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The Evolving Role of Retirement Income Protection

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What's this?

Saving For the Golden Years

A combination of better healthcare and worse economic conditions has conspired to delay retirement for a significant percentage of today's workforce. The realities of workers living longer and needing to find enough savings to finance their lifestyles mandate the critical nature of retirement savings. Unfortunately this has coincided with an erosion of traditional defined benefits retirement plans in which the employer assumed all the risk and funding for the workers' retirements; and their replacements with defined contribution plans in which both are borne by the workers. In some cases, the employer may partner in matching certain percentages of contributions, but only after the employee has taken the primary responsibility (and risk) for his or her retirement savings. Paradoxically, employers realize that they need to be aggressive in attracting and retaining top-quality employees, but they also must offer cost-effective funding methods that will entice star candidates and not show preferential treatment to senior stars that might jeopardize taxing advantages that they have always realized. Employers cannot waver on whether or not to offer a retirement program for their employees, but they must determine cost-effective ways to fund this critical benefit. Cost sharing between staff and management continues to predominate, as with so many other benefits.

The great news for both employee and employer is that, since employer contribution to a company-sponsored retirement program is a tax-deductible expenditure, these contributions ultimately help to reduce the organization's tax liability and raise bottom line profits. Employees realize that as their organization implements a company-sponsored retirement program to attract and retain productive people, an employee can, in turn, use that same benefit to take advantage of solid, tax-deferred investment earnings to hasten the growth of their retirement savings accounts.

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There are two major plan designs in delivering retirement savings. These are *defined benefits plans* and *defined contribution plans*. In the former, pensions are funded totally by the employer's contributions. With these contributions serving as a major expense, organizations are moving toward the latter, which involve contributions from both the employee and the employer. Regardless of who is the primary contributor, a pension is a current financial investment for the purpose of providing future income during retirement. These invested funds accrue interest and yield dividends, growing and accumulating to again provide income during retirement. Pension plans are subject to very complex financial, legal, and tax rules and regulations established by the government. Most pension plans are considered *qualified*, meaning they conform to the rigorous rules and regulations established and enforced by the federal government, the Internal Revenue Service, and the Employee Retirement Income Act (ERISA). Both employer and the employee contributions to a qualified pension plan are exempt from income tax. Interest, dividends, and market gains on these invested funds are allowed to accumulate tax free. At the time of retirement, employees must begin to pay income taxes on the payments they receive from their pension plans, but their tax liabilities are lower than when they were working full time and receiving higher salaries. In short, employee contributions are a very valuable method of deferring tax on income.

There are also pension plans designed specifically to provide retirement benefits for a select group of management or executive-level employees that are considered nonqualified plans, meaning they do not conform to the rules and regulations of the IRS and ERISA and therefore are not eligible for the favorable tax savings as qualified plans. Normally, nonqualified plans cannot be made available to employees company-wide. Plans that are made available company-wide must be administered as qualified plans, must be subject to the IRS and ERISA rules, and cannot be geared toward management or executive-level employees. The employer may decide that a certain class of executives is so critical to the future well-being of the organization that their reward structure justifies additional tax treatment that is normally shielded from most staff. Below, we discuss further how the types of plans differ.

As noted above, retirement plans are structured in one of three ways: defined benefit plan (DBP), defined contribution plan (DCP), and hybrid retirement plan (HRP), which combines attributes of both the DBP and DCP plans. In a traditional DBP, the employer agrees to provide the employee with a retirement benefit amount based on an established formula. The employer accepts the full risk of ensuring that sufficient funds will be available in the DBP account for retirement payments. In a DCP, both the employer and the employee pay an established amount into the retirement plan. The critical distinction between the two is which party (employer or employee) assumes risk for funding and investment success.

Gaining a deeper understanding of the various retirement plans and how they function to provide employees with future income and tax savings is contingent upon understanding the laws that govern these plans, as well as facets of the Internal Revenue Code (IRC). Given the unique nature of how funding is treated, as well as deferral of taxing consequences for retirees, many companies' decisions are driven by these laws and regulations. The laws governing pension have been developed primarily to correct past abuse in the system by employers and also to reflect changes in the way employees work in the workplace. The three major laws affecting the establishment and governance of retirement plans include the Employee Retirement Income Security Act (ERISA), the Retirement Equity Act (REA), and the Pension Protection Act (PPA).

ERISA is a very critical piece of legislation affecting retirement plans. This act and all of its amendments set minimum, uniform guidelines to make certain that employee retirement plans are created and maintained in a fair and financially sound manner. ERISA seeks to protect both the interests of the employees paying into the retirement plan and their beneficiaries. For employers, retirement plans are considered a discretionary benefit, but if the employer offers one, it must conform to ERISA guidelines. One key provision of ERISA was the development of the Pension Benefit Guarantee Corporation (PBGC), which insures plans to protect against their inabilities to pay out promised benefits. The PBGC is funded by employer taxes on pension plans and has weathered several plan challenges throughout the years.

The REA offers legal protections for spousal beneficiaries of qualified retirement plans. Under the REA, married participants cannot make changes to their retirement plans with regard to their benefit distribution, spousal beneficiary, and so forth.

The PPA is also deemed as a monumental reform of the nation's pension laws since the passage of ERISA. PPA, signed into law in August of 2006, was enacted to help protect employee retirement assets. It created new funding requirements for defined benefit pensions and includes reforms that will have an effect on cash balance pension plans, defined contribution plans, and deferred compensation plans for highly compensated employees and organizational executives. This act also established the restriction conditions under which payment of lump sums from defined benefit plans can be distributed.

Plan Design Features

All defined benefits plans and most defined contribution plans are also regulated completed a minimum of 100 hours in a calendar year and to attain the age of 18 vesting and 21 for participation. Vesting is defined as the ability to carry forward all earned pension contributions in the event of the employee leaving the company. There are numerous vesting schedules but most allow for employer contributions transfer after 3–5 years of service. Of course, all employee contributions are 100% vested immediately. Benefits are calculated in whatever prescribed manner defined within plan design. Most defined benefits plans call for a calculation of an average of the last 5 years of service with the company, whereas some specify the highest 5 years. Defined contribution plans are funded by whatever formula is used in the plan design, including the matching provisions as identified. Plan payouts are usually identified using a *joint and survivor* designation, which specifies 100% of the payouts to the participant and continuing to the spouse in the event of the participant's death. This provision is mandatory in most plans and can only be waived with the spouse's signature.

Putting It All Together

As the American workforce continues to age and the critical mass of workers known as the baby boomers actually begins to retire, retirement income will become a national agenda. Additionally, the role of Social Security and its questioned future viability will call this issue into sharp relief. The ability of our country to support an aging population without severely taxing the younger members of society demands that we define savings for retirement as a major cycle issue for young workers. This will have serious implications for benefits communications during early enrollment periods, and employers will need to better articulate the case for all staff members including this provision as part of their benefits calculation while still in the early years of their careers versus waiting until their 40s and 50s. This suggests a stronger communication policy among employers during the employment onboarding process and continued communication in choices of investment vehicles utilized throughout the participant's plan lifetime. Retirement savings will fuel a segment of the economy going forward that will need a vibrant population who can maintain a lifestyle that affords sustainability and dignity.

Benefit Contribution Plan

1. A family owned restaurant with roughly 150 employees wants to establish a retirement plan for its owners and management group. If the company establishes a qualified defined benefit contribution plan, what type of restrictions, if

View Answer

Parachutes

2. Parachutes are generally written into contracts of key executives for what purpose?

View Answer