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# 401(k) Plan

## What is it?

The "401(k) plan," the popular name for a qualified cash or deferred arrangement (CODA) permitted under Section 401(k) of the Internal Revenue Code (IRC), has become one of the most popular types of employer-sponsored retirement plans.

**Tip:** A qualified cash or deferred arrangement can be included as part of a profit-sharing plan, stock bonus plan, pre-ERISA money purchase pension plan, or rural cooperative plan.

With a 401(k) plan, an employee can elect either to receive cash payments (wages) from his or her employer immediately, or to defer receipt of a portion of that income to the plan. The amount deferred (called an "elective deferral" or "elective contribution" or "pretax contribution") isn't currently includable in the employee's income; it's made with pretax dollars. Consequently, the employee's federal taxable income (and federal income tax) that year is reduced. The deferred portion is taxed to the employee when it's withdrawn or distributed.

**Example(s):** Assume Melissa is employed by a department store. She earns \$30,000 annually. Melissa defers \$5,000 of her earnings to the store's 401(k) plan. As a result, Melissa's taxable income is now \$25,000. She isn't taxed on the deferred money (\$5,000) until she receives a distribution or makes a withdrawal.

**Caution:** State tax laws may differ from federal law. Consult your pension advisor for the tax impact in your particular state.

**Caution:** Special rules apply to qualified individuals impacted by certain presidentially-declared natural disasters.

**Caution:** Special rules apply to SIMPLE 401(k) plans and safe harbor 401(k) plans.

## Roth 401(k)s

A 401(k) plan can allow employees to designate all or part of their elective deferrals as qualified Roth 401(k) contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. Unlike pretax contributions to a 401(k) plan, there's no up-front tax benefit, but if certain conditions are met, employees' Roth contributions and earnings are entirely free from federal income tax when distributed from the plan.

Separate accounts must be established within a 401(k) plan (the "Roth accounts") to track each employee's Roth contributions. Under IRS proposed regulations, the Roth 401(k) account is treated as a "separate contract" under the 401(k) plan, requiring separate accounting for the Roth contributions and any gains or losses on those contributions. The taxation of distributions from the Roth account is also determined separately from any other 401(k) plan dollars. (Note: Employers don't have to allow Roth contributions to their 401(k) plans.) See Roth 401(k) for a detailed discussion of Roth 401(k) contributions.

## Contributions in general

### *Employee contributions*

Whether an employee elects to make pretax contributions or Roth after-tax contributions to the 401(k) plan, careful attention must be paid to the elective deferral limits. In 2010 and 2011, an employee can't contribute more than \$16,500 of his or her salary to a 401(k) plan. Participants who are age 50 or older may also make additional "catch-up" contributions of up to \$5,500 in 2010 and 2011. Other limits also apply (discussed later).

## ***Employer contributions***

To encourage employee participation, some employers offer to "match" employee contributions under a specific formula. For example, you might decide to match 50 cents on every dollar contributed by employees up to a maximum of 10 percent of each employee's salary. As an employer, you also have the option of making discretionary contributions ("nonelective contributions") to the employees' accounts. These contributions are subject to specific tests to ensure that they don't discriminate in favor of highly compensated employees (see Questions & Answers for the definition of "highly compensated employee").

**Caution:** Your employer contributions to the plan are always made on a pretax basis. That is, your employees aren't taxed on these contributions until they're distributed from the plan. This is true even if you choose to match employees' Roth contributions.

**Tip:** In 2011 (and 2010) annual additions to an employee's plan account (or accounts, if the employer offers more than one defined contribution plan) can't be more than the lesser of 100 percent of that employee's compensation or \$49,000. Employees age 50 or older can make catch-up contributions of up to \$5,500 in 2010 and 2011) over and above the annual addition dollar limit. Annual additions include employer contributions, forfeitures, and employee contributions (pretax, after-tax, and Roth). Further, the maximum tax-deductible employer contribution is limited to 25 percent of total compensation of all employees covered under the plan. (Employee pretax deferrals are deductible separately.) Compensation for this purpose can't exceed \$245,000 for any one employee in 2010 and 2011.

## **Generally, any employer is eligible to set up a 401(k) plan**

All organizations except governmental entities are eligible to set up 401(k) plans. However, these plans may be particularly attractive to those employers who:

- Employ over 25 employees
- Have a sufficient number of non-highly compensated employees who will defer a portion of their salaries
- Are willing to make employer matching and discretionary contributions to encourage deferrals, and
- Are willing to spend the time and money that a 401(k) plan requires for plan design, administration, and communication

## **What are some advantages offered by 401(k) plans?**

### ***Your employer contributions are income tax deductible***

Your business may currently deduct (from business income) employer contributions it makes to the 401(k) plan.

### ***Employer contributions are discretionary***

A 401(k) plan offers a certain amount of flexibility. When you establish a 401(k) plan, you choose whether or not you want to contribute to your employees' 401(k) accounts. If you decide to contribute, you can match all or a portion of your employees' contributions. You also have the flexibility to decide whether to make discretionary profit-sharing contributions each year.

### ***Employees can contribute with pretax dollars***

Your employees can elect to receive a portion of their compensation in cash, or instead defer those dollars into your 401(k) plan. The amount deferred by an employee (the "elective deferral") isn't currently includable in the employee's income; it's made with pretax dollars. This lowers your employee's federal taxable income in the year of the deferral. Employee pretax contributions are taxable when distributed from the plan.

### ***Employees can make after-tax Roth contributions***

If your plan permits, your employees can elect to designate all or part of their elective deferrals as Roth 401(k) contributions. Your employees' Roth contributions are made on an after-tax basis. Roth 401(k) contributions don't provide any up-front tax benefit, but they're always tax free when distributed from the plan.

### ***Earnings accrue tax deferred***

Investment earnings on your contributions and your employees' contributions accumulate tax deferred while inside your 401(k) plan. Earnings aren't taxed to your employee until he or she takes a distribution from the plan, and earnings on Roth contributions are tax free if paid to the employee in a qualified distribution.

### ***Employees have the option of receiving the cash immediately from you rather than deferring it to the plan***

A 401(k) plan provides flexibility to your employees. Employees aren't required to make contributions to the plan. If they do contribute, however, they can change the amount of their contribution, or even cease contributing altogether.

### ***Employees may find it easier to save for retirement***

Because employees make 401(k) contributions through payroll deductions, they may find it easier to save. The money is "out of sight, out of mind."

### ***Plan loans can be made available to plan participants***

You may structure your 401(k) to allow employees to borrow as much as one-half of the vested benefits in their 401(k) plan account, to a maximum of \$50,000.

**Caution:** All loans are required to bear a reasonable rate of interest, and must not be offered in a discriminatory fashion.

### ***In-service withdrawals can be made available to plan participants***

An employee's ability to access his or her own elective deferrals to a 401(k) plan is limited by federal law. You can, however, structure the plan to allow certain in-service withdrawals. For example, you can let your employees withdraw their pre-tax contributions, and any investment earnings on those contributions, after they turn age 59½.

You can also let your employees withdraw their elective deferrals prior to age 59½ if the employee, or the employee's spouse, dependent, or plan beneficiary incurs a financial hardship. Hardship withdrawals are permitted only for immediate and heavy financial need and only in an amount necessary to meet that financial need. Examples of immediate and heavy financial need include the need to:

- Pay medical bills for your employee, and his or her spouse, children, other dependents, or plan beneficiary
- Pay costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments)
- Pay post-secondary tuition for your employee and his or her spouse, children, other dependents, or plan beneficiary
- Prevent an eviction from or foreclosure of the employee's principal residence
- Pay funeral expenses for an employee's parent, spouse, children, other dependents, or plan beneficiary
- Repair damage to the employee's principal residence after certain casualty losses
- Pay income tax and/or penalties due on the hardship withdrawal itself

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In general, an employee can't take a hardship withdrawal to the extent the employee is eligible for a non-hardship withdrawal or a loan from your 401(k) plan or from any other retirement plan you sponsor.

**Caution:** IRS regulations contain complex rules that apply to hardship withdrawals from 401(k) plans. A pension professional can help guide you through the various options available to you.

**Caution:** Keep in mind that hardship distributions of pretax contributions are subject to ordinary income tax. They're also generally subject to the federal 10-percent additional penalty on distributions prior to age 59½ (unless an exception applies), and possibly a state penalty tax. Also, in most cases, an employee's participation in your 401(k) plan must be suspended for at least six months following a hardship withdrawal. The taxation of hardship withdrawals from an employee's Roth 401(k) account depends on whether the distribution is a qualified or nonqualified withdrawal (discussed in more detail below).

**Caution:** The amount of a hardship withdrawal is limited to the total amount of your employee's contributions (pre-tax or Roth) to the plan, reduced by the amount of any previous hardship withdrawals. Investment earnings aren't available for hardship withdrawal, except for certain pre-1989 grandfathered amounts.

If your plan permits after-tax (non-Roth) contributions you can generally let employees withdraw those dollars at any time. And if you make matching or discretionary employer contributions to the plan you can generally let employees withdraw those contributions after an employee reaches a specified age, after the employee has been a plan participant for at least five years, after the contribution has been in the trust for a specified period of time (at least two years), after the employee becomes disabled, or after the employee incurs a hardship. Special rules apply to so called "qualified matching contributions" (QMACs) and "qualified nonelective contributions" (QNECs) which are special employer contributions that are generally made to help employers meet nondiscrimination requirements.

**Tip:** The Pension Protection Act of 2006 lets you structure your 401(k) plan to allow "qualified reservist distributions." A qualified reservist distribution is a distribution (1) to a reservist or national guardsman ordered or called to active duty after September 11, 2001 for a period in excess of 179 days or for an indefinite period, and (2) That's made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after active duty ends (or, if later, the two year period beginning August 17, 2006) make one or more contributions to an IRA in an aggregate amount not to exceed the amount of the qualified reservist distribution. The dollar limitations otherwise applicable to contributions to IRAs don't apply to, and no deduction is allowed for, these contributions. Qualified reservist distributions are exempt from the 10 percent early distribution penalty tax.

**Tip:** Keep in mind that you are not required to allow in-service withdrawals from your plan. The terms of your plan document control.

***If your plan has discretionary (nonelective) profit-sharing contributions, it may be "integrated" with Social Security***

Basically, this means that you can, within specific limits, allow your plan to pay more to higher-paid employees. This is because benefits provided by a qualified retirement plan and those provided by Social Security are viewed by the IRS as one retirement program. Because Social Security provides a higher percentage of salary benefit to lower-paid employees, the IRS may allow a 401(k) plan that has discretionary profit-sharing contributions to favor higher-paid employees within specific limits (this is known as permitted disparity).

***Participants who are age 50 or older can contribute more than the limit***

Individuals age 50 and older may make an additional yearly "catch-up" contribution to their 401(k) plans (over and above the regular employee elective deferral limit, and over and above the annual addition dollar limit). The catch-up contribution amount is \$5,500 in 2010 and 2011, and is indexed for inflation. The purpose of this provision is to help older individuals increase their savings as they approach retirement. Catch-up contributions can be either pretax elective deferrals or, if your plan permits, after-tax Roth contributions

### ***Distributions from 401(k) plans may qualify for special tax treatment***

If your employee elects to take his or her 401(k) balance in the form of a lump-sum distribution, and meets all necessary requirements, he or she may qualify for special income tax treatment. However, certain rollovers from or to the 401(k) plan may jeopardize your employee's ability to take advantage of this special tax treatment.

### ***Employees may qualify for the tax saver's credit***

Certain low- and middle-income taxpayers may claim a partial, nonrefundable income tax credit (" Saver's Credit ") for amounts contributed to 401(k)s and certain other retirement savings vehicles. The maximum annual contribution eligible for the credit is \$2,000. In addition, the amount of the credit (if any) depends on your employee's adjusted gross income (AGI). Only joint returns with AGI of \$56,500 or less, head of household returns of \$42,375 or less, and single returns of \$28,250 or less are eligible for the credit. Here are the credit rates based on 2011 AGI limits:

Joint Filers	Heads of Household	Single Filers	Credit Rate
\$0 - \$34,000	\$0 - \$25,500	\$0 - \$17,000	50% of contribution (up to \$2,000)
\$34,000 - \$36,500	\$25,500 - \$27,375	\$17,000 - \$18,250	20%
\$36,500 - \$56,500	\$27,375 - \$42,375	\$18,250 - \$28,250	10%
Over \$56,500	Over \$42,375	Over \$28,250	0%

To claim the credit, your employee must be at least 18 years old and not a full-time student or a dependent on another taxpayer's return.

### ***Your business may qualify for the small employer pension plan start-up tax credit***

If you establish a new 401(k) plan, your business may be eligible to receive an income tax credit of up to \$500 (50 percent of the first \$1,000 of qualified start-up costs to create or maintain the plan) in three tax years. The credit may be claimed for qualified costs incurred in each of the three years starting with the tax year when the plan became effective.

### ***Rollovers are allowed***

You can, but you aren't required to, let employees roll over assets from other retirement plans to your 401(k) plan. For example, you can allow participants to roll over pretax (but not after-tax) IRA funds to your plan. Pretax IRA funds generally include deductible contributions to the IRA, tax-deferred earnings, and rollovers of taxable dollars from an employer-sponsored plan. You can also let your participants roll over eligible taxable and nontaxable (after-tax) funds from another employer's qualified, 403(b), governmental 457(b), or SIMPLE IRA plan to your 401(k) plan. The plan must receive after-tax contributions in a direct rollover and must account for those contributions (and any earnings) separately.

While you're not required to accept rollover contributions to your plan, you must let employees roll over eligible distributions from your plan to an IRA or another employer's retirement plan, if the other plan agrees to accept the contributions. Surviving spouses must also be given the option to roll over inherited 401(k) funds to the spouse's own IRA or another employer's plan. Beneficiaries other than surviving spouses may be given the opportunity to directly roll over inherited 401(k) funds to an inherited IRA.

Special rules apply to Roth 401(k) contributions and earnings. Distributions from an employee's Roth account can only be rolled over to a Roth IRA or to a Roth account maintained in another employer's 401(k) or 403(b) plan. And a Roth 401(k) account can only receive a rollover contribution from another 401(k) or 403(b) Roth account (not from a Roth IRA).

**Tip:** Beginning in 2008, the Pension Protection Act of 2006 lets employees roll over eligible distributions from 401(k) plans directly to a Roth IRA, subject to the present law rules that generally apply to rollovers from traditional IRAs to Roth IRAs. For example, a rollover from a 401(k) plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax doesn't apply.

## What are some disadvantages associated with 401(k) plans?

### *You will need professional assistance to establish and administer your 401(k) plan*

Like other qualified plans, a 401(k) plan is subject to reporting and disclosure requirements under the Employee Retirement Income Security Act (ERISA). Therefore, you'll require professional assistance to establish and administer your plan.

### *Like all defined contribution plans, a specific benefit level isn't guaranteed*

Unlike a defined benefit plan, a 401(k) plan doesn't guarantee a specific benefit at retirement. Participants' accounts are subject to market forces, so if plan investments perform badly, participants could suffer a financial loss.

### *Access to elective deferrals limited before termination of employment*

In general, a 401(k) plan can distribute elective contributions and earnings to an employee only upon the employee's death, disability, severance from employment, attainment of age 59½, hardship, or termination of the plan. Only pre-1989 earnings are eligible for distribution on account of hardship. The Pension Protection Act of 2006 also allows the payment of "qualified reservist distributions" (see "In-service withdrawals can be made available to plan participants," above).

### *Various contribution limits apply to 401(k) plans*

Several rules and limitations involving contributions to 401(k) plans exist, including:

- In 2010 and 2011, employee contributions (combined pretax and Roth) are limited to \$16,500. Employees age 50 or older can make catch-up contributions of up to \$5,500 in 2010 and 2011 over and above the \$16,500 annual dollar limit.

**Tip:** This dollar limit applies per person across all employer boundaries. Consequently, an employee who has several jobs with different employers and participates in several plans can't contribute more than a total of \$16,500 in 2011 (plus any applicable catch-up contribution for those age 50 or older) to all plans. Deferrals to 401(k) plans, 403(b) plans, SIMPLEs, and SAR-SEPs are included in this limit, but deferrals to Section 457(b) plans are not. In addition, only employee pretax salary deferrals and after-tax Roth contributions amounts count. Employer contributions and employee traditional (non-Roth) after-tax contributions, if allowed, aren't subject to this dollar limit.

**Tip:** Your employee is responsible for making sure the overall limit isn't exceeded if he or she participates in plans of more than one employer during a calendar year.

**Caution:** If your employee contributes too much in any particular year, the employee must withdraw the excess by April 15 of the following year to avoid adverse tax consequences. If your employee fails to do so, the excess will be treated as taxable income both in the year contributed to the plan and again in the year the excess contributions (and earnings) are distributed from the plan. This applies to both pretax and Roth excess contributions.

- Annual additions (the aggregate of employee contributions plus any employer contributions you make on behalf of the employee plus any reallocated forfeitures (see Questions & Answers for the definition of reallocated forfeitures) may not exceed the lesser of \$49,000 or 100 percent of the participant's compensation in 2011. Participants age 50 or older can make catch-up contributions of up to \$5,500 in 2011 over and above the \$49,000 annual addition dollar limit. You must treat all qualified defined contribution plans you maintain as a single plan for purposes of calculating the annual additions limit.
- The maximum annual deductible employer contribution that you can make on behalf of all plan participants (in addition to employee pretax salary deferrals) is 25 percent of the compensation paid to all participants.

**Tip:** This 25 percent deduction limit isn't per participant, but is a single overall limit based on total employer contributions and total participant compensation (up to \$245,000 per participant in 2011).

## ***Your 401(k) plan may not discriminate in favor of highly compensated employees***

Basically, this means that your highly compensated employees (see Questions & Answers for the definition of "highly compensated employee") may not defer a substantially higher percentage of their compensation than non-highly compensated employees. In order to ensure that this is the case, your 401(k) plan is generally required to undergo annual nondiscrimination testing.

These tests compare the average contribution rates of your highly compensated employees and your non-highly compensated employees.

**Technical Note:** The "ADP test" compares the average rate (stated as a percentage of each employee's compensation) of employee pretax and Roth elective deferrals. The "ACP test" compares the average rate of employer matching contributions and employee traditional (non-Roth) after-tax contributions.

**Tip:** You don't have to perform annual nondiscrimination testing if you create a "safe harbor" plan. As part of such a plan, you must make a 100 percent vested contribution of either:

- A dollar-for-dollar match of all non-highly compensated employee deferrals up to three percent of compensation and 50-cents-on-the-dollar match of deferrals between three and five percent of compensation, or
- Three percent of compensation for all non-highly compensated employees, regardless of whether these employees contribute to the plan

## ***Your 401(k) plan is subject to "top-heavy" requirements***

Unless it meets the safe harbor nondiscrimination requirements above, a 401(k) plan is subject to the "top-heavy" requirements of the Internal Revenue Code. A plan is considered to be top-heavy if (as of the determination date) the total of the accounts of all key employees (generally the owners and officers of the business) exceeds 60 percent of the total of the accounts of all employees. If the plan is top-heavy, you must make a minimum contribution of three percent of pay to the accounts of all non-key employees.

## **Qualified auto-enrollment arrangements**

401(k) plans often automatically enroll employees in the plan as they become eligible, and require them to affirmatively elect out of participation. These provisions are designed both to encourage employee retirement savings, and help 401(k) plans satisfy the nondiscrimination tests described earlier. Effective for years beginning after December 31, 2007, the Pension Protection Act of 2006 provides that a 401(k) plan that contains an automatic enrollment feature that satisfies certain deferral, contribution, and notice requirements (a "qualified automatic enrollment feature") is treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions. In addition, a plan consisting solely of contributions made pursuant to a qualified automatic enrollment feature isn't subject to the top-heavy rules. The Act also clarifies that state law can't directly or indirectly prohibit or restrict the inclusion of an automatic contribution arrangement in a 401(k) plan.

A qualified automatic enrollment feature must provide that, unless an employee elects otherwise, the employee is treated as making an election to defer a stated percentage of compensation not in excess of 10 percent and at least equal to: three percent of compensation for the first year the deemed election applies to the participant; four percent during the second year; five percent during the third year; and six percent during the fourth year and thereafter. The stated percentage must be applied uniformly to all eligible employees who haven't made an affirmative election to participate, or not participate, in the plan.

An automatic enrollment feature satisfies the contribution requirement if the employer either:

- Satisfies a matching contribution requirement or
- Makes a nonelective contribution to a defined contribution plan of at least three percent of compensation for each nonhighly compensated employee who is eligible to participate in the automatic enrollment feature

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A plan generally satisfies the matching contribution requirement if, under the arrangement:

- The employer matches 100 percent of the first one percent of each nonhighly compensated employee's elective deferrals, and 50 percent of the employee's elective deferrals between one and six percent, and
- The rate of matching contributions applicable to deferrals by highly compensated employees is not greater than the rate of matching contributions applicable to deferrals by nonhighly compensated employees

A plan including an automatic enrollment feature that provides for matching contributions is also deemed to satisfy the ACP test if the following additional requirements are met:

- Matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation,
- The rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and
- The rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee

Any matching or other employer contributions taken into account in determining whether the requirements for a qualified automatic enrollment feature are satisfied are subject to the withdrawal rules applicable to elective contributions, and must vest at least as rapidly as under two-year cliff vesting. That is, employees with at least two years of service must be 100 percent vested with respect to such contributions.

Each employee eligible to participate in the arrangement must receive notice of the arrangement which is sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and is written in a manner calculated to be understood by the average employee to whom the arrangement applies. The notice must explain:

- The employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to elect to have contributions made in a different amount; and
- How contributions made under the automatic enrollment arrangement will be invested in the absence of any investment election by the employee. The employee must be given a reasonable period of time after receipt of the notice and before the first election contribution is to be made to make an election with respect to contributions and investments.

## How do you establish a 401(k) plan?

### *Have a plan developed for your business*

You'll want a retirement plan specialist to develop a plan that meets all the necessary legal requirements. In addition, you'll want the plan to serve the needs of your business. Here's how to proceed:

- Determine the plan features most appropriate for your business: Carefully review your business, looking at factors such as your cash flow and profits, how much you and your employees will benefit from the plan, the tax deduction needed by your business, and employee population (tenure, age, salary, turnover), to determine plan features such as investment vehicles, employer match (if any), employee eligibility requirements, auto-enrollment, and safe-harbor provisions.
- Decide if you will allow only pretax employee contributions, or if you will also allow employees to make Roth after-tax contributions: Roth contributions may make administration of the 401(k) plan a bit more complex.
- Choose the plan trustee (this may or may not be you): The assets of the plan must be held in a trust by a trustee. The trustee has overall responsibility for managing and controlling the plan assets, preparing the trust account statements, maintaining a checking account, retaining records of contributions and distributions, filing tax reports with the IRS, and withholding appropriate taxes.

- Choose the plan administrator: Administering the plan involves many duties, including managing the plan (determining who is eligible to participate in the plan, the amount of benefits, and when they must be paid) and complying with reporting and disclosure requirements. The plan administrator may also be responsible for investing plan assets and/or providing investment educational services to plan participants. The employer is legally permitted to handle these responsibilities in-house, but plan sponsors will frequently hire a third-party firm or financial services company to assist in performing recordkeeping and other functions of plan administration. Be sure to comply with ERISA's bonding requirements, if applicable.

### ***Submit the plan to the IRS for approval***

Once a plan is developed, the written document should be submitted to the IRS, unless it is a previously approved prototype plan. Since there are a number of formal requirements (for example, you must provide a formal notice to employees), a retirement plan specialist should assist you in this task. Submission of the plan to the IRS isn't a legal requirement, but it is highly recommended (for more information, see Questions & Answers). The IRS will carefully review the plan and make sure that it meets all of the legal requirements. If the plan meets all the requirements, the IRS will issue a favorable "determination letter." If the plan doesn't meet all the requirements, the IRS will issue an adverse determination letter indicating the deficiencies in the plan.

### ***Adopt the plan during the year in which it is to be effective***

You must officially adopt your plan during the year in which it is to become effective, so plan ahead and allow enough time to set up your plan before your company's year-end. A corporation "adopts" a plan by a formal action of the corporation's board of directors. An unincorporated business should adopt a written resolution in a form similar to a corporate resolution.

### ***Provide a copy of the summary plan description to all eligible employees***

ERISA requires you to provide a copy of the summary plan description (SPD) to all eligible employees within 120 days after your 401(k) plan is adopted. A SPD is a booklet that describes the plan's provisions and the participants' benefits, rights, and obligations in simple language. On an ongoing basis you must provide new participants with a copy of the SPD within 90 days after they become participants. You must also provide employees (and in some cases former employees and beneficiaries) with summaries of material modifications to the plan. In most cases you can provide these documents electronically (for example, through email or via your company's intranet site).

### ***File the appropriate annual report with the IRS***

Most qualified plans must file an annual report (Form 5500 series) with the IRS. Simplified reporting rules apply to certain single participant plans. A single participant plan is generally one that covers only an owner (and his or her spouse) or only partners (and their spouses). In general, single-participant plans aren't required to file a return for a plan year (other than the final plan year) if the total value of the plan's assets at the end of the plan year is \$250,000 or less.

## **What are the tax considerations?**

### ***Income Tax--Employer***

#### **Your employer contributions to a 401(k) can be deducted from income**

If your business contributes to the 401(k) plan, it can currently deduct such contributions up to 25 percent of the total compensation of all participants. For purposes of calculating your maximum tax-deductible contribution, the maximum compensation base that can be used for any one plan participant is \$245,000 in 2010 and 2011. Employee pretax salary deferrals are deductible in full separately from this 25 percent limit on other employer contributions.

#### **Elective deferrals are subject to Social Security and federal unemployment payroll taxes**

Employee elective deferrals (including pretax and Roth contributions), but not employer contributions, are subject to payroll taxes under the Federal Insurance Contribution Act (FICA), Federal Unemployment Tax Act (FUTA), and Railroad Retirement Act.

## Your business may qualify for the small employer pension plan start-up tax credit

If you establish a new 401(k) plan, your business may be eligible to receive an income tax credit of up to \$500 (50 percent of the first \$1,000 of qualified start-up costs to create or maintain the plan) in three tax years. The credit may be claimed for qualified costs incurred in each of the three years starting with the tax year when the plan became effective.

## *Income Tax--Employee Pretax and Employer Contributions*

### Plan contributions and earnings are income tax deferred

Your employee's pretax deferrals aren't currently includable in the employee's income--they're tax deferred, and included in income only when distributed from the plan. Likewise, your employee isn't taxed on any employer contributions you make to his or her 401(k) account until a distribution is taken from the plan. Similarly, investment earnings on employee pretax contributions and employer contributions grow tax deferred, and aren't subject to income tax until withdrawn.

**Caution:** Taxable income from a 401(k) plan is taxed at ordinary income tax rates even if the funds represent long-term capital gains or qualifying dividends from stock held within the plan.

**Caution:** A federal 10 percent premature distribution tax may be assessed on distributions made prior to age 59½ (unless an exception applies), and possibly a state penalty tax, too.

## *Income Tax--Employee Roth Contributions*

### After-tax Roth contributions

You can (but you aren't required to) let your employees designate all or part of their elective deferrals as Roth 401(k) contributions. Because your employees' Roth contributions are made on an after-tax basis, there is no up-front tax benefit. They're included in your employee's gross income at the time the employee contributes to the 401(k) plan. And because they're made on an after-tax basis, an employee's Roth contributions are tax-free when distributed from the plan. Investment earnings on an employee's Roth contributions grow tax-deferred while they remain in the 401(k) plan. Whether they're subject to tax when distributed depends on whether the distribution is qualified or nonqualified.

### Qualified distributions

If an employee receives a qualified distribution from his or her Roth account, the entire amount distributed, both the Roth contributions and investment earnings, is totally free from federal income tax. A qualified distribution is a payment from an employee's Roth account that meets both of the following requirements:

- The payment is made after your employee turns age 59½, becomes disabled, or dies, and
- The payment is made after the end of the five-year period that starts with the year the employee makes his or her first Roth contribution to your 401(k) plan

**Example(s):** Example: Nicole makes her first Roth 401(k) contribution to your 401(k) plan in December, 2008. 2008 is the first year of Nicole's five-year waiting period. The five-year waiting period ends on December 31, 2012.

**Tip:** You can let your employees roll over Roth contributions from another employer's 401(k) or 403(b) plan to your Roth 401(k) plan. If your plan accepts these rollovers, then the five-year period starts with the year your employee made his or her first contribution to the prior employer's plan (if that's earlier than the year the employee first contributed to your plan).

### Nonqualified distributions

If a payment doesn't satisfy the conditions for a qualified distribution, the portion of the payment that represents the return of your employee's Roth contributions will still be tax-free, but the portion of the payment that represents earnings on those contributions will be subject to income tax and a potential 10 percent premature distribution tax

(unless an exception applies).

A distribution that's made before the five-year waiting period has elapsed will always be a nonqualified distribution. A distribution that's made prior to age 59½, disability, or death (for example, a distribution to your employee upon termination of employment before attaining age 59½ will also always be a nonqualified distribution.

**Tip:** IRS proposed regulations provide that each distribution from a Roth 401(k) account is deemed to consist of a pro-rata share of an employee's Roth contributions and investment earnings on those contributions.

### ***Gift and Estate Tax--Employee***

#### **The value of the 401(k) account is included in the decedent's gross estate**

The entire vested value of a 401(k) plan death benefit is included in a deceased participant's gross estate for federal estate tax purposes.

### ***Saver's Credit***

#### **Your employees may qualify for the tax credit for IRAs and retirement plans**

Some low- and middle-income taxpayers may claim a federal income tax credit for contributing to a 401(k) plan (or to certain other employer-sponsored retirement plans).

## **Questions & Answers**

### ***Which employees must you include in your 401(k) plan?***

Generally, plan participation must be offered to all employees who are at least 21 years of age and who worked at least 1,000 hours for the employer in a previous year. For eligibility purposes, one year of service generally means a 12-month period during which the employee has at least 1,000 hours of service. Two years of service may be required for participation in a discretionary employer contribution (if your plan has one) as long as the employee will be 100 percent vested immediately. The two-year service requirement can't be required for employee pretax or Roth contributions. Consequently, if your plan includes both employee contributions and discretionary employer contributions, you could have two eligibility requirements. If you want, you can impose less (but not more) restrictive requirements. Many 401(k) plans don't impose any age or service restrictions at all.

### ***When does plan participation begin?***

An employee who meets the minimum age and service requirements of the plan must be allowed to participate no later than the earlier of:

- The first day of the plan year beginning after the date the employee met the age and service requirements, or
- The date six months after these conditions are met

**Example(s):** Lou, age 48, was hired by Channel 2 on December 1, 2010. Channel 2 has a 401(k) plan, and the plan year begins on January 1 of each year. Lou will have one year of service as of December 1, 2011. He must therefore be allowed to participate in the plan by January 1, 2012.

If you want, you can impose less (but not more) restrictive requirements.

**Tip:** Your plan can also provide for automatic enrollment once your employee is eligible to participate in your plan. For example, you could provide that an employee will be automatically enrolled in the plan at a 3 percent pretax contribution rate (or any other percentage) unless the employee elects a different deferral percentage, or chooses not to participate in the plan. This is sometimes called a "negative enrollment" because the employee must affirmatively act to change or stop contributions. You must notify the employee of the automatic enrollment procedures and allow the employee a reasonable amount of time to make a different deferral election. Automatic enrollment can help your

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plan satisfy nondiscrimination requirements, while also encouraging your employees to save for retirement. Note that if your employee has not made an affirmative investment election you have a fiduciary duty under ERISA to invest automatic enrollment contributions in a prudent manner- typically this means investment in lifestyle or balanced funds.

### ***What is a highly compensated employee?***

For 2011, a highly compensated employee is an individual who:

- Was a 5 percent owner (i.e., an employee who owns more than a 5 percent interest) of the employer during 2010 or 2011, or
- Had compensation in 2010 in excess of \$110,000 and, at the election of the employer, was in the top 20 percent of employees in terms of compensation for that year. (This \$110,000 limit is subject to cost of living adjustments each year.)

In general, to be qualified (i.e., tax exempt), a plan must meet employee coverage tests that demonstrate that the plan doesn't discriminate in favor of highly compensated employees. These tests are met by having a plan that covers any or all highly compensated employees also cover a certain minimum number or percentage of the non-highly compensated employees. Under the most basic minimum coverage test, a plan may cover any or all of the highly compensated employees if it also covers a number of non-highly compensated employees that is at least equal to 70 percent of the percentage of highly compensated employees covered. For example, if the plan covers 100 percent of the highly compensated employees, then the plan must also cover at least 70 percent of the non-highly compensated employees of the employer; or if the plan covers only 50 percent of the highly compensated employees, then the plan must also cover at least 35 percent of the non-highly compensated employees of the employer (70 percent of 50 percent equals 35 percent).

### ***When do employees have part or full ownership of their 401(k) accounts?***

Employee contributions must vest immediately. In general, employer contributions either must vest 100 percent after three years of service ("cliff" vesting), or must gradually vest with 20 percent after two years of service, followed by 20 percent per year until 100 percent vesting is achieved after six years ("graded" or "graduated" vesting).

**Caution:** Plans that require two years of service before employees are eligible to participate must vest 100 percent after two years of service.

**Tip:** A plan can have a faster vesting schedule than the law requires, but not a slower one.

### ***What happens if an employee leaves employment before he or she is fully vested in your contribution?***

The participant forfeits the non-vested portion of his or her account. In most 401(k) plans, forfeitures are reallocated to the accounts of the remaining participants. Also called reallocated forfeitures, these forfeitures can be used to reduce future employer contributions and/or administrative costs, as well. Forfeitures can't be allocated to an employee's Roth account.

### ***Do you have fiduciary responsibility for your employees' 401(k) accounts?***

You have a fiduciary responsibility to exercise care and prudence in the selection and appropriate diversification of plan investments. However, participants choose their own investment allocation. Your liability for investment returns may be reduced if you allow participants to direct the investments of their own accounts. A plan is participant-directed if, among other requirements, it:

- Allows participants to choose from a broad range of investments with different risk and return characteristics
- Allows participants to give investment instructions at least as often as every three months
- Gives participants the ability to diversify investments generally and within investment categories
- Gives each participant sufficient information to make informed investment decisions

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Note that if you sponsor a participant-directed plan, you may assume additional responsibility--participant education. A balance must be struck between providing not enough--or too much--investment educational support for plan participants. Too much and you could be considered to be providing investment advice, and become legally responsible for your employees' investment decisions. Employee education is an issue to be carefully considered when implementing a qualified retirement plan.

**Tip:** The Pension Protection Act of 2006 creates a new prohibited transaction exemption under ERISA that allows certain related parties ("fiduciary advisers") to provide investment advice (including, for example, recommendation of the advisor's own funds) to profit-sharing (and other defined contribution) plan participants if either (a) the advisor's fees don't vary based on the investment selected by the participant, or (b) the advice is based on a computer model certified by an independent expert, and certain other requirements, including detailed disclosure requirements, are satisfied. The Act also provides protection to retirement plan fiduciaries where an employee's account is placed in a default investment in accordance with DOL regulations because the participant failed to make an affirmative investment election. These provisions are generally effective January 1, 2007.

***Must you obtain a favorable determination letter from the IRS in order for your plan to be qualified?***

No, a plan does not need to receive a favorable IRS determination letter in order to be qualified. If the plan provisions (both the written provisions and as implemented) meet Code requirements, the plan is qualified and entitled to the appropriate tax benefits. Nevertheless, without a determination letter, the issue of plan qualification for a given year doesn't arise until the IRS audits your tax returns for that year. By that time, however, it is generally too late for you to amend your plan to correct any disqualifying provisions. Consequently, a determination letter helps to avoid this problem, because auditing agents generally won't raise the issue of plan qualification if you have a current favorable determination letter. Alternatively, pre-approved "prototype" plans are often used.

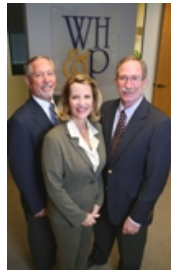
***What happens if the IRS determines that your 401(k) plan no longer meets the qualified plan requirements?***

The IRS has established programs for plan sponsors to correct defects. These programs are designed to allow correction with sanctions that are less severe than outright disqualification. If, however, you are unable to correct the defects in your program appropriately, your plan may be disqualified. Loss of a plan's qualified status generally results in the following consequences:

- Employees are taxed on their pretax contributions in the year they're made to the plan, rather than the year the contributions are paid from the plan
- Employees are taxed on employer contributions, and all plan investment earnings, in the year they vest rather than the year benefits are paid
- Your deduction for employer contributions must be taken in the year your employees vest in the contribution, rather than the year you made the contributions to the plan
- The plan trust would have to pay taxes on its earnings
- Distributions from the plan may be ineligible for special tax treatment and can't be rolled over tax free

**Caution:** Note that a plan may be disqualified retroactively. This means that you and your employees would need to file amended returns to reflect the tax effects of disqualification for those prior years. Penalties for under reporting income in those prior years could also be imposed. However, the IRS can generally not go back more than three years (six years if there was a substantial underreporting of income). While the IRS wouldn't be able to collect taxes for any earlier year, the Service might require correction of those closed years if you seek to re-qualify your plan.

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**WHP Financial**  
TODD ROTH  
6390 Greenwich  
San Diego, CA 92122  
858-550-7090