

answers to
key questions
about
private
pension
plans

September 18, 2002

The Honorable Amo Houghton
Chairman, Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives

The Honorable William J. Coyne
Ranking Member, Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives

This document responds to your request to provide information about the basic features of the private pension plan system and the federal framework that governs how private plans must operate. As you requested, this private pensions primer includes questions and answers about the types of plans that private employers may sponsor, the benefits these plans provide, and the basic requirements that govern how these plans are administered. The answers are intended to be clear, concise, and easy-to-understand. Although the primer summarizes and explains some of the fundamental aspects of private pensions, the material does not provide a complete technical interpretation regarding the many complexities of these plans or all of the rules and requirements that govern these plans.

We are also sending copies of the document to the Chairmen and Ranking Members of the House and Senate Appropriation Committees, the House Committee on Education and the Workforce, the House Government Reform and Oversight Committee, the Senate Finance Committee, the Senate Health, Education, Labor, and Pensions Committee, the Senate Government Affairs Committee, the Secretary of Labor, the Secretary of the Treasury, and the Executive Director of the Pension Benefit Guaranty Corporation. Copies will be made available to others upon request.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D.M. Walker", with a long horizontal line extending to the right.

David M. Walker
Comptroller General of the
United States



Preface

Private pensions serve as a key supplement to Social Security and can help workers receive adequate incomes in retirement. Employer-provided pensions are an important source of income for many retired persons. About thirty percent of all households aged 65 and older receive income from private pensions, and such income represents 9 percent of their total income. Over 50 million workers actively participated in over 730,000 private pensions, and such plans in 1998 represented over 4 trillion dollars in retirement savings. However, since the 1970's, only about half of all private sector workers aged 25 to 64 have participated in an employer-sponsored pension. The millions of workers who have no individual pension coverage are at particular risk for inadequate incomes during their retirement years.

To encourage employers to establish and maintain pension plans for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code (IRC) for plans that meet certain requirements.¹ The purpose of tax preferences for employer-sponsored pensions is to encourage savings for workers' retirement. Pension tax preferences are structured to strike a balance between providing incentives for employers to start and maintain voluntary, tax-qualified pension plans and ensuring participants receive an equitable share of the tax-favored benefits. In fiscal year 2002, these tax preferences for employer-sponsored (public and private sector) pension plans are estimated at about \$88 billion and represent the largest federal "tax expenditure," exceeding those for home mortgages or health benefits.²

In addition to certain requirements that private plans must meet to receive tax-favored treatment, federal law also stipulates certain obligations that plan sponsors must fulfill with respect to plan operation, funding and management. These obligations are designed to protect private plan participants and beneficiaries from mismanagement and misuse of assets and to ensure that they are entitled to benefits under their plans. The rights and obligations of plan sponsors and participants are spelled out in the Employee Retirement Security Act of 1974 (ERISA). For example, the Employee Retirement Income Security Act requires plan fiduciaries, or individuals who exercise discretionary control or authority over a plan's management or assets, to follow certain standards of conduct with respect to the administration of the plan. The primary responsibility of plan fiduciaries is to run the plan solely in the interest of participants and for the exclusive purpose of providing benefits.

The financial collapse of the Enron Corporation and other recent corporate failures, and their effects on the companies' workers and retirees, have prompted policy-makers and the public to want to know more about private pensions and the benefits

¹Pension contributions that fall within certain statutory limits, as well as investment earnings on pension assets, are not taxed until benefits are paid to participants. See section I of this primer for more information on tax-favored treatment for qualified plans.

²Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006*, JCS-1-02 (Washington, D.C.: January 2002).

these plans provide. The private pension plan system is complex because employers offer a variety of plans to their employees, and sponsors must ensure that the design and operation of their plans satisfies a myriad of laws and regulations.

This publication is intended to provide answers to questions about the most basic features and components of the private pension plan system in a concise and easy-to-understand format. We provide answers to basic questions about the types of plans that employers may sponsor and about various rules that govern pension plans. We prepared this publication to be a primer for those who need to begin to develop an understanding of private pensions as well as a resource for looking up common terms, such as "401(k)" plans, or basic questions, such as "what is a defined benefit plan?" In general, the information in this publication provides a foundation for understanding fundamental aspects of the private pension plan system. Although we provide information to summarize and explain basic terms and features, we do not provide complete details regarding the many technical complexities of private pension plans and the rules and requirements that these plans must satisfy. This pension primer is not intended to provide a legal interpretation of the labor and tax laws that govern private plans or be used as a substitute for relevant laws and regulations.

Information is grouped into five sections of questions and answers. The first section discusses the public policy framework for private pensions, including general information about the labor and tax laws that apply to private plans. The second section defines the different types of plans that private employers may sponsor and explains how these plans provide benefits to participants. The third section describes the role of the Employee Retirement Income Security Act of 1974 in protecting plan participants. The fourth section discusses certain fundamental Internal Revenue Code requirements that govern how plans must cover employees and provide benefits to participants. The fifth section highlights the role of federal government insurance in protecting the benefits that participants in certain private defined benefit plans are entitled to receive. For readers interested in more detailed information on the topics covered in this primer, we also include a bibliography of related GAO products. Links are provided to agency web pages with information on private plans and/or the rules and protections that apply to these plans. For easy reference, we include a glossary defining key terms in the back of this primer. Terms that are defined in the glossary appear in bold type the first time they are used in the text.

This report was prepared under the direction of Barbara D. Bovbjerg, Director Education, Workforce and Income Security Issues, who may be reached at (202) 512-7215 if there are any questions. Joseph Applebaum, Jeremy Citro, Tamara Cross, Patrick Dibattista, Tim Fairbanks, Kimberly Granger, Barbara Hills, Corinna Nicolaou, George Scott, Roger Thomas, and Stephanie Wasson made key contributions to this publication.

TABLE OF CONTENTS

Preface	iii
I. Private Pensions and Public Policy	1
1. Why do private employers offer pension plans?	1
2. Who may sponsor a pension plan?	2
3. What is a multiemployer plan?	2
4. What types of pension plan arrangements can private employers sponsor for their employees?	3
5. What are the tax advantages of sponsoring a qualified plan?	5
6. What is the process by which plan sponsors obtain tax-qualified status? ..	5
7. What laws govern private pension plans?	6
8. Which agencies are responsible for enforcing federal laws and regulations that govern private pension plans?	6
II. Types of Pension Plans Employers May Sponsor	8
1. What is a defined benefit plan?	8
2. What is a defined contribution plan?	9
3. What types of contributions can be made to defined contribution plans? ..	12
4. What is the accrued benefit provided by defined benefit and defined contribution plans?	13
5. How may defined benefit and defined contribution plans pay benefits? ...	14
6. What is pension portability?	17
7. How may workers preserve their pension benefits for retirement?	18
8. Who operates an employer-sponsored pension plan?	18
9. What is a 401(k) pension plan?	19
10. What is an Employee Stock Ownership Plan (ESOP)?	21
11. What are hybrid pension plans?	22
12. What is a pension plan floor-offset arrangement?	22
13. What is a cash balance plan?	23
14. What pension plans are available to governmental employees?	24
III. The Role of ERISA	25
1. What is the Employee Retirement Income Security Act (ERISA) of 1974? ..	25
2. Who is a plan fiduciary?	26
3. How do the fiduciary provisions of ERISA protect participants?	27

4.	What is a trust, and what requirements govern trusts?	27
5.	Who makes investment decisions regarding qualified pension plan assets?	28
6.	Are plan fiduciaries responsible for investment decisions made by plan participants?	29
7.	What rules govern investment of plan assets in employer stock?	30
8.	Can employers provide investment education and investment advice to plan participants?	31
9.	What kinds of information are plans required to report to the federal government?	32
10.	What kinds of information are employers required to disclose to plan participants?	33
11.	What is the difference between a plan freeze and a plan blackout?	34
IV.	Internal Revenue Code Provisions on Plan Coverage and Benefits	36
1.	What are the rules for employee eligibility and participation in pension plans?	36
2.	What rules govern employee coverage in pension plans?	36
3.	What are the nondiscrimination rules that private plans must satisfy?	37
4.	What are the “top heavy” rules and when do they apply to private plans? . .	38
5.	What does vesting mean?	39
6.	To what extent can accrued benefits be reduced or eliminated?	41
7.	What rules govern age discrimination in the provision of pension benefits?	41
V.	Government Insurance Protection of Pension Benefits	43
1.	Under what circumstances may a private employer terminate a pension plan?	43
2.	Are participants’ benefits protected when their plan terminates?	45
3.	What is the role of the Pension Benefit Guaranty Corporation in protecting retirement benefits?	46
4.	What are PBGC’s financial resources to carry out its mission?	47
5.	To what extent does the Pension Benefit Guaranty Corporation insure benefits provided by defined benefit plans?	48
6.	What plan benefits does PBGC guarantee?	48

Glossary of Key Terms 50

Related GAO Products 55

Figures

Figure 1: Number of Private Defined Benefit and Defined Contribution Plans . 12

Figure 2: Active Participants in DB and DC plans 17

Figure 3: Growth in the Number of 401(k) Plans 20

Figure 4: Coverage and Participation of Private Sector Employees. 37

Figure 5: Vesting Status of Participants in DB and DC Plans 40

Figure 6: PBGC Trusteeship of Terminated Defined Benefit Plans 45



1 Private Pensions and Public Policy

Section 1 provides general information on the public policy framework for private pensions, including a broad discussion of standards that employers must meet to sponsor plans that qualify for preferential tax treatment.

Q. Why do private employers offer pension plans?

Private employers voluntarily offer pension plans to attract and retain workers and enable workers to take advantage of the tax preferences associated with pensions.

A. Private employers are not required to offer pension plans for their employees. The private pension plan system is voluntary; employers decide whether to establish a retirement plan and make decisions regarding the design, terms and features of the plan or plans they choose to sponsor.³ One of the fundamental determinations that private employers make if they decide to sponsor a plan relates to the level of benefits that the plan provides.

Although private employers are motivated to offer a pension plan for many reasons, the most important involve (1) the employer's need to attract and retain a workforce in a competitive

labor market and (2) the tax advantages, or preferences, associated with pensions.⁴

Employers typically want to attract workers, motivate them to perform efficiently in pursuit of the firm's goals, and retain them to reduce the costs associated with turnover. Pensions provide a tool for accomplishing these objectives. For example, pensions are a means of providing deferred compensation that may encourage workers to make long-term commitments to employers. At the same time, employers also want to manage the retirement of their workforce, and pensions are a means of offering incentives for workers to retire sooner or later than they would otherwise.

Employers also choose to sponsor pension plans because of the favorable federal tax treatment of contributions that employees make and the investment returns on these contributions. While workers' cash earnings are taxed immediately, pension plan participants typically do not include their employer's

³The determination that a plan sponsor makes to sponsor a plan is termed a "settlor" function. Other settlor functions that an employer performs include the decision regarding the type of plan to offer, the decision regarding level of benefits to provide under the plan and the decision to terminate the plan. Settlor functions do not subject the employer or its executives to fiduciary responsibility under the Employee Retirement Income Security Act. Plan fiduciaries and their responsibilities are discussed in section III.

⁴Public sector employers may choose to offer a pension plan to attract and retain a workforce in a competitive market and to enable workers to take advantages of the tax preferences associated with pensions.

or their own contributions (and the investment earnings on these contributions) to a qualified plan in determining their tax liability until they receive benefits. The employer is also entitled to a current deduction (within certain limits) for contributions to a tax-qualified plan even though contributions are not currently included in an employee's income.

Q. Who may sponsor a pension plan?

Private and public-sector employers may sponsor pension plans for their employees.

A. Private and public-sector employers may sponsor pension plans for their employees.⁵ Employers may sponsor plans either individually or collectively. A single-employer plan is a plan that is established and maintained by only one employer. Single-employer plans can be established unilaterally by the sponsor or through a collective bargaining agreement with a labor union. Generally, the sponsoring single-employer has the ultimate responsibility for the administration of the plan (pension plans that may be sponsored jointly by two or more employers are discussed below). A plan that is collectively sponsored by two or more employers may be sponsored through a collective bargaining agreement with a labor union (i.e., union contract) or by a professional or trade association. Two or more employers who collectively sponsor a plan are not required to enter into a collective bargaining agreement with a union.

Q. What is a multiemployer plan?

A multiemployer plan is a collectively bargained arrangement between a labor union and a group of employers in a particular trade or industry.

A. Since the passage of the National Labor Relations Act in 1935, collective bargaining has been the primary means by which U.S. workers can negotiate, through unions, the terms of their pension plan, in addition to other employee benefits. Collective bargaining is a process that consists of negotiations between representatives of organized workers and one or more employers. Typically labor and management negotiate the terms of employment, which include benefits such as salary increases, work rules, health care, and pension plan contributions and accrual rates.

Multiemployer plans typically cover groups of workers in the unionized sector of such industries as trucking, building and construction, clothing and textiles, food and commercial workers, among others. Management and labor representatives must jointly govern these plans, in which participants can negotiate the plan benefits through a union. Workers can continue to participate in the plan when they change jobs if their new employer also participates as a plan sponsor. These plans offer a means for workers in industries where job change is frequent to build up pension rights over a career. Multiemployer plans may provide the same annual retirement benefit to all partici-

⁵A plan sponsor may include an employer, employee organization, or both.

pants with the same amount of service, regardless of pay level, or individual employers who participate in a multi-employer plan may set employer-specific benefit levels for their participants.

Multiemployer plans should not be confused with multiple-employer plans.⁶ Multiple-employer plans are typically established without collective bargaining agreements. Generally, separate accounts are maintained for each employer-sponsor so that an individual employer's contributions provide benefits only for the employees of the contributor. Multiple-employer plans may provide advantages to employers in certain trades or professions, such as pooling plan assets for investment purposes and reducing the cost of plan administration.

Q. What types of pension plan arrangements can private employers sponsor for their employees?

Private employers can sponsor qualified plans and nonqualified deferred compensation plans or arrangements.

A. To encourage employers to establish and maintain pension plans for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code for plans that meet applicable requirements. A **qualified pension plan** is a retirement plan that satisfies certain requirements set forth in the **Internal**

Revenue Code of 1986 (IRC or “Tax Code”).⁷ In order to be tax-qualified, private pension plans must satisfy a number of requirements, including minimum requirements on coverage and benefits (requirements on who is covered by plans and how plans must provide benefits are discussed in section IV). These minimum benefits and coverage requirements are intended to ensure that rank-and-file employees, not merely a top group of highly paid employees such as owners and executives, participate in and receive benefits from the plan. Plan sponsors must provide coverage and benefits in a manner that generally does not discriminate against workers who are not among an employer's officers, executives, or highly compensated employees.

Employers who sponsor tax-qualified plans are entitled to a current deduction (within certain limits) for the contributions they make to their plan even though the contributions are not currently included in an employee's taxable income. This means that an employer who sponsors a tax-qualified defined benefit plan is generally allowed to deduct contributions that it makes to the plan's trust fund from its taxable income; an employer who sponsors a tax-qualified defined contribution plan is generally allowed to deduct contributions that it makes to participants' accounts from its taxable income (defined benefit and defined contribution plans are discussed below in section II). In addition to favorable tax treatment for contributions, taxes on

⁶Both the American Bar Association *and* the Teachers Insurance Annuity Association and College Retirement Equities Fund sponsor a multiple-employer plan.

⁷Favorable tax treatment for employer-sponsored pensions was first provided in the Revenue Act of 1926.

the investment earnings on employer and employee contributions to qualified plans are deferred until plan participants receive their benefits.

Employees do not include the benefits they accrue in qualified plans in their gross incomes until the benefits are distributed. Employer contributions and employee pretax contributions are not included in an employee's income at the time the contributions are made. Thus, tax deferral on contributions and earnings is provided from the time that contributions are made to the plan until the time that plan participants receive benefits.

A plan of deferred compensation that satisfies the applicable provisions of the Tax Code is termed a "qualified retirement plan." The Tax Code classifies qualified pension plans as either defined benefit or defined contribution plans and includes separate requirements for each type of plan.

Private pension plans must also generally meet the requirements of the **Employee Retirement Income Security Act of 1974 (ERISA)**.⁸ Title I of ERISA, among other requirements, contains requirements regarding information that plan sponsors must provide to participants and defines the obligations of the individuals who administer employer-sponsored plans. The Employee Retirement Income Security

Act also sets standards concerning how long an employee must work before becoming eligible to participate in a plan (participation), how long a plan participant must wait until receiving a right to benefits that cannot be taken away (vesting), and minimum funding rules for defined benefit plans (and certain defined contribution plans) that require plan sponsors to provide funding for the benefits participants are entitled to receive (funding). These standards are contained in title I of Employee Retirement Income Security Act, and are also part of the Internal Revenue Code (section III and section IV below discuss specific requirements that qualified plans must satisfy in greater detail).

Nonqualified pension plans are plans that do not meet the applicable requirements for tax-qualification under the Tax Code. Sponsors of nonqualified plans typically do not have to satisfy laws and regulations requiring a minimum level of benefits or contributions to the plan. Additionally, sponsors of nonqualified plans do not have to meet certain reporting, disclosure, bookkeeping, and core fiduciary requirements. Nonqualified plans are also typically designed for highly compensated employees or selected company executives, and are typically not meant to cover the broad spectrum of employees that a qualified plan covers. However, certain nonqualified plans may be subject to the Employee

⁸The Employee Retirement Income Security Act does not govern governmental, church, and excess benefit plans among certain other plans excluded from coverage. ERISA also prescribes standards for welfare benefit plans which employers may voluntarily establish to provide health benefits, disability benefits, death benefits, prepaid legal services, vacation benefits, childcare, scholarship funds, apprenticeship and training benefits, or other similar benefits to their employees.

Retirement Income Security Act's title I provisions (see section III for more detail on ERISA).

Q. What are the tax advantages of sponsoring a qualified plan?

There are several tax advantages that employers and employees receive for making contributions to a tax-qualified plan.

A. The favorable tax treatment accorded a qualified pension plan includes:

- the amount that the employer contributes to the plan is tax deductible (within certain limits) in the year contributions are made;
- the earnings on the investment of plan assets are tax-exempt;
- participants do not have to pay income tax on the employer's contribution to the plan on their behalf or on the earnings to those contributions until benefits are received;
- income taxes on certain distributions may be deferred by rolling over the distribution into an **Individual Retirement Account** or to another qualified plan; and
- installment or annuity payments (section II discusses these types of benefit payments provided by

pension plans) are taxed only when the participant receives them.

Q. What is the process by which plan sponsors obtain tax-qualified status?

Private plan sponsors may obtain tax-qualified status by applying to the Internal Revenue Service (IRS).

A. By applying to the Internal Revenue Service, a private employer is seeking an advance determination as to the qualified status of its plan rather than waiting for the IRS to review its plan in connection with an audit. Upon review of the plan sponsor's application, the Internal Revenue Service provides a determination letter to the employer. A favorable letter of determination provides the plan sponsor with IRS' opinion that the terms of the plan conform to the requirements of the Internal Revenue Code. Employers are not required to apply to the Internal Revenue Service to receive preferential tax treatment as long as the terms and operation of their plans meet the applicable Internal Revenue Code standards. However, employers who do not apply to the Internal Revenue Service do not get the advantage of a favorable determination letter, which affords the employer some assurance that if the plan operates in accordance with the terms that IRS reviewed, then the plan is qualified.

Q. What laws govern private pension plans?

Generally, private plans must meet the standards and requirements set forth under the Employee Retirement Income Security Act. In order for a plan to be tax-qualified, or for contributions to the plan and investment earnings on those contributions to be eligible for deferral of federal income taxes, the plan must also comply with relevant provisions of the Internal Revenue Code.

A. The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974, as amended, set forth standards and requirements that generally apply to private pension plans.⁹ The Tax Code and the Employee Retirement Income Security Act contain certain requirements that are similar in delineating standards and rules private plan sponsors must satisfy. For example, both the Tax Code and the Employee Retirement Income Security Act impose minimum requirements regarding employee participation in plans and requirements regarding when participants receive a right to benefits that cannot be taken away. Additionally, both the Tax Code and the Employee Retirement Income Security Act include separate requirements that private plan sponsors must satisfy. For example, the Tax Code contains nondiscrimination provisions that are intended to ensure qualified pension plans provide benefits to a broad group of employees, while the Employee

Retirement Income Security Act contains standards that govern the conduct of pension plan fiduciaries. Fiduciaries are the individuals with discretionary authority or control over the operation of a pension plan and/or the investment of plan assets.

Q. Which agencies are responsible for enforcing federal laws and regulations that govern private pension plans?

The Internal Revenue Service, the Department of Labor's Pension and Welfare Benefits Administration (PWBA), and the Pension Benefit Guaranty Corporation (PBGC) are primarily responsible for enforcing laws that govern private pension plans.

A. The Internal Revenue Service enforces standards for coverage and participation, vesting, and funding under the Internal Revenue Code that, respectively, determine the extent to which employees must participate and how employees become eligible to participate in benefit plans, define how participants become eligible to earn rights to benefits, and the minimum amount that plan sponsors must contribute to their plans.¹⁰ IRS also enforces provisions of the Internal Revenue Code that apply to tax-qualified pension plans under section 401(k) of the Code. The Pension and Welfare Benefits Administration enforces the Employee Retirement Income Security Act's reporting and disclosure provi-

⁹Certain non-qualified plans are subject to title I of ERISA.

¹⁰Under Reorganization Plan Number 4 of 1978, the Internal Revenue Service principally administers provisions relating to these functions. The Department of Labor principally administers provisions relating to reporting and disclosure and fiduciary responsibility.

sions and fiduciary responsibility standards, which among other things concern the type and extent of information provided to the federal government and plan participants and how pension plans are operated in the interests of plan participants. The Pension Benefit Guaranty Corporation is a federally chartered organization (established by title IV of ERISA) that insures the benefits of participants in certain defined benefit pension plans (see section V for a discussion of The Pension Benefit Guaranty Corporation and the insurance it provides).

The Department of Labor (DOL) and the Internal Revenue Service have various mechanisms to enforce the requirements and standards private plans must satisfy. For example, DOL

may initiate administrative actions or lawsuits to ensure that plans comply with relevant provisions of the Employee Retirement Income Security Act. The Internal Revenue Service can disqualify a plan (or revoke its tax-preferred status) when the plan fails to meet applicable provisions of the Internal Revenue Code. As an alternative to disqualification, the Internal Revenue Service may impose sanctions and require the plan sponsor to correct any violation of applicable rules and regulations. IRS has established procedures to identify and remedy “qualification failures,” or instances of noncompliance with Internal Revenue Code requirements. Both agencies have voluntary compliance programs to encourage plan sponsors to identify and correct compliance violations.

Types of Pension Plans Employers May Sponsor

2

Section II describes the types of pension plans that private employers may sponsor and explains key differences in how certain pensions provide benefits.¹¹

Q. What is a defined benefit plan?

A **defined benefit plan** promises to provide a benefit that is generally based on an employee's salary and years of service.

Defined benefit plans use a formula to determine the ultimate pension benefit that participants are entitled to receive. Typically, benefit formulas are either based on an employee's final average pay or career average pay in combination with the participant's years of service and a multiplier, or percentage factor that is part of the formula.

Defined benefit plans usually express benefits as an **annuity**, or series of periodic payments over a specified period of time or for the life of the participant, beginning at a normal retirement age specified by the plan. Plans typically specify normal retirement age as 65. For example, a final average pay formula might determine monthly benefits payable at retirement on the basis of 1.25 percent multiplied by years of service completed multiplied by the participant's average salary over the last

5 years of service.¹² Typically, annuity payments are received on a monthly basis by the retired participant and continue as long as the recipient lives. An annuity is the normal form of benefit payment that defined benefit plans provide to participants.

Example of defined benefit plan formula used to determine annual pension benefits:

1.25 percent (multiplier) × 25 (years of service completed) × \$65,000 (average of employee's final 5 years' annual salaries) = \$20,313 (annual pension benefit commencing at normal retirement age).

Plan sponsors must offer married participants a **joint and survivor annuity** payment at retirement (joint and survivor annuities are discussed below). Defined benefit plans may also offer those participants (who have a nonforfeitable right to accrued benefits under the plan) the option of receiving their accrued benefits as a **lump sum distribution**, or a nominal cash amount, when they leave the plan

¹¹For information on various types of private plans and other topics of interest regarding the benefits that plans provide, go to http://www.dol.gov/pwba/faqs/faq_consumer_pension.html

¹²Qualified defined benefit plan benefit formulas must provide benefits in a way that satisfies accrual methods specified in the Internal Revenue Code. These rules are intended ensure that benefit accruals are not excessive for older participants or participants with many years of service in relation to younger participants or participants with fewer years of service.

sponsor before or at retirement (see below in this section).¹³ Participants may elect to receive a lump sum amount only if the plan provides this benefit payment option and if spousal consent is obtained. If a participant receives a lump sum distribution, he or she may “**roll-over**” the amount directly to another qualified retirement plan, such as an Individual Retirement Account or a defined contribution plan. An Individual Retirement Account is a retirement savings arrangement authorized by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code. Banks and other financial institutions may make these arrangements available to workers. Individual Retirement Accounts allow workers to make tax-deductible and/or nondeductible contributions to an individual account.

The employer, as plan sponsor, is responsible for making contributions that are sufficient for funding the promised benefit, investing and managing the plan assets, and bearing the investment risk. Defined benefit plan sponsors make contributions to a pension trust fund that is invested on behalf of employees in the plan. Employer contributions to a defined benefit plan must satisfy **minimum funding requirements** set forth in the Employee Retirement Income Security Act. Minimum funding standards establish the minimum amounts that defined benefit plan sponsors must contribute to ensure that their plans have sufficient assets to pay benefits when due. The minimum funding standards, while

technically complex, are designed to ensure that the value of benefits accumulated to date under the plan and the plan’s assets bear a reasonable relationship to one another such that the plan can pay benefits due participants when they retire. The standards also provide flexibility to increase or decrease a plan’s funding as that relationship deteriorates or improves, respectively. Generally, if a defined benefit plan terminates with assets that are insufficient to pay the benefits accrued to date, the Pension Benefit Guaranty Corporation pays benefits promised by the plan up to levels specified by law (insurance for defined benefit plans is discussed in section V).

Q. What is a defined contribution plan?

Under a **defined contribution plan**, employees have individual accounts to which the employer, employees, or both make periodic contributions.

A. Defined contribution plan benefits are based on the contributions to and investment returns (gains and losses) on **individual accounts**. For each participant, the plan sponsor periodically contributes a specific dollar amount or percentage of pay into each participant’s account. Depending on the design of the plan, contributions may consist of pretax or after-tax employee contributions, employer matching contributions (i.e., employer contributions that are made only if an employee makes contributions to the plan), and other employer contributions that may

¹³Unlike traditional defined benefit plans, cash balance plans are a type of “hybrid” defined benefit plan that express accrued benefits as hypothetical account balances, and benefits accrue annually based on a set percentage of salary and interest earnings (see below in this section).

be made independent of any participant contributions. Defined contribution plans provide benefit portability because they typically pay benefits to participants by distributing their current account balances, in full, when they leave their employer to change jobs or retire. These lump sum distributions may be rolled-over into another qualified retirement plan, such as another defined contribution plan or Individual Retirement Account (see below in this section). Unlike defined benefit plans, defined contribution plans are not required to provide an annuity option to participants.

Example of annual increase in defined contribution plan account balance:

\$20,000 (beginning of year account balance) + 6 percent of \$50,000 salary (employee contribution) + 3% of \$50,000 salary (employer contribution) + 6% investment return (earnings on beginning of year account balance) = \$25,700 end of year account balance.

[Note: This example is simplified. Contributions may be made to individual accounts during the course of the year; such contributions begin to earn interest immediately upon being deposited in participants' accounts.]

In a defined contribution plan, the employee bears the investment risk and often controls, at least in part, how his or her individual account assets are invested. Defined contribution plan participants realize any investment returns, or gains or losses on the investment of assets in their account balances. Defined contribution plan participants do not have insurance

protection against the risk of losses they may incur on the investment of their account balances.

In addition to lump sum distributions that a participant may receive from a defined contribution plan when he or she changes jobs, a defined contribution plan may also allow pre-retirement access to participant account balances while they are working for the employer. For example, a defined contribution plan may allow participants to take out a loan on the portion of their account balance that is vested (see section IV for a discussion on vesting). A defined contribution plan may also permit pre-retirement withdrawals under certain conditions, such as financial hardship or the purchase of a home.

Defined contribution plans are classified into one of three main types: profit-sharing, stock bonus, or money purchase plans.

A profit-sharing pension plan is a type of defined contribution plan that provides for contributions to employees on the basis of employer profits. Profit-sharing plans were originally created as a means to enable employees to share in the profits of their employer's business. However, under current law, employers who sponsor these plans may make contributions regardless of whether they are profitable. Profit-sharing plans may provide for annual employer contributions based on profits from the previous year or may provide that contributions are made each year at the discretion of the employer. Profit-sharing contributions are not paid out currently but are

deferred to individual accounts the employer has established for each employee.

Profit-sharing plans provide for employer contributions to participants on the basis of a contribution formula, which specifies how the sponsor's contribution is determined. The contribution formula is generally based on employee compensation but may be based on employer profits or employee contributions. For example, profit-sharing plans can specify that contributions to participant accounts are based on a flat percentage of pay or determined by calculating the proportion of each employee's compensation relative to the total compensation of all participants. Profit-sharing plans must also specify the events upon which distributions will be made to participants, such as separation from service with the employer or retirement. Profit-sharing plans may provide benefit payments to participants while they are working.

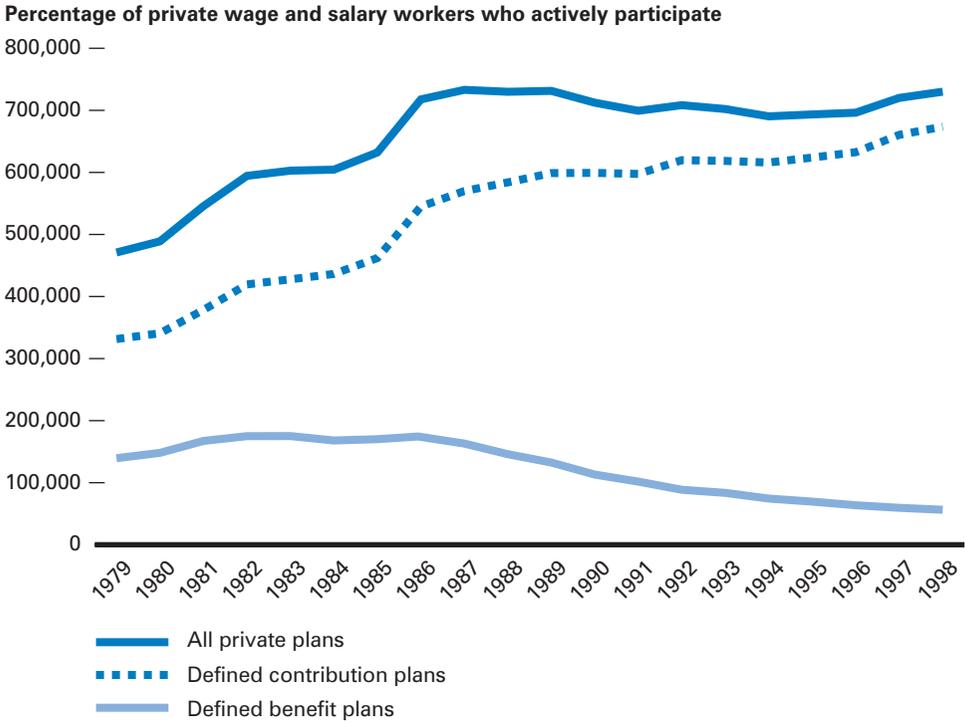
A stock bonus plan is similar to a profit-sharing plan except that the plan benefits are payable in the form of employer stock. Stock bonus plans may make benefit payments in cash amounts but must permit participants to receive their benefit payments in the form of employer stock. If the plan sponsor pays benefits with shares of company stock that are not readily tradable on an established financial market, the parti-

cipant must be allowed to sell the shares back to the employer at a fair market price. This requirement ensures that benefits provided in the form of company stock have some financial value to participants.

A money purchase plan is a defined contribution plan where the plan sponsor is required to make contributions. The required contribution that the sponsor must make on behalf of each participant is based on the plan's formula, which is specified in the plan's document. These contributions are generally determined as a specified percentage of a participant's salary. Retirement benefits are equal to the amount in a participant's account at retirement. Similar to qualified defined benefit plans, money purchase plans must satisfy minimum funding requirements because employer contributions are mandatory. A money purchase plan may not provide for benefit payments that may be made to participants while they are working for that employer except in the event of plan termination.

Within these types of defined contribution plans, plan sponsors may add special features, such as a qualified cash-or-deferred-arrangement ("**401(k) Plan**") or an **Employee Stock Ownership Plan (ESOP)** feature. Both of these qualified plan features are discussed below.

Figure 1: Number of Private Defined Benefit and Defined Contribution Plans



Source: *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports* (table E1), U.S. Department of Labor, Pension and Welfare Benefits Administration.

Q. What types of contributions can be made to defined contribution plans?

Both plan sponsors and employees may make contributions to defined contribution plans.

A. There are several types of employer and employee contributions that may be made to tax-qualified defined contribution plans. Employers may make nonelective and/or matching contributions to defined contribution plans. Nonelective contributions are contributions that the plan sponsor makes

regardless of whether the participant makes contributions. These contributions are made independently of any employee contributions. Nonelective contributions may be provided on a regular or discretionary basis according to the terms of the plan. Matching contributions are contributions that a plan sponsor makes only when participants make contributions. The level of matching varies among plan sponsors. Employers that make matching contributions may make these contributions in shares of the employer’s stock without the option to direct the investment of these contributions until

certain conditions – relating to the participant age and/or service – are met.

Employees, in accordance with plan provisions, may contribute on a pretax or after-tax basis to defined contribution plans. Employee pretax contributions are generally treated the same for income tax purposes as employer contributions. Unlike pretax contributions, after-tax contributions are included in the participant's taxable income for the year the contributions are made, however, taxation of the investment income earned on such contributions is deferred until it is received.

Q. What is the accrued benefit provided by defined benefit and defined contribution plans?

For defined benefit plans, the **accrued benefit** is the amount that the plan participant would receive annually as a life annuity beginning at the plan's normal retirement age. A participant's accrued benefit is determined by the plan's benefit formula. This amount is calculated for each year as a participant completes an additional year of service with the plan sponsor.

For defined contribution plans, the accrued benefit is the balance of a participant's individual account. This balance includes the sum of participant and/or employer contributions and investment returns (gains or losses), dividends, and capital gains (or losses) attributable to those contributions. Also, the account balance is less any administrative expense that participants must incur to maintain the account.

A. For defined benefit plans, the plan formula determines the rate at which the accrued benefit grows on a yearly basis. Defined benefit plans generally express accrued benefits as an annuity, or series of periodic payments that begin at retirement for a specified period of time or the life of the recipient. Defined benefit plan participants are required to have the option of receiving their accrued benefits as an annual benefit for the rest of their lives beginning at retirement, or the plan's normal retirement age. Participants, however, must work for a certain

period of time in order to earn a right to their accrued benefits under the terms of the plan before they are entitled to receive their benefits. This is called vesting (vesting is discussed in Section IV). If a participant's benefit is paid as an amount other than an annual benefit commencing at normal retirement age, the plan sponsor must pay the accrued benefit as a lump sum amount in current dollars. A lump sum distribution is the present value of the annuity benefit payment stream that the participant would receive at retirement. Lump sum benefit payments must be (actuarially) equivalent to the annuity benefit that the participant has accrued to date under the plan's benefit formula.¹⁴ Lump sum distributions may be paid only if they are provided for under the terms of the plan, and the departing participant elects this form of payment.

Defined contribution plan benefits generally accrue when contributions are allocated to individual participant accounts. However, participants are only entitled to the contributions they have made (and any investment returns on these contributions) and not those that have been made by their employer until they meet certain requirements. Similar to defined benefit plan participants, defined contribution plan participants may have to work for a certain period of time in order to earn a right to their employer's contributions. With respect to a participant's contributions, the accrued benefit is the portion of the

participant's account balance that is attributable to his or her contributions and investment returns (gains or losses) on those contributions.

Q. How may defined benefit and defined contribution plans pay benefits?

Defined benefit plans may pay benefits as annuities or lump sum distributions, while defined contribution plans may pay benefits as annuities, lump sum distributions, or installment payments. Married participants who receive annuity payments are generally required to receive a joint and survivor annuity.

A. Defined benefit and defined contribution plans typically pay out accrued benefits at retirement (i.e., at the plan specified normal retirement age – commonly age 65), early retirement (usually between the ages of 55 to 62) or when an employee separates from service.

Plan sponsors must meet certain requirements regarding when they must pay benefits to participants and when participants may request to begin receiving benefit payments.¹⁵ Both defined benefit and defined contribution plans may pay benefits as both annuities and as lump sums. An annuity is a series of periodic payments

¹⁴26 U.S.C. 411(a)(7) and 411(c)(3). Defined benefit plans must express an employee's accrued benefit as an annual benefit beginning at normal retirement age or the actuarial equivalent to a deferred annuity. The actuarial equivalent to a participant's annual retirement benefit is determined by using a set of mortality factors and a discount rate specified under law.

¹⁵Rules regarding when participants must receive benefit payments are referred to as minimum distribution rules. Other rules define certain distribution events, or circumstances under which plans may pay benefits to participants.

that begins at retirement¹⁶ and continues through a person's lifetime and the lifetime of their surviving spouse, if they are married.

For defined benefit and defined contribution plans married plan participants who receive accrued benefits in the form of an annuity are normally required to receive joint and survivor annuities. Joint and survivor annuities guarantee that the plan participant's surviving spouse will continue to receive payments after the plan participant dies.¹⁷ The pension income that a surviving spouse receives from a qualified joint and survivor annuity must be at least equal to one-half of the annuity benefit payment the retired participant received. The spouse of the plan participant may waive his or her right to a joint and survivor annuity.

Both defined benefit and defined contribution plans may pay out benefits as lump sum distributions (or cash amounts in current dollars). Plans that provide lump sum distributions promote benefit portability by allowing participants to take their benefits when they leave the plan sponsor prior to retirement, such as when a participant

changes jobs. For defined benefit plan benefits the lump sum a participant receives must be at least equivalent to the present value of a participant's accrued benefits as calculated using actuarial assumptions specified in the Internal Revenue Code.

Defined contribution plans usually pay benefits in the form of a lump sum distribution. For defined contribution plan benefits the lump sum amount a participant receives is based on the employee's contributions and the investment earnings on those contributions. If the plan participant is vested, the lump sum amount includes the employer's contributions (if any) and the earnings on those contributions.

Participants who receive accrued benefits as lump sum amounts may or may not preserve these assets for retirement income purposes. For example, a participant may elect to receive a lump sum distribution directly from his or her plan sponsor. In such instances, the recipient may or may not reinvest the amount (after taxes) into another tax-qualified retirement plan or other savings instrument. If a departing participant, prior to attaining age 59 and

¹⁶Defined benefit (DB) plans may offer early retirement benefits to employees who meet certain age and/or service requirements. Early retirement benefits may be subsidized or unsubsidized. Unsubsidized early retirement benefits are adjusted fully to reflect that the plan participant begins receiving these benefits before normal retirement age. The benefit adjustment lowers the benefit amount that the participant receives when he or she retires before the plan's normal retirement age to take into account the earlier receipt of benefits and the longer period over which benefits will be paid. Subsidized early retirement benefits, however, are adjusted with a discount that is favorable to the participant or with no discount to make the value of the early retirement benefit worth more to the participant than the benefit he or she would receive at normal retirement. DB plans are not required to offer either form of early retirement benefit, but if a DB plan does, participants typically must satisfy certain age and/or service requirements specified by the plan.

¹⁷Defined benefit plans are also required to offer an annuity benefit to surviving spouses of plan participants who are vested and die before they begin receiving benefits. These benefits are called pre-retirement survivor annuities. Pre-retirement survivor annuities are available to married participants from the time they become vested in their accrued benefits.

½ years, elects to receive a lump sum distribution directly and does not have his or her employer transfer the amount directly to an Individual Retirement Account or another qualified plan, the amount of the distribution is subject to an excise tax of 10 percent in addition to ordinary income taxes. To avoid paying taxes on the distribution, the participant must deposit the distribution into an Individual Retirement Account or another employer's qualified retirement plan within 60 days of receiving the distribution. Also, the employer is required to withhold 20 percent of the lump sum amount if the participant elects to receive it directly.

Alternatively, participants who receive lump sum distributions may roll-over, or transfer these amounts into certain retirement plans free of taxes. Employers who sponsor qualified plans and enable departing participants to receive lump sum distributions must give participants the option to have these amounts directly transferred into a Individual Retirement Account or another employer's tax-qualified plan (if that plan accepts rollovers). A participant who receives his or her accrued

benefit as a lump sum distribution and elects to roll-over the amount preserves the pension benefit as a source of retirement income.

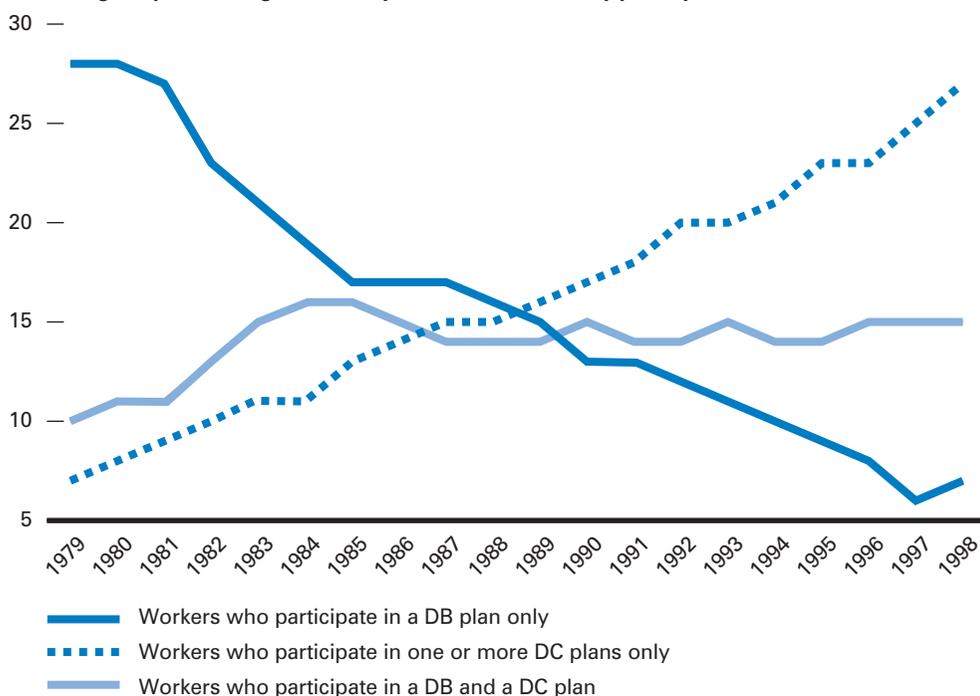
An employer has the option – without the participant's consent – to pay pension benefits as a lump sum distribution when a terminating participant has accrued benefits that are worth no more than \$5,000 in current dollars. Also, if a departing participant receives a lump sum distribution worth more than \$1,000 but less than \$5,000, the distribution is automatically rolled-over into an Individual Retirement Account, unless the participant elects otherwise.¹⁸

In addition to taking their benefits as an annuity or lump sum, defined contribution plans participants may have a third option. They may also have the option of receiving benefits at retirement as a series of periodic withdrawals, determining both the amount and frequency of these withdrawals under the terms of the plan, until their accounts are exhausted. These periodic payments are called installments.

¹⁸Pending Department of Labor issuance of applicable regulations.

Figure 2: Active Participants in DB and DC plans

Percentage of private wage and salary workers who actively participate



Source: *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports* (table E4b), U.S. Department of Labor, Pension and Welfare Benefits Administration.

Q. What is pension portability?

Pension portability refers to the ability of plan participants to transfer accrued benefits from one plan to another.

A. Portability of assets refers to the ability to cash out one's pension benefits before retirement and have them transferred to another retirement plan – an Individual Retirement Account or another qualified defined contribution plan. Defined contribution plans typically pay benefits as lump sum distribu-

tions. Defined benefit plans may or may not provide separating participants the option of receiving accrued benefits as a lump sum amount in cases where accrued benefits are worth more than \$5,000 in current dollars. Plans that provide lump sum distributions must also allow participants to elect a direct “roll-over” of assets from the plan sponsor to another qualified retirement plan. When a participant transfers his or her pension benefits from one plan to another defined contribution plan or to an Individual Retirement Account, the assets can continue to grow.

Q. How may workers preserve their pension benefits for retirement?

Pension plan preservation refers to efforts to prevent the loss of retirement assets when a worker moves from one employer to another.

A. Workers may preserve their pension benefits for retirement by either leaving their benefits in their previous employers' retirement plan, or rolling them over by transferring the assets directly to another tax-deferred retirement plan, such as another qualified defined contribution plan or an Individual Retirement Account. Workers who do not preserve benefits in one of these two ways potentially lose some or all of the assets they had accumulated and may be subject to certain taxes on the distribution. This can occur when a worker receives a lump sum benefit payment and decides to spend, rather than save, some of the distribution or the entire amount. Both the 10 percent excise and 20 percent employer withholding tax on lump sum distributions that are paid directly to the employee are intended to encourage the preservation of pension assets.

Q. Who operates an employer-sponsored pension plan?

Responsibility for all aspects of the plan's operations, including the management of its assets, ultimately rests with the **plan fiduciary**.

A. A fiduciary is any person who exercises discretionary authority or control with respect to management or disposition of plan assets, renders investment advice for a fee or compensation, or has discretionary responsibility in the administration of the plan.

Fiduciaries may include executives and senior management of the employer depending on the functions they perform with respect to the plan. Some employers have a collective bargaining unit (union) covering their workforce.¹⁹ When there is a union, typically the union and the employer may negotiate the design and operation of the pension plan.²⁰

A private employer may adopt any change to its plan by amending the terms of its plan so long as the plan's operation continues to satisfy the requirements for tax-qualification (and title I of the Employee Retirement Income Security Act). Changes to the features, operation, and terms of the plan are not considered to be fiduciary responsibilities (fiduciaries and their obligations are discussed in section III). If an employer changes its plan and the change violates one or more provisions of the Internal Revenue Code relating to plan qualification, the Internal Revenue Service can pursue disqualification of the plan. The main constraint on an employer's ability to modify the terms and operation of its plan is the general prohibition on reducing or eliminating

¹⁹ A collectively bargained plan that has been established under the Taft-Hartley Act must be jointly trustee - management and union representatives are equally represented among the plan's trustees.

²⁰ Terms such as the rate of benefit accruals, employer contribution amounts, and the period in which the contract is in effect are typically negotiated within the bargaining process. Thus, control over the time period in which changes can be made, and the design and benefits provided by the pension plan are often shared with the union.

participants' accrued benefits (section IV discusses the rules that govern the extent to which an employer can reduce or eliminate accrued benefits).

Q. What is a 401(k) pension plan?

A "401(k) plan" is a type of defined contribution plan that contains a 401(k) feature, which generally allows participants to make pre-tax contributions to individual accounts.

A. When a profit-sharing or stock bonus defined contribution plan includes a 401(k) feature it is referred to as a "qualified cash or deferred arrangement" (CODA). Such plans, generally called 401(k) plans, must generally satisfy the rules and requirements applicable to all qualified pension plans and to 401(k) plans in particular. These arrangements allow employees to elect to reduce part of their current compensation to save for retirement income purposes.

Private employers may sponsor 401(k) plans that allow employees to choose to contribute a portion of their current compensation, on a pretax basis, to a qualified retirement account. These tax-deferred contributions are made to individual 401(k) plan accounts on a pretax basis instead of receiving the same amount as taxable salary.

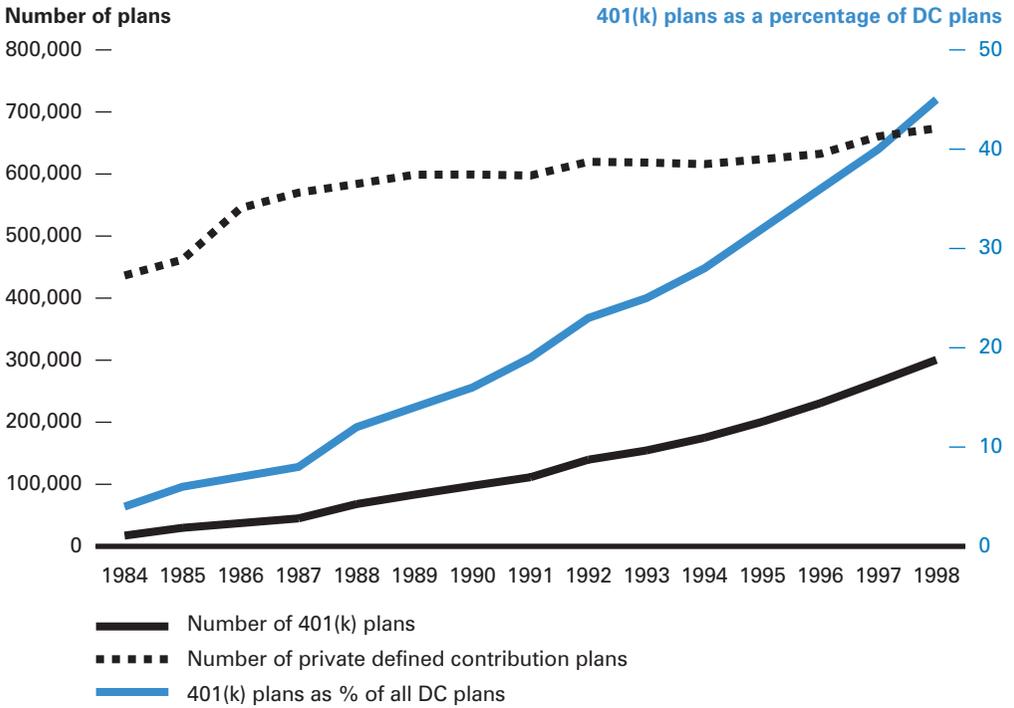
Employees' pre-tax contributions to a 401(k) plan are commonly referred to as "elective contributions" or "elective deferrals."

Investment income earned on 401(k) account balances accumulates tax-free until the individual withdraws the funds at or prior to retirement. Many 401(k) plan sponsors provide matching contributions to participants who make elective contributions. Employer matching contributions are often made in whole or in part up to some percentage of the employee's base salary. Matching contributions can be made in the form of shares of the employer's stock. Plan sponsors, however, are not required to provide a match.

In a typical 401(k) plan, employees must elect to participate by authorizing the employer to make payroll salary reductions. Typically, participants may allocate the investment of their account balances among a menu of investment options selected by the employer and/or fiduciaries appointed by the employer. The pension benefits that a participant receives depend on the balance in his or her 401(k) plan account, which is based on the contributions to and the investment returns or losses on the assets in the account. Employer stock can be one of the 401(k) plan's investment options. In 2002, 401(k) plan participants can elect to contribute up to the legal limit of \$11,000 on elective deferrals (gradually increasing to \$15,000 in 2006).²¹ Also, 401(k) plan participants age 50 and older may make an additional annual, pre-tax "catch-up" contribution to their individual accounts up to a certain legal limit.

²¹26 U.S.C. 402(g).

Figure 3: Growth in the Number of 401(k) Plans



Source: *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports* (tables E1 and E23), U.S. Department of Labor, Pension and Welfare Benefits Administration.

Q. What is an Employee Stock Ownership Plan (ESOP)?

An Employee Stock Ownership Plan (ESOP) is a defined contribution plan feature that requires the plan sponsor to invest plan assets primarily in shares of the sponsor's stock.

A. Through an Employee Stock Ownership Plan, the employer makes tax-favored contributions of company stock to individual participant accounts.

Employees do not actually buy shares in an Employee Stock Ownership Plan. Instead, the company contributes its own shares to the plan, contributes cash to buy its own stock (often from an existing owner), or, most commonly, has the plan borrow money to buy stock to contribute to the plan, with the company repaying the loan.

In general, Employee Stock Ownership Plans must meet the requirements for tax-qualified status under the Internal Revenue Code, such as rules that govern coverage, participation, and vesting, but are exempt from certain fiduciary requirements (e.g., diversification of plan assets). Employee Stock Ownership Plans must also satisfy additional requirements that apply specifically to ESOPs. For example, Employee Stock Ownership Plans must primarily invest plan assets in employer stock and are obligated to furnish participants with certain rights regarding the stock contributions they receive. Employee Stock Ownership Plans can qualify for

favorable tax treatment as either a stock bonus plan or as a combination stock bonus and money purchase plan.

An Employee Stock Ownership Plan may be designated by the sponsor as a separate pension plan or be combined with another pension plan such as a profit-sharing plan or a 401(k) plan. An employer who sponsors both an Employee Stock Ownership Plan and a 401(k) plan may use their ESOP contribution to purchase employer stock and match employee contributions to the 401(k). An employer who sponsors such a plan may also make a matching contribution to the 401(k) plan directly; the plan sponsor may require the matching contribution to be invested in the employer's stock. Alternatively, an employer who sponsors a 401(k) plan and an ESOP may use the participants' elective contributions to purchase employer stock or repay a loan whose proceeds have been used to purchase employer stock from the plan.

Employee Stock Ownership Plans are classified as "leveraged" and "nonleveraged." A leveraged Employee Stock Ownership Plan is a plan that has borrowed money to purchase employer stock. To do this a plan sponsor may take out a loan and then lend the proceeds of the loan to the ESOP. Alternatively, the Employee Stock Ownership Plan may borrow from a lender with the plan sponsor guaranteeing the loan. The Employee Stock Ownership Plan in turn uses the borrowed funds to buy company stock. An Employee Stock Ownership Plan loan is secured by employer-held stock and the employer makes annual cash contributions to the ESOP, which the Employee

Stock Ownership Plan uses to repay the loan. Each year, the sponsor pays off a portion of the loan and interest on the loan as it makes tax-qualified contributions to the Employee Stock Ownership Plan. As the employer makes these contributions, shares of stock are allocated to participant accounts.

A nonleveraged Employee Stock Ownership Plan may obtain stock gradually through employer contributions or receive a large block of stock through an “immediate allocation loan.” An employer who sponsors a nonleveraged Employee Stock Ownership Plan may make periodic contributions to the plan’s trust. The sponsor may contribute stock or cash, which the trust fund uses to purchase stock. The stock in the trust fund is then allocated to participant accounts. The employer may take out an immediate allocation loan to buy company stock with borrowed funds; the shares are transferred immediately to the ESOP, which in turn allocates the shares immediately to Employee Stock Ownership Plan participants. Thus, the ESOP itself has not borrowed money to pay for company stock and is not leveraged.

Q. What are hybrid pension plans?

Hybrid pension plans are plans that contain features of both defined benefit and defined contribution plans.

A. Hybrid plans combine certain features of defined benefit and defined contribution plans. For example, a **hybrid plan** may provide benefits based on a formula like a defined benefit plan, but pension benefits are

expressed as an account balance like a defined contribution plan. A cash balance plan is a hybrid defined benefit plan that uses a formula to determine benefits but expresses benefits as account balances (see below in this section). Alternatively, a hybrid plan may be a defined contribution plan in which contributions are based on a definite benefit formula.

Q. What is a pension plan floor-offset arrangement?

Floor-offset arrangements are a type of hybrid plan that consists of two separate, but associated pension plans—a defined benefit “floor” plan and a defined contribution “offset” plan.

A. The defined benefit plan provides a minimum level of benefits based on a typical formula (for example, final average pay formula based on years of service and an average annual earnings over a specified number of years). These benefits are expressed as a series of payments commencing at the plan-specified normal retirement age. Benefits provided by the defined benefit formula represent the minimum level, or the “floor,” of total pension benefits that a plan participant is entitled to under the arrangement but are offset by benefits under a defined contribution plan. The defined contribution plan (“offset” plan) establishes individual accounts for participants to which the employer and/or participant may make contributions. A participant’s account balance determines whether or not he or she receives a benefit from the defined contribution plan only or both

the defined benefit and the defined contribution plans.

If the defined contribution plan provides a total benefit that equals or exceeds the benefit provided by the defined benefit floor plan, the participant receives (only) the accumulated balance in his or her defined contribution plan account. In the event that a participant's defined contribution account balance provides a benefit that is less than the benefit from the defined benefit plan, the defined benefit plan makes up the difference between the benefit it provides and the amount the participant has accumulated in the defined contribution plan. Therefore, participants receive a total benefit, which is the greater of the benefit from the defined benefit or the defined contribution plan. In 1987, Congress limited the use floor-offset arrangements that are invested significantly in employer securities. However, plans in existence when the provision was enacted were grandfathered.

Q. What is a cash balance plan?

A **cash balance plan** is a hybrid plan that is legally classified as a defined benefit plan because participants' benefits are determined by a benefit formula. However, a cash balance plan has certain features, such as hypothetical "individual accounts," that make it resemble a defined contribution plan.

A. Unlike traditional defined benefit plans, cash balance plan formulas regularly credit a percentage of salary or

compensation for each participant (pay credit) and credit investment earnings or interest on these amounts at a rate or index of rates specified by the plan (interest credit). For example, a cash balance plan formula might base benefits on an annual pay credit of 6 percent of employee salary and wages and an annual interest credit equal to the rate of return on 30-year Treasury bonds. These pay and interest credits are credited to hypothetical participant "accounts," which express benefits as a current account balance rather than an annuity beginning at retirement. Cash balance plan participants who separate from their employers prior to retirement are generally able to take their current account balances (accrued benefit) in the form of a lump sum distribution from the plan. These features make cash balance plans appear similar to defined contribution plans.

Example of annual increase in hypothetical account balance under a cash balance plan formula:

\$10,000 beginning of year account balance + 6 percent of 50,000 salary (pay credit) + 6% interest on beginning of year account balance (interest credit based on 30-year Treasury bond yield) = \$13,600 end of year account balance.

Federal law treats cash balance plans as defined benefit plans because cash balance benefits are not based on actual individual account earnings.²² The normal form of benefit under a cash balance plan – like all defined benefit plans – must be an annuity benefit that

²²26 U.S.C. 414(j).

commences at retirement. Benefits under cash balance plans, as with other defined benefit plans, are paid from funds invested by the employer in a pension trust on behalf of all participants. However, participants' hypothetical account balances receive interest credits that do not depend on the actual investment returns on plan assets. Plan participants neither own these accounts nor make investment decisions regarding the account balances. Cash balance plans, like other defined benefit plans, must comply with minimum funding standards.

Q. What pension plans are available to governmental employees?

Governmental employers may and do offer defined benefit and defined contribution plans to provide pension benefits to their employees. The federal government and state and local governments offer defined benefit and defined contribution plans that are generally similar to privately-sponsored defined benefit and defined contribution plans. However, the Employee Retirement Income Security Act does not cover governmental plans.

3

The Role of ERISA

Section III describes how the Employee Retirement Income Security Act of 1974 protects private pension participants. This section highlights standards that define the obligations of individual who run plans and requirements that govern the investment of plan assets.²³

Q. What is the Employee Retirement Income Security Act (ERISA) of 1974?

The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets certain minimum standards for pension plans sponsored by private employers.

A. Among other things, ERISA does the following with respect to private pension plans:

- Requires plans to provide information to participants and the federal government about the plan including information about plan features, such as benefits they provide, summary financial information, and information about how the plan is funded (these requirements are discussed in more detail later in this section);
- Sets minimum standards regarding who can participate and when they can participate (participation), how long participants must wait to begin accruing pension benefits (benefit accrual), how long a participant must wait before they have a right to benefits that cannot be taken away (vesting), how much must be set aside each year to provide benefits when they are due (funding);
- Sets responsibility standards and requires accountability for the people who run or provide investment advice to plans (plan fiduciaries);
- Allows participants to sue for benefits when those who run or provide investment advice to the plan fail to meet their duties and obligations;
- Guarantees payment of certain benefits if a defined benefit plan is terminated without sufficient assets to pay accumulated benefits, through a federally chartered corporation, known as the Pension Benefit Guaranty Corporation, which provides insurance protection (subject to certain limits) to plan participants; and
- Gives the Secretary of Labor the authority to bring legal actions to enforce title I of ERISA.

²³For more information on pension plan participants' rights and the role of ERISA, go to <http://www.dol.gov/dol/topic/retirement/index.htm>, and go to <http://www.dol.gov/pwba/pubs/youknow/knowtoc.htm> for a Department of Labor brochure on workers' pension rights.

Title I of ERISA, among other things, prescribes standards for information that participants are entitled to receive, obligations for plan fiduciaries, and participants' right to sue for breaches of fiduciary duty. Title I also prescribes minimum standards for participation, benefit accrual, vesting, and plan funding. These provisions concern who can participate and when they can participate, how long a participant must wait to begin accruing pension benefits, how long a participant must wait before they have a right to benefits that cannot be taken away, and how much must be set aside each year to provide benefits when they are due. There are corresponding provisions in the Internal Revenue Code. Title IV established the Pension Benefit Guaranty Corporation and sets forth duties of this agency in providing insurance protection to defined benefit plan participants.

The Employee Retirement Income Security Act's title I standards generally apply to all private pension plans. However, there are certain pension plans that are not covered by Title I, such as pension plans sponsored by governmental agencies and churches.

Q. Who is a plan fiduciary?

A plan fiduciary is a person who has discretionary control or authority over the management or administration of the plan, including management of plan assets.

A. The Employee Retirement Income Security Act defines a plan fiduciary as a person²⁴ who (1) exercises any discretionary control or authority over management of the plan, (2) exercises any authority or control over the management of plan assets, (3) renders direct or indirect investment advice with respect to assets of the plan, or has authority to do so, for a fee or other compensation, or (4) has any discretionary authority or responsibility in the administration of the plan. Also, ERISA requires that the plan have at least one named fiduciary.

Any person who makes investment decisions with respect to a qualified plan's assets is generally a plan fiduciary. The duties a person performs for the plan, rather than his or her title, or office, determines whether that person is a plan fiduciary.

The employer and its officers and directors may be considered plan fiduciaries to the extent they act or serve in a capacity by performing functions that are covered in ERISA's definition of a plan fiduciary. Plan fiduciaries generally include plan trustees, plan administrators, investment managers, and members of a plan's investment committee.

²⁴A fiduciary may also be a partnership, corporation, joint venture, or other organization as defined under the Employee Retirement Income Security Act.

Q. How do the fiduciary provisions of ERISA protect participants?

The Employee Retirement Income Security Act protects participants from mismanagement and misuse of assets by requiring accountability on the part of those who administer plans.

The Employee Retirement Income Security Act defines several core standards of conduct for plan fiduciaries. For example, ERISA stipulates that plan fiduciaries must perform their duties with respect to the plan solely in the interest of plan participants, run plans for the exclusive purpose of providing benefits to plan participants and their beneficiaries, act prudently²⁵ and may pay only reasonable expenses of administering the plan. Fiduciaries must diversify the plan's investments in order to minimize the risk of large losses. They must also follow the terms of plan documents to the extent the terms are consistent with the provisions of the Employee Retirement Income Security Act. Plan fiduciaries must avoid conflicts of interest whereby they or parties that manage or provide services to the plan could benefit from the fiduciary's actions. ERISA specifically prohibits plan fiduciaries – when acting on behalf of the plan – from engaging in transactions that benefit parties related to the plan. Such parties include but are not limited to other fiduciaries, service providers, employee organizations, and plan sponsors. Fiduciaries who do not follow these principles of conduct may

be personally liable for any losses to the plan, or for restoring any profits made through improper use of plan assets.

A fiduciary who is responsible for control or management of plan assets may appoint a qualified investment manager to manage all or part of the plan's assets. An investment manager who has been appointed by a plan fiduciary to manage the plan's assets is a fiduciary with respect to the management, acquisition, or disposition of plan assets. As long as the plan permits the delegation of investment responsibility and the delegation of investment responsibility is prudent, the fiduciary is not liable for the actions or omissions of the investment manager.

Q. What is a trust, and what requirements govern trusts?

A trust is a legal arrangement that holds title to the plan's assets. ERISA generally provides that one or more trustees must hold all assets of an employee benefit plan, such as a pension plan, in trust for the exclusive benefit of participants and beneficiaries.

A. Contributions to a qualified plan and the plan's assets must be held in trust. Plan assets in a qualified trust are generally immune from the claims of the plan sponsor's creditors (including from an employer's bankruptcy) because qualified plan assets must be used for the exclusive purpose of

²⁵29 U.S.C. 404(a)(1)(A) and (B). ERISA's prudence standard requires that each fiduciary of a plan act with "care, skill, prudence, and diligence under the circumstances then prevailing and act as a prudent person serving in a like capacity and familiar with such matters would in conducting an enterprise of like character and with like aims."

paying benefits to participants and their beneficiaries.

A trustee may be a bank, a broker-dealer, trust company, or group of individuals with exclusive authority and discretion to manage and control the assets of the plan. For example, a plan trustee invests contributions made to the plan, accumulates the earnings on those contributions, and pays benefits directly to participants or makes funds available to the plan administrator to pay benefits. However, the plan may stipulate that the investment of plan assets is subject to the direction of a named fiduciary or is delegated to one or more investment managers.

The trustees of the plan hold the legal title to all plan assets whether they are responsible for the investment of plan assets or such responsibility has been delegated to a named fiduciary or an investment manager.

A plan's trust is established through a written agreement with the plan sponsor; these written instruments set forth the duties and rights of plan trustees. Plan trustees must be named by the plan or appointed by a plan fiduciary. There are certain arrangements that are not subject to the Employee Retirement Income Security Act's trust requirements, including plans that are not subject to ERISA's participation, vesting, funding, and termination insurance provisions. There are also certain

types of assets, such as assets that consist of insurance contracts, that are not subject to the Employee Retirement Income Security Act's trust requirements.

Q. Who makes investment decisions regarding qualified pension plan assets?

The Employee Retirement Income Security Act requires that plan sponsors specify who is responsible for the investment of plan assets in their plan documents.

With defined benefit plans, the plan trustee or other designated fiduciary makes investment decisions, unless the authority to manage the investment of plan assets is delegated, under the plan's provisions, to one or more investment managers. An investment manager must be either a person who is registered as an investment advisor under the Investment Advisors Act of 1940, a bank (as defined in that Act), or an insurance company with the power to manage, acquire, or dispose of any plan asset under the laws of more than one state. For defined contribution plans with individual accounts, the plan may allow participants to make investment decisions with respect to the balances in their accounts. For example, many 401(k) plans permit participants to make investment decisions regarding their elective contributions.

Q. Are plan fiduciaries responsible for investment decisions made by plan participants?

If the plan sponsor meets certain Employee Retirement Income Security Act requirements, plan fiduciaries are not responsible for investment decisions made by plan participants. Under ERISA, plan fiduciaries may be relieved of responsibility for the investment decisions of plan participants when they exercise control over the investment of assets in their individual accounts in accordance with applicable Department of Labor regulations. These regulations contain special fiduciary rules that apply to plans with "participant-directed" investments.

A. Special fiduciary rules contained in Department of Labor regulations protect plan fiduciaries from liability for individuals' investment decisions with respect to plans that provide participant-directed investments. These special fiduciary rules for plans with participant-directed investments are set forth pursuant to section 404(c) of the Employee Retirement Income Security Act.

There are certain requirements that must be satisfied in order for these special rules to apply to plans that provide for participant-directed investments. Among other requirements, plans must offer participants at least 3 investment options, information about and investment instructions with respect to each of the investment options, and allow participants to exercise independent control over their

investments. The protection afforded by satisfying these rules applies only with respect to transactions where participants in fact exercise independent control over the assets in their accounts. When a plan satisfies the special requirements for participant-directed investments, the plan fiduciary receives limited liability from the results of decisions made by participants who exercise independent control over the investment of their account balances.

For plans that permit investment in employer securities, the Department of Labor's regulations prescribe additional fiduciary rules. Among other things, there are specific requirements regarding the decisions that employees make with respect to buying, selling, and voting of shares of employer stock. These requirements are intended to ensure that participants' decisions are made confidentially and free from employer influence.

Plans are not required to meet the standards prescribed in the applicable regulations. However, failure to satisfy these special rules means that plan fiduciaries might be held liable for the breach of fiduciary duty regarding the investment decisions of participants. Regardless of whether the plan satisfies the requirements for participant-directed investments under 404(c), plan fiduciaries must satisfy the responsibilities that apply to fiduciary conduct as prescribed by ERISA. For example, plan fiduciaries must exercise care and prudence in selecting and monitoring investment options available to participants under the plan and must ensure that the plan is administered in accor-

dance with plan documents to the extent to they are consistent with the Employee Retirement Income Security Act.

Q. What rules govern investment of plan assets in employer stock?

Generally, defined benefit and defined contribution plan assets may be invested in employer stock, but there are certain rules that plans must follow regarding the amount employer stock they may hold.

A. Both defined benefit and defined contribution plan assets may be invested in employer stock. The Employee Retirement Income Security Act permits plans to hold “qualifying employer securities.” Employer stock is one type of qualifying employer security.²⁶ There are certain requirements that defined benefit plans must satisfy regarding the portion of employer stock that may be acquired and held by the plan in order for the stock to be deemed a qualifying employer security. The Internal Revenue Code also delineates the type of employer stock that may be held by an Employee Stock Ownership Plan. In addition to qualifying employer securities, plans may also hold qualifying employer real property.²⁷

Although ERISA permits plans sponsors to invest plan assets in employer stock, there are different rules relating to the amount of plan assets that may be invested in employer stock for defined

benefit and defined contribution plans. Under ERISA, defined benefit plans may not acquire any qualified employer security or real property if immediately after the acquisition, the aggregate fair market value of such assets exceeds 10 percent of the fair market value of the plan’s total assets. However, defined contribution plans, including 401(k) plans, Employee Stock Ownership Plans, and other defined contribution plans with individual accounts, are generally exempt from this requirement. Plans that are not subject to the 10 percent limitation are referred to in ERISA as eligible individual account plans.

While the vast majority of 401(k) and other types of defined contribution plans are not subject to any restriction on the amount of employer stock that they may hold, there are limited circumstances under which the 10 percent limit on employer stock could apply to a 401(k) plan. For example, if a plan sponsor requires participants to invest their elective contributions in employer stock, the portion of the plan’s assets that consists of employee contributions could be subject to the 10 percent restriction. However, there are exceptions under which the 10 percent limitation would not apply to a 401(k) plan that requires employees to invest their elective contributions in employer stock. Employee Stock Ownership Plans that are designated as 401(k) plans are exempt entirely from this restriction.

²⁶Qualifying employer securities also include certain publicly traded partnership interests as defined in the Internal Revenue Code and marketable obligations such as a bond, debenture and note or certificate of indebtedness. 29 U.S.C. 407(d)(5).

²⁷29 U.S.C. 407(d)(4).

Defined contribution plans may require that some contributions to participant accounts be invested in employer stock. For example, 401(k) plans may provide matching contributions in the form of shares of employer stock. A defined contribution plan may also require participants to hold employer contributions that the plan sponsor requires to be invested in employer stock (e.g., employer matching contributions) – without the opportunity to change investments – until certain conditions are met. For employees who make elective contributions and have the option to invest in employer stock, there is no limit on the amount of elective contributions that they may choose to invest in employer stock (in an eligible individual account plan).

There are specific rules regarding the investment of plan assets in employer stock that apply to Employee Stock Ownership Plans. The Internal Revenue Code delineates the type of employer stock that may be held by such plans. Also, Employee Stock Ownership Plans are permitted to require that employee contributions be invested in the employer's stock, and there is no limit on the amount of employee contributions that the plan sponsor may require to be invested in employer stock except

in cases where a limited diversification requirement applies for certain participants.

Employee Stock Ownership Plans are subject to a limited diversification requirement. The Internal Revenue Code stipulates that Employee Stock Ownership Plans must allow a participant who is 55 years old and has 10 years of participation to diversify a portion of his or her account. Additional diversification is allowed after 5 more years.

Q. Can employers provide investment education and investment advice to plan participants?

Employers who sponsor defined contribution plans that permit participants to direct the investment of their contributions may provide both investment education and advice to plan participants.

A. With respect to investment education, plan sponsors may provide certain types of investment information and materials that are not considered to be investment advice. Plan sponsors who provide investment advice directly to plan participants are subject to fiduciary liability. The Department of Labor (DOL) issued guidance²⁸ that defines certain categories of investment information and education employers may provide to plan participants without

²⁸The Department of Labor's guidance describes four categories of investment education plan sponsors may provide to participants: (1) information about the plan, (2) general financial information, (3) information based on "asset allocation models," and (4) "interactive investment materials." This guidance is contained in DOL's *Interpretive Bulletin 96-1*. According to the Department of Labor, these investment education categories merely represent examples of investment information and materials that if furnished to participants would not constitute the rendering of investment advice.

such information being considered investment advice. This guidance defines four categories of investment education. The four categories are defined under “safe harbors,” which exempt employers who provide these types of investment education from fiduciary liability that plan sponsors are subject to when they provide investment advice. Each safe harbor stipulates certain conditions that employers must meet when they provide the types of investment information and education defined by the DOL’s guidance.

Plan sponsors may also provide investment advice to plan participants. Investment advice is information that is rendered on a regular basis and is directly related to the investment options under the plan or the appropriateness of one or more of these options for a plan participant.²⁹ For example, a recommendation to invest in one of the plan’s investment alternatives is considered investment advice that could subject the plan sponsor to fiduciary liability. Instead of providing investment advice to plan participants directly, a plan sponsor may arrange for an external, unaffiliated party, such as a brokerage company, to provide investment advice.

The selection of an unaffiliated party to provide investment advice is also a fiduciary act. These parties are considered investment advisors under the Employee Retirement Income Security Act. ERISA currently prohibits investment advisors from engaging in transactions with clients’ plans where they have a conflict of interest. For

example, an investment advisor that provides investment options and/or plan administration services to the plan may not also provide advice to the plan’s participants about these investment options without approval from the Department of Labor.

Q. What kinds of information are plans required to report to the federal government?

Plan sponsors must provide certain information to the Department of Labor, Internal Revenue Service and Pension Guaranty Benefit Corporation regarding the operation, terms, and funding of their plans.

A. The Employee Retirement Income Security Act requires plan administrators to report certain information to the Department of Labor, Pension Benefit Guaranty Corporation and Internal Revenue Service, the agencies that administer the federal pension laws. The Form 5500 Annual Return/Report is a three-agency form. The Department of Labor, in conjunction with the Internal Revenue Service and Pension Benefit Guaranty Corporation publishes the Form 5500 to be used by plan administrators and employers in order to satisfy their annual reporting obligations under ERISA and the Internal Revenue Code. Plan administrators must also submit certain schedules, depending on the features of the plan that accompany the Form 5500. Filing requirements for these schedules differ for plans with 100 or more participants and plans with fewer than 100 participants. The Department of Labor can

²⁹29 C.F.R. 2510.3-21(c).

also request from plan administrators other documents describing the plan or modifications to the plan.

The Internal Revenue Service also requires that plan administrators file returns in certain instances. For example, plan administrators must file certain forms that disclose changes to the plan that the sponsor wants to make. These changes include combining plans after a company merger or consolidation, or in some cases when terminating a plan. IRS also requires plans to file forms that relate to reporting or paying additional taxes.

Finally, the Pension Benefit Guaranty Corporation requires that plan administrators file forms that are used to report and pay their premiums to PBGC.

Q. What kinds of information are employers required to disclose to plan participants?

Plan administrators are required by ERISA to disclose information about plan benefits, participants' rights, material changes to the terms of the plan, and the plan's financial status to participants.

A. The Employee Retirement Income Security Act requires plan administrators to disclose to participants and beneficiaries a summary plan description, describing their rights, benefits, and responsibilities under the plan in understandable language. The Summary Plan Description includes such information as

- name and type of plan,
- plan's requirements regarding eligibility,
- description of benefits and when participants have a right to those benefits,
- statement detailing that the plan is maintained pursuant to a collective bargaining agreement with regard to the plan,
- statement about whether the plan is covered by termination insurance from the Pension Benefit Guaranty Corporation,
- source of contributions to the plan and the methods used to calculate the amount of contributions,
- provisions governing termination of the plan,
- procedures regarding claims for benefits and remedies for disputing denied claims, and
- statement of rights available to plan participants under ERISA.

New employees must receive a copy of their plan sponsor's latest Summary Plan Description within 90 days after becoming covered by the plan. Plans sponsors are not required to file the Summary Plan Description with the Department of Labor, although they are required to provide it to DOL upon request.

In addition to the Summary Plan Description, plan participants are entitled to receive a Summary of Material Modifications. The Summary of Material Modifications discloses what constitutes a significant modification in the benefits that the plan provides or in the administration of the plan and must be written in a manner that the average participant can understand. Plan administrators must furnish participants with a Summary of Material Modifications within 210 days after the close of the plan year in which the modification was made and also when there is a change to the information that is required to be included in the Summary Plan Description.

Participants and individuals receiving benefits from the plan must also receive a Summary Annual Report from their plan's administrator each year. The Summary Annual Report summarizes the plan's financial status based on information that the plan administrator provides to the Department of Labor on its annual Form 5500. This document must generally be provided no later than nine months after the close of the plan year.

Participants may request information about their plan from the plan's administrator. This information includes an updated Summary Plan Description, the latest annual Form 5500, a statement of the participant's accrued benefits to date, or other documents under which the plan is established or operated. Upon the written request of a plan participant or beneficiary, plan adminis-

trators must provide certain information, such as a statement of the participant's accrued benefits to date.

Q. What is the difference between a plan freeze and a plan blackout?

A plan freeze occurs when a plan sponsor amends its plan to cease participants' benefit accruals, while a **blackout** is when a defined contribution plan sponsor temporarily suspends transactions involving participants' individual accounts.

A. A plan sponsor may amend its plan to cease all benefit accruals indefinitely in the future. When a plan sponsor does this, it is called a plan freeze. A plan sponsor may decide to freeze its plan when it can no longer afford the cost of the plan and termination is not a practical option, when it wishes to make changes to the plan, or to merge the plan with a new plan that the sponsor decides to offer. When a plan is frozen, current employees who participate in the plan do not accrue any additional benefits after the effective date of the plan freeze, and employees hired after that date are prevented from participating in the frozen plan.³⁰ A plan sponsor who freezes its plan is obligated to pay all vested accrued benefits that current and past participants are entitled to receive under the plan.

Employers who sponsor defined contribution pension plans with individual accounts sometimes suspend or restrict transactions in participants' accounts

³⁰Defined contribution plan participants continue to accrue interest on their individual account balances even though the accounts may no longer receive contributions.

for various reasons, such as when the plan sponsor changes administrators or when the plan must perform administrative tasks that require a temporary suspension of account activity. When a plan sponsor suspends, restricts, or limits – for a period of three or more consecutive business days – the ability of participants or beneficiaries (as otherwise available under the terms of the plan) to direct the investment of assets in their accounts, obtain loans, or obtain benefit distributions, these suspensions are called “blackouts.” In contrast to a plan freeze, a plan blackout does not discontinue participants’ benefit accruals. During a blackout, plan participants cannot make changes to the investment of their

account balances, such as changing investment options, or execute other transactions. Generally, plan sponsors must provide a 30-day advance notice to participants prior to instituting a blackout. Among other things, the advance notice must include the reasons for the blackout and a statement that the participant or beneficiary should evaluate their investment choices in light of the impending blackout. Also, rules relating to fiduciary standards continue to apply to the operation of an employer-sponsored pension plan during such periods. That is, when a plan sponsor suspends transactions, it must still act in the best interest of the plan participants.

4

Internal Revenue Code Provisions on Plan Coverage and Benefits

Section IV describes relevant provisions of the Internal Revenue Code that govern how tax-qualified plans must cover and provide benefits to employees. This section discusses rules and requirements that prescribe minimum standards on participation and benefits that participants are entitled to receive.³¹

Q. What are the rules for employee eligibility and participation in pension plans?

Plan sponsors may generally define the groups of employees that are eligible to participate in the plan and when these groups may begin to participate subject to certain requirements.

A. Generally, a plan sponsor may define the groups of employees that are eligible to participate in the plan and the conditions that these eligible employees must meet to begin participating.³² Plans may exclude employees who do not work at least 1,000 hours in a year (i.e., never complete one year of service) but may not exclude part-time employees. Plans may also exclude hourly employees or certain salaried employees within a specific job classification. However, eligible employees must be allowed to participate in the plan as of age 21 and after completing one year of service, subject to certain exceptions.

A plan participant is an individual that is specifically included under his or her employer's plan. Active employees who are or may become eligible to accrue or receive benefits under the plan, as well as former employees with a right to benefits and retired employees who receive benefits, are considered plan participants.

Q. What rules govern employee coverage in pension plans?

Tax-qualified plans must satisfy coverage requirements that are designed to ensure a minimum proportion of rank-and-file employees are covered by and are benefiting under the plan.

A. In order to be tax-qualified, plans must satisfy certain coverage requirements under the Internal Revenue Code. These requirements are designed to ensure that a minimum portion of employees is covered by private plans, beyond those employees who are highly compensated, such as management or executives. Each coverage requirement applies a specific test to compare coverage among rank-and-file

³¹For more information on tax laws, regulations, and programs that apply to private pension plans, go to <http://www.irs.gov/> and select "retirement plans."

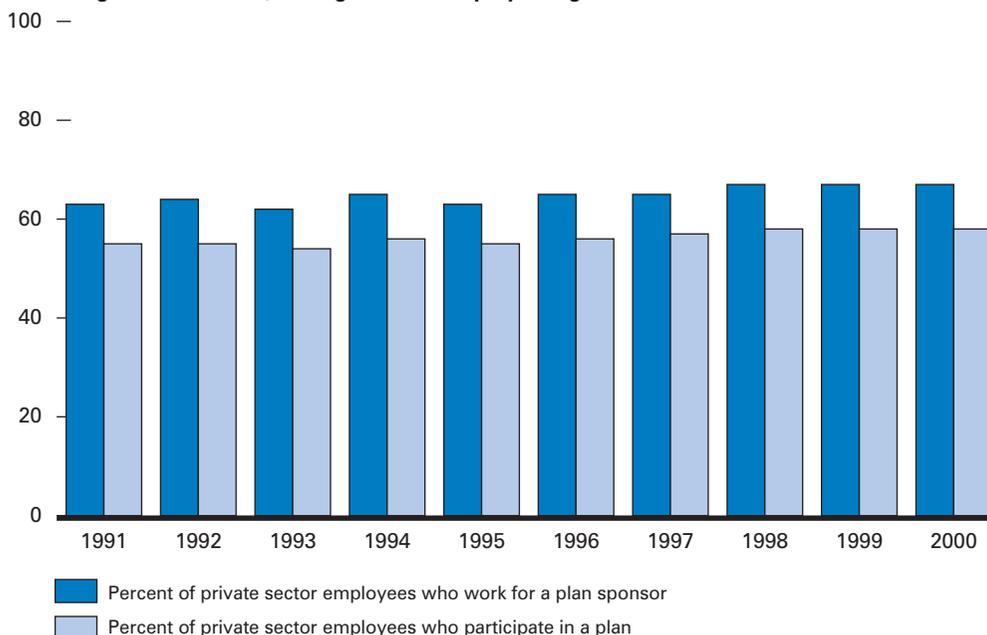
³²A plan's specific eligibility requirements are allowed if applicable Internal Revenue Code rules on coverage are satisfied.

employees and highly compensated employees. Employers are generally permitted to exclude employees who

have not satisfied certain minimum age and service requirements described previously.

Figure 4: Coverage and Participation of Private Sector Employees

Percentage of all full-time, non-agricultural employees aged 25 to 64



Source: *Pension Sponsorship and Participation: Summary of Recent Trends* (table 3), Congressional Research Service, Oct. 4, 2001.

Q. What are the nondiscrimination rules that private plans must satisfy?

Nondiscrimination rules provide that private employers who sponsor tax-qualified plans must meet certain requirements regarding how benefits or contributions are distributed between rank-and-file employees and highly compensated employees, such as company executives and owners.

A. These rules are intended to ensure that company executives and owners do not receive too large a share of the plans contributions and benefits in relation to the portion received by rank-and-file employees. This is known as the general nondiscrimination requirement.

The general nondiscrimination requirement applies to all benefits, rights, and features of the plan.

If an employer sponsors a 401(k) plan or a qualified defined contribution plan that provides matching contributions or allows after-tax employee contributions, the plan must satisfy special nondiscrimination rules. Plans that satisfy these special rules are also treated as satisfying the general nondiscrimination rule.

There are standard plan designs, termed “safe harbors,” which allow employers to comply with nondiscrimination rules. Standard plan designs are available under the Internal Revenue Code for 401(k) plans and for certain qualified defined contribution plans that provide employer matching contributions or allow after-tax employee contributions. If a qualified defined contribution plan adopts a safe harbor design, then the plan is treated as satisfying both the special requirements to which the safe harbor applies and the general nondiscrimination rule on contributions. If employers choose not to use safe harbor designs, they still have to meet the general nondiscrimination rule on contributions or benefits. To do this they must tailor their plan design to provide both coverage and contributions (or benefits) for rank-and-file employees at rates that do not differ too greatly from the rate at which the employer provides coverage and contributions (or benefits) for highly compensated employees.

In addition, simplified defined contribution pension plans are available to small employers. A private employer with 100 or fewer employees that does not already sponsor a pension plan may

sponsor a Savings Incentive Match Plan for Employees (“SIMPLE”).³³ A private employer with 25 or fewer employees that does not already sponsor a pension plan may sponsor a Simplified Employee Pension (SEP). These two types of plans provide relief from certain administrative or regulatory requirements in exchange for satisfying eligibility and mandatory employer contribution requirements that apply to these plans. For example, an employer who sponsors a Savings Incentive Match Plan for Employees and meets specific requirements regarding employee eligibility and mandatory employer contributions is relieved from satisfying certain nondiscrimination requirements that apply to qualified plans in general or qualified 401(k) plans. Simplified Employee Pensions are subject to minimum reporting and disclosure requirements (reporting and disclosure requirements are discussed in section III).

Q. What are the “top heavy” rules and when do they apply to private plans?

Top heavy rules, like the rules on nondiscrimination, address how benefits and contributions are distributed, as well as when participants have rights to their accrued benefits (vesting).

A. These rules identify pension plans in which owners and officers receive the majority of benefits or contributions, and require that workers (in these plans) receive higher minimum benefits

³³There are two types of Savings Incentive Match Plan for Employees – a SIMPLE 401(k) plan and a SIMPLE IRA plan.

and faster vesting rights of these benefits than they would otherwise receive. A private plan is deemed top-heavy if it fails the top-heavy test; that is, the firm's top employees receive more than 60 percent of its benefits or contributions. Plans that provide the required top-heavy minimum contributions or benefits, and vesting, do not have to apply the top-heavy test.

Q. What does vesting mean?

A participant who is fully vested has earned a right to his or her accrued benefit that cannot be taken away.

A. Vesting means that a plan participant has earned a nonforfeitable right to an accrued benefit, or a right to a benefit that cannot be taken away. Participants may have to work for a certain period of time before they have a right to accrued benefits (or the portion of accrued benefits) based on their employer's contributions. Once a participant is fully vested, he or she has the right to 100 percent of the benefit that he or she has accrued to date, including benefits derived from both employer and employee contributions. However, if a participant leaves his or her employer before vesting, all or a part of the participant's accrued benefit based on the employer's contribution may be forfeited. In the event that a plan terminates, participants become fully vested in their accrued benefits as of the termination date if the plan has sufficient assets to cover accrued benefits participants are entitled to receive.

There are rules regarding the maximum amount of time an employee must participate in order to be vested.

Defined benefit and defined contribution plan participants who vest are entitled to the portion of their accrued benefits based on the employer's contributions even if they leave the plan sponsor before retirement. Also, both defined benefit and defined contribution participants are vested in their accrued benefits when they reach their plan's normal retirement age.

Participants are always 100 percent, immediately vested in any pre-tax or after-tax contributions, such as elective deferrals to a 401(k) plan, they make to a qualified defined benefit or defined contribution plan. However, participants may have to complete a certain number of years of service before vesting in their employer's contributions.

There are two basic schedules under the law that plan sponsors may satisfy to determine when participants have a right to their accrued benefits: 1) cliff vesting and 2) graded vesting. Cliff and graded schedules set forth the minimum years of service that must be counted for vesting. These vesting schedules apply to both defined benefit and defined contribution plans.

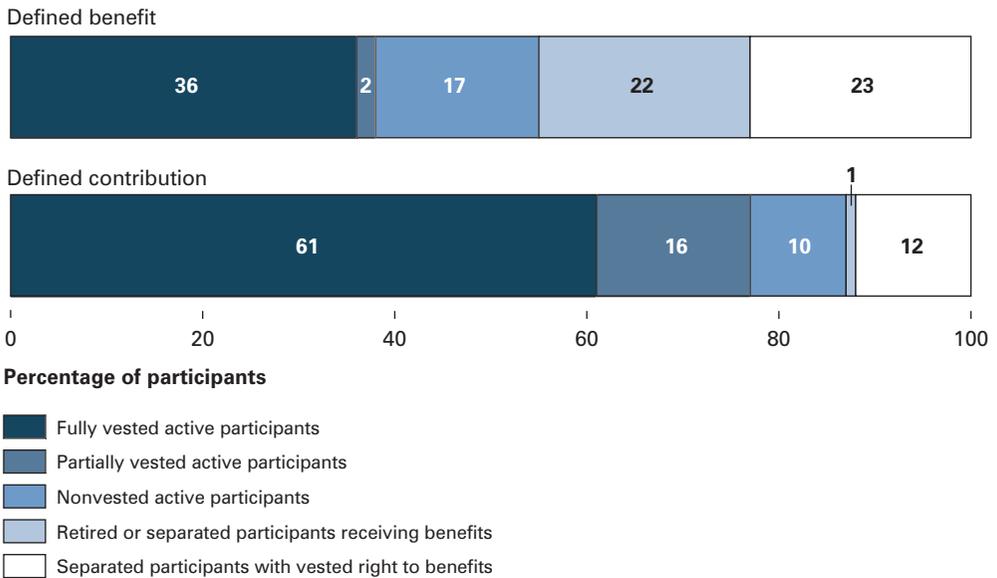
In plans with cliff vesting, there is a specified point at which plan participants have a right to their benefits accrued to date and benefits accrued thereafter. Current law stipulates that full vesting must occur no later than after 5 years of participation under cliff vesting.

Vesting can take longer under a graded schedule than under a cliff schedule. Under graded vesting, plan participants

have a right to an increasing percentage of their total accrued benefit over time, but full vesting must occur no later than after 7 years of participation. For defined benefit plans and certain contributions to defined contribution plans, participants have a right to 20 percent of their accrued benefits after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and a right to 100 percent after seven years of service.

For defined benefit plans, participants under a cliff vesting schedule are fully vested after 5 years of service, while participants under a graded vesting schedule are fully vested after 7 years of service. For defined contribution plans that provide matching contributions, participants under a cliff vesting schedule must be fully vested in their employer’s matching contributions after 3 years of service, while participants under a graded vesting schedule must be fully vested after 6 years of service. As previously mentioned, “top-heavy” plans must vest benefits faster than under general vesting requirements.

Figure 5: Vesting Status of Participants in DB and DC Plans



Source: Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports (table A2), U.S. Department of Labor, Pension and Welfare Benefits Administration.

Q. To what extent can accrued benefits be reduced or eliminated?

Generally a participant's accrued benefit may not be reduced or eliminated by amending the plan. The general prohibition on reducing or eliminating accrued benefits is known as the anticutback rule.

A. The anticutback rule³⁴ applies only to benefits that participants have accrued up to the date of the amendment.³⁵ However, plan sponsors are not prohibited from reducing the rate of future benefit accruals. For example, this means that a defined benefit plan may be amended to reduce the accrual factor (that is combined with years of service and average salary) in its benefit formula from 1.5 percent to 1.25 percent for determining accrued benefits for service after the plan amendment has been adopted. Alternatively, a defined contribution plan may be amended to reduce an employer's contribution to participant accounts from 3 percent of salary to 2 percent of salary after the plan amendment has been adopted. These reductions must not apply to accrued benefits prior to the amendment or the plan will be in violation of the anti-cutback rule. Generally, a plan may not be amended to significantly reduce the future rate of benefit accruals unless the plan's

administrator provides a written notice to all participants at least 45 days before the effective date of the amendment.³⁶ Additionally, if a plan offers participants benefit payment options, such as a subsidized early retirement benefit, an early retirement benefit, or a retirement-type subsidy, the plan sponsor cannot amend the plan to reduce the benefits that participants have accrued to date under these options.

Q. What rules govern age discrimination in the provision of pension benefits?

There are two types of age discrimination in the provision of pension benefits that are prohibited. Plan sponsors may not reduce or cease benefit accruals on the basis of age, and plan sponsors may not deny employees the opportunity to participate in plans on the basis of age.

A. The Employee Retirement Income Security Act, the Internal Revenue Code, and the Age Discrimination in Employment Act (ADEA) all have provisions that make it unlawful for pension plans to reduce a participant's benefit accrual rate on the basis of age. The Internal Revenue Code prohibits a defined benefit plan from ceasing

³⁴26 U.S.C. 411(d)(6).

³⁵There are limited circumstances under which a plan may reduce or eliminate accrued benefits. For example, a plan sponsor may adopt an amendment that reduces or eliminates accrued benefits under certain conditions, such as when a change in law affects the plan's qualification status and a reduction in or elimination of accrued benefits is necessary to comply with the change.

³⁶29 U.S.C. 204(h).

accruals, or reducing the rate of benefit accruals because of the attainment of any age.³⁷ For example, a defined benefit plan may not provide benefits based on a formula with a 1.5 percent accrual factor for employees under age 40 and an accrual factor less than 1.5 percent for employees age 40 or older. The Internal Revenue Code also prohibits defined contribution plans from ceasing allocations, or reducing the rate at which amounts are allocated, to a participant's account because of the attainment of any age. Similar provisions are found in both ERISA and ADEA.³⁸

A pension plan cannot discriminate on the basis of age with respect to participation in the plan. Accordingly, a plan sponsor may not exclude employees who have attained a specific age from participating in the plan. In general, pension plans are considered to be discriminatory on the basis of age if they require, as a condition of participation, that an employee complete a period of service with an employer beyond the basic requirement of the employee being 21 years of age or completing one year of service.

³⁷26 U.S.C. 411(b)(1)(H).

³⁸Federal pension law does, however, permit a reduction in the rate of benefit accrual based on years of service even though such a reduction in practice is more likely to affect older participants than younger participants. For example, a defined benefit plan may provide that participants with up to 20 years of service receive benefits based on a 1.5 percent accrual factor and participants with 21 or more years of service receive benefits based on 1.2 percent accrual factor.

Government Insurance Protection of Pension Benefits

5

Section V discusses the role of federal government insurance in protecting pension benefits.³⁹

Q. Under what circumstances may a private employer terminate a pension plan?

Private employers may voluntarily terminate their plans so long as they meet certain conditions for **plan termination**.

A. An employer may voluntarily terminate its pension plan under certain circumstances depending on the funded status of the plan. There are different requirements for defined benefit and defined contribution plan sponsors.

An employer who wishes to terminate a defined benefit plan has to meet certain conditions under the Employee Retirement Income Security Act and procedures prescribed by the Pension Benefit Guaranty Corporation (PBGC) in order to do so. When a single-employer defined benefit plan is terminated in accordance with PBGC's requirements for plan termination and with enough assets to pay all the liabilities of the plan, the termination is referred to as a standard termination. Before initiating a standard termination, a plan sponsor must also provide 60-day advance

notice to plan participants. Under a standard termination, the plan must pay all benefits accrued under the plan up to the date of plan termination owed to participants. To do so, the plan sponsor may purchase an annuity from an insurance company or pay accrued benefits as lump sum amounts (if allowed under the terms of the plan). PBGC's insurance protection ends once the plan sponsor has provided for the payment of benefits owed to participants. The Pension Benefit Guaranty Corporation maintains the right to stop the plan's termination if it determines that the plan sponsor has not met these termination requirements.

In some standard terminations, the plan has more than sufficient assets to cover all benefits that participants are entitled to receive as of the date of plan termination. In such cases, a plan sponsor will often distribute these excess assets to participants. Alternatively, surplus assets can revert to the employer if such a reversion is allowed under the terms of the plan.⁴⁰ If excess assets revert to the plan sponsor upon termination, the employer is responsible for a 50 percent excise tax on the surplus

³⁹For more information about insurance protection for benefits from certain private plans, go to <http://www.pbgc.gov/about/pensioninfo.htm>

⁴⁰A plan amendment allowing reversion of surplus assets to the plan sponsor must be adopted at least five years prior to plan termination.

assets, which are also subject to ordinary corporate income tax. Under certain circumstances, the excise tax can be reduced to 20 percent.

If a single-employer defined benefit plan does not have enough assets to pay benefits due to participants, the plan can be voluntarily terminated only if the conditions for a distress termination are satisfied. Generally, the plan sponsor must prove to the Pension Benefit Guaranty Corporation, which will trustee and administer the plan, that its business is unable to financially support the plan. In particular, a distress termination of a single employer's plan may occur if the employer meets at least one of the following conditions:

- (1) liquidation in bankruptcy or insolvency proceedings;
- (2) reorganization in bankruptcy or insolvency proceedings; or
- (3) termination in order to enable payment of debts while staying in business or to avoid unreasonably burdensome pension costs caused by a decline of the employer's covered workforce.

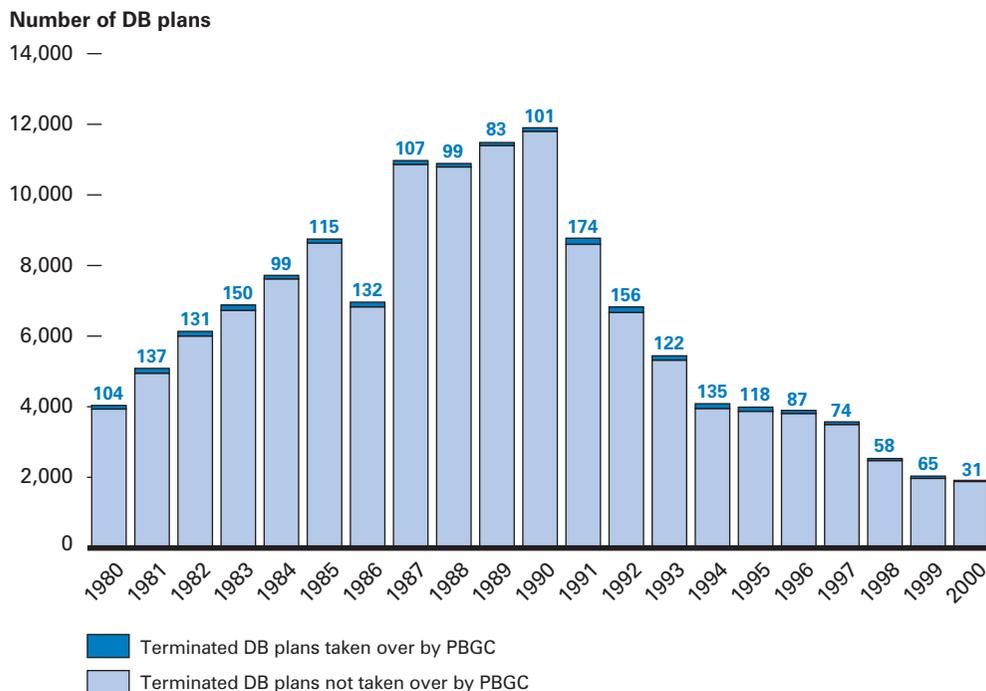
An employer wishing to voluntarily withdraw from a multiemployer plan will generally only do so when it ceases to have an obligation to contribute to

the plan or ceases operations covered by the plan. These events occur, for example, when a collective bargaining agreement is not extended or when an employer goes out of business. The employer may incur a withdrawal liability upon leaving the plan. Even if all sponsoring employers withdraw from a multiemployer plan, the plan may continue to operate because the plan's trustees are not required to close out (terminate) the plan as would be the case with the standard termination of a single-employer plan.

PBGC becomes involved with a multi-employer plan when the plan becomes insolvent and is unable to pay benefits when they are due. When insolvency occurs, PBGC will provide financial assistance to enable the plan to pay guaranteed benefits to its payees.

In order to terminate a defined contribution plan, an employer generally must adopt a resolution terminating the plan, notify participants of the termination, and distribute plan assets as soon as administratively feasible. Although the federal government does not insure defined contribution plans, a plan participant is entitled to his or her accrued benefit to date (account balance), including any employer contributions (to the extent funded), upon termination of the plan.⁴¹

⁴¹In the event of plan termination, plan participants become fully vested in their accrued benefits.

Figure 6: PBGC Trusteeship of Terminated Defined Benefit Plans

Source: *Pension Insurance Data Book 2000* (table S-10), Pension Benefit Guaranty Corporation.

Q. Are participants' benefits protected when their plan terminates?

Participants in most private sector defined benefit plans have insurance protection in the event of plan termination.

A. The federal government provides insurance protection up to certain limits for benefits from most tax-qualified defined benefit plans. Insurance protection is provided for certain defined benefit plan participants in order to pay benefits these participants are entitled to receive in the event that

a plan terminates with insufficient assets.

A federal insurance program administered by the Pension Benefit Guaranty Corporation provides protection up to certain limits for benefits from underfunded qualified defined benefit plans that are covered by PBGC insurance. The Pension Benefit Guaranty Corporation provides this protection under two programs – the single-employer and the multiemployer programs. Under the first program, the insurance protection pays benefits in the event that a covered single-employer plan terminates with insufficient assets. Under

the second program, financial assistance is provided to enable multiemployer plans to pay guaranteed benefits.

Defined benefit plans that are subject to the Employee Retirement Income Security Act must satisfy certain minimum funding requirements. Also, the Employee Retirement Income Security Act requires plan sponsors to estimate their liabilities each year to determine whether their plans are fully funded or underfunded. An underfunded plan is a plan with liabilities for current and future benefits that exceed the value of the plan's assets (i.e., the plan would not have sufficient assets to pay the value of all present and future benefits).

When a fully funded single-employer plan terminates in a standard termination, the benefits of participants are protected because the plan is required to either purchase annuities from a private sector insurance company or make lump sum distributions to participants that are no smaller than the present value of their accrued benefits.

Defined contribution plans are, by definition, always fully funded because they make no promises regarding the level of benefits they will provide in retirement. The amount available to finance retirement from these accounts will equal the contributions made by the participant and/or the employer plus the net investment returns on the account. No government insurance exists for participants' individual account balances in qualified defined contribution plans.

Q. What is the role of the Pension Benefit Guaranty Corporation in protecting retirement benefits?

The Pension Benefit Guaranty Corporation is a federally chartered government corporation established by the Employee Retirement Income Security Act of 1974 to insure the pension benefits of participants in qualified defined benefit plans.

A. The Pension Benefit Guaranty Corporation was created to insure the pension benefits of participants – in certain private sector defined benefit plans – in the event that these plans terminate without sufficient assets to pay all present and future benefits owed. Pension Benefit Guaranty Corporation insurance covers both single-employer and multiemployer defined benefit plans. PBGC does not insure defined contribution plans, such as 401(k) plans, and does not provide coverage for defined benefit plans that are not subject to the Employee Retirement Income Security Act. In particular, the termination insurance program does not cover public sector plans.

If a covered single-employer defined benefit plan terminates without sufficient assets, the Pension Benefit Guaranty Corporation takes over the plan's assets and is responsible for paying benefits up to limits set by law to participants who are entitled to receive them. PBGC will take over an underfunded single-employer plan that has been terminated under two different scenarios: where the employer initiates a distress termination (voluntary) and where the PBGC initiates the termination (involuntary). An employer in

financial distress may voluntarily terminate an underfunded single-employer plan only if certain conditions are satisfied. These conditions demonstrate to PBGC that the employer business cannot financially support the funding of pension benefits.

The Pension Benefit Guaranty Corporation may initiate the termination of a single-employer defined benefit plan when the plan does not have the assets needed to pay out benefits.⁴² For example, PBGC may terminate a plan when that plan has not met the Employee Retirement Income Security Act's minimum funding standards or will not be able to pay benefits when they are due to participants. Also, PBGC must terminate a plan when it determines a plan is unable to pay benefits currently due to participants. PBGC may also terminate a single-employer plan when the continuation of the plan would unreasonably increase the risk of a long-term loss to the agency's insurance fund.

The Pension Benefit Guaranty Corporation becomes involved with a multiemployer plan when the plan becomes financially insolvent and is unable to pay benefits owed to retirees and beneficiaries when they are due. However, unlike for underfunded single-employer defined benefit plans, PBGC does not trustee multiemployer plans that become insolvent. Rather, PBGC provides financial assistance to enable insolvent multiemployer plans to pay benefits owed to participants.

Q. What are PBGC's financial resources to carry out its mission?

The Pension Benefit Guaranty Corporation is financed through insurance premiums by PBGC-covered plans and the agency's financial assets.

A. The Pension Benefit Guaranty Corporation is financed through insurance premiums by employers that maintain insured plans, investment returns on PBGC's assets, and assets acquired from terminated plans that PBGC takes over as trustee. There are certain risks, beyond PBGC's control, that affect the agency's long-term financial condition. These risks include downturns in the economy, failures of businesses with underfunded plans, a significant and long-lasting decline in the stock market, and a substantial and lasting drop in interest rates. These risks could increase plan underfunding by reducing the future returns on the assets of PBGC-insured plans and thus increase the value of PBGC-covered pension plan liabilities.

Currently, sponsors of single-employer defined benefit plans pay the Pension Benefit Guaranty Corporation a flat-rate premium of \$19 per participant, per plan year. Unless they meet certain legal exemptions, underfunded single-employer plans pay a variable-rate premium, in addition to the basic, flat-rate premium, of \$9 for every \$1,000 (or fraction thereof) of unfunded vested

⁴²For more information on the circumstances under which the Pension Benefit Guaranty Corporation may terminate a qualified defined benefit plan, see www.pbgc.gov.

benefits. The premium rate for multi-employer defined benefit plans is \$2.60 per participant, per plan year.

Q. To what extent does the Pension Benefit Guaranty Corporation insure benefits provided by defined benefit plans?

The benefit that the Pension Benefit Guaranty Corporation pays depends on certain factors including the provisions of the terminated plan and certain statutory limits that specify maximum benefit payments.

A. The pension benefit that the Pension Benefit Guaranty Corporation pays to a participant whose single-employer plan has been terminated depends on (1) plan provisions, (2) statutory limits on PBGC benefit payments, (3) the type of benefit the participant is entitled to receive, (4) the participant's age, and (5) amounts of assets that PBGC recovers from employers whose plans they have taken over.

Pension Benefit Guaranty Corporation benefit payments are subject to a maximum dollar limit. For single-employer plans, this limit is set each year in accordance with the Employee Retirement Income Security Act. For single-employer plans that PBGC takes over in 2002, the maximum insured monthly amount is \$3,579.55 (\$42,954.60 per year) for a worker who retires at age 65. The maximum amount payable is lower if payments commence before age 65, and is higher if payments begin after age 65. The maximum amount payable is also lower if the

insured benefit amount includes benefits for other beneficiaries, such as a survivor, in addition to the participant.

The maximum amount payable for participants in PBGC-covered multiemployer plans is determined by using a formula that does not change each year. The maximum amount, which depends on the participant's years of service, is \$12,870 per year for a participant with 30 years of service.

The Pension Benefit Guaranty Corporation's single-employer insurance program has two additional limitations regarding the benefits that PBGC will pay to a participant whose plan has terminated. First, there is a limit on the level of supplemental benefits that PBGC will pay (supplemental benefits are often temporary benefits the participant receives until he or she is eligible for Social Security benefits). Second, there is a five-year phase in period for the guarantee of benefit increases that were granted through plan amendments prior to the plan's termination.

Q. What plan benefits does PBGC guarantee?

The Pension Benefit Guaranty Corporation provides insurance protection for annuity benefit payments that defined benefit plans pay to participants at retirement and other forms of benefits that these plans may provide.

A. The Pension Benefit Guaranty Corporation guarantees four types of benefits. These benefits include (1) benefits payable at the plan-specified normal retirement age, (2) early retire-

ment benefits, (3) disability benefits that plans may offer to participants who become disabled before plan termination, and (4) certain benefits for survivors of plan participants.

The Pension Benefit Guaranty Corporation typically pays benefits as a stream of monthly payments for life. However, PBGC may pay small benefits yearly rather than monthly. If the present value of future benefits is less than \$5,000, the recipient may elect a lump sum instead of a stream of payments.

Glossary of Key Terms

This section contains definitions for key terms found throughout the publication.

Accrued Benefit – For defined benefit plans, the accrued benefit is the amount that the plan participant will receive annually as a life annuity beginning at the plan’s normal retirement age, as determined by the plan benefit formula. For defined contribution plans, the accrued benefit is the balance of a participant’s individual account. This balance includes the sum of participant and/or employer contributions and investment returns (gains or losses), dividends, and capital gains (or losses) attributable to those contributions.

Annuity – A series of periodic benefit payments (either annual or monthly) that begins at retirement and continues for a certain period of time or the participant’s lifetime. Annuities may continue through the lifetime of a participant’s surviving spouse.

Blackout – A blackout occurs when a plan sponsor suspends, restricts, or limits – for a period of three or more consecutive business days – the ability of participants or beneficiaries (as otherwise available under the terms of the plan) to direct the investment of assets in their accounts, obtain loans, or obtain benefit distributions. Although the plan sponsor has suspended account transactions, participants continue to accrue benefits. Blackouts may be implemented for a number of reasons such as when a plan sponsor

changes administrators or when a plan must perform administrative tasks that require a temporary suspension of account activity.

Cash Balance Plan – A type of defined benefit plan that combines certain features found in both defined benefit and defined contribution plans. Participants’ benefits are determined by a formula, like a defined benefit plan, but benefits are expressed as account balances, similar to a defined contribution plan.

Defined Benefit Plan – A type of qualified plan where the plan sponsor provides a guaranteed benefit generally expressed as monthly benefit based on a formula that generally combines salary and years of service to the company. Defined benefit plans express benefits as an annuity, but may offer departing participants the opportunity to receive lump sum distributions.

Defined Contribution Plan – A type of qualified plan that establishes individual accounts for employees to which the employer, participants, or both make periodic contributions. Defined contribution plan benefits are based on employer and participant contributions to and investment returns (gains and losses) on the individual accounts.

Participants may be able to direct the investment of the assets in their individual accounts.

Elective Deferrals – Voluntary contributions that a defined contribution plan participant may elect to have made to his or her individual account. These contributions are made from the employee's pretax income, and participants do not include these contributions as taxable income until they receive benefits.

Employee Retirement Income Security Act of 1974 (ERISA) – The federal law that sets minimum standards for pension plans sponsored by private employers. These standards govern the management, operation, and funding of the plan. The Department of Labor's Pension and Welfare Benefits Administration enforces these ERISA provisions.

Employee Stock Ownership Plan (ESOP) – A defined contribution plan feature that requires the plan sponsor to invest plan assets primarily in shares of the employer's stock. Through an Employee Stock Ownership Plan, the employer makes tax-favored contributions of company stock to individual participant accounts.

Employer Matching Contributions – Employer contributions made to defined contribution plan participants' accounts only if the participant makes elective contributions to the plan. Matching contributions are generally based on a specified percentage of the employee's salary and the rate at which the participant contributes.

401(k) Plan – A type of defined contribution plan feature (provided under section 401(k) of the Internal Revenue Code) that allows employees to reduce a portion of their current compensation for a contribution, on a pretax basis, to a qualified retirement account. Generally, participants may direct the investment of their account balances among a menu of investment options offered by their employer. Many sponsors match a portion of participants' pretax contributions.

Floor-offset Arrangement – Floor-offset arrangements are a type of hybrid plan that consists of two separate, but associated pension plans—a defined benefit “floor” plan and a defined contribution “offset” plan. Benefits provided by the defined benefit formula represent the minimum level, or the “floor,” of total pension benefits that a plan participant is entitled to. The defined contribution plan (“offset” plan) establishes individual accounts for participants to which the employer and/or participant may make contributions. If the defined contribution plan provides a total benefit that equals or exceeds the benefit provided by the defined benefit floor plan, the participant receives (only) the accumulated balance in his or her defined contribution plan account. In the event that a participant's defined contribution account balance is less than the benefit from the defined benefit plan, the defined benefit plan makes up the difference between the benefit it provides and the amount the participant has accumulated in the defined contribution plan.

Hybrid Plan – A plan that contains features of both defined benefit and defined contribution plans. For example, a hybrid plan may provide benefits based on a formula like a defined benefit plan, but pension benefits are expressed as an account balance like a defined contribution plan. Cash-balance plans and floor-offset arrangements are hybrid plans.

Individual Account – Defined contribution plan participants have individual accounts to which they and/or the employer may make periodic contributions. The benefits that participants receive are based on the contributions to and the investment returns on these accounts.

Individual Retirement Account – A retirement arrangement authorized by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code. Banks and other financial institutions may make Individual Retirement Accounts (IRAs) available to workers. IRAs allow workers to make tax-deductible and nondeductible contributions to an individual account. For workers who meet certain conditions regarding their income or who are not eligible to participate in their employer's pension, contributions to an Individual Retirement Account receive favorable tax treatment; workers may take a current deduction on the contributions they make to their retirement accounts. Recently, another type of Individual Retirement Account, known as the ROTH IRA, that allows workers to make after-tax contributions and provides tax-free withdrawal of assets at retirement has been made available.

Internal Revenue Code of 1986 (IRC) – Establishes requirements that private pension plans must satisfy, including minimum requirements on coverage and benefits, in order to be qualified for tax-favored status. Employers who sponsor tax-qualified plans are entitled to a current deduction (within limits) for the contributions they make to their plans. Also, contributions to a tax-qualified plan are not included in an employee's income until he or she received benefits. The Internal Revenue Service enforces IRC requirements that apply to tax-qualified plans.

Joint and Survivor Annuity – A type of annuity payment option that provides an annuity benefit for the surviving spouse of a retired plan participant after the participant dies. In a defined benefit plan, the normal form of payment must provide a joint and survivor annuity to married participants. The benefit payment received by the surviving spouse must equal at least one half of the annuity benefit payment that the plan participant had received.

Lump Sum Distribution – The payment of a participant's accrued benefit as a one-time lump sum cash payment. Upon separation from the company, disability, or retirement a participant may be able to elect to receive his or her benefit in this form.

Minimum Funding Requirements – Certain defined benefit and defined contribution plans subject to the Employee Retirement Income Security Act must satisfy minimum funding

requirements that are intended ensure plan assets are sufficient to pay benefits when due to participants.

Multiemployer Plan – A multiemployer plan is a collectively bargained arrangement between a labor union and a group of employers in a particular trade or industry. Management and labor representatives must jointly govern these plans.

Nondiscrimination Rules – Private employers that sponsor tax-qualified plans must satisfy certain requirements regarding how benefits or contributions are distributed between rank-and-file employees and highly compensated employees such as company executives and owners. These rules are intended to ensure that highly compensated employees do not receive a disproportionate share of the plan's benefits. There is a general nondiscrimination requirement that applies to all benefits, rights, and features of the plan.

Nonqualified Pension Plan – An employer-sponsored pension plan that does not meet the applicable requirements for tax-qualification under the IRC. Employers do not receive a current deduction on contributions they make and employees do not receive a tax deferral on the contributions they make to nonqualified plans. Unlike qualified plans, nonqualified plans typically do not have to satisfy laws and regulations requiring a minimum level of benefits or contributions to the plan.

Pension Benefit Guaranty Corporation (PBGC) – A federal corporation created by ERISA to insure the pension benefits of participants in

qualified defined benefit pension plans. The Pension Benefit Guaranty Corporation takes over terminated defined benefit plans with insufficient assets to pay the benefits to which participants are entitled, and is responsible for paying those benefits up to certain limits set by law. PBGC does not cover defined contribution plans.

Plan Fiduciary – Defined by ERISA as any person who exercises discretionary control or authority over the management of a private pension plan and/or the plan's assets, has the authority to render advice regarding plan assets in return for compensation, and/or has discretionary authority or responsibility in the administration of the plan. The plan fiduciary is obligated to act prudently and exclusively in the interest of the plan participants and beneficiaries.

Plan Freeze – A period in which a plan sponsor amends the retirement plan to stop all benefit accruals. When a plan is frozen, employees who participate in plan do not accrue any additional benefits after the effective date of the plan freeze, and new employees are prevented from participating in the frozen plan. This can be done in order to terminate the plan, transfer the plan to another employer, or to make other changes to the plan after participants' currently accrued plan benefits have been paid.

Plan Termination – An employer may terminate its plan so long as it meets certain requirements. In certain instances, a plan may not have sufficient assets to pay participants' accrued

benefits, and the Pension Benefit Guaranty Corporation may take over the plan.

Qualified Pension Plan – An employer pension plan that receives preferential tax treatment in exchange for satisfying certain requirements established in the Internal Revenue Code of 1986 (employers receive a current deduction on contributions they make to qualified plans within certain limits). Under current law, there are a number of requirements that private pension plans must satisfy, including non-discrimination, benefit or contribution limitations, and minimum requirements on coverage and benefits, in order to be tax-qualified.

Roll-over – A direct transfer of pension benefits received as a lump sum payment to another tax-qualified retirement plan or an Individual Retirement Account free of taxes. Employers who sponsor qualified plans and enable departing participants to receive benefits as lump-sum amounts must give

participants the option to have these amounts “rolled-over.”

Trust – A legal arrangement distinct from the plan sponsor where the contributions to the pension plan are deposited with a trustee. The trustees of the plan hold the title to all plan assets, whether they direct the investment of plan assets or the investment of plan assets is the responsibility of an appointed fiduciary or plan advisor.

Vesting – Refers to when a plan participant has earned a right to a benefit that cannot be taken away (i.e., a nonforfeitable right to the participant’s accrued benefit). There are certain rules that private plan sponsors must follow regarding the length of time that participants must work in order to be fully-vested in their accrued benefits. Participants are 100 percent vested in any contributions they make to a qualified plan, but may have to work for a certain period of time before earning a right to their employer’s contributions.

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