

Retirement Plan Option for Small Employers May Make 401(k) Plan Affordable

Q.: *What, exactly, is a 401(k) plan?*

A.: A 401(k) plan is a type of profit-sharing plan under which employees can elect to defer a portion of their compensation. The employer may, but is under no obligation to, “match” all or a portion of the employees’ deferrals.

Q.: *My employees would like my company to consider offering a 401(k) plan, but my business is small. Is such a plan affordable for small business owners?*

A.: Due to low employee contributions and relatively high administrative costs, 401(k) plans were not typically the most advantageous retirement plan option for many small business owners. However, plans can now provide a significant new design option that can benefit business owners at a relatively low employee cost. Although 401(k) plans previously allowed employees to defer a portion of their compensation to the plan, the owner’s contribution was limited by the level of employee deferrals. Under a recent change in the Internal Revenue Code, the complex and costly nondiscrimination rules have been simplified by optional “safe harbor” rules.

Specifically, a business owner can defer \$13,000 in 2004 (\$14,000 in 2005; \$15,000 in 2006) to a plan on his or her own behalf regardless of the level of participation by other employees, provided the employer makes a contribution on behalf of each eligible employee to the 401(k) plan equal to three percent of that employee’s compensation. Alternatively, the employer can contribute a “safe harbor” matching contribution equal to 100 percent of the first three percent of compensation deferred by employees and 50 percent of the next two percent of compensation deferred (e.g., if the employee defers five percent of compensation, the matching contribution will be four percent of compensation). Stated another way, for a three or four-percent employee cost, the business owner can obtain a significant contribution with administrative costs which should be significantly reduced from those with traditional 401(k) plans.

Further, an employee aged 50 or older can defer additional “catch-up” contributions into the 401(k) plan up to \$3,000 in 2004 (\$4,000 in 2005, \$5,000 in 2006). The catch up contribution is in addition to the normal \$13,000 limit. Thus, the maximum elective deferral for an employee aged 50 or older is \$16,000 (i.e., \$13,000 + \$3,000) for 2004, \$18,000 (\$14,000 + \$4,000) for 2005 and \$20,000 (\$15,000 + \$5,000) for 2006.

Q.: What, exactly, are the benefits to a small business owner?

A.: The following example illustrates the significant benefits available to the small business owner. Assume the following: annual revenues are \$400,000, staff compensation is \$108,000, and owner compensation \$170,000.

EXAMPLE:

- 1) The owner has \$170,000 compensation.
- 2) $\$170,000 \times 3 \text{ percent (safe harbor contribution)} = \$5,100$.
- 3) The owner can defer \$13,000 (\$16,000 if aged 50 or older) to the plan because the safe harbor 3 percent contribution is satisfied.
- 4) Total for owner: $\$5,100 + \$13,000 = \$18,100$ (or \$21,100 if age 50).
- 5) The employer cost for non-highly-compensated employees is 3 percent of compensation or \$3,240, i.e., $\$108,000 \times 3 \text{ percent} = \$3,240$.

Under a safe harbor 401(k) plan, the benefit to the business owner is as follows: for a staff cost of 3 percent or \$3,240, the business owner can receive a total retirement plan contribution of \$18,100 (\$21,100 if age 50) from a total contribution pool of \$21,340 or 84.8 percent (\$24,240 or 87 percent if owner is age 50 or older) of all monies put into the retirement plan by the business and the owner.

Additionally, employees have been provided with the opportunity to save for their own retirement through the 401(k) plan.

Due to the safe harbor rules for 401(k) plans, the administrative burdens for such plans have been reduced. With the availability of significant contributions to the business owner which, in practice, may not have been previously available, small business owners should consider changing both traditional profit-sharing plans and/or costly cross-tested plans into safe harbor 401(k) plans.

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