IMPORTANT INFORMATION FOR DEFINED BENEFIT PLANS

Defined benefit plans are qualified retirement plans where the employer makes deductible contributions to a trust to fund participant benefits. Participants do not individually contribute to the plan and cannot have individual investment accounts. The entire plan is invested with the trustees making the investment decisions.

The goal of a defined benefit plan is to have enough money to pay the vested accrued benefits when participants reach a distributable event such as retirement age or termination of employment. Each year, contributions to the plan are determined based upon the assets in the plan at the valuation date, the expected return on future investment and participant data. If the plan experiences an asset loss due to market fluctuations, the employer's required contribution will tend to increase to make up the loss. Similarly, if the plan experiences a gain, the contribution will tend to decrease.

The actuary determines minimum required contributions and maximum deductible contributions. The actual contribution will usually be somewhere in between. Contributing only the minimum required contribution will tend to underfund the plan (not provide enough assets to pay all benefit obligations). Contributing the maximum each year will tend to overfund the plan (create a surplus of assets that may not be distributable in the manner intended). Typically, the actual contribution will be the amount that fully funds the benefits accrued through the end of the plan year.

ADJUSTED FUNDING TARGET ATTAINMENT PERCENTAGE

The Adjusted Funding Target Attainment Percentage (AFTAP) is a measure the plan's funded status and must be certified by the actuary each year.

If the AFTAP is below 80%, certain benefit distributions may be restricted and amendments to increase benefits may be prohibited. If it is below 60%, future benefits accruals freeze.

If the AFTAP is not certified by the first day of the fourth month of the plan year, the AFTAP is presumed to be 10% less than the previous year AFTAP. If the AFTAP is not certified by the first day of the tenth month of the plan year, the AFTAP is presumed to be less than 60%.

REQUIRED AND DEDUCTIBLE CONTRIBUTIONS

Contributions necessary to meet minimum funding requirements must be deposited no later than the fifteenth day of the ninth month following the end of the plan year. For calendar year plans, the minimum required contribution is due September 15 of the following year.

Contributions must be deposited by the due date of the employer's federal tax return, including all extensions granted, to be deductible for that tax year.

DISTRIBUTIONS TO TERMINATED PARTICIPANTS

Participants that have left employment may be eligible to receive a distribution from the plan. An individual benefit calculation needs to be prepared and distribution forms provided to the participant.

Any recipient of a distribution, whether as cash or rollover to an IRA, must receive a Form 1099-R by the January 31 following the calendar year of distribution.

Please contact our office for assistance in the distribution process.

PLAN INVESTMENTS

The following is from www.irs.gov:

“Are there special limits on the type of investments available to retirement plans? Although there is no list of approved investments for retirement plans, there are special rules contained in the Employee Retirement Income Security Act of 1974 (ERISA) that apply to retirement plan investments. In general, a plan sponsor or plan administrator of a qualified plan who acts in a fiduciary capacity is required, in investing plan assets, to exercise the judgment that a prudent investor would use in investing for his or her own retirement…”

The fiduciary may also be the participant with the largest benefit in the plan, but they must consider all participants and beneficiaries when investing plan assets.

Non-traditional investments such as real estate and limited partnerships, while not prohibited, may create difficulties with liquidity and determining the fair market value of assets.

All plan investments must have their fair market value determined at least once per year, which is often difficult with real estate. Since the contributions are determined using fair market value, undervaluing, or overvaluing assets overstates or understates minimum required and maximum deductible contributions.

Contributions must be cash and not property. The plan sponsor may not transfer securities or other investments to the plan.

RETIREMENT PLAN RISKS

Measuring pension liabilities and calculating contributions requires the use of assumptions regarding future economic and demographic experience. There are risks that expected future liabilities might differ significantly from actual future liabilities.

The minimum required contribution and the maximum deductible contribution use interest rates and mortality tables prescribed under the laws and regulations governing pension plans. Interest and mortality are the two most impactful assumptions used in determining the contribution range. Other assumptions include rates of turnover, disability, and death and the probability participants will receive a lump sum distribution or an annuity distribution. Most small plans assume participants will not leave employment before retirement. This is reasonable because small plans generally do not offer additional benefits for early retirement, death, or disability. The probability of a lump sum distribution is very high in small plans since participants usually elect a lump sum distribution when available.

Interest rates for determining the contribution range are based on the 24-month average corporate bond segment rates. The interest rates for determining the minimum contribution are further adjusted for the 25-year average segment rates. These adjustments result in interest rates that are higher than the rates for determining the maximum contribution, but as years go by the interest rates for the minimum are getting closer to the rates for the maximum.

Lower interest rates lead to higher liabilities and required minimum contributions. This may be a concern to employers that are contributing close to the minimum. This may be less of a concern to employers that contribute significantly more than the minimum.

The amount contributed for current and past years has an impact on future years. Generally, always contributing the minimum required contribution leads to inadequately funding the plan for distributions and long-term financial soundness. Always contributing at or near the maximum deductible contribution could lead to overfunding. An overfunded plan may result in participants receiving more than expected upon plan termination or excess assets returned to the employer. IRS penalizes excess assets and excess assets are included in the employer's taxable income.

Future investment returns will not always meet expectations. Future benefits are paid for by both contribution and investment gain. If actual returns are lower than expected, the contributions necessary to maintain an adequately funded plan may increase. If returns are higher than expected, smaller contributions may be needed.

Plans should be appropriately situated such that the assets match changes in liabilities in the plan. If large distributions are expected soon, assets should be available for those distributions without the plan incurring fees or losses due to selling off investments early. Generally, plans with near-term liabilities should be invested in more liquid assets and plans with longer-term liabilities can invest more in long-term investments. Investments should consider the immediate and long-term needs of the plan.

Annuity distributions have longevity risk because participants may live longer than expected which results in increased liabilities. Alternatively, a plan may experience an unexpected cost when purchasing an annuity from an insurance company. Purchasing annuities is often a larger cost than paying the participant's lump sum. This is not common to most small plans which generally pay lump sum distributions.

Since most plans have benefits related to payroll, changes in payroll usually lead to changes in contributions. A rapidly increasing payroll often results in proportional increases to the pension contribution. Expansions in the number of employees through normal hiring or purchase of additional business may shift the plan demographics.

We endeavor to choose the appropriate assumptions and help in the determination of the appropriate contribution. Please feel free to contact us regarding the risks associated with your plan.

ERISA/FIDELITY BOND REQUIREMENTS

Plans are required to have an ERISA bond to protect against losses due to acts of fraud or dishonesty from plan officials, who handle funds or other property of the plan. However, plans covering only a sole-proprietor, the sole shareholder of a corporation, or a sole-proprietor or shareholder and their spouse do not need an ERISA bond.

Bond coverage is disclosed on the Form 5500. The bond must be at least 10% of the funds handled and is not required to exceed $500,000 unless additional coverage is necessary to avoid small plan audit requirements.

DOL regulations require audits by independent qualified public accountants for small plans unless at least 95% of the plan assets are qualifying assets. Qualifying assets include assets held by a bank or similar institution or an insurance company, shares issued by a registered investment company, participant loans, and participant directed accounts if participants receive statements from the regulated financial institution.

If less than 95% of the plan assets are qualifying assets, the small plan audit requirements can still be avoided by bonding the non-qualifying assets for 100% of their value.

FIDUCIARY RESPONSIBILITIES

A fiduciary meets at least one of these criteria: (1) exercises any discretionary authority or discretionary control respecting management of the plan, or exercises any authority or control respecting management or disposition of assets; (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any assets of the plan, or has any authority or responsibility to render such advice even if not actually rendered; (3) has any discretionary authority or discretionary responsibility in the administration of the plan

The basic responsibilities of a fiduciary include (1) acting solely in the interest of the participants and beneficiaries; (2) acting for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of the plan; (3) carrying out duties with the care, skill, prudence, and diligence of a prudent person familiar with such matters; (4) following the plan documents; and (5) diversifying plan investments.

Further information is at the dol.gov website. Search “DOL fiduciary responsibilities” or send us an email to request the web address.

WHO ARE THESE PEOPLE? ME? KNOW YOUR ROLE

In a small plan, the plan administrator, plan sponsor, employer, and trustee are often one person – one person with many responsibilities.

The PLAN ADMINISTRATOR is identified in the plan document as having responsibility for the administration and operation of the plan. The plan administrator is most often an employee of the plan sponsor authorized to make decisions on behalf of the company and not an outside service provider. The plan administrator must sign Form 5500 each year.

The PLAN SPONSOR is the employer if only one entity sponsors the plan. The plan sponsor is responsible for complying with the requirements in the Internal Revenue Code.

The EMPLOYER is the entity that employs the participants in the plan. The employer contributes to the plan.

The TRUSTEE is the person or persons named in the trust document with the authority to manage and control the assets of the plan.

MISSING PARTICIPANTS

Missing participants are terminated employees that the plan administrator is unable to locate. Since terminated participants are still required to receive benefit statements, summary annual reports and other notifications if they have vested benefits, the plan administrator cannot meet their duties if participants are missing.

This could be avoided if participants are reminded that they have a benefit when they terminate employment and should keep your office apprised of any change of address. They should be informed that distributions most often do not occur until their final contribution is made, which usually happens in the year following the year of termination.

When mail is returned as undeliverable, the internet and social media can be used to try to locate missing participants. If that fails, a commercial locator service specializing in finding contact information may be necessary.

Making timely distributions goes a long way to avoid this problem and may have other beneficial consequences such as a reduction in notification requirements and forfeiture of nonvested balances.

ADDITIONAL INFORMATION

The information provided covers general requirements of the regulations and is not exhaustive in details. Additional information for retirement plans can be found on the DOL and IRS websites:

www.dol.gov/ebsa
www.irs.gov/ep

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