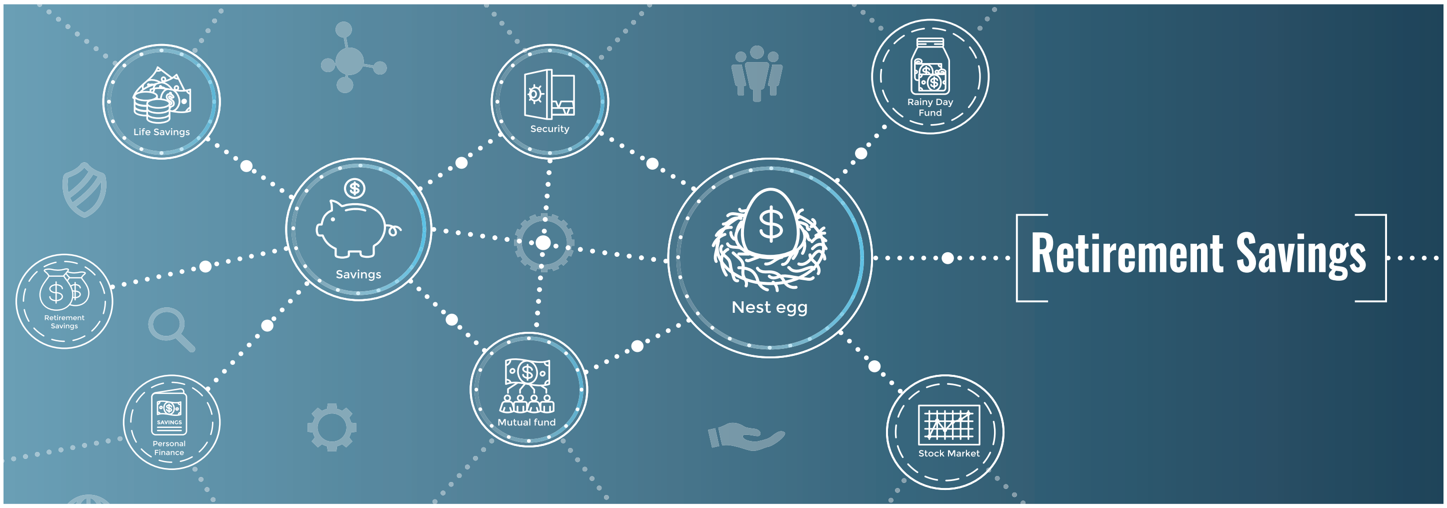
USI CONSULTING GROUP

401(k) Restoration Plan Overview | Addressing the issue of Contribution limitations for highly compensated employees (HCEs)



Current law establishes maximum elective contributions to 401(k) plans of $22,500 for all participants (2023).

In addition, certain other limitations are placed on Highly Compensated Employees (HCEs) in order to eliminate discrimination. HCEs are defined as employees with income in excess of $150,000 or 5% or greater stockholders of the sponsoring employer. Non-Highly Compensated Employees (NHCEs) are defined as anyone not meeting the definition of a HCE. The actual deferral percentages (ADP) to a plan by HCEs cannot exceed 1.25 times the ADP by NHCEs, or the ADP for HCEs does not exceed the ADP for NHCEs multiplied by 2.0, provided that the ADP for the HCEs does not exceed the ADP for NHCEs by more than two percentage points.

In order to eliminate the ADP testing and limitations, an employer may elect to use one of two "Safe Harbor" contribution elections. The employer may make a non-elective contribution on behalf of all eligible plan participants equal to 3% of covered compensation. Under the contribution matching alternative, the employer may elect to match 100% of the first 3% of employee elective contributions plus 50% on the next 2% of employee elective contributions. All "Safe Harbor" contributions made by an employer are 100% vested. The $22,500 statutory elective contribution limit still applies.

An employee classified as a HCE due to compensation at $150,000 or over in 2023 is limited to a contribution of $22,500. That equals a little over 15% of compensation but starts to decrease as a percentage of income as incomes rise above the HCE threshold. Social Security wage coverage is capped at $160,200 for 2023. These limitations create a form of reverse discrimination for HCEs in that they cannot set aside the same percentage of compensation for retirement on a tax incentivized basis as NHCEs.

Solution: The 401(k) Restoration Plan

In order to create comparable opportunities for HCEs to prepare for retirement, we have developed the 401(k) Restoration Plan. This program is made up of three parts:

- **A Plan:** That allows employee elective contributions in excess of those allowed under their 401(k) plan due to statutory maximums or percentage maximums imposed as a result of ADP testing. An employer will establish an aggregate maximum contribution between the 401(k) Plan and the 401(k) Restoration Plan (typically somewhere between 15%

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and 25%) of total compensation. An HCE would have to first maximize their contribution to the qualified 401(k) plan up to the allowed maximum ADP testing limit or the statutory limit of $22,500 if possible before being allowed to contribute to the Restoration Plan.

- **A Bonus:** An employer paid bonus equal to an assumed tax liability on the contributions made by the employee in excess of the allowed 401(k) contribution up to the employer established maximum percentage of compensation (15% - 25%). This requires the employee to actually make a contribution in order to receive a bonus. The bonus has the net effect of making the employee contribution comparable to a regular 401(k) contribution. The amount of the bonus is usually a fixed percentage since it would require private information to identify the actual tax impact to the employee (due to spousal income or investment income and itemized deductions). A typical minimum bonus is 50% of the employee contribution, or higher if a significant number of HCEs are subject to the 37% maximum federal income tax bracket. That creates a double bonus affect so that the net after tax bonus is sufficient to cover most, if not all, of the tax liability the employee incurs on the Restoration Plan contribution. The net after tax bonus offsets the employee's tax liability on their contribution to the Restoration Plan making the net tax affect the same as though the employee had made a tax-deductible contribution to a 401(k) plan. Instead of deferring taxation on all contributions and earnings until funds are distributed as would happen with a qualified plan, the employer bonus pays the tax liability at the time of contribution so that benefits without taxation at retirement.

- **An Investment Vehicle:** We use institutional life insurance investment contracts that provide:
  - multiple mutual fund families and/or equity indexed accounts as investment options,
  - tax-deferred earnings,
  - and tax-free distributions at retirement[1].
  - For those with less than 5 years to retirement, variable annuity contracts will be offered with tax-deferred earnings, but the earnings portion will be taxable when withdrawn – the tax basis is tax-free.
  - The use of a variable or indexed universal life insurance contract provides a plan:
    - that is self-completing in the event of death,
    - provides for tax-deferred earnings,
    - and the ability to take a combination of tax-free withdrawals and/or loans at retirement.

The combination of taxable and non-taxable income in retirement helps the employee manage their post retirement income tax liabilities.

Why Consider a 401(k) Restoration Plan as Opposed to a Traditional Non-Qualified Corporate Sponsored Deferred Compensation Plan Subject to Section 409A?

Issues with traditional non-qualified deferred compensation plans:

- Plans subject to 409A have become administratively burdensome.
  - Company must account for deferred account balances and they are carried on the books of the company as a disclosed liability.
  - Tax deductions to the company are deferred until actual distribution to the employee.
  - Amounts deferred are general assets of the company and at risk for the participant.
- Distribution options are limited and must be elected in advance by the employee with limitations on making changes as they near retirement.
- All distributions from non-qualified plans are income taxable as received if structured properly. Qualified retirement plan distributions are also income taxable as received and are subject to minimum distribution requirements.
- In light of current government spending, income tax liabilities are not likely to decrease significantly in the future. A participant may be deferring income from a period of relative low taxation to a period of higher taxation in retirement in traditional deferred compensation arrangements.
- The investment income and resulting tax liability on money set aside to fund traditional deferred compensation plans can get burdensome to the company as the plan assets grow.

How are these issues favorably addressed by the 401(k) Restoration Plan?

- There are no accounts maintained by the employer. The accounts are the property of the participant.
- The employer tax bonus is immediately tax deductible to the company. No deferred liabilities on the balance sheet.
- Employees must contribute to be eligible for the company tax bonus.

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[1]Distributions are tax free when structured as withdrawals to cost basis, then loans under the insurance contract.

- Unlike traditional deferred compensation arrangements subject to Section 409A, employees can make 401(k) Restoration plan contribution changes during a plan year if needed.
- The tax bonus makes the plan the equivalent of a tax deferred contribution from the employee's perspective. However, distributions at retirement are not taxable. The effect is roughly the same as making a traditional 401(k) pre-tax contribution (without Section 415 limits) with Roth IRA tax treatment on distributions.
- With no minimum or maximum distributions, the employee can use the account as needed to supplement other sources of taxable income in retirement without compounding their tax liabilities. That opens the door to effective income tax management in retirement.
- Post-retirement, any money left in the account at death is distributed to the participant's named beneficiary(ies) income tax free as a life insurance death benefit.
- Pre-retirement, the plan is self-funding due to the insurance death benefit providing additional retirement income security to the surviving family.

- In most situations, the net cost to the employer of the 401(k) Restoration Plan tax bonuses is considerably less than the cost of making a fully vested safe harbor contribution for all employees.
- The HCEs participants can make contributions in excess of the statutory IRS maximum of $22,500 for 401(k) plans. All employees can now contribute at least 15% of income to tax favored retirement savings.

The USI ONE Advantage®

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