ABA RETIREMENT FUNDS PROGRAM

# Plan Design Options

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When you choose a retirement plan for your firm, you want flexibility in a plan design that addresses your needs as a plan sponsor, as well as the needs of your plan participants. Whether establishing a new plan or converting your existing plan, the ABA Retirement Funds Program ("Program") provides you with the options and flexibility you require. This guide is intended to assist you in understanding the plan design options available to your firm.

*The ABA Retirement Funds Program is committed to providing legal professionals with the education, motivation, tools, advice, and retirement plan necessary to help achieve retirement security.*

# Which Retirement Plan Option is Right for You?

**Select the key objective for your plan**

| Minimize Cost | Attract & Retain Employees | Maximize Tax Benefits |
|---|---|---|
| Based on your choice, here are plan designs that may fit your needs: | | |
| Profit Sharing Plan<br>401(k) Plan | Safe Harbor 401(k)<br>Cash Balance Plan | Social Security Integration with 401(k)<br>Cross-tested 401(k) Plan<br>Personal Pension Plan |

## Defined Contribution Plans

A defined contribution plan is a retirement savings vehicle that lets employees, and sometimes their employers, contribute to a tax-advantaged retirement account. In most plans, contributions and growth in the account are tax-free until the money is withdrawn. In all defined contribution plans, investment risks and the potential for gain are borne by the participating employee, not the employer. Though some employers offer matching contributions to encourage workers to contribute to the plan, the ultimate decision to save rests with the employee.

Employees have substantial control over how the contributions to their plan are invested and may generally choose from an assortment of investment options allowing for diversification. Examples of defined contribution plan options and features include profit sharing employer contributions, 401(k) employee deferrals, Safe Harbor contributions, and Social Security Integration.

## Profit Sharing Plan

**Typically used when the firm seeks flexibility in making contributions.**

- Funded by the firm – tax-deductible contributions.
- Contributions can be discretionary and are generally not required every year.
- Contributions can be subject to a vesting schedule.
- Contributions based on a flat percentage of salary for all eligible employees.

| DEMOGRAPHICS | | | CONTRIBUTIONS | | | |
|---|---|---|---|---|---|---|
| Eligible Employee | Age | Eligible Compensation | Uniform Allocation Rate for Employer Contribution | Discretionary Employer Contribution | 401(k) Salary Deferral | Total Contribution |
| Owner 1 | 55 | $305,000 | 20% | $61,000 | 0 | $61,000 |
| Owner 2 | 45 | $305,000 | 20% | $61,000 | 0 | $61,000 |
| Staff 1 | 55 | $60,000 | 20% | $12,000 | 0 | $12,000 |
| Staff 2 | 40 | $50,000 | 20% | $10,000 | 0 | $10,000 |
| Staff 3 | 30 | $40,000 | 20% | $8,000 | 0 | $8,000 |
| Staff 4 | 25 | $30,000 | 20% | $6,000 | 0 | $6,000 |

*Here we display a profit sharing plan where the employer contribution is structured to allow the owners to reach the maximum annual additions limit of $61,000. In this example, this requires a contribution from the firm to each employee of 20% of eligible compensation.*

## 401(k) Plan

**Typically used when the firm seeks to offer an employee-funded benefit.**

- 401(k) is a feature of a profit sharing plan.
- Funded by participants – 100% vested immediately.
- Employer-matching contributions are available, but are not required.

| DEMOGRAPHICS | | | CONTRIBUTIONS | | | |
|---|---|---|---|---|---|---|
| Eligible Employee | Age | Eligible Compensation | Uniform Allocation Rate for Employer Contribution | Discretionary Employer Contribution | 401(k) Salary Deferral | Total Contribution |
| Owner 1 | 55 | $305,000 | 13.27% | $40,482 | $27,000 (6.72%[1]) | $67,482 |
| Owner 2 | 45 | $305,000 | 13.27% | $40,482 | $20,500 (6.72%) | $60,982 |
| Staff 1 | 55 | $60,000 | 13.27% | $7,964 | $3,000 (5%) | $10,964 |
| Staff 2 | 40 | $50,000 | 13.27% | $6,636 | $2,500 (5%) | $9,136 |
| Staff 3 | 30 | $40,000 | 13.27% | $5,309 | $2,000 (5%) | $7,309 |
| Staff 4 | 25 | $30,000 | 13.27% | $3,982 | $1,500 (5%) | $5,482 |

*In this example, the addition of a 401(k) feature to the profit sharing plan lowers the amount of contributions the firm is making, from a 20% rate to a 13.27% rate. The example shows that the total amounts allocated to the owners does not change because each owner has deferred $20,500 (Owner 1 also contributes the $6,500 over-50 catch-up amount), the limit for 401(k) salary deferrals for 2022. All staff members are assumed to contribute 5% of pay annually.*[2]

## Safe Harbor 401(k)

In a 401(k) plan, the ADP test can prevent highly compensated employees from making the highest possible deferrals and in some cases may even require refunds of excess 401(k) contributions. However, Safe Harbor 401(k) plans may eliminate ADP testing, which enables highly compensated employees to defer up to the legal limit each year the Safe Harbor is in effect. But it also requires either an employer contribution or matching contributions to eligible employees.

**Option A:** A fully vested non-elective contribution of 3% eligible compensation to all employees eligible to participate (or only on behalf of non-highly compensated eligible participants.)

**Option B:** A fully vested matching contribution, equal to 100% of a participant's elective contributions not in excess of 3% of the participant's compensation for the plan year, plus 50% of the participant's elective contributions over 3% but not in excess of 5% of compensation for the plan year.

Safe Harbor matching contributions may be made on behalf of all participants who defer, or only non-highly compensated participants who defer. If the only contributions to a plan are 401(k) salary deferrals and either Safe Harbor matching or Safe Harbor non-elective contributions, the plan is deemed not a top-heavy plan.

Safe Harbor 401(k) plans must provide all eligible employees with a notice of the Safe Harbor contribution at least once a year, and at certain other times. Failure to provide the safe harbor notice in a timely manner will negate the benefits of the Safe Harbor design, subject the plan to the ADP test, and may still require the employer to make the Safe Harbor contribution and/or other corrective actions.

**Option C:** available to firms participating in the Program is a special form of Safe Harbor plan called a Qualified Contribution Arrangement ("QACA"). QACAs allow some flexibility in vesting of the Safe Harbor contribution but also require certain changes to the process by which employees are able to choose to make contributions.

| DEMOGRAPHICS | | | CONTRIBUTIONS | | |
|---|---|---|---|---|---|
| Eligible Employee | Age | Eligible Compensation | Safe Harbor Employer Non-elective Contribution–3% of Eligible Compensation | 401(k) Salary Deferral | Total Contribution |
| Owner 1 | 55 | $305,000 | $9,150 | $27,000 (6.72%[1]) | $36,150 |
| Owner 2 | 45 | $305,000 | $9,150 | $20,500 (6.72%) | $29,650 |
| Staff 1 | 55 | $60,000 | $1,800 | $3,000 (5%) | $4,800 |
| Staff 2 | 40 | $50,000 | $1,500 | $2,500 (5%) | $4,000 |
| Staff 3 | 30 | $40,000 | $1,200 | $0 (0%) | $1,200 |
| Staff 4 | 25 | $30,000 | $900 | $0 (0%) | $900 |

*In this example, the firm has adopted a profit sharing plan with a 401(k) Safe Harbor feature. The firm has chosen to make a 3% employer non-elective contribution (Option A). Owner 1 and Owner 2 each make contributions of $20,500 (Owner 1 also contributes the $6,500 over-50 catch-up amount) in 401(k) salary deferrals, the maximum in 2022. Staff 1 and Staff 2 have elected 5% deferral rates, but Staff 3 and Staff 4 have elected not to defer this year. The ratio of deferrals between highly and non-highly compensated employees would cause this plan to fail ADP testing if the Safe Harbor design were not utilized. However, in this case the deferral ratios are not relevant as long as the Safe Harbor requirements are met.*

1 *Percentage excludes catch-up contributions, $6,500 in 2022.*

2 *The rate at which non-highly compensated employees defer, relative to the rate at which highly compensated employees defer, is critical to passage of the ADP test. In the 401(k) example above, the ADP test generally requires that the average deferral rate of highly compensated employees cannot exceed the average deferral rate of non-highly compensated employees by more than 2%. The example shows that the ADP test is passed because the owners' deferrals average 6.72%, and the staff's deferrals average 5%, a difference of 1.72%, is within the allowable 2% maximum.*

## Social Security Integration

Qualified plans generally cannot discriminate in favor of highly compensated employees. However, disparity is permitted through "integration" with Social Security. As such, all eligible employees who participate in a plan are allocated a certain percentage of their eligible compensation, not to exceed $305,000 in 2022. Furthermore, all eligible employees who participate in the plan and whose compensation exceeds the Social Security Taxable Wage Base in effect for that year ($147,000 in 2022) are allocated an additional percentage not to exceed 5.7% of the difference between the Social Security Taxable Wage Base and their eligible compensation.

| DEMOGRAPHICS | | | CONTRIBUTIONS | | |
|---|---|---|---|---|---|
| Eligible Employee | Age | Eligible Compensation | Employer Contribution– 5.7% of All Eligible Compensation | Integrated Employer Contribution– 5.7% of All Eligible Compensation Above $147,000 | Total Contribution |
| Owner 1 | 55 | $305,000 | $17,385 | $9,245 | $26,630 |
| Owner 2 | 45 | $305,000 | $17,385 | $9,245 | $26,630 |
| Staff 1 | 55 | $60,000 | $3,420 | $0 | $3,420 |
| Staff 2 | 40 | $50,000 | $2,850 | $0 | $2,850 |
| Staff 3 | 30 | $40,000 | $2,280 | $0 | $2,280 |
| Staff 4 | 25 | $30,000 | $1,710 | $0 | $1,710 |

*In the example above, a profit sharing plan has been designed to utilize Social Security integration in calculating the employer contribution. To create the greatest leverage, the design provides 5.7% contributions both above and below the Social Security Taxable Wage Base.*

## Cross-testing

Cross-tested plans may enable some firms to direct a greater portion of contributions to highly compensated employees.[1] Whether this type of plan design is appropriate for your firm will depend greatly on the demographics and goals of your firm. Cross-testing refers to one method by which a qualified defined contribution plan can demonstrate compliance with non-discrimination testing requirements.

| DEMOGRAPHICS | | | CONTRIBUTIONS | | | | |
|---|---|---|---|---|---|---|---|
| Eligible Employee | Age | Eligible Compensation | 3%[2] Safe Harbor | Non-Uniform Allocation Rate | Discretionary Employer Contribution | 401(k) Salary Deferral | Total Contribution |
| Owner 1 | 55 | $305,000 | $9,150 | 9.26% | $28,250 | $27,000 | $64,400 |
| Owner 2 | 45 | $305,000 | $9,150 | 9.26% | $28,250 | $20,500 | $57,900 |
| Staff 1 | 42 | $60,000 | $1,800 | 1.44% | $864 | $0 | $2,664 |
| Staff 2 | 40 | $50,000 | $1,500 | 1.44% | $720 | $0 | $2,220 |
| Staff 3 | 30 | $40,000 | $1,200 | 1.44% | $576 | $0 | $1,776 |
| Staff 4 | 25 | $30,000 | $900 | 1.44% | $432 | $0 | $1,332 |

*Here we display a profit sharing plan with 401(k) which utilizes cross-testing in order to determine the non-uniform employer contribution. This design is very sensitive to the ages and incomes of plan participants.*

Unlike a traditional profit sharing plan which allocates contributions using a uniform percentage of participants' compensation, a cross-tested plan allocates contributions using a non-uniform formula and passing the non-discrimination tests requires actuarial analysis. Effectively, a cross-tested plan employs a testing methodology that is customarily used in defined benefit plans and applies it to a defined contribution plan, hence the term "cross-tested."

*1 Cross-tested plan design may require actuarial services, and may result in additional fees, depending on the transaction or service.*
*2 3% of the allocation rate is classified as a non-elective Safe Harbor contribution that satisfies ADP/ACP and top-heavy testing requirements.*

# Cross-Tested Plan Design

**Strategically target benefits based on age, service and compensation to make your 401(k) plan more effective.**

Traditional 401(k) plans are typically designed to benefit your employees, partners, owners and targeted group(s) alike. But if you are currently making a traditional profit sharing contribution to your 401(k), you know that your ability to strategically target those contributions is limited.

## What can cross-tested plan design do for you?

Depending on your firm's demographics, the owners or other targeted group(s) may be able to receive a much larger allocation as a percentage of pay than other plan participants. For many companies, especially for small to mid-size firms, the flexibility to target employer contributions can be a powerful strategic benefit, offering potential savings in corporate and personal taxes.

## How does it work?

Cross-tested plans define different employee groups within the plan document. Employers make separate contributions to each employee group, and contributions are allocated to employees within their respective groups in proportion to salaries. Because of cross-testing, the age of employees is an important factor. Cross-tested plans work best in organizations where owners and highly compensated employees are older on average than non-highly compensated employees.

As shown in the example, if you're an owner with younger employees, the contribution amounts that result from applying cross-testing may be more beneficial to older employees than profit-sharing plans that use a pro rata formula.

While IRS non-discrimination tests must be met, cross-tested plans feature flexibility that can provide greater benefits for small to mid-size firms than a typical retirement plan. Because of the added work involved in establishing a cross-tested plan, and the complex nature of the rules governing qualified benefit plans, you will need a pension specialist to develop a plan that meets legal requirements and the unique needs of your firm.

### Benefits of Cross-Testing

- Contribution flexibility
- Provide higher contributions to owners or targeted groups
- Larger allocations (often up to the DC plan maximum) for owners and older employees
- Reward classes of employees
- Keep retirement funding to a minimum
- Be strategic with compensation

## Typical Cross-Tested Plan

| Owner/Employee | Age | Salary | Traditional Profit Sharing | % of Salary | Cross-Tested | % of Salary |
|---|---|---|---|---|---|---|
| Owner | 60 | $180,000 | $28,800 | 16% | $45,000 | 25% |
| Employee | 33 | $33,000 | $5,280 | 16% | $1,650 | 5% |
| Employee | 34 | $31,000 | $4,960 | 16% | $1,550 | 5% |
| Employee | 54 | $29,000 | $4,640 | 16% | $1,450 | 5% |
| Employee | 42 | $23,000 | $3,680 | 16% | $1,150 | 5% |
| Employee | 43 | $24,000 | $3,840 | 16% | $1,120 | 5% |
| **Totals** | | **$320,000** | **$51,200** | | **$52,000** | |
| **Owner's % of Allocation*** | | | **56%** | | **87%** | |

**The overall profit sharing contribution that goes to the owner.*

# Cash Balance Option

**A cash balance plan is a hybrid retirement plan designed to combine some of the best features of defined contribution and defined benefit plans.**

A cash balance plan is a defined benefit plan with much of the flexibility and portability of a defined contribution plan. The defined benefit characteristics allow for larger tax-deductible contributions, and require minimum funding and a promise to pay benefits. But unlike traditional defined benefit plans, benefits are communicated as notional or hypothetical account balances and are easier for participants to understand.

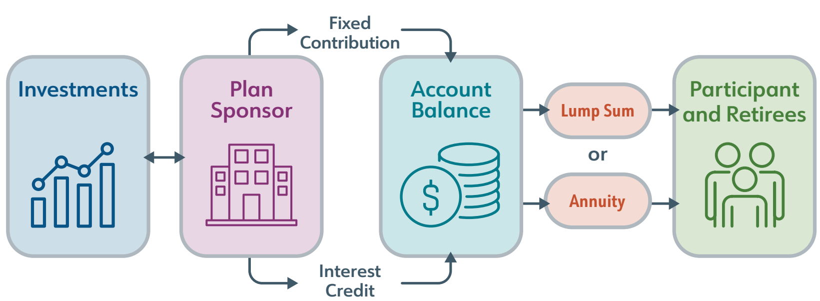
### Is a Cash Balance Plan right for you?

| | YES | NO |
|---|---|---|
| Do you currently sponsor a 401(k) or other retirement plan? | ○ | ○ |
| Are you looking to increase tax-deductible contributions beyond what is permitted under profit sharing plans such as 401(k)s? | ○ | ○ |
| Does your firm have consistent cash flow? | ○ | ○ |
| Is your firm willing to commit to making larger retirement plan contributions for at least 5 years? | ○ | ○ |
| Are you willing to make a contribution up to 7.5% of employee compensation to benefit from larger tax deductions? | ○ | ○ |

**If you answered YES to any of these questions, a Cash Balance Plan may be right for you.**

### How does it work?

- **Hypothetical Account:** The firm makes annual contributions to the plan. Those contributions and interest are credited to participant hypothetical account balances.
- **Retirement Benefits:** The hypothetical account balance can be converted into a monthly benefit (annuity) payable at retirement or paid as a lump sum.
- **Pooled Investments:** Employers make all investment decisions from the Program's platform of investments and generally invest in assets in a manner intended to track the plan's stated interest credit.
- **Required Contributions:** Employer contributions are required and the annual amount must not be less than the minimum amount determined by an actuary.
- **Combo Plans:** A cash balance plan can be in addition to a 401(k) or profit sharing plan to allow for even higher savings.




If investment returns ⇩, then Plan Sponsor's contributions may ⇧ (and vice versa)

# How Should Contributions be Invested/Managed?

- Employer is responsible for the selection of investments from the Program's platform of investment options.
- Employer contributions to the plan will be held in a trusteed investment account.
- Employers can utilize an investment strategy meant to achieve an investment return equivalent to the interest rate set forth in the plan document.

## A Potential for more savings

**Exhibit 1:** This provides an example of a cash balance plan that credits 4% of compensation per year with an interest credit of 5%. The illustration only shows the first 3 years.

Asset accumulation in cash balance plans can become an important part of an individual's retirement planning. The maximum annual dollar amount that may be credited is related to the age of the participant, and can potentially exceed $2 million in some circumstances.[1]

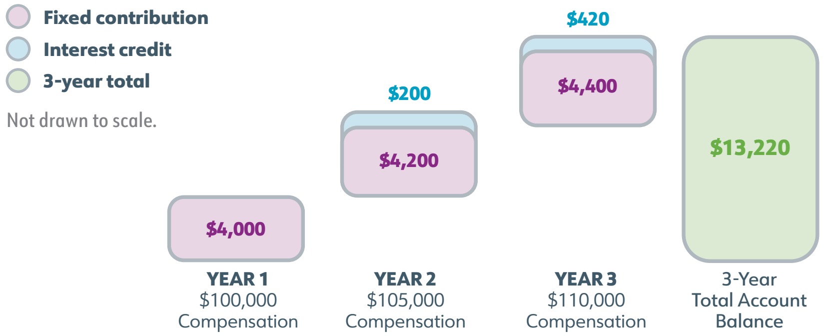



**Exhibit 2:** This highlights potential contributions under a combination 401(k) and cash balance plan.

| DEMOGRAPHICS | | | CONTRIBUTIONS | | | |
|---|---|---|---|---|---|---|
| Employee | Age | Salary | 401(k) Employee Contribution | Profit Sharing | Cash Balance Credit | Total Without 401(k) Employee Contribution |
| Owner | 55 | $305,000 | $27,000 | $10,000 | $150,000 | **$160,000** |
| Employee 1 | 25 | $30,000 | $0 | $1,650 | $600 | **$2,250** |
| Employee 2 | 30 | $25,000 | $500 | $1,925 | $700 | **$2,625** |
| Employee 3 | 35 | $40,000 | $1,500 | $2,200 | $800 | **$3,000** |
| Employee 4 | 45 | $45,000 | $3,000 | $2,475 | $900 | **$3,375** |
| Employee 5 | 55 | $50,000 | $5,000 | $2,750 | $1,000 | **$3,750** |
| **% of contribution to owner** | | | | **47.62%** | **97.40%** | **91.43%** |

*In this example, the owner was able to contribute more than 60% of compensation by making contributions for the employees of approximately 7.5% of pay. This is a hypothetical example dependent on specific assumptions and used for illustrative purposes only.*

1 *For illustration purposes only. Refer to your cash balance plan document for fixed contribution and interest credit details.*

**Contact a Program Regional Representative to get started today.**

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ABA Retirement Funds Program

*The ABA Retirement Funds Program has been providing affordable retirement plans to the legal community for nearly 60 years. It is organized as an Illinois not-for-profit corporation and is dedicated to providing retirement services exclusively to the legal community. It currently services over 4,000 law firm retirement plans and bar associations and has over $7.9 billion in assets (12/31/2021).*