Your Firm LLC

401(k) Retirement Plans

Retirement planning is important for both businesses and individuals and one of the most popular types of plans is a 401(k).

A 401(k) is a type of retirement plan that an employer can offer to employees. Under a 401(k) plan, an employee can contribute a portion of their compensation, known as an elective deferral, to their 401(k) account, usually through automatic payroll withholding.

In addition to the employee contributions, the employer may also contribute to the employee's 401(k) account by matching the employee's contributions, making contributions on behalf of all employees, or both.

Tax Advantages of a 401(k)

Funds contributed to a 401(k) by the employee are pre-tax and are able to grow tax-deferred. However, distributions from a 401(k) are generally taxable.

If an employee designates some or all of their contributions as "Roth elective deferrals", then the contributions are made post-tax, but income earned on the account and withdrawals are tax-free provided that they are qualified distributions.

For the employer, contributions made to an employee's 401(k) account are tax-deductible, up to specific limits.

Types of 401(k) Plans

There are several types of 401(k) plans including a Traditional 401(k), a Safe Harbor 401(k) and a SIMPLE 401(k).

Traditional 401(k) Plans

A Traditional 401(k) plan enables eligible employees to contribute to the 401(k) account through payroll deductions. Additionally, the employer can make contributions to the employee's 401(k) account.

With a Traditional 401(k), the employer can set up a vesting schedule for the employer contributions. So even though an employer might contribute to an employee's 401(k) account, some or all of the employer contributed funds may be forfeited if the employee does not vest according to a predetermined schedule. A vesting schedule is often used by employers to help retain employees.

Most traditional 401(k) plans face annual non-discrimination tests to see if highly compensated employees or business owners are maxing out their 401(k) contributions for the year, while the rest of the employees lag in their savings.

Generally speaking, Congress wants to make sure that all employees benefit from a company's 401(k) plan, not just the owners and highly compensated employees.

As of 2020, highly compensated employees are people who work at a company and earned at least $125,000 in the preceding year, or owned more than 5% of the interest in the business at any time during the year or the preceding year.

A general rule of thumb is that the average percentage contribution by highly compensated employees can't be more than 2% more than the average of all employees who are not highly compensated.

In order to ensure that the plan satisfies these requirements, the employer must perform annual tests, known as the Actual Deferral Percentage and Actual Contribution Percentage tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees.

If a 401(k) plan fails the annual non-discrimination tests, then the company may need to refund or limit contributions for the highly compensated employees to become compliant. If the plan can't be fixed through refunded contributions, there's a risk that the entire 401(k) plan will become taxable.

Safe Harbor 401(k) Plans

Many companies add a Safe Harbor provision to their 401(k) plan that enables business owners and highly compensated employees to maximize contributions to their 401(k) plan, while automatically passing the non-discrimination tests.

With a Safe Harbor provision, the employer makes annual contributions on behalf of employees, and those contributions are vested immediately.

The employer contribution can be set up in one of three ways; a Non-Elective Safe Harbor, a Basic Safe Harbor Match, or an Enhanced Safe Harbor Match.

With a Non-Elective Safe Harbor provision, all eligible employees get an annual employer contribution of 3% or more of their salary. This amount is immediately fully vested and the employee gets it whether or not they contribute to the plan.

With a Basic Safe Harbor Match provision, the employer matches 100% of the first 3% of each employee's contribution and 50% of the next 2%. Employees are required to contribute to their 401(k) in order to get the match.

With an Enhanced Safe Harbor Match provision, the employer typically matches 100% of the first 4% of each employee's contribution. Like a Basic Safe Harbor Match, employees are required to contribute to their 401(k) in order to qualify for the match.

If you elect to establish a Safe Harbor plan, it's important to understand that employer contributions are immediately vested so an employee could leave with the money at any time, depending on the plan's terms. Also, if the safe harbor provisions remain in place, employer contributions are required each year so your company must have sufficient future cash flow.

Simple 401(k) Plans

Small businesses may want to consider a SIMPLE 401(k) plan which does not require the annual nondiscrimination tests and is more cost-effective and efficient to manage. A SIMPLE 401(k) plan is available to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding calendar year. With a SIMPLE 401(k) plan, employers are required to make contributions that are immediately fully vested and employees may not receive contributions from any other qualified plans of the employer.

Employee Contribution Limits

Regardless of the type of 401(k) plan, there are limits to how much the employee and employer may contribute in a given year.

The limit on employee contributions to traditional and safe harbor 401(k) plans is $19,500 in 2020 and 2021, subject to cost-of-living adjustments. The limit on employee contributions to a SIMPLE 401(k) plan is $13,500 in 2020 and 2021, subject to cost-of-living adjustments.

Employees who are age 50 or older at the end of the calendar year may be able to make catch-up contributions by contributing more than the standard limit. The limit on catch-up contributions is $6,500 in 2020 and 2021 for traditional and safe harbor 401(k) plans and $3,000 in 2020 and 2021 for SIMPLE 401(k) plans.

Finally, even though IRS guidelines stipulate specific limits, the terms of the employer's specific plan may impose lower limits.

Overall Contribution Limits

When calculating contribution amounts, no more than $285,000 of an employee's 2020 compensation can be taken into account so this may limit highly compensated employees.

In addition to the limits imposed on an employee's contributions to a 401(k), there are limits on the total annual contributions made to all of an employee's accounts in plans maintained by one employer and any related employer. The annual contributions made to an employee's account cannot exceed the lesser of 100% of the employee's compensation or $57,000 for 2020 and $58,000 for 2021. If the employee is age 50 or older then the overall limits are $63,500 for 2020 and $64,500 for 2021 due to the catch-up contribution amount.

Next Steps

This whitepaper is meant to provide an overview of 401(k) plans and is not a substitute for expert advice. If you have questions about a 401(k) or would like to discuss your specific situation, please contact our office. We're always happy to help.

About Your Firm LLC

We have hand-picked a team with tax, auditing, accounting, business and management advisory expertise in a multitude of fields, including healthcare, professional-services firms, commercial contractors, home builders, real estate companies, manufacturing and distribution companies, dealerships, non-profit organizations and pension funds.

We have the expertise and the resources to provide not only the critical services you need during these evolving economic times, but also, importantly, to build for the future. Our strategic alliances with professional organizations across the country allow us to bring our clients the talent and expertise of national firms with the high-touch service of a local firm. While we remain focused on the core services of tax, accounting and audit, we expand and offer you the business consulting needed to remain competitive. We believe the success of our clients is the greatest measure of our own.

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