Employer Sponsored Retirement Savings Plans

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A financially secure retirement is a goal for many workers, and the ability to achieve that plan can be helped by employer-sponsored retirement plans. Employer-sponsored plans can be qualified or unqualified. Qualified plans are approved by the IRS and provide a tax-advantaged way to save for retirement. An example of a qualified plan is a defined-contribution plan such as a 401(k) plan. Smaller employers may offer non-qualified plans such as Simplified Employee Pension plans or Savings Incentive Match Plan for Employees (SIMPLE), and even though these plans are considered non-qualified, they do come with tax advantages. Since employer-sponsored plans are designed as retirement plans and have tax advantages, typically there is a penalty for withdrawing funds before reaching retirement age.

For many plans, both the employer and the employee contribute money into the plan. The employee's contributions are owned by the employee. The employee gains ownership of the employer's contributions through vesting. Once an employee is fully vested, they “own” the employer's contributions and earnings and are entitled to those funds even if employment is terminated. Qualified plans may offer different vesting schedules that can range from immediate vesting to 100% vesting after 3 years, to a vesting schedule that increases the employee's vested percentage for each year of service. SEP and SIMPLE IRA plans require that the employee is always 100% vested.

Many employers match employee contributions up to a certain limit. For example, a company might match each dollar an employee contributes up to 3% of the employee's pay. This is a great benefit, and, when feasible, an employee should contribute the amount or percentage required to obtain the maximum match the employer has to offer, which equates to receiving “free” money.

Defined-Benefit Plan

Defined-benefit plans are also known as pension plans. Once the traditional way companies helped an employee prepare for retirement, the availability of these plans has sharply declined over the last 2 decades. In this type of plan, the company defines the benefits that the employee will receive in retirement. Most companies provide the funds as monthly payments during retirement, but some plans

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may provide lump sum cash payouts at retirement. The amount of money that an employee will receive is typically based on number of years with the company and salary. The employer contributes the funds and the employer or an appointed financial company makes the investment decisions. Most private-sector traditional pension plans are guaranteed by the US Pension Benefit Guaranty Corporation (PBGC). So if an employer is unable to sustain payments to a retiree, PBGC becomes the trustee of the plan. The maximum amount of continued retiree payment that PBGC will guarantee is set yearly by federal law. In 2015, PBGC guaranteed up to $60,136 per year to workers who started receiving payments from PBGC at age 65. For workers who started receiving benefits from PBGC before age 65 or who had surviving spouses or beneficiary benefits, the maximum guaranteed was lower.

An employee working for a company with a defined benefit plan should investigate:

- The formula used for calculating benefits.
- Whether the plan provides cost of living adjustments and how those are calculated.
- The impact of early retirement.
- Whether or not the plan is guaranteed by the PBGC.

In addition, an employee should not assume the plan will fully fund all retirement needs. A person who has the potential for a variety of resources in retirement—such as pensions, investments, and Social Security—will have a better chance at financial security in later life.

**Cash Balance**

Cash balance plans are another type of defined benefit plan in which the employer makes all of the contributions, the amount of the benefit is guaranteed, and the employer bears the financial risk of being able to maintain the plan. Cash balance plans are different from traditional pension plans in that each employee's funds are tracked in an individual account; thus, an employee can track the “cash” balance of their account. Employers can choose among several methods to determine how much they will contribute to their employees' accounts. These methods include a fixed percentage of earnings, age plus years of service, or a percentage based on years of service, age, or earnings. Regardless of method, the amount the employer contributes must be sufficient to pay a defined retirement benefit. The employer will work with an actuary to determine the amount of contribution that is needed to ensure that benefit obligation can be met.

When an employee reaches retirement age, they can choose to receive their benefits as a monthly annuity or a lump sum benefit. If employment with the company is terminated prior to retirement age, a vested employee can receive the benefits as a lump sum or roll the funds into an IRA or a new employer’s retirement plan.

**Defined- Contribution Plan**

A defined-contribution plan is a plan in which the contribution is specified. The amount received at retirement will depend on how much money is contributed and investment performance. This means that the burden of investment risk of the account is on the employee, not the employer. As discussed earlier, some employers provide matching contributions.

One common example of a defined contribution plan is a 401(k) plan. In this type of plan, employee contributions are made tax-deferred. In 2015, the maximum amount that an employee can contribute to their 401(k) will be $18,000. Participants who are age 50 or older at the end of the calendar year can make additional catch-up contributions of $6,000. An employee in a 401(k) plan may have a variety of investment products from which to choose, such as different types of mutual funds, stocks, bonds, and deposit accounts. The employee can make changes to their defined contribution amount up to the limits and also may make changes to how their contributions are allocated among the investment products.

If employment with the employer is terminated, an employee may choose to roll over their 401(k) plan to an Individual Retirement Account (IRA), keep the funds in the plan (if permitted by the existing plan), transfer the money to a new employer’s 401(k), or cash out. Cashing out before retirement age will lead to a 10% penalty and taxes at the employee's current tax rate. If the funds are transferred directly from the 401(k) plan to a new retirement plan, it is called a trustee-to-trustee rollover, and the employee will avoid paying taxes and penalties to the federal government.

**Hybrid Plans**

Money-purchase and target-benefit plans have characteristics of both defined-benefit and defined-contribution plans. The amount the employer contributes is defined. However, the amount received in retirement will depend on investment performance, so the risk of not having adequate funds in retirement is carried by the employee.
Money Purchase
In a money purchase plan, the employer puts a fixed percentage of an employee's income into the employee's retirement account every year. The employee can also contribute to the plan. In 2015, federal tax rules limited contributions to the lesser of 25% of the employee's compensation or $52,000.

The actual amount received in retirement will depend on how much the employee has contributed and the investment performance of their accounts. These plans are a better fit for younger rather than older people. Younger people will have more money added and a greater length of time to gain returns (Dalton, 2008).

Target Benefit
Target benefit plans are similar to a defined contribution plan because the goal is to provide a specific or “targeted” retirement benefit amount to the employee. The amount the employer contributes to the plan is based on that projection. However, the actual amount received will depend on investment performance. This type of plan may work well for older employees. In order for the employer to meet the employee's approaching retirement need, they will have to contribute larger amounts (Dalton, 2008).

Simplified Employee Pension (SEP)
This type of retirement plan is one in which all the contributions are made by the employer into a traditional IRA (each employee has a separate IRA). SEPs provide an employee with a tax-deferred savings benefits and portability. A benefit of SEPs is that contribution levels can be high. They are much higher than the maximum allowed deductible contribution to a traditional IRA. Federal law sets the 2015 the contribution limits for a SEP at the lesser of 25% of the employee's compensation or $53,000. SEPs do not allow for additional catch-up contributions for those who are 50 years of age or older. SEPs do require that all employees are immediately 100% vested. There is no required schedule for how often or how much an employer must contribute to an employee's SEP. The employee is dependent on the frequency and amount of the employer's contributions to the plan. There is a risk of an employer not adding regularly or not adding a large enough amount (Dalton, 2008).

Savings Incentive Match Plans for Employees (SIMPLEs)
SIMPLEs are allowed for companies that have 100 employees or less, so these types of plans are common for self-employed individuals and small business owners. An employer can set this plan up in the form of a SIMPLE IRA or a SIMPLE 401(k). The SIMPLE IRA is more common because it is the easier of the two to administer. Both employees and employers can make tax-deferred contributions to the plan. The employee is 100% vested from the start of the plan.

In 2012, tax rules allow employees to contribute up to $11,500 and an additional $2,500 if the employee is over the age of 50 by the end of the calendar year. Each year an employee can make changes to the level of their contributions during a designated election period. Generally, rollovers from a SIMPLE to another IRA are permitted as long as it has been more than 2 years since the employee started participating in the plan.

Employers can choose between two different contribution methods. One method is for the employer to contribute 2% of each employee's salary regardless of whether the employee contributes. The other option is for the employers to provide a dollar-for-dollar match for up to 3% of the employee's salary. In this matching situation, only employees who have elected to make contributions will receive the employer's contribution.

References


