401(k) Plans

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A 401(k) plan is a type of profit-sharing plan under which employees may elect to defer a portion of their compensation to the plan. For plan years beginning January 1, 1999 and ending thereafter, 401(k) plans now provide a significant benefit to the practice owner at a relatively low employee cost. Although 401(k) plans previously allowed employees to contribute a portion of their contribution, the practice owner's contribution was limited by the federal tax regulations in accordance with the level which employees choose to contribute. As a result of typically low practice owner contributions and the relatively high administrative costs of 401(k) plans, such plans were not typically the most advantageous retirement plan options for the dental or specialty practice.

However, for plan years beginning January 1, 1999 and thereafter, the complex coverage rules will be simplified by a new "safe harbor" rule. In effect, the practice owner or employer may make a contribution equal to 3% of compensation for each non-highly compensated employee who is eligible to participate in the 401(k) plan. As a result, the key employee or practice owner can contribute $10,000 to a plan on his or her own behalf for a safe harbor contribution of 3%. Therefore, for a 3% employee cost, the practice owner can attain a significant contribution with administrative costs which should be significantly reduced from the pre-December 31, 1998 plan year cost.

The following safe harbor examples illustrate the significant and available benefits to the practice owner. Assume the following: the annual practice revenues are $400,000, staff compensation (chairside and clerical) is $108,000 or 27% of revenues and owner compensation is $160,000 or 40% of revenues.

401(k) plan integrated with Social Security at Social Security taxable wage base:

(A) The practice owner/key employee has $160,000 compensation

(B) $160,000 × 3% (safe harbor contribution) = $4,800

(C) $160,000 – $72,600 (1999 taxable wage base) – $87,400 × 3% = $2,622

(D) The practice owner/key employee can defer $10,000 to their plan because the safe harbor 3% contribution is satisfied.

(E) Total for key employee: $4,800 + $2,622 + $10,000 = $17,422 ÷ $160,000 = 10.89%

(F) The employer/practice owner cost for non-highly compensated employees is 3% of compensation.

Same example as above, but contribution is increased to 5.7% of compensation less than the taxable wage base and 11.4% of compensation in excess of the taxable wage base:

(A) $160,000 × 5.7% = $9,120

(B) $160,000 – $72,600 = $87,400 × 5.7% – $4,981.80

(C) Key employee/practice owner can defer $410,000 to their plan because safe harbor 3% contribution is satisfied.

(D) Total for key employee/practice owner: $9,120 + $4,981.80 + $10,000 = $24,101.80 ÷ $160,000 = 15%

(E) The employer/practice owner cost for non-highly compensated employees is 5.7% of compensation.

These two examples demonstrate the benefit to the practice owner at a staff cost of 3% or 5.7%, respectively. In the first example, the staff received 3% of compensation or $3,240. The practice owner received a contribution of $17,422 from a total compensation of $20,662 or 84%. In the second example, the staff received 5.7% of compensation or $6,156. The practice owner received a contribution of $24,101.80 from a total contribution of $30,257.80 or 80%.

Although in the first example the practice owner received a higher percentage contribution than in the second, the contribution in the second example provided an additional contribution of $6,679.80 to the practice owner at a relatively low cost. Therefore, the highest contribution percentage may not be the highest possible contribution. Stated differently, for an additional staff contribution of $2,916, the practice owner received an additional $6,679.80 by utilizing Social Security integration. Thus, for a total additional cost of $9,595.80, the practice owner received 70% of the contribution.

Due to safe harbor rules for 401(k) plans, the administrative burdens for such plans are reduced beginning on and after January 1, 1999. And with the new availability of significant contributions to the practice owner which were not previously available, practice owners should consider changing both traditional profit-sharing plans and the costly cross-tested plans to 401(k) plans.

Because the law requires all retirement plans to be amended for the 1999 plan year, request that your retirement plan advisor(s) revisit the question of whether your current retirement plan(s) meets the needs of your practice, particularly in light of the 401(k) safe harbor provisions. ●