Common Defined Contribution Plans

Learning Objective: Identify primary characteristics of profit-sharing plans, solo 401(k) plans, 403(b) plans, stock bonus plans, and employee stock ownership plans (ESOPs).

Although the 401(k) plan is the most common type of DC plan, there are several other types of DC plans available to employers. In this section, we will cover some common types, including

- Profit sharing plans
- Solo 401(k) plans
- 403(b) plans
- Stock bonus plans and employee stock ownership plans (ESOPs)

Profit Sharing Plans

One type of DC plan is a **profit-sharing plan**(A defined contribution retirement plan that allows the plan sponsor to make discretionary contributions funded primarily from its profits.) A qualified profit-sharing plan allows employers to make discretionary, nonelective contributions to employees' retirement accounts that are deductible within IRC limits. Profit sharing plans are funded solely by employer contributions.

A profit-sharing plan may be integrated with a 401(k) plan that allows employees to defer a portion of their compensation into their account, as well as accepting employer matching and profit sharing or stock bonus contributions.

While employers aren't required to make contributions to a profit-sharing plan every year, contributions are required to be "recurring and substantial." According to IRS guidelines, employers who haven't made contributions in three of the past five consecutive years risk violating the "recurring and substantial" requirement.

Profit sharing plans must provide a definite predetermined formula for distributing profits among the plan participants. Contributions to each participant account are limited to the lesser of

- 25% of compensation or
- $66,000 for 2023

Plans typically distribute profits to employee accounts based on their compensation, although some plans allocate profits based on both compensation **and** length of service.

Under the compensation only method, an employer uses the ratio below to determine the amount to contribute to each participant's account.

$$\text{Amount of employer contribution to participant's retirement account} = \frac{\text{Participant's total annual compensation}}{\text{Total compensation of all covered participants for the year}} \times \text{Annual profit-sharing contribution by the company}$$

Examples: This year, The Atlas Company will make an annual profit-sharing contribution of $60,000 to its qualified plan. The total annual compensation of all covered participants is $800,000. Rick Macy is a plan participant with annual compensation of $40,000.

$$\text{Amount of employer contribution to participant's retirement account} = \frac{\$40{,}000}{\$800{,}000} \times \$60{,}000$$

$$= 0.05 \times \$60{,}000$$

$$= \$3{,}000$$

So, the amount allocated this year to Rick's retirement account is $3,000.

Solo 401(k) Plans

A **solo 401(k) plan** (A type of 401(k) plan covering a business owner with no employees, or that person and his or her spouse. These plans have the same rules and requirements as any other 401(k) plan.) sometimes known as a *one-participant 401(k) plan*, is available to business owners who do not have any employees. IRS rules specify that the plan can cover only the business owner and the business owner's spouse, if the spouse earns an income from the business.

Solo 401(k) plans have the same contribution requirements as any other 401(k) plan, but the business owner is both the employee and the employer. In such plans, the business owner can

- Make employee pre-tax contributions up to the plan's annual maximum limit, with taxes deferred until funds are withdrawn in retirement
- Include a Roth feature that allows for after-tax contributions
- Make employer plan contributions up to annual maximum limits
- Increase contributions in good years or save less in other years because there are no annual minimum contribution requirements
- Achieve additional tax savings by
    - Deducting pre-tax contributions made as an *employee* from personal income taxes, and
    - Deducting the *employer* contributions as business expenses

There are points to remember about solo 401(k) plans. First, contribution limits on elective deferrals are by *person* and not by plan. As a result, a self-employed individual who is also employed by a second company and participates in that company's 401(k) plan must calculate the total of elective deferrals to all plans during a year when determining maximum contributions. Second, if the business grows and adds an employee, the solo 401(k) plan must be converted to a regular 401(k) plan.

Examples: Lindsay Bozardt, age 58, earned $60,000 as the owner and employee of Lindsay's Landscapes. As an employee in 2023, she could defer up to $30,000 ($22,500 maximum employee elective contribution + $7,500 catch-up contribution limit) to the solo 401(k) plan. Her business could contribute 25% of her compensation, or $15,000 (0.25 × $60,000) to the plan. Total contributions would equal $45,000 ($30,000 employee deferral + $15,000 employer contribution).

If Lindsay was employed by another company and participated in a 401(k) plan there, she would need to ensure that the combination of her elective deferrals to both plans did not exceed the $30,000 maximum for employees age 50 or older.

Note: A special calculation is required for self-employed individuals to determine the maximum amount of elective deferrals and nonelective contributions. This computation is outside the scope of this course.

Administration

Solo 401(k) plans are not subject to nondiscrimination testing because a potential disparity would not occur. Administration requirements are less onerous than traditional 401(k) plans: although solo 401(k) plans are required to file a Form 5500-EZ once they reach $250,000 in assets, plans with lower amounts may be exempt from the filing requirement.

403(b) Plans

A **403(b) plan** (A defined contribution retirement plan available to employees of tax-exempt organizations established for religious, charitable, and educational purposes and public schools. Employees save for retirement by contributing to individual accounts on a pre-tax or post-tax basis, and earnings accrue on a tax-deferred basis. Employers can also contribute to employees' accounts.)is a retirement plan that is similar to a 401(k) plan but available only to employees of certain public sector and private tax-exempt organizations. Tax-exempt organizations that can set up 403(b) plans include those established for religious, charitable, and educational purposes. Plans sponsored by private tax-exempt employers are usually subject to ERISA, while plans sponsored by a government agency or school and church organizations are typically exempt from ERISA.

Contributions

Contributions to a 403(b) plan may include

- Employee contributions:
  - Pre-tax
  - Designated Roth
  - After-tax
- Employer contributions — allowed but not required
  - Matching
  - Discretionary

Contributions to a 403(b) plan can be invested in either annuities or mutual funds. Once known as *tax-sheltered annuities* or *tax-deferred annuities*, 403(b) plans provided only annuity contracts prior to 1974. Because the participants usually have the ability to direct the investment of the contributions, they are assuming the investment risk.

403(b) Plan and 401(k) Plan Similarities

- Plan participants can make contributions to their own accounts.
- Plan participants are eligible, at times, to contribute to multiple retirement plans that are subject to an annual combined maximum contribution limit that applies to the participant rather than the plan.
- Plan sponsors can make matching and/or discretionary contributions, although they are not required to do so. If a private, tax-exempt employer contributes to a 403(b) plan, however,

the plan becomes subject to the requirements of ERISA, and nondiscrimination testing requirements will apply.

- The plan may, but is not required to, allow loans and hardship withdrawals.
- Distribution rules allow participants to make withdrawals if they
  - Suffer a qualifying hardship
  - Are eligible for a plan loan
  - Terminate employment (change jobs, retirement, disability, or death)
  - Reach age 59½

403(b) Plan and 401(k) Plan Differences

In addition to requiring that 403(b) participants work for certain types of employers, 403(b) plans are different from 401(k) plans in that a 403(b) plan

- May allow additional 15-year catch-up deferrals for employees who have completed at least 15 years of service; these deferrals are separate from the age 50+ catch-up contribution.
- Is unable to accept profit sharing contributions from the sponsoring employer.
- Is not usually required to comply with ERISA, which may result in lower administrative costs. However, as mentioned earlier, if a private tax-exempt employer contributes to a 403(b) plan, the plan becomes subject to the requirements of ERISA.
- Is limited to the following types of plan assets:
  - An annuity contract
  - Mutual funds
  - A retirement income account (plans for church employees only)

Stock Bonus Plans and Employee Stock Ownership Plans (ESOPS)

Other types of defined contribution plans allow an employer to contribute stock to employee accounts. A **stock bonus plan**(A type of profit-sharing plan that is funded primarily by employer contributions and that provides benefits in the form of shares of company stock rather than cash.) allows participants to share in employer profits through distributions of the employer's stock rather than in cash. The employer funds the plan with shares of its own stock or with a cash contribution, which is then used to purchase the employer's stock on behalf of the participant. The value of a participant's account at any given time is stated as a specific number of shares of stock.

An **employee stock ownership plan (ESOP)** (A type of bonus plan under which employer contributions are invested primarily in the employer's stock, and the employer can borrow money to fund the plan.)is similar to a stock bonus plan but has slightly different tax and legal characteristics. In an ESOP, an employer can borrow money from the company or, using its credit, borrow from a lender to pay for its own stock to fund the plan. Thus, the employer receives cash in exchange for the stock. The employer then makes annual tax-deductible contributions to the plan that are used to repay the loan.

Employer contributions for both stock bonus plans and ESOPs are tax deductible up to IRC limits. For both types of plans, rules regarding eligibility, vesting, and taxation of distributions are generally the same as for other DC plans. Hardship withdrawals and loans may be permitted by these plans.

Example

The Collective Corp sponsors an ESOP for its employees. Last year, the plan borrowed $10,000 from a commercial lender and paid this amount to Collective Corp in exchange for Collective Corp stock.

This year, Collective Corp can make tax-deductible plan contributions in cash, which the plan can use to repay the loan.

Considerations for Employers and Participants

With a stock bonus plan or an ESOP, a disproportionate amount of an employee's retirement savings might be in one investment—the company's stock. Public companies are required to allow their employees to diversify out of the company's stock into another investment option. The requirement that companies buy distributed stock back at an employee's request can be considered a disadvantage to employers. If the stocks are traded publicly, however, employers may not have to purchase them.

- Employer contributions to profit sharing plans are not fixed and may change from year to year. Employers may decide not to make any contribution in some years. Even though employer contributions are not required every year, these contributions must be recurring and substantial over time. Profit sharing plans are required to have a definite formula for distributing profits among plan participants. Employees are not allowed to make contributions.
- A self-employed individual who is also employed by a second company can participate in that company's 401(k) plan, but the individual must calculate the total of elective deferrals to all plans during a year when determining maximum contributions.
- The value of a participant's account in a stock bonus plan at any given time is stated as a specific number of shares of stock.

Retirement Plans for Small Businesses and the Self-Employed

Learning Objective: Describe simplified employee pension (SEP) plans and SIMPLE plans (savings incentive match plans for employees).

A variety of workplace retirement plans are available for small businesses and the self-employed. In comparison to 401(k) plans, these workplace retirement plans typically cost more to establish and administer.

In addition to solo 401(k) plans, there are other types of workplace retirement plans geared toward small businesses and those who are self-employed. SEP plans and SIMPLE plans provide a way for small employers to help fund retirement for their owners and employees.

Simplified Employee Pension (SEP) Plans

A **simplified employee pension (SEP)** (A written arrangement that allows an employer to make deductible contributions to a traditional IRA—referred to as a SEP IRA—set up for a plan participant to receive such contributions.) plan is a type of employer-sponsored retirement plan available to employers of any size. SEPs are popular with small employers and the self-employed because they allow discretionary contributions and have no IRS filing requirements, which reduces complexity and administrative costs. The employer sets up an account, known as a **SEP IRA**(A traditional IRA account set up under a SEP plan to receive contributions.), for each eligible employee, at a financial institution.

SEP Characteristics

Let's look at some characteristics of SEPs. Click or touch each item below to learn more.

Eligibility

An employer that offers this type of arrangement must allow all employees to participate in the plan if they meet the maximum age, service, and earnings requirements.

Who's eligible to participate?

- Participants who have reached age 21.
- Participants who have worked for the employer for three of the last five years.
- Participants who earn at least a stated minimum amount, which is $750 in 2023. This relatively low amount means that the plan must usually include part-time workers.

Employers can be less, but not more, restrictive in their eligibility requirements. For example, an employer could allow employees who are at least 18 years old to participate instead of the mandatory age of 21.

Contributions

Only the employer may make contributions to a SEP IRA, and these contributions are discretionary. Beginning in 2023, employers are allowed to offer employees the option of receiving contributions as either pre-tax or Roth contributions. Either type of employer contribution is 100% immediately vested.

Total annual employer contributions are limited to the lesser of 25% of an employee's compensation or a stated dollar amount ($66,000 for 2023). For the self-employed, compensation is based on net earnings, with a calculation that is outside the scope of this lesson. Employees cannot contribute to a SEP, so there are no employee elective deferrals or catch-up contributions.

Investment Risk

Employees are able to choose the investments in their SEP IRA, so they bear the investment risk.

Vesting

Employees are always 100% vested in the balance of their accounts. Employees can withdraw all or part of the account balance at any time.

Distributions

SEP rules do not permit participant loans. Because employees may withdraw funds from their SEP IRA at any time, for any reason, hardship withdrawal rules do not apply.

Participants may roll over amounts in a SEP IRA to another type of IRA or qualified plan that allows it.

Generally, distributions from SEP IRAs are subject to the withdrawal and tax rules that apply to traditional IRAs, which we'll cover in a later module.

Example

Maggie Clark is an employee of Retro Records, a store with 15 employees. Maggie makes $40,000 per year. Retro Records contributes 25% of her compensation, equal to $10,000 (0.25 × $40,000), into her

SEP IRA for the year. Maggie is able to select the investments in her account. Although she is not permitted to make contributions, she is always fully vested and owns the entire account balance.

Though she is not allowed to take a hardship withdrawal or a loan from her SEP IRA, she may take a withdrawal from the account at any time. Any distributions will be subject to taxation, and early distribution penalties may apply if she is under age 59½.

SIMPLE IRAs and SIMPLE 401(k) Plans

SIMPLE IRAs(*Savings incentive match plan for employees (SIMPLE) IRA; a defined contribution plan for businesses with less than 100 employees that allows employees and employers to contribute to traditional IRAs.***)** and **SIMPLE 401(k)(**Savings incentive match plan for employees (SIMPLE) 401(k); a type of 401(k) plan an employer with 100 or fewer employees can establish for eligible employees (including self-employed individuals).) plans are similar workplace retirement plans available to employers with 100 or fewer employees. Like SEP plans, SIMPLE IRAs and SIMPLE 401(k) plans have lower start-up and operating costs than standard 401(k) plans.

SIMPLE IRAs are established by adopting either Form 5304-SIMPLE (if plan participants select the financial institution holding the account) or Form 5305-SIMPLE (if the employer designates the financial institution). An employer may choose to use a custom-designed plan document. SIMPLE IRAs do not require annual filings with the IRS.

SIMPLE 401(k) plans are qualified plans and do require an annual Form 5500 filing, just like regular 401(k) plans. As with a 401(k) plan, SIMPLE 401(k) plans must also issue summary annual reports and individual benefit statements to participants. However, these plans are not subject to the nondiscrimination rules that apply to regular 401(k) plans.

Unlike SEP plans, the employer utilizing a SIMPLE IRA or SIMPLE 401(k) plan is required to meet a minimum level of contributions, and employees are allowed to make elective deferrals into SIMPLE plans.

SIMPLE IRA and SIMPLE 401(k) Plan Characteristics

Now, let's learn more about the characteristics of SIMPLE IRAs and SIMPLE 401(k) plans.

Eligibility

Like all plans, an employer that offers a SIMPLE IRA or SIMPLE 401(k) plan must allow all employees to participate in the plan if they meet the eligibility requirements. Employers may have less, but not more, restrictive eligibility requirements.

Employees are eligible to participate in a SIMPLE IRA if they

- Earned at least $5,000 during any 2 years prior to the current calendar year AND
- Expect to earn at least $5,000 during the current calendar year

There is no minimum age requirement to participate in a SIMPLE IRA.

Employees are typically eligible to participate in a SIMPLE 401(k) plan when they

- Reach at least 21 years of age
- Complete one year of service
- Earn at least $5,000 during the prior year

Contributions

Employees may and employers must make contributions to a SIMPLE IRA or SIMPLE 401(k) plan. These plans may also have an automatic enrollment feature.

For both types of plans, starting in 2023, employee contributions can be made on a pre-tax basis or designated as Roth contributions. Employee contributions are subject to an annual maximum of $15,500 (2023). A catch-up contribution of $3,500 is allowed for employees age 50 or older.

The employer has two options for making required annual SIMPLE IRA contributions:

- *3% matching contribution*: Match an employee's contributions dollar-for-dollar on the first 3% of the employee's compensation* OR
- *2% nonelective contribution*: Contribute 2% of each eligible employee's compensation to that employee's account, regardless of whether or how much the employee contributes. Nonelective contributions are subject to the employee compensation limit ($330,000 for 2023).

* The employer may make a matching contribution as low as 1% in a given year but may not contribute less than the 3% match for more than 2 calendar years out of a 5-year period from when the reduction occurs.

In a similar manner, the employer has two options for making required annual SIMPLE 401(k) plan contributions, ***both*** of which are subject to the annual employee compensation limit ($330,000 for 2023):

- *3% matching contribution*: Match an employee's contributions dollar-for-dollar on the first 3% of the employee's compensation OR
- *2% nonelective contribution*: Contribute 2% of each eligible employee's compensation to that employee's account, regardless of whether or how much the employee contributes

For both types of plans, the employer may choose the method each year and must notify employees during the **election period** which method will be used for the following year. Effective in 2023, employers may allow employees the option of receiving pre-tax or Roth contributions. Employer contributions are deductible as a business expense. Employees may change their contribution levels for the coming year during the election period and may discontinue contributions at any time during the plan year.

Election period: Generally, the 60-day period immediately before January 1 of a calendar year (November 2 to December 31 of the preceding calendar year) before which an employer must notify employees of their option to make or change salary deferrals to a plan and the employer's choice to make either matching or nonelective contributions to the plan.

Investment Risk Employees are able to choose investments in their SIMPLE IRA or SIMPLE 401(k), and they bear the investment risk.

Vesting Employees are always 100% vested in the balance of their SIMPLE IRA or SIMPLE 401(k) accounts. Employees can withdraw all or part of the account balance at any time.

Distributions

Distributions

- Are taxable as ordinary income in the year in which they are received.
- Are subject to a 10% penalty for withdrawals before the person reaches age 59½, with some exceptions. For plan participants in the plan for less than two years, the 10% penalty is increased to 25%.
- Are subject to required minimum distribution rules.

SIMPLE IRAs

- SIMPLE IRAs are subject to most of the same withdrawal and tax rules that apply to traditional IRAs.
- Like SEPs, SIMPLE IRAs do not permit participant loans. Because employees may withdraw funds from their SIMPLE IRA at any time, for any reason, hardship withdrawal rules do not apply.
- Participants may roll over a SIMPLE IRA into another type of IRA or qualified plan that allows it.

Distributions

- Are taxable as ordinary income in the year in which they are received.
- Are subject to a 10% penalty for withdrawals before the person reaches age 59½, with some exceptions.
- Are subject to required minimum distribution rules.

SIMPLE 401(k) Plans

- May permit loans
- May permit hardship withdrawals
- May be rolled over to another plan or IRA

Examples: Chris Templeton, age 30, is an employee of Vintage Vinyl, a store with 20 employees. Chris makes $50,000 per year. Vintage Vinyl has a SIMPLE IRA for employees and makes nonelective contributions of 2% of compensation to the plan for each employee. If Chris contributes $15,500 (the maximum amount for 2023) to his SIMPLE IRA, the contributions for the year would be:

	$15,500	(Chris's employee contribution)
	$ 1,000	(Employer contribution of 2% = 0.02 × $50,000)
Total	$16,500	

Chris is able to direct the investments in the account. Chris is fully vested in the entire account balance and may make withdrawals at any time. The plan does not permit hardship withdrawals or loans. Any distributions will be subject to taxation, and early distribution penalties may apply if he is under age 59½.

Taylor Cronley, age 25, is also a Vintage Vinyl employee. Taylor makes $40,000 per year but does not contribute to the plan. Because Vintage Vinyl makes nonelective contributions of 2%, the contribution for the year would be $800 (employer contribution of 2% = 0.02 × $40,000). Like Chris, Taylor is able to select the investments and is fully vested in the account balance. Taylor can take withdrawals at any time, even though Taylor did not contribute to the plan.

If either Taylor or Chris makes a withdrawal prior to participating in the plan for two years, the early distribution penalty will be 25% instead of 10%.

Let's Put It All Together

Check out the table below to compare the features of DB, DC, and other types of workplace retirement plans.

	Type of Employer	Who Is Allowed to Contribute?	Who Assumes Investment Risk?	Roth Feature Allowed?	Vesting	Hardship Withdrawals	Loans
Traditional DB Plan	Any	Usually Employer only	Employer	No	Schedule	No	Yes, but rare
Cash Balance Plan	Any	Usually Employer only	Employer	No	Schedule	No	Yes, but rare
401(k)	Any	Employer and Employee	Employee	Yes	Schedule	Yes	Yes
Solo 401(k)	Business owner with no employees other than a spouse	Employer and Employee (Business owner serves as both)	Employee	Yes	Immediate	Yes	Yes
Profit Sharing	Any	Employer only	Employee	No	Schedule	Yes	Yes
403(b)	Tax-exempt organizations, such as nonprofits and educational institutions	Employer and Employee	Employee	Yes	Schedule	Yes	Yes
Stock Bonus/ESOP	Any with stock, private or public	Employer only	Employee	No	Schedule	Yes	Yes
SEP	Any	Employer only	Employee	Yes	Immediate	No	No
SIMPLE IRA	Employers with 100 or fewer employees	Employer and Employee	Employee	Yes	Immediate	No	No
SIMPLE 401(k)	Employers with 100 or fewer employees	Employer and Employee	Employee	Yes	Immediate	No	Yes

401(k), 403(b), and SIMPLE IRAs allow employee contributions to the plan. Profit sharing, stock bonus, and SEP plans are funded only by employer contributions.

401(k) and 403(b) plans, and now SIMPLE IRAs, may have a Roth feature for employee contributions. Profit sharing, stock bonus, SEP, and SIMPLE IRA plans are funded only by pre-tax contributions.

401(k), 403(b), profit sharing, and stock bonus plans must follow a minimum vesting schedule for pre-tax employer contributions as outlined in the plan document. All contributions to SEP and SIMPLE IRAs (and SIMPLE 401(k) plans) vest immediately.

SIMPLE IRAs (and SIMPLE 401(k) plans) are only available to employers with 100 or fewer employees. Although SEP plans are frequently used by small businesses, there is no restriction on the number of employees.

Retirement Plans: Beyond the Basics

Learning Objectives:

- Distinguish between a qualified and a nonqualified retirement plan, and describe the characteristics of nonqualified deferred compensation (NQDC) plans.

- Identify common challenges employers encounter when deciding whether to offer a retirement plan.
- Describe the provisions of the SECURE Act designed to increase access to and participation in retirement plans and encourage the use of lifetime income options in plans.
- Describe the benefits of multiple employer plans (MEPs), as well as the reasons they have failed to gain traction among employers.
- Describe SECURE Act changes that make pooled employer plans (PEPs) appealing to employers, and describe the responsibilities of a pooled plan provider (PPP).

Nonqualified Retirement Plans

Learning Objective: Distinguish between a qualified and a nonqualified retirement plan, and describe the characteristics of nonqualified deferred compensation (NQDC) plans.

The vast majority of employer-sponsored retirement plans are qualified plans subject to ERISA requirements. However, employers may offer types of retirement plans, such as nonqualified deferred compensation (NQDC) plans, that don't have to satisfy ERISA requirements. Employers usually provide NQDC plans to select employees in addition to a qualified plan. Employers typically offer NQDC plans to reward key employees for meeting performance goals and staying with the company.

Nonqualified Deferred Compensation (NQDC) Plans

Deferred compensation is any arrangement between an employer and an employee that defers the payment of compensation until some point in the future. Within this context, qualified 401(k) and 403(b) plans that are subject to ERISA can be considered deferred compensation plans. However, the term "deferred compensation plan" is more commonly associated with **nonqualified deferred compensation (NQDC) plans (**An arrangement that provides for the delay of payment of income to a future year.**)**, which are exempt from ERISA's requirements.

Nonqualified deferred compensation plans offer tax advantages—but not the same ones that qualified plans offer. For example, employer contributions to an NQDC plan are not deductible to the employer until received by the employee. To maintain their tax advantages, NQDC plans must comply with Section 409A of the IRC.

Nonqualified deferred compensation plans are a way some employees can defer the taxation of compensation earned in one year until a later time or event, as stated in the plan. With the exception of some governmental plans, NQDC plans are generally not required to cover a broad range of employees. In the private sector, NQDC plans are usually designed to benefit key employees or top-level executives.

NQDC plans have many names and come in many varieties, but in this lesson we describe the most common types.

457 Plans

A **457 retirement plan(**A deferred compensation plan established by a state or local government or a tax-exempt organization.**)** may be offered by a state or local government or a nonprofit institution. Although exempt from ERISA, 457 plans are similar to qualified 401(k) and 403(b) plans that are subject to ERISA, and a 457 plan may be offered as a complement to those plans.

Governmental 457(b) Plans

Governmental 457(b) plans(A tax-advantaged nonqualified deferred compensation plan designed especially for employees of state and local governments.**)** are available to a wider range of employees than other NQDC plans discussed in this lesson. See below for characteristics of these plans and ways they are similar to, or different from, most qualified plans.

Contributions These plans may allow participants to make pre-tax or designated Roth contributions. Pre-tax contributions lower a participant's current taxable income, and income taxes are deferred on those contributions—as well as on the investment earnings—until the participant takes withdrawals from the account. Designated Roth contributions are made on an after-tax basis, and withdrawals from Roth accounts are not taxed if they satisfy certain requirements.

If a government employer sponsors both a 457(b) plan and either a 401(k) or 403(b) plan, participants may contribute the stated maximum amount to both plans. For example, in 2023, a participant under age 50 could contribute a maximum of $22,500 to a 401(k) plan and a maximum of $22,500 to a 457(b) plan.

Employer contributions to 457(b) plans are allowed but rare. Any contributions by a government employer to a 457(b) plan will count toward the participant's contribution limit for the year.

Example: Harley Hanover, age 45, works for a government agency that offers a 401(k) plan and a 457(b) plan. Harley earned $150,000 in 2023 and is eligible to participate in both plans. The agency matches 401(k) contributions 100% on the first 5% of employee contributions and makes a matching contribution of 100% of the first 3% of employee contributions to its 457(b) plan.
For 2023, Harley contributed the maximum allowable amount to each plan.

	401(k) Plan	457(b) Plan
Harley's contribution	$22,500 (maximum)	$18,000
Employer contribution	$ 7,500 (0.05 x $150,000)	$ 4,500 (0.03 x $150,000)
Total Contributions	**$30,000**	**$22,500 (combined maximum)**

Similar to 401(k) and 403(b) plans, participants age 50 or older can make catch-up contributions (up to $7,500 in 2023) to a governmental 457(b) plan.

Funding and Protection of Plan Assets

Like qualified plans, governmental 457(b) plans are required to be funded. Plan assets must be held in a trust for the benefit of plan participants.

Required Minimum Distributions (RMDs)

Like qualified plans, governmental 457(b) plans are subject to the RMD rules. Recall that, under the RMD rules, participants generally must begin receiving distributions from their plan accounts by a certain date.

Special Catch-Up Contributions

Governmental 457(b) plans may allow special catch-up contributions for participants in the three years prior to the normal retirement age specified in the plan.

Withdrawals

Unlike a qualified plan, withdrawals from a governmental 457(b) plan made before the participant retires or reaches age 59½ are **not** subject to a 10% penalty tax. However, ordinary income taxes are payable on any distributions.

Nongovernmental 457(b) Plans

Nongovernmental 457(b) plans can be established by non-church tax-exempt organizations, such as non-profit hospitals. These plans are limited to groups of highly compensated employees (HCEs)—such as managers, directors, or officers.

While the IRS does not legally define these HCEs, it does state that the intent is to cover a small percentage of the employee population comprised of key management employees and/or those who earn significantly more in compensation than other employees.

Contributions

Who Contributes: Nongovernmental 457(b) plans may allow employer and employee contributions. Employer contributions to nongovernmental 457(b) plans are more common than in governmental 457(b) plans.

Contribution Limits: Contribution limits apply to the total of employee and employer contributions. For 2023, the maximum contribution is the lesser of $22,500 or 100% of compensation.

Catch-Up Contributions: Participants age 50 or older are not permitted to make catch-up contributions, but catch-up contributions for those within three years of normal retirement age are allowed.

Designated Roth Accounts: Designated Roth contributions are not allowed in nongovernmental 457(b) plans.

Example

Dr. Treva Turner, age 51, is a physician employed by Mountaintop Hospital, which offers a 403(b) plan and a 457(b) plan. Dr. Turner earned $300,000 in 2023 and is eligible to participate in both plans, which have a normal retirement age of 65. The hospital matches 403(b) contributions 100% on the first 5% of employee contributions and makes a matching contribution of 100% of the first 3% of employee contributions to its 457(b) plan.

For 2023, Dr. Turner contributed the maximum allowable amount to each plan.

	403(b) Plan	457(b) Plan
Dr. Turner's contribution	$22,500 (maximum)	$13,500
Catch-up contribution	$ 7,500 (maximum)	$ 0
Employer contribution	$15,000 (0.05 x $300,000)	$ 9,000 (0.03 x $300,000)
Total Contributions	**$45,000**	**$22,500 (combined maximum)**

Dr. Turner is eligible to make an age 50 catch-up contribution to the 403(b) plan. She is not allowed to make a catch-up contribution to the 457(b) plan because these contributions are not allowed, and she is not within three years of the normal retirement age for the plan.

Funding and Protection of Plan Assets

To secure the tax deferral of contributions, a nongovernmental 457(b) plan must be unfunded with a "substantial risk of forfeiture," which means the amounts in the plan are merely a promise by the employer to pay the deferred compensation at some point in the future. As a result, assets are not held in a trust protected from creditors* as are qualified plan assets, so nongovernmental 457(b) plans are available to creditors in the event of bankruptcy, litigation, or mismanagement by the employer.

Note: A "rabbi trust" may be used to hold employee deferrals and is outside of the employer's control. However, these assets are still available to creditors in the case of bankruptcy or litigation.

What happens if a nongovernmental 457(b) plan is funded?

In this case, contributions are immediately taxable as income to the participant.

Withdrawals

As with governmental 457(b) plans, nongovernmental 457(b) plans are not subject to early withdrawal penalties.

Both governmental and nongovernmental 457(b) plans are subject to the RMD rules.

Additional Differences between Qualified Plans and Nongovernmental 457(b) Plans

Unlike qualified plans, such as 401(k) and 403(b) plans, nongovernmental 457(b) plans may **not**

- Use automatic enrollment
- Allow Roth designated contributions
- Permit loans
- Allow hardship withdrawals **UNLESS**
  - The distribution is required as the result of an unforeseeable emergency, AND
  - The participant has exhausted other sources of satisfying the financial emergency
- Be rolled over to other retirement plans, such as 401(k), 403(b), governmental 457(b) plans, or IRAs

Note: Some organizations sponsor "ineligible" 457 plans, known as 457(f) plans, which are outside the scope of this course.

Comparison of NQDC Plan Features with Qualified Plan Features

	NQDC Plans		Qualified Plans	
	Governmental 457(b)	Nongovernmental 457(b)	401(k)	403(b)
Eligible participants	Employees or independent contractors	Select employees; usually management or highly compensated	Employees who meet age and service requirements	Employees who meet age and service requirements
Subject to nondiscrimination testing	No; not subject to ERISA	No; not subject to ERISA	Yes; unless safe harbor plan	Only if subject to ERISA
Automatic enrollment permitted	Yes	No	Yes	No

Automatic enrollment permitted	Yes	No	Yes	No
Contributions	Usually employee only; elective salary deferral limit applies to all contribution sources	Both employer and employee; elective salary deferral limit applies to all contribution sources	• Employee: elective salary deferral limit • Employee and Employer: combined subject to higher limit based on compensation	• Employee: elective salary deferral limit • Employee and Employer: combined subject to higher limit based on compensation
Catch-up contributions	• Yes, for age 50+ • Special provision for employees within 3 years of NRA	• No age 50 catch-up • Special provision for employees within 3 years of NRA	Yes, for age 50+	• Yes, for age 50+ • Special provision for employees with at least 15 years of service
Roth feature allowed	Yes	No	Yes	Yes
Plan funding	Assets held in trust and protected from creditors	Unfunded; not protected from creditors	Assets held in trust and protected from creditors	Assets held in trust and protected from creditors
Hardship withdrawals permitted	Yes	Restricted	Yes	Yes
Loans permitted	Yes	No	Yes	Yes
Rollovers to other eligible plan or IRA	Yes	Restricted to other nongovernmental 457(b) plans	Yes	Yes
Withdrawals prior to age 59½ subject to 10% penalty tax	No	No	Yes	Yes
Subject to RMD rules	Yes	Yes	Yes	Yes

Supplemental Executive Retirement Plans (SERPs)

A **supplemental executive retirement plan (SERP)** (A nonqualified deferred compensation plan wherein a company promises supplemental retirement income to an executive or key employee, and that is funded by the company's current cash flow or through a cash value life insurance policy.) is an NQDC plan that companies often use as a way to reward and retain key employees. Like nongovernmental NQDC plans in general, SERPs are often referred to as **top-hat plans** (A type of nonqualified deferred compensation plan designed to benefit management and executive level employees of an organization.) because they're reserved for executives at the "top" of the organization.

A SERP is an agreement between a key employee and the employer in which the employer promises to pay the employee income in the future if the employee satisfies the conditions in the agreement.

SERP benefits are frequently tied to employee and company performance. Often the benefit payment is contingent on the employee working for the employer for a certain number of years.

The agreement specifies how the SERP benefit amount will be determined and when it will be paid. For example, the agreement may specify that the employer will credit a specific dollar amount annually to the employee for each year of employment or will credit an amount to fund a benefit equal to a percentage of the employee's salary over a certain number of years. Typically, the promised benefit payments begin in retirement.

Paying for a SERP

Although SERP benefits can be paid from current company funds, many employers use **cash value life insurance** (Life insurance that provides insurance coverage throughout the insured's lifetime and provides a savings element, known as the cash value. Sometimes referred to as permanent life insurance. Contrast with term life insurance.) on the life of the key employee to fund the future benefit payments. The employer uses the accumulated cash value in the policy to make payments to the employee. The policy is an asset of the business because the business is both the policyowner and the beneficiary of the policy. The employee pays no costs for the policy but must consent to the issuance of the policy.

When used to fund a SERP, cash value life insurance policies provide

- Tax-deferred growth of the policy's cash value
- Tax-free access to the policy's cash value by the employer
- A tax-free death benefit upon the death of the insured key employee to the employer

Unlike qualified plans and 457 plans, SERPs do **not** have contribution limits. The employer is not limited in how much it can provide to the key employee in retirement benefits through a SERP, and this amount is in addition to any other contributions to qualified plans or a 457 plan.

The employee pays income taxes on benefits in the year they are paid. The employer is able to take a tax deduction for the benefit amount in the same year the employee receives it.

Example: Lisa Lowenski, age 55, is an executive employed by Grammar Genius, Inc. and is included in Grammar Genius, Inc.'s SERP. If Lisa achieves her performance objectives and stays with the company for 10 years, she will be eligible to receive a benefit equal to 60% of her final salary for five years, beginning at age 65.
Grammar Genius, Inc. purchased a cash value life insurance policy on Lisa's life (with her consent) to pay Lisa's future benefits. Grammar Genius will be able to take a tax deduction for the premiums paid on the policy in the years in which Lisa receives payment of the benefit, and Lisa must pay taxes on the benefit payments when received.

Benefit Payments and Withdrawals

Although benefit payments are usually made at retirement, other events—such as death, disability, or termination of the plan—may also trigger benefit payments. The SERP will specify how benefits will be paid in each circumstance. Although the company is the policy beneficiary, provisions are usually made for a payout of accrued benefits to an employee's family when death or disability occurs prior to retirement.
As with 457 plans, withdrawals from SERPs prior to age 59½ are not subject to the early withdrawal tax penalty rules.
Unlike qualified plans and 457 plans, SERPs are not subject to the RMD rules.

Executive Bonus Plans

Like a SERP, an executive bonus plan may use cash value life insurance to attract and retain key employees. In this lesson, we will focus on bonus plans funded with life insurance. In addition to providing retirement income, such plans provide the insured executive with valuable pre-retirement life insurance protection.

Unlike a SERP, with an executive bonus plan, the premium the employer pays for the life insurance is a deductible expense for the employer in the year in which a payment is made, and the premium amount is taxable as income to the employee in the year the premium is paid. The employee, not the employer, is the owner of the policy and, as with any insurance policy, the employee has certain rights to the policy's cash value. If the employee dies, the policy's death benefit goes to the employee's family.

The cash value of the policy grows tax deferred, and the employee may be able to use the cash value to

- Make withdrawals
- Take a policy loan
- Supplement income in retirement

Typically, the plan will restrict the employee's access to the policy's cash value until a specific date, often retirement, as part of an arrangement to retain the employee. Executive bonus plans are not subject to RMD rules.

The employer may give the employee a "double bonus" to pay for any income taxes the employee owes as a result of having the executive bonus plan. If the executive leaves the company prior to retirement, the executive may have the right to continue paying premiums for the policy.

Comparison of SERPs and Executive Bonus Plans

	SERP	Executive Bonus Plan
Benefit Focus	• Retirement income • Pre-retirement death or disability benefit to survivors	Pre-retirement life insurance with cash value to provide retirement income
Tax Deduction for Employer/Recognition of Taxable Income by Employee	• Employer takes tax deduction when benefits are paid • Employee pays income taxes on benefits in the year they are received	• Employer takes tax deduction when premiums are paid • Employee pays income taxes on premiums in the year the premiums are paid
Owner of Life Insurance Policy	Employer	Employee
Beneficiary of Policy	Employer	Named by employee
Access to Cash Value	Employer	Employee, with potential restrictions

In comparison to qualified retirement plans, it is correct to say that nongovernmental NQDC plans

Ans: Though it's true that, compared to qualified plans, NQDC plans offer the potential for select employees to save more for retirement, nongovernmental NQDC plans do **not** offer the protection of plan assets that qualified plans offer. Unlike qualified plans, NQDC plans are not subject to tax penalties for withdrawals made prior to age 59½. Both qualified and NQDC plans are subject to RMD rules.

Governmental 457(b) plans are allowed to have automatic enrollment and Roth contribution features. Governmental and nongovernmental 457(b) plans **are** subject to the RMD rules. However, SERPs and executive bonus plans **are not** subject to the RMD rules. SERPs and executive bonus plans may be and often are funded with life insurance policies.

The SECURE Act

Learning Objectives

Identify common challenges employers encounter when deciding whether to offer a retirement plan.

Describe the provisions of the SECURE Act and the SECURE 2.0 Act designed to increase access to and participation in retirement plans and encourage the use of lifetime income options in plans.

In 2022, Congress passed the SECURE 2.0 Act as part of the Consolidated Appropriations Act to further expand access to retirement plans and encourage retirement savings. In this lesson, we'll use the term SECURE Acts to encompass the latest effective provisions in these bills.

Which of the following do employers often cite as reasons for not sponsoring a workplace retirement plan?

Ans: Employers often cite all of these reasons for not sponsoring a workplace retirement plan. Although administrative duties, fiduciary responsibilities, and plan costs are challenges associated with plan sponsorship, employees do seem to be interested and are likely to participate in workplace retirement plans when they have access to them.

Employer-sponsored retirement plans are a critical component of the retirement system in the United States. In 2019, the U.S. Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act to strengthen retirement security. The SECURE Act provisions expanded access to workplace retirement plans by providing additional incentives for employers to sponsor their own plan or join a group plan. The SECURE Act also updated plan requirements to increase plan participation and encourage the use of guaranteed lifetime income options in plans.

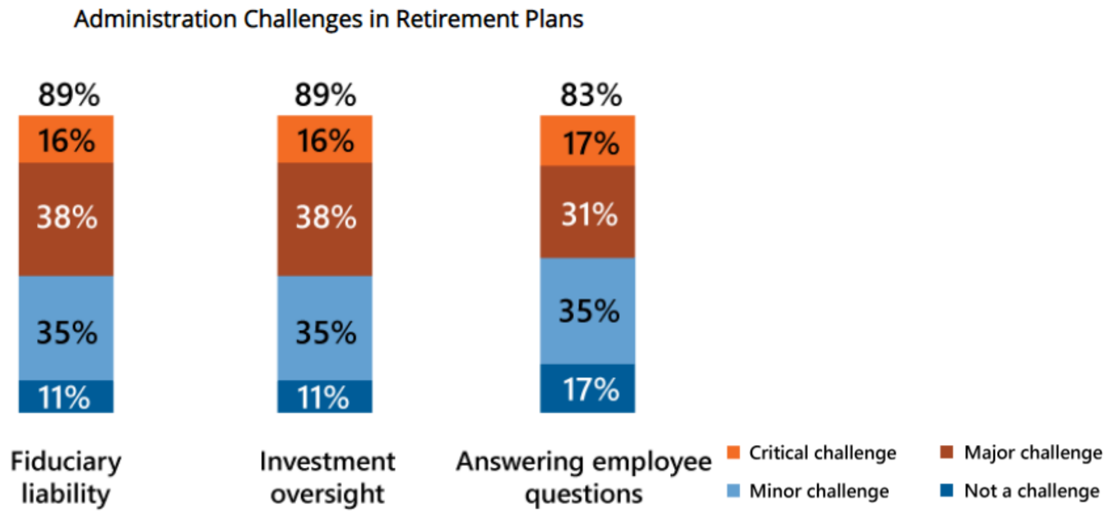
Studies show that people are more likely to save for retirement when they have access to an employer-sponsored workplace plan. For instance, workers earning between $30,000 and $50,000 are 15 times more likely to save for retirement if they have access to a payroll deduction savings plan at work. However, not every American has access to a retirement savings plan at work. According to LIMRA, 64% of all private industry workers have access to a defined contribution (DC) plan; that number decreases significantly for small companies.

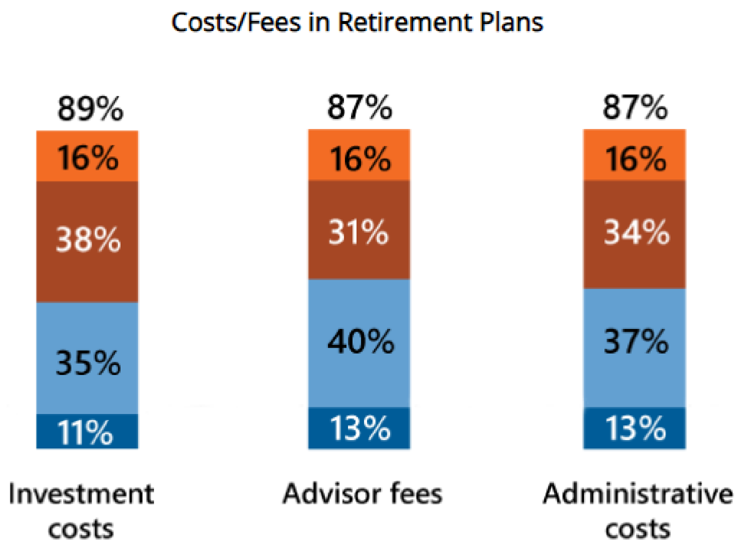
The following bar chart, categorized by company size, shows the percentages of private industry workers with access to DC plans.

Private Industry Workers with Access to DC Plans, by Company Size:

The percentage of private industry workers with access to DC plans is 48% for those working at a company with fewer than 50 workers, 62% for those working at a company with 50 to 99 workers, and 77% for those working at a company with 100 to 499 workers.

Why don't more employers offer a workplace retirement plan? In general, costs/fees and administration are two of the top challenges in offering a retirement plan.
The following figures—based on a LIMRA survey of plan sponsors—provide more details about these challenges.





Large companies are often better able to handle these duties. They can employ specialists and hire advisors, but many small companies do not have the same resources. For small companies, the responsibilities associated with employer-sponsored retirement plans can be overwhelming—which, unfortunately, may discourage them from offering a plan.

Expansion of Retirement Plan Access and Participation

Several provisions in both of the SECURE Acts are designed to encourage employers, in particular small employers, to become retirement plan sponsors. The SECURE Acts seek to expand access to retirement plans by offering tax credits for small employers who offer a plan. Small employers that include an automatic plan enrollment feature in either a new or existing plan receive an additional tax credit.

In order to encourage employee participation in 401(k) and 403(b) retirement plans, employers of any size are allowed to offer a small financial incentive, such as a gift card, to employees who join the plan.

In addition, the SECURE Acts mandate eligibility of part-time workers for 401(k) plan participation in certain circumstances. Plus, the SECURE Acts allow two or more unrelated employers to join a 401(k) plan. We will describe multiple employer plans (MEPs) later in this lesson.

Tax Credit to Establish and Maintain a Plan

The SECURE 2.0 Act increased the tax credit for employers with 50 or fewer employees who establish and maintain a retirement plan. The credit covers 100% of qualified start-up costs with an additional incentive schedule for defined contribution plans over the first five years of implementation. The credit is limited to $1,000 per employee. The tax credit phases out as the number of employees grows from 51 to 100.

Schedule of Tax Incentives for Employers with 50 or Fewer Employees	
Year	Tax Credit as % of Matching Contributions
First two years	100%
Third year	75%
Fourth year	50%
Fifth year	25%

A tax credit is also available for the first three years to small employers retroactively who joined MEPs in 2020 or later, after the passage of the first SECURE Act.

Tax Credit to Incorporate Automatic Enrollment Feature

To encourage employee participation in retirement plans, small employers can receive an additional $500 per year tax credit for either adding automatic enrollment to an existing retirement plan or incorporating automatic enrollment into the design of a new plan. The $500 credit is also available for up to three years.

Eligibility of Part-Time Workers in 401(k) Plans

Prior to the SECURE Act, part-time workers were typically excluded from plan participation if they had not worked 1,000 hours in a 12-month period. The SECURE Act requires employers to consider long-term, part-time workers to be eligible to participate in a 401(k) plan. Employees who complete at least 500 hours of service each year for three consecutive years and who are age 21 or older will be eligible.

However, these participants can be excluded from employer contributions, nondiscrimination testing, and top-heavy requirements.

Provisions to Increase Savings and Lifetime Income Options

Additional SECURE Act provisions are designed to increase savings and encourage plans to include a lifetime income option.

Savings

Studies show that, because inertia plays a role in employees' retirement plan savings behavior, automatic features in retirement plans can improve retirement outcomes. In one study, participation rates for new hires increased from 28% to 91% through the use of automatic enrollment.
Many participants remain at the initial deferral percentage (typically under 5%) rather than increasing their contribution rate over time. Setting a minimum initial deferral rate and incorporating an automatic escalation feature into the plan—increasing the savings rate by 1% per year up to a maximum percentage rate—can greatly increase participants' savings.
Under the SECURE Act, employers can increase the maximum deferral percentage for employee contributions from 10% of compensation to 15%.

Lifetime Income

Retirement plan funds allow plan participants to accumulate savings during working years that can be converted into income during retirement. However, workers often find it difficult to estimate how much income their account balance will provide, and, as a result, are unable to determine how much they need to save for retirement. The SECURE Act contains provisions addressing lifetime income illustrations for plan participant account balances, as well as provisions that may encourage the use of guaranteed lifetime income options in retirement plans.

Lifetime Income Illustrations

The SECURE Act requires ERISA-qualified DC plans to provide illustrations of the lifetime income a participant might receive if the total account balance were used to provide a lifetime income stream such as that provided by an annuity. A plan must include the lifetime income disclosure at least once during any 12-month period. Armed with this information, some participants may be motivated to increase contributions to the plan to improve their projected retirement income.

Goliath Global, Inc.
123 Winning Way
Greendale, CT 12345
800-555-4321

Retirement Statement
Voyage Financial At Your Service
https://GoliathGlobal401k.voyage.com
800-555-1357

Lifetime Income Illustration

This illustration projects the amount of monthly income the account balance would provide for your life only, or your life plus the life of your surviving spouse.

Account Balance as of 12/31/2021	$150,000
Single Life Annuity	$750 per month for life
Qualified Joint and 100% Survivor Annuity	$600 per month for life and life of surviving spouse

Assumptions used to create your lifetime income illustration:

- You are 67 years old and income payments begin on 12/31/2021.
- Your spouse, if applicable, is the same age.
- The interest rate in the calculation equals the current 10-year constant maturity Treasury securities yield rate.

Lifetime Income Annuity Options

The illustrations required by the SECURE Act are raising awareness of the importance of guaranteed retirement income. Annuities are an insurance product that provides guaranteed income and that might be suitable as a retirement plan option. However, plan sponsors worry about their fiduciary liability should an annuity provider not provide promised benefits in the future. These concerns are one reason that, prior to the SECURE Act, less than 10% of DC plans offered a lifetime income option. To protect plan sponsors, the SECURE Act contains safe harbor protection for plan sponsors who follow guidelines for the annuity provider selection. Generally, plan sponsors are protected from liability if they select an annuity provider, which, among other requirements, for the preceding seven years has

- Been licensed by the state insurance commissioner to offer guaranteed retirement income contracts
- Filed audited financial statements in accordance with state insurance laws
- Maintained reserves that satisfy all the statutory requirements of all states where the annuity provider does business

Other questions employers often have about adding an annuity option to a DC plan relate to what happens when a participant with an annuity leaves employment or when a plan discontinues the annuity option. In such situations, the SECURE Act allows participants to move their annuity to another qualified plan or IRA without being subject to surrender charges or fees. In other words, lifetime income annuities in retirement plans are now portable.

- The SECURE Act did increase the tax credit for small employers who establish and maintain a retirement plan. The Act also introduced a tax credit for small employers who include an automatic enrollment feature in a retirement plan. The Act requires DC plans to provide lifetime income estimates on statements at least annually to participants. However, the SECURE Act did not introduce a tax credit for including an automatic escalation feature in a plan. The Act did raise the maximum deferral percentage under automatic escalation from 10% to 15%.
- The SECURE Act makes lifetime income annuities in retirement plans portable by allowing participants to move their annuity to another qualified plan or an IRA without being subject to surrender charges or fees.

Multiple Employer Plans

Learning Objectives:

Describe the benefits of multiple employer plans (MEPs), as well as the reasons they have failed to gain traction among employers.

Describe SECURE Act changes that make pooled employer plans (PEPs) appealing to employers, and describe the responsibilities of a pooled plan provider (PPP).

In a multiple employer plan (MEP), a group of participating companies offers the same 401(k) plan to all employees of those companies.

The SECURE Act allows two or more unrelated employers to join together to form a 401(k) plan. To understand how this change may improve plan access, it is important to first look at how MEPs worked prior to the SECURE Act.

Multiple Employer Plans

Multiple employer plans (MEPs) (A type of retirement plan comprised of participants from two or more related or unrelated companies.) have been around for a while and present opportunities for administrative and cost efficiencies. A MEP enables multiple companies to pool their assets and join a single 401(k) plan—with a single plan document—that they can offer to their employees. The companies in the MEP who adopt the plan are called participating employers. A company that participates in a MEP may recognize several potential benefits:

- **Reduced fiduciary responsibility:** Some of the fiduciary responsibilities—such as selecting and monitoring a plan's investment options—shift to a party known as the MEP sponsor. However, each participating company retains the fiduciary responsibility for overseeing the MEP sponsor.
- **Economies of scale:** By pooling assets, the MEP is likely to have more negotiating power than any of the individual companies in the MEP. Thus, the MEP likely benefits from economies of scale for expenses such as plan document design, asset custody, recordkeeping, investment management, and filing Form 5500. In contrast, a small company sponsoring a single-employer 401(k) plan may incur a higher cost per employee for such plan expenses.
- **Reduced administrative duties:** Companies participating in a MEP consolidate the administrative workload by operating as a single plan. For example, instead of each company needing to prepare and file a Form 5500, the MEP sponsor can prepare and file one Form 5500 on behalf of all participating employers.

The following table compares the features of a single-employer 401(k) plan with a MEP 401(k) plan:

	Single-Employer 401(k) Plan	MEP 401(k) Plan
Number of Employers	One	Multiple
Number of Plan Documents	One	One
Fiduciary Responsibility	Employer has the fiduciary responsibility	Participating employers pass some fiduciary responsibility to the MEP sponsor

Administrative Duties	Employer is responsible for all	Participating employers are not responsible for all administrative duties
Plan Design	Employer has total control	Participating employers may cede control to the MEP sponsor
Investment Options	Employer has flexibility to change the options	Participating employers must accept investment options that are fixed at plan design
Form 5500	Employer prepares and submits the form	MEP sponsor prepares and submits one form for all participating employers
Plan Costs	Employer assumes all costs	Participating employers share some costs and may realize cost savings via economies of scale

In theory, MEPs are a way of expanding workplace retirement plan access for small business employees. Historically, however, two regulatory rules prevented them from doing so to any great extent: the commonality requirement and the "one bad apple" rule.

Commonality Requirement: Initially, the Department of Labor (DOL) required companies interested in forming a MEP to satisfy a commonality requirement. To form a MEP, the participating companies had to share a "common nexus"—that is, be a part of the same industry, be located in the same geographic region, or be members of the same trade association. In other words, unrelated companies couldn't come together to form a MEP, a restriction that greatly slowed MEP adoption. Because MEP participation was, in effect, closed to companies that didn't share the common nexus, this MEP structure became known as a closed MEP.

"One Bad Apple" Rule: Another reason that MEPs failed to gain traction was an IRS rule that became known as the "one bad apple" rule. Basically, if any participating employer in a MEP failed to comply with plan qualification requirements, the entire MEP could be disqualified—to the detriment of the compliant companies' plan participants.

Pooled Employer Plans

The SECURE Act made it easier for U.S. employers to pool assets in MEPs. Which barriers do you think this legislation addressed?
Ans: Provisions in the SECURE Act removed the barriers created by the commonality requirement and the one bad apple rule. However, the legislation did not remove the requirement of filing Form 5500.

The SECURE Act created the **pooled employer plan (PEP) (**A type of retirement plan that enables unrelated employers to pool assets to form a single 401(k) plan under ERISA, as long as the plan is administered by a pooled plan provider and meets other SECURE Act requirements.**)**, which is similar to a MEP but has attributes that many industry practitioners have long desired. The provision of the SECURE Act that pertained to PEPs took effect on January 1, 2021; the first PEPs hit the marketplace in the same year.

Like a MEP, a PEP provides its participating companies with the benefits of operating as a single retirement plan: reduced fiduciary responsibility and the potential for lower plan costs and fewer administrative duties. For instance, like a MEP, a PEP can complete and file one Form 5500 on behalf of all participating companies.

Notably, the SECURE Act removed the commonality requirement. Unrelated companies—such as ones from different industries—can join together in the same PEP. This provision will give employers more choices when determining whether to act as a single plan sponsor or to join with other employers to sponsor a plan.

In addition, the SECURE Act eliminated the liability risk of the "one bad apple" rule by providing pooled plans with a new method for handling noncompliant companies without affecting the compliant ones. The rule change, which was extended to MEPs, allows a MEP or PEP to remove the assets of the noncompliant company from the plan if the company cannot restore its compliance. By allowing a MEP or PEP to isolate a noncompliant company, the rule change prevents the "bad apple" from jeopardizing the compliance status of the plan's other participating companies. Thus, this rule change removes one of the deterrents to businesses interested in joining a MEP or PEP.

The SECURE Act gives PEPs a different audit structure than MEPs:

- For MEPs, an annual plan audit is required once the MEP has 100 participants in the plan.
- For PEPs, an audit is not required until there are more than 1,000 total participants or any single participating employer reaches more than 100 participants.

Pooled Plan Providers

One of the most significant provisions of the SECURE Act relates to plan administration and fiduciary responsibility. By law, a PEP must be administered by a **pooled plan provider (PPP) (**A party that serves as the named fiduciary and plan administrator for a pooled employer plan and is registered with the federal government, as required by the SECURE Act.**)**, a legal entity that assumes most of the fiduciary responsibility for the plan. A PPP must register with the DOL and the IRS before it can begin operating a PEP.

The PPP performs all of a PEP's administrative duties—such as conducting compliance testing, filing Form 5500, performing plan audits, and providing participants with required disclosures. In addition, the PPP is responsible for selecting and monitoring any service providers it chooses to use.

Although the PPP takes on the majority of the fiduciary responsibility, participating employers still retain the fiduciary responsibility of selecting and monitoring the PPP. For example, a participating company has a fiduciary responsibility to its plan participants to ensure the PPP's compensation is reasonable.

Who can become a PPP? Some of the likely candidates are third-party administrators (TPAs), **recordkeepers(**In the context of retirement plans, a company that maintains records and processes transactions for retirement plans and individual plan participants' accounts and that may perform other plan administration activities such as benefit payment, plan compliance testing, required reporting, and participant education.**)**, and **registered investment advisers (RIAs)***(According to the Investment Advisers Act of 1940, "A person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications."). For instance, a 401(k) recordkeeper might see value in expanding its business to provide PPP services. Other parties—such as banks, **asset management firms(**A firm that engages in the activity of investing and managing a portfolio of securities on behalf of an individual or an organization.**)**, **broker-dealers(**A financial institution that (1) buys and sells securities either for itself or for its customers and (2) provides information and advice to customers regarding the purchase and sale of securities.), and insurance companies—may also see value in registering as PPPs.

Registered Investment Advisors (RIAs): At the time of this writing, RIAs were awaiting further guidance regarding the potential for **prohibited transactions (**A transaction that is prohibited under ERISA or the Internal Revenue Code, unless the transaction qualifies for an exemption.**)**. IRC Section 4975(c)(1) bars a plan fiduciary from dealing with a plan's income or assets for its own interest or receiving compensation related to transactions involving the plan's income or assets. If an RIA serves as a PPP for a plan—thereby assuming most of the fiduciary responsibility—and provides affiliated investment services, it may be considered to have a conflict of interest. To be safe, an RIA who wants to serve as a PPP would have to hire a separate, unrelated advisor to provide investment management services—even though advising on the PEP's investments is one of the reasons an RIA would be interested in being a PPP in the first place! While RIAs may eventually receive exemptions from prohibited transaction rules, it isn't a regulatory certainty.

The following table compares MEPs and PEPs.

	MEPs	PEPs
Number of Employers	Multiple	Multiple
Number of Plan Documents	One	One
Commonality Requirement	Removed under the SECURE Act	No; open to unrelated employers
One Bad Apple Rule	Removed under the SECURE Act	Does not apply, per the SECURE Act
Fiduciary Responsibility	Participating employers share with the MEP sponsor	Mostly assumed by the pooled plan provider (PPP)
Plan Administrator	MEP sponsor performs some administrative duties	PPP performs most administrative duties
Form 5500	MEP sponsor prepares and submits one form for all participating employers	PPP prepares and submits one form for all participating employers
Plan Audits	Required once plan has 100 participants	Required once plan has 1,000 participants or any employer reaches 100 participants
Plan Costs	Participating employers may see cost savings via economies of scale	Participating employers may see cost savings via economies of scale

- MEPs may realize cost savings and can consolidate some administrative duties, such as preparing and filing a single Form 5500. Although participating companies transfer some fiduciary responsibilities to the MEP sponsor, they still retain some fiduciary responsibility, such as oversight of the MEP sponsor. In addition, by using a single plan document, participating companies cede control over certain aspects of the plan, such as plan design.

- With respect to the “one bad apple” rule, which of the following statements is true about the SECURE ACT?

➢ Ans: The SECURE Act decreased the liability risk of the “one bad apple” rule. The rule change applies to both MEPs and PEPs. As a result of the change, a plan can remove a noncompliant company without jeopardizing the compliance status of the plan’s other participating companies.

- A PEP must be administered by a [**plan participant** / **pooled plan provider**], which is a legal entity that assumes most of the [**fiduciary responsibility** / **tax benefits**] for the plan.

➢ Ans: By law, a PEP must be administered by a pooled plan provider (PPP). The PPP assumes most of the fiduciary responsibility for the plan.

- Suppose an employer is starting a workplace 401(k) plan and has certain objectives for the plan. Which of the following objectives might lead the employer to choose a PEP rather than a single 401(k) plan?

➢ Ans: A PEP would allow the employer to reduce fiduciary responsibility, pool assets with unrelated employers, and delegate administrative duties to a PPP. However, a PEP will not allow the employer to customize the plan design or retain control over investment options.

Conclusion

Employer-sponsored retirement plans are a critical component of the retirement system of the United States. In this module, we’ve described the primary types and characteristics of qualified and nonqualified retirement plans available to provide participants with retirement benefits or to assist in accumulating retirement savings. Employers have a wide variety of plans to choose from to fit the needs of their company and employees.