

# **RETIREMENT PLAN DESIGN CONSIDERATIONS IN LIGHT OF THE INCREASING PERMITTED ELECTIVE DEFERRAL**

Mary E. Vandenack  
Parsonage Vandenack Williams LLC  
pvwlawoffice.com  
402-504-1300

Mary E. Vandenack Biography

**MARY E. VANDENACK** practices in the areas of tax, business, qualified retirement plans and ERISA, employee benefits, and estate and succession planning primarily for closely held businesses and their owners, health care and other professional practices, including clients in

the agri-business, health care, computer, transportation, construction, telecommunications and various other industries. Mary graduated magna cum laude from Creighton University School of Law and summa cum laude with a B.S. in Business Administration and Accounting from College of Saint Mary. At Creighton, Mary served as Editor-in-Chief of the Creighton Law Review, was inducted into Alpha Sigma Nu Jesuit Honor Society and was a Domestic Moot Court Best Oral Advocate. Mary has been active in leadership roles in Bar Associations at both the state and national level. She is currently active in the American Bar Association Business and Tax Law Sections and the State Section on Real Estate, Probate and Trust Law. Mary has been active in the health care arena serving on the Omaha Chamber of Commerce Health Care Council, participating in ACTivate Omaha and writing and testifying for legislation on a variety of health care issues. Mary frequently speaks at seminars on estate, tax and business issues and has published several articles on topics in those areas.

## PLAN DESIGN CONSIDERATIONS IN LIGHT OF THE INCREASING PERMITTED ELECTIVE DEFERRAL

### 1. PLAN DESIGN GENERALLY

- a. The purpose of the employer in sponsoring a plan drives the particular plan design.
  - Is the employer sponsoring a plan for the purpose of attracting and/or retaining a certain type of employee? (e.g. high tech).
  - Is the employer sponsoring a plan for the purpose of maximizing retirement plan benefits to the owner of the company?
- b. Plan design should consider the business structure of the employer and the demographics of the employees of the business.
- c. Plan design should consider the desirability of staying on a prototype as opposed to becoming individually designed.
- d. This outline assumes that the employer has analyzed plan design generally and adopted a plan with a 401(k) feature subject to ADP testing.
- e. This outline focuses on ADP. Coverage and ACP should be considered in conjunction with any of the approaches in this outline.
- f. Prototype vs. Individually Designed Plan.

### 2. THE INCREASING ELECTIVE DEFERRAL LIMIT

- Plans with a 401(k) feature permit participants to defer a portion of salary up to an annual limit.
- Amount that employees can defer is increasing:

<u>Year</u>	<u>Maximum Elective Deferral Limit</u>	<u>Catch Up Contributions</u>
2002	\$11,000	\$1,000
2003	\$12,000	\$2,000
2004	\$13,000	\$3,000
2005	\$14,000	\$4,000
2006	\$15,000	\$5,000

### 3. IMPACT OF INCREASING DEFERRAL LIMIT ON THE ADP TEST

- HCEs often defer the maximum permissible. As the deferral limit increases, HCEs increase contributions to the maximum.
- NHCEs often do not increase their contributions, or increase contributions by a lesser amount.

Result:

- More plans are struggling to pass the ADP test.

4. WHAT IS THE ADP TEST?

- a. Plans with a 401(k) feature must meet one of two actual deferral percentage tests for the plan year:
  - Test 1. ADP for eligible highly compensated employees (HCEs) is not more than the ADP of all other eligible employees (non highly compensated employees, or NHCEs) multiplied by 1.25; or
  - Test 2. The ADP for eligible HCEs is not more than 2 percentage points over the ADP for eligible NHCEs, and the ADP for the HCEs is not more than 2 times the ADP of eligible NHCEs.
  
- b. Definitions
  - Compensation for the ADP test is Code Section 414(s) compensation.
  - HCE
    - 5% owner (or spouse)
    - \$95,000 compensation (2005) – includes elective deferrals and elective contributions to cafeteria plans and certain other plans
    - top-paid group – earns more than \$95,000 (2005) and is in top 20%, ranked by compensation
  - NHCE is everyone else

Example 1:

	Comp.	<u>2004</u>	<u>ADP</u>
HCE1	\$205,000	\$13,000	6.34%
HCE2	\$180,000	\$12,000	6.67%
NHCE1	\$ 60,000	\$ 6,000	10.00%
NHCE2	\$ 40,000	\$ 3,200	8.00%
NHCE3	\$ 40,000	\$ 2,000	5.00%
NHCE4	\$ 40,000	\$ 0	0.00%
NHCE5	\$ 20,000	\$ 600	3.00%
NHCE6	\$ 20,000	\$ 300	1.50%

2004 HCE ADP% = 6.51%  
NHCE ADP% = 4.58%

ADP Test 1 Failed  
 $6.51\%/4.58\% = 1.42$   
 $1.42 > 1.25,$   
□ADP Test 1 Failed

ADP Test 2 Passed  
 $6.51\% - 4.58\% = 1.93\%$

1.93% < 2 % and  
 1.93% < 9.15 (2 times the NHCE ADP%)  
 ADP Test 2 Passed

Therefore, PLAN PASSES ADP TEST IN 2004

	Comp.	<u>2005</u>	<u>ADP</u>
HCE1	\$210,000	\$14,000	6.67%
HCE2	\$190,000	\$14,000	7.37%
NHCE1	\$ 61,800	\$ 6,180	10.00%
NHCE2	\$ 41,200	\$ 3,296	8.00%
NHCE3	\$ 41,20	\$ 2,060	5.00%
NHCE4	\$ 41,200	\$ 0	0.00%
NHCE5	\$ 20,600	\$ 600	2.91%
NHCE6	\$ 20,600	\$ 309	1.50%

2005 HCE ADP% = 7.02%  
 NHCE ADP% = 4.57%

ADP Test 1 Failed  
 ADP Test 2 Failed  
 Therefore, PLAN FAILS ADP TEST IN 2005

What is the greatest ADP available to HCE group based on NHCE ADP:

<u>NHCE ADP</u>	<u>Maximum HCE ADP</u>
Less than 2%	2 x NHCE ADP
2% - 8%	2% + NHCE ADP
More than 8%	1.25 NHCE x ADP

5. PLAN DESIGN CONSIDERATIONS

1. Safe Harbor Plan
2. Definition of Compensation
3. Component Plans
4. Change Eligibility Requirements
5. Other Options are available. Outline is limited to the above four options.

Design Consideration 1 – The Safe Harbor Plan

- 3% nonelective to all eligible employees regardless of deferral levels
  - The 3% safe harbor plan can also be designed to resolve top heavy issues and ACP concerns.

- Employer match 100% to 3% and 50 % for amounts over 3% up to 5%.
- Enhanced Matching Contribution
- Safe Harbor Plan Factors
  - Match or nonelective is always 100% vested
  - Safe Harbor can be designed to satisfy top heavy contribution requirement, if applicable.
  - Safe Harbor contributions can be contributed to a plan other than the 401(k) plan.
  - Notice Requirement.
- The MAYBE non-elective safe harbor plan.
  - The employer has the flexibility to decide, late in the plan year, to provide the safe harbor nonelective contribution, if the employer gives a “maybe” notice on a timely basis and satisfies the regulatory requirements. Only applies to safe harbor nonelective and not safe harbor match.
  - Plan may be amended during plan year to provide that employer will make the safe harbor *nonelective* contribution for the entire plan year.
  - Notice
    - Safe harbor “maybe” notice must be provided to participants at least 30 days and not more than 90 days prior to the beginning of the plan year.
    - Supplemental safe harbor notice to plan participants at least 30 days before the last day of the plan year informing them of the amendment.

#### Design Consideration 2 – Compensation Definitions

- Deduction Compensation, Contribution Compensation and Testing Compensation.
  - Employer bases its deduction for plan contributions on gross compensation.
  - A plan may provide for allocating contributions on gross or net compensation. The Employer must specify in its Plan document the definition of “compensation” for purposes of contribution allocations.
  - The plan administrator may test plan allocations for non-discrimination using gross or net compensation. A plan is not required to specify a compensation definition for testing purposes. Avoid limiting your flexibility in this manner unless there is good reason to.
  - Gross Compensation is total non-deferred compensation includible in gross income plus elective contributions under the 401(k) plan and under a plan described in Section 125.
  - Net Compensation is:

- a. W-2 Compensation - total nondeferred compensation includable in gross income.
- b. Compensation for purposes of federal income tax withholding – determined without regard to remuneration included base on the nature or location of the work (i.e. agricultural labor described in Code § 3401(a)(2)).

Contribution Allocation Compensation

- In plan design, consider carefully the demographics of your company to determine the compensation definition that should be used for your plan. RUN THE NUMBERS and monitor them from year to year.
- Should bonuses be included?
  - If all HCEs with income of \$150,000 have deferred the max, then including bonuses may reduce the ADP of the HCEs.

Example 2:

	<u>Comp</u>	<u>Deferral</u>	<u>ADP</u>	<u>Comp w/bonus</u>	<u>Deferral</u>	<u>ADP</u>
HCE	\$100,000	\$14,000	14.00%	\$150,000	\$14,000	9.33%
NHCE	\$ 50,000	\$ 4,000	8.00%	\$ 55,000	\$ 4,400	8.00%

- If HCEs generally have compensation in excess of \$210,000 and generally defer to the maximum, consider providing for the opportunity to defer additional amounts on bonuses.

Example 3:

	<u>Comp</u>	<u>Deferral</u>	<u>ADP</u>	<u>Comp w/bonus</u>	<u>Deferral</u>	<u>ADP</u>
HCE	\$210,000	\$14,000	6.67%	\$210,000	\$14,000	6.67%
NHC	\$ 50,000	\$ 3,000	6.00%	\$ 55,000	\$ 8,000	14.55%

(assumes deferral of entire NHCE bonus)

- If HCEs generally have compensation less than \$210,000 and are likely to receive a bonus and defer the entirety and NHCEs are likely to use the bonuses as Christmas cash, then inclusion of bonuses will increase the difference between HCE deferral percentage and non-HCE deferral percentage.

Example 4:

	<u>Comp</u>	<u>Deferral</u>	<u>ADP</u>	<u>Comp w/bonus</u>	<u>Deferral</u>	<u>ADP</u>
HCE	\$150,000	\$10,000	6.67%	\$180,000	\$14,000	7.77%
NHCE	\$ 50,000	\$ 3,000	6.00%	\$ 55,000	\$ 3,000	5.45%

- Should fringe benefits be included?
  - Same issues generally as bonuses.
  - If HCEs are primary recipients of fringes and HCEs are under Covered Compensation maximum, then consider including as the inclusion will reduce the deferral percentage of HCEs.

#### ADP COMPENSATION

- Administrator can make operational elections annually.
- Run a pre-test and determine how various possible definitions impact test results (consider expense).
- Results will change from year to year.

#### Design Consideration 3 – Component Plans

- Consider component plans that will enhance employee deferrals.
- Employer may restructure a plan into selected groups of employees using any criteria. Each component consists of all of the allocations, accruals, and other benefits, rights and features provided to a particular group of employees under the plan.
- Consider the employer's work force
  - Is there a group of high-tech employees who are likely to contribute more if there is a quicker vest in conjunction with a traditional work group that is likely to prefer a greater match with a vesting schedule?
  - Is there a group of long-term employees with respect to whom the employer is willing to offer a higher rate of match with a vesting schedule?
- Each component group must include a nondiscriminatory group of employees. If a component group satisfies coverage, then it is appropriate for the plan to apply the nondiscrimination test without regard to the contributions or benefits provided to employees outside of that group.

#### Design Consideration 4 – Eligibility Requirements

- Consider eligibility requirements that will exclude certain classifications of employees from ADP testing.
  - An employee who irrevocably elects not to participate in the plan is not included in ADP testing. Consider such an election for employees with long-term reasons for opting out.
  - Part-time employees
  - Union employees
  - Minimum Age – use 21.

#### 6. Other Considerations

- Catch-up Contributions – Ask older HCEs to classify contributions as catch-up contributions first.

- Limit elective deferral contributions of HCEs.
- QNECs and QMACs - employer contributions which satisfy certain nonforfeitability requirements and distribution requirements.
  - QMACs - employer matching contributions that are 100 percent vested at all times and that are subject to the same restrictions on distributability as are elective contributions.
  - QNECs - employer nonelective contributions, other than matching contributions, that satisfy the same requirements.
- For ADP purposes, may be treated as elective contributions if the allocation of nonelective contributions is nondiscriminatory.
- QMACs instead of bonuses
  - If an employer 401(k) plan does not provide for matching contributions other than QMACs and if the plan does not permit employee after tax contributions, the employer may shift QMACs to the ADP test. Caution: Shifting QMACs could make things worse.
- Do monitor the testing inclusions. The employer is responsible for getting the right data to the third party administrator. Even the best third party administrator does not know your employees. The vigilant eye of the employer HR department will save a lot of ADP inaccuracies. Little inaccuracies have a big swing.

## 7. What To Do When You Fail the ADP Test?

A plan that fails the ADP test has “excess contributions.” To correct excess contributions, the employer may:

- Make corrective QNECs or QMACs.
  - Additional contributions are made to one or more of the NHCEs with the lowest compensation.
  - Reduces the cost of nondiscrimination compliance.
  - Regulations limit the use of these methods of compliance.

### Example 5: Using QNECs to correct failed ADP Test

	<u>Comp</u>	<u>Deferral</u>	<u>ADP</u>	<u>QNEC</u>	<u>Corrected ADP</u>
HCE	\$210,000	\$14,000	6.67%	\$ 0	6.67%
NHCE	\$ 70,000	\$10,000	10.00%	\$ 0	10.00%
NHCE	\$ 25,000	\$ 1,000	4.00%	\$ 920	7.68%
NHCE3	\$ 20,000	\$ 0	0.00%	\$ 1,000	5.00%

Pre Correction:            HCE ADP = 8.34%  
                                       NHCE ADP = 2.00%

Post Correction            HCE ADP = 8.34%  
                                       NHCE ADP = 6.34%

- Rules for bottom-up QNECs
  - The employer may not take a QNEC into account for an NHCE in the ADP test to the extent the QNEC for the NHCE exceeds the greater of 5% of compensation or two times the plan's representative contribution rate times the NHCEs compensation.
  - Employer may not count a QNEC in the ADP test if less than half of all NHCEs receive QNECs or if the QNEC is more than double the QNECs most other NHCEs are receiving, except that a QNEC not in excess of 5% of compensation is always permissible.
- Make corrective distributions to HCEs. Distribute timely the excess contribution (plus allocable income). IRC provides rules to calculate the amount that must be returned.
  - IRS Advance Notice 97-2.
  - Distributions must include allocable income.
  - Timely distribution is generally 2 ½ months after the end of the plan year.
- Recharacterize the excess contributions as after-tax employee contributions.
  - May cause other problems.

The plan may provide for more than one correction method or may provide for a combination of methods as to any or all affected HCEs.

#### AVOID FAILING THE ADP TEST

- Review ADP status in the month prior to plan year-end.
- IRS correction procedures.