

The Dawn of a New Era—Opportunities and Responsibilities for Pension Professionals

by John S. Agatston, MSPA

Now that the Pension Protection Act of 2006 (PPA) has passed, it is imperative that we—pension professionals, pension firms and ASPPA itself—take a fresh look at our industry from a long-term perspective. It is easy to get caught up in concerns related to funding for some large companies or to be overwhelmed with uncertainties brought about by the new legislation and miss the big picture.

As you will see from this article, there are abundant new consulting opportunities in the small to medium size market. But with these new opportunities come new responsibilities as tens of millions of “baby boomers” get ready to retire in the next two decades.

More Freedom—Fewer Limits

For too long we have been bogged down by the many restrictions of pension regulations and have become accustomed to being lost in the details. We can now apply actuarial skills to benefit our clients rather than merely comply with the Internal Revenue Code.

Many issues addressed in PPA have eased the restrictions that we have been coping with. The increased EGTRRA limits have been made permanent, reasonable advanced funding of defined benefit (DB) plans is permitted, funding methods have virtually been eliminated in lieu of minimum and maximum funding levels (in 2008) and combined plan deduction limits have been greatly eased or eliminated. The question now becomes “what *should* I fund” rather than “what *can* I fund,” which creates consulting opportunities for advising employers based on overall funding objectives. With the youngest of the baby boomers reaching age 43 this year, we can now say that every baby boomer at the \$220,000 compensation level can have contributions over \$100,000 [combining a DB with a 401(k)/profit sharing plan]. More and more of our clients will enjoy substantial accumulations without being near the Section 404 or Section 415 limits.



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Passing the Baton

We are entering a new era for our industry and the baton of carrying out the responsibilities of national pension policy has been passed, in part, to ASPPA and its members. Just a short time ago we saw various aspects of our profession threatened by various tax and pension reform proposals. Not long ago, we wore buttons fighting to keep 401(k) plans. There was the fear that in the near future we would be inviting career counselors to help us retool for new careers. Thankfully, the tide turned and this concern did not come to fruition.

The reason ASPPA is so well poised to take the baton and lead us into this new era is that it is the *only* pension organization with a strong presence in both the DB and defined contribution (DC) sides of the business. There is a growing realization in the industry that in many cases, neither a sole DB plan nor a sole DC plan can do the job by itself. Hence, we need pension professionals who, either individually or by networking with other ASPPA members, are well-trained in both DB and DC plans and can design and consult on combination DB/DC arrangements.

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The baton can stay with ASPPA as long as its members are a catalyst to carry out the desire of Congress such that the private sector does its share to provide adequate benefits for retirees. If we take this responsibility seriously, we can avoid the hypothetical situation of a future congressional hearing where a congressional representative is talking about a small company in which the owner is retiring after having accumulated \$3,000,000 in qualified money and a long service secretary is retiring with only a \$250 monthly pension. What we need to avoid is giving that congressional representative ammunition by way of multiple examples from an industry in which practitioners were presenting plan designs that only favored the owner and ignored long service employees because they were not needed to pass discrimination testing.

Business Motivation: The Opportunity to Put Away More and Take Less Risk

Now let us look at what business owners want in order to participate in the private pension system and how several provisions in PPA will encourage their participation.

For businesses to participate in qualified plans, there needs to be sufficient rewards and limits to the risks. In my 30 years of pension consulting, I have noticed that business owners are interested to varying degrees in:

- Maximizing the amount that can be deferred in a tax-advantaged manner, either expressed as a maximum benefit (*i.e.*, Section 415) or a deductible contribution (*i.e.*, Section 404);
- Controlling the allocation of benefits and contributions to the employees. This control might mean taking care of a key and/or a long service employee while limiting costs for the other employees;
- Maintaining flexibility in funding from one year to the next so that the qualified plan does not get in the way of efforts to grow or otherwise protect a business; and
- Having their employees, when administratively feasible, contribute toward their retirement in a 401(k) plan.

In the past, owners usually have had to make trade-offs among the above four goals to reach a reasonable but less than ideal solution. In many cases, they avoided a DB plan and settled for just a 401(k) or a 401(k)/Profit Sharing plan. With the passage of PPA, business owners are much closer to “having their cake and eating it too.” I believe realization of this fact will take time, but with that time, I believe we will see many new DB plans.

The business community needs to do more than sponsor plans that favor the key people and comply with all the rules and regulations. They only need to do their part so that employees that work for them, for a significant part of their careers, can accumulate an adequate retirement income. Unfortunately, the focus on anti-discrimination rules for more than the last decade has encouraged pension professionals to focus on younger employees to maximize benefits for the key people. The longer service, older employees are not usually needed to pass a test, and hence, can be ignored for testing. While Top Heavy, Gateway and “Meaningful Benefits” per 401(a)(26) rules attempt to take care of the longer service people, my observation is that there has been very limited focus on benefit adequacy, particularly in the small plan market. My hope is that our profession will make a concerted effort to look at benefit adequacy and encourage our clients to do likewise. While we cannot force a business owner to fund more for long service employees, we can accept the responsibility to show the effect and the costs of this type of funding as an alternative, whether or not we think the business owner is interested initially.

Two Plans Are Better Than One

Now let us look at the cumulative effect of recent changes in the law and regulations, culminating in PPA, on businesses, on practitioners and on ASPPA from the viewpoint of both new opportunities and related responsibilities.

Advantages for Business Owners

PPA, along with the maturing of the 401(k) industry, the clarification of the anti-discrimination rules and improved correction programs with less severe corrections for honest mistakes, has made the qualified plan market more attractive to business owners and their accountants and other advisors. In particular, the small plan market has benefited from Congress trying to help the big companies to get on sound actuarial funding. These advantages include (but are not limited to):

The ability to over-fund DB plans in good years

- For plans that have been in place for a few years, we may find that the maximum deductible contribution based on the new 50% plus buffer rules (with an initial phase-in of 150% of current liability in 2006) meets or exceeds most clients’ needs even in a very good year. For new plans, the two-year wait for over-funding on the highly compensated employee takes a little more strategizing.

The greater freedom to design dual plans

Currently, we have a very limited obstacle with the 25% dual plan limit. Starting in 2008, the IRC 404(a)(7) limit would be determined without regard to DB plans covered by the PBGC. In the meantime, some relief is given with the provision that only employer contributions to a DC plan that exceed 6% of participant compensation (excluding elective deferrals) would be subject to the current limit.

This new freedom allows us to create dual plan designs such as:

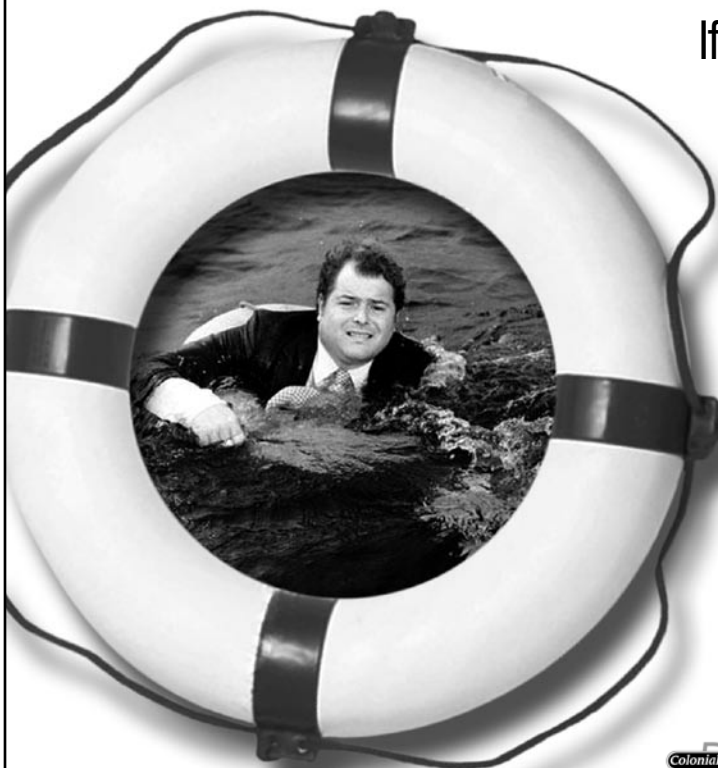
- Add a DB plan (usually Cash Balance) to a maximized Profit Sharing/401(k) without having to worry about a trade-off between maximizing contributions for a key person and reducing amounts for other employees. (There may need to be some shifting of contributions from the Profit Sharing to the Cash Balance plan to avoid exceeding the new 6% aggregate limit.)
- Add a Profit Sharing plan in the case where large contributions are made to a frozen DB plan so that employees can benefit currently while the sponsor funds the old plan.
- Reduce excessive employee costs from a final average pay DB plan by converting to a Cash Balance plan and then add a Profit Sharing plan along with, perhaps, a 401(k) feature. Aggregate Testing would then be used to optimize deductions and cost effective allocations.
- Add a Safe Harbor 401(k) plan to a DB plan where the contribution is already over 25% of eligible pay.

The ability to comfortably add Cash Balance plans to our design routine

The clarification on what constitutes age discrimination for hybrid plans such as Cash Balance plans, as well as clarification on the wearaway rules in the case of conversion to Cash Balance plans, allows these plans to be a serious part of the tools that can be used in plan design. (The favorable court rulings on Cash Balance coming within days of PPA also helped.) The three things I particularly like about Cash Balance plans are:

- They are generally career average plans and so they have a reduced “run away” liability risk when compared with final average pay DB plans.
- The account balance aspects allows for them to be more easily understood by participants who are used to DC plans.
- Even though they are trustee-directed, they appear to participants to be fixed income, hence, encouraging the participants to allocate a higher portion of their 401(k) balances to equities. Also, they allow a way to provide for extra amounts for longer service, older employees without having to contribute more for shorter service older employees.

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The ability by statute to count pre-participation compensation in the determination of the 415 limit

The limit of the PBGC premium for plans with fewer than 25 lives

With these new provisions, business owners can now:

- Both contribute and deduct higher amounts and have higher accumulations at retirement.
- Effectively use 401(k)/Profit Sharing plans along with DB plans to effectively favor long service and key employees while limiting costs for other employees. For example, the changes in Code Section 404(a)(7) make it possible to design safe harbor 401(k)s while still maximizing the contribution for even a very small business owner.
- “Fund First and Promise Later”—meaning they can use the new buffer rules to fund more than the promised benefits and then increase the benefits in later years when they know they can easily be afforded.

Advantages for Actuaries Specifically and Pension Practitioners in General

If we can rise above a sole focus on compliance issues, there are many exciting new consulting opportunities. Here are some of the consulting issues to consider:

- DB plans
 1. At what level above the target liability should a company fund? Should the common level funding actuarial cost methods be used or should there be other strategies? Strategies can include open group valuations, funding as a level percent of projected revenues and/or profit or funding to a future year in which the owner is expected to retire.

2. Should a sponsor consider a lower level of promised pension benefits but with a higher level of funding and then increasing the benefit level as funding permits? As part of this strategy, you want to make sure the 415 limits will not be exceeded. Also, you might focus on who is going to retire in the short-term and increase their benefits to provide for an adequate level at retirement.

- DC plans
 1. Can new comparability type formulas be developed to provide for adequate benefits for long service employees? This approach can include coordinating with a frozen DB plan.
 2. Should a higher level of match be offered for longer service/older employees?
- Dual plan strategies
 1. After maximizing for the key person(s) with an add-on DB plan, how should longer service employees be taken care of between the two plans?
 2. Realizing that missed profit sharing contributions cannot be “made up” in the future as they can with DB plans, how should contributions be allocated between these two plans when you are trying to maximize the accumulation for a key individual?
 3. How should “extra” contributions be allocated between the DB plan and the profit sharing plan? How is the answer to this question affected by where the company is in a business or spending cycle?
- Benefit adequacy studies
 1. Adjust for possible reductions in Social Security.
 2. Take into account what happens when the owner retires long before some of the employees reach retirement age.
 3. Look at the effect of phased retirement on benefit adequacy.

The above list should not be considered a complete list. What is going to make this fun and challenging is that there are no single right answers for each question. Some of these questions will need software to be properly addressed, some will not. The software needed may or may not be currently provided by the various software vendors, so vendor opportunities may also exist.

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Opportunities for ASPPA—A New Focus on Adequate Benefits for Retiring “Baby Boomers”

While continuing to do its crucial work in the lobbying and compliance arena, ASPPA needs to be pro-active in encouraging its members to focus on the issue of retirement security. While we cannot control how our clients spend their money, we do have a job to educate them on the long-term effects of plan design on all their employees, particularly those that spend most of their career at the company. Here are some suggestions for ASPPA:

- At conferences
 1. Have sessions on performing benefit adequacy studies under different scenarios.
 2. In plan design sessions, do not just show techniques on maximizing for owner while limiting contributions for everyone else, but show creative ways to take care of long service employees, too. We have come across several designs for passing tests based on the few oldest, longest service employees as opposed to the few youngest employees.

3. Have cross-training sessions—DB and Cash Balance plans for 401(k) people and 401(k)/Profit Sharing plan issues for actuaries. Just because we have designed a DB/Profit Sharing plan to maximize the owner does not mean we should not include a 401(k) feature to encourage employees to contribute. And even if a plan has a safe harbor feature and the employer does not need to worry about passing 401(k)/(m) testing, we should still encourage employee contributions to the 401(k) plan.

- Take a pro-active role in developing new laws related to phased retirement. Understanding our place in the history of the American retirement industry and acting accordingly will help us to ensure that we ourselves will have a long-term future in this industry. There is no better place than ASPPA to network with peers to foster these new ideas and to meet the challenges and realize the opportunities of this new and exciting era in retirement planning. ↗



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