals are withheld from compensation

401(k) Plans

- Subject to special nondiscrimination rules
  - ADP test - deferrals
  - ACP test - matching contributions
  - Safe harbor 401(k) plans and QACAs
- Special limits apply in determining amount of elective deferrals
  - 402(g) limit = $18,500 for 2018 (applies only to elective deferrals)
  - 415 limit = 100% of compensation or $55,000 for 2018
    - Applies to all contributions under the plan

401(k) Plans

- Catch-up contributions
  - Permits employees who are at least age 50 to make additional deferrals
  - Catch-up limit for 2018 = $6,000
- Roth 401(k) deferrals
  - Employers may allow for Roth deferrals
  - Roth 401(k) deferrals are a type of deferral under a 401(k) plan - NOT a new type of plan
  - Roth 401(k) deferrals are subject to current taxation - earnings are not taxable if qualified distribution

401(k) Plans

- Roth 401(k) Deferrals
  - Must make irrevocable election to treat deferrals as Roth deferrals - cannot retroactively change nature of deferral election
  - Roth deferrals must be held in separate account
  - Roth deferrals are subject to same 402(g) limit that applies to pre-tax elective deferrals
  - Roth deferrals are subject to the ADP test, even though after-tax
  - Roth deferrals always 100% vested

401(k) Plans

- Automatic enrollment plans
  - "Negative" election plans
- Participant automatically enrolled at a default salary deferral rate
- Employee may elect to change rate
- Types
  - Automatic contribution plans
  - Eligible automatic contribution plans
  - Qualified automatic contribution plans

401(k) Plans

- Matching contributions
  - Based on all or portion of elective deferrals
  - Fixed match
    - 50% of deferrals
    - 25% of deferrals up to 6% of compensation
  - Discretionary match
    - Employer decides the rate of match
    - Plan should specify a cap if applicable
  - Tiered match
    - 100% match on deferrals up to 2% of compensation and 50% match of the next 2% of compensation deferred
  - Catch-up contributions can be matched

401(k) Plans

- Nonelective contributions
  - Profit sharing plan
  - Discretionary contribution
  - Definite allocation formula
- Nonelective contributions not required

401(k) Plans

- Why an employer might establish a 401(k) plan
  - Individual contribution flexibility - Employees can determine individually how much to contribute
  - Immediate compensation effect for employees - ability to make pre-tax deferrals immediately reduces employee's taxable compensation
  - No effect for employer - deferrals do not increase cost of employer-provided benefit
  - Cost sharing - employer can make other contributions to plan, including matching contributions
  - Elective deferrals will not reduce employer's deductible contribution

Target Benefit Plans

- Target benefit plan
  - Type of money purchase plan
  - Provides a target benefit formula similar to a defined benefit plan to establish annual employer contribution
  - Does not guarantee benefit
  - Account balance just like other defined contribution plans

Stock Bonus Plans / ESOPs

- Stock bonus plan
  - Like a profit sharing plan
  - Benefits distributable in employer stock
- ESOP
  - Primarily invested in employer securities
  - Leveraged or nonleveraged
    - Leveraged ESOPs permit ER to take out loan to purchase ER stock

SEPs

- Simplified Employee Pension Plans
- Contribution is made to individuals' IRAs
- No separate trust

Defined Contribution Allocation Rules

- Plan prescribes allocation date
- Most employer contributions allocated once per year – usually the last day of the plan year
  - Can have multiple allocation dates
- Allocation of elective deferrals
- Allocation of matching contributions

Conditions on Receiving Allocations

- Hours of service condition
  - May not exceed 1,000 hours of service for the plan year
  - Separate from eligibility requirement
  - Primarily affects part-time and seasonal workers
- Last day employment condition
  - Must be employed on the last day of the plan year or perhaps a specific allocation date
  - May be in addition to an hours of service condition
- Other allocation conditions
  - Death, disability, retirement, employment classification

Conditions on Receiving Allocations

- Right to make elective deferrals not affected by allocation conditions
- Allocation on matching contributions
- Coverage testing may be affected
- Top-heavy rules may require an allocation

Allocation of Forfeitures

- Reducing employer's contribution by amount of the forfeiture
  - Timing
  - Use for matching contribution obligation
- Using forfeiture to provide additional allocations to participants
- Payment of plan expenses
- Forfeitures may now be used to fund QNECs, QMACs and safe harbor plan contributions

Allocation of Investment Earnings

- Accounts valued at least annually
- Pooled investments
  - Any reasonable method allowed for allocation of earnings or loss (e.g., balance forward method)
- Participant-directed investments

Defined Benefit Plans

- Defined benefit plan
  - Promised benefit (e.g. life annuity) at normal retirement age - employer bears investment risk
  - Employer contributes amount necessary to fund promised benefit
    - Contribution depends on gain or loss on plan assets
    - Need actuary to determine funding obligation
  - Upon termination of employment - employee entitled to accrued benefit equal to present value of the normal form of benefit payable at Normal Retirement Age (e.g., life annuity)
    - Plan may permit distribution in another actuarially equivalent form of benefit (e.g., lump sum)

Defined Benefit Plans

- Accrued benefit determined under formulas that provides for definitely determinable benefits
  - Generally a promised benefit at NRA
- Benefit formulas
  - Fixed (or flat) benefit formula
    - E.g., 40% of final average compensation – Final average compensation = $50,000, benefit will be $20,000 annuity
  - Unit benefit formula
    - E.g., 2% times average compensation times years of service
      - Average compensation – highest average, final average or a career average

Cash Balance Plans

- Defined benefit plan that looks and acts like a defined contribution plan
- DB characteristics
  - Contribution is based on actuarial funding concepts - employer bears risk of gain or loss
  - DB §415 limits apply - permits greater contributions than DC plan
  - Subject to PBGC coverage
  - Must file a Schedule B with Form 5500
  - Subject to QJSA rules

Cash Balance Plans

- DC characteristics
  - Benefit expressed as a hypothetical account balance
  - Benefit and interest credited to the account each year
  - Credits must be defined in plan document
  - Participants receive a DC-type statement showing value of hypothetical account
  - Distribution option generally will be a lump sum

Cash Balance Plans

Yr	Comp	Beg. Balance	Pay Credits	Interest Credits	Ending Balance
1	$60,000	$0	$2,400	$0	$2,400
2	$63,000	$2,400	$2,520	$120	$5,040
3	$66,150	$5,040	$2,646	$252	$7,938
4	$69,458	$7,938	$2,778	$397	$11,113

- Assumes a 5% salary increase each year
- Pay credits equal 4% of salary
- Interest credits equal 5%

Defined Benefit Plans

- Fully insured-plans
  - Invested exclusively in annuity and life insurance contracts
  - A fully insured plan is exempt from the minimum funding requirements if it satisfies certain requirements

Defined Benefit Plans

- Accrual methods
  - Plan must state how a participant will accrue the benefit
  - Minimum accrual methods under Code §411(b) which are designed to prevent backloading of benefits
    - Fractional rule accrual method
    - 133 1/3 accrual method
    - 3% accrual method

Session 1 Conclusion

- Session 1 Topics
  - Introduction to Qualified Plans
  - Participation, Coverage and Vesting
  - Controlled and Affiliated Service Groups
  - Leased Employees
  - Contributions and Allocations
  - Defined Benefit Plan Formulas and Accrual Rules

Session 1 Conclusion

- **Session 2 Topics**
  - **Limitations on Contributions and Benefits**
  - **Compensation Definitions**
  - **General Nondiscrimination Testing**
  - **ADP/ACP Testing**
  - **Automatic Enrollment**