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Overcoming Retirement Plan Contribution Limitations in Mid-Sized Corporations

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I recently worked on an interesting employee benefits case with a mid-size employer who presented the classic symptoms of “benefit stress.” The case demonstrated how modern insurance tools and techniques can solve multiple problems employers face in retaining their key people.

Backstory

For this story, we’ll call this company ABC Corporation. It is a multinational, private C corporation based in New York with more than 2,000 employees, most of whom are hourly wage earners. ABC Corp. also has about 90 management and highly compensated employees who are key to growing this company in its specific marketplace.

The benefits broker, a mid-sized property-casualty firm with a benefits practice, was having problems increasing 401(k) participation. Specifically, over the three prior years, rank and file participation was so low that the plan had to refund thousands of dollars a year to the highly compensated participants because of the “top hat” testing. The net amount contributed to the 401(k) plan each year, per highly compensated employee, after the mandatory refunds, was only \$955.

To rectify this problem, ABC had to increase plan participation. The company was willing to make matching contributions to the 401(k) plan, but only for those employees who were making their own contributions as well. For the previous eight to 10 months, ABC had consulted with outside “benefit” firms that had recommended solutions, but those solutions were judged to be either improper or too expensive. The owners’ ultimate goal was to build up the business and then sell it off in five to 10 years. Keeping key management was important, but not as important as preserving the future value of the company.

Problem #1: 401(k) Limitations

The 401(k) plan was cross-tested and severely limited highly compensated employee contributions. The initial recommendation was to convert the plan to a Safe Harbor design that would allow the key employees to “max out” their contributions up to the annual contribution limit (\$14,000 at the time). This would eliminate the need to refund contributions to the highly compensated employees and give them another reason to remain with the company.

Solution #1: Increase Participation Through Company Match

While changing the 401(k) plan to a Safe Harbor structure was an easy fix, it was going to cost ABC almost \$350,000 annually. Also, in looking at the distribution of those funds, most of the money went to the rank-and-file employees who were not contributing voluntarily. This violated ABC ownership’s desire to make contributions only to those employees who already contributed on their own behalf.

ABC needed a less costly solution. Our idea was to increase the 401(k) matching contribution to a dollar-for-dollar match of the first 3% of compensation, with a graded vesting of six years on the employer match. Combining this with higher employee participation, driven by additional enrollment meetings, would increase the amount that highly compensated employees could contribute, without forcing ABC to give away “free money.”

Problem #2: Further Bonus Deferral Opportunity

ABC was losing trusted key employees each year because of the limitations in the 401(k), as well as the inability to defer large bonuses that were paid quarterly. While the bonuses were handsome, the key people did not need this money to live on, and yet they could not defer it to a future date. A number of the consulting benefit firms had suggested nonqualified deferred compensation for these bonuses, but the recommended solution was usually a mutual fund offering that would generate taxation on growth as dividends and capital gains were distributed by the funds to the corporation.

There was another problem, too. Until the Financial Accounting Standards Board (FASB) came out with FAS Statement 159 in

Advisors who have clients in similar situations should be asking:

- Has your 401(k) failed a “top hat” test in the past three years?
- Would any of your employees like to exceed the IRS 401(k) contribution limit?
- Would you like to give a bonus to select employees, but have it vest over a period of time?
- Would you like to recover the costs of providing benefits to all your employees, by selectively insuring your key employees?
- Have you thought about giving ownership to your key employees, but are afraid you would thereby give up control?

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