Chapter 22
Employee Benefits: Qualified Retirement Plans

■ Overview

Americans, on average, are spending a longer period of their lives in retirement. The early retirement trend combined with increasing life expectancy makes income during retirement a critical concern. There are three primary sources of retirement income: Social Security old-age benefits, income generated from personal investments and savings, and private retirement plans. To encourage employers to provide retirement plans, tax benefits have been made available. To qualify for these tax benefits, the employer is required to satisfy certain coverage and nondiscrimination requirements, as well as other rules. This chapter examines the basic features of private retirement plans, the distinctions between defined benefit plans and defined contribution plans, the funding instruments used to finance retirement plans, and the features of several types of retirement plans.

■ Learning Objectives

After studying this chapter, you should be able to:

• Explain the basic features of private retirement plans, including: minimum age and service requirements, retirement ages, and vesting rules.
• Distinguish between defined-contribution and defined-benefit retirement plans.
• Describe the basic characteristics of Section 401(k) plans.
• Explain the major features of profit-sharing plans.
• Describe the basic characteristics of Keogh plans for the self-employed.
• Identify the major features of SIMPLE retirement plans for small employers.
• Define the following:
  Actual deferral percentage (ADP) test
  Career-average earnings
  Cash-balance plan
  Deferred retirement age
  Defined-benefit plan
  Defined-contribution plan
  Early retirement age
  Employee Retirement Income Security Act of 1974 (ERISA)
  Final average pay
  Funding agency
  Funding instrument
  Guaranteed investment contract (GIC)

Highly-compensated employees
Individual 401(k) plan
Investment guarantee contract
Keogh plans
Minimum age and service requirement
Minimum coverage requirements
Minimum vesting standards
Money purchase plan
Normal retirement age
Past-service credits
Pension Benefit Guaranty Corporation (PBGC)
Pension Protection Act of 2006
Profit-sharing plan
Qualified plan

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   H. Integration with Social Security
   I. Top-Heavy Plans

II. Types of Qualified Retirement Plans

III. Defined-Benefit Plans
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X. SIMPLE Retirement Plans
   A. Eligible Employees
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XI. Funding Agency and Funding Instruments
   A. Trust-Fund Plan
   B. Separate Investment Account
   C. Guaranteed Investment Contract (GIC)
   D. Investment Guarantee Contract

== Short Answer Questions ==

1. What tax benefits are available to qualified retirement plans?

2. Explain the minimum coverage tests for qualified retirement plans.
3. What is the difference between a defined benefit plan and a defined contribution plan?

4. What formulas can be used to determine retirement income under a defined benefit plan?

5. What is vesting? Explain the two minimum vesting standards for qualified defined benefit retirement plans.
6. What is the early distribution penalty? What distributions are exempt from the early distribution penalty?

7. What is a top-heavy pension plan? What additional restrictions are imposed on top-heavy plans?

8. What is a 401(k) plan? What is the actual deferral percentage (ADP) test for 401(k) plans?
9. What are the major characteristics of Keogh (HR-10) plans?

10. What are the major characteristics of Simplified Employee Pension plans (SEPs)?

11. What employers are eligible to establish SIMPLE (Savings Incentive Match Plan for Employees) plans? What special incentive exists for these employers to establish SIMPLE plans?

12. What are the major types of funding instruments for private pension plans?
Multiple Choice Questions

Circle the letter that corresponds to the BEST answer.

1. Which of the following benefit formulas is used in defined contribution plans?
   (a) flat dollar amount for each year of service
   (b) unit-benefit formula
   (c) flat dollar amount for all employees
   (d) fixed percentage of salary

2. Which statement(s) is(are) true with regard to qualified retirement plans?
   I. Distributions from qualified plans are not taxable.
   II. Investment income accumulates tax-deferred in qualified plans.
   (a) I only
   (b) II only
   (c) both I and II
   (d) neither I nor II

3. Jennings Inc. just started a pension plan. The company has many long-term employees who are within 10 years of retirement. Which of the following will help Jennings provide more adequate retirement benefits to these workers?
   (a) early distribution penalties
   (b) advance funding
   (c) past service credits
   (d) minimum vesting standards

4. Bailey Company just started a qualified plan for their employees. Under the plan, Bailey provides an additional 5 percent of each employee’s salary as a bonus, and each employee is given the option of receiving the bonus in cash or putting some or all of the bonus funds aside for retirement. What type of plan did Bailey initiate?
   (a) Keogh (HR-10) plan
   (b) Simplified Employee Pension (SEP)
   (c) SIMPLE plan
   (d) 401(k) plan

5. The present value of the cumulative accrued pension benefits of highly compensated employees at JL Drug Company is 70 percent of the total of all accrued benefits. JL’s plan therefore is described as:
   (a) defined contribution
   (b) top-heavy
   (c) overfunded
   (d) qualified

6. All of the following statements about profit sharing plans are true EXCEPT:
   (a) Profit sharing plans are a type of defined-contribution plan.
   (b) Profit sharing plans provide an incentive for employees to work more efficiently.
   (c) Profit sharing plans are exempt from the 10 percent penalty tax on early distributions.
   (d) Profit sharing contributions are more flexible than defined benefit plan contribution.
7. Which statement(s) is(are) true with regard to minimum vesting for qualified defined benefit plans?
   I. Under cliff vesting, workers must be fully vested after three years.
   II. Under the graded vesting rule, the worker must be 60 percent vested after three years, and then vested an additional 10 percent for each of the next four years.

   (a) I only
   (b) II only
   (c) both I and II
   (d) neither I nor II

8. Mom and Pop’s Grocery is a sole proprietorship. Mom and Pop would like to establish a qualified plan to take advantage of the same tax advantages to which corporations are entitled. Mom and Pop should establish a(n):

   (a) 401(k) plan
   (b) Simplified Employee Pension (SEP)
   (c) Individual Retirement Account (IRA)
   (d) Keogh (HR-10) plan

9. A funding arrangement in which an insurer guarantees the interest for a number of years on a lump-sum deposit is called a(n):

   (a) guaranteed investment contract (GIC)
   (b) separate investment account
   (c) unit benefit formula
   (d) trust fund plan

10. Lewis Company adjusts retirement benefits to consider Social Security retirement benefits. As Social Security slants benefits in favor of the less highly compensated workers, this adjustment reduces benefits for lower-paid employees and increases benefits for the highly-compensated employees. Because the Lewis Company plan makes this adjustment, it can be described as:

    (a) indexed
    (b) discriminatory
    (c) top-heavy
    (d) integrated

11. One type of retirement plan is designed for the employees of public schools and tax-exempt organizations such as hospitals, non-profit groups, and churches. These plans are called:

    (a) 401(k) plans
    (b) 403(b) plans
    (c) Keogh plans
    (d) SIMPLE plans
**True/False**

*Circle the T if the statement is true, the F if the statement is false. Explain to yourself why a statement is false.*

1. Profit sharing plans provide greater funding flexibility than other types of qualified plans provide.  
   T F

2. For most workers, a pension benefit based on career average earnings is more beneficial than a pension benefit based on final pay.  
   T F

3. Although the normal retirement age in most plans is 65, many workers retire before the normal retirement age.  
   T F

4. Under present law, all employees eligible for coverage who are at least age 21 and who have completed one year of service must be allowed to participate in a qualified retirement plan.  
   T F

5. Employees must pay taxes on the amount they elect to defer in a 401(k) plan in the year the deferral is elected.  
   T F

6. A self-employed 401(k) plan combines a profit sharing plan with an individual 401(k) plan.  
   T F

7. A top-heavy plan is one that is over-funded.  
   T F

8. The amount that can be contributed each year to a defined contribution plan is limited.  
   T F

9. Under a unit-credit formula, both earnings and years of service are considered.  
   T F

10. An employee has a better idea what his or her retirement benefit will be prior to retirement under a defined contribution plan than under a defined benefit plan.  
    T F

11. Early distributions from qualified plans are subject to a 10 percent penalty tax.  
    T F

**Case Applications**

**Case 1**

Stained Panes (SP) is a small company specializing in stained-glass windows, primarily for churches. The company was just purchased and the new owner was amazed to learn that there was no retirement plan for SP workers. The new owner would like to provide adequate retirement benefits for workers and reward long-time service. The work force consists of 14 skilled artisans, each of whom is over age 50 and has been with the company for over 25 years; two salespeople ages 40 and 55; three packing and delivery workers ages 35, 27, and 38; and a bookkeeper age 54. Based on this situation, should this company adopt a defined benefit or a defined contribution plan? Explain your answer.
Case 2

Midsouth Diesel specializes in the repair and overhaul of diesel engines. The company has 10 employees who are “highly compensated,” and eight of these employees are covered by the company’s 401(k) plan. There are 40 “nonhighly compensated” employees, and 24 of these workers are covered under the 401(k) plan. Is Midsouth Diesel satisfying the minimum coverage requirement for qualified plans?

Solutions to Chapter 22

Short Answer Questions

1. If a private retirement plan meets certain standards, favorable income tax treatment is afforded the plan. These tax benefits include: the employer’s contributions are tax deductible up to specified limits as an ordinary cost of doing business, the employer’s contributions are not considered currently taxable income to the employee, the investment income accumulates on a tax-deferred basis, and benefits attributable to employer contributions are not taxed until the employee retires or receives the funds.

2. There are two minimum coverage tests. To qualify, the plan must satisfy one of the tests:

   Ratio percentage test: The plan must cover a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees covered. So if 90 percent of the highly compensated employees are covered, at least 63 percent (.70 × .90 = .63) of the nonhighly compensated employees must be covered.

   Average benefits test: Under this test, two requirements must be satisfied: (1) the plan must benefit a reasonable classification of employees and must not discriminate in favor of highly compensated employees, and (2) the average benefit for the nonhighly-compensated employees must be at least 70 percent of the average benefit provided to the highly-compensated employees.

3. With a defined benefit plan, the retirement benefit is known in advance, but the contributions needed to fund the benefit vary. For example, the benefit may be defined as 50 percent of career average earnings. With a defined contribution plan, the contribution is known in advance, but the benefit is variable. For example, an employer may agree to contribute 5 percent of a covered employee’s salary to the retirement plan. The benefit that these contributions plus investment income will provide at retirement is unknown—all the employer defines is the contribution to the plan.

4. A number of formulas can be used to determine retirement income under defined benefit plans. They include: flat dollar amount for all employees, flat percentage of annual earnings, flat dollar amount for each year of service, and a unit-benefit formula which considers both earnings and service.
5. Vesting refers to the employee’s right to the benefits attributable to the employer’s contributions or benefits promised by the employer if employment terminates prior to retirement. A qualified defined benefit retirement plan must meet one of the two minimum vesting standards. Under the first standard, the employee must be 100 percent vested after five years of service. This rule is sometimes called “cliff vesting,” because up until five years, nothing is vested. The second rule, the graded vesting rule, provides for gradual vesting over a longer period of time. Under this standard, an employee must be 20 percent vested after three years, and then vested an additional 20 percent for each of the next four years so that after seven years the employee is fully vested. These two standards are minimums—the employer is free to vest benefits more rapidly.

6. Under the law, there is a 10 percent early distribution tax penalty if funds are withdrawn from a qualified retirement plan before age 59.5. In addition to the penalty, ordinary income taxes must be paid on part or all of the amounts withdrawn. The early distribution tax penalty does not apply to any of the following distributions: distributions after age 59.5, distributions made after death or total and permanent disability of the employee, termination of employment after age 55, substantially equal payments over the worker’s life expectancy or over the joint life expectancy of the worker and beneficiary after termination of employment, payments to an alternate payee as a result of a qualified domestic relations order, and payments in connection with certain employee stock ownership plans. Additional exceptions apply to certain IRA, SIMPLE plan, and SEP distributions.

7. A pension plan that primarily benefits highly-compensated employees is considered top-heavy. If the present value of the cumulative accrued benefits for highly-compensated exceeds 60 percent of the present value of the all accrued benefits, the plan is top-heavy. If a plan is top-heavy, additional restrictions apply. A rapid vesting schedule must be used for nonhighly compensated employees and certain minimum benefits or contributions must be provided for nonhighly compensated employees.

8. A 401(k) plan is a qualified cash or deferred arrangement (CODA) that allows eligible employees the option of deferring income by making a contribution to the plan or receiving the funds in cash. The 401(k) plan can use employer contributions only, employee contributions only, or a mixture of employer and employee funding.

To prevent discrimination in favor of highly compensated employees, an actual deferral percentage (ADP) test must be met. Covered employees are divided into two groups, the highly-compensated and the nonhighly compensated. The percentage of salary deferred is calculated for each employee and averaged for the members in each group. Then the average ADP of the two groups is compared. There are rules that specify by how much the ADP of the highly-compensated employees can exceed the ADP of the nonhighly compensated employees. Employers often provide generous matching contributions to encourage less-highly compensated employees to participate in the plan.

9. Keogh (HR-10) plans are qualified retirement plans for sole proprietorships and partnerships. These plans allow owners of unincorporated businesses to enjoy the same tax advantages that qualified corporate plans enjoy. Contributions to the plan are tax deductible up to certain limits, investment income accumulates on a tax-deferred basis, and the funds are not taxed until distributed.

10. Simplified Employee Pension plans (SEPs) are essentially employer-sponsored IRAs that meet certain requirements. Each employee establishes and owns an individual IRA with fully-vested rights. The employer makes annual tax-deductible contributions to the account. Contribution limits are substantially higher than for individual IRAs.
11. SIMPLE retirement plans are limited to employers with 100 or fewer eligible employees and who do not maintain another qualified retirement plan. Because SIMPLE plans are exempt from most nondiscrimination and administrative rules that apply to qualified plans, employers have an incentive to establish these plans.

12. The major types of funding instruments for private pension plans include: trust-fund plans, separate investment accounts, guaranteed investment contracts, and investment guarantee contracts.

**Multiple Choice Questions**

1. (d) A fixed percentage of salary formula is used in defined contribution plans. The other choices are all defined benefit formulas.

2. (b) Only the second statement is true. As pre-tax dollars are usually used to fund benefits, and the investment income accumulates tax-deferred, taxes must be paid on part or all of retirement plan distributions.

3. (c) If Jennings Inc. allows credit for past service to the company, additional benefits can be credited for long-term employees. Jennings can fund the past service benefits over time.

4. (d) Bailey Company established a 401(k) plan. These plans give employees the option of taking the benefit in cash or deferring some or all of the benefit for retirement. If a deferral is elected, the income is not currently taxable.

5. (b) JL’s plan is top-heavy because more than 60 percent of the present value of the accrued benefit is for the highly-compensated employees.

6. (c) Profit sharing plans are subject to the 10 percent penalty tax for distributions prior to age 59.5.

7. (d) Neither statement is correct. Cliff vesting uses a five-year cut-off rather than three years. Under the graded vesting standard, employees must be 20 percent vested after three years, with an additional 20 percent vested per year for the next four years.

8. (d) A Keogh (HR-10) plan is a qualified plan for proprietorships and partnerships.

9. (a) The funding alternative described is called a guaranteed investment contract (GIC).

10. (d) Private pension plans can be integrated with Social Security. Low-income workers have their benefits reduced through integration, while high-income workers benefit from integration.

11. (b) The plans designed for employees of public schools and tax-exempt organizations such as hospitals, nonprofit groups, and churches are called Section 403(b) plans.

**True/False**

1. T

2. F As an employee’s salary tends to increase over his or her working years, an average that considers final pay only is more beneficial than an average based on career earnings. A benefit based on career earnings would average-in early years when compensation was lower.

3. T
4. T

5. F One of the advantages of 401(k) plans is that employees do not pay taxes on the amount they defer until the funds are distributed.

6. T

7. F A top-heavy plan is a plan in which over 60 percent of the present value of the accrued benefits are for the highly-compensated employees. Additional restrictions apply to top-heavy plans.

8. T

9. T

10. F If the retirement benefit is defined (e.g., $300 per month or 40 percent of final pay), the employee has a better idea of what his or her retirement benefit will be than if the contribution is defined (e.g., the employer contributes $250 per month to a retirement plan).

11. T

Case Applications

Case 1
Stained Panes should adopt a defined benefit plan for several reasons. Of the company’s 20 employees, 16 are over age 50. Adopting a defined contribution plan would not allow enough time to accumulate adequate funds for retirement. If a defined benefit plan was adopted, however, the plan could base benefits on career earnings or final pay. The company could also give credit for past service under a defined benefit plan, and fund these past service credits over time. This strategy will permit Stained Panes to enjoy the tax advantages of qualified plans while rewarding the long-term service the employees have provided to the company.

Case 2
Under the percentage test, the plan must cover at least 70 percent of the nonhighly compensated employees. As only 24 out of 40 nonhighly compensated workers are covered (60 percent), this test is not met. Under the ratio test, the plan must benefit at least 70 percent of the percentage of the highly compensated who are covered. As 80 percent of the highly compensated are covered (8 of 10), at least 56 percent of the nonhighly compensated (0.70 × 0.80 = 0.56) must be covered. As 60 percent (24 of 40) of the nonhighly compensated employees are covered, this minimum coverage test is satisfied.