Benefits Insights

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401(k) Plans for Small Businesses

401(k) plans can be a powerful tool to promote financial security in retirement. They provide a host of benefits for employers, including aiding in hiring and retention, tax-advantaged contributions, and the ability to include all employees, owners and managers. Employees also enjoy advantages such as flexibility with contributions and investment options, tax-free contributions and earnings, and often portability if they leave the company.

Establishing a 401(k) Plan

You must decide whether to set up the plan yourself or to consult a professional to help establish and maintain the plan. You also need to decide which type of 401(k) plan is best for you.

- **Traditional 401(k) plans** offer the most flexibility. Employers have discretion over whether to make contributions on behalf of all participants, to match employees' deferrals, or to do both. Annual testing ensures that benefits for rank-and-file employees are proportional to benefits for owners/managers.
- **Safe harbor 401(k) plans** include several kinds of 401(k) plans that aren't subject to the annual benefits testing required with traditional 401(k) plans. However, employees in these plans must receive a certain level of employer contributions.
- **Automatic enrollment 401(k) plans** allow you to automatically enroll employees and place deductions from their salaries in certain default investments, unless the employee elects otherwise. This is an effective way for employers to increase participation in their 401(k) plans.

In addition, there are four initial steps to establishing your 401(k) plan.

- **Adopt a written plan document**. This serves as the foundation for day-to-day plan operations and you are bound by the terms of this document. If you have hired someone to help with your plan, that person likely will provide the document, or you may want to obtain assistance from a financial institution or professional. You have flexibility in choosing some plan features, while others are required by law.
- **Arrange a trust fund for the plan's assets**. A plan's assets must be held in trust to assure that assets are used solely to benefit the participants and their beneficiaries. The trust must have at least one trustee to handle contributions, plan investments and distributions. If you set up your plan through insurance contracts, the contracts do not need to be held in trust.
- **Develop a recordkeeping system.** An accurate recordkeeping system will track and properly attribute contributions, earnings and losses, plan investments, expenses and benefit distributions, and will help prepare the plan's annual return/report that must be filed with the government. If a financial institution assists in managing the plan, it typically will help keep the required records.
- **Provide plan information to employees eligible to participate.** You must notify employees who are eligible to participate in the plan about certain benefits, rights and features. In addition, a summary plan description (SPD) must be provided to all

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participants. The SPD is the primary vehicle to inform participants and beneficiaries about the plan and how it operates. The SPD is typically created with the plan document. You also may want to provide employees with information on the advantages of your 401(k) plan to encourage participation. and benefits provided do not discriminate in favor of HCIs or certain shareholders or owners. If discrimination is found in a dependent care assistance program, these individuals must include dependent care benefits in their gross income.

Operating a 401(k) Plan

Once you have established a 401(k) plan, you assume certain responsibilities—or you may choose to hire a professional to help in the operation of the plan. The following are the main responsibilities associated with a 401(k) plan.

Participation

Typically, a plan includes a mix of rank-and-file employees and owners or managers. However, some employees may be excluded from a 401(k) plan if they are under 21, have not completed a year of service or are covered under a collective bargaining agreement that does not provide for participation in the plan.

Contributions

In all 401(k) plans, participants can make contributions through salary deductions. Employers can also make contributions for participants.

Traditional 401(k) Plan—If you decide to contribute to your plan, you have options. You can contribute a percentage of each employee's compensation to the employee's account (a non-elective contribution), you can match the amount your employees decide to contribute, or you can do both. Under a traditional 401(k) plan, you also have the flexibility of changing the amount of employer contributions each year, according to business conditions.

Safe Harbor 401(k) Plan—Under a safe harbor plan, you can match each eligible employee's contribution, dollar for dollar, up to 3 percent of the employee's compensation, and 50 cents on the dollar for employee contributions that exceeds 3 percent, up to 5 percent of each employee's compensation. Alternatively, you can make a non-elective contribution equal to 3 percent of compensation to each eligible employee's account. Each year you must make either matching or non-elective contributions. The plan document will specify which contributions will be made and this information must be provided to employees before the beginning of each year.

Roth Contributions - 401(k) plans may permit employees to make after-tax contributions through salary deduction. These designated Roth contributions, as well as gains and losses, are accounted for separately from pretax contributions. However, they are treated the same as pretax contributions for many key aspects of the plan, such as contribution limits. A 401(k) plan may allow participants to transfer certain amounts in the plan to their designated Roth account in the plan.

Contribution Limits - Employer and employee contributions and forfeitures (non-vested employer contributions of terminated participants) are subject to a per-employee overall annual limitation. This limit is the lesser of:

- 100 percent of the employee's compensation, or
- $56,000 for 2019

In addition, the amount employees can contribute under any 401(k) plan is limited to $19,000 for 2019.

All 401(k) plans can allow catch-up contributions of $6,000 for 2019 for employees age 50 and over.

Vesting

Employee salary deferrals are immediately 100 percent vested—that is, the money that an employee has contributed cannot be forfeited. When an employee leaves employment, he or she is entitled to those deferrals, plus any investment gains (or minus losses). In safe harbor 401(k) plans, all required employer contributions are always 100 percent vested. In traditional 401(k) plans, you can design your plan so that employer contributions become vested over time.

Nondiscrimination

To preserve the tax benefits of a 401(k) plan, the plan must provide substantive benefits for all employees, not just owners and managers. These requirements are called nondiscrimination rules and compare both plan participation and contributions of rank-and-file employees to owners or managers. Traditional 401(k) plans are subject to annual nondiscrimination testing; most safe harbor 401(k) plans are not.

Investing 401(k) Plan Monies
You will need to decide whether to permit employees to direct their investments or to manage the monies on their behalf. If you choose the former, you also choose investment options to make available to the participants. Depending on the plan design you choose, you may want to hire someone either to determine the investment options to make available or to manage the plan's investments. Continually monitoring the investment options ensures that your selections remain in the best interests of your plan and its participants.

Fiduciary Responsibilities
Many of the actions needed to operate a 401(k) plan involve fiduciary decisions. Controlling the assets of the plan or using discretion in administering and managing the plan makes you (and the entity you hire) a plan fiduciary to the extent of that discretion or control. Fiduciary status is based on the functions performed for the plan, not a title. Persons or entities that are fiduciaries are in a position of trust to the participants and beneficiaries in the plan and must carry out the following responsibilities:

- Acting solely in the interest of the participants and their beneficiaries
- Acting for the exclusive purpose of providing benefits to workers participating in the plan and their beneficiaries, and defraying reasonable expenses of the plan
- Carrying out duties with the care, skill and diligence of a prudent person familiar with such matters
- Following the plan documents
- Diversifying plan investments

It is important that fiduciaries are familiar with the requirements and laws regarding operation of a 401(k) plan—you may want to consult legal and investment professionals in carrying out these duties.

Disclosing Plan Information to Participants
Plan disclosure documents keep participants informed about the basics of plan operation, alert them to changes in the plan's structure and operations, and provide them a chance to make decisions about their accounts.

The summary plan description (SPD) is a plain-language explanation of the plan and must be comprehensive enough to apprise participants of their rights and responsibilities under the plan. It also informs participants about the plan features and what to expect of the plan. This document must be given to participants when they join the plan and to beneficiaries when they first receive benefits. SPDs must also be redistributed periodically during the life of the plan.

A summary of material modification (SMM) alerts participants of changes made to the plan or to information required to be in the SPD. The SMM or an updated SPD must be automatically furnished to participants within a specified number of days after changes.

An individual benefit statement shows the total plan benefits earned by a participant, vested benefits, the value of each investment in the account, information describing the ability to direct investments, and (for plans with participant direction) an explanation of the importance of a diversified portfolio. Plans that provide for participant-directed accounts must furnish individual account statements on a quarterly basis. Plans that do not provide for participant direction must furnish statements annually.

When plans allow participants to direct their investments, fiduciaries need to take steps to regularly make participants aware of their rights and responsibilities under the plan related to directing their investments. This includes providing plan and investment-related information, including information about fees and expenses. Participants need this information to make informed decisions about the management of their individual accounts. Participants must receive the information before they can first direct their investment in the plan and annually thereafter. The investment-related information needs to be presented in a format, such as a chart, that allows for a comparison among the plan's investment options. A model chart is available. If you use information provided by a service provider that you rely on reasonably and in good faith, you will be protected from liability for the completeness and accuracy of the information.

A summary annual report (SAR) is a narrative of the plan's annual return/report, the Form 5500, filed with the federal government. It must be furnished annually to participants.

A blackout period notice gives employees advance notice when a blackout period occurs, typically when plans change record-keepers or investment options, or when plans add participants due to corporate mergers or acquisitions. During a blackout period, participants' rights to direct investments, take loans or obtain distributions are suspended.

Reporting to Government Agencies

In addition to the participant disclosure documents, plans must also report certain information to government entities.

- **Form 5500 Annual Return/Report**—Most plans are required to file an electronic annual return/report with the federal government, to disclose information about the plan and its operation to the IRS and the U.S. Department of Labor. These returns/reports are made available to the public. Most one-participant plans (sole proprietor and partnership plans) with total assets of $250,000 or less are exempt from the annual filing requirement.
- **Form 1099-R**—This form is given to both the IRS and recipients of distributions during the year to report distributions (including rollovers) from the plan.

Distributing Plan Benefits

Benefits in a 401(k) plan are dependent on a participant's account balance at the time of distribution. When participants are eligible to receive a distribution, they typically can elect to take a lump sum distribution, roll over the account to an IRA or other employer's retirement plan, or purchase an annuity.

Terminating a 401(k) Plan

401(k) plans must be established with the intention of being continued indefinitely. However, business needs may require that employers terminate their 401(k) plans—for example, if they want to establish another type of retirement plan instead. Typically, the process of terminating a 401(k) plan includes amending the plan document, distributing all assets and filing a final Form 5500. You must also notify your employees that the 401(k) plan will be discontinued.

Compliance

Even with the best intentions, mistakes in plan operation can still happen. The U.S. Department of Labor and IRS have correction programs to help 401(k) plan sponsors correct plan errors, protect participants and keep the plan's tax benefits. These programs are structured to encourage early correction of the errors. Having an ongoing review program makes it easier to spot and correct mistakes in plan operations.

A 401(k) Checklist

The following checklist can help you establish a sound 401(k) program:

1. Have you determined which type of 401(k) plan best suits your business?
2. Have you decided whether to make contributions to the plan, and, if so, whether to make non-elective and/or matching contributions?
3. Have you decided whether to hire a financial institution or retirement plan professional to help with setting up and running the plan?
4. Have you adopted a written plan that includes the features you want to offer, such as whether participants will direct the investment of their accounts?
5. Have you notified eligible employees and provided them with information to help in their decision-making?
6. Have you arranged a trust fund for the plan assets or will you set up the plan solely with insurance contracts?
7. Have you developed a recordkeeping system?
8. Are you familiar with your fiduciary responsibilities?
9. Are you prepared to monitor the plan's service providers?
10. Are you familiar with the reporting and disclosure requirements of a 401(k) plan?