

# Retirement Plans for Closely Held Businesses:

*A Business Owners/CPA's Reference Guide*

Prepared By:



[www.meloneprivatewealth.com](http://www.meloneprivatewealth.com)

## Important information about this piece:

This material is designed to provide accurate and authoritative information regarding the subject matter covered. You should understand that neither Melone Private Wealth provide tax or legal advice. If tax or legal advice is required, you should seek the services of an appropriate, competent professional.

Investment decisions should be based on investment merit, not solely on tax considerations. However, the effects of taxes are a critical factor in pursuing a desired after-tax return on your investment. The information provided is based on internal and external sources that are considered reliable; however, the accuracy of the information is not guaranteed. You should direct specific questions on taxes as they relate to your situation to your tax advisor.

CAR#1-05096579

# Table of Contents

Page	Topic
4-7	Introduction to Retirement Plans and Fiduciary
8-10	IRA Based Plans: SEP IRA
10-14	IRA Based Plans: Simple IRA
14-16	401(k) Plan
16-19	401(k) Safe Harbor Feature
19-21	Roth 401(k) Feature
21-24	Profit Sharing/New Comparability/Age-Weighted/Permitted Disparity
25-26	Defined Benefit/Cash Balance
27-28	Author Bio

## **Introduction to Retirement Plans and a Fiduciary**

SEP, Profit Sharing, Defined Benefit Plan, SIMPLE, 401(k) and Safe Harbor 401(k). As a business owner, you've probably heard these names before but found them to be quite confusing. Not surprising, most business owners have become successful because they have a product, process or solution to solve for an industry (or some combination of these), however when it comes to understanding how to implement a retirement plan for their thriving business, it can be uncharted territory. And human nature tells us that something unfamiliar typically gets placed at the bottom of the "to-do" list for another day. Well, it's now "another day."

Understanding the different types of retirement plans can be just as important to the growth of your business as the product/process that allowed you to get where you are today. Why? People. More to the point...your employees. In an attempt to attract and retain the quality personnel needed to grow or continue the growth of the business, your company should consider offering a suitable plan. You may be saying to yourself, "I already have a plan in place," great- but is it the correct plan? Have you and your advisors (CPA and CFP) continued reviewing the changing dynamics of the retirement plan world to validate if the plan makes sense from both a cost and tax structure? For instance, have you outgrown the plan you originally implemented or restructured your company so you no longer need the current type of plan in place? These are the questions that need to be asked as a business owner- and answered.

According to Author, Nick Murray, there are three primary issues that have led to an interest in business owners looking to implement a retirement plan for their closely held business:

- I. As the population continues to shift, over next 20 years around 70-80 million people will reach retirement age.
- II. Most people can't comprehend a normal retirement of up to three decades
  - a. Why? No one they know has experienced it and they've most likely watched their parents die in their 60's.
- III. The EBRI's (Employee Benefit Research Institute) 2018 Retirement Confidence Survey, in its 28<sup>rd</sup> year- just four in ten workers (38 percent) report they and/or their spouse have ever tried to calculate how much money they will need to have saved so that they can live comfortably in retirement.

Now, they will most likely figure it out, but will it be too late- this is why business owners need to understand the tools available to properly structure a retirement plan.

What I will be discussing throughout this guide is what are and how the different types of plans

can be utilized for closely held businesses. In addition, how advisors (CPA's and CFP's) can become more comfortable helping identify the correct plan for the business structure, as they are the front line for these conversations with business owners.

### **The first question to answer is...What is a retirement plan?**

Designed to meet the rules set forth by the Internal Revenue Code, a qualified retirement plan is a tax-deferred savings program that benefits employees (and owners). Retirement plans fall into two types of programs — either a defined benefit plan or a defined contribution plan.

*A defined benefit* plan is commonly referred to as a pension plan. With this type of plan, the company/owner makes all the contributions and agrees to pay a certain benefit to an employee upon his or her retirement. This benefit is usually based on the employee's income and years of service. This defined plan is trustee-directed, meaning the employer or the retirement plan trustees decide how to invest the funds in order to pay out the promised future benefit.

*Defined contribution, SEP and SIMPLE plans* can be offered in various forms. Some are entirely trustee-directed; some allow employees to invest only their own money; others allow some combination of the two. The latter two are most often participant-directed; allowing the employee to choose from a set of investment alternatives determined by the employer or the retirement plan trustee(s). Common types of plans include 401(k) plans, profit sharing plans, SEP IRAs or SIMPLE IRAs.

With defined contribution (DC) plans, employees receive what they have invested in the plan as a retirement benefit, along with any earnings accumulated through the investments in the plan. Any employer contributions made to the DC plan may be subject to vesting, which means that employees must accumulate a certain number of years of service before they are eligible to receive the accumulated employer contributions and related earnings from the plan. However, contribution to a SEP or SIMPLE are always 100 percent vested, once eligibility is met.

All these plans are tax-advantaged, meaning any employee contributions reduce pretax earnings so that the employee can defer tax on them until they are distributed.\* In addition, contribution the company may make to the plan can be tax deductible to the business.

*\*Withdrawals are subject to ordinary income tax and may be subject to a federal 10% penalty if taken prior to age 59½.*

**The next question a business owner should have, now that you understand the difference between the two types of programs is...What is my risk of offering a plan through my company, if any?**

A fiduciary is anyone who has authority or control over the management of a retirement plan or the assets in that plan. In other words, if you own a business and you offer a retirement plan, you will likely have fiduciary responsibilities. Making good fiduciary choices allows you to have control over the integrity of the retirement savings for you and your employees.

The responsibility may not lie on your shoulders alone. Plan sponsors (the business owner or corporation), plan trustees, officers and retirement committee members often share in these responsibilities as well.

The Employee Retirement Income Security Act (ERISA) rules and regulations protect the participants and beneficiaries of retirement plans. Honesty and integrity are an issue and the laws obligate fiduciaries to:

- Act in the best interest of plan participants and beneficiaries.
- Understand and disclose all expenses paid from the plan.
- Make prudent decisions regarding the plan, including investments and service providers.
- Act in accordance with the plan document's terms and provisions.
- Monitor the plan's investments.

**Now that you know what a Fiduciary is, here are the responsibilities:**

Your fiduciary responsibilities give you the opportunity to control the retirement investment plan for you and your employees. There are serious legal repercussions for ignoring fiduciary responsibilities such as heavy fines, restoration of losses, and other financial penalties that can intrude into personal assets, as well as incarceration in extreme situations.

For many small-business owners, the fiduciary and legal responsibilities are a major concern. In light of the highly publicized mishandling of some plans, there is also increased employee concern over their retirement plan investments. If you have not reviewed your plan annually with an investment professional, you should.

The review, as well as the ongoing management of your plan, need not be an overwhelming task. Your advisor and representatives from your plan provider can assist you in providing the resources you'll need to help you work toward fulfilling your fiduciary responsibilities. With the help of knowledgeable partners, you will be able to evaluate the benefits of offering a plan.

## How do you know if you're fulfilling your Fiduciary responsibilities?

It may be easier than you expect to judge how well you're fulfilling your duties by starting with the checklist below. If you cannot answer all questions positively, you may need to review your plan. Your Financial Advisor, third-party administrator or the vendor of your current retirement plan can provide a more in-depth review.

- Do you fully understand your existing plan's document and design?
- Do your plan fiduciaries meet regularly and keep notes from these meetings?
- Does your plan have a written investment policy statement?
- Does your plan offer diversified investments?
- Have you reviewed the investments available in your plan within the past 12 months?
- Have you completely reviewed your plan during the last three to four years?
- Do you understand the costs for the services provided by the various organizations and persons who service your plan?
- Does your plan provide employee enrollment programs that explain the benefits of their participation in the plan?
- Does your plan provide periodic education programs to increase participants' understanding of the choices available to them, as well as other financial and retirement planning topics?
- Does your plan provide qualified default investment alternatives (QDIA) for employees who are default enrolled and have not made an investment election?
- Do you understand the ERISA requirements?

An investment policy statement is a first step in fulfilling your responsibilities as a fiduciary as it relates to the investments offered in your company's retirement plan. While not a legal requirement, this process helps you create a road map to guide investment choices. The purpose of the statement is to do the following:

- Create written guidelines and standards to use in selecting investment options for your plan
- Provide a basis to periodically evaluate investment performance within your retirement plan

Your professional advisors can assist you in creating and reviewing your investment policy statement.

The following pages will act to summarize the concepts you will need to know to begin your process of implementation or updating a retirement plan.

## **IRA Based Plans:**

### SEP IRA

#### General Information

---

A **Simplified Employee Pension (SEP)** is a cost effective means for an employer to provide a retirement plan for their employees. The plan allows an employer to make deductible contributions for employees; however, this plan must adhere to provisions contained in a plan document.

A big advantage the SEP IRA plan offers is the ability to be established and funded up to the due date of the employer's tax return plus extensions for the previous calendar year.

- Ideal Company Profile
  - Self-employed, closely held business, or individuals with earned income outside their primary employment
  - Desire for low-cost, easy-to-operate plan
  - Participant investment direction
  - Low employee turnover, with few part-time employees, or high turnover in first two years of employment
  - Willing to contribute to eligible employees including part-time

Any business entity, such as: C-Corp., Partnership, S-Corp., non-profit, government entities and LLC may establish a SEP IRA.

#### Eligibility

---

Employers can generally exclude employees:

- Under age 21
- Who have not worked or performed any service during any part of three of the prior five years
- Who are covered by a collective bargaining agreement
- Who earn less than \$650 in the year in which the contribution is made
- Employees who are nonresident aliens with no U.S. sources of earned income from the employer

The employer specifies the eligibility requirements in the plan adoption agreement. Keep in mind these requirements can be more liberal if the employer elects. Employees will enter the plan on the 1st day of the plan year following completion of the eligibility requirements

specified in the plan adoption agreement and any eligibility requirements chosen for the plan apply to the owner as well as all full and part-time employees.

## Contributions

---

### Contributions are:

- Fully funded by the employer (except grandfathered SAR SEP plans)
- Flexible (the employer can change or discontinue contributions each year)
- Limited to 25% of eligible compensation (the compensation cap is \$290,000 in 2021) not to exceed a total contribution of \$58,000 for 2021, for each individual (including eligible employees that are required to take mandatory distributions). Unincorporated business owners must make adjustments to their own contributions; therefore the full 25% limit doesn't apply to self-employed or unincorporated businesses.
- Made directly to each eligible employees IRA. A new IRA can be established or an existing IRA (traditional, SEP or rollover) can be used. However, a non-SEP IRA would need to be re-coded as a SEP IRA before SEP contributions could be deposited.
- Due by the employer's tax filing deadline, including tax extensions
- Announced, by the employer, to each employee when and how much the company contributed to his or her IRA

Participants are 100% vested in all contributions. Employees cannot make salary deferral contributions to a SEP IRA except those grandfathered in by SAR SEPs.

## Distributions

---

SEP IRAs and traditional IRAs follow the same distribution rules; in addition to ordinary income tax, distributions prior to age 59½ may also be subject to a 10% IRS early withdrawal penalty.

- A premature distribution is a payment from an IRA to a participant BEFORE the age of 59½
- The early distribution penalty does not apply to the following types of distributions from SEP IRAs:
  - Payments made after age 59½
  - Payments made due to the account holders death to the named beneficiary
  - Payments made on account of disability
- Required Minimum Distributions (RMDs) must be taken from SEP IRAs by April 1, following the year you reach age 72
- All withdrawals/distributions taken from a SEP plan are required to be reported to the IRS on form 1099-R.

## Documents

---

Setting up a SEP plan requires completing a SEP adoption agreement, by the employer, which outlines the provisions of the plan.

When the SEP plan is established, the employer completes the SEP adoption agreement and gives a copy to all eligible employees. As mentioned previously, a key benefit of the SEP plan is the ability to be established up to the employer's tax filing deadline, including tax extensions.

*Reclassifying an existing traditional / rollover IRA to a SEP IRA* - An existing Traditional IRA can be re-coded to receive SEP contributions. In addition to SEP contributions, a SEP IRA will accept the IRA owner's personal IRA contribution, direct or indirect rollover transfer from qualified plans, and rollover and transfers from other traditional IRAs.

### **Administration**

There are no annual IRS reporting requirements, other than IRS form 5498, which is provided by the custodian of each IRA.

The employer is required to provide an announcement to each employee when, and how much the company contribution amount is to the IRA for that particular year.

Any newly eligible employees must receive a copy of the SEP Adoption Agreement.

## SIMPLE IRA

### General Information

---

A SIMPLE IRA (**S**avings **I**ncentive **M**atch **P**lan for **E**mployees) allows employees and employers to contribute to an IRA based plan that is set up and designated as SIMPLE IRAs for employees. Under a SIMPLE IRA, employees can elect to defer a portion of their pay known as salary deferral or salary reduction contributions and the employer will make either a matching or non-elective contribution. All contributions, both employee and employer, must be deposited into a SIMPLE IRA for each employee. In essence, the SIMPLE IRA plan is similar to a 401(k) without the required complexity and cost of administration.

As a means of encouraging employee savings, SIMPLE IRA plans have a special holding period requirement. During the first two years (the 2-year period starts from the date of the first deposit into each SIMPLE IRA account) of participation, SIMPLE IRAs can only be commingled (transfers or rollovers) with other SIMPLE IRAs. After the participant has satisfied the two year

requirement, the balance in a SIMPLE IRA can be transferred or rolled into other IRAs (SEP, SAR SEP or Traditional) or qualified retirement plans (401k, 403b, Profit Sharing, Money Purchase) assuming the retirement plan allows for such rollovers. Monies from non-SIMPLE IRA (traditional, SEP, SARSEP, 401(k), Profit Sharing, etc.) accounts can be moved into a SIMPLE IRA after two years from first deposit.

## Eligibility

---

*Employer* – Any employer that has 100 or fewer employees who earned at least \$5,000 in the preceding year. The employer must not maintain any other employer-sponsored retirement plan where contributions are made or accrued during the calendar year in which the SIMPLE plan is effective. However, this does not apply to plans that cover only union employees who are excluded from the SIMPLE plan.

*Employees* – The employer establishes the eligibility requirements for the employees on the plan adoption agreement during the initial plan establishment.

- All employees of the employer who received at least \$5,000 in compensation from the employer during any previous 2 years and is expected to receive at least \$5,000 during the current year must be eligible to participate in the plan for the current calendar year.
- In addition, an employer may also elect to exclude employees that are covered under a collective bargaining agreement, keep in mind the employer does have the ability to reduce these eligibility requirements, however, they cannot make them more stringent.

As a final note, SIMPLE IRA plans do not have an hourly requirement like 401(k) plans. Therefore part-time employees cannot automatically be excluded.

Generally employers will need to include:

- Any employee who has received at least \$5,000 in compensation from the employer during any 2 prior calendar years (whether or not consecutive) and who is reasonably expected to receive at least \$5,000 in compensation during the current year.
- The employer may elect a less restrictive eligibility requirement in the plan adoption agreement. For example: the employer may use any dollar amount from \$0 to \$5,000 and may use 0, 1 or 2 years. If the plan sponsor elects 0 years of service, required compensation must be \$0.
- Once the employee satisfies the eligibility period they will enter the plan based on the entry date defined within the document.

## Contributions

---

Only employee salary deferral and employer (matching or non-elective) contributions and transfer or rollovers from an existing SIMPLE IRA can be deposited into SIMPLE IRAs.

Employer contributions have some flexibility to vary from year to year but must use one of the below formulas:

1. **Matching Contribution** - The lesser of the participant's salary deferral or 3% of such participant's compensation. A lesser match (not less than 1%) cannot occur more than two out of any five year period and there is no compensation cap when using the match method for contributions.
2. **Non-matching Contribution** - 2% of each eligible employee's compensation. Compensation is limited (per employee) to \$290,000 for 2021.

Employee contributions will be selected by the employee on the salary deferral form that is returned to the employer. The maximum dollar amount that can be deferred by an employee is determined based on Cost of Living Adjustments each year. The current limits are as follows:

Year	Limit	Catch Up*
2021	\$13,500	\$3,000

\*Individuals age 50 or older (individuals must turn 50 during the calendar year) may be allowed to make annual catch-up contributions to SIMPLE plans as outlined in the adoption agreement.

*Salary deferral discontinuance* – Employees can modify their salary deferral elections throughout the year.

## Deadlines

---

- **New Plan Establishment** - A newly established SIMPLE IRA plan can be setup any time between January 1 and October 1 provided the employer did not previously sponsor a SIMPLE IRA plan. If the employer has previously sponsored a SIMPLE IRA plan, then they may only establish the new SIMPLE IRA plan effective January 1.
- **Notice to Employees (new plan)** - Employer must give employees at least a 60 day election/notification period to enroll. For the initial year the notification can begin up to the effective date of the plan.
- **Notice to Employees (existing plan)** - November 2 - Notice must be given 60 days prior to plan year.
- **Employee Contributions** - Employer must deposit employee contributions within a reasonable period of time but no later than 30 days after the last day of the month the

employee would have been payable to the employee in cash (this includes self employed individuals).

- *Employer Contributions* - Employer must deposit matching or non-elective contributions into the employees SIMPLE IRA by the businesses tax due date plus extensions for that year.

## Distributions, Rollovers & Transfers

---

- *Distributions* – SIMPLE IRA plan are similar to traditional IRAs as distributions are subject to income taxes. Distributions taken before an employee reaches the age of 59 ½ may have a premature penalty tax imposed by the IRS. The standard premature penalty tax rate is 10%, however in a SIMPLE IRA that penalty is increased to 25% on distributions taken within the first 2 year of participation in the SIMPLE IRA plan. The traditional IRA premature distribution penalty exceptions apply to SIMPLE IRAs.
- *Transfers* – Direct transfer between SIMPLE IRA plans are not subject to income taxes or penalties. SIMPLE IRAs can only be transferred into another SIMPLE IRA during the first two years of participation, as noted above not limited to just the first two years.
- *Rollovers* - To qualify as a tax-free rollover, a rollover made from a SIMPLE IRA during the 2-year period beginning on the date on which you first participated in your employer's SIMPLE plan must be rolled to another SIMPLE IRA. After the 2-year period, amounts in a SIMPLE IRA can be rolled over or transferred tax free to an IRA other than a SIMPLE IRA, or to a qualified plan, a tax-sheltered annuity plan (section 403(b) plan), or deferred compensation plan of a state or local government (section 457 plan).
- All withdrawals/distributions taken from a SIMPLE plan are required to be reported to the IRS on form 1099-R.

## Plan Termination/Discontinuance

---

- *Plan termination* - Other than initial establishment, SIMPLE IRA plans are maintained on a whole-calendar-year basis. Once started for a year, a SIMPLE IRA plan must continue for the entire calendar year and must fund all contributions promised in the employee notice. You can terminate a SIMPLE IRA plan prospectively, beginning with the next calendar year, after you have informed employees that there will be no SIMPLE IRA plan for the upcoming year.

*For Example:* If in 2017 an employer decides to terminate its SIMPLE IRA plan as soon as possible, the employer must inform employees within a reasonable period of time before the 60-day election period ending on December 31, 2017 (November 2), that there will be no SIMPLE IRA plan for 2018. For 2018, the employer can establish and maintain another kind of qualified plan for its employees and, if this other qualified plan is not operative in 2017, re-establish a SIMPLE IRA plan for 2018.

To terminate a SIMPLE IRA, you must also notify your employees by November 2 that you will discontinue the SIMPLE IRA plan.

You do not need to give any notice to the IRS that you have terminated the SIMPLE IRA plan.

## **Qualified Plans – Define Contribution**

### 401(k) Plan

#### General Information

---

A 401(k) is a defined contribution plan that allows both the employee and employer to make contributions into an account for the benefit of the employee in a tax deferred status. Employees contribute to the plan through salary reduction on either a pre-tax basis or post tax basis, depending on the provisions of the 401(k) plan. Employers also have several options to choose from when selecting their contribution formula – matching, non-elective or straight profit sharing contributions. Keep in mind, in order to establish a 401(k) plan an adoption agreement/plan document must be completed and signed by the employer that outlines the parameters of the plan such as eligibility, vesting, contributions, distributions, etc. prior to the end of the year in which it is effective. Failure to have an adoption agreement/plan document could jeopardize the entire tax qualified status of the plan.

#### Eligibility

---

*Employer* – Any business (except Government entities), whether a C Corporation, S Corporation, Partnership, Sole Proprietor, self-employed or even a nonprofit agency can establish a 401(k) plan.

*Employee* – The employer establishes the eligibility requirements in the plan adoption agreement when they are establishing the plan. Typical exclusions that an employer may implement to determine eligibility include minimum age, years of service and union employee status. Listed below are the maximum requirements an employer can implement. Keep in mind, an employer can lessen these requirements if they choose.

- Age requirements: 21
- Years of Service: 1 year (defined by working 1,000 hours) not 365 days

As a note, in some situations there might be additional classes/categories of employees that are excluded from participation in the plan. The provisions of the plan document will determine who is eligible for participation in the plan. The employer should speak with their third party administrator for assistance in determining the correct eligibility parameters for their situation.

## Plan Features / Types

---

There are different types and features of 401(k) plans that have evolved over the years. Some of the types permit employers to minimize the discrimination testing required on 401(k) plans, while others permit employees to make Roth (after-tax) contributions. It is important to understand these are characteristics built into the 401(k) plan, rather than a completely different plan. Below are many of those features, which will be covered later:

- Safe Harbor 401(k)
- Roth 401(k)
- Individual 401(k)
- Profit Sharing- includes integrated social security, age weighted and new comparability

## Contributions

---

In all 401(k) plans, employees that meet eligibility can make contributions through salary deductions. However, whether or not the contributions are pre-tax will depend on whether the employee is making after tax contributions, Roth deferrals or pre-tax contributions. This is determined based on what features are available within the plan document and what elections are made by the employee on their salary deferral form. An employee is always 100% vested in their own salary deduction contributions. The current contribution limits for an individual employee is as follows:

In traditional 401(k) plans, the highly compensated employee's (as defined in the Plan Document) contributions are limited based on the results of the (ADP/ACP) Discrimination Test.

Year	Limit	Catch Up*
2021	\$19,500	\$6,500

\*Individuals age 50 or older (individuals must turn 50 during the calendar year) may be allowed to make annual catch-up contributions to 401(k) plans as outlined in the adoption agreement.

In addition, employers have the ability to make employer contributions to the plan on either a matching, non-elective or straight profit sharing basis. In some cases, the employers may also have the flexibility to not make any contributions to the plan. This will be determined based on the features utilized within their plan adoption agreement. Keep in mind, both employee and employer contributions (including forfeiture allocations) are subject to an individual employee limit that is determined based on annual COLA limits.

## Distributions

---

Participants have access to a distribution upon meeting specific triggering events as defined in the plan document. Generally, employees are not permitted to take withdrawals from a 401(k) plan until they reach the age of 59 1/2 unless there are certain financial and other hardship events. In some situations, a plan (as determined by the plan document) may permit an employee to take an (non-hardship) in-service withdrawal for reason other than hardship. If this happens, it is important to understand the in-service withdrawal is still subject to ordinary income taxes and if younger than age 59 ½ potentially a premature distribution penalty. All withdrawals/distributions taken from a 401(k) plan are required to be reported to the IRS on form 1099-R.

If the plan does not permit in-service withdrawals, there might be another avenue available for participants that have a short-term need for access to their 401(k) plan assets, through a loan.

Once participants have reached the age 72 they are required to begin receiving required minimum distribution, unless they are still employed and the plan permits them to defer distributions. However, 5% owners are required to take RMD's.

## Plan Termination / Discontinuance

---

Although retirement plans must be established with the intention of being a permanent and ongoing plan, employers have the ability to terminate the plan. If a 401(k) plan terminates or becomes insolvent, participant benefits under the plan automatically become 100% vested. In addition, there are several steps that the employer must follow to properly terminate the plan. Employers are encouraged to work with their third party administrator or record-keeper to implement a plan termination strategy which also encompasses participant notification, required filings and ultimate distribution of plan assets.

## 401(k) Safe Harbor Feature

### General Information

---

The Safe Harbor provisions of a 401(k) plan allow the employer to avoid discrimination testing (ADP/ACP) usually associated with a traditional 401(k). A Safe Harbor 401(k) provides a way for the Highly Compensated Employees to maximize their salary deferrals through payroll deduction of \$19,500 for 2021. The tradeoff is the employer must make a minimum fully vested Safe Harbor contribution to the plan. The following are the two types of Safe Harbor contributions the employer can choose from:

*Matching Contribution - Basic or Enhanced* Under the match formula, the employer will provide the Safe Harbor contribution to any eligible employee that elects to participate, through payroll deduction, into the plan. The matching formula provides two options to choose from:

1. The basic match formula is defined as a 100% match on the first 3% of compensation deferred and a 50% match on the next 2% of compensation deferred. Ex: Employee earning \$50,000 defers 5% which = \$2500; the employer match calculation is  $\$50,000 \times 3\% = \$1500$ ;  $+ \$50,000 \times 1\% = \$500$ . The total employer contribution added together = \$2000.
2. The enhanced match formula allows the plan sponsor to "tailor" the formula used to calculate the match. It must be equal to at least the amount a participant would receive under the basic match; for example 150% on the first 3% of compensation or 100% on the first 4% of compensation. However, the match formula cannot require participants to defer more than 6% to receive the full matching contribution.

*Non-Elective Contribution* Under the Non-Elective formula the employer will provide a minimum of a 3% (or more) Safe Harbor contribution to all eligible employees, regardless of their participation in the plan.

#### General Rules for Safe Harbor Contributions

---

- All Safe Harbor contributions are 100% vested.
- There cannot be any restrictions imposed on the allocations of Safe Harbor contributions (hour or last day requirement). This is not the same as the eligibility requirements for the plan.
- Safe Harbor contributions are not available for in-service withdrawals before age 59½. If the plan document allows, you can take hardship distributions from Safe Harbor funds.
- All eligible participants must receive an annual Safe Harbor notice, 30 days prior to the beginning of the plan year, for the Safe Harbor provisions of the plan. There is an exception to the 30 day notice for a new 401(k) plan adopting the Safe Harbor design. The plan sponsor can provide the notice simultaneously at the time the plan is established.

- Safe Harbor contributions cannot be used to satisfy permitted disparity (social security integration); however permitted disparity can be used with additional profit sharing contributions made to the plan.

## Mid-Year Changes

---

Safe harbors also include limits on mid-year changes and a requirement to provide notice to plan participants explaining the safe harbor feature. If the mid-year change is to a plan's required safe harbor notice content, the plan sponsor generally must:

- Provide an updated safe harbor notice that describes the mid-year change and its effective date within a reasonable period before the effective date of the change to each employee that must otherwise receive a safe harbor notice. Providing the notice 30-90 days before the effective date is deemed reasonable.
- Give each notified employee a reasonable period of time to change their cash or deferral election after receipt and before the effective date of the change. A 30-day election period is deemed reasonable.
- Under the SECURE Act (Section 103) for plan years beginning after December 31, 2019, the safe harbor notice requirement for nonelective contributions is eliminated. The requirement to allow employees to change their cash or deferral at least once a year is maintained. Plan Sponsors are allowed to switch to a safe harbor 401(k) plan with nonelective contributions prior to the 30th day before the end of the plan year. Alternatively, if the amendment provides for a nonelective contribution of 4% (instead of 3% of compensation) for the plan year, the amendment may be made any time prior to the last day of the following plan year.

## Additional Contributions

---

A Safe Harbor plan may make additional matching and/or profit sharing contributions. These additional contributions can be structured as discretionary or non-discretionary and matching or non-matching. If structured as a discretionary match, the match formula cannot be structured where the match exceeds 4% of compensation and it cannot require a participant to defer more than 6% of their eligible compensation to receive the match, thus subjecting the plan to the discrimination testing and possible top heavy testing. Vesting schedules can be applied to the additional contributions.

## Establishing a Safe Harbor 401(k) Plan

---

### *Existing 401(k) Plan*

A traditional 401(k) can only be amended to allow Safe Harbor provisions prior to the beginning of the plan year in which it becomes effective (i.e. calendar year plan amends document by December 31, to be effective by January 1, of the next year). The plan sponsor must

provide notice no less than 30 days prior to the first day of the new plan year of the Safe Harbor election. For calendar year plans, the notice must be provided by Dec.1, of the prior year.

*New 401(k)  
Plan/Converting an  
Existing Profit Sharing  
Plan*

A new 401(k) plan/feature may adopt the Safe Harbor provision at the same time the plan is being established, assuming the notice is provided at that time. In order to use the Safe Harbor provision, there must be at least 3 months remaining in the plan year to make salary deferral contributions to the plan. Example: A newly established calendar year Safe Harbor plan must be set up no later than October 1.

IRS Notice 2000-3, "Maybe Notice" or "Flexible Non-Elective Notice"

---

The "maybe notice" provides plan sponsors considering the Safe Harbor 401(k) some additional flexibility when establishing or converting their plan. An employer may adopt a new Safe Harbor 401(k) provided it will have at least a three-month plan year. However, to take advantage of the flexibility three conditions must be satisfied:

- Eligible employees must be given notice 30 days prior to the beginning of the plan year stating the plan sponsor may choose to amend the plan to a Safe Harbor.
- The Safe Harbor contribution must be the 3% non-elective contribution.
- Participants must receive a second notice, at least 30 days before the end of the plan year, if the plan is amended to a Safe Harbor. The notice must also state a 3% non-elective contribution will be made for the plan year.

Terminating Safe Harbor Status

---

A Safe Harbor 401(k) can be amended to a Traditional 401(k) at any time. However, a 30 day notice must be provided to employees stating the plan is being amended to remove the Safe Harbor provision. The Safe Harbor contribution is required up until the 30 day notice expires. This will also subject the plan to ADP, ACP and top heavy testing for the entire year, could lead to highly compensated employees contributions refunded to them by the end of the year and possibly requiring additional contributions, if the plan is found to be top heavy.

## Roth 401(k) Feature

General Information

---

The plan document will determine the availability of the Roth feature and the eligibility to participate in the retirement plan.

## The Basics of Roth 401(k) Contributions

- Only available to employees eligible to make elective contributions.
- Irrevocably designated by employee as Roth contribution at the time of deferral. An employee cannot later elect to re-characterize these deferrals.
- Separate accounting applies at the time the first contribution is made and continues to apply until complete distribution of the Roth account. Roth 401(k) contributions must be kept separate from traditional after tax employee contributions.
- A qualified distribution from a Roth account will not be subject to taxation.
- Elective contributions are treated by the employer as wages and subject to applicable withholding requirements at the time the employee would have received the contribution amount in cash.
- Unlike Roth IRAs, no income restrictions on the ability to make Roth 401(k) contributions.
- Roth contributions are 100% vested at all times.
- Employers are restricted from offering a Roth 401(k) only option; if Roth 401(k)'s are offered a pretax elective deferral option must also be offered.

## Contributions and Testing Requirements

Roth contributions are subject to the:

- Annual dollar limit on deferrals \$19,500 for 2021. In other words, pre-tax elective deferrals and after-tax Roth deferrals are combined together in determining this limit.
- Catch-up contribution limits \$6,500 for 2021. In other words, the catch-up limit applies to a participant's combined pretax deferrals and Roth contributions.
- Actual Deferral Percentage (ADP) test, but not Actual Contribution Percentage (ACP) test.
- Overall contribution limits under section 415, currently the lesser of 100% of compensation or \$58,000 for 2021 and is subject to cost of living adjustments in future years.
- Form W-2 reporting instructions and are included as taxable wages on W-2.
- Top-heavy rules.

If Roth contributions are matched, the matching contributions will be made on a pretax basis and subject to taxes upon distribution.

## Distributions and Rollovers

- A qualified distribution is one that is made after age 59½, death or disability and is made at least 5 years after the date of the first Roth contribution.
- A qualified distribution from a Roth 401(k) may only be rolled over to another Roth 401(k) plan that accepts rollovers or to a Roth IRA. Roth 401(k)s cannot be rolled into a 403(b) or Governmental 457(b), unless the 403(b) states it will accept such rollovers. If rolled to a Roth IRA, the amount of the rollover will be recorded as basis in the Roth IRA. The 5 year holding period will begin at the time of the rollover (the 5 year period starts over), unless the participant already maintains a Roth IRA before the rollover.
- If the distribution is not a qualified distribution, then the accumulated earnings will be subject to tax and additional tax penalties may apply.
- Roth contributions are treated as elective contributions, so distributions may only be made upon termination of employment, death, disability, retirement, or if permitted under the plan, attainment of 59½ or hardship. Although distributions are permitted for the above reasons, tax-free distributions are only available to qualified distributions.
- Roth 401(k) contributions are subject to minimum required distribution rules, which is opposite of the Roth IRA rules.
- Roth distributions will be reported on Form 1099-R.

### Documentation and Administration

- Plan Sponsors will need to amend their documents to offer the Roth 401(k) provision within their plan by the end of the plan year in which the provision is added.
- If an employer intends to add Roth 401(k) contributions to their plan, they will want to consider the following action steps:
  - Check whether payroll and recordkeeping systems have been adjusted to separately account for Roth contributions.
  - Prepare and distribute employee communications describing the benefits of Roth contributions.
  - Prepare and distribute a revised Summary Plan Description.
  - Obtain new deferral election forms from participants prior to the time that Roth contributions are permitted.
  - Amend the plan to provide for Roth contributions.

### Roth Conversions

In-plan Roth Conversion options are now available, if the following requirements are met:

- Plan must accept or has previously accepted Roth elective deferrals

- In-service withdrawals are not required to permit distributions from the plan
- Amendment to the plan document is required

In late 2012, the requirement that an account balance can only be converted to a Roth if the amount is otherwise distributable has been eliminated. A plan which permits Roth elective contributions can allow any amount in a Non-Roth account to be converted to a Roth account.

## Profit Sharing/New Comparability/Age-Weighted/ Permitted Disparity

### General Information

---

A profit sharing plan is a type of defined contribution plan. This type of plan can be used as a stand-alone plan or in many cases it is used in conjunction with a 401(k) plan. If used in conjunction with a 401(k), typically the employer adopts a 401(k) plan document with a profit sharing feature to avoid having two plan documents. Contributions to profit sharing plans can vary in method of allocation and dollar amount from one year to the next. However, an employer does have the ability to have a fixed (stated) contribution in the plan document.

The most common contribution formula to a profit sharing plan is a discretionary formula where the employer determines the amount of the contribution each year. If the plan is determined to be top-heavy, each non-key employee must receive a minimum top heavy contribution. The maximum contribution that can be deducted (the 404(a) limit) by an employer for a profit sharing plan is 25% of the total plan's eligible compensation. Eligible compensation will be defined by the plan document but the maximum amount of eligible compensation per eligible participant is \$290,000 for 2021. The most that can be allocated to a participant under the plan is the lesser of 100% of compensation or \$58,000 for 2021 under the code section 415.

The participant limit includes any employee salary deferrals, employer contributions and forfeitures if allowed in the plan. There are several different allocation methods that can be used with a profit sharing plan including proportionate compensation, Social Security integration/permitted disparity, age-weighted and new comparability/cross-tested. Each allocation formula is highlighted below. Keep in mind profit sharing plans are not considered pension plans, and therefore the ultimate benefits at retirement age from the plan are based on the investment performance and the frequency of contributions. There are no guarantees of benefits.

### Proportionate Compensation

---

In this allocation formula, the plan sponsor will select the percentage to be allocated to each participant under the plan. Typically, the percent is between 0 - 25. Each participant (whether owner or eligible employee) will receive the same percentage of contribution based on their compensation. The actual dollar amount of the contribution will vary based on the compensation received by each participant. This is the easiest of allocation methods.

### Permitted Disparity

---

Permitted disparity refers to special rules which permit employers to take into account contributions to the Social Security system, on behalf of employees, when they compute retirement plan contributions. These rules result in contributions weighted in favor of highly paid employees. The benefits of the plan, when combined with Social Security benefits, result in a uniform non-discriminatory level of total benefits. In general, the goal of integration is to provide the same percentage level of employer-paid retirement income for each participant.

With permitted disparity, contributions to retirement plans are reduced for all workers, but only to the extent of retirement plan contributions relating to salary below a certain level, "the permitted disparity level". Typically, the permitted disparity level is the taxable wage base in effect for the year, \$142,800 for 2021. Permitted disparity levels below the taxable wage base are allowed, depending on the plan document, but certain other adjustments to the calculation must be made if a lower level is chosen.

When performing the social security permitted disparity calculation specific requirements must be met to avoid being discriminatory. As an example:

- The permitted disparity level used in the plan must meet certain requirements.
- The percentage of contribution allocated to excess compensation (the amount of compensation earned over the stated permitted disparity level in the plan is limited based on the permitted disparity level and the contribution percentage allocated to base compensation is the amount of compensation at or below the permitted disparity level).

The actual calculation can vary somewhat depending on the specific integration formula chosen and if the plan is top heavy. For this reason, the calculation should be performed by the plan administrator, CPA, pension attorney or independent third party administrator.

When should an employer consider using this method?

- The employer has a desire to reduce the total contributions to the plan, but still provide a larger benefit to the higher paid participants.

- There is a disparity between the compensation levels of those employees targeted for the higher benefits.

### Age-Weighted

---

An age-weighted allocation provides the ability to skew contributions in favor of older employees, given these contributions are based on both the age and compensation of the employees. The theory behind age weighting is that older employees, nearing retirement age have less time for retirement assets to grow therefore allowing them to receive larger retirement allocations compared to younger employees who have time on their side.

An age-weighted allocation is based on a participant's eventual benefits rather than the contributions allocated to his or her account. This type of plan will not be considered discriminatory as long as the projected retirement age benefits are "equivalent" according to actuarial guidelines established by the IRS. For example, it is possible that a 1% allocation for a 20 year old employee and a 10% allocation for a 55 year old employee will result in the same equivalent benefit.

Before implementing an age-weighted allocation, confirm with the plan's third party administrator they have the capabilities of performing the calculation.

### New Comparability/Cross-Tested

---

The new comparability method also referred to as cross-tested is an age sensitive allocation method that allows the employer to divide employees into specific groups and allocate the contribution differently to each group. The plan must define groups; employees can be divided by "class" distinctions, for example: Owner/highly compensated employees as Group 1 and all other employees as Group 2. Typically these plans should be used for companies where the employees who are targeted to receive larger contributions are on average older and higher compensated than other employees. It is possible to have younger employees in the "preferred" group and still pass IRS testing requirements if the remaining employee base is large enough and young enough. The disparity between the percentage of the contribution allocated between the different groups can be significant. It is dependent on the average age and salary of each employee. These plans are designed to be top heavy.

Discrimination testing under a new comparability allocation formula is achieved by either testing contributions alone or converting contributions to an equivalent benefit accrual rate (EBAR) such as in defined benefit plans. These accrued benefits are then tested against each other to pass discrimination tests. This is usually a complicated set of calculations and normally requires actuarial consulting, but is still less expensive and more flexible than a defined benefit plan.

Given the complexity of these plans it is strongly encouraged to hire a professional third party administrator for assistance in operating the plan. Consequently, an employer wishing to establish this type of plan typically utilizes the services of a third party administrator to provide document and administrative assistance.

When should an employer consider using this allocation method?

- There is a desire to maximize contributions to the owners/key employees and still minimize contributions to remaining employees
- The employer wants to give different contribution percentages among various groups of employees according to job classification or descriptions. A typical example:
  - Business = Law Firm
    - Group 1 - Partners
    - Group 2 - Non-Partner Attorneys
    - Group 3 - Paralegals
    - Group 4 - Clerical Staff

Keep in mind the above is just an example and actual group classifications and contribution allocations depend upon all eligible employees' age and compensation.

## DEFINED BENEFIT/CASH BALANCE

### General Information

---

#### Traditional Defined Benefit Plans

---

A traditional defined benefit plan is a required funding plan, meaning the employer doesn't have discretion for making contributions each year. The contributions are required in order to pay the benefits the employees are earning. These plans provide employees a benefit at retirement that is communicated as a specific monthly benefit. The amount of the benefit is usually calculated based on such factors as:

- Age
- Years of service
- Compensation

There are many different formulas that can be utilized to determine the compensation used in the benefit calculation. Keep in mind the plan document will outline the criteria used to calculate benefits under the plan, given the contributions to a traditional defined benefit plan are determined on an actuarial basis and dependent on factors such as changes in employee census, assumed interest rates and investment performance.

## Distribution Options

The normal form of payment for a traditional defined benefit plan is a monthly benefit normally payable in the form of an annuity. The plan might offer several annuity options that need to be carefully evaluated prior to making an election. In some situations, the plan might also offer a lump-sum distribution, which can be rolled into an IRA.

## Cash Balance Plan

---

A cash balance plan is a defined benefit plan but operates more like a hybrid retirement plan in that it has the features of both a traditional defined benefit plan and a defined contribution plan. A cash balance plan resembles a defined contribution plan in the fact that participants receive their benefits communicated as an account value. In a typical cash balance plan, each year a participant's account is credited with the following:

- Pay credits (percentage of compensation)
- Interest credits (interest on the account balance)

Keep in mind the plan document will outline the formulas used in these calculations.

## Distribution Options

The required form of payment on a cash balance plan is an annuity, however many participants elect payment on a cash balance plan as a lump sum payment to an IRA.

## Contributions/Investments (Traditional Defined Benefit and Cash Balance)

---

In cash balance plans, the interest credit (or a traditional defined benefit plan assumed rate or return) plays a vital role in the amount of required funding by the employer. If the plan provides for an interest credit/rate of return of 5% and the plan only earns 3%, the employer will need to make a larger contribution to make up the difference in the promised benefit to the participants. Vice versa, if the plan earns more than the stated interest credit/rate of return, the contributions to the plan will be lower than projected. Keep in mind, the actual out of pocket contribution is where the business receives the tax deduction. These plans also hold all assets in the plan as a pooled account, so the employer should implement an investment policy statement and consider an investment mix that:

- Can provide a predictable rate of return.
- Is based on a long-term investment strategy.
- Is liquid enough to pay benefits at precisely the time they are needed.

The Supreme Court has ruled that in-kind contributions to a pension plan is a prohibited transaction. Therefore, only cash contributions are permitted.

\*This information was developed as a general guide to educate plan sponsors. Each plan has unique requirements, and you should consult your attorney or tax advisor for guidance on your specific situation. In no way does advisor assure that, by using the information provided, plan sponsor will be in compliance with ERISA regulations.

## About the Author:

### **Lou Melone, CFP® Managing Partner**

As a board CERTIFIED FINANCIAL PLANNER™ professional, Lou provides comprehensive financial planning strategies for higher net-worth families to help protect and preserve current levels of wealth, plan for retirement, as well as, designing retirement plans for closely held businesses.

Lou began his career with Dean Witter which evolved into Morgan Stanley. He then moved his practice to Smith Barney before forming Melone Private Wealth, LLC, A Registered Investment Advisory Firm.

### **Affiliations and Memberships**

- Consultant for the Michigan Association of CPA's (MICPA) Financial Planning Task Force

### **Thought Leadership**

- Featured speaker at the Michigan Association of CPA's Mega/Summer Conferences for the past nineteen years

- Provides webinars for MICPA members across the United States. Topics have ranged from Behavioral Finance, Comprehensive Financial Planning Process, and Types of Qualified Plans for Small Business Owners
- Former Columnist DBusiness.com, Detroit's Premiere Business Journal

### **Recognition**

- 9-time winner of 5 Star Wealth Planner Award\* awarded by *Hour Detroit Magazine* and *Forbes* which is given to top 7% of wealth planners in South East Michigan

### **Education**

- BA, Northern Michigan University
- Certified Financial Planner (CFP® Certification), The American College
- Certificate- Applied Behavioral Finance, IMCA®

*Securities offered through LPL Financial, Member FINRA/SIPC. Investment Advice offered through Melone Private Wealth, a registered investment advisor. Melone Private Wealth is a separate entity from LPL Financial.*

\*Award based on 10 objective criteria associated with providing quality services to clients such as credentials, experience, and assets under management among other factors. Wealth managers do not pay a fee to be considered or placed on the final list of 2012/2013/2014/2015/2016/2017/2018/2019 Five Star Wealth Managers.