QUALIFIED PLAN CONSULTING WITH HNW CLIENTS

High net worth clients are looking for strategies for a plan design that achieves their goals. By taking a solutions-oriented approach, you can become more than just their TPA—a trusted partner. **By Jason Brown**

I think we can all agree on a fundamental basis that regardless of a plan sponsor's size, strategic and customized plan design is one of the primary foundational elements of a retirement plan. However, plan design is not a one-size-fits-all approach. A proper plan design consultant will take the time to understand what a plan sponsor wants to accomplish and then formulate a design that best achieves those goals by leveraging their intellectual capital, which is the real value in what is being purchased by a plan sponsor.

One subset of plan sponsor types is professional or high net worth (HNW) individuals, who come with their own set of unique variables. This article will share some of the questions, thoughts and opportunities in working with HNWs.

WHAT DO YOU WANT TO ACCOMPLISH?

The first question I always ask regardless of the opportunity's scale is, "What do you want to accomplish?" This question may seem superfluous when working with HNWs, since generally they want to maximize their deferral and employer contribution capabilities while limiting obligations to their staff. However, I have experienced HNWs wishing to provide higher employer contribution than required for a particular plan design and others that have had no interest in actively participating in the company plan. Taking the time to have this conversation is essential to learn their goals.

After determining their primary objectives on a macro level, it is time to investigate further to delineate the variables with which you will be working.

- **Deferrals**—How much do the HNWs want to target?
- **Employer Contributions**—How much are the HNWs wanting to provide themselves and the staff?
- **Demographics**—What is the age and income composition of the HNWs and staff?
- **Compensation**—How much will/do the HNWs show for plan contribution purposes?

The answers provided to these questions will lead the TPA down the road to developing a thought process (much like a mental flow chart) on what plan design structure will best suit the needs of the HNWs.

THE COMPENSATION DISCUSSION

One would think that the conversation about compensation would be a very straightforward discussion; however, that is not always the case. When a TPA asks an HNW to provide information about their compensation, they are referring to compensation that can be considered for retirement plan purposes. Meanwhile, the HNW is thinking about how much they make in total, which can be a completely different amount.

For example, let's assume an HNW is a shareholder in an S-Corp. In that scenario, they are most likely receiving W2 income and distributions, so when asked the compensation question, they typically provide a total that incorporates both buckets of income. While they are not incorrect on how much they make, the TPA can only utilize the W2 portion for plan contribution purposes.

The mix of these income sources can significantly impact the plan design strategy. Many HNWs are directed to limit their W2 pay and leverage distributions more to help mitigate payroll taxes associated with W2 income. They are required to show a reasonable amount of W2 per the IRS, but if the amount targeted is on the lower end of what is considered reasonable, then trying to incorporate concepts like New Comparability and Cash Balance combination concepts most likely won't be as efficient as desired. In this situation, it would take a more significant percentage of employer contributions to maximize their accounts, which would lead to a higher contribution requirement to the staff in most circumstances.

The discussion of compensation boils down to the value of tax-deductible retirement plan contributions and the efficiency of those dollars within the plan design allocation versus the additional taxes associated with increasing W2 pay. So if an HNW does not want to show a level of W2 needed to have advanced plan design concepts make a meaningful impact, they are typically best suited for a Safe Harbor Match plan (for example) to maximize their deferral capabilities. This design also works well if they have a spouse working at the company, as they can also maximize their deferrals and benefit from tax-deductible contributions.

LEVERAGING TAX EFFICIENT PLAN DESIGNS

So now that we have had the compensation discussion, it is time to evaluate the company's employee demographics to see what we

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are working with for plan design variables. In an optimal situation, you want to see the HNWs older than staff (10+ years) and compensation higher than the staff. If these metrics are in place, then incorporating strategies like New Comparability and Cash Balance Combination plans can show as effective options to maximize HNW contributions. If the HNW is comfortable providing 5% to the staff in employer contributions to maximize their account to the Section 415 limit, then New Comparability is a good solution.

Also, keep in mind that this arrangement does not always have to be a max scenario, and the profit-sharing contribution amount can vary from year to year. I have seen numerous HNWs go to what I refer to as a "min scenario" where they get 6% (plus the 3% SHNE) in profit-sharing while only providing the 3% Safe Harbor non-elective contribution to the staff. Also, when selecting Safe Harbor options, the 3% SHNE should be used in most cases since it counts toward satisfying the gateway minimum for cross-testing.

If an HNW is looking to increase contributions above and beyond what a 401(k) alone allows, it is time to analyze the benefits of adding a Cash Balance plan. This design works on principles similar to New Comparability plans, so if New Comp works, Cash Balance will too.

A combo design's ideal target contribution threshold is 7.5% in total employer contributions (between both plans) to the staff. The trade-off for this additional cost is that contribution thresholds for the HNWs can be increased significantly. The evaluation of the effectiveness of these designs always comes down to the net cost of the tax-deductible employer contributions versus the total percentage of plan contributions that go to the HNWs. A general rule of thumb is if 70%+ is going to the HNWs, then the design makes sense, and if it is at 80%+, it should be a "no brainer."

In either of these designs, it is recommended to carve out the HCEs from receiving the 3% SHNE to build maximum flexibility for the HNWs.

AFTER-TAX/VOLUNTARY CONTRIBUTIONS

This contribution source has gotten a lot of attention over the past few years and subsequently has begun to draw the scrutiny of the federal government. This money source has limited application in most cases since it is treated as match money for ACP compliance testing. Even if the plan provides Safe Harbor contributions, it can still fail testing, resulting in the money being refunded to participants.

However, this can be a powerful tool for an HNW who wants to further diversify their income tax liability at retirement in the right circumstances. In most cases, the adjusted gross income of HNWs is higher than the income phase-out level permitted ($208,000 AGI if married and filing jointly, or $140,000 if single in 2021) for them to contribute to a Roth IRA. However, after-tax/voluntary contributions can be distributed from a retirement plan and utilized to fund a Roth IRA (often referred to as a backdoor Roth IRA). This strategy can work exceedingly well for owner-only and Solo-K plan arrangements. This strategy also gives the business owner the option (if needed) to either gross up their W2 compensation and pay more payroll taxes to maximize tax-deductible profit-sharing contributions or maintain a lower W2 and contribute money on an after-tax/voluntary basis.

SUMMARY

HNWs are looking for strategies to help build a plan design that meets their objectives, and they want to partner with firms that can provide intellectual capital and consulting. If you take a solutions-oriented approach, you will become more than simply their TPA and be considered a trusted partner. PC