PLAN DESIGN CONSIDERATIONS - INITIAL PLAN DESIGN

Objective:

- Optimize contributions for owners/partners
- Provide options for plans with multiple owners/partners to allow each owner/partner to determine their own contribution amount
- Provide maximum discretion for contributions to not "lock" employer into "required" amounts
- Provide a flexible allocation formula and other design options that satisfy required testing
- Keep employer costs low for staff and allow employer the choice to increase from minimum contribution amounts required to satisfy testing

If the employer is looking to maximize contributions to the owner(s)/partner(s) and possibly other specific individual employees, we first look at a cross-tested method of allocating employer contributions. This method of allocating employer contributions allows leverage typically to the owner or partners of the business.

Essentially, and dependent upon testing, a cross-tested allocation would provide the owners/partners with an employer contribution of roughly 3 times the amount that would be required to be allocated to non-highly compensated employees in the plan.

Some important limitations that must be taken into consideration with plan design (limits described below are 2019 limits and do change for COLA):

The IRS contribution dollar limit to any individual during a plan year is $56,000. In addition to this amount, participants at least age 50 can contribute up to an additional $6,000 as a catch-up contribution. This contribution limit would include all sources of contributions allocated to the individual, such as pre-tax deferrals, Roth, profit sharing, matching contributions, etc., but catch-up is an additional amount. Therefore, an individual at least age 50 can receive total contributions of up to $62,000 in a limitation year.

Additionally, the current IRS limitation for compensation that can be considered for plan purposes for any individual is up to $280,000 annually.

The current IRS limit for 401k and/or Roth contributions is $19,000 for the calendar year. This ***additional*** catch-up contributions for those participants age 50+ is $6,000.

In a cross-tested plan, there is a minimum "***gateway***" contribution that must be made to non-highly compensated employees (NHCEs). This minimum is *"generally"* the lesser of 1/3 the amount of employer contribution provided to a highly compensated employee (HCE) or 5% of their pay. This contribution must be made as a non-elective contribution, like profit sharing. *(i.e. not a match*).*

***Note**: Employer matching contributions cannot be considered to help satisfy "gateway" minimums, which is why we don't always recommend an employer matching contributions with a cross-tested plan design. We do design the plan to allow for discretionary matching contributions, in case the owner desires to make them.*

Many businesses have owners/partners who fund their own retirement entirely. Therefore, it does not matter to them what is classified as "employee" vs. "employer", but it does matter to the IRS and for plan testing. *This is why it is extremely important for owners/partners to maximize their 401k or Roth.* Keep reading to learn why.

Gateway minimums only consist of EMPLOYER paid contributions. Employer paid contributions are tested to determine what needs to be paid as a contribution to the NHCEs. So whenever we are looking to maximize the owners/partners we typically recommend the HCE defer the IRS maximum 401k or Roth amount, again which is currently $19,000. By doing so will *decrease* the required "gateway" minimum contribution, which is the "employer" contribution. The reason is 401K and Roth contributions are considered an EMPLOYEE contribution for plan purposes. Since gateway is determined based upon the EMPLOYER funding amount, if a portion of the maximum overall contribution for the owner/partner is considered EMPLOYEE contributions, it reduces the amount funded as an EMPLOYER contribution. As an example, the maximum individual contribution is $56,000, *(not including catch-up for those age 50+)* if the owner/partner contributed $19,000 as an EMPLOYEE contribution, then the employer only has to fund $37,000 as an EMPLOYER contribution for this individual to maximize their contribution. *($56k minus $19k).* Obviously, $37,000 as an EMPLOYER contribution is much less than $56,000 – thereby reducing the minimum required gateway to be funded to the NHCEs.

Again, considering the IRS limit on compensation that can be used for plan purposes, which is currently $280,000. If the owner/partner contributed the $19,000 in deferral or Roth contributions *(employee contributions),* then they would need to fund $37,000 as an employer contribution to maximize their contributions. This is 13.21% of their pay *($280,000 divided by $37.000).* This percentage is what is used to calculate the minimum gateway to the NHCEs. Dependent upon testing, the minimum gateway is approximately 1/3 the amount of employer contribution the HCEs received. Therefore, in this scenario, the minimum gateway contribution to be provided to the NHCEs is 4.40%.

If an owner/partner did not contribute any pre-tax 401k or Roth and still wanted to receive the maximum IRS contribution of $57,000, then 100% of the contribution would be considered EMPLYOYER contributions and they would have to provide a contribution of at least 5% to all NHCEs. *This is why it is so important to have any HCE who is trying to maximize their contributions to contribute the 401k or Roth maximum contribution so they can reduce overall plan costs!*

Other Plan Design Considerations

When constructing a cross-tested plan design, other compliance tests must be considered. Specifically, naming a few of these tests are the Top Heavy Test (IRC 416) and the ADP/ACP Qualification Test (401k/401m), as described next.

Top Heavy– The plan is considered *"top-heavy"* if the Key Employees' account balances make up at least 60% of total plan assets. A key employee is defined as:

- Any employee with ownership of at least 1% who earns at least $150,000 annually
- Any officer earning $180,000 or more annually
- Any employee with more than 5% ownership, including certain family members

If the plan is deemed to be Top Heavy, a minimum contribution must be made to all non-key *eligible* employees ***regardless*** of whether or not they defer to the plan ***IF***:

- Any employer contributions or forfeitures are allocated during the plan year; OR
- Key employees defer employee 401(k) contributions (pre-tax or Roth) to the plan

ADP/ACP Qualification Test – The average deferral percentage test (ADP) compares the ADP of HCEs versus the ADP of NHCEs. Generally, the threshold between the two averages cannot be more than 2%. A HCE is defined as:

- Any employee with 5% or greater ownership, including certain family members, in either the current or prior plan year; OR
- Any employee with wages of $125,000 in the prior plan year

Example of the ADP Test:

Step 1: Divide the employee's annual deferral into the employee's annual salary *(i.e. Employee A earns $50,000 annually and defers $5,000, their deferral percent is 10%).*

Step 2: Add all HCE's deferral percentages together and then divide the total by the number of HCE's = ADP for HCE's.

Step 3: Add all NHCE's deferral percentages together and then divide the total by the number of all NHCE's = ADP for all NHCE's.

Step 4: Compare the ADP of HCE's to the ADP of NHCE's. The ADP of the HCE's generally cannot exceed the ADP of the NHCE's by more than 2%.

Example: Highly Compensated Employees ADP = 6.86%
Non-Highly Compensated Employees ADP = 2.35%

Since the HCE's ADP cannot exceed 4.35% (2.35% + 2%). Therefore, the plan would not meet qualification testing.

Safe Harbor Contributions **–** Safe Harbor Contributions are amounts contributed by the employer to *automatically satisfy the ADP/ACP test and possibly the Top-heavy test*. There are essentially three types of Safe Harbor contributions.

Types of Safe Harbor Contributions:

1. Basic Match – A contribution equal to 100% match up to 3% of salary and an additional 50% match on the next 2% of salary for all participants who contribute to the plan. This equates to a dollar for dollar match up to 4% of pay if the employee contributes (*defers*) at least 5% of their compensation.

2. Enhanced Match – Essentially, anything better than above not to exceed 6% of pay.

3. Non-elective – A contribution of 3% of salary to all eligible employees of the plan regardless of whether or not they defer/contribute to the plan.

Things to note regarding Safe Harbor Elections:

- The plan document ***must*** allow for the safe harbor election selected
- A notice must be provided to all plan participants at least 30-days prior to the beginning of the plan year for all existing retirement plans. Newly established plans have until the 1st day of the plan's effective date
- Safe Harbor Contributions are always 100% immediately vested
- The safe harbor non-elective feature can utilize a "Maybe" notice. This means the plan does not have to declare the Safe Harbor election until the 1st day of the 11th month of their current plan year. However, if electing the "Maybe" safe harbor election, you must provide notice to all plan participants at least 30-days prior to the beginning of the plan year. The notice must state that the "Maybe" safe harbor election is being made and that when the election is determined a subsequent notice will be provided.
    - The subsequent notice must be provided no later than the 1st day of the 11th month of the current plan year whether or not a safe harbor non-elective contribution will be made.
    - If the plan does make a safe harbor non-elective contribution, the plan must also be amended to allow for safe harbor contributions.

Comparison of Safe Harbor Elections:

Required Tests	Basic & Enhanced Match Safe Harbor	Non-elective Safe Harbor
ADP/ACP	Automatically satisfies	Automatically satisfies
Top Heavy	Satisfies with conditions	Automatically satisfies
Gateway	Does not help satisfy	Does help satisfy

NOTE: *When designing a cross-tested plan we would ONLY consider the safe harbor NON-ELECTIVE contribution of 3%, because it is the ONLY safe harbor contribution that can be considered to help satisfy the gateway minimum. A matching contribution CANNOT be considered to help satisfy the gateway minimum contribution.*

As was used with our initial example, all NHCEs would need to receive a minimum of 1/3 the amount allocated to the owners/partners. If the owners/partners received 13.21%, then the non-highly compensated employees must receive a minimum amount of 4.40%. If a 3% safe harbor contribution were elected, the employer contributions allocated would be 3% safe harbor and 1.40% profit sharing to satisfy the gateway minimum.

With all the above assumptions, the plan will pass all required IRS testing and allow the shareholders the greatest benefit for the least cost. Typically, owners can receive the maximum benefit and save 3%-5% of their payroll costs with a *"cross-tested"* or *"new comparability"* plan design. ***Again, profit sharing amounts are discretionary and can be determined by year to year. Safe Harbor elections are REQUIRED to be paid.***

Although we are using generalized examples, the design is a bit more involved. MVP will always design the retirement plan to best maximize the owners/partners for the least overall plan costs. Once the contribution number is determined, the employer can decide to increase individuals or groups of employees of their choosing.

MVP Plan Administrators, Inc. is committed to designing a plan that fits the company and not a making a company fit a plan! We understand each company is unique and we will develop the best plan design.

Let's Talk

Sounds like a good time to strike up a conversation about MVP and services we offer. You can get in touch with us by calling us at 1-866-687-6877 or by emailing us at sales@mvp401k.com.

