

CHAPTER 1

**INTRODUCTION TO RETIREMENT PLANS:
SURVEY OF LEGISLATION FROM ERISA TO PENSION PROTECTION ACT
AND OVERVIEW OF BASIC RULES**

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Chapter 1
Introduction to Retirement Plans:
Survey of Legislation From ERISA to Pension Protection Act
And Overview of Basic Rules*

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§1.01 STATUTORY FRAMEWORK

ERISA wasn't the first attempt at regulating employee benefit plans, just the most comprehensive. It was followed by a multitude of other laws that constantly changed the rules for retirement plans. This section examines the legislative history of employee benefit law and examines the organization of ERISA, as well as significant changes made through such laws as TEFRA, DEFRA, GATT and the Pension Protection Act.

Foreword: Prequel to Era of ERISA

Most professionals entering the practice of pension law after the late 1970s are likely to believe that, before the Big Bang that was ERISA, there was a vast void in the field that was suddenly completely filled by that monumental enactment. Even many in practice before that time will have difficulty remembering that there was an active pension bar in existence well before ERISA was signed into law by President Ford on Labor Day of 1974. Not only was there an active bar, but also a body of statutory law, and an active regulatory structure operating within the Internal Revenue Service, and even committees in bar associations and actuarial and accounting societies around the country, serving clients, confronting the Service with protests, attending conferences, writing papers, giving speeches.

Indeed, the contributor to this foreword to Chapter 1 can provide first-hand evidence of a meeting between the then chairman of the pension committee of the American Bar Association tax section and its vice-chairman, when they were preparing their year's agenda for committee action, and the first item, they both agreed, was to be a white paper addressed to the Service detailing how far the agency had gone beyond its mission of administering the tax law, within the confines of the statutory tests of "reasonable compensation", "ordinary and

necessary expense”, and “nondiscriminatory benefits”. Viewed from today’s perspective they seemed quaintly naive. You must remember that this was before ERISA, when the Internal Revenue Service was the only government instrumentality for the regulation of pension benefits, and the Internal Revenue Code was its only tool.

Pensions in fact abounded in this country for decades before ERISA. The American Express Company is generally credited with having adopted the first private pension plan, in 1875; but the government had provided pensions for soldiers and widows during the Civil War. By the time of World War I major private companies were also doing so, due in no small measure to the organizing efforts of national unions in the auto, steel, coal and other major industries, through the multiemployer plan mechanism.

The first federal statute to deal with private pensions was the Revenue Act of 1921, and successive revenue acts in the Twenties expanded upon the regulatory framework. World War II provided the next major stimulus for the growth of private pensions, because of the salary stabilization laws, that capped straight compensation levels but left the door open to supplemental benefits. Pensions became the chief vehicle for overcoming these wage and salary limits. Further expansion occurred when, in 1947, the unions won, under the Taft-Hartley Act, the right to compel collective bargaining over pensions.

It wasn’t long before the insurance companies got into the act, developing so-called master and prototype plans that their agents could carry into their clients’ offices, funded, of course, by life insurance and annuity policies. That development so worried lawyers – not because of its effect on legal fees (as one might assume), but out of concern for protection of the interests of their clients and of participants, where the lawyer’s input could so easily be by-

passed by simply adopting the insurance company's off-the-shelf, boiler-plate document – that at least one state bar association marched down to Washington when its members learned that the Service was actually considering approving of the use of “M and P” designs. Their expectation that the Service would be equally concerned about this, because of its adverse effect upon the Service's own policy goals of protecting the integrity of the private pension system, received a rude shock when the then head of the IRS pension organization informed them that the Service was preparing an announcement approving of these mass-manufactured instruments as a way of dealing with the Service's overloaded determination letter program. (Shades of the cyclical filing system now in place, likewise borne of the Service's inability to cope with the workload demands of the determination letter program.)

ERISA did not just happen. Various unlikely and unrelated occurrences had to come together for it to materialize. An early impetus was the report of a so-called Cabinet Committee formed during the Eisenhower Administration (not generally thought to be in the forefront of social welfare initiatives), that put together a series of postulates for establishing, for the first time, a national pension policy, the seeds of which later took root in some of the overarching reforms of ERISA. One ambitious proposition that did not find its way into the law would have actually imposed a mandatory uniform pension scheme (generally termed “MUPS”) on all employers except the very smallest, not that different in concept from the Social Security system that had come into being in 1935 with Roosevelt's New Deal.

At about that same time a movement grew to permit the self-employed (partners and other unincorporated self-employed persons) to achieve access to qualified employee retirement plans, that was then prohibited (they weren't technically “employees”, the argument went); but their warrior in Congress, a little-known congressman from New York named Keogh,

persistently pushed his bill, prophetically named "H.R. 10", for 10 years until its adoption in 1962, as a way to induce such entities to extend pension benefits to their employees.

Not long after that a similarly lengthy effort began in Congress to enact the Employees Retirement Income Security Act, with the approval of massive bills, first in the labor committees and then in the tax committees of the House and Senate; but achieving agreement among the various bills did not come easily. Even the bankruptcy of the once vaunted Studebaker-Packard auto company, with an insufficiently funded pension plan, which became a rallying cry for the reform legislation, did not achieve its enactment. What galvanized the Congress into action was the improbable, unexpected and imminent impeachment proceedings against President Nixon in 1974, when the leadership in each House advised the committee chairs and ranking minority members that once those proceedings commenced, no other legislation would go anywhere. That did it, and almost overnight ERISA was enacted, and signed into law by Gerald Ford, who had become President when the beleaguered Nixon was induced to resign.

Will history in time credit Nixon with having instigated the ERISA legislation, so joining Bismark, another leader not generally associated with social welfare reforms, whom historians have anointed as the father of modern pensions? At least one recognized historian of the retirement movement in this country would presumably find nothing surprising in that eventuality. He has indicated receptivity to the notion that "the retirement system was constructed haphazardly and arbitrarily at every stage." Graebner, *A HISTORY OF RETIREMENT*, at 249 (Yale University Press, 1980). As for Bismark's place in the pension pantheon, he is equally cynical. Citing those who "have a historical rationale that contrasts past ignorance with present enlightenment", he observed: "According to this script, the entire American retirement system dates to German chancellor Otto von Bismark, 'who happened on the age of 65' while

constructing an old-age pension plan in 1875." He was more partial to the view that accidents of history, more often than advanced enlightenment, account for reforms in the retirement system.

The particular reform he was referencing was the near-sacred place age 65 holds in the retirement scheme, as witness its central role in the Social Security law. He could as well have pointed to ERISA, where the so-called "normal retirement age", age 65 if not otherwise specified in a plan, has such large significance. In any case, the purpose here is not to identify the particular factor, or congeries thereof, that led to ERISA's enactment -- whether the Studebaker-Packard demise, or the Nixon-Watergate business, or perhaps the fervor of those two Senate stalwarts, Long and Javits, to find a legislative vehicle for instituting employee stock ownership on a pension platform. It is rather the purpose of this foreword to shine a light on the extensive pension activity that obtained BEE (Before the ERISA Era).

That is not to diminish the overarching significance of that landmark legislation. ERISA changed everything, not least in joining the IRS at the hip with the Labor Department in overseeing and assuring performance of the vast new range of duties and obligations which that statute imposed on the private sector, and on the federal government itself, both as regulator and as employer. Parenthetically, it should be observed that ERISA left a vast segment of the pension universe untouched, namely, the public sector, more technically "governmental plans", defined extensively and with particularity to refer to plans maintained for employees of federal, state and local governments, their agencies and instrumentalities. Such plans are completely exempted from Title I (the so-called Labor title), and from the minimum standards, revised prohibited transaction rules and most other provisions of Title II (the Treasury and IRS title). Hence, there is no dual jurisdiction between DOL and IRS in this area. The most powerful of IRS' weapons, plan disqualification, is largely blunted because its consequence -- loss of tax deduction -- is meaningless to a government body that is tax exempt, except to the extent that it

also impacts the tax deferral of plan participants. Efforts to enact an ERISA-like set of provisions for government plans, called PERISA (for Public Employees Retirement Income Security Act), failed, and intermittent efforts subsequent to ERISA's passage never attained traction.

It is possible to argue that this failure worked to the advantage of the government plan in one celebrated matter that arose shortly after ERISA's enactment, when New York City sought the government's rapid approval of its need to borrow from its municipal pension plans to avert imminent bankruptcy in the Fall of 1975; and the IRS found a way to facilitate this under the pre-ERISA rules governing prohibited transactions, that might have been difficult to accomplish in the necessary short time-frame under the more cumbersome modalities associated with a dually-authorized prohibited transaction exemption requiring the approval of DOL and IRS.

However, it should be noted that a major test of the efficacy of dual jurisdiction was posed at the very onset of ERISA, when a major joint investigation was undertaken into the kinds of abuses of pension plans that ERISA had been enacted to avert, before IRS and the Employee Benefits Division of the Labor Department had a chance to get their acts together. The investigation related to the notorious misdeeds of the Central States Teamsters Multiemployer Pension Plan, arising principally from the handling of loans by the plan to Las Vegas hotels and gambling casinos. At issue was the faithless performance of duties by trustees and other fiduciaries of the Union over a period of many years long preceding enactment of ERISA. The Service and Labor, under continuous scrutiny of the Congress, jointly devised and implemented a series of remedies deriving from long existing powers of the Service to disqualify pension plans, coupled with the new powers conferred on the Labor Department and the Service to sanction self-dealing and other improprieties.

By cobbling together their respective powers, they were able to devise a nuanced program that included removal of the plan trustees *en masse*, the appointment of new, independent asset managers, and the institution of procedures, reporting and review mechanisms that enabled them to maintain continuing surveillance over the administration of the plan for an extended period. At the same time the remedies were carefully crafted to insulate the innocent – in this case, the thousands of sponsoring teamster companies and their employees – from the harsh sanctions and heavy consequences of plan disqualification and other enforcement actions that ensued, by finely-tuned exercise of the Service's far-reaching powers under section 7805(b) of the Code.

So began, under the most trying circumstances, this unusual exercise of dual jurisdiction that ERISA had decreed for two administrative agencies of the Executive Branch that had had no prior history of joint enforcement. The effort succeeded beyond the expectations of many. In time the Teamsters plan qualification was restored, and the method of appointment of plan trustees reverted to the customary procedures appropriate to the collective bargaining process. The lessons that the two agencies learned, and the habits inculcated, in this joint enterprise were to stand them in good stead in performing the more normal roles ERISA envisaged for them. For evidence that government does not always mesh the actions of its many parts so effectively, one need only examine the celebrated instances of disharmony among the intelligence gathering bodies that surfaced in the wake of 9/11.

This chapter now picks up the story of the legislation that began with ERISA and continued relentlessly – sometimes with annual legislative accretions – in the ensuing 32 years until the passage of the Pension Protection Act of 2006. The chapter will stop there, but one can be certain that the outpouring of legislation, alas, will not. Those two officers of the pension committee of the American Bar Association, noted in the opening paragraphs of this foreword,

could never have imagined what Congress and the regulators would do to the pension system in the half century following development of their committee's agenda that day long ago. Had they possessed the supernatural power to foresee this unending stream of laws, they would surely have predicted that the system would fall of overregulation long before now. But they could not have reckoned with the resilience of the pension practitioner. This treatise is dedicated to helping practitioners help their clients to overcome.

The emphasis in this chapter and in the ensuing chapters of this treatise will be on the private sector, principally as regards the tax law. But, of course, the provisions of ERISA and its progeny are two-headed, albeit largely parallel as affecting the dual jurisdiction of the Labor and Treasury Departments (including IRS, as the enforcer of the tax provisions). It should be added here that there is a third enforcer deputized by ERISA, the Pension Benefit Guaranty Corporation. The Age Discrimination in Employment Act added another, the EEOC, which also has new responsibilities under PPA '06, relating to cash balance and pension equity plans; but except for the treatment of such plans in chapter 6 *supra*, this treatise does not discuss matters exclusively within the jurisdiction of the EEOC.

A.D.L.

[1] ERISA – The Employee Retirement Income Security Act of 1974

ERISA was the first comprehensive enforcement scheme for employee benefits, including qualified retirement plans. The goal was to protect the interests of plan participants by replacing largely inadequate law with standard reporting and disclosure rules, vesting and benefit accrual standards, anti-alienation provisions and fiduciary standards with specified prohibited transactions. The law is divided into four Titles. Title I is enforced by the Department of Labor ("DOL"). Title II is within the jurisdiction of the Internal Revenue Service. Title III provided basic ground rules for coordination between the government agencies and for the

enrollment and regulation of actuaries. Title IV creates an insurance program for defined benefit plans through the government-owned corporation called the Pension Benefit Guaranty Corporation ("PBGC"), which is housed within the jurisdiction of the DOL.

Title I, under the jurisdiction of DOL, includes:

- reporting and disclosure requirements, e.g.
 - annual reporting (Form 5500)
 - summary plan descriptions--summary annual report
 - summary of material modifications
 - plan documentation
- fiduciary standards (including prohibited transactions)
- retirement plan standards
 - participation
 - vesting
 - benefit accrual
 - minimum funding
 - rules for ESOPs
- enforcement and preemption rules
- access to federal courts for participants and beneficiaries, fiduciaries, and DOL

Title II amends the Internal Revenue Code's rules for qualified plans by amending the minimum requirements. It also mirrors many provisions in Title I. The most significant provisions are:

- minimum participation

- vesting
- benefit accrual
- funding standards
- survivor annuities
- anti-alienation
- discrimination rules
- reporting rules
- fiduciary standards (including prohibited transactions)
- limitations on benefits under defined benefit plans and on contributions to participants' accounts under defined contribution plans
- new rules for the taxation of lump sum distributions
- new declaratory judgment provisions for challenging a plan's qualification
- individual retirement accounts
- substituted excise taxes for disqualification, as the penalty for failing to satisfy the funding rules or engaging in a prohibited transaction
- rules for ESOPs

Title III is an administrative section that provides basic ground rules for coordination between the agencies and for the enrollment and regulation of actuaries.

Title IV establishes a pension plan termination insurance program and creates the PBGC for administration and enforcement of the program. PBGC's main responsibilities include:

- termination insurance for defined benefit plans for single employers

- termination insurance for defined benefit multiemployer plans
- monitoring the financial health of these plans

PBGC is empowered to require plan administrators to report various Reportable Events considered to be warning signs that a defined benefit plan might be in financial difficulty.

As initially enacted, ERISA, representing a composite of the views of the Finance and Labor committees of Congress, contained myriad overlapping functions requiring coordination between IRS and DOL (and, to a much lesser extent, with PBGC) to accomplish effective enforcement and interpretation of the new law. While this accommodation of the respective positions of the turf-sensitive congressional committees was essential to the enactment of ERISA, it was inevitable that there would inhere in the duality of jurisdiction between IRS and the DOL built-in impediments to efficiency. Therefore, the White House issued Reorganization Plan No. 4 of 1978, under which DOL was assigned primary jurisdiction over fiduciary matters and prohibited transactions (with some exceptions) and IRS retained its traditional oversight of minimum standards for vesting, participation, accrual and distributions. DOL was given primary jurisdiction for fiduciary matters and prohibited transactions, while IRS officially maintained its traditional oversight of vesting, participation, accrual and distributions from qualified plans.

[2] Major Legislation Since 1974

From the moment ERISA was passed, there was a call for revisions and additions to the law. Some of its novel provisions simply did not work out as planned or were considered to be too burdensome. Many wanted to expand on ERISA's provisions to government plans. Technical errors were discovered. At first, Congress resisted, believing that even the simplest attempt at technical corrections would open the law to massive revisions. Inevitably, however, a

multitude of laws were enacted that made significant changes to many provisions of the law. The Pension Protection Act of 2006 was far and away the most comprehensive overhaul of the rules since ERISA itself, but numerous other significant amendments of ERISA, the Code and other pension-related laws occurred between the time of those two milestones, including:

[a] Tax Reform Act of 1976 (P.L. 94-455).

- Removed certain contribution limitations on Keogh plans.
- Provided for 10-year income averaging of lump sum distributions.

[b] Revenue Act of 1978 (P.L. 95-600).

- Established Code Section 401(k) plans under which employer contributions are not included in an employee's income merely because such employee has the option of receiving the contribution in cash or having it paid to trust.
- Created Simplified Employee Pensions ("SEPs").

[c] Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA", P.L. 96-364).

- Increased multiemployer pension plan premiums.
- Provided for payment of liability to plan from contributing employers who withdraw during year in which plan is less than

fully funded, thereby effectively shifting primary risk of underfunding from PBGC to contribution employers.

- Provided for “reorganization” of financially troubled multiemployer pension plans, and cutback of accrued benefits for participants in acutely distressed plans.

[d] Economic Recovery Tax Act of 1981 (“ERTA”, P.L. 97-34).

- Expanded availability of IRAs.
- Raised contribution limits on IRAs and Keogh plans.

[e] Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”, P.L. 97-248)

- Instituted top heavy rules.
- Eliminated most distinctions between Keogh plans (retirement income plans maintained by partnerships and sole proprietorships) and corporate plans.
- Restricted allowable contributions or benefits.
- Changed plan integration rules.

[f] Retirement Equity Act of 1984 (“REA”, P.L. 98-397).

- Enhanced survivor annuity rules.
- Qualified domestic relations orders (“QDROs”) insulated from ERISA preemption.

- Clarified effect of ERISA's and the Code's rules prohibiting plan amendments which reduce accrued benefits as to early retirement subsidies, lump-sum distributions and other "ancillary" benefits.

[g] Tax Reform (Deficit Reduction) Act of 1984 ("DEFRA"), P.L. 98-369)

- Modified top-heavy plan rules.
- Clarified participant loan cap.
- Excluded from income 50 percent of interest on ESOP loans made by commercial lenders.
- Modified §401(k) discrimination test.

[h] Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), P.L. 99-272). Included Single Employer Pension Plan Amendments Act of 1986 ("SEPPAA"), revising the Title IV single employer pension plan insurance program:

- Raised annual premiums (raised again in OBRA '87).
- Restricted company's freedom to terminate pension plans to standard terminations and distress terminations.
- Increased liability owed to PBGC when underfunded plans terminate.
- Instituted sham transaction rule, ERISA Section 4069(a), to prevent solvent companies from transferring pension funding obligations to PBGC.

[i] Age Discrimination in Employment Amendments Act of 1986, (P.L. 99-592).

- Eliminated maximum age limitations.

[j] Omnibus Budget Reconciliation Act of 1986, ("OBRA '86", P.L. 99-509).

- Prohibited elimination of accruals on account of attainment of specified age.

[k] Tax Reform Act of 1986, ("TRA '86", P.L. 99-514).

- Placed new limitations on tax-favored status of Code Section §401(k) plans, matching and employee contributions, IRAs, and deferred annuity contracts.
- Revised discrimination rules and tightened standards regarding coverage, minimum participation, vesting, and integration.
- Placed limits on tax deferral (contribution and benefit limits, deduction rules, reversion tax).
- Revised treatment of plan distributions.
- Changed ESOP rules.

[l] Omnibus Budget Reconciliation Act of 1987, (“OBRA ‘87”, P.L. 100-203).

- Revised pension funding provisions (full funding limit, minimum funding, deduction limits).
- Changed PBGC provisions (raised premiums, termination reversions, plan reversions language, excess asset allocation).
- Clarified and revised interpretation of provisions under the Code and ERISA (statute of limitations under ERISA, penalty for incomplete annual report, ERISA civil penalty provisions, DOL enforcement, and Code interpretation provisions).

[m] Technical and Miscellaneous Revenue Act of 1988 (“TAMRA”, P.L. 100-647).

- Increased pension plan reversion excise tax.
- Required allocations in the case of plan spinoffs.

[n] Omnibus Budget Reconciliation Act of 1989 “OBRA ‘89”, P.L. 101-239

- Changed rules for asset reversions from defined benefit plans.
- Revised defined benefit plan funding rules.
- Limited “normal retirement age” to age 65 or five years after participation begins.
- Revised rules for ESOPs.

[o] Omnibus Budget Reconciliation Act of 1990 P.L. 101-508

- Increased excise tax on defined benefit plan asset reversions.
- Allowed transfers of excess plan assets to retiree health account within the plan.

[p] Omnibus Budget Reconciliation Act of 1993 P.L. 103-66

- Reduced the amount of compensation that could be taken into account for qualified retirement plans.

[q] Uniformed Services Employment and Reemployment Rights Act of 1994

“USERRA”, P.L. 103-353

- Required qualified plans to recognize military service for accrual purposes.
- Prevented breaks in service because of military service.
- Required employers to make up contributions to defined contribution plans upon reemployment of a veteran, and allows returning veterans to make up employee contributions.

[r] General Agreements on Tariffs and Trade; Uruguay Round Agreements Act of 1994 (“GATT”), P.L. 103-465

- Limited range of interest rate and mortality assumptions.
- Changed method of COLA adjustments.
- Coordinates contributions when employer has both a defined benefit and defined contribution plan.
- Changed acceptable lump sum calculation methods.
- Required higher minimum contributions, and revises allowable changes in assumptions.

[s] Small Business Job Protection Act of 1996 P.L. 104-188

- Created safe-harbor 401(k) plan designs.
- Changed definition of "highly compensated employee".
- Changed combined defined benefit/defined contribution plan limit.
- Created simplified plans for smaller employers (SIMPLE plans).
- Allowed plans to use social security retirement age as a uniform retirement age for purposes of nondiscrimination tests.
- Changed rules for 403(b) and 457 plans.

[t] Taxpayer Relief Act of 1997 P.L. 105-34 and The Balanced Budget Act of 1997 P.L. 105-33

- Raised limit for involuntary cash outs.
- Increased full funding limit for defined benefit plans.
- Limited investment of 401(k) elective deferrals in employer securities.

- Eliminated requirement to file summary plan descriptions and summaries of material modifications with the Department of Labor.
- Allowed paperless administration of employee communications.

[u] Economic Growth and Tax Relief Reconciliation Act of 2001 P.L. 107-16

- Modified top heavy rules.
- Required notification of plan amendment resulting in significant reduction in the rate of future benefit accruals.
- Changed rollover rules.
- Changed permitted plan valuations.
- Changed hardship withdrawal rules.

[v] Pension Protection Act of 2006 ("PPA") P.L. 109-280

- Changed calculation of both assets and liabilities to determine plan funding.
- Restricted use of credit balances.
- Increased funding requirements for "at-risk" plans.
- Imposed benefit restrictions for underfunded plans.
- Increased deduction limitations.
- Hybrid plans not deemed to violate age discrimination rules.
- Imposed faster vesting for hybrid plans.
- Required plans to offer joint and 75% survivor option.

- Allowed phased retirement distributions where employee reduces work schedule.
- Allowed small employer combined 401(k) defined benefit plan.
- Additional funding notices for participants.
- Expanded Form 5500 information.
- Permitted automatic enrollment in 401(k) plans.
- Created new plan design safe harbors.
- Encouraged employers to provide investment advice.
- Required ESOPs to allow participants to diversify under certain conditions.
- Expanded rules permitting plan to transfer excess assets from defined benefit plan to retiree health account.

§1.02 OVERVIEW OF RETIREMENT PLANS

Qualified retirement plans are divided into defined benefit and defined contribution plans. Each of these groups is subdivided into plans with different approaches to retirement funding. This section examines the different types of plan designs including fixed benefit plans, cash balance plans, money purchase plans and 401(k) plans.

[1] Introduction

[a] In general

Two interlocking statutory frameworks, ERISA and the Code, govern the employee benefits area, including all of the plans discussed below. Violations of these statutes (even if unintentional, innocent, or non-injurious) can result in severe sanctions and, in certain cases, personal liability for plan fiduciaries.

This section addresses qualified retirement plans. A qualified plan permits payment of remuneration to an employee, as well as the tax on such remuneration, to be deferred until after the employee's retirement. Unlike non-qualified deferred compensation plans, qualified retirement plans allow an employer to deduct contributions to a qualified plan when they are made rather than when the employee is paid such benefits. The employer's contributions to such a plan are placed into a trust which is not subject to being reached by the employer's creditors. Additionally, because this trust is tax exempt, interest earned on trust contributions accumulates tax free. Further, the employer incurs no tax liability for such earnings, and the employee is taxed only upon the receipt of plan benefits. This section examines these tax benefits, as well as varying retirement plan options.

[b] Definition of a Pension Plan

Under ERISA §3(2)(A), a "pension plan" or "employee pension plan" is any plan fund or program which by its express terms or as a result of surrounding circumstances provides retirement income to employees or results in a deferral of income by employees for periods extending to termination of covered employment or beyond. To be tax-qualified a plan must also meet the vast array of qualification requirements contained in Code §401(a) et seq. There are two broad categories of qualified plans, "defined benefit plans" and "defined contribution plans."

An employer may adopt and maintain one or more qualified plans. Any type of legal entity (proprietor, partnership, corporation) can adopt a qualified plan covering its employees and, if applicable, the self-employed persons (proprietor or partnership) working in the business.

Plans referred to as “Keogh” or “H.R.10” plans are qualified defined benefit or contribution plans adopted by a proprietorship or partnership, rather than a corporation. The special rules and limitations formerly applicable to these types of plans were largely abolished by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), which imposed, instead, the so-called “top-heavy” rules.

[c] Advantages of Maintaining Tax-Qualified Plan

One of the main advantages of maintaining a tax-qualified plan is that employers receive an immediate tax deduction for contributions, subject to the following limits: (1) profit sharing plans – 25% of all participants compensation for the year;¹ (2) money purchase pension plans – 25% of all participants' compensation;² (3) defined benefit plans – a “full funding limitation”; (4) combination plans (i.e., both pension and profit sharing plan sponsored by the same employer) limit of the greater of 25% of the compensation of participants under the plans, or the defined benefit contribution necessary to satisfy the minimum funding rules of I.R.C. § 412.³ However, if the defined contribution plan is a salary reduction only 401(k) plan, there is no applicable 25% of compensation limitation. In addition, special rules exist for ESOPs, terminating pension plans, carryovers, and timing of contributions.

¹ I.R.C. § 404(a)(3)(A), as amended by the Economic Growth and Tax relief Reconciliation Act of 2001 (“EGTRRA”).

² I.R.C. § 404(a)(1) and Rev. Rul. 72-302, 1972-1 C.B. 110.

³ I.R.C. § 404(a)(7); This limitation has been significantly liberalized effective in 2008 by the Pension Protection Act of 2006.

Additionally, employees are not currently taxed on employer contributions, and earnings on assets in trust accumulate tax free.⁴ On receipt of distributions, employees can often defer recognition of income by "rolling over" the distributions to an individual retirement account ("IRA") or another qualified plan. Assets in the qualified trust are protected from the employer and from creditors of both the employer and the employee.⁵ Participants in defined benefit pension plans qualify for PBGC guarantees of certain levels of benefits if the plan terminates without sufficient funds to pay all promised benefits.⁶ Qualified plan benefits are becoming increasingly portable, particularly since the advent of the "direct rollover" rules.⁷

[2] Defined Benefit Plans

[a] Definition of Defined Benefit Plan

Code Section 414(j) defines a defined benefit plan in these words: "any plan which is not a defined contribution plan". It is effectively the default category for plan classification, ascertainable only by reference to the definition of the only other classification recognized under ERISA. The proper classification of a plan is critical under ERISA and the Internal Revenue Code, since most of the rules governing qualified and unqualified retirement plans are keyed to the classification, and are very different depending on which category is considered applicable. The consequences of this system of classification are perhaps nowhere more apparent than in the case of cash balance plans, where the plan design is largely adapted from the defined contribution model, but lacks distinctive characteristics that would mark a plan as fitting within

⁴ I.R.C. § 402(a)(1); I.R.C. § 501(a).

⁵ I.R.C. § 401(a)(2); I.R.C. § 401(a)(13).

⁶ ERISA § 4022.

⁷ I.R.C. § 402(c), as amended by P.L. 102-318, applicable to distributions after December 31, 1992, and, more recently, the expanded rollover rules in the pension portability provisions of EGTRRA, effective for 2002 and later years.

the defined contribution class, namely the existence of "an individual account for each participant". See subsection [3][a] of this section below; and see, generally, discussion of cash balance plans in chapter 6 of this treatise.

A "defined benefit plan" provides the employee with a certain specified pension benefit that is determined by formula. The amount of the pension may be determined with reference to several factors, including the employee's compensation, years of employment, and, perhaps, Social Security benefits. Benefits are normally stated in terms of, and actually paid as, an annuity for life after retirement. The employer's regular annual contributions toward the cost of the plan are determined actuarially. The trust or other investment fund supporting a defined benefit plan is not segregated into "accounts" for individual employees, but instead is invested as a single fund and available for payment of all pensions and, if applicable, death benefits arising under the plan.

A floor-offset plan is a type of defined benefit pension plan providing for a calculated pension amount, that is offset by the retirement benefit payable under another qualified plan (typically, a profit sharing plan) covering the employee. The floor-offset plan thus establishes a basic benefit or floor amount which is guaranteed if the other plan does not produce a greater pension.

[b] Types of Defined Benefit Plans

(i) Fixed Benefit Plan

A fixed benefit plan is a pension where the benefit payable at normal retirement is a stated dollar amount (e.g., \$100 per month commencing upon retirement on or after age 65).

This approach provides the employer inflation protection, but not the employee. Changes in compensation to reflect inflation, deflation, promotion or demotion will not affect the amount of the pension benefit. As a result, this approach is more advantageous to lower paid employees by providing a higher benefit as a percentage of compensation.

(ii) Flat Benefit Plan

A flat benefit plan provides a benefit to the employee that is a stated percentage of the employee's pay (e.g., 30% of pay commencing upon retirement on or after age 65). This approach automatically adjusts the pension for changes in compensation due to inflation, deflation, promotion or demotion. The definition of "pay" is very important and must be nondiscriminatory both on its face and in operation.

(iii) Unit Benefit Plan

A unit benefit plan is a system where the benefit payable to an employee upon normal retirement depends upon the period of service with the employer (or under the plan) prior to retirement (e.g., 1% of pay for each year of service, or \$10 per month for each year of service). This approach rewards longer service employees but may not provide a large enough pension for a key employee recruited later in his career.

(iv) Cash Balance Plan

A cash balance plan is a defined benefit plan which looks, from the employee's point of view, like a defined contribution plan. Each employee's benefit is converted into a lump sum equivalent, to which "interest" is credited at a specified, guaranteed rate. The principal attribute

of a cash balance plan is the employer's promise to provide, and obligation to fund, the benefit defined by the plan formula. Hence, the investment risk is born by the employer which is why the plan is classified as a defined benefit plan. The result is that each participant appears to have an individual account which is earning interest. However, the plan does not really maintain individual accounts; the "balance" an employee sees is simply the lump sum actuarial equivalent of his accrued benefit, which may or may not be fully funded by assets actually in trust at any given time.

[c] Methods for Calculating Pay

A compensation based pension formula (such as either the flat benefit or unit benefit formulas described above) requires a definition of the compensation to be used to calculate the pension to be paid. Two methods are used to determine compensation for the purpose of establishing the pension benefit – Final Average Pay and Career Average Pay.

Under the Final Average Pay method, the benefit paid to the employee at normal retirement is based upon the employee's average compensation over a defined period of time (e.g., final five years preceding retirement, or highest five consecutive years of the ten consecutive years preceding retirement). This approach has a leveling effect on changes in compensation occurring during a short period preceding retirement. Increases in compensation later in an employee's career significantly increase the pension paid with respect to his entire career with the employer. Further, inflation tends to take the decision to increase pension costs out of the hands of the employer.

Under the Career Average Pay method, the benefit paid at normal retirement age is based upon the participant's average compensation during the entire period he is either

employed by the plan sponsor or is a participant in the plan, depending on the plan provision. This approach will produce a lower benefit in an inflationary economy than the final average pay approach. However, rather than experiencing increasing costs due to inflation, the decision to increase pensions to match inflation is retained by the employer. As a result, this method tends to penalize a "fast track" employee whose pay rises significantly during his career when comparing his pension as a percentage of final average pay to the pension of an employee whose earnings stay relatively the same throughout his career.

One important note of consequence regarding both methods is that a pension plan may not consider more than \$230,000 (for 2008) of compensation per year, as indexed, in determining a participant's benefit.⁸

[d] Integration with Social Security

Social Security generally produces a higher benefit as a percentage of pay for lower paid employees than it does for employees whose pay exceeds the Social Security taxable wage base. For that reason, employers often prefer to calibrate the benefit provided under their qualified plans to provide a relatively higher benefit for higher paid employees. The Tax Reform Act of 1986 ("TRA '86") amended Code Section 401(l), to strictly limit the differentiation permitted in integrated plans between higher and lower paid employees. There are three ways to integrate a defined benefit plan with Social Security.

First, under an Excess Plan, no benefit is paid on compensation below a certain level (e.g., 30% of the final average compensation in excess of \$6,600).

⁸ I.R.C. § 401(a)(17).

Under the Offset Plan, the benefit paid by the employer into the pension plan is reduced by a portion of the Social Security benefit payable (e.g., 50% of final average pay reduced by 50% of the Social Security benefit payable at age 65).

Under a Step Rate Plan, the benefit paid on compensation below a certain level is less than the benefit paid on compensation above that level (e.g., 30% of the final average compensation equal to or less than \$6,600 and 50% of the final average compensation in excess of \$6,600). If the employee's final average compensation equals \$20,000, the employee's benefit equals \$8,680. ($30\% \times \$6,600 = \$1,980$; plus $50\% \times (\$20,000 - \$6,600) = \$6,700$).

Within this Step Rate Plan category, there is a Unit Step Rate Plan. A Unit Step Rate Plan would contain a formula such as: 1.5% of pay below \$6,600 per year and 2% of pay in excess of \$6,600 for each year. The annual "units" would be aggregated to determine the benefit payable at retirement.

[e] Characteristics of Defined Benefit Plans

Under a defined benefit plan, the employer will have a fixed commitment to contribute to the plan an amount sufficient to provide the plan's definitely determinable benefits. In this type of plan, the investment risk is borne by employer. A defined benefit plan can better recognize past service benefits than can a defined contribution plan. For that reason, defined benefit plans generally favor older employees because of the plans' ability to provide benefits based on past service. Under defined benefit plans, it is generally easier to provide cost of living allowances ("COLAs"). Defined benefit plans may pay disability and incidental death benefits as

well as retirement benefits. Also, payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and dependents is authorized under certain circumstances.⁹

Although employee contributions are permitted under defined benefit plans, defined benefit plans are less likely to provide for such contributions. Also, in-service distributions are generally not permitted under defined benefit plans. Finally, under defined benefit plans the PBGC guarantees the employees' benefits, and the employer must pay PBGC premiums, which are fixed by law.

[3] Defined Contribution Plans

[a] Definition of a Defined Contribution Plan

Code Section 414(i) classifies a defined contribution plan as "a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gain and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." A defined contribution plan is also referred to as an "individual account plan." These plans maintain separate bookkeeping accounts in the trust fund or other funding medium for each covered employee. The employee's share of his employer's contributions are allocated to his account; investment gains and losses are allocated to his account. The benefits available to the employee are limited to his vested interest in the value of his account in the trust fund. The account could be paid out in the form of a life annuity (for example, by using the account to

⁹ I.R.C. § 401(h); see also I.R.C. § 420 which permits excess pension assets to be used to fund retiree medical benefits.

purchase an insurance company annuity contract), but more commonly benefits from defined contribution plans are paid in a lump sum or in a fixed number of annual installments.

[b] Types of Defined Contribution Plans

(i) Money Purchase Pension Plan

A money purchase pension plan provides for a fixed rate of annual employer contributions for allocation to the accounts of employees. Normally, the contribution rate is stated as a percentage of each employee's compensation. The employer's contribution is a legal obligation, as long as the plan remains in effect, and must be paid quarterly to the plan's trust fund regardless of whether the employer is currently profitable.¹⁰

A target benefit plan is a money purchase pension plan which determines the employer's annual contribution with reference to a projected or "target" pension benefit that the plan expects to provide to each covered employee. The target plan is like a defined benefit plan in that the employer's annual contribution for each employee is determined pursuant to actuarial computations working backward from the targeted benefit for that employee. The target plan is a defined contribution plan, however, in that individual accounts are maintained and the amount of pension actually payable will be determined solely on the basis of the value of the employee's account when benefits commence.

(ii) Profit Sharing Plan

A profit sharing plan typically provides for employer contributions only to the extent of the employer's current or accumulated profits. The employer's annual contributions can be a fixed amount or rate, determined in accordance with a formula, or contributions may be subject to the discretion of the employer, or some combination of the foregoing. However, there is no legal

¹⁰ I.R.C. § 412

requirement that contributions to a profit sharing plan be limited to current or accumulated profits.

Some profit sharing plans are established as "age weighted" or "new comparability" plans whereby different categories of employees receive different benefits, with the older, more highly compensated employees receiving greater annual allocations than younger, less well-paid employees. As a result of the time value of money, a dollar contributed on behalf of a 25 year old with forty years to retirement is worth significantly more than a dollar contributed on behalf of an older person who will retire in only a few years, thus enabling the older person to receive a greater dollar allocation while the plan provides actuarially equivalent benefits.

(iii) Code Section 401(k) Plan

A Section 401(k) plan is a profit sharing plan (or a stock bonus plan) which meets the additional requirements in Section 401(k) for a "cash or deferred arrangement" (thus sometimes being referred to as a "CODA"). Under a Section 401(k) plan, within certain limits, covered employees may elect to have a portion of the compensation they would otherwise have received from the employer in cash contributed to the Section 401(k) plan. Contributions made in this manner are excludable from the employee's current income for federal income tax purposes. Employer contributions, such as "matching contributions," may be added to the employee's account.

Section 401(k) plans may be so-called Roth 401(k) plans, under which employees make after-tax contributions to the plan and distributions of principal and earnings are tax-free. For 2008, the maximum amount a participant may electively defer is \$15,500, and, if he or she is over 50, a "catch up" contribution of \$5,000 (as indexed).

(iv) Thrift Plan

The term "thrift plan" typically describes a profit sharing plan or money purchase pension plan under which, in order to participate, the employee must make contributions from his own funds, which are then matched to some extent by employer contributions, all of which are allocated to the employee's account. Before enactment of Code Section 401(k), such employee contributions were made from an employee's after-tax income. Most thrift plans are now structured to enable employee contributions to be excluded from the employee's current income under Code Section 401(k) arrangements.

(v) Stock Bonus Plan

A stock bonus plan is similar in most respects to a profit sharing plan adopted by a corporation, with one important difference: benefits from the plan are paid in the form of stock of the employer corporation. Stock bonus plans normally invest substantially all of the plan's trust fund in stock of the employer corporation.

(vi) Employee Stock Ownership Plan

An employee stock ownership plan ("ESOP") is primarily a stock bonus plan which meets certain additional tax law requirements. The ESOP can borrow funds to acquire stock of the employer corporation. Benefit distributions from an ESOP are normally made in the form of stock of the employer corporation, but cash may be distributed in lieu of stock if the employee consents.

[c] Characteristics of Defined Contribution Plans

In general, defined contribution plans provide employers' with several key advantages in comparison to defined benefit plans. First, there is greater flexibility in the employer's contribution commitment under defined contribution plans, as opposed to the rigid requirements associated with defined benefit plans. There are lower administrative costs, and an actuary is not required to assure compliance with minimum funding standards. Additionally, the terms and structure of defined contribution plans are easier to communicate and understand, and the investment risk is on the employee. Defined contribution plans generally favor younger employees as there is little flexibility to provide for past service, and defined contribution plans often permit in-service (e.g., hardship) distributions. Furthermore, with defined contribution plans, there is the possibility of allowing the employee to direct the investment of assets in his or her account. Finally, there are no PBGC premium payments required for most defined contribution plans (but, as a consequence, there is no PBGC insurance for benefits).

§1.03 BASIC RULES FOR QUALIFIED PLANS

A brief overview of the qualified plan requirements, including qualification procedures and rules for participation, nondiscrimination, vesting, top heavy rules, minimum funding standards and limits on contributions and benefits.

[1] Qualification of Plans

The rules for qualification of pension plans are extremely complicated and subject to many IRS regulations and rulings. Although not legally required, most plan sponsors, as a best practice, request a determination letter from the IRS. A determination letter is the method by

which a plan sponsor receives the IRS's approval that its retirement plan complies with legal tax-qualification requirements.

The IRS processes applications for determination letters using a five-year system. Under this system, each individually designed retirement plan is assigned to one of five "cycles" (12-month periods starting on February 1 and ending the following January 31) based upon the last digit of the sponsor's federal employer identification number ("EIN"). These cycles are as follows:

<u>EIN ends in:</u>	<u>Cycle:</u>	<u>First day of cycle:</u>	<u>Last day of cycle:</u>
1 or 6	A	February 1, 2006	January 31, 2007
2 or 7	B	February 1, 2007	January 31, 2008
3 or 8	C	February 1, 2008	January 31, 2009
4 or 9	D	February 1, 2009	January 31, 2010
5 or 0	E	February 1, 2010	January 31, 2011

Special rules apply to new plans, plans sponsored by controlled groups, multiple employer plans and other special situations.

The determination letter system anticipates that plans will file for a new determination letter only once every five years, but plans must still be amended from time to time as the law and regulations governing tax qualified plans change.

[2] Participation and Nondiscrimination Standards

While it may appear, from the foregoing sections, that an employer has a great deal of flexibility with respect to structuring its retirement system, in fact, ERISA and the Code impose a variety of very strict rules with which qualified plans must comply. The philosophy behind all of these regulations is that, in order to be deserving of special tax treatment, a company's retirement system must help advance certain government social policies.

The best example of this can be seen in the nondiscrimination rules and regulations which are, in general, designed to insure that: (i) a company provides retirement benefits for its lower compensated employees that are comparable (although not necessarily equal) to the retirement benefits provided to highly compensated employees, (ii) lower and higher compensated employees have comparable opportunities to participate in the retirement system, and (iii) a participant can be fully vested in his benefit after a certain number of years of service (so that an employer cannot deprive an employee of retirement benefits as the employee approaches his retirement date). Below is a discussion of some of the more important rules with which an employer should be familiar when deciding how to design its retirement system.

[a] Participation Standards

Pursuant to the Code, a plan may not exclude an employee from participation on account of age beyond the date the employee attains age 21.¹¹ Also, a plan generally may not exclude an employee from participation on account of a minimum service requirement greater than one year of service. However, a two-year service requirement may be imposed if the plan

¹¹ I.R.C. § 410(a)(1).

provides for all benefits to be 100 percent vested and non-forfeitable at all times.¹² Moreover, a plan may not exclude an employee from participation on the basis of the attainment of a specified age.¹³

Also, under the Code, a year of service is a 12-consecutive month period during which the employee completes at least 1,000 hours of service.¹⁴ Such period initially is required to be based on the 12-month period beginning with the employee's employment commencement date.¹⁵ In addition, a plan must permit an employee who has satisfied its age and service requirements to commence participation in the plan within 6 months.¹⁶

[b] Nondiscrimination Rules

A plan must satisfy one of three tests (excluding from consideration employees who have not met the statutory minimum age and service requirements referred to above) to determine if the minimum coverage requirements found in the Code are met.¹⁷ Under the percentage test, a plan must benefit at least 70% of all non-highly compensated employees. Under the ratio test, the percentage of non-highly compensated employees benefited under a plan must be at least 70% of the percentage of highly compensated employees benefited under the plan. Finally, under the average benefit percentage test, a plan must (i) benefit a classification of employees that does not discriminate in favor of highly compensated employees, and (ii) the average benefit percentage (i.e., employer-provided contributions or benefits expressed as a percentage of compensation) for non-highly compensated employees must be at least 70% of the average benefit percentage of highly compensated employees. The

¹² *Id.*

¹³ I.R.C. § 410(a)(2).

¹⁴ I.R.C. § 410(a)(3).

¹⁵ *Id.*

¹⁶ I.R.C. § 410(a)(4).

above stated tests are applied on a controlled group basis or, at the election of the employer, on a separate line of business basis.¹⁸ Also, a defined benefit pension plan must meet a minimum participation standard by benefiting, at the least, the lesser of 50 employees or 40% of the employer's employees.

A plan is qualified only if (i) the contributions to or benefits provided under the plan do not, in either form or effect, discriminate in favor of highly compensated employees, (ii) the benefits, rights and features provided under the plan are available to participants on a nondiscriminatory basis, and (iii) the effect of the plan in certain special circumstances (amendment, termination and grant of past service credit) is nondiscriminatory.¹⁹

[3] Minimum Vesting Standards

[a] Employee Contributions

Pursuant to the Code, an employee's rights in his or her accrued benefit derived from employee contributions must be 100% vested and non-forfeitable at all times.²⁰

[b] Employer Contributions

[i] Defined Benefit Plans

¹⁷ I.R.C. § 410(b).

¹⁸ I.R.C. § 414(r).

¹⁹ I.R.C. § 410(a)(4).

²⁰ I.R.C. § 411(a)(1).

Defined benefit plans must vest after five years of service (5-year cliff vesting) or at least as quickly as the following table²¹:

<u>Years of Service</u>	<u>Non-Forfeitable Percentage</u>
Less than 3	0%
at least 3	20%
at least 4	40%
at least 5	60%
at least 6	80%
7 or more	100%

[ii] Defined Contribution Plans

According to the Code, a plan must satisfy one of the following statutory requirements: an employee with three or more years of service must be 100% vested (3-year "cliff" vesting), or employees are vested at least as quickly as required by the following table.²²

<u>Years of Service</u>	<u>Non-forfeitable Percentage</u>
Less than 2	0%
at least 2	20%
at least 3	40%
at least 4	60%
at least 5	80%
6 or more	100%

²¹ I.R.C. §411(a)(2)(A)

²² I.R.C. §411(a)(2)(B).

Effective for plan years beginning after 2006, the vesting schedules listed above will apply to all employer contributions made to defined contribution plans. Prior to 2007, the vesting schedules listed above applied only to matching contributions made to defined contribution plans.²³

For years prior to 2007, employer contributions to defined contribution plans, other than matching contributions, could have been subject to 5-year cliff vesting or 7-year graded vesting (20% vesting per year commencing in year 3).

[c] Top-Heavy Rules²⁴

Any plan which is top-heavy (i.e., when more than 60% of the benefits provided under the plan are on behalf of "key employees"), must satisfy the vesting standards for defined contribution plans:

- (i) 3-Year "Cliff" Vesting – an employee with three or more years of service must be 100% vested
- (ii) 6-Year Graded Vesting – employees are vested at least as quickly as required by the following table under top heavy plans and, as a result of EGTRRA, for matching contributions:

²³ Pension Protection Act of 2006.

²⁴ I.R.C. § 416.

<u>Years of Service</u>	<u>Non-forfeitable Percentage</u>
Less than 2	0%
at least 2	20%
at least 3	40%
at least 4	60%
at least 5	80%
6 or more	100%

[d] Vesting Upon Attainment of Normal Retirement Age

A plan must provide that an employee's right to his normal retirement benefit is non-forfeitable upon attainment of normal retirement age.²⁵ Normal retirement age is the age set forth in the plan, but not after the later of age 65 or, if the employee commenced plan participation within five years of the plan's normal retirement age, the fifth anniversary of commencement of participation.²⁶

[e] Years of Service for Vesting Purposes

A year of service is a 12 consecutive month period during which the employee completes at least 1,000 hours of service.²⁷ Such period can be designated by the plan. Moreover, all service is required to be counted except: years of service prior to age 18; years of service during which the employee declined to make required employee contributions; years of

²⁵ I.R.C. § 411(a)(8).

²⁶ Id.

²⁷ I.R.C. § 411(a)(5).

service during which neither the plan nor a predecessor plan was maintained; and service disregarded under the "break in service" rules.²⁸

[4] Accrued Benefit Requirements for Defined Benefit Plans

A defined benefit plan must satisfy one of the following rules concerning a participant's accrued benefit: the 3-percent method, the 133 1/3 percent rule, or fractional rule.²⁹ The rules are complex, as expressed in the Code, and their application is extensively detailed in the regulations and numerous rulings. Compliance with them is generally beyond the competence of practitioners lacking actuarial training and experience, and reliance must generally be placed on the plan's actuary. Only an actuary "enrolled" under the procedures ordained by ERISA is qualified to sign the annual report which demonstrate compliance with the funding rules.

[5] Minimum Funding Standard

[a] Purpose of Minimum Funding Rules

The minimum funding rules are intended to ensure that inadequate financing does not result in benefit plans being unable to satisfy their obligations to pay benefits to participants when such obligations become due. Thus, ERISA and the Code require plans (other than those specifically exempted) to be funded in a manner which Congress has determined would help ensure solvency. The funding rules require that employers make contributions with respect to benefits accrued both for current and past service and require that contributions be made to fund accrued benefits even if they are not vested. The requirements are backed by a 10%

²⁸ Id.

²⁹ I.R.C. § 411(b)(1).

excise tax in the event the funding rules are not satisfied. A 100% excise tax is imposed if the deficiency is not corrected. The excise tax liability is applied on a controlled group basis.

[b] Plans Exempt from Minimum Funding Rules

The minimum funding rules apply to all plans qualified under Code Section 401(a) and to all qualified annuity plans described in Code Section 403(a), except that the rules do not apply to profit sharing or stock bonus plans.³⁰

[6] Limitation on Contributions and Benefits

[a] Defined Contribution Plans

The Code imposes limits on the "annual additions" which may be made to a plan on behalf of an employee. Annual additions are limited to the lesser of 100% of compensation or \$46,000 (in 2008, as indexed).³¹ Annual additions consist of employer contributions, employee contributions, and forfeitures allocated to an employee's account.³²

[b] Defined Benefit Plans

The Code imposes limits on the annual benefits which may be paid from a defined benefit plan. Benefits payable annually in the form of a straight-life annuity derived from employer contributions may not exceed the lesser of \$185,000, as adjusted for increases in the cost of living or 100% of an employee's average compensation for his high three consecutive

³⁰ I.R.C. § 412(h).

³¹ I.R.C. § 415(c).

years.³³ The limits are actuarially adjusted if benefits are paid in a form other than as a straight-life annuity, or if employee contributions or rollovers have been made to the plan.³⁴

The dollar limits are actuarially adjusted if benefits commence prior to Social Security retirement age (i.e., age 65 if born prior to 1938; age 66 if born between 1938 and 1954; and age 67 if born after 1954).³⁵ The dollar limit applicable to benefits which commence after Social Security retirement age is actuarially increased and the dollar limit is reduced proportionately for participants with less than ten years of participation.³⁶

§1.04 WHICH TAX-QUALIFIED PLAN IS RIGHT?

Each employer must look at its own needs, requirements, objectives, and those of its employees, to determine which plan is best. This section includes examples of how plans are matched to business needs.

Once an employer is acquainted with the various types of qualified requirement benefit plans available, a determination must be made as to which plan best meets its needs. In making such a decision, it is important to gather information about both (i) the nature of the employer and its business goals, and (ii) the needs of the employees who are targeted to benefit from the plan.

[1] Nature of the Employer and its Business Goals

Below are numerous questions relating to the employer's business goals that must be answered before organizing a qualified requirement benefit plan for the employer:

³² Id.

³³ I.R.C. § 415(b).

³⁴ Id.

³⁵ Id.

³⁶ Id.

- How is the business organized?
- What is the business's relationship with other entities?
- Is it part of a controlled group?³⁷
- Is it an affiliated service organization?³⁸
- Does it lease employees?³⁹
- How long has it been in existence? Does it have predecessors or successors?
- What fringe benefits does the business presently offer? Are any changes currently being contemplated?
- With whom must the business compete with respect to its benefits package?
- Is the business unionized or concerned about an organizational campaign?
- What are the ages, years of service and earnings of individuals to be covered?
- Does the business experience significant employee turnover?
- How much is the employer willing/able to spend for retirement benefits?
- What is the employer's financial history and projections?
 - Is it cash rich or poor; profit rich or poor?
 - Does it have accumulated earnings problems?
 - Is its business cyclical and, if so, to what degree?
- What discretion does the business have with respect to funding a plan? Would it be able to make a commitment to fund quarterly?
- Does the business want employees to partially or fully share in the cost of funding a plan?

³⁷ I.R.C. §§ 414(b), (c) and (o).

³⁸ I.R.C. § 414(m).

³⁹ I.R.C. § 414(n).

[2] Needs of Employees

Owners employed in the business will typically have three main needs that should be addressed by a qualified requirement benefit plan: enhancing current income, deferring income for retirement, and estate planning.

Key employees (generally, long-term, highly compensated employees in management positions who are critical to the functioning of the business⁴⁰) will have the same basic needs as owners. Other factors which must be considered include rewards for past service and retention of a valuable employee.

Rank and file employees (including salaried employees, union and non-union employees, salespeople, employees of a particular division or plant) will have the following needs that that should be addressed when creating a qualified retirement benefit plan: reward for past service; retention (i.e., benefits are comparable to those offered by competitors); retirement planning (consider total benefits package, including: federal programs (Social Security, Medicare), state programs (workers' compensation, mandated health benefits), benefits from previous employers).

[3] Examples of Qualified Plans Specifically Designed to Meet Business Needs

[a] To maximize benefits for owners, upper management and/or key employees

- If the owners, upper management and key employees are generally older than the rank and file employees, an age-weighted or new comparability discretionary profit sharing plan (by which contributions are made to fund

benefits payable at retirement) could be designed which would allow smaller contributions to be made on behalf of younger employees and larger contribution to be made on behalf of older employees. (The theory is that, since younger employees have more time to accrue benefits, comparable retirement benefits would result.)

- If there is generally a large turnover among the rank and file employees, a defined benefit pension plan could be designed using a benefit formula which takes into account years of service.
- A defined benefit pension plan could be designed using a benefit formula which takes into account final average pay.
- A defined benefit pension plan or defined contribution plan could be designed which is integrated with Social Security, such that employees above the Social Security wage base (\$102,000 for 2008) would receive a greater benefit than employees below the wage base.⁴¹

[b] To provide retirement benefits at minimal cost to employer

- A §401(k) plan can be funded in whole or in part with employees' own monies.
- The employer may choose to provide matching contributions (or discretionary profit sharing contributions) if it so desires.

⁴⁰See also definition in I.R.C. § 416.

⁴¹See, however, limitations on permitted disparity contained in I.R.C. § 401(l).

[c] To encourage long-term employment with company

- A defined benefit plan by its nature rewards older employees and employees with the most years of service (both highly and non-highly compensated employees). Cost of living adjustments are often built into such plans.

[d] To give a company flexibility from year to year as to contributions

- Profit sharing plans can be tied to company profits such that an employer has great flexibility with respect to its plan contributions.

[e] To provide employees with a fixed contribution (where certainty is desired)

- The annual contribution made under a money purchase pension plan is generally a fixed percentage of the employee's compensation.

An individually-designed plan, as described above, is usually prepared by an attorney and can be expensive to implement (of course, in the long run, it may save the employer money since it will be designed to specifically meet the employer's needs). A less expensive approach may be the "prototype plan" -- a form plan available through many large financial institutions (e.g., life insurance companies, investment companies) which is, in most cases, qualified (and has received an opinion or notification letter to that effect from the IRS), and which usually makes use of the financial institution's own investment vehicles. A company which is considering adopting a prototype plan would be well advised to have the prototype documents first reviewed by an attorney.

§1.05 OTHER APPROACHES TO PROVIDING RETIREMENT BENEFITS

Not all retirement plans are qualified plans. This section examines other options including IRAs, SEPs, SARSEPs and nonqualified deferred compensation plans.

If the employer does not wish to maintain a "full blown" qualified plan, it can encourage its employees to contribute to their own individual retirement accounts or purchase individual retirement annuities, or the employer can establish a "simplified employee pension arrangement" (i.e., a SEP or a simple retirement account (see below)).

[1] Individual Retirement Accounts ("IRAs")

An IRA must meet the requirements of Code Section 408(a). Additionally, it must be a trust or a custodial account, the trustee or custodian of which is a bank or similar "qualified person." Contributions may only be made in cash, and not in an amount in excess of \$4,000 on behalf of any individual for any taxable year (except qualified rollovers). Assets cannot be invested in life insurance contracts. The individual's account balance must be fully vested and non-forfeitable at all times. The IRA must be maintained pursuant to a written document.⁴² In this regard, the IRS has published Forms 5305 and 5305-A which may be used to establish an IRA. A married individual who wishes to make contributions to an IRA for the benefit of his non-working spouse may establish a separate IRA for that purpose (usually referred to as a

⁴² Treas. Reg. § 1.408-2(b); see also Phelan v. U.S., No. 83-1997-2 (D. Mass.) September 13, 1984 (deposit of funds in bank not sufficient to constitute an IRA where bank's acknowledgment did not meet the statutory requirements of Code Section 408).

"spousal IRA"). The spousal IRA need contain no special terms or particular designations (although it must meet the requirements set forth above for all IRAs).

[a] Deductible IRAs

Certain individuals may deduct up to \$5,000 in 2008 for contributions to an IRA in a tax year. However, if the individual or his or her spouse is an active participant in a tax-qualified plan, the contribution deduction is phased out for individuals with adjusted gross income ("AGI") above certain levels.

[b] Non-deductible IRAs

The SBJPA added a new nondeductible tax-free IRA, commonly referred to as the "Roth IRA". Qualified distributions (including earnings) from these IRAs are tax-free. A qualified distribution generally is a distribution made at least five years after the contribution was made, and that is made due to one of the following: (i) the individual's attainment of age 59-1/2; (ii) the death of the individual; (iii) the disability of the individual; or (iv) first-time homebuyer expenses for the individual.

There is an annual limit on contributions made to a Roth IRA of \$5,000 in 2008, which phases out for individual and joint tax filers with higher AGIs.

Contributions are permitted to be made to a Roth IRA for all individuals, including those who are age 70-1/2 or older. Also, the minimum required distribution rules of Internal Revenue Code Section 401(a)(9) do not apply to Roth IRAs.

[2] Individual Retirement Annuity

An individual retirement annuity is a type of IRA pursuant to a contract issued by an insurance company⁴³ for which the individual pays all premiums. The individual retirement annuity may not be transferable to another owner, and has an annual premium that is not fixed and is not over \$5,000 for 2008. Any refund of premium must be applied, within a prescribed period of time, to purchase additional benefits or pay future premiums. The entire interest of the owner is non-forfeitable.

[3] Simplified Employee Pension Plans ("SEPs")

[a] Requirements

Through a SEP an employer may offer a very simple retirement program by funding IRAs for its employees. Code Section 408(k) requires that a SEP must meet the following requirements each year:

- The SEP must be in the form of an IRA or an individual retirement annuity (and must meet all of the requirements applicable to an IRA or an individual retirement annuity);
- An employer must make contributions to the SEP for each employee (with certain exceptions) who during the calendar year has attained age 21 and who has "performed service" for the employer in at least 3 of the 5 years immediately preceding the year in question;

⁴³ I.R.C. § 408(b); see also Treas. Reg. § 1.408-3(a).

- The rate of contribution must not discriminate in favor of highly compensated employees. Code Section 408(k)(3)(C) establishes that contributions by an employer to a SEP are considered discriminatory unless the contributions bear a uniform relationship to compensation of each employee maintaining a SEP. Note, however, that this rule does not prohibit non-uniform contributions to integrated arrangements or to salary reduction SEPs;
- Employee withdrawal of employer contributions must be permitted without penalty;
- Contributions must be made pursuant to a "definite written allocation formula" which specifies the requirements an employee must satisfy to share in the allocation and how the amount allocated is computed;
- If the foregoing requirements are met, an IRA contribution or an individual retirement annuity premium may be paid by the employer to the employee's SEP in an amount up to \$46,000, as indexed;⁴⁴
- Because a SEP is also an IRA, the employee may also be eligible to make up to \$5,000 in contributions to the SEP;⁴⁵
- Code Section 408(k)(3)(D) permits contributions under a SEP to be integrated with Social Security in accordance with the rules that apply to qualified defined contribution plans, under which limits are placed on the permitted disparity and contribution percentages applicable to compensation above and below the Social Security wage base.

⁴⁴ I.R.C. § 408(j).

[b] Deductibility of Employer Contributions to SEP

An employer cannot deduct SEP contributions in excess of 25% of the aggregate compensation paid to employees who are SEP participants during the calendar year.⁴⁶ Note that a SEP is subject to the minimum contribution rules that are applicable to "top-heavy" plans.⁴⁷ Accordingly, if the sum of the account balances in the SEP established for key employees exceeds 60% of the sum for all employees of the employer, a SEP will be subject to the top-heavy requirement that the employer make a minimum contribution to the SEP of the lesser of 3% of compensation of the SEP participants who are non-key employees or the highest amount that was contributed as a percentage of compensation on behalf of the key employee.⁴⁸

[c] Salary Reduction SEP ("SARSEP")

SARSEPs are designed for employers who have 25 or fewer employees eligible to participate, at least 50% of whom actually do participate.⁴⁹ Under a SARSEP, elective pre-tax contributions by employees are permitted pursuant to rules similar to those that apply to §401(k) plans.

[4] SIMPLE Plans

Small Business Job Protection Act of 1997 ("SBJPA") created a new type of savings plan for small employers called the "SIMPLE Retirement Account", which takes the place of

⁴⁵ Id..

⁴⁶ I.R.C. § 404(h)(1)(C).

⁴⁷ I.R.C. § 408(k)(1)(B).

⁴⁸ See, generally, I.R.C. § 416.

⁴⁹ I.R.C. § 408(k)(6).

SARSEPs.⁵⁰ Employers with 100 or fewer employees who sponsor no other qualified retirement plan may establish these accounts for their employees. Generally, employees earning \$5,000 or more per year are considered to be eligible to participate, and eligible employees may make salary reduction contributions up to \$10,500 (in 2008) plus a catch up contribution of \$2,500 if the participant is over age 50. The employer must either: (1) contribute two percent of compensation for all eligible employees, or (2) match 100 percent of employees' contributions, up to three percent of compensation (with a limited ability to reduce the level of matching contributions). The accounts can be funded through IRAs or a §401(k) plan⁵¹ and are subject to ADP or top-heavy testing. Also, if IRAs are used, simplified reporting and disclosure rules apply.

[5] Non-Qualified Deferred Compensation Plans

Although this chapter does not discuss nonqualified retirement plans, employers should be aware that this is also an option that is available to them. Nonqualified deferred compensation arrangements are subject to limitations under Code Section 409A, which have been extensively amplified by regulations. These are discussed at length in succeeding chapters of this treatise. Non-qualified plans are almost always individually designed, and may be desirable in cases where, for example, an employer wishes to provide retirement benefits only to certain highly compensated employees.

The most common function for non-qualified retirement plans is to supplement benefits payable under the qualified plans of an employer. For example, most sizable employers

⁵⁰ I.R.C. § 408(p)(1).

⁵¹ I.R.C. § 408(k)(11).

maintain one or more supplemental executive retirement plans (“SERPs”) for executive employees. These include:

- “Excess benefit plans” – ERISA §3(36) defines an excess benefit plan as one maintained “solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by §415 of the Internal Revenue Code of 1986 ...” ERISA §4(b)(5) completely exempts such plans from ERISA coverage if they are unfunded.
- “Top hat plans” – these are plans which are unfunded and are maintained by an employer “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.”⁵²

Because excess benefit plans and top hat plans are unfunded, they do not need tax qualified status under Internal Revenue Code Section 401(a), and therefore do not need to be nondiscriminatory. By design, they do discriminate in favor of highly compensated employees.

Funding such plans through a “rabbi trust” (a trust whose assets are subject to the claims of creditors on the company’s bankruptcy) will not result in their being treated as “funded” for income tax purposes.

§1.06 CONCLUDING OBSERVATIONS

Proceed with caution and rely on experts.

The ever-changing rules and requirements of qualified retirement plans were complex when ERISA was enacted and have become more complicated with each new employee benefits law that Congress has passed. In fact, as can be seen in Section 1 of this chapter, the most recently enacted law, the Pension Protection Act of 2006 has probably made more changes than any law since ERISA itself was enacted. Plan sponsors of almost every qualified plan will be affected by the additional requirements and regulations of the PPA. Most defined benefit plans will need to accelerate plan contributions, sometimes by a very significant amount, because plans will be subject to a single set of funding rules with adverse consequences for plans that fall below specified funding levels. These plans will also need to have 75% joint and survivor annuity options and may permit early distributions for certain working employees. Most defined contribution plans are now required to have an expedited vesting schedule and others are subject to new rules on investments. The PPA also provides new options on automatic enrollments and plan design safe harbors. In addition, the PPA added new plan communication requirements. And, despite these massive changes, it is likely that future legislation will continue to add to the regulatory burdens of qualified plans

Section 3 of this Chapter merely touches on the many rules and requirements that must be met for tax qualification and favorable tax treatment of a retirement plan. This complexity must be taken into account when examining the objectives of the employer and the needs of employees in determining which of the many retirement plan designs, as enumerated in sections 2 and 5, is the right plan for a particular situation. Then, there is the additional complexity involved in designing the proper plan for an individual employer's situation and taking it through the determination letter process to ensure plan qualification.

⁵² See, e.g. ERISA §§201(2); 301(a)(3); and 401(a)(1), which exempt such plans from the participation, funding and vesting requirements, respectively, of ERISA; such plans are still subject to abbreviated reporting and disclosure

Therefore, given the complex regulatory environment in which qualified plans exist, and the many variations of qualified plans from which an employer may choose, it is essential, when creating a new pension plan or evaluating an existing plan or program, that an employer hire the best team of experts possible. Only in this way can the employer safely and effectively establish and achieve its retirement plan goals.

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requirements, and also to the fiduciary provisions of ERISA.