401(k) Primer

A Primer on 401(k) Plan Design Alternatives

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I. A 401(k) Plan with only Salary Deferrals

A. Many times a Plan Sponsor simply wants to make a 401(k) plan available to employees so that the employees have the ability to do personal salary deferrals on either a Roth or traditional pre-tax basis. This might be necessary because employees are demanding it or the company needs the 401(k) plan for recruiting purposes. Some employees want the ability to do Roth 401(k) deferrals, including some who cannot take advantage of Roth IRA's because their Adjusted Gross Income is too high.

1. For 2009, the salary deferral limit is $16,500. There is no a limitation as a percentage of pay.
2. For 2009, if someone is age 50 or more by the last day of the Calendar Year, the limit is $22,000 (the regular $16,500 plus $5,500 of over age 50 "make-up" contributions).

B. 401(k) plans are subject to what is known as an "ADP Test" (average Actual Deferral Percentage Test).

1. Eligible participants are divided up into two groups. Highly Compensated Employees ("HCE's) and Non-Highly Compensated Employees ("NHCE's) for testing purposes.
2. For 2009, HCE's are defined primarily as greater than 5% owners or shareholders, certain family members of greater that 5% owners and participants who made more than $105,000 in the prior plan year.
3. Note: A person hired during a plan year who is not an owner cannot be an HCE for their first year of employment because they did not make more than $105,000 in the prior year. For example, suppose you hire someone on 1/5/2009 and pay them $400,000 for 2009. That person would still not in the HCE group for 2009. They would be an HCE for 2010 unless other limitations apply (such as a Top Paid Group Election).
4. HCE's are limited in what they can do as salary deferrals based on what the average is for the NHCE's, Generally, NHCE's will average at least 2% but less than 8% of pay and if that is the case, then the HCE's can average 2% more than the NHCE's.
5. For example, if the NHCE's average the following, the HCE's can average the percentages shown:
   a) 2% for NHCE's allows 4% for HCE's
   b) 4% for NHCE's allows 6% for HCE's
   c) 5.25% for NHCE's allows 7.25% for HCE's, etc.
6. Unfortunately, this can result in the HCE's not being allowed to do as much in salary deferrals as they would like to do. For example, suppose the

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NHCE's average 4% and this limits the average of the HCE's to 6% and suppose an HCE makes $100,000 in salary. This HCE would be limited to 6% of $100,000 or $6,000 vs. the limit of $16,500. Even an HCE making $150,000 would be limited to $9,000 in salary deferrals rather than being able to do the $16,500 limit.

7. Note: Most everything we are stating in this Primer is a gross oversimplification of the real rules, however, our goal here is to communicate just the basics.

C. If the NHCE's do less than a 2% average, then the HCE's can do double what the NHCE's do. For example, if the NHCE's only averaged 1.5%, then the HCE's can only average 3% (2 x 1.5%).

D. If the NHCE's do more than 8% average, then the HCE's can do 1.25 x the NHCE average. For example, if the NHCE's were to average 10%, then the HCE's could average 12.5%.

E. If the Plan Sponsor is not making any matching contributions, or any "Safe Harbor contributions" or any Profit Sharing contributions, then the only cost to the employer is for the set-up and administration of the plan.

F. A new plan will qualify for a three year tax credit of $500 per year. At a 33% tax bracket, that is the equivalent of an extra $1,500 business deduction.

G. The primary way to encourage NHCE's to utilize the plan is to provide quality education showing them all the reasons why they should participate and making sure they feel they understand the plan. If you simply provide a quick overview to them or throw enrollment forms at them, they will not do much. People do not take part in something they do not understand or something with which they are not comfortable.

H. Automatic enrollments with default investments is one way to overcome the inertia of people not enrolling. They have to take action not to participate.

II. A 401(k) With A Small Matching Contribution

A. Sometimes, the Plan Sponsor may want to offer some sort of an economic incentive to participants in order to bring up the average deferrals of the NHCE's.

B. There is a unlimited number of ways of doing this, but one very effective way is to make a small Qualified Matching Contribution ("QMC").

C. For example, the Plan Sponsor might offer a match of 50% of what the employee puts in with a maximum dollar amount such as $750. That means that an employee needs to do a salary deferral of at least $1,500 in order to earn the full matching contribution that is available. You can require the participant to be employed at the end of the year to benefit.

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D. This helps raise the average salary deferral percentages of the NHCE's in several ways

1. All financial and newspaper articles the participants will read tell them to contribute enough to earn the maximum matching contribution available under the 401(k) plan
2. If the match is a QMC (which means it must be defined as such in the plan document and must be 100% vested), then it can be counted in the basic ADP test.
3. For example, let's suppose a participant's annual salary is $30,000. They must put in $1,500 to earn the full $750 of matching contribution. This encourages them to do the $1,500 which is 5% of their annual salary. The $750 QMC (matching contribution) is another 2.5% of pay for this person, so their ADP is considered to be 7.5% of pay.
4. Now take an HCE who makes $150,000. The $750 matching contribution for them only adds 0.5% to their ADP as opposed to the 2.5% for the lower paid employee.
5. This really helps raise the average for the NHCE's and therefore permits a higher average of salary deferrals for the HCE's. However, even under this approach, the HCE's are probably not going to be able to do the maximum salary deferrals of $15,500.
6. The Plan Sponsor can easily calculate the maximum exposure they have for such matching contributions since it is merely the number of participants times $750 each. For example, if there was 20 eligible participants, the maximum exposure would be $15,000. Under any circumstances, not all participants would normally make salary deferrals, in spite of having a matching contribution available.

III. Eliminating the ADP Test in a 401(k) Plan Using a "Safe Harbor" Approach

A. If the Plan Sponsor is in a position financially to make a Safe Harbor contribution, then the ADP test can be completely eliminated and all of the HCE's can do up to the limit for the year regardless of what the NHCE's decide to contribute.

B. One type of Safe Harbor contribution is a 3% of pay contribution for all eligible participants whether they do any salary deferrals of their own or not.

C. Another alternative type of Safe Harbor contribution is a matching contribution of at least 100% of the first 3% of pay in salary deferrals plus 50% of the next 2% of pay in salary deferrals. For example, if the participant does not do a salary deferral, then they get no matching contribution. If the participant does 3% of pay or less as a salary deferral, then they would get the same matching contribution to their account. If the employee does 5% of pay or more, then they would get a 4% of pay matching contributions (100% of 3% plus 50% of the next 2%).

D. All Safe Harbor contributions must be 100% vested and must even be made to

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participants who leave during the year. Also, it is absolutely mandatory that a Safe Harbor Notice is made at least 30 days before the beginning of the Plan Year.

E. If the Plan Sponsor is going to use the 3% of pay for everyone approach, it is important to have a quality plan document with flexible provisions. For example, the plan document used by Plan Design Consultants, Inc. allows for a "Maybe Notice" as opposed to a fixed notice. Under this approach, a notice is issued 30 to 90 days before the next Plan Year begins saying that a 3% Safe Harbor contribution "might" be made for the following year and then at least 30 days before the Plan Year is over, another notice is issued indicating if the contribution will be made or not.

F. It is also extremely important to use a plan document that provides some flexibility as to who is to get the Safe Harbor contribution. Many "Standardized Prototypes" such as used by some of the major payroll providers allocate the Safe Harbor contributions to only the NHCE participants.

G. Starting in 2008, a third type of Safe Harbor became available based around automatic enrollments. This is called a "Qualified Automatic Contribution Arrangement" or "QACA". If you have an automatic enrollment program that meets certain requirements (known as a "Eligible Automatic Contribution Arrangement") and if you make certain matching contributions, then your plan is also exempt from the ADP test.

1. You must have minimum automatic enrollment provisions where if someone does not specifically elect to be in or out of the plan, then they are automatically enrolled. The minimum automatic enrollment for the participant's first year of eligibility is 3% and this must be increased to 4% the second year, 5% the third year and 6% the fourth year and thereafter. You can automatically enroll them for more than the above, but not for more than 10% of pay. Remember, if they turn in an enrollment form, then you just do whatever they elected.
2. For this Safe Harbor, you must make a matching contribution of 100% of the first 1% and then 50% of up to the next 5%. For example, if the participant elects a 1% salary deferral, you match 1%. If they elect a 6% salary deferral or more, then you must match at least 3.5% (100% of the first 1% plus 50% of the next 5% or 2.5%).

H. Plan Sponsors currently using the Basic Safe Harbor Match of 100% of the 1st 3% plus 50% of the next 2% should seriously consider converting for 2009 to the new QACA Safe Harbor (Qualified Automatic Contribution Arrangement) for the following reasons:

1. Under the Basic Safe Harbor Match, if an employee does a salary deferral of 6% or more, then the match is 4%. Under the QACA approach the match would only have to be 3.5%. In fact, the Safe Harbor match would be less at every level except the first 1% of pay. See the table below:

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Employee Salary Deferral	Old Match	New Match
1%	1%	1%
2%	2%	1.5%
3%	3%	2%
4%	3.5%	2.5%
5%	4%	3%
6% +	4%	3.5%

2. Plan Sponsors of any size should seriously consider adding Automatic Enrollment to their 401(k) plan in order to overcome procrastination by confused participants.
3. Coupled with the new Qualified Default Investment Alternative ("QDIAs"), some significant Fiduciary protection is achieved, as well.

IV. 401(k) Plans Can Allow Additional Profit Sharing Contributions and Profit Sharing Plans Be Amended To Allow 401(k) Salary Deferrals

A. There are several ways for Profit Sharing contributions to be allocated to eligible participants.

1. Pro-rata: everyone gets the same percentage of compensation
2. Permitted Disparity: those who make over the Social Security wage base will get slightly higher allocations than those who make less than the wage base.
3. Based upon special allocation groups defined in the document – amount of contribution determined separately for each group. Discrimination testing done on the basis of projected benefits from the contribution – a defined contribution plan tested like a defined benefit plan and therefore this type of plan is normally referred to as a "Cross Tested Plan".

B. The client's objectives dictate which approach might be the most appropriate. If the HCE's are somewhat older than approximately 50% of the support staff, then we might be able to allocate a significantly higher percentage of pay to the HCE's as a profit sharing contribution using the special allocation groups methodology (the Cross Tested methodology). For example, we have done plans where we had a profit sharing allocation of 5% of pay for the NHCE's and this allowed us to contribute 35% of pay (or more) to the business owner (subject to the overall deductible limitations for the business entity for the year).

C. The overall limitations for someone who is age 50 or more is $54,500 for 2009. We would normally design the plan to have $22,000 of salary deferrals for the owner and $32,500 of profit sharing contributions for the $54,500 total.

D. If a company sponsors just a Profit Sharing Plan, they might want to explore adding the ability for participants to do Salary Deferrals to the plan as well.

E. For example, suppose a company is making an annual contribution of 15% of everyone's compensation. Suppose the major owners or professionals have compensation of more than $245,000 (the 2009 compensation limit). Then the

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15% contribution would be $36,750. The limit for the 2009 if someone is 50 years of age or more is $49,000 of regular allocations plus $5,500 of over age 50 salary deferrals or a total of $54,500. So, by adding the ability to do 401(k) salary deferrals to the plan, the owner's can increase their total contributions to the limit by doing $17,750 of salary deferrals ($36,750 + $17,750 = $54,500).

F. Even if a professional firm was contributing the maximum $49,000 to the owners (20% of $245,000), if they are over age 50, they could still have more put away by adding the 401(k) salary deferral feature and contributing another $5,500 in over age 50 "make-up" contributions. If a regular employee was being paid $50,000 and got a company contribution of 20% or $10,000, they could do up to $16,500 of 401(k) salary deferrals if under age 50 and up to $22,000 of 401(k) salary deferrals if over age 50. We understand that to do such large contributions, they would probably have to be married to someone making pretty good money to be able to afford such large amounts. On the other hand, they could do smaller 401(k) salary deferrals – whatever they can afford.

G. Conclusion: many companies who have just Profit Sharing Plans now should seriously consider adding the 401(k) salary deferral feature to allow both the owners and the staff the ability to supplement any company contributions with personal salary deferrals.

V. Safe Harbor Cross-Tested 401(k) Plans

A. A very powerful design technique for the right situations is what we refer to as a "Safe Harbor Cross-Tested 401(k)". In a nutshell, it combines a 3% Safe Harbor employer contribution with Profit Sharing contributions allocated by using special allocation group definitions in the document.

B. A Safe Harbor Cross-Tested 401(k) plan, as we normally design it, consists of the following contributions:

1. A 3% Safe Harbor contribution to be made for Non-Highly Compensated Employees only. We do this with a "Maybe Notice" so that it is not mandatory if the Plan Sponsor has a horrible financial year and cannot afford it.
2. Because of the above 3% Safe Harbor contribution for all of the NHCE's, the HCE's can each do the maximum allowable personal salary deferrals either as pre-tax or as Roth 401(k)'s.
3. Normally, but not necessarily, if the 3% is going to be made for the NHCE's, a profit sharing contribution is going to be made as well using special allocation groups. If the 3% Safe Harbor is made for the NHCE's, then up to 9% can be made for the HCE's, if the discrimination tests can be passed. This is normally not a problem if we have a plan sponsor where many of the HCE's are somewhat older than a good portion of the NHCE's. That does not mean, that all of the NHCE's have to be younger – in fact, some of them can even be older than the HCE's. We just need a portion of the support staff which are somewhat younger, relatively speaking.

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4. With a small additional profit sharing contribution allocated to the NHCE's ranging from 1.4% to 2%, we can, in the right circumstances, allocate enough profit sharing contributions to the HCE's to get them to their maximum limits for the year.
5. Example:
   a) 50 year old HCE with compensation above $245,000; $22,000 of Salary Deferrals plus $32,500 of profit sharing allocation (13.26% of $245,000) for a total of $54,500
   b) 35 year old support person with compensation of $40,000 doing no salary deferrals of their own; profit sharing allocation of 4.42% of $40,000 or $1,768 (includes the 3% SH plus 1.42% extra).

C. The Safe Harbor Cross-Tested plan design technique can be very effective for established firms of various sizes from small to large as long as a portion of the HCE's are in their late 40's or more and a portion of the staff (approximately 50% of the support staff) are some 10 to 15 years younger such as:

1. Law firms
2. CPA firms
3. Medical Groups
4. Small, Closely-Held Businesses

D. This very common type of design of a 401(k) plan CANNOT BE ACCOMPLISHED using a Standardized Prototype document such as the ones normally provided by the payroll services or the bundled providers.

VI. Cash Balance Defined Benefit Plans Combined with 401(k) Plans

A. Business owners or professionals such as surgeons, attorneys, etc. who have just a 401(k) Plan, are limited to $54,500 in 2009 from all contributions if over age 50 by 12/31/2009. However, many of them are very interested in how to get more than that contributed to their account.

B. A viable option for larger contributions would be to combine a Cash Balance Defined Benefit Pension Plan with a 401(k) Plan. This might allow the owners or professionals to shelter from $100,000 to over $200,000 per year depending upon their attained age.

C. The additional cost for the support staff can be very reasonable compared to the size of the extra deductions for the owners.

D. These "Combo Plans" are not really the subject of this 401(k) Primer, but we just wanted to make sure that you are aware that contributions and deductions beyond the stand-alone 401(k) Plan limits are allowable and can be a terrific solution for the right circumstances, namely:

1. Owners of the business or professionals are over age 45
2. Earned income or available contributions are very high
3. About 50% of the support staff is somewhat younger than the owners.

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If you have any questions at all about the above material, call Paul Carlson or JD Carlson at (650) 341-3322 – we would welcome the opportunity to help! Or you can email us at:

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