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Retirement Plan Administrators, Consultants, Actuaries

401(k) Plans

(Cash or Deferred Profit Sharing Plans)

What is a 401(k) plan?

A 401(k) plan is a special type of tax qualified profit sharing plan that is flexible, cost effective and enormously popular.

Like a traditional profit sharing plan, a 401(k) plan offers flexible and fully tax-deductible employer contributions together with tax-sheltered growth of plan assets.

Unlike traditional plans, a 401(k) plan allows employees to choose whether to receive a portion of their income in cash, fully taxable, or to defer receipt of income, and payment of taxes on the income, until retirement.

Because a 401(k) plan allows employees to choose cash or deferral of income, it is also known as a "cash or deferred plan".

What problem does a 401(k) plan solve?

A 401(k) plan answers the traditional dilemma of business owners who want to meet the needs of all their employees:

"Many of my employees want to save for retirement and would really appreciate a company retirement plan. Some of them are my best and most loyal employees. I'd like to help them. And I'd like to be able to put more money away for myself!

"But my younger employees don't care about retirement—they want cash to pay their bills or buy a new car or stereo.

"How can I meet the needs of both groups of employees?"

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How can employees be encouraged to save for their retirement in a 401(k) plan?

Many 401(k) plans provide for employer matching contributions to encourage and reward elective deferrals by employees and to maximize employee appreciation of the plan.

For example a plan provides dollar-for-dollar matching of employee's deferrals up to a maximum of 3% of pay. An employee who chooses to defer 10% of pay will have an additional 3% contributed by the employer. An employee who defers 2% of pay will have an additional 2% contributed.

Even young employees who would rather have cash often will happily elect to defer at least the amount that is matched by the employer.

Can an employer make contributions for all participants, regardless of elective deferrals?

Yes. Many employers do contribute a percentage of all eligible employee's compensation to a 401(k) plan. These "discretionary" employer contributions may be a fixed percentage of pay or may vary from year to year, as in a traditional profit sharing plan.

As an example, a plan might provide for a discretionary contribution equal to 3% of pay to the accounts of all eligible employees; elective deferrals by employees of up to 10% of pay; and dollar-for-dollar employer matching contributions for up to 2% of pay; for a maximum total contribution of 15% of pay.

What are the maximum limits on elective deferral and other contributions to a 401(k) plan?

Total contributions to a 401(k) plan and all other profit sharing plans of an employer (including simplified employee pension, employee stock ownership and stock bonus plans) may not exceed 15% of the total compensation of participating employees.

Elective deferrals by an individual employee are limited to 20% of pay up to an annual maximum dollar limitation, \$10,000 in 1998, which is adjusted annually for inflation.

Deferrals by "highly compensated employees" are further limited based on actual deferrals by "non-highly compensated employees."

Who is a highly compensated employee?

A highly compensated employee is any employee who, during the current or previous plan year:

- owned, directly or indirectly, more than 5% of the employer;
- received compensation of \$80,000 or more in the prior year;
- is a family member of a 5% shareholder.

Who is a non-highly compensated employee?

Anyone who is not a highly compensated employee is a non-highly compensated employee.

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How are the elective deferrals of highly compensated employees limited by those of non-highly compensated employees?

The average deferral percentage (ADP) of the highly compensated employees is limited based on the average deferral percentage of the non-highly compensated group of employees.

The formula is complicated, but the results can be summarized with a simple chart:

<u>If the average deferred by the non-highly compensated group is:</u>	<u>The average deferred by the highly compensated group may not exceed</u>
0%	0%
1%	2%
2%	4%
4%	6%
8%	10%
12%	15%

How can non-highly compensated employees be encouraged to defer more, so that the highly compensated group can defer more?

1. Effective communication of the plan to the employees can help to increase participation by demonstrating the substantial advantage of saving early for retirement.

Employees who understand and appreciate the plan are much more likely to take advantage of elective deferrals.

2. Employer matching and discretionary

contributions encourage elective deferrals and increase employees' overall appreciation of the plan.

Most employees will elect to defer at least the amount which is eligible for employer matching contributions, and many, once committed to some deferral, will find it easy to increase the percentage of their pay deferred.

In certain circumstances, matching contributions can also be factored into the average deferral percentage calculation, increasing the non-highly compensated employees' ADP and allowing a higher average deferral percentage by the group of highly compensated employees.

3. Non-elective employer contributions generate additional appreciation of the plan by employees and, in certain circumstances, can also be used to increase the ADP of the non-highly compensated group.

When can employer contributions be taken into account in determining the average deferral percentage (ADP) of highly and non-highly compensated employees?

Employer contributions which are 100% vested immediately, and are otherwise treated the same as elective deferrals, can be taken into account in the ADP calculations.

To allow highly compensated employees to defer a higher percentage of their income, many plans provide for 100% immediate vesting of employer matching and non-elective contributions. The resulting increase in the ADP of the non-highly compensated group can mean a much higher maximum ADP for the highly com-

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pensated group.

What's so great about 401(k) plans?

401(k) plans give employees the choice of receiving all cash income or deferring some of their income, before tax, to a tax sheltered retirement plan.

Because no employer contributions are required, 401(k) plans can be extremely cost effective. Even modest discretionary or matching contributions can create a tremendously attractive and popular benefit for employees.

401(k) plans are very flexible and can be designed to meet a wide variety of retirement plan objectives for a broad spectrum of businesses. The design flexibility of a 401(k) plan makes it a major plus in the overall design of any employee benefit program.

Are 401(k) plans difficult to administer?

They certainly can be. 401(k) plans can be very complex, and the more complex a plan is, the more detailed the calculations and

paperwork involved in its administration.

However, a 401(k) plan can also be relatively simple, if proper care is taken during the plan design process, and if "bells and whistles" aren't added indiscriminately.

Factors affecting plan complexity include the plan's basic design, the number of investment options offered to employees, and optional provisions such as loan and hardship withdrawal provisions.

Who can best assist you with the design, installation and ongoing administration of a 401(k) plan?

Effective and efficient operation of a 401(k) plan requires experience and commitment to 401(k) plan administration and a personal approach to the design and day-to-day operation of the plan.

We have the experience, commitment, and knowledge to give you the help you need, whether in designing and administering a new plan or improving an existing plan to better meet your needs and objectives.



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