

401(k) Matching Contributions — Management's Options

SITUATION: Company A matches its employees' 401(k) contributions 50 cents on the dollar on the first 4% of pay. Management wants to consider other contribution possibilities.

QUESTION: What other types of matching and contribution formulas are available?

ANSWER: A 401(k) plan sponsor has a wide range of matching possibilities — fixed or discretionary, or a combination of the two, or even no match.

DISCUSSION: With a fixed match, the company simply chooses to match a fixed percentage of an employee's plan contributions. Many plans have a single matching formula. The plan matches a percentage of each dollar that an employee contributes (most often either 50 cents or one dollar on each employee dollar) up to a specified percentage of pay. Other plans offer a two-tier match — dollar for dollar up to a certain percentage of pay and less than a dollar for additional amounts, again within a specified percentage of pay. With a discretionary match, the company determines its contribution amount annually, usually based on profits.

Federal tax law limits the annual additions that may be made to an employee's 401(k)



or other defined contribution retirement plan account. This year, the maximum is the lesser of 100% of compensation or \$40,000. Employers may deduct contributions of up to 25% of compensation (not counting 401(k) elective deferrals). Within these overall constraints, the matching formula, if any, is the plan sponsor's decision. (Note, however, that a 401(k) plan may not discriminate in favor of higher compensated employees.)

When considering matching contributions, it may be useful to examine the choices other companies have made. More than 85% of the 401(k) plans responding to the *2002 Annual 401(k)*

*Benchmarking Survey** offer a matching contribution. About half (47%) begin matching within the first three months of service — 26% immediately after hiring. Fixed match formulas are dominant; 83% of the companies that match their employees' contributions have a fixed match. Only 11% use a discretionary formula. The remaining 6% of the plans have a combination of fixed and discretionary matching.

Of the plans with matches, 73% use a single matching formula, 5% have different formulas for two employee groups, and 13% use tiered contribution formulas. Tiered plans usually match a small part

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Owner-only 401(k) Plans — A New Opportunity

Do you run your own business alone or with a partner — but without the help of other employees? If so, new tax rules may make it beneficial for you to start a 401(k) plan. Similarly, if you already have a profit sharing plan, adding a 401(k) salary deferral feature to your existing plan may allow you to set aside more money for your retirement on a tax-deferred basis.

Defer Salary

With a 401(k) plan, you elect to set aside a portion of your annual compensation. In 2003, the tax law allows you to defer as much as \$12,000 of compensation — \$14,000 if you are age 50 or over. These annual deferral limits are scheduled to increase to \$15,000 and \$20,000 by 2006. You are not taxed on the deferrals, or on

plan investment earnings, until you receive distributions from the plan. Your business deducts the deferred compensation as an expense.

Contribute More

That's not all the law allows, however. At your discretion, the business also can make *additional* tax-deductible profit sharing contributions to the plan on your behalf. (Total annual additions to your account are limited to \$40,000. Other limits apply.) The combination of your annual 401(k) deferral, your company's profit sharing contributions, and plan investment earnings could result in a sizable nest egg by the time you retire. If your spouse works in your business, note that he or she would be able to participate in the plan as well.



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of pay at 100% or another very high level and a larger part at a much lower level. This type of formula effectively encourages enrollment, but requires continuing effort to raise contributions above the generous first tier.

Similarly, the Profit Sharing/401(k) Council of America's *45th Annual Survey of Profit Sharing and 401(k) Plans*** found the most popular matching formula to be 50 cents on the dollar. Nearly half (45.6%) of the plans surveyed used a 50% match, with 26% of these plans matching up to 6% of employees' pay. Only 2.7% of the plans surveyed match less than 25 cents on the dollar; 23% use a dollar for dollar formula.

COMMENT: The matching choices of other companies can be useful input in determining an appropriate company match. However, a plan sponsor must balance both company and employee needs within the context of the company's financial situation. A knowledgeable outsider's perspective may be helpful. If you want assistance with your matching decision, please talk with your employee benefits professional.

*Conducted by Deloitte & Touche

**Available online at www.pasca.org or by calling 312-441-8550

Some Ways Plans Determine Contributions

(401(k) and combined 401(k)/profit sharing plans)

Method	% of Plans Using
Fixed match only (excluding safe harbor)	21.6%
Fixed match and discretionary profit sharing match only	18.4%
Discretionary profit sharing match only	11.3%
Discretionary profit sharing match and other contributions	7.3%
Safe harbor match only	6.6%
Fixed match and other contributions	6.6%
Discretionary profit sharing contribution only	6.5%
Fixed match and discretionary profit sharing contribution only	5.7%
No company contribution	5.7%
Guaranteed percentage of participants' pay only	4.5%
Formula-based percentage of profits only	1.7%
Discretionary profit sharing contribution and other contributions	1.7%

Source: *45th Annual Survey of Profit Sharing and 401(k) Plans*, Profit Sharing/401(k) Council of America

Don't Overlook Top-heavy Regulations

SITUATION: When Company X was establishing its 401(k) plan, one of the features that appealed most to the company's CEO was the flexibility a 401(k) plan offers in terms of company contributions. After some analysis, Company X decided to match employee salary deferrals up to 2% of pay. During the plan's fourth year of operation, however, the CEO learned that Company X would have to make an extra contribution to some of its employees' accounts in order to comply with tax law requirements.

QUESTION: Why would a plan suddenly become subject to a minimum contribution requirement?

ANSWER: The Company X plan became "top heavy." The sponsor of a top-heavy 401(k) plan generally must contribute at least 3% of compensation on behalf of nonkey employees. The rules also call for the use of a specific minimum vesting schedule.

DISCUSSION: A tax-qualified retirement plan must include provisions that take effect whenever the plan becomes top heavy. That happens when the accounts of "key employees" represent more than 60% of the total value of all employee accounts. The difference between "key" employees and other employees is not simply a question of compensation. A "key employee" is any individual whose role in the company, *based on ownership, position, or compensation*, fits the law's key employee definition. For purposes of the top-heavy rules, a key employee is:

- An individual who owns more than 1% of the plan sponsor and earns more than \$150,000 a year,
- A more than 5% owner, or
- A company officer with compensation greater than \$130,000.

In determining the 1% and 5% ownership, an individual is considered to own stock owned by certain family members.

A plan that tests as top heavy on the last day of the preceding plan year is subject to the top-heavy rules for the entire current plan year. Under these rules, a



401(k) plan sponsor generally must make the 3%-of-compensation contribution mentioned earlier. If the plan provides

less than 3% as a maximum contribution, the sponsor's minimum top-heavy contributions to nonkey employees' accounts may be determined by the highest deferral rate of any key employee in the plan. Thus, if the highest salary deferral by any key employee is 2%, the sponsor would have to contribute 2% of compensation to nonkey employees' accounts.

All nonkey employees who are plan participants at the plan's year end must receive the minimum contribution. However, no additional contributions are required for employees who leave the

company before the end of the year in which the plan becomes top heavy. Not making required minimum top-heavy contributions can jeopardize a plan's tax-exempt status.

The top-heavy vesting requirement allows a choice of two schedules: three-year 100% vesting or six-year graded vesting — at least 20% by the end of the second year of employment, and 20% each in the succeeding four years, so that participants are fully vested at the end of the sixth year.

COMMENT: Plan sponsors should be aware that smaller plans that are designed to benefit the owners and other key employees have the potential to become top heavy in the future. Consequently, sponsors of these plans, in particular, need to conduct top-heavy testing annually and be prepared to operate their plans under the top-heavy rules.



Final Loan Regulations

The IRS has released final regulations on loans from qualified retirement plans to plan participants and beneficiaries. The final regulations retain the general structure of the proposed regulations released in 2000, with a few changes.

Refinancings

As in the proposed regulations, the final regulations treat a loan refinancing as a continuation of the prior loan plus a new loan to the extent the loan balance



is increased. The new amount may be repaid over as long as five years, but the outstanding balance of the old loan generally must continue to be

repaid in substantially level installments over the remaining original loan period. However, a loan with an original repayment schedule of less than five years may be extended to five years from the date of the original loan.

Military Leave

The final regulations also follow the proposed regulations that permit a plan to suspend loan repayments during a participant's military leave of absence without having the loan treated as a deemed distribution — if certain conditions are met. Under the proposed regulations, if a loan was suspended due to a military leave of absence, it had to be fully repaid by the end of the original loan period, plus the time of military service. Final regulations provide that the repayment period for loans that have an original repayment period of less than five years may be extended to five years from the date of the original loan plus the length of the military service.



Borrowing after a Deemed Distribution

Also, the final regulations provide that, if a loan has been deemed distributed (and, thus, was taxable) to a participant and the participant has not repaid that loan amount to the plan, then all future loans will also be considered to be taxable distributions unless one of two conditions is met. Either the participant and the plan sponsor must enter an agreement under which new loan repayments will be made by payroll deductions or the participant must provide adequate security for the new loan that is in addition to the participant's accrued benefit under the plan.

No Limit on Number of Loans

In a departure from the proposed regulations, the final regulations do *not* limit



the number of plan loans a participant may have. The proposed regulations provided that a deemed distribution occurs if a participant obtains more than two loans in a year.

The final regulations generally apply to loans made on or after January 1, 2004.