

Insider

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Attracting and Keeping Employees: The Strategic Value of Employee Benefits

Results from Towers Watson's 2013/2014 Global Benefit Attitudes Survey

By Jonathan Gardner and Steve Nyce

Attracting and retaining a talented, committed workforce is crucial for employers. Our research shows that employees' attitudes toward their health and retirement benefits are correlated with their employment choices, as well as with their levels of commitment and engagement. Employers that are able to target their benefit package to attract and keep the employees they need to succeed gain a valuable competitive advantage.

This article examines the importance of benefits in giving employees reasons to join and stay with their employer, and the relationship to sustainable engagement. We also look at the effects of benefit cutbacks on workers' attitudes and behavior. This is the third in a series of three articles based on Towers Watson's 2013/2014 Global Benefit Attitudes Survey. The first article described employees' perceptions of financial security and retirement planning, and the second examined the value employees assign to various benefits and plan features.¹

Retirement and health care continue to attract and retain employees

As we showed in "Retirement Security Tops List of Employee Concerns," retirement and health care programs are an important part of employees' rewards. Employees worry about rising health care costs and retirement security, and most look to their employer's

benefits for solutions. Health care benefits have traditionally carried more weight than retirement benefits in terms of attraction and retention, but in this year's survey, the gap has almost completely closed.

The attraction value of both health and retirement benefits has tempered since peaking in 2011. Between 2011 and 2013, the percentage of employees who said their health care benefits attracted them to their job fell by 13 percentage points, and the number saying those benefits keep them at their job fell by eight percentage points (*Figure 1*). Similarly, fewer employees say their employer's retirement plan either attracted them to the job (six percentage point drop) or gives them a good reason to stick with their job (two percentage point drop).

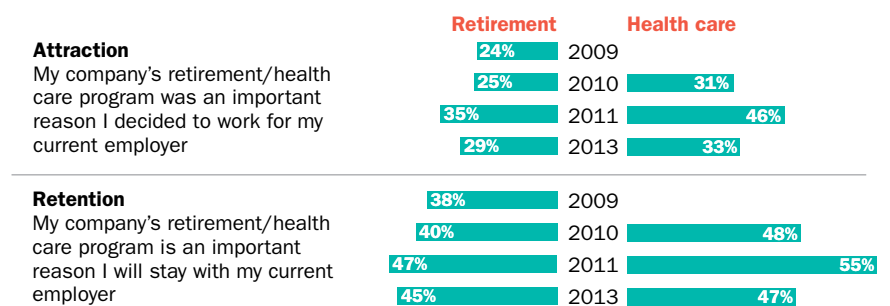
DB plans have stronger attraction and retention effects

Many employees have strong feelings about retirement security, and one way of measuring their attitudes is to segment the workforce by retirement plan type. Workers who seek out companies that offer defined benefit (DB) plans and then feel strongly committed to

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Figure 1. Attraction and retention value of retirement and health care plans



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

¹ See the first two articles in this research series, "Workers Still Uneasy About Financial Security and Retirement," Towers Watson Insider, March 2014; and "Retirement Security Tops List of Employee Concerns," Towers Watson Insider, April 2014.

Insider

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those employers typically assign a high value to both retirement and health benefits, and their attitudes carry over into their behavior.

So retirement plan type matters when it comes to attraction and retention. Employees with a DB plan are nearly twice as likely as those with only a defined contribution (DC) plan to cite their retirement plan as an important reason for joining their company (Figure 2). The attraction value of DB plans has fallen slightly from its 2011 peak of 51%, but DB plan participants remain more likely — 68% in both 2011 and 2013 — to say their plan gives them a reason to stay with their employer (Figure 3).

Among workers with DB plans, the importance of the health care plan as a reason to join the employer is up from 2010 but down from the 2011 peak, when 52% cited the health plan as an important reason for joining the company. Both health and retirement benefits are most highly appreciated by workers whose employers offer DB plans.

Figure 2. Attraction value of retirement and health care programs by plan type

		2009	2010	2011	2013	Percentage point change 2011 – 2013
My company's retirement program was an important reason I decided to work for my current employer	DB plan	31%	33%	51%	45%	-6
	DC plan only	21%	21%	26%	25%	-1
My company's health care program was an important reason I decided to work for my current employer	DB plan	-	36%	52%	39%	-13
	DC plan only	-	28%	43%	32%	-11

Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Figure 3. Retention value of retirement and health care programs by plan type

		2009	2010	2011	2013	Percentage point change 2011 – 2013
My company's retirement program is an important reason I will stay with my current employer	DB plan	52%	59%	68%	68%	0
	DC plan only	33%	32%	37%	39%	+2
My company's health care program is an important reason I will stay with my current employer	DB plan	-	55%	65%	53%	-12
	DC plan only	-	45%	50%	45%	-5

Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Who values retirement benefits?

In addition to DB plan participants, mid- and late-career employees and higher earners are more likely to have been attracted to their company at least partly for its retirement program and to cite the plan as a reason to stay (Figure 4, next page). There is an even stronger link between employees who are highly engaged, those who want to work for their current employer until retirement, and those who cite the retirement program as an important reason for joining and staying with the company. Effective retirement plans are clearly related to employees' emotional connection to their employer. In fact, 60% of employees who plan to work for their company until they retire also identify their retirement program as a very important reason for staying.

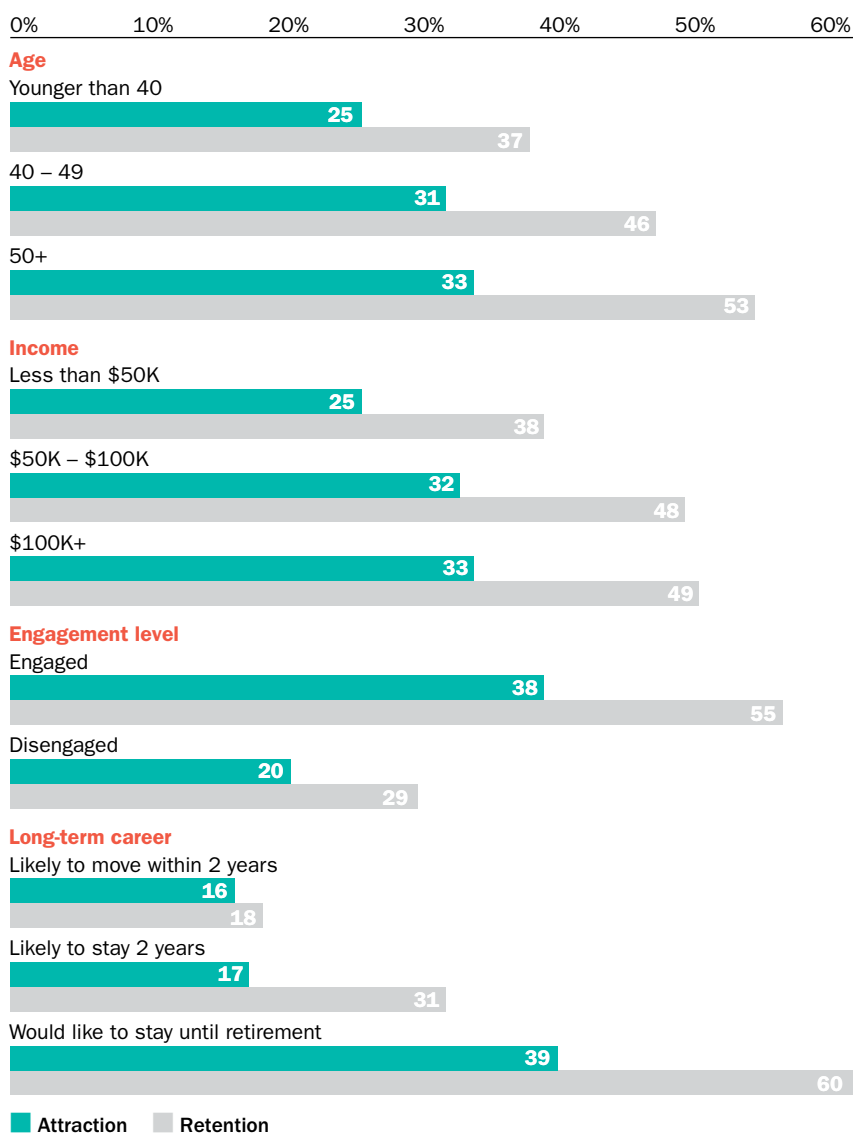
Appeal of retirement plans strongest for midcareer and older employees

A secure retirement appeals to workers of all ages, but the appeal is strongest among mid- and late-career employees, especially those with a DB plan. Between 2009 and 2013, the percentage of workers age 50 and older who cited their DB retirement plan as an important factor in accepting their job climbed 19 percentage points, compared with a one percentage point gain for employees with only a DC plan (Figure 5). Among midcareer workers, the upswings apply to both plan types, but sponsors of DB plans have a significant attraction advantage.

Since our last survey, however, younger workers appear to have changed their minds about the importance of retirement programs, especially those working at companies with DB plans. The number of young workers who cite their retirement plan as a reason for accepting their job plummeted by 24 percentage points. While the reason for the abrupt drop-off is not clear, younger employees might have become more concerned about shrinking opportunities, as the effects of slow economic growth and delayed retirement among older workers trickle through the organization, and they increasingly settle for jobs they feel don't match their skill set or career goals. In fact, nearly half of younger workers (45%) cite opportunities for promotion and new skills as their top reason for taking their current job compared with only 20% of older workers.

Retirement plans remain persuasive retention tools, with the desire for long-term employment with their current employer strongest among DB participants of all ages. And regardless of plan type and age, retirement plans have become even more effective retention tools since 2009. Nevertheless, in 2013, the percentage of younger participants regardless of program type who cited their retirement plan as a

Figure 4. Attraction and retention value of retirement programs



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Figure 5. Attraction, retention and long-term career by age and retirement plan type

	Age	DB plan				DC plan only			
		2009	2010	2011	2013	2009	2010	2011	2013
Attraction My company's retirement program was an important reason I decided to work for my current employer	<40	28%	43%	63%	39%	19%	17%	28%	22%
	40 – 49	38%	24%	43%	45%	21%	24%	22%	27%
	50+	30%	35%	40%	49%	27%	20%	25%	28%
Retention My company's retirement program is an important reason I will stay with my current employer	<40	37%	63%	72%	58%	29%	26%	36%	33%
	40 – 49	61%	51%	61%	68%	32%	37%	33%	41%
	50+	61%	61%	68%	76%	37%	32%	45%	44%
Long-term career I would like to continue working for my current employer until I retire	<40	44%	70%	74%	58%	37%	39%	47%	39%
	40 – 49	74%	76%	77%	74%	58%	66%	63%	57%
	50+	81%	87%	86%	89%	80%	76%	76%	74%

Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

“Employees who say their plan meets their needs are much more likely to intend to work for the company until they retire.”

reason to stay declined from the 2011 peak, while there was a pronounced uptick for older employees with a DB plan. But the security of a generous retirement program lays the foundation for a strong, long-term relationship between employers and employees. In fact, 58% of younger employees with a DB plan say they would like to spend the rest of their career with their current employer compared with 39% of those with only a DC plan.

Attraction and retention value of hybrid plans

Many organizations with DB plans have transitioned from traditional to hybrid designs.² Hybrid plans are defined benefit plans and accrue benefits under a fixed formula, but the benefit is typically defined as a lump-sum account balance rather than an age-65 annuity. While hybrid plans tend to be less generous than traditional designs, their ability to attract workers is comparable to traditional DB plans, with both having attraction values nearly twice that of DC-only environments (Figure 6). Hybrid plans are

slightly less powerful than traditional DB plans in terms of retention, but, again, the security they offer generates greater retention value than DC-only programs by a wide margin.

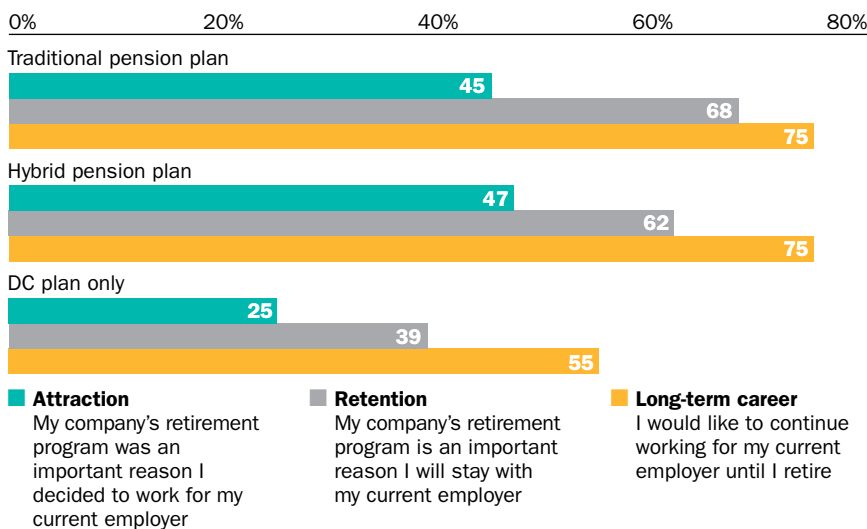
Higher retention value for plans that meet employees’ needs

Employees increasingly identify their employer-sponsored retirement program as the primary way they save for retirement (74%).³ While employer programs are generally designed to work in tandem with Social Security and personal savings, those that meet employees’ expectations are more likely to create an enduring bond between employers and employees, especially those who identify their plan as a top reason for joining the company. Given heightened concerns about future retirement risks and a desire for more generous retirement programs, it’s not surprising that nearly two-thirds (64%) of DB plan members say their plan meets their needs compared with 43% of DC-plan-only participants.

Employees who say their plan meets their needs are much more likely to intend to work for the company until they retire (Figure 7). Forty-nine percent of younger workers whose plans meet their needs intend to work for the employer until retirement versus 30% of younger workers whose plans don’t meet their needs. Conversely, younger employees whose plans do not meet their needs are more than twice as likely to plan to leave their employer within the next two years. Older employees are even more sensitive to a plan not meeting their needs, but younger employees are more likely to intend to leave their employer overall or are more mobile.

A retirement plan that fails to meet expectations can be a drag on employees’ financial outlook. In fact, two-thirds of employees (65%) whose plans meet their needs are satisfied with their current financial situation, compared with only one-third (29%) whose plans do not meet expectations.

Figure 6. Attraction, retention and long-term career by plan type



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Figure 7. Retention and long-term career by age and whether plan meets needs

Age	Plan Status	Likely to leave within 2 years	Likely to stay for 2 years, but not until retirement	Would like to work for current employer until retirement
<40	Plan meets needs	19%	32%	49%
	Plan does NOT meet needs	40%	31%	30%
40 – 49	Plan meets needs	12%	16%	72%
	Plan does NOT meet needs	25%	27%	48%
50+	Plan meets needs	6%	3%	90%
	Plan does NOT meet needs	23%	12%	65%

Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

² See Brendan McFarland, “Retirement Plans Offered by 2013 Fortune 100,” Towers Watson Insider, November 2013.

³ See “Retirement Security Tops List of Employee Concerns,” Towers Watson Insider, April 2014.

Figure 8. Financial satisfaction of employees who were attracted by their retirement program by whether the plan meets their needs

Age		I often worry about my current financial state	I often worry about my future financial state	Expects to retire after age 70 or never
<40	Plan meets needs	47%	53%	22%
	Plan does NOT meet needs	57%	68%	39%
40 – 49	Plan meets needs	39%	50%	19%
	Plan does NOT meet needs	52%	64%	43%
50+	Plan meets needs	26%	39%	16%
	Plan does NOT meet needs	56%	67%	45%

Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

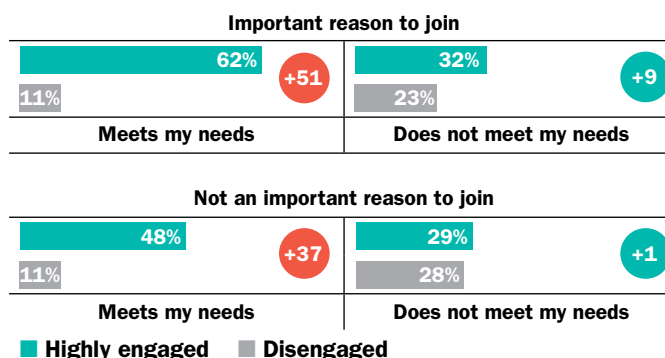
Furthermore, whether a plan meets employees' needs relates to their worries about both current and future finances, as well as their plans for retirement (Figure 8). Workers whose plans attracted them to their jobs but do not enable them to afford retirement must take some action, which usually means delaying retirement.⁴ Older employees who say their plan does not meet their needs are more than twice as likely to put off retirement until age 70 or later, or even give up on the idea of retiring at all.

An important question is whether workers' financial worries get in the way of their engagement or job performance. Figures 9 and 10 show direct connections between whether a plan meets employees' needs, the emotional toll on employees if it doesn't and sustainable engagement, which is Towers Watson's measure of employee engagement. Sustainable engagement captures the intensity of an employee's connection to the employer through three core elements:

- Being engaged — the extent of employees' discretionary effort applied to work goals
- Being enabled — a work environment that provides the support and resources employees need to work efficiently and effectively, and removes barriers to success
- Feeling energized — a work experience that promotes social connectedness and feelings of enthusiasm and accomplishment

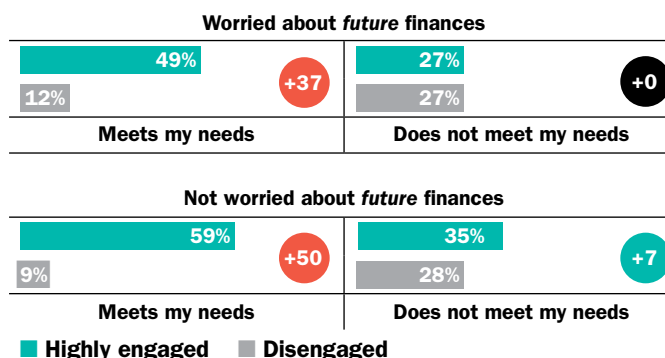
Figure 9 shows a strong association between a retirement plan that meets employees' needs and higher levels of employee engagement. There is a payoff for helping employees take care of their financial future, especially among employees who considered the retirement plan an important reason for joining the employer. Among this group, employees who say their retirement plan meets their needs are five times more likely to be highly engaged than disengaged. Conversely, when the retirement program misses the mark, employees are much less engaged. In fact, among those who say their

Figure 9. Sustainable engagement by whether retirement plan meets needs



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Figure 10. Impact of plan adequacy and financial worries on engagement



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

retirement plan fails to meet their needs, roughly equal numbers are highly engaged and disengaged. When overall productivity requires everyone on the team to pull their weight, there is an enormous difference between having five highly engaged employees for every disengaged employee and managing a team with a one-to-one ratio.

A retirement program that meets employees' expectations can alleviate long-term financial worries that might compete for employees' time and attention. Figure 10 shows an impressive 50 percentage point boost in the proportion of highly engaged employees, as well as fewer financial

“Figure 9 shows a strong association between a retirement plan that meets employees' needs and higher levels of employee engagement.”

⁴ See “Workers Still Uneasy About Financial Security and Retirement,” Towers Watson Insider, March 2014.

worries, among workers whose plans meet their needs. Where workers are worried about their finances, a retirement plan that meets their needs is strongly related to higher employee engagement. On the other hand, when workers are worried about their finances and the retirement plan does not meet their needs, the percentages of disengaged and highly engaged employees are equal.

While the retirement plan is unlikely to be the only factor creating this wedge in engagement, attitudes toward the plan certainly capture a broader set of employees' sentiments about their organization. Financial worries can distract workers from their jobs and enact a toll on their well-being and ultimately their job performance — and thus that of the organization.

“Employees whose plans have undergone cutbacks are much less satisfied with their current finances and more worried about their future finances.”

Plan changes have broad impacts

In response to broader economic pressures, many employers have been cutting benefit costs. About one-quarter of employees with a retirement plan have witnessed changes to their plans,⁵ which most often reduce plan generosity, shift more financial risks to employees or both. How have these changes affected attraction and retention, employees' satisfaction with their financial situation, intent to stay until retirement and job performance?

To get some answers, we divided employees into five groups:⁶

1. *DB plan, no change*: Currently earning benefits under a DB plan for each year of additional service and no significant changes to the plan over the last two years

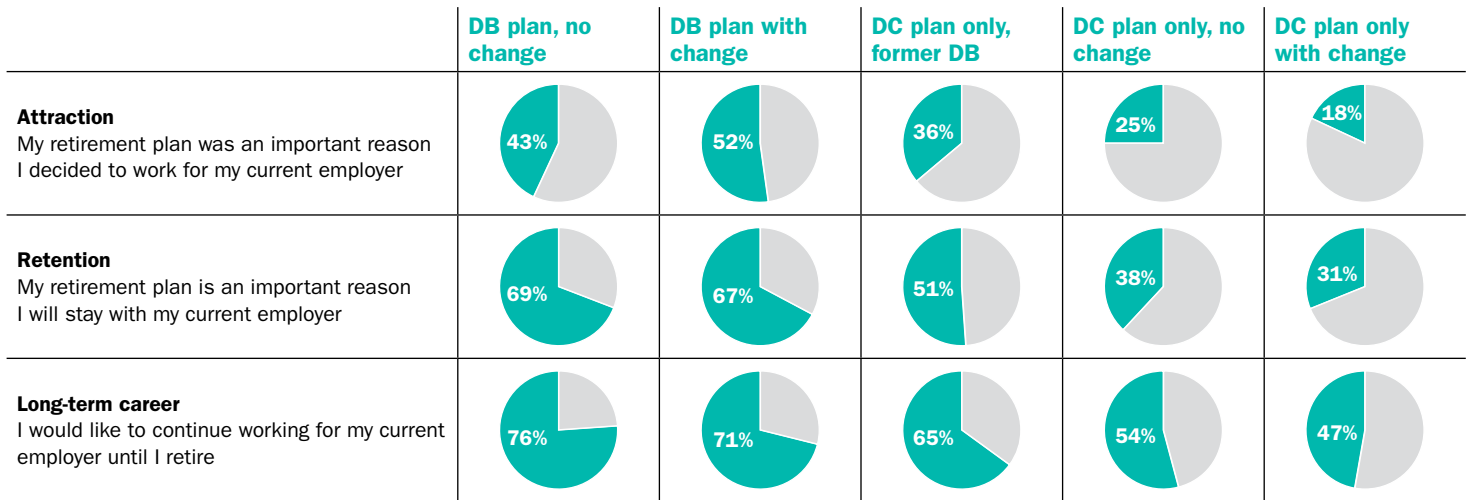
2. *DB plan with change*: Currently earning benefits under a DB plan for each year of additional service, and the plan underwent a *significant change* in the last two years, such as a redesign or benefit cut
3. *DC plan only, former DB*: DB benefit accruals were frozen but employees have a DC plan
4. *DC only, no change*: Have a DC plan that has not had a significant change in the last two years
5. *DC only with change*: Have a DC plan that has undergone a *significant change* in the last two years, such as a redesign or cut to employer contributions

Changes to benefits can be disruptive. The importance of attraction and retention is slightly lower for DB plans that were recently frozen, compared with active plans, although scaled-back DB plans remain more effective than DC-only environments. While attraction and retention value is lowest for a DC-only plan that has recently undergone cuts, nearly half of those plan participants still intend to work for their employer until they retire (*Figure 11*). An important question is whether this segment of the workforce is enthused about their career track and willing and able to go the distance.

Employees whose plans have undergone cutbacks are much less satisfied with their current finances and more worried about their future finances, with DC plan members whose plans have been cut being the most concerned (*Figure 12*, next page).

While employees with a DB plan generally have the highest levels of financial satisfaction and the fewest financial worries, they are not immune from concerns

Figure 11. Attraction, retention and long-term career following cutbacks to retirement plans



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

⁵ Changes to DB plans could be a significant design change, a reduction in generosity, or benefits being frozen and a switch to a DC-only environment. Changes to DC-only plans include modifications to the plan design or reduced employer contributions.

⁶ Distribution of responses by the five groups is: DB plan, no change, 15%; DB plan with change, 5%; DC plan only, former DB, 10%; DC plan only, no change, 60%; DC plan only with change, 10%.

Figure 12. Financial satisfaction and worries by changes in retirement plan

	DB plan, no change	DB plan with change	DC plan only, former DB	DC plan only, no change	DC plan only with change
Satisfaction with current financial situation	59%	55%	49%	43%	34%
I often worry about my current finances	37%	43%	48%	49%	54%
I often worry about my future finances	50%	56%	59%	58%	65%
Satisfaction with retirement plan	82%	66%	56%	69%	43%
Retirement plan meets needs	66%	59%	46%	44%	33%

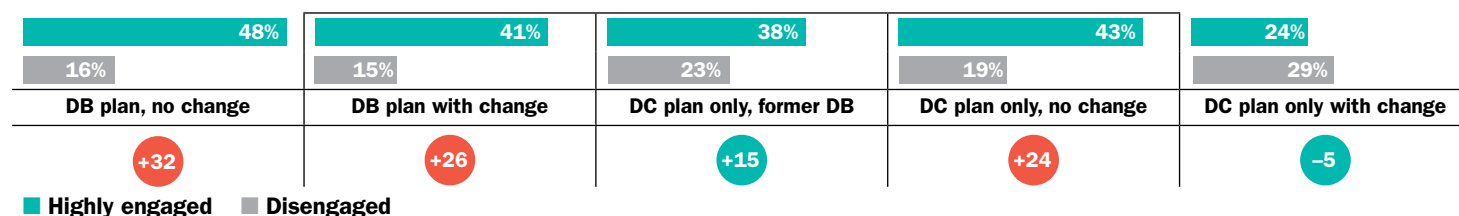
Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Figure 13. At what age do you expect to retire?

Expected retirement age	DB plan, no change	DB plan with change	DC plan only, former DB	DC plan only, no change	DC plan only with change
Under age 65	38%	41%	28%	20%	21%
Age 65	23%	19%	19%	25%	16%
Over age 65	38%	39%	51%	52%	61%
Age 66 – 69	19%	16%	23%	19%	18%
Age 70 – 79	15%	18%	22%	26%	30%
Never retire	4%	5%	6%	7%	13%
Don't know	1%	1%	1%	2%	1%

Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

Figure 14. Impacts of plan change on sustainable engagement



Source: Towers Watson 2013/2014 Global Benefit Attitudes Survey – U.S.

about the future. In fact, workers whose DB plans recently underwent a change are the most worried, perhaps fearing the change is only the first of many. Two-thirds of participants in scaled-back DB plans fear further reductions lie ahead, and more than half worry about their benefits being frozen in the future. Only one-third of DB plan members whose plans remain intact are worried about future reductions in plan value, and slightly fewer fear their plan will be frozen altogether (31%).

Satisfaction with the retirement plan also takes a hit when the program changes. Conversely, employees whose plans haven't changed are the most satisfied and most likely to report their plan meets their needs. In fact, DC-only plan members are more satisfied with their plans than DB plan participants whose plans were recently scaled back or frozen. Eliminating a DB plan entirely is linked to a 15-to-20 percentage point drop in meeting employees' needs. What drag could this have on employee engagement?

Cutbacks to retirement plans often prompt employees to reevaluate their retirement prospects.

Employees who fear they can't afford to retire must work longer, save more, live on less in retirement or some combination of the three. The vast majority of workers, particularly those who are older, identify working longer as their best option.⁷ Former DB plan members who now have only a DC plan are more than 30% more likely than those with an active DB plan to expect to work beyond age 65 (Figure 13). Although again, employees with only a DC plan whose employers recently reduced contributions expect the longest working careers: Nearly two-thirds of them (61%) plan to work beyond age 65 and 43% expect to work to age 70 or later (possibly never retiring).

Cutbacks to retirement programs increase employees' concerns about their financial future and worries about retirement, which is negatively related to employee engagement. Again, workers who once had an active DB plan but were shifted into a DC-only environment and those with only a DC plan that recently reduced employer contributions report the highest levels of disengagement (Figure 14). In fact, workers with only a scaled-back DC plan are 20%

“Employees with only a DC plan whose employers recently reduced contributions expect the longest working careers.”

⁷ See “Workers Still Uneasy About Financial Security and Retirement,” Towers Watson Insider, March 2014.

“Employers whose benefit programs meet employees’ needs enjoy a significant competitive advantage in attracting and retaining employees.”

more likely to be disengaged than highly engaged. Conversely, engagement is strong among DC-only members whose benefits have not been cut. Likewise, the security and generosity that employees covet from their DB programs — even when the program has been changed — are reflected in significantly higher engagement rates.

Conclusion

As economic growth continues its plodding pace, many employers remain in an employment holding pattern. A slowdown in worker productivity growth over the last few years has further delayed hiring in many organizations. This period of sluggish growth and increased uncertainty has in some ways been a boon for organizations, many of which have successfully boosted their bottom lines by closely managing costs without the risk of unwanted turnover.

Many companies have been asking quite a lot from employees in recent years, including longer hours at work and more responsibilities, even in the face of smaller pay increases and greater uncertainty about their jobs. The toll is in employee stress and feelings of burnout, which are a growing challenge for many organizations.

In this uncertain environment, employees want more financial security in return for their greater efforts — a trend that solidified during the financial crisis in 2008/2009 and has remained strong ever since. And more secure rewards appeal to employees of all ages, although the appeal is strongest for midcareer and older workers.

Health and retirement benefits are part of the foundation of a secure reward package. Not only do employees want more generous and secure benefits, there is a clear link between better benefits and a company’s ability to attract and retain employees. While retirement and health care plans generally have similar attraction and retention effects, more generous and secure retirement programs can create a stronger bond between employers and workers. This research shows that employers whose benefit programs meet employees’ needs — particularly DB plans — enjoy a significant competitive advantage in attracting and retaining employees, especially employees with a long-term outlook who chose their employer at least partly to obtain this level of security. When such benefits are absent or the employer changes the deal, employees’ financial worries often serve as a source of stress and distraction that can degrade employee engagement and productivity, which is ultimately a drag on company performance, perhaps even offsetting the direct savings from the change.

While more secure benefits are important, achieving the right balance with performance-based pay is critical for attracting, developing and retaining a talented workforce that provides a competitive edge. Companies should consider their rewards in terms of the appropriate mix between security for all and incentives that drive individual and team-based performance. With employees of all ages coveting more security, conventional approaches that segment employees by age or generation might overlook important differences and emerging trends in employee preferences that directly motivate behaviors. Employers need to tailor their rewards to suit their goals and continually improve performance management to measure and reward the behaviors needed to deliver on the business strategy. Those who find the right balance are in the best position to reduce human capital risk and increase the returns on their programs.

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About the survey

Towers Watson’s 2013/2014 Global Benefit Attitudes Survey is a nationally representative survey fielded in 12 countries.⁸ The U.S. survey includes 5,070 respondents employed by nongovernment organizations with 1,000 or more employees. It builds on several previous Towers Watson surveys to track evolving employee attitudes.

This article reflects responses from a subset of 4,248 retirement plan participants working full time. All respondents are provided a DB and/or DC retirement plan by their current employer. DB plan participants are those who currently participate in an active DB plan. Respondents with only a DC plan include both those who contribute to the plan and those who decline to participate. All results are weighted by age, gender and salary to the national average of similar workers.⁹

⁸ Countries include Australia, Brazil, Canada, Chile, China, Germany, India, Japan, Mexico, Netherlands, the United Kingdom and the United States.

⁹ The margin of error is +/- 1.38% for the total sample.



Second Unfavorable Court Ruling on Church Plan Status

By Lynn Cook and Bill Kalten

In *Kaplan v. Saint Peter's Healthcare System*, a U.S. District Court in New Jersey ruled that a pension plan sponsored by a church-affiliated, tax-exempt health care system is not a “church plan” and thus not exempt from the Employee Retirement Income Security Act (ERISA). The hospital’s motion to dismiss the case was denied. The court determined that, under the definition of “church plan” in ERISA Section 3(33), a church-affiliated, tax-exempt entity may “maintain” a church plan, but a plan cannot be a church plan unless it was directly “established” by a church or a convention of churches.

This interpretation of the ERISA church plan definition is consistent with the December 13, 2013, ruling in *Rollins v. Dignity Health* (see “Federal Court Issues Unfavorable Ruling on Church Plan Status,” Towers Watson *Insider*, February 2014). Both the *Saint Peter's* and *Dignity Health* decisions rejected the position taken by courts in other cases, such as *Thorkelson v. Publishing House of Evangelical Lutheran Church* and *Catholic Charities of Maine, Inc. v. City of Portland*, and the many rulings issued by the Internal Revenue Service (IRS) and Department of Labor over the last 30 years.

Saint Peter's and *Dignity Health* are two of six similar lawsuits filed in 2013 and 2014 alleging that large church-affiliated, tax-exempt hospital groups have been improperly operating their pension plans as church plans. The other four cases — Ascension Health, Catholic Health East, Catholic Health Initiatives and Advocate Health Care — have not been decided. All the plans involved in the lawsuits are maintained by tax-exempt organizations that rely on their association with a church for church plan treatment under the Internal Revenue Code and ERISA. *Saint Peter's* is notable for the fact that the plan was operated as an ERISA plan for many years and had only recently received church plan status in a letter ruling from the IRS on August 14, 2013.

Implications

The *Saint Peter's* and *Dignity Health* decisions run counter to more than 30 years of regulatory and judicial precedent, and they signal a worrisome trend. These decisions could trigger additional lawsuits against other sponsors that rely on the alternative definition of “church plan” under ERISA. Further, the IRS might decide to rethink its long-standing position if these unfavorable court rulings continue.

The stakes are significant. These lawsuits demand that the plans comply with ERISA, so losing a case could require a sponsor to make additional, large plan contributions to comply with minimum funding requirements, pay penalties to participants for noncompliance with ERISA’s notice requirements and pay other fees.

Church-affiliated, tax-exempt organizations that are considering seeking a church plan status ruling from the IRS should consider the potential for litigation, particularly in light of the notice that must be provided to participants as part of the ruling request. A church plan may waive its exemption from ERISA and various Code requirements by making a special irrevocable election. Plan sponsors who are concerned about the recent trend in church plan litigation might consider making such an election prospectively as a way to reduce the risk of a participant class action lawsuit (and minimize potential damages). However, the benefit of doing so would need to be balanced against the costs related to compliance with ERISA and the qualification rules, such as increased contribution requirements and Pension Benefit Guaranty Corporation (PBGC) premiums.

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“The *Saint Peter's* and *Dignity Health* decisions run counter to more than 30 years of regulatory and judicial precedent, and they signal a worrisome trend.”

TW Pension 100: Investment Strategies And Plan Funding Since the Financial Crisis

By Brendan McFarland

An earlier Towers Watson analysis¹ of funding results for defined benefit (DB) plans sponsored by the Towers Watson Pension 100 (TW Pension 100)² showed that funded status climbed significantly higher from year-end 2012 to year-end 2013.

Over the analysis period, the projected benefit obligation (PBO) declined due to rising interest rates, while investment returns and plan contributions gave assets a boost.

Our analysis also found that during 2013, pension plans with large allocations to equity had higher absolute investment returns than those with larger concentrations of fixed-income investments. However, when funded status — a comparison of asset values to plan liabilities — is measured over the full six-year analysis period, the outcomes look very different.

Over the last several years, some pension sponsors have been gradually paring back their equity allocations in favor of fixed-income and alternative asset classes, with the growth of the former linked to an investment strategy focused on matching the value of plan liabilities rather than pursuing absolute returns.³

This analysis looks at how sponsors' investment strategies have affected DB plan funding since the start of the financial crisis in 2008. Where applicable, all historical values shown are for companies in the 2013 TW Pension 100.

Investment approaches and funding volatility

In 2013's booming equity market, pension plans with large allocations to stocks performed very well.

Returns were much lower for pension sponsors with large fixed-income holdings — many of whom were somewhere in the process of de-risking their plans. Nevertheless, overall funded status improved in 2013.

Between 2008 and 2013 — a tumultuous time in the financial markets — companies that had already shifted to a majority bond approach outperformed stock-heavy investors in terms of both absolute returns and performance relative to plan obligations. These sponsors also had lower plan contributions over the six-year period.

We looked at 90 companies in the TW Pension 100 that reported target asset allocation data from 2008 to 2013. To better understand how their asset strategies affected their plan funding, we categorized these pension sponsors into three groups and then tracked their results.

Group 1 (which is the vast majority of sponsors in this analysis) consists of plan sponsors that held less than 50% of plan assets in fixed-income investments from 2008 through 2013. Group 2 held more than 50% of assets in fixed income over the period, while Group 3 allocated less than 50% of assets to fixed income in 2008 but held more than 50% in fixed income by 2013. We assume that Groups 2 and 3 either had a liability-driven investment (LDI) strategy in place by the beginning of the analysis period or have since adopted one.⁴

LDI strategies typically use fixed-income assets as a hedge against interest-rate-driven movements in plan liabilities. In years when long-term, high-quality corporate bond interest rates decline, with corresponding increases in plan obligations, corporate bonds will produce positive returns and vice versa. *Figure 1* depicts historical stock and corporate bond returns as well as average pension plan discount rates from 2008 through 2013.

“Between 2008 and 2013, companies that had already shifted to a majority bond approach outperformed stock-heavy investors.”

Figure 1. Investment index returns and discount rates, 2008 – 2013

	Equity index returns			Bond index returns	Discount rates	
	S&P 500	Russell 2500	MSCI EAFE	Citigroup Credit AAA/ AA 10+Yr	Average discount rate for TW Pension 100	Year-to-year change (basis points)
2008	-37%	-37%	-43%	9%	6.37%	
2009	26%	34%	32%	2%	5.92%	-45
2010	15%	27%	8%	13%	5.46%	-46
2011	2%	-3%	-12%	18%	4.80%	-66
2012	16%	18%	17%	11%	4.02%	-78
2013	32%	37%	23%	-8%	4.85%	+83

Source: Towers Watson

¹ See “TW Pension 100: Year-End 2013 Disclosures of Funding, Discount Rates, Asset Allocations and Contributions,” Towers Watson *Insider*, March 2014.

² The 2013 TW Pension 100 consists of sponsors of the 100 largest U.S. pension programs among U.S. publicly traded organizations, ranked by PBO at year-end 2012. For some companies, the allocation of disclosed PBO and assets between U.S. and non-U.S. is estimated.

³ See “U.S. Pension Risk Management — What Comes Next,” November 2013, Towers Watson.

⁴ There is no explicit indicator in disclosure data about whether a plan has adopted an LDI strategy. So for purposes of this analysis, we assumed plans with more than 50% of assets in fixed income have an LDI strategy. Actually, some companies that hold less than 50% in bonds could have adopted an LDI strategy recently with a DB glide path. Under a glide path, asset allocations are modified in a dynamic and systematic manner to reduce risk and increase the fixed-income share of assets as the plan's funded status improves. So as funding improved significantly toward the end of 2013, additional employers might have more than 50% in fixed income in 2014, which will show up in future analyses.

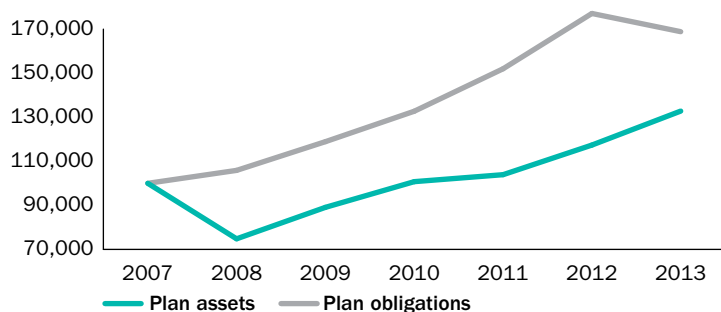
Figure 2. Average funded status for the TW Pension 100 by investment strategy, 2007 – 2013

	2007	2008	2009	2010	2011	2012	2013	Standard deviation
Group 1: Less than 50% fixed income all years (n=71)	100.9%	71.9%	78.7%	82.2%	76.1%	75.4%	90.2%	10.1%
Group 2: More than 50% fixed income all years (n=6)	119.6%	102.4%	99.8%	102.9%	101.7%	99.3%	105.7%	6.7%
Group 3: Shift from less than 50% fixed income to more than 50% (n=13)	102.9%	76.3%	80.5%	81.6%	79.5%	79.8%	87.2%	9.0%

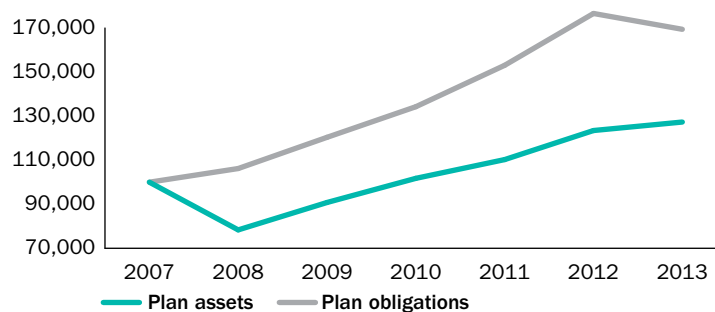
Source: Towers Watson

Figure 3. Hypothetical growth of plan assets and obligations (net of cash flows and additional benefits) based on investment strategy for the TW Pension 100, 2007 – 2013

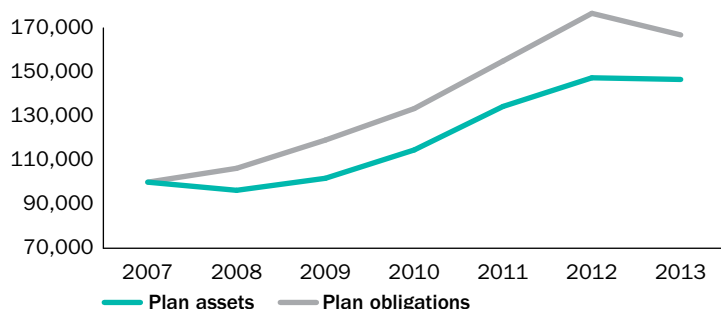
Group 1 plan (less than 50% fixed income all years)



Group 3 plan (shift from less than 50% to more than 50% fixed income)



Group 2 plan (more than 50% fixed income all years)



“Group 2 companies might have been attracted to an LDI strategy to safeguard their solid funded position.”

Source: Towers Watson

In years when the interest rates used to measure pension plan obligations declined, corporate bond returns were generally strong (as shown in the Citigroup column), but, as should be expected, when discount rates moved up dramatically in 2013, bond returns were negative.

Figure 2 shows average funded status for the three groups. On average, funded status was least volatile in Group 2 companies, those presumed to have had an LDI strategy in place over the entire analysis period. Group 2 started out with an average funded status of nearly 120% at the end of 2007, and these companies might have been attracted to an LDI strategy to safeguard their solid funded position. And, on average, their strategy paid off: Group 2 plans remained close to or fully funded throughout the analysis period.

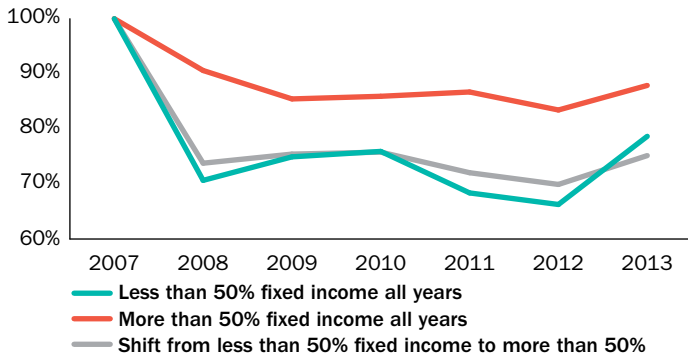
While Group 3 companies —those that switched to an LDI strategy midstream — averaged the lowest 2013 funding levels, they also had less funding volatility than Group 1.

Of course, the funding levels shown in Figure 2 reflect more than just asset returns and interest rates. Asset values are also affected by the level of plan contributions, while obligations reflect benefits accrued during the year and interest costs, as well as other factors such as demographic experience. The impact of benefit payments, settlements and similar transactions is reflected in both assets and liabilities.

To explore the correlation between asset and liability movement and isolate the effects of these three investment strategies on plan funding over the analysis period, we simulated three hypothetical pension plans, each starting out with \$100 million in assets and obligations at year-end 2007 (Figure 3).

Figure 4. Hypothetical levels of plan funding (net of cash flows and additional benefits) based on investment strategy for the TW Pension 100, 2007 – 2013

Investment strategy	2007	2008	2009	2010	2011	2012	2013	Std. dev. (2007 – 2013)	Std. dev. (2010 – 2013)
Plan 1: Less than 50% fixed income all years	100%	70.7%	74.9%	75.9%	68.4%	66.3%	78.7%	11.3%	5.9%
Plan 2: More than 50% fixed income all years	100%	90.6%	85.4%	85.9%	86.7%	83.4%	87.9%	5.5%	1.9%
Plan 3: Shift from less than 50% fixed income to more than 50%	100%	73.8%	75.4%	75.8%	72.0%	69.9%	75.2%	10.2%	2.8%



“Funded status for the Group 2 plan was roughly 88%, while funded status for the Group 1 plan was 79%.”

Source: Towers Watson

We assume these plans have the same inflows and outflows and exclude all other factors, so growth reflects investment performance experience for plan assets, and accumulation of interest and changes in discount rate assumptions for obligations. These factors are derived using the averages on an annual basis for the three groups.

Looking at changes in assets and liabilities based strictly on capital market changes (i.e., investment returns and interest rate fluctuations), results for the Group 2 plan — with more than 50% fixed income throughout the period — were strong. At the end of the simulation period, funded status for the Group 2 plan was roughly 88%, while funded status for the Group 1 plan — with less than 50% of fixed-income assets throughout the period — was 79%: nine percentage points lower (Figure 4). Thanks to the benefits of hedging, the Group 2 plan also had the lowest volatility over this period.

“The Group 2 plan also had the lowest volatility over this period.”

The Group 3 plan — which switched to 50% fixed income midstream — ended up with the lowest funding level. These sponsors invested heavily in equity when the market was down and then shifted to fixed income just before stocks rebounded. On the other hand, funding levels were less volatile in Group 3 than in Group 1, especially over the last four years (when most of these companies shifted to LDI, as shown in Figure 5, next page). The lower volatility in plans with higher fixed-income allocations is, of course, no surprise, and the primary reason plan sponsors decide to de-risk their plan assets.

Investment returns (which are reflected in Figures 3 and 4), including averages and standard deviations, are shown in Figure 5 for the three groups of TW Pension 100 plan sponsors.

Pension contributions have been higher for Group 1 plan sponsors, which allocated less than 50% of assets to fixed-income investments over the entire period, than for Groups 2 and 3 (Figure 6, next page). Roughly half of Group 1 plan sponsors held more than 50% of assets in public equity, and among this group, average contributions were almost double — 5.0% versus 2.7% — those from sponsors in Group 2. Group 2’s contributions were lower mostly because these sponsors had higher funding levels to begin with. However, the higher allocations to bonds over a period when interest rates generally declined improved returns and reduced funding volatility, which could also have played a role in reducing contribution levels.

Conclusion

The analysis covers only six years and the financial environment exhibited some consistent, possibly unique, patterns — most notably the persistent drop in interest rates. It will be instructive to capture future periods with different economic conditions in forthcoming analyses. The results so far, however, suggest the value of LDI, especially given the volatility in financial markets over the analysis period.

Over the six years of the study, the asset/liability hedging in plans with an LDI strategy reduced funding volatility. While sponsors in the LDI group also had higher cumulative investment returns, that outcome could be unique to the period. To some extent, companies that implement fixed-income strategies should be prepared for reduced returns along with the lower volatility. The purpose of LDI is to keep pension funding on a steady, upward path, which tends to shield plans from extreme volatility, catastrophic losses and, on the flip side, outsized rewards. That's what makes the strategy particularly suitable for companies in solid funded positions whose primary focus is protecting their assets.

Plan sponsors that recently adopted an LDI approach missed out on high equity returns in 2013 and might be disappointed in their current numbers, but they can take comfort in their lower volatility and long-term risk reduction. To minimize the timing risk associated with switching investment strategies, sponsors might consider dynamic asset allocation or DB glide paths. These strategies gradually shifts assets (typically from equity to fixed income) as a plan's funded status improves. A dynamic strategy that shifts assets based on interest rates should improve the results.⁵

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Figure 5. Asset allocation and investment returns by investment strategy for TW Pension 100, 2008 – 2013

Investment strategy	Year	Cash	Public equity	Fixed income	Real estate	Other	Rate of return
Group 1: Less than 50% fixed income all years (n=71)	2008	0.5%	60.7%	29.9%	3.2%	5.7%	-25.2%
	2009	0.5%	58.6%	30.5%	3.6%	6.9%	19.1%
	2010	1.0%	56.4%	30.6%	3.7%	8.3%	13.1%
	2011	1.1%	55.4%	31.4%	3.4%	8.9%	3.1%
	2012	1.1%	53.0%	32.8%	3.1%	10.1%	12.9%
	2013	1.2%	52.2%	33.1%	3.1%	10.5%	13.2%
Average ROR	6.0%						
Standard deviation	14.2%						
Group 2: More than 50% fixed income all years (n=6)	2008	0.0%	30.8%	60.0%	3.9%	5.3%	-3.7%
	2009	0.0%	22.7%	66.2%	4.3%	6.8%	5.7%
	2010	1.0%	20.8%	61.7%	4.8%	11.8%	12.6%
	2011	1.0%	20.6%	63.3%	4.4%	10.8%	17.2%
	2012	0.0%	17.4%	68.6%	3.8%	10.2%	9.7%
	2013	1.1%	19.0%	66.5%	4.1%	9.3%	-0.5%
Average ROR	6.8%						
Standard deviation	7.3%						
Group 3: Shift from less than 50% fixed income to more than 50% (n=13)	2008	0.4%	57.3%	32.2%	1.8%	8.3%	-21.7%
	2009	0.4%	54.2%	35.3%	1.4%	8.7%	15.9%
	2010	0.8%	44.3%	43.6%	1.5%	9.8%	12.1%
	2011	1.2%	36.3%	50.3%	1.1%	11.1%	8.4%
	2012	0.4%	29.1%	58.1%	2.4%	10.0%	12.0%
	2013	0.5%	25.1%	62.2%	2.2%	10.0%	3.1%
Average ROR	5.0%						
Standard deviation	12.5%						

Source: Towers Watson

Figure 6. Pension contributions as a percentage of plan obligations for TW Pension 100, 2008 – 2013

	2008	2009	2010	2011	2012	2013	Average
Group 1: Less than 50% fixed income all years	3.8%	5.1%	5.1%	4.6%	4.1%	3.1%	4.3%
Group 2: More than 50% fixed income all years	2.9%	3.7%	4.1%	1.7%	2.6%	1.0%	2.7%
Group 3: Shift from less than 50% fixed income to more than 50%	2.5%	5.2%	3.3%	3.7%	5.1%	3.4%	3.9%

Source: Towers Watson

⁵ See, for example, "Dynamic Asset Allocation for Defined Benefit Plans," Towers Watson (November 2013).

“To minimize the timing risk associated with switching investment strategies, sponsors might consider dynamic asset allocation or DB glide paths.”

Retirement Security: Helping Workers Set Realistic Savings Goals

By Gaobo Pang and Sylvester J. Schieber¹

Many retirement research analysts and policymakers believe that most American workers are not on a viable path to a financially secure retirement. Fifty-three percent of working-age households are at risk of having insufficient retirement resources, according to one analysis,² and 84% of workers are behind savings targets, according to another.³ To maintain living standards into old age, workers are advised to accumulate eight, 11 or even 20 times their annual earnings in personal financial resources for retirement.⁴ The task looms so large that one researcher concluded that saving adequately through the modern 401(k) “do-it-yourself pension system” is beyond the capability of most workers.⁵

This article describes approaches to defining retirement income goals and some of the measurement flaws and discrepancies behind the dire predictions for American workers’ retirement. Carefully considering workers’ income, consumption and savings patterns over their life cycle reveals undue overestimates of earnings to be replaced in retirement and misperceptions about workers’ own responsibility for securing their retirement prospects. We believe that American workers are generally better equipped for retirement than depicted in some studies. We stop short of suggesting a universal model or target for retirement savings because the one-size-fit-all approach would be out of touch with the varying household situations.

¹ This summary discussion is based on Gaobo Pang and Sylvester J. Schieber’s paper, “American Workers’ Retirement Income Security Prospects: A Critique of Recent Assessments,” mimeo, 2014.

² Alicia H. Munnell, Anthony Webb and Francesca Golub-Sass, “The National Retirement Index: An Update,” *Issue Brief* (Boston: Center for Retirement Research at Boston College, 2012), no. 12–20.

³ Nari Rhee, “The Retirement Savings Crisis: Is It Worse Than We Think?” Washington, D.C.: National Institute on Retirement Security (2013), found on July 15, 2013 at: www.nirsonline.org/index.php?option=com_content&task=view&id=768&Itemid=48.

⁴ These retirement savings targets are suggested in the following studies, respectively: Fidelity Investments, “Fidelity Outlines Age-Based Savings Guidelines to Help Workers Stay on Track for Retirement,” found on August 7, 2013 at: www.fidelity.com/inside-fidelity/employer-services/age-based-savings-guidelines; Aon Hewitt, “The Real Deal: 2012 Retirement Income Adequacy at Large Companies,” found on October 29, 2013 at: www.aon.com/human-capital-consulting/thought-leadership/retirement/survey_2012_the-real-deal.jsp; and Teresa Ghilarducci, “Our Ridiculous Approach to Retirement,” *The New York Times*, July 21, 2012.

⁵ Ghilarducci, 2012.

⁶ Jack VanDerhei and Craig Copeland, “The EBRI Retirement Readiness Rating: Retirement Income Preparation and Future Prospects,” *EBRI Issue Brief* (July 2010), no. 344.

Measuring savings constraints and capacity over the life cycle

Assessments of workers’ retirement savings are usually built off a life-cycle model for distributing career earnings evenly across the adult lifespan, with consumption during retirement financed from savings over the career. Consumable income is what remains after netting out expenses related to working and paying taxes.

To estimate consumption levels both before and after retirement, analysts often use survey data on income, consumer expenses and spending behavior. These amounts are then used to estimate target income replacement rates: the percentage of preretirement income required to maintain working standards of living during retirement. In regard to health care for retirees in particular, some analysts use survey data and then add estimated health insurance premiums and out-of-pocket health expenses, plus estimated probabilities of long-term care and related expenses at advanced ages.⁶

Analysts working with administrative data that reflect contributions to employer-sponsored plans often project retirement accumulations based on current savings rates and annual rate-of-return assumptions. Extrapolating from a young worker’s financial situation to retirement age, however, is shaky. Workers save at different rates over their lifetimes and accumulate capital in various ways. They buy homes and start businesses, and many also save in individual retirement accounts or other employer-sponsored retirement plans.

Administrative databases do not include all these assets and so paint an incomplete picture of workers’ savings. Survey data might provide more complete financial information, but self-reports often have lower accuracy.

“American workers are generally better equipped for retirement than depicted in some studies.”

Most retirement income models do not account for the presence of children in the household. Studies using lifetime earnings histories have found that parents generally have less net worth than those without children because of higher consumption levels when children are present.⁷ Consumption levels tend to decline when children leave the home, and several studies have found that controlling for the number and sometimes the ages of children is important in explaining savings rates and accumulated savings.⁸ Some researchers have suggested that adult children are living with their parents longer than they used to, but a review of *Current Population Surveys* shows that, while the prevalence of adult children living at home has risen slightly in recent years, it has generally been declining over the past decades.

Home equity is another important factor often overlooked in setting income targets. According to the *2004 Survey of Consumer Finances*, 81% of households headed by 65- to 74-year-olds owned a home and 60% were mortgage free.⁹ Thus, many retired homeowners should need that much less income to maintain a comparable standard of living in retirement.

Setting replacement rates (more) scientifically

Unsurprisingly, estimated replacement rates and retirement savings targets vary widely. Fidelity Investments suggests a savings target of eight times annual earnings at retirement, which, with Social Security, should provide retirees with an income of 85% of preretirement earnings. Aon Hewitt holds that average-earning full-career workers should amass assets worth roughly 11 times their final salary to replace 85% of preretirement income.

A study by Scholz and Seshadri used two measures of preretirement earnings for retired households: the sum of lifetime earnings indexed by the cost of living and average real earnings in the five years before retirement. Because reported wages often decline as workers approach retirement and scale back work levels, they measured preretirement standards of living as average earnings in the five to nine years before retirement.¹⁰ At every earnings level, their estimated replacement targets were in the 46%-to-76% range for different earnings levels and marital

status, significantly lower than the 85% targets set by Aon Hewitt and Fidelity.

Target replacement rates are also much lower than 85% under the model developed by the Center for Retirement Research at Boston College. The Center's measure of preretirement income includes earnings, returns on retirement plan assets, income on other financial assets net of non-mortgage debt and "imputed rent from housing (net of interest paid on mortgage debt)."¹¹ The Center uses the average wage index series to determine preretirement earnings.

Determining whether workers are on track

Are workers on track to achieve adequate incomes for their retirement years? Nari Rhee used Fidelity's "Age-Based Savings Guidelines" to address this question in her National Institute on Retirement Security report. Fidelity intended these guidelines as "rules of thumb," but Rhee applied them rigidly to assess whether workers are saving adequately. Rhee's assessment held that workers should accumulate savings equivalent to their salary by age 35, three times salary by 45, five times salary by 55 and eight times final salary in the year before retirement. Rhee ignored Fidelity's stipulation that its savings goals were intended for average earners. She failed to consider that Social Security's relatively high benefits for lower earners would reduce the amount they needed to save, or that higher earners would need to save more under the model.

Rhee also ignored the reality that there is more than one path to successful career savings. Her analysis assumed that workers would save 6% of pay at age 25, increase their savings rate by 1 percentage point of pay each year up to 12%, and then save at that rate until retirement. What if, instead of following that arbitrary timetable, a worker contributed 6% per year from age 25 to age 40, after which he or she increased the contribution rate by 1 percentage point per year up to 20%? The worker would be behind the Fidelity path by 21% at age 30, by 34% at age 40, by 23% at age 50 and exactly on target by retirement age. After getting early life debts and start-up expenses under control, many workers can ramp up their contributions during peak earning years and as children are launched. Yet at every point but the end point, these workers would be deemed at risk of an impoverished retirement.

"After getting early life debts and start-up expenses under control, many workers can ramp up their contributions during peak earning years and as children are launched."

"Yet at every point but the end point, these workers would be deemed at risk of an impoverished retirement."

⁷ John Karl Scholz and Ananth Seshadri, "Children and Household Wealth" (Madison: University of Wisconsin, 2009), mimeo found on February 13, 2014 at: www.ssc.wisc.edu/~scholz/Research/Children.pdf.

⁸ See, for example, James Banks, Richard Blundell and Ian Preston, "Life-Cycle Expenditure Allocations and the Consumption Costs of Children," *European Economic Review* (1994), vol. 38, pp. 1391-1410; Orazio P. Attanasio and Martin Browning, "Consumption over the Life Cycle and over the Business Cycle," *American Economic Review* (December 1995), vol. 85, no. 5, pp. 1118-1137; and Martin Browning and Mette Ejrnaes, "Consumption and Children," *Review of Economics and Statistics* (February 2009), vol. 91, no. 1, pp. 93-111.

⁹ Peter J. Brady, "Measuring Retirement Resource Adequacy," *Journal of Pension Economics and Finance* (April 2010), vol. 9, no. 2, pp. 235-262.

¹⁰ John Karl Scholz and Ananth Seshadri, "What Replacement Rates Should Households Use?" University of Michigan Retirement Research Center, Working Paper 2009-2014, p. 16.

¹¹ Center for Retirement Research at Boston College, "Retirements at Risk," p. 7.

Figure 1. Estimated Social Security benefits and replacement rates for hypothetical workers born in 1949 and retiring in 2014

	Very low earner	Low earner	Medium earner	High earner	Maximum earner
Monthly Social Security benefit	\$719	\$941	\$1,550	\$2,059	\$2,481
Measure of preretirement earnings:					
AIME based on age-64 average wage	934	1,681	3,735	5,977	8,992
AIME used for PIA calculations	850	1,530	3,399	5,438	8,229
Average price-indexed high 35 years	830	1,494	3,320	5,312	8,079
Average monthly earnings, final five years	689	1,242	2,759	4,416	9,070
Replacement rates based on:					
AIME based on age-64 average wage	77.0%	56.0%	41.5%	34.4%	27.6%
AIME used for PIA calculations	84.6%	61.5%	45.6%	37.9%	30.1%
Average price-indexed high 35 years	86.7%	63.0%	46.7%	38.8%	30.7%
Average monthly earnings, final five years	104.3%	75.7%	56.2%	46.6%	27.4%

Source: Developed by the authors

“A lifetime savings target of eight to 11 times earnings at retirement age would overstate the savings needs of the majority of workers.”

How much do workers *really* need to save?

The models used to estimate whether workers are saving enough for retirement either explicitly or implicitly build off Social Security. The Social Security Administration (SSA) regularly publishes its estimated Social Security replacement rates for hypothetical workers. Their actuaries use the national average wage index to adjust the workers' earnings to age-64 levels and then calculate the average of the highest 35 years of indexed earnings (“SSA’s method,” hereafter) as the denominator for income replacement rates.¹² Most retirement studies use a different measure of average earnings.

We estimated Social Security benefits for five hypothetical workers at various earnings levels. These estimates are based on the SSA’s method (indexed to age 64), average indexed monthly earnings (AIME) officially used to calculate the Social Security benefit (indexed to age 60), the CPI-W index (indexed to age 64) and average earnings from the worker’s last five working years (nominal).

According to SSA’s actuaries, Social Security benefits would replace 41.5% of the medium earner’s preretirement earnings, as shown in *Figure 1*. Using the high 35-year average of price-indexed earnings would push the replacement rate at least five percentage points higher, and using average earnings over the final five years would boost the replacement rate by 15 percentage points for the medium earner and by 12 percentage points for the high earner.

According to our calculations, medium earners would not need eight or 11 years’ worth of earnings to replace 65%, 75% or even 85% of their preretirement income by most measures (*Figure 2*, next page). Based on price-indexed earnings, the worker would need about six years’ worth of earnings to meet the 75% target and four years for 65%. Many workers who saved eight times earnings would have significantly higher spendable income in retirement than they did while working. Social Security would enable very low earners to maintain their preretirement income levels without any supplemental savings — indicated by dashes in the table. To be clear, there are substantial retirement savings needs for most workers regardless of preretirement income measures or replacement targets used. However, the results indicate that a lifetime savings target of eight to 11 times earnings at retirement age, as suggested by some analyses, would overstate the savings needs of the majority of workers. Why should people scrimp on substandard consumption levels while they’re working to finance a higher standard of living in retirement?

Assessing policy proposals

The perceived retirement savings “crisis” has prompted several proposals to ameliorate the problem. One proposal would curtail tax preferences for retirement savings plans and use the money to finance a supplemental flat Social Security benefit, which would bring combined average Social Security benefits up to 60% of a medium earner’s preretirement earnings.¹³

¹² For a full discussion regarding the derivation of the earnings histories for these workers and Social Security replacement of preretirement earnings, see Gaobo Pang and Sylvester J. Schieber, “Understanding Social Security Preretirement Income Replacement,” mimeo, 2014.

¹³ Michael Lind et al., “Expanded Social Security: A Plan to Increase Retirement Security for All Americans,” p. 21.

Figure 2. Supplemental savings requirements as a multiple of the specified earnings base for hypothetical workers born in 1949 and retiring in 2014

Earnings basis for replacement rates	Very low earner	Low earner	Medium earner	High earner	Maximum earner
Savings target as a multiple of earnings base at 85% target					
AIME based on age-64 average wage	1.68	6.08	9.11	10.58	12.02
AIME based on age-60 average wage	0.08	4.92	8.25	9.87	11.49
Average price-indexed high 35 years	—	4.61	8.02	9.68	11.37
Average monthly earnings, final 5 years	—	1.94	6.04	8.04	12.07
Savings target as a multiple of earnings base at 75% target					
AIME based on age-64 average wage	—	3.98	7.02	8.49	9.93
AIME based on age-60 average wage	—	2.52	6.15	7.78	9.39
Average price-indexed high 35 years	—	2.82	5.93	7.59	8.27
Average monthly earnings, final 5 years	—	—	3.94	5.94	9.98
Savings target as a multiple of earnings base at 65% target					
AIME based on age-64 average wage	—	1.89	4.92	6.40	7.83
AIME based on age-60 average wage	—	0.73	4.06	5.68	7.30
Average price-indexed high 35 years	—	0.42	3.83	5.49	7.18
Average monthly earnings, final 5 years	—	—	1.85	3.85	7.88

Source: Developed by the authors

Figure 3. Estimated replacement rates under proposals for hypothetical workers born in 1949 and retiring in 2014

Current replacement rates and proposals	Very low earner	Low earner	Medium earner	High earner	Maximum earner
Current Social Security replacement of earnings indexed to age 64	77.0%	56.0%	41.5%	34.3%	27.6%
New America Foundation proposal Combined Social Security and Supplemental Benefits replacement rate	151.0%	97.1%	60.0%	46.0%	35.3%
Ghilarducci proposal Combined Social Security and Supplemental Benefits replacement rate	115.9%	92.2%	76.0%	68.0%	59.6%

Source: Developed by the authors

Another proposal would replace current tax preferences for retirement savings with a mandated 5% annual contribution on earnings up to the Social Security tax base that would accumulate in accounts managed by Social Security. These accounts would provide guaranteed returns, and low earners would receive tax credits. According to the proposal, the new payouts combined with existing Social Security benefits would boost replacement rates to 89% for low earners, 71% for average earners and 61% for high earners.¹⁴

These proposals would adopt income security policies that significantly reward some people much more when they are not working than when they are,

as indicated in *Figure 3*. Creating a savings-based earnings replacement system where benefits exceed preretirement income levels makes little sense in the context of income smoothing across the life cycle, which is part and parcel of what the retirement income security system is intended to achieve.

“These proposals would adopt income security policies that significantly reward some people much more when they are not working than when they are.”

¹⁴ Teresa Ghilarducci, “Guaranteed Retirement Accounts: Toward Retirement Security” (The Economic Policy Institute, 2007), p. 4, EPI Briefing Paper #204, found on August 9, 2013 at: www.gpn.org/bp204.html.

“Although clearly some workers are not saving enough for a comfortable retirement, the situation is less dire than many studies have suggested.”

Conclusion

Most of the recent assessments suggesting that the majority of American workers are insufficiently prepared for retirement are based on models that fail to reflect patterns of income, consumption and savings that vary over workers' lives. They extrapolate younger workers' observed savings behavior into the future, ignoring their capacity to catch up after children leave home and the mortgage is paid off. Many measures of preretirement income and consumption are overstated owing to inappropriate indexing, which leads to overestimates of earnings replacement targets and underestimates of the income replacement capacity of Social Security.

Although clearly some workers are not saving enough for a comfortable retirement, the situation is less dire than many studies have suggested. And poorly conceived standards of how much workers will need as they approach retirement, naive models of retirement savings behavior and underestimates of existing savings programs cannot help us discern how many workers are at risk, who they are and how best to help them.

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Final Regulations Offer Employers Streamlined PPACA Reporting Options

By Anu Gogna and Kathleen Rosenow

The Internal Revenue Service (IRS) has issued final regulations for providers of minimum essential health coverage that are subject to reporting requirements under the Patient Protection and Affordable Care Act (PPACA). The IRS also issued a separate set of final regulations with guidance for applicable large employers that must submit reports for purposes of the individual and employer mandates. The major news is that the guidance gives both providers and employers some simpler reporting methods.

These final regulations take effect January 1, 2015, and reporting entities will not be subject to compliance penalties for 2014. Reports (including employee statements) must be made in 2016 for calendar-year 2015. The government continues to encourage reporting entities to voluntarily comply for 2014.

Background

The government will use reports from providers of minimum essential coverage and applicable large employers to enforce the individual and employer mandates, and to administer premium tax credits. When health insurers and plan sponsors file taxpayer information with the IRS, they must also provide a copy to the taxpayer, along with their own contact information (name, address and phone number). The information from health insurers will enable taxpayers to establish — and the IRS to verify —

whether taxpayers were covered by minimum essential coverage and their months of enrollment during a year.

The reports from providers of minimum essential coverage are required under Internal Revenue Code Section 6055, and the coverage reports from applicable large employers (generally employers with 50 or more full-time or full-time equivalent employees in the prior year determined on a controlled group basis) are required under IRC Section 6056.

The IRS proposed regulations on the reporting requirements in September 2013 (see Towers Watson *Insider*, October 2013).

Streamlined reporting provisions

In addition to providing a general method for reporting, the regulations also provide several ways to streamline reporting.

Single, combined reporting form: Under the final regulations, employer/sponsors of self-insured group health plans may report required information under both Sections 6055 and 6056 on a single, combined form (not yet released). The combined form (Form 1094-C for transmittal and Form 1095-C for the employee statement) will have two sections: the top half will cover Section 6056 reporting and the bottom half Section 6055. So, applicable large employer/sponsors of self-insured group health plans will need to complete both parts of the form, while applicable large employers with insured group health plans will need to complete only the top section. Insurers and other providers, such as

“The major news is that the guidance gives both providers and employers some simpler reporting methods.”

self-insured multiemployer plans and providers of government-sponsored coverage, will report only under Section 6055 using a separate form.

Simplified option for employer reporting: The final regulations offer a simplified alternative to monthly reporting for employers that provide a “qualifying offer” to any full-time employees. Instead of providing employee-specific information, the employer would report employees’ names, addresses and taxpayer identification numbers (TINs), as well as a code indicating a qualifying offer was made.

- A qualifying offer is an offer of minimum value employee-only coverage that costs the employee up to 9.5% of the federal poverty level (FPL) (about \$1,100 in 2015) plus an offer of coverage for the employee’s family.
- For employees receiving qualifying offers for all 12 months of the year, employers must report the full-year qualifying offer to the IRS and give employees a copy of the simplified report or a standard statement showing that they received the offer.
- For employees receiving a qualifying offer for part of the year, employers can simplify reporting by entering a code for the months in which the qualifying offer was made.

The final regulations phase in the simplified reporting option by allowing an even simpler alternative method for 2015. In 2015 only, an employer may optionally certify having made a qualifying offer to at least 95% of its full-time employees (plus an offer of minimum essential coverage to their spouses and dependents). Note that an employer using the transition relief in the final play-or-pay regulations pertaining to the offer of coverage to dependents in 2015 will not be treated as having offered coverage to an employee’s dependents for purposes of this simplified reporting option.

Employers that provide this 95% certification can use the simplified, streamlined reporting method for their entire workforces, including employees who did not receive a qualifying offer for the full year. Under this simplified method, instead of providing Form 1095-C, an employer would furnish a standard statement to all full-time employees for the year by the following January 31. The statement will be in an IRS-prescribed format and may vary depending on whether the employee received a qualifying offer from the employer for all, some or none of the months of the preceding calendar year. The statement also will describe employees’ possible eligibility for premium tax credits (presumably the IRS will issue model language).

Finally, employers may optionally avoid identifying which employees are full time. To use this simplified

method, an employer must certify having offered minimum essential coverage that is affordable and provides minimum value to at least 98% of the employees on whom it is reporting.

Rules applicable to both Sections 6055 and 6056

Taxpayer identification number/date of birth: Under the final regulations, reporting entities may report dates of birth (DOB) instead of taxpayer identification numbers (TINs), but only after either being informed the individual has no TIN or making reasonable but unsuccessful efforts to obtain it. Reporting entities may not terminate coverage because a TIN is not provided. After reporting a DOB in one year, the reporting entity must make reasonable efforts to obtain the TIN for the next year. In addition, reporting TINs for responsible individuals not enrolled in the coverage is optional. Using truncated TINs for security purposes will likely be allowed.

Electronic filing: In a departure from the proposed rules, the final regulations require Form 1094-C and Form 1095-C to be filed electronically only if the reporting entity is required to file at least 250 of the specific form (instead of 250 returns of any type).

Substitute statements: The final regulations allow the use of substitute statements under Sections 6055 and 6056 that conform to IRS requirements (such guidance has not yet been issued). Employers using combined reporting on Form 1095-C will also provide a single statement to individuals.

Penalties and corrected returns: The IRS will not impose penalties on a reporting entity for failure to file or incorrect filing as long the entity made a good-faith effort to comply with requirements. Thus, there will be no penalties for returns and statements filed and furnished in 2016 on coverage in 2015 with incorrect or incomplete information, including Social Security numbers, TINs or DOBs. There is no relief for reporting entities that did not make a good-faith effort to comply or failed to file on time.

The final regulations clarify that reporting entities that do not timely file corrected returns and corrected statements when a participant’s circumstances have changed may be subject to penalties.

Employee statements January 31 deadline:

Generally, employee statements must be provided before January 31 of the year following the calendar year of coverage, but the final regulations allow reporting entities with good cause to apply for an extension of up to 30 days. Reporting entities may furnish the statement in the same mailing with Form W-2.

“The final regulations offer a simplified alternative to monthly reporting for employers that provide a “qualifying offer” to any full-time employees.”

Provider reporting (Section 6055) final regulations

In addition to providing the above simplified reporting alternatives, the final regulations clarify numerous other issues, including:

Minimum essential coverage: The final regulations confirm that all providers of minimum essential coverage, including employers with self-insured group health plans, must file an information return and a transmittal on IRS-prescribed forms, even for those who may be exempt from the individual mandate and retirees covered under an employer's self-insured group health plan.

Supplemental coverage: Section 6055 reporting is not required on arrangements that provide benefits in addition to or as a supplement to a health plan or another arrangement that constitutes minimum essential coverage, including health reimbursement arrangements and health savings accounts. The final regulations clarify that the following are not considered minimum essential coverage and thus are not subject to Section 6055 reporting:

- Onsite medical clinics
- Medicare Part B
- Wellness programs that are an element of other minimum essential coverage, such as wellness programs offering reduced premiums or cost-sharing under a group health plan
- Minimum essential coverage that supplements a primary plan of the same plan sponsor or that supplements government-sponsored coverage (such as Medicare)

Mailing address: Generally, statements must be sent to the individual's last known address. The final regulations add that a first-class mailing to the last known address or, if no permanent address is known, a temporary address, satisfies the requirement, even if the statement is returned.

Employer reporting (Section 6056) final regulations

For full-time employees for each calendar month, it is anticipated that reporting entities will submit the following information to the IRS and to the full-time employee using indicator codes rather than specific information:

- Minimum essential coverage meeting minimum value was offered to: employee only; employee and dependents only; employee and spouse only; or employee, spouse and dependents.
- Coverage was not offered to the employee and (1) any failure to offer coverage will not result in

a penalty, (2) the employee was not full time, (3) the employee was not employed for the month, or (4) no other code or exception applies.

- Coverage was offered to the employee for the month even though he or she was not full time.
- The employee was covered under the plan.
- The applicable large group member met one of the affordability safe harbors under the final play-or-pay regulations with respect to the employee.

Applicable large employers with fewer than 100 full-time employees:

Under the final regulations, employers with 50 to 100 full-time employees are exempt from penalties for 2015. However, these employers must still report under Section 6056 for 2015, certifying eligibility for the transition relief.

Combinations of alternative reporting methods:

Employers may use different reporting alternatives for different employees.

Governmental employers: An applicable large-employer governmental unit may report for itself or may designate another agency to report on its behalf (which then becomes responsible for the reporting and any associated penalties for noncompliance). For example, a state may report for a political subdivision of the state. Such a designation must (1) be in writing, (2) contain specific language, (3) be signed by both the applicable large employer and the designated person, (4) be effective under all applicable laws, and (5) acknowledge that the designated person is both appropriate and responsible for the reporting. The designation must also identify the category of full-time employees whose coverage will be reported. If the designated person is responsible for reporting for all full-time employees, the document should state that.

Multiemployer plan members: In a multiemployer plan scenario, the multiemployer plan provides the health coverage and participating employers contribute. Section 6056 applies only to the employer providing coverage to an employee, not to the multiemployer plan itself. However, the regulations allow the multiemployer plan administrator to prepare returns pertaining to full-time employees covered by the collective bargaining agreement and eligible to participate in the multiemployer plan for each contributing employer.

The employer must submit returns for the remaining full-time employees (i.e., those not eligible for the multiemployer plan). The administrator of the multiemployer plan will file a separate 6056 return for each contributing employer, providing the name, address and identification number for both the plan and the contributing employer. The multiemployer

“All providers of minimum essential coverage must file an information return and a transmittal on IRS-prescribed forms.”

plan may help the employer furnish statements to the employees as well. However, there must be one Section 6056 transmittal form (Form 1094-C) reporting aggregate employer-level data for all full-time employees of the employer and one employee statement for each full-time employee. The forms and instructions will provide further detail on these requirements. Note that the employer will remain responsible for the Section 6056 reporting and any penalties.

Third-party reporting: Applicable large employers may contract with third parties to assist in filing Section 6056 returns and furnishing employee statements, but the employers remain responsible for any penalties for failure to comply.

Going forward

Employers will want to figure out whether they can use one of the simplified reporting methods rather than the general method of reporting. They might also want to assess whether to contract with a third party to file the appropriate reports and/or furnish employee statements. As soon as the IRS issues draft Form 1095-C, employers will want to design administrative processes to support the reporting function.

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2014 Tax Reform Act Would Affect Employee Benefits and Compensation

By Precious Abraham and Ann Marie Breheny

The Tax Reform Act of 2014 proposed by Ways and Means Committee Chair Dave Camp (R-Mich.) would overhaul the tax code and change retirement, compensation, health and other employer-provided benefits, as well as individual and corporate tax rates, deductions, tax exclusions and credits.

Background

Early in 2013, Representative Camp and ranking member Sandy Levin (D-Mich.) established 11 working groups to recommend reforms to the tax code. The Ways and Means Committee also sought comments and recommendations from the public. On May 6, 2013, the Joint Committee on Taxation released a report outlining existing tax reform proposals, discussions within working groups and suggestions from the public. On February 26, 2014, Representative Camp released a discussion draft of the Tax Reform Act of 2014. This article describes some of the key proposals from the discussion draft to amend the tax preferences for benefit programs.

Retirement plan proposals

The proposed reforms would significantly change the tax treatment of qualified retirement plans and individual retirement accounts (IRAs), thus affecting employee savings and employer plan administration. The reforms would align the rules for 401(k), 403(b) and 457 plans and streamline the types of available retirement savings plans.

Focus on Roth model

Representative Camp's tax reforms would promote Roth accounts — both Roth IRAs and Roth accounts within employer-sponsored defined contribution (DC) plans. The summary notes that Roth approaches "... would help Americans achieve greater retirement security by effectively increasing the amounts they have available at retirement. Many people saving in traditional 401(k) plans do not consider the taxes that will be due upon distribution, and assume that their entire account balance will be available to them upon retirement."

In employer-sponsored plans, the proposed reforms would limit employee contributions to traditional DC plans to one-half the maximum annual elective deferral amount and require that any additional amounts be contributed to a Roth arrangement. Under the current \$17,500 limit, for example, a participant could contribute \$8,750 to a traditional account and additional amounts would have to go into a Roth account. Employer plans generally would have to include a Roth account. Employers would continue contributing to traditional DC plans.

For IRAs, the proposed tax reforms would shift toward the Roth model by:

- Eliminating income limits for contributions to Roth IRAs
- Prohibiting new contributions to traditional and nondeductible IRAs
- Repealing the rule allowing Roth IRA contributions to be re-characterized as traditional IRA contributions

"The proposed reforms would significantly change the tax treatment of qualified retirement plans and IRAs, thus affecting employee savings and employer plan administration."

Suspension of limit indexing

The proposal would suspend the inflation adjustment for Internal Revenue Code (IRC) Section 415 benefit and contribution limits, maximum elective deferral limits, catch-up contributions and Roth IRAs until 2024. After the freeze ends, the Roth IRA limit would increase based on the chained consumer price index — a metric expected to result in smaller annual increases. It appears the limits for employer-sponsored plans would be indexed based on the traditional consumer price index for urban consumers (CPI-U).

Other retirement proposals

Representative Camp's tax reforms would also change many other rules for employer plans:

- Repeal the exception from the early withdrawal penalty for distributions taken for first home purchases and educational expenses and apply the early distribution penalty to governmental 457 plans
- Require the Internal Revenue Service to allow employees to continue contributing to a plan after taking a hardship distribution
- Extend the period allowed for employees to pay back outstanding loans upon plan termination or separation of employment to the filing due date for the individual's tax return
- Allow all plans, including defined benefit plans and state and local government DC plans, to provide in-service distributions beginning at age 59½
- Repeal the exclusion for net unrealized appreciation from income for distributions of employer securities from tax-deferred retirement plans
- Align limits under 403(b) and 457 plans with 401(k) plan limits, with no additional limits for different classes of employees
- Disallow new Simplified Employee Pensions (SEPs) and Savings Incentive Match Plan for Employees (SIMPLE) 401(k) plans. Workers could continue contributing to existing plans, and SIMPLE IRAs would remain available. The start-up credit for plans sponsored by small employers would be repealed.
- Provide that if an employee becomes a 5% owner of the company after age 70½ but before retirement, required minimum distributions would have to begin on April 1 of the next year
- Eliminate "stretch IRAs" (non-spouse beneficiaries would have to take distributions from inherited IRAs, DC plans and defined benefit plans within five years, unless they are disabled, chronically ill or less than 10 years younger than the deceased; minor children would have to take distributions by age 26)

"Under the reforms, carried interest would be treated as ordinary income, and all severance payments would be subject to income and employment taxes."

Health care proposals

There is less focus on health care than on retirement and compensation. While the proposed reforms generally leave the Patient Protection and Affordable Care Act (PPACA) in place, some provisions would affect health care reforms, health care benefits and medical expenses.

The proposal would make the following changes to the PPACA:

- Repeal the excise tax on medical device manufacturers
- Repeal the prohibition on tax-free payments or reimbursements from health flexible spending accounts (FSAs), health reimbursement arrangements and health savings accounts (HSAs) to pay for over-the-counter medications without a prescription
- Repeal the nonprofit Consumer Operated and Oriented Plans (CO-OPs) that are being offered in some public health insurance exchanges
- Repeal the tax credit for health coverage offered by small employers

Other health-related changes would:

- Repeal the health coverage tax credit, which was generally available to trade-displaced workers and Pension Benefit Guaranty Corporation (PBGC) recipients over age 55 until it expired on December 31, 2013
- Repeal the itemized deduction for out-of-pocket medical expenses
- Repeal the above-the-line deduction for contributions to Archer medical savings accounts (MSAs) (existing Archer MSA balances could be rolled over to an HSA)

The employee tax exclusion for some employer-provided health benefits (amounts reported on W-2s, contributions to HSAs and salary reduction contributions to health FSAs) would be capped at the 25% tax bracket.

Compensation proposals

Under the reforms, carried interest would be treated as ordinary income, and all severance payments would be subject to income and employment taxes. Most of IRC Section 409A would be repealed and a new Section 409B would include nonqualified deferred compensation (and related earnings) in gross income as soon as there was no substantial risk of forfeiture of the right to the compensation. Previously earned amounts would be temporarily grandfathered — delaying their inclusion in income. Regulations would allow for acceleration of payments. Section 409B would also extend the short-term deferrals exemption to six months after the end of the taxable year.

The \$1 million deduction limit under IRC Section 162(m) would be expanded to:

- Repeal the exception for performance-based compensation and commissions
- Change the definition of covered employee under Section 162(m)(3) to include the chief executive officer, chief financial officer and three next-highest compensated officers (and once someone was designated as a covered employee, he or she would remain a covered employee)
- Apply the limit to beneficiaries of covered employees
- Apply the \$1 million compensation limit to tax-exempt organizations by imposing a 25% excise tax on excess compensation (including severance or parachute payments paid to the five highest-paid employees)

Corporate-owned life insurance (COLI) would no longer be exempt from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20% owners of a business that is the owner or beneficiary of the contracts.

Proposed tax brackets

The act would establish three tax brackets: 10%, 25% and 35%. The 35% bracket would apply to taxpayers with modified adjusted gross income (MAGI) of \$400,000 (individuals) and \$450,000 (married couples). Certain tax preferences, including those for pretax contributions to DC plans, would be capped at the 25% bracket. In general, MAGI would equal the AGI plus the following:

- Standard deduction
- Itemized deductions (except charitable contributions)
- Excluded foreign earned income (including income from Puerto Rico and other U.S. possessions)
- Tax-exempt interest
- Employer contributions to health, accident and DC plans (to the extent excludable)
- Amounts deducted for health insurance premiums for the self-employed
- Amounts deducted for contributions to HSAs and excluded Social Security income

Other proposed tax reforms

- The act addresses worker classification and establishes a safe harbor for services performed and payments made after 2014.
- The \$5,250 exclusion for undergraduate and graduate education under IRC Section 127 would be repealed.
- Qualified parking benefits and qualified transportation benefits would be frozen at their current limits of \$250 per month and \$130 per

- month, respectively. The limits would not be indexed for inflation. The act would repeal reimbursement of qualified bicycle commuting expenses and the employer deduction for transportation fringe benefits.
- Tax credits for dependent care, adoption and employer-provided child care would be repealed. The income exclusions for employer-provided dependent care and adoption assistance programs appear to continue.

Little chance for near-term action

The full reform proposal is not expected to advance, but some elements could gain traction, especially those that raise revenue. Proposals to freeze the indexing of retirement plan and IRA limits, shift contributions from traditional to Roth retirement programs, eliminate stretch IRAs, and limit the value of retirement and health care tax benefits for higher-income taxpayers are revenue raisers that have received recent legislative attention. The focus on these provisions is likely to continue, and other provisions may attract new attention as a result of the discussion draft.

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“The full reform proposal is not expected to advance, but some elements could gain traction, especially those that raise revenue.”



Health FSA Carryovers and HSA Eligibility, and Correcting Improper Payments From Health FSAs

By Rich Gisonny and Anu Gogna

Advice memos released by the Office of Chief Counsel at the Internal Revenue Service (IRS) address the interaction between carryovers from health flexible spending accounts (FSAs) and eligibility for contributions to health savings accounts (HSAs), and correction procedures for improper health FSA payments.

To contribute to an HSA, an employee generally must be enrolled in a qualifying high-deductible health plan (HDHP) and not enrolled in any non-HDHP coverage. But while HSA participants may not be enrolled in “general purpose” health FSAs, the IRS makes an exception for “limited purpose” health FSAs. These HSA-compatible FSAs may reimburse dental, vision or preventive care expenses only, or reimburse medical expenses after the participant has satisfied the HDHP deductible.

In October 2013, the IRS decided to allow health FSA carryovers of up to \$500 to the next plan year, but there have been questions about the interaction between the carryover feature and HSA eligibility.

Health FSA carryovers and HSA contribution eligibility

The IRS memo reaches the following conclusions about the interplay between carryovers from health FSAs and eligibility to make HSA contributions:

- A participant in a general purpose health FSA cannot make HSA contributions even if he or she is in the general purpose FSA due to a carryover of unused amounts from the prior plan year.
- A participant in a general purpose health FSA may not contribute to an HSA during the entire FSA plan year. This restriction applies, for example, even for months in that plan year after the FSA carryover balance has been used up.
- A participant in a general purpose health FSA who elects to participate in an HSA-compatible health FSA for the next year may also elect to have any unused amounts from the general purpose health FSA carried over to the HSA-compatible health FSA.

- An individual who elects to deposit a carryover balance from a general purpose health FSA into an HSA-compatible health FSA in the following year may contribute to an HSA during that following year.
- A cafeteria plan that offers both a general purpose health FSA and an HSA-compatible health FSA may automatically consider an employee who joins an HDHP for the following year as enrolled in the HSA-compatible health FSA. In this situation, any unused amounts from the general purpose health FSA would be carried over to the HSA-compatible health FSA for the following year.
- A cafeteria plan may provide that a participant in a general purpose health FSA with a carryover feature may decline or waive the carryover balance before the next plan year, thereby remaining eligible to make HSA contributions.
- If an employee elects to carry over unused amounts from a general purpose health FSA to an HSA-compatible health FSA, he or she may use the remaining balance for any permissible medical expenses incurred before the general purpose health FSA plan year ends. In addition, any covered claims must be timely reimbursed up to the amount elected for the HSA-compatible health FSA plan year. Any claims in excess of the elected amount may be reimbursed after the run-out period when the amount of any carryover is determined. An example in the advice memo further explains these rules.

Correcting improper FSA payments

An improper payment is typically a reimbursement for medical expenses that was not properly substantiated or that later turns out to be for an item or service that isn't a qualified medical expense. The guidance addresses three points:

- Improper payments under a health FSA may be corrected using the regular correction procedures that were articulated in prior IRS guidance for improper debit card payments:
 1. Until the improper FSA payment is recovered, the employer must deactivate the debit card, and the employee must use other methods to request FSA reimbursements, such as submitting a receipt or invoice.

“A cafeteria plan may provide that a participant in a general purpose health FSA with a carryover feature may decline or waive the carryover balance before the next plan year, thereby remaining eligible to make HSA contributions.”

2. The employee must repay the improper FSA payment to the cafeteria plan.
 3. If the employee fails to make the repayment, the employer must withhold the improper payment amount from the employee's pay.
 4. If the employer is unable to recover the full amount, claims substitution or offset must be used where possible. For example, if an employee receives an improper payment of \$200 and subsequently submits a substantiated claim for \$250, the employer reimburses only \$50.
 5. If the employer is still unable to recover the improper payment, it should be treated in the same way as any other business debt.
- Although employers may apply the above correction procedures in any order (as long they are consistent for all participants), an employer may proceed to the fifth step only after trying the other steps first. Correction procedures should be applied during the plan year in which the improper payment was made. Finally, repaid amounts are available for reimbursing other claims incurred during that plan year (or in the next plan year, if the plan has a carryover feature).
 - If the employer treats the improper FSA payment as a business debt, because it was not repaid by the employee, the amount is considered income

to the employee and thus subject to withholding for federal income tax, FICA and FUTA purposes. It should be reported as income on the employee's Form W-2 in the tax year in which the debt is forgiven.

Conclusion

Sponsors of both a health FSA and an HSA should consider whether to have an FSA carryover feature and, if so, the best way to coordinate the two accounts. For example, an employer could require any carryover from an FSA (up to \$500) to be carried over to an HSA-compatible FSA, such as a limited purpose FSA or post-deductible FSA. Employers could also give FSA participants the option to decline or waive the carryover amount to preserve their eligibility to make HSA contributions. In light of the recent IRS guidance, employers also should review and determine the corrective steps that will be used when improper payments have been made from a health FSA.

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“Sponsors of both a health FSA and an HSA should consider whether to have an FSA carryover feature and, if so, the best way to coordinate the two accounts.”

News in Brief

IRS Announces 2015 HSA Limits

By Cindy Brockhausen and Anu Gogna

The IRS has announced the 2015 inflation-adjusted amounts for health savings accounts (HSAs). This includes the maximum annual contribution, the minimum annual deductible for a high-deductible health plan (HDHP) and the maximum annual out-of-pocket (OOP) expense for an HDHP.

The maximum annual OOP expense limits in 2015 for an HSA-qualifying HDHP are \$6,450 for self-only coverage and \$12,900 for family coverage. These limits are different from the 2015 in-network OOP expense limits for group health plans under the Patient Protection and Affordable Care Act (PPACA), which are \$6,600 for self-only coverage and \$13,200 for family coverage.

Self-only coverage	2014	2015
Maximum annual HSA contribution	\$3,300	\$3,350
Minimum annual deductible for HDHP	\$1,250	\$1,300
Maximum annual out-of-pocket expense limit for HDHP	\$6,350	\$6,450

Family coverage	2014	2015
Maximum annual HSA contribution	\$6,550	\$6,650
Minimum annual deductible for HDHP	\$2,500	\$2,600
Maximum annual out-of-pocket expense limit for HDHP	\$12,700	\$12,900

For plan participants who are age 55 or older by December 31, 2015, the 2015 HSA catch-up contribution limit for 2015 remains \$1,000.

DOL Proposes Fee Disclosure Guide For Plan Fiduciaries

By Lynn Cook and Stephen Douglas

Under the Employee Retirement Income Security Act (ERISA), plan fiduciaries¹ must act prudently and solely in the interest of plan participants and beneficiaries when selecting and monitoring service providers and plan investments. Arrangements with service providers, including compensation, must be “reasonable.”

According to the Department of Labor (DOL), the services provided to employee benefit plans and associated compensation arrangements, such as revenue-sharing, have become increasingly complex and less transparent. To help address these issues, the DOL published final regulations in 2012 that require service providers to disclose specific fee and compensation information to retirement plan fiduciaries so they can satisfy their fiduciary responsibilities.

Proposed regulatory amendment

Since publishing the final rules in 2012, the DOL has been reviewing service providers' disclosures and plan fiduciaries' experiences and has concluded that a separate guide would be helpful. As a result, the DOL has proposed to amend its regulations to include a guide that would have to (1) identify the document and page number of any required disclosures, or (2) provide some other “sufficiently specific locator,” such as section identification or electronic links, so that a responsible plan fiduciary could quickly and easily find the disclosures enumerated in the 2012 rules. The guide, however,

would be required only for service provider disclosures that include multiple or lengthy documents. And while the guide would have to be a separate document, it could apparently be sent in the same mailing as other documents.

The DOL requested comments on numerous issues in the proposed regulation and simultaneously announced that it intends to conduct focus group sessions with fiduciaries to small pension plans (those with fewer than 100 participants) to explore current practices and the effects of the final disclosure regulations. The results of the focus group testing will be made available to the public.

The DOL indicates that the requirement to issue a guide will not become effective until 12 months after the proposed regulatory changes are finalized.

Outlook

The proposed regulation is most troublesome for covered service providers who disclose their fee and compensation information in multiple documents. The additional documents might include mutual fund prospectuses, investment account forms and applications, insurance contracts and applications, and related addendums and notices. In addition, the documents containing the required information are likely to vary from plan to plan, which could make creating the DOL's fee disclosure guide burdensome and expensive.

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¹ Fiduciaries are the individuals or entities who manage an employee benefit plan and its assets. Determining whether an individual or an entity is a fiduciary depends on whether such individuals are exercising discretion or control over the plan.

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