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Employers Should Consider a Single Plan Document With Pension Benefits and Employee Salary Deferrals

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In 2006, Congress provided certain employers with the ability to establish and administer a single plan that contains both a defined benefit and a cash or deferred arrangement component. These combined plans have become even more attractive through subsequent Treasury regulations on other aspects of qualified plans. However, a quick Google search of "employers that offer 414(x) eligible combined plans" yields a shocking lack of articles on the success of this exciting program design. I only found a few blog posts trying to explain why no benefits consultants are discussing these programs with their clients and why employers are afraid to take up this retirement plan design.

After a quick history refresher, I will explain how an "eligible combined plan," in its current statutory form, can be a great idea for many employers and how that, if a simple barrier is eliminated by Congress, it can be a great idea for all employers.

First, There Were Defined Benefit Pension Plans

Before 1974, when the Employee Retirement Income Security Act was simply the proverbial gleam in Sen. Jacob K. Javits' eyes, employers offered, for a variety of reasons, pension plans. The employees received a promise of a specified benefit, under circumstances such as "when old age overtakes you," and the employers controlled the incentives to its workforce on how a successful career with the employer would be rewarded. Life was simple before ERISA was enacted, but simplicity came at a cost. The pre-ERISA world of pension plans allowed employers to make promises that could be easily broken or simply withdrawn, or that would evaporate along with all other employer assets upon bankruptcy, change in control or when they otherwise closed down their business operations. State laws regulated these plans and offered the legal options available to employees to redress any complaints they might have had with this important piece of their compensation packages.

During that time, employers could also provide, usually as an additional benefit but seldom as the exclusive benefit, a profit-sharing plan. The concept of a profit-sharing plan revolved around actual profits borne by the employer, which, in a high income tax regime, were better off shared among the employees through tax-deferred accounts than distributed to individual shareholders who might have already hit the 90% income tax bracket.

Before ERISA, employees were allowed to voluntarily contribute part of their compensation, strictly on an after-tax basis, to purchase additional annuity benefits in the pension plan or to accumulate additional savings through a thrift savings plan.

Then There was ERISA

The first major legislation signed by President Gerald Ford, on Labor Day in 1974, was ERISA, which ostensibly provides security to employees promised retirement benefits by their employers. ERISA bifurcated the world of employer retirement plans into those that fit the definition of an individual account plan (where the benefit at retirement is based solely on the accumulation of contributions, forfeitures and fund earnings, without any guarantees) and those plans that were not individual retirement account plans (i.e., defined benefit plans). ERISA also allowed for combined plans, under the ominous rules of Internal Revenue Code §414(k). ERISA first introduced the concept of traditional IRAs as tax-advantaged savings vehicles for employees not covered by an employer plan or for some lower income individuals, as a vehicle to accumulate personal savings and as a retirement nest egg in addition to their employer-promised benefits.

When ERISA became effective, the predominate plan design was some variation on a defined benefit plan. While some employers only offered a defined contribution plan, the more common practice was to sponsor both: a defined benefit plan as the retirement floor and then some sort of an individual account plan as a supplement. Originally, there were combined limits for employees who participated in both an employer's defined benefit and defined contribution plans, but those combined plan limits under IRC §415(e) have since been repealed.

Congress only added the concept of elective pre-tax salary deferrals in 1978. From the start, there were a lot of restrictions on amounts that any individual plan participant could elect to defer into a 401(k) plan (hence, the term cash or deferred arrangement), and the group of higher-paid employees could be limited in their desired salary deferrals by the average amount deferred by the lower-paid group. From the labor side of ERISA, employers could continue with the patriarchal practice of investing the participants' salary deferrals under their fiduciary duties or, after jumping through a few hoops, could pass along the investment decisions to the participants themselves.

Next Came Computer Technology

Yes, my millennial brethren, there was a time when there was a thing called a computer in some large back room, where computer-science techs guarded the input cards with their lives, and where a simple report might take a week to arrive in your in-box. But through the 1980s and 1990s, computer technology allowed

- Financial institutions to develop business models for extracting profits off these smaller account balances in 401(k) plans
- Third-party administrators and benefits consultants to develop business models for performing frequent, and eventually daily and instantaneous, valuations of the accounts
- Many higher-paid employees access to the internet through their desk computers and the ability to make their own investment choices in their 401(k) accounts; many of them became self-educated, self-accredited and self-satisfying "day traders"

There is not enough space in this essay to provide all of the reasons that during the 40+ years since ERISA was enacted, individual account plans, especially in the form of 401(k) plans, have become more popular than defined benefit plans, both among employers and employees. The Economic Growth and Tax Relief Reconciliation Act, or "Bush tax cuts," of 2001 introduced the concept of Roth IRAs and Roth 401(k) after-tax contributions to a 401(k) plan, which seemed to further support this paradigm shift. Many experts in the early 2000s opined about how to swing the pendulum back—the so-called renaissance of defined benefit plans (me among them).

Next up: Pension Protection Act

According to Congress, one of the major purposes of enacting the Pension Protection Act of 2006 was to revitalize the importance of defined benefit plans (however, a more cynical interpretation is that they wanted to place more burdens on employers to properly fund pension plans, thus lessening the risk on the Pension Benefit Guaranty Corp. insurance program). For purposes of this essay, however, there are two other provisions of PPA that are extremely important:

- Congress specifically blessed "applicable defined benefit plans" (hybrid plan designs that had been developed in actual practice, which were colloquially referred to as cash-balance plans)
- Congress allowed for in-service distributions after age 62 from defined benefit plans (although the unintended consequence of this provision was to stifle Treasury's analysis of bona fide phased retirement programs, which had by that time been published in proposed regulation format, and which I hope will be revisited soon)

As to defined contribution plans, PPA made 401(k) plans seemingly even more attractive with the addition of automatic enrollment and automatic escalation concepts.

PPA also added a new definition. Under IRC §414(x) and ERISA §210, beginning in 2010, "small" employers could adopt an "eligible combined plan"—a single plan document (and therefore a single form 5500 filing requirement, and a single summary plan description and participant benefit statement disclosure) that has a defined benefit component and a defined contribution component. Of course, to take advantage of this program, which allows the plan to automatically meet the annual tests that many plan sponsors find onerous, there are certain minimum benefits the employer needs to provide to plan participants, and all participants need to be treated uniformly. These plans can only be adopted by "small" employers—this particular definition only requires that as of the date of adoption, the employer is deemed to have not employed more than 500 employees in the prior year.

Two major sets of Treasury regulations have been promulgated since 2006 that bolster my appreciation of these eligible combined plan designs:

- The larger discussion of lifetime income options in defined contribution plans that led to the definition of qualified longevity annuity contracts (i.e., letting a plan participant purchase a deeply deferred annuity to protect against the risk of large long-term care costs in old age)
- The mechanics of operating an applicable defined benefit plan (i.e., a cash-balance plan), especially for those plan designs that seek to credit interest at an appropriate and reasonable market rate

What Can an Eligible Combined Plan Look Like in 2018?

The proposal here is for a small employer (up to 500 employees) to adopt an eligible combined plan or to convert their existing 401(k) and/or defined benefit plan into an eligible combined plan. But the plan itself is not enough. Sponsoring employers also should offer qualified retirement planning services (a true fringe benefit described at IRC §132(a)(7)) and other financial wellness education (which can be designed to not trigger fiduciary duties, even under the currently in-limbo Labor regulations). With these additions, a plan participant might truly understand and appreciate the value of an annuity stream and of the spend-down of an account through retirement, and can plan appropriately as she ages through her career. She then can hopefully make appropriate distribution choices upon retirement.

The following discussion applies to employers with less than 500 employees as the statute now stands, but the universe of employers who could embrace this concept would increase significantly if Congress simply eliminated the small employer requirement.

The 401(k) portion of the plan must:

- Meet the requirements of an "automatic contribution arrangement" (where the default, with proper notice, is 4% of compensation unless the participant affirmatively changes that amount)
- Require the employer to make minimum matching contributions (at least 50% of the first 4% of compensation deferred by each participant)
- Meet vesting minimums (employee deferrals are always 100% vested and employer contributions are fully vested within three years)
- Otherwise be uniform as to all plan participants

The defined benefit portion of the plan must:

- Meet minimum benefit accrual rules (if a traditional defined benefit plan, then at least 20% of compensation after 20 years of service, but if an applicable defined benefit plan, then service credits based on age bands need to be at least as favorable as those shown in the chart in the statute)
- Meet vesting minimums (fully vested within three years)
- Otherwise be uniform as to all plan participants

The uniformity and otherwise minimum requirements seem to stifle modern practices where employers stretch the limits of nondiscrimination testing to provide maximum benefits, rights and features to higher-paid and other favored employees and then lesser benefits, rights and features to the rest of the plan participants. This strategy leads to expensive and time-consuming annual testing for nondiscrimination, minimum coverage and top-heaviness. A uniform eligible combined plan eliminates favoring some participants over others but also eliminates the time, money and energy needed to perform the annual tests (by definition, eligible combined plans automatically comply with all of those annual testing requirements). Employers that adopt an eligible combined plan and save some of their time, money and energy on the program administration can re-direct their time, money and energy on developing better-suited nonqualified plans of deferred compensation for favored employees.

In my opinion, during the accumulation period, all other aspects of normal qualified cash or deferred arrangements can be included in the 401(k) portion of the eligible combined plan, which includes, among other things, plan loans, hardship distributions for employee deferrals, in-service distributions after five years of service, Roth after-tax contributions, automatic escalation features and even the welcoming of additional profit-sharing contributions from time to time by the employer if they are allocated to all eligible participant accounts. Therefore, as costly life events happen before retirement, such as unexpected medical expenses, unexpected funeral expenses, wedding gifts, the purchase of a primary residence, higher education expenses, and retrofitting the home for chronic illnesses and long-term care, the plan participant can receive distributions from the 401(k) account, without having any impact on the accrued benefits in the defined benefit plan portion of the combined plan (obviously, the more in-service distributions any individual participant takes will leave a lower-than-desirable 401(k) account at retirement).

For the defined benefit portion of the plan, employers should consider a market-rate cash-balance plan design (yes, there are currently many experts out there to advise on this design), so that each participant's 401(k) account and the balance of her hypothetical account in the defined benefit plan can be communicated, side by side. In essence, the communication is comparing apples to apples (other than, for the 401(k) account, there is no preservation of capital requirement, there are no spousal rights and there is no PBGC insurance coverage). However, since defined benefit plans require the communication of retirement benefits as annuities under the disclosure of relative value rules, the whole idea of annuitization for both accounts can be properly communicated to plan participants during the accumulation phase, especially if the employer also provides qualified retirement planning services to the plan participants and their spouses, and other forms of financial wellness programs.

Upon retirement, the plan can allow, within reasonable administrative parameters, each plan participant to transfer assets between their 401(k) account and their hypothetical cash-balance account —all lump-sum distributions needed in retirement can come from the 401(k) account and all annuities can be "purchased" through the defined benefit account (the plan can pay out the annuities, or at least find favorably priced annuities in the market, and can allow immediate annuities, deferred annuities, temporary annuities and other features that make sense to their particular workforce).

Call to Action for Benefits Consultants

Bottom line, Congress has already provided an updated retirement program that assists workers and retirees better prepare for retirement (at least for those employers considered to employ no more than 500 employees on the date of adoption). The fact that few employers have actually embraced an eligible combined plan since IRC §414(x) was added should not suppress the discussion.

This combined plan design, the recent discussions about lifetime income options in defined contribution plans, the allowance of cash-balance plans in general (and market-rate cash-balance plans, specifically), the qualified retirement planning services (considered to be a fringe benefit) and the current conversations (and yes, essays) about financial readiness, all seem to justify a current conversation with our clients about "eligible combined plans."

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