Definitions of Plan Types

This is a glossary explaining many of the terms used in Covering the Uncovered.

Defined Benefit Plan
A defined benefit plan is a pension other than an individual account plan that provides a regular monthly income after retirement that is determined according to a formula. It is not dependent on the actual contributions made to the plan or investment performance of the plan's assets. Benefits typically are determined based on a fraction of a worker's average earnings (either over the course of the worker's career or over the course of certain high-earning years at the end of the worker's tenure), or a flat dollar amount multiplied by the number of years worked for the employer. For example, a defined benefit plan might offer employees a monthly retirement benefit equal to one percent of average compensation a year multiplied times the number of years worked. For example, if a worker earning $40,000 a year accrues a pension of one percent or $400 a year toward an annuity, then after 30 years, the individual has accumulated a pension of 30 multiplied by $400 or $12,000 a year. This is an annuity income of $1,000 a month. In the alternative, a plan might promise a benefit of $40 per month multiplied by the number of years worked. If a worker put in 20 years of service, he or she would also receive $800 a month or $9,600 a year. The maximum benefit payable by a defined benefit plan in 2007 is $180,000 a year.

Some newer defined benefit plan designs provide benefits that mimic the appearance of defined contribution plans, reporting benefits as a lump-sum account balance (see cash balance plans below). Private-sector defined benefit pension plans must provide annuities as the default form of benefit. The annuities offered are either single-life annuities for unmarried participants or joint and 50 percent survivor annuities for married participants. The annuity from a defined benefit plan helps retirees (and their surviving spouses) by assuring them of a regular income based on a set formula for the rest of their lives.

Not all retirees receive their defined benefit as a regular monthly stream of income, known as an annuity. Instead, some employers allow retirees to receive their accumulated benefit as a lump sum (with the consent of their spouses). If a retiree elects to take a lump sum, where it is allowed, that retiree is responsible for deciding how to manage and invest those funds, as well as when and how much to pay out as income. In a defined benefit plan, the worker does not have to make decisions about how to invest assets contributed by the employer into the plan. The employer is responsible for determining the amount of contributions needed to fund the promised benefits, making those contributions each year, investing the assets in such a way they will earn a sufficient return to provide for the funds needed to pay the promised benefit, and making up for any shortfall in the assets. Most benefits provided by private defined benefit plans are guaranteed by the federal pension insurance program managed by the Pension Benefit Guaranty Corporation. The maximum insured annual benefit for 2007 is $49,500.

Defined Contribution Plan
A defined contribution plan is one that provides workers with an individual account and pays out benefits equal to contributions to the account and net investment earnings on the contributions. The 401(k) plan is the most well-known example of this type of plan. In a 401(k) plan, contributions can be made by the employer or the worker, and employers often match employee contributions; that is, they provide an additional contribution tied to the amount of contribution the employee
makes. In some defined contribution plans – typically 401(k) plans – employees must decide how to allocate all or part of their account balances among a set menu of investment options selected by the employer (e.g., among various mutual funds and employer stock).

In other kinds of defined contribution plans – such as profit sharing, money purchase, and employee stock ownership plans – contributions are made by the employer. In these plans, the employer often invests the money in the employees’ accounts. In most defined contribution plans, workers receive their benefits as lump sums when they leave their jobs. They may either roll over the account balance to an IRA or a new employer plan or use the money for other, nonretirement purposes. Defined contribution plans, other than money purchase plans (discussed below) are not required to offer annuity payouts and most do not. Upon retirement, an employee has accumulated retirement savings that he or she will have to decide how to manage. The retiree has to decide whether to take part or all of the assets as an annuity, if that is an option. Or, perhaps the retiree may choose to set up a schedule of regular withdrawals. The retiree also has to decide how to invest the assets in retirement, including whether to change the asset allocation. With the 401(k), there are minimum distribution rules, which dictate a minimum withdrawal each year beginning at the age of 70-1/2. Defined contribution plans, unlike defined benefit plans, are not insured by the Pension Benefit Guaranty Corporation.

Hybrid Plan
A hybrid plan has characteristics of both defined benefit plans and defined contribution plans. The most common hybrid plan is the cash balance plan.

Cash Balance Plan
A cash balance plan is a defined benefit plan that defines the benefit as a stated account balance. In a typical cash balance plan, each worker is credited on a periodic basis with a pay credit, a percentage of one’s earnings, and an interest credit, which sets the rate of return for the account balance for that year. The interest rate can be either a fixed rate or a variable rate. Although cash balance benefits are reported as individual account balances, these accounts are only hypothetical. Workers’ benefit amounts are unrelated to the employer’s actual cash contributions to the plan and unrelated to the actual investment performance of plan assets. The benefit is based on the accumulated amount credited to each employee’s account. As with all defined benefit plans, employers must offer employees the option of taking the benefit as an annuity as the default form of benefit.

Money Purchase Plan
The money purchase plan is an employer-sponsored defined contribution plan that allows employers to contribute a set percentage of compensation for workers into the plan with a maximum annual contribution of $45,000 in 2007. This is the maximum for all defined contribution plans and, thus, is not a unique design element of the money purchase plan. Once an employer establishes a contribution level, the amount in subsequent contributions must be maintained until the employer makes a formal, prospective pronouncement that the contribution will be decreased or discontinued. Thus, contributions are made whether or not the business has a profit, which differentiates the money purchase plan from a profit-sharing plan, where contributions are made to employees’ accounts at the discretion of employers, usually when there are profits. Unlike other defined contribution plans, money purchase plans must provide joint and survivor annuities for married participants and single life annuities for unmarried participants.

SIMPLE
SIMPLE is an acronym for Savings Incentive Match Plan for Employees. The two basic types –
SIMPLE IRAs and SIMPLE 401(k)s – are employer-sponsored retirement plans that are available to small employers with no more than 100 employees, as well as self-employed people. A SIMPLE IRA plan is an IRA-based plan that gives small employers a highly simplified method to offer employees an opportunity to make contributions toward their retirement. It involves no annual reports to the IRS, no lengthy plan document, no need for IRS approvals or determination letters, no nondiscrimination testing, and no trust for the employer to administer. Under a SIMPLE IRA plan, employees may choose to make salary-reduction contributions and the employer makes either matching or nonelective contributions. (A nonelective contribution is a type of contribution an employer chooses to make to each eligible employee’s account, whether or not the employee makes a salary-reduction contribution.) All contributions from employers and employees are made directly to an Individual Retirement Account or Individual Retirement Annuity (IRA) set up for each employee. The employer may choose to have all of the IRAs established at the same financial institution. (See IRS Publication 560, IRS Publication 590 and IRS Notice 98-4 for detailed information on SIMPLE IRA plans.)