What is a 401(k) Plan?

The term 401(k) Plan comes from a section of the Internal Revenue Code, IRC Paragraph 401(k). This section permits a business to set up a retirement plan for it's employees where they can contribute a portion of their pay to the plan on a pre-tax basis. The plan can include both employee Salary Deferral and Employer Contributions.

Salary Deferrals – The maximum Salary Deferral, (Employee's money), is now a dollar amount, it's no longer a percentage amount. The contributions can be 100% of the employee's pay based on the below schedule. (There is a special Catch Up feature for older employees.)

Year	Employees under age 50	Employees 50 Plus
2003	$12,000	$14,000
2004	$13,000	$16,000
2005	$14,000	$18,000
2006	$15,000	$20,000

According to the law there are limitations as to what Key Employees, (5% owner, spouse & children of a 5% owner), Highly Compensated Employees, (HCE, anyone who makes over $90,000), can contribute into a plan. The plan has several tests it must pass each year.

Anti-Discrimination Percentage Test or ADP Test.

This is a test where the Keys & HCE's can contribute only 2% above the average of what the Non-Highly Compensated Employees, (NHCE, anyone who makes less than $90,000), contribute into the plan.

Ex: If the total payroll for the Keys & HCE's is $500,000 and the total payroll for the NHCE is $1,000,000 and the NHCE only contribute $25,000 then the Keys & HCE can only contribute a total of $22,500 among all of them.

If the plan fails the ADP Test then the Keys & HCE's get a refund of their contribution.

Top Heavy Test.

A plan fails the Top Heavy Test when 60% or more of the plan's assets are owned by the Key & HCE's. When this happens either the Keys & HCE's must stop contributing or the company must make an Employer contribution for all eligible employees.

How to pass these tests. The key to a successful plan is to have good participation from all of it's employees.

1. Employer Leadership. This is where the "Boss" tells his people this is good for them and they should do it. Make the employees answer to the "Boss". If the Boss doesn't think it's important then the employees won't think it's important.

2. Company Matching Contribution. This is where the company will help the employees who want to help themselves by providing extra money for their retirement savings. The formulas are varied and are completely discretionary. Some typical matching contributions are 50% of 4% of pay. This means that if an employee contributes 4% of his pay the company will match that with an additional 2% of his pay. If the employee contributes more than 4% of his pay, the company will only match up to that amount. Employees will usually contribute up to the matched amount. The Employer's exposure could up to 2% of payroll. This matching contribution is subject to a vesting schedule, (see below). Even with the Matching Contribution the plan is still subject to the ADP & Top Heavy Test.

3. Safe Harbor Plans. The IRS will waive the ADP and Top Heavy Tests if the Employer will make a Safe Harbor Contribution for their employees. This contribution is 100% vested. A Safe Harbor plan must be communicated to the employees 30 days prior to the beginning of the plan year. There are two types of Safe Harbor Contributions.

Safe Harbor Match. Only the people who put their money in will get this. So if only the Key and HCE's contribute to the plan, it will pass the tests. The Matching formula is either 100% of the first 3% of pay and 50% of the next 2% of pay, this equals a 4% match or 100% of the first 4% of pay. Again, this goes only to the employees who put in their own money.

Safe Harbor Non-Elective. This is where the employer makes a 3% contribution for all eligible employees. This can be used quite effectively when the employer tells his people instead of getting a cash raise they will be getting a retirement plan contribution.

We highly recommend Safe Harbor Plans. They work very well when the employer wants to max out his salary deferrals. If the employer adds their spouse to payroll, then each of them can max out the salary deferral limits and also get the company contribution as well.

Profit Sharing Plans

This is where the Employer makes a contribution for all eligible employees. This contribution is totally discretionary and based upon what the employer would like to put in. The contribution limit is $41,000 per individual. (The $41,000 includes all money types, salary deferral, match and profit sharing, does not include catch-up.)

The contribution formula varies. It can either be based upon income, age or service. This usually requires illustrations based upon the company census information.

Cross Tested Plans

This is a form of a Profit Sharing Plan that works well with a high income owner. If the owner is older and makes considerably more than their employees such as medical, law or accounting offices.

Under this program the employer can make a 5% contribution of their employees and up to a $41,000 for the employer. Again, this is based upon the ages and income of all the employees.

Below are considerations when setting up a plan.

Vesting:

This is the ownership schedule applied to employer contributions either Matching or Profit Sharing. This is usually over a 6 year time period with an employee owning an additional 20% each year.

Year	1	2	3	4	5	6
Percentage	0	20	40	60	80	100

Eligibility:

This is the requirements for when an employee can qualify to enter the plan. This is based on age, hours and length of employment. The maximum length is age 21, 1000 hours per year and 12 months of employment. When an employee becomes eligible to enter the plan is when he is included in the testing.

Entry Date:

This is the date the employee can enter the plan after the eligibility requirements are met. This can be monthly, quarterly, semi-annually or annually. If an annual entry date is used then the 12 month length of service cannot be used.

Investment Options

We use Lincoln Life as our main investment vehicle. They offer over 60 mutual funds from such well known companies as Fidelity, American Funds, Janus, Delaware, Franklin Templeton and State Street Research.

Employees have internet & telephone access and there are no limitations as to how often they can move their money around. There are direct links to this information at www.pensionswest.com.

This is just a brief overview of a 401(k) plan.