

An Alternative to the Safe Harbor 401(k) Plan

By William L. MacDonald

The author discusses how to reduce the costs of 401(k) plans by redirecting contributions to highly compensated employees.

Human Resource (HR) professionals are positive by nature and resilient by necessity—until the president calls to ask why he or she received an unexpected taxable return from 401(k) contributions. At that point, as they say, “there’s some ‘splainin to do.”

This scene is played out often in American office buildings because highly compensated employees (HCEs) may, unintentionally, over contribute to their 401(k) plans. When this happens, an HCE’s excess contributions have to be refunded or reclassified as an after-tax contribution.

In a typical voluntary 401(k) plan, the majority of “rank and file” employees either elect to contribute a minimal percentage of their income or they do not contribute to the plan at all. In a recent report by the Center for Retirement Research at Boston College, it was noted that up to 89 percent of eligible participants chose to not contribute the maximum to their defined benefit or contribution plan; up to 25 percent do not contribute at all.¹

Impact of ADP/ACP Test

Strangely, those HCEs who want to make maximum contributions to their 401(k) plans are precluded from doing so if the plan fails the actual deferral percentage (ADP) or actual contribution percentage (ACP) test. By

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law, the ADP/ACP testing is one of the most significant nondiscrimination tests because most 401(k) plans are compelled to address its consequences or consider its outcome throughout the year. For example, failure to meet the filing deadline can cause a plan to incur stiff penalties, including disqualification of the plan.

The ADP/ACP tests are designed to prevent an employer from managing a 401(k) plan that discriminates in favor of highly compensated employees. The HCE group is often comprised of owners, executives, or management employees. These individuals, by the nature of their roles, are generally in the best position to operate an unfair retirement plan. That is, according to the Government’s viewpoint on the matter.

A plan favors HCEs when it is not beneficial to “rank and file” employees. For example, let us say that Plan A matches only contributions made by employees who contribute large sums to the plan. Plan A favors the HCE group because it is the HCE group that can afford to make large contributions; they will receive the employer’s matching contribution. The HCE group gains a greater benefit under Plan A than the rank and file.

Fairness Measured

The ADP/ACP tests reveal the unfairness of a plan, as described above, by examining the contribution percentages of each group—the highly and non-highly compensated employees (NHCEs). First, the testing separates the company’s employees into one

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of the two groups based largely on a set compensation amount. If compensation is greater than a specified dollar amount, the employee is highly compensated. If it is less than the specified dollar amount, the employee is non-highly compensated. You then need to run a number of related tests, which adds to plan complexity. Human resource professionals lament full testing as an experience they prefer to avoid.

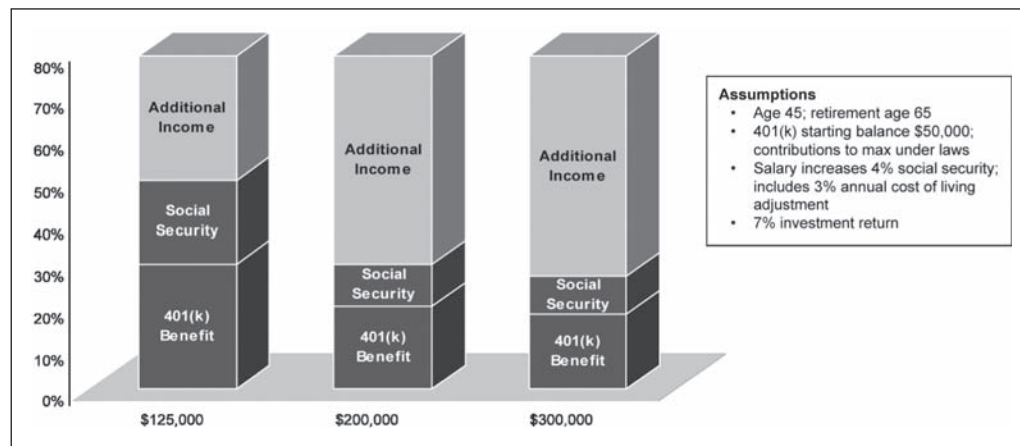
The goal of this article is to examine how to redesign a plan in order to motivate rank and file employees to defer compensation. In turn, this will make it possible for an HCE group to defer more compensation, overcome the retirement savings gaps and reach a sustainable retirement. You may question: Are we trying to spend unnecessary dollars on the rank and file to design the plan so it will also be attractive to the highly compensated?

Key to Success

Unquestionably, an employer must find a way to implement a cost-efficient strategy to benefit HCEs. More than likely, the talent and expertise of a company's HCE group is the key to its business success. Smart companies will do everything in their power to retain this talent and reward equitably, especially in an environment where there is a dearth of senior talent.

In compensation and retention situations, a plan administrator often recommends the creation of a "safe harbor" plan; that is, for the price of a safe harbor employer contribution, the applicable discrimination tests on employee deferrals (ADP), as well as matching contributions or ACP tests, are deemed satisfied. Thus, HCEs are permitted to make the maximum allowable compensation deferral without the need for the plan to pass the discrimination tests.

Figure 1. Retirement Savings Gap – 80% of Final Salary



However, this solution carries a fairly steep price tag. Let us cite the two safe harbor contribution approaches:

- Three-percent non-elective contribution: three percent of total payroll
- Basic match: 100 percent of first three percent deferred, plus 50 percent of next two percent deferred (which tops out at four percent of payroll)

Under a safe harbor plan, employer contributions for all employees are fully vested when made. This requirement leaves employers with little or no retention leverage. While this strategy solves the contribution dilemma, it does not meet the reasonable cost criteria so important to an employer.

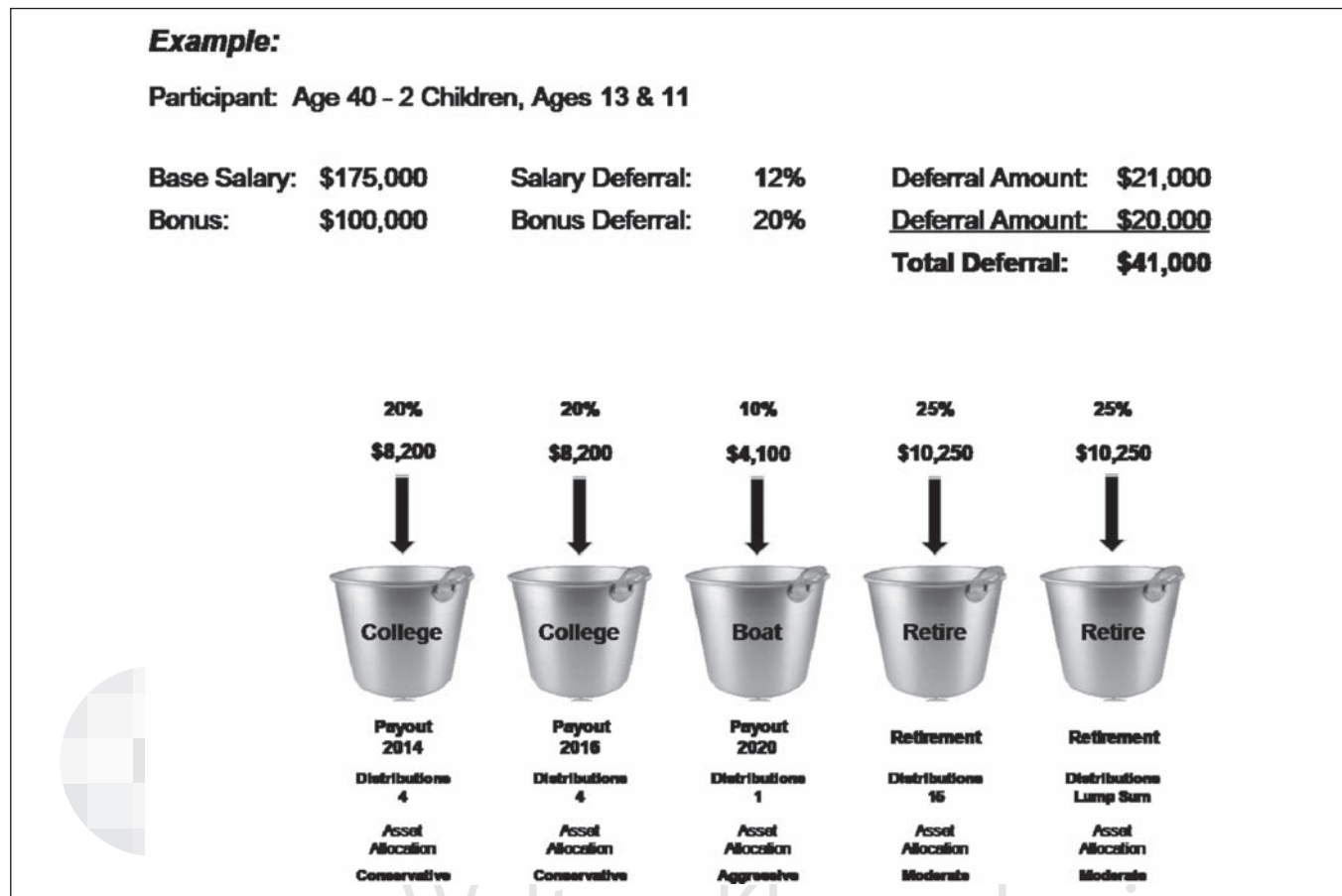
Historically, due to government limitations, the 401(k) plan has had reverse discrimination problems because HCEs have not been able to contribute enough money for a comfortable retirement. As illustrated in Figure 1, HCEs will quickly encounter a retirement savings gap, as a 401(k) plan is insufficient to fulfill their savings needs.

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Narrowing Gaps Nonqualified Plans

One solution to retirement shortfalls is the use of a nonqualified deferred compensation plan (NQDC). NQDC plans are employer-sponsored retirement plans (or other deferred compensation arrangements) that do not meet the tax qualifications under Internal Revenue Code Sec. 401 for qualified plan requirements. These plans allow an employee to defer the receipt of taxable wages or bonuses until a future

Figure 2.



year when (hopefully) the employee is in a lower tax bracket, thereby paying less in taxes when compensation is received.

When compared to qualified plans, NQDC plans are far easier to establish. However, specific rules must be followed in order to achieve the objective of deferring an employee's taxable compensation. In fact, all nonqualified plans must satisfy the following three requirements:

- The deferred compensation arrangement between the employer and the employee must be entered into before the compensation is earned by the employee.
- The deferred compensation cannot be available to the employee until a previously agreed future date or event (including multiple payout options). (See Figure 2)
- The amount of the deferred compensation cannot be secured (*i.e.*, it must remain available to the employer's creditors).

Clearly, a nonqualified retirement plan provides a cost-effective alternative that allows an employer to:

- leave an existing voluntary 401(k) plan in place,
- allow for maximum deferrals by key employees,
- choose specific employees to participate,
- offer the same or an alternative investment menu,
- provide short-term and retirement distribution options not found in 401(k) plans (without penalty for early distribution before age 59 ½) and
- deliver ease of administration.

Four Million Dollar Advantage

Figure 3 compares the costs of a nonqualified deferred compensation plan for HCEs with the costs of a typical safe harbor plan. The example is based on a 300-employee group with 20 HCEs, and a total annual payroll of \$19.5M. In this case, a NQDC plan can be installed with a total outlay that is only 35 percent of the cost of the safe harbor plan. The impressive result is \$4.56M in savings in direct costs over a 10-year period.

Let us further assume that the employer offers a five percent contribution to the HCEs, which could

be a match, compared to a three percent safe harbor contribution to all 300 employees. As shown in Figure 3, at a modest hurdle rate of six percent, the NQDC plan provides the company another \$367,744 in indirect savings over that same period.

Based on the numbers alone, the NQDC solution for HCEs makes sound business sense with the added benefit of current tax deductibility. For full benefit security, plan designers might consider using a tax restoration plan as a desirable alternative.

Figure 3. Management Security Plan vs. Safe Harbor Plan

| | | | | |
|----------------------|------------|----------------|---------------------|-----------|
| Participants: | 300 | | Top Heavy Employees | |
| Top Heavy Employees: | 20 | | Total Payroll: | 2,400,000 |
| Total Payroll: | 19,500,000 | | MSP Contributions: | 120,000 |
| Safe Harbor Cost %: | 3% | | | |
| Safe Harbor Costs: | 585,000 | 1,950/employee | | |
| Handle Rate: | 6% | | | |

| Year | Safe Harbor Cost | MSP Cost | MSP Direct Savings | MSP Indirect Savings | Total MSP Company Benefit |
|--------------|------------------|------------------|--------------------|----------------------|---------------------------|
| 1 | 585,000 | 120,000 | 465,000 | 27,900 | 492,900 |
| 2 | 585,000 | 120,000 | 465,000 | 29,574 | 494,574 |
| 3 | 585,000 | 120,000 | 465,000 | 31,348 | 496,348 |
| 4 | 585,000 | 120,000 | 465,000 | 33,229 | 498,229 |
| 5 | 585,000 | 120,000 | 465,000 | 35,223 | 500,223 |
| 6 | 585,000 | 120,000 | 465,000 | 37,336 | 502,336 |
| 7 | 585,000 | 120,000 | 465,000 | 39,577 | 504,577 |
| 8 | 585,000 | 120,000 | 465,000 | 41,951 | 506,951 |
| 9 | 585,000 | 120,000 | 465,000 | 44,468 | 509,468 |
| 10 | 585,000 | 120,000 | 465,000 | 47,136 | 512,136 |
| Total | 5,850,000 | 1,200,000 | 4,650,000 | 367,744 | 5,017,744 |

Note: All employees eligible for Safe Harbor 401(k) plan.

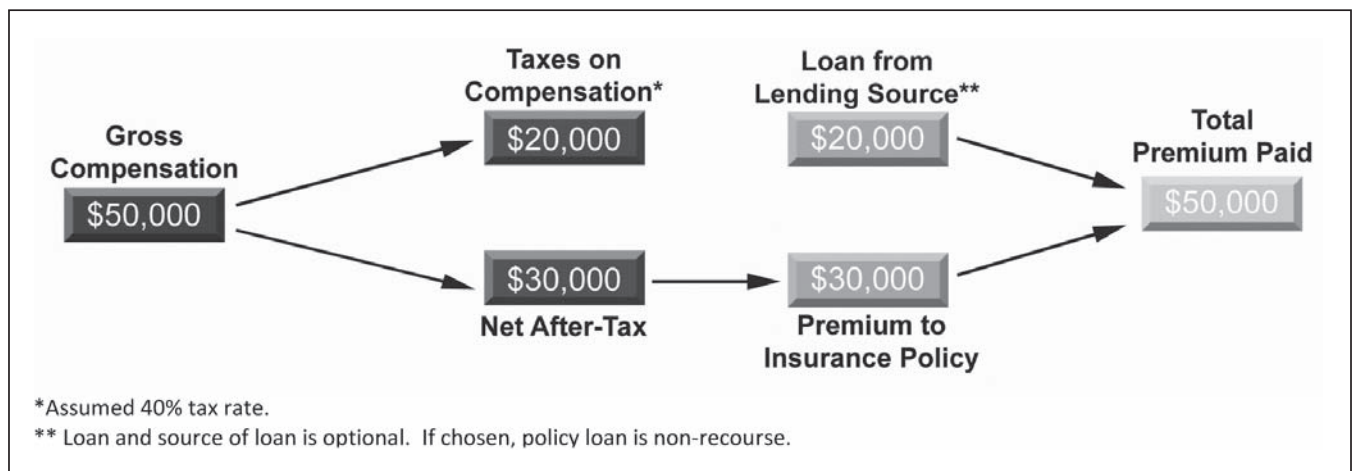
Management Security Plan

In a traditional deferred compensation plan, an employee's contribution cannot be secured (i.e., it must remain available to the employer's creditors). If this is a major concern, the Management Security Plan (MSP) could be an alternative. The primary differentiator between a MSP and a traditional NQDC plan is the manner in which investment gains are taxed. Contributions made to an MSP are made with after-tax dollars, however, all earnings accumulate,

tax deferred on the pre-tax amount. This outcome is reached through a tax restoration loan that is built into the program, as shown in Figure 4.

Structured properly, distributions from the MSP are not subject to current taxation. Equally important, the MSP includes a nontaxable life insurance benefit. It is powered by an institutionally priced variable universal life (VUL) policy, which creates the tax-advantaged status.

Figure 4.



The following is a summary of MSP benefits:

- Contributions made with after-tax dollars
- Pre-tax savings with tax-deferred investment growth
- Nontaxable distributions
- No contribution limits
- Nontaxable life benefit
- Completely portable
- Fully secured against an employer's creditors

Summary

The attractiveness factor in retirement benefits affects corporate performance and sustainability. Quite naturally, top talent will always gravitate to the most appealing compensation and benefits package offered. Whether it is a combination of 401(k) plans, buttressed by a NQDC plan or customized Management Security Plan is easy enough to analyze. What is difficult to do is shift one's thinking. In reality, the quality of a company's executive benefits plan is the true centerpiece of an effective risk management strategy. If you have any doubt, contemplate this next point:

In a 2008 poll of 1,000 U. S. employers,² Aon Consulting clearly uncovered the depth of challenges employers now face. Consider this trend point:

Anticipated leadership and talent shortages threaten organizational sustainability. Nearly 60 percent of respondents report that they have a leadership talent shortage right now that will impede their organization's performance. That is up from 16 percent just one year ago. Another 31 percent expect a leadership shortage will impede performance within the next four years.

How much time is there to revisit and revamp retirement programs? Can the employer hold onto senior people? Have young managers been tested sufficiently to take the reins? Can the employer attract the "next" generation of best-of-breed talent?

After all, the nation's 80 million Baby Boomers are retiring at a rapid clip. At the same time, the world of work has radically changed. Seismic shifts in global economies and technologies have uprooted everything as we knew it.

While it may sound simplistic, one solution in an employer's control is to refocus and redirect retirement contributions to the highly compensated executives leading the company.

ENDNOTES

¹ An Update on 401(k) Plans: Insights from the 2007 Survey of Consumer Finance from the Center of Retirement Research at Boston College.

² 2008 Benefits and Talent Survey, Aon Consulting.

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