

# Cash or Deferred – IRC Sec. 401(k) Plan

## The Basics

Any profit sharing or stock bonus plan that meets certain participation requirements of IRC Sec. 401(k) can be a cash or deferred plan. An employee can agree to a salary reduction or to defer a bonus which he or she has coming. Tax-exempt entities may also adopt a 401(k) plan.



## How It Works

- Employee has the option of taking cash or having it paid to the trust for retirement. This is equivalent to an employee tax-deductible contribution. However, employee deferrals are subject to FICA and FUTA payroll taxes, with applicable payments from both the employer and employee.
- Any additional employer contributions are tax deductible.
- Employer contributions, if any, are not taxed currently to the employee.
- Earnings accumulate income tax-deferred.
- Distributions are generally taxed as ordinary income. Distributions may be eligible for 10-year income averaging<sup>1</sup>, or, at retirement from the current employer, rolled over to a Traditional or a Roth IRA<sup>2</sup> or to another employer plan if that plan will accept such a rollover.

## Two Types of Plans

- **Salary reduction:** An employee can agree to a salary reduction; e.g., 10% of compensation, which the employer then pays to the retirement plan trust. It is deductible to the employer but is not included in the employee's gross income.
- **Cash or deferred:** The employer can decide to pay a bonus and give the employees the following choices.
  - Take it as cash.
  - Defer it to the trust.
  - Take part and defer the rest.

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<sup>1</sup> Those born before 1936 may be able to elect 10-year averaging or capital gain treatment.

<sup>2</sup> Beginning in 2008, distributions from qualified retirement plans, IRC Sec. 457 plans, and tax-sheltered annuities may be rolled directly into a Roth IRA. These rollover distributions are taxable events, subject to the same requirements as a Roth conversion.

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## Deposit of 401(k) Salary Deferrals

The Department of Labor (DOL) has conducted many 401(k) plan audits. The deposit rule originally issued by the DOL was that “The employer must deposit the funds as soon as practical, but not later than 15 business days following the close of the calendar month during which the deferrals were made.” It is now clear that the DOL is enforcing the “as soon as practical” portion of this rule and not the “15 business days” part. For a small employer, “as soon as practical” is the day the payroll is paid. If this is not done, the employer will be required to make up lost earnings and possibly be subject to other sanctions.

## How Much Will There Be at Retirement?

This will depend upon three factors.

1. The frequency and amount of contributions
2. The number of years until retirement
3. The investment return

The risk of good or bad investment returns rests upon the employee.

<b>An Example of What \$10,000 Per Year Will Grow to Over Several Years at Various Rates of Growth Without Tax<sup>1</sup></b>				
<b>Years</b>	<b>4.00%</b>	<b>6.00%</b>	<b>8.00%</b>	<b>10.00%</b>
<b>5</b>	\$54,163	\$56,371	\$58,666	\$61,051
<b>10</b>	\$120,061	\$131,808	\$144,866	\$159,374
<b>15</b>	\$200,236	\$232,760	\$271,521	\$317,725
<b>20</b>	\$297,781	\$367,856	\$457,620	\$572,750
<b>25</b>	\$416,459	\$548,645	\$731,059	\$983,471
<b>30</b>	\$560,849	\$790,582	\$1,132,832	\$1,644,940
<b>35</b>	\$736,522	\$1,114,348	\$1,723,168	\$2,710,244

## Additional Considerations

- **Maximum annual allocation:** Employers may deduct contributions of up to 25% of covered payroll. This amount includes employer contributions and account forfeitures.
- **Individual limits:** The allocation total of employer contributions and employee deferrals to a participant’s account may not exceed the lesser of 100% of compensation or \$46,000 per year. An employee’s elective contributions to the plan are limited to \$15,500 on a calendar year basis. For those age 50 and older, additional “catch-up” contributions of \$5,000 may be made.<sup>2</sup>
- **Roth 401(k):** Federal law allows a 401(k) plan sponsor to modify plan provisions to allow participants the option to contribute to a Roth account. Contributions to a Roth 401(k) account are made with after-tax dollars and are subject to the same employee elective deferral limits as the 401(k) plan.

<sup>1</sup> The rates of return used in this illustration are not indicative of any actual investment and will fluctuate in value.

<sup>2</sup> These values apply to 2008.

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- **Investment of plan assets:** Plan investments must be diversified and prudent. Subject to plan provisions, plan assets can be invested in equity products like mutual funds, stocks and debt free real estate; or in debt instruments like T-Bills and CDs. Insurance products such as life insurance and annuity policies may also be used. If the plan mandates that employee deferrals must be invested in employer stock, or the trustee can direct such an investment, then the maximum that can be invested in employer stock is generally 1%.
- **Typically, participants direct the investment of their own deferrals:** They may also direct the investment of employer contributions.
- **Parties which are favored:** Since funds are typically employee dollars, the higher paid younger employee is favored because he or she has a longer time for funds to accumulate tax-deferred.
- **Matching programs:** Some employers choose to match each dollar put in by the employee with some multiple; e.g., 50%, 75%, etc. If the employee does not defer, the employer does not make a match.
- **Qualification contributions:** If the non-highly compensated employees have not deferred enough, relative to what the highly compensated employees would like to defer, the Treasury Regulations permit the employer to make a contribution which is sufficient to bring the non-highly compensated employees up to the level necessary to support the highly compensated employee's deferral percentage. This type of contribution must always be fully vested.

Highly compensated employees include 5%-or-more owners and those earning more than \$105,000<sup>1</sup> in the prior year. If the employer so chooses, the plan may include only those earning more than \$105,000 who are also among the top-paid 20% of employees.

- **Salary reductions:** Participants must enter into or be deemed to have entered into a salary-reduction agreement permitting a payroll deduction. This must be done prior to being eligible to receive the compensation.
- **Withdrawal of funds:** As with other profit sharing plans, the funds can generally be withdrawn in the event of (a) termination of employment, (b) death or disability, (c) attainment of age 59½.
- **Financial hardship:** Under a Sec. 401(k) plan, elective contributions can be withdrawn if the participant has a "financial hardship." Under the Treasury Regulations, this is defined as "immediate and heavy financial need where funds are not reasonably available from other sources." There are safe harbor rules that spell out the conditions and requirements for hardship distributions.
- **Forfeitures:** As participants leave the company and separate from the plan, those less than 100% vested in the employer contribution account forfeit that part of the account in which they are not vested. The nonvested forfeitures may then be allocated to the remaining participants. Those participants who remain in the plan the longest will share in the most forfeitures, or forfeitures may reduce future employer contributions.

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<sup>1</sup> This limit applies to 2008. This limit was \$100,000 for 2007.

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- **Top-heavy plans:** If 60% or more of plan assets are allocated to key employees,<sup>1</sup> the employer will be required to contribute up to 3% of compensation to all non-key participants if any key participant defers, and/or receives an employer contribution, up to 3% of his or her compensation. In order to meet top-heavy minimum allocation requirements, employee contributions are not recognized.<sup>2</sup>
- **Discretionary contributions:** In addition to any matching and/or top-heavy contributions, an employer may make discretionary contributions from year to year so long as the allocation among the participants is on a non-discriminatory basis. These contributions may be allocated in several different ways. These contributions can be made to the plan up to the due date of the return plus any extension granted to the employer. Any employer contributions made on a discretionary basis that are not required to maintain the plan qualification may have gradual vesting.
- **Automatic enrollment arrangement:** An employer may adopt an arrangement under which a specified percentage of salary will automatically be contributed to the 401(k) plan for each employee unless an employee chooses to “opt-out” of the system.

### Nondiscrimination Rules

A mathematical test is used to determine whether a plan is discriminatory. First, all employees eligible to participate are divided into two groups according to their compensation and ownership in the employer. The highly compensated<sup>3</sup> may defer up to two times what the non-highly compensated can for the first 2%. If the non-highly compensated on average defer between 2% and 8%, the highly compensated may contribute an additional 2%. (If more than 8%, then up to 125% of the rate.)

In the first year of a 401(k) plan, a 3% deferral rate for non-highly compensated employees may be used if greater than the actual deferral rate.

The amounts contributed by the non-highly compensated employees will set the limit on how much the highly compensated can defer. The deferral percentages must be satisfied for the entire year. An excise tax is assessed if excess deferral amounts are not returned within 2½ months after the close of the plan year. Or, instead of returning deferrals, the employer may make a contribution to the non-highly compensated participants.

<b>If the Nonhighly Compensated Employees Defer (on average)</b>						
.75%	2%	4%	6%	8%	10%	12%
<b>Then the Highly Compensated Employees Can Defer (on average)</b>						
1.5%	4%	6%	8%	10%	12.5%	15%

Average percentages: Highly compensated = 8%; Nonhighly compensated employees = 6%—The test is satisfied.

<sup>1</sup> A “key” employee is someone who, at any time during the plan year was: (1) an officer of the employer whose compensation from the employer exceeded \$150,000; or (2) a more than 5% owner; or (3) a 1% owner whose compensation from the employer exceeded \$150,000.

<sup>2</sup> Employer-matching contributions, if any, count toward satisfying the top-heavy requirement. However, if a non-key person does not defer and, hence, not receive a match, the employer would have to make the top-heavy contribution.

<sup>3</sup> In general, a highly compensated participant is one who owns 5% or more of the employer or was paid \$105,000 or more (year 2008 limit) in the prior year.

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## Cash or Deferred – IRC Sec. 401(k) Plan

Example			Percentage of Compensation		
Employee	Salary and Bonus	Contribution to 401(k) Plan	Individual	Group	Average
HC1	\$230,000	\$15,500	6.74%		
HC2	150,000	15,500	10.33%	17.07%	8.54%
NHC3	55,000	12,000	21.82%		
NHC4	30,000	1,500	5.00%		
NHC5	30,000	1,200	4.00%		
NHC6	30,000	900	3.00%		
NHC7	25,000	0	0.00%	33.82%	6.76%

### IRA vs. 401(k)

Since most 401(k) plans are funded with employee money, the chart below compares the 401(k) plan to an individual retirement arrangement.

Concern	IRA	Sec. 401(k)
<b>Limitations on contributions/allocations</b>	\$5,000 or \$10,000 (if nonworking spouse is included) <sup>1</sup>	Lesser of 100% or \$46,000 of net compensation. Maximum employee elective deferral is \$15,500 <sup>2</sup> in 2008
<b>Mandatory withdrawal at age 70½</b>	Yes, if traditional IRA No, if Roth IRA	Maybe <sup>3</sup>
<b>Subject to Social Security tax (FICA) and federal unemployment tax (FUTA)</b>	Yes	Yes
<b>Can life insurance be purchased?</b>	No	Yes
<b>Do distributions qualify for 10-year income averaging?</b>	No	Maybe <sup>4</sup>
<b>Can funds be borrowed?</b>	No	Yes, within limits
<b>Anti-discrimination test?</b>	None	Yes - highly compensated/nonhighly compensated employees
<b>Access to funds for financial hardship before age 59½</b>	10% penalty applies, with limited exceptions <sup>5</sup>	Yes, as to elective contributions, but subject to 10% penalty <sup>6</sup>

<sup>1</sup> For those aged 50 and older, additional "catch-up" contributions of \$1,000 may be made.

<sup>2</sup> For those age 50 and older, additional "catch-up" contributions of \$5,000 may be made.

<sup>3</sup> Except for more-than-5% owners, payments must begin by the later of (1) April 1 of the year following the year in which the participant reaches age 70½, or (2) the year following the year in which the participant retires. If the employee is a 5%-or-more owner, withdrawals may not be delayed beyond April 1 of the year he or she reaches age 70½.

<sup>4</sup> Those born before 1936 may be able to elect 10-year averaging or capital gain treatment.

<sup>5</sup> Distributions made because of disability or to pay medical expenses in excess of 7.5% of adjusted gross income are not subject to the 10% penalty. In certain situations, withdrawals by unemployed individuals to pay health insurance premiums, or withdrawals made to pay certain first-time homebuyer or educational expenses, may also avoid the 10% penalty.

<sup>6</sup> Unless covered by penalty exception.

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# Cash or Deferred – IRC Sec. 401(k) Plan

## Advantages to Employer

- A. Employers are not required to make discretionary contributions.
- B. If the employer does make a discretionary contribution, it is deductible.
- C. Any employer discretionary contribution is flexible.
- D. The plan is easily understood by employees.
- E. An employer matching contribution is a very popular benefit to employees and can be provided at a modest cost.
- E. The plan can provide employees with permanent life insurance benefits that need not expire nor require costly conversion at retirement age.
- F. The employer can direct employer investments.
- G. Of all the allocation techniques that can be used for employer discretionary contributions, the one best fitting the employer's objectives can be utilized.
- H. If former participants do not provide the plan with distribution instructions, the plan may automatically distribute accounts less than \$5,000. In the case of a plan that provides for such mandatory distributions, the plan must automatically roll an eligible distribution amount that exceeds \$1,000 to a Rollover IRA in the former participant's name. A plan may allow direct rollovers of less than \$1,000.

## Advantages to Employees

- A. Participant deferrals are with pre-tax dollars.
- B. Any employer contributions are not taxable to participant.
- C. Participants may have the right to direct investments.
- D. Federal law allows a qualified plan to establish an "eligible investment advice arrangement" under which individually tailored investment advice is provided to plan participants. Any fees or commissions charged must not vary with the investment options chosen, or else a computer model meeting certain requirements must be used.
- E. Participants may also have a traditional, deductible IRA (subject to certain income limitations based on filing status), a traditional, nondeductible IRA, or a Roth IRA.
- F. There is the ability to purchase significant permanent life insurance that is not contingent upon the company group insurance program. Purchase of life insurance will generate taxable income to the employee.

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## Cash or Deferred – IRC Sec. 401(k) Plan

- G.** Younger employees can accumulate a larger fund than with a defined benefit plan.
- H.** The forfeited, unvested portion of any employer-generated accounts may be reallocated to the active participants' accounts.
- I.** Participant may borrow from the plan within certain guidelines if provided for in the plan documents.
- J.** If the plan permits, participants can make hardship withdrawals within the requirements of the plan;<sup>1</sup> these may not be rolled over to any IRA.
- K.** The employer may make matching contributions of some amount.
- L.** The employer may be required to make additional contributions to satisfy top heavy and/or discrimination tests.
- M.** Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

### Disadvantages to Employer

- A.** Employers may be required to make a variety of mandated contributions to satisfy top-heavy requirements and/or discrimination requirements.
- B.** The more highly paid participants may not be able to make sufficient contributions to build an adequate retirement. This may bring pressure on the employer to provide additional retirement benefits.
- C.** Since a 401(k) plan can be the most complicated type of plan to have, the administration costs will be greater than with other types of plans.
- D.** If the plan fails the discrimination tests, it may have to make refunds to the highly compensated participants, or make a contribution on behalf of non-highly compensated individuals.
- E.** Because there are employee contributions made through payroll, a 401(k) plan increases the workload of company staff who handle payroll.

### Disadvantages to Employees

- A.** There is no guarantee as to future benefits.
- B.** The investment risk rests on the participant.
- C.** The employer may or may not make discretionary contributions.

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<sup>1</sup> See IRC Sec. 402(c)(4) as amended by the IRS Restructuring and Reform Act of 1998.

# How a 401(k) Cash or Deferred Plan Works



## Employer

- May provide a voluntary matching fund.
- Contributions are tax deductible to the business.<sup>1</sup>
- May make discretionary contributions any year, so long as allocation is nondiscriminatory.
- Special rules apply for nondiscrimination.



## Employee

- Employee elects to defer a portion of salary or bonus.
- Amounts deferred are subject to FICA and FUTA taxes but not current income tax.
- Employee's elective contributions are limited to \$15,500<sup>2</sup> per year (2008).<sup>3</sup>

**Sec. 401(k) Plan**

- Employer contributions are not currently taxable to employee and earnings accumulate tax deferred.
- Most plans are self-directed (employee controls investments).
- Investment risk remains on employee.

**Early Withdrawal**

- A 10% penalty generally applies if withdrawals are made before age 59½.
- Some exceptions to the 10% penalty are available.
- Employee elective contributions can be withdrawn for financial hardship.<sup>4</sup>

**Retirement**

- Distributions must begin by specified date.<sup>5</sup>
- Funds may be distributed as a lump sum or periodic payments.
- Earnings + deductible contributions taxed as ordinary income in the year received.

**Death**

- Value of account is included in owner's gross estate.
- Proceeds can pass to surviving spouse with payments over the survivor's lifetime.
- Income and estate taxes can severely reduce funds left to nonspousal heirs.

<sup>1</sup> The total deductible employer contribution may not exceed 25% of covered payroll, including employer contributions and account forfeitures.

<sup>2</sup> For those age 50 and older, additional "catch-up" contributions of \$5,000 may be made.

<sup>3</sup> For 2008, the allocation total of employer contributions and employee deferrals to a participant's account may not exceed the lesser of 100% of compensation or \$46,000 per year.

<sup>4</sup> If provided for by the plan. Under Treasury regulations, financial hardship is defined as "immediate and heavy financial need where funds are not reasonably available from other sources."

<sup>5</sup> Except for more than 5% owners, distributions must begin by the later of April 1 of (a) the year following the year in which the participant reaches age 70½, or (b) the year following the year in which the participant retires.