
About 401(k) Plans

A 401(k) Profit Sharing Plan can provide your company with a competitive, flexible and cost effective employee benefit program.

401(k) Plans permit employees to defer a portion of their income through individual *Salary Reduction Agreements*. The company contributes this deferral amount into the plan's trust account, where the funds accumulate on a tax-deferred basis.

Principal Advantages of a 401(k) Plan: Employees

- Investment earnings within the trust are not currently taxable (i.e., they accumulate tax deferred).
- Employee taxable income is reduced by pre-tax salary deferrals contributed to the plan.
- Roth salary deferrals may be taken on an after-tax basis, allowing qualified distributions to be taken tax free.
- Contributions to the plan (including deferrals) are not currently taxable to the employees.
- Builds a fund for use at retirement, death or disability.

Principal Advantages of a 401(k) Plan: Employer

- A competitive benefits package to attract good personnel, and improve employee morale and retention.
- Employer contributions to the plan are tax deductible.
- Employer has the option of making an annual "discretionary" contribution (also called a "profit sharing" contribution) to all eligible employees.

What follows is some important information about 401(k) Plans. The information is general in nature, and is not intended to be taken as a comprehensive description of the regulations covering such plans or as tax or legal advice.

Features of a 401(k) Plan

Eligibility Requirements

The *Eligibility Requirements* of a plan must be met in order for an employee to become a participant in the plan. The plan sponsor may specify up to 12 months of service and, if desired, a minimum age (not greater than age 21) as requirements for eligibility.

Requiring 12 months of service to be eligible for the plan tends to exclude short-term and part-time employees. This tends to reduce the paperwork and expenses required for the enrollment and participation of such employees.

However, immediate entry into the 401(k) Plan may be an important recruitment factor. In such circumstances, a shorter eligibility period may be indicated. Please note that, with a

service requirement of less than one year, part-time employees will also be included as eligible employees.

Entry/Enrollment Dates

Once an employee has met the *Eligibility Requirements*, they enter the plan on the next *Entry Date*. Generally, the plan would be setup with *Entry Dates* on two or more specific dates during the year.

For example, consider a plan requiring 12 months of service, with entry dates of January 1 and July 1. If an employee completes his first 12 months of service on April 7, **he does not enter the plan until July 1**. This means that he cannot start deferrals until the first pay period that begins after July 1, even though he met the *Eligibility Requirements* on April 7.

You should notify participants of upcoming *Entry Dates* so that newly eligible employees have the opportunity to complete a *Salary Reduction Agreement* prior to the *Entry Date*.

Elective Deferral Contributions

The *Salary Reduction Agreement* amounts are known as "elective deferrals" (or "deferrals"). A participant's deferral amount may not exceed the calendar year dollar limit set by IRS (\$16,500 in 2011), and generally should not exceed 90% of gross pay to allow for Social Security and other withholdings. A participant age 50 or older may make an additional \$5,500 "catch-up" deferral.

Basic elective deferrals are taken on a pre-tax basis: they are not subject to federal or (in most states) state income taxes (though they are subject to FICA and FUTA taxes). These assets are then invested on a tax-deferred basis. However, the entire amount (both deferral basis and any gain) is subject to taxation when a taxable distribution is taken.

If the plan document allows, participants may make "**Roth**" elective deferrals which are made on a post-tax basis, rather than on a pre-tax basis. Roth deferrals are subject to normal payroll taxes at the time the wages are paid, but the entire amount (both Roth deferral basis and any gain) may be distributed tax free (subject to certain restrictions on the timing of distributions).

The participant's deferral election generally is applied to all W-2 wages, including bonuses, overtime, etc. Alternative definitions of compensation could result in special discrimination testing.

Timing of Payroll Submission

Due to IRS and DOL requirements, the employer should deposit employee deferrals in the trust and transmit payroll data as soon as administratively feasible after the pay period ending date, and should not consolidate multiple payroll periods on one payroll transmission or deferral deposit.

Deferral Change Dates

A deferring participant can elect to stop deferrals at any time. However, to otherwise change his deferral rate, or to commence deferring (if the participant has not been deferring), the participant may do so only on the plan's *Deferral Change*

Dates. You should notify participants of upcoming *Deferral Change Dates* so that participants have the opportunity to submit a new *Salary Reduction Agreement* specifying any changes.

Company Contributions

In addition to employee salary deferrals, there are two basic types of company contributions: company match contributions, and company discretionary contributions (also called “profit sharing” contributions). The match contribution is made to accounts of employees who deferred salary to the plan. The discretionary contribution is made to the accounts of **all eligible** employees.

Sponsoring a 401(k) Plan does not obligate the company to make a match or discretionary contribution. However, once made, participants are entitled to these contributions according to the plan’s *Vesting Schedule*.

Vesting of Benefits

Employee deferral accounts are always 100% vested.

However, company match and discretionary contributions are subject to the plan’s *Vesting Schedule*. Participants who leave the company before they are 100% vested forfeit the non-vested portion of their accounts.

The two standard maximum vesting schedules are a 6-year graded vesting schedule (beginning with 20% in the 2nd year, and increasing in 20% increments each year thereafter), or a 3-year “cliff vesting” (100% after 3 years). However, schedules more liberal than this may be used.

The forfeitures resulting from the use of a vesting schedule are generally used to reduce the employer’s cost of contributions, to pay plan expenses, or are allocated to remaining participants.

Participant Loans

Participant loans can permit access to retirement funds on a short-term basis without triggering tax consequences. However, plan sponsors are not required to offer a participant loan program.

Standard participant loans are limited to the lesser of 50% of the participant’s 100% vested money or \$50,000. The term of a standard participant loan cannot exceed 60 months (5 years).

IRS regulations have made loans an administrative burden for the employer that can increase the time and cost associated with the plan. On the other hand, a loan program may help to promote employee participation in the plan.

Hardship Withdrawals

If the plan includes a *Hardship Withdrawal* provision, participants may withdraw funds from their elective deferral accounts under special circumstances of financial hardship, such as medical emergencies, secondary education, purchase of a primary residence, or to prevent eviction/foreclosure on a primary residence. Prior to applying for a *Hardship Withdrawal* the participant must first use funds available from other sources (for example, obtain a loan for the maximum amount). A *Hardship Withdrawal* is a taxable event for the

participant and subject to a 10% excise tax if the participant is not age 59 ½ or older.

A participant taking a *Hardship Withdrawal* must stop deferring for 6 months after the receipt of the distribution. It is the plan sponsor’s responsibility to ensure that the participant does not defer during the 6 month period. It is also the plan sponsor’s responsibility to commence deferrals after the 6 month period based on the participant’s election.

Distributions

Normal distributions of a participant’s account may occur when the participant terminates employment with the company, retires, or becomes disabled.

Participants may “roll” all of the distribution into an Individual Retirement Account (IRA) and continue tax-deferred earnings, or they may elect to take a lump-sum distribution and pay the tax required. Any taxable distribution before age 59 ½ (or age 55, with separation of service) may be subject to an additional 10% excise tax.

Nondiscrimination Testing

Nondiscrimination testing generally compares the benefits received by eligible *Highly Compensated Employees* to the benefits received by the other eligible employees (i.e., the *Non-Highly Compensated Employees*).

Highly Compensated Employees

Currently, *Highly Compensated Employees* in the current year generally include the following:

- Any employee who received compensation in excess of \$110,000 (indexed) in the **prior** year.
- Any owner with an interest greater-than-5% in either the current year or prior year.
- The spouse of a greater-than-5% owner, as well as their children, parents and grandparents.

ADP/ACP Nondiscrimination Test

To pass the ADP Test, the average deferrals of the *Highly Compensated* group must bear a specific relationship to the average deferrals of the *Non-Highly Compensated* group.

- If the average deferral of the *Non-Highly Compensated* group is less than 2% of compensation, then the deferral percentage for the *Highly Compensated* group may be twice as much.
- If the average deferral percentage of the *Non-Highly Compensated* group is 2% or greater, but less than 8%, then the *Highly Compensated* group’s average may be two percentage points higher than the *Non-Highly Compensated* group.
- If the average deferral percentage of the *Non-Highly Compensated* group is 8% or greater, then the *Highly Compensated* group’s average may be 1.25 times the percentage of the lower group.

The Average Contribution Percentage (ACP) Test for match contributions by the company follows the same ratios.

ADP/ACP Failure

If handled in a timely manner, the plan sponsor can choose from two simple solutions to ADP/ACP failure: the plan may “give back” to *Highly Compensated* employees deferrals sufficient to pass the test; or, the company may choose to make a *Qualified Non-Elective Contribution* (a “*QNEC*”) to all *Non-Highly Compensated* employees (*QNECs* are always 100% vested).

The “give back” solution must be completed within two and one-half months after the plan year end. If completed after this due date, the amount of the “give back” is subject to a 10% excise tax. The “*QNEC*” requires that the plan use the “current year” testing method.

To maintain maximum flexibility with regard to these solutions, be sure to review, sign and return Benetech’s “*Census Package*” as soon as possible after the end of the year.

Safe Harbor Provisions

Plan sponsors who wish to eliminate ADP and ACP testing in addition to allowing *Highly Compensated* employees to maximize their deferrals without regard to the amount deferred by the *Non-Highly Compensated* employees may elect to use the *Safe Harbor* provisions.

The sponsor has two basic *Safe Harbor* contribution options to choose from: a 3% Non-Elective Contribution (“*NEC*”) to all eligible employees; or a mandatory matching contribution capped at 4% of compensation.

Once elected, all *Safe Harbor* contributions are mandatory for that plan year, and are required by law to be 100% immediately vested.

If the plan sponsor elects to use the 3% contribution option, this contribution will satisfy the plan’s *Top Heavy* requirement (if any), and can be used to help satisfy the non-discrimination testing in a *Tiered 401(k) Plan*. This is the preferred *Safe Harbor* option for plans with fewer than 50 participants.

Safe Harbor contributions are intended to satisfy *Top Heavy* contribution requirements in most circumstances. However, in certain situations, plans with *Safe Harbor* matching contributions may be required to make additional *Top Heavy* Minimum contributions. For this reason, for plans that are or may be *Top Heavy*, it is recommended that the plan either (i) use the *Safe Harbor* 3% non-elective contribution to all employees, (ii) make all participants 100% vested in all contribution sources and only make *Safe Harbor* contributions, or (iii) assume that a *Top Heavy* minimum contribution of 3% of compensation for each participant may be required.

IRS regulations require the plan sponsor to provide a written notice to employees **30 days prior** to the implementation of a *Safe Harbor* plan (though not more than 60 days), and, in each successive year, **30 days prior** to the beginning of the plan year. This notice must stipulate which option the employer has elected to meet the *Safe Harbor* provisions.

Top Heavy Plans

This rule considers the trust accounts of “*Key*” employees (an owner; an owner’s spouse, child or parent; and certain other employees).

If 60% or more of the trust assets are in accounts of *Key* employees, the plan is considered “*Top Heavy*.” The following applies only if the plan is *Top Heavy*.

If a *Key* employee receives a benefit under the plan (including deferring salary), all *Non-Key* employees eligible for the plan (regardless of their participation in the “salary deferral” part of the plan) will receive a *Top Heavy Minimum* contribution from the company (not to exceed 3% of compensation).

For example, if the plan is *Top Heavy* and, if a *Key* employee were to defer 3% or more under the plan, the company would be required to make a 3% contribution to the accounts of all eligible *Non-Key* employees (even if they have never deferred under the plan).

Safe Harbor contributions are intended to satisfy *Top Heavy* contribution requirements in most circumstances. However, in certain situations, plans using *Safe Harbor* matching contributions may be required to make *Top Heavy* Minimum contributions.

Tiered Profit Sharing Contributions

Although not required, a plan sponsor may also make a discretionary profit sharing contribution to a 401(k) Plan. By using the *Tiered* allocation method, as much as 90% of the contribution could be allocated to targeted employees.

The *Tiered* allocation method begins by splitting employees into different categories (for example, “*Owners*” and “*All Others*”).

It then targets the owners (and, if desired, other important employees) for the maximum contribution, in exchange for a contribution to other employees of as little as 5% of compensation (subject to special age-sensitive discrimination testing).

The result is a plan design that may allocate as much as 90% of the plan’s total contribution to the accounts of the owners (up to \$49,000 each – up to \$54,500 each for those age 50 or older). This could save a business owner thousands of dollars each year in employee contributions.

To further minimize company contribution costs, the *Tiered* allocation method is often combined with the *Safe Harbor* 3% Non-Elective Contribution. The *Safe Harbor* 3% *NEC* is included in the *Tiered* discrimination testing, but also allows owners and other *Highly Compensated Employees* to defer at the maximum rate.