



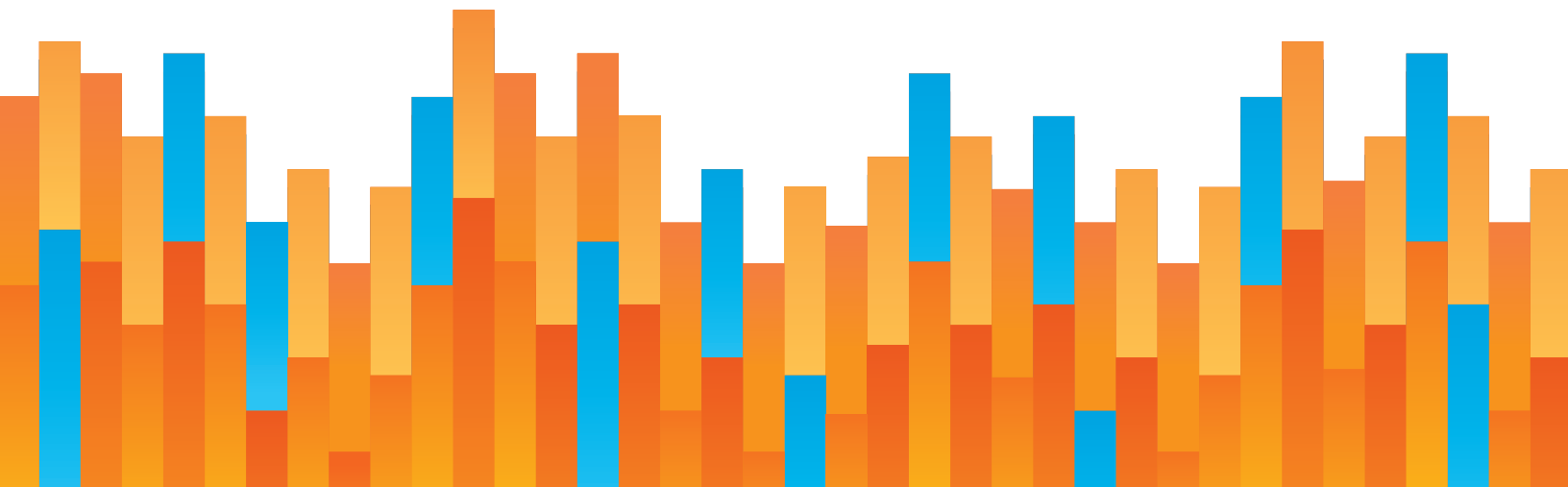
HOW-TO GUIDE

# A LEGISLATIVE TEMPLATE FOR A MODERNIZED PUBLIC SECTOR DEFINED CONTRIBUTION PLAN

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By Reason Foundation's Pension Integrity Project

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## PART 1

# OUTLINE OF THE MODEL DC PLAN

This model legislation is intended to provide a policy-driven framework for state and local governments to create a new (or improve an existing) defined contribution (DC) retirement system for public employees. The legislation uses Retirement Benefit Policy Statements to establish the purpose and objectives of the plan sponsor and as directives to the fiduciary and other entities charged with the ongoing administration of the program. This approach is consistent with modern trust law practices to clearly define the plan sponsor's objectives for the plan and trust as necessary guidance to plan fiduciaries and administrators in their duties. This cutting-edge, next-generation DC system framework is an emerging policy-based plan design that synthesizes the best aspects of the DB pension and DC retirement models.

This model legislation sets the major elements for the retirement plan, including provisions regarding employee eligibility and participation, vesting, contribution amounts, investment structures, benefit forms, recordkeeper structures, and plan governance and administration. The model legislation also requires communicating with and educating plan participants on the plan and the shared responsibility of employers and employees in creating a successful retirement program. It requires participants to be checked periodically to assess whether each participant is on track to meet their retirement needs and objectives and to recommend corrective actions.

Key features include:

- A core IRC Section 401(a) defined contribution platform forms the primary vehicle for the mandatory features of the plan. One or a combination of additional voluntary savings plans (IRC Section 401(k), 403(b), and eligible 457(b) DC plans) can be used to create an integrated system of plans as needed.
- Mandatory participation to eliminate the inherent weaknesses of voluntary-only savings approaches.
- A defined retirement income target:
  - The DC plan starts with a specified retirement income replacement objective defined by the employer (similar to a DB plan, except that there are no employer guarantees of reaching the targeted income level so there is no chance to accrue unfunded pension liabilities of any kind).
- A defined contribution rate:
  - Total employer and employee contributions are defined based on what is determined to be necessary to provide that retirement income objective and are paid into a personal individual retirement account that belongs to the employee.
  - [Note: Matching employer contributions may also be considered but are not a best practice for a core plan intended to provide substantial accruals for a broad class of employees.]
- Short or immediate vesting rules to reduce the risk of benefit forfeiture.
- A professionally managed set of investment offerings:
  - The individual accounts' assets are default invested in professionally managed funds that are designed to create high probabilities of meeting the retirement income objective based on available demographic and financial information for each participant and do not require decisions from the employee.
  - An alternative investment menu of diversified funds allows participants to personally direct their plan investments with plan-provided investment advice and counseling.
- A mobile benefit:
  - Ultimately, the assets in the account are owned by the employee and can be taken with them if they leave employment before completing a full career.

- A default benefit payment structure provides lifetime income benefits through group in-plan annuity products with additional options (lump-sum, periodic payments, etc.) that can be customized by each participant to meet their own individual needs and circumstances.

Part 2 provides model language for enacting this legislation.

## PART 2

# MODEL DC PLAN TEMPLATE

### ***PUBLIC SECTOR RETIREMENT INCOME PLAN ACT***

#### ***Chapter 1. Creation of Retirement Plan and Trust***

**CH. 1 - Sections 1 and 2 below provide language for establishing a new DC plan. An important feature of this model legislation is the explicit statement of the plan's objectives. Clearly stated objectives are often overlooked in establishing retirement plans and are crucial for setting and maintaining the purpose of a plan over multiple generations of policymakers.**

*Section 1. An individual account defined contribution retirement plan is created to provide retirement benefits for eligible employees. The primary objective for the plan is to help eligible employees achieve an adequate and secure income for life in retirement. The plan provides opportunities and services for eligible employees to customize the investments and benefit forms to meet their personal needs and objectives.*

*Section 2. A trust is created for the investment of plan assets. The trust shall be held, invested, and administered by the board acting as trustee and fiduciary in accordance with the terms of the plan under this chapter and applicable law solely in the interest of plan participants and their beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. Except as provided*

*in chapter 2, section 9, no assets of the plan shall inure to the benefit of any participating employer.*

## **Chapter 2. [Name of Plan] Defined Contribution Plan**

**CH. 2 - Section 1 sets definitions for the rest of the bill. These are all standard definitions found in retirement plan laws.**

### *Section 1. Definitions*

*In this article, unless the context otherwise requires:*

- A. “Beneficiary” means the recipient designated by the participant to receive the plan benefits payable upon the death of the participant.*
- B. “Board” means the board of trustees of the [Plan Name] established by this chapter.*
- C. “Code” means the federal Internal Revenue Code of 1986, as amended.*
- D. “Compensation” means [insert desired definition or appropriate cross reference to related statute definition].*
- E. “Defined contribution retirement plan” means the [Plan Name] defined contribution retirement plan established pursuant to this chapter.*
- F. “Employee” means [insert desired definition or appropriate cross-reference to related statutory definition that contains provisions relating to eligible classes of employees and exclusions based on minimum age or service requirements or part-time, full-time, or temporary status.]*
- G. “Employer” means [insert desired definition or appropriate cross-reference to related statutory definition].*
- H. “Individual account” means an account that is established for each participant to record the deposit of participant contributions, employer contributions and interest, dividends or other accumulations credited on behalf of the participant.*
- I. “Participant” means an employee participating in the plan under section 3 of this chapter.*



**CH. 2 - Section 2 below does four things:**

- 1. Establishes a board of trustees to manage the DC plan**
- 2. Sets their responsibility in providing flexible and retirement security-minded investment options, as well as the process for contracting with investment management companies to provide these products**
- 3. Sets reporting standards for transparency with lawmakers**
- 4. Specifies that the DC benefits should be held in 401(a) accounts**
  - Using the 401(a) classification is the optimal policy because it allows employers to require employee contributions. While the proposed DC plan focuses on flexible retirement savings, consistent employee contributions are essential to achieving retirement security goals. Allowing employees to under-contribute to their retirement plan carries significant long-term individual and societal costs.**

*Section 2: Board of trustees; powers and duties of the board; investments, administration*

- A. *[Insert provisions identifying or creating the fiduciary body charged with governance and administration of the plan. This could be a new board of trustees or an existing board (e.g., an existing pension board). The board shall administer the defined contribution retirement plan established under this chapter.]*
- B. *The plan shall be a qualified governmental plan under section 401(a) of the Code and be exempt from taxation under section 501 of the Internal Revenue Code.*
- C. *The board shall provide participants with individualized ongoing investment and retirement income planning services, including education and plan-based tools and independent investment advice to help set, measure, and adjust personal retirement income and savings goals as appropriate during their working years to help the participant meet their financial objectives in retirement and changing circumstances.*
- D. *The board shall create an operating plan document consistent with this chapter and may adopt any additional provision to the plan necessary and appropriate for its operation and purpose. The board may submit to the Internal Revenue Service a request for a determination letter or other rulings that the plan and its features are qualified under section 401(a) of the Code.*
- E. *The board shall:*
  1. *Enter into a contract with a company or companies to provide and administer retirement plan investments, retirement lifetime income products and in-plan annuity products, plan administrative services and participant-level education,*

*advice, communication and retirement planning services supporting individualized lifetime retirement income objectives for participants.*

2. *Provide appropriate long-term retirement-oriented investment that can satisfy two distinct goals: management of future retirement income risk (including investment risk and longevity risk) and portfolios that strive to reduce volatility of participant account balances as they grow closer to retirement.*
3. *Consider all the following when determining a company or companies with which to contract:*
  - a. *The financial stability of the company and the ability of the company to provide the contracted rights and benefits to the participants.*
  - b. *The cost of the investments offered, plan administration, and services to the participants.*
  - c. *The quality of the investment design or designs provided to achieve the specified replacement income using targeted retirement income principles.*
  - d. *The experience of the company and its ability to record keep and administer retirement income-focused plans like the plan created under this chapter.*
  - e. *The experience of the company in providing lifetime retirement income to plan participants.*
  - f. *The experience of the company in providing plan education, retirement planning, counseling, and independent advice to plan participants with varying sources and levels of retirement income.*
4. *Require under the contract that the provider provide education, retirement savings planning, counseling, and objective participant-specific plan investment advice to participants.*
5. *Provide participants with a menu of in-plan immediate or deferred lifetime annuity options, either fixed or variable or a combination of both. Annuity options may include both nominal and inflation-protected options. Qualified longevity annuity contracts under the Code shall be provided to allow participants another option for managing longevity risk.*

*F. The board may:*

- 1. Employ other services it deems necessary, including legal services, for the operation and administration of the defined contribution retirement plan.*
- 2. Perform all acts, whether or not expressly authorized, that it deems necessary and proper for the operation and protection of the plan.*

*G. The board shall adopt policies regarding the defined contribution retirement plan, including the administration of the participant and employer contributions, investment options, termination of participation in the defined contribution retirement plan, administration of the payout options under the defined contribution retirement plan, and administration of the participant distributions.*

*H. The board shall participate in a competitive bid process at least once every five years to contract with a private person or any qualified company or companies to administer the defined contribution retirement plan established pursuant to this article.*

*I. Any contract for a third party administrator of the defined contribution retirement plan shall include competitive fees and provisions requiring quarterly meetings with the system, annual updates to the board on the status of the defined contribution retirement plan, and quarterly statements to each participant.*

*J. On or before [DATE FOR STATE'S PRE-EXISTING PLAN REPORTING] of each year, the board shall report the status of the defined contribution plan to the governor, the president of the senate, the speaker of the house of representatives and [ADD ADDITIONAL STANDING LEGISLATIVE COMMITTEES AS DESIRED]. The report shall include a summary of demographic data and cumulative account balances for participants in the plan, as well as summary statements as to the progress of the participants for achieving the plan's retirement income replacement objectives.*

**CH. 2 - Section 3 establishes that all future employees will be enrolled in the DC plan, and that existing members in a DB plan will have the opportunity to take part in the new DC plan. Language can be adjusted to make the DC plan an option in addition to a DB plan, or to make the DC plan the default option for new hires.**

### *Section 3. Eligibility and participation in the plan*

- A. *An employee with employment beginning on or after [Date] shall be a participant in the plan effective with the beginning of the month following employment date. [Add alternative language as needed for plan sponsor's desired entry dates.]*
- B. *[Add additional eligibility and participation provisions for other groups of employees—e.g., current employees in an existing DB pension or another DC plan that may elect participation in this plan for future service and transfers of assets from those plans to this plan.]*

**CH. 2 - Section 4 sets the rules for both employee and employer contributions in the new DC plan.**

### *Section 4. Participant and employer contributions; employer pick-up arrangements*

*[Note: Total employer and employee contributions should be at least 12%-16% of compensation for non-safety employees. The total contribution for public safety should be 18%-25%. The proportionate share is at the discretion of lawmakers but a 50%/50% share is recommended.] Contributions must be at the higher end of the ranges, or above, if the employer does not participate in Social Security.]*

- A. *Each participant in the plan shall contribute [x] percent of the participant's compensation by salary reduction that shall be deposited in the participant's individual account.*
- B. *[OPTIONAL PROVISION] A participant may make a one-time irrevocable election, before the participant is eligible to participate in any qualified plan of the employer, to contribute more than the percentage subsection A, up to the amount allowable under Section 415(c) of the Internal Revenue Code, which shall be the participant's contribution rate for the remainder of the participant's employment with any employer.*
- C. *Although designated as employee contributions, all participant contributions made to the plan shall be paid by the employer as permitted under Section 414(h) of the Internal Revenue Code. The contributions picked up by an employer may be made through either a reduction in the participant's compensation or an offset against future salary increases. A participant in the plan may not choose to receive the contributed amounts directly instead of the employer paying the amounts to the plan. All participant contributions that are paid by the employer as provided in this subsection shall be treated as employer contributions under 414(h) of the Internal Revenue Code, shall be excluded from the participant's gross income for federal and state income tax purposes, and are includable*

*in the gross income of the participant or the participant's beneficiaries only in the taxable year in which they are distributed.*

- D. Each employer shall annually contribute an amount equal to [x] percent of each participant's compensation.*
- E. The employer share of the amount paid in [SUBSECTION D] of this section shall be paid on each date that a participant contribution is made and shall be credited to the participant's individual account.*
- F. A participant may not take loans on any portion of the accumulated assets in the participant's individual account.*
- G. [Optional Provision: Participants may make after-tax voluntary contributions in accordance with requirements set by the board.]*

**CH. 2 - Section 5 sets the vesting rules for the new DC plan. The legislation encourages a vesting period no longer than three years, which ensures the plan is providing adequate retirement savings for most public workers.**

#### *Section 5. Vesting*

- A. A participant's contributions and earnings on those contributions are immediately vested and nonforfeitable. A participant is fully vested in the employer contributions and related earnings in the plan after [NO MORE THAN 3] years of participating employment or reaching age 65 [or other normal retirement age definition]. [Immediate or short vesting schedules are a best practice, but other cliff or graded vesting provisions may be adopted if needed.]*
- B. The plan will disregard all periods of participation and service of a non-vested participant who leaves eligible employment and takes a total distribution of the participant's accounts. If the former participant returns to eligible employment, the participant will be treated as a new employee under the plan.*

**CH. 2 - Section 6 establishes the investment choices that shall be made available to DC participants. The legislation requires multiple flexible options to meet a variety of needs and situations, with a default that is in line with the average best practices based on age.**

*Section 6. Direction of Investments*

- A. A participant shall direct the investment of their individual account to one or more investment choices provided by the board.*
- B. The board shall provide a standard investment menu of investment choices for participants, including:*
  - 1. A set of predetermined investment portfolio options designed to reflect different risk profiles that automatically reallocate and rebalance contributions as a participant ages and constructed to help create high probabilities of achieving the retirement income objectives of the plan. The standard options under this provision shall be the default investments for individual accounts unless the participant chooses alternative investments under the plan. The standard investment portfolios shall be constructed to adjust the investment allocation on an individual basis over an individual's career with the intent to accumulate assets at retirement sufficient, in combination with federal social security benefits, to provide the retirement income objectives of each participant. The standard investment portfolios shall be constructed to allow participants to include other assets and retirement plan benefits outside of the plan in determining their investments under the plan. While the level of retirement income may be targeted, it is in no way an obligation of the plan, the employer, the board, or the state, nor is there any expressed or implied guarantee of a certain outcome.*

*[Note: The model legislation does not prescribe a particular way for the board to build the automatic default option. It could be a target date, or LDI or some other approach that may change based on changing products and investment environments.]*
  - 2. A set of diversified investment options allowing the participant to construct an alternative investment portfolio.*

**CH. 2 - Section 7 establishes rules for benefit distribution and the types of distribution options that will be available to retirees.**

*Section 7. Plan distributions; standard lifetime annuity form of benefits; alternative forms of distribution*

- A. *A participant may receive distribution of vested benefits from their individual account in the plan after:*
  - 1. *Attainment of age 65,*
  - 2. *Separation of all eligible employment under this chapter.*
- B. *The standard form of distribution shall be a lifetime annuity made available by the board based on the value of the individual account of a participant. The standard lifetime annuity shall be paid as a 50% joint and survivor annuity if the participant has a spouse unless the spouse waives this form in a manner established by the board.*
- C. *A participant may elect one or a combination of the following alternative distribution forms:*
  - 1. *A lifetime annuity based on a portion of their individual account,*
  - 2. *Lump-sum amounts,*
  - 3. *Periodic distributions, as authorized by the board,*
  - 4. *Deferred distributions until otherwise required by federal law.*
- D. *If the participant dies before receiving the entire value of the individual account, it shall be paid to the surviving spouse or an alternative beneficiary designated by the participant or under applicable law in a form allowed under this section.*

**CH. 2 – Sections 8 and 9 offer optional language to include existing disability and health benefits to the core DC benefit.**

*Section 8. Disability benefits [OPTIONAL PROVISION: Modify as needed to define the disability benefit and funding sources to be provided].*

- A. *Each participant and each employer shall contribute to the [NAME] disability program established under [citation].*

*Section 9. Retiree health benefits [OPTIONAL PROVISION: Modify as needed to define the retiree health benefit and funding sources to be provided].*

- A. *Each participant and each employer shall contribute to the [NAME] Retiree health program established by under [citation].*

**CH. 2 – Section 10 is the termination clause.***Section 10. Amendment and termination of plan*

*The plan may be amended or terminated by appropriate legislation at any time without obtaining the approval or consent of any employer which has adopted this plan and trust provided that no amendment shall authorize or permit any part of the corpus or income of the plan to be used for or diverted to purposes other than for the exclusive benefit of participants and their beneficiaries. No amendment to the plan shall be effective to the extent that it has the effect of decreasing a participant's accrued benefit.*



## PART 3

# FREQUENTLY ASKED QUESTIONS

### #1 Why is a 401(a) type plan recommended vs a 401(k), 403(b), or 457(b) as a vehicle for a defined contribution primary retirement plan?

The primary advantage of a 401(a) plan is that it is uniformly available for all public employers and not subject to certain limitations that may apply to other potential IRC plan types.

- a) Not all public employers are eligible to offer a 401(k) plan. Only plans established before May 1986 are permitted. Generally, after that date, state and local governments are prohibited from establishing new 401(k) plans. A grandfathered 401(k) plan is a type of 401(a) plan and could be used as the vehicle for the primary retirement plan.
- b) 401(a) plans may use IRC Section 414(h)(2) employer pick-up arrangements, which allow mandatory employee contributions to be made on a pre-tax basis.
- c) 403(b) plans may be offered by education-related public sector entities but not by other entities (e.g., states, cities, counties, special districts) and have limitations on allowed investment vehicles (i.e., collective investment trusts are not permitted).
- d) 457(b) plans are a type of non-qualified deferred compensation plan best used as a vehicle for voluntary employee retirement savings. Also, employer contributions count against the annual contribution limits that employees could otherwise make.

## #2 How is adequate and secure income for life in retirement defined and determined?

Benefit adequacy can be defined in several ways, but it is typically expressed through an “income replacement rate,” which represents the percentage of a person’s final income that is replaced for their lifetime, indexed for 3% inflation, once they begin drawing regular retirement income. It is generally a good practice to target a replacement rate between 70% and 90%, and when it comes to DC plans, which means total contributions (employee and employer combined) at around 12% to 15%. If a public employee is not participating in Social Security, that rate should be higher (18% to 25%).

## #3 Can we determine an adequate contribution rate with the target replacement rate in mind?

DC contribution rates should not be set arbitrarily. Policymakers should set these rates with a goal (namely, a target adequate replacement rate) in mind. The table below demonstrates how policymakers can evaluate the necessary DC contribution rate using a hypothetical employee with an ending salary of \$75,000 who is participating in Social Security:

Income Replacement Target	80%
Social Security Replacement	32%
Net target income replacement for DC	48%
DC savings required at age 67 to achieve 48% replacement	\$760,065
Fixed contribution rate (combined employer/employee) to accrue \$760k through a full career	13.7%

## #4 Will members have access to a self-directed brokerage account?

This model legislation does not specifically include this option. Self-directed accounts can be made available by legislators and administrators, but certain consequences should be considered. When it comes to a core retirement benefit, it is advised to keep investment decisions in line with industry best practices and to avoid high-risk/high-reward strategies. Some individuals have the experience and capabilities to pull this off with a self-directed

brokerage account, but most public workers do not. It is more common to see this option offered with a supplementary (not a primary) retirement plan.

### **#5 What is a Liability-Driven Investment?**

Liability-Driven Investment (LDI) is an investment strategy that focuses on making sure a retirement plan has enough assets to cover its future promises (its liabilities). Generally, it ensures that an account has enough to cover a liability at the expense of any upside potential (the possibility of earning more than needed). Since the liability of a DC plan falls to the employee, the principles of LDI are being adapted and applied to help individuals manage their own personal retirement liability. It addresses the individual's personal need for a sustainable income stream throughout their retirement.

### **#6 How are people educated about the pros and cons of various distributions?**

Plan administrators typically set up a consultation when an employee is nearing retirement, in which various options are presented. This gives employees the opportunity to evaluate the regular benefits and the strategies for managing various retirement risks. Administrators also publish educational materials and provide consultation throughout a worker's career. Currently, third-party recordkeepers and service providers have well-developed consultation services and tools that can allow this customization of distributions to fit the needs of all employees.

### **#7 Can a distribution include a pop-up feature?**

A "pop-up" provision—the ability to adjust one's benefit if their spouse dies—is not specifically included in this model legislation, but can be made available by seeking this feature from their annuity provider.

### **#8 Can employees take out loans?**

Loan features are not recommended because they mitigate against the preservation of primary plan assets for retirement. Another characteristic of a 401(a) plan is that members cannot borrow against their retirement savings. Again, this level of flexibility is more appropriately applied to a supplemental plan, rather than a primary retirement benefit.

### **#9 How do lawmakers facilitate the cooperation of a plan's board?**

Legislators are the stewards of a public retirement plan, and it is legislators who will ultimately face the consequences if a plan becomes underfunded or fails in any way. It is essential to communicate the aims of this model policy to the plan's board and administrators, who will implement the reform. The best approach to this is to use hard numbers and the experiences gathered from reforms in other states.

The Model DC Plan outlines specific benefit policies and objectives for fiduciaries and administrators managing the plan, helping ensure they implement the legislative directives effectively. They are bound by law and fiduciary duty to implement the plan as designed.

### **#10 How do lawmakers ensure previous and active member benefits are fully financed?**

A common misconception associated with switching from a DB to a DC plan is that it will cut off the necessary funding for DB benefits. This idea stems from hefty pension debt (amortization) payments, which will remain despite cutting off the inflow of new members. The truth is that these debt payments exist regardless of whether new members enter into a plan, and changing the type of plan will not alter this fixed cost in any way. In fact, having new members go into a DC plan prevents the accrual of debts associated with new members. The way this has been handled by all states making the switch from DB to DC is by calculating the amortization payment based on all members combined (DB and DC).

# ABOUT THE AUTHOR

The **Pension Integrity Project** at Reason Foundation offers pro-bono consulting to public officials and other stakeholders to help them design and implement policy solutions aimed at improving plan resiliency and promoting retirement security for public employees.

## What We Do for Policymakers and Pension Plan Stakeholders:

- Customized analysis of pension system design, trends, and fiscal trajectory
- Independent actuarial modeling to weigh the impact of policy scenarios
- Assistance with stakeholder outreach, engagement and relationship management
- Design and execution of public education programs and media campaigns
- In-depth case studies on jurisdictions that have adopted reforms, highlighting key lessons learned
- Peer-to-peer mentoring from state and local officials who have successfully enacted reforms

### Why We Do It:

We believe that public sector retirement systems should work for all public employees and taxpayers. Affordable retirement plans with transparent and accountable management are necessary to support all aspects of good governance generally. States, cities, and counties will increasingly struggle to provide public services unless they are able to adopt financially sustainable retirement benefits.

### Policy Objectives:

- **Keeping Promises:** Ensure the ability to pay 100% of the benefits earned and accrued by active workers and retirees
- **Retirement Security:** Provide retirement security for all current and future employees
- **Predictability:** Stabilize contribution rates for the long term
- **Risk Reduction:** Reduce pension system exposure to financial risk and market volatility
- **Affordability:** Reduce long-term costs for employers/taxpayers and employees
- **Attractive Benefits:** Ensure the ability to recruit 21<sup>st</sup> century employees
- **Good Governance:** Adopt best practices for board organization, investment management, and financial reporting.

