

## **Part IV Defined-Contribution Plans**

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### **Basics of Defined-Contribution Plans**

Defined-contribution plans are considerably different from defined-benefit plans. From a participant's perspective, perhaps the greatest difference is that the eventual benefits are not guaranteed, but rather are determined by the performance of the investments selected. With most defined-contribution plans, it is up to the employee to select these investments, and to decide how much to contribute to the plans, within certain limits. Much more responsibility falls to the employee.

Under defined benefit plans the company owns and invests funds and pays people based on a formula. In the 1990s, a number of pension funds were seriously under funded -- with the average fund containing only 80 percent of the amount needed to pay their obligations. Since then, many companies have moved to replace their **traditional defined benefit plans** with **defined contribution plans**.

Defined contribution plans allow workers to direct their own 401(k)-style plans. Several companies have set up defined-contribution plans or added components of them for workers. Employers have become less generous than they had been in the past with pension benefits. Corporate restructuring has left many people working for smaller businesses which usually don't offer generous pensions. Many big established companies have changed from, or rely less on, the more costly defined-benefit plans. Instead, many companies now use the less expensive and more flexible defined-contribution plans.

Defined contribution plans are actually a broad range of programs including

- profit-sharing plans
- money-purchase plans
- 401(k) plans
- employee stock ownership (ESOP) plans and others.

### **Mechanics of Defined-Contribution Plans**

Either the employee alone, or the employee and the employer make contributions into the plan, usually based on a percentage of annual earnings. Each participant has an individual, separate account. There is no way to determine in advance what the final payout at

retirement will be. One's benefits depend on how much was contributed in his name and how well the pension fund investments performed. So, the risk of fluctuations in investment return is shifted to the employees. The government sets a limit on how much can be contributed in one's name each year no matter how many different plans he participates in. The total amount that can be contributed in one employee's name is the lesser of \$30,000 or 25% (indexed) of the employee's annual earnings. The contributions are allocated to separate accounts for each participant based on a definite, predetermined formula. Forfeitures can be reallocated to remaining participants.

### ***Profit-Sharing Plans***

Profit-sharing plans are now the most popular type of plan, especially for small businesses. They offer the greatest flexibility in contributions and are simple to administer. Initially developed to encourage hard work and loyalty, the plans encourage companies to set aside money in the employees' names when the company shows a profit. Each year, the employer has the discretion to contribute up to the lesser of \$25,500 or 15% of compensation for each plan participant. The employer may decide not to contribute in any given year, if it so desires.

### ***Money-Purchase Plans***

In the money-purchase plans, the employer is obligated to contribute even if the company did not make a profit. The contributions are determined by a specific percentage of each employee's compensation and must be made annually.

### ***401(k) Plans***

Many qualified defined-contribution plans permit participating employees to make contributions to a plan on a before-tax basis. These plans are called cash or deferred arrangements or CODAs (or, more popularly, a 401(k) plan, named after the Internal Revenue Code provision dealing with CODAs). They enable participants to save for retirement on a before-tax basis. The employees authorize their employer to reduce their salary and contribute the salary reduction on their behalf to a qualified retirement plan. In addition to these employee elective deferrals, an employer can make supplemental contributions on behalf of employees. These employer contributions can be subject to a vesting schedule, but the employees' contributions must be nonforfeitable. The employee's elective deferral to all 401(k) plans is limited to \$10,500 (this amount is adjusted annually for inflation), and the employer contribution is also subject to separate, complex limitations. Generally, withdrawals from 401(k) plans are not permitted before age 59 1/2 unless the employee retires, dies, becomes disabled, changes jobs, or suffers a financial hardship as

defined by Internal Revenue Service regulations. 401(k) plans are often offered in combination with other plans, such as profit-sharing plans.

### ***Employee Stock Ownership Plans (ESOP)***

An ESOP is a stock bonus plan or a combination stock bonus plan and money purchase plan that is designed to invest primarily in qualifying employer securities and to use borrowed funds to do so. An ESOP is funded by employer contributions of stock in the corporation or allows one to buy shares of stock as a plan investment option. ESOPs must comply with all the requirements imposed on other types of defined-contribution plans. ESOPs cannot be integrated with social security.

Other examples of defined contribution plans for small businesses to consider include:

- SIMPLE plans
- SEPs (simplified employee pensions)
- SARSEPs (salary reduction simplified employee pensions — these plans may no longer be started, but an existing SARSEP plan may be continued)

### **Perils of Single Stock 401(k)**

Many companies have adopted defined-contribution plans, such as 401(k) plans, where the employees share in the responsibility for providing retirement income. Rather than provide investment options for the employees, many companies restrict employees' investing to only the employer's stock or the employers make contributions matching those of the employees but, again, only with company stock. In the current climate of rising stock prices, many workers are actually asking their benefits departments to add company stock as a plan option.

The perils of this over-concentration in single stock are that a steep decline in the stock price or long-term underperformance can seriously damage the value of the retirees' pensions. Indeed, employees' nest eggs can virtually disappear if the employer, whose stock comprises the majority of the retirement account, files for bankruptcy or the company enters into a merger that depresses the stock price.

Many employees have no choice and are even required to keep their investments in the company's stock until the employee reaches age 55. Yet, for an increasing number of defined contribution plans, the total returns when assets are not diversified may be less than the return from a no-risk fixed-income investment and far less than the Standard & Poor's 500-stock index.

Companies' reasons for employees investing pension monies in company stock are varied. Company stock is a valuable resource for low cost capital. If the company issues treasury shares to employees directly, it bypasses the costs of buying on the open market, thereby conserving cash for other uses.

Some companies prefer to have plans with a great concentration in their stock to allow management to vote those shares, thereby insulating the company from takeovers. Some employers perceive employees as more dedicated to the company if they also own shares. Unfortunately, the federal Employee Retirement Income Security Act (ERISA) does not cover 401(k) plans in this instance.

In light of the significant risks to the value of many retirees' pensions, Senator Barbara Boxer of California introduced a bill that sought to limit mandatory investments in an employer's stock to 10% of 401(k)' plan's assets. A weaker version of the bill was passed in 1997 as part of the Taxpayer Relief Act of 1997. Pension professionals seem to agree that regulation requiring diversification might be appropriate for plan participants who are close to retirement age because they have less time to rebuild their nest eggs if the company's financial profile turns sour.

However, even without strong legislation protecting retirement security for those with 401(k) plans, there are ways under ERISA to protect one's pension benefits. If an employer causes employee retirement plans to be overly concentrated in high risk company stock or does not diversify the assets owned by the plans to mitigate the investment risks, it may be subject to liability. In the event of loss of retirement assets, the company could be liable for having breached ERISA's fiduciary "prudent person" rule.

Companies can deduct the shares they contribute as if they were bought on the open market, thereby saving on taxes without a cash expense. By contrast, ERISA expressly prohibits traditional defined benefit pension plans from investing over 10% of assets in securities and real estate of the employer. 401(k) plans are specifically exempt from this rule.

## **Estate Tax Deferral**

Many prosperous Americans with corporate jobs, have money in a tax-deferred 401(k), profit sharing or employee stock ownership plan. Most taxpayers, haven't thought out an estate plan for these assets. Once this issue didn't matter much because not much money was at stake. But now it does: This year, for the first time, assets in these defined-contribution plans are expected to outstrip those in conventional pension plans. Paying 40% in immediate taxes on a distribution is something to be avoided if one can. Unfortunately

the tax rules that apply to such payouts are studded with traps for unwary taxpayers. Companies, too, need to check their procedures and consider revisions.

If one dies with assets in a firm retirement plan such as a 401(k), applicable estate taxes will be due soon after. Income taxes, however, may be deferred, allowing the assets **further tax-free accumulation**.

There is only one way to accomplish this. One should name his or her spouse—not their estate or a trust or anyone else—as beneficiary of the plan assets. Then, if one dies, the law allows the beneficiary to take the money and roll it over into an individual retirement account.

The problem comes if this option does not fit one's needs. Suppose one is divorced and wants his assets to go to his children. At some firms they might get a payout over five or ten years, but at many others, the money would all have to come out in a lump sum, taxable immediately.

Or perhaps one is single and wants the assets to benefit a favorite friend or charity. Or one is married, but wants to restrict access so that his assets benefit his spouse and children but not his spouse's next husband or wife. In each case no deferral is currently available, and full income taxes would be due on the assets soon after one's death.

Owners and heirs should carefully peruse their individual company plans. They should check to see whether any payout options other than a lump sum exist, such as spreading out payments over five or more years, which the IRS allows. They should also find out whether the firm would consider taking the earmarked assets and using them to buy a variable annuity for the heir. This isn't ideal, but could be done using pretax money.

Another possibility, if it's worth the trouble, is to set up a charitable remainder trust and name it as the heir of one's plan assets. This also could receive pretax assets, and the payout ratio could be set high enough so that little remainder is left for the charity.

Best of all, short of getting Congress to change the law on rollovers, is to roll as much money as possible out of one's company's plan(s) and directly into an IRA while he is still alive. Typically one can take the full value of the employer's contributions minus those of the last two years.

## **Part Four -- Defined-Contribution Plans**

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This works because IRAs are much more flexible than 401(k) plans as elements of estate plans. One can keep an IRA alive after his or her death for a non-spouse heir, for example, and one can wrap a trust document around one as well.

The only trouble here is that many 401(k) plans don't allow such "in-service rollovers." One survey found that only 40% of 600 large-company plans did. Companies want this money saved and worry that if people take it out, they will spend it.