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Basic Elements of the Plan Design Process

by Richard L. Sorrell

When design specialists speak to sponsors about advanced plan design, they typically focus on achieving the desired benefit levels for owners, highly compensated employees and/or perhaps certain non-highly compensated employees (targeted groups) without a substantive increase in the cost of benefits for the non-targeted group. The challenging question: For every dollar of benefit achieved for the targeted group(s), what will it cost for the non-targeted group? The lower that figure, the better. We refer to this concept as “design efficiency.”

It is wise to prepare a simple and abbreviated after-tax analysis to reflect the tax benefits associated with a design or redesign. If you can be successful in delivering the target group 80% or more of total plan benefits, consider the plan an efficient design. The target companies for such specialized design are frequently “micro-market” employers with fewer than 100 employees.

In starting a plan design study, always begin with the basics of “how much?” How much does the sponsor want to commit to the targeted group(s) and how much is the sponsor willing to commit to the non-targeted group to achieve the goals? Sometimes the answers are just vague notions in the mind of the sponsor; other times the sponsor might be very specific. Either way, having a sense of the sponsor’s goals is an important first step in advanced plan design studies.

Helping the Employer to Determine “How Much?”

The fundamental issue in any type of design is always budgetary in nature. An employer sponsored plan is an extension of the overall compensation package—a fully funded, ERISA protected, deferred wage benefit. One simple approach that sponsors can readily relate to is to determine an estimated percentage of gross payroll



that might be allocated to the retirement plan. Beginning with what the employer is currently spending is a great conversation starter. Getting the answer to the question of “how much can you spend?” is essential to creating an effective design that the employer can live with.

Targeted Employees

Once the budget amount is determined, the next area of focus is to determine the targeted beneficiaries. In general, this group (or groups) nearly always includes the business owner, but it is not unusual for the sponsor to have a

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handful of other highly compensated employees and non-highly compensated employees to target.

Once both the targeted group(s) and targeted budget are established, the work of designing a plan to achieve the sponsor's objectives may begin.

Tolerance for Complexity

"The simplest solution is the best solution." This statement suggests that you should determine the least complex method of achieving the sponsor's savings goals. As the plan design evolves and is presented to the sponsor for approval, it is very important that the client's tolerance for complexity be considered. With a successful plan design the "numbers sell themselves," but there are always technical intricacies associated with sophisticated plan design. More often than not, the average sponsor will have no interest in the details. It is at this point that sponsors need to be "warned." What might work very well this year with existing demographics could change next year. Will the employer be amicable to major design changes (*i.e.*, more expensive) if key demographic elements change, making a well structured, but complex design no longer feasible? Forewarned is forearmed and providing the sponsor a "one page" overview of cautionary issues prior to implementation may go a long way to soothing an unhappy sponsor if things change.

IRS Limits

In creating a tax shelter for targeted employees, IRS maximum contribution limits are a key consideration of plan design. Under Section 415, the individual contribution limit in a defined contribution plan is the lesser of 100% of wages or \$49,000 in 2009; if we consider 401(k) catch-up contributions, that limit goes to \$54,500. To achieve this level of benefit, two sources of funding are involved—employee contributions and employer contributions. Sticking with the mantra of "the simplest solution is the best solution," if these limits can satisfy the sponsor's need as a targeted savings amount, the solution will be a defined contribution solution. It is not uncommon, however, for very high income business owners to see these amounts as "less than adequate" from what they had hoped for, in which case a defined benefit solution should be considered. For this article we will assume a defined contribution solution is adequate to meet the defined goals.

Employee Contributions

Section 401(k) contributions are funded directly through voluntary individual payroll deductions.

Tax benefits are achieved through a reduced earned income. 401(k) contributions are exempt from state and federal tax, but are subject to FICA taxes and other types of payroll taxes. Nonetheless, Section 401(k) permits a fairly generous personal deferral of \$16,500 in 2009; add a catch-up contribution of \$5,500 and that amount goes to \$22,000. This design can be an extremely inexpensive benefit since it does not require any employer paid contributions to the employee – very efficient. 401(k) plans are, however, subject to rigid discrimination testing and in most cases it is very difficult for the small business owner to achieve the maximum benefit without running afoul of the antidiscrimination rules governing these contributions, even when considering the current maximum wage limits established by the IRS (\$245,000 for 2009) used in testing.

Employer Contributions

Assuming the discrimination issues governing 401(k) contributions can be surmounted, employer contributions permitted under IRC Section 404(a) will make up the remaining portion of contributions to achieve Section 415 maximums. Employer contributions are also subject to very rigid antidiscrimination rules, but assuming we can satisfy the discrimination requirements, the employer can contribute an additional \$32,500 for an individual to achieve the maximum contribution permitted, \$49,000 (\$54,500 with catch-up contributions).

Discrimination Rules and Testing

Stated succinctly, retirement plan benefits and contributions must be provided to all participants in a manner that does not discriminate in favor of highly compensated employees. Highly compensated employees are generally defined as greater than 5% owners and employees earning in excess of \$105,000 in 2008 or \$110,000 in 2009. Discrimination rules apply to all sources of funds—employer or employee. Passing rigid testing requirements poses hurdles that must be overcome to achieve targeted objectives at the lowest possible cost in terms of benefits paid to non-targeted employees.

Section 401(k) requires that the average deferral rate of highly compensated employees as a group not exceed the average deferral rate of non-highly compensated employees by 125%. Violating this rule requires the return of excess deferrals to highly compensated employees. This rule is relaxed if the average deferral rate for non-highly compensated employees is less than 8%, at which point a 2% differential is permitted.

The IRS provides a mechanism for avoiding this test if an employer makes a “safe harbor” contribution to all eligible employees. This contribution may be a direct employer contribution in the form of a safe harbor nonelective contribution of 3% of eligible wages. An alternative safe harbor matching contribution may also be made. In advanced plan design the 3% nonelective contribution provides the greatest leverage and efficiency for achieving maximum benefits for highly compensated employees. The employer’s commitment to a safe harbor 401(k) contribution will guarantee that highly compensated employees may defer the maximum and avoid 401(k) discrimination testing. In the majority of our advanced plan designs, both defined contribution and defined benefit, a safe harbor 401(k) plan with a discretionary “cross-tested” profit sharing component forms the foundation of the plan design.

Employer profit sharing contributions are also subject to discrimination testing. As with 401(k) contributions, the employer may avoid this testing using a safe harbor contribution method of allocating contributions. In its most basic form, the IRS rules state that if all employees receive the same percentage of salary as a contribution, the plan will be deemed nondiscriminatory. A variation on this approach is referred to as “permitted disparity” which permits benefits associated with Social Security payments to be considered. These methods are by far the most common methods used in allocating profit sharing contributions; however, they can be very inefficient and are never used in an advanced defined contribution design scenario.

Cross-testing Defined Contribution Benefits

If an employer is willing to forgo the safe harbor method and adopt a more complex method for testing employer contributions, under the right circumstances a much more efficient design may be developed. This testing is outlined in Section 401(a)(4). Under this code section, the employer is permitted to test hypothetical projected monthly retirement benefits that may be derived from a defined contribution instead of testing the contribution itself.

Simply stated, if the equivalent benefits at retirement (EBAR) derived from the profit sharing contribution are nondiscriminatory, the defined contribution is deemed nondiscriminatory regardless of the amount or percentage of the contribution allocated to each employee. The

ILLUSTRATIONS

Safe Harbor 401(k) with Cross-tested Profit Sharing Plan

NAME	AGE	COMP.	401(k)	SH 3%	PS	TOTAL
Owner 1	50	\$ 245,000	\$ 22,000	\$ 7,350	\$ 25,150	\$ 54,500
NHCE 1	55	\$ 50,000		\$ 1,500	\$ 713	\$ 2,213
NHCE 2	50	50,000		1,500	713	2,213
NHCE 3	45	40,000		1,200	570	1,770
NHCE 4	45	40,000		1,200	570	1,770
NHCE 5	40	40,000		1,200	570	1,770
NHCE 6	35	35,000		1,050	499	1,549
NHCE 7	30	35,000		1,050	499	1,549
NHCE 8	25	30,000		900	428	1,328
NHCE 9	25	25,000		750	356	1,106
NHCE 10	20	20,000		600	285	885
HCE TOTALS		\$245,000	\$ 22,000	\$ 7,350	\$ 25,150	\$ 54,500 (77%)
NHCE TOTALS		365,000	—	10,950	5,201	18,151
PLAN TOTALS		610,000	22,000	18,300	30,351	70,651

ILLUSTRATIONS

Safe Harbor 401(k) with a Traditional Integrated Profit Sharing Formula

NAME	COMP.	401(k)	COMPANY		TOTAL
			SH 3%	PS	
Owner 1	\$ 245,000	\$ 22,000	\$ 7,350	\$ 25,150	\$ 54,500
NHCE 1	\$ 50,000		\$ 1,500	\$ 3,374	\$ 4,941
NHCE 2	50,000		1,500	3,374	4,941
NHCE 3	40,000		1,200	2,699	3,952
NHCE 4	40,000		1,200	2,699	3,952
NHCE 5	40,000		1,200	2,699	3,952
NHCE 6	35,000		1,050	2,362	3,458
NHCE 7	35,000		1,050	2,362	3,458
NHCE 8	30,000		900	2,025	2,964
NHCE 9	25,000		750	1,687	2,470
NHCE 10	20,000		600	1,350	1,976
HCE TOTALS	\$ 245,000	\$ 22,000	\$ 7,350	\$ 25,150	\$ 54,500 (61%)
NHCE TOTALS	365,000	—	10,950	24,632	35,582
PLAN TOTALS	610,000	22,000	18,300	49,782	90,082

testing mirrors the testing of a traditional defined benefit plan; hence the term “cross testing” because the defined contributions are tested in a manner similar to a defined benefit plan. The testing process itself is a complex actuarial calculation where the contribution is projected to grow at a specified rate of interest (typically 8%) to retirement (age 65) and then converted to a hypothetical monthly benefit to be paid over the expected lifetime of the participant. By testing in this manner, a younger employee who has a long time until retirement will typically have a much greater equivalent benefit at retirement than an older employee for each contribution dollar expended due to the compounding of interest.

This method of testing in a defined contribution plan can be quite effective and dramatic especially where age differences are substantive. In order to place a cap on benefits that can be derived from this testing method, the IRS initiated rules for its application—the most important of which is the “gateway” requirement. This requirement states that in a cross-tested plan the defined contribution paid to highly compensated employees as a percentage of wages cannot exceed three times that of non-highly compensated employees. This requirement further states that if the employer is willing to commit at least a 5% defined contribution benefit to non-highly compensated employees, the “three times” rule is relaxed. Meeting the gateway requirement does not automatically guarantee passage of 401(a)(4); it merely permits the employer to test the plan in this manner.

Combining a Safe Harbor 401(k) Contribution and Cross-testing

By committing to a basic 3% 401(k) safe harbor nonelective contribution, the employer assures highly compensated employees can defer the full 401(k) contribution. By also adopting cross-testing rules, another advantage can be gleaned from this contribution. The 3% contribution can be “leveraged” in a cross-tested scenario so that targeted employees receive not only the maximum 401(k) deferrals and the 3% safe harbor contribution, but may also receive an additional 6% discretionary profit sharing contribution without having to commit any additional dollars for non-targeted employees. In other words, under the gateway rules a 3% contribution for non-targeted employees (*i.e.*, the safe harbor contribution) can permit a total 9% contribution for targeted employees (a 3:1 ratio). The full 9% must be cross-tested, but assuming favorable age demographics,

this test will be passed. Contrast this design with a traditional safe harbor profit sharing allocation where all employees must receive the same percent of wage allocation. Further, if the employer is willing to commit an additional 2% of wages to a discretionary profit sharing contribution for non-highly compensated employees (for a total contribution of 5%), the employer no longer needs to be concerned about the 3:1 test and the only concern will be in passing Section 401(a)(4). It is through this testing mechanism that the targeted employees can achieve the maximum contributions permitted by law.

It is important to note that the rules do not permit the employer to use any matching contributions in cross-testing benefits; hence, a safe harbor matching contribution is seldom ever used in advanced plan designs.

Utilizing Rate Groups

Where there are multiple highly compensated employees, some of which are to be targeted and others not, then a very sophisticated testing technique may be used. The technique permits the sponsor to create “rate groups.” The easiest way to describe this technique is to imagine the plan as several “mini-plans” for testing purposes. Each mini-plan must contain at least one highly compensated employee and a group of non-highly compensated employees. The selection of non-highly compensated employees is not an arbitrary choice but is determined by the projected benefits at retirement. By using the rate group methodology, it may be possible to develop different levels of benefits for individual members of the highly compensated group and for the non-highly compensated group. As long as targeted employees pass discrimination testing within their rate groups, no further testing or contribution adjustments will be required. Using rate groups is extremely complex because each group and their given level of benefits must be actuarially tested. This method will allow employers to target both highly and non-highly compensated employees under different benefit structures. This design technique is effective when there are several highly compensated employees with a wide range of ages. In many cases, by relaxing eligibility requirements, groups of employees who might have otherwise been excluded from plan participation (especially younger employees) are invited into the plan to help testing results. It may also be necessary to reduce the benefits of one or more highly compensated employees to achieve the results desired for the target employee.

It is not uncommon with a small plan sponsor that only one or two young non-highly compensated employees permit the plan to pass discrimination tests. Warning employers about such narrow “passing results” is very important. While we never recommend that employers hire new employees with this concept in mind, it is good for them to be aware of the positive and negative impacts new employees can have on their plan design.

Beyond Cross-tested Profit Sharing Design

The Section 415 contribution threshold is a typical goal in an advanced defined contribution design, but what about those sponsors who want something more? A defined benefit solution can offer targeted employees a much greater contribution than permitted under a defined contribution plan. The level of sophistication for these designs is at another level of magnitude, requiring actuarial certification and sometimes individually designed plan documents. However, for those employers who want to shelter substantial dollars, this design alternative must be considered. These plans often combine a basic safe harbor 401(k) profit sharing plan with a cash balance defined benefit plan.

Closing Comments

The majority of 401(k) profit sharing plans are of the traditional type. Most employers have not been exposed to advanced planning ideas. Custom plan design provides a great opportunity to pension advisors to add value to their relationships with plan sponsors. Even for larger plans, where the primary interest may not be the owner or shareholder employees, cross-testing and rate group testing can be used to reward specially targeted groups who are key to the organization’s success. Although creative strategies may not always be the direction a sponsor chooses, making a sponsor aware of design alternatives should be part of every pension advisor’s best business practices. ↗



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