Independent Actuaries, Inc.

Popular Retirement Plan Myths (and Realities)

As a retirement plan consultant and attorney, I occasionally hear or read statements about tax qualified retirement plans that are patently false. Unfortunately, such misinformation may prevent plan participants from fully engaging with their retirement plans; worse, it may prevent some individuals or employers from starting a retirement plan in the first place.

Here are some of the most common misconceptions that I have heard about tax qualified retirement plans:

Myth: 401(k) participants want more investment choices.

Reality: The typical plan participant is frustrated by numerous investment choices and, as a result, may avoid making any choice altogether. A recent study showed that when provided only two investment choices, 75% of employees participated in their 401(k) plan. For each additional 10 fund options, about 2% of employees discontinued participation.[i]

Myth: 401(k) participants must be allowed to direct their own investments.

Reality: Many small business owners *choose* to allow participants to direct their own investments, often so that the business owner may select his or her own investments. However, 401k plan assets may be invested by the plan's trustee in a pooled account (or accounts). The upside to pooling investments is potential cost savings from an investment management perspective. Pooling investments also prevents participants from making poor investment decisions or not participating out of confusion (see above). The downside of pooled investments is that the investment mix (i.e., equity to bond ratio) is typically weighted based on the average age of the overall group of participants. There are, however, alternatives to traditional pooled accounts and participant directed accounts. For example, a trustee may direct the investments of each individual participant, or could categorize groups of participants by their expected retirement dates and appetite for risk and select the investments for each group.

Myth: A 401(k) plan cannot provide adequate retirement plan income.

Reality: Consistently contributing relatively modest amounts over a long period of time really adds up. For example, a 30-year-old investing $6,000 per year into his/her 401(k) Plan with annual returns of 8.0% will have an account worth over $1 million at age 65.
Older employees and business owners can build up their nest eggs more rapidly. In 2013, a 50-year-old sole proprietor with no employees and income of $204,000 or more may contribute up to $56,500 to his/her 401(k) plan. With an 8% annual rate of return and annual contributions of $56,500, the individual's 401(k) account will have swelled to nearly $1.6 million dollars at age 65.

Myth: Defined benefit plans are a thing of the past.

Reality: It is true that the overall percentage of private sector employees participating in defined benefit plans peaked somewhere around 1980 (at roughly 38%).[ii] As of 2011, roughly 18% of private sector employees participated in defined benefit plans,[iii] although the declines in overall percentages appear to have slowed or leveled off somewhat around 2007.[iv] While the overall number of defined benefit plan participants has declined over the last 30 years, our experience is that small employers in certain industries continue to find defined benefit plans a superior means of tax-deferred retirement savings. As of 2011, 25% of employees in the professional services industry were covered by a defined benefit plan.[v] At IAI, we routinely help set up dozens of new defined benefit plans each year.

Myth: Defined benefit plans must hold annuity products and 401k plans must have expensive mutual funds.

Reality: There are certain defined benefit plans that are created for the purpose of investing in annuity or insurance products, but generally, under federal law, plans may invest in anything so long as the investment is prudent. Typical investments may include inexpensive index bond and equity funds to not-so-inexpensive hedge funds to real estate and mortgages and everything in between.

Myth: There's no reason to have separate investment strategies for your 401k and defined benefit plans.

Reality: In 401k plans, the individual participants bear the investment risk/reward, and in defined benefit plans the employer generally bears that risk. As a result, each party's appetite for risk should be factored into the investment decision.
The motive for having the defined benefit plan should be examined as well. For owners of small businesses, one main motive for setting up a defined benefit plan is that it provides significant tax deferral (in the form of contributions to the plan) each year. In these cases having a conservative investment strategy is often advisable, since high investment returns can limit the amount of future contributions (deductions).

Myth: It is impossible to save an adequate amount for retirement beginning at age 55.

Reality: Under the Internal Revenue Code, the lump sum maximum payment from a defined benefit plan (including cash balance plans) at age 65 with 10 years of service is nearly $2.4 million. Adding a 401k plan to the mix could result in even higher savings.

A BRIEF (REAL LIFE) CASE STUDY:

In 2012, Dr. X was a 39 year old emergency room doctor with no employees. Dr. X incorporated his practice (S-Corporation). As of the end of 2011, Dr. X had three years of average compensation from his S-Corp which exceeded $245,000. We helped Dr. X design and establish a defined benefit plan and 401(k) plan effective January 1, 2012.

Given Dr. X's compensation and age, Dr. X was able to make the following tax deferred contributions to the plans for the 2012 tax year:

DB Plan:	$115,362
401(k) Plan:	$27,920
Total:	$147,362

For the 2013 tax year, Dr. X is eligible to make the following contributions:

DB Plan:	$111,963
401(k) Plan:	$28,624
Total:	$144,763

How much might Dr. X's plans' benefits be worth at age 55?
The maximum lump sum value (based on current Internal Revenue Code limits and mortality assumptions) of Dr. X's accrued defined benefit at age 55 would be nearly $1.3 million. Assuming that Dr. X's income stays the same, that he contributes $28,624 per year to the 401(k) plan (plus an additional $5,500 once he reaches age 50), and that his 401k account earns a 5% annual rate of return, Dr. X's 401k account grow to nearly $800,000 at age 55. **Dr. X is expected to accumulate over $2 million by his 56th birthday—all tax deferred.**

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This article was written by Jason W. Douthit, J.D. Jason's work focuses on defined contribution plans and executive deferred compensation plans. He also represents employers in matters related to IRS and Department of Labor qualified plan correction programs. Jason holds a B.A. in Labor Studies and Philosophy, a J.D. from University of California at Davis School of Law, and is a member of the Oregon State Bar.

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[i] http://money.cnn.com/magazines/moneymag/moneymag_archive/2010/06/01/105937451/index.htm?iid=EL
[ii] http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14
[iii] http://www.bls.gov/opub/mlr/2012/12/art1full.pdf
[iv] http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14
[v] http://www.bls.gov/opub/mlr/2012/12/art1full.pdf

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