# American Benefits Council
# Hot Topics for 401(k) Sponsors
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# 2:00 – 3:30 pm ET

*The Real Reason to Offer a Roth 401(k) Plan*

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*Peanut Butter & Jelly Sandwiches and 401(k) Non-Discrimination Testing*

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# The Real Reason to Offer Roth 401(k)

**Anticipating Changes in Tax Rates – *NOT***

- Many discussions of Roth center on whether tax rates are going up or down.
- Occasionally they focus on whether your individual tax rate is going up or down.

# The Real Reason to Offer Roth 401(k)

**Anticipating Changes in Tax Rates – *NOT***

- The key to tax rates is your personal marginal rate.
- Taxes "going up" could happen in many ways
  - Broadening the base / reducing deductions (which could involve lower rates)
  - Changes in Social Security / Medicare / New taxes / VAT or sales tax
  - Changes to AMT / phase outs / retirement plan limits / govt subsidies
- History of top tax rate: 7% → 77% → 24% → 94% → 50% → 28% → 39.6% → 35% → 39.6%


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# The Real Reason to Offer Roth 401(k)

**For certain employees, Roth is a "no-brainer"**

- Very young employees, just starting (low income)
  - If you're in the 0% or 10% bracket, your tax rate at retirement will presumably be higher
  - More upside potential than downside risk
- Very high income earners who are hitting the maximum contribution
- Individuals who anticipate being in a high tax bracket in retirement (skim off the top)
- People who want to leave more money to their heirs

# The Real Reason to Offer Roth 401(k)

## Skimming off the Top

- For certain retirees collecting Social Security, the combined Federal / State income tax can go as high as 90%. (This includes the effect of the phase in of Social Security benefits as taxable, and the "earnings test" which can reduce Social Security benefits by 33% on the dollar as income goes up).
- One strategy for dealing with high tax rates is to have a portion of your retirement savings in Roth accounts. These can be used to "skim" income off the top bracket, so that your taxable income is confined to the lower brackets.

# The Real Reason to Offer Roth 401(k)

## Have More *Stuff*

- ***Stuff*** is the correct measure of retirement accumulation
- What is ***stuff***?
  - Movie ticket
  - Breakfast at McDonalds
  - Gallon of gas
- However, ***stuff*** is still measured in units of money
- Jane and Jim have the same amount of retirement savings in ***stuff***


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# Jane vs. Jim (35% Bracket)

| | Jane (Regular) | Jim (Roth) |
|---|---|---|
| (1) 401(k) Contribution | 20,000 | 13,000 |
| (2) Less value of tax exemption | 7,000 | 0 |
| (3) Net cost to employee's paycheck | 13,000 | 13,000 |
| (4) Account with investment growth to retirement (4 Years Contribution + 25% return) | 100,000 | 65,000 |
| (5) Taxes on withdrawal at retirement | 35,000 | 0 |
| (6) Spendable cash at retirement (***Stuff***) | 65,000 | 65,000 |


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# The Real Reason to Offer Roth 401(k)

## Exceeding the Contribution Limits

- See Regular vs. Roth on the next two slides.

# Regular vs. Roth 401(k)

| | |
|---|---|
| (1) Regular 401(k) Contribution | 17,500 |
| (2) Less value of tax exemption | 6,125 |
| (3) Net cost to employee's paycheck | 11,375 |
| (4) Account with investment growth to retirement | 35,000 |
| (5) Taxes on withdrawal at retirement | 12,250 |
| (6) Spendable cash at retirement | 22,750 |
| (7) Value at retirement of $1 from paycheck = 6/3 | 2.00 |


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# Regular vs. Roth 401(k)

| | |
|---|---|
| (1) Roth 401(k) Contribution | 17,500 |
| (2) Less value of tax exemption | 0 |
| (3) Net cost to employee's paycheck | 17,500 |
| (4) Account with investment growth to retirement | 35,000 |
| (5) Taxes on withdrawal at retirement | 0 |
| (6) Spendable cash at retirement | 35,000 |
| (7) Value at retirement of $1 from paycheck = 6/3 | 2.00 |

# 401(k) Non-Discrimination Testing

Techniques for making your 401(k) Plan work better

Also known as the “Peanut Butter & Jelly Method”

# 401(k) Non-Discrimination Testing

## A Quick Recap of Rules

- Employees who earn > $115,000 per year – highly compensated employees (HCEs). All others, Non-highly (NHCEs)
- Coverage test – Percentage of NHCEs covered must be at least 70% of percentage of HCEs (or could be as little as 20% if you have 70% “average benefits”).
- Test done on a controlled group basis or qualified separate lines of business (SLOBs).

# 401(k) Non-Discrimination Testing

## A Quick Recap of Rules

- ADP test – HCEs can have average deferrals 2% more than NHCEs (but not more than 2x). NHCE 2% → HCE 4%
- ACP test – same thing but for match.
- QNEC – qualified non-elective contribution typically given to NHCEs, can be used either in ADP test or ACP test.
- Union employees tested separately.
- NHCEs under 1 YOS or age 21 ignored.
- Averages measured as average of percentages.

# Starting Plans

| | Info Systems | Auto Repair |
|---|---|---|
| HCEs | 800 | 200 |
| ADP for HCEs | 5% | 10% |
| NHCEs | 2,500 | 7,500 |
| ADP for NHCEs | 1% | 5% |

# Combine or “Aggregate” Plans

| | Info Systems (“Jelly”) | Auto Repair (“PB”) | Aggregated (“Sandwich”) |
|---|---|---|---|
| HCEs | 800 | 200 | 1,000 |
| ADP for HCEs | 5% | 10% | 6% |
| NHCEs | 2,500 | 7,500 | 10,000 |
| ADP for NHCEs | 1% | 5% | 4% |
| | Fail | Fail | Pass |

# Tricks and Traps in Aggregating Plans

- HCEs in both plans – count twice in separate plans (using total contribution), once in aggregated plan

- NHCEs in both plans – count in both plans but only using the contribution in that plan, once in aggregated plan.

- Do plans have the same features (loans, withdrawals, benefit forms, vesting, match, etc.) and investments?

# Aggregated Plan – Ease Up on HCEs (Increase HCE Limit)

| | Aggregated ("Sandwich") |
|---|---|
| HCEs | 1,000 |
| ADP for HCEs | 7% |
| NHCEs | 10,000 |
| ADP for NHCEs | 4% |

# Cut Sandwich into Two Triangles

| | Combined ("Sandwich") | Salaried | Hourly |
|---|---|---|---|
| HCEs | 1,000 | 980 | 20 |
| ADP for HCEs | 7% | 6.98% | 8% |
| NHCEs | 10,000 | 6,000 | 4,000 |
| ADP for NHCEs | 4% | 5.33% | 2% |


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# Ways to Cut

- Hourly / Salaried
- Exempt / Non-exempt
- Business Unit
- Location
- Line of Business
- Attorney / Staff
- Partners / Associates
- **Each plan must somehow pass coverage test**

# Additional Ingredients

- Targeted QNEC (or "bottom up QNEC")
  - For ADP: Limited to 5% or 2 x median deferral percentage
  - For Average benefits test – not limited
  - So, for ABT, give 100% of pay QNEC to those employees who earned under $1,000 (typically terminated in January). $1,000 for one employee is equivalent to $50,000 spread among 20 employees who each make $50,000 per year.
  - Note for ABT, may weight by age ("benefits basis") further increasing the effect.

# Borrowing

| | Pass 1 | Pass 2 | Pass 3 |
|---|---|---|---|
| HCEs – ADP | 7.0% | 7.0% | 5.0% |
| NHCE – ADP (w/ QNEC) | 4.1% | 5.0% | 3.0% |
| HCE – ACP (QMAC) | 2.0% | 2.0% | 4.0% |
| NHCE – ACP (QMAC) | 0.9% | 0.0% | 2.0% |
| Result | Fail! | Pass | Pass |


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# Additional Ingredients

- Qualified Separate Lines of Business (QSLOB) IRC § 414(r) and 410(b)(5)
- Test excludable employees separately § 410(b)(4)
- Safe harbor contributions § 401(k)(12)
- QACA § 401(k)(13)
- Roth 401(k)
- Boosting participation

# QSLOB

- Lines of business
- Separate management / organizational unit
- Separate financial reports
- Separate workforce
- 50 Employees
- Notice requirement – Form 5310-A
- Administrative scrutiny !

# QSLOB Administrative Scrutiny Alternatives

- Request ruling from IRS
- Different industries – IRS industry categories
- Same average benefits
- Min / Max benefits
- M&A test – for limited time period (two years longer than 410(b) transition period
- Industry segments – separate financial statement schedule required
- 50 / 200 test

# QSLOB 50 / 200 Test

- (S-HCE / (S-HCE+S-NHCE)) / (HCE / (HCE+NHCE))
- 50% <= Ratio <= 200%
- Or SLOB has at least 10% of HCEs