# Synopsis of Qualified Retirement Plan Options

## 401(k) Salary Deferral Only

- No contribution cost for employer
- Subject to ADP non-discrimination test under 401(k)
  - Failure of test means highly compensated employees receive refunds of deferral contributions
  - Alternatively, the plan can impose an overall limitation for highly compensated employees
- Able to use traditional pre-tax or Roth type contributions
  - Roth deferrals are post tax, but all gains on the account become tax free after achieving both 5 years participation and age 59 ½
- 2012 contribution limit is $17,000 with additional $5,500 catch up contribution for those 50 and older
- Top heavy trap: if 60+% of account balances belong to “key” employees, then a company paid contribution equal to 3% of compensation (in most cases) for all non-key participants is triggered. A participant is someone who was eligible to make a salary deferral, whether or not he/she chose to do so. This cost can be high and represent an unpleasant surprise
- Most common situations
  - Groups of professionals and other well paid groups, where the employees are expected to fund their retirement from their own compensation
  - Companies with decreased profitability that may have previously had a profit sharing or matching contribution
  - Start up companies that do not yet have a budget for company paid contributions

## 401(k) with Matching Contributions

- This adds a matching contribution feature. Matching contributions are company paid contributions that relate to the amount of salary deferrals a participant makes.
- A matching contribution can be fixed by a formula, or at the discretion of the employer.
- Example of a fixed matching contribution are:
  - 25% of salary deferrals for salary deferrals up to 4% of pay
  - $1 for each $1 of salary deferral up to $1,000

- 50% of salary deferrals for salary deferrals up to 2% of pay, then 25% of salary deferrals for the next 4% of pay. Therefore, if a participant defers 6% or more of pay, the participant will receive a matching contribution up to 2% of pay.

- A discretionary match is decided each year by the company. In most cases the company decides on a rate of matching contribution, with a cap on the total deferrals considered.
  - Flexible percentage of salary deferral considering salary deferrals up to 6% of pay.
- Matching contributions are subject to their own special non-discrimination test, called the ACP test, under Code Section 401(m). It generally parallels the ADP test for salary deferrals
- Complicated matching contribution formulas can also be subject to an additional test, called a "benefits, rights and features" test prescribed in regulations.
- A plan can apply a "last day of the year" rule which means that participants who are not employed on the last day of the year do not receive a match. If a plan applies this rule, then there is another coverage test that must be performed.
- Matching contributions can be applied towards a top heavy minimum (see Salary Deferral only section above). However, this is most often used as a "damage control" strategy when a plan is discovered to be top heavy and has not prepared for it. This is because participants who do not receive a sufficient match to cover the full amount of the top heavy minimum, must receive additional company contributions. This applies to all eligible participants whether they make salary deferral contributions. Therefore, in this circumstance, the match looks like a profit sharing contribution since all participants can end up receiving the same of company contribution as a percentage of pay.
- In theory, between salary deferral contributions and company contributions, a participant can receive allocations of $50,000($55,500 for age 50 and older). Of this potentially $17,000 ($22,500 forage 50 and older) would come from salary deferrals and $33,000 would come from matching contributions. However, this would require a matching contribution to salary deferral rate of approximately 2:1 which is unlikely.
- In the aggregate, matching contributions cannot exceed 25% of the compensation of all eligible participants (whether or not they choose to defer).

**Profit Sharing**

- This can be a "standalone" plan or part of a 401(k) plan. There can also be a match associated with the 401(k), in addition to the profit sharing.
- A company can make profit sharing contributions without having profits.

    - Not for profits can have profit sharing plans although they would be more properly called “incentive compensation,” “flexible contribution” or “discretionary contribution” plans
    - Self-employed people, such as proprietors, partners, LLC members, etc. cannot reduce their self-employed income below zero with profit sharing contributions
- Profit sharing contributions would be most appropriately defined as contributions paid by the employer to the account of a participant, that does not relate to the amount of salary deferral contributions, or whether the participants makes salary deferral contributions.
- The simplest profit sharing plans decide on a contribution amount each year. All eligible participants would receive contributions that equal the same percentage of compensation, e.g. 5% of compensation.
- Plans can become much more complex and even decide profit sharing contributions on an individual basis.
    - These kinds of profit sharing plans are often referred to as “cross-tested” plans or “new comparability” plans
    - These kinds of plans are subject to fairly complex actuarially type testing. If the tests do not pass, then adjustments must be made in the allocation of contributions
    - This technique is often used to provide large contributions to owners and executives of a company, while controlling the costs for other employees
    - A company must have certain demographics for this technique to work well.
- The same comments concerning the “last day of the year” rule that apply for matching contributions (above section), also apply to profit sharing contributions
- If a plan is top heavy (see above) it will usually require a company paid profit sharing contribution of 3% of compensation for each non-key participant
- Profit sharing contributions can be as large as $50,000 either alone, or along with 401k) and matching contributions. A profit sharing contribution cannot exceed a participant’s compensation. For example, if a participant has $30,000 of salary, then $30,000 would be the largest profit sharing allocation
- Deduction limitations may reduce the maximum amount. The total of all profit sharing and matching contributions cannot exceed 25% of the aggregate compensation of all eligible participants.

**Safe Harbor Match Plans**

- This is a special type of matching contribution plan.
- If the plan uses this type of matching contribution then:
    - It automatically passes the 401(k) (ADP) non-discrimination test

  - If there is a safe harbor match, and no other additional match, then there is no 401(m) (ACP) test
  - If there are no other allocations to participants besides the salary deferrals and the safe harbor match, then the top heavy rules do not apply.
- Safe harbor match equals:
  - $1 match for each $1 deferred up to 3% of pay, plus
  - $0.50 match for each additional $1 deferred for the next 2% of pay
  - So if a participant defers 5% or more of pay, then the match is 4% of pay
- A few of the special rules that apply:
  - No last day of the year rule permitted
  - Safe harbor match is always fully vested
  - Special notices required
  - Some enhancements to the matching formula are possible
  - There is a lower cost version of the safe harbor match which is associated with certain “automatic contribution” arrangements and which can have 2 year “cliff” vesting

**Safe Harbor Non-Elective**

- Instead of the match described above, the plan allocates a profit sharing contribution equal to 3% of compensation to each eligible participant regardless of whether and how much salary they defer.
- In general, all the benefits and restrictions of the safe harbor match plan apply to this kind of plan, when the term “safe harbor non-elective” is substituted for “safe harbor match”

**Defined Benefit Pension**

- This works in reverse from profit sharing and 401(k) plans which are described above.
- In a defined contribution plan, the amount going into the plan is defined and the amount available for retirement is the account value at retirement. It is based on the contributions and the investment performance.
- In a defined benefit plan, the amount available at retirement is defined and the amount that the company contributes equals the amount needed to arrive at the target retirement accumulation. Therefore, if investments perform well, the company needs to contribute less than if the investments do not perform well.
- Another way of looking at it, is that in a defined contribution plan, the contributions are limited. In a defined benefit plan, the amount accumulated at retirement is limited, but the amount contributed to arrive at the accumulation is not limited.

- The amount of contribution that is required each year is determined through actuarial calculations.
- In the second and later years of a defined benefit plan there is also a maximum deductible contribution that is calculated. It is often substantially higher than the minimum funding amount.
- Contributing the minimum funding each year will likely result in the underfunding of benefits since the actuarial factors used to determine the lump sum settlement of benefits, or to purchase an annuity are different than the actuarial factor used to determine the minimum funding.
- In recent years many defined benefit plans have terminated or have frozen the accrual of benefits because of the high funding costs for these kinds of plans
    - A frozen plan often suggests a plan that is underfunded and cannot yet terminate and pay full benefits
- At a given level of benefit, the contributions required to fund the benefits of older employees are larger than that required to fund similar benefits for younger employees. This is because there are fewer contributions to retirement age for older employees and also less time for the money to grow. This disparity in funding can be very significant with large age differences
- Small businesses, including small professional groups, may find defined benefit plans particularly attractive since these plans might provide much greater contributions for principals (relative to those for other employees) since the principals are often older, on average, than the other employees.
- Contributions for older principals can approach and even exceed $200,000 in a particular year.
- Minimum contributions determined actuarially and have little room for variance. Some flexibility can be achieved through a plan design that increases the sensitivity of benefit accrual to changes in compensation. Amending the benefit formula can also affect funding, although frequent amendments to the benefit formula will invalidate the plan.
- Defined benefit plans can also be “fully insured” under Code Section 412(e)(3).
    - Funded entirely by annuity contracts (sometimes in conjunction with life insurance) that meet specific requirements of the tax code
    - Do not require actuarial certification of calculation since the internal rates of the insurance company govern
    - Often result in larger initial contributions than other defined benefit plans because of the insurance company’s internal rates
    - Ultimately limited to the same retirement accumulation as other defined benefit pension plans

**Cash Balance Pension**

- This is a type of a defined benefit pension plan
- Instead of defining a benefit at retirement, the Cash Balance Pension usually specifies an annual accrual or pay credit equal to a percentage of the participant's pay
- The pay credit is "deposited" in a hypothetical account
- Each year there is also added an interest credit
    - Cannot exceed a market rate of interest
    - This rate can be fixed up to 5% or be based on a variety of indexes with or without adjustment
    - The rate can also be based on the actual return of assets, if assets are diversified
- The accumulated pay credits and interest credits form a hypothetical account
- In most cases the hypothetical account also forms the participant's lump sum benefit, making this kind of defined benefit plan "feel" just like an individual account defined contribution plan
- Behind the scenes, the hypothetical account is actuarially converted to a benefit at retirement
    - A participant is entitled to receive this periodic benefit at retirement
- Minimum and maximum funding are also determined as if the plan provided retirement benefits
    - A "recommended" contribution would consist of the amount needed to bring the total assets up to the level of the accumulated hypothetical account balances
    - Usually this falls somewhere in between the minimum and maximum funding
- Since the plan assets do not have to always equal the sum of the hypothetical accounts, the risk for providing retirement benefits falls upon the sponsoring. This is the essence of the defined benefit plan
- Cash Balance plans are often useful in situations where a plan has multiple principals each at a different age, where the objective is to have similar "contributions" or pay credits for each principal. In a traditional defined benefit plan, it would be difficult or impossible to meet this objective on a multi-year basis.

**Defined Benefit/Cash Balance and Defined Contribution Combinations**

- These are sophisticated arrangements that combine both defined benefit and defined contribution plans.
- The idea is to have large contributions for the principals and control the costs for other employees

- Through sophisticated testing methods, it is often possible to  level the costs for other employees
- Principals derive the majority of their benefits through the defined benefit plan and other employees derive the majority of their benefits through the defined contribution plan.