



Retirement Savings Plans Under § 401(k)

(For Plan Years Beginning in 2009)

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A retirement savings plan is an arrangement permitted by Section 401(k) of the Internal Revenue Code that allows employees to contribute part of their compensation on a “pre-tax” basis. Retirement savings plans or 401(k) plans are individual account plans like traditional profit sharing plans with a few additional requirements. The additional requirements are:

1. Withdrawals are permitted only after severance from employment, age 59-1/2, or incurring a substantial financial hardship
2. The plan cannot require more than one (1) year of service before an employee is eligible to participate.
3. The plan cannot discriminate in favor of “highly compensated employees” (“HCEs”). The test for discrimination is a mechanical one. The “average deferral percentage” (“ADP”) for HCEs cannot exceed a certain multiple of the ADP for all other eligible employees. See Examples below.
4. If matching contributions are made, the matching contributions cannot discriminate in favor of HCEs. The “average matching contribution percentage” (“ACP”) for the HCEs cannot exceed a certain multiple of the ACP of all other eligible employees.

The ADP and ACP tests may use the deferral and matching percentages for the non-HCEs for the **current** year **or** the **preceding** year. If a plan flunks the test, corrections may be made by returning excess contributions to the HCEs who contributed the largest **amounts** for the year rather than to those who contributed the largest **percentages** of compensation.

HCEs for plan years beginning in 2009 are:

1. Employees who own more than 5% of the sponsoring employer during the current or preceding year; or
2. Employees whose “gross” compensation during the **preceding** year (2008) was more than \$105,000 and who were in the top-paid 20% of all employees. The employer has to elect to apply the top 20% requirement and may simplify the definition even further by not doing so. Gross compensation is compensation before reduction for elective contributions to 401(k) plans and cafeteria plans.

The discrimination test limits the ADP of HCEs for the **current** year to the following multiples of the ADP of the other eligible employees for the **preceding** year:

ADP for Other Employees	Maximum ADP for Highly Compensated Employees
Less than 2%	2.0 times ADP of other employees
2% to 8%	ADP of other employees plus 2%
More than 8%	1.25 times ADP of other employees



The employer may elect to use the ADP for other employees for the current year rather than the preceding year. If the employer elects to use current year ADPs, the employer must follow this testing procedure for at least five years.

If a plan flunks the ADP test, the amounts contributed by HCEs in excess of the allowable amounts should be returned to those employees within 2-1/2 months after the end of the plan year and must be returned by the end of the next plan year. If the excess amounts are not returned within the first 2-1/2 months, the employer must pay an excise tax equal to 10% of the excess contributions.

The amounts that can be contributed are limited by the following factors:

1. An employee's 401(k) contributions are limited to \$16,500 for calendar year 2009. This limit may be further limited if the employee is also participating in another tax-favored employee savings program such as a SIMPLE plan, a SEP, or a tax-sheltered annuity plan. If the employee will be age 50 or older before the end of the plan year, the employee may make an additional \$5,500 "catch-up" contribution after maximizing the regular 401(k) contributions.
2. Employer contributions (profit-sharing and matching) are deductible in amounts of up to 25% of the gross compensation of eligible employees. The voluntary 401(k) contributions by employees do not count against this 25% limit. Contributions in excess of the 25% limit may be carried forward and deducted in later years, but may be subject to a 10% penalty tax.
3. The total amounts credited to the account of any employee for any year cannot exceed 100% of gross compensation or \$49,000, whichever amount is smaller. These limits apply to employer or employee contributions and forfeitures, but not to catch-up contributions, so the limit for a participant who is 50 or older is \$54,500.

For 2009, the maximum compensation that can be taken into account when determining employer and employee contributions is \$245,000. The following are some examples of the results that can be achieved within the 401(k) limits:

EXAMPLE ONE: All Voluntary Contributions

Employee	Compensation	Employee Contribution	Deferral %	Average Deferral %
A	\$120,000	\$9,600	8	6
B	110,000	4,400	4	
C	20,000	600	3	
D	20,000	600	3	
E	15,000	600	4	4
F	10,000	600	6	

Satisfies lower paid ADP + 2% Test

EXAMPLE TWO: All Voluntary Contributions

Employee	Compensation	Employee Contribution	Deferral %	Average Deferral %
A	\$120,000	\$4,800	4	3.5
B	110,000	3,300	3	
C	50,000	2,000	4	
D	20,000	600	3	
E	20,000	600	3	
F	20,000	800	4	1.75
G	15,000	0	0	
H	15,000	0	0	
I	10,000	0	0	
J	10,000	0	0	

Satisfies two (2) times lower paid ADP Test

EXAMPLE THREE: Employer Contribution of 8% Compensation

Employee	Compensation	Employer Contribution	Employee Contribution	Deferral %	Average Deferral %
A	\$120,000	\$9,600	\$3,000	10.5	10.5
B	25,000	2,000	500	10	
C	20,000	1,600	-0-	8	
D	20,000	1,600	-0-	8	
E	15,000	1,200	-0-	8	8.4
F	10,000	800	-0-	8	

Satisfies 1.25 times lower paid ADP Test if employees are fully vested in employer contribution.

Retirement savings plans can be designed and administered as part of an existing profit sharing plan or as a separate plan. A retirement savings plan is a “qualified plan” under Section 401(a) of the Code and must satisfy the “coverage” provisions of the Code. The amounts contributed to a retirement savings plan must be aggregated with amounts contributed to other defined contribution plans for purposes of the limits on deductible contributions and individual allocations. An employee’s contributions are not taxable to the employee as income, but are subject to FICA and FUTA taxes.

Use of Matching Contributions with Retirement Savings Plan:

Matching contributions are used frequently to provide an incentive for employees to make voluntary contributions. These are particularly important for younger and lower paid employees for whom tax incentives may not be enough. Section 401(m) of the Code adds another discrimination test that is designed to ensure that HCEs do not get a disproportionate share of matching contributions.

This discrimination test compares the ACP for HCEs with the ACP for all other eligible employees. The ACP is the average of the percentages of compensation contributed for each employee in the test group as a matching contribution. The discrimination test is the same as the ADP test for 401(k) contributions.

If the plan does not satisfy the ACP test, matching contributions for HCEs that are in excess of the amounts allowable must be paid to those employees in the same manner and subject to the same rules as excess 401(k) contributions.

Safe Harbor Plans that avoid the ADP and ACP Test:

Employers may avoid the ADP and ACP tests by adopting a safe harbor program:

■ **Traditional Safe Harbor Program**

The “traditional” safe harbor program is available for all 401(k) plans, including those with automatic enrollment. The traditional safe harbor program requires the employer to commit to making a contribution for all eligible employees equal to 3% of compensation for the year or a matching contribution equal to the following:

- Dollar for dollar (100%) on the first 3% of compensation contributed by the employee; and
- 50¢ on the dollar (50%) on the next 2% of compensation contributed by the employee;

Traditional safe harbor contributions are 100% vested and can be withdrawn by employees only after termination of employment or age 59-1/2. The amounts cannot be withdrawn for reasons of hardship. Employers do not have to make the 3% contribution or matching contributions for participants who are “highly compensated” employees.

■ **Automatic Enrollment Safe Harbor Program**

The automatic enrollment safe harbor program is available for 401(k) plans under which eligible employees are automatically enrolled for contributions equal to 3% of compensation in their first year of participation with 1% increments each year to 6% in the fourth year. Employees may elect to make contributions of more or less than these percentages or “opt out” altogether.

The automatic enrollment safe harbor program requires the employer to commit to making a contribution for all eligible employees equal to 3% of compensation for the year or a matching contribution equal to the following:

- Dollar for dollar (100%) on the first 1% of compensation contributed by the employee; and
- 50¢ on the dollar (50%) on the next 5% of compensation contributed by the employee.

Automatic enrollment safe harbor contributions must be 100% vested after two (2) years of service and can be withdrawn by employees only after termination of employment or age 59-1/2. The amounts cannot be withdrawn for reasons of hardship.

■ **Notice Requirements**

The safe harbor programs must be announced to employees in writing at least 30 days before they become enrolled for the first time and before each plan year. This notice may be provided in hard copy or electronically.

Administration:

The rules applicable to retirement savings plans under Section 401(k) are complicated and will require employers to train a staff member to administer the program internally or hire a competent administrative service agency to do so. There are several banks, insurance companies, and consulting firms that are capable of administering 401(k) plans and performing the tests required to ensure compliance.

If you have any questions about the design or administration of retirement savings plans or other qualified plans, the members of our employee benefits practice group will be happy to work with you. The members of the group are Tom Bergh, Nancy Farnam, Larry Titley, Tim Tornga, Mary Manguse, and Liz Hitchcock.