

*All About*  
**401(k)**  
*Plans*

---

TRUSTED. PROVEN. ACCOMPLISHED.



# 401(K) BASICS

**A 401(k) plan is an employer-sponsored retirement plan made possible by Section 401(k) of the Internal Revenue Code. The plan allows employees to save a portion of their salary on a pre-tax basis for accumulation until retirement. If the plan so provides, employees can also contribute on an after-tax basis (Roth after-tax contributions), which can be withdrawn tax-free at a later date (certain conditions apply).**

## HOW DOES A 401(K) PLAN WORK?

1. Employees can voluntarily elect to contribute a percentage of their salary into the plan (called elective contributions or salary deferrals).
2. Each pay period, the elected amount is withheld from the employee's paycheck and deposited into his or her 401(k) account. (Employees cannot make pre-tax contributions from money they have already received).
3. Employee pre-tax contributions are not subject to federal (and, in most cases, state) income tax. They are, however, subject to FICA (social security) tax, so participation in a 401(k) will not reduce an employee's social security benefits.
4. All contributions and investment earnings grow tax-deferred until the employee receives a distribution from the plan.
5. The employer may choose to make additional contributions to the plan, although there is generally no requirement to do so.
6. Both employee and employer contributions are fully tax deductible by the employer.

## WHY ARE 401(K) PLANS SO POPULAR?

### Employer Advantages

1. **Low-Cost Employee Benefit.** The plan is funded partially or totally with employee pre-tax contributions. The employer may contribute as much or as little as desired.
2. **Employee Appreciation.** Unlike many other benefit programs, 401(k) plans are highly visible because employees are actively involved in the contribution and investment decision-making.
3. **Increases Competitive Position.** The popularity of 401(k) gives employers a competitive edge in attracting and retaining quality employees.
4. **Deductible Contributions.** Employee and employer contributions are fully deductible, so a relatively small outlay can provide a very cost-effective program.

### Employee Advantages

1. **Tax Savings.** Employees reduce their current taxes by making pre-tax contributions to the plan. All contributions and investment earnings grow tax-deferred until paid out. This tax-deferred compounding assures a much larger accumulation than an equal amount invested in an identical taxable investment. Plus, funds are usually paid at retirement when the employee may be in a lower tax bracket. Alternatively, if the plan so provides, the employee can choose to make after-tax contributions, which can be distributed on tax-free basis.
2. **Financial Security.** Employees can accumulate significant retirement benefits through the plan.
3. **Automatic Saving.** 401(k) offers the ease and discipline of saving through automatic payroll deduction.
4. **Matching Contributions.** Many 401(k) plans offer an employer match—a guaranteed return on the employee's money even before it's invested.

## WHAT ENTITIES MAY ESTABLISH A 401(K) PLAN?

A 401(k) plan may be established by any corporation, partnership or sole proprietorship, *other than a governmental entity*. (Governmental entities that established a 401(k) before 1986 may continue the plan.)

## HOW IS A 401(K) PLAN ESTABLISHED?

An employer must set forth the provisions of the plan by adopting a plan document. Various elections are made in the document, such as plan eligibility requirements, employer contributions, vesting schedules, and loan provisions. These elections are known as the plan design.

## WHAT TYPES OF PLAN DOCUMENTS ARE AVAILABLE?

There are three types of documents an employer may use, depending on the degree of flexibility desired in plan design.

1. **Standardized prototype.** This is a document that has been pre-filed with the Internal Revenue Service (IRS) by a prototype sponsor, such as a financial institution or plan administration firm. Any employer who is authorized to use the document can rely upon the prototype sponsor's IRS approval letter and will not need to file for an additional approval.
2. **Non-standardized prototype.** A non-standardized prototype allows the employer greater flexibility in plan design. For example, it allows employers to include a provision that requires participants to be working for the company on the last day of the plan year to receive a matching contribution. This optional provision is not available in a standardized prototype. An employer using a non-standardized prototype can rely upon the prototype sponsor's IRS approval letter unless optional provisions are included. In that case, the employer should file independently for approval, for which the IRS charges a \$300 fee.
3. **Individually designed document.** An employer desiring maximum flexibility in plan design can use an individually designed document. An individually drafted document is written by an ERISA attorney, and then filed with the IRS for an approval letter. The IRS will charge a fee of \$1,000 or more, depending on plan specifics.

## WHAT KINDS OF EMPLOYER CONTRIBUTIONS ARE AVAILABLE TO A 401(K)?

An employer may choose to make matching contributions or profit sharing contributions to a 401(k) plan. A plan may include both kinds of contributions, if authorized by the employer in the plan document. Employers are not required to contribute unless the plan is determined to be top-heavy (described in a later question) or unless a contribution amount is specified in the plan document (e.g. 5% of compensation for all eligible employees).

1. **Employer Matching Contributions.** To encourage participation, an employer may match some or all of the employees' contributions. For example, a plan could provide a 50% match on the first 6% of pay deferred by the employee. Thus, if an employee contributes 4% of pay, the employer would contribute 2% of the employee's pay. The employer may establish a fixed matching formula in the plan document or may elect a discretionary formula that can be changed from year to year as business circumstances require. Matching contributions may be subject to a vesting schedule, if elected by the employer in the plan document.
2. **Employer Profit Sharing Contributions.** Unlike matching contributions, which are made only for employees who make elective salary deferrals, profit sharing contributions are made for all employees who meet the plan's eligibility requirements. If a discretionary contribution formula is used, employers have complete control each year over whether and how much to contribute. These contributions are typically allocated to employees as a level percentage of compensation, but they may use permitted disparity (integrated with social security), age-weighted, or new comparability formulas if specified in the plan document. Profit sharing contributions also may be subject to a vesting schedule.

## WHAT ARE THE LIMITS ON CONTRIBUTIONS TO A 401(K) PLAN?

There are **five types of limits** on contributions to a 401(k) plan.

1. **Combined Employee/Employer Contribution Limit.** Annually, an employee's total contributions (elective contributions or salary deferrals, employer match, profit sharing, and allocated forfeitures) cannot exceed the lesser of \$49,000 or 100% of the employee's reduced compensation (as indexed). This limit is adjusted for cost of living on an annual basis.
2. **Employee Elective Deferral Limit.** An employee's elective salary deferrals alone cannot exceed \$16,500 per year (as indexed). The \$16,500 limit is increased periodically by the IRS for inflation. Employees 50 years of age or older are allowed to make a catch-up contribution of an additional \$5,500.

3. **Nondiscrimination Test Limits.** 401(k) plans must pass certain nondiscrimination tests each year. These tests can impose an additional limit on contributions made by highly paid employees.
4. **Employer Deduction Limit.** There is a 25% of compensation deductible limit for the plan in general, but this limit does not include salary deferrals. So, if all of the employer's participants made a total of \$500,000 for the year, the employer could deduct up to \$125,000 plus the amount of 401(k) deferrals made by participants (as indexed).
5. **Plan Imposed Limits.** To prevent problems with excess contributions, some plans impose limits on elective deferrals that are more restrictive than the law requires. Such limits are defined by the employer in the plan document.

In addition, an employee's annual compensation for plan purposes is limited to \$245,000 (as indexed; increased periodically by the IRS for inflation).

## 401(K) ADMINISTRATION

### WHAT ARE THE EMPLOYER'S ADMINISTRATIVE RESPONSIBILITIES?

The employer has responsibility for the overall plan operation, and usually hires a third-party administrator ("TPA") to handle administrative functions. Some of the major administrative requirements are:

- △ Plan design and documents, including IRS filings where required, and summary plan descriptions for employees
- △ Record keeping for individual participant accounts, tracked separately for different contribution types such as employee salary deferrals, employer match and profit sharing contributions
- △ Periodic participant account statements, and summary reports for the employer
- △ Participant loan processing (amortization schedules, security agreements, tracking of payments and outstanding balances, etc.)

- ⚠ Participant distribution processing (vesting calculations, IRS 1099-R tax reporting forms, government-required notices, etc.)
- ⚠ Discrimination testing (ADP, ACP, top heavy, coverage, etc.) and monitoring of contribution limits
- ⚠ Annual Form 5500 filings

Fees for plan administrative services are fully tax-deductible by the employer.

## WHAT DOES DAILY VALUATION MEAN?

Daily valuation refers to the frequency for updating participant accounts. With a daily-valued plan, the record keeper posts contributions, investment gains and losses, and transfers between investments on a daily basis. Thus, a participant can get up-to-date account values and make investment changes on any business day, often through the Internet or a toll-free line. With a non-daily valued plan, the record keeper updates participant accounts only periodically, such as quarterly, monthly, or at some other frequency chosen by the employer (called “plan valuation dates”). Investment transfers may occur only on plan valuation dates. The information delay associated with periodic valuations may be acceptable to an employer who wants lower administration fees and believes that retirement investing does not require daily access to accounts.

## WHAT DOES THE PLAN TRUSTEE DO?

The main functions of a plan trustee are to oversee plan assets by maintaining records of plan assets, receiving plan contributions, investing plan assets, or transferring money between plan investment options as directed by participants (if participants direct their own investments), making sure that expenses are paid and that participant loan and distribution checks are prepared, and remitting withholding taxes to the IRS. The employer in the plan document designates the plan trustee. Many employers will “self-trustee” their plan by designating one or more company officers to serve as trustee. Alternatively, an outside corporate trustee may be retained for a fee. When using a turnkey program, there is little need to pay for an outside trustee since the record keeper will handle most functions.

# 401(K) NONDISCRIMINATION TESTS

## WHAT NONDISCRIMINATION TESTS APPLY TO 401(K) PLANS?

The law requires several annual tests to ensure that a 401(k) plan does not disproportionately favor company owners and highly paid employees over other employees.

1. **Actual Deferral Percentage (ADP) Test.** The ADP test sets a limit on the amount of salary that may be deferred by highly compensated employees based on the amount deferred by non-highly compensated employees. For example, if elective deferrals for non-highly compensated employees average 4% of pay, deferrals for highly compensated employees may not exceed 6% of pay. The effect of this test is that greater participation among the lower paid group will permit larger contributions by the higher paid group. To encourage participation, many employers offer a matching contribution.

### Definition of Highly Compensated Employees:

- a) Employees who own more than 5% of the company. (Ownership is attributable from spouse, children, grandchildren, and parents.)
  - b) Employees who receive annual compensation over \$110,000 (indexed annually).
2. **Actual Contribution Percentage (ACP) Test.** The ACP test limits the amount of matching contributions an employer can make on behalf of highly compensated employees, using calculations similar to the ADP test.
  3. **Top-Heavy Test.** If more than 60% of a plan's total assets are in the accounts of "key" employees, the plan is deemed "top-heavy". In this case, the employer will have to make a minimum contribution equal to 3% of pay for all non-key employees. Generally, only small plans are top-heavy because they have a high concentration of company owners (and their family members) relative to total employees.

Note: The top-heavy test should not be confused with the ADP/ACP tests; these are separate tests with different rules. Also, key employees for top-heavy test purposes are not the same as highly compensated employees for ADP/ACP test purposes.

### Definition of Key Employees:

- a) Employees who own more than 5% of the company. (Ownership is attributable from spouse, children, grandchildren, and parents.)
- b) Employees who own more than 1% of the company and receive annual compensation over \$160,000.
- c) Company officers who receive annual compensation over \$160,000 (indexed annually).

## WHEN IS THE ADP TEST PERFORMED?

401(k) plans must pass the ADP test annually based on information from the entire plan year. Many plan administrators take a proactive approach, performing preliminary tests during the year. If it looks like the test will not be satisfied, the employer will require highly paid employees to cut back contributions in order to meet the ADP test by the end of the year.

## WHAT HAPPENS IF A PLAN FAILS THE ADP TEST?

Failure to satisfy the ADP test can result in tax penalties and plan disqualification (i.e., loss of all tax advantages) if the situation is not corrected within 12 months after the end of the plan year. The law allows several correction techniques, the most common of which is to refund excess contributions to HCEs for inclusion in their taxable income.

## HOW DOES THE ADP TEST WORK?

The test compares the average deferral percentage of all highly compensated employees ("HCEs") to the average deferral percentage of the non-highly compensated employees ("non-HCEs"). The average for HCEs cannot exceed the average for non-HCEs by more than a prescribed amount, as illustrated.

If the ADP for Non-HCEs is **less than 2% of pay**, then the ADP of HCEs cannot exceed **2 x non-HCE ADP**.

If the ADP for Non-HCEs is **2% to 8% of pay**, then the ADP of HCEs cannot exceed **2% + non-HCE ADP**.

If the ADP for Non-HCEs is **more than 8% of pay**, then the ADP of HCEs cannot exceed **1.25 x non-HCE ADP**.

For example, if on average the non-HCEs defer only 1% of pay, the average deferral for HCEs cannot exceed 2% of pay (2x1%). If non-HCEs defer an average of 5% of pay, the average for HCEs can be up to 7% of pay (2% + 5%). And if the non-HCE average is 12% of pay, the HCE average can be as high as 15% of pay (1.25 x 12%). Of course, the other limits on contributions will still apply and may separately limit contributions to the plan.

**Example: ADP Test**

A 401(k) plan has five eligible employees as shown below. The owner and officer are highly compensated employees (HCEs). Employees A, B and C are non-highly compensated employees (non-HCEs). Is the ADP test satisfied?

<b>Participant</b>	<b>Compensation</b>	<b>Elective Deferral</b>	<b>Calculation</b>	<b>ADP</b>
Owner	\$160,000	\$6,400 (4%)	(4 + 8) / 2	6%
Officer	110,000	8,800 (8%)		
Employee A	50,000	3,500 (7%)	(7 + 5 + 0) / 3	4%
Employee B	40,000	2,000 (5%)		
Employee C	20,000	0 (0%)		

The ADP of the non-HCE group is 4%. This means the ADP of the HCE group can be up to 2% more, or 6%. Thus, the ADP test is satisfied.

## 401(K) ELIGIBILITY AND VESTING

### WHAT ELIGIBILITY REQUIREMENTS MAY BE IMPOSED IN A 401(K)?

A plan may exclude employees who:

- △ are under age 21
- △ have not completed one year of service (up to 1,000 hours may be required)

More liberal eligibility requirements may be used if desired. The employer also may waive the age and service requirements for employees hired before the plan was established.

## MAY AN EMPLOYER EXCLUDE OTHER GROUPS OF EMPLOYEES?

It is possible to exclude other classifications of employees, such as employees of specific subsidiaries, divisions or holding certain job positions. In order to do so, the plan must satisfy the minimum coverage test on an annual basis.

## WHAT ARE PLAN ENTRY DATES?

A plan entry date is the point in time that an eligible employee may begin putting dollars into the plan. The first step is to determine whether an employee has met the plan's eligibility requirements. The next step is to determine when an eligible employee can actually start deferring dollars. Most 401(k) plans have quarterly entry dates on January 1, April 1, July 1 and October 1. However, an employer can elect monthly, semi-annual or any other entry date frequency (but no less than semi-annually). A common error to avoid is allowing an employee to start contributing prior to the appropriate plan entry date.

## WHAT VESTING SCHEDULES MAY BE USED IN A 401(K)?

Employee elective salary deferrals are always 100% immediately vested and cannot be forfeited for any reason. This is also true of any money an employee has rolled into the plan from a previous employer's plan.

Employer matching or profit sharing contributions may vest according to the number of years worked for the company, based on one of the following schedules or any more liberal schedule:

Years of Service	Mandatory Vesting for Employer Contributions	
	3- Year Cliff	6- Year Graded
1	0%	0%
2	0	20
3	100	40
4	100	60
5	100	80
6	100	100
7	100	100

If a plan is top-heavy, the employer must choose a vesting schedule at least as rapid as 3-year cliff or 6-year graded.

## WHAT HAPPENS IF AN EMPLOYEE LEAVES BEFORE FULLY VESTED?

Amounts forfeited by terminating employees may be reallocated among remaining participants or used to reduce future contributions, whichever is established in the plan document. The plan may permit forfeitures to be used to pay plan expenses with the remainder to be reallocated or used to offset future contributions as specified in the plan.

# TAKING MONEY OUT OF A 401(K)

## WHEN CAN AN EMPLOYEE TAKE MONEY OUT OF A 401(K) PLAN?

Because 401(k) plans are designed to help employees build retirement security, the IRS places strict limitations on withdrawals. Generally, money can be paid out only when an employee retires, terminates employment with the company, attains age 59 ½, becomes disabled or dies. A plan may also allow loans or hardship withdrawals if authorized by the employer in the plan document.

## HOW ARE PAYOUTS FROM A 401(K) PLAN TAXED?

Payouts are taxed as regular income and may be subject to a 10% additional income tax if received before age 59 ½. However, amounts rolled over to an IRA or another employer's plan are not subject to taxes or penalties and continue to grow tax-deferred until withdrawn. Unless an employee chooses to make a direct rollover of his or her payout to an IRA or other plan, the plan administrator must withhold 20% and remit it to the IRS to be applied against the employee's federal tax liability.

## ARE THERE EXCEPTIONS TO THE 10% ADDITIONAL INCOME TAX ON EARLY WITHDRAWALS?

Distributions received before age 59 ½ are generally subject to a 10% additional income tax, with the following exceptions:

- △ Distributions due to death or disability
- △ Distributions following termination of employment with the company after age 55

- △ Distributions that meet the substantially equal periodic payment rules of Section 72(t) of the Internal Revenue Code

## WHY MIGHT AN EMPLOYER ALLOW PARTICIPANT LOANS?

Loans create tax-free access to 401(k) accounts during employees' working years and may result in higher plan participation. Unlike hardship withdrawals, which require a demonstration of need, loans can be made available for any purpose.

## WHAT ARE THE RULES FOR PARTICIPANT LOANS?

A participant may borrow up to 50% of his or her vested account balance with a maximum loan of \$50,000. Most plans set a minimum loan of \$1,000 to avoid the paperwork and expense of small loans. The plan must charge the employee interest at a rate comparable to commercial lending rates at the time the loan is made. Plans often charge the prime lending rate plus 1 or 2 percent. All interest is credited back to the employee's own account. Loans must be repaid within 5 years (unless used to purchase a primary residence). Loans are usually repaid through automatic payroll deduction.

## WHAT HAPPENS TO A LOAN IF THE EMPLOYEE LEAVES THE COMPANY?

Some employers will allow employees to continue repaying a loan after termination of employment. However, most plan loans become immediately due and payable upon termination. If the employee is unable to repay, the balance is deducted from the employee's 401(k) account. This is considered a taxable withdrawal, subject to regular tax plus 10% additional income tax if the employee is under age 59 ½.

## WHAT ARE THE RULES FOR HARDSHIP WITHDRAWALS?

A plan may permit hardship withdrawals during active employment if authorized by the employer in the plan document. Hardship is defined by the IRS to include:

- △ Medical expenses of the employee, spouse or dependents.
- △ Purchase of the employee's principal residence.

- △ College tuition, room and board for the next 12 months for the employee, spouse, children or dependents.
- △ Rent or mortgage money needed to prevent eviction or foreclosure on the employee's principal residence.
- △ Funeral expenses of a parent, spouse, children, or dependents
- △ Expenses to repair casualty damage to the employee's principal residence

Only the employee's own contributions may be withdrawn, not including earnings. In addition, the employee must take any loans available from the plan before taking a hardship withdrawal, and the employee must stop making elective deferrals for the next 6 months. Hardship withdrawals are subject to regular income tax plus 10% additional income tax if the employee is under age 59 ½.

## 401(K) INVESTMENTS

### HOW MANY INVESTMENT CHOICES SHOULD A 401(K) PLAN OFFER?

The number of investment choices should be closely related to the degree of investment sophistication of company employees. As the number of available choices increase, the complexity of the plan increases. Complexity will make the plan less attractive to employees unless they fully understand their options. Statistics show that the typical plan today offers employees 11 to 15 investment choices.

### WHAT IS A PLAN FIDUCIARY?

A fiduciary is a person that exercises discretionary authority or control over the management of a plan, the administration of a plan, or the disposition of its assets. Anyone responsible for investing a plan's assets is a fiduciary. A fiduciary that makes imprudent investment decisions can be liable for resulting losses. However, there are provisions under ERISA Section 404(c) whereby plan fiduciaries are protected from liability for participants' decisions when participants are given investment control over their own accounts. Fiduciaries remain responsible, however, for selecting prudent options from which the participants may choose.

## WHAT ARE THE REQUIREMENTS OF 404(C)?

The law does not mandate that a plan comply with Section 404(c). However, if it does, the employer will not be held liable for any loss that results from an employee's investment decisions. The guidelines for meeting 404(c) include informing employees that they have control over their investments and providing them with:

1. **Diversified Investment Choices.** The plan must offer a broad range of investment choices including at least three with materially different risk/return characteristics.
2. **Transfer Flexibility.** The plan must allow employees to move all or part of their account balance from one investment option to another at least quarterly (or more often if the investment option is volatile).
3. **Investment Information.** Employees must receive sufficient information to make informed investment decisions.

CPI Qualified Plan Consultants, Inc. is a member of CUNA Mutual Group, a leading insurance and financial services organization based in Madison, WI.

Serving your retirement plan needs since 1972.

**CPI Qualified Plan Consultants, Inc.**  
1809 24th Street | P.O. Box 1167  
Great Bend, KS 67530-1167  
www.cpiqpc.com®  
800.279.9916 ext. 765  
620.793.7463 *fax*