Give your HCEs some TLC

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The best retirement packages for your HCEs

You have worked hard to provide participants in your retirement plans the education they need to understand the value of the tax-deferred savings available to them. You see that your education efforts have paid dividends in employee engagement and increased participation. Your highly-compensated employees are now fully utilizing your plans by contributing the maximum amount of their own money ($24,000 in 2017 for employees over 50). But what if the plan does not currently provide what is needed to meet their retirement goals? An optimized qualified plan design may be able to provide all your key employees with the benefit levels they need. The challenge is to meet those needs in a cost effective manner.

What is an HCE and why does it matter?
For the purpose of employer-sponsored, tax-advantaged retirement plans, a highly compensated employee is one who has a 5% or more ownership in the company or who earned more than $120,000 in 2016. Familial relationships should also be considered when determining whether someone is a 5% owner: interest owned by a spouse, child, grandchild or parent would count; interest owned by a sibling or grandparent would not. An employer can also choose to limit the number of HCEs (due to pay not ownership) to those in the top 20% of compensation for that company.

At the heart, the laws and regulations related to retirement plans is the mandate that a tax-qualified employee retirement plan must not discriminate in favor of HCEs. There are various Internal Revenue Code (IRC) sections that cover different aspects of non-discrimination. Some requirements like the minimum participation rules in IRC 401(a)(26) only apply to defined benefit plans. The core requirements that apply to plans relate to non-discrimination in who a plan covers (IRC 410(b)) and non-discrimination in the benefits that are provided to those who are covered (IRC 401(a)(4)).

There are various "safe-harbor" designs that can make compliance with the rules virtually automatic, but generally those designs by themselves will not provide for optimized HCE benefits. Keep in mind that the maximum allowable contribution for 2017, if you include the $6,000 catch-up contribution for those over the age of 50, is $24,000. For many HCEs and business owners this is not enough of a tax deferral to meet their goals, especially if they are starting to save late in their career. This figure can be reduced even further if non-HCEs are not contributing to the plan and the plan is not utilizing a "safe-harbor" design.

How to optimize a plan under HCE rules
The first question that needs to be asked in order to optimize a qualified plan design is, how much tax-deferred savings is needed and for which employees. There are limits to what can be done within a qualified plan design but the range is quite large. The amount that needs to be saved also determines what types of plans need to be included in the design.

For example, if there are no HCEs that need to save more than $60,000 a year then their goals can be achieved within a single defined contribution (DC) plan. However, if there are HCEs that are looking to defer $75,000, $150,000 or even $200,000 a year, then that can only be accomplished by adding a defined benefit (DB) plan, typically a cash balance plan. A DB plan can allow for the accumulation of over $2.6 million in tax deferred savings in addition to what has been saved through a defined contribution (DC) plan. Depending on the age at initial participation, that can translate into tax deductible annual contributions of over $200,000.

The second question is, what is the employer willing to facilitate to help obtain additional tax deferred savings for HCEs? If the answer is nothing then the goal of the design would be to see if there is any room with the current plan design to add more benefits for HCEs and still pass all the applicable non-discrimination tests.
If the employer is willing to pay a higher percentage (usually 80% or higher) of the additional dollars that will go towards achieving the HCEs goals, the door opens to additional plan design options.

The rules can be quite complicated and depending on the size of the employer, the goals for the plan overall and the goals with regard to HCEs, there may be multiple designs that accomplish those goals. As the monetary goals for HCEs increase, there tends to be a progression in the plan designs considered by plan sponsors, as follows:

Plan	Description
Qualified 401(k) Plan *This is the most common qualified plan and can allow for both employee and employer contributions*	If the plan only provides for employee contributions, then there is no cost to the employer. If the employer has high participation levels by non-HCEs, then this plan design can be the most cost-effective way to provide HCEs with up to $24,000 in annual tax-deferred savings ($18,000 if under age 50).
Safe Harbor 401(k) Plan *This is a 401(k) plan that provides certain prescribed employer benefits in order to eliminate the need for non-discrimination testing*	The employer benefits can be a “match” (employer contribution conditional on how much the employee contributes) or a fixed percentage that the employee receives independent of their own contributions. The match design can be the most cost effective if non-HCE participation levels are low and HCE goals are $40,000 or less annually. The fixed percentage design works best for plans looking to get HCEs to the maximum $60,000 defined contribution limit (2017 annual limit for HCEs age 50 or older).
Safe Harbor 401(k) Plan + “Cross-Tested” Employer Profit Sharing Contribution *This is a fixed percentage safe harbor plan design with an additional employer contribution intended to maximize HCE benefits*	The employer safe-harbor contribution can be used to help pass the “cross-test” which is not true of the safe harbor match contribution. A “cross-test” is a test that demonstrates the plan does not discriminate in favor of HCEs by converting the contribution to a benefit. If the HCEs that the design is trying to benefit are significantly older than a group of non-HCEs, the design can support maximized HCE contributions. For an HCE over age 50, the result is an employer contribution of $36,000 annually ($60,000 less $24,000 in deferrals) in 2017. To satisfy the testing rules, the non-HCEs would need to receive an employer contribution of at least 4.44% annually.
Cash Balance Plan (Defined Benefit Plan) *This is an additional qualified plan that is added on top of the 401(k) plan design*	In some cases a traditional defined benefit plan design works best. However, with changes implemented as a result of the Pension Protection Act (PPA) of 2006 and subsequent regulations, a Cash Balance Plan with an interest crediting rate equal to the plan’s investment return is typically the best way to provide for DB type (contributions of $200,000+) savings with the least amount of downside of a DB plan (unfunded liabilities). Additional testing and reporting considerations are often required, but for HCEs looking to make contributions that are significantly greater than the $60,000 a year limit available in a DC plan, an appropriately designed cash balance plan is usually the best vehicle.

Traditional defined benefit plans have been steadily declining since the mid-1980s, while hybrid plans are becoming increasingly popular with small and mid-sized business. The bottom line is: a cash balance plan design offers maximum flexibility and optimal saving opportunities for business owners and HCEs. They can lower risk, remove cost volatility, deliver consistency and fairness, and are fully portable.

Did you miss part 1? Read about effective plan design strategies at **hhconsultants.com/HCE**

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