Week Eight
MAP 8-6

What Is a 401(k) Plan?
(refer to page 327)

A 401(k) plan is a type of profit-sharing or stock bonus plan that allows employees to elect to have their employers make pretax contributions (e.g., salary deferrals) on the employees' behalf in lieu of paying an equivalent amount in currently taxable cash wages. These plans are sometimes called "cash or deferred arrangements" (CODAs).

Advantages to Employees

Contributions accumulate in the plan, along with investment gains, and are taxed when distributed to the plan participant from the plan. One potential benefit to the participant of deferring taxation on contributions and earnings until retirement is that he/she may be in a lower tax bracket than during the period when he/she accumulated the assets in his/her 401(k).

Because the 401(k) plan is part of a profit-sharing plan, employers still have the advantage of flexibility in making discretionary contributions. Even if an employer cannot afford to make discretionary contributions, a 401(k) plan is still an attractive benefit for employees who wish to contribute on their own.

Requirements for 401(k) Plans

Nondiscrimination requirements. Contributions made to 401(k) plans must meet certain tests to ensure they are not discriminatory in favor of highly compensated employees. Salary deferral contributions must satisfy one of two nondiscrimination tests that apply only to 401(k) plans. Each of these tests relates the salary deferrals made by highly compensated employees to the salary deferrals made by nonhighly compensated employees. This may present a problem because lower-paid employees often elect to receive cash in lieu of deferring salary. To encourage their participation, employers can offer to "match" salary deferrals under a formula stated in the plan. For example, an employer may match 50 cents of each dollar deferred by employees. The employer can also set a cap on the maximum amount they will match. For example, the employer may match 50 cents of each dollar, up to a maximum of 6 percent of compensation (resulting in a maximum match amount of 3 percent of compensation). Matching contributions may also be discretionary (i.e., decided at year-end), but they must be made according to the terms of the plan document.

Defer only future compensation. Employees must elect to defer only future compensation. In other words, only compensation that has not yet been earned or that the employee does not have the right to receive is eligible for salary deferrals.

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Internal Revenue Code requirements. To qualify as a 401(k) plan, the plan must satisfy all the requirements of Internal Revenue Code Section 401(k). These include the following:

1. Limits on plan distributions. These limits restrict an employee from receiving a distribution before completing a stated number of years of service or the passing of a fixed number of years.
2. An employee's salary deferral contributions must be nonforfeitable (i.e., the employee is always 100 percent vested in his/her contributions and the related earnings).
3. Generally, an employee cannot be required to have more than one year of service to participate in a salary deferral feature.
4. Benefits (other than matching contributions)—(e.g., employer discretionary contributions) must not be contingent on the employee's election to make salary deferrals.
5. Employees eligible to participate in the salary deferral feature (regardless of whether they elect to contribute) must satisfy the coverage tests (see "What Are the Minimum Coverage Rules"). Under the coverage tests, the plan must meet either the ratio percentage test or the average benefit test.
6. Limitations on the maximum salary deferrals. The limit is $12,000 for 2003. In addition, a participant can elect to contribute up to an additional $2,000 in 2003 if he/she is age 50 by year-end. (This is the maximum amount of compensation the employee can elect to defer in a given year. It does not include employer contributions, earnings on contributions, or plan forfeitures that are credited to the employees' account).

Example: Using a 401(k) plan.

John Nagel, D.D.S., Inc., maintains a 401(k) plan that allows employer contributions to be made on a discretionary basis. The employer does not match any elective contributions made by employees to the 401(k) plan. Employer contributions are based on the participants' compensation in relation to total qualified compensation. In the current year, the corporation authorizes a contribution equal to 10 percent of compensation. The employees' elective deferrals are shown in the following table, as well as the allocation of the employer's contribution.

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Participant	Compensation	10% Employer Contribution	Employee 401(k) Deferrals	Total Annual Additions (Allocations)
John Nagel	$170,000	$17,000	$4,000	$21,000
Betsy Smith	40,000	4,000	2,000	6,000
Jane Davis	25,000	2,500	1,000	3,500
Alisia Barker	28,000	2,800	1,120	3,920
Totals	**$263,000**	**$26,300**	**$8,120**	**$34,420**

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