Employee 401k Planning

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Employee 401 (k) Planning

The 401(k) type of retirement plan is perhaps the fastest growing plan in the country. This is true because employers find it a cost-efficient and attractive addition to their benefit package and because assets grow quicker when employers and employees are both contributing. The demand for administrative, communication, investment and insurance services have increased for these plans.

General Description

401(k) is the section of the Internal Revenue Code that allows pre-tax contributions to a qualified profit sharing or stock bonus plan. This type of plan is also known as a Cash or Deferred Arrangement (CODA). The most common CODA is a salary reduction arrangement where each plan participant agrees in writing with the employer to defer a percentage of his or her salary into the plan. Some plans also permit payment of bonuses to be treated as a CODA. Employees may play a very active role in a 401(k) plan and that may explain why they are so popular. Employees can choose:

- Whether or not to participate
- How much they will defer
- Where their contributions will be invested

Suitable Employers

Many companies and institutions have at least considered establishing a 401(k) plan, and are most likely to fit at least some of these descriptions:

- More than 30 employees
- Employing “white collar” or professional employees

- Where the general employee group expresses an interest
- With current profit sharing plans
- Those expressing dissatisfaction with current plans
- Those desiring greater investment control

Companies whose objectives are primarily tax advantages are not usually good prospects, and nonprofit or governmental organizations generally do not establish a 401(k) plan.

Key Benefits

A 401(k) plan is one of the least expensive benefits an employer can offer. Health and life insurance benefits are usually much more costly. Employers' costs are predictable – expenses are a known factor and employer contributions can be determined each year. In fact, an employer may decide not to contribute in any year.

A 401(k) plan can be a major factor in reducing turnover, motivating employees and recruiting new, qualified employees. Most companies either currently maintain or are considering a 401(k) plan. Employers and employees who can no longer make deductible IRA contributions find 401(k) an excellent alternative.

Eligibility Rules

The benefits of a 401(k) plan should be available to all levels of employees who meet specific eligibility requirements. The typical maximum eligibility requirements in a 401(k) plan are one year of service and age 21. However, these requirements can be lower. An employee completes one year of service when he or she works at least 1,000 hours in a twelve-month period. The service requirement eliminates most part-time employees. Employees covered under a collective bargaining agreement can also be excluded.

Eligibility Design Issues

Setting the eligibility requirements at age 21 and one year of service means that employees must be eligible to participate in the Plan on the next entry date after they meet the eligibility requirements – January 1 or July 1 for a calendar year plan. This is called a dual entry date. Eligibility of age 20 ½ and 6 months of service permits a single entry date, usually January 1 for a calendar year plan.

More frequent entry dates can be used, but will increase employer costs. The Plan can allow all current employees to be immediately eligible while imposing different age and service requirements on new employees. Eligibility requirements allow an employer to leave out younger, short-service employees, which in turn will help control costs. By not including short-service employees, who are least likely to participate, it is easier to meet special discrimination tests.

Contribution Rules

Four different types of contributions can be made to a 401(k) plan, and most plans permit several types:

Employee Elective Deferrals

Eligible employees sign an agreement with the employer to defer a percentage of their salary or forego a bonus into the plan. An employee is permitted to revise the election – generally at the end of a payroll period or quarter. These contributions are made to the plan on a pre-tax basis although Social Security tax (FICA) must still be paid. The maximum amount a participant may contribute on this basis in 2007 is $15,500, which will increase in increments of $500 based on inflation.

A plan participant who reached 50 years of age before the end of the taxable year is eligible for “catch up” contributions (deferrals) of $2,500 for Simple 401(k) plans and $5,000 for other 401(k) plans.

Employer Matching Contributions

The employer contributes a percentage of each employee’s elective deferrals. This is a great way to motivate employees to participate in the plan.

Employer Non-Matching Contributions

The employer contributes on behalf of all the eligible employees regardless of whether or not they made employee elective deferrals. This is identical to a profit-sharing contribution and can be made in combination with a Matching Contribution. The maximum the employer can contribute is the lesser of $45,000, or 100% of compensation (catch up contributions not included).

Rollover Accounts

A rollover is a transfer from another qualified plan. If an employee wishes to roll over funds from another plan, these are placed in the employee’s personal account on a non-forfeitable basis. There is little reason to exclude this feature.

Contributions Design Issues

The Employer Matching contributions may be made only on employee deferrals up to a specified percentage. To help control and limit the employer’s expense, a match on the first 6% of employee deferral is common.

These contributions may be left flexible and not specified at a particular percentage in the plan. They can also be tied to the prior year’s profits. It is felt this matching provision can help motivate employees to achieve higher profits in future years in order to receive a high match.

Declaring the match for the coming year, just prior to when the employees enroll is a good way to encourage participation. Even if it is not used initially, it may be desirable in the future.

Employer Non-Matching Contributions

Employers who want to maximize a deduction for the company frequently make these contributions at the end of the year. They can then contribute the difference remaining between the maximum allowable deduction of 15% of the total compensation for all of the eligible employees and what has already been contributed, in a year of significant profits.

This is another way to maximize the dollars that are being saved for the highly compensated employees whose employee deferrals may have been limited because of the special discrimination test or because they reached the maximum dollar limit. Even if it is not used initially, it may be desirable to do so in a big profit year.

Rollover Amounts

This provision is recommended when the 401(k) Plan is replacing a prior terminated plan. It may also be used by employees who wish to transfer their balances from a prior employer's plan. Including this provision is of value to new employees and will maximize the benefits of the Plan.

Contribution Considerations

Employer and employee contributions to a 401(k) plan can accumulate a comfortable retirement for employees. Pre-tax employee contributions, deductible employer contributions (deductible to the employer and not currently taxed to employees) and tax-deferred growth of the contributions through investment combine to offer one of the most logical ways to save for retirement. The total of all contributions can be projected for the plan year by reviewing the employee enrollment forms. This projection may allow a company to take advantage of reduced expense charges.

Vesting Considerations

A vesting schedule is frequently applied to Employer Non-Matching contributions because employers use this feature to both attract and retain employees.

Many employers find a vesting schedule appealing because it represents a "hook" to retain employees. The non-vested amount the employee leaves behind when he or she terminates employment is forfeiture. Using forfeitures to reduce the employer's future contributions may help to make the plan as cost-efficient as possible.

Roth Options

Roth plans, while not deductible from current income, afford the advantages of tax free growth and no required distribution. A Roth 401(k) feature combines certain advantages of the Roth IRA with the convenience of 401(k) plan elective deferral-style contributions. The Roth 401(k) provisions were implemented by EGTRRA 2001 for plan years beginning on or after January 1, 2006, and were made permanent by the Pension Protection Act of 2006.

The IRS has issued a sample Roth amendment that may be adopted or tailored to the needs of 401(k) plan sponsors offering a Roth 401(k) feature. The amendment provides pre-approved plan language and an adoption agreement for adding the Roth feature to existing 401(k) plans.

The Feliciano Financial Group has been in business since 1983 serving individuals, families, businesses and professionals throughout Texas. Our open and process-driven, client-centered approach, has helped make us one of the fastest growing and established financial services firms in Texas.

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- To provide competent, prompt, client focused service which, in the same circumstances, we would expect for ourselves.
- To treat all clients with fairness and equity, to assure the best value possible.
- To remain your life-long financial partner to take care of your ever-changing needs.
- To help you reach your life's financial goals by understanding what is important to you.

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