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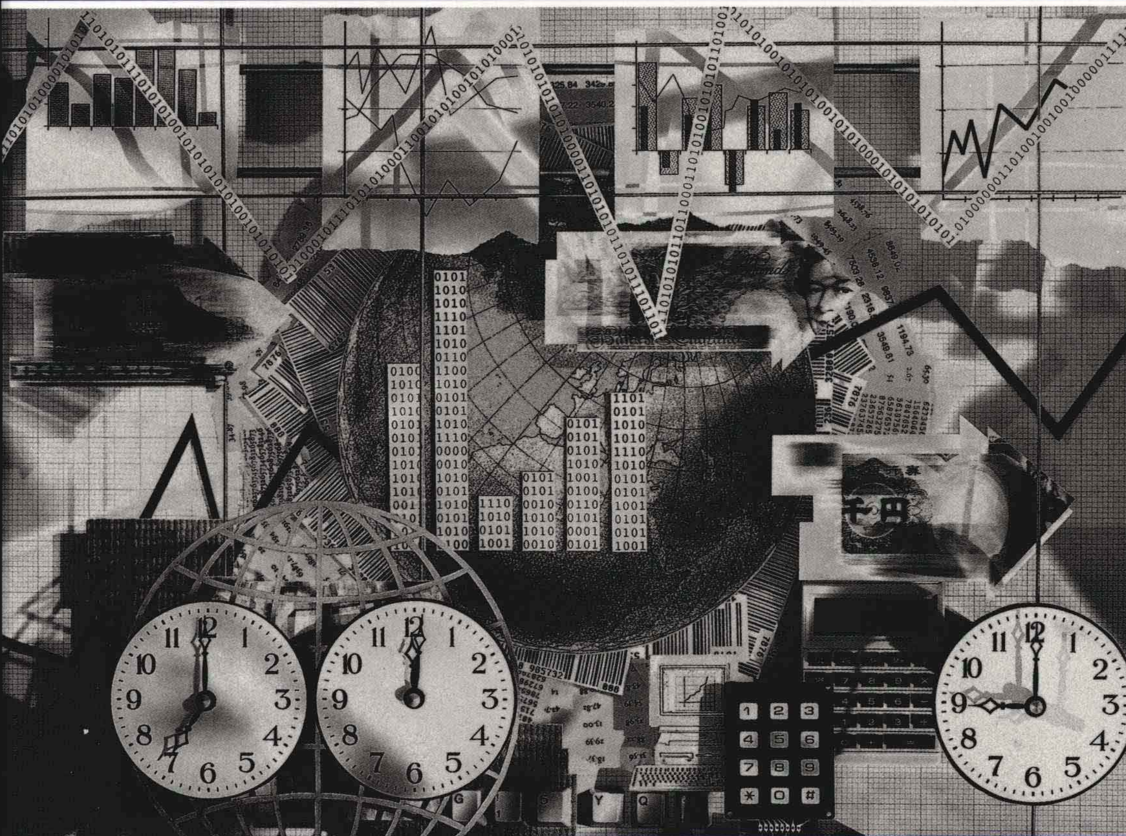

Allen • Melone • Rosenbloom • Mahoney

PENSION PLANNING

Pension, Profit-Sharing, and Other Deferred Compensation Plans

Pension Planning:

Pension, Profit Sharing, and Other Deferred Compensation Plans

Ninth Edition

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Preface to Pension Planning, Ninth Edition

The ninth edition of this book has been completely revised in response to the significant developments in the pension field since publication of the eighth edition. An overview of recent legislation is provided in Chapter 1 placing legislative themes in proper context. Provisions from the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and the Job Creation and Worker Assistance Act (JCWAA) of 2002 enacted into law are reflected throughout the text. For instance, the increases in elective deferral limits for future years as passed by EGTRRA are detailed where applicable throughout the book. Clarifications regarding the allowable deduction for simplified employee pensions (SEPs), as amended by JCWAA, is shown in Chapter 18.

Some restructuring of this ninth edition has occurred because of changes in the law and marketplace practices. Because of the evolution in various types of individual retirement arrangements (IRAs) that has occurred over time, this edition separates IRAs into a separate chapter distinct from plans for the self-employed. Chapter 17 covers IRAs while Chapter 18 details the characteristics of Keoghs, SEPs and savings incentive match plans for employees (SIMPLE plans).

The nature of EGTRRA itself has resulted in additional complexity when planning for pensions. The law indicates that its enacted changes will "sunset" or expire come January 1, 2011 unless forthcoming legislation either extends or makes these amendments to prior law permanent. Although it seems inconceivable to many tax practitioners that all of these legal provisions will be revoked, particularly some provisions that simplify or improve prior law, such an occurrence is within the realm of possibility at this writing. It is very difficult when writing a textbook like *Pension Planning* to attempt to foretell the future. Accordingly, the authors made a conscious decision to attempt to document explicitly those legal changes enacted as part of EGTRRA. Therefore, those using the text are alerted to potential problem areas should future legislative action stall or fail to materialize. This approach has resulted in additional historical coverage that would have been less detailed without the "sunset" provision. For instance, EGTRRA eliminated the application of the maximum exclusion allowance calculation for 403(b) plans beginning in 2002. The intricacies of this calculation, which were formerly very important, were moved to an appendix in Chapter 12. Administrators of these plans will decry the reemergence of this calculation if it occurs. Though its reemergence is considered highly unlikely, at the time of publication such an occurrence was within the realm of remote possibility.

EGTRRA made substantial changes to Section 457 plans. With the de-coupling of the limit on elective deferrals for 457(b) plans from coordination with 401(k) and 403(b) plans, these arrangements may now be used as an additional tool in rewarding executives in tax exempt organizations. Because of their increased significance as an additional executive reward mechanism, Appendix 3 is included explaining the evolution, use, and characteristics of 457 plans.

This edition of *Pension Planning* now covers stock options, an important component of compensation not only for executives, but for a broader range of employees in many organizations. Though not a form of a qualified plan, these rewards often are such an integral part of the compensation package, that they must be contemplated when designing other retirement-related arrangements. Chapter 21 explains Employee Stock Compensation Plans.

Tax regulations continue to clarify possibilities for more innovative retirement plan designs. Though some interest in cash balance plans has ebbed because of the controversy surrounding conversions of traditional defined benefit plans into cash balance plans, there is still interest in hybrid plans combining advantages of both defined benefit and defined contribution approaches. Accordingly, Chapter 19 covers Hybrid Retirement Plans.

The shift from defined benefit to defined contribution plans and the continued expansion in participant-directed investing has resulted in wider investment choice for plan participants. This trend heightens needs of plan sponsors to provide investment education. As a result, Chapter 23 examines Investment of Defined Contribution Plan Assets. Due to the collapse of Enron and the horrific losses which plan participants holding Enron stock suffered in their retirement plans, a variety of legislative initiatives have been introduced to better protect plan participants in the future.

EGTRRA was initially heralded by many as ushering in a new era of positive and expanded pension policy with increased benefit and contribution limits and enhanced opportunities for pension portability. However, the tragic events of September 11, 2001 resulted in a detrimental shock to the economy and a need for resources aimed at a global war on terrorism. Though all of us felt the pain of human suffering related to these terrible events, the economic and tax implications of these events are not immediately clear at this point. Though the government responded with an economic stimulus package when the Job Creation and Worker Assistance Act of 2002 was passed into law, the revitalization of the economy has not yet occurred. If longer-term economic growth is adversely impacted, the need for tax revenues could jeopardize an expansion in favorable tax treatment for retirement plans.

We truly live in turbulent times. Long-term economic security is of vital importance to a growing and prosperous economy. It is hoped that this textbook will be helpful in educating those individuals who administer and design retirement plans. To make this edition useful in this aim, educational learning tools are a part of every chapter including an outline of subject matter, learning objectives, insights into important topic areas and chapter summaries.

Acknowledgments

We want to express our appreciation once again to the many individuals who assisted us in prior editions of the text. Many of their contributions have survived in this ninth edition. We are also very much indebted to the individuals in the insurance, financial, and consulting professions who have reviewed portions of this text and made many valuable suggestions, and to the many teachers and students who over the years have given us extremely constructive comments and have enabled us to improve the readability and quality of the text. Special thanks are also due representatives of The American College, the College for Financial Planning, the International Foundation of Employee Benefit Plans, the Society of Actuaries, the Employee Benefit Research Institute (EBRI), and the Life Office Management Association for their comments and review over the years.

A special debt of gratitude is owed to Robert J. Myers, one of the world's leading authorities on Social Security for writing the appendix on Social Security and Medicare. Similarly, a special debt of gratitude is owed to Cynthia J. Drinkwater, Senior Director of Research, International Foundation of Employee Benefit Plans for the appendix on Multiemployer Plans and to Daniel J. Ryterband, CEBS, Managing Director and David Cole, Consultant, both from Frederic W. Cook & Co., Inc. for the appendix on Section 457 Plans.

In addition we would like to thank the many organizations and publishers that granted permissions to use material provided in "Insights" throughout the book. Also, the authors express their appreciation to G. Victor Hallman, a lecturer in financial and estate planning at the Wharton School of the University of Pennsylvania for his contribution to the chapter on Employee Stock Compensation Plans. This chapter is adapted from the sixth edition of *Personal Financial Planning,* which he co-authored. Thanks also are due to Dawn Bizzell, CEBS Benefit, an Economist with the Pension Guaranty Corporation for her help in reviewing Chapter 16, Plan Termination Insurance. The authors greatly appreciate the cooperation of Towers Perrin in providing material from their books, *The Handbook of 401(k) Plan Management* and *The Handbook of Executive Benefits.*

The authors also would like to express their deep appreciation to Dr. Jack L. VanDerhei, Professor of Risk Management and Insurance, Temple University, for his excellent contributions as a co-author on editions six through eight.

Finally, another major change in this edition is the addition of another name to the masthead, that of Dennis F. Mahoney, Associate Director of the Certified Employee Benefit Specialist Program at the Wharton School of the University of Pennsylvania. Mr. Mahoney brings a new perspective to this text and has extensive experience in the retirement and financial planning areas. We are pleased to have him join us for this ninth edition.

Everett T. Allen, Jr.
Joseph J. Melone
Jerry S. Rosenbloom
Dennis F. Mahoney

Contents

PART SIX
INVESTING, ADMINISTRATION, AND TAXATION

Chapter 1

Development of Private Pension Plans

After studying this chapter you should be able to:

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

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

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

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

Growth of Private Plans

The beginnings of industrial pension plans in the United States date back to the establishment of the American Express Company plan in 1875.[3] The second formal plan was established in 1880 by the Baltimore and Ohio Railroad Company. During the next half century, approximately 400 plans were established. These early pension plans were generally found in the railroad, banking, and public utility fields. The development of pensions in manufacturing companies was somewhat slower, largely because most manufacturing companies were still relatively young and therefore not confronted with the superannuation problems of the railroads and public utilities.

Insurance companies entered the pension business with the issuance of the first group annuity contract by the Metropolitan Life Insurance Company in 1921.[4] The second contract was issued by the Metropolitan in 1924 to an employer who already had a retirement plan on a "pay-as-you-go" basis.[5] In 1924, The Equitable Life Assurance Society of the United States announced its intention of offering a group pension service, thus becoming the second company to enter the field.[6]

Although the beginnings of private pensions date back to the 1800s, the significant growth in these programs has come since the 1940s. In 2000, the percentage of wage and salary workers ages 21-64 who participated in a pension plan reached 52.3 percent.[7] At year-end 2000, total U.S. retirement assets stood at $11.5 trillion. Of this $11.5 trillion, $2.6 trillion were held in defined contribution plans, $2.1 trillion were held in private defined benefit plans, $2.3 trillion were held in state and local government retirement funds, $0.7 trillion were held in federal defined benefit plans, $2.7 trillion were held in individual retirement accounts, and $1.1 trillion were held in fixed and variable annuities. It is worth noting there has been a significant increase in the relative growth of defined contribution plan assets. A similar evaluation of these relationships in 1983 would have shown defined benefit assets exceeding defined contribution assets by a significant margin.[8]

Economic Problems of Old Age

Longevity is a source of economic insecurity in that individuals may outlive their financial capacities to maintain themselves and their dependents. The extent to

[3]Murray Webb Latimer, *Industrial Pension Systems* (New York: Industrial Relations Counselors, Inc., 1932), p. 21.
[4]Kenneth Black, Jr., *Group Annuities* (Philadelphia: University of Pennsylvania Press, 1955), p. 9.
[5]Ibid., p. 11.
[6]Ibid.
[7]*EBRI Notes Executive Summary* 23, no. 3, March 2002.
[8]Investment Company Institute, *Fundamentals: Investment Company Institute Research in Brief* 10, no. 2 (Washington, DC: Investment Company Institute, June 2001), p. 3.

The Tripod of Economic Security: 1
A Voluntary System

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

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

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

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

which an aged person will have the financial capacity to meet self-maintenance costs and those of dependents relies upon the standard of living desired during retirement years, employment opportunities, and other resources (e.g., personal savings, social insurance, and inherited assets) available to meet this contingency.

Standard of Living after Retirement

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

Another major factor preventing a decrease in the financial needs of retirees is the likely cost of long-term care. It is estimated that a person reaching age 65 will have a 40 percent probability of being in a nursing home before death.[9] Although the federal government briefly experimented with the possibility of assuming a greater portion of this burden through the Medicare Catastrophic Coverage Act of 1988, the manner in which this additional coverage was financed proved to be politically unpalatable and was repealed the following year. The Health Insurance Portability and Accountability Act of 1996 made employer-paid long-term care tax-excludable beginning in 1997. Also, employer premiums became tax deductible to employers and tax-free to employees, although employee premiums cannot be paid from a flexible spending account or by elective pretax contributions under a cafeteria plan. Though this favorable tax treatment is an incentive for some employers to provide long-term care coverage to employees, the expense of this benefit limits its use for many employers. Even if retirees are fortunate enough to have comprehensive health insurance coverage continued by their employers after retirement, recent changes in the accounting standards applied to these plans are likely to cause modifications in the type of coverage, cost sharing, or financing of this benefit.

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

Employment Opportunities

The proportion of persons age 65 and over with some income from earnings is currently about 18 percent.[10] Obviously, many reasons account for the withdrawal of the aged from the labor force. A large number of older workers voluntarily retire. If workers have the necessary financial resources, they may wish to withdraw from active employment and live out their remaining years at a more leisurely pace. Others find it necessary for reasons of health to withdraw from the labor force. The aging process takes its toll, and many individuals are physically unable to operate at the level of efficiency attainable at a younger age. Disabilities at the older ages tend to be more frequent and of longer duration.

[9] Anthony J. Gajda and Morris Snow, "Long-Term Care," *The Handbook of Employee Benefits*, ed. Jerry S. Rosenbloom, 5th ed. (New York: McGraw-Hill, 2001), p. 310.
[10] Deborah Holmes, Lynn Miller, and Maureen Richmond, *EBRI Databook on Employee Benefits* (Washington, DC: Employee Benefit Research Institute, 1997), p. 58.