Overcoming Retirement Plan Contribution Limitations in Mid Sized Corporations

Key Goals

- ✓ Overcoming 401(k) limitations
- ✓ Key employee retention
- ✓ Integration of nonqualified deferred compensation plan with the 401(k) contributions
- ✓ Tax free growth
- ✓ Cost recovery of the employee benefits

Backstory

ABC Corporation, a multinational, private C Corporation based in New York had over 2000 employees who were mostly hourly wage earners. They also had about 90 management and highly compensated employees who were key to growing this company in their specific marketplace.

The benefits broker, a mid-sized property casualty firm with a benefits practice was having problems getting 401(k) participation up. Specifically, over the three prior year's rank and file participation was so low that the highly compensated individuals received thousands of dollars per year in refunds from their 401(k) plan because of the "top hat" testing. The net amount contributed to the 401(k) per year per highly compensated employee after the mandatory refunds ended up being only $955.

To rectify this problem the employer had to try and increase 401(k) participation. The employer was willing to making matching contributions to the 401)k) plan, but it only wanted to make those contributions to those employees that were putting money away. They had spent the last 8 to 10 months consulting with outside "benefit" firms that had recommended some solutions but those firms either could not convey the proper solution or the employer perceived it as and added expense. The ultimate goal was to build up the business and then sell it off in five to ten years. Keeping key management was important but not so much that it would reduce the future value of the company.

Problem #1 401(k) Limitations

The 401(k) plan was a cross tested plan and severely limited highly compensated employee contributions. The initial recommendation was to convert the plan to a Safe Harbor plan where the key employees would be able to "max out" their contributions up to the annual contribution limit ($14,000 at the time). This would alleviate refunds from the retirement plan for 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 Corporation almost $350,000 annually. When looking at the distribution of those funds, most of the money went to the rank and file employees who were not contributing voluntarily. The owner was willing to make contributions to the retirement plan, but only to those who already contributed on their own behalf.

Instead of taking the Safe Harbor approach an alternative, and less costly solution was to increase the 401(k) matching contribution to a dollar for dollar match of the first three percent of compensation with a graded vesting of 6 years on the employer match. Combining that with additional enrollment meetings by the 401k company they could increase the amount that highly compensated employees would be able to contribute without giving away "free money".

Problem #2 Further Bonus Deferral Opportunity

The employer 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, this money was not needed to live on and could not be deferred to a future date. A number of the consulting 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.

Separately, until the Financial Standards Board came out with FAS statement 159 in August of 2007, which allows for booking the "unrealized gain" of a marketable security, the mutual fund choice was less than desirable for the employer because the mutual fund was accounted for under FAS 115 (the purchase price of the asset). This accounting imbalance made the company's financials less attractive to a potential acquirer, which was important to the current owner who hoped to sell the company in the coming years. In the rare instances that Corporate Life Insurance was discussed, it had always been presented as a benefit cost item, not an asset that could provide a useful funding vehicle.

Solution #2 COLI Fund Nonqualified Deferral Plan

By showing the employer a nonqualified deferred compensation plan informally funded with Corporate Owned Life Insurance (better known as "COLI" where the employer is the premium payor, owner, and beneficiary) funded at the "net after tax" cash flow of elective employee deferrals, the employer accomplished a savings program that accomplished all of the following:

- Could discriminate in favor of only management employees.
- Had no material impact on cash flow (net after tax funded)
- Created an asset on the balance sheet equal to the employee benefit liability (Accounting of COLI under FASB TB 85-4)
- Created a tax deferred vehicle for the growth of the mutual funds inclusive of the dividends and capital gains on a year by year basis
- Created a cost recovery mechanism that made the employer "whole" for their costs upon the death of the key executive
- Allowed the insurance policies to be issued on a guaranteed to issue basis

Problem #3 Coordination with 401(k) Plan Deferrals

After implementing the quarterly deferral program and revising the 401(k) plan, the employer recognized that there still may be a need to integrate any potential distributions from the 401(k) back into the deferred compensation plan (something that have been clarified somewhat in the final 409A regulations). To prevent the 401(k) refunds from coming back in a taxable manner when the intent was to defer them until retirement, changes had to be made to the 401(k) plan to allow for automatic deferral of those distributions to the deferred compensation plan.

Solution #3 Pour Over Election

To really bring everything together it was determined that ABC Corporation should establish a "pour over" election from the 401(k) into the deferred compensation plan. These elections had to be done in the December of the year prior to making any contributions to the 401(k) plan (i.e. December of 2006 for 401(k) distributions in March of 2008). If the plan failed its annual test then any distributions would roll into the existing deferred compensation plan. This was not mandatory but allowed employees to max out their 401(k) contribution automatically and let the 401(k) TPA determine how much money would roll into the deferred compensation plan in the following year. It also allowed employees to make a deferral election that might be above the IRS limits in any year and have those funds automatically be placed in the nonqualified deferred compensation plan seamlessly.

When all the changes were made, the employer had created a deferred compensation plan with almost fifty COLI policies, $275,000 of after tax

annual contributions (or about $415,000 pre-tax), implemented key man insurance, had a matched asset against future liabilities and had created an asset that would recover most, if not all, of the out of pocket expenses for both the 401(k) plan as well as the nonqualified deferred compensation program.

Added Opportunity

On top of working with the employer on implementing the changes on their 401(k), we were able to create a program where we had the opportunity to work with over ninety highly compensated employees on many facets of their financial planning. In this case, it was the advisor who introduced us to the corporation who met individually with the participants.

On top of the initial sales, each and every quarter we have the opportunity to meet with senior management to work with them on cost recovery of their disability, long term care and health insurance premium costs. Every time a new key employee joins the firm we automatically enroll this employee into the deferred compensation program and the employer once a year adds to the COLI pool if and when the deferrals would cause a modified endowment on the existing insurance.

Lessons Learned

As part of the implementation of the integrated programs we had some logistical issues of enrolling key employees from around the world. By using WebEx and conference calls we were able to do two enrollment meetings for all ninety employees (even those half way around the world) when it was convenient for all. And by properly conveying the program with charts and sample pages we were able to get almost 70% plan participation in the deferral program.

Key Questions

Advisors should be asking their clients in similar situations . . .

- ✓ Has your 401(k) failed a “top hat” test in the last 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?
- ✓ Do you want 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 that would give up control?

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