Pension Planning

Pension, Profit-Sharing, and Other Deferred Compensation Plans

Eighth Edition

Allen
Melone
Rosenbloom
VanDerhei

PENSION PLANNING

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PREFACE

The eighth edition of this book has been completely revised in response to the significant developments in the pension field since publication of the seventh edition. An overview of recent legislation is provided in Chapter 1, placing legislative themes in proper context. The provisions of the Small Business Job Protection Act of 1996 and pension simplification are reflected throughout the text. For instance, simplified nondiscrimination testing procedures are included in Chapter 11. Savings incentive matching plans for employees (SIMPLE plans) are covered in Chapter 17, bringing together the array of pension plans available to the self-employed and small-business person. Pension-related issues from the Health Insurance Portability and Accountability Act of 1996 such as the ability to make withdrawals penalty-free from individual retirement accounts for the payment of medical expenses, are included.

Because the Omnibus Budget Reconciliation Act of 1993 lowered limits for high-income taxpayers to contribute to qualified plans, there has been wider use of nonqualified plans. Accordingly, Chapter 19 on Executive Retirement Arrangements was rewritten to explore a variety of nonqualified plan approaches and the merits of these options.

Tax regulations have clarified possibilities for more innovative retirement plan designs. There is growing interest in hybrid plans, which combine advantages of both defined benefit and defined contribution approaches. Accordingly, Chapter 18, on Hybrid Retirement Plans, is a completely new chapter explaining innovative plan designs and the situations where these plans are appropriate.

The shift from defined benefit to defined contribution plans and the 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 21 has been added: Investment of Defined Contribution Plan Assets.

In addition, many new educational learning tools have been added to every chapter, including an outline of subject matter, learning objectives, insights into important topic areas and chapter summaries.

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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 1993, among all civilian workers (118 million), 57 percent, or 67 million, worked for an employer where a retirement plan was sponsored; and 38 percent of the civilian workforce, or 44 million workers, had a vested right within a pension plan.[7] At the end of 1993, total financial assets of private trusteed funds exceeded $2.5 trillion. Of this $2.5 trillion, $1.13 trillion represented single-employer defined benefit plan assets; $1.06 trillion represented single employer defined contribution plan assets; and $310 billion represented multiemployer plan assets. It is worth noting there has been a significant increase in the relative growth of single-employer defined contribution plan assets. A similar evaluation of these relationships in 1983 would have shown single-employer defined benefit assets exceeding defined contribution assets by a margin of two to one.[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 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.

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. Carolyn Pemberton and Deborah Holmes, *EBRI Databook on Employee Benefits* (Washington, DC: Employee Benefit Research Institute, 1995), p. 694.
8. Ibid., p. 191.

EMPLOYER PERSPECTIVES ON THE TRIPOD OF ECONOMIC SECURITY

KPMG's Compensation & Benefits Practice released its third national retirement benefits survey of employers with 200 or more employees . . . Based on data gathered in early 1995, *Retirement Benefits in the 1990s: 1995 Survey Data* reports on retirement benefits offered and plan design features from a randomly based sample of 1,183 employers, including both for-profit and not-for-profit organizations . . . The survey sought to determine employers' attitudes toward the employees' level of responsibility for their own retirement security. In 1995, 82 percent of employers subscribed to the traditional three-legged stool philosophy for retirement security, consisting of employer-provided benefits, Social Security, and personal savings. Certainly, that attitude is supported by the data from other questions on wage replacement goals for career employees. Those data indicate even employers with wage replacement goals for their retirement plans left a substantial shortfall in income to be supplied by the employees' own savings.

Only 4 percent of respondents agreed with the view that an employee should expect a secure retirement income based solely on employer-provided retirement benefits . . . Seven percent thought the employee should be primarily responsible for his or her own retirement security and that employer-provided benefits should serve merely as a "supplement" to employee-provided savings. Seven percent of respondents . . . thought the employee could rely only on employer benefits and Social Security . . .

Source: Martha Priddy Patterson, "Retirement Benefits in 1995: KPMG's Third Annual Survey Findings," *Journal of Compensation and Benefits*, November–December 1995, pp. 15, 20, 21. Reprinted with permission from *Journal of Compensation and Benefits*, Copyright © 1995 by Warren, Gorham & Lamont, Park Square Building, 31 St. James Avenue, Boston, MA 02116-4112. 1-800-950-1211. All rights reserved.

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 15 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.

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9. Anthony J. Gajda, "Long-Term Care," *The Handbook of Employee Benefits*. ed. Jerry S. Rosenbloom, 4th ed., Irwin Professional Publishing, 1996, p. 290.
10. Carolyn Pemberton and Deborah Holmes, *EBRI Databook on Employee Benefits* (Washington, DC: Employee Benefit Research Institute, 1995), p. 117.

Voluntary retirement and the physical inability to continue employment are undoubtedly important reasons for the decrease in the percentage of older persons participating in the labor force. However, these are probably not the most important factors affecting employment opportunities for the aged. The effects of industrialization, expansive technological advances, and the development of the federal Old-Age, Survivors, Disability, and Health Insurance (OASDHI) program, private pensions, and other employee benefit programs probably have had a more significant impact on this problem.

The rapid pace and dynamic evolution of industrial employment operated to the disadvantage of older persons. Automation and mass-production assembly lines put a premium on physical dexterity and mental alertness. Employers generally were of the opinion, justifiable or not, that younger workers were better suited to the demands of industrial employment. In an agricultural economy, on the other hand, the able-bodied older person could continue to work, at least on a part-time basis.

Similarly, as organizations adapt to the information systems age and increasingly look to enhance productivity through the use of computers and other technology applications, it appears that older workers will continue to be at risk. In fact, the 90s have seen technological enhancements result in corporate restructurings and downsizings. Some social philosophers expect that greater labor market dislocations will occur and postulate that the systems age could mean a decreasing need for mass labor.[11]

The OASDHI program and private pension plans, although created to alleviate the financial risk associated with excessive longevity, have actually aggravated the problem. These programs have tended to institutionalize age 65 as the normal retirement age, although the 1986 amendments to the Age Discrimination in Employment Act (ADEA) banned mandatory retirement (at any age) for most employees. The 1983 amendments to The Social Security Act will gradually raise the normal retirement age for Social Security benefits to age 67 by the year 2027.[12] Also, some employers may hesitate to hire older workers on the assumption that these employees will increase pension and other employee benefit plan costs. It is difficult to generalize the impact of the older worker on employee benefit plan costs. Nevertheless, it must be recognized that an employer's attitude toward the hiring of older workers may be influenced by the assumption, justified or not, that employee benefit costs will be adversely affected.

Self-employed members of the labor force have greater control as to the timing of their retirement from active employment. For example, physicians and lawyers frequently continue in practice, at least on a part-time basis, until advanced ages. Owners of businesses also continue to be active in their firms until relatively old ages. The fact remains, however, that employment opportunities for the majority of older workers have become more limited. It is quite likely that this will be a temporary phenomenon for many employees given the expected impact of changing demographics and the potential shortage of certain segments of the workforce as early as the year 2000.

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11. Jeremy Rifkin, *The End of Work* (NY: G. P. Putnam's Sons, 1995), p. 5.

12. The retirement benefits provided under The Social Security Act are discussed in detail in Appendix I at the end of this book.

Individual Savings of the Aged

If employment opportunities for the aged are decreasing and financial needs are still substantial at advanced ages, the need for savings becomes quite apparent. However, studies indicate that a substantial proportion of the homes owned by the aged are clear of any mortgage. Home ownership reduces the income needs of the aged insofar as normal maintenance costs and taxes are less than the amount of rent required for comparable housing accommodations. It has been estimated that the maintenance costs for an unencumbered home are about one-third to 40 percent less than the costs of renting comparable facilities. Furthermore, there is the possibility that the home can be used in part as an income-producing asset or that a home equity loan can be used to provide additional cash.

There is growing interest in the concept of a so-called **reverse annuity**. Under this approach, the homeowner receives a lifetime monthly income in exchange for the title to the home at the homeowner's death. The amount of the monthly annuity payment depends on the equity in the home and the life expectancy of the homeowner.

Jacobs and Weissert have analyzed the potential for using home equity to finance long-term care. Their results strongly suggest that a significant number of elderly Americans could use their homes' equity to meet their health care expenses. They also conclude that those in the highest risk group and those with the lowest incomes, who are often the same individuals, also can be significantly helped by the use of reverse annuity mortgages.[13]

Pricing this type of financial instrument has proven to be both extremely difficult and a major obstacle to its widespread use. Another problem faced by private institutions is the possibility that the outstanding balance on the mortgage will eventually exceed the value of the property.

As a result of the Housing and Community Development Act of 1987, the federal government began an experimental program in which the Department of Housing and Urban Development (HUD) insured a maximum of 2,500 reverse annuity mortgages. The experimental program was further extended. On March 28, 1996, the National Housing Act was amended and the mortgage insurance authority of the Federal Housing Authority (FHA) Reverse Mortgage program was extended through September 30, 2000. The maximum number of reverse mortgages was increased to 50,000. As of February 1996, 15,000 reverse mortgages had closed.[14] Although the complexity of the HUD program, the inherent risks, and the small profit potential have reduced the number of original lenders, it is anticipated that the reverse annuity concept will become more important in the future.[15]

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13. Bruce Jacobs and William Weissert, "Using Home Equity to Finance Long-Term Care," *Journal of Health Politics, Policy & Law* 12, no. 1 (Spring 1987), pp. 77–95. However, a more recent study analyzes the potential of reverse annuity mortgages to increase the current income of the elderly and concludes that most low-income elderly also have little housing equity. See Steven F. Venti and David A. Wise, "Aging and the Income Value of Housing Wealth," *Journal of Public Economics* 44, no. 3 (April 1991), pp. 371–97.
14. Mortgagee Letter 96–15 of the U.S. Department of Housing and Urban Development (HUD).
15. Robert J. Pratte, "A Mortgage for the 21st Century," *Mortgage Banking* 50, no. 8 (May 1990), pp. 45–52.

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