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401 (K) PLANS

SUMMARY

A 401(k) plan is a type of profit-sharing plan permitted under Section 401(k) of the Internal Revenue Code. Under a 401(k) plan, an employee elects to receive an amount from the employer in cash or to defer it under the plan. One of the advantages of a 401(k) plan is that it encourages employees to take an active role in planning, saving and preparing for retirement.

401 (k) plans offer employees and employers significant tax advantages including the following: a) the employee elects to make his contributions to the plan on a pre-tax basis. Pre-tax contributions are not subject to taxes until they are received in the form of a plan distribution; b) the employer will often match a portion of the employee's contributions. The employer contribution is deductible by the employer and is not included in the employee's income; c) in addition, investment earnings on employee and employer contributions are not subject to taxes until they are received as distributions.

In implementing a 401(k) plan, employers have many plan design options to consider within the framework of the federal regulations that govern such plans. Once the plan design is finalized, a legal plan document from which the plan is administered must be drafted. Also, a trust must be established to accept and invest the contributions.

HOW MUCH CAN AN EMPLOYEE DEFER?

The plan document specifies the percentage of compensation the employee can contribute to a 401 (k) plan. Employee contributions may range from 1% to 15% of compensation. The maximum pre-tax amount an employee can defer annually is limited by the IRS ($9,500 in 1997). The dollar limit, indexed each year according to changes in the Consumer Price index, has increased since 1987.

Recent yearly maximum pre-tax salary deferral limits are shown below:

1987 - $7,000	1988 - $7,313	1989 - $7,627
1990 - $7,979	1991 - $8,475	1992 - $8,728
1993 - $8,994		
1994 and 1995 - $9,240		
1996 and 1997 - $9,500		

HOW MUCH CAN AN EMPLOYER CONTRIBUTE FOR EACH EMPLOYEE?

To encourage employees to participate in a 401(k) plan, many employers match employee contributions. The employer typically contributes up to 2%-4% of the employee's compensation in matching amounts. If the employer maintains both a defined benefit and a defined contribution plan, the combined employer contribution is limited to 25% of an employee's compensation. However, the maximum contribution to the 401 (k) plan is limited to 15% of the employee's compensation. Because employee pre-tax contributions are considered employer contributions, the total annual employee and employer contributions cannot exceed the maximum of 15% of compensation.

NON-FORFEITABILITY REQUIREMENTS

An employee is 100% vested at all times in the value of his own contributions to the plan. Company contributions may also be immediately vested or subject to one of the following minimum vesting schedules: Schedule 1 - 100% vesting after five years of service. Schedule 2 - 20% vesting after three years of service with another 20% vesting for each additional year of service. Under this schedule, the employee is fully vested upon completion of seven years of service.

Most 401(k) plans, moreover, will provide that the employee becomes 100% vested in company contributions if he becomes disabled or dies while an active employee, or when he retires at age 65. The plan document also defines-in accordance with federal regulations-how service is counted 'and when forfeited past service is reinstated in the case of a rehired employee.

TAX ADVANTAGES OF A 401 (K)

For Employees:

Employees who participate in a 401(k) plan currently realize a number of tax advantages. First, the amount they elect to contribute to the plan is tax deferred, as are any employer contribution made for them. They pay no federal income tax and in most cases, state and local tax, on the contributions until they receive the money later. However, their contributions are considered wages for Social Security purposes. FICA taxes are paid on such amounts and are taken into account in determining the employee's Social Security benefits.

Secondly, the investment earnings on employee and employer contributions while in the 401 (k) plan are also tax-deferred until the money is distributed.

Finally, at the time of distribution, participants may be able to delay tax payment or receive favorable tax treatment. For example, an employee may make a tax- free rollover of his distribution into an IRA or another qualified plan.

Even when an employee elects to receive the value of his 401 (k) account, he may save on taxes. For instance, if an employee is retiring and his annual income will drop, his plan distribution may be taxed at a lower rate.

For Employers

Employers also receive a tax advantage from a 401 (k) plan. The amount an employer contributes to a 401(k) plan can be deducted from taxable income. The deduction is limited to 15% of employee compensation.

HOW 401 (K) ACCOUNTS ARE INVESTED

Most 401(k) plans provide participants with the opportunity to direct how their plan account is invested through a choice of professionally managed investment funds. The plan may provide several options with a variety of levels of risk. Investment options may include a guaranteed interest fund, mutual funds or stock funds, bonds, or a company stock fund. Rules regarding how contributions can be divided among the funds, how often the employee can change his investments, how often he can stop contributions, if there is a penalty for doing so, etc. are defined within the plan document. And, generally, each plan participant receives a report at least once a year, often quarterly, of his account performance.

WITHDRAWALS WHILE EMPLOYEES ARE STILL WORKING

Hardships Withdrawals

Because of the tax advantages of saving with pre-tax dollars, the IRS restricts distributions to active employees. Before age 59 1/2, employees may withdraw pre-tax money from the plan for reasons of financial hardship only. Hardship withdrawals are limited to the amount of the employee's elective pre-tax contributions and interest obtained on pre-tax contributions before 12/ 31/86. The procedures and criteria for granting hardship withdrawals must meet federal rules. The in-service withdrawal must be because of immediate and heavy financial need, and the amount withdrawn must be necessary to satisfy the financial need. The IRS has stated that a withdrawal will be on account of an immediate and heavy financial need if the distribution is for:

- costs related to the purchase of a primary residence;
- educational expense for a family member (for the next 12 months only);
- expenses for medical care which are not reimbursed and which are in excess of 7.5% of adjusted gross income;
- payments necessary to prevent eviction from, or foreclosure on, a primary residence.

After making a hardship withdrawal, the employee cannot make pre-tax contributions for 12 months. In addition, the federal pre-tax contribution maximum for the following year is reduced by the amount contributed during the year of the withdrawal.

BORROWING MONEY FROM THE PLAN

Some 401(k) plans include a loan feature that gives the employees access to their accounts without incurring taxes. If the plan permits loans, they too must be administered according to federal regulations. For example, the amount of a loan may not exceed 50% of the vested account value. Loans are typically repaid through payroll deductions over a period of up to five years. If a loan is used to buy a primary residence, employers may permit repayment for a period of up to 10 years. All plans must maintain non-discriminatory rules relating to defaults and interest rates on loans.

HOW DISTRIBUTIONS ARE MADE

Employees are eligible for a distribution from the plan upon retirement, death, or termination of employment. Employers have a choice of how to pay out distributions. These include lump sum payments, annual installments for a determined number of years, or an annuity. The plan document will spell out the distribution terms.

TAXATION OF DISTRIBUTIONS

If after-tax employee contributions are made to the plan, they are not subject to taxes when distributed. However, any interest gained on after-tax contributions will be subject to tax.

Otherwise, the entire distribution is taxable as regular income, but as indicated earlier may receive favorable tax treatment. In addition, a 10% penalty tax may apply to distributions made before the employee attains age 59 1/2. Specifically, this 10% penalty tax applies to all distributions unless, at the time of distribution, the employee:

- Retires at age 55 or later;
- Is age 59 1/2 or older;
- Is disabled;
- Has died and the payment is made to the beneficiary;

- has tax-deductible medical expenses that exceed 7.5% of adjusted gross income;
- rolls over the distribution (within 60 days);
- is receiving a joint or life annuity following separation from service.

The 10% penalty tax also does not apply if the distribution is made under a qualified domestic relations order.

ADMINISTERING A 401(K) PLAN

Due to the complexity of the laws regulating 401(k) plans, most companies may look to an outside firm with expertise in this area to administer their plans. Plan administration includes the establishment of payroll systems, valuation process, preparation of individual employee statements, and performing the non- discrimination and other tests required under IRS Sections 401 (k), 401 (m), and 41 5.

The valuation process includes reconciliation of the account balances to the trust information, allocation of net gains and losses to employee accounts, calculation and allocation of company contributions based on the plan formula, preparation of administrative reports reflecting individual account changes, current plan account, and summary information.

This BMA was prepared by Mary Ann McGowanThe Wyaft Company, 1500 K Street, N.W., Washington, D.C. 20005.