401(k) basics

1. 401 k plans are "defined contribution plans."

A 401 k plan is what's called a defined contribution retirement savings plan. In defined contribution plans...

✓ the amount contributed to each participant's account is set ("defined") -- either by the plan participant or by the employer, and as either a flat rate or a percentage of pay.

AND...

✓ the amount each participant will receive upon retirement is left up to the effect of investment performance on the contributions.

Other defined contribution retirement savings plans include SEPs, Simple IRAs, Profit Sharing Plans, and Money Purchase Plans. The 401 k is by far the most popular.

Defined contribution plans differ from traditional pension plans, called defined benefit plans, which specify specific amounts of money (the "benefit") employees will receive when they retire rather than the periodic contribution amounts that will be put into the plan to ensure that final benefit amount.

In 401k plans...

✓ Each participating employee decides the amount to be withheld each month from his or her pay as their 401 k contribution.

✓ The employer withholds these amounts BEFORE calculating income taxes on each employee's pay.

✓ The employer forwards the money to a third party administrator, who is responsible for investing the employees' contributions per specific instructions provided by the employees.

✓ Some employers choose to add to participants' 401 k contributions through employer matching contributions.

2 The new 401 k auto enrollment feature can improve participation rates.

The new "auto enrollment" procedure allows employers to AUTOMATICALLY enroll an employee in the 401 k plan as soon as the employee meets the plan's eligibility requirements. Employees can elect to decline enrollment at any time.

✓ The company must set the auto enrollment contribution level in advance; 3% to 5% of compensation is the typical auto enrollment contribution level chosen.

✓ The company must set an auto enrollment investment selection ahead of time; a money market fund is the most typical auto enrollment investment.

✓ Employers must, at least annually, notify all employees that the company 401 k uses the auto
enrollment feature and how an employee can cease participation in the plan.

✓ Employers must immediately notify auto-enrolled employees of their new 401 k participation status.

✓ Any employer matching contributions being made to traditionally-enrolled participants' accounts must also be made to auto-enrolled participants' accounts.

✓ Auto-enrolled plan participants must have the opportunity to change their default investment selection and/or contribution rate.

✓ If an automatically-enrolled employee soon after cancels his or her participation in the plan, any money put into the plan on the person's behalf must stay in the plan until the person's employment is terminated, or the employee reaches age 65. At that point, the employee has the same withdrawal choices (IRA rollover, rollover into another employer's qualified retirement plan, or distribution) as any 401 k participant of the same age and employment status.

Automatic enrollment is also referred to as passive enrollment or negative enrollment; the automatic contribution and investment designations are called the plan's negative elections.

The IRS has only recently approved negative elections and certain legalities outside of the IRS's scope remain unclear. Consulting a legal advisor would be prudent before adopting automatic enrollment for your 401 k plan.

3. Plan vendors supply and maintain your 401 k; the employer sponsors it.

✓ 401 k plans are supplied by a vendor, or third-party administrator who typically supplies the plan itself and all its related documentation.

✓ Investments for a 401 k plan are sometimes supplied by the vendor and sometimes by another party, the investment custodian.

✓ Administration of the 401 k is sometimes supplied by the vendor and sometimes by another party, under contract to the vendor.

401 k plans must be "sponsored" by an employer; they can only be offered through a sponsoring company. The Internal Revenue Code does provide for retirement savings plans that don't require employer sponsorship (these include annuities and Individual Retirement Accounts), but most people find 401 k plans far superior:

✓ 401 k plans are extremely convenient for participants.

✓ 401 k plans allow for significantly higher annual contribution levels.

✓ Higher contribution levels mean a greater impact on lowering participants' current income taxes.

✓ Higher contribution levels mean more money being set aside -- and allowed to compound -- for retirement.
401 k plans can include loan features that allow participants to borrow from their retirement savings; IRAs and most annuities do not offer the possibility of loans.

Plan sponsorship generally entails the employer appointing an in-house person to act as liaison between the plan's vendors and the company's employees. This person is the plan administrator (not to be confused with the outside vendor party providing the overall plan administration!).

4. Employee 401 k contributions are pre-tax contributions.

Contributions to a 401 k account can come from employees and/or their employers. Employee contributions are withheld from the participant's pay BEFORE income tax withholding is calculated. Thus, 401 k contributions are pre-tax contributions.

Employees can also transfer their money into their current 401 k from their previous employer's 401 k in the form of a rollover. Consolidating accounts can simplify oversight and management of a comprehensive investment strategy under the direction and control of the plan participant.

Participating in a 401 k plan can reduce a person's lifetime income tax burden, because income taxes aren't assessed on 401 k contributions until the money is withdrawn from the plan, usually years down the road, during retirement, when the participant is likely in a lower income tax bracket.

Employees cannot contribute more than 15% of their annual earnings to their 401 k account. Additionally, they cannot contribute more than $10,500 (for year 2000) of their annual earnings to their 401 k account, a limit adjusted each year by lawmakers.

These limits apply to employee contributions only.

Employer contributions to an employee's account can take the total annual contribution amount much higher.

Returns earned on 401 k investments are never included in these annual contribution limits and can be a substantial source of growth for a 401 k account.

5. Employer 401 k contributions add to employees' accounts.

Contributions to a 401 k account can come from employees and/or their employers. Employers choose whether or not to contribute to their employees 401 k accounts. If they choose to contribute, they can take are of three forms:

In a flat fixed-dollar amount to each participant's account (e.g., $500 to each participant's account annually)

At a fixed rate of each participant's pay (e.g., each participant gets an amount equal to 3% of his or her salary). This is called a profit sharing contribution.

At a rate that depends on how much the employee contributes to the 401 k plan. This is called a matching contribution.
Employer contributions do not have to immediately become the property of the employees. Instead, employers can require a vesting schedule by which the 401(k) participants gain full ownership of employer contributions incrementally, over time. For example...

✓ An employer chooses to make matching contributions and chooses to do so at a rate of $.25 to each dollar a participant contributes. This is the matching formula.

✓ The employer stipulates that people who have participated in the plan two years or less only get 25% ownership of these employer-provided matching contributions. People who have participated in the plan three years get 50% ownership of the matching contributions. People who have participated in the plan four years get 75% ownership of the matching contributions, and people who have participated in the plan five years or more get 100% ownership of matching contributions. This schedule of ownership is an example of a vesting formula. It is relevant if a participant leaves the plan before reaching fully-vested status. Any non-vested employer contributions revert back to the plan and are later distributed among the remaining participants.

✓ The Internal Revenue Code places dollar amount ceilings and other restrictions on matching and vesting formulas.

✓ Because matching contributions depend on the employee's level of participation ($0.25 for every dollar the employee contributes, for example), they encourage employees to join the 401(k), contribute as much money as they can, and stay with the company over the years!

✓ Employers are NOT required to contribute to their employees' 401(k) accounts in any way. Employer contributions are completely voluntary on the part of the employer.

6. Qualified investments for 401(k) plans

Certain types of investments are "qualified" under the Internal Revenue Code to receive 401(k) contributions. These include:

✓ Mutual fund investments (stock, bond and money market funds). Mutual fund investments are by far the most popular 401(k) investments.

✓ publicly traded stocks and bonds (excepting municipal or tax free bonds)

✓ bank collective funds, and

✓ insurance company investments.

Every 401(k) plan must offer a minimum spectrum of investments, as defined in the Internal Revenue Code.

✓ Most plans offer between five and 15 investment choices.

✓ Returns earned on 401(k) investments are automatically reinvested in the participants' accounts, increasing the account value over time.

✓ Removing investment returns from a 401(k), just like removing any other money from a 401(k)
account, constitutes a withdrawal and is subject to the penalties and withholdings of such.

7. Tax-deferred 401k saving means compounding growth potential.

All 401k contributions -- employee, employer and even returns earned on 401k investments -- are exempt from income taxation (in most cases state, in all cases federal) so long as the money remains in the plan. Delaying income taxation can have a dramatic positive effect on the compounding growth of an account:

- An investor can amass nearly **THREE TIMES** as much money in a 401k tax-deferred investment over a 30-year period as in a taxable savings plan or investments earning the same rate of return but whose returns are reduced each year by income taxation!

- When money is taken out of a 401k plan -- for ANY reason except a 401k loan or rollover into an IRA or new employer's 401k plan -- it is considered income and taxed as such.

8. 401k Withdrawals & 401k Loans

Although 401k plans are meant to be long-term savings vehicles, participants cannot leave money in a 401k account indefinitely:

- Plan participants generally MUST begin taking withdrawals from their 401k accounts when they reach age 70 1/2.

- Plan participants CAN begin taking withdrawals from their 401k accounts as soon as they reach age 59 1/2.

- Earlier withdrawals can be made without penalty if the participant dies or incurs a qualifying permanent disability.

- At any time, a plan participant leaving the company can remove his or her 401k money without subjecting it to early withdrawal penalties by rolling the money over into a Rollover IRA or new employer's qualified retirement savings plan -- 401k or other.

Outside of these instances, there are only two ways for participants to withdrawal money from a 401k account while employed: hardship withdrawal and 401k loan.

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<tr>
<th>HARDSHIP WITHDRAWL</th>
<th>401k LOAN</th>
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<tbody>
<tr>
<td>does NOT have to be paid back</td>
<td>must be paid back within the agreed-upon time (within six months if the participant leaves the company)</td>
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<tr>
<td>no interest</td>
<td>bear interest (market rate, or thereabouts)</td>
</tr>
<tr>
<td>substantial federal early withdrawal penalties</td>
<td>no federal early withdrawal penalties, unless the loan goes into default</td>
</tr>
<tr>
<td>one year suspension of 401k participation upon taking out of a hardship withdrawal</td>
<td>no participation suspension</td>
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substantial long-term negative effect on the compounding growth of the 401 k account

less substantial long-term effect on the compounding growth of the 401 k account – but still a significant negative effect

sometimes asset liquidation fees

sometimes asset liquidation fees

plan participant generally ends up with about ½ of the amount withdrawn (the remainder goes to taxes and federal early withdrawal penalties)

plan participant generally ends up with most of the amount withdrawn

withdrawn money taxed as income for the year

no tax consequences (unless participant defaults on loan)

must be included in all 401 k plans

does NOT have to be included in 401 k plans

generally involve nominal administrative processing costs

generally involve nominal administrative processing costs

all other resources must have been exhausted for person to qualify

qualifications much less stringent

Hardship withdrawal and 401 k loans increase a plan's popularity, because employees don't feel participation means sending their money into some never-to-be-seen-again abyss. Retirement, after all, may be decades away.

9. ERISA helps protect 401 k plan participants' rights and retirement savings.

Two bodies of legal work comprise the framework for 401 k plans: the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA).

ERISA sets standards for:

✓ participant eligibility,
✓ investment choice,
✓ plan funding/bonding,
✓ vesting,
✓ disclosure of plan and investment information to current and prospective plan participants and their beneficiaries,
✓ and more.

ERISA aims to ensure that retirement monies actually exist at employees' retirements by preventing fund mismanagement by administrators, trustees and others. An employer interested in purchasing an ERISA bond for the company's 401 k typically buys a bond that covers 10% of the plan's total assets. ERISA bonds are very economical and easy to buy --- most insurance agents offer these bonds to small companies at very low annual rates.
**Fiduciary liability insurance** is different than an ERISA bond. Fiduciary liability insurance is a completely discretionary purchase on the part of the employer, and provides broad coverage for all persons who are de facto "fiduciaries" of the company's plan. A fiduciary is someone who provides investment advice to the plan for a fee, and/or has discretionary control or authority over the administration of the plan, an/or has authority or control over plan assets. (note: NASD Registered Representatives are not considered fiduciaries; they earn commissions on plan assets, and typically do not charge fees for investment advice.)

Fiduciary liability insurance is very inexpensive; the cost is approximately 5 percent of the coverage limits purchased, unless the company offers its own stock as an investment option, which increases the premium. Coverage is broad, and the only exclusions are for deceptive practices and fraud, which is covered by the ERISA bond. Providers of fiduciary liability insurance coverage include American International Group (AIG); Chubb Executive Risk; Lloyd's of London; Reliance Insurance; and Travelers Property Casualty to name a few.

10. IRS 401 k compliance testing

To prevent employers from designing 401 k plans that economically benefit only highly-paid personnel, lawmakers wrote compliance test mandates into the rules governing 401 k plans.

 ✓ In general, no plan can be set up in a way that discriminates "as to the availability of rights, benefits and features" available to different employees under the plan.

Specifically...

 ✓ Every 401 k must pass mandated compliance testing every year. The tests compare the participation rates of different classes of employees (see below).

 ✓ Beginning in 1999, employers can choose to skip the tests and instead make a requisite contribution to their so-called non-highly-compensated employees' 401 k accounts. This is called the safe harbor method of plan administration.

 ✓ Employers can decide as late as 30 days before the end of each plan year whether or not to take the safe harbor route. However, if, as its safe harbor contribution, the employer wants to make matching contributions rather than the flat 3% of compensation contribution (explain), the employer must define the matching formula well ahead of those 30 days; in fact, any safe harbor matching contribution must be defined and communicated to employees no later than 30 days before the START of the applicable plan year so employees have plenty of time to adjust their contribution rates accordingly.

Not correcting a failed year-end compliance test can mean substantial penalties and possibly even disqualification of the plan's tax-exempt status. Test failures can be VERY expensive in terms of IRS penalty fees, man-hours spent trying to correct the problems and lost rapport with your employees, who may have to amend and re-file their income tax forms -- and often pay additional income taxes, too.

The most common compliance tests are the ADP test, ACP test, multiple-use test and top-heavy test.
The ADP test (Actual Deferral Percentage test) compares the percentage of salaries that different classifications of employees are diverting into the 401 k plan.

The ACP test (Actual Contribution Percentage test) compares the percentage of employer contributions being diverted into the 401 k accounts of different classifications of employees.

The multiple-use test compares the results of the ADP and ACP tests.

The top-heavy test looks at how much higher-paid employees' money dominates the 401 k plan.

11. Safe Harbor option

401 k compliance tests are designed to ensure 401 k plans have a threshold balance, at minimum, of participation of rank-and-file employees in relation to highly paid employees.

The IRS offers an alternative means of achieving 401 k plan balance: The safe harbor method of plan operation lets 401 k plans skip their annual 401 k discrimination testing so long as the sponsoring employer meets certain employer 401 k contribution requirements designed to ensure broad participation in the company plan and provides 100% immediate vesting of the contributions.

To qualify a 401 k plan as a safe harbor plan, an employer must make matching contributions that fulfill the below requirements or make non-elective contributions equal to 3% of each eligible employee's compensation.

Non-elective contributions are made to all eligible employees, regardless of if the employees participate in the company 401 k plan. Matching contributions, on the other hand, being based upon salary deferral amounts, are made only to active 401 k participants' accounts.

If the employer chooses to make safe harbor matching contributions, those contributions must meet two requirements: First, each non-highly-compensated employee must receive a dollar-for-dollar match on salary deferrals up to 3% of compensation and a $.50 to the dollar match on salary deferrals from 3% to 5% of compensation. Second, the rate of any matching contributions being made to highly compensated employees cannot exceed that being made to non-highly compensated employees.

The employer must provide annual information to employees explaining the 401 k plan's safe harbor provisions and benefits, including that safe harbor contributions cannot be distributed before termination of employment and that they are not eligible for financial hardship withdrawal.

Employers can decide as late as 30 days before the end of each plan year whether or not to take the safe harbor route. However, if, as its safe harbor contribution, the employer wants to make matching contributions rather than the flat 3% of compensation contribution, the employer must define the matching formula well ahead of those 30 days; in fact, any safe harbor matching contribution must be defined and communicated to employees no later than 30 days before the START of the applicable plan year so employees have plenty of time to adjust their contribution rates accordingly.

Your 401 (k) Easy system includes such notification within your customized 401 k plan's Summary Plan Description, a document that's updated at least annually for all eligible employees.
If you don't choose the safe harbor method of 401(k) plan administration, we encourage you to use your customized 401(k) plan administration software's point-and-click compliance testing every month to keep well apprised of your plan's health.


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<tr>
<th>Issue</th>
<th>Current Law</th>
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<tr>
<td>Tax Credits for New Small Employer Plans</td>
<td>An employer’s costs related to the establishment and maintenance of a retirement plan generally are deductible as business expenses. However, there is no tax credit for such expenses.</td>
<td>Beginning in 2002, small businesses with 100 employees or less will be eligible for an annual tax credit of 50 percent on up to $1000 of administrative costs for the first three years of a new plan. The credit is available only if at least one non-highly compensated employee is participating.</td>
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<td>Participant Loans for Small Business Owners</td>
<td>Generally, plans may make loans to Participants. But, prohibited transaction rules prevent sole proprietors, partners, and Subchapter S corporation shareholders from taking participant loans.</td>
<td>The prohibited transaction rules are modified to allow for participant loans to sole proprietors, partners, and Subchapter S corporation shareholders. The provision also applies prospectively to pre-existing loans.</td>
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<td>Repeal of the Multiple use Test</td>
<td>In addition to two nondiscrimination tests (the ADP and ACP tests), some 401(k) plans must also satisfy the complicated multiple use test.</td>
<td>The multiple test is repealed.</td>
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<td>Tax Credits for Lower Income Savers</td>
<td>Currently, there is no tax credit for low and moderate income savers.</td>
<td>Eligible persons will receive a non-refundable tax credit of up to 50 percent on up to $2000 in contributions to an IRA, 401(k), 403(b), SIMPLE, SEP or 457 plan. This credit is in addition to the tax deduction already associated with these contributions. In the case of joint filers, individuals whose adjustable gross income is less than $30,000 are eligible for a 50 percent credit. Joint filers with adjusted gross income between $30,000 and $32,500 are eligible for a 20 percent credit. Joint filers with income between $32,500 and $50,000 are eligible for a 10 percent credit. The income threshold for single filers is one-half the threshold for joint filers.</td>
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<td>Catch-up Contribution for Older Workers</td>
<td>The Code limits the amount that can be contributed to a defined contribution plan on behalf of an employee for any year. In the case of elective deferrals, the limit is $10,500 per year. There are no separate limits for older workers.</td>
<td>Beginning in 2002, individuals who are age 50 or older will be allowed to make an additional contribution to a 401(k), 403(b), 457 plan equal to $1,000 in 2002, then increased by $1,000 each year until $5,000 in 2006, and then indexed in $500 increments. The catch-up amounts for SIMPLE plans will be one-half of these amounts. The amount of the catch-up contribution will not be subject to nondiscrimination testing, provided all participating employees over age 50 are eligible to make a catch-up contribution. Also the catch-up contribution will not count against the employers deduction limit under Section 404, or against the individual’s overall 4115© dollar limit.</td>
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| Modifying of Top Heavy Rules | A plan is generally considered “top heavy” if more than 60 percent of plan assets are held on behalf of “key employees.” Due to the design of this test, top heavy rules essentially affect only small business. Key employees generally include officers earning over half the Section 415 defined benefit plan dollar limit ($70,000 in 2001), 5 percent owners, 1 percent owners earning over $150,000, and the 10 employees with the largest ownership interest in the business (as long as they earn more than $30,000). Further, family members of 5 percent owners are deemed to be key employees under family attribution rules. Top heavy plans must meet a special vesting schedule and make minimum contributions to all non-key employees to the extent contributions are made on behalf of key employees. | A number of changes have been Made here:
- The definition of “key employee” is modified to delete the “top 10 owner” rule, provided that an employee will not be treated as a key employee based on his/her officer status unless the employee earns more than $130,000, and to eliminate the 4-year look-back rule for identifying “key employees.”
- Matching contributions will now count toward satisfying the top heavy minimums.
- The matching contributions 401(k) plan safe harbor will be deemed to satisfy the top heavy rules. This does not mean that an accompanying profit sharing contribution automatically satisfies the top heavy rules, although the matching contributions will count toward |
| Modification of Safe Harbor Relief for 401(k) Plan Hardship Withdrawals | 401(k) plans generally must restrict distributions of amounts attributable to elective contributions. An exception to this restriction applies in the case of certain hardship distributions. Treasury regulations provide a safe harbor for determining whether a distribution qualifies as a hardship distribution. To qualify for this safe harbor, a participant receiving a hardship distribution must be prohibited from making elective contributions to the plan for 12 months following the date of distribution. | Treasury is directed to revise its safe harbor hardship distribution rules to reduce to 6 months the period of time participants must be prohibited from making additional elective contributions. Also, hardship withdrawals under the terms of the plan will not be treated as eligible rollover distributions. |
| Modifications to Limits on Retirement Plan Contributions and Benefits | Current tax limits:  
- 401(a)(17): annual compensation taken into account limited to $170,000.  
- 402(g): elective deferrals limited to $10,500 per year.  
- 415(b): maximum annual benefits are the lesser of 100 percent of three-year high salary or $140,000 (or less for pre-65 retirees).  
- 415(c): maximum defined contribution plan contribution is the lesser of $35,000 or 25 percent of compensation.  
- 457(b): contribution limit is generally $8,500 per year. | Beginning in 2002, the Act raises all of the significant dollar limits as follows:  
- 401(a)(17) compensation limited to $200,000; and then indexed in $5,000 increments.  
- 402(g) elective deferral limit to $11,000 in 2002; then increased $1,000 each year until $15,000 in 2006; and then indexed in $500 increments.  
- 415(b) annual benefit limit to $160,000; and then indexed in $5,000 increments. Note that this provision applies to years ending after December 31, 2001.  
- 415(b) annual benefit limit will otherwise satisfying the minimum.  
- The 5-year look-back rule applicable to distributions will be shortened to one year. However, the 5-year look-back rule will continue to apply to in-service distributions.  
- A frozen top heavy defined benefit plan will no longer be required to make minimum accruals on behalf of non-key employees. |
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<tr>
<th>Deduction Limits</th>
<th>A sponsor of a profit sharing plan cannot deduct contributions to the plan in excess of 15 percent of aggregate employee’s compensation. In the case of a stand-alone money purchase plan, the deduction limit is the minimum funding requirement for the plan.</th>
<th>The deduction limit for profit Sharing plans is increased to 25 Percent of aggregate employees’ Compensation. Money purchase Plans will be treated as profit Sharing plans for purposes of the 404 deduction limit and thus will be subject to the 25 percent limit.</th>
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<tr>
<td>Increase in 25 Percent of Compensation Limitation</td>
<td>Under Section 415(c), total annual contributions to a defined contribution plan may not exceed the lesser of 25 percent of compensation or $35,000.</td>
<td>The 25 percent of compensation Limitation has been increased to 100 percent of compensation. The dollar limitation will still apply. The provision also repeals the maximum exclusion allowance applicable to 403(b) plans.</td>
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<td>Repeal of “Same Desk Rule”</td>
<td>Under the “same desk rule”, a distribution to a terminated employee is not allowed if the employee continues performing the same functions for a successor employer. The same desk rule applies to 401(k), 403(b) or 457 plans.</td>
<td>The same desk rule is eliminated by replacing “separation from service” under Section 401(k)(2)(B) with “severance from employment.” Conforming changes are also made for 403(b) and 457 plans. The provision applies to distributions are after December 31, 2001, regardless of when the severance from employment occurred.</td>
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<tr>
<td>Employers May Disregard Rollovers for Purposes of Cash-Out Amounts</td>
<td>Terminated participants’ benefits may be cashed out if the non-forfeitable present value of such benefits does not exceed $5,000.</td>
<td>A plan is permitted to ignore amounts attributable to rollover contributions when determining the cash-out amount.</td>
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