

401(k) Profit Sharing Plan

General Overview (For plan years beginning in 2020)

A profit sharing 401(k) plan allows contributions through three different methods: employer profit sharing, matching and employee 401(k) salary deferrals.

Profit Sharing

Contrary to what the name may imply contributions to a profit sharing plan are not based on the profitability of the company. Contributions can be allocated based on the amount of each participant's compensation, job class, and/or age. The employer may vary the contributions year to year, ranging from 0 to 25% of eligible compensation, considering no more than \$285,000 (2020 index) individually as compensation. The deadline for company contributions is the company's year-end tax return deadline including extensions.

For eligibility, the employer may be more lenient, but not stricter than excluding any employee: under age 21, less than 1 year of service (may be 2 years if 100% vested), under 1,000 hours per year and union employees. There may also be a class exclusion of 30% of the eligible non-highly compensated employees. Generally the only class excluded is employees not employed on the last day of the plan year. Once an employee meets the eligibility requirements they will typically enter the plan the first day of the plan year or seventh month (January 1 or July 1).

Employer contributions may come under a vesting schedule. Vesting is the employees' right to the employers' contribution. The most common schedule is 20% per year up to six years and goes 0-20-40-60-80-100%. Vesting may start at date of hire or for new plans, everyone may start at 0% vesting. The forfeitures under vesting may be reallocated to the remaining employees as a percent of compensation or used to reduce employer contributions.

401(k) / ADP Test

Employees may contribute 100% of compensation up to \$19,500 (2020 index). All employee contributions will be 100% vested. There are no Federal or State income taxes on 401(k) contributions. The Actual Deferral Percentage (ADP) test must be passed where the average of the non-highly compensated employees is calculated and the highly compensated employees may contribute a slightly higher average. Either the current or prior years' non-highly compensated average should be elected at plan set up. In 2020, highly compensated is defined as: over 5% owner, compensation over \$125,000 in 2019 (may limit to top 20%), or a spouse or linear relation.

Individuals age 50 or older may contribute an additional catch-up contribution of \$6,500 in 2020. This will not be subject to any tests (ADP) or limits.

Roth 401(k) contributions are also available. These contributions are after-tax and therefore not taxed at retirement. Employees are not limited by the IRA compensation limits. Roth and regular 401(k) contributions are combined for testing and limited to \$19,500 (\$26,000 if age 50). Separate accounting is required for the Roth 401(k).

Employers may choose to require an Automatic Enrollment provision with a 30 day employee notice. This usually deducts about 3-10% of compensation unless employees opt out within 90 days after the first salary deferral.

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Match

The employer may offer a match, to increase participation, which can come under a vesting schedule. For example, 25¢ on the \$1 up to 4% of pay. The match may be discretionary, as long as the employer allows the employees to change their 401(k) election if the match is changed.

Top-Heavy Test

If your plan is top-heavy (the total of the accounts of all key employees exceeds 60% of the total of the accounts of all employees) you are required to make a minimum contribution to non-key employees equal to the lesser of 3% of compensation or the highest contribution percentage rate for a key employee. You may also contribute the same percent for the key employees. This contribution will come under the vesting schedule. If the plan is top-heavy a contribution can be avoided if none of the key employees use the 401(k) in that year.

For 2020, key employee is defined as: over 5% owner, a >1% owner with compensation at or above \$150,000, an officer with compensation at or above \$185,000, or a spouse or linear relation.

Safe Harbor Options

An employer may choose to make a 100% vested contribution (except auto enroll) to the employees to pass the ADP and top-heavy tests. This must include eligible employees who terminate before the end of the year. New plans must be in place for at least 90 days. These options are:

- 1) 3% contribution to all eligible non-highly compensated employees (may also include highly compensated). 3% may do “double duty” counting as a basis for new comparability plans based on job class. Final notice due 30 days prior to plan year-end.
- 2) Match non-highly compensated employees \$1 for \$1 up to 3%, plus 50¢ on the \$1.00 from 3% to 5% (may increase match to \$1 for \$1 up to 6% of pay and include highly compensated). Final notice due 30 days prior to plan year beginning, except for new plans.
- 3) Automatic Enrollment provision at 6% of compensation over 4 years and a \$1 for \$1 match up to 3½% with vesting after 2 years. Final notice due 30 days prior to plan year beginning.

Limits

No more than \$285,000 (2020 index) may be considered as a basis of compensation. The most an individual may receive from the three sources (profit sharing, match and 401(k)) is 100% of compensation up to \$57,000 (\$63,500 if age 50).

The plan is still a profit sharing plan that has matching and 401(k) provisions within. Therefore, the employer match and profit sharing (401(k) excluded) plan contributions are limited to 25% of eligible compensation. Since this is an average of all employer contributions (401(k) excluded) some individuals may receive 100% while the total employer contribution is still under the 25% limit.

Investments

The plans are self-trusted so the employer can choose any legal non-foreign investment. Often the employer will control the profit sharing as it comes under the vesting schedule and therefore may not yet be owned by the employee.

The employees usually control their own 401(k) contribution. Each employee can have their own segregated account where they can obtain their balance at any time as well as trade the account within a menu of funds. Employees should be given the choice of at least four investments, ranging from conservative to aggressive.

If you have any questions or would like to meet with a plan consultant, please call FARMER & BETTS.