



employee benefits update

year end 2010

Back to the future

Should defined contribution plans offer lifetime income?

Getting to know the tax code

401(k) plan design defined by IRS rules

**How paid time off can
make a contribution**

**5 highlights of MetLife's
employee benefits trends study**



Back to the future

SHOULD DEFINED CONTRIBUTION PLANS OFFER LIFETIME INCOME?

Employer-sponsored plans have become the most common way to provide retirement income for many workers. In the past 20 years, the retirement plan of choice has shifted from defined benefit (DB) plans to defined contribution (DC) plans.

But with the financial turmoil over the past couple of years, some plan participants have come up short in their retirement savings. In response, the Department of Labor (DOL) is working with the retirement plan industry to increase the use of another option.

DB vs. DC

In DB plans, the employer contributes and invests in the plan so that benefits are available at the participant's retirement. The employer bears the investment risk and generally pays a lifetime annuity at retirement to the employee.

In DC plans, there's no guarantee of a specific benefit or amount that will be available at retirement — the investment risk and responsibility are the participant's. And the plan generally distributes benefits as lump sums; in fact, it's often the only option offered.

The shift from defined benefit plans to defined contribution plans has triggered concern for the retirement security of participants.

The RFI

The shift from DB plans to DC plans (or hybrid DB plans, such as cash balance plans, which provide for lump sum distributions) has triggered



concern for the retirement security of participants. In response, the DOL and Department of the Treasury issued a Request for Information (RFI) in February 2010 to determine whether to take steps to enhance retirement benefits with arrangements that provide for a lifetime stream of income at retirement, similar to DB plans.

The RFI solicited general information regarding the advantages and disadvantages of lifetime arrangements to both the participant and the sponsor. It wanted to know what types of arrangements companies currently offer and the reasons companies don't use lifetime income arrangements within DC plans — even when available. Importantly, the RFI asked what “behavioral” strategies the DOL could implement to improve the use of lifetime arrangements in DC plans.

The RFI also addressed participant education, asking about what information participants need to make knowledgeable decisions, whether plans could use plan assets to provide this information, and what legal concerns sponsors might have about educating participants. In addition, it asked for opinions on whether participants should be given information on their benefit statements that shows not only their current account balance, but also their benefit as a lifetime annuity — and then how this should be expressed and what actuarial assumptions would be used.

Finally, the RFI asked respondents to consider the effect of, and the possibility of changes to, ERISA's plan qualification rules. In particular, it mentioned qualified joint and survivor annuities, spousal consent, and minimum distribution rules.

The RFI requested responses by mid-year 2010 but didn't indicate when the government would act on the information.

Options to consider

The big question is what kinds of products will provide an increased opportunity for guaranteed lifetime arrangements. For example, lifetime income payments could be “in plan” (directly from the plan) or “out of plan” (purchased after a distribution from the

DB(k) plans offer another alternative

As of Jan. 1, 2010, another alternative addressing the issue of retirement security became available when the so-called “DB(k) plan” became effective. Established by the Pension Protection Act of 2006, it includes both defined benefit (DB) and defined contribution (DC) components. Employers with at least two but no more than 500 employees may sponsor one.

The DB component provides for a benefit of 1% of final average pay for each year of service up to 20 years (or it can be based on an age-related cash balance design). The DC component includes automatic enrollment at 4% of pay (employees can opt out or change this amount) with a fully vested employer match of 50% of the first 4% of compensation deferred. Employer nonelective contributions are also permitted.

This plan design offers employees the security of a guaranteed pension benefit, along with the option to supplement their pensions with savings of their choosing. Yet it's also advantageous for employers in that it allows you to provide these combined benefits at a reduced administrative cost — only one document, one Form 5500 and one trust — compared with the expense of offering two plans. But because of the employer funding commitment for the DB portion, this plan design may suit only those employers with sufficient profitability.

plan has been made). Various types of arrangements might be available, such as fixed, variable or deferred.

Should participants have the opportunity to take part of their distributions as a lump sum while purchasing a lifetime annuity with the remainder, or have the flexibility to increase distributions while receiving lifetime payments? Certain product features might have a significant effect on the cost of providing the lifetime feature. The RFI sought comments on the advantages and disadvantages of these issues as well.

The million dollar question

With some of today's workers living decades after they retire, the concern that their saved income will last is real. Along with declining investment value, accumulating and preserving retirement income is an ongoing problem. Are lifetime income arrangements an answer? That's the million dollar question. 🕒



Upcoming compliance deadlines:

- 12/31** Deadline for making minimum distributions
- 12/31** Deadline for making corrective distribution for 2009 failed average deferral percentage/ average compensation percentage (ADP/ACP) test with 10% excise tax as well as for making a qualified nonelective contribution (QNEC)
- 1/31** 2010 Form 1099s due to participants
- Blackout notice:** 30 to 60 days before the last day participant may make change

Getting to know the tax code

401(K) PLAN DESIGN DEFINED BY IRS RULES

The name “401(k) plan” should provide the first hint that qualified retirement plan design is governed, in part, by the IRS. While Internal Revenue Code (IRC) Section 401(k) governs many aspects of qualified retirement plans, other IRC sections govern coverage requirements, employee contributions and the elective deferral limit. These rules impact your plan’s design and its ultimate success.

Coverage requirements

One IRC section that sponsors must be aware of is Sec. 410(b), which governs the rules as to who is — and isn’t — eligible to be included in a qualified retirement plan. The rule’s purpose is to ensure that the plan benefits all or most of the company’s employees, rather than only key or highly compensated employees.

The two simplest ways to ensure your plan meets this requirement are to have the plan either:

1. Benefit 70% of employees who aren’t highly compensated employees (the percentage test), or
2. Benefit nonhighly compensated employees to an extent that’s at least 70% of the percentage of highly compensated employees benefiting under the plan (the ratio test).



Plan sponsors generally consider this rule when designing a plan to appeal to key or highly compensated employees. There's nothing illegal about attempting to tailor a plan to benefit these employees, as long as the plan design falls within the Sec. 410(b) rules.

Other tests, such as the average benefit percentage test or cross testing, enable plan sponsors to further tailor plans to these employees. But they require more intricate testing.

There's nothing illegal about attempting to tailor a plan to benefit highly compensated employees.

Keep these coverage-related rules in mind if you have a major change in employee demographics. For example, a merger, acquisition or divestiture of a business unit could inadvertently lead to coverage issues.

Employee contributions and matching

Another general area of concern relates to employee contributions, including any possible related matching contributions under Sec. 401(m). You must test both contribution types annually to ensure that nonhighly compensated employees benefit from the plan in a reasonable ratio compared with highly compensated employees. The tests on both contribution types involve ensuring that the average deferral or match percentage of nonhighly compensated employees is within a certain percentage of that of highly compensated employees.

It's possible to design a plan that is exempt from these tests, but the employer must make a safe harbor contribution to the plan and file a timely notice that it's doing so. When designing or amending your plan, you'll need to

consider whether the benefit of making safe harbor contributions outweighs the extra costs involved.

Elective deferral limit

One last general limit to consider is the Sec. 402(g) elective deferral limit. It governs the amount that employees are allowed to put into their 401(k) plans each year. The 2010 limit is \$16,500.

Those 50 or older can defer up to an additional \$5,500 under the Sec. 401(k) "catch up" provisions, for a total of \$22,000. Remind your higher income earners about the limits when they determine how much to defer per pay period so that they don't exceed the limit by the end of the plan year.

Know the IRC rules

If your plan violates these or any other IRC rules, the IRS can disqualify your plan — with devastating effects to all involved. For example, in a retroactive disqualification, all previous contributions lose their tax-deferred status, causing plan participants to have to immediately pay tax on these old contributions, which could also knock them into higher tax brackets. The lesson is obvious: Know the IRC rules and stick to them. ⚠

Don't forget about your plan document

The most general rule that a plan sponsor must follow is that the plan operate according to the plan document. This may seem simple enough, but the multitude of case law involving this issue shows that plan administrators often think that there isn't much harm in skirting the plan document's written rules in a seemingly minor and specific case.

For example, consider an outstanding employee who falls one year short of the plan document's minimum age of plan eligibility. Admitting the employee into the plan may not seem like a large infraction, but it could, in fact, lead the IRS to disqualify the entire plan if subsequently discovered during a plan audit.

Review your plan document before allowing or disallowing special exceptions. If you find an issue, you can make a plan amendment allowing for the exception. It's easier to amend the plan before making an exception than it is to prove to the IRS, after the fact, that no harm was intended.

How paid time off can make a contribution

Are you looking for ways to increase benefits while staying within your budget? The IRS may have found a way for you to do just that. It established paid time off (PTO) contribution arrangements that allow employees with unused leave and vacation time to convert these dollars to retirement plan contributions.

This is good news for plan sponsors who are looking for ways to boost benefits without breaking the bank. And the initiative has generated a positive reaction in the retirement plan community.

How it works

The special election allows participants to convert unused PTO, including sick pay and vacation time, to benefits dollars and contribute them to a qualified plan. The participant must elect to make these contributions and have the option to receive cash in lieu of making the contribution.

If the plan has a 401(k) feature, it can treat these amounts as a pretax benefit, similar to employee deferrals. Alternatively, the plan can treat the amounts as employer profit sharing, converting the excess PTO amounts to employer contributions.

The special election allows participants to convert unused paid time off to benefits dollars and contribute them to a qualified plan.

The IRS guidance provides the following example: Suppose a sponsor offers a PTO arrangement. The sponsor allows excess PTO hours to be converted



to dollars that are deposited into employees' accounts on behalf of the plan. The sources are either funded as pretax contributions (employee deferrals) or employer contributions.

The amounts contributed aren't included in the participant's gross income until the plan distributes the amounts. This includes in-service, hardship and separation from service distributions.

What you need to do

Plans were able to offer this feature starting with the 2009 plan year. If you'd like to offer this option, you'll need to amend your plan to allow for these contributions. Sponsors don't need a complete document revision; a simple amendment is all that is necessary. However, you must still follow the plan document's eligibility, vesting, rollover, distribution and loan terms.

And, remember, contributions from PTO conversions are subject to nondiscrimination testing and annual contribution limits just like other contributions. This includes all annual limit tests, deduction tests and other required testing. In the event of testing failures, the plan must treat these amounts as it handles other contributions.

Welcome opportunity

Often, employees who have extended service may accumulate excess PTO. With a simple plan amendment, the participant will gain additional benefits in an easy and effective format. Plan sponsors interested in this benefit should be sure to discuss the matter with their benefits advisors. ⓘ

5 highlights of MetLife's employee benefits trends study

MetLife recently published its eighth annual *Study of Employee Benefits Trends*, which is a compilation of the results of surveys of employers and employees about issues that are facing the U.S. benefits industry today. Here are five of the study's major findings:

- 1. Employers are reprioritizing their objectives in response to the recession.** Understandably, employer objectives changed during the economic downturn. For the first time since 2006, managing employee benefits costs surpassed former top employer objectives such as employee retention. Increasing employee productivity has also become an important objective as employers cut costs to maintain a competitive edge.
- 2. Employee benefits appeared relatively resilient in this recession, with few reductions.** The majority of employers continued benefits and 401(k) matches despite pressure on company profits. This indicates that retirement benefits remain a useful tool for employers to meet business objectives — and that employers can maintain these benefits in a shaky economy.
- 3. Benefits programs may be effective at improving employee productivity.** The study found that health and wellness, financial advice and guidance, and work-life balance programs can help improve productivity when employees face increased workloads, as many have during the recession.
- 4. Employees' concerns and attitudes about their financial security are subsiding, but still significant.** While the economy isn't growing as quickly as many had hoped, employees are unexpectedly optimistic about the future. Many have taken steps to improve their financial situations by paying off debt and saving more.
- 5. Employers are becoming more engaged in retirement programs, but the gap between employer actions and employee priorities persists.** Employers are interested in guaranteeing that their retirement programs will support management objectives in assisting the systematic retirement of older workers. Employees are looking to employers to provide education earlier, with more choices to help minimize the risk of outliving their retirement funds.

