Pension Parlance

What's right for your employees' nest eggs: Defined contribution or defined benefit pension plans?

By Tracey Regan, Contributing Writer

Just as it is a fact of modern life that fewer and fewer American workers can expect to spend their entire professional lives with a single company, it is also true, tax and benefits specialists say, that a declining number of workers will collect regular payments from their employers upon retirement.

A recent report on retirement benefits by the U.S. Bureau of Labor Statistics (BLS) found that participation in defined-contribution plans, for which employers make specified contributions into individual employee accounts, grew in private industry from 36 percent of employees in 1999 to 43 percent in 2008. By comparison, the level of participation in defined-benefit plans, for which employers guarantee payments to their retirees based on a formula, hovered around 20 percent throughout the same period.

These changes reflect trends in the workplace, where increasingly mobile workers favor portable retirement benefits and more direct control over their investment, while employers increasingly eschew what many see as the rigid regulation and costly liability of traditional plans.

These trends were accelerated by the recession, which put many traditional plans under water, tax and benefits attorneys say.

"With a flat market in the 1990s and then the downturn in 2008, employers' required pension contributions rose as the value of the investments underlying them fell. They had been properly funded and then the bottom fell out," says Edwin Leavitt-Gruberger, chairman of the trusts and estates division for law firm Wilentz, Goldman & Spitzer, with headquarters in Woodbridge. "Employers were saying, 'What have I gotten myself into.' "

"Traditional defined benefit plans rise sharply toward the end of a person's career, because benefits are based on an average of an employee's salary earned in the final, highest-paid years," notes Andrew Graw, of Lowenstein Sandler.

Edwin Leavitt-Gruberger, of Wilentz, Goldman & Spitzer, notes that during the downturn in 2008 and 2009, many employers stopped matching employees' 401(k) contributions or reduced the matches.

"Stock market volatility became a real problem for pension plans. In the old days, if the market was down, an employer could amortize the shortfall over 30 years. With the Pension Protection Act of 2006, however, Congress shortened the period to seven years and plans must be fully funded within that period. This is one of the changes that continues to drive companies away from defined benefit plans, although for smaller employers pension plans can offer tremendous advantages to owners who want to accumulate large benefits," says L. Gerald Rigby, a partner with the Haddonfield-based law firm Archer & Greiner, who specializes in employee benefit plans, executive compensation and ERISA-related issues.

Employers responded to their pension woes in several ways.

Many simply terminated or froze their defined benefit plans - closed them to new participants, while in some cases placing limits on future benefits - and adopted defined contribution, or individual account, plans. As of 2009, 19 percent of private industry workers were in frozen plans, according to BLS figures.

Others switched their defined benefit plans to what are known as "cash balance" plans by converting accrued benefits to present value and then agreeing to contribute each year to plan participant accounts at a set rate, such as a flat percentage of employee pay, plus interest credits.

"A cash balance plan is a hybrid plan – a cross between a defined contribution and a defined benefit plan – but is treated as a defined benefit plan, and while employers are still on the hook to contribute to them based on actuarially determined funding levels, in general, cash balance plans may be less costly and reduce overall employer funding liability in the long run," notes James N. Karas, Jr., a law partner in Morristown-based Riker Danzig's Tax and Trusts & Estates Group.

These plans also provide some psychological security for workers, who have become increasingly concerned in recent years about whether they will receive promised retirement benefits years from now, Karas says, because they "allow workers to see their employer's actual contributions to their plan accounts."

They are not without controversy, however.

"The closer to retirement you are, the less time there is to accrue savings. In a cash balance plan, employees accrue a given percentage of pay each year. By contrast, traditional defined benefit plans rise sharply toward the end of a person's career, because benefits are based on an average of an employee's salary earned in the final, highest-paid years," notes Andrew Graw, who heads the Employee Benefits and Executive Compensation Practice Group for Lowenstein Sandler, a law firm headquartered in Roseland.

Prior to the Pension Protection Act of 2006 (PPA), some traditional formula plans were converted to cash balance plans in a way that prevented older employees from accruing a benefit for a period of time, Graw says, adding that an initial lack of guidance on rules from the IRS "created uncertainty and that resulted in a lot of litigation involving cash balance conversions."

Some 401(k) plan participants also saw the value of their plans decline during the recession.

Leavitt-Gruberger notes that during the downturn in 2008 and 2009, many employers stopped matching employees' 401(k) contributions or reduced the matches.

According to James N. Karas, Jr., of Riker Danzig, "Individuals have been hopping from one employer to another and they want portability, which they don't get with a traditional defined benefit plan. Employees also want more control over how their pensions are invested."

"Automatic enrollment in [retirement plans] is a new feature which hopefully will grow, because once people are enrolled they tend to stay in," says L. Gerald Rigby, of Archer & Greiner.

Over the past several years, the federal government has eased pension rules to encourage companies to offer 401(k) plans.

"Since the early 2000s, I've seen a lot of companies turn to 'safe harbor' 401(k) plans that allow employers to avoid complex and costly annual nondiscrimination testing. Without the safe-harbor, an employer must be able to show wide and meaningful participation at the lower pay scales, and the test is not just that these employees be given the opportunity to contribute, but that they actually contribute," Graw says.

"Before PPA, the safe harbor rules required an employer to either contribute 3 percent of each participant's pay or match employees' contributions at a rate of up to 4 percent of pay. In 2006, a new automatic enrollment safe harbor was added that was much less expensive to employers because it only needed to be applied to new participants and allowed for a maximum matching contribution of 3.5 percent of pay," he adds.

Changes in pension law to permit features such as automatic enrollment of employees in retirement plans were also designed to encourage workers to save. Indeed, not all employees who are offered retirement plans choose to participate in them. A 2010 BLS report found that 59 percent of private industry workers had access to a defined contribution retirement plan, but that only 41 percent of those workers participated in one.

"Automatic enrollment is a new feature which hopefully will grow, because once people are enrolled they tend to stay in," Rigby says. This feature has increased the average retirement savings rate among plans that offer it. A related feature escalates an employee's automatic contribution rate each year, he notes.

"But employers are not moving too

quickly, because there is a lot of inertia. The companies who tend to do it are bigger companies."

The shift from defined benefit to defined contribution has also brought about major changes in plan administration.

"Over the last 20 years, the people who manage money have taken over the drafting of retirement plans. Companies like Prudential and Fidelity offer packaged plans," Rigby says. "The fees for drafting the plans may be incorporated into fund expense ratios or payments from the funds to TPAs (third party administrators) and brokers. These plans are standardized for ease of administration and might not fit all circumstances. Thoughtful employers should consult independent advisors."

"The financial industry promoted 401(k)s because they brought in fresh money. It fed the engine," says Leavitt-Gruberger.

He notes, however, that plan management came under recent federal regulatory scrutiny, resulting in changes. The fees paid to fund managers - costs embedded in retirement plans, but often hidden from view - were the subject of U.S. Department of Labor hearings in 2008 that resulted in the adoption of new rules ensuring transparency.

"Congress has been tinkering with pension laws almost annually," Rigby notes.

Karas says, "Individuals have been hopping from one employer to another and they want portability, which they don't get with a traditional defined benefit plan. Employees also want more control over how their pensions are invested." He adds, "Employee retention strategies are now focused on more immediate incentives, such as bonuses, higher salaries and higher matches on 401(k) plans."

The employers who still offer defined benefit plans are for the most part large, long-established companies in sectors such as manufacturing, finance and insurance, where the plans arose in some cases out of collective bargaining agreements and were then extended to non-union workers.

"There are still a lot of traditional companies around, but a lot of these pensions are dramatically underfunded and the companies need to bring them back up to solvency," Leavitt-Gruberger says. NJB