
Twelfth Edition

Retirement Plans

401(k)s, IRAs, and Other Deferred
Compensation Approaches

Allen | Melone | Rosenbloom | Mahoney

Retirement Plans

**401(k)s, IRAs, and Other
Deferred Compensation Approaches**

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Retirement Plans

**401(k)s, IRAs, and Other Deferred
Compensation Approaches**

Twelfth Edition

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For Marie, Chris, Sam, Carlyn, Bob, and Lauren.

Joseph J. Melone, PhD, CLU, ChFC, CPCU

In memory to Lynn; and to my daughters, Debra, Heather and Amy.

Jerry S. Rosenbloom, PhD, CLU, CPCU

For Josephine, the love of my life, and for our loving children: Diana, Dennis, Matthew, Timothy, Judith Ann, and Gabrielle. I also wish to express gratitude to my mother and father, Joseph and Edna, for a lifetime of love and support, and to Joe and Shaun for their many positive influences on my life.

Dennis F. Mahoney, CEBS, CFP[®]

Preface to *Retirement Plans*, Twelfth Edition

Retirement planning is a central concern for workers at all points along the extended age continuum. Not only is it a concern for workers on the cusp of entering the payout or distribution phase of the retirement life cycle, but it is also an issue of analysis and deliberation for midcareer workers and recently “minted” graduates of our educational systems who are new entrants to the workforce. The rationale for why there is universal concern with retirement planning issues across all strata of the demographic continuum is many and varied. As indicated in the previous eleventh edition of *Retirement Plans*, the private retirement system in the United States has undergone dramatic structural transformation. The shift of the nation’s private retirement program from a system that was primarily defined benefit (DB) based to one whose emphasis is now substantially defined contribution (DC) based has meant an important altering both of asset management responsibilities and of who retains risks for funding deficiencies when investments fail to deliver anticipated returns. Likewise, the allowance for plan participants to self-direct investments within their employer retirement plans has meant that nonprofessional investors are now bridled with responsibility for determining their financial destinies amidst the fluctuating uncertainties of volatile and uncertain capital markets.

The volatility in capital markets and the prolonged low-yield nature of historically “safe” fixed-income investments has meant challenges for the most seasoned and experienced of investors. For novices and part-time investing dilettantes, these circumstances have been especially treacherous. Unfortunately, the majority of plan participants fall within this latter category of investor. The current state of affairs for retirement planning is spawning considerable angst. Will 401(k) and other similar defined contribution plan structures be capable of assuring retirement security to the next generation of retirees, especially given the large demographic cohort that comprises the “baby-boom” generation? Will more individuals prematurely tap their retirement asset balances because of persisting unemployment and a lack of job opportunities? Will plan balances evaporate and vanish if equity markets contract? Will unseasoned, nonprofessional investors capitulate and transfer out of equity investments sustaining nonrecoverable losses when asset values later bounce back from short-term or intermediate-term declines? Though these concerns are most pressing for those workers nearing retirement, they are extremely relevant for midcareer employees, the self-employed, and those leaving their academic pursuits to begin their actual working careers. Are the vast majority of workers capable of managing investments over a career or even able to save enough resources to provide a genuine sense of financial security?

There are indeed a plethora of challenges and uncertainties pervading today’s economic landscape. How are benefit plan specialists and human resources (HR) professionals responding to these monumental and daunting adverse conditions? First,

the next generation of retirement planners is well aware of the severity of the impediments they are facing. As noted in Chapter 11, “Behavioral Finance Impacts on Defined Contribution Plan Designs,” it is now well recognized that plan participants, like all human beings, are not the totally rational decision makers as traditionally portrayed by classical economic theory. Research has shown that individuals use “rules of thumb” and often they are limited in their ability to rationally decipher the best economic choices. As a result of behavioral economics, retirement plans are now being designed to anticipate such flawed thinking and to capitalize on individual inertia by defaulting individuals into plan options that will create greater long-term returns based on historical patterns. Also, it has been recognized that the next generation of retirees will need to be equipped both during the accumulation phase and the later payout period with greater understanding of investment principles and financial planning concepts. Accordingly, enhanced efforts are being made to heighten financial literacy and supply investment education programs. While the marketplace is responding to these needs, governmental policymakers are also crafting legislation and issuing regulations that facilitate and bolster these initiatives.

As previously noted in the eleventh edition of this text, though the challenges of the current environment appear troublesome and are indeed plentiful, so also are the opportunities that accompany this dynamic environmental context. Today’s generation of workers possesses unprecedented access to information, far-reaching and expanded control over the management of their retirement resources, and genuine empowerment to configure and safeguard their emerging financial destinies. For those prepared to embrace these challenges and willing to plan, retirement security can be a pleasant and prosperous journey.

The twelfth edition of this text expands on the efforts of the eleventh edition which completely revised the presentation of retirement planning concepts to align with this rapidly evolving and exciting new reality. Whereas prior editions of the text emphasized retirement plan administrative functions, the new direction of *Retirement Plans* emphasizes shared responsibilities between plan sponsors and plan participants in creating and managing retirement wealth. As in prior editions, the twelfth edition details the plethora of retirement savings plan structures that now comprise the retirement planning landscape. These varied structures include 401(k) plans, 403(b) plans, eligible and ineligible 457 plans, Keogh plans, traditional and Roth individual retirement accounts (IRAs), profit sharing plans, employee stock ownership plans (ESOPs), savings incentive match plans for employees (SIMPLE plans), simplified employee pensions (SEPs), as well as solo 401(k) plans. Indeed with each subsequent edition of *Retirement Plans* the list of retirement savings vehicles appears to become longer and more complicated! Not only are new plan types added, but various tax treatments of some existing plans allow for added structural permutations. Although most of this proliferation has occurred within the defined contribution (DC) plan space, the defined benefit (DB) plan types have not been entirely sedentary. Most notably new variations of hybrid plans, especially with cash balance plan innovation, have occurred.

As is always the case within the realm of retirement planning, there has been significant legislative and regulatory activity. *Retirement Plans* integrates updated legislative

and regulatory pronouncements into the fabric of its exposition on the evolving retirement planning structures, tools, and techniques. Although the past few years covered by updating of the twelfth edition did not witness the same level of pervasive foundational change as occurred with enactment of the Pension Protection Act (PPA) of 2006, governmental policy initiatives have continued to reengineer retirement planning practice and fuse it with the pressing economic challenges of our age. The text chronicles the legal framework that has developed, allowing for the creation and maturation of retirement plans. Beginning with the original passage of the Employee Retirement Income Security Act (ERISA) of 1974, the text explains the foundational elements that allow for the funding, safeguarding, and ongoing management of retirement plan assets. *Retirement Plans* then continues the progressive legislative journey that has transpired with the vicissitudes of governmental policy. It explains the rationale for fiduciary standards, spousal protections, funding requirements, diversification mandates, and a host of other plan features that we often take for granted without recalling the grueling legal contests that have resulted in these consumer protections. While providing significant coverage of the watershed legislative outcomes like ERISA and the PPA, the text also highlights targeted legislative initiatives that resulted in important protections for spouses, men and women called into active military service, and those who are nonhighly compensated employees.

Part I, “Environmental Influences on Private Retirement Plans,” is the first section of the text. This section provides a framework for understanding the current context in which modern-day retirement plans function. Chapter 1 chronicles the evolutionary historical forces that have shaped today’s private plans and the environmental domain in which they operate. It also scrutinizes governmental policy objectives and provides a summary of key retirement plan-related legislation, commencing with the Employee Retirement Income Security Act (ERISA) of 1974 and extending into the current era. Chapter 2 moves away from the macroenvironmental perspective and moves to an individual firm perspective to determine the philosophical and business objectives that influence selection of various retirement plan designs and features. The section also examines the fundamental differences in defined contribution (DC) and defined benefit (DB) plan structures and surveys how retirement planning serves to mitigate particular individual and societal risks.

Part II, “Defined Contribution Plan Types,” provides a detailed analysis of the various plan types available under the law to accommodate the accumulation of retirement savings. Part II begins with Chapter 5, “Overview of Defined Contribution Plan Types and Their Use in Retirement Plan Design.” This chapter is intended to provide a quick sense of the variety of defined contribution plan structures, the constituencies that these structures serve, and the situations where their use is appropriate. Such an overview is useful before taking a “deep dive” into the intricacies of the various types of plans and their distinguishing features. This part of the book examines the following types of programs: profit-sharing plans, money purchase pension plans (MPPs), employee stock ownership plans (ESOPs), 401(k) plans, 403(b) plans, and Section 457 deferred compensation plans. Part II concludes with Chapter 11, “Behavioral Finance Impacts on Defined Contribution Plan Designs.” This chapter illuminates the continued exciting breakthroughs in behavioral economic research that contribute to our understanding of

the psychological factors influencing individual decision making with direct relevance to individual investment selection within DC plans offering self-directed accounts. As was the case when this chapter was introduced in the tenth edition, it is hoped that an understanding of behavioral finance will allow benefit plan practitioners and governmental policymakers to use insights from these research findings to design plan features and craft governmental regulations that enhance participant financial security.

Part III, “Special Purpose Retirement Planning Structures,” provides a panoramic view of retirement savings vehicles outside the qualified plan arena. Not only are individual retirement accounts (IRAs), in their various forms, and small-employer plans portrayed, but other capital accumulation plans such as executive retirement arrangements and employee stock compensation plans are examined. Chapter 16, “Managing Retirement Assets in Multiple Plan Structures,” looks at the planning challenges and opportunities as individuals move between employers throughout their careers and eventually possess a collection of retirement accounts comprised by myriad characteristics and disparate features. The chapter is intended to provide a context for discerning whether to consolidate or retain an amalgam of distinct plan types. The chapter is helpful in setting strategy for ongoing asset management and distribution planning.

Part IV, “Defined Benefit Plans and Hybrid Retirement Plans,” deals with administrative issues for defined benefit and hybrid plans. This part of the book explains nuances resulting from substantive changes in defined benefit funding rules with the Moving Ahead for Progress in the 21st Century (MAP-21) Act. MAP-21 changed the methodology for computing interest rates to be utilized for funding defined benefit pension plans by using an average of interest rates going back 25 years. This interest rate computation methodology allowed plan sponsors to make smaller contributions to defined benefit plans than would have occurred under the rules instituted with passage of the Pension Protection Act (PPA) of 2006. MAP-21 was a result of the prolonged economic slowdown that the United States suffered following the financial crisis of 2008. During this time period, the Federal Reserve held interest rates at extremely low levels relative to historical norms for a long time. Using these low market interest rates served to enlarge pension liabilities causing plan sponsors to find themselves with underfunded plans. MAP-21 provided relief to alleviate the financial burden of increased pension funding during an economic slowdown. Part IV also highlights certain changes at the Pension Benefit Guaranty Corporation (PBGC) resulting from passage of MAP-21. Among these changes were increased insurance rates and creation of a Participant and Plan Sponsor Advocate at the PBGC. Chapter 23 of Part IV provides a detailed look at the Accounting Standards Codification system that the Financial Accounting Standards Board (FASB) adopted in 2009. Accounting Standards Codification structurally altered the compilation of accounting standards, changing from a standards-based model to a topic-based model. Chapter 23 contains a detailed appendix to assist retirement plan professionals in understanding and accessing accounting guidance under the new topic-based model.

Part V, “Tax and Legal Requirements,” contains a detailed description of various administrative requirements. In addition to noting various compliance requirements in order to tax qualify a retirement plan, this part of the book, primarily Chapter 28 titled

“Fiduciary Oversight and Plan Governance,” authored by a noted retirement expert, explains best practices to secure the highest fiduciary and ethical standards in plan management. This chapter also notes the fee disclosure requirements that became applicable in 2012 to increase the level of transparency regarding plan costs. Two sets of regulations established requirements for fee disclosure. The first set required retirement plan service providers to supply written disclosure detailing the total compensation they received either directly from the plan or indirectly from a source other than the plan or plan sponsor. The second set involved participant disclosures reported by plan sponsors providing plan-related expense information and investment-related performance comparisons.

Part VI, “Wealth Management and Distribution Planning,” profiles the emerging paradigm of retirement plan design and ongoing oversight within a wealth management context. This portion of the book explains new insights and research findings relevant to integrating a participant’s or beneficiary’s lifelong retirement planning process within a broader perspective. Such a perspective encompasses total individual wealth management using a more comprehensive and more holistic, personalized approach both during the career years of asset accumulation and during the retirement years of distribution.

Finally, a series of three related appendices provide detailed information on elements of the Social Security system. Since its inception, Social Security has always played an important role in providing financial resources for the U.S. populace. Though alterations in the demographic composition of the workforce have occurred and there are certain challenges resulting in the funding of this social insurance program because of deviations from the program’s original demographic assumptions, the authors feel confident that Social Security, even if modified in some ways, will continue to comprise a foundational portion of the population’s financial security, probably in perpetuity into the future.

The intent of this book, as was true in prior editions, is to advance the knowledge and best practices of retirement planning. This objective has expanded to a broader audience in today’s world of shared responsibility involving not only plan sponsors, consultants, actuaries, and retirement plan specialists, but also the individual plan participants and their beneficiaries empowered to manage their individual and family retirement wealth. Therefore, it also is hoped that the book—ultimately through education—will serve to enhance retirement security for all those using or participating in any type of retirement savings plan.

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Joseph J. Melone

Jerry S. Rosenbloom

Dennis F. Mahoney

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Retirement Plans

**401(k)s, IRAs, and Other
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Chapter 1

The Dynamic, Ongoing Evolution of Private Retirement Plans

After studying this chapter you should be able to:

- Describe the components of the tripod of economic security.
 - Explain the economic problems encountered with aging.
 - Discuss the factors that have contributed to the historical growth of the private retirement plan system.
 - Discuss the changing perceptions that unions have had of retirement plans.
 - Describe the economic rationales for private retirement plans.
 - Cite the major acts of legislation and their impact in shaping the private retirement plan system.
-

Individuals generally seek means to enhance their economic security. One cause of economic insecurity is the probable reduction of an individual's earning power at an advanced age. In the United States, this risk is met through one or more of the following means: personal savings (including individual insurance and **annuities**¹), employer-sponsored retirement plans (private plans), and social insurance programs. When combined, these three elements produce a multifaceted approach to economic security sometimes referred to as the **"tripod of economic security,"** the "three-legged stool of economic security," or the "pillars of economic security." The dramatic growth of private plans since the 1940s has focused considerable interest on this form of income maintenance.²

¹An annuity is a contract with an insurance company whereby the insurance company pays an income for a specific time period, such as a number of years or for life, in exchange for an initial cash payment.

² *Private plans*, as used in this text, refer to plans established by private agencies, including commercial, industrial, labor, and service organizations, and nonprofit religious, educational, and charitable institutions. Social Security is covered in Appendix 1 at the end of the book.

Growth of Private Plans

The beginnings of industrial retirement plans in the United States date back to the establishment of the American Express Company plan in 1875.³ Benefits under this first private pension plan were equal to 50 percent of average pay earned in the final 10 years of employment, but could not exceed \$500 annually.⁴ The second formal plan was established in 1880 by the Baltimore and Ohio Railroad Company. During the next half century, approximately 400 plans were established. These early pension plans were generally found in the railroad, banking, and public utility fields. The development of pensions in manufacturing companies was somewhat slower, largely because most manufacturing companies were still relatively young and therefore not confronted with the superannuation problems of the railroads and public utilities.

Insurance companies entered the pension business with the issuance of the first group annuity contract by the Metropolitan Life Insurance Company in 1921.⁵ The second contract was issued by the Metropolitan in 1924 to an employer who already had a retirement plan on a “pay-as-you-go” basis.⁶ In 1924, The Equitable Life Assurance Society of the United States announced its intention of offering a group pension service, thus becoming the second company to enter the field.⁷

Although the beginnings of private pensions date back to the 1800s, the significant growth in these programs has come since the 1940s. In a recent year, the percentage of wage and salary workers ages 21–64 who participated in a retirement plan was 45.8 percent.⁸ As of September 30, 2016, total U.S. retirement assets stood at \$25.0 trillion. Of this \$25.0 trillion, \$7.0 trillion were held in defined contribution plans, \$2.9 trillion were held in private defined benefit plans, \$5.3 trillion were held in government retirement funds, \$7.8 trillion were held in individual retirement accounts, and \$2.0 trillion were held in fixed and variable annuity reserves. It is worth noting there has been a significant increase in the relative growth of defined contribution plan assets. Defined contribution plans and individual retirement accounts made up 59.2 percent of all retirement assets at the end of the third quarter of 2016, up from 39 percent in 1990.⁹

³ Murray Webb Latimer, *Industrial Pension Systems* (New York: Industrial Relations Counselors Inc., 1932), p. 21.

⁴ Hewitt Associates LLC, *Microhistory of Employee Benefits and Compensation 1794–2005* (Lincolnshire, IL: August 2005), p. 3.

⁵ Kenneth Black, Jr., *Group Annuities* (Philadelphia: University of Pennsylvania Press, 1955), p. 9.

⁶ *Ibid.*, p. 11.

⁷ *Ibid.*

⁸ *EBRI Issue Brief No. 405* (Washington, DC: Employee Benefit Research Institute, October 2014), p. 31.

⁹ Investment Company Institute, “Quarterly Retirement Market Data, Third Quarter 2016,” December 2016, p. 1. www.ici.org/research/stats/retirement/ci.ret_16_q3.print. (December 2016).

The Tripod of Economic Security: 1

The Dangers of a Voluntary System

Retirement income in the United States is structured on the often-referenced “three-legged” stool of Social Security, employer-sponsored retirement plans and personal savings. In addition to the fact that one or two of these “legs” is often missing or woefully inadequate, the matter has been exacerbated by a restructuring of employer-provided retirement income programs. There has been a massive shift from defined benefit (DB) pension plans to defined contribution (DC) plans. The result has been a transfer of much of the cost and risk of longevity and the attending decision-making requirements from employers to the often-unprepared employee. . . .

No group (human resources and employee-benefits professionals) is in a better position to help educate employees on the importance of retirement savings and to counsel employers on the importance and feasibility of sponsoring retirement income programs. . . .

The bottom line is that some progress has been made in encouraging small employers to sponsor retirement plans and more is possible, and when employees have access to a plan, they participate to a high degree. However, under a system based on voluntary retirement plan sponsorship by employers and voluntary participation by employees, a significant number of employees will always lack access or elect not to participate.

Source: John G. Kilgour, “Responding to Changing Retirement Savings Programs,” *Compensation & Benefits Review*, 33, no. 5, September–October 2001, pp. 25–35. 2001 by Sage Publications, Inc.

Economic Problems of Aging

Longevity is a source of economic insecurity in that individuals may outlive their financial capacities to maintain themselves and their dependents. The extent to which an aged person will have the financial capacity to meet self-maintenance costs and those of dependents relies on the standard of living desired during retirement years, employment opportunities, and other resources (e.g., personal savings, social insurance, and inherited assets) available to meet this contingency.

Standard of Living after Retirement

The assumption usually is made that the financial needs of an individual decrease after retirement. To some extent, this assumption is valid. The retired individual may have no dependent children, and a home and its furnishings generally have been acquired by retirement age. However, the actual aggregate reduction in the financial needs of a person upon retirement has probably been overstated. Personal expectations and preferences discourage any drastic change in one’s standard of living upon retirement, and an increasing tendency exists for retired persons to remain fairly active, particularly in terms of civic, social, travel, and other recreational activities. Furthermore, urbanization,

geographic mobility, demographics, and changing culture minimize the prospect of retired parents moving in with their children.

Another major factor preventing a decrease in the financial needs of retirees is the likely cost of long-term care (LTC). It is estimated that at least 70 percent of people over age 65 will require LTC services at some point in their lives.¹⁰ Although the federal government briefly experimented with the possibility of assuming a greater portion of this burden through the Medicare Catastrophic Coverage Act of 1988, the manner in which this additional coverage was financed proved to be politically unpalatable and it was repealed the following year. Again in 2010 with passage of the Patient Protection and Affordable Care Act (PPACA), policymakers attempted to address LTC issues with a provision for long-term care coverage under the Community Living Assistance Services and Supports (CLASS) Act. However, the CLASS Act was also subsequently abandoned. The Health Insurance Portability and Accountability Act (HIPAA) of 1996 made employer-paid LTC tax excludable beginning in 1997. Also, employer premiums became tax deductible to employers and tax free to employees, although employee premiums cannot be paid from a flexible spending account or by elective pretax contributions under a cafeteria plan. Although this favorable tax treatment is an incentive for some employers to provide LTC coverage to employees, the expense of this benefit limits its use for many employers. Even if retirees are fortunate enough to have comprehensive health insurance coverage continued by their employers after retirement, changes in the accounting standards applied to these plans have caused modifications in the type of coverage, cost sharing, or financing of this benefit.

The authors are not suggesting that retired workers require income benefits equal to their earnings levels immediately preceding retirement, nor even the level of preretirement take-home pay. Presumably, at least at the higher income levels, these individuals have been allocating a portion of their take-home pay to individual savings. However, it is suggested that the reduction in standard of living after retirement is not very great; and, more important, the trend in social thinking seems to be in the direction of not expecting retired workers to have to take much of a reduction in standard of living after retirement. The effect of inflation also has militated against a lower standard of living. Therefore, it is questionable whether one should assume any significant decrease in basic financial needs upon retirement, at least for individuals in the low- and middle-income categories.

Employment Opportunities

In recent years the percentage of men participating in the labor force was 36.5 percent for ages 65–69 and 10.4 percent for those 75 or over. In this same time period the percentage of women participating in the labor force was 27 percent for ages 65–69 and 5.3 percent for those 75 and over.¹¹ Obviously, many reasons account for the withdrawal of older people from the labor force. A large number of older workers voluntarily retire. If workers have the necessary financial resources, they may wish to withdraw from active employment and live out their remaining years of life at a more leisurely pace. Others find it necessary

¹⁰ Jan McFarland, "Long-Term Care Insurance," *The Handbook of Employee Benefits*, ed. Jerry S. Rosenbloom, 7th ed. (New York: McGraw-Hill, 2011), p. 332.

¹¹ Mitra Toossi, "Labor Force Projections to 2020: A More Slowly Growing Workforce," *Monthly Labor Review*, January 2012, p. 9.

for reasons of health to withdraw from the labor force. The aging process takes its toll, and many individuals are physically unable to operate at the level of efficiency attainable at a younger age. Disabilities at the older ages tend to be more frequent and of longer duration.

Voluntary retirement and the physical inability to continue employment are undoubtedly important reasons for the decrease in the percentage of older persons participating in the labor force. However, these are probably not the most important factors affecting employment opportunities for them. The effects of industrialization, expansive technological advances, and the development of the federal Old Age, Survivors, Disability, and Health Insurance (OASDHI) program, private retirement plans, and other employee benefit programs probably have had a more significant impact on this problem.

The rapid pace and dynamic evolution of industrial employment operated to the disadvantage of older persons. Automation and mass-production assembly lines put a premium on physical dexterity and mental alertness. Employers generally were of the opinion, justifiable or not, that younger workers were better suited to the demands of industrial employment. In an agricultural economy, on the other hand, the able-bodied older person could continue to work, at least on a part-time basis.

Similarly, as organizations adapt to the information systems age and increasingly look to enhance productivity through the use of computers, the Internet, mobile devices, and other technology applications, it appears that older workers will continue to be at risk. Some social philosophers expect that greater labor market dislocations will occur and postulate that the systems age could mean a decreasing need for mass labor.¹²

The OASDHI program and private retirement plans, although created to alleviate the financial risk associated with excessive longevity, have actually aggravated the problem. These programs have tended to institutionalize age 65 as the normal retirement age, although the 1986 amendments to the Age Discrimination in Employment Act (ADEA) banned mandatory retirement (at any age) for most employees. The 1983 amendments to The Social Security Act are gradually raising the normal retirement age for Social Security benefits to age 67 by the year 2027.¹³ Some Social Security reform proposals have suggested that normal retirement age for Social Security benefits be linked to life expectancy and automatically increase as life expectancies rise. Also, some employers may hesitate to hire older workers on the assumption that these employees will increase retirement and other employee benefit plan costs. It is difficult to generalize the impact of the older worker on employee benefit plan costs. Nevertheless, it must be recognized that an employer's attitude toward hiring older workers may be influenced by the assumption, justified or not, that employee benefit costs will be adversely affected.

Self-employed members of the labor force have greater control as to the timing of their retirement from active employment. For example, physicians and lawyers frequently continue in practice, at least on a part-time basis, until advanced ages. Owners of businesses also continue to be active in their firms until relatively older ages. The fact remains, however, that employment opportunities for the majority of older workers have become more limited. It is quite likely that this will be a temporary phenomenon for

¹² Jeremy Rifkin, *The End of Work* (New York: Penguin Group, 2004), p. 5.

¹³ The retirement benefits provided under The Social Security Act are discussed in detail in Appendix 1 at the end of this book.

many employees given the expected impact of changing demographics and the potential shortage of certain segments of the workforce projected for the future.

Individual Savings of Older Persons

If employment opportunities for older persons are decreasing and financial needs are still substantial at advanced ages, the need for savings becomes quite apparent. However, studies indicate that a substantial proportion of the homes owned by older individuals are clear of any mortgage. Homeownership reduces their income needs insofar as normal maintenance costs and taxes are less than the amount of rent required for comparable housing accommodations. It has been estimated that the maintenance costs for an unencumbered home are about one-third to 40 percent less than the costs of renting comparable facilities. Furthermore, there is the possibility that the home can be used in part as an income-producing asset or that a home equity loan can be used to provide additional cash.

There is growing interest in the concept of a so-called **reverse annuity**. Under this approach, the homeowner receives a lifetime monthly income in exchange for the title to the home at the homeowner's death. The amount of the monthly annuity payment depends on the equity in the home and the life expectancy of the homeowner.

Jacobs and Weissert were early researchers who analyzed the potential for using home equity to finance long-term care. Their results strongly suggested that a significant number of elderly Americans could use their homes' equity to meet their health care expenses. They also concluded that those in the highest risk group and those with the lowest incomes, who are often the same individuals, also could be significantly helped by the use of reverse annuity mortgages.¹⁴

As a result of the Housing and Community Development Act of 1987, the federal government began an experimental program in which the Department of Housing and Urban Development (HUD) insured a maximum of 2,500 reverse annuity mortgages. The experimental program was further extended. In 1993, the National Housing Act was amended and the mortgage insurance authority of the Federal Housing Authority (FHA) Reverse Mortgage program was made permanent. Throughout the 1990s, reverse mortgages insured by the HUD program grew dramatically. According to HUD Secretary Andrew Cuomo, the number of reverse mortgages quadrupled in the 10 years that coincided with the start of the new millennium.¹⁵ Although the complexity of the HUD program, the inherent risks, and the small profit potential have reduced the number of original lenders, it is anticipated that the reverse annuity concept will become even more important in the future.¹⁶

However, the downturn in real estate prices that occurred in 2008 and subsequent years tempered the appeal and demand for reverse annuities.

¹⁴ Bruce Jacobs and William Weissert, "Using Home Equity to Finance Long-Term Care," *Journal of Health Politics, Policy & Law* 12, no. 1 (Spring 1987), pp. 77–95. However, other researchers analyzed the potential of reverse annuity mortgages to increase the current income of elderly persons and concluded that most low-income elderly people also had little housing equity. See Steven F. Venti and David A. Wise, "Aging and the Income Value of Housing Wealth," *Journal of Public Economics* 44, no. 3 (April 1991), pp. 371–97.

¹⁵ Ilyce R. Glink, "The Latest on Reverse Mortgages" (ThinkGlink.com, January 31, 2002), p. 1.

¹⁶ Robert J. Pratte, "A Mortgage for the 21st Century," *Mortgage Banking* 50, no. 8 (May 1990), pp. 45–52.

Personal savings rates have been running at historically low levels in the recent past. The distribution of savings by savings media has changed considerably over the years. The change that is most pertinent to this discussion is the relative increase in private retirement plan reserves in relation to purely individual forms of saving. Annual employer contributions to private retirement funds now amount to a sizable amount.¹⁷ It should be noted that many pieces of legislation in the late 80s and early 90s impacted overall retirement plan contributions by changing the limits on allowable retirement plan contributions for plan sponsors.¹⁸ However, a major shift in tax policy resulted with the passage of the **Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001**. For the first time in several years, limits on allowable retirement plan contributions were actually increased. The tremendous increases in disposable income over the last 50 years previously had not resulted in any increase in the proportion of personal savings. Although many questioned whether the expanded contribution limits of EGTRRA would be sustained following the tragedy of September 11 in 2001 and the subsequent economic costs related to the Iraq War, passage of the **Pension Protection Act (PPA) of 2006** made these expanded contribution limits permanent. Without inclusion of the PPA provision making the EGTRRA contribution limits permanent, these limits would have been rescinded after 2010 when the sunset provision of the EGTRRA legislation would have occurred. It will be interesting to see whether these expanded retirement plan contribution limits, now made permanent by the PPA, have a sustained impact on personal savings, especially with the tepid economic growth that ensued.

There have been many forces at work that have restricted the growth of savings. Advertising, installment credit, and the media of mass communications encourage individuals to set their sights on a constantly increasing standard of living. This competition from consumption goods for current income dollars results in a lower priority being placed on the need for accumulating savings for retirement. Also, the high levels of federal income tax rates reduce an income earner's capacity to save. Although tax rates were reduced by the Tax Reform Act (TRA '86) of 1986, they subsequently increased. EGTRRA reduced income tax rates again, although not as dramatically as TRA '86 did. Subsequently the American Taxpayer Relief Act of 2012, adopted on January 1, 2013, increased rates on taxpayers considered to be high earners. Inflation was an additional deterrent to increased levels of saving. Inflation is a particularly serious threat to the adequacy of savings programs of persons who already are retired. For employed persons, increases in the cost of living may be offset, in part or in whole, by increases in current earnings; however, inflation protection is likely to be less comprehensive for most older persons.¹⁹ Therefore, they are faced with the alternatives of accepting a lower standard of living or more rapidly liquidating their accumulated savings. Although the initial years

¹⁷ As the private retirement system has changed, many of these retirement assets are now in individual account types of plans.

¹⁸ This reduction in allowable retirement plan contributions results from the conflict between the social policy objectives of encouraging employers to provide retirement plans and the federal revenue loss occurring since retirement plans are afforded preferential tax treatment. At the end of this chapter is a more detailed discussion of legislation affecting retirement plan contribution limits.

¹⁹ Appendix 1 at the end of this book describes the inflation protection inherent in Social Security payments; Chapter 17 analyzes the techniques used by many private plan sponsors to provide partial ad hoc relief.

of the new millennium experienced low levels of inflation, it is important to realize the threat to purchasing power that an increased rate of inflation can mean.

The proportion of individual (as opposed to group) savings, then, is decreasing at a time when the pattern of living for the older individual is becoming increasingly more costly. Under such circumstances, the tremendous importance of retirement programs in meeting the economic risk of aging is obvious.

Increasing Longevity

Still another dimension to the overall economic problem of aging is the number of aging adults in the population. The fact that life expectancy has been increasing is well recognized. However, that this increase in **longevity** is a recent and quite dramatic development often is not appreciated. Since 1900, life expectancy at birth has increased from 47 years to approximately 78.8 years (for 2015). The rates of mortality at the earlier ages are now so low that further improvements in mortality at these ages would have little impact on further extensions of the average length of life. If additional improvements in longevity are to be realized, reductions in mortality at the older ages are required. This impediment to further extensions in life expectancy may be overcome if medical advances result from the current concentration of research in the areas of the chronic and degenerative diseases. Medical research in fields such as biotechnology and gene therapy may result in such advances.

One effect of the improvements in longevity in the twentieth century has been an absolute and relative increase in the population of persons age 65 and over. In 1900, there were approximately 3 million persons age 65 and over, whereas there were about 40 million such persons in 2010. The proportion of the U.S. population age 65 and over in 2010 was about 13 percent, whereas the proportion of the population in this age bracket in 1900 was about 4 percent.

Another important dimension in the analysis of the changing **demography** of aging adults—those age 65 and over—is their age distribution. A generation ago, 68 percent were 65 to 74 years old, 27 percent were 75 to 84 years old, and only 5 percent were 85 or older. However, today's (2010) elderly population reflects a shift toward the upper end of the age scale: Approximately 13.6 percent are 85 or over; 32.4 percent are 75 to 84; and 53.9 percent are 65 to 74.²⁰

The problem of retirement-age economic security, therefore, is of concern to an increasing number and percentage of the U.S. population.

Reasons for Growth of Private Retirement Plans

From the preceding discussion it can be seen that the problem of economic security for elderly Americans is a serious and increasingly important one. However, the mere existence of the problem does not explain the sustained growth of private retirement plans. In other words, given the existence of the old-age economic problem, why did employers and employees choose to meet the need, at least in part, through the vehicle of private retirement programs? In a broad sense, the major reason is the fact that private

²⁰ *Statistical Abstract of the United States, 2012* (Washington, DC: U.S. Government Printing Office, 2012), pp. 11 and 77. Note: 2015 data utilize projections based on the 2010 census.

retirement plans offer substantial advantages to both employers and employees. Without this foundation of mutual benefit, the private retirement plan movement could not have achieved the substantial and sustained growth it has enjoyed. In addition, for several decades, government officials have recognized the social desirability of retirement programs and have acted to encourage the growth of these plans through favorable treatment under the tax system and by other means. As indicated in Chapter 3, some observers have noted that many legislative initiatives have tended to favor defined contribution over defined benefit approaches. The growth of these different types of plans and the historical impact of favorable legislation are chronicled in that chapter. However, it appears that this attitude of encouraging private retirement plan growth through preferential tax treatment stalled when large federal budget deficits occurred in the 80s and 90s.

The specific factors generally considered as having influenced the growth of private retirement plans are discussed in the following text. It must be recognized that the reasons giving rise to the establishment of one plan are sometimes quite different from those in the case of another plan. As noted earlier, a policy shift appeared to occur with the passage of EGTRRA. This policy of foregoing tax revenues with expanded contribution limits to retirement plans was bolstered with enactment of the PPA. Future retirement plan policy will likely depend on both the robustness of the economy and the ability to curtail a growing federal deficit.

Increased Productivity

A systematic method of meeting the problem of **superannuated** employees can be easily justified on sound management grounds. Due to advanced age, an employee may reach a point where he or she experiences a diminishment in productivity. That is, at some advanced age, an employee's contribution to the productivity of the firm may be worth less than the compensation he or she is receiving.

The employer has several courses of action if an employee reaches this point. One, the employee can be terminated without any further compensation or any retirement benefits as soon as the value of the employee's services is less than the salary being paid. For obvious reasons, this course of action is seldom followed by employers. Two, the employer can retain the less-productive, superannuated employee in the employee's current position at the current level of compensation, the difference between the employee's productivity and salary being absorbed by the employer as a cost of doing business. This alternative is also undesirable and would undoubtedly be the most costly method of meeting the problem of less-productive, superannuated employees. Furthermore, the longer range indirect costs that would be incurred from the resultant inefficiencies and poor employee morale among the productive, active workers would be significant. Three, the employer could retain the less-productive, superannuated worker but transfer the employee to a less-demanding job at the same or a reduced level of compensation. In the former case, the direct costs would be similar to alternative two, but the indirect costs would be reduced in that a more capable person would now be staffing the more demanding position. If the employee's salary is reduced, the direct costs of superannuation also would be reduced.

Most employers who do not have a retirement plan generally handle the problem of the less-productive, superannuated worker in the latter manner. The effectiveness of this approach to the problem has certain important limitations. First, a firm usually has only a limited number of positions to which such workers can be transferred. For a medium- or

even large-sized firm, only a fraction of such employees can be efficiently employed. With the onset of the systems age and the increasingly higher levels of skill required in most jobs, the limitations of this solution are apparent. Furthermore, the less-productive, superannuated employee is generally still overpaid in the less-demanding jobs since, for practical purposes, salary reductions commensurate with the decrease in employee productivity are seldom made. Last, this approach does not solve the problem of productivity; it merely defers it, since a point will be reached where the employee's productivity is considerably below even a minimum level of wage.

The fourth alternative available to the employer in meeting the problem of productivity loss with superannuation is to establish a formal retirement plan. A retirement plan permits employers to provide less-productive, superannuated employees with an acceptable alternative to continued employment in a humanitarian and nondiscriminatory manner, and the inefficiencies associated with retaining employees beyond their productive years are reduced. Furthermore, the sense of security derived from the knowledge that some provision will be made, at least in part, for their retirement income needs should increase the morale and productivity of employees. Also, the systematic retirement of older workers will keep the channels of promotion open, thereby offering opportunity and incentive to the younger employees—particularly those aspiring to executive positions. Therefore, a retirement plan should permit an employer to replenish the workforce in a highly efficient and systematic manner.

The problem of productivity loss with superannuation, then, exists for most business firms. Any solution, except the unlikely alternative of arbitrary termination of older workers without any retirement benefit, results in some cost, direct or indirect, to the employer. Unfortunately, some employers assume that the retirement plan solution is the only approach that carries a price tag, but the hidden costs of the other alternatives must be recognized as well. The decision, therefore, is which solution is best suited to the needs and financial position of the employer. For a large number of employers, the formal retirement plan approach has proven to be the superior solution.

Tax Considerations

The bulk of the growth in private pension plans has occurred since 1940. One reason for the growth of these plans during the World War II and Korean War periods was that normal and excess-profit tax rates imposed on corporations during these years were extremely high. Since the employer's contributions to a qualified retirement plan are deductible (within limits) for federal income tax purposes, a portion of the plan's liabilities could be funded with very little effective cost to the firm. Furthermore, the investment income earned on retirement trust assets is exempt from federal income taxation until distributed.²¹

The tax advantages of qualified retirement plans are attractive from the standpoint of employees covered under the plan; for example, the employer's contributions to a retirement fund do not constitute taxable income to the employee in the year in which contributions are made. The retirement benefits derived from employer contributions are taxed when distributed to the employee. In addition, under limited circumstances, distributions from a retirement plan may be taxed on a favorable basis.

²¹ For a complete discussion of the tax aspects of qualified retirement plans, see Chapters 25 and 26.

Therefore, qualified retirement plans generally offer significant tax advantages to participants; prior to 1988, employees in high income tax brackets received the greatest advantages.²² Since the high-salaried senior officers of corporations often make the decision regarding the establishment and design of employee benefit plans, their role as participants under the plans may have influenced their decisions on these matters. However, in the case of large corporations, costs and other considerations minimized or eliminated the personal tax situations of key employees as factors influencing the establishment or design of a retirement plan. In the case of a small, closely held corporation, on the other hand, one can readily see how the tax implications for stockholder-employees might have been a decisive factor in the establishment and design of a retirement plan. Last, tax considerations are certainly one reason, although not the most important, why some labor leaders negotiate for the establishment and liberalization of employee benefit programs in lieu of further wage increases.

The Tax Reform Act of 1986 and subsequent legislative initiatives have diminished the benefits available to highly compensated employees. As a result, there is a much greater interest in nonqualified plans for the highly compensated, and the number of employees covered by such arrangements has increased.²³

Wage Stabilization

The second wartime development that helped stimulate the growth of retirement plans was the creation of a **wage stabilization program** as part of a general price control effort. Employers competing for labor could not offer the inducement of higher wages. Under these conditions, union leaders found it difficult to prove to their memberships the merits of unionism.

Therefore, the War Labor Board attempted to relieve the pressure on management and labor for higher wage rates by permitting the establishment of employee benefit programs, including retirement plans. This policy further stimulated the growth of retirement plans during the period.

²² Up until 1986, the federal income tax law had 14 progressive tax brackets and a maximum rate of 50 percent. The Tax Reform Act of 1986 reduced the number of tax brackets to two (15 percent and 28 percent), effective in 1988. The maximum tax bracket was subsequently increased to 31 percent. The Omnibus Budget Reconciliation Act of 1993 created a further marginal income tax rate of 36 percent and imposed an additional 10 percent surtax on taxable income over \$250,000, while increasing the alternative minimum tax rate. The combination of these changes had resulted in some individuals' experiencing marginal federal tax rates at, or exceeding in some cases, 42 percent. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 reduced tax rates so that when fully phased in for year 2006 and later years, base rates were 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. Originally EGTRRA's lower tax rates were to sunset and expire at the end of 2010. Whether to renew the lowered rates, and how, became the subject of intense political debate. During the presidency of Barack Obama, lowered rates were extended for two years through 2012 as part of a larger economic and tax package, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. These rates were retained with passage of the American Taxpayer Relief Act of 2012 adopted by Congress on January 1, 2013. However, a new top marginal rate of 39.6% was imposed on taxable income exceeding \$400,000 for single filers, \$425,000 for head-of-household filers, and \$450,000 for married taxpayers filing jointly.

²³ For a detailed discussion of nonqualified plans, see Chapter 14.

Union Demands

Labor leaders have had differing views over the years regarding the desirability of employer-financed retirement plans. In the 1920s, labor generally did not favor such plans for its membership. It held the view that retirement plans represented an additional form of employer paternalism and were instituted to encourage loyalty to the firm. Labor leaders felt that the need would be best met through the establishment of a government-sponsored universal social security system; in the absence of that solution, unions should establish their own retirement plans for their members. The former objective was achieved with the passage of The Social Security Act of 1935. By the 1930s, several unions had established their own plans. However, many of these plans were financed inadequately, a condition that became apparent during the Depression years. Recognition of the financial burden of a pension program and enactment of wage controls led some labor leaders, in the early 1940s, to favor the establishment of employer-supported retirement plans.

From 1945 to 1949, the rate of growth of new plans fell off markedly. During this postwar period, employee interest centered on cash wage increases in an attempt to recover the ground lost during the period of wage stabilization. In the latter part of the 1940s, union leaders once again began expressing an interest in the negotiation of retirement programs. The renewal of interest in retirement plans probably came about because of two factors. First, there was increasing antagonism on the part of the public toward what were viewed by many persons as excessive union demands for cash wage increases. The negotiation of employee benefits was one way of possibly reducing pressures from this quarter. Second, some union leaders argued that Social Security benefits were inadequate, and a supplement in the form of private retirement benefits was considered to be necessary. Also, certain labor officials believed the negotiation of employer-supported retirement plans would weaken the resistance of the latter toward liberalizations of Social Security benefit levels. Thus, retirement plan demands became a central issue in the labor negotiations in the coal, automobile, and steel industries in the late 40s. Although unions had negotiated retirement plan benefits prior to this period, it was not until the late 40s that a major segment of labor made a concerted effort to bargain for private retirement plans.

Labor's drive for retirement benefits was facilitated by a National Labor Relations Board (NLRB) ruling in 1948 that employers had a legal obligation to bargain over the terms of retirement plans. Until that time, there was some question as to whether employee benefit programs fell within the traditional subject areas for collective bargaining—that is, wages, hours, and other conditions of employment. The issue was resolved when the NLRB held that pension benefits constitute wages and the provisions of these plans affect conditions of employment.²⁴ Upon appeal, the court upheld the NLRB decision, although it questioned the assumption that such benefits are wages.²⁵ These decisions determined that an employer cannot install, terminate, or alter the terms of a retirement plan covering organized workers without the approval of the authorized bargaining agent for those employees. Furthermore, management has this obligation regardless of whether the plan is contributory or noncontributory, voluntary or

²⁴ *Inland Steel Company v. United Steelworkers of America*, 77 NLRB 4 (1948).

²⁵ *Inland Steel Company v. National Labor Relations Board*, 170 F.2d 247, 251 (1949).

compulsory, and regardless of whether the plan was established before or after the certification of the bargaining unit.

Labor was quick to respond to these decisions, and the 1950s were marked by union demands for the establishment of new retirement plans, the liberalization of existing plans, and the supplanting of employer-sponsored programs with negotiated plans. Undoubtedly, labor's interest in private retirement plans has been an important factor in the tremendous growth in plans since 1949.

Business Necessity

Employers hire employees in a free, competitive labor market. Therefore, as the number of plans increases, employees come to expect a retirement benefit as part of the employment relationship. Employers who do not have such a plan are at a competitive disadvantage in attracting and retaining human resources. Therefore, some employers feel they must install a plan even if they are not convinced that the advantages generally associated with a retirement plan outweigh the cost of the benefit. Admittedly, this is a negative reason for instituting a plan. In other words, while these employers believe little evidence exists that retirement plans truly result in improved morale and efficiency among their workforce, they feel there would clearly be an adverse employee reaction if they did not offer a retirement plan. Also, in contrast to situations where a plan is established in response to labor demands, an employer may offer a retirement plan as part of an employee relations objective aimed at keeping a union out of the firm.

Reward for Service

There is a tendency to argue that employers never provide any increase in employee benefits unless they can expect an economic return in some form. Although this philosophy may generally prevail in a capitalistic system, the fact remains that many employers have established plans out of a sincere desire to reward employees who have served the firm well over a long period of time. Also, some employers may feel a moral responsibility to make some provision for the economic welfare of retired employees.

Efficiency of Approach

Part of the growth of private retirement plans must be attributed to the belief that a formal group savings approach has certain inherent advantages. The advantages are not such that they eliminate the need for individual savings, but the merits of private retirement plans as a supplement to Social Security benefits and individual savings programs are indeed significant. First, the economic risk of aging derives from the fact that a point is reached when an employee is unable or unwilling to continue in active employment. A formal plan as an integral part of compensation arrangements and employment relationships, therefore, is quite logical. There is no additional wage cost to the employer to the extent that retirement plan benefits are provided in lieu of other forms of compensation. If retirement plan benefits are provided in addition to prevailing wage rates, the employer's extra wage costs resulting from the retirement plan may be able to be passed on to the consuming public in the form of higher prices.

It has been argued that from a broad social point of view, the private retirement plan system is the lowest cost method of providing economic security for the aged. In

addition to the administrative efficiency of group savings arrangements, it is argued that the small increase in consumer prices that might be required to provide retirement plan benefits is a relatively painless method of meeting the risk. In other words, the burden of retirement security is spread over a large number of people and over a long period of time. Still another aspect to the argument is the assumption that private retirement plans increase consumption levels among retired individuals, which in turn helps maintain a high level of economic activity.

Last, private retirement plans constitute a form of forced savings. This advantage is extremely important in view of the apparent desire of many people to maintain a relatively high standard of living during their active employment years. Thus, it may be argued that it is economically more efficient if at least part of the risk is met through a forced savings private retirement plan scheme.

Sales Efforts of Funding Agencies

For all these reasons, there has been a considerable demand over the years for private retirement plans. However, in many instances, the advantages of these programs have had to be called to the attention of specific employers. This function of creating effective demand for the retirement plan product has been aggressively performed by those parties interested in providing services in this area. Insurance companies, through agents, brokers, and salaried representatives, were undoubtedly instrumental in the growth of retirement plans, particularly in the decades of the 20s and 30s. The trust departments of banks also are equipped to handle retirement funds, and many corporate trustees and asset managers have been actively soliciting retirement plan business, particularly since the early 1950s. Similarly, the sales efforts of mutual fund representatives in recent years, particularly with 401(k) plans, have contributed to the growth of private retirement and savings plans.

Rationale of Private Retirement Plans

The growth of private retirement plans is attributable, as seen previously, to a variety of reasons. It is difficult to determine the extent of the growth contributed by each factor, but it seems reasonable to conclude that the dominant reasons leading to the establishment of specific plans have varied depending on the circumstances surrounding each case. In other words, productivity considerations have been dominant forces leading to the creation of some plans, while labor pressures, tax considerations, or other factors have encouraged the establishment of others. With such variety of motivation, it is difficult to characterize private retirement plans in terms of a single philosophy or rationale. Nevertheless, attempts have been made over the years to explain private retirement plans in terms of an underlying concept or philosophy.²⁶

Early industrial pension plans were viewed as gratuities or rewards to employees for long and loyal service to the employer. Closely related to this view is the concept that private retirement plans constitute a systematic and socially desirable method of releasing employees who are no longer productive members of the employer's labor force.

²⁶ For an excellent discussion of pension philosophies, see Jonas E. Mittelman, "The Vesting of Private Pensions" (Ph.D. dissertation, University of Pennsylvania, 1959), ch. 2.

Regardless of the view taken, it is clear that these early plans were largely discretionary, and management made it quite evident that employees had no contractual rights to benefits under the plans. Continuation of the retirement plan was dependent on competitive conditions and management policy. Furthermore, management reserved the right to terminate benefit payments to pensioners for misconduct on the part of the beneficiary or for any other reasons justifying such action in the opinion of the employer.

Thus, the growth of early retirement plans might be best categorized by a single concept: business expediency. Business expediency, by the very nature of the concept, implies that the establishment of a plan is a management prerogative and that the primary motivation for the creation of such plans is the economic benefit, direct or indirect, that is accrued to the employer. But as the economy became more and more industrialized and retirement plans became more prevalent, there was increasing expression of the view that employers had a moral obligation to provide for the economic security of retired workers. This point of view was expressed as early as 1912 by Lee Welling Squier, as follows: “From the standpoint of the whole system of social economy, no employer has a right to engage men in any occupation that exhausts the individual’s industrial life in 10, 20, or 40 years; and then leave the remnant floating on society at large as a derelict at sea.”²⁷

This rationale of private retirement plans has come to be known as the **human depreciation concept**. It was the point of view taken by the United Mine Workers of America in its 1946 drive to establish a welfare fund:

The United Mine Workers of America has assumed the position over the years that the cost of caring for the human equity in the coal industry is inherently as valid as the cost of the replacement of mining machinery, or the cost of paying taxes, or the cost of paying interest indebtedness, or any other factor incident to the production of a ton of coal for consumers’ bins [The agreement establishing the Welfare Fund] recognized in principle the fact that the industry owed an obligation to those employees, and the coal miners could no longer be used up, crippled beyond repair, and turned out to live or die subject to the charity of the community or the minimum contributions of the state.²⁸

This analogy between human labor and industrial machines also was made in the report of the president’s fact-finding board in the 1949 steelworkers’ labor dispute in support of its conclusion that management had a responsibility to provide for the security of its workers: “We think that all industry, in the absence of adequate government programs, owes an obligation to workers to provide for maintenance of the human body in the form of medical and similar benefits and full depreciation in the form of old-age retirement—in the same way as it does now for plant and machinery.”²⁹ The report continues as follows: “What does that mean in terms of steelworkers? It should mean the use of earnings to insure against the full depreciation of the human body—say at age 65—in the form of a pension or retirement allowance.”³⁰

²⁷ Source: Lee Welling Squier, *Old Age Dependency in the United States* (New York: Macmillan, 1912), p. 272.

²⁸ Source: United Mine Workers of America Welfare and Retirement Fund, *Pensions for Coal Miners* (Washington, DC, n.d.), 1946 p. 4.

²⁹ Source: Steel Industry Board, *Report to the President of the United States on the Labor Dispute in the Basic Steel Industry* (Washington, DC: U.S. Government Printing Office, September 10, 1949), p. 55.

³⁰ *Ibid.*, p. 65.

The validity of the human depreciation concept of private retirement plans has been challenged by many retirement planning experts.³¹ The process of aging is physiological and is not attributable to the employment relationship. Admittedly, the hazards of certain occupations undoubtedly shorten the life span of the employees involved. In those instances, the employer can logically be held responsible only for the increase in the rate of aging due to the hazards of the occupation. More important, the analogy between humans and machines is inherently unsound. A machine is an asset owned by the employer, and depreciation is merely an accounting technique for allocating the costs of equipment to various accounting periods. Employees, on the other hand, are free agents and sell their services to employers for a specified wage rate. An employee, unlike a machine, is free to move from one employer to another. The differences between humans and machines are so great that one must question the value of the analogy as a basis for a rationale of private retirement plans. As Dearing notes, "Any economic or moral responsibility that is imposed on the employer for the welfare of workers after termination of the labor contract should be grounded on firmer reasoning than is supplied by the machine-worker analogy."³²

A more recent view of private retirement plans that has achieved broader acceptance is the **deferred wage concept**. This concept views a retirement plan benefit as part of a wage package that is composed of cash wages and other employee benefits. The deferred wage concept has particular appeal with reference to negotiated retirement plans. The assumption is made that labor and management negotiators think in terms of total labor costs. Therefore, if labor negotiates a retirement plan benefit, the funds available for increases in cash wages are reduced accordingly. This theory of private retirement plans was expressed as early as 1913:

In order to get a full understanding of old-age and service pensions, they should be considered as a part of the real wages of a workman. There is a tendency to speak of these pensions as being paid by the company, or, in cases where the employee contributes a portion, as being paid partly by the employer and partly by the employee. In a certain sense, of course, this may be correct, but it leads to confusion. A pension system considered as part of the real wages of an employee is really paid by the employee, not perhaps in money, but in the forgoing of an increase in wages which he might obtain except for the establishment of a pension system.³³

The deferred wage concept also has been challenged on several grounds. First, it is noted that some employers who pay the prevailing cash wage rate for the particular industry also provide a retirement plan benefit. Thus, it can be argued that in these cases the retirement plan benefit is offered in addition to, rather than in lieu of, a cash wage increase. Second, the deferred wage concept ignores the possible argument that the employer is willing to accept a lower profit margin to provide a retirement plan for employees. Third, it is sometimes argued that if retirement benefits are a form of wage,

³¹ For example, see Dan M. McGill and Donald S. Grubbs, Jr., *Fundamentals of Private Pensions*, 6th ed. (Burr Ridge, IL: Richard D. Irwin, 1989), pp. 18–19. See also Charles L. Dearing, *Industrial Pensions* (Washington, DC: Brookings Institution, 1954), pp. 62–63 and 241–43; and Mittelman, "Vesting of Private Pensions," pp. 28–34.

³² Source: Charles L. Dearing, *Industrial Pensions* (Washington, DC: Brookings Institution, 1954), pp. 243.

³³ Source: Albert de Roode, "Pensions as Wages," *American Economic Review* 3, no. 4 (June 1913), p. 287.

then terminated employees should be entitled to the part of the retirement benefit that has been earned to the date of termination. In practice, one finds that not all plans provide for the full and immediate vesting of all benefits. However, it can be argued that the deferred wage concept does not necessarily require the full and immediate vesting of benefits. Proponents of this concept view retirement benefits as a wage, the receipt of which is conditioned on the employee's remaining in the service of the employer for a specified number of years. This view of the retirement benefit is similar, conceptually, to a pure endowment in which the policyholder receives the full face benefit of the policy if he or she lives to the maturity of the policy; however, the beneficiaries receive nothing if the policyholder dies prior to this time period. The consideration of the employee in this case is the reduction in cash wages accepted in lieu of the retirement benefit.

In spite of the appeal of the deferred wage theory, it is questionable whether the private retirement movement can be explained solely in terms of this concept. Indeed, there is probably no one rationale or theory that fully explains the reason for being of private retirement plans. This conclusion is not surprising since these plans are private, and the demands or reasons that give rise to one plan may be quite different from those leading to the introduction of another plan.

Legislative History and Recent Legal Changes

Employee benefits in general and retirement plans in particular have been the subject of substantial legislative activity in recent years.

After many years of discussion and debate concerning reform of the private retirement system, the **Employee Retirement Income Security Act (ERISA) of 1974** became law on September 2, 1974. ERISA effected some of the most significant changes ever enacted in the private retirement movement. These changes affected virtually all aspects of corporate and self-employed retirement plans from a legal, tax, investment, and actuarial viewpoint. In addition, ERISA established new reporting, disclosure, and fiduciary requirements as well as a program of plan termination insurance. Another major feature of ERISA was the establishment of the individual retirement account (IRA) concept, which was initially designed for individuals not covered under a qualified retirement plan.

The Economic Recovery Tax Act (ERTA) of 1981 was one of the biggest tax reduction acts in history. It also included several provisions that affected retirement plans. Most notable were the provisions that greatly expanded IRA opportunities to anyone with personal service income, allowed for voluntary contributions to qualified plans, and increased contribution and deduction limits for both simplified employee pension (SEP) programs and Keogh (HR-10) plans. ERTA also made changes that affected stock ownership plans and executive compensation arrangements.

Following on the heels of ERTA came another massive act, the **Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982**, considered by some to be the biggest revenue-raising bill in history. TEFRA probably touched everyone in the United States in some manner and affected retirement plans in many ways. It reduced the maximum limits of retirement plan benefits and contributions; brought about parity between corporate plans and plans for self-employed persons; introduced special restrictions on

plans that are considered “top heavy,” that is, plans that appear to be heavily weighted toward key employees; and provided for federal income tax withholding on retirement and annuity payments.

After a one-year hiatus, in 1984 Congress passed two acts with significant implications for qualified retirement plans. The Deficit Reduction Act (DEFRA) of 1984 contained several provisions that substantially modified savings incentives. Cost-of-living adjustments for contribution and benefit limits were frozen for a second time. Estate tax exclusions for distributions from qualified plans and IRAs were repealed. Rules for cash-or-deferred plans, also known as 401(k) plans, were tightened. The Retirement Equity Act (REACT) of 1984 represented an attempt on the part of Congress to provide what was perceived by some as a more equitable distribution of retirement benefits from qualified plans. Young employees and females were the chief benefactors, as REACT required a reduction in the minimum age for mandatory participation, modified rules relating to breaks in service, changed the survivor benefit requirements, and allowed for the assignment of qualified plan benefits in divorce proceedings.

In the most pervasive changes since ERISA, the **Tax Reform Act (TRA '86) of 1986** imposed new coverage tests and accelerated vesting requirements for qualified plans, changed the rules under which qualified plans could be integrated with Social Security, lowered limits for retirement benefits that begin before age 65, changed the timing and taxation of plan distributions, and terminated IRA deductions for many qualified plan participants. Substantial changes also were made with respect to employee stock ownership plans and executive compensation. Following TRA '86, Congress passed the Omnibus Budget Reconciliation Act (OBRA '87) of 1987, which made significant changes with respect to (1) minimum funding and maximum tax deductions for qualified plans and (2) plan termination obligations for defined benefit plans.

Under the Technical and Miscellaneous Revenue Act (TAMRA) of 1988, Congress provided the possibility that certain minimum participation requirements enacted in TRA '86 may be applied separately with respect to each separate line of business of an employer.³⁴ TAMRA also added an additional sanction for highly compensated employees, requiring them to include in their gross income for the year in which the minimum participation standard is not met an amount equal to their vested accrued benefit as of the close of that year.

The Omnibus Budget Reconciliation Act (OBRA '89) of 1989 made numerous changes in the statutory provisions that permitted a lender to an employee stock ownership plan (ESOP), or ESOP plan sponsor, to exclude 50 percent of the interest from its income for federal tax purposes.³⁵ OBRA also amended, among other things, provisions

³⁴ The Small Business Job Protection Act of 1996 modified minimum participation rules as they apply to separate lines of business. The act allowed that fewer than 50 employees could be participants in a defined benefit plan for a separate line of business if it otherwise would meet the requirements to qualify as a separate line of business.

³⁵ The Small Business Job Protection Act of 1996 repealed the interest income exclusion for ESOP loans that allowed banks, insurance companies, regulated investment companies, and certain corporations to exclude 50 percent of the interest received on ESOP loans. Repeal of the interest income exclusion became effective with loans where a contract for the loan agreement occurred on or after June 10, 1996.

pertaining to the Section 404(k) dividend deduction, the ESOP tax-free rollover, and the ESOP estate tax exclusion.

The Omnibus Budget Reconciliation Act (OBRA '90) of 1990 increased Pension Benefit Guaranty Corporation (PBGC) premiums as well as the excise tax on reversions of excess pension plan assets to the employer on termination of a pension plan. However, OBRA '90 presented an opportunity to increase corporate cash flow and possibly decrease near-term expenses through the use of excess pension assets to pay retiree health benefits. The existence of this opportunity depends on the funded status of a pension plan.

The Older Workers Benefit Protection Act of 1990 amended the Age Discrimination in Employment Act (ADEA) to apply to employee benefits but singled out early retirement incentive plans as allowable if they were voluntary, conformed with the purposes of the ADEA, and met certain minimum standards.

The Unemployment Compensation Amendments (UCA '92) of 1992 instituted a 20 percent mandatory withholding tax on lump-sum distributions that are not directly transferred to a qualified type of retirement account and provided notification requirements that plan sponsors must distribute to participants requesting lump-sum distributions. Furthermore, these amendments liberalized the rollover rules, affording most taxable distributions eligibility for rollover treatment, and required plan sponsors to provide a direct rollover option by the end of the 1994 plan year.

The Omnibus Budget Reconciliation Act (OBRA '93) of 1993 lowered the allowable compensation limit for computation of qualified plan contributions to \$150,000 from the \$235,840 it had risen to through indexing. The law also limited the indexing of the \$150,000 compensation cap to \$10,000 increments, thus slowing its rise. This sharp reduction in the allowable compensation base that could be used in determining contributions to qualified pension, 401(k), and other retirement plans of highly compensated employees, caused increased interest in nonqualified plans for replacing lost benefits. The law uncapped the wage base on which employers would pay the 1.45 percent Medicare portion of the Federal Insurance Contributions Act (FICA) tax. Additionally, OBRA '93 increased the amount of Social Security benefits subject to taxation from 50 percent to 85 percent for middle- and higher-income individuals beginning in 1994.

The Uniformed Services Employment and Reemployment Rights Act of 1993 guaranteed a veteran's right to retirement plan benefits that would have accrued during military service and clarified various retirement planning issues that arise with a military leave.

The Retirement Protection Act of 1994 that was part of the General Agreement on Tariffs and Trade (GATT) had a number of provisions directly impacting retirement plans. A number of provisions were instituted to strengthen minimum funding for certain underfunded plans. Premiums to PBGC were increased. Large underfunded plans were required to engage in additional disclosure to the PBGC and plan participants. Certain limitations were instituted on the use of actuarial assumptions for lump-sum distributions, and rounding rules were instituted for the upward indexing of inflation-indexed retirement plan limits. Essentially, these limits were rounded down until inflation adjustments move them up to the next even multiple of \$5,000 (\$500 or \$50, in some cases). These indexing features affected the cap on included

compensation for retirement plan contributions, dollar amounts for determining highly compensated employees in nondiscrimination testing, elective deferral, and Section 415 limits. Section 415 of the Internal Revenue Code (IRC) impacts allowable limits on contributions and benefits through retirement plans. The rounding rules slow the rate of escalation in cost-of-living increases.

Immediately before the 1996 congressional summer recess and the fall 1996 presidential election, several pieces of legislation were passed into law. This legislation included the Small Business Job Protection Act of 1996 and the Health Insurance Portability and Accountability Act of 1996. Within these pieces of legislation and some other enacted laws were considerable tax-related provisions that in combination represented the most sweeping alterations to the tax code since the Tax Reform Act of 1986. Most of the pension-related provisions were included in the **Small Business Job Protection Act of 1996**, where these provisions were assembled thematically as pension simplification provisions. Many of these provisions were advanced as a necessary compromise to gain the support of the small business community for an increase in the minimum wage, although, because of bipartisan support for the retirement plan simplification issue, many technical corrections to earlier legislation were included.

Among the major provisions in the Small Business Job Protection Act of 1996 were the following: the creation of the savings incentive match plans for employees (SIMPLE plans); a simplified definition of highly compensated employees (HCEs) for nondiscrimination testing purposes; simplified nondiscrimination testing procedures; the establishment of testing safe harbors for 401(k) plans; the repeal of family aggregation rules; a change in the definition of compensation used for computing the limitations of IRC Section 415; modification of plan distribution rules; an increase in the maximum tax-deductible contribution for spousal IRAs, and several provisions of significance to plans for tax-exempt entities (403(b) plans) and state and local governments (457 plans).

The Health Insurance Portability and Accountability Act of 1996, although not primarily dealing with pensions, included some provisions that related to retirement security. For example, this act permitted penalty-free early distributions from an IRA for payment of certain medical expenses and health insurance premiums. The act also provided favorable tax treatment for qualified long-term care (LTC) insurance and non-insured LTC expenses, although LTC employee premiums were prohibited from being sheltered under cafeteria plans.

In 1997 two major pieces of legislation were passed impacting employee benefits and retirement plans. Most of the provisions affecting retirement and employee benefit plans were included in the **Taxpayer Relief Act of 1997**, the tax portion of the budget legislation. The spending portion of the legislation known as the Balanced Budget Act of 1997 included many changes related to the Medicare program.

The Economic Growth and Tax Relief Reconciliation Act of 2001 made extensive and far-reaching changes to retirement plans. Among the many changes to be phased in over several years were increased contribution, benefit, and deduction limits for all types of retirement savings vehicles; business credits for the startup of retirement plans; tax credits to lower- and middle-income employees making contributions to retirement plans; greater parity between plans with elimination of the 403(b) exclusion allowance

and various changes to eligible 457(b) plans; greater contribution limits permitted for retirement plan participants who were age 50 and over; plan loans permitted for sole proprietors; S corporation shareholders and partners; a new provision allowing 401(k) and 403(b) plans to incorporate a feature called a “qualified Roth contribution program”; and greater portability for all types of retirement programs by providing for easier rollover of distributions between various types of plans. However, EGTRRA also introduced an element of uncertainty for these extensive retirement plan changes since the act contained a sunset provision stating that all the rule changes would not apply to taxable, plan, or limitation years after December 31, 2010. Effectively all these retirement plan rule changes that were phased in over the next several years would automatically be eliminated in 2011 unless further legislation was passed to extend or retain these changes. Therefore, EGTRRA created both great promise and great uncertainty concerning the expansion of tax incentives for retirement plans.

The **Job Creation and Worker Assistance Act of 2002** increased the interest rate range for computing a defined benefit plan’s current liability; specified that contribution deduction limits applicable to employers that maintain a combination of plans do not apply when only elective contributions are contributed to an employer’s defined benefit plan; clarified certain issues for rollovers of after-tax contributions; and conformed the percentage of compensation for allowable contributions to simplified employee pensions (SEPs) to the permissible deduction limit.

On August 17, 2006, President George W. Bush signed the Pension Protection Act of 2006 into law. The PPA was the most comprehensive retirement plan legislation in decades. Some observers viewed the PPA as the most substantial retirement plan legislation enacted since the passage of ERISA in 1974. The PPA made the retirement-related provisions of EGTRRA permanent, thus avoiding their sunset on the last day of December 2010. The PPA included new funding rules for defined benefit plans, rules applicable to cash balance plans and other “hybrid type” plans, and rules designed to increase participation in employer-sponsored defined contribution plans. Some of the PPA provisions were effective for plan years beginning in 2008, while others were effective immediately upon enactment or for plan years beginning in 2007.

Among the provisions related to DC plans were those that increased employee participation in these plans by providing employers with incentives to automatically enroll employees into defined contribution plans and to default automatic enrollees into certain balanced long-term investment vehicles or managed accounts. The PPA also affected DC plans by making all contributions subject to faster vesting schedules; allowing financial service providers to give personal investment advice to participants in 401(k) plans and individual retirement accounts; and requiring that DC plans provide participants with quarterly benefit statements if participants direct investments or annual statements if participants do not direct investments. Furthermore, additional diversification requirements were instituted for certain DC plans holding publicly traded employer stock if the plan was not a stand-alone employee stock ownership plan (ESOP). The PPA made permanent Roth 401(k) and Roth 403(b) contributions and allowed an exception to the 10 percent early withdrawal tax for distributions from an IRA, 401(k) plan, or other similar retirement arrangements to certain reservists who were called to active duty military service. To qualify for this exemption, a reservist

had to be called up to active duty between September 11, 2001, and December 31, 2007, for a period longer than 179 days.

The Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 made this exception to the 10 percent early withdrawal tax permanent. This provision of the HEART Act was effective December 31, 2007, when the formerly allowed exception would have expired.

With regard to defined benefit plans, the PPA completely overhauled the funding rules for DB plans in an attempt to make these retirement plans more secure. These updated funding rules generally applied to plan years beginning in 2008, although transition rules applied to the 2006 and 2007 plan years. The PPA encouraged DB plans to create a funding cushion by increasing the limits on deductible contributions. The PPA also attempted to facilitate phased retirement arrangements by allowing plans to distribute retirement benefits to active employees before the plan's normal retirement age. The PPA permits the distribution of retirement benefits to active employees age 62 or older, even if the plan's normal retirement age is later than age 62. The PPA modified the ability to transfer excess assets from defined benefit plans to a separate account to fund retiree health benefits. Although such transfers could occur in the past to fund current year benefits, the PPA permitted such transfers after August 17, 2006, to fund future retiree health benefits as well.

Following passage of the comprehensive retirement plan reform legislation that comprised the Pension Protection Act of 2006, the legislative activity regarding retirement plans was somewhat less pervasive during the next few years, although the PPA did result in the issuance of many clarifying regulations related to the original statute. Over the next few years some legislative activity occurred, but such legislation usually was appended to other pieces of legislation. For example, the Small Business Job Protection Act of 2010 liberalized distributions to an employee or surviving spouse from a 401(k), 403(b), or governmental 457(b) plan to allow accounts to be rolled over into a designated Roth account under the plan if such designated Roth accounts were currently offered. This provision became operable after September 27, 2010.

Also, the Moving Ahead for Progress in the 21st Century (MAP-21) Act was signed into law on July 6, 2012. Although MAP-21 was primarily focused on authorizing funding for the nation's highways and for extending low interest rates for federal student loans, it also contained a package of pension-related provisions. Because the U.S. economy was experiencing what were viewed as abnormally low interest rates, this remedial legislation adjusted rates used to compute contributions to defined benefit pension plans. When interest rates are low, pension plan liabilities are estimated to be higher and employers must contribute more money to meet their pension obligations. Conversely, when interest rates are higher, pension liabilities are valued at a lower level and employers are required to contribute less money. MAP-21 changed the methodology for computing interest rates to be utilized for funding defined benefit pension plans by using an average of interest rates going back 25 years. This computation methodology resulted in employers being able to contribute less money into their defined benefit pension plans during a period of economic slowdown in the U.S. economy.

MAP-21 also enacted certain pension plan changes that were revenue-raising provisions for the federal government. The act increased premiums paid by defined benefit pension plans to PBGC. The act established a Participant and Plan Sponsor Advocate at PBGC. The advocate acts as a liaison between PBGC and participants in terminated pension plans to ensure that participants receive the benefits to which they are entitled. The advocate also assists plan sponsors in resolving disputes with PBGC.

Generally, defined benefit plans cannot transfer funds to the employer unless a plan is terminated and all liabilities are satisfied. However, overfunded pension plans previously were allowed to use excess pension assets to fund retiree health benefits if transfers were made before December 31, 2013. MAP-21 extended the ability to transfer such funds through December 2021, and broadened the types of programs that could be funded to include group life insurance accounts benefiting retirees who participate in the plan. Additionally, the act created a federal phased retirement program that allowed federal workers to receive a part of their retirement benefit while working part-time. This provision was to become effective after the Office of Personnel Management (OPM) issued implementing regulations.

The American Taxpayer Relief Act was adopted by Congress on January 1, 2013, to address key elements of the so-called fiscal cliff. If Congress had failed to act, a number of tax and spending cuts mandated by prior legislation would have automatically been triggered as of the start of 2013. This tax and budgetary legislation included increased tax rates for high-income taxpayers and a payroll tax increase for working Americans. Though these tax measures were of primary importance, there were notable provisions affecting retirement plans. Among the most prominent retirement-related measures were provisions allowing for more flexibility in converting accumulated balances in 401(k), 403(b), and 457(b) plans into designated Roth accounts. Previously such a conversion could occur only when assets within the plans were “distributable.” This increased flexibility was projected to be a “revenue raiser” that would generate governmental tax revenues in the short term. Some commentators observed that although this provision would generate tax revenues in the short term, it would do so at the expense of collecting greater revenues in future years. Additionally, the American Taxpayer Relief Act reinstated and temporarily extended through December 31, 2013, the tax law provision that allowed tax-free distributions from individual retirement accounts (IRAs) for charitable purposes.

Though not directly retirement plan related, the American Taxpayer Relief Act of 2012 formally repealed the Community Living Assistance Services and Supports (CLASS) Act, which was enacted as part of the Patient Protection and Affordable Care Act (PPACA). The CLASS Act established a voluntary, public long-term care program. Both the Protecting Americans from Tax Hikes (PATH) Act of 2015 and the Bipartisan Budget Act of 2015 had limited technical changes affecting retirement plans. Similarly, 2016 and the initial months of 2017 saw limited legislative change to retirement plans. The Department of Labor’s multi-year regulatory initiative to introduce a final conflict of interest rule regarding investment advice to retirement plans and IRAs would have substantially modified retirement practices and communications if implemented as scheduled for April 2017. However, this rule was delayed, placed under review

with the possibility of being eliminated entirely by an executive memorandum from President Trump as of February 2017.

Many changes, rulings, and regulations relating to these various pieces of legislation have occurred since their enactment. The legislation and the changes, as well as their impact on retirement plans, are discussed throughout this book.

Chapter Summary

- One cause of economic insecurity is the probable reduction of an individual's earning power at an advanced age. Most often, the problem of economic insecurity is remedied by the "tripod of economic security"—personal savings, employer-sponsored retirement plans, and social insurance programs.
- Although the assumption usually is made that financial needs decrease after retirement, the actual aggregate reduction in financial needs upon retirement is probably overstated.
- Private retirement plans have experienced dramatic growth since the 1940s for a number of reasons. Among the economic, sociological, and historical reasons for this growth are the following:
 - A systematic method of meeting the problem of superannuated employees can be justified on sound management grounds. Economists have theorized on the economic rationale of private retirement plans using the human depreciation concept and the deferred wage concept.
 - Tax considerations provide financial incentives for the provision of qualified retirement plans.
 - Union demands and the actions of the War Labor Board when increases in wages were prohibited have contributed to retirement plan growth.
 - Employers may be motivated to provide pensions to compete in recruiting and retaining workers, or they may provide retirement plans to reward service or forestall unionization. At times employers have been encouraged to implement retirement plans by the sales efforts of funding agencies.
- Retirement plans have been the subject of substantial legislative activity and the development of these plans is better understood when the provisions of these legislative acts are known. One of the most notable pieces of legislation is the Employee Retirement Income Security Act (ERISA) of 1974, which established a major foundation from a legal, tax, investment, and actuarial viewpoint. The Tax Reform Act of 1986 (TRA '86) probably provided the most pervasive changes in pension regulation since the passage of ERISA. The Small Business Job Protection Act of 1996 contained many pension-related provisions that were linked as pension simplification initiatives. Within the Small Business Job Protection Act of 1996 were many technical corrections relating to earlier retirement plan legislation. In 1997 the Taxpayer Relief Act and Balanced Budget Act were passed.

- The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 made extensive and far-reaching changes to retirement plans. Among the many changes to be phased in over several years were increased contribution, benefit and deduction limits for all types of retirement savings vehicles; business credits for the startup of retirement plans; tax credits to lower- and middle-income employees making contributions to retirement plans; greater parity between plans with elimination of the 403(b) maximum exclusion allowance and various changes to eligible 457(b) plans; greater contribution limits permitted for retirement plan participants who were age 50 and over; plan loans permitted for sole proprietors; S corporation shareholders, and partners; a new provision allowing 401(k) and 403(b) plans to incorporate a feature called a “qualified Roth contribution program”; and greater portability for all types of retirement programs by providing for easier rollover of distributions between various types of plans. However, EGTRRA also introduced an element of uncertainty for these extensive retirement plan changes since the act contained a sunset provision stating that all the rule changes would not apply to taxable, plan, or limitation years after December 31, 2010.
- On August 17, 2006, President George W. Bush signed the Pension Protection Act (PPA) of 2006 into law. The PPA was the most comprehensive retirement plan legislation in decades. Some observers viewed the PPA as the most substantial retirement plan legislation enacted since the very passage of ERISA in 1974. The PPA made the retirement-related provisions of EGTRRA permanent, thus avoiding their sunset on the last day of December 2010. The PPA included new funding rules for defined benefit plans, rules applicable to cash balance plans and other “hybrid type” plans, and rules designed to increase participation in employer-sponsored defined contribution plans. Some of the PPA provisions were effective for plan years beginning in 2008, while others were effective immediately upon enactment or for plan years beginning in 2007.
- Among the provisions of the PPA related to defined contribution plans were those that increased employee participation in these plans by providing employers with incentives to automatically enroll employees into DC plans and to default automatic enrollees into certain balanced long-term investment vehicles or managed accounts. The PPA also affected DC plans by making all contributions subject to faster vesting schedules; allowing financial service providers to give personal investment advice to participants in 401(k) plans and individual retirement accounts; and requiring that DC plans provide participants with quarterly benefit statements if participants direct investments or annual statements if participants do not direct investments. Furthermore, additional diversification requirements were instituted for certain defined contribution plans holding publicly traded employer stock if the plan was not a stand-alone employee stock ownership plan (ESOP). With regard to defined benefit plans, the PPA completely overhauled the funding rules for DB plans in an attempt to make these retirement plans more secure.
- The Moving Ahead for Progress in the 21st Century (MAP-21) Act was signed into law on July 6, 2012. MAP-21 changed the methodology for computing interest rates

to be utilized for funding defined benefit pension plans by using an average of interest rates going back 25 years. This computation methodology resulted in employers being able to contribute less money into their defined benefit pension plans during a period of economic slowdown in the U.S. economy. The act increased premiums paid by defined benefit pension plans to PBGC. The act also established a Participant and Plan Sponsor Advocate at PBGC.

- The American Taxpayer Relief Act of 2012, adopted by Congress on January 1, 2013, increased tax rates for high-income earners and resulted in a payroll tax increase for working Americans.

Key Terms

annuities, p. 1	Job Creation and Worker	Tax Equity and Fiscal
deferred wage concept,	Assistance Act of 2002,	Responsibility Act
p. 16	p. 21	(TEFRA) of 1982, p. 17
demography, p. 8	longevity, p. 8	Taxpayer Relief Act of
Economic Growth and Tax	Pension Protection Act	1997, p. 20
Relief Reconciliation	(PPA) of 2006, p. 7	Tax Reform Act (TRA '86)
Act (EGTRRA) of	reverse annuity, p. 6	of 1986, p. 18
2001, p. 7	Small Business Job	tripod of economic
Employee Retirement	Protection Act of 1996,	security, p. 1
Income Security Act	p. 20	wage stabilization
(ERISA) of 1974, p. 17	superannuated, p. 9	program, p. 11
human depreciation		
concept, p. 15		

Questions for Review

1. Describe the basic economic problems facing aging adults.
2. Why have private pension plans grown so rapidly since the 1940s?
3. Explain the alternatives that exist for an employer dealing with less-productive superannuated employees. What are the limitations of these alternatives?
4. Briefly describe the principal tax advantages of qualified retirement plans.
5. Describe how wage stabilization during World War II affected private retirement plans.
6. Explain the role played by the National Labor Relations Board (NLRB) in the development of retirement plans.
7. Describe the merits of private retirement plans as a supplement to Social Security benefits and individual savings programs.
8. Briefly describe the impact of recent legislation on the design process for private retirement plans.

Questions for Discussion

1. Economists have often argued that retirement benefits are a form of deferred compensation accepted by employees in lieu of higher present wages. Assume that the employees of a firm ask you how much the retirement plan benefit they earned this year is actually worth in current dollars. In general terms, how would you perform this valuation? What types of assumptions would you need to make? If the employees told you that they would forfeit the entire retirement plan attributable to employer contributions if they were terminated within five years of the time they were originally hired, how would you factor this information into your analysis?
2. For several years it has been argued that one of the primary advantages of a retirement plan for employees is that it allows them to avoid taxation on a portion of their total compensation during the time they are in a high tax bracket and to postpone the receipt—and consequently the taxation—of this money until after they retire. If, as was usually the case prior to the Tax Reform Act of 1986, the employee expected to be in a lower tax bracket after retirement, the tax savings inherent in this deferral could be substantial. However, if the federal income tax system evolved into a modified form of a flat tax system in which many taxpayers expected to be taxed at the same rate, regardless of when their money was received, does this necessarily imply that the tax advantages of private retirement plans have ceased to be an important advantage for employees? (*Hint*: Even if all money received from a retirement plan is taxed at the same rate, does the fact that money can accumulate at a before-tax rate of return, instead of an after-tax rate of return, affect the eventual amount of money received by the employee?)
3. The text suggests that a private retirement plan allows the burden of retirement security to be spread out over a long period of time. Discuss how this specifically applies in the case of investment risk. Assume that there are only two forms of investments for retirement: a risk-free asset with a known rate of return, and a risky asset with a higher expected rate of return. Unfortunately, the risky asset may experience large decreases as well as increases in any particular year. If employees were to invest for their retirement on an individual basis, why might they be willing to choose the risk-free asset, knowing their expected accumulation at retirement will be smaller? In contrast, if employees allowed the employer to invest for their retirement through a defined benefit pension plan (in which the employee's retirement benefit is guaranteed regardless of the level of the pension assets), would the employer be as likely to choose the lower yielding, risk-free asset for the pension plan? (*Hint*: What is the relevant investment horizon for a pension plan if it is assumed to be an ongoing operation?)

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www.ifebp.org—website of the International Foundation of Employee Benefit Plans.

www.ici.org—website of the Investment Company Institute.

www.pensionresearchcouncil.org—website of the Pension Research Council at the Wharton School of the University of Pennsylvania.

Chapter 2

Strategic Plan Design

After studying this chapter you should be able to:

- Identify important environmental factors an employer should consider when designing a retirement plan.
 - Describe alternative plan design approaches to achieve employer goals and objectives.
 - Explain techniques that may be used to make comparisons between the retirement plans of various employers.
 - Identify opportunities to comply with legal requirements by modifying elements of plan design.
 - Describe how the entire portfolio of benefits for a retiree may affect the goals and objectives set for the retirement plan.
 - Explain the purpose of income-replacement objectives, why they are less than 100 percent of preretirement gross income, and why they may vary depending on salary level.
-

It is reasonable to speculate that the first employee benefit plans were established to serve specific purposes—for example, to avoid “passing the hat” among employees when someone died. For many years, the design of these plans was influenced largely by the insurance industry’s attitude toward underwriting, funding, and administration, since the plans were made available by insurers under the terms and conditions they chose to offer.

Over the years, many factors have influenced the design of employee benefit plans, and a body of law has emerged that affects these plans in terms of minimum requirements and permissible provisions. The taxation of contributions and benefits also has influenced plan design, and the process of collective bargaining and the interests of organized labor have been a major influence, as has the availability of alternate funding mechanisms. These, and other factors, including a growing degree of sophistication and knowledge of the field, have created an environment in which an employer has a wide degree of choice and flexibility in benefit plan design. In recent years, however, the increasing level of federal regulation has caused retirement plans to gravitate toward

common plan provisions. For example, plans that have eligibility requirements almost always settle on the use of one year of service and a minimum age of 21.¹

The cost of employee benefits is significant. A well-rounded program (including paid time off) can easily generate a total cost in the vicinity of 30 percent or more of an employer's base payroll. If the cost of statutory benefits also is included, total cost can easily reach 40 percent of payroll or more. Indeed, some companies have total benefit costs that approach 50 percent of payroll. The amounts accumulated under these plans also are of major importance. For example, the assets accumulated by some companies in their retirement plans alone exceed their net worth.

Given the substantial costs involved in employee benefit plans, the importance they have to millions of workers, and the complex legal, tax, and funding environments that exist, it is most important that such plans be designed with particular care, that they be fully supportive of the employer's philosophy, goals, and objectives, and that they at least partially satisfy the perceived needs of the employees. This concept is of equal importance to small employers and to larger organizations.

The major focus of this text is on the various mechanisms that exist for the delivery of retirement benefits and the ways in which a specific retirement plan might be designed. However, matters that influence the design of a retirement plan also influence the design of other employee benefit plans. Thus, while the primary emphasis of this chapter is on retirement plans, the subject matter is broad enough to apply to all employee benefits.

In this chapter, some of the environmental considerations that can influence plan design are described first. Then employer philosophy and attitudes are discussed. The final portion of the chapter deals with specific employee benefit plan objectives.

Environmental Considerations

Before passage of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, the employer's legal status often influenced plan design. Federal tax law dealt differently with sole proprietorships, partnerships, Subchapter S corporations, nonprofit organizations, and regular corporations. For example, defined contribution pension or profit sharing plans generally were adopted by unincorporated organizations and by Subchapter S corporations because of the deduction limits previously imposed on these organizations. Often, these deduction limits and the potential benefits of a defined benefit pension plan caused such organizations to incorporate either on a regular basis or as a professional corporation or association. While the parity provisions of TEFRA eliminated most of the distinctions in tax law that formerly applied to partnerships and sole proprietorships, precedents established by prior practice and prior law still may continue to influence plan design for some organizations.

Section 501(c)(3) organizations need to take special matters into account when considering employee benefits. One such matter is that contributions are not deductible and will not operate to reduce plan costs. Thus, the "out-of-pocket" costs for a given level of employee benefits will be higher for a tax-exempt organization than they would be

¹ See Chapter 26 for a discussion on the determination of service.

for a profit-making corporation under like circumstances. Also, these organizations have frequently used defined contribution concepts because of the availability of tax-deferred annuities under Section 403(b) of the Internal Revenue Code.

The basic characteristics of the employer and its industry are part of the background for designing an employee benefit program. Is the firm a young, growing organization, or is it relatively mature? Is its history of profits stable and predictable, or have profits been, or are they likely to be, volatile? Does the firm anticipate moderate or significant growth, and what will its need for employees be in the foreseeable future? Is the industry highly competitive? Are profit margins narrow? Is the business cyclical? What are the firm's short- and long-term capital needs? The answers to these questions and others like them can be of great importance in structuring benefit plans that will both meet employee needs and offer funding patterns compatible with the employer's objectives and capabilities.

The characteristics of the individuals employed by the employer also play an important role in plan design. The distribution of employees by age, service, gender, and pay can have significant implications in terms of the type of benefit provided, cost levels generated, and similar matters.

An employer with diversified operations has special considerations when it comes to employee benefit plan design. For example, such an employer needs to consider whether the same benefit program is appropriate for all facets of the business. Factors such as cost, profit margins, competitive need, and geographic differences should be taken into account. Another factor related to this issue is the employer's attitude regarding the transfer of employees. A uniform program facilitates such transfers, while different plans at different locations may create impediments. Obviously, the employer's basic policy concerning employee transfers, whether encouraged or discouraged, bears on the matter. One approach used by some employers is to combine a basic or "core" program that applies in all areas of the business with a flexible or varying program of supplemental benefits to accommodate different industry needs.

The communities in which the employer does business also can be an environmental factor in plan design. This is less the case in large, urban areas, but it can become quite meaningful when the company is the dominant or a major employer in a discrete geographic area. In this case, the design and structure of an employee benefit plan could reflect the employer's degree of concern over the image it wishes to create in the communities in which it does business. If such a concern exists, it often indicates the need for liberal benefit provisions—not only by the employer's own industry standards, but by the standards established by different employers involved in the same communities.

The presence or absence of collective bargaining units also can be a significant consideration. The demands of labor, both on a local and a national or "pattern" basis, can influence plan design, even for nonbargaining employees. Many employers follow the practice of extending bargained-for benefits to nonbargaining unit employees, or they make the plans of the nonbargaining unit employees slightly better than those of the bargaining unit employees, to the extent that this does not violate labor laws. Others, however, treat the programs as totally separate, particularly in the context that benefit plans are part of total compensation and that basic salary and wage structures also are quite different between the two groups.

The foregoing is not intended to be an exhaustive discussion of environmental factors that influence plan design. Rather, it is intended to give some indication of the various items that should be considered. With these in mind, it is appropriate to turn to a discussion of employer philosophy and attitudes.

Employer Philosophy and Attitudes

Specific objectives for employee benefit plans should be considered in the context of the employer's philosophy and attitudes for the management of human resources. The following list of questions and observations, again not all-inclusive, is designed to suggest the nature of some of the items that need to be considered.

1. What is the employer's basic compensation philosophy? Many employers believe benefit plans are part of total compensation and that the cost and benefit structure of these plans should reflect the employer's basic attitude toward other compensation elements. Thus, the employer who has adopted a policy of paying high wages and salaries may very well adopt a liberal benefit program. On the other hand, an employer may choose to establish a benefit program that keeps total compensation costs at an acceptable level while presenting one element of compensation on a more favorable basis. For example, an employer may wish to establish highly competitive wages and salaries but, to keep total compensation costs in line, may provide only modest benefits. Such a compensation strategy, of course, can affect the type of employee attracted and also can influence matters such as turnover rates. It also is possible for an employer to adopt a reverse compensation strategy mix and have a liberal benefit program to go along with a cash compensation program that is not fully competitive. This type of compensation mix often is found in governmental units, where cash compensation is fixed by law and where incentive compensation may not be payable. Here, it is common to find liberal benefit programs. However, this may be changing amidst a difficult economic outlook and historically generous benefits that are largely unfunded.
2. Is the employer's basic attitude toward providing employee benefits one that emphasizes the protection and maintenance of income in the event of economic insecurity? Or is its attitude oriented more toward providing additional current, although tax-deferred, compensation? Most employers do not have a clear-cut and total preference for one or the other of these positions; however, one position might be of greater significance than the other. The employer's leaning toward one or the other of these two concepts can find expression in a number of plan decisions. For example, a preference for the **income-maintenance approach** could suggest the choice of a defined benefit pension plan integrated to the maximum extent with Social Security benefits² or the choice of a death benefit that provides an income

² The basic concept of integration is that the benefits of the employer's plan are dovetailed with Social Security benefits in such a manner that employees earning over the Social Security taxable wage base will not receive combined benefits under the two programs proportionately greater than the benefits for employees earning less than this amount. Although the benefit formula under the private plan may favor the higher paid employees, the additional amounts provided for them cannot exceed levels allowed under the Internal Revenue Code and supporting regulations. This concept is presented in more detail in Chapter 25.