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ISSUE BRIEF

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DB-K Plus: A Defined Benefit Plan With 401(k) Features

In the wake of Enron and WorldCom, many policy-makers have asked why there are not more defined benefit (DB) plans.[1] The answer is obvious. The playing field for retirement plans is not level. Plans with 401(k) features can have pre-tax employee contributions, matches (from the employer and the federal government), phased retirement at age 59 ½, market returns, and many other items that DB plans cannot have. In addition, pension laws over the past two decades have made DB plans much more complex to administer than defined contribution (DC) plans. Furthermore, employees appreciate the larger benefits at young ages and the simplicity inherent in 401(k)s. Thus, even though DB plans were the most common pension plan through the 1970s (and 401(k)s were only seen as a supplemental savings plan), as of today many more employees are covered by 401(k)s than by DB plans.

However, while younger employees understand and value the cash nature of DC plans, many older employees and retirees still feel that cash does not equal retirement security — a stable lifetime pension does. Thus, there are advantages to having both types of plans, and many large employers do just that — they have a DB plan and a 401(k).

Some advantages of DB plans are:

(1) For employees, DB plans are more likely to provide a secure, stable income for life. Employees won't have to worry about a bear market when they want to retire or after they retire.
(2) For employers, DB plans provide contribution flexibility and help keep a stable workforce.
(3) For the nation, DB plans help reduce poverty rates at older ages more effectively than defined contribution plans.

But DB plans need a level playing field to survive.[2] The American Academy of Actuaries' Pension Committee suggests a way to greatly level this playing field by adopting one change — allow DB plans to have 401(k) features.[3] This "DB-K Plus" plan could have many of the advantages of DB and DC plans in one plan. For example, it could look like a 401(k) to employees (with pre-tax employee contributions and employer matches) but also allow employers funding flexibility. Employers might also promise investment returns based on bond rates. The assets of the 401(k) portion could be held separately from the DB assets or merged with them. The following ideas contemplate one trust fund where all assets are available to pay all benefits. However, these ideas are compatible with other DB-K proposals that contemplate a separate pool of assets.

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The DB-K Plus

Simultaneous compliance with all of the DB and 401(k) rules, some of which contradict each other, is essentially impossible. Thus, it would be preferable for the "DB-K Plus" plan to follow DB rules, with the following modifications:

1. Allow voluntary pre-tax employee contributions in DB plans.
This is similar to what employers may do in a 401(k) now. Government employers may also do this in a DB plan using the Section 414(h) pick-up rules. Private sector companies could do it, too. Employee deferrals could be tested using the 401(k) non-discrimination tests or the DB non-discrimination tests (but it does not make sense to test them under both sets of rules).

These employee deferrals should be exempt from the Section 411(c)(2)(C) requirement to accumulate at 120 percent of the federal mid-term interest rate, as long as all participants receive or can choose a market-related rate.

2. Allow employer matches in DB plans.
Currently, many hospitals and other non-profit organizations match employee 403(b) deferrals and put the match into a DB plan. However, for-profit organizations cannot do this under current law.

Allowing the match in the DB plan under IRC Section 401(k)(4)(A) could benefit employees by reducing investment and longevity risks on the match portion.

Note: Non-profits test these matches under the DB general test non-discrimination rules. Matches could be tested under either the 401(m) or the DB non-discrimination rules, but it does not make sense to force them to comply with both sets of non-discrimination rules.

a. Concerns about the matching contribution. Non-profits may already have a matching contribution in DB plans, and for-profits can match in profit-sharing plans. Banning the practice in DB plans simply encourages more profit-sharing plans and ESOPs, where the risks for employees are higher.

Currently, DB plans generally provide benefits for most employees. Matches would mean that some employees (more likely lower-paid ones) might not make a contribution, and therefore would not get an accrual. The 401(m) rules handle this concern for a 401(k). Some other remedies follow in items 2b, 2c, and 3 through 8.

b. Non-elective employer contributions. Some employers provide such contributions to all participants in order to meet the nondiscrimination tests. DB accruals and pay credits that already exist in a cash balance plan could also help satisfy these rules. When a 401(k) merges into a cash balance plan, the 401(k) non-elective contributions could be included with the non-elective cash balance accruals in the non-discrimination tests.[4]

c. Safe harbor rules. IRC Section 401(k)(12)(C) allows employers to avoid the non-discrimination tests in their 401(k)s if they promise a 100 percent match on the first 3 percent of pay, and a 50 percent match on the next 2 percent of pay. Allowing this on the DB side might raise concerns for employees.

Past remedies for this concern have been to require the employer to make the first contribution.[5] For example, in the federal employee Thrift Savings Plan, the employer makes an automatic contribution equal to 1 percent of pay to everyone first and then contributes the match on top.

However, policy-makers need to be careful about placing more requirements on the DB-K Plus than on the DC 401(k). If they do, the playing field will not be level, and the law will bias employers to 401(k)s, even if they and their employees would prefer a DB plan. That is why we recommend that the changes for DB-K Plus plans be in IRC Section 401(k) rather than by using a new section. That way the rules will be the same for both DB and DC-type plans.

3. Allow the IRC Section 25B and 45E tax credits in the DB-K Plus plan, too.
Low-income employees should get the Economic Growth Tax Relief and Reconciliation Act of 2001 (EGTRRA) Section 25B tax credit match[6] in a DB plan, just as they can in a DC plan. This will help encourage more low-income employees to participate.

Small employers can get a tax credit from the government for starting a new DC plan. This tax credit, in EGTRRA Section 45E, should also be made available to the DB-K Plus plan. It equals 50 percent of the first $1,000 of administrative and educational expenses for the first three years of a pension plan.

4. Better returns than Treasury rates.
This is a very important change in the law. Employees would appreciate DB plans more if it were easier for employers to provide higher rates of return on employee contributions (deferrals, matches, and non-elective contributions). Some people suggest that IRS Notice 96-8 makes it difficult to provide a rate of return higher than the Treasury rate. Since employees can get a higher return in their 401(k)s, they would have little incentive to voluntarily contribute in their DB-K Plus plan if the return were less.

Policy-makers could clarify that the IRC currently handles this well in Section 411(a)(7)(A)(i). Extending this treatment to DB-K Plus plans would allow them to provide a market-related rate without causing myriad problems for the DB plan.[7] (See our issue brief, "What's Whipsaw?" for a more detailed explanation of this issue.)

In fact, employees would probably prefer that the 417(e) rules prescribe a minimum rate of return based on market rates rather than have a maximum discount rate.[8] That would especially help older employees who are more likely to have large accounts earned over long periods of service.

Other ideas are suggested by Pension Equity Plans (PEPs), which are similar to cash balance plans except that they effectively increase the account by the increase in the employee's wages. Other plans might want to increase accounts by a productivity index or the GDP (like Sweden). If the 417(e) rules are changed for account-based plans, it could include these hybrid plans, too. For example, it could allow interest credits equal to any market-related return or any wage index.

5. Allow the special rule 401(k)s have for early participation.
Policy-makers could encourage employers to provide DB plans with elections to contribute at hire as in IRC Section 401(k)(3)(F). This allows employers to exempt employees who have not met the age and service rules in ERISA from the non-discrimination tests.

6. Encourage default automatic elections.
Pension law could encourage employers to have automatic deferral elections at hire and at each pay anniversary. The law could give specific approval to have a default amount placed in a default fund. It could increase an employee's deferrals by 1 percent or 2 percent of pay, up to a total of 6 percent of pay unless the employee affirmatively requests otherwise.

7. Phased retirement.
Employees over age 59 ½ who are phasing into retirement and taking distributions from their 401(k) will want this ability in a DB-K Plus plans. Employees in DB plans should be able to get distributions at age 59 ½, just as in their DC 401(k) plan, as permitted under IRC Section 401(k)(2)(B). Otherwise, employees might contribute less to the DB-K Plus plan.

The law might also allow phased retirement at the plan's early retirement age, or after age 55 or 30 years of service. This would help employees who want to go part-time to get some of the early retirement subsidy in the plan, if applicable.

8. Pension Benefit Guaranty Corporation (PBGC) guarantees.
The employee contributions to a DB-K Plus plan could be in priority categories 1 and 2, and thus get top protection from the PBGC on those assets (or deferrals) just like any other employee contributions to the DB plan. Otherwise, employees would prefer contributing to the DC 401(k). This will also help employees in plans that *already* allow employees to buy a pension from their DB plan with their 401(k) contributions at retirement. Note: The PBGC may only want to guarantee their interest or annuity rate after the date of plan termination (DOPT).[9] PBGC may even want to discuss paying lump sums if there is really no special guarantee after DOPT (other than the lifetime annuity, which can be bought from an insurance company when the annuitant so desires).

9. Maximums applied separately.
The maximum benefit, contribution, and deferral rules should be applied separately to the DB and 401(k) parts. Otherwise, if an employer folds its 401(k) into a generous DB plan, some contributions/deferrals might have to be reduced.

10. Allow employers to change asset choices.
DB-K Plus plan sponsors should be able to change asset options, just as in a 401(k), without worrying about any requirements in Section 411(d)(6). The plan could be required to continue having at least one market-related equity return, a bond rate, and a money market rate. For example, if an index or mutual fund disappeared or fell into disfavor, the plan should be able to change it to some other market-related return.

11. Accrual rules.
It might be preferable to have the DB-K Plus accounts follow the DC accrual rules, not the DB accrual rules (or at the very least, allow the plan to have "greater of" formulas and allow them to test using the DB accrual rules on each formula separately). This would also ensure that increases (and decreases) in employees' contributions (and therefore their match in the DB plan) would not cause any violation of the accrual rules.

This might also give policy-makers a chance to clarify and simplify accrual rules for hybrid plans. For example, pay credits could be tested by comparison to an age-weighted formula with a maximum discount rate of 8 percent. The test would result in accruals that were much less age-weighted than a traditional DB plan because DB plans are also age-weighted through the increase in the final-pay average. If less age weighting is desired, the rule could limit the discount rate to, for example, 6 percent.

12. Switching between DB and account.
As long as the account earns a market rate, employees could be allowed to switch the lump sum value of their DB benefit to the account side when they leave the employer. (If the account could lose principal, the employee would need to acknowledge this on the election form.) They could move it back later in order to convert to an annuity. Perhaps they could do this at the date minimum distributions are required. Some pension plans do this already, but one has to move money between plans in order to do it.

13. Other uses of 401(k) funds in DBs.
This new feature could be added to an already existing DB plan. It could create a plan that has significant accounts for young employees and old-style annuity guarantees for older employees. Other uses for this idea are:

a. The extra assets in the accounts could be used to provide cost-of-living-adjustments (COLAs) to traditional DB pensions or past service credits for prior service or prior jobs (which would help make DB plans more portable).

b. The DB-K Plus plan could allow the two floor-offset plans to be aggregated into one DB plan, so the employee would get the greater of an account and a traditional DB benefit.

14. New funding rule for DB-K Plus plans.
The application of the minimum funding rules to DB-K Plus plans should be investigated to ensure that these plans, which are more front-loaded than the traditional DB plan, are adequately funded. For example, a simplified minimum funding rule could be considered, such as the value of current accruals plus 20 percent of the amount by which the account balances exceed plan assets. More consideration of this issue is needed.

15. Reduced Investment Risk.
One of the major advantages of DB plans is that they reduce investment risks to employees. Traditional DB plans often promise a benefit that is related to the employee's final average compensation. Most cash balance plans promise a return that is always positive. In addition, there are a few cash balance plans that allow contributions to stock or bond indexes, with an added proviso that the employee will at least receive the return of their contributions. Adding guarantees to a plan is easy, but it can be expensive to the employer, so the employer needs to be careful. For example, guarantees may not make sense on risky indexes because they could be very expensive and employees could take advantage of the guarantees. Employers may want compensation for providing a guarantee, and suggestions are described in the next paragraph. Alternatively, the employer could restrict the investment options to just bond (or annuity) rates. These automatically preserve principal, since the rates are always positive (they do not include depreciation in them). As mentioned earlier, employers already do this in hybrid plans, and they generally don't have an explicit charge for the guarantee.

16. Compensation for Guarantee.
For some investment options, the law would need to allow employers to limit their risk. Otherwise, this idea might not be sufficiently attractive to them. For example, the plan could guarantee a return of contributions only if the plan could also keep some of the investment returns. Clear, enabling legislation could open up new kinds of assets for employees similar to guaranteed investment contracts (GICs) and bank investment contracts (BICs).[10]

17. Other Advantages.
Protecting principal or providing other guarantees in a 401(k) will turn the plan into a DB plan.[11] This does not pose a problem. In fact, complying with DB rules could automatically bring other advantages that some policy-makers have been advocating, namely:

a) Offering the qualified joint and survivor annuity (QJSA)[12] option on the benefits;
b) Limit employer securities to 10 percent, unless the 401(k) assets are in a separate pool;
c) Reduced administrative expenses; and
d) Funding,[13] investment,[14] and design[15] flexibility.

18. Administrative Costs.
Employers' administrative costs could actually decrease because they will be maintaining only one plan and one trust.[16] They would also not have to physically send a check to each employee's selected mutual fund every pay period. The employers would just allocate the plan assets among the various asset classes as they see fit, and promise the employees that they will get whatever the mutual fund would have provided (modified by whatever guarantees and charges are in the plan documents).

19. Conversions:
This idea should not be limited just to new plans. Policy-makers have expressed a desire to allow a conversion from a 401(k) to this kind of plan, so that the employee has less risk. Allowing conversions would mean that the 401(k) would not have to be terminated in order to convert it. In order to encourage employers to convert their 401(k)s to this plan with guarantees and annuity options, it will be important to enact the suggestions above. And whenever a new advantage is provided to 401(k)s, it would need to be provided on the DB side, too.[17] Otherwise, employers might convert back to the 401(k).

Rules for converting a traditional DB plan to a DB-K Plus might be needed.[18] Some employers might provide a benefit formula that was the greater of (or the sum of) a DB benefit and a 401(k) type benefit. This would meet the objective of creating a plan that has robust accounts for young employees that elect them and traditional annuity guarantees for older employees who elect them. In addition, if the prior DB plan has a surplus, some policy-makers may want to require some future DB accruals that are not contingent on an employee deferral.[19]

Summary

DB plans have many advantages but need a level playing field to survive. The American Academy of Actuaries' Pension Committee suggests a way to greatly level this playing field with one change — allow DB plans to have 401(k) features. This "DB-K Plus" plan could have many advantages. For example, DB-K Plus plans could have some features that DC plans already have, such as:

(1) Pre-tax employee contributions or deferrals (government DB plans have them through Section 414(h) pickup rules);
(2) Matches (hospitals and other non-profits can have matches in their DB plans); [20]
(3) Additional matches from the government for low-income employees (as in DC plans);[21]
(4) A small-business tax credit for starting new plans (just like the one for new DC plans);[22]
(5) Better returns than Treasury rates,[23] including returns based on stock and bond indexes;
(6) Safe harbors (using benefits or pay-related credits in cash balance plans, and/or cash matches) which could provide some regulatory relief; [24]
(7) Immediate participation at hire without affecting ADP and ACP rules;[25]
(8) Automatic elections;

(9) Phased retirement at age 59 ½, which a 401(k) can have pursuant to IRC 401(k)(2)(B),[26]
(10) DC accrual rules and the ability to test greater of benefit formulas separately.

DB-K Plus plans could have features from DB plans, in which policy-makers have expressed a renewed interest, such as:

(1) Automatic qualified joint and survivor annuities as the default option;
(2) Reduced administrative expenses;
(3) Funding, investment,[27] and design[28] flexibility;
(4) Guarantees (if the employer so desires, possibly for a charge); and
(5) PBGC guarantees.

Other rules will be needed to ensure that these plans are viable for employers and employees, such as:
(1) Separately applied maximums to DB and DC parts;[29]
(2) Ability to revise investment credits/guarantees in the future;
(3) Ability to move benefits from the DB to the DC side and vice-versa;
(4) Rules on conversions from current plans; and
(5) Simple funding rules appropriate for account-based plans.

This will create a more level playing field. And it's important that we act soon, because the earliest baby boomers have already started to reach retirement age. Let's help them have a more secure retirement.

Endnotes

[1] In defined benefit (DB) plans, the employer promises a benefit. In defined contribution (DC) plans, the employer specifies the contribution, and the benefit depends on how well the investments perform.

[2] In our governmental, non-profit, and church sectors where the playing field is more level, DB plans are more prominent. In addition, a paper in the North American Actuarial Journal (NAAJ) noted that a more level playing field is why Canada has more DB plans. See Professor Rob Brown's paper discussing this in the July 2001 issue of NAAJ and discussions in the April 2002 NAAJ.

[3] Congress could revise IRC Section 401(k) to allow 401(k) features in DB plans. For example, add the words "defined benefit plan" to the first sentences of IRC Sections 401(k)(1), 401(k)(2), 401(k)(2)(B)(i)(III) and (IV), and 401(m)(1), and add a sentence to 401(k) that Treasury will specify in regulations how the words "contributions" and "deferrals" can include pay credits to DB plans. Other sections of the law may also need revisions.

[4] Employee advocates will be interested in surveys showing that pay credits in cash balance plans and other hybrid plans are less likely to be integrated than traditional DB plans.

[5] Others have suggested the reverse match. If the employer contributes 5 percent of pay, then employees can contribute up to 5 percent of pay, no more. If certain employees want to contribute more, they would have to encourage the employer to make a larger non-elective contribution to everyone.

[6] The current EGTRRA tax credit rule has cliffs. The tax credit match drops from 50 percent to 20 percent when adjusted gross income (AGI) goes over $15,000. Thus, someone earning one more dollar means he could lose 30 percent of $2,000, or $600 in taxes. This could be fixed by making the tax credit match equal to 50 percent of the contribution minus, for example, 3 percent of an employee's AGI.

[7] Alternatively, the accrued benefit could be defined to be the account balance in hybrid plans.

[8] Policy-makers might want make the rate no larger than a market-related rate, so that other pension rules, such as back-loading, are not manipulated.

[9] If this rate were fixed at DOPT, it would be easier to for plan administrators to determine the accrued pension payable at retirement and settle the liability.

[10] As with GICs and BICs that are in 401(k)s, employers may need to restrict large movements of funds between certain asset classes. For example, it would be risky for the employer if employees could move large blocks of their money from stocks (or bonds) into this plan's guaranteed fund when the stock market was falling (interest rates rising), and then move it all out when they thought the stock market would yield more than the index. The employer could be allowed to limit the amount transferred in and out of risky stock indexes with the guarantee. The employees should still have other asset classes they could switch to when they wanted to reduce their risk.

[11] Defined contribution plans can do this by purchasing GICs, BICs, equity indexed annuities, or variable annuities. However, large plans could self-insure and avoid this risk and profit charges of insurers in a DB-K Plus plan.

[12] In fact, a DB plan would not have to pay out the 401(k) account in a lump sum. However, even if some employers liked the idea of not allowing lump sums, many employees would not, so many employers will have a lump-sum provision in the plan. Currently, employees are more likely to take the lump sum. Actuaries have no choice but to inform inquiring participants that the lump sum is more valuable than the pension that provides continuation to the surviving spouse. This doesn't have to be the case. In fact, IRS regulations require that the joint and survivor pension be the most valuable option. However, the low Treasury rate, called for under current law, negates this good policy. A better approach might be to enable the qualified joint and survivor annuity (QJSA) to be the most valuable benefit in IRC 417(e) by requiring that the conversion to lump sums be calculated using annuity rates or corporate bond rates.

[13] For example, DB plans can efficiently invest their one pool of money, reduce administrative and investment expenses, invest on the efficient frontier (and less in conservative funds), reflect future non-vested terminations, and thus contribute less, but still have enough funds to accrue benefits smoothly and pay benefits when due.

[14] For example, it is difficult for a DC plan to invest in real estate and other hard-to-value assets. The move from DB plans to 401(k)s hurts the industries thus affected.

[15] For example, early retirement windows, past service credits, etc.

[16] You could also allow one DB trust and one Section 414(k) trust for the accounts, but it would help to clarify these rules.

[17] For example, when Roth 401(k)s are allowed, DB-K Plus plans should also be allowed. Roth money is more tax efficient than current post-tax employee contributions. Similarly, if the DB-K Plus plan has a restriction placed on

it, it should also be placed on the 401(k), too. That's why it makes sense to have the rules in the same place in IRC 401(k) for both DB and DC plans.

[18] If desired, traditional DB plans could be allowed to convert to these plans in the future, through one of the methods below:

(1) Employees could **choose** whether they want to switch to the DB-K Plus plan or stay under the prior formula (although there can be problems with choice, if the employee doesn't choose well).

(2) Each employee could get the **greater of** the old or new plan benefit (no choice required).

(3) Each employee could get the old plan benefit (with contingent subsidies at early retirement) plus accruals in the new plan (the **A + B wear-away fix**). Or the prior plan benefit could be converted to a lump sum and added to the 401(k) guarantee account, as long as it got the contingent subsidy at early retirement. This could happen, for example, through a subsidized annuity price at early retirement ages equal to the prior plan's lump sum at that age divided by the plan's early retirement reduction factor at that age.

(4) Each employee could get a minimum benefit equal to the benefit the employee would have received if the new plan had always been in effect.

In addition, the law could allow idea (2) be provided to **future** employees, if desired. Most of these ideas were in the Senate Finance Committee markup in September 2000 (e.g., agencies should accommodate "choice" and "greater of").

[19] You won't want to make the requirement too onerous, or employers won't convert. For example, you could require the non-elective pay credit in the federal Thrift Savings Plan of 1percent of pay or a non-elective pension at retirement of 0.25 percent of pay times service, with a maximum of 30 years of service allowed. In addition, you could waive the ADP and ACP tests if the plan has a pay credit of, say, 3 percent of pay or a non-elective pension at retirement of 0.75 percent of pay times service, with a service maximum allowed. Having identical safe harbor 401(k) rules would be preferable. You could also consider allowing a two-tier formula, to provide greater pension accruals if the participant deferred contributions, although that might entail adding some non-discrimination rules.

[20] Revise IRC 401(k)(4)(A) to include DB plans.

[21] Revise IRC 25B to include pay-related credits in DB plans.

[22] Revise IRC 45E to include DB plans

[23] Revise IRC 417(e) to allow account-based DB plans with market-related returns to pay just the account at termination of employment. Another way to do this is to define the account as the accrued benefit.

[24] Include DB plans in the IRC 401(k)(12)(C) safe harbor, with the same rules for account-based DB plans, and allow Treasury to define the equivalent accrual for traditional DB plans (e.g., a ¾ percent pension accrual could be equivalent to the 3 percent rule in the 401(k) safe harbor).

[25] Include DB plans in IRC 401(k)(3)(F).

[26] We suggest allowing phased retirement at age 55 or after 30 years of service.

[27] For example, it is difficult for a DC plan to invest in real estate and other hard-to-value assets. The move from DB plans to 401(k)s hurts the industries thus affected.

[28] For example: early retirement windows, good benefits for all employees through an account-based formula at young ages and a traditional DB pension formula at older ages (using a greater-of-formula), portability credits (cash or benefits) from prior jobs or prior service, COLA purchases from the account side, transfers from account side to pension side at benefit commencement to buy a level pension.

[29] Clarify IRC 414(k)(2) so that employers could designate whether a pay credit is tested as DB or DC for Section 415 purposes.