Pension Plans

Even if you are serving only as a trustee of a health and welfare plan, it is recommended that you read this chapter. Pension issues (e.g., retiree medical coverage) may overlap into a health and welfare plan trustee’s areas of interest and responsibilities.

The purpose of this chapter is to give you an overview of the design, funding and administration of multiemployer pension plans. Sometimes, multiemployer pension plans are referred to as retirement plans, annuity plans or another term that means providing income to a participant at retirement. In addition to providing retirement benefits, trustees may want to use a pension plan to provide income protection to participants who become disabled before reaching retirement age. The cost of providing a disability benefit to a small number of participants affects the level of retirement benefits that can be provided to the majority of participants who reach normal retirement age.

Trustee Responsibility

Trustees of a multiemployer pension plan have a fiduciary duty to manage the assets of the plan in the best interest of participants. New trustees quickly discover that a pension plan cannot be all things to all people; some benefits favor one group of participants over another group. The diverse needs and interests of all participants must be balanced.

Pension policy and objectives guide trustees in managing plan assets. Professional advisors can assist plan trustees in defining these policies and objectives. While the objective of one pension plan might be to provide each member who has 25 years of service a pension benefit that equals 60% of a member’s final working wage at the age of 65, another plan’s objective might be to provide each member who has 30 years of service a pension benefit that equals 80% of the member’s final working income by combining the plan’s pension benefit with the benefit the member will receive from Social Security.

Assume your pension plan’s current benefit is $40 per unit of credit. A participant who retires with 25 units of credit will receive a pension annuity of $1,000 per month ($40 \times 25$ units of credit). Further assume the average industry wage is $15 per hour and the average participant works 1,800 hours per year for a $27,000 ($15 \times 1,800$ hours) annual gross income. A $1,000 per month pension benefit is equal to $12,000 per year, or 45% of the worker’s current $27,000 annual gross income. If 45% of the average industry wage is the trustees’ benefit objective, how will trustees continue to meet this 45% benefit objective five, ten, 15 and 20 years from now? If wages increase at 4% per year, the plan’s current $40 benefit must be $48 in five years and $56 in ten years to continue the 45% objective. How will this goal be financed?
A new trustee should understand the basic principles of how a pension plan works, what it costs to provide different pension benefits (e.g., early, disability and normal retirement) and how each of these benefits interacts with the plan as a whole. Benefit changes and adjustments are a political reality of the collective bargaining process, and federal law may mandate some benefit changes. Keeping abreast of these changes is essential.

Tips for New Trustees

✔ Manage your pension plan for the long term. Pension contributions made today will provide retirement benefits for participants in the future. Understand both the benefit objectives and the investment policy established for your plan.

Categories of Plan Participants

Participants in a multiemployer pension plan are made up of several groups. In a typical plan, these groups are:

• **Active participants.** Persons who currently work and whose employers are submitting contributions to the plan on their behalf. Actives are normally subdivided into two groups: vested and nonvested. The **vested** group has worked sufficient time to meet the plan’s minimum vesting requirements and has nonforfeitable rights to pension benefits. The **nonvested** group has not yet met the plan’s vesting requirements.

• **Terminated vested participants.** Previously active participants who have worked sufficient time to meet the minimum vesting requirements. At present, these participants are not active employees and no contributions are being made on their behalf. Vested participants do not forfeit their vested benefit rights. When they meet a plan’s requirements for retirement, they may apply for and draw benefits. See page 45 for more information on accumulating vesting credits.

• **Terminated nonvested participants.** Previously active participants who have not worked sufficient time to meet the minimum vesting requirements. If a terminated nonvested participant does not return to the plan as an active participant within a specified number of years as defined in plan documents, the person forfeits his or her rights to benefits under the plan. Once a person forfeits pension rights, the person starts as a new participant if he or she later returns to active status.

As an example, assume a woodworkers’ pension plan has a five-year forfeiture rule. Dave participates in the plan for one year then leaves the industry to work as a bricklayer. After 12 years as a bricklayer, Dave decides to become a woodworker again. Dave has forfeited his one year of service in the woodworkers’ plan and must start anew. If he had returned to active status as a woodworker before the expiration of the five-year forfeiture period, he would have been able to continue earning vested and pension credits. He would also have been allowed to retain his previous one year of credits and start earning benefit and vesting credits for the second year. His “break in service” while working as a bricklayer would have been erased.

• **Retirees.** People who currently receive plan benefits. Retirees are often referred to as “in-pay status” by the plan actuary, attorney and administrator.

• **Surviving spouses.** The spouses of deceased retirees as well as the spouses of vested participants who died before reaching retirement age. ERISA and the Retirement Equity Act (REA) require pension plans to provide a benefit to a surviving spouse unless both the participant and spouse previously signed a written notarized waiver of the spouse’s right. This waiver is often identified as the **spousal consent form.**

• **Divorced spouses.** Former marital part-
ners who have obtained a qualified domestic relations order (QDRO) from a divorce court granting them a right to a portion of a participant's pension benefit in a divorce proceeding. The QDRO is served on the plan administrator. Assume the QDRO says the divorced spouse is entitled to 50% of the participant's pension rights earned between 1995 and 2008. When the participant reaches the minimum age and meets any other eligibility requirements for a pension, the divorced spouse may apply to the plan to exercise his or her rights under the QDRO. The law requires a trust to comply with the QDRO. The plan administrator is normally delegated with the responsibility of properly processing all QDROs.

- **Nonspouse beneficiaries.** Family, friends, etc. of an unmarried vested participant that some plans allow to be designated as a recipient of a death benefit in the event the participant dies before he or she begins receiving pension benefits. A beneficiary can also receive the remainder of a retiree’s guaranteed single life annuity. Not all multiemployer pension plans provide a death benefit option; some plans provide it through life insurance in a health and welfare plan.

### Defined Benefit Plans

A defined benefit (DB) pension plan is one type of multiemployer pension plan. Some multiemployer plans have a defined contribution (DC) plan that supplements a DB plan.

Contributions to a defined benefit plan are pooled to provide benefits for all participants who meet the vesting and eligibility requirements. Once an employer contributes $2 for an hour worked by Sue, the $2 is no longer associated with Sue. A defined benefit pension plan specifies the benefit Sue will receive at retirement. The benefit is normally in the form of an annuity, paid during the lifetime of the participant and spouse. If Sue’s plan pays $50 per benefit credit and she has 20 benefit credits, her pension at normal retirement age will be $1,000 ($50 \times 20 \text{ credits}) per month during her lifetime.

The collective bargaining agreement and the trust participation agreement specify the contributions an employer must make on behalf of each employee working in covered employment. Trustees are responsible for managing the contributions and investment earnings to finance participants’ future retirement benefits. Contributions must be prudently invested so both the contributions and investment earnings are available to pay the pension benefit promised each participant.

#### Funding a Defined Benefit Plan

A plan's actuary is responsible for performing the calculations that determine how a DB plan will be funded. Trustees should understand the basic principles of funding a DB pension plan and draw on them when evaluating proposed changes to eligibility rules, benefit levels, contribution levels and investment guidelines. The following very simple example explains the basic principles of funding a DB plan. Vesting and other plan rules are not part of this example.

Assume trustees have established a pension plan objective to pay a $10 lump-sum benefit to participants who have ten years of service. Disregarding investment income, the trustees could fund Jane’s $10 lump-sum pension benefit several ways:

- Deposit $10 during Jane’s first year of employment to be sure the $10 benefit can be paid at the end of year ten. The problem with this method is that while Jane’s pension is fully funded, she may not work the full ten years to earn it.
- Ignore the first nine years of Jane’s employment and deposit the $10 in the tenth year. The problem with this method is the risk of owing Jane a $10 pension but not being able to collect the $10 from the employer in the tenth year of employment.
- Deposit $1 during each year of Jane’s ten years of employment.

The typical multiemployer defined benefit pension plan receives employer contributions periodically, and the plan earns investment income on these contributions. Table 3-I shows how variable contribution amounts made at the beginning of
each year for ten years with 7% compounded investment earnings will yield a $10 lump-sum benefit for Jane.

The first year contribution is only $.59 because the $.59 contribution has ten years to earn 7% compounded investment earnings. The $.59 contribution plus $.41 investment earnings equal the $1 necessary to fund Jane's pension. In year ten, however, the contribution must be $.93 because there is only one year of 7% investment earnings to obtain the necessary $1. The $.93 contribution plus $.07 investment earnings equal the $1.

A multiemployer pension plan normally requires an employer to make a regular fixed contribution rather than a variable contribution. In Table 3-II, the actuary has calculated the trust fund can achieve its $10 lump-sum pension for Jane by having Jane's employer make an annual contribution of $.68 combined with an investment return of 7%.

The actuarial funding principles shown in Tables 3-I and 3-II can be taken another step to illustrate how a defined benefit pension plan is funded. Let’s assume Jane will live exactly ten years after retirement, and the trustees want to pay the $10 benefit to Jane as an annuity of $1 each year, rather than as a lump sum. Now, the trustees have a total of 20 years (ten years working and ten years of retirement) to fund Jane’s $10 pension benefit. This scenario introduces new actuarial principles into the equation:

- A ten-year contribution factor
- A 7% investment factor
- An annuity payment of $1 per year
- A ten-year mortality factor (Jane will live ten years after retirement).

Table 3-III shows how the trustees are relying on 20 years of investment income but only ten years of contributions to pay Jane’s ten-year retirement pension. By averaging contributions over ten years and 7% compounded investment earnings over 20 years, the trust can fund Jane’s $1 per year for a ten-year annuity benefit with an average employer contribution of $.51 per year. This is substantially less than the $.68 necessary for the $10 lump-sum pension shown in Table 3-II.

A new trustee should recognize the importance of investment income in providing a pension for Jane. Nearly one-half of Jane’s $1 per year pension annuity illustrated in Table 3-III was funded by investment income.

### Table 3-I

**Funding Based on Variable Contributions**

(Contributions Made at the Beginning of the Year and Interest Income at 7%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Contribution</th>
<th>Interest Over Ten Years</th>
<th>Account Balance</th>
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<tr>
<td>1</td>
<td>$.59</td>
<td>$.41</td>
<td>$1.00</td>
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<tr>
<td>2</td>
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<td>.39</td>
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<td>.64</td>
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<td>1.00</td>
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<td>4</td>
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<td>.33</td>
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<td>5</td>
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<td>10</td>
<td>.93</td>
<td>.07</td>
<td>1.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10</strong></td>
<td><strong>$7.39</strong></td>
<td><strong>$2.61</strong></td>
</tr>
</tbody>
</table>
### Table 3-II

**Funding Based on Fixed Contributions**
(Contributions Made at the Beginning of the Year at 7% Interest)

<table>
<thead>
<tr>
<th>Year</th>
<th>Contribution</th>
<th>Interest Earned Each Year</th>
<th>Account Balance</th>
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<tbody>
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<td>1</td>
<td>$ .68</td>
<td>$.05</td>
<td>$.73</td>
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<tr>
<td>2</td>
<td>.68</td>
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<tr>
<td>10</td>
<td>.68</td>
<td>.65</td>
<td>10.04</td>
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<tr>
<td><strong>Total</strong></td>
<td>$6.80</td>
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<td>$10.04</td>
</tr>
</tbody>
</table>

### Table 3-III

**Funding Base on Averaged Contributions**
(Contributions Made at the Beginning of First 10 Years and Interest income of the 7% for 20 Years)

<table>
<thead>
<tr>
<th>Year</th>
<th>Employer Contribution (Jan. 1)</th>
<th>Interest Earned Each Year</th>
<th>Payment During Year (Jan. 1)</th>
<th>Year-End Balance</th>
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<td>1</td>
<td>$ 0.51</td>
<td>$ 0.04</td>
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<td>0.07</td>
<td>0.00</td>
<td>1.13</td>
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<td>4</td>
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<td>2.42</td>
</tr>
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<td>5</td>
<td>0.51</td>
<td>0.21</td>
<td>0.00</td>
<td>3.14</td>
</tr>
<tr>
<td>6</td>
<td>0.51</td>
<td>0.26</td>
<td>0.00</td>
<td>3.91</td>
</tr>
<tr>
<td>7</td>
<td>0.51</td>
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<td>0.00</td>
<td>4.73</td>
</tr>
<tr>
<td>8</td>
<td>0.51</td>
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<td>5.61</td>
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<td>9</td>
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<td>4.44</td>
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<tr>
<td>16</td>
<td>0.00</td>
<td>0.24</td>
<td>1.00</td>
<td>3.68</td>
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<tr>
<td>17</td>
<td>0.00</td>
<td>0.19</td>
<td>1.00</td>
<td>2.87</td>
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<tr>
<td>19</td>
<td>0.00</td>
<td>0.07</td>
<td>1.00</td>
<td>1.07</td>
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<tr>
<td>20</td>
<td>0.00</td>
<td>0.00</td>
<td>1.00</td>
<td>.07</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$5.10</td>
<td>$4.97</td>
<td>$10.00</td>
<td></td>
</tr>
</tbody>
</table>
provides more information on the importance of investments and the trustee’s role in establishing investment guidelines.

These very simple examples illustrate the basics of funding a DB plan that has only one participant: Jane. A multiemployer pension plan, however, has many participants. A multiemployer DB plan does not identify contributions or investment earnings by each individual participant. The plan pools contributions and investment earnings to fund the benefit for all participants. The basic funding principles, however, are the same whether the plan is for one or many participants. A plan actuary typically develops the funding for the entire plan by looking at the pieces of funding needed for each participant and then adds up the pieces. The factors the actuary will consider are:

- The age and gender of participants
- The average years of service or number of benefit credits that participants will earn before retiring. The previous example used ten years.
- The total annual income the trust will receive from employer contributions
- The number of nonvested participants who will forfeit their rights under the plan. The forfeited contributions and investment income are kept in the pool and fund benefits for vested participants.
- The age that participants retire
- An estimate of the number of participants who will take disability or early retirement each year. Also, the number of participants who will work beyond normal retirement age.
- The average life span of retirees, known as the mortality rate. Ten years was used in the example.
- The average age of participant spouses and how long they will live beyond the retiree
- The contributions the employer will make each year based on the average hours the average participant works. In the example, $.51 per year was used.
- An assumption of the investment earnings. For Jane’s plan, 7% was used.
- The annual administration expenses.

The actuary develops statistical data on all of the factors listed above and applies basic actuarial principles of funding. Over time, plan demographics and characteristics change. If retirees in a plan are living longer, the actuary must make a funding adjustment.

### Tips for New Trustees

✔ **Ask your plan actuary for a copy of the last actuarial report.**

✔ **Meet with the actuary and review the report.**
  - Ask the actuary to explain how your plan is funded.
  - Ask whether the actuary has reliable administrative data upon which to base the actuarial assumptions.
  - Ask if the actuary sees major problems if the assumptions are not met. Ask what trustees can do to minimize these problems or risks.

To help ensure retirement savings are adequate, ERISA requires actuaries to use assumptions that are “reasonable in the aggregate.” The actuary must annually prepare an actuarial report and submit it to pension plan trustees for review. Parts of this report are also part of the Form 5500 filing with the federal government.

Congress established additional protections for DB plans with the passage of the Pension Protection Act of 2006. The most sweeping pension legislation since ERISA, PPA ’06 set minimum funding standards for multiemployer and single employer DB plans, and established new rules governing the valuation of plan assets and liabilities. The PPA ’06 also requires actuaries to include in the annual actuarial report an assessment of the general financial health of the plan. A plan’s zone status may be red (critical), orange (seriously endangered), yellow (endangered) or green (none of the above).

Plans in the **green zone** (1) have a funded percentage of at least 80% at the beginning of the
A plan’s professional advisors will assist trustees in developing the improvement or rehabilitation plan and the schedules to improve funding in the required period.

**Advantages and Disadvantages**

A defined benefit pension plan has both advantages and disadvantages. Advantages include:

- **Lifetime benefit.** Throughout a participant’s working years, he or she knows what his or her pension benefit will be. This simplifies planning for retirement. For example, if the current pension benefit is $50 per benefit credit and the participant has 20 benefit credits, the participant knows that at normal retirement age he or she will receive an annuity of $1,000 ($50 per credit × 20 credits) per month for life.

- **Lifetime spousal benefit.** If the spouse has retained the joint and survivor benefit, the retirement benefit is provided for the lifetime of both the retiree and the retiree’s spouse.

- **Design flexibility.** Retirement benefits in a DB plan can be designed to meet specific objectives. Trustees might have an objective to provide benefits to participants who become disabled before retirement age. Trustees could decide to provide a retirement benefit equal to 50% of the average industry wage to participants with 20 years of service.

- **Participant investment risk is minimal.** An individual participant does not have the risk of investment loss, because plan assets are pooled. (Nor does the individual participant benefit from investment gain.) If the plan’s benefit is $50 per benefit credit, a participant with 20 credits will receive a retirement benefit of $1,000 per month whether the plan has compound investment earnings of 5% or 10%. If the plan has insufficient investment earnings, the loss must be made up by increased employer contributions.

There are also disadvantages to defined benefit plans:

- **Young workers subsidize older workers.** Because an actuary uses averages to fund a pension plan, older employees are favored...
over younger employees. Assume normal retirement age is 65. One dollar contributed on behalf of a 55-year-old employee invested at 7% equals $1.97 in ten years. However, $1 contributed for a 20-year-old is worth $21 at 7% earnings over 45 years. Both the older and younger employees, however, are eligible for the same fixed benefit (e.g., $50 per credit). Remember, the actuary uses “averages” of all employees to establish funding. In addition, all contributions and earnings are pooled. The extra earnings on contributions for younger workers subsidize the limited investment earnings on contributions made for older workers.

- **Benefit is not portable.** A retirement benefit in a DB pension plan is not portable if the employee changes occupations and enters another industry. If Bill leaves the woodworking industry after ten years to enter the bricklayers’ industry, Bill’s vested benefit rights remain in the woodworkers’ DB pension fund. Bill cannot transfer his woodworkers’ benefit rights to the bricklayers’ pension fund. (Note: There is a de minimis rule that permits a defined benefit plan to cash out a terminated vested participant if the actuarial value of the benefit is less than $3,500.)

- **Limits to recognition of skill or time worked.** Every plan participant is treated the same regardless of skill or amount of time worked. If a DB plan offers a unit of credit for 1,500 hours worked, an employee who works 2,500 hours still gets just one benefit credit. When an actuary determines the funding level of the plan, the additional hourly contributions made for the high-hour worker are normally “averaged” with those who work less. (Note: Some multiemployer plans overcome this disadvantage by awarding additional benefit credit for more hours worked or by basing benefit levels on an hours-worked formula. Awarding additional benefit credits, however, requires higher employer contributions to fund the plan.)

- **Withdrawal liability.** There is potential withdrawal liability if an employer decides to no longer participate in a plan. See question 2 on page 51 for additional discussion regarding this issue.

- **Potential for underfunding.** Although the plan bears the risk of a poor investment return, participants can also be affected because future benefit accruals can be reduced. If a plan is underfunded (the current market value of the assets is less than the actuarial accrued liability), the Pension Protection Act permits a combination of benefit reductions and increased employer contributions to resolve the underfunding.

- **PBGC premiums.** The trust must pay premiums to the Pension Benefit Guaranty Corporation (PBGC), which is an added administrative expense. PBGC premiums are explained on page 50.

### Defined Contribution Plans

Many multiemployer pension trusts offer a defined contribution (DC) plan as a supplement to a primary defined benefit plan. A DC pension plan does not guarantee a specific retirement benefit for a retiree. The contributions made on behalf of each employee are placed in an individual account. The investment earnings on contributions are credited to each employee’s individual account.

Assume an employer contributes $1 per hour under a collective bargaining agreement. During the year, Mary works 2,000 hours, Pete works 1,000 hours and investment earnings are 10%. After one year, Mary has $2,200 (2,000 hours × $1 per hour plus 10% earnings) in her account while Pete has $1,100 (1,000 hours × $1 per hour plus 10% earnings). When Mary retires, she will receive a lump sum of $2,200 and Pete will receive a lump sum of $1,100. Added to these lump sums are any additional contributions and investment earnings up to the date each employee retires.

The funding principles of a DC plan are very simple: “What you see is what you get.” Mary sees $2,200 in her individual account,
and $2,200 is her current benefit. There is no need for an actuary. The only funding issue is the payment of administrative expenses. Trustees normally use forfeitures of nonvested terminated participants to cover these costs. If the administrative expenses are greater, each plan participant pays a pro-rata share of the costs from his or her individual account. If forfeitures exceed expenses, the excess money is distributed to participants’ accounts on a pro-rata basis.

**Advantages and Disadvantages**

A defined contribution plan is not the most favorable plan for all participants. Such plans have advantages and disadvantages. On the plus side:

- **Portable benefit.** The benefit is portable. If a participant leaves employment in the industry or union jurisdiction, the individual’s DC account can be rolled over into another DC plan or an individual retirement account (IRA) set up by the individual on his or her own.

- **No administrative costs after a rollover.** The trust fund does not have to bear the administrative and management expenses of a vested terminated participant when that participant elects to roll over his or her account to another plan.

- **Shorter vesting options.** Trustees may design a plan with a shorter vesting period because the retirement benefit does not depend on averaging and actuarial funding.

- **No withdrawal liability.** There is no withdrawal liability for employers, and the plan does not have to pay premiums to the PBGC.

- **Loan option or hardship withdrawal.** Since the benefit is like a savings account, the trustees may offer participants the option of borrowing from their individual DC account. There may also be a provision in the plan permitting a withdrawal to pay for education, a home purchase or economic hardship. However, be aware that preretirement withdrawals are strictly controlled by IRS regulations. If a participant violates the regulations, he or she must pay income taxes on the money received and, in some cases, penalties. If trustees violate the regulations, a plan can lose its tax-exempt status, and trustees may be personally liable for fines, penalties and damages. Participant loans from an account are also very costly to administer.

- **Investment choices.** Trustees can but are not required to offer an option that permits participants to direct how the assets in their individual accounts will be invested. While a younger worker may want to invest in the stock market, an older worker may want an investment with less risk. Keep in mind that the self-direction investment option is also controlled by government regulations and is very costly to administer.

Among the disadvantages of these plans:

- **Younger workers favored.** DC plans favor younger workers over older workers; an older worker does not have as many years to receive the advantage of compounded investment earnings. Remember the previous example with 7% interest. At age 65, $1 in the individual account of a 20-year-old participant will have compounded to $21. In comparison, $1 in a 55-year-old’s account will have grown to only $1.97.

- **No lifetime benefit.** There is no definite lifetime annuity benefit that a participant can rely on at retirement. Instead, the participant receives a lump sum of cash that he or she must allocate. The participant can use the lump-sum payment to purchase an annuity from an insurance company, but the purchase price that an insurance company charges for the annuity fluctuates daily based on the national economy and financial markets. This makes it difficult for a participant to make financial plans for retirement.

- **Participant investment risk.** The participant takes the risk of investment gains and losses in his or her individual retirement account. Even with prudent investments, stock and bond markets rise and fall. When investment values decline, the participant takes a loss. If values rise, the participant gets the gain.
Let’s say Sheila has $20,000 in her account at the beginning of the year and her investments lose 10% over a 12-month period. Sheila will have only $18,000 in her account at the end of the year. This risk makes financial planning for retirement very challenging for Sheila.

- **Benefits vary.** Not all participants receive the same benefit in a DC plan. Two participants who both worked 30 years in an industry can have substantially different retirement benefits based on the number of hours they worked, when they entered and left the industry, and investment results.

- **Poor management.** Participants may be financially imprudent and squander their individual account—defeating the purpose of establishing a stable retirement benefit. These participants may borrow from their individual accounts prior to retirement and not repay the loans, or upon retirement use the lump sum of cash to purchase expensive items such as a recreational vehicle instead of annuities. Participants who receive a large lump sum of cash are also prey for unscrupulous persons with investment or financial management “deals.”

- **Ongoing administrative costs.** A plan will continue to have administrative costs on small vested accounts if the participant does not elect to roll over his or her individual account into another plan.

### The Role of the Actuary With Defined Benefit Plans

The actuary is responsible for gathering data and making calculations that determine DB pension plan funding. The actuary works with the pension policy and objectives established by trustees, the contribution level provided in the collective bargaining agreement, the statistical data on participants and the funding standards required by law. An actuary has a legal duty to “use his or her best judgment” in making assumptions and calculations concerning plan funding. Under the law, the actuary must annually submit an actuarial report to trustees. Parts of this report must be included with Form 5500, which is filed each year with the U.S. Department of Labor. Form 5500 is explained in Chapter 5.

A pension plan has a long-term horizon. If Sue is aged 20, plan trustees must manage contributions for 45 years to provide Sue with a pension benefit when she reaches the age of 65. Some actuarial questions about Sue are: What investment income will the contributions earn? How many years will Sue work in the industry? Will Sue become disabled? Will she retire before the age of 65 or continue to work after aged 65? When she retires, how long will she live? Will Sue have a spouse at retirement and, if so, how long will the spouse live?

No one really knows the answers to these questions about Sue as an individual. With many participants in a multiemployer pension plan, however, the actuary can calculate averages among the participant population based on historical data. For example, the actuary might determine the average participant in a plan is 35 years old and works 8.9 years in the industry. In addition, 8% of participants take disability retirement, 64% take early retirement, 21% retire at 65 and 7% work beyond the age of 65. Eighty-two percent of the participants have spouses when they retire. The average retiree lives to the age of 76.9 years, and the average retiree spouse lives to the age of 79.1 years.

The actuary must make assumptions about investment income as well. The actuary cannot predict how stock and bond markets rise and fall daily. With the advice of plan investment managers, however, the actuary can predict what average investment returns can be reasonably expected over a five- or ten-year period.

The following are typical assumptions an actuary makes when determining the funding of a defined benefit pension plan:

- The number of plan participants
- The age and gender of participants
- The marital status of participants
- The expected error on participant and spousal birth dates, and marital status (e.g., the participant fails to notify the plan about a new spouse, or lists his or her birth-day incorrectly on the enrollment card)
• The average units of service or credits each participant will earn
• How many participants will not become vested and will forfeit their pension rights
• The number of inactive, nonvested participants who will return to the industry before they forfeit their rights under the plan
• How many participants will take the different forms of retirement (e.g., disability, early and normal)
• The average age of participants at retirement
• The life expectancy (mortality rate) of retirees and spouses
• The investment return on assets
• Plan administrative expenses.

Once a year, the actuary uses these assumptions to develop and submit an actuarial valuation for plan trustees. The actuarial valuation is a snapshot look at the plan's funding status—normally on the last day of the plan's fiscal year. The actuary places a value on all of the liabilities owed to participants and compares these liabilities to the market value of trust assets. The actuarial valuation permits trustees to see once a year whether current funding is meeting retirement benefit liabilities and what the plan will have one, five, ten, 20 and 40 years in the future.

Trustees have a responsibility to inform the plan actuary of pension policy and objectives, and to provide other information that will affect actuarial assumptions. If either the labor or the management trustees have information on the foreseeable economics of the industry or projected employment levels, they should share this with the actuary. When an economic downturn is foreseeable and downsizing in an industry labor agreement will be by seniority, the actuary must assume the total amount of employer contributions will decrease. There will also be an increase in the average participant's age and service because a larger proportion of younger workers will be laid off. A serious economic downturn may also lead to an increase in the number of early and disability retirements. All of this information is very important to the actuary and will affect plan funding.

**Plan Design**

Trustees establish who may participate in a pension plan, plan benefits and how participants apply for benefits. The law, however, sets some standards that trustees must abide by. For example, federal law dictates the benefit and vesting rights of participants who enter military service. The plan attorney has the responsibility to advise trustees of their legal obligations and any new legal developments that affect plan design.

The summary plan description (SPD) must explain the design provisions of a plan as well as how a participant may appeal when a pension benefit is denied.

**Eligibility Provisions and Benefit Policy**

The following are typical eligibility and benefit provisions in a multiemployer pension plan that are communicated to participants in the SPD:

- **Covered employment.** This is the work in a job that is covered by a collective bargaining agreement. An employer is required to contribute to the trust for all workers in covered employment. Sometimes covered employment is called *unit work*, which refers to the jurisdictional unit of the collective bargaining agreement.

- **Vesting.** A vesting requirement may be specified as a length of time (e.g., years, months or hours) worked or a specific number of credits earned by the participant. Once vested, a person never forfeits his or her right to a pension. Let's say a participant can be fully vested in a plan after earning five full vesting credits. The plan might give a vesting credit if the participant works six or more months in covered employment for a participating employer between January 1 and December 31. Another plan might provide a vesting credit if a participant works 1,000 or more hours in covered employment each calendar year. Partial vesting credits might also be granted. In the latter situation, three-fourths of a credit might be given for 750 hours (.75 credit × 1,000 hours) and half a credit for 500 hours (.5 credit × 1,000 hours).
Federal law dictates minimum vesting requirements. ERISA requires participants in a multiemployer plan covered by a labor agreement be vested for “normal retirement” if they work 1,000 or more hours each year for five years. A trust may also adopt vesting alternatives that comply with ERISA. If an employee leaves a bargaining unit to work in another capacity for the same employer (e.g., supervisor or office employee), vesting credit must be given for the time the person works for the same employer in the other capacity.

Federal law mandates that plans give vesting credits to certain participants even though they are not working under a labor agreement. The Uniformed Services Employment and Reemployment Rights Act (USERRA) requires pension plans give vesting and benefit credit to participants who are called to active military duty (including reserve duty). Assume Jake, a participant in a bricklayer pension plan, is called to active military duty from January through October. When Jake returns to work in November, the plan must give him vesting and benefit credits for the period of January to October while he was serving in the military.

Because ERISA only mandates a standard for normal retirement, trustees may establish different vesting requirements for early and disability retirements. For example, trustees might require 15 vesting credits for early retirement and five vesting credits for disability retirement.

The plan attorney and actuary are responsible for advising trustees on all laws and regulations that affect vesting.

- **Benefit credit.** In a DB pension plan, a benefit credit requirement specifies the length of time a participant must work to earn a credit. The benefit credit criterion may be the same as or different from the vesting credit. As stated previously, federal law requires a vesting credit be given to participants who work 1,000 or more hours per year. Trustees might give a full benefit credit for the same 1,000 hours. Alternatively, they might require 1,500 hours for a full benefit credit. In this scenario, a participant who works 1,000 hours during one year would receive one full vesting credit and two-thirds of a benefit credit.

A benefit credit does not need to be defined in terms of hours worked. It can be defined in terms of other units such as months or years worked. Trustees might provide that participants working six or more months between January 1 and December 31 earn a full benefit credit. Some federal laws (e.g., USERRA) require benefit credit be given to nonworking employees. The plan attorney will advise trustees regarding these legal requirements.

In a defined benefit plan, the benefit is paid in the form of a lifetime annuity. The participant's accrual of benefit credits determines the amount of the participant's pension annuity at normal retirement. Assume a plan has a pension benefit that is $50 per benefit credit. A participant with 20 benefit credits is entitled to a lifetime annuity of $1,000 ($50 per credit × 20 credits) per month at normal retirement.

A benefit credit in a defined contribution pension plan is the actual dollar amount paid into a participant's individual account for the year.

- **Forfeiture.** A SPD must clearly set forth when nonvested participants forfeit their rights to a pension benefit. Forfeiture normally occurs when an employee has not worked for a participating employer for a specified period of years. Plans frequently have a rule that nonvested participants forfeit all pension rights if they have not received one or more hours of contribution for ten consecutive years.

ERISA dictates some forfeiture rules. For example, a retirement plan must provide that an employee's right to his or her normal retirement benefit is nonforfeitable when the employee reaches a plan's “normal retirement age.” Likewise, the death of a participant cannot be treated as a cause for forfeiture. Other laws, such as the Preg-
nancy Discrimination Act and the Family and Medical Leave Act (FMLA), provide that time away from work for pregnancy and other covered leaves cannot be used to calculate forfeiture. A trust attorney is responsible for keeping trustees advised of all forfeiture laws and regulations.

- **Normal retirement.** Federal law requires that trustees establish a “normal retirement age” when a participant who has met the minimum vesting standards required by law can apply for and receive benefits. It is common for multiemployer plans to select 65 as the normal retirement age. Some plans, however, select another age, such as 62. The plan attorney and actuary can advise trustees of the legal and funding significance of selecting an age other than 65.

- **Early retirement.** This is usually a period before the person is eligible for normal retirement. For example, if a plan’s normal retirement age is 65, trustees might establish an early retirement period from ages 55 through 64. Trustees may set higher eligibility standards for early retirement than the law requires for normal retirement. For example, trustees might require participants earn 15 full benefit credits to be eligible for early retirement, whereas federal law requires that participants who have five 1,000-hour years must be vested for normal retirement.

  In a DB plan, trustees normally provide that an early retirement benefit is “actuarially reduced” for each month of early retirement prior to “normal retirement age.” The actuarial reduction compensates for the additional time the retiree will receive benefits.

For a very simple example of an actuarial reduction for a benefit, assume normal retirement is age 65 and the average retiree dies at age 75. Also assume the pension benefit for normal retirement is $1 per year. The normal retirement benefit in this simple example has a value, ignoring interest earnings, of $10 (ten years × $1 per year equals $10). If the participant takes early retirement at the age of 64, he or she will receive 11 annual payments of 90.9¢ between the ages of 64 and 75. The “actuarial reduction” of 9.1¢ per year permits the retiree to receive the full value of the $10 normal retirement benefit over 11 rather than ten years (11 years × 90.9¢ per year equals $10).

Some multiemployer DB plans provide long-service participants with an additional early retirement benefit by not applying an actuarial reduction. In this scenario, participants with 30 or more years of service might be allowed to retire between the ages of 55 and 65 without an actuarial reduction. When there is no actuarial reduction, the extra benefit amount can be very expensive. As shown in the previous example of an actuarial reduction, a normal retirement benefit is valued at $10. An unreduced early

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**Tips for New Trustees**

✔ Meet with your plan administrator to review who can participate in your plan and what the eligibility requirements are. Review the various vesting and benefit credit rules including when benefits are forfeited. Also, review the administrative procedure used to process applications for retirement.

✔ Always have a current copy of the plan SPD in your trustee notebook. It is virtually impossible to remember the many types of retirement and benefit options along with the different eligibility rules that determine vesting credit, benefit credit and forfeiture. Whenever there is a question or claim appeal, you will have an easy reference if the SPD is handy.

✔ Meet with the plan actuary and review the costs the actuary places on each type of retirement benefit (e.g., normal, early, disability). Also, review the actuarial formula used to reduce benefits for early retirement, and the joint and survivor (J&S) option.

✔ Ask your plan actuary to review with you what role forfeitures have in funding your plan.
retirement benefit of $1 per year for a long-service employee retiring at age 55 will give this retiree a $20 benefit between the ages of 55 and 75 (20 years × $1 per year equals $20). This additional $10 benefit must be funded by the plan.

**Disability retirement.** Eligibility for a disability retirement normally requires a participant to suffer a disability that prevents the person from engaging in any gainful employment activity. However, some multiemployer pension plans define *gainful employment* as work in the trade or industry. Many multiemployer trusts require a participant to be eligible for a Social Security disability pension to qualify for the plan’s disability benefit.

Trustees may impose a length-of-service requirement (e.g., five, ten or 15 years of industry service) as part of the eligibility rules for a disability benefit. Normally, trustees do not apply an actuarial reduction to the disability pension benefit even though the disabled participant may receive benefits for a substantial period before reaching normal retirement age. A disability benefit is usually the most costly benefit a DB pension plan provides participants. As a result, trustees normally establish administrative procedures to check periodically on a disabled retiree’s disability status. Since the purpose of a disability benefit is to provide income protection, trustees do not want to pay disability benefits to a person who has recovered and is gainfully employed.

**Joint and survivor (J&S) option.** Federal law requires both DB and DC pension plans to provide a married participant with a pension benefit in a J&S form, unless both the participant and the spouse submit a written notarized waiver of J&S. In a DB pension plan, the J&S benefit pays the married couple a monthly annuity for the lifetime of both the participant and the surviving spouse.

Some multiemployer plans offer only the 50% J&S required by law. A 50% J&S is a fixed sum for the lifetime of the participant and one-half (50%) of that sum for the lifetime of the surviving spouse. Assume John retires and has a spouse, Jane. The trust pays John a retirement benefit of $1,000 a month until his death. The trust then pays Jane a benefit of $500 ($500 × $1,000) a month until her death. Some plans offer 75% or 100% J&S options. To compensate for the higher amount the surviving spouse receives when the 75% or 100% option is selected, the monthly benefit during the lifetime of the participant and the spouse is lower than for the 50% option.

Typically, an “actuarial reduction” compensates for the additional payments the plan will make for both the lifetime of the participant and the spouse. If the participant elects early retirement, there is also an actuarial reduction for early retirement.

An example of the actuarial reduction for a 50% J&S follows. Assume the pension benefit is $1 per year, the “mortality assumption” for a 65-year-old retiree is ten years, and 14 years for the retiree’s 62-year-old spouse. Since the value of the normal retirement benefit is based only on the retiree’s projected ten-year lifetime, it is worth $10 ($1 per year × ten years), ignoring interest earnings. The plan actuary develops a table to equate the value of the $10 normal retirement benefit over the ten-year lifetime of the 65-year-old participant and 14-year lifetime of the 62-year-old spouse. In this example, a 17¢ per year J&S reduction factor is applied. The participant and spouse will receive 83¢ per year for the ten-year predicted lifetime of the retiree, and the surviving spouse will receive 41.5¢ (.50 × 83¢) for four additional years of the spouse’s predicted lifetime. This actuarial reduced payment schedule for the retiree and spouse over 14 years equals the $10 value ($8.30 [10 years × 83¢] plus $1.66 [4 years × 41.5¢]) of the normal retirement benefit.

**Death benefit.** A death benefit may be payable to the beneficiary of an unmarried vested participant who dies before taking retirement. The participant selects a parent,
child, friend or other party to receive the death benefit. Not all multiemployer plans offer a death benefit to nonspouses because it is more like life insurance than a pension benefit.

• **Reciprocity.** Some multiemployer plans enter into agreements with other plans to grant reciprocity for vesting. For example, assume Plan A and Plan B both require five years of service for vesting. In addition, assume Sally participates four years in Plan A and four years in Plan B. Under normal circumstances, Sally is not vested or eligible for benefits in either plan, because she does not have five years of service in either plan. If both pension plans grant reciprocity and count the four years in the other plan, however, Sally is vested in both plans with a total of eight years. Plan A and Plan B pay Sally benefits based only on the four years of service she actually spent in each plan.

**Withdrawal Liability**
The Multiemployer Pension Plan Amendments Act (MPPAA) mandates liability for an employer that withdraws from a multiemployer defined benefit pension plan with assets less than the plan’s vested liability. Each year an actuary calculates the value of the assets and vested liabilities for a DB pension plan. If vested liabilities exceed assets, there is an **unfunded vested liability**. If an employer withdraws from a pension plan in a year that the plan has an unfunded vested liability, the withdrawing employer must pay its pro-rata share of the liability. For example, if the unfunded vested liability is $100 million and the withdrawing employer’s pro-rata share is 1%, the employer’s withdrawal liability is $1 million (1% of $100 million). The trust document must set forth the formula trustees use to determine a withdrawal employer’s liability and method of payment.

Some trustees welcome a withdrawal liability because it functions as a penalty for any employer that withdraws from the pension plan. Other trustees, however, view any actual or potential withdrawal liability as a deterrent that discourages new employers from joining the plan.

**Tips for New Trustees**

✔ **Meet with your plan actuary and review the last actuarial report. Have the actuary explain how vested benefit liability is calculated and how the actuary values the assets.**

✔ **If you have a defined benefit pension plan with an unfunded vested liability, ask the plan actuary if trustees should reduce the liability and how to do so. If there is no liability, ask whether trustees should continue to maintain assets above vested liabilities and how this can be accomplished.**

Consider what happens if an employer withdraws from a pension plan because it has gone out of business or bankrupt. The withdrawing employer has liability, but the trustees cannot collect it because the employer has no assets. All remaining employers in the plan must assume a larger prorated portion of the unfunded liability.

Due to the negative aspects of withdrawal liability, trustees of many multiemployer DB pension plans have adopted a policy of maintaining sufficient assets above the point of unfunded vested liability to avoid the potential of any participating employer having withdrawal liability. For additional discussion concerning withdrawal liability, see question 2 at the end of this chapter.

**Key Government Agencies**
**The Pension Benefit Guaranty Corporation (PBGC)**

PBGC is the federal agency charged with guaranteeing the pension benefits of employees who participate in a DB pension plan. If a plan has financial difficulties and is unable to pay retirement benefits to participants, PBGC guarantees payments within specified limits. PBGC obtains a pool of assets to finance this guarantee by charging each DB plan, including multiemployer plans, an annual premium. The premiums are based on the number of participants. Even
a well-funded plan with no unfunded liabilities must pay premiums to PBGC.

PBGC also issues regulations that dictate some of the funding rules and standards that an actuary must follow. The plan actuary and attorney will keep trustees advised of PBGC rules and regulations that impose obligations on the pension plan.

The Internal Revenue Service (IRS)
Part of the U.S. Department of the Treasury, the IRS is responsible for administering the requirements of qualified retirement, health and welfare plans provided by employers. Plans meeting these requirements are qualified plans and receive favorable tax treatment. Contributions to qualified retirement plans made by an employer are a tax-deductible business expense for the employer. In addition, these contributions—as well as earnings resulting from the investment of these contributions—are not taxable income for the employee until the employee actually receives payment from the plan.

A tax-qualified plan must obtain a tax qualification letter from the IRS. When certain plan amendments are made, the plan attorney must submit the changes to the IRS for approval.

The IRS periodically audits pension plans to be sure they are administered according to law. The IRS reviews the trust document, the SPD, the Form 5500 filings and administrative procedures to be sure the plan is in compliance. The agency might review plan administrative procedures to determine if married retirees receive a J&S pension benefit unless both the participant and spouse filed the proper written, signed and notarized waivers. How a plan applies its vesting and forfeiture rules might also be examined.

The IRS has numerous regulations that a plan attorney must follow when drafting plan language, and an actuary must follow when performing the annual actuarial valuation.

Tips for New Trustees

✔ Meet with your plan administrator and ask what the annual premium to PBGC is.

Tips for New Trustees

✔ Obtain a copy of the IRS tax qualification letter from your plan administrator for your trustee notebook.

✔ Meet with the plan administrator, attorney or auditor to review the requirements the IRS imposes upon your plan.

✔ Ask your plan administrator and attorney if your plan has ever had an IRS or DOL audit and, if it has, ask what the results were. If the plan has not had an audit, ask what the DOL or IRS would question if the plan were audited today.

Department of Labor (DOL)
DOL is responsible for enforcing the laws and regulations pertaining to fiduciary duty and the rules on prohibited transactions (see Chapter 1). DOL also has the authority to conduct a plan compliance audit.

Common Questions and Answers

1. Which is better, a defined benefit (DB) or a defined contribution (DC) plan?

The answer to this question depends on the policy and objectives established by plan trustees. As explained earlier in this chapter, both DB and DC plans have advantages and disadvantages.

Some multiemployer plans have a DB plan with a supplemental DC plan for participants. For example, under the collective bargaining agreement the pension contribution might be $1.25 per hour. The collective bargaining agreement directs $1 per hour to fund a DB plan and 25¢ to fund a DC plan. In this situation, the plan participants have both a DB annuity benefit and a DC individual account. Plan trustees have fiduciary responsibility for both plans.

Some multiemployer plans use a plan design that combines features of both a DB and a DC plan by using a formula to calcu-
late the retirement benefit. The benefit formula might be .025 multiplied by the total annual contributions to equal the benefit credit each participant earns for that year. Table 3-IV illustrates how a “formula benefit” works.

The benefit formula has characteristics of DC plans in that participants who work more hours receive higher benefits and each participant has an annual accrual. The formula also has a DB plan advantage in that each participant receives a guaranteed annuity benefit. For example, in Table 3-IV, Sheila has earned a guaranteed $60 monthly benefit when she retires.

A plan attorney and actuary can advise you on the many funding alternatives and benefit formulas that can be applied to DB and DC plans. Make sure you fully understand all of the advantages and disadvantages of both types of plans each when establishing a plan’s benefit structure and funding.

2. What is a prudent balance between employer withdrawal liability and benefit increases?

Assume an actuary tells you there is a surplus of $10 million in your pension fund. If an employer withdraws in part or completely from the plan, should the $10 million be used for benefits, or to offset actual or potential employer liability? There is no right or wrong answer. The decision depends on pension policy and objectives in conjunction with the economic outlook for your industry.

There are several disadvantages for a plan with employer withdrawal liability. First, withdrawal liability may discourage new employers from joining a multiemployer trust. The new employer envisions a number of competitors going bankrupt, leaving the new employer with the competitors’ debt. A multiemployer plan is not a service to the industry if it does not have the confidence of participating employers.

Second, when there is withdrawal liability, less funding is available for current active participants. A portion of the current contribution is being used to fund benefits for vested participants who are no longer working. Trustees have to evaluate the best interests of participants over the long term in determining whether withdrawal liability should be reduced.

Many multiemployer plans with withdrawal liability have adopted a policy to reduce or eliminate unfunded vested liability over time. Plans without withdrawal liability have adopted a policy to maintain a specific level of assets above the amount that would cause withdrawal liability to occur. A plan actuary, together with investment counselors, can assist you in establishing and maintaining these goals.

3. What if we disagree with the assumptions the actuary uses?

ERISA requires an actuary to use his or her best judgment in the assumptions applied to actuarial valuation. In theory, therefore, the actuary has the final call because he or she is responsible for the actuarial assumptions.
being “reasonable in the aggregate.”

The answer to this question depends on what assumption you and the actuary disagree on. For example, if you want to assume 12% interest because it will produce high benefits with low contributions but the actuary feels 7% is prudent, the vote goes to the actuary. It would be imprudent to pursue the high-interest assumption. On the other hand, if you foresee a decline in employment within the industry, the actuary should take your advice regarding employer contribution assumptions, regardless of what past contribution assumption the plan has used.

As another example, the actuary may believe averaging investment returns as permitted by the Pension Protection Act is a sound actuarial method to stabilize interest assumptions. You and the other trustees, however, may prefer to set benefit and funding policy based on the actual market value of plan assets. In this situation, the actuary can give you the advantages and disadvantages of averaging, but you must make the final decision.

An actuary should bow to your desires on items the actuary believes are good actuarial practice when these items conflict with trustee duty to set policy. As a trustee, be prepared to ask the actuary how he or she arrived at the determinations and calculations that make up each actuarial assumption. Often, there is an acceptable range from which to choose. Your input is valuable in deciding what figure to choose within the acceptable range. Record all factors the actuary provides guidance on and that you consider in plan meeting minutes.

4. We want to start a defined contribution (DC) supplement to our defined benefit pension plan. Can the vesting be different for the DC plan?
The simple answer is yes. However, ask your plan attorney to discuss the various laws that affect vesting. You and your fellow trustees must determine what your pension objectives are. The lower the vesting requirements, the more a DC plan becomes a savings account for short-term employees rather than a retirement plan for long-term employees. Administrative expenses for a DC plan must be paid from the income and earnings of the DC plan assets. Administrative expenses are normally paid from the forfeitures of nonvested terminated participants. The lower the vesting criteria, the fewer forfeitures there will be.

5. Recently some participants have asked us to provide a cash-out option for our defined benefit pension plan. Should we take this step?
The answer depends on your pension objectives. An annuity benefit provides participants with a lifetime guaranteed retirement income. If a participant has a spouse, the J&S benefit also provides income for the surviving spouse. A lump-sum option does not meet these retirement income objectives.

Investigate why participants are asking for a cash-out option. Are younger participants looking for more income to spend? Someone may have told these participants that if they terminate their employment, they can get their hands on their pension money if the plan will cash them out. This is not a valid pension objective and should be rejected by trustees. Be wary—In ten to 15 years the participants who cashed out may be claiming that the union and management sponsor an insufficient pension plan because they now have a low retirement benefit.

6. Should we have a preretirement planning program for our pension plan participants?
Yes. This is a valuable service a plan can provide participants. Encourage both participants and spouses to participate as early as ten years before their retirement date. In addition, communication that emphasizes the importance of saving for retirement should occur throughout the working lives.
of participants. Retirement is a big financial and psychological adjustment, and planning is essential to success.

Evaluate the preretirement program. The presentation and materials distributed should be purely educational in form and content. Many organizations offer to present a preretirement program for participants at ‘no cost.’ These organizations may primarily be seeking a forum to market their products.