Although switching from a defined benefit to a defined contribution pension plan can have advantages for multiemployer plan sponsors, trustees will be required to make a number of decisions.

Changing From a DB to a DC Plan in the Multiemployer World
Why would the sponsors of a multiemployer defined benefit (DB) pension plan decide to switch to a defined contribution (DC) plan? There are at least four common reasons why plan trustees might consider a change:

1. **Future withdrawal liability.** Withdrawal liability applies to underfunded multiemployer DB plans, but not to DC plans. The union that co-sponsors a retirement plan might find that having a DC plan makes it easier to organize new employers because the future contribution obligation is limited to the contributions specified in the collective bargaining agreement (CBA)—There are no surprises.

2. **Flexibility in benefit design.** DC plans may permit lump-sum distributions, installment payments for a set number of years and benefit forms other than single or joint life annuity payments, although a DC plan also has the flexibility to include annuities. Creativity in benefit design is possible; for example, the plan can allow partial lump-sum distributions and require the remainder to be paid over time.

3. **Simplicity.** DC plans can be simpler and less expensive to administer. Benefits can be easier to calculate because if the benefit is in a form other than an annuity, the administrator does not have to use mortality tables or interest rate assumptions. DB plans must keep their assets and liabilities in balance, avoiding underfunding and overfunding. In a DC plan, the benefit is simply the participant’s account balance, so there should be no difference between the assets and the liabilities and no underfunding or overfunding. DC plans have no red or green zones and no rehabilitation or funding improvement plans. But DC plans may have features that DB plans do not have that can add some complexity, such as partici-
pant elective contributions and participant-directed investments.

4. Risk of loss. In DB plans, the risk of investment loss is on the plan, because the plan has guaranteed a specific benefit amount based on the number of years of service. In DC plans, the risk of loss is on the participant.

Options for the DB Plan

Once multiemployer plan sponsors decide to make this change, they must figure out what to do with the existing DB plan.

One option is to merge the DB plan into a larger regional or national plan, or into one or more plans of a similar size. The idea is that a larger participant base will cut the per participant administrative costs and will increase the plan's stability.

Another option is to annuitize and terminate the plan. This involves selecting an insurance company to take all of the assets and to assume all of the liabilities. However, this is not an option for an underfunded plan unless the parties can find an infusion of cash—The plan can be annuitized only if it has sufficient assets to meet all “benefit liabilities.” Low-interest-rate environments make it more difficult to annuitize because the plan needs more in present dollars to provide the benefits that it has promised to provide in future years.

Specific fiduciary standards that apply to the selection of an insurance company include:

• Conducting an objective, thorough and analytical search for a reliable insurance company that is not likely to go out of business
• Getting advice from a qualified independent expert
• Taking steps calculated to obtain the safest annuity available, unless under the circumstances it is prudent to do otherwise—for example, if one annuity is only marginally safer than another but would be disproportionally more expensive
• Not purchasing a riskier annuity solely because there are insufficient assets in a DB plan to purchase a safer annuity
• If there are insufficient funds, conditioning the purchase of annuities on additional employer contributions sufficient to purchase the safest available annuity.1

The final option for dealing with an existing DB plan is to freeze it to new benefit accruals and maintain it, at least for a while. Technically, this is also a termination, but it does not seem like one because the trustees continue to administer the benefits that have already accrued, perhaps for many years. It is not a permanent solution, because as the number of participants diminishes, the assets and liabilities will grow out of balance and the per participant cost to maintain the plan will become burdensome. Eventually, the plan will have to either merge or annuitize and terminate, unless changes in the law permit other solutions.

Plan sponsors should be especially careful if they are dealing with a plan that has withdrawal liability, because a cessation of the contribution obligation will trigger a mass withdrawal assessment. The law imposes withdrawal liability on employers when their contribution obligation stops, even if the employers are not voluntarily leaving the plan. (For the construction and entertainment industries, withdrawal liability does not apply to employers that go out of business and stay out of business.) The bargaining parties might be able to avoid an assessment on employers or a mass withdrawal by providing for a small continuing contribution into the plan to improve its financial condition so that it eventually can be annuitized. It might also be possible to work out an arrangement with the Pension Benefit Guaranty Corporation so that the employers get credit for their new contributions into the new DC plan.

What Type of DC Plan Is Best for Members?

There are many different types of DC plans, but in the multiemployer world the most common choice is a profit-sharing plan because it allows for elective contributions, participant-directed investments and hardship distributions.
Before the Tax Reform Act of 1986 took effect, only employer profits could go into profit-sharing plans. This meant that multiemployer plans could not be “profit sharing” because (a) the administrators had no way of knowing whether contributions were actually from profits or from money that an employer borrowed from a bank to meet its contribution obligations, and (b) multiemployer plans typically cover the employees of the union and the apprenticeship fund, which, as nonprofit entities, could not make contributions from profits.

Profit-sharing plans no longer have to be funded by profits, and they are by far the most common choice in the multiemployer arena because of their flexibility.

When multiemployer plan sponsors decide to set up a DC plan, trustees have a number of choices to make. They may want to consider starting with a simple plan because while it’s possible to add features as a plan grows, it’s much more difficult to take features away from a plan.

How Will Employer Contributions Be Structured?

One consideration is how bargaining parties want to structure employer contributions. The most common formula is a fixed dollar amount per hour worked or hour paid. Another option is a percentage of compensation.

If the plan will be using a recordkeeper that primarily works with corporate plans, the recordkeeper probably will have online financial planning tools that are designed to take a percentage of compensation as input. These tools will be more difficult to use if the contributions are in dollars per hour.

Employer contributions are typical, and the CBA should specify the amount or formula for these. However, a plan could have only employee contributions.

Will Elective Contributions Be Permitted?

A 401(k) feature, named for Internal Revenue Code Section 401(k), gives participants the opportunity to choose to defer some of their wages into the plan free from federal and state income taxes until distribution. However, Federal Insurance Contributions Act (FICA) taxes (Social Security and Medicare contributions) apply to elective deferrals, while there are no FICA taxes on employer contributions. If the goal is to have every employee put, for example, $1 per hour into the plan, it is cheaper in the short run to simply include a $1 per hour employer contribution in the CBA and avoid FICA on it. However, participants will ultimately have smaller Social Security accounts.

As with employer contributions, the formula for elective contributions can be fixed amounts per hour worked or hour paid, or it can be a percentage of compensation. The plan may have a qualified automatic contribution arrangement (QACA), in which the employee makes the deferrals automatically unless he or she opts out.

The plan will need a mechanism to notify an employer of the employee’s choice to make elective contributions, and then the employer will have to withhold them from wages and report them separately on the trust fund’s employer reporting form, creating a small amount of extra work for the employer. This can be a challenge in industries such as construction, where employees typically move from one employer to another. The plan can note the employee’s election on a referral card, but then the union rather than the plan is taking some responsibility for the process.

Nondiscrimination testing requirements apply to plans with elective contributions. The testing has nothing to do with race or gender, but involves owners and other non-bargained participants who might be highly compensated or key employees as defined by the IRC and involves an annual calculation of the average deferral percentage (ADP) and a determination of whether the plan is “top heavy.” For multiemployer plans, the challenge generally is not in passing these tests, but in getting compensation information in order to perform them. Plan sponsors will have to send out a questionnaire to all contributory employers each year and entice...
DB to DC plans

**takeaways >>**

- A DC plan allows for a more flexible design and may be simpler and less expensive to administer than a DB pension plan, but may have more complex features, as well.
- The existing DB plan can be merged with another plan, annuitized and terminated, or frozen to new benefit accruals and maintained, at least temporarily.
- Among the types of DC plans available, the profit-sharing plan is most common in the multiemployer world.
- Bargaining parties have options in how to structure employer contributions: The most common formula is a fixed dollar amount per hour worked or hour paid.
- Plan sponsors need to decide whether to allow participants the opportunity to defer wages into the plan free from taxes until distribution.
- Sponsors also need to decide who will direct investments—the plan or participants—and factors such as the structure of recordkeeping and which forms of distribution and types of distribution events will be allowed.

or force them to respond. Plans that have a QACA are exempt from nondiscrimination testing.

**Will Trustees or Participants Direct Investments?**

The fact that a plan sponsor now has a DC plan with a 401(k) feature does not mean that the plan must have participant-directed investments. The trustees can choose who will direct investments based on what they think is in the participants’ best interest.

Trustees can decide to use similar investment vehicles, such as individual managers for various asset classes, as they do for assets in a DB plan once the DC plan has built up some assets. If the DC plan permits lump-sum distributions, distributions upon separation of employment or in-service distributions, it will have to keep assets more liquid than otherwise in order to be able to pay benefits.

Having participants direct their own investments adds some complexity to the plan, which will have to provide at least three investment alternatives and an opportunity for participant investment education. While the trustees of a properly structured plan will not have fiduciary responsibility for the participant’s investment decisions, they will have fiduciary responsibility for selecting and monitoring the investment alternatives.

There will always be some plan participants, perhaps even a majority, who do not want to self-direct. The trustees will have to provide a *qualified default investment alternative (QDIA)* for those people. It will have to be an investment product that takes into account the individual’s age or retirement date, such as a lifecycle or target-date fund, or the characteristics of the group as a whole, such as a balanced fund.

**How Will Recordkeeping Be Structured?**

Whether the plan is trustee- or participant-directed, it will need a recordkeeper to track individual accounts. Trustees will have to make two important decisions concerning the individual accounts:

1. **Frequency of account valuation:**
   - Do trustees want to value individual accounts daily, monthly, quarterly or annually? Daily valuation is the gold standard, but typically, third-party administrators that handle multiemployer plans are not set up to handle daily valuation recordkeeping. Deciding to use daily valuations likely will mean using a 401(k) recordkeeping firm that mostly handles corporate accounts.

2. **Allocation formula for expenses:** Do trustees want to allocate expenses in proportion to the size of the account (*pro rata*) or with a fixed expense charge per account regardless of size (*per capita*)? If there is one account that is $50,000 and another is $1,000, should the plan assess that same expense charge on each, or should it assess a higher one on the larger account?

**What Forms of Distribution Will Be Permitted?**

When most people think of 401(k) plans, they think of lump-sum distributions. However, there are many alternatives to consider including in the plan, perhaps in place of lump sums, such as life annuities, installment payments over a number of years, or some limited or partial form of lump sum. If the plan allows lump-sum distributions, especially immediately on termination of employment, more of its participants will have new pickup trucks and fewer of them will actually have retirement benefits when they are too old to work.

As an alternative, trustees could permit lump sums for participants taking distributions at a certain age, such as 62 or 65, but only permit other forms for younger ones. Trustees could also
include a maximum lump-sum distribution amount and require another form of distribution for the balance, at least for those who are taking a distribution before a specified age. The plan could allow installment payments, with the participants selecting either a number of years or a set amount per month or year, and it can have annuity payments as the normal form of benefit, as the only form of benefit or as an optional form of benefit.

What Types of Distribution Events Will Be Allowed?

There will be provisions for distributions on retirement and death, which are required, and probably for disability, with a requirement for Social Security disability award, as in DB plans.

Trustees can choose to allow other distribution events, as well. Four optional events that are permitted are:

1. **Separation from employment.** This presents challenges to multiemployer plans in the construction and entertainment industries in which participants typically move often among employers. If the plan allows employees to take a distribution when they leave an employer, particularly as a lump sum, there will be participants who quit their jobs, take distributions and go back to work. This means that the plan will resemble a savings plan more than a retirement plan. Many multiemployer plans limit this event to separations followed by several plan years without covered employment or employment in the trade.

2. **In-service distributions at the age of 59½ or later.** The plan does not have to permit distributions to plan participants who are still working at all, or trustees can set a higher age at which participants who are still working may start their distributions. There is one exception: Under the minimum distribution requirements, if the plan permits working owners to participate, any participants who own 5% or more of a contributing employer must start their distributions no later than April 1 of the year after the year in which they reach the age of 70½.

3. **Hardship.** This form of distribution applies only to elective contributions. The trustees can set this up in either of two ways administratively. They can either use the IRS safe harbor, which currently includes six specific categories of hardship circumstances, or they can set up their own financial hardship standards, within the IRS general limits, and have the plan’s administrative staff review each case individually. The latter generally takes more administrative time and poses the risk that IRS will not agree that a particular set of circumstances qualifies as a hardship.

4. **Loans.** Participants often do not distinguish between loans and other forms of distributions, figuring, logically, that the account balances are all their money. But the trustees have a fiduciary obligation to enforce the repayment agreement, which means that the plan will have additional administrative and legal expenses. It also could mean that there will be some unhappy participants. Many multiemployer plans that had loan programs eliminated them because of the administrative burdens and costs that they imposed on the plan.

The trustees and the bargaining parties have many choices to make. If they decide to change from a DB to a DC plan, they should carefully consider what their goals are in making a change and which features of the new DC plan will help them to reach those goals.

Endnotes

1. See 29 CFR §2509.95-1, Interpretive Bulletin relating to the fiduciary standards under ERISA when selecting an annuity provider for a defined benefit pension plan.

2. Please note that this article is a survey of the issues that the trustees and bargaining parties face and not intended to be a comprehensive discussion of each possible feature of a multiemployer DC plan.