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Plan Design for Professional Groups

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Plan design is like art—there is no way to define what is good, and people will disagree on the quality based on their own preferences. However, "good" plan design will always satisfy certain principles.

First and foremost, the plan design will meet the objectives of the client in the simplest way possible. Second, it must be cost-effective for the owners of the practice. Third, the design should be flexible enough to prevent surprises in later plan years and, to that extent, should be stable if the demographics of the practice changes slightly. Fourth, it should not be so complex that it becomes error prone and impossible for the client and/or the third party administrator (TPA) to understand and administer. Fifth, it should be flexible enough to avoid the need for frequent "tweaks" and amendments. And last, it must be able to withstand any challenge by the IRS and it should not be so aggressive that its legality could be questioned.

This article will discuss various general plan design options for professional groups that follow the above principles. It will assume the following:

- The group has more than one shareholder or partner, who we will refer to collectively as "owners" for the rest of the article; and
- The owners' goals are to achieve deductible contributions in excess of the defined contribution (DC) annual addition maximum of $46,000.

"Combo" Plan Designs

Combination plan designs, often referred to as "combo" plans, combine two or more types of plans together to form a "combined" design. Combo plans are frequently used because they provide the flexibility to meet goals such as the ones identified previously according to the principles outlined in the introduction. Combo plans can accomplish objectives in ways that a standalone defined benefit or a standalone profit sharing plan cannot. This article will show how combo plans can be used effectively for professional groups.

Profit Sharing/401(k) Combo Designs, Cross-testing and Safe Harbor

Inevitably, the goals of our typical group (as described previously) will be accomplished by using a profit sharing (PS) plan with a 401(k) feature as part of the design. Generally, this plan should have the following features:

Combo plans can accomplish objectives in ways that a standalone defined benefit or a standalone profit sharing plan cannot.

- The PS allocation should generally be "cross-tested," ideally with individual allocation groups to provide the greatest flexibility because:
  - — This type of design allows the practice to make different contributions for the owners and for different job classes or employees. It also allows the firm to provide bonuses as plan contributions, generally eliminating the FICA taxes that would be paid if those bonuses were paid as salary.
  - — This design avoids the need for corrective amendments under Treasury Reg. 1.401(a)(4)-11(g) to pass testing because all required contributions can be made per the allocation provisions.

  Note: Prototype plans generally will not be able to use individual groups in the EGTRRA restatements.
- Generally the (k) feature will be a safe harbor (SH) plan with the 3% non-elective PS contribution. [Because there is usually a cross-tested formula, the 3% SH contribution does triple duty as the SH contribution, the required top heavy (TH) minimum and as part of any required gateway contribution.] The SH feature allows all owners to defer the maximum amount possible without Average Deferral Percentage (ADP) testing, and the employer contribution to maximize them at the $46,000 annual addition maximum is reduced to $29,500, putting less pressure on 401(a)(4) and gateway testing.

  Note: Low earning spouses or children of owners who defer the maximum 401(k) amounts can hurt the ultimate testing result because of the impact on the average benefits percentage test. Projected nondiscrimination testing should be run before employees in this category are given the go-ahead to defer the maximum.

In law and accounting practices, the issue of associates must be considered, as with the treatment of hygienists in dental practices. Consider my Associate Principle: "The willingness of professional firms to provide any employer-funded benefits to associates decreases with the size of the practice." Generally we see that:

- Firms usually allow associates to make 401(k) deferrals and are willing to pay the administrative expenses associated with a 401(k) plan covering only the associates.
- Associates are usually highly compensated employees (HCEs), but are always non-key employees, so if the firm's plans are deemed top heavy (TH), then there is a required TH contribution if associates are allowed to defer. *Note: This result can be undesirable for owners.*
- The above outcome can be avoided by putting associates in a separate, deferral-only 401(k) plan that is tested separately under 410(b). Note, however, that if the owners' plan relies on the plan for the associates to pass 410(b), then the plans become part of the required aggregation group for top heavy purposes, and the associates must receive TH minimums.

DB/DC Combo Designs, Deductible Limits and Top Heavy Minimums

When the owners want deductible contributions in excess of the $46,000 maximum, as outlined in our original goals, an additional DB plan will also be adopted. The rules under 404(a)(7) will determine how the employer contributions between the DB and the PS plan are coordinated.

The combined deduction limit under 404(a)(7) applies when the employer contributes to both a DB and a DC plan for the same fiscal year and at least one employee is an active participant in both plans. The basic rule is that the deduction limit is the greater of 25% of compensation in the fiscal year; or the minimum required contribution for the DB plan. Prior to the Pension Protection Act of 2006 (PPA), the effect of this rule was that it was often not possible for a firm making large DB contributions to provide any PS contributions, because the DB contribution already exceeded 25% of pay.

PPA modified the rule under 404(a)(7) to say that the 404(a)(7) limit *does not apply* if the PS contribution does not exceed 6% of compensation for the participants benefiting in the PS plan. This modification now allows for designs where the PS plan is designed to keep the employer contributions to the PS contribution under 6% and to maximize on the DB side. The IRS has further clarified that the effect of the rule is that the 25% limit effectively becomes a 31% limit, because the first 6% of pay is always deductible as a PS contribution.

One significant impact on professional firms as a result of this change is the way in which TH minimums can be provided. As a quick primer, remember that when a DB/DC combo plan contribution is top heavy, the employer can provide the TH minimum in the DB plan, as a 5% of pay contribution in the DC plan, or can use comparability or offset approach between the two. It is always best to provide TH minimums in the PS plan because these contributions are age neutral and almost always significantly cheaper than the cost of funding DB TH minimums, where the cost is dependent upon age.

Typical allocation provisions often found in a PS plan, including a last day of employment requirement and a 1,000 hours of service requirement to receive a PS contribution, need to be carefully considered when the PS plan is designed to provide the TH minimum. The DB/DC gateway requirement (which will be discussed in more detail later) also requires consideration, as it affects the allocation requirement. Any employee who receives the SH contribution must then receive a TH minimum and then becomes subject to the DB/DC gateway; therefore, employees who work fewer than 1,000 hours must also receive a contribution even if they have terminated employment. The PS plan design that provides the greatest flexibility to deal with all of these issues uses individual allocation groups as mentioned before, *but with no end of year employment and no hours requirement*. The employer can then provide PS contributions as desired based on the practice objectives, and the employer has the flexibility to satisfy the SH, the TH and the DB/DC gateway with no corrective amendments and no confusion between these contributions and the PS plan allocation provisions.

Special Considerations Regarding PBGC Coverage

Larger firms that are subject to Pension Benefit Guaranty Corporation (PBGC) coverage (they have or have had more than 25 active participants) are subject to an additional loosening of the effect of 404(a)(7) in their 2008 plan year. For such entities whose plans are covered by PBGC, the 404(a)(7) limit does not apply at all *regardless of the level of PS contributions*. As a result, these plan designs can allow maximum PS contributions and a maximum DB design for owners of larger professional firms, while focusing the remaining design on the minimum contribution necessary for the NHCEs to pass the general test. In past years, it was often preferable to design plans that avoided PBGC coverage; there will have to be real consideration in 2008 as to whether to try to bring in enough employees to become covered by PBGC if the firm would normally be excluded from coverage using the statutory exclusions. The inability to waive benefits for a PBGC standard termination if there are no majority owners (for example, if there are four 25% owners) is the key issue to consider as you review this option.

Cash Balance Designs as an Alternative Approach

When a DB plan is added to provide larger contributions than the DC plan allows, consideration must be given as to whether to use a traditional DB plan or a cash balance (CB) plan. The CB plan has generally become the design of choice for professional firms because:

- It allows a direct tracking of contributions to ultimate benefits paid (because contributions are normally funded out of the owner's compensation package, this approach is desirable).
- It allows age-neutral contributions to employees.
- The contributions and benefits are transparent, so everyone has a much better understanding of their benefits than the benefit under the traditional DB plan.

Nondiscrimination Testing for DB/DC Combo Plans

When a firm has a DB and PS plan that are tested together for nondiscrimination purposes, there are additional rules above and beyond the general test. These rules were created several years after the 401(a)(4) regulations were passed. At that time, the IRS looked at designs that satisfied the regulations, but determined that naughty practitioners were taking too much advantage of the rules and that contributions were being too heavily skewed in favor of owners. As a result, in addition to passing the general test, the plans must now satisfy one of the following requirements:

- The DB plan must be primarily DB in character. This requirement is met if more than 50% of the NHCEs benefiting under the plan have a normal accrual rate under the DB plan that exceeds their normal benefit accrual rates under the DC plan.
- The plans must be broadly available separate plans. This requirement is met if the DC plan and the DB plan would each pass 410(b) and 401(a)(4) if each plan were tested separately.
- The plans must satisfy the minimum allocation gateway. This requirement is met if each NHCE's combined normal allocation rate (*i.e.,* the sum of the NHCE's allocation rate under the DC plan and the NHCE's equivalent allocation rate under the DB plan) is not less than a minimum percentage, based on the highest HCE rate. These rates are determined by calculating the hypothetical contribution to fund the DB benefit plus the PS allocation. If the DB plan is designed to fund for maximum benefits for owners, then this percentage is usually 7.5% of pay. The use of this DB/DC gateway on top

of the general test essentially provides that a DB plan tested with a PS plan has to be tested for non-discrimination purposes on the basis of both benefits and contributions. In most DB/PS combination designs for professional firms, this approach is the most common because the plans are almost always designed in a way that the other two requirements cannot be satisfied.

With a design subject to the DB/DC gateway, one must remember that since the gateway is a combination of the hypothetical contribution to fund the DB increase plus the PS allocation, the amount of gateway provided to NHCEs by their DB benefit will differ based on their age. For example, a cash balance credit of 7.5% of salary does not necessarily satisfy the 7.5% of pay gateway for all participants.

Special Considerations for Cash Balance Plan Designs

At the design stage, a key consideration is how to design the cash balance credits for owners. It is critical not to sell a CB plan as a glorified PS plan, and owners should not be surveyed to determine how much of a contribution they "want" each year, as operating in this manner could effectively create a cash or deferred arrangement.

In designing the cash balance credits, keep in mind the "similarly situated" employee requirement of PPA, which says that cash balance plans *are not age-discriminatory if a participant's accrued benefit determined under the terms of the plan would be equal to the accrued benefit of any similarly situated, younger individual (in every respect):*

- *Period of service;*
- *Compensation;*
- *Position;*
- *Date of hire; and*
- *Work history.*

The proposed regulations on this issue are still fairly vague as they pertain to how credits for owners can be structured. They do make it clear that if you use different crediting formulae for different classes of employees, you test within that class to determine if this requirement is met.

Let's consider various ways to define credits for owners and discuss whether they satisfy the requirement:

Example 1: Equal credits as a flat dollar amount or as a percentage of pay. This approach is often used where the cash balance plan "tops-up" an existing PS/(k) plan and the owners want identical contribution levels. Clearly there is no similarly situated employee issue with this approach. A good design tool when using flat dollar credits is to limit the credit to a percentage of salary (*e.g.,* $92,000, but not to exceed 40% of compensation), so that if an owner's compensation decreases (*e.g.,* a year in which the owner leaves the firm) he or she is not faced with an onerous cash balance credit.

Example 2: Credits by name.

Mr. Huey	$ 50,000
Mr. Dewey	$ 20,000
Mr. Louie	$ 125,000
All other participants	$ 1,250

It is not clear if this example satisfies the similarly situated employee requirement. A reading of the proposed regulation suggests that each named individual could be considered a separate formula, which would then result in this design being acceptable.

Example 3: Maximum credits—where the goal is to maximize owners in the cash balance plan. There are various ways to accomplish this goal:

- *Absolute maximum approach:* With this approach, the cash balance credit for owners is defined as the amount of annual credit that provides a cash balance account as of the last day of the plan year that is equal to the maximum lump sum under Section 415 that can be distributed as of that date. This design guarantees that the owner always has a cash balance account that is the maximum amount that can be distributed. There is no possible similarly situated employee issue using this approach.
- *Age band approach:* With this approach, the cash balance credits for owners is defined based on a table, where each owner's age at the time he or she first enters the plan is based on the age

	Age	Compensation	Cash Balance Credit	Profit Sharing Contribution	Profit Sharing Contribution as a Percent of Pay	401(k) Deferral	Total
Principal A	56	$ 230,000	$ 180,000	$ 13,100	5.70%	$ 20,500	$ 213,600
Principal B	50	$ 230,000	$ 140,000	$ 13,100	5.70%	$ 20,500	$ 173,600
NHCE 1	40	$ 50,000	$ 1,200	$ 3,500	7.00%	?	$ 4,700
NHCE 2	25	$ 50,000	$ 1,200	$ 3,500	7.00%	?	$ 4,700
NHCE 3	28	$ 40,000	$ 1,200	$ 2,800	7.00%	?	$ 4,000
Totals		$ 600,000	$ 323,600	$ 36,000	6.00%	$ 41,000	$ 400,600

band he or she is within. You set the amount for each band as the amount that will accumulate to the 415 maximum lump sum at retirement age, based on the *lowest age* in that age band, and you can use as many or as few age bands as you see fit. For example, if we used the age band table below, the result would be that a participant who enters between age 40 and 45 will forever receive a credit of $48,000, where $48,000 is the estimated level annual amount that would accumulate to the 415 maximum lump sum at age 62.

Age at First Entry	Annual Credit
Under 40	$ 34,000
40 to 45	$ 48,000
46 to 50	$ 78,000
51 to 55	$ 129,000
56 and over	$ 174,000

If you use the age band approach to target the 415 maximums for all ages, it is important for the owners to understand that their credit is *forever* determined by their age as of first entry into the plan. They do not move into the higher credit level as they get older! There is no possible similarly situated employee issue using this approach.

A Close-up Look at a "Generic" Combo Design

As this article points out, there is no one cookie cutter design for professional groups. Obviously there are an infinite number of plan designs that can be used. However, to the extent there is a generic approach, it would look similar to the design shown below:

Designs using this approach operate as follows:

- The plans are tested together for 410(b) and 401(a)(4) purposes;
- The firm may choose to carve out non-owners from the DB plan for it to pass 401(a)(26)—for example, in the above group a DB that covered the owners only would pass 401(a)(26), or in smaller firms may cover all eligible employees to avoid instability in the design or to avoid the confusion of having some employees covered in one plan and not the other;
- The cash balance credits are designed to meet the goals of the owners;
- The 401(k) plan is a safe harbor plan to ensure that the owners can defer the maximum;
- The PS plan uses individual allocation groups or a group allocation to allow different contribution as a percent of pay for owners and other employees;
- The PS contribution to the NHCEs satisfies the dual plan top heavy minimum—5% of salary;
- The NHCEs receive enough of a PS contribution in excess of the TH minimum such that the DB/DC gateway is satisfied in combination with their cash balance credits;
- The combination of the benefit provided by the cash balance plan and the PS allocation is tested on a benefits basis under 401(a)(4); and
- The owners receive a PS contribution such that the total PS contribution does not exceed 6% of pay.

Conclusion

While there are a variety of plan design options, many of the approaches used for professional firms follow the generic combo design. In your own practice, you will, of course, tailor each approach to your own preferences and the specific goals of the client.

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