JOURNAL OF ACCOUNTANCY

EMPLOYEE BENEFITS / BUSINESS & INDUSTRY

Small Retirement Plans Face Funding Dilemma

Explore strategic options to realign your plan withcurrent and future business needs.

BY JAMES PODLESKI AND NICHOLAS PALEVEDA
MAY 2009

Many traditional defined benefit pension plans are underfunded due to market declines. As a result, barring congressional action, they could face future excise taxes ranging from 10% to 100% of the underfunded amounts as mandated by the Pension Protection Act of 2006 (PPA). Funding liabilities are especially difficult for smaller plans whose sponsors typically have fewer options to make up shortfalls caused by rapid declines in plan assets.

This article reviews key laws and regulations impacting defined benefit plans and explores options available to plan sponsors and their advisers.

MINIMUM FUNDING STANDARDS

A plan must fully fund its funding target, although not in one year. The funding target is the present value of accrued benefits determined under IRS rules. To determine the funding percentage at the beginning of each plan year, a defined benefit plan's funded level is measured by comparing the value of benefits earned as of that date with plan assets. Divide the assets by the value of benefits earned to determine a funded percentage, which is called the funding target attainment percentage (FTAP).

Example 1: Market Value of Trust Investments = $2,000,000
Present Value of Accrued Benefits = $2,000,000

$2,000,000/$2,000,000 = 1 or an FTAP of 100%

In 2008, the S&P 500 lost 37%. If a 40% loss is applied to the assets in Example 1, the calculation becomes $1,200,000/$2,000,000 = 0.6 or an FTAP of 60%. Because the FTAP is below 80%, this pension plan would be subject to higher pension benefit guaranty premiums (the Pension Benefit Guaranty Corp. (PBGC) variable-rate premium) and higher quarterly contributions. In addition, there would be some benefit payment restrictions.

But for many employers, FASB Statement no. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which moved plan losses (or gains) onto company balance sheets, will have an even greater effect (see also "Perfect Storm Prompts Changes in Pension Accounting," May 07, page 36).

Under the PPA, defined benefit plans that experienced losses must contribute the normal contribution or "target normal cost" (TNC) plus an amount to make up the losses or other shortfalls between the funding target and assets over the

next seven years. Lump-sum distributions may be limited or, in many cases, not available.

All defined benefit plans require actuarial certification and an FTAP calculation that must be completed by Oct. 1, or the plan will be "deemed" to be underfunded, preventing lump-sum distributions and ceasing benefit accruals. A "range" certification is allowed during the first nine months of the year that can certify that the plan is between 60% and 80% funded, or 80% and 100% funded, or over 100% funded (see Prop. Treas. Reg. § 1.436-1).

HOW WE GOT HERE

As a result of a series of actions taken by Congress in the mid- to late 1980s, the number of defined benefit plans plummeted from 145,952 plans in 1988 to 56,405 plans in 1998, according to Labor Department data.

Concerned that retirement savings were insufficient, Congress began to hold hearings in 1994 to improve the private retirement system. The result of these hearings has been a series of new laws.

The Small Business Job Protection Act of 1996 (SBJPA) repealed IRC § 415(e), the combined plan limitation that diminished the tax benefits when a corporation paired defined benefit plans and defined contribution plans.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) encouraged smaller companies to establish defined benefit plans by raising the lifetime income benefit to $160,000 a year and providing a tax credit for newly established plans. The IRS by way of Treas. Reg. § 1.401(a)(4)-8(b) clarified the "cross-testing" rules by establishing a "minimum gateway" and a "minimum allocation aggregation gateway" for paired plans to allow cross-testing. The "gateway" also established a "cap" of 7.5% of compensation and a floor of 5% of compensation. This new regulation gave actuaries a green light for cross-tested plans (see "Compliance Tests").

Although the number of large defined benefit plans has steadily declined since the 1980s, the number of small defined benefit plans (for fewer than 100 participants) bottomed in 2001 and has shown a gradual increase through 2006. As of this writing, 2007 and 2008 data were not available.

The PPA most notably modified IRC § 404(a)(7)'s combined plan limitation that applies to deductible contributions for a corporation to both a defined benefit plan and a defined contribution plan. Now a corporation can deduct contributions to both plans if the plan is covered by the PBGC. However, if a plan is not covered by the PBGC, the deduction is limited.

The PBGC covers all defined benefit plans except those sponsored by professional services firms such as accountants, doctors, lawyers, architects and engineers that have always had fewer than 25 employees. If you are uncertain whether a plan is covered, the PBGC will issue a determination letter, generally within 30 days.

The IRS resisted the deduction of both plans under section 404(a)(7) until this issue was finally clarified in favor of the taxpayer in the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) that was passed in December. Also in 2008, the IRS announced the new cost-of-living adjustments (COLA) in IR 2008-118, which increased the lifetime income benefit of defined benefit plans to $195,000 a year. The higher lifetime income benefit allows for significantly larger contributions to defined benefit plans as more funds are required to provide a lifetime income of $195,000 a year for life as opposed to the EGTTRA's $185,000 in 2008. The IRS also raised the maximum considered compensation to $245,000 in 2009 that can be used to set formulas for cross-testing.

THE SECTION 412(e)(3) EXEMPTION

IRC § 412(e)(3) exempts a plan from the minimum funding rules under the PPA and the WRERA (now in IRC § 430, formerly in IRC § 412) provided the plan's assets are in certain investments such as annuity contracts that have guaranteed returns.

Another method is to purchase annuities with guaranteed minimum investment benefit riders to guarantee the benefits.

In the annuity contract model, the plan's TNC is considered to be the contribution to the annuity and life insurance contract. A defined benefit plan funded with guaranteed annuity contracts by a major domestic insurance company is fully funded and does not become a balance sheet item under Statement no. 158.

Defined benefit plans purchase $60 billion of fixed annuities annually, according to a recent article, "The Art and Science of Annuity Portfolio Management," *Contingencies*, January/February 2009, page 40.

Life insurance can also be purchased in the plan as an incidental benefit. However, the ability to purchase insurance in such plans has led to a series of abuses by some third-party administrator firms that marketed abusive plans solely funded with life insurance. Plans like these are now "listed transactions," and a Form 8886, *Reportable Transaction Disclosure Statement*, must be filed with the IRS or penalties up to $200,000 will be assessed against the corporation, individual or promoter. Other plans such as 401(k) accelerators are also listed transactions since creative abuse is not limited to any one code section.

The plan sponsor and third-party administrator need to ensure that their plan meets compliance requirements (see Revenue Ruling 2004-20 at tinyurl.com/dhx3z3).

THE ADVANTAGES OF PAIRED PLANS FOR SMALL BUSINESSES

IRC § 412(e)(3) plans have been criticized by some as poor investments relative to other types of diversified plans over the long term. Modern portfolio theory, however, dictates that a mix of equities and bonds will perform better than a portfolio comprised exclusively of one or the other. Diversification can be accomplished by incorporating a profit sharing plan along with the pension plan, or adding a pension plan to a profit sharing plan.

Under such a paired plan, the 401(k) profit sharing plan has the benefits and burdens of the equities market. The 412(e)(3) has the benefit of a guaranteed retirement, with guaranteed lifetime income and lump-sum distributions depending on how the plan is structured. The 412(e)(3) cannot be in the equities market and by law must be invested in guaranteed contracts. The benefit of a dual plan design is to allow market and nonmarket exposure in a company's retirement planning structure. Of course, similar investment strategies can be made using money market funds as the nonmarket investments.

The most important rule in investing retirement funds is not to lose money. For example, if an account is worth $100,000 and has a 40% loss, it is now worth $60,000. A 40% gain in the following year would bring the account up to $84,000. A gain of 68% is needed to bring the account current in the following year. The greater the loss, the greater the percentage gain needed to restore the account. For example, an account worth $100,000 has a loss of 90% and is worth $10,000. The account now has a 90% gain and is worth $19,000. A gain of 90% each year over 3 years would not restore the account.

Historically, the crediting rate for contracts used in qualified plans has ranged between 3% and 8% annually. In the authors' experience, 412(e)(3) plans funded solely with guaranteed annuity contracts (GACS) outperformed the S&P 500 from 2000 to 2008. Of course, 2008 was an unusual year.

Consider these two paired plan examples:

1. A small company contributes $100,000 to retirement accounts. The 412(e)(3) defined benefit plan receives $80,000, and the 401(k) profit sharing plan receives $20,000. The market declines 40%. The defined benefit plan assets were invested in a guaranteed annuity, earned 5%, and made $4,000. The 401(k) profit sharing plan was invested in the market and lost 40% or $8,000. The overall retirement program lost 4% (4,000 - 8,000 = -4,000).

2. A small company contributes $100,000 to retirement accounts. The defined benefit plan receives $60,000, and the profit sharing plan receives $40,000. The defined benefit plan earns 5% or $3,000. The 401(k) profit sharing plan lost 40% or $16,000. The overall retirement program loss is 13%.

When paired with a 412(e)(3) plan, most existing 401(k) plans will need to be modified. If the plan is a match plan or safe harbor match plan, the plan needs to be converted to a 401(k) profit sharing plan because the employer

contributions for safe harbor match or non-safe harbor match cannot be used to satisfy IRC § 401(a)(4) in a cross-tested plan with a defined benefit plan.

A 401(k) with a profit sharing contribution allows the profit sharing contribution to be used for cross-testing, and the plan sponsor can make a qualified non-elective contribution (QNEC) by vesting part or all of the profit sharing contributions if the plan fails actual deferral percentage (ADP) testing. Additionally, the profit sharing contribution funds can serve double-duty in passing the gateway and rate group cross-testing (see Treas. Reg. §§ 1.401(a)(4)-8(b) and 1.401(a)(4)-9(c).

401(k) AND PENSION PLAN LIMITS

The PPA allows 6% of pay to be placed into a profit sharing plan and deducted along with the pension plan if the plan is not covered by the PBGC. Non-PBGC covered plans include professional groups, accountants, doctors, lawyers, architects, engineers and the like. Non-PBGC plans allow up to $14,700 to be placed into the profit sharing plan in 2009 along with an additional $16,500 in elective deferrals for a total of $31,200 in 2009.

If the pension plan is covered under the PBGC, the plan sponsor may deduct the entire contribution to the 401(k) profit sharing plan (up to $49,000 in 2009) and the entire contribution to the 412(e)(3) pension plan. The contribution to the 412(e)(3) plan in some cases can be as high as $300,000 per participant.

In a defined contribution plan, the annual addition to the plan can be no greater than $49,000 for tax year 2009. This limit for 2009 can be met by elective deferrals in a 401(k) up to $16,500 and a profit sharing plan of $32,500. There are few restrictions on where to place these assets as the plan sponsor (employer) guarantees nothing except a plan for retirement and the investment risk is with the employee.

CONCLUSION

CPAs should work with third-party administrator firms that have enrolled actuaries to explore the full array of pension plan options. CPAs serving professionals (or executives) who wish to contribute more than $49,000 a year for retirement should look at defined benefit plans that in many cases will allow substantial contributions.

Editor's note: *Also see "Compliance Tests," by Dale R. Vlasek.*

EXECUTIVE SUMMARY

■ **A defined benefit plan must meet its funding target.** To determine the funding target at the beginning of each plan year, a defined benefit plan's funded level is measured by comparing the value of benefits earned as of that date to plan assets. Divide the assets by the value of benefits earned to determine a funded percentage, called the funding target attainment percentage (FTAP).

■ **A defined benefit plan that experiences losses must contribute the normal contribution or "target normal cost" plus an amount to make up the losses over the next seven years.** If these plans are converted to cash balance defined benefit plans, lump-sum distributions may be limited or, in many cases, not available. All cash balance plans require actuarial certification and an FTAP calculation that must be completed by Oct. 1, or the plan will be "deemed" to be underfunded, preventing lump-sum distributions.

■ **IRC § 412(e)(3) exempts a plan from the minimum funding rules** under the Pension Protection Act of 2006 and the Worker, Retiree, and Employer Recovery Act of 2008 provided the plan's assets are in certain investments such as annuity contracts that have guaranteed returns.

■ **Modern portfolio theory dictates that a mix of equities and bonds will perform better than a portfolio comprised exclusively of one or the other.** Diversification can be accomplished by incorporating a profit sharing plan along with the pension plan, or adding a pension plan to a profit sharing plan.

■ **When paired with a 412(e)(3) plan, most existing 401(k) plans will need to be modified.** If the plan is a match plan or safe harbor plan, the plan needs to be converted to a 401(k) profit sharing plan because the employer contributions for safe harbor or match cannot be used to satisfy IRC § 401(a)(4) in a cross-tested plan with a defined benefit plan.

■ **The PPA allows 6% of pay to be placed into a profit sharing plan and deducted along with the pension plan if the plan is not covered by the PBGC.** Non-PBGC plans allow up to $14,700 to be placed into the profit sharing plan in 2009 along with an additional $16,500 in elective deferrals for a total of $31,200 in 2009. If the pension plan is covered under the PBGC, the plan sponsor may deduct the entire contribution to the 401(k) profit sharing plan (up to $49,000 in 2009) and the entire contribution to the 412(e)(3) pension plan, which in some cases can be as high as $300,000 per participant.

***James Podleski** is the CEO of Los Angeles-based pension services firm Griffin & Associates Inc., and **Nicholas Paleveda**, Esq., is the CEO of Bellingham, Wash.-based Executive Benefits Design Group. Their e-mail addresses are, respectively, james@griffinpensions.com and nick@ebdgonline.com.*

AICPA RESOURCES

JofA articles

- "Audit Quality Leader: EBSA's Chief Accountant Discusses Major Changes Afoot in Employee Benefit Audits," Sept. 08, page 50
- "Obtaining Quality Employee Benefit Plan Audit Services—The Request for Proposal," May 08, page 31
- "Managed Accounts: A New Direction for 401(k) Plans," Aug. 07, page 32
- "Dirty Little Secrets of 401(k) Plan Fees," May 07, page 34
- "Perfect Storm Prompts Changes in Pension Accounting," May 07, page 36
- "Time to Rethink Your 401(k) Plan?" May 07, page 50
- "To Roth or Not to Roth?" Feb. 07, page 64

Publications

- *Accounting Trends & Techniques—Employee Benefit Plans* (#006651)
- *SAS 70 Reports and Employee Benefit Plans* (#061061)

To order or for more information, go to www.cpa2biz.com or call the Institute at 888-777-7077.

PFP Section and PFS credential

Membership in the Personal Financial Planning (PFP) Section provides you with access to specialized resources in the area of personal financial planning, including complimentary access to Forefield Advisor. Go to www.aicpa.org/PFP to learn more about the PFP Section, or to join visit tinyurl.com/d6w8j8. Members who specialize in personal financial planning may also be interested in applying for the Personal Financial Specialist (PFS) credential. For more information visit pfp.aicpa.org/Memberships/Personal+Financial+Specialist.htm.

Copyright © 2008 American Institute of Certified Public Accountants. All rights reserved.