

# **401(k) PLAN EXECUTIVE SUMMARY**

January 2010



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## 1. What is a 401(k) plan?

A 401(k) plan is a qualified profit sharing plan that includes a provision giving participating employees the option of deferring part of their wages into the plan trust on a pre-tax or post-tax basis (see *question 19*). In addition, the plan may contain an employer matching and/or profit sharing provision.

## 2. What are the tax benefits of a 401(k) profit sharing plan?

**For the eligible employee (participant):** Pre-tax employee salary deferral contributions reduce the participant's income for federal and state income tax purposes. Employer matching contributions and profit sharing contributions are not taxable to the participant until withdrawn from the plan trust. Investment earnings on plan assets are tax-deferred. In addition to reducing taxable wages, low- and middle-income participants may claim a saver's credit of up to \$1,000 (\$2,000 for couples). The schedule below is our understanding of the credits and income breakdowns for 2010:

<u>Joint filers</u>	<u>Single filers</u>	<u>Tax credit</u>
earning < \$33,501	earning < \$16,751	50%
\$33,501 to \$36,000	\$16,751 to \$18,000	20%
\$36,001 to \$55,500	\$18,001 to \$27,750	10%

**For the employer:** Employer matching contributions and profit sharing contributions are tax deductible and excluded from payroll taxes. Employee **pre-tax salary deferrals are included** for both employee and employer payroll taxes. Also, businesses with 100 employees or less receive an annual tax credit of 50% on the first \$1,000 of administrative costs (\$500 maximum) for each of the first 3 years of a new plan. The credit is available only if at least one non-highly compensated employee (NHCE) is participating. *As with any tax matter, you are urged to discuss the tax credit with your tax advisor to verify current IRS requirements.*

## 3. When are taxes due?

All pre-tax contributions and investment earnings are taxable in the year they are distributed from the plan. In addition, participants who are less than age 59½ may\* incur an additional 10% federal early withdrawal penalty. However, taxation can be deferred further by rolling the plan distribution directly to an Individual Retirement Account (IRA) or to another qualified retirement plan.

\* A complete explanation of all the exceptions to the penalty would take four more pages.

In brief they are:

- a) if the distribution is taken in substantially equal payments,
- b) if the participant separates from service in the calendar year they reach age 55,
- c) death or disability,
- d) Qualified Domestic Relations Order (QDRO),
- e) P.S. 58 (life insurance) costs, and
- f) Employee Stock Ownership Plan (ESOP) dividend distributions.

*Please seek further guidance before applying these exceptions.*

## 4. Must all employees be eligible to participate?

No. The plan may exclude:

- Union employees
- Employees under age 21
- Employees who have less than 12 months of service (up to 24 months may be required for employer matching contributions and/or profit sharing contributions)
- Employees who work less than 1,000 hours per year

If certain discrimination tests under IRC Section 410 can be passed, the plan may also impose certain class exclusions, such as hourly employees, salespersons, etc.

## 5. What types of contributions are there?

Roth 401(k) Contributions: (a.k.a. Roth deferrals) These are post-tax employee contributions made via payroll deduction. Gross income is not reduced by these post-tax contributions. All investment earnings accrue on a tax-free basis (*see question 19*).

Salary Deferral Contributions: (a.k.a. Employee elective deferrals or traditional 401(k)) These are pre-tax employee contributions made via payroll deduction. Gross income is reduced by these pre-tax contributions. All contributions and investment earnings accrue on a tax-deferred basis.

Employer Matching Contributions: A participant needs to contribute his/her own money to receive a matching contribution from the employer. Regardless of whether a participant contributes post-tax or pre-tax money as outlined above, the employer match monies are tax deductible and excluded from payroll taxes. There may be other requirements too, such as 1,000 hours of service and/or being employed on the last day of the plan year.

Employer Discretionary Contributions: (a.k.a. profit sharing contributions) Participants do not need to contribute his/her own money to be eligible to receive a profit sharing contribution. There may be other requirements, such as 1,000 hours of service and/or being employed on the last day of the plan year.

Safe Harbor Contributions: Exempts the employer from ADP testing requirements (*see questions 8 & 9*). Contributions may be made in the form of employer matching or non-elective (*see question 10*).

Qualified Non-Elective Employer Contributions (QNEC): If the Actual Deferral Percentage (ADP) Discrimination Test fails (*see questions 8 & 9*), one way for the employer to pass the test is to make a contribution to non-highly compensated employees.

## 6. When must contributions be made?

Employee contributions (post-tax and pre-tax) must be deposited as soon as they can be reasonably separated from the employer's payroll account. The Department of Labor (DOL) mandates that 3 to 4 days is reasonable. Employer matching contributions and profit sharing contributions can be made as late as the employer's tax filing deadline, including extensions.

## 7. What are the contribution limits?

The maximum employee contribution amount (post-tax or pre-tax) for the year 2010 is the lesser of 100% of compensation or \$16,500. Participants who are 50 years old or older in 2010 may make an additional “catch-up” contribution of \$5,500. *Note: The \$16,500 is a combined limit of pre-tax and Roth contributions, and is inclusive of all other 401(k) contributions made to the plan of another employer.* (IRC §402(g))

If the ADP discrimination test fails, some highly compensated employees (HCEs) may not be able to contribute the full \$16,500 (*see question 8*).

The maximum annual addition/contribution limit for a participant is the lesser of \$49,000 or 100% of the participant's gross annual compensation. This limit applies to the sum of the employee contributions (post-tax and/or pre-tax) (but not the \$5,500 catch-up), employer matching contributions, profit sharing contributions, QNEC, and forfeiture allocations (IRC §415).

The employer **deduction limit is 25%** of the total compensation of participants receiving an employer allocation. This deduction limit includes employer matching contributions, profit sharing contributions, and QNEC contributions, but not the employee contributions (post-tax and/or pre-tax) (IRC §404).

For example:

Company A has 30 employees with a payroll totaling \$1,500,000. However, the 20 participants who receive the profit sharing contributions have a payroll of \$1,000,000. Therefore, the maximum allowable deduction is \$250,000 ( $\$1,000,000 \times 25\%$ ).

Exemption to 25% deduction limit: If the employer also sponsors a defined benefit plan that is not covered by the Pension Benefit Guaranty Corporation (PBGC), employer deductions to the 401(k) plan are limited to 6% of total compensation.

For calculation purposes, compensation is limited to \$245,000 in 2010 for any individual participant.

## 8. Why do I need to be concerned about the ADP test?

The ADP test is a required test each year which compares the participation level of the highly compensated employees to the rest of the employees. If the test fails, either highly compensated employees must take taxable distributions from the plan or the employer must make a 100% vested contribution for the rest of the employees.

A Highly Compensated Employee (HCE) is defined as any employee who:

- Is a greater than 5% owner of the company (including family members of the owner: spouse, children, grandchildren or parents) at any time during the current or preceding year; OR
- Received compensation in excess of \$110,000 in the preceding plan year, for plan years beginning in 2010.

The first step is to calculate the average deferral percentage for the non-highly compensated employee group. The allowable average deferral percentage for the highly compensated employees can then be determined using the following table:

<b>NON-HIGHLY COMPENSATED AVERAGE DEFERRAL RATE</b>	<b>MAXIMUM HIGHLY COMPENSATED AVERAGE DEFERRAL RATE</b>
1.00%	2.00%
2.00%	4.00%
3.00%	5.00%
4.00%	6.00%
5.00%	7.00%
6.00%	8.00%
7.00%	9.00%
8.00%	10.00%
Greater than 8%	1.25 times NHCE%

Example of a failed ADP test with the distribution to the owner:

<b>Participant</b>	<b>Wage</b>	<b>Deferral</b>	<b>%</b>	<b>Group Average</b>	<b>Allowable %</b>	<b>Allowable \$</b>	<b>Taxable Distribution</b>
Owner	\$100,000	\$16,500	16.5%	16.5%	4.5%	\$4,500	<u>\$12,000</u>
A	\$40,000	\$4,000	10%				
B	\$40,000		0%	2.5%			
C	\$40,000		0%				
D	\$40,000		0%				

## 9. Can the ADP test be avoided?

Yes. If your plan qualifies as a Safe Harbor 401(k) plan. Each year, the employer may elect, before the beginning of the plan year, if the 401(k) plan is to be designated as a Safe Harbor plan for that year.

## 10. Why are Safe Harbor 401(k) plans so popular?

The ADP test is waived and the highly-compensated employees' deferrals are not restricted by the lack of participation from the rest of the employees. However, in a Safe Harbor plan the employer must commit to making either a matching or non-elective contribution for the employees. If the employer decides to designate the plan as Safe Harbor then the plan must meet the following conditions:

- Participants cannot be required to be employed on the last day of the plan year or to work a specified number of hours to share in the contribution,
- A written notice announcing the Safe Harbor contribution must be given to participants at least 30 days **BEFORE** the beginning of the plan year, and
- Employer matching contributions are required for non-highly compensated employees and optional for highly compensated employees.

There are three Safe Harbor alternatives:

- 1) **Matching Contribution,**
- 2) **Non-Elective Contribution,**
- 3) **Qualified Automatic Contribution Arrangement (QACA).**

- 1) **Matching Contribution:** The employer contribution is 100% immediately vested. There are several formulas available, and each one is 100% immediately vested. The two most often used are:
  - a) 100% of the first 3% of the participant's compensation that is deferred, plus 50% of the next 2% deferred, or
  - b) 100% of the first 4% of the participant's compensation that is deferred.

Safe Harbor matching contributions are allocated only to those participants who have made salary deferrals to the plan. If a participant elects not to defer, they are not eligible to receive a matching contribution. From a cost standpoint, this is a good choice for plans with low participation rates.

### **Example of a Safe Harbor match of 100% of the first 4% of compensation that is deferred:**

<b>Participant</b>	<b>Compensation</b>	<b>Employee Deferral</b>	<b>4% Safe Harbor Match</b>
100% Owner	\$100,000	\$16,500	\$4,000
Employee A	\$40,000	\$4,000	\$1,600
Employee B	\$40,000	\$1,600	\$1,600
Employee C	\$40,000	\$600	\$600
Employee D	\$40,000	\$0	\$0
<b>Total</b>			<b>\$7,800</b>

- 2) **Non-Elective Contribution:** The employer contribution is 100% immediately vested. The Safe Harbor formula is 3% of compensation for all eligible, non-highly compensated employees.

**Example of 3% employer contribution to all eligible employees:**

<b>Participant</b>	<b>Compensation</b>	<b>Employee Deferral</b>	<b>3% Non-Elective</b>
100% Owner	\$100,000	\$16,500	\$3,000
Employee A	\$40,000	\$4,000	\$1,200
Employee B	\$40,000	\$1,600	\$1,200
Employee C	\$40,000	\$0	\$1,200
Employee D	\$30,000	\$0	<u>\$900</u>
<b>Total</b>			<b>\$7,500</b>

- 3) **Qualified Automatic Contribution Arrangement (QACA):** There are three differences between QACA and the previous Safe Harbor alternatives:

- a) **Automatic enrollment of employees:** Automatic enrollment applies to all employees, including HCEs; however, you may exempt certain employee groups. In addition, employees have a 90-day, penalty-free, opt-out period, provided the plan satisfies the 30-day notice requirement. Employers must withhold at least 3% of pay during the first year, increasing to 4% of pay for the second year, 5% for the third year, and 6% thereafter. Employers may withhold up to 10% of pay for any year.
- b) **Safe Harbor formulas:** Employer **must** contribute **either:**
  - A 100% match on the first 1% of pay, plus 50% match on the next 5% of pay (maximum match of 3.5% of pay); **OR**
  - A non-elective contribution of at least 3% of pay.
- c) **Vesting:** Employer contributions do not need to be 100% vested until a participant has two years of service.

**Example of an automatic enrollment Safe Harbor match:**

<b>Participant</b>	<b>Compensation</b>	<b>Automatic Employee Deferral</b>	<b>Safe Harbor Match</b>
100% Owner	\$100,000	\$16,500	\$3,500
Employee A	\$40,000	\$4,000	\$1,400
Employee B	\$40,000	\$1,600	\$1,000
Employee C	\$40,000	\$1,200	\$800
Employee D	\$30,000	\$900	<u>\$600</u>
<b>Total</b>			<b>\$7,300</b>

## 11. When is a 401(k) plan top-heavy?

If, as of the end of the prior plan year<sup>1</sup>, the key employees have more than 60% of the plan assets, the plan is considered top-heavy. The 60% excludes rollovers from another unrelated qualified plan or from IRA rollovers. Please note that the definition of a key employee is different than that of a highly compensated employee used in the ADP Test.

### A key employee is:

- A more than 5% owner;
- A more than 1% owner earning over \$150,000;
- An officer earning over \$160,000; or
- Family members (spouses, children, grandchildren or parents) of owners.

## 12. Is the top-heavy test the same as the ADP test?

No. The ADP test compares the *ratio of highly compensated employees' salary deferrals* and all other employees' salary deferrals. The top-heavy test compares the *assets* of the *whole* plan, as allocated between *key employees* and *non-key employees* at the beginning of a plan year.

## 13. What happens in a year when the plan is deemed top-heavy?

The employer must make a minimum profit sharing contribution to non-key employees<sup>2</sup> equal to the contribution received by any key employee<sup>3</sup>, up to, but not in excess of, 3% of pay.

- For example, if a key employee defers 6% of pay, then the employer must make a 3% contribution for all the non-key employees. It is important to note that the non-key employee's own employee elective deferrals are not counted towards meeting the 3% minimum.

Employer matching contributions and profit sharing contributions count towards the minimum top-heavy contribution. Employee elective deferrals do not count towards the minimum top-heavy contribution.

The minimum contribution is waived in any plan year where the only contributions to the plan include employee elective deferrals and employer Safe Harbor contributions. (*see Exhibit B*)

## 14. Is the plan required to allow participant loans?

No. 401(k) plans may allow participant loans. The same rules that apply to other qualified plans apply to 401(k) plans.

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<sup>1</sup> Assets from plans that existed in the prior year and in-service distributions made during the last 5 years may also be included in the top-heavy calculation.

<sup>2</sup> Non-key employees must be employed on the last day of the plan year to be eligible to receive the top-heavy contribution.

<sup>3</sup> A key employee's own elective deferrals are included.

**15. Is the plan required to allow the participants to direct the investments in their own accounts?**

No. Contrary to popular opinion, 401(k) plans may be designed so that all investment decisions (including those for the employee elective deferrals) are directed by the Trustee and Trustee advisors. However, there are many factors and considerations that must be explored before a decision is made in this matter.

**16. How long can a participant be required to work before becoming 100% vested in the contributions?**

Plans may utilize a vesting schedule no longer than the 6-year graduated or 3-year cliff shown below. Employee elective deferrals and employer QNEC accounts must always be 100% vested immediately.

GRADUATED	
Year	%
0-1	0
2	20
3	40
4	60
5	80
6+	100

CLIFF	
Year	%
1	0
2	0
3	100

**17. What events allow a participant to take a distribution from the plan?**

Attainment of the retirement age specified in the plan and, if the plan allows in-service distributions, termination of employment, hardship condition, death, or disability.

**18. Can the employer decide to contribute different profit sharing or matching contributions for each participant?**

Yes. If the plan discrimination testing passes then contributions may vary per employee at the employer's discretion.

**19. What is a Roth 401(k)?**

It is a 401(k) plan that gives participating employees the option of contributing part of their wages on a post-tax basis. The deferral will be subject to federal and state income taxes when made, but the entire Roth account (including earnings) can be withdrawn tax-free after meeting certain distribution requirements (*see question 22*). The post-tax Roth deferrals and the current pre-tax elective deferrals will be combined for all plan purposes, including the maximum contribution limits, catch-up contributions, and discrimination testing.

## 20. What are the possible advantages of a Roth 401(k)?

The Roth 401(k) option appeals to:

- Participants who anticipate higher personal income tax rates in the future.
- Participants who would like to avoid the minimum distribution requirement at age 70 ½ by rolling Roth deferrals to a Roth IRA where minimum distributions are not required.
- Participants who want to diversify retirement accounts between pre and post-tax.

## 21. What are the disadvantages of a Roth 401(k)?

Post-tax employee contributions do not reduce the participant's gross income for federal and state income tax purposes. However, the employee's future earnings on these post-tax dollars will accrue on a tax-free basis so long as the account is in existence for at least 5 years.

## 22. Are all of the Roth 401(k) investment earnings tax-free when distributed?

Yes, *the only condition* for a tax-free qualified distribution is that the account must be in existence for at least 5 years, starting with the first contribution.

**And** once one of the following occurs, there will be NO TAXES on the distribution:

- Attainment of Age 59 ½
- Death
- Disability

Note: If the account is less than 5 years old, all earnings on the Roth account are taxable to the participant in the year distributed. In addition, participants who are younger than age 59 ½ may incur a 10% federal early-withdrawal penalty.

However, taxation can be deferred by rolling the plan distribution directly to a Roth IRA or to another qualified retirement plan with the Roth 401(k) option.

## 23. What are the additional costs of a Roth 401(k)?

The addition of the Roth 401(k) option will add administrative complexity and costs to your 401(k) plan.

- Roth 401(k) accounts will require separate recordkeeping.
- Corrective distributions will require special elections.
- Distribution processes will need to cover the use of different rollover options for Roth and non-Roth dollars, keep track of the timing of the contributions and distributions, and incorporate the changes to the 1099-R reporting requirements.
- In addition, the plan document and summary plan description (SPD) need to reflect the Roth 401(k) option.

## **24. Can contributions from a qualified plan roll directly to a Roth IRA?**

Yes. Prior to January 1, 2010, if a participant's compensation was less than \$100,000, rollovers were permitted from a qualified plan to a Roth IRA. As of January 1, 2010, there are no compensation restrictions.

## **25. What are some questions to ask before adopting a 401(k) plan?**

Should we adopt a SIMPLE IRA instead of a 401(k)? (*see Exhibit B*)

Should we survey the employees first to see if there is adequate interest in having a plan?

Should we consider an automatic enrollment plan?

Should we have a Safe Harbor 401(k) plan so we don't have to worry about the ADP test?

Do we want a plan that rewards employees who stay with the company by requiring they work a minimum of 1,000 hours a year and/or be employed on the last day of the year to be entitled to receive the employer matching contribution or profit sharing contribution?

Do we want to make higher employer matching contributions or profit sharing contributions for certain groups of employees?

In addition to the 401(k), do we want to have a supplemental pension plan that might allow deductible contributions above the \$49,000 per person limit of a 401(k) plan?

# Exhibit A

## Safe Harbor Plus Plan

### SAFE HARBOR 401(k) PLAN AND TIERED ALLOCATION PROFIT SHARING

Doctors A and B would like the maximum allocation for themselves and no more than a 3% profit sharing contribution for the employee. They do not mind matching any employee 401(k) deferrals up to 4% of the employee's compensation. The practice surveyed the employees and found that only half would contribute into a 401(k) plan and in relatively small amounts.

The following creative plan design combines a Safe Harbor 401(k) plan with a multiple-tiered profit sharing allocation. We refer to this design as the **Safe Harbor Plus Plan**.

Name	Age	Wage	Employee Deferral	Employer Match	Employer Profit Share	Total
Dr. A	58	\$245k	\$22,000	\$14,700	\$17,800	\$54,500
Dr. B	49	245k	16,500	14,700	17,800	49,000
EE 1	26	50k	1,400	1,400	1,500	4,300
EE 2	37	50k	0	0	1,500	1,500
EE 3	60	40k	1,650	1,600	1,200	4,500
EE 4	34	40k	0	0	1,200	1,200
EE 5	39	30k	0	0	900	900
EE 6	44	30k	1,000	1,000	900	2,900
EE 7	23	20k	600	600	600	1,800
EE 8	22	20k	0	0	600	600

### ANALYSIS

Amount for Doctors	<b>\$38,500</b>	<b>\$29,400</b>	<b>\$35,600</b>	<b>\$103,500</b>
Employer Contribution for Employees		<b>4,600</b>	<b>8,400</b>	<b>13,000</b>
Total Contribution	<b>38,500</b>	<b>34,000</b>	<b>44,000</b>	<b>116,500</b>
Percentage of Contribution to Doctors	<b>100%</b>	<b>86%</b>	<b>81%</b>	<b>89%</b>

**Tiered Profit Sharing contributions are subject to 6-year graded vesting.**

## Exhibit B

	<b>IRA (Simple)</b>	<b>Safe Harbor 401(k) (Matching and Non-Elective)</b>	<b>Safe Harbor 401(k) (QACA)</b> <i>**If blank, same as box to the left.</i>
Maximum employee elective deferral	Lesser of 100% of pay or \$11,500	Lesser of 100% of pay or \$16,500	
“Catch-up” for age 50 and older	\$2,500	\$5,500	
Maximum allocation for any employee (both employee and employer contributions)	\$22,000 (\$26,500 if employee is at least 50 years old)	Lesser of \$49,000 or 100% of compensation (\$54,500 if Employee is at least 50 years old)	
Is an employer contribution required every year?	Yes, employer must do either: (a) 100% match on first 3% of pay in 3 of 5 years. (100% match on first 1% in other years); OR (b) 2% of pay for all eligible employees	Yes, employer must do one of three: a) 100% match on first 3% of pay plus 50% on next 2% of pay; OR b) 100% match on first 4% of pay ; OR c) 3% of pay for all eligible employees	Yes, employer must do either: a) 100% match on first 1% of pay plus 50% on next 5% of pay. Maximum obligation of 3.5%; OR b) 3% of pay for all eligible employees
Are additional employer profit sharing contributions allowed?	No	Yes	
Are 1,000 hours and last day accrual requirements allowed on employer contributions?	No	Not on Safe Harbor contributions. Yes on any additional employer contributions.	
Are vesting schedules allowed on employer contributions?	No	Not on Safe Harbor contributions. Yes on any additional employer contributions.	Yes, employer may use a two-year cliff vesting schedule for Safe Harbor contributions.
Are employers required to automatically enroll employees?	No	No	Yes, all employees eligible to participate in the plan must be covered except employees who either elect not to participate or elect to participate at a different contribution rate.
Can the Employer sponsor other plans?	No	Yes	
Is there a penalty for Withdrawals?	25% for the first two years, 10% after first two years	10%	
Age no longer penalized for distributions upon termination of employment	59½	55	
Maximum number of eligible employees	100	No limit	
Eligibility maximum	Earned over \$5,000 in prior two years	One year wait; 1000 hour minimum: dual-entry date	
Are participant loans allowed?	No	Yes	
Includes bankruptcy/judgment protection?	No	Yes	
Is IRS Form 5500 required?	No	Yes	
What is the deadline for distributing my Safe Harbor notice?	60 days before beginning of plan year	30 days before beginning of plan year	