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Marketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: The Hot Ticket in Retirement Planning – Defined Contribution Plan Basics.

MARKET TREND: The topic of workers' preparedness for retirement is the subject of widespread discussion. A significant percentage of these individuals' retirement income comes from employer-sponsored retirement plans, which may still place a good portion of the savings burden on the worker.

SYNOPSIS: Defined contribution plans allocate funds among accounts maintained for participants. The major considerations for these plans include the following: (1) the Internal Revenue Code ("Code") imposes various limits on the maximum amount that can be allocated to a participant's account during various periods; (2) the law requires that participants vest in their account balances within specified time periods and that the plans do not provide allocations that discriminate in favor of highly compensated employees; (3) earnings on plan contributions are typically determined by investments selected by participants; (4) applicable law governs the times at which distributions are made to ensure that they are not made too early or too late to provide for retirement income; and (5) contributions generally are taxed to participants when distributed, unless the distribution is a qualified distribution from a Roth IRA or is rolled over to an IRA or other employer's qualified plan.

TAKE AWAYS: Defined contribution plans can provide a valuable benefit to employees as a retirement savings mechanism. They are typically the easiest way for an employer to provide opportunities for employees to accumulate retirement funds through contributions by the employer, the employees, or both. Many plans can offer flexibility by allowing participants to take loans from the plan, subject to certain monetary limits and repayment terms. Distribution options that allow distribution of a plan account into an IRA or an annuity contract providing lifetime income can help participants preserve sufficient retirement income to last their lifetimes.

WHAT IS A DEFINED CONTRIBUTION PLAN?

A defined contribution plan is an employer-sponsored retirement plan where the employer and/or employees make specified contributions to the plan. The plan participant's benefit is determined by the amount of contributions credited to his or her account, along with the earnings or losses accrued with respect to those contributions.

It contrasts with a “defined benefit plan,” under which the plan specifies the amount that will be paid to the participant, and the employer makes contributions during the participant’s period of participation sufficient to fund that promised payment.

HOW ARE CONTRIBUTIONS ALLOCATED TO PARTICIPANTS’ ACCOUNTS?

Contributions are allocated to participant’s accounts in accordance with the methodology specified in the plan document. To satisfy applicable tax qualification requirements, a plan must have a definitely determinable allocation formula. Usually, contributions made by employers are allocated in proportion to participants’ compensation, while contributions by employees are allocated in proportion to the contribution amount elected by the participant. Contributions made by employees are typically made pursuant to what is known as a “401(k) plan.”

ARE THERE LIMITS ON ANNUAL ALLOCATIONS TO A PARTICIPANT’S ACCOUNT?

Under Code § 415, the maximum amount that can be allocated to a participant’s account for any “limitation year” is the lesser of 100% of the participant’s compensation for the year and the amount specified under the Code for the year. For 2015, this limit is **$53,000**. In addition, contributions made by employees pursuant to a salary reduction election under a 401(k) plan are limited under Code § 402(g) to **$18,000** for a calendar year, though participants who have attained age 50 during a calendar year can contribute an additional **$6,000** for the year.

As noted above, employer contributions are often allocated on the basis of a participant’s compensation for a year. Alternatively or additionally, an employer may elect to make contributions that match the amounts contributed by employees pursuant to their salary reduction elections. For the purposes of calculating these contributions, there is a limit on the amount of compensation that can be taken into account for any year. For 2015, this limit is **$265,000**.

HOW DOES A PARTICIPANT VEST IN HIS OR HER ACCOUNT?

A participant vests in his or her plan account balance (i.e., the participant’s rights to amounts allocated to his or her plan account become nonforfeitable) in accordance with the schedule set forth in the plan document. If a “cliff” vesting schedule is used, however, the plan’s vesting schedule cannot delay vesting beyond the participant’s completion of three years of service. If a “graded” vesting schedule is used, a participant must become vested in his or her account balance at least as rapidly as the following:

Years of Service	Nonforfeitable percentage
2	20%
3	40%
4	60%
5	80%
6 or more	100%

HOW DO NONDISCRIMINATION RULES AFFECT ANNUAL ALLOCATIONS TO A PARTICIPANT'S ACCOUNT?

For a plan to maintain its tax-qualified status, it must not discriminate in favor of "highly compensated employees" in terms of the amount contributed or allocated to their accounts. For contributions made by employers not pursuant to employees' elections, plans typically comply with the nondiscrimination requirements by allocating them in proportion to the participants' compensation.

With respect to 401(k) contributions made pursuant to employee deferral elections and employer contributions made to match these elective deferrals, a numerical test is generally applied annually. This test compares the average percentage of compensation either deferred by an employee or contributed by an employer as a matching contribution on behalf of the participant population that consists of highly-compensated employees to those made on behalf of non-highly compensated employees. The average deferral percentage (in the case of employee elective contributions) and the average contribution percentage (in the case of employer matching contributions) made on behalf of highly compensated employees cannot exceed the relevant percentage made on behalf of non-highly compensated employees by more than a prescribed amount. If this test is not satisfied, either amounts need to be refunded to highly compensated employees or the employer must make nonelective contributions on behalf of non-highly compensated employees.

A 401(k) plan can be structured to avoid performing this test. Such a plan is referred to as a "safe harbor plan." To be a safe harbor plan, the employer must make either (1) a matching contribution on behalf of each non-highly compensated participant at least equal to the sum of (A) 100% of the elective contributions of the participant to the extent the elective contributions do not exceed 3% of the participant's compensation and (B) 50% of the elective contributions of the participant to the extent that the contributions exceed 3% of the participant's compensation but do not exceed 5% of the participant's compensation, or (2) a nonelective contribution at least equal to 3% of the participant's compensation. The safe harbor contributions must be fully vested at all times and not eligible for withdrawal before the participant terminates employment or attains age 59½, and the employer must satisfy certain notice requirements before the beginning of each plan year.

HOW DO EARNINGS OR LOSSES ACCRUE WITH RESPECT TO AMOUNTS ALLOCATED TO PARTICIPANTS' ACCOUNTS?

The vast majority of defined contribution plans are established as "self-directed plan," allowing participants to choose among a menu of investment options. If the plan complies with the requirements of ERISA § 404(c), the plan fiduciaries will not be liable for losses resulting from participants' investment decisions. To satisfy this requirement, a plan must allow a participant to choose from at least three investment alternatives that satisfy the following: (1) each alternative is diversified, (2) each alternative has materially different risk and return characteristics, (3) in the aggregate, the alternatives enable the participant, by choosing among them, to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant, and (4) each alternative, when combined with investments in the other alternatives, tends to minimize, through diversification, the overall risk of a participant's

portfolio. In addition, standards regarding the dissemination of information to participants and the ability to change investment directions must be met. The plan fiduciary must still monitor the investment alternatives offered under the plan to ensure that they are and remain prudent investment choices for the plan participants.

CAN A PARTICIPANT BORROW FROM HIS OR HER PLAN ACCOUNTS?

If the plan document so provides, a plan participant can take one or more loans from his or her plan account without the loan being treated as a distribution. The maximum amount that may be borrowed at any one time is equal to the lesser of (1) $50,000 reduced by the excess (if any) of (A) the highest outstanding balance of loans from the plan during the one-year period ending on the day before the date on which such loan is made, over (B) the outstanding balance of loans from the plan on the date on which the loan was made, and (2) the greater of (A) one-half the participant's vested benefit under the plan and (B) $10,000.

The loan must be repaid pursuant to a level amortization schedule based on a reasonable rate of interest over a period not to exceed five years (though the term of the loan can be longer if its purpose was to enable the participant to purchase a principal residence). Loans are usually paid via payroll deduction from current compensation payable to the participant. Outstanding loan balances frequently become due and payable upon a participant's termination of employment, but some employers and plan administrators allow the participant to continue repaying the loan throughout its original term. If a participant defaults on the repayment of a loan, the outstanding balance becomes immediately taxable to the participant.

WHEN ARE AMOUNTS DISTRIBUTED TO PLAN PARTICIPANTS?

Plan distributions are generally made at the election of the participant. Most plans provide for distributions to be elected at the time the participant separates from service with the employer sponsoring the plan. Many plans allow for in-service distributions, though some plans limit the times or circumstances under which an in-service distribution may be elected. Specifically, a plan that includes a 401(k) feature can generally only permit an in-service distribution in the event the participant has attained age 59½, experienced a financial hardship, or become disabled. To preserve a participant's retirement savings, it is not unusual for plans to limit in-service distributions of employer contributions (matching and nonelective).

If a participant's account balance exceeds $5,000, a plan cannot distribute the participant's account without the participant's written consent before the participant attains age 65.

If a participant has terminated employment but has not taken a distribution of his or her account balance by the time the participant attains age 70½, the plan must begin making distributions by the April 1 following the date on which the participant attains age 70½. If the participant remains employed beyond that point, distributions must begin following the participant's termination of employment. Distributions must be made at least as fast as ratably over a period equal to the joint life expectancy of the participant and a person ten years younger than the participant if the participant's designated beneficiary is not his or her spouse, otherwise distributions must be made over the joint life expectancy of the participant and his or her spouse. (Distributions are made over the life expectancy of the participant if the participant has no designated beneficiary of

his or her plan account.) Failure to make these distributions can result in a **50% penalty tax on the amount that was required to be distributed but was not**.

Distributions also may be made following the death of a participant.

IN WHAT FORM ARE DISTRIBUTIONS MADE TO PLAN PARTICIPANTS?

The vast majority of defined contribution plans provide for distributions to be made in the form of a **lump-sum** distribution. Some plans limit distributions to the participant's entire account balance, while others allow distribution of a portion of the participant's account balance at the participant's election. A distinct minority of defined contribution plans allow participants to take distributions in the form of **installments**. Other plans allow participants to invest their account balances in **annuity contracts** that will pay out the participant's benefit in the form of a life annuity. This last form of distribution is increasing in popularity as participants and employers become concerned about participants having sufficient retirement income to last their lifetimes.

Most distributions must be made available in the form of a **direct rollover**, which is a distribution of the participant's plan interest directly to an IRA or other employer's qualified retirement plan.

HOW ARE PARTICIPANTS TAXED ON CONTRIBUTIONS TO AND DISTRIBUTIONS FROM A DEFINED CONTRIBUTION PLAN?

Generally, contributions made on behalf of an employee under a defined contribution plan are not subject to income tax at the time they are made to the plan. This is true of employer nonelective and matching contributions. Amounts contributed to a plan pursuant to an employee's salary deferral election are made on a pre-tax basis if the 401(k) feature is a "traditional" 401(k) arrangement (though these contributions are subject to FICA taxes at the time they are made to the plan). Contributions made by an employee under a "Roth" 401(k) arrangement, however, are made on an after-tax basis.

Distributions from a defined contribution plan are generally subject to income tax at the time they are made to the participant. These distributions are **not** subject to tax at that time, however, if they are rolled over to an IRA or another employer's tax-qualified plan.

Distributions from a Roth 401(k) plan, however, are not taxable if certain requirements are satisfied. Specifically, the distribution must **not** be made (1) before the completion of the five-taxable-year period that begins on the date the participant first made designated Roth contributions to the plan or (2) before the participant's attainment of age 59½, death, or disability. If a distribution is made before such a date, the portion of the distribution attributable to earnings on the contributions is subject to income tax unless the distribution is properly rolled over.

TAKE AWAYS

- Defined contribution plans can provide a valuable benefit to employees as a retirement savings mechanism.
- They are typically the easiest way for an employer to provide opportunities for employees to accumulate retirement funds through contributions by the employer, the employees, or both.
- Many plans can offer flexibility by allowing participants to take loans from the plan, subject to certain monetary limits and repayment terms.
- Distribution options that allow distribution of a plan account into an IRA or an annuity contract that will pay out a life annuity over the participant's life can help participants preserve sufficient retirement income to last their lifetimes.

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