



RPS

PLAN ADMINISTRATORS

- ◆ **INTERNET-BASED
401(K) PLANS**
- ◆ **RETIREMENT
PLANS**
- ◆ **403(B) PLANS**
- ◆ **CAFETERIA
PLANS**
- ◆ **EMPLOYEE
COMMUNICATION**

303-369-7886
1-800-651-4855
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Designing a Qualified Plan

Background

The proper design of a qualified retirement plan must consider a variety of factors, all of which are important to the plan's ongoing success. Most important, the plan must be designed to meet specific employer objectives while also complying with federal law and regulations, as specified in a body of law commonly known as ERISA.

At RPS Plan Administrators, Inc. we examine many characteristics of the employer including:

- Employer size
- Employee demographics such as income, turnover, amount of discretionary income, history of savings, general knowledge of investments, ratio of Highly Compensated to Non-Highly Compensated employees
- Nature of the business, cash-flow history, age of the owners, presence of family members in the business and any succession issues
- The primary purpose of the qualified plan—benefit owners and highly compensated employees; provide a competitive benefits structure; or provide retirement income for rank and file employees
- Mandatory vs. discretionary employer funding
- Do employees also wish to contribute?

The consultants at RPS will evaluate the above employer characteristics in light of the many and varied plan designs including:

401(k) and 401(k) Safe-Harbor Plans

401(k) plans may elect Safe-Harbor status. A properly designed Safe Harbor plan is not required to pass the ADP/ACP discrimination tests. A plan is a Safe Harbor plan if it meets the following requirements:

1. Provides a matching formula equal to 100% of the first 3%, plus 50% of the next 2% of salary deferral; or provides a 3% employer contribution to every eligible employee (whether or not they participate in the 401(k) plan).
2. The Safe Harbor match (or the 3% employer contribution) is 100% vested.
3. Employees are given advanced written notice of the employer's Safe Harbor election 30 to 60 days prior to the start of the plan year.



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Cross-Tested Plans

A Cross-Tested plan is designed so that eligible participants received different levels of employer contributions. Usually, these formulas are designed to favor a targeted group of participants (i.e., owners or highly compensated employees) over other participants. This is permitted under ERISA as long as the plan passes the non-discrimination tests found under Section 410(b) and 401(a)(4) of the Internal Revenue Service.

A Cross-Tested plan compares the future values (at age 65) of the contributions allocated to the various groups. Typically, the owners of the corporation and/or the highly compensated employees are older than the rank and file employees. Therefore, the future value of their benefit will be less, allowing for a greater allocation to the highly compensated employees.

Example of the future value calculation:

John, the owner, is 55 years old receives a profit sharing allocation of \$20,000. Jill, his secretary, is 25 years old and receives a profit sharing allocation of \$2,000. The future value of John's allocation of \$20,000 at 8% interest at age 65 is \$43,178. The future value of Jill's allocation of \$2,000 (8%, age 65) is \$43,449. So even though John receives \$18,000 more than Jill, his future value at age 65 is less.

Although this is a simplistic example, it illustrates the concept behind Cross-Tested Plans.

Cross-Tested/Safe Harbor 401(k) Plan

Normally, a 401(k) plan must pass certain discrimination tests; tests which usually limit the amount that highly compensated employees can contribute. A Safe Harbor 401(k) plan eliminates these discrimination tests thus allowing the highly compensated employees to always contribute the full amount (\$15,500 in 2007). The attached Information Bulletin explains Safe Harbor plans in detail. Basically, the employer "buys" Safe Harbor status by making either a 3% profit sharing or a matching contribution to the plan. This Safe Harbor contribution must be 100% vested.

A Cross-Tested/Safe Harbor 401(k) plan uses a second time the 3% profit sharing contribution which has been contributed to fulfill the Safe Harbor status. This 3% allocation provides a "spring board" to fund additional Cross-Tested allocations to the highly compensated employees. In a Cross-Tested/Safe Harbor 401(k) plan, the employer can also fund an additional matching contribution which is subject to the vesting schedule.

Integrated Profit Sharing Plan

Social Security is a regressive benefit since no social security benefits accrue on compensation that is above the Social Security wage base. To compensate, the law allows retirement plans to allocate additional employer contributions to those individuals who have compensation above the Social Security wage base. Such a plan is "integrated" with Social Security, hence the name.



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An example of an Integrated Profit Sharing allocation.

*John has compensation of \$210,000. Jill has compensation of \$20,000. The employer declares a 10% profit sharing contribution. John receives \$20,000 and Jill receives \$2,000. If the plan is integrated with Social Security John would also receive an additional allocation of \$6,840 [(\$210,000 - \$90,000) * 5.7%] for a total of \$26,840. (Note, \$90,000 was the 2005 Social Security wage base).*

Age-Weighted Profit Sharing Plan

An Age-Weighted plan is designed so that older employees receive a greater allocation than younger employees. The employer profit sharing contribution is allocated using compensation that has been weighted by age.

An example of an Age-Weighted allocation

	<u>Compensation</u>	<u>Age</u>	<u>Weighted Comp</u>	<u>Allocation of \$1,000</u>
Jack	\$20,000	55	\$820.74	\$897.40
Jane	\$20,000	25	\$ 93.74	\$102.60
			\$914.48	\$1,000.00

In a normal Profit Sharing allocation, two employees with the same compensation would receive the same allocation--in this case \$500 each. However, as this example illustrates, the allocation can change dramatically once age is considered.