The Ultimate 401(k) Plan Design Guide for Plan Sponsor and Advisors

Why you have a 401k and how to get the most out of your 401k Plan

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Your plan design will depend on many different factors. You should always seek the advice of a professional regarding your specific circumstances before implementing a retirement plan.

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1. Background on setting up or changing your current plan

401k plans are great vehicles for saving money on tax deferred or after tax basis, and can be a great tool to retain employees. Due to all the regulations and testing requirements there are several entities that are involved in the administration and compliance of these plans. I have seen many plans that are not designed with what the business owner has intended them to be and there are many ways to save money on the administration of these plans. Current regulations allow for a plan participant to get a maximum contribution of $55,000 (2012 limit). This combines all employee and employer contributions.

The players involved include s, custodians, administrators, investments, advisory services, plan design and a number of different add on services that will need to be considered when sponsoring a 401k plan.

Setting up the right plan for your business or businesses can seem a little overwhelming. I will walk you through the process step-by-step a in the process if you are just starting a plan, or are looking to change providers.

2. IRS / Dept of Labor Definition Rules and Regulations of the 401k Plan in One Sentence

In order to maximize your contributions as a plan sponsor / business owner you have to give something to your employees.

3. Where to begin (even if you already have a plan) and why have a plan in the first place

The first thing that you need to think about if you are starting a plan or looking to change services providers is to get a clear picture in mind of what you are trying to accomplish. What are your goals? Do you want to save for yourself? Is the plan going to be set up to retain employees? Are you getting the service you deserve and are looking for? Is your advisor giving you the attention that you want? Are you getting refunds of your deferrals and not sure why? Most business owners look at fees and forget about what they actually desire is value for the service that is being offered.

I urge you to take a step back and figure out why you want to set up a plan in the first place or why you want to change service providers in order to find the solution you are looking for.
How much do you want to contribute Mr. Owner?

One thing I ask business owner clients is how much do you want to contribute to the plan? Don’t think about the rules. Put a dollar amount on it and write that down. How much would that be? Your service providers’ job is to figure out how to make that happen within the regulations. Do you want to do $3,000, $15,000, $50,000 or more? There are plan designs that can accomplish this, it’s simply a matter of deciding what you want to defer for yourself.

How much do you want to give to your employees?

Do you have a dollar amount you want to set aside for your employees? Part of the rules that govern company-sponsored retirement plans is that there is a give and take between what you can contribute for yourself as a business owner and what you have to contribute on behalf of your employees.

Who do you want to benefit?

Are there certain employees that you would like to make sure they get a company contribution? Is there a class of employees that you do not want to benefit for some reason or another? There are rules that limit the exclusion of employees, but if we know what you want then a plan can be designed around that.

Why do you want to change service providers?

Are you not getting the service you deserve? Are you looking to save money? Has your advisor not contacted you since he sold you the plan? What is it that you are trying to accomplish?

4. Players involved and what they do

There are several entities that are involved in the management of the retirement plan. Some of these services can and are provided by more than one provider and some plans can be put together a la carte.

Business Owner / Plan Sponsor

You are the decision maker and hire all of the other players involved. You can outsource most of the work to other companies but the ultimate decision to select the service providers comes down to you. You are the ultimate decision maker (what else is new).

Custodian

The custodian is the company that does hold the assets and does the buying and selling on a plan basis. The custodian fees are somewhere between 5 and 15 basis points of plan assets depending on the size of your plan.
The recordkeeper keeps track of each of the participants’ money in the plan. When you look at a 401k plan, all of the mutual funds and investments are held in one account at the custodian and the recordkeeper breaks those down to a participant level. The recordkeeper is the one that provides statements, any type of internet access, participant services, etc. Recordkeeping fees vary because some recordkeepers are also perform duties as the custodian. You can expect these fees to be between 25 and 60 basis points on average. One thing to remember is that the lower the price typically means lower service, so you will want to make sure you look at more than just fees. Most recordkeepers charge on a percentage of assets, some may have hard dollar per participant fees. Your plan size will determine what fee is charged.

**Compliance / Administration**

This is sometimes referred to as the Third Party Administrator (TPA). The TPA performs any required testing and prepares all of the government reports. TPA Fees will vary and typically have a base fee plus some level of per participant fee. It is not uncommon for a TPA to charge asset fees as well. This number will definitely be different based on the complexity of your plan, number of participants, etc. TPA Fees are typically billed to the employer because the more fees that are taken out of the participants accounts the lower their returns are going to be. If you have a participant that is putting in $100 per month but $5 per month is taken out in fees then they are losing 5% before the money has a chance to work for them. These fees will largely depend on your plan assets and the number of participants in your plan. The higher these numbers are, the lower on a per participant basis the fees will be.

**Investment Advisor**

The investment advisor is typically the relationship manager and overseer of the plans investments. They will give investment related guidance to you as the plan sponsor and to the participant. Advisory fees vary depending on the amount of money you have in your plan. The larger you plan assets the lower the fee as a percentage of assets for this service.

**5. Plan design – Many Companies Overlook this!**

The first step in determining plan design is figure out how much you want to contribute. Do you want to get a contribution of 10k 30k 50k or more? Your plan will be designed around what you want to do. The next step is to look at your census which will determine the best profit sharing formula you will want to use in order to maximize your contributions.

There are several components to get to the maximum limit in a 401(k) Plan. They are Deferral, Catch-up contribution, Match and Profit Sharing.
You can save a tremendous amount of money for this. You may be able to exclude some employees. Have different allocation conditions entry dates and eligibility requirements. You will want to look at your turnover. Some service providers will simply pull a plan document off the shelf and it may not be the ideal for your company.

**The two types of employees**

For testing purposes there are two basic types of employees. They are Highly Compensated Employees (HCE) and Non-Highly Compensated Employee (NHCE)

Highly Compensated Employee (HCE) is an individual who:

- Owned more than 5% of the interest in your business at any time during the year or the preceding year, regardless of how much compensation that person earned or received, or
- For the preceding year, received compensation from you of more than $110,000 (if the preceding year is 2009, 2010, or 2011)

Non-Highly Compensated Employee (NHCE) is an individual who:

- Is not an HCE

**Eligibility** – is the amount of time or requirements each participant has to meet in order to participate in the plan. Your goals will determine what is right for your situation.

**Entry date** - Once an Eligible Employee satisfies the minimum age and service conditions, the Employee will be eligible to participate under the Plan as of his/her Entry Date. January one and July 1 are the most common entry dates. For example employees must wait 1 year to be eligible for the plan. After they meet that 1 year they would wait until the next entry date to start making or receiving contributions.

**Deferrals**

There are two options for deferrals. Traditional and Roth. Traditional is the pretax version and Roth is the after tax option. There is no AGI inside the 401k. Roth is only available for the deferral and catch up portion of the plan. Any match or profit sharing will go to pretax.

The maximum amount that can be deferred into a 401(k) plan in 2012 is $17,000 and if you are older than 50 you can defer an additional $5,500. There is a test that is called the aggregate deferral test (ADP) that will determine what you can actually defer as an HCE. However do not worry there are “Safe Harbors” that will eliminate this test. If you already have a plan and are an HCE and getting refunds you may want to look at adding a safe harbor provision to your plan. Safe harbor provisions are a plan year election and a notice to the participants will need to go out by December 1.
Here is a simple chart to explain the ADP test:

<table>
<thead>
<tr>
<th>Average Aggregate Deferral Percentage of NHCE</th>
<th>Average Aggregate Deferral Percentage of HCE</th>
</tr>
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<tbody>
<tr>
<td>Under 2% of pay</td>
<td>Not more than 2 times NHCE</td>
</tr>
<tr>
<td>2% - 8% of pay</td>
<td>Not more than 2% greater than NHCE</td>
</tr>
<tr>
<td>Over 8% of pay</td>
<td>Not more than 1.25 times NHCE</td>
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Example for the ADP test:

If the average deferral of all the NHCE’s is 5% then the average deferral of all HCE’s can’t be more than 7%.

**Maximizing Deferrals with Safe Harbor**

There are two main Safe Harbors the Safe Harbor 3% and the Safe Harbor Match approach.

3% to all participants or 100% of the first 3% and 50% of the next 2% what this does is if an employee puts in 5% they will get a 4% match. The reason one may choose to do one of the other is: if you as the business owner want to max out you will want to do the 3% or if you have employees that have worked for you for a long time and want them to have some sort of retirement then you will want to go with this option.

Do you have a lot of hce’s that do not want to contribute? If not then you may not need a safe harbor plan. Your service provider should help you determine what the best plan design is for you. If you are only going after the “cheapest” then you may actually get something more expensive if you get a plan design that is not right for your company.

If you are trying to get to the maximum limit then the safe harbor 3% is the way to go. There are some tests that you get out of and actuarially will work out to be cheaper than going with the match approach.
The two most common safe harbors are:

**SAFE HARBOR – MATCH APPROACH**
- Eliminates the need to perform ADP testing on HCEs
- Employer required to make contribution to employees that defer.
- 100% of the 1<sup>st</sup> 3% and 50% of the next 2%
- 100% immediate vesting.

**SAFE HARBOR – 3% APPROACH**
- Eliminates the need to perform ADP testing on HCEs.
- Employer required to make contribution for all eligible employees - even if they do not defer.
- 3% of compensation
- 100% immediate vesting.

**Matching Contributions**

Matching is also an option for the plan even if you have a safe harbor. If you want to give a generous match you may not need a safe harbor in order to pass the ADP test.

**Profit Sharing**

Cross tested will test your profit sharing contribution as if it were a defined benefit plan. This will give most of the contribution to the older higher paid employees. You may be able to get 25% of your pay and only have to give the employees 7% of their pay. Once again your census will determine the best way to make your profit sharing.

**Allocation Conditions**

The participants have to “x” in order to receive their contribution. On the profit sharing side you will want to have a last day requirement in order to receive a contribution. On matching, typically there is no allocation conditions because most matching is done on a payroll period basis and most employers do not want to take money away on the matching side once they have given the participants the money.

**Vesting**

Is simply making the employee earn the employer contributions over a period of time they most common vesting schedule is the six year graded vesting schedule.
### Maximum Vesting Schedule

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**Loans**

Not required to be added to the plan and can be taken off of the plan. These are more of an administrative burden to you.

**Hardships**

Hardships are more common than loans and are not required on plans either. One thing to look out for is that adding hardships on a plan require you to determine if there is actually a hardship for the participant as defined by regulations.

**Excluding Employees**

Some employees can be excluded from the plan. Obviously if employees do not meet eligibility requirements then they can’t contribute, but you have to include 70% of the eligible employees. This means you can exclude 30% base on a job description.

**Control Groups and Affiliated Service Groups**

Do you own any other businesses? Depending on your ownership percentage these companies will need to be included in the plan.

**Timing of deferrals**

Employee deferrals need to be made into the plan ASAP.

**Timing of Employer Money**

Employer money is anything except employee deferrals. This is any match, profit sharing, safe harbor, etc. This money need to be contributed to the plan by the time you file your corporate taxes.
6. Investments and Considerations

Almost everyone you talk to probably has a different opinion on investing and selecting investments. The core line-up in a 401(k) plan is a little different than selecting investments outside the plan.

On a higher level you want to offer what some refer to as “the lowest common denominator” and what the Department of Labor calls “a wide range of investment options.” This means you will want to select a fund list that is tailored to the majority of your workforce and you want to have several options in the plan. You may or may not want to add a specialty funds depending on your workforce. Some providers will offer a fund window that will give the participants the ability to select additional funds outside the core list.

You can’t control returns but you can control process when selecting funds you will rank the funds according to each style class. If you have a large growth fund you will want to see how it compares to large growth funds.

There have been many studies done on the number of funds you should have in your plan. The research says there should be somewhere between 10-20 funds and no more than about 20 funds on the core line-up. After that the participants are more likely to get the “deer in the headlights” look and more likely to do nothing after that.

Make sure you have an Investment policy statement. This will dictate how the funds are selected, monitored and replaced. You can’t control returns, but you can control the process.

Don’t forget about returns. Providers may only show you the low cost items. You will want to look at the “all in”. All in is the total fees involved in the managing of the plan. A lot of the funds are at net asset value and no upfront sales charge. Make sure you do not see a termination fee to get out of the funds if you want to change service providers. There are two reasons why there may be a back end charge: if the broker takes an up-front sales charge or if you are changing providers and the new provider is buying a termination charge from your current provider. If your termination charge is low then you may want to pay that out of pocket rather than having the new provider buy that out. Termination charges are becoming less common with fee disclosure and competition.

3(38) Fiduciary

A 3(38) fiduciary is a “stand alone” fiduciary. They can take you as the plan sponsor and the advisor completely out of the fund selection process. You will still need to review them as a service provider and make sure you get the agreement in writing.

3(21) Fiduciary
A 3(21) is a co-fiduciary they will stand beside you not by themselves.

**Do not only look at investment fees**

That being said I urge you not to get lost in the analysis of fees and forget about returns.

To give you an example:

Fund A costs .50% annually and returns 7% annually

Fund B costs .80% annually and returns 10% annually

Fund C costs .90% annually and returns 9% annually

I know this is an over simplified version but it is just to get you thinking of the bigger picture. When service providers show you their “suggested” fund line up you will probably be shown fund A on that list and be given Fund C when everything is all said and done. My point is don’t get lost only thinking about fees with no regard to the returns and make sure you are seeing the recommended fund list during your decision making process.

**Index Vs. Actively managed funds**

If you are looking at costs only you may want to look at indexed funds only. Everyone has a different philosophy on which type performs better, but if you want cheap then go with the index funds.

**Investment Lineup Games:**

When you get a fund lineup from prospective providers make sure that you know the stipulations behind the recommended options. Some of the games that are played is there will be an overestimation of funds that will be mapped into the fixed account. My suggestion is to have all providers use the same fund line up and to use only index funds. The reason I suggest index funds is because some of the providers will play games with the revenue sharing.

**7. Fees**

Now I want address fees. Fees will vary because of many factors. The amount of money in the plan, the number of participants and your plan design. Your fees will also depend on the service providers you select. There are a lot of games that are played with the proposal process and how service providers are selected. Investment – having different set of funds shown during the proposal process as compared to what is actually used for the plan. On a takeover a provider may propose a “mapping” fund list that are different than the current make up of your plan. I am not saying that mapping is bad just make sure you know what you are getting. Make sure the assumptions are correct and are the same among all providers. Is the participant count correct? Is the amount of plan assets correct on the proposal? Make sure you know what you are getting
for your fees. On the investment side do not overlook returns you may be shown a “cheap” option but gets lousy investment returns. When comparing two different providers do the fund expenses and returns equal? If they do not then there may be additional fees that are not being disclosed properly.

**My thought on Fees**

You can always get something “cheaper” but if you do the quality or services will typically be lower. Make sure you know what services you are getting and that you are getting value for the money you pay.

**8. Resources**

Below are links to industry organizations, retirement plan market media sites, advocacy groups and other useful websites for plan sponsors and advisors.

**ASPPA** - The American Society of Pension Professionals & Actuaries (ASPPA) is a national organization of more than 6,500 retirement plan and benefits professionals that serves as the educator, voice, and advocate for the employer-based retirement system.

**Employee Benefits Security Administration** - U.S. Department of Labor site that gives information about retirement plans including 5500 filings, rules and regulations.

**IRS Information for Retirement Plans Community** – The IRS site that give tax and regulator information for the retirement plans community.

**EBRI** - The mission of the Employee Benefit Research Institute (EBRI) is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education.

**Fi360** - Fi360 offers investment fiduciary education, practice management tools, and resources that are essential for fiduciaries and those who provide services to fiduciaries to effectively and successfully manage their roles and responsibilities.

**Plan Sponsor** - Plan Sponsor Magazine is a leading online resource providing coverage of the US pension industry to plan sponsors and advisors who work with them.

**Plan Adviser** - PlanAdviser.com is a leading online resource for advisers and consultants in the retirement plan space looking for practical information on the administration of retirement plans as well as features on practice management and business growth.

**IRS Retirement Plans Navigator** - This is an IRS site that helps selecting the right retirement plan for your business.
9. Final Thoughts

Thank You!

I hope you’ve enjoyed this eBook. I can’t thank you enough for your continued support. I appreciate each and every one of you for taking time out of your day or evening to read this.