

Financial Forum

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Q. What is the difference between a defined benefit plan and a defined contribution plan?

These two retirement programs differ in the method of computing required contributions, and the employer's resulting financial obligations.

- **Defined benefit plans** are based on the participant's receiving future benefits, usually expressed in a monthly benefit based on a percentage of future earnings. Since townships are required to use level-cost funding methods—where obligations for retirement benefits are funded as the service to the township is rendered—an annual study called an actuarial valuation is usually required. This study reviews the various assumptions of investment earnings, pay increases, retirement, disability and mortality rates, and any changes to the employee group and to the retirement package. Annual contributions required to meet these obligations are then determined.

Since the township is ultimately responsible for any shortfalls to the retirement system, care should be taken prior to entering into these plans. Substantial risks arise from economic conditions causing actuarial assumptions of plan investment earnings not meeting projections, future pay increases exceeding assumptions, as well as non-economic risks from mortality, disability and retirement rates exceeding projections.

- **Defined contribution plans** are much less complex to administer since the "promise" required to be funded is based on a percentage of today's compensation. For example, if a township established a money purchase pension plan and determined to fund 10 percent of pay, the township's obligation would likely be to fund 10 percent of the eligible employees' compensation. The participants would then have a number of investment choices to consider. Upon retirement, employees receive a lump sum or an annuity of their investment, depending on plan options.

Either plan should be considered only after careful review by the township's administration, attorney and financial advisors.

Q. Our township would like to use a plan mostly funded by employee contributions. Can we have a 401(k) plan?

Generally, state and local units of government are prohibited from using 401(k) plans, which are a tax qualified deferred compensation arrangement. Plans established prior to July 2, 1986, however, are "grandfathered" by this change. If your township wishes to

consider plans funded by employer elective deferrals, it should select a plan established under Internal Revenue Code Section 457, or SIMPLE retirement plans, established by the Small Business, Health Insurance and Welfare Reform Acts of 1996.

Q. How do these plans differ?

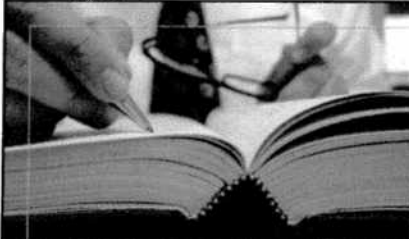
While both provide your employees with the ability to fund retirement plans on a pre-tax basis, they have different approaches:

	457 Plans	SIMPLE
<i>Maximum annual contribution</i>	\$15,500 (for 2007 & 2008)	\$10,500 (for 2007 & 2008)
<i>How contributions determined</i>	100% of annual compensation	100% of compensation
<i>Required matching</i>	None	2% of all eligible employees', (or 3% of participating employees') annual pay
<i>Maximum number of eligible employees</i>	No limit	100
<i>Definition of eligible employee</i>	Generally, township can determine	Employees making over \$5,000 must be in plan
<i>Funding mechanism</i>	Trust	IRA
<i>Catch-up provision—Over 50</i>	Additional \$5,000	Additional \$2,500
<i>Additional catch-up for three years prior to retirement</i>	Yes	No
<i>Ability to have other employee pension plans</i>	Yes	No

In summary, 457 plans offer much more flexibility, while SIMPLE plans are much easier to operate. Note: According to the IRS, employer contributions to 457 plans, known as "pick-ups," may be subject to FICA taxes, while SIMPLE match payments are not. We suggest that employers wishing to have pension contributions do *not* use 457 pick-ups, but instead consider a money purchase (defined contribution) pension plan.

Q. What is the limit on wages subject to Social Security taxes?

For township employment subject to Social Security, the annual wage limit for 2007 was \$97,500; \$102,000 for 2008. Medicare wages have no annual ceiling.



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