# Innovative Plan Designs With 401(k) and Cash Balance Plans

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- Topics
  - Basics of 401(k) Plans
  - Advanced 401(k) Plan Design
  - Basics of Cash Balance Plans
  - Advanced Cash Balance Plan Design

# Basics of 401(k) Plans

# Basics of 401(k) Plans

- Referred to as a Defined Contribution Plan ("DC Plan").
- Contributions are split into three general categories:

1. Employee salary deferrals – Pre-tax or Roth
    - Deferral from Plan eligible wages (e.g., W-2 wages) or Earned Income for Sole Props/Partners
    - Must be from services rendered: passive and S-corp distributions are not eligible
2. Employer Matching contributions
    - Match is determined as a % or $ of Employee salary deferral
    - If Employee does not contribute then they do not receive a match
3. Employer Nonelective / Profit Sharing
    - Not dependent on level of Employee salary deferrals (i.e., if meet conditions then receive it).
    - Usually a % of pay, but could be a $ amount

# Basics of 401(k) Plans

- Contribution Limits are imposed at time of contribution – account balance can grow to an unlimited amount.  Two types of contribution limits:
  1. Employee salary deferrals – 2014 limit is $17,500 if under age of 50 or $23,000 if over the age of 50 (“catch-up contributions”).
  2. Total Contributions (Employee + Employer) – 2014 limit is $52,000 (or $57,500 if made catch-up contributions above).

  Limits adjust annually by Cost of Living (incremental changes).

- Employer contributions are tax deductible up to 25% of eligible wages.
  - This is determined at plan level, not individual (i.e., an individual can receive more than 25% of their compensation as long as the total of all contributions is less than 25% of total compensation).

# Basics of 401(k) Plans

- Safe Harbor Contributions (i.e., Safe Harbor 401(k) Plan)
  - Allow HCE's to defer up to IRS limits without possibility of refunds.  Otherwise HCE's salary deferrals are limited by how much the NHCE's defer into the plan.
  - An HCE is anyone who is more than a 5% owner or had compensation in prior year in excess of IRS threshold (for 2014 limit is $115,000).
  - Two types of Safe Harbor Contributions:
    1. Nonelective – generally 3% of wages
    2. Match – two common matching formulas:
       a. Basic: 100% of first 3% deferred + 50% of next 2% deferred
       b. Enhanced:  100% of first 4% deferred
  - Safe Harbor contribution is immediately 100% vested

# Basics of 401(k) Plans - Case Study

Case Study:

- One owner with four employees:

| | Age | Pay | Salary Deferrals |
|---|---|---|---|
| Owner | 60 | $260,000 | $23,000 |
| | | | |
| Employee A | 25 | $30,000 | $100 |
| Employee B | 50 | $50,000 | $2,500 |
| Employee C | 23 | $30,000 | $0 |
| Employee D | 40 | $40,000 | $0 |

# Basics of 401(k) Plans - Case Study #1

Plan Design #1:

- Safe Harbor Match: 100% of first 4% Deferred
- Discretionary Nonelective: Pro-rata (equal % of pay for all)

| | Age | Pay | | Salary Deferrals | Safe Harbor Match | % | Discretionary Nonelective | % | Total [1] |
|---|---|---|---|---|---|---|---|---|---|
| Owner | 60 | $260,000 | | $23,000 | $10,400 | 4% | $24,100 | 9.27% | $57,500 |
| | | | | | | | | | |
| Employee A | 25 | $30,000 | | $500 | $500 | 1.67% | $2,780.77 | 9.27% | $3,280.77 |
| Employee B | 50 | $50,000 | | $2,500 | $2,000 | 4% | $4,634.62 | 9.27% | $6,634.62 |
| Employee C | 23 | $30,000 | | $0 | $0 | 0% | $2,780.77 | 9.27% | $2,780.77 |
| Employee D | 40 | $40,000 | | $0 | $0 | 0% | $3,707.69 | 9.27% | $3,707.69 |
| Total | | | | $3,000 | $2,500 | | $13,903.85 | | $16,403.85 |
| [1] Includes Salary Deferrals and Employer Ctbs for Owner only | | | | | | | Owner % of Benefits[1]: 77.80% | | |

# Basics of 401(k) Plans - Case Study #2

Plan Design #2:

- Safe Harbor Match: 100% of first 4% Deferred
- Discretionary Nonelective: Integrated at $50,000

| | Age | Pay | | Salary Deferrals | Safe Harbor Match | % | Discretionary Nonelective | % | Total [1] |
|---|---|---|---|---|---|---|---|---|---|
| Owner | 60 | $260,000 | | $23,000 | $10,400 | 4% | $24,100 | 9.27% | $57,500 |
| | | | | | | | | | |
| Employee A | 25 | $30,000 | | $500 | $500 | 1.67% | $1,738.85 | 5.8% | $2,238.85 |
| Employee B | 50 | $50,000 | | $2,500 | $2,000 | 4% | $2,898.08 | 5.8% | $4,898.08 |
| Employee C | 23 | $30,000 | | $0 | $0 | 0% | $1,738.85 | 5.8% | $1,738.85 |
| Employee D | 40 | $40,000 | | $0 | $0 | 0% | $2,318.46 | 5.8% | $2,318.46 |
| Total | | | | $3,000 | $2,500 | | $8,694.24 | | $11,194.24 |

[1] Includes Salary Deferrals and Employer Ctbs for Owner only

Owner % of Benefits[1]: 83.7%

# Advanced 401(k) Plan Design

# Advanced 401(k) Plan Design

- Now let's look at an alternative plan design called a "New Comparability" or "Cross-tested" plan design.
  - This plan design creates groups in which different levels of Employer Nonelective/Profit Sharing contributions can be given to each group.
  - Depending on the plan document there can be flexibility in defining the groups each year.
  - Plan is subject to additional compliance tests to ensure the overall benefits given are Non-discriminatory.
  - Plan can still offer additional employer contributions (i.e., Safe Harbor, discretionary match, etc.).
  - Staff costs are generally dependent on relative age difference between owner and staff.  If there is a shift this may result in higher staff contributions.

# Advanced 401(k) Plan Design - Case Study #3

Plan Design #3:

- Safe Harbor Nonelective: 3% of pay
- Discretionary Nonelective: New comparability (i.e., by groups)

| | Age | Pay | | Salary Deferrals | Safe Harbor Nonelective | % | Discretionary Nonelective | % | Total [1] |
|---|---|---|---|---|---|---|---|---|---|
| Owner | 60 | $260,000 | | $23,000 | $7,800 | 3% | $26,700 | 10.27% | $57,500 |
| | | | | | | | | | |
| Employee A | 25 | $30,000 | | $500 | $900 | 3% | $429 | 1.43% | $1,329 |
| Employee B | 50 | $50,000 | | $2,500 | $1,500 | 3% | $715 | 1.43% | $2,215 |
| Employee C | 23 | $30,000 | | $0 | $900 | 3% | $429 | 1.43% | $1,329 |
| Employee D | 40 | $30,000 | | $0 | $1,200 | 3% | $572 | 1.43% | $1,772 |
| Total | | | | $3,000 | $4,500 | | $2,145 | | $6,645 |
| [1] Includes Salary Deferrals and Employer Ctbs for Owner only | | | | | | | Owner % of Benefits[1]: 89.64% | | |

# Advanced 401(k) Plan Design - Case Study #3

## Comparison of Plan Design #3 to Plan Design #2

| | Plan Design #2<br>Integrated | Plan Design #3<br>New Comparability | Difference |
|---|---|---|---|
| Owner Totals | $57,500 | $57,500 | $0 |
| Employee Totals | $11,194 | $6,645 | $4,549 |
| Owner % of Benefits | 83.7% | 89.64% | 5.94% |
| Maximum ER Contrib. | $14,694 | $6,645 | $8,049 |
| (if all employees deferred 4% of wages to get maximum Safe Harbor Match) | | | |
| Minimum ER Contrib. | $8,694 | $6,645 | $2,049 |
| (if all employees deferred 0% of wages; therefore, no Safe Harbor Match) | | | |

# Advanced 401(k) Plan Design

When does New Comparability make sense?  Who are candidates?

- Owner(s) want to maximize or make substantial contributions.
- Owner(s) are older relative to staff.  Note: does not require all employees to be younger – ultimately depends on demographics and number of employees.
- Age difference between owner(s) and staff will be constant (or have minimal change).
- Company would like to benefit different groups at different levels or have flexibility to do so.  I.e., staff does not all have to receive the same contribution level (although a minimum has to be given).  Subject to testing and other considerations.  Also owner(s) don't have to receive the same contribution level (e.g., younger owner does not want to maximize).

# Basics of Cash Balance Plans

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- A Cash Balance Plan is a Defined Benefit Plan (DB Plan).
- There has been a significant increase in Cash Balance Plans – double digit annual growth (20%+) – especially in the small/mid plan markets - 84% of all Cash Balance plans are sponsored by firms with less than 100 employees.
- Each Participant has a hypothetical account balance that increases each year in two ways (both pieces are defined in the plan document):
  - By a contribution credit (equal to a % of pay, flat $ amount, etc.).
  - By an interest credit (e.g., fixed amount - 5%, or equal to a published performance measurement (High-yield Corp Bonds, Treasury rates), etc.)
- Upon distribution participant will receive hypothetical account balance. May have annuity options as well.
- Total of all hypothetical account balances does not necessarily equal total plan assets (DB Plan characteristic).

# Basics of Cash Balance Plans

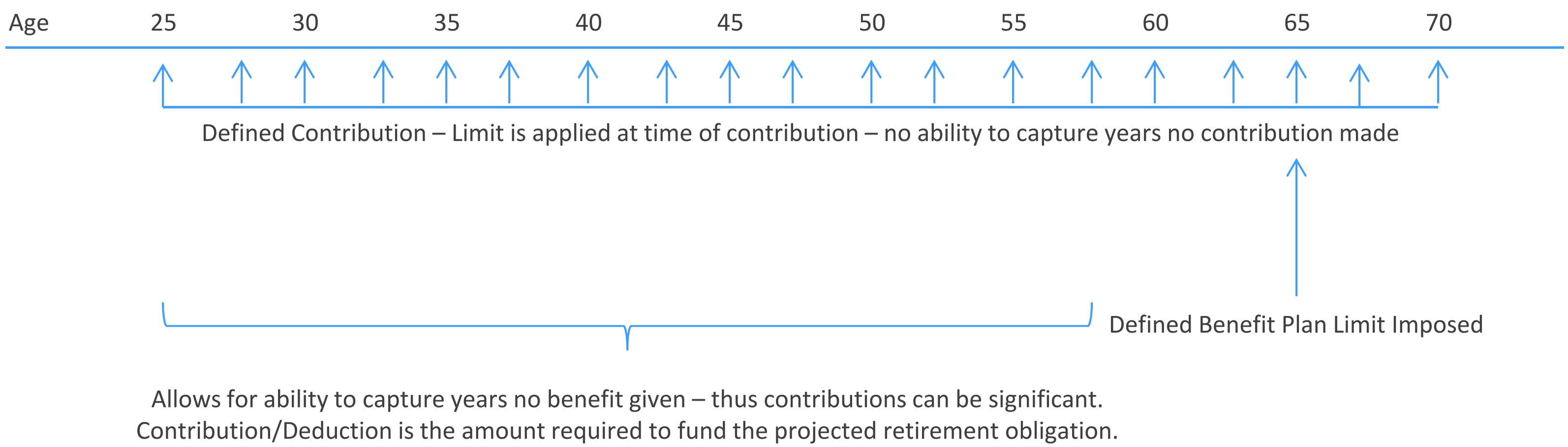
- Employer promises to pay hypothetical account balance or equivalent annuity (i.e., they are guaranteeing stated return – interest credit). They are taking on investment risk.
- A minimum contribution is generally required annually. The contribution is based on the expected benefits that will accrue as well as how well funded the plan currently is (the more underfunded the higher the contribution).
  - Thus, less than expected investment earnings will increase contribution requirement.
  - Also based on various assumptions which may change each year (affecting the expected contributions).
- Implementation requires a "long-term" commitment by the employer.
- Does not offer discretionary or flexible contribution obligations. Also, consideration needs to be made before altering benefit formula.
- Harder to stop or reduce – may require funding up until plan is terminated.

# Basics of Cash Balance Plans

- May require premiums payable to the Pension Benefit Guarantee Corporation (PBGC).
- Assets are pooled and trustee directed (i.e., no participant direction).
- Care / advance planning is needed if plan covers multiple owners (i.e., to help ensure that each owner upon exit is paid their entitled/fair benefit).

# Basics of Cash Balance Plans

- Maximum benefit is determined at time of distribution (or retirement). Defined in terms of a monthly annuity payable at retirement age (e.g., age 65). For 2014 the limit is $17,500 per month or $210,000 per year (at age 65).



# Basics of Cash Balance Plans

- Projected contributions to maximize benefit at various ages:

| Age | | Projected Annual Contribution |
|---|---|---|
| 35 | | $19,000 |
| 45 | | $46,000 |
| 55 | | $149,000 |
| 60 | | $190,000 |
| 62 | | $210,000 |

# Advanced Cash Balance Plan Design

# Advanced Cash Balance Plan Design

- Adopt a Cash Balance Plan in conjunction with a New Comparability 401(k) Plan.
- Design Cash Balance plan to provide different benefit levels by groups.
- Generally each plan covers all employees – but does not have to (additional testing may be required if they don't).
- 401(k) design is generally Plan Design #3 (3% Safe Harbor with Discretionary Profit Sharing by groups).
- Designed to have the majority of the employer's contribution on behalf of the staff to be provided under the 401(k) plan (minimizes employer's investment risk).
- Plans' are aggregated together and tested as one plan for non-discrimination testing.
  - In order to pass aggregated testing, the profit sharing/nonelective employer contributions in 401(k) plan generally become required (even if discretionary in document).

# Advanced Cash Balance Plan Design-Case Study #4

Case Study (Same as 401(k) Plan):

- One owner with four employees:

| | Age | Pay | Salary Deferrals |
|---|---|---|---|
| Owner | 60 | $260,000 | $23,000 |
| | | | |
| Employee A | 25 | $30,000 | $500 |
| Employee B | 50 | $50,000 | $2,500 |
| Employee C | 23 | $30,000 | $0 |
| Employee D | 40 | $40,000 | $0 |

# Advanced Cash Balance Plan Design-Case Study #4

DC Plan: Plan Design #3 – 3% Safe Harbor and New Comparability

DB Plan: Cash Balance - contribution equal to a % of pay by groups, 5% interest crediting rate

| | Age | Pay | | 401(k) Plan Totals [1] | % | Cash Balance | % | Grand Total [1] | Employer % |
|---|---|---|---|---|---|---|---|---|---|
| Owner | 60 | $260,000 | | $57,500 | 22.12% | $190,453 | 73.25% | $247,953 | 95.37% |
| | | | | | | | | | |
| Employee A | 25 | $30,000 | | $2,088 | 6.96% | $600 | 2% | $2,688 | 8.96% |
| Employee B | 50 | $50,000 | | $3,480 | 6.96% | $1,000 | 2% | $4,480 | 8.96% |
| Employee C | 23 | $30,000 | | $2,088 | 6.96% | $600 | 2% | $2,688 | 8.96% |
| Employee D | 40 | $40,000 | | $2,784 | 6.96% | $800 | 2% | $3,584 | 8.96% |
| Total | | | | $10,440 | | $3,000 | | $13,440 | |
| [1] Includes Salary Deferrals and Employer Ctbs for Owner only | | | | | | | Owner % of Benefits[1]: 94.86% | | |

# Advanced Cash Balance Plan Design-Case Study #4

Comparison of Plan Design #4 (401(k) & Cash Balance) to Plan Design #3 (401(k) Only)

| | Plan Design #3<br>New Comparability<br>401(k) Only | Plan Design #4<br>With Cash Balance | Difference |
|---|---|---|---|
| Owner Totals | $57,500 | $247,953 | $190,453 |
| Employee Totals | $6,645 | $13,440 | $6,795 |
| Owner % of Benefits | 89.64% | 94.86% | 5.22% |

# Advanced Cash Balance Plan Design

When does a Cash Balance Plan make sense?  Who are candidates?

- Owner(s) want to make substantial contributions (above 401(k) Plan).
  - Recommendation: first implement 401(k) plan then if desire additional tax deductible contributions then add a DB plan.
- Owners are generally later in their career (generally age 50 or older).
- Substantial tax deductions are needed.
- Owner(s) are older relative to staff.  Note: does not require all employees to be younger – ultimately depends on demographics and number of employees.
- Age difference between owner(s) and staff will be constant (or have little change).
- Company has consistent profits – contributions should be expected each year and can fluctuate from year to year.
- Does add complexity and removes flexibility – candidate should be comfortable with this.
- Generally small to mid-size businesses.

Questions?

Thank you