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Q. Our township is looking at retirement plan options. What is the difference between a defined benefit plan and a defined contribution plan?

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

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

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

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

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

Q. Which of these pension plans qualify for the exception from Social Security taxes?

Employees not covered by 218 Agreements can be excluded from the Social Security portion—6.2 percent of an employee's pay, with a 6.2 percent township match—if they are covered by a public pension plan. This plan must contain the following:

Defined Benefit Plans:

- Basic benefits accrued under the plan must be comparable to basic benefits the employee would have accrued under Social Security.

Defined Contribution Plans:

- Allocation of at least 7.5 percent of the employee's compensation is made to their accounts.
- Contributions from employee and employer taken into account for above test.
- All contributions for part-time and seasonal employees must be non-forfeitable.

Other exceptions include election workers earning less than \$1,200 per year.

Q. Do deferred compensation plans count as pension plans for this exception?

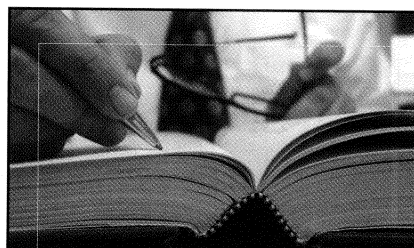
Participation in a 457 deferred compensation plan, as discussed in the December 2009 *Financial Forum*, can qualify under the defined contribution rules, outlined above. Employee and employer contributions (if any) count toward the 7.5 percent threshold.

If the board decides to use this employee contribution approach, it is recommended that mandatory participation be considered to simplify payroll administration, since elective deferrals could result in Social Security contributions in the calendar quarters that participation falls short of the threshold.

Q. If an employee is subject to Social Security taxes, are all of his or her wages or salaries subject to these taxes?

The Medicare portion of Social Security taxes—1.45 percent of an employee's pay, 1.45 percent employer match—is not capped; all covered employees' wages are subject to this tax. The Social Security portion is limited to the first \$106,800 (unchanged from 2009) wages paid in calendar year 2010. This limit is adjusted annually and published in IRS Circular E.

Information provided in Financial Forum should not be considered legal advice, and readers are encouraged to contact their township auditor and/or attorney for advice specific to their situation.



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