The Lost Art of Plan Design
For more than a decade, the Learning Center has consistently and persistently delivered high-end, high touch consultations on over 100,000 retirement cases. We work with elite advisors, providing them with not only the “knowledge” but the “know-how” to close new business, gather new assets and create repeatable business practices.

The Learning Center provides exclusive access to our key partners to a unique blend of timely technical information, actionable sales ideas, marketing seminars and workshops, real-time sales support and top of the line continuing education courses. This value-add program is designed to not only provide the tools but also assist you at each step of the way down the path of success.
Learning Objectives

- Understand the importance of plan design in meeting plan sponsor objectives
- Comprehend why plan design has been de-emphasized
- Identify strategies to
  - Help ascertain plan sponsor objectives and
  - Apply specific plan design options to meet those objectives
Why Plan Design Is Important

- Ensure the plan achieves identified goals and objectives for the business
- Secure tax advantages for the sponsor and participants
- Maximize contributions for the sponsor and participants
- Provide another source of retirement income
Plan Design Has Faded

- Despite the importance of plan design it has taken a back seat over the last 10 years.
- The causes are multi-faceted, and related to a lack of understanding.
- This is unfortunate as modern plan documents are robust and flexible.
The Market Has De-Emphasized Plan Design

- Platform providers and TPAs are increasingly margin driven; simple designs are:
  - Less costly to administer and support
  - More checklist driven with fewer options
- Safe-harbor options are less work to administer
  - Often safe-harbor has become the default design
- Plan design specialists are hard to find
Your Opportunity

- Opportunity exists for plan sponsors, consultants and advisors
  - A plan that truly meets goals and objectives is important and attractive
  - Better alignment with goals and objectives results in increased support for the plan
  - Plan design skill set can be a key differentiator among advisors and consultants
  - Modern plan documents are streamlined and designed to augment plan design — Set-up checklists are not!
The Plan Design Process
The Plan Design Process

1. Identify plan sponsor’s goals and objectives
2. Consider the plan document
3. Understand plan design options
4. Execute
5. Re-evaluate
Step 1: Identify Plan Sponsor’s Goals and Objectives

- Plan design is a strategy to ensure the plan meets the goals of plan sponsor
  - Many options and choices are available
  - Plan sponsors often unaware of their options and choices
Common Goals and Objectives

<table>
<thead>
<tr>
<th>Common Goals/Objectives</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution/deduction augmentation and redirection</td>
<td>Sponsor wants certain employees or groups of employees to receive additional contributions</td>
</tr>
<tr>
<td>Additional contributions/deferral opportunities</td>
<td>HCEs want to maximize their employee deferrals</td>
</tr>
<tr>
<td>Eliminate compliance test failures and contribution/deferral limitations</td>
<td>Sponsor wants to avoid distributions to corrected excesses</td>
</tr>
<tr>
<td>Cost containment</td>
<td>Sponsor wants to control or limit the cost of the plan</td>
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<tr>
<td>Recruitment</td>
<td>Sponsor wants to use the plan to attract and retain targeted employees</td>
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<tr>
<td>Simplification</td>
<td>§ Sponsor wants to streamline administrative process</td>
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<td></td>
<td>§ Reduce staff time needed to support plan</td>
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</table>
Sponsors Unsure of Goals and Objectives

- Plan sponsors are often unsure of plan goals or even why they have the plan
- Stimulate the plan sponsor thought process
- Ask the questions and *listen* to their answers:
  - Ideally, what would you like the plan to do?
  - What would you like to change about the plan?
  - Gee, it would be nice if …
Step 2: Consider the Plan Document

- Modern plan documents are flexible
- Start on the right foot: Select plan provisions that align with the sponsor’s goals and objectives
- Consider pros and cons and trade-offs
- Ongoing plan and objective reviews are essential to an effective governance process
- Plans can be amended to reflect changes in the plan sponsor’s objectives
Step 3: Understand Plan Options and Choices

- Effectively aligning goals and objectives with plan provisions requires an understanding of the available options and choices and their impact on plan testing.
- Selecting the correct options is not sufficient without understanding the impact on plan testing and outcomes.
Importance of Satisfying Compliance Testing

- Satisfying plan testing is essential to maintain the tax preferred status of plans
  - Failure to meeting testing could result in loss of tax deductions to plan sponsor
  - Test failure could result in participants benefits becoming immediately taxable
Types of Plan Compliance Tests

Broadly speaking, the plan must satisfy two types of compliance tests

- Group testing and related issues
  - HCE determination
  - ADP/ACP testing
  - IRC §410(b) testing
  
- Individual testing (beyond the scope of this presentation) includes
  - IRC §415 annual addition
  - IRC §402(g) limitations
Group vs. Individual Testing

- Group testing ensures the plan covers and provides appropriate contributions to enough NHCEs compared to the number of HCEs covered and the HCEs’ contribution amounts.
- Individual testing ensures allocations to participants’ accounts do not exceed specified limits.
Who is Considered an HCE?

- HCE determination is necessary for plan testing
- HCE
  - Owns more than 5% of the organization
  - Compensation over $120,000
  - Top paid group election
  - Calendar year election
ADP and ACP Tests Apply to 401(k)s

- The ADP test limits what HCEs can defer based on the average deferral rates of the NHCEs.
  - Generally, the average HCEs' deferrals cannot exceed the average NHCEs’ deferrals by more than two percentage points
- The ACP test limits what the HCEs can receive in matching and after-tax contributions based on the average contribution rate of the NHCEs
ADP Testing Example

- The Martco 401(k) plan covers four employees

- HCE 1: 10% deferral
- NHCE 3: 8% deferral
- HCE 2: 0% deferral
- NHCE 4: 0% deferral
ADP Testing Example

- HCE average deferral: \( (10 + 0)/2 = 5\% \)
- NHCE average deferral: \( (8 + 0)/2 = 4\% \)
- The Martco 401(k) satisfies the ADP test because the HCE ADP of 5% is not more than 2 percentage points greater than the NHCEs’ ADP of 4%
ACP Testing Example

The ACP test is identical to the ADP test except matching and after-tax contributions are combined and tested.
IRC §410(b) Coverage Test

- The IRC §410(b) coverage test is commonly known as the “70% test”
- The percentage of NHCEs eligible to participate must equal at least 70% of the percentage of HCEs eligible to participate
Plan Coverage: Who is Eligible to Participate?

- Sponsors may use the following plan provisions to limit participation
  - Exclude those under age 21
  - Require 1 (or in some cases 2) years of service
  - Exclude those covered by a collective bargaining agreement (union)
  - Exclude non-resident aliens
  - Other exclusions
    - Require 1,000 hours of service in a year
    - Require employment on the last day of the year
    - Exclude certain group of employees
IRC §410(b) Testing Example

- Kellco has 10 HCEs and 100 NHCEs
- The Kellco plan excludes all 25 employees working in the shipping department
- The Kellco plan still satisfies IRC §410(b)
  - 10 of 10 HCEs covered = 100%
  - 75 of 100 NHCE covered = 75%
  - Minimum level of coverage required
    - 100% (HCE coverage percent) X 70% = 70%
Multiple Benefit Structures

- Plan can provide different benefits to different groups if the coverage rules are satisfied
  - Example: A 401(k) plan could provide different levels of matching contributions to different employee groups
Step 4: Execute and Follow the Plan Document

- Correctly executing the plan document is critical
- Following the plan document is essential
  - Knowing the document and operating the plan in accordance with its terms is the first step of a successful plan.
  - The Firestone case affirmed that following the plan is the first line of compliance defense
Amending the plan is not difficult … **BUT**

It must be done correctly

- Execute board resolution
- Sign plan document amendment
- Provide employee notification (update Summary Plan Descriptions)
- Generally, amendments are not retroactive
Step 5: Re-Evaluate

- Ongoing plan and objective reviews are essential to an effective governance process.
- Plans can be amended to reflect changes in the plan sponsor’s objectives.
Profile 1: MCC, Inc.

- Allow HCEs to defer additional amounts
- A safe-harbor option allows HCEs to make additional deferrals
Profile 1: MCC, Inc. — Background

- MCC, Inc., has a 401(k) plan and the NHCEs average deferral is 2% of compensation
  - NHCE Average = 2% (8% / 4)
Profile 1: MCC, Inc. — Background

The sole HCE at MCC Inc., wants to defer 10% of compensation but is currently limited to 4% due to the low NHCE ADP

- HCE 1 4% maximum
- NHCE ADP 2% + 2% (maximum spread) = 4%
Profile 1: MCC, Inc. — Design Solution

- Sponsor amends plan to include a safe-harbor provision so the HCE may defer additional amounts and the ADP is deemed satisfied.
- The safe-harbor requires MCC Inc., to make a 3% employer contribution to the NHCEs or provide a 100% match up to 4% of compensation.
Profile 1: MCC, Inc. — Pros and Cons

The safe-harbor strategy has advantages and disadvantages

- **Pros**
  - Testing is simplified
  - ADP and ACP testing is deemed satisfied
  - HCE deferrals not linked to NHCE deferral percentages
  - Top Heavy testing is deemed satisfied

- **Cons**
  - Expense of employer contributions
  - Additional reporting and disclosure
  - Additional contributions (after-tax) not permitted (unless plan allows and ACP is tested separately)
Profile 2: Multicorp

- Augment matching contributions for certain employee groups to encourage retention and support recruiting

- Utilize a plan document that permits multiple benefit structures
Profile 2: Multicorp — Background

- Multicorp has significant turnover in the IT department
- They offer a 401(k) plan with a 50% matching contribution up to 6% of compensation
- They want to provide additional matching to the IT staff to retain and attract these employees
Profile 2: Multicorp — Design Solution

- Sponsor amends the plan to reflect the following matching contribution schedule:
  - HCEs 50% match up to 6%
  - IT NHCE 100% match up to 10%
  - Other NCHE 50% match up to 6%

Nota: The ACP test still must be satisfied
Profile 2: Multicorp — Why it Works

- Multiple benefit structures, in this case different matching formulas, are permitted if the ACP and overall coverage testing is satisfied.
Profile 2: Multicorp — Pros and Cons

The multiple benefit structure approach has advantages and disadvantages

- **Pros**
  - Targeted group receives additional matching contributions
  - Plan sponsor attains its goals

- **Cons**
  - Plan administration is more complex
  - Higher costs on account of increased matching contributions
Profile 3: CoverageCorp

- Allow HCEs to make additional deferrals by improving ADP/ACP testing results
- Reduce plan costs
- Exclude one or more groups of NHCEs with low deferral rates
Profile 3: CoverageCorp — Background

- CoverageCorp has a group of NHCEs with very low deferral rates. These employees work in the shipping department.
- The plan sponsor is not interested in a safe-harbor plan.
- If the shipping department employees were excluded from ADP testing the NHCE average deferral would increase from 2% to 5%.
Profile 3: CoverageCorp — Design Solution

- Sponsor amends the plan to exclude the employees in the shipping department
Profile 3: CoverageCorp — Why It Works

IRC §410(b) testing is satisfied

- Two of two HCEs covered = 100% coverage
- 75 of 100 NHCEs covered (25 NHCEs in shipping excluded)
- NHCE coverage percent = 75%
- IRC §410(b) satisfied: HCE percent 100% X 70% = 70% percent. Currently, 75% of NHCE are eligible to be covered—test passed

Note: The ACP test still must be satisfied
Profile 3: CoverageCorp — Pros and Cons

The multiple benefit structure approach has advantages and disadvantages

- **Pros**
  - The ADP/ACP testing results improve
  - The low participating group is excluded

- **Cons**
  - Compliance testing is more complex
  - Dissatisfaction within the excluded group
Profile 4: Lawco

- Reduce costs through exclusions
- Excluding certain HCEs allows additional exclusions of NHCE
Profile 4: Lawco — Background

- Lawco has the following employee make-up:
Profile 4: Lawco — Design Solution

- Sponsor amends the plan to exclude associate HCEs; consequently, the 10 administrative staff NHCEs and 4 investigator NHCEs can be excluded.
Profile 4: Lawco — Why it Works

- IRC §410(b) testing
  - HCEs’ coverage is 40% (2 of 5 HCEs are covered)
- Determine minimum NHCEs coverage percentage
  - 40% (HCEs’ coverage) × 70% = 28% of NHCEs must be covered
- NHCEs’ coverage
  - 6 NHCE (paralegals) 6/20 = 30%
Profile 4: Lawco — Pros and Cons

The exclusion strategy has advantages and disadvantages

- **Pros**
  - Plan sponsor’s coverage objective is met
  - Plan contribution costs are reduced

- **Cons**
  - Compliance testing is more complex
  - Dissatisfaction within the excluded group
Profile 5: BurgerCorp

Objective:

- Provide additional matching contributions to certain NHCEs
- Simplify compliance testing

Design solution:

- Exclude HCEs from the plan and provide additional matching contribution to select NHCEs
Profile 5: BurgerCorp — Background

- BurgerCorp is a regional restaurant chain with the following employee makeup:
  - 10 HCEs
  - 50 NHCE managers
  - 150 NHCE assistant managers
  - 700 other NHCEs
Profile 5: BurgerCorp — Design Solution

- Sponsor amends the plan to exclude HCEs and provide the following:

<table>
<thead>
<tr>
<th>Matching contributions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Managers</td>
<td>100% matching up to 10% of compensation</td>
</tr>
<tr>
<td>Assistant managers</td>
<td>50% matching up to 10% of compensation</td>
</tr>
<tr>
<td>All others</td>
<td>25% matching up to 10% of compensation</td>
</tr>
</tbody>
</table>
Profile 5: BurgerCorp — Why it Works

- If the HCEs are excluded no ADP or ACP testing is necessary
- Matching contributions can vary among the NHCE groups
- The excluded HCEs can participate in a non-qualified arrangement in lieu of the 401(k) plan
Profile 5: BurgerCorp — Pros and Cons

The exclusion strategy has advantages and disadvantages

- **Pros**
  - The specified NHCEs receive increased matching contributions
  - No ADP or ACP testing is required

- **Cons**
  - Corporation loses immediate tax deduction for contributions to non-qualified plan
  - Dissatisfaction with differing matching contribution rates among NHCEs
Profile 6: SummerCo

Objective:

- Reduce costs through exclusion of seasonal employees
- Simplify plan administration and data gathering

Design solution:

- Count hours of service based on an equivalency method
Profile 6: SummerCo — Background

- SummerCo is a resort with most of its business occurring during the three summer months.
- During the summer, the seasonal employees generally work over 1,000 hours
- Employee make-up
  - 3 HCEs
  - 20 year-round NHCEs
  - 250 seasonal NHCE
Profile 6: SummerCo — Design Solution

- Sponsor adopts an alternative, simplified, method for counting hours of service known as the Equivalency Method
- Plan does not count actual hours of service
- Employee is credited 190 hours of service for each month in which he/she works at least one hour
Profile 6: SummerCo — Why it Works

- A seasonal employee would be credited as follows:
  - Months worked: June, July, August
  - Hours credited: 570 (3 months X 190)

- Seasonal employees do not have the 1,000 hours needed to receive credit for a year of service
Profile 6: SummerCo — Pros and Cons

The equivalency strategy has advantages and disadvantages.

- **Pros**
  - Seasonal employees are excluded
  - Hour of service data gathering is simplified

- **Cons**
  - Employees working extra months may end up in the plan
  - Dissatisfaction among those excluded
Profile 7: LittleCo

Objective:

- Make contributions to a Roth IRA through conversions of plan assets

Design solution:

- Allow after-tax contributions and in-service distributions
Profile 7: LittleCo — Background

- LittleCo has one HCE and one NHCE.
- The HCE likes the concept of Roth IRAs and wants to make after-tax contributions to the 401(k), roll the amounts to his Roth IRA and treat the transaction as a conversion.
- The plan calls for a 3% safe-harbor contribution.
Profile 7: LittleCo — Background

LittleCo calculations

<table>
<thead>
<tr>
<th>Employee</th>
<th>Comp.</th>
<th>3% S/H</th>
<th>Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>HCE</td>
<td>$200,000</td>
<td>$6,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>NHCE</td>
<td>$ 20,000</td>
<td>$ 600</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
Profile 7: LittleCo — Design Solution

- Sponsor amends plan to allow after-tax contributions and in-service distributions
- HCE makes a $20,000 after-tax contribution and elects a Roth IRA conversion of an in-service distribution
- After-tax contributions require plan to satisfy ACP test despite safe harbor
- ACP test is based on the following:
  - HCE's ACP = 10% ($20,000 (after-tax) / $200,000)
  - NHCE's ACP must be 8% to satisfy the ACP test
Profile 7: LittleCo — Why it Works

- Employer can make an 8% QNEC to the NHCE to satisfy the ACP test
- QNEC contribution ($1,600) allows the plan to satisfy the ACP test
- QNEC allows HCE to convert $20,000 to his Roth IRA
Profile 7: LittleCo — Pro and Cons

The after-tax/in-service/conversion strategy has advantages and disadvantages.

- **Pros**
  - The HCE can make significant after-tax contributions to the plan
  - The after-tax contributions can be distributed and converted to a Roth IRA

- **Cons**
  - Additional contributions for NHCE is required
  - Plan administration is more complex
The Return of Plan Design and Next Steps
Return of Plan Design and Next Steps

- Good plan design helps ensure a plan meets the goals and objectives of the sponsor
- Plan design has been de-emphasized in the last 10 years
- Opportunity exists for plan sponsors, advisors and consultants
- Following a process facilitates plan design
- Understanding sponsor goals and objectives is essential to beginning an effective plan design process
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