Learning Objectives

- Identify the primary characteristics of traditional defined benefit (DB) plans.
- Describe DB plan distribution and benefit payment requirements.
- Explain how traditional DB plans differ from cash balance plans.
- Identify the primary characteristics of defined contribution (DC) plans and recognize characteristics of 401(k) plans.
- Describe DC plan requirements for hardship withdrawals, plan loans, and distributions at termination of employment.
- Identify primary characteristics of profit-sharing plans, solo 401(k) plans, 403(b) plans, stock bonus plans, and employee stock ownership plans (ESOPs).
- Describe simplified employee pension (SEP) plans and SIMPLE plans (savings incentive match plans for employees).

Defined Benefit Plan Characteristics

In the last lesson, we discussed the requirements for qualified retirement plans and the agencies that regulate them. In this lesson, we turn our attention to the types of qualified retirement plans employers can select to provide benefits for their employees, or, in the case of self-employed individuals, themselves.

What works well for one company may not be right for another company. That's why it's important to understand how various retirement plans work and the factors that may influence an employer's decision of which type of plan to provide to employees.

We'll start with defined benefit (DB) plans. DB plans provide a stated benefit to plan participants, usually as a lifetime monthly income benefit beginning at retirement. These plans typically allow employer contributions only. The employer bears the investment risk for the plan assets and the responsibility for ensuring the funding of the plan.

According to the Bureau of Labor Statistics, only 15% of all current private sector workers have access to a DB plan.

A DB plan must have an **enrolled actuary**, who calculates the amount of the plan's required annual contributions. The calculation includes expected investment returns and projects the makeup of the employee group that will receive benefits. The amounts are adjusted each year due to factors such as salary increases, staffing changes, and actual investment returns on plan assets.

An employer must make mandatory contributions to its DB plan to ensure that the plan is adequately funded according to rules established by the IRS. These contributions must be made no later than 8.5 months after the end of the plan year.

The plan sponsor is responsible for the investment of plan assets and carries the investment risk for those assets. Investment earnings affect the amount of future contributions.

The IRC places limits on the *benefit payments* to participants.

In general, an annual benefit cannot exceed the lesser of

- 100% of the participant's average compensation for the participant's highest three consecutive calendar years of employment, or
- $265,000 for 2023

Some plans periodically make cost-of-living adjustments, which are increases made to pension benefit payments to fully or partially match the rate of inflation.

Enrolled actuary: An individual who has satisfied the standards and qualifications established by the Joint Board for the Enrollment of Actuaries and who has been approved by the Joint Board to perform actuarial services required for defined benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA).

Benefit formula: A formula that describes the calculation of a plan's financial obligation to participants in a retirement plan.

Benefit Formulas

Funds are allocated to plan participants at their retirement using a **benefit formula** that is established in the plan. Traditional defined benefit formulas typically consider either years of service, compensation history, or both factors to determine benefits.

Ex. Bronwyn Price participated in Onyx's pension plan and retired after 35 years. Bronwyn's career-average salary was $45,000, and her final average earnings—based on her last three years of work—were $62,000.

Flat Benefit Formula: **Benefit = Years of Service × Flat Dollar Amount**

If Onyx used a flat benefit formula and provided $1,200 for each year of service, Bronwyn's annual benefit would be calculated as follows:

$$\begin{aligned} \text{Benefit} &= \text{Years of Service} \times \text{Flat Dollar Amount} \\ &= 35 \times \$1{,}200 \\ &= \$42{,}000 \end{aligned}$$

Career-Average Earnings Formula:

Benefit = Percentage of Career-Average Salary × Number of Years of Service

If Onyx used 2.5% in its career-average earnings formula, Bronwyn's annual retirement benefit would be calculated as follows:

Benefit	=	Percentage of Career-Average Salary × Number of Years of Service
	=	(0.025 × $45,000) × 35
	=	$1,125 × 35
	=	$39,375

Final Average Earnings Formula:

Benefit = Percentage of Final Average Earnings × Number of Years of Service

If Onyx used a 2% final average earnings formula, Bronwyn's annual retirement benefit would be calculated as follows:

Benefit	=	Percentage of Final Average Earnings × Number of Years of Service
	=	(0.02 × $62,000) × 35
	=	$1,240 × 35
	=	$43,400

As demonstrated by the examples:

- The flat benefit formula provides benefits that will be higher for employees with more years of service.
- The career-average earnings formula typically results in a lower benefit amount than other methods because it includes the earnings in all years, averaging the lower (perhaps entry-level) earnings with years of higher earnings generated through raises and promotions.
- The final average earnings formula is usually the most favorable to an employee because it considers the earnings just prior to retirement, which are likely to be the years with the highest compensation.

Now let's turn our attention to how these benefits vest, or become available, for participants in DB plans.

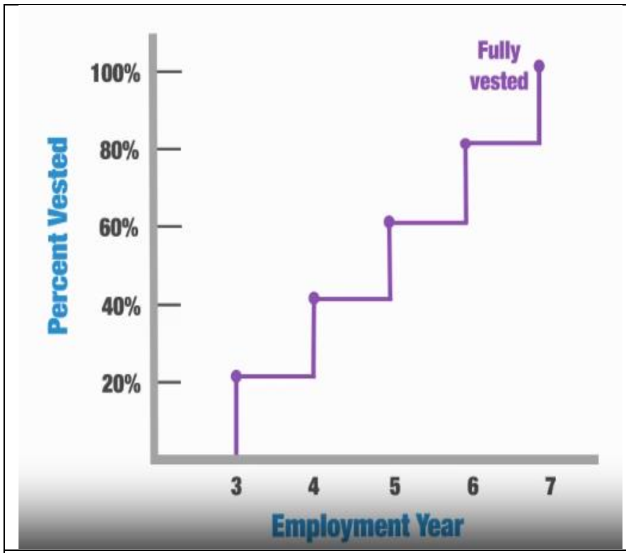
DB Plan Vesting Schedules

A DB plan will outline a schedule for when employees are 100% vested in employer-funded benefits. Two common schedules are the **graded vesting schedule** and the **cliff vesting schedule**. Some plans may specify that employees are immediately 100% vested.

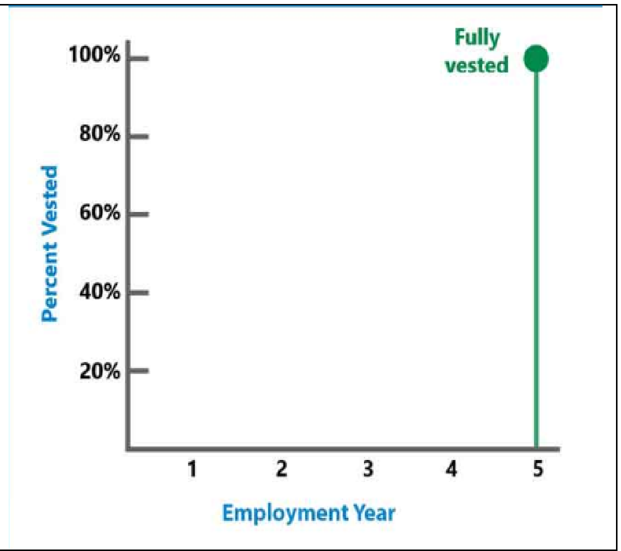
Graded vesting schedule: A vesting schedule under which a plan participant is gradually vested in retirement plan benefits over a stated number of years of employment. *Contrast with* **cliff vesting schedule**. **Cliff vesting schedule:** A vesting schedule under which a plan participant is fully vested in retirement plan benefits after a stated number of years of employment. *Contrast with* **graded vesting schedule**.

Graded Vesting Schedule

Graded vesting schedules for DB plans require that employees be fully vested after seven years of employment. Employees must be at least 20% vested after three years, gaining an additional 20% vesting after each subsequent year until reaching 100% vesting no later than the end of year seven.



Graded Vesting Schedule Example



DB Cliff Vesting Schedule Example

Cliff Vesting Schedule

If a qualified DB plan uses a cliff vesting schedule, employees must be 100% vested in the employer-funded benefits after five years of service. During the five-year period, the employee is not vested in any of the plan's benefits.

Other DB Plan Requirements

In addition to funding and vesting requirements, DB plans must satisfy certain other requirements.

Minimum Participation

In the last lesson, we explained the age and service requirements an employee must meet to be eligible to participate in a qualified plan. For employees who meet these requirements, a DB plan must benefit the **LESSER** of

- 50 employees, or
- The greater of:
  - 40% of all eligible employees, or
  - 2 employees (or one if the only employee)

Ex. 1) Wally's Warehouse has 200 employees who meet the minimum age and service requirements for coverage under its DB plan. To meet the minimum participation requirements, Wally's Warehouse must provide a benefit to at least 50 of these eligible employees.

<u>Note:</u> 40% of 200 = 80 employees, which is higher than the minimum requirement of 50.

2) Betty's Bakery has 50 employees; 30 are eligible to participate in the company's DB plan. Betty's Bakery needs to provide a plan benefit to at least 40% of the 30 eligible employees, or 12 employees (0.40 × 30) to be in compliance.

<u>Note:</u> If all 50 employees were eligible, Betty's Bakery would be required to offer benefits to at least 40% of those 50 employees, or 20 employees (0.40 × 50). Betty's Bakery would not be obligated to cover all 50 eligible employees to meet the requirement as it applies to the *lesser* of 50 employees or 40% of eligible employees, assuming other nondiscrimination requirements are satisfied.

Minimum Coverage

In order to meet requirements for qualified plan status, a DB plan must provide reasonable benefits to lower-paid employees when compared with the coverage of highly compensated employees (HCEs). Recall that HCEs are employees or owners who meet certain company ownership and/or compensation thresholds. A DB plan must cover, or benefit, at least 70% of non-highly compensated employees (non-HCEs) relative to the number of HCEs.

Example- Sande's Sub Shop has 110 employees who meet the age and service requirements to participate in the company's DB plan. Of these 110 employees, 10 are HCEs and 100 are non-HCEs. All 10 of the HCEs (100%) benefit under the DB plan. Of the 100 non-HCEs, 80 (80%) benefit under the plan.

The ratio of non-HCEs to HCEs who benefit is 80% (80% non-HCEs/100% HCEs). Because this ratio is greater than 70%, the plan meets the minimum coverage requirement.

Investment Management

The plan sponsor is responsible for investing plan assets but typically hires investment professionals to oversee the investments on behalf of the plan. The plan sponsor must monitor the performance of the investment professionals and still bears all of the investment risk for the plan. Plan participants are not involved in the investment decisions for the plan's assets, and their benefits are not affected by the plan's investment returns.

For DB plans, the trust document outlines the investment arrangements for the plan assets. DB plans have a great deal of flexibility in how they invest assets, so plans invest in a variety of instruments with the goal of generating returns to cover promised plan benefits.

PBGC Premiums

Most private sector (nongovernmental) DB plans must participate in and pay premiums to the Pension Benefit Guaranty Corporation (PBGC), which provides insurance designed to partially protect plan participants if their employer is unable to pay the promised benefits in retirement. Pension plan failures may occur due to underfunding of the pension fund, inadequate investment performance, or bankruptcy of the employer. Statutory rules limit the amount and type of plan benefits that the PBGC can guarantee, so payments from the PBGC to participants (or their beneficiaries) may be less than the full retirement benefit amount originally promised by the DB plan.

- The plan sponsor is responsible for investing in plan assets and bears all of the investment risk for a DB plan. The plan sponsor typically hires an investment professional but is responsible for monitoring the performance of the investment professional.

- Eddie Lunberg participated in Kalel Manufacturing's DB plan and retired after 30 years of service. Eddie's career average salary was $56,000, and his final average salary (for the most recent 3 years) was $68,000. If Kalel used a 3% career-average earnings benefit formula, what would Eddie's annual retirement benefit be?

Ans:

If Kalel used a 3% career-average earnings benefit formula, Eddie's annual retirement benefit would be calculated as follows:

Benefit = Percentage of Career-Average Salary × Number of Years of Service

$$= (0.03 \times \$56{,}000) \times 30$$

$$= \$1{,}680 \times 30$$

$$= \mathbf{\$50{,}400}$$

- With a graded vesting schedule, Sheila would become vested in her employer's contributions to the DB plan over the course of several years of employment. The plan document will define the percentage that vests each year, subject to the IRS maximum graded vesting schedule requiring full (100%) vesting no later than the end of the seventh year.

More on DB Plans

Learning Objectives:

Describe DB plan distribution and benefit payment requirements.

Explain how traditional DB plans differ from cash balance plans.

DB Plan Distributions and Benefits

We introduced distributions from qualified plans in the prior lesson. Now we'll cover the unique aspects of distributions and benefit payments from qualified DB plans.

Hardship Withdrawals and Plan Loans

Hardship withdrawals are generally not allowed from DB plans.

DB plans may permit plan loans, but most plans do not provide this option. The summary plan description (SPD) will contain details on a plan's loan provisions if available.

Retirement Benefits

Retirement benefits usually start at a specified retirement age and are paid in monthly installments over the lifetime of the participant, and in some cases, a surviving spouse. However, some plans provide for a lump-sum payment of the value of the benefit at the time of retirement, with no further payments to the participant or the participant's survivors.

DB plans set an NRA generally not later than age 65, when a plan participant is eligible to receive plan benefits. The plan's NRA may not be earlier than age 62. DB plans may offer an early retirement benefit, which allows a participant to receive a reduced benefit at an earlier age. Also, a DB plan may pay benefits to participants who are still working if they have reached the NRA.

The plan may pay benefits as early as age 59½ or when the participant terminates employment due to disability, death, or other severance of employment.

For a plan with employer contributions only, employees are not taxed on the employer contributions until their benefits are distributed. Upon distribution, benefits, which consist of employer contributions and investment earnings, are taxable to the employee as ordinary income. If a plan participant made after-tax contributions, a portion of the benefit payment attributable to the after-tax contributions is excluded from taxation.

Termination of Employment

Employees often leave an employer before retirement. DB plans typically specify that vested benefits are payable following the participant's separation from service and attainment of the plan's NRA. Prior to attainment of the NRA, vested amounts may remain invested in the plan.

Some plans allow the participant to receive a lump-sum amount of the vested benefit as a distribution or a rollover into another qualified plan or IRA. The lump-sum value of the vested benefits will be determined using assumptions in the plan.

Disability Benefits

DB plans can include disability benefits for participants; if the plan includes such benefits, it will also include a definition of disability. The PBGC, which we discussed earlier, guarantees up to 100% of a participant's disability benefit if the DB plan provides such a benefit.

Death Benefits

If a plan participant with vested benefits dies before retiring, the plan must state how it will distribute those benefits. Plans may include a provision for accrued benefits to fully vest upon the death of the plan participant.

The IRC requires that a surviving spouse be offered a **qualified preretirement survivor annuity (QPSA)**. The plan may allow a surviving spouse to elect a lump-sum distribution of the accrued vested benefit instead of the QPSA. If the total value of the participant's benefit is $5,000 or less, the plan may pay a lump sum without obtaining the surviving spouse's consent.

The amount of the QPSA is usually the amount that would have been paid to the surviving spouse under a **qualified joint and survivor annuity (QJSA) option**, which applies when a participant dies AFTER retiring. That amount is calculated as if the participant retired the day before his death.

Note that a participant is allowed to waive the QJSA option and choose another payment option prior to retirement with spousal consent.

Qualified preretirement survivor annuity (QPSA): A retirement plan benefit that provides a life annuity to the surviving spouse of a deceased plan participant.
Qualified joint and survivor annuity (QJSA): An annuity that pays monthly benefits for the lifetime of both a plan participant and the participant's spouse; at the death of the participant, the surviving spouse receives a reduced benefit that is actuarially equivalent to a single life annuity equal to at least 50% but no more than 100% of the joint benefit.
Cash balance plan: A defined benefit plan that has features of a defined contribution plan. The promised benefit is stated in terms of an account balance. The benefit amount available to the participant is not dependent on investment returns as the employer bears the investment risk.

Another type of defined benefit plan is a **cash balance plan**, which has features similar to a traditional DB plan in that

- Participants have the option of receiving either a lump sum or a monthly benefit for the rest of their lives, and these benefits are protected by the PBGC
- Plan contributions are invested by the plan sponsor for the benefit of the participants
- The plan sponsor bears the plan's investment risk
- Loans are allowed if the plan document specifies this provision

How do cash balance plans differ from traditional DB plans?

The major difference between these two plans is in how they determine the amount of a participant's benefit at retirement.

- In a traditional DB plan, the plan's **benefit formula** determines the participant's retirement benefit.
- In a cash balance plan, the participant's **hypothetical account balance** determines the retirement benefit.

A cash balance plan establishes an account for each participant that is for recordkeeping purposes only. This account, which is commonly referred to as a **hypothetical account**, indicates the benefits the employer intends to provide to the participant. The plan doesn't hold any actual funds or assets in these individual accounts; rather, all plan funds are held in one combined investment account.

How is the individual's hypothetical account balance calculated?

Each year that a participant is employed with a company, the participant accumulates benefits in the hypothetical account according to this formula:

Annual Benefit = (Wage × Pay Credit Rate) + (Account Balance × Interest Credit Rate)

The annual benefit is subject to the same plan benefit limits as a traditional DB plan.

The pay credit rate is the percentage of the employee's wage that the employer provides in contributions, such as between 5% and 8%. The account balance is what the employee has already accrued in benefits and earnings in previous years.

The interest credit rate is a percentage the employer sets for growth of contributions over time. The interest credit rate can be a fixed rate, such as 3%, or a variable rate that's tied to something else, such as the interest rate on 30-year Treasury bonds.

At retirement, the employee receives the amount of the account balance as the plan benefit. As with a traditional DB plan, payout options may include a lump-sum payment or guaranteed income payments to the participant and a surviving spouse, if applicable. Increases and decreases in the value of plan assets do not directly affect benefit amounts for plan participants.

Cash balance plans have certain advantages:

- Participants often find it easier to understand their benefits when they are based on an account balance.
- If a plan participant terminates employment prior to retirement, the vested account balance is portable and may be rolled over to another qualified retirement plan or IRA.
- Younger, more mobile employees often find the portability of the vested account balance attractive.

Cash Balance Plan Example:
Clyde Freeman participated in Wildflower's cash balance plan. He retired at age 65 with an account balance of $100,000.

Clyde wanted to receive monthly payments for the rest of his life, so he chose to receive a life annuity giving him monthly income payments in whatever amount the $100,000 account balance provided.

Cash balance plan: A defined benefit plan that has features of a defined contribution plan. The promised benefit is stated in terms of an account balance. The benefit amount available to the participant is not dependent on investment returns as the employer bears the investment risk.

Hypothetical account: A type of account for recordkeeping used by cash balance pension plans to state a participant's benefit balance.

- Attainment of retirement age, disability, and death are all circumstances that may trigger a distribution from a DB plan. DB plans do not allow hardship withdrawals. DB plans may, but are not required to, permit plan loans.

- If a married participant dies, the IRC requires that a surviving spouse be offered a qualified preretirement survivor annuity (QPSA). In the event of the death of a married participant already receiving benefits, the plan would continue to pay benefits according to the qualified joint and survivor annuity (QJSA) option that is in place, if applicable. A participant may have waived the QJSA option and chosen another payment option prior to retirement with spousal consent.
- The major difference between traditional DB plans and cash balance plans is in how they determine the amount of a participant's benefit at retirement.

- In a cash balance plan, the participant's hypothetical account balance determines the retirement benefit. At retirement, the employee receives the amount of the account balance as the plan benefit from the investment account that the employer maintains for all pension plan funds.
- Like DB plans, DC plans must have eligibility requirements, vesting schedules, and distributions in the event of a participant's disability or death. In this section, we'll explore how these requirements apply to DC plans.
- DC plans are usually funded with employee contributions and may allow hardship withdrawals. In contrast, DB plans are not typically funded with employee contributions and are not allowed to provide hardship withdrawals to participants.

Defined Contribution Plan Characteristics

Learning Objective: Identify the primary characteristics of defined contribution (DC) plans and recognize characteristics of 401(k) plans.

In contrast to the 15% of private sector workers with access to a DB plan, 64% of private sector employees have access to a DC plan.

DC plans hold plan assets in individual accounts. Each individual account holds

- The participant's contributions
- Any contributions made on behalf of the participant by the employer
- Any investment earnings on contributions

The individual account assets are held in a trust for the benefit of the participant and kept separate from the employer's other assets.

Unlike DB plan participants, DC plan participants can decide how contributions are invested by selecting investments from a menu provided by the plan sponsor. The plan participant bears the investment risk and responsibility of contributing enough to the plan to meet retirement income goals. The participant's retirement benefit depends on the balance in the account when the participant retires.

One of the most popular types of DC plans is the **401(k) plan**. "Did you know that in 2020, 600,000 401(k) plans in the U.S. covered 60 million active participants, and held approximately $6.7 trillion in assets?"

Let's take a look at the rules for contributions and vesting for DC plans.

DC Contribution Limits

The IRC establishes annual limits on the amount of (1) employee and employer contributions to a DC plan and (2) employee compensation that can be considered when calculating plan contributions.

Note that a plan may impose a lower limit on an employee's elective deferrals than the law allows. Also, managers or highly compensated employees (HCEs) may need to limit elective deferrals so that the plan can pass nondiscrimination tests.

Employee Contributions

In some types of DC plans, including 401(k) plans, employees can use **elective deferrals** to contribute part of their compensation to their retirement accounts through payroll deductions. Elective deferrals may occur before or after the employer deducts taxes from the employee's pay.

- Pre-tax deferrals reduce the employee's income in the year of the contribution, postponing taxes on the contributions and associated earnings until withdrawal.
- Some plans allow **designated Roth contributions**, which are after-tax deferrals made into a designated Roth account inside the retirement plan and do not reduce the employee's income in the year of the contribution. An employee receives **qualified distributions** from the Roth account tax free.

401(k) plan: An employer-sponsored retirement plan to which eligible employees may contribute on a pre-tax or post-tax basis. Employers may make matching contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings in a 401(k) plan accrue on a tax-deferred basis.

Elective deferral: The portion of a retirement plan participant's periodic compensation that the participant chooses to have deducted from his compensation and contributed into his plan account as a pre-tax contribution or designated Roth contribution.

Designated Roth contributions: In the context of defined contribution retirement plans, a type of elective deferral that is (1) deducted on an after-tax basis from a participant's compensation and (2) not deductible from the participant's taxable income, but that will be distributed on a tax-free basis, subject to certain regulatory requirements.

Qualified distribution: For a Roth IRA, a distribution that is tax free because it satisfies certain requirements.

After-tax contributions: In the context of defined contribution retirement plans, a contribution that a plan participant makes to the plan with money already received as income.

Plan sponsors who offer both pre-tax and after-tax elective deferrals must establish separate accounts for proper accounting and taxation on distributions.

The IRC employee contribution limits apply to the total amount of elective deferrals an employee makes, regardless of whether the employee elects to make pre-tax or designated Roth contributions, or a combination of these two types.

In 2023, the maximum amount of elective deferrals for an employee under age 50 is $22,500.

Employees age 50 and older may make additional catch-up contributions. In 2023, the catch-up contribution limit is $7,500. Therefore, employees age 50 and older may make a total maximum contribution of $30,000 ($22,500 + $7,500) for 2023.

Examples: In 2023, Walt Witherspoon, age 38, can contribute a maximum of $22,500 to his 401(k) plan.

In 2023, Beverly Banks, age 52, can contribute a maximum of $30,000 ($22,500 + $7,500 catch-up contribution) to her 401(k) plan.

These contributions may be made as pre-tax contributions or designated Roth contributions, or a combination of the two types.

Employer Contributions

Employer contributions into a DC plan on behalf of an employee are not required. However, many employers do make such contributions to help employees save for retirement.

The sum of employer and employee contributions (pre-tax, Roth, and after-tax contributions) to a participant's account cannot exceed a stated dollar amount established in the IRC.

What Are After-Tax Contributions?

Some plans allow employees to make **after-tax contributions**, which do not reduce the employee's income in the year of the contribution. Investment earnings on the contributions are subject to taxation at withdrawal. After-tax contributions allow an employee to contribute beyond the pre-tax and designated Roth elective deferral limits up to the stated IRC annual limit for both employee and employer contributions.

In 2023, the maximum contribution limit from all sources (employee and employer) is typically the lesser of 100% of an employee's compensation or $66,000 for employees younger than age 50.

As noted above, the IRC allows employees age 50 and older to make catch-up contributions in addition to the maximum combined contribution limit. In 2023, the total contribution limit from all sources for employees age 50 and older is $73,500 ($66,000 + $7,500 limit for catch-up contributions).

Example: Tommy Tucker, age 45, earned $70,000 in 2023. The maximum annual contribution from his elective deferrals, employer matching contributions, and any other contributions to his 401(k) account is $66,000 (the maximum contribution for employees younger than age 50).

Employer contributions to a participant's account are usually made on a pre-tax basis, allowing the employer to take a business deduction in the year of the contribution. The contributions and associated earnings accumulate on a tax-deferred basis and are taxed when distributed to the participant.

Starting in 2023, 401(k), 403(b), and governmental 457(b) plans may allow employees the option of receiving employer contributions as Roth contributions. Roth employer contributions are included in the participant's income and vest immediately. Years later, the participant receives qualified distributions from the Roth account tax free.

Below, see various ways employers may make contributions to employee 401(k) plan accounts.

Matching Contributions

Employer contributions are typically made on a matching schedule outlined in the plan document. For example, an employer might make a **matching contribution** on 50% of the first 6% of compensation that an employee contributes to a plan.

Example: Janie Jones works for Technical Electric (TE). Janie contributes 8% of her $100,000 annual compensation to TE's 401(k) plan. The plan provides a 50% employer match on the first 6% of employee contributions. The total contribution to her plan for the year will be:

	$ 8,000	(Janie's 8% employee elective deferral: 0.08 × $100,000)
+	$ 3,000	(TE's 50% match on the first 6%: 0.06 × $100,000 = $6,000, multiplied by 0.50 = $3,000)
	$11,000	Combined employee and employer contributions for the year

Nonelective Contributions

Some plans permit employer contributions regardless of whether an employee makes contributions to the plan. These **nonelective contributions**, sometimes known as profit-sharing contributions, are discretionary, meaning the employer can change the amount annually. Although they are discretionary, these contributions must be made according to a nondiscriminatory formula in the plan document. Below are some common options for allocating nonelective contributions:

- *Pro rata* – allocates a uniform percentage, based on compensation, to all employees.
- *Flat dollar* – contributes the same amount to each employee.
- *Comp-to-comp* – allocates the contribution based on the percentage of an employee's compensation in relation to the total compensation of all employees.
- *Integrated* – allows the employer to make contributions based on integration with the Social Security Taxable Wage Base. This type of allocation is complex and beyond the scope of this lesson.

The plan document specifies the requirements employees must satisfy to receive these contributions, such as (1) a minimum number of hours worked during the year or (2) being employed on the last day of the year on which the contribution is based.

Matching contribution: A plan sponsor contribution of assets to a defined contribution plan that is based on contributions by the plan participant and is typically a percentage of the participant's compensation.
Nonelective contribution: A plan sponsor's contribution of assets to a defined contribution plan that is not dependent on contributions by the plan participant.

Safe harbor plan: A retirement plan that meets requirements to excuse it from required vesting and non-discrimination testing.

Examples: When Technical Electric (TE) has a profitable year, it makes nonelective contributions to the plan in addition to the matching employer contributions. This year, TE plans to distribute up to $500,000 in nonelective contributions to employee plan accounts.

Let's look at some ways TE may choose to make these nonelective contributions:

- *Pro rata*: TE contributes 1% of each employee's compensation. For Janie Jones, earning $100,000, that would equal a $1,000 contribution (0.01 × $100,000).
- *Flat dollar*: TE contributes $1,200 to each employee account.
- *Comp-to-comp*: TE calculates the total compensation for all employees and divides each employee's compensation by that amount to determine the allocation. If the total compensation of all employees equaled $20,000,000, Janie's allocation would be calculated as:
    - $100,000/20,000,000 = 0.005 (Janie's % of total compensation)
    - 0.005 × $500,000 = $2,500

Safe Harbor Contributions

Some employers choose to structure their plan as a **safe harbor plan**, which is exempt from nondiscrimination testing. Employer contributions fully vest immediately. For 401(k) plans, safe harbor provisions use the following methods for employer contributions:

- **Matching** – the employer makes minimum matching contributions of 100% of the first 3% of employee compensation and 50% of the next 2% contributed by the employee. An enhanced matching option of at least 100% of employee contributions up to 4% also meets the requirement.
- **Nonelective** – the employer makes nonelective contributions equal to at least 3% of employee compensation.

An employer must make one of these types of contributions each year for the plan to retain its safe harbor status.

Example: Pete's Plumbing offers a safe harbor 401(k) plan, matching 100% of the first 3% of employee compensation and 50% of the next 2% of contributions. Zach Johnson contributes 5% of his $60,000 compensation to the plan. The total contribution for the year to Zach's account will be:

- $3,000 (Zach's 5% deferral: 0.05 × $60,000)
- $2,400 Employer contribution:
    - $1,800 (Employer contribution of 100% on first 3%: 0.03 × $60,000 = $1,800)
    - $600 (Employer contribution of 50% on next 2%: 0.02 × $60,000 × 0.50 = $600)

Total contribution to Zach's account for the year = **$5,400**

What if Zach had contributed only 3% to the plan for the year?

The total contribution for the year to Zach's account will be:

- $1,800 (Zach's 3% deferral: 0.03 × $60,000)
- $1,800 (Employer contribution of 100% on first 3%: 0.03 × $60,000 = $1,800)

Total contribution to Zach's account for the year = **$3,600**

By contributing less than the defined employer match, Zach is not only saving less for retirement; he is also forgoing extra employer contributions on his behalf.

If Pete's Plumbing decided instead to use the nonelective safe harbor contribution option, the employer contribution would be 3% of employee compensation regardless of whether the employee contributes to the plan. In this case, Pete's Plumbing would contribute $1,800 (0.03 × $60,000) to Zach's account, regardless of Zach's contributions to the plan.

The IRC limits the amount of an employee's compensation that can be considered when calculating plan contributions and benefits. In 2023, the maximum compensation is $330,000. The IRS periodically adjusts this dollar limit for inflation.

Example: Returning to our nonelective employer contribution example with Technical Electric (TE), assume TE chooses to allocate 1% of each employee's compensation to the plan. TE's CEO Stanley Silverman earned $350,000 in compensation for the year. TE must limit the 1% of compensation contribution calculation to $330,000 for Stanley because that is the IRS limit on compensation to be considered when determining contributions. TE will make a $3,300 (0.01 × $330,000) contribution to Stanley's 401(k) plan account.

- Pre-tax deferrals reduce the employee's income in the year of the contribution, postponing taxes on the contributions and associated earnings until withdrawal.
- Designated Roth contributions are after-tax deferrals made into a designated Roth account and do not reduce the employee's income in the year of the contribution. An employee receives qualified distributions from the Roth account tax free.
- Catch-up contributions to most DC plans are available to participants who are age 50 or older.
- Employer contributions to a participant's account are made on a pre-tax basis or as a Roth contribution. The employer is allowed to take a business income tax deduction in the year of the contribution. Nonelective contributions, sometimes known as *profit-sharing contributions*, are discretionary, meaning the employer can change the amount annually.
- Edward's Electrical (EE) offers a 401(k) plan in which the company will make a nonelective contribution of 4% of compensation to each 401(k) plan participant's account every year. These employer contributions vest immediately to the plan participant. Select the true statement about this situation.

Ans: EE's 401(k) plan qualifies as a safe harbor plan because the employer makes nonelective contributions equal to at least 3% of employee compensation that vest immediately to plan participants. A plan that qualifies as a safe harbor plan does not have to meet requirements for nondiscrimination testing.

Another method for qualifying as a safe harbor plan is for the employer to make minimum matching contributions of 100% of the first 3% of employee compensation and 50% of the next 2% contributed by the employee. An enhanced matching option of at least 100% of employee contributions up to 4% also meets the requirement.

- Tyrone Trent works for Fletcher Financial. Tyrone contributes 10% of his $100,000 annual compensation to Fletcher Financial's 401(k) plan. The plan provides a 50% employer match on the first 6% of employee contributions. The total contribution to Tyrone's plan account for the year will be

Ans: The total contribution for the year to Tyrone's plan account will be $13,000 calculated as $10,000 (Tyrone's 10% employee elective deferral: 0.10 × $100,000) + $3,000 (Fletcher Financial's 50% match on the first 6%: 0.06 × $100,000 = $6,000, multiplied by 0.50 = $3,000).

- ERISA's minimum vesting requirements differ for DB and DC plans.

DC Plan Vesting Schedules

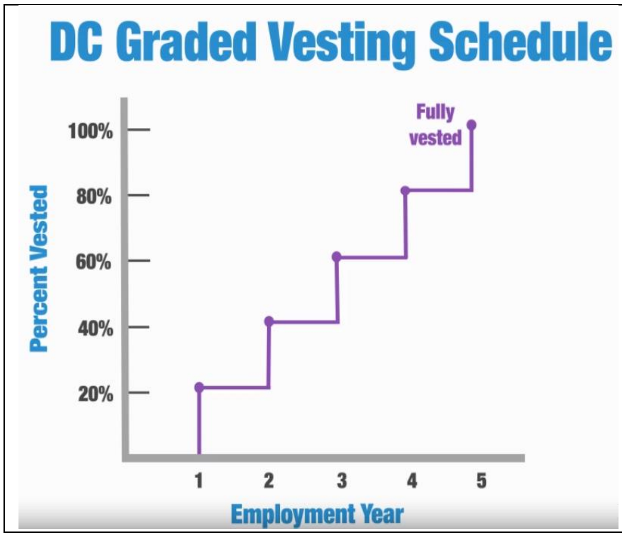
Similar to DB plans, DC plans may utilize a graded or cliff vesting schedule, but the two types of schedules differ in terms of requirements.

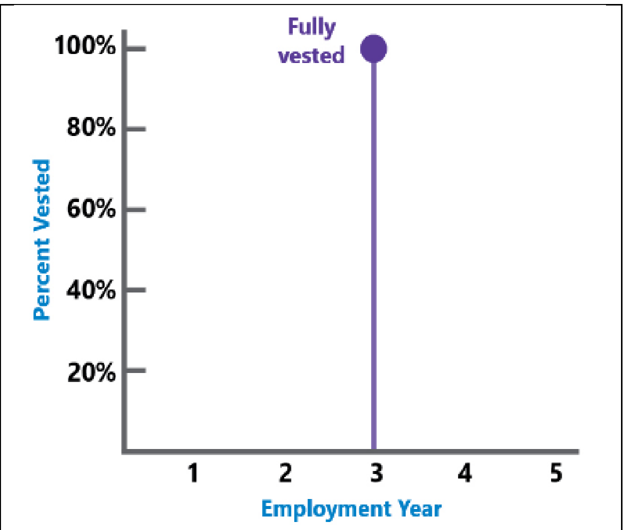
Note: Recall that employees are always 100% vested in their own contributions to a DC plan. Employees are immediately 100% vested in Roth contributions made by employers.

With some DC plans, such as safe harbor plans, SEP, and SIMPLE plans (discussed later in this lesson), employees are immediately 100% vested in the employer contributions.

Graded Vesting Schedule

Some DC plans, such as 401(k) plans, are subject to a six-year maximum on graded vesting schedules, meaning the employee must be fully vested after six years of employment. Often, employers use a five-year schedule with 20% vesting after the first year, and then an additional 20% each year until a participant is fully vested after five years of employment. If the employee leaves before completing the defined number of years of employment in the plan's vesting schedule, the employee only gets to keep the percentage of the employer's pre-tax matching contributions in which the employee is vested.





Graded Vesting Schedule Example	Cliff Vesting Schedule Example

Cliff Vesting Schedule

In a cliff vesting schedule for a 401(k) plan, a participant is fully vested in employer contributions after three years of employment. Until the participant has been employed for three years, however, the participant has no vested interest in the employer's pre-tax contributions. An employee who leaves for a new job after two years won't get to take any of the employer's pre-tax matching contributions.

Comparison of DB and DC Vesting Schedules

Years of Service	DB Graded Vesting	DC Graded Vesting	DB Cliff Vesting	DC Cliff Vesting
1	0%	0%	0%	0%
2	0%	20%	0%	0%
3	20%	40%	0%	100%
4	40%	60%	0%	100%
5	60%	80%	100%	100%
6	80%	100%	100%	100%
7	100%	100%	100%	100%

Regardless of the vesting schedule, participants must become 100% vested in either a DB or DC plan when they reach the NRA defined in the plan document or when the plan is terminated.

Note: Nonelective safe harbor contributions and employer Roth contributions are always immediately 100% vested.

Additional DC Plan Requirements

Similar to DB plans, DC plans must satisfy certain additional requirements to be classified as qualified plans.

Eligibility

Recall that there are typically age and service requirements for participation in qualified plans. Generally, a plan can require an employee to be at least 21 years old and complete a year of service to participate in a plan.* If a plan allows immediate vesting, it may require completion of two years of service to become eligible. However, plans can be more lenient in their eligibility requirements for employee participation.

Note: Compared to plans with voluntary enrollment, plans with automatic enrollment have much higher participation rates. A 2020 Vanguard study found that plans with automatic enrollment for new hires experienced a 91% participation rate vs. 28% for plans with voluntary enrollment. And, the auto-enrolled participants tended to stay in the plan: 92% were still participating after three years, vs. 29% of those under voluntary enrollment. The most common default deferral rate is 3%, and participants can change this rate.

Many plans contain an **automatic escalation** feature, which increases the participant's contributions at an established rate and interval. Automatic escalation can be a default or voluntary feature in a plan. The most common percentage and interval is 1% per year, up to a stated maximum. With automatic escalation, the most common maximum deferral rate is 10%.

Example: Kayla Kroft, age 25, is a computer engineer for Network Software making $70,000 per year. Once Kayla completes a year of service, Network Software will automatically enroll her in the company's 401(k) plan with a default deferral rate of 3% of her compensation. Network Software also has an automatic escalation schedule that will apply to Kayla's contributions, raising them 1% per year until her deferral rate reaches 10%.

Network Software offers a company match of 100% on the first 5% of compensation. In the first year Kayla is eligible, she would be automatically enrolled at a 3% deferral rate, and the contributions to her plan account would be:

		$2,100	(Kayla's contribution: 0.03 × $70,000)
		$2,100	(Network Software's matching contribution: 0.03 × $70,000)
Total	=	**$4,200**	

In the second year, Kayla's contribution would increase by 1% to 4%. Because that amount is still below the company matching percentage, that amount would rise as well:

		$2,800	(Kayla's contribution: 0.04 × $70,000)
		$2,800	(Network Software's matching contribution: 0.04 × $70,000)
Total	=	**$5,600**	

In the third year, Kayla's contribution would increase by another 1% to 5%. That amount now reaches the company's maximum matching percentage:

		$3,500	(Kayla's contribution: 0.05 × $70,000)
		$3,500	(Network Software's matching contribution: 0.05 × $70,000)
Total	=	**$7,000**	

In the fourth year, Kayla's contribution would increase by another 1% to 6%. The company matching contribution would remain at the 5% maximum set by the plan:

		$4,200	(Kayla's contribution: 0.06 × $70,000)
		$3,500	(Network Software's matching contribution: 0.05 × $70,000)
Total	=	**$7,700**	

As this example illustrates, automatically enrolling employees in a plan and encouraging automatic escalation of contributions can add up to substantial retirement savings over time. Note that, for simplicity, this example does not factor in the impact of (1) potential increases in compensation or (2) the investment gains compounding on the contributions.

Plan Testing

Plans that allow employee elective deferrals must pass the **Actual Deferral Percentage (ADP) test**, which requires that deferrals by HCEs be proportional to the deferrals of non-HCEs. Plans with employer safe harbor contributions are not required to conduct ADP testing.

Plans that permit employee and/or matching contributions must satisfy the **Actual Contribution Percentage (ACP) test**, which requires that employee and matching contributions for HCEs be proportional to the contributions for non-HCEs. As with the ADP test, plans that make safe harbor contributions are exempt from ACP testing. The mechanics of conducting these tests are outside the scope of this lesson.

Investment of Plan Accounts

DC plans, such as 401(k) plans, offer investment options with different risk and return characteristics. Plan participants typically select investments from a menu of investment choices.

If participants fail to select investments for contributions, most plans will direct the contributions to a **qualified default investment alternative (QDIA)**. QDIAs are usually a better option than leaving the contributions in a cash account, which may generate little to no returns. Most plans employ a target date fund for the QDIA, which ties the investment allocation to the participant's anticipated retirement date based on the participant's age. QDIAs are an important plan feature because almost 75% of plan participants who are automatically enrolled in a plan remain in the default investment.

Plan sponsors must offer plan participants at least three investment options, but twenty or more investment options is not uncommon. Some plans have a self-directed investment feature, which allows participants to select from a wider range of investments. Plans must allow participants to transfer assets among the options at least quarterly and must provide participants with sufficient information to make informed investment decisions.

Actual Deferral Percentage (ADP) test: A qualified plan nondiscrimination test that compares the average actual deferral percentage of eligible highly compensated employees to that of eligible non-highly compensated employees.
Actual Contribution Percentage (ACP) test: A qualified plan nondiscrimination test that compares the matching and after-tax contributions as a proportion of compensation for eligible highly compensated employees to that of eligible non-highly compensated employees.
Qualified default investment alternative (QDIA): An investment option that serves as a default if participants in a self-directed plan fail to provide directions for investing plan contributions.

Examples: 1) Kayla Kroft, age 25, works for Network Software and did not make any investment selections for the contributions into her 401(k) account. The plan has a QDIA where her contributions will be invested. The plan's QDIA consists of target date funds tied to the participant's age and projected retirement age. Because Kayla is 25, the QDIA is a target date fund with an allocation for a retirement date 40 years from today. Kayla may redirect the investment of her contributions to other investment options in the plan.

2) Nick Nottingham, age 40, also works for Network Software. He chose to allocate his investments between the variety of options in the plan, including a bond fund, a U.S. Large Cap stock fund, an

international stock fund, and a stable value fund. He also has the ability to change his investment selections.

Let's Put It All Together

Want to see how the most common DC plan characteristics differ from a traditional DB plan?

	DB Plan	DC Plan
Contributions	Usually employer only	Usually employee and employer
IRC Limitations	Limit on participant benefits	Limit on total amount of contributions
Investment Risk	Plan sponsor	Participant
Advantages	• Participants have option to receive predictable lifetime income benefit* • Plan sponsors can potentially contribute more money	• Lower cost to establish and maintain plan • Costs for funding are more predictable than for a DB plan

*DC plans may offer in-plan annuities that provide a lifetime income option, but at this time not many DC plans contain this feature.

- With a 3-year cliff vesting schedule, Rita would be fully vested in her employer's pre-tax contributions after three years of employment. Until Rita has been employed for three years, however, she has no vested interest in her employer's contributions.

Of the following actions, which ones are likely to encourage higher levels of participation and improve savings outcomes for participants in a DC plan? (Choose all that apply.)

- [x] Using an automatic enrollment feature
- [x] Using an automatic escalation feature
- [x] Providing a qualified default investment alternative (QDIA)
- [x] Employer matching contributions

- Automatic enrollment and escalation features combat inertia in savings behaviors. A QDIA promotes investing contributions to grow savings over time. An employer match encourages employees to participate in the plan and also immediately increases employee savings.

Distributions from DC Plans

Learning Objective: Describe DC plan requirements for hardship withdrawals, plan loans, and distributions at termination of employment.

DB plans are not allowed to provide hardship withdrawals to participants, but DC plans may allow them. Both DB and DC plans are permitted to allow loans. Similar to DB plans, DC plans must satisfy requirements for distributions in the event of a participant's disability or death. In this section, we'll explore how these requirements apply to DC plans.

DC Plan Distributions

Although retirement plans are designed for providing funds during retirement, some plans permit distributions to employees before retirement. Most DC plans, including 401(k) plans, permit a distribution when the employee

- Suffers a qualifying hardship
- Wishes to take out a plan loan
- Terminates employment
- Reaches age 59½

Hardship Withdrawals

A qualified DC plan *may*, but is not *required* to, permit participants to take **hardship withdrawals**. (A distribution made to a plan participant on account of financial difficulties) The IRC specifies that, if an immediate and heavy financial need exists, the employee may be allowed to take a hardship withdrawal from a DC plan. Hardship withdrawals are available to meet the needs of the

- Employee
- Employee's spouse
- Employee's dependent
- Employee's beneficiary

To simplify the administration of hardship withdrawals, regulations specify that an employee is considered to have an immediate and heavy financial need if the withdrawal is for Hardship withdrawals are subject to income taxes and may be subject to a 10% additional tax penalty if the participant is under age 59½. In general, employees who take a hardship withdrawal cannot repay the funds to the plan.

Note: The CARES Act of 2020 for coronavirus-related relief did give qualified individuals who took COVID-19 related hardship withdrawals in 2020 the option of repaying the funds to the plan.

Plan Loans

Sometimes employees need to take money from their retirement plan, but they would like the ability to repay the funds. Some DC plans, including 401(k) plans, may allow loans to participants.

Maximum Loan Amount

The maximum loan amount that any retirement plan can allow is (1) $50,000, or (2) 50% of the vested account balance, whichever is less. If the vested balance is less than $10,000, the participant may borrow up to the full account balance.

Not all plans will allow participants to take loans as large as the maximum allowed amount.

Examples: Jerry Cranston and Susie Milton participate in the 401(k) plan of the Tiger Company. Tiger allows plan participants to take the maximum allowed amounts in plan loans.

Jerry Cranston has a vested 401(k) account balance of $90,000. He can borrow $45,000, which is 50% of $90,000.
Susie Milton has a vested 401(k) account balance of $8,000. Susie could borrow a maximum of the vested account balance, which is $8,000.

Time Allowed to Repay Loan

A plan participant who has taken a loan generally must repay the loan within five years and must make level payments, including principal and interest, at least quarterly.

Exceptions to this rule include that a plan may

- Allow longer than five years to repay a loan used to purchase the employee's principal residence.
- Suspend loan repayments for participants during a period of active military service.
- Suspend loan repayments during a leave of absence from work, for up to one year. With a leave of absence, the participant must make up missed payments so that the loan is repaid in the original five-year term.

Loans as Distributions

Loans are not taxable distributions unless they do not comply with regulations regarding the amount, duration, and repayment terms.

If a loan is not paid back according to the repayment terms, it is treated as a distribution, and the following become due immediately:

- Taxes on the outstanding loan balance. The distribution is taxed as ordinary income.
- A 10% early withdrawal penalty on the outstanding loan balance, if the participant is younger than 59½.

If an employee leaves the company, the plan sponsor may require the employee to repay the outstanding loan balance. If the employee does not repay the loan, the plan sponsor will treat it as a distribution, subject to income taxes and potential penalties, as noted above.

Termination of Employment

Plan participants or their beneficiaries have rights to their vested plan assets in specific situations, such as when the participant changes jobs or retires, becomes disabled and unable to work, or dies. The plan document will outline how the plan participant or a beneficiary accesses the vested amounts in these situations.

Changing Jobs or Retiring

DC plans may give a participant whose employment terminates the option to leave vested amounts in the plan. More commonly, a DC plan offers a lump-sum payment, or the participant transfers the account balance to another qualified plan or IRA.

See below for some key ages for distribution rules.

Age	Significance for Distributions
55	Participants who separate from an employer and are at least age **55** in the year of separation may receive distributions from a qualified plan. These distributions are subject to income tax but not the 10% early withdrawal penalty.

59½	- Distributions from qualified plans and IRAs once the recipient reaches age **59½** are subject to income taxes but not the 10% early withdrawal penalty. - In-service withdrawals (participant is still employee) once the recipient reaches age **59½** may be permitted by the plan as rollovers to an IRA or another qualified plan, without being subject to income tax or the 10% early withdrawal penalty.
73	After plan participants reach age **73**, they generally must withdraw a required minimum distribution (RMD) each year by December 31. The RMD rules apply to all DC retirement plans. RMDs that are not taken in accordance with rules are subject to a 25% penalty tax on the amount that was not taken when required.

Let's review the distribution options for 401(k) plans, which are the most common type of DC plan.

Lump-Sum Payment

When a participant's employment terminates, the IRS allows 401(k) plans to make a lump-sum distribution of small account balances—those in which the participant's entire vested benefit is $5,000 or less—without the participant's consent, which is known as a **cash-out**(An IRS-allowed, lump-sum retirement plan distribution of small account balances—those in which the participant's or beneficiary's entire vested benefit is $5,000 or less—without consent.) Regulations allow plan sponsors to set cash-out thresholds up to $5,000, but they do not require plan sponsors to have a cash-out option. The plan document will contain any cash-out provisions.

The table below summarizes the regulations that apply to cash-out provisions for plans that contain them.

Amount of Distribution	Method	Consent Requirements
Below $1,000	Plan makes lump-sum payment to participant	None
$1,000 - $5,000	Plan transfers to IRA if participant does not elect a direct payment or initiate a rollover	None; participant notified of new IRA
Above $5,000	Lump-sum payment or rollover	Written consent from participant and spouse, if applicable

Direct Rollover

A direct rollover of a 401(k) balance avoids the tax consequences of a lump sum payment. In a direct rollover, funds are moved directly from one account to the other without the participant ever taking possession of them—which is why a direct rollover is not a taxable distribution.

Example: Maria Rodriguez, age 48, changed jobs and chose to roll over funds from her 401(k) plan with her prior employer to an IRA. If the 401(k) plan administrator made a payment from the plan directly to the IRA on her behalf, no taxes would be withheld or due on the rollover.

60-Day Rollover

A participant who receives a lump-sum payment has 60 days in which to roll the money over into another qualified retirement plan or IRA. However, a mandatory federal withholding tax of 20% is due at the time of distribution, even if the intention is to roll over the funds later. If the rollover for the entire lump sum occurs within 60 days, any income tax withheld or penalty paid on the lump-sum distribution will be refunded after it is reported on the participant's federal tax return.

This option can be challenging for participants because they will have to make up the amount withheld for taxes from other funds to fully fund the transfer and not incur taxes on the distribution.

Example: Maria Rodriguez (age 48) requested a distribution from her 401(k) plan when she changed jobs. The 401(k) plan administrator made a lump-sum payment directly to Maria. Maria's plan balance was $100,000, so the plan administrator withheld $20,000 (20% of the lump sum) in taxes. Maria received a check for the remaining $80,000.

- If Maria rolls over the $100,000 distribution to another plan or an IRA, she will need to provide $20,000 from other sources to fully fund the rollover and not owe taxes on the distribution. When she files her taxes for that year, the $20,000 amount withheld on the distribution will be refunded, and no penalties would apply.
- If Maria rolls over only the $80,000 she received from the plan into an IRA, she will need to report the $20,000 withheld as income on her tax return for that year. Because Maria is only 48, she will also owe a 10% additional tax on the $20,000 early distribution (0.10 × $20,000 = $2,000), unless an exception applies.

Disability Benefits

Each DC plan will include a definition of disability. In general, disability refers to the inability to engage in any substantial gainful activity. Disabled participants who satisfy the plan's definition of disability become fully vested in their DC retirement accounts. Although distributions from a vested account for a participant younger than 59½ are subject to income taxes, the distribution is not subject to the 10% early distribution penalty tax if the participant has a total and permanent disability.

Death Benefits

If an employee with vested benefits in a DC retirement account dies, the plan must state how it will distribute those benefits. In general, the form of payment is either a lump-sum payment or annual installments to a beneficiary named by the participant.

Let's Put It All Together

See the chart below for a comparison of withdrawals, plan loans, and distributions from DB and DC plans.

	DB Plan	DC Plan
Hardship Withdrawals	Not allowed	Allowed
Loans	Allowed, but rare	Allowed
Distributions	• Benefits are usually distributed as a stream of income payments • If permitted by the plan, the benefit may be distributed as a lump sum or rolled over to another qualified plan or IRA	The vested account balance may be distributed as a lump sum or rolled over to another qualified plan or IRA

- Jerry Cranston took a $15,000 hardship withdrawal from his 401(k) account balance of $90,000 to help pay for his daughter's college tuition. Do you think Jerry will owe taxes on the distribution?

Ans: Hardship withdrawals are subject to income taxes and may be subject to a 10% additional tax penalty on early distributions if the participant is under age 59½. In general, employees who take a hardship withdrawal cannot repay the funds to the plan. If Jerry had taken a loan instead, he may have been able to avoid a taxable distribution if he complied with plan repayment rules.

- Shannon Day, age 65, retired from Delicious Donuts after many years of service with a fully vested 401(k) account balance. Choose all of the possible options Shannon may select for the account.

Ans: Shannon has several options for the account balance in the 401(k) plan, including leaving it in the plan, taking a direct lump-sum distribution (this could have big tax consequences), or making a direct rollover of the balance to an IRA. However, if Shannon takes a lump-sum distribution, there is only a 60-day period in which to roll over those funds to an IRA or another qualified plan.