For Small Business Owners: Introducing a New Hybrid Qualified Plan

By Michael Gunnar

In recent years, there has been a shift away from defined benefit plans in favor of defined contribution plans. One of the consequences of this trend is that participants of defined contribution plans have become their own pension managers, assuming responsibility for managing their own retirement funds.

Given the stock market volatility of the past few years, defined benefit plans are being viewed in a new light. Their promise of guaranteed retirement income is enticing, and some people have begun to question the wisdom of moving away from defined benefit plans to defined contribution plans. The two basic issues are: 1) can the average participant do an effective job of managing his/her retirement portfolio, and 2) can people retire and stay retired without some form of guaranteed income in retirement?

For many employers, the choice has come down to an “either/or” approach. They either establish a defined contribution plan or they establish a defined benefit plan. As a result of the Pension Protection Act of 2006 (PPA), employers may no longer be faced with that either/or dilemma. Beginning in 2010, employers will be able to establish a new type of qualified plan—one that offers features of both a defined benefit and defined contribution plan all in one. As a result, employers can theoretically reduce the cost of administering two separate plans. Additionally, such a plan will provide participants with a retirement plan that provides a source of guaranteed retirement income AND the ability to have their own individual account in which they can manage a portion of their retirement funds.

The PPA created provisions for this new qualified retirement plan for small employers, effective for plan years beginning after December 31, 2009. This new plan, known as an “eligible combined plan,” will enable small employers to maintain both a defined contribution plan and a defined benefit plan within one plan. The plan assets will be held within one single trust. Section 414(x) was added to the Internal Revenue Code as a result of these new regulations brought about by the PPA.

A small employer is defined as employing an average of at least two, but not more than 500 employees, during the preceding calendar year, and at least two employees on the first day of the plan year.
Under §414 (x)(2)(a) of the Internal Revenue Code, an eligible combined plan is a plan: 1) maintained by an employer that is considered a small employer at the time the plan is established; 2) consists of a defined benefit plan and an applicable defined contribution plan; 3) whose assets are held in a single trust that constitute the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan; 4) that meets the benefit, contribution, vesting and nondiscrimination requirements under §414(x).

Beginning in 2010, employers will be able to establish a new type of qualified plan, one that offers the features of both a defined benefit and defined contribution plan all in one.

Section 414(x)(2)(b) dictates that the defined benefit portion of an eligible combined plan must provide each participant with a minimum employer-provided accrued benefit. The minimum accrued benefit must be an annual retirement benefit that is not less than the applicable percentage of the participant’s final average pay. The applicable percentage is the lesser of: 1) 1% multiplied by years of service or 2) 20%. Final average pay is determined by using the period of years (not to exceed five) in which the participant had the greatest aggregate compensation.

An applicable defined contribution plan is defined as one that includes either a qualified cash or deferred arrangement under §401(k)(2). Under §414 (x)(2)(c), an applicable defined contribution plan that forms part of the eligible combined plan must meet certain contribution requirements. Namely, the qualified cash or deferred arrangement included in such a plan must constitute an automatic contribution arrangement.

In order to be considered an automatic contribution arrangement, a plan must meet certain notice and election requirements and provide that each employee eligible to participate in the arrangement is treated as having chosen to make elective contributions in an amount equal to 4% of salary unless the employee specifically elects not to contribute or contributes at a rate other than 4%.

In addition, the employer must be required to make matching contributions on behalf of each employee eligible to participate in the qualified cash or deferred arrangement. Matching contributions must equal 50 percent of employee’s elective contributions, to the extent such elective contributions are not to exceed 4% of employees’ compensation.

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Vesting requirements per §414 (x)(2)(d) are as follows: 1) for defined benefit plans, a participant’s accrued benefits from employer contributions must be fully vested after completing three years of service; 2) for defined contribution plans, participants must be fully vested immediately in any matching contributions, including those exceeding required matching contributions. In addition, a participant must be fully vested in any non-elective employer contributions after completion of three years of service.

The requirements of §414(x) will be applied to both components of the eligible combined plan as separate parts of the combined plan. Additionally, the defined benefit plan and the applicable defined contribution plan must be terminated separately by the plan administrator.

This new plan gives employers something they have never had before: 1) easier administration, quite likely leading to lower costs, and 2) the ability to offer a component of guaranteed income along with the opportunity to manage one’s individual account.

With the addition of life insurance inside this new type of plan, participants could have a qualified retirement plan that not only offers them guaranteed income with the ability to manage a portion of their retirement funds, but also one that provides a guaranteed legacy for loved ones in the form of a death benefit.

In times of stock market volatility and economic uncertainty, the promise of guarantees takes on a whole new light. Whether in the form of guaranteed income in retirement or a legacy for loved ones, guarantees play an important role in helping people accomplish their goals.

The advent of the eligible combined plan provides yet another opportunity to speak to business owners about the important role life insurance plays in providing them with guarantees in retirement.
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