Appendix A: Types of Retirement Plans

(Congress periodically changes the applicable dollar amounts, percentages, and employee age requirements for the various retirement plans discussed in this section through amendments to the IRC and ERISA.)

Employee Benefit Pension Plans

ERISA defines an employee pension benefit plan as any plan, fund, or program that is established or maintained by an employer or employee organization and that provides retirement income to employees or results in a deferral of income by employees for periods extending to the termination of employment or beyond.

An employer-sponsored retirement plan can be either a qualified plan or a non-qualified plan. A qualified plan, one that “qualifies” for special tax treatment under Section 401(a) of the Internal Revenue Code, provides the following tax advantages to the employer and the employee:

- Employer contributions to the accounts of plan participants are not taxable to plan participants until they are withdrawn;
- Employer contributions to the plan are immediately tax deductible, up to specified limits;
- Employees may be able to contribute salary to the plan on a pre-tax basis;
- Employer and employee contributions and investment earnings accumulate tax-deferred or tax-free in a tax-exempt trust fund; and
- Certain favorable tax treatments are available when the plan ultimately distributes benefits to plan participants.

Not only corporations but also self-employed persons can establish qualified retirement plans.

To qualify for favorable tax treatment, a retirement plan must meet certain standards including:

- Adequate, nondiscriminatory coverage of employees;
- Minimum vesting requirements;
- Minimum distribution requirements; and
- Nondiscriminatory contributions and benefit accruals.
Qualified retirement plans are categorized as defined benefit or defined contribution plans. The difference between the two is in how contributions and distributions are made. Defined benefit plans, if they are in the private sector, do not usually require participants to contribute, and thus have come to be known as “fully funded” plans. All defined benefit plans, private and public, determine benefits by a formula set forth in the plan. Defined contribution plans, in which each participant has an individual account, determine benefits solely from the amounts contributed and investment gains and losses allocated to the individual account.

Because qualified retirement plans cannot discriminate in favor of highly compensated employees, nonqualified plans have been created to attract, retain, reward, and supplement the income of higher paid employees. A nonqualified plan, funded through a vehicle such as a Rabbi Trust, defers compensation, including most forms of executive or incentive compensation, or otherwise provides benefits payable at retirement or termination of employment. It does not qualify for favorable tax treatment.

**Master and Prototype Plans**

When a bank provides retirement plan services to a defined benefit or defined contribution plan, the bank’s file will generally include documents that specify whether the retirement plan is a “master” or “prototype” plan. Master and prototype plans provide employers with alternatives to preparing custom documents for their specific employee benefit plan(s). Use of master and prototype plans streamlines the process to gain IRS approval of the form of the plan. While there is no legal requirement to request a Letter of Determination from the IRS that states that they approve a plan as to form, making the request is a standard risk management practice for master and prototype plans, and for custom plan documents.

A **master plan** is a form of qualified plan typically established by a sponsoring financial institution. The plan is preapproved by the IRS and is then made available to employers for adoption. Under a master plan, the sponsoring organization establishes a single funding medium (i.e., trust or custodial account) for joint use by all adopting employers. The plan consists of three parts:
- A basic plan document, which is identical for all the employers that adopt the plan;
- An adoption agreement, which generally contains options that an employer may select that relate to eligibility, vesting, and contribution or benefit levels; and
- A trust agreement under which all participating plan investments are held.

The employer executes an adoption agreement to establish a plan using the master plan document. The financial institution, as the sponsoring organization, files the plan document form, the adoption agreement, and the trust agreement with the IRS and asks for an opinion that the master plan is acceptable to the IRS as a qualified plan and meets all the latest IRS 401(a) requirements.

A prototype plan is similar to a master plan except that the sponsoring organization establishes a separate funding medium for each adopting employer. Prototype plans are much more prevalent in the retirement plan services industry than master plans. In addition to financial institutions, law firms and accounting firms are common sponsors of prototype plans.

Master or prototype plans may use either standardized or non-standardized adoption agreements. An employer that adopts a standardized DC plan may generally rely on the sponsoring organization’s IRS opinion letter and does not need to secure a separate determination letter. While a non-standardized plan provides an adopting employer more choices with regard to plan design, it also creates the potential for a plan to become discriminatory. Employers may request a determination letter from the IRS regarding non-discrimination issues.

### Defined Benefit Pension Plans

**Standard defined benefit pension plans** (DB plans) guarantee a specific or determinable benefit to participants at retirement. Eligibility for retirement is generally established by a formula that is based upon factors such as employee’s age and years of service. DB plans require the sponsoring employer to contribute over a period of years the amounts necessary to fund those benefits. Funding policies for DB plans are complex because they must address the issue of liabilities (both accumulated and projected) in the form of benefit payments, and determine how these liabilities will be funded through
contributions and the expected return on investment of these funds. Because DB plans guarantee a certain level of benefit, the employer is required to make up the shortfall through additional contributions if investments do not perform as expected. While a sponsoring employer may decide to freeze some or all of the benefits associated with its DB plan, ensuring compliance with ERISA’s requirements (e.g., notices, distributions, nondiscrimination rules, and benefit eligibility) remains an ongoing issue for a bank that serves in a fiduciary capacity for that frozen plan.

ERISA created the Pension Benefit Guarantee Corporation (PBGC) to provide a federal insurance program that insures participants against the loss of benefits arising from the complete or partial termination of their pension plan by their employers. Plan participants, especially those that are highly compensated, may not be insured for their total plan benefits. These insurance benefits are funded by premiums paid by plans covered by the program. With minor exceptions, all DB plans are covered.

Cash balance plans. Cash balance plans and other “hybrid” plans are a form of DB plan having attributes of both DB and DC plans. Unlike traditional DB plans, in which an employer aggregates assets, cash balance plans establish individual accounts for each participating employee. Traditional DB plans define an employee’s benefit as a series of monthly payments for life to begin at retirement; by contrast, cash balance plans define the employee’s benefit using a stated hypothetical account balance that may be used to purchase an annuity. Like other DB plans, cash balance plans have minimum funding standards. Employer contributions are determined actuarially to ensure that the plan’s funds (the cash balance) are sufficient to provide the promised benefits.

Defined Contribution Pension Plans

DC pension plans, or eligible individual account plans, do not promise or guarantee a specific benefit. Each participant has an individual account under the plan and is entitled only to the amount in his or her account at retirement age. Some plan members access funds before they retire or before they reach retirement age; such drawdowns are potentially subject to tax penalties. The amount of an employee’s benefit is based upon the cumulative net contributions, distributions, income, expenses, gains or losses in that participant’s account. In some instances, plan participants may also benefit from forfeitures resulting from employees who left the plan prior to
vesting. Contributions are based on criteria established in the plan. Company contributions may be based on a percentage of profits of the company, the salary of a participant, or other factors. Some plans allow employees to contribute a percentage of their salary. Defined contribution plans are not insured by the PBGC. There are several types of DC plans, as described below.

In **profit-sharing plans**, the employer contributes to the plan each year an amount determined at the employer’s discretion or based on a formula in the plan. They typically allocate the contribution, pro rata, according to the compensation paid to each participant. While these plans are called “profit sharing,” the company need not make a profit to contribute to the plan.

**401(k) plans** are individual account plans. The employee may direct the employer to contribute part of the employee’s salary to his or her account. Known as “elective deferral contributions,” these amounts are usually a percentage of compensation. Subject to certain limits, elective contributions are made on a pre-tax basis. These employee contributions, up to a maximum of $15,500 per year (as of 2007) that will be periodically adjusted for inflation increases, as well as an additional maximum “catch-up” amount of $5,000 (as of 2007) per year for persons age 50 and over (which will be periodically adjusted for inflation increases), are excluded from the employee’s gross income for the year in which they are made and are not subject to taxation until distributed. Like other profit-sharing plans, 401(k) plans may include employer stock as one of the investment options. In addition to employee deferral contributions, the employer may make profit-sharing or matching contributions. The employer’s contribution is often determined by a matching formula (e.g., the employer contributes $1 for each $1 contributed by the employee, to a maximum of 3 percent of salary). Employer contributions may be in cash or in company stock, as provided in the plan document.

**404(c) plans** are individual account plans (similar to 401(k) plans) that are designed to take advantage of a safe harbor provided under ERISA 404(c). ERISA 404(c) plans allow each participant to exercise control over the assets in his or her account. Although the participants are not considered fiduciaries, the trustees and other fiduciaries will be relieved from liability for losses resulting from the participant’s exercise of control, provided the following stated conditions are met:
• Plan participants must have the opportunity to exercise control by investing their accounts among a broad range of investment alternatives. At least three investment alternatives must be provided, each of which is diversified and has materially different risk and return characteristics. In practice, the three alternatives are generally the following types of investment vehicles:
  – A “no-risk” investment,
  – A stock investment (employer stock may be a choice, but special requirements apply); and
  – A fixed-income investment.

• A plan sponsor must provide a plan participant the opportunity to make investment changes with a frequency that is appropriate to the market volatility of the investment alternatives. Plan participants must be able to make changes to at least three of the investment vehicles no less than once a quarter.

• If an investment vehicle permits investment changes more often than quarterly, the participant must have the ability to immediately roll the proceeds into another plan investment vehicle that is a low-risk, liquid investment choice. Special provisions pertain to investments in stock of the employer/sponsor.

• Plan participants must be given sufficient information to make informed investment decisions. The plan’s sponsors must make specific disclosures about the plan itself, as well as each authorized investment alternative.

Fiduciaries that do not comply with 404(c)’s specific requirements may be liable for damages resulting from participants’ investment choices.

Money purchase pension plans (MPPPs) are plans that require an employer to declare and contribute a specific percentage of eligible employees’ compensation to the plan each year. Employers are obligated to fund the plan, and are subject to the imposition of a penalty tax if required contributions are not made. The advantage offered by MPPPs is that an employer, such as a small business, may contribute the lesser of 25 percent of compensation or $44,000, to an employee’s MPPP account. These contributions are tax deductible by the employer and accumulate on a tax deferred basis until withdrawn at retirement.
Target benefit plans are individual account plans that are a hybrid of a money purchase plan and a defined benefit plan and are intended to provide a “targeted” benefit upon retirement. They are like DB plans in that the employer contributions to each participant account are established through a DB formula calculated by an actuary. They are like typical DC plans in that there are no guarantees that the targeted benefit will be paid at retirement. If the earnings of the fund differ from those assumed, it increases or decreases the benefits payable to the participant, instead of causing an increase or decrease in employer contributions. In this regard, a target benefit plan operates much like a MPPP. The difference is that with a MPPP, contributions for identically compensated employees are the same even though their ages differ; in a target benefit plan, age is one of the factors that determine the size of the contributions.

Employee stock ownership plans (ESOPs) are DC plans established to invest primarily in employer stock. A company sets up a trust, into which it contributes either new shares of its own stock or cash to buy existing shares. As discussed in greater detail below, if the trust borrows money to buy new or existing shares, it is known as a leveraged ESOP. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain IRC limits. Shares in the trust are allocated to individual employee accounts. The ESOP plan document specifies whether an employee leaving the company receives the vested balance in stock or cash. If it is in stock, the company must agree to buy it back from the employee at its fair market value (unless there is a public market for the shares). In private companies, employees must be able to vote their allocated shares on major issues, such as closing a plant or relocating employees. In public companies, employees must be able to vote on all issues.

When an ESOP purchases employer securities that are not publicly traded, including convertible preferred stock, the stock must be valued by a qualified independent appraiser, and it must be reappraised at least annually thereafter. Appraisals are also required at the time of significant transactions, e.g., transactions with major shareholders. The DOL imposes a high standard for appraisals, and there have been a number of court cases that pertain to the proper valuation of employer securities. Because of the elevated risk associated with acting as trustee for an ESOP, bank fiduciaries are cautioned to exercise care when determining whether appraisers and their appraisals are independent and competent.
In a leveraged ESOP, the ESOP borrows money from a bank (which may also be the trustee bank) or other qualified lender. The company usually guarantees that it will make contributions to the trust to enable the trust to amortize the loan on schedule. Alternatively, the parties may agree that the company will borrow directly from the lender and make a loan to the ESOP. There are specific exemptions from ERISA’s prohibited transaction rules for loans to leveraged ESOPs. These exemptions require that any shares of qualifying employer securities that are used as collateral for such a loan be held in a segregated account. The employer makes annual contributions to the plan that are used to fund ESOP loan payments. The shares held as collateral are released and allocated to participants as the loan is paid off.

Specific ESOP requirements are found in 26 CFR 54.4975-11.

**403(b) plan.** Established under IRC section 403(b), this type of DC plan is a tax-sheltered or a tax-deferred annuity program. A 403(b) is limited to the employees of educational, religious, or charitable organizations. The maximum contribution rules and withdrawal privileges for a 403(b) are similar to those of a 401(k) plan. Like the 401(k), pre-tax contributions and earnings remain tax free until withdrawn.

There are two main differences between a 401(k) and 403(b) plan. First, unlike the 401(k) plan, investment options in the 403(b) plan are limited to annuities and mutual funds (except for church plans). Second, the 403(b) plan permits additional contributions under certain conditions that would otherwise exceed the normal 401(k) annual limit.

A **457(b) plan** is a “non-qualified” retirement plan established for the benefit of state and local government employees, or the employees of tax-exempt organizations. In 2007, 457(b) participants could make contributions (elective or non-elective) of up to $15,500 (an amount that will be periodically adjusted for cost of living increases). Governmental participants may make additional contributions beginning in the year they attain age 50. Until withdrawn, these contributions and all earnings remain untaxed. The 457(b) plan assets of tax-exempt employers are subject to the claims of the employer’s creditors, but those of plans sponsored by governmental entities are not. Plan distributions may occur at retirement, on separation from employment, as the result of an unforeseeable emergency, or at death. Distributions are subject to immediate taxation at ordinary income tax rates.
Proceeds from plans of tax-exempt organizations are ineligible for transfer to an IRA.

A Keogh (HR-10) plan is a qualified retirement plan established by the Self Employed Individuals Tax Retirement Act of 1962, otherwise known as the Keogh Act, or HR-10. Keogh plans may be set up by self-employed persons, partnerships, or owners of unincorporated businesses. Keoghs may be either DB or DC plans. As DC plans, they may be structured as a profit-sharing, a money purchase, or a combined profit-sharing/money purchase plan. Keogh plans may not authorize loans. Contributions and all earnings accumulate free of tax until withdrawn, generally at retirement. Under normal circumstances, withdrawals prior to age 59 1/2 are subject to a 10 percent distribution penalty in addition to ordinary income tax, however, distributions are eligible for transfer to an IRA.

Simplified employee pensions (SEPs) are “non-qualified plans” defined in IRC section 408(k). A SEP allows a small employer to avoid the complex administration and expense of qualified retirement plans when establishing a retirement plan for employees. Under a SEP, an employer may contribute to IRAs established in each employee’s name. Such arrangements are known as SEP-IRAs. An employer’s contributions to a SEP are discretionary, and employee vesting is immediate. Employees may withdraw or transfer funds at any time. Because these accounts are IRAs, the amounts held in a SEP-IRA are subject to all IRS rules regarding transfer, withdrawal, and taxation of IRAs. (See IRA discussion below.)

Taft-Hartley plan benefits may be provided under collective bargaining agreements to those union workers who typically move from one employer to the next as specific jobs (such as construction) start and finish. Each Taft-Hartley fund is a trust that typically has an equal number of sponsoring union and management representatives serving as trustees. A Taft-Hartley plan may provide union members with DB or DC benefits, including 401k options, as well as health and welfare benefits. Depending upon the benefits provided, these plans not only require traditional investment management and administration services, but generally require specialized expertise in tax, ERISA, labor and health care laws and regulations.
Individual Retirement Accounts (IRAs)

An IRA is a tax-advantaged personal retirement savings plan authorized under section 408 of the IRC that is available to most persons who receive taxable earned income during the year. There are several types of IRAs for which banks routinely offer services. The most common are described below. While most banks accept IRA assets, bank retirement plan service departments generally focus on rollover IRAs and converted Roth IRAs because smaller accounts are less likely to benefit as fully from the professional retirement plan services banks can offer.

The three most common types of IRAs are traditional IRAs, rollover IRAs (i.e., IRAs funded with proceeds “rolled over” from an employee benefit plan such as a 401(k) plan), and Roth IRAs. Traditional and Roth IRAs funded with annual contributions are generally smaller in size and may be administered on the retail side of the bank if they are held in a custodial capacity rather than as trustee. National banks are very active in servicing rollover IRAs, including ones that are converted to Roth IRAs. IRAs that are funded with rollovers from 401(k) plans may be sizeable and can benefit from professional investment management expertise.

Contributions to an IRA may be tax deductible in whole or in part. Tax-deductible contributions and income earned in a traditional IRA are not taxed until distributions commence. In a Roth IRA, contributions are made on an after-tax basis and qualifying withdrawals, including withdrawals of earnings, are not taxed. In order to retain tax advantages, the IRA owner must not have any personal use of the assets held in the IRA. Should there be such improper use, the account would be disqualified as an IRA, favorable tax treatment would be lost, and the amounts involved would be considered taxable income to the IRA owner.

The IRC requires a bank, broker, or other trustee/custodian to hold the assets of the IRA. The IRC uses the terms “trustee” and “custodian” interchangeably, and custodians of IRAs are considered equivalent to trustees by the IRS and the DOL. However, for purposes of 12 CFR 9, a bank is a fiduciary with respect to an IRA only if the bank is named trustee, exercises investment discretion, or otherwise acts in a “fiduciary capacity” as defined in 12 CFR 9.2(e). National banks are required to have fiduciary powers to serve as a trustee for an IRA. They do not, however, need fiduciary powers to act as an IRA custodian.
Traditional IRAs are available to those under age 70 1/2 who have employment compensation (i.e., wages). Non-working spouses are also eligible to contribute to traditional IRAs. Contributions to a traditional IRA are only fully tax deductible to the extent that the employee and any non-working spouse are not covered by a retirement plan at the employee’s work. If they are covered by a retirement plan, the deductibility of an IRA is subject to an income test.

An eligible wage-earning individual may contribute up to $4,000 per year ($5,000 in 2008 and adjusted for inflation thereafter) and an additional $1,000 per year catch-up contribution if age 50 or older. A non-working spouse of an eligible individual may also contribute up to those amounts. While anyone may contribute up to the maximum annual amounts to an IRA, based upon their annual wages and retirement plan coverage, they may not be able to deduct some or all of their annual IRA contribution.

Earnings within the traditional IRA grow tax-deferred until withdrawn. Penalty-free withdrawals may begin after age 59 ½. Prior to 59 ½, penalties apply to any withdrawn earnings unless the IRA holder has died, or unless the funds are used for certain eligible expenses (e.g., part of a series of substantially equal periodic payments; health insurance premium payments for unemployed individuals; payments of medical expenses in excess of 7.5 percent of an individual’s adjusted gross income; home purchase by a qualified first-time buyer; higher-education expenses; or an IRS levy). Traditional IRA withdrawals must begin when the owner reaches age 70 ½, and taxes are owed on the earnings. In order to ensure that IRA assets, like most retirement assets, are withdrawn and taxed prior to death, the IRC generally imposes an annual required minimum distribution (RMD) based upon life expectancy. Particularly for owners over 70, proper valuation of IRA assets is critical in order to ensure the required RMD is made each year.

The PPA of 2006 made several significant changes to the IRC pertaining to IRA contribution and withdrawal requirements. For example, persons who are at least 70 ½ may make direct transfers of up to $100,000 per year from their IRA to a charity and incur no federal tax obligation for withdrawal of IRA assets. However, any such transfer must have occurred by January 1, 2008.

Roth IRAs were created in 1998. The primary difference between a Roth IRA and most traditional IRAs is that contributions to a Roth IRA are not tax deductible and eligibility is restricted to those whose earned income, as
measured by their adjusted gross income (AGI), falls below income caps established for each of the tax filing statuses. The benefit of a Roth IRA is that earnings are not taxed, and RMDs are not imposed upon a Roth owner, even at age 70 ½.

Until 2010, amounts in traditional IRAs may be converted to a Roth IRA, provided the taxpayer’s modified AGI for the transfer year falls below IRC limits (currently $100,000). Transferred amounts must be included in that year’s income, but the money transferred is exempt from the customary 10 percent excise tax for IRA withdrawals prior to age 59 1/2. No withdrawal of earnings on the transferred amounts can be a qualified distribution until five tax-years after the transfer. For years 2010 and beyond, the IRC currently includes a provision that eliminates the $100,000 income limitation on Roth conversions.

**Rollover IRAs** are traditional IRAs set up by individuals who wish to receive a distribution from a qualified retirement plan. While traditional and Roth IRAs are contributory (i.e., they are designed to accept annual contributions subject to IRC limits), a distribution transferred to a rollover IRA is a one-time event that is not subject to any contribution limits. Additionally, the distribution may be eligible for subsequent transfer into another IRA or a qualified retirement plan available through a new employer. To retain this eligibility, the IRA must be composed solely of the original distribution and earnings (i.e., be non-contributory), and the new employer’s plan must permit the acceptance of rollover contributions.

Further details on IRA provisions may be found in IRS Publication 590, “Individual Retirement Accounts.” See also 26 USC Section 408.

**SEP-IRA** (See simplified employee pensions above.)

**Savings Incentive Match Plan for Employees (SIMPLE).** Established by the Small Business Protection Act of 1996, a SIMPLE may be set up by employers who have no other retirement plan and who have 100 or fewer employees. Employees with at least $5,000 in compensation are eligible to participate. Contributions are immediately vested with the employee, and deposits and earnings in the account accumulate tax free until withdrawn. In general, distributions from a SIMPLE are taxed as are those from an IRA. Unlike an IRA or SEP, however, employees who withdraw money from a SIMPLE IRA within two years of their first participation in the plan will be assessed a...
penalty tax on such withdrawals of 25 percent (rather than the customary 10 percent).