The Guaranteed Account Plan (GAP)

The Guaranteed Account Plan (GAP) is a new kind of hybrid retirement plan that would help to fill a gap in coverage by encouraging small- and mid-sized employers to offer a defined benefit plan for their workers. The plan provides guaranteed benefits to employees while at the same time providing attractive features for employers who might otherwise be reluctant to set up a defined benefit plan. The plan offers features and incentives that are not currently available in any kind of tax-qualified plan.

Key features of GAP:

- **Simple and easy design:** GAP is an individual account plan with minimum guarantees on account balances. It operates like a cash balance plan inside a defined contribution plan framework (specifically, a money purchase plan), rather than inside a defined benefit framework. Such a design avoids some of the legal complexities raised by cash balance plans.

- **An optional 401(k) bonus feature:** GAP can be designed to permit employees to make voluntary contributions on a pre-tax basis. Employers can also match the employee contribution, just as in a 401(k), thereby giving GAP a two-in-one appeal. The employee contribution and matching features follow current Internal Revenue Code requirements governing 401(k) plans.

- **Significant contributions for senior employees are allowed in exchange for an increased minimum contribution for all employees:** By allowing employers to follow the tax rules of defined benefit plans, which, unlike defined contribution plans, permit employers to vary contributions based on seniority, an employer can make significant contributions for senior employees. However, in return for the higher contribution limit, employers would have to provide at least a 6.5 percent of compensation contribution for all employees, regardless of age. This is a win-win for rank-and-file employees and for the older key employees that the employer wants to benefit.

- **The use of current defined contribution plan testing methodologies, including cross-testing and use of rate groups, is permitted.**

- **Generous credit for past service:** GAP would be able to provide contribution credits for up to seven years of past service, i.e., for service completed before the employer adopted the plan. Experience shows that permitting generous past-service credits is a strong incentive for employers to establish plans, since such credits will help the long-tenured employees that firms most want to benefit.

- **Predictable and easy funding.** GAP rules are designed to address a key concern of employers regarding traditional defined benefit plans – the unpredictability of the annual

1350 Connecticut Avenue, N.W., Suite 206, Washington, D.C. 20036
Telephone 202.296.3776 Facsimile 202.296.1571

contribution employers have to make to keep plans fully funded**.** With GAP, a plan sponsor will determine required funding in accordance with standardized and conservative interest assumptions. If a GAP becomes underfunded, the employer will have a five-year period to amortize the shortfall.

The employer would also be permitted to fund a GAP up to 150 percent of its current liability.

- **Unique vehicle for funding flexibility and security**. An innovative feature of GAP is the "side-car trust," a funding vehicle to which employers can contribute. The employer would receive a current deduction for contributions to the side-car trust, which is itself tax-exempt.

  The employer could transfer assets from the side-car trust to GAP at any time, for any reason, including to meet its annual contribution obligation, to fund a benefit improvement, or simply to improve GAP's funding ratio.

  The employer could make withdrawals from the side-car trust at any time, as long as the GAP itself has a funding ratio of at least 110 percent. The withdrawals would be subject to a flat 12 percent reversion tax (plus regular income tax). The reversion tax is designed to recover the side-car trust's tax deferral benefits without discouraging employers from setting up the side-car trust in the first place. The side-car trust would be required to transfer assets to GAP if GAP's funding ratio falls below 110 percent.

- **Flexibility in plan design:** Employers are permitted to design a GAP to provide either a fixed rate of return or a variable rate of return tied to an equity or bond index.
  - For a fixed rate of return, GAP must provide a rate of return of at least three percent.
  - For a variable rate of return, GAP must guarantee that, at the end of an employee's service, the employee's account will be at least the sum of all pay credits plus a three percent fixed rate of return on such pay credits.
  - There will some protection for employees to allow them to switch from a variable to a fixed rate of return as they near retirement.

- **The normal form of benefit is an annuity:** A GAP may be designed to allow employees to elect a lump-sum benefit equal to his or her account balance.

- **Lower PBGC insurance premiums:** The plan would be insured by the PBGC and employers would pay a premium of $5 per participant per year, lower than the cost charged traditional plans.

For more information about GAP, visit www.conversationoncoverage.org or call Karen Friedman at 202-296-3776.