An Overview of Money Purchase Retirement Plans

Prepared by
David D. Bohyer, Research Director
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INTRODUCTION

As a component part of the HJR 59 study of state employee retirement systems being conducted by the State Administration and Veterans' Affairs Interim Committee (SAVA), Committee members requested staff to prepare information on "money purchase retirement plans" which are a subcategory of defined contribution retirement plans. The members' interest in money purchase plans as an alternative for Montana public employees and policymakers may have been piqued by conversations with staff of the Montana Teachers' Retirement System about the money purchase plans available to various public employees in Texas, primarily employees of local governments, including school districts, through the Texas County and District Retirement System or TCDRS.[1]

However, the TCDRS appears to be a relatively complicated combination of money purchase plan options and, as such, involves complexities that are probably premature for an overview. Therefore, the remainder of this paper focuses on money purchase plans in their basic form.

MONEY PURCHASE PLANS ACCORDING TO THE IRS [2]

According to the Internal Revenue Service, a money purchase retirement plan is a defined contribution plan into which the employer is required to contribute money.[3] The plan prescribes the contribution percentage that the employer is required to make and the employer makes the contribution, typically annually, to a separate account for each eligible employee based on the employee's pay.

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[1] The "Texas County and District Retirement System" is enabled under Texas law in Article 16, Section 67, Texas Constitution, and in Texas Government Code, Title 8, Public Retirement Systems.

[2] The narrative under this heading is largely taken from "Choosing a Retirement Plan: Money Purchase Plan", available on line at http://www.irs.gov/retirement/article/0,,id=108949,00.html.

[3] The law also allows, but does not require, employees to contribute to the plan if the plan is so designed by the employer and approved by the IRS. Interest and income earned on the contributions are reinvested (tax deferred) and may also be considered to be "contributions".

A participant's retirement benefit is based on the total amount of contributions to the employee's account and the gains or losses associated with the account at time of retirement. The final account balance from contributions and earnings and, hence, the retirement benefits are potentially larger if the plan is designed for both employer and employee contributions.

According to the IRS, the employer can make a money purchase plan as simple or as complex as desired. The IRS has preapproved several money purchase plan designs which, if one is adopted, cuts down on administrative headaches.

Also according to the IRS, a money purchase retirement plan makes it possible to grow larger account balances than could otherwise occur under some other arrangements. (The IRS does not indicate to which arrangements it is comparing the relative size of money purchase plan account balances, but it would most likely be plans with maximum contribution limits that are lower than the maximum contributions allowed for money purchase plans.) Even so, the IRS also notes that administrative costs may be higher for money purchase plans than under different types of retirement plans.

The IRS also cautions that the employer needs to test that retirement benefits do not discriminate in favor of the employer's highly compensated employees.

Under provisions of the Internal Revenue Code (IRC), the maximum amount that may be contributed to a participant's account is the lesser of 25% of the employee's compensation or $46,000 (in 2008 and subject to cost-of-living adjustments for later years).

A participant in a money purchase plan may take a loan against the balance of the participant's account balance in the plan (which must be timely repaid with interest). Prior to retiring, however, a participant may not outright withdraw funds from the account absent exigent circumstances.

If an employee leaves the sponsoring-employer's employment prior to retirement, the employee may transfer the account balance to an individual retirement account (IRA) or, in some cases, another employer plan, where it can continue to grow based on investment earnings. The employee also may take the balance out of the plan, but will owe taxes and possibly penalties, thus reducing retirement income. Plans may cash out small accounts.[4]

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[4] Excerpted from *What You Should Know About Your Retirement Plan*, "Table 1. Characteristics Of Defined Benefit And Defined Contribution Plans" (see under Leaving the Company Before Retirement Age), U. S. Department of Labor, Washington, DC, April 2008, on line at http://www.dol.gov/ebsa/publications/wyskapr.html.

A money purchase plan must offer participants in the plan a retirement benefit in the form of a life annuity, which means that the retiree will receive equal, periodic payments, often as a monthly benefit, which will continue for life. Money purchase plans may also offer other payment options. The plan may pay retirement benefits in a single lump-sum payment as well as offer other options, including payments over a set period of time (such as 5 or 10 years).[5]

Under a money purchase plan, unless the retiree (and spouse) choose otherwise, the form of benefit payment will include a survivor's benefit. This survivor's benefit, called a qualified joint and survivor annuity (QJSA), provides payments over the retiree's lifetime and his or her spouse's lifetime. The benefit payment that the surviving spouse receives must be at least half of the benefit payment the retiree received while alive.[6]

ANOTHER PERSPECTIVE ON MONEY PURCHASE PLANS

The following narrative, basically starting here and continuing through the section labeled "Contributions" on page 6, is excerpted from *Fundamentals of Private Pensions*, 8th Ed., by Dan M. McGill, Kyle N. Brown, John J. Haley, and Sylvester J. Schieber, Pension Research Council, The Wharton School of the University of Pennsylvania, October 2004 · Oxford University Press, pp 282 - 284. Thanks is due to Dr. Olivia S. Mitchell, Executive Director, Pension Research Council, The Wharton School, University of Pennsylvania, for providing the information.[7]

> A money purchase pension plan is a defined contribution plan that may be used by an employer to provide retirement income to employees. The primary difference between a money purchase pension plan and a profit-sharing plan is that contributions to the former must be based on a fixed formula specified in the plan

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5 Excerpted from *What You Should Know About Your Retirement Plan*, "In what form will your benefits be paid?", U. S. Department of Labor, Washington, DC, April 2008, on line at http://www.dol.gov/ebsa/publications/wyskapr.html.

6 Excerpted from *What You Should Know About Your Retirement Plan*, "Can a benefit continue for your spouse should you die first?", U. S. Department of Labor, Washington, DC, April 2008, on line at http://www.dol.gov/ebsa/publications/wyskapr.html.

7 Dr. Olivia S. Mitchell has been earned several titles and serves in various capacities in recognition of her expertise in and contributions to the field of retirement and pensions. Among her roles and titles, Dr. Mitchell is: the International Foundation of Employee Benefit Plans Professor in the Department of Insurance & Risk Management at the Wharton School, Universtity of Pennsylvania; the Director of the Boettner Center for Pensions and Retirement Research at The Wharton School; and Professor of Insurance & Risk Management within the Department of Insurance & Risk Management at The Wharton School, University of Pennsylvania in Philadelphia.

document. A profit-sharing plan can have discretionary employer contributions, since it is not subject to the definitely determinable benefit rule. A money purchase plan, since it is a pension plan, is subject to the definitely determinable benefit rule, and therefore contributions must be fixed.

Since it is also a defined contribution plan, a money purchase pension plan is subject to many of the same requirements for profit-sharing and stock bonus plans. Money purchase pension plans are more common among small employers who want to offer their employees the benefit security of a pension plan but do not want to assume the financial responsibility of a defined benefit plan. Additionally, the deduction rules prior to EGTRRA, the 2001 changes to the tax laws, permitted larger deductions to money purchase plans than to profit-sharing plans, a potentially desirable result for small to mid-size employers seeking to maximize deductions.[8] Currently, there are no differences between a profit-sharing and money purchase pension plan in determining the deductible limit.

A money purchase pension plan is quite different from a defined benefit plan in its approach to providing retirement income for employees. A defined benefit plan uses a determinable benefit formula, and employer contributions are made as required to provide that benefit. In contrast, a money purchase pension plan follows a contribution formula, and the ultimate retirement benefit is based upon the accumulated employer contributions and earnings and losses thereon. The fixed contribution formula is said to satisfy the definitely determinable benefit requirement for pension plans.[9]

Like a defined benefit pension plan, a money purchase plan is subject to the minimum funding requirements[10] and the qualified joint and survivor annuity requirements.[11] Like a defined contribution plan, a money purchase plan is subject to the annual limit on contributions to the plan[12] and the annual valuation of plan assets. This duality of requirements significantly affects the design of money purchase plans.

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8 The full title of the federal law is the "Economic Growth and Tax Relief Reconciliation Act of 2001", Public Law 107–16 107th Congress. This footnote does not appear in *McGill* because the acronym is defined earlier in the chapter text.

9 Treas. Reg. 1.401-1(b)(1)(i). Note: This footnote is denoted in *McGill* as footnote 14 of Chapter 11.

10 Treas. Reg. 1.412(a)(1)(A). Note: This footnote is denoted in *McGill* as footnote 15 of Chapter 11.

11 IRC §401(a)(11)(B)(ii). Note: This footnote is denoted in *McGill* as footnote 16 of Chapter 11.

12 IRC §415(c). Note: This footnote is denoted in *McGill* as footnote 17 of Chapter 11.

Traditional Money Purchase Pension Plan Design

The contribution formula for a traditional money purchase pension plan is usually quite straightforward, requiring the employer to contribute a fixed percentage of employees' compensation, such as 5 percent or 10 percent, each year. In fact, the contribution formula for a money purchase plan can so strongly resemble the contribution formula for a profit-sharing plan that the repeal of the requirement that profit-sharing plan contributions be made out of employer profits has blurred the distinction between a money purchase plan and a profit-sharing plan with a nondiscretionary contribution. For that reason, when the profit contribution requirement was removed from the Internal Revenue Code, the IRS began requiring that money purchase plans and profit-sharing plans designate what type of plan they intend to be in the plan document,[13] simply so government regulators could tell the difference.

One of the most common differences between money purchase plans and other defined contribution plans is the presence of annuity options in a money purchase plan. As a pension plan, a money purchase plan must offer participants a QJSA benefit option.[14] Since participants' benefits are individual accounts, annuity benefits from a money purchase plan are usually provided through the purchase of annuity contracts from an independent annuity carrier.

Target Benefit Plan

A target benefit plan is a money purchase plan designed to emulate a defined benefit plan. Employer contributions are actuarially determined as those necessary to achieve a targeted benefit for the employee based on various reasonable assumptions. So while a target benefit plan has a benefit formula, as does a defined benefit plan, rather than a contribution formula, the actual benefit ultimately delivered to employees is based on their individual accounts and will fluctuate with the earnings and losses of that account. In other words, the difference between a target benefit plan and a traditional money purchase plan or profitsharing plan is that the target benefit plan bases contributions on a benefit formula, while the difference between a target benefit plan and defined benefit plan is that the employee still carries the risk of investment loss in a target benefit plan.

Target benefit plans are a relatively rare type of plan design that has gained little favor among either large employers or small employers. A large employer who desires to provide a specified retirement income benefit for employees is more likely to adopt a defined benefit plan, while a small employer is more likely to opt for the simplicity of a standard defined contribution plan. A target benefit plan does make

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[13] IRC §401(a)(27). Note: This footnote is denoted in *McGill* as footnote 18 of Chapter 11.

[14] Treas. Reg. 1.401(a)-20, Q&A 3. Note: This footnote is denoted in *McGill* as footnote 19 of Chapter 11.

larger annual contributions for older employees than for younger employees, a feature often coveted by small business owners, but the annual contributions to each employee's account are still limited to the lesser of $40,000 or the participant's compensation.[15]

Contributions

The employer makes all required contributions to a money purchase plan according to a fixed and determinable formula. In addition to the contractual obligation to follow the fixed contribution formula in the plan document, an employer is required to contribute the proper amount each year under the contribution formula in order to satisfy the plan's minimum funding standards. The funding standard account for a money purchase plan is essentially each year's specified contribution.

To be currently deductible by the employer, the contribution for a year may be made at any time up to the due date for filing the employer's tax return for that taxable year (including extensions), provided the contribution is designated as being on account of that taxable year.[16]

The requirement for making quarterly contributions to a pension plan does not apply to a money purchase plan.[17] The quarterly contributions were added to the funding standards in order to improve cash flow for defined benefit plans and thereby reduce in some manner the underfunding of defined benefit plan liabilities. Since underfunding of benefit liabilities is generally not possible in a money purchase plan (the account balances are the benefit liabilities), there was no need to apply the quarterly contribution requirements to money purchase plans.

Except for target benefit plans discussed earlier, contribution formulas in money purchase plans are expressed as a percentage of covered compensation. The definition of compensation is subject to the same concerns present in deferred profit-sharing and defined benefit plans, including the requirement that compensation in excess of $200,000 (indexed) may not be recognized after 2003.[18] [19]

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[15] IRC §415(c). Note: This footnote is denoted in *McGill* as footnote 20 of Chapter 11.

[16] IRC §404(a)(6). Note: This footnote is denoted in *McGill* as footnote 21 of Chapter 11.

[17] IRC §412(m)(1). Note: This footnote is denoted in *McGill* as footnote 22 of Chapter 11.

[18] IRC §401(a)(17). Note: This footnote is denoted in *McGill* as footnote 23 of Chapter 11.

[19] This is the end of the material excerpted from *McGill*.

Summary

Money purchase retirement plans are a subcategory within the larger category of defined contribution retirement plans. As such, money purchase plans are governed by U.S. tax, pension, and labor law, IRS regulations, state law, and the plan document.

Money purchase pension plans are subject to the IRS's "definitely determinable benefit rule" and, therefore, contributions must be fixed. The fixed contributions are typically determined as a percentage of each employee's compensation, are typically paid by the employer, and are typically deposited to each plan participant's account annually. The IRS does allow for more complex money purchase plans in which employees are also permitted or required to contribute.

A participant in a money purchase plan vests immediately in his or her own contributions to the plan and income on the contributions. A participant becomes fully vested in the participant's total account balance, including the employer's contributions, after a specified period of time stated in the plan, such as 5 or 10 years, or may become vested incrementally, e.g., 50% after 5 years, 75% after 8 years, and 100% after 10 years of employment.

Interest and income earned on contributions to individuals' accounts in money purchase plans are ultimately deposited to each individual participant's account. In parallel, each participant shares in the cost of administering the plans. Administrative costs for money purchase plans are typically higher than administrative costs for defined benefit plans.

Although money purchase plan participants usually have several options for receiving their retirement benefits from a money purchase plan, one option required by law to be offered to participants is a lifetime annuity.

In contrast to defined benefit retirement plans, money purchase plans fully shift investment risks and longevity risks from the employer to the employee.

Money purchase plans are more prevalent among smaller, private sector employers, in part because of fixed liability to the employer, ease of administration, and certain tax benefits.

Conclusion

Money purchase retirement plans may become a part of the public policy-option mix as the SAVA continues its investigation of public employee retirement plans. As of this writing, however, the Committee members have continued to focus on ensuring the health of the state's existing defined benefit and defined contribution retirement plans. If

SAVA members exhibit a deeper interest in money purchase retirement plans, SAVA staff will work with Committee members and with the respective staffs of the Montana Public Employees' Retirement Administration, the Montana Teachers' Retirement System, the Board of Investments, and perhaps others to develop and present additional information.

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