The Magic of a 401 (k) Plan

More and more contractors today are using these plans to cut their taxes while putting away money for retirement.

by Joseph Arkin, C.P.A., M.B.A.

Your firm may be operating as a corporation because of your lawyer’s insistence that you insulate your personal assets from everyday potential liabilities incurred in the course of doing business in the wall and ceiling industry.

With tax savings in mind, with the rewards of a large retirement fund available for your twilight years, the usual avenue was the adoption of a pension or profit-sharing plan. Prior to ERISA this usually could favor to a great extent the highly paid executives and adversely affect the rank and file employees.

Irrited by horror stories of abuses, the ERISA rules imposed new restrictions, new reporting requirements costing a great amount to administer, and generally causing many smaller contracting firms to abandon their pension plans.

Thus, shareholder-officers of businesses found themselves on the outside, looking in, when it came to setting aside tax-deferred money for retirement.

Without a pension plan the IRA’s seemed to be the only way to put away

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a nest-egg with tax deferred dollars. Then along came what some business consultants call the “savior” to retirement plans of contractors looking for a tax edge. This is the Section 401(k) plan; part of the Tax Reform Act of 1978.

A salient feature of the plan for the owner of a business operating as a corporation is that the executives as well as rank and file employees can defer payment of current income taxes on a portion of salary earned by making payments to a qualified 401(k) plan.

And, the plan can discriminate in favor of top-level persons (stockholder-officers, key employees, etc.) without losing its qualified status. The discrimination does, however, have limitations.

This is how the plan works: (1) the plan must qualify under provisions of Section 401 of the Internal Revenue Code. Appropriate filing must be accomplished and approval granted by the IRS. (2) The corporation’s employees then advise the employer to deduct a portion of their salaries and pay such amount to a plan trustee. (3) The trustee then invests the monies in various ways—mutual funds, money market funds, CD’s, cash value life insurance, etc.

Better Than An IRA . . .

The beauty of this is that all participants can set aside greater amounts than that permitted for IRA accounts. And, the 401(k) plan does have decided advantages over IRA’s.

For instance, any withdrawals from an IRA prior to age 59½ means the reporting of the withdrawals as ordinary income (5-yr income averaging is allowed) plus a 10% penalty, non-refundable, on the amount withdrawn. But 401 (k) plans can have monies removed without penalty if the employee can prove an immediate hardship, loosely defined as funds needed for buying a new home, payment of tuition for children, and other large needs.

Can’t prove a hardship? Just borrow the money needed, up to $50,000. The tax law says that the money must be repaid with interest within five years. Such interest payments are then tax-deductible to those who itemize on Schedule A of form 1040.

After retirement there is a great difference in the tax status of 401(k) plans and IRA’s. Rates change with each tax act passed yearly, but at the time of this writing an employee who elects to take a lump sum withdrawal from a 401(k) plan, of say $100,000, would pay only $14,370 in taxes, using the 10-year average rule. If the same amount was taken out of an IRA the tax would be $34,064. This illustrates the disparity in the amounts of income taxes paid and it doesn’t matter if in the coming years rates of taxes change.

The amount allowed to be set aside in the 401(k) plan is 25% of total salary, with a maximum of $30,000 per year.

The allowable discrimination previously mentioned is that employees who have not yet attained the age of 25 can be left out of the plan, the same for employees who do not have 3 years of service.

Unlike an IRA where there is a penalty for putting too much money into an account, a participant in a 401(k) plan can contribute 6% of salary voluntarily. Such contributions are not sheltered from current taxation but the earnings from them are not taxed currently.

As with any complex tax code, there are a certain amount of ifs and buts. Suppose the rank and file employees balk at putting away 25% of their salaries?

It is hardly likely that a $10,000 per year employee who normally can’t even afford to open an IRA account, will be willing to have your corporation deduct $2500 from his salary.

There are rules to cover this contingency and they are somewhat complicated.
### Elective Ratio—Contribution to Compensation

<table>
<thead>
<tr>
<th>Employees</th>
<th>Compensation</th>
<th>Elective Contribution</th>
<th>Ratio-Contrib. to Compensation</th>
<th>Actual Deferral—%</th>
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<tr>
<td>A (executive)</td>
<td>$100,000</td>
<td>$6,000</td>
<td>6000/100000</td>
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<tr>
<td>B (executive)</td>
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<td>$4,800</td>
<td>4800/80000</td>
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<tr>
<td>C (manager)</td>
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<td>$1,200</td>
<td>1200/40000</td>
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<tr>
<td>D (selling)</td>
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<td>$900</td>
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<td>E (shipping)</td>
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<td>$600</td>
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<tr>
<td>F (office)</td>
<td>$10,000</td>
<td>$300</td>
<td>300/10000</td>
<td>3</td>
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</tbody>
</table>

Formulas based on thirds of those in different salary scales prevail. Cutting through the arithmetic, computations show that you can let the average rank-and-file employee contribute only 2% of his salary, allowing for no more than 5% of the total salaries of the upper one-third to be contributed to the plan. There is an averaging of percentages so that the key executives can put away as much as 8% even if a group only contributes 2%. Listed above is an illustration:

How this works out tax-wise in dollars and cents can be shown as follows: The executive above who puts away $4,800 of his $80,000 salary will pay current taxes on only $75,200, but he’d pay taxes on $78,000 if he only had an IRA account. And, the rule that a participant in a corporate (or employer pension plan) could not also have an IRA account was done away with. So here our participant can open an IRA account and reduce taxable income to $73,200.

Note: for the sake of clarity we are not taking into account whether or not the spouse is working, and if not, whether the spousal IRA is being taken.

Remember too that the items mentioned as 401(k) vs IRA still constitute a big factor in deciding whether or not to adopt a 401(k) plan.

### Ideal for Small Shops . . .

It is possible that some of the readers of this publication are mom and pop operations, operating without employees. Here they can call their own shots and put away the maximum they could afford up to the 25% or $30,000 limitation. Other readers may be operating corporations with anywhere from 1 to 50 employees. Here they can eliminate the two classes previously mentioned.

By the foregoing we certainly don’t mean to imply that the smaller corporation is the best candidate for a 401(k) plan. The list of corporations that have adopted 401(k) plans reads like the Fortune “500” and the trend is on the upside with each passing day. AWCI itself is evaluating such a plan for our staff.

The 401(k) plan can be a godsend to those operating businesses where means are being sought to provide tax-deferred savings. The key factor to watch for is the structure of the plan where professional help is being used to properly draw an acceptable plan, both to the IRS and the needs of the participants. This is not a do-it-yourself project.  

Continued
A plan properly drawn can assure management and employees alike that they will be getting the utmost in tax advantages. With the scare stories of a possible collapse of the Social Security system, this adds greater incentive to provide for one’s own old age security.

You’ll find that if you engage a plan designer there will be communications with the employees to get them to participate.

Some of those who balk at making up to 25% of salary contributions can be shown how they can discontinue making certain payments for life insurance premiums (and other items) and have their premiums paid directly by the trust. And, it is with pre-tax dollars.

For example, a $20,000 key employee, married, one child, may be paying $500 annually for life insurance premiums and putting away $25 per month for payments to a mutual fund investment program. Here he is paying $800 annually with after-tax dollars. Suppose he was induced to pay $200 to the plan, and had the $800 obligation deducted from salary and paid into the plan, and the plan would make the payments. The tax-savings on the $800 would probably exceed the $200 additional payment, so that this employee would be contributing $1000 on the books to the plan, aiding in the computation of the percentage to determine what could be put away by upper-level paid employees.

401(k) plans do work. Thousands of firms make contributions to them. Even if all the features could not all be fully explained in this article, you owe it to yourself and to your employees to pursue the matter. Find out exactly what this new plan can do for your firm.

Editor’s Note: Although the Reagan Administration proposed to greatly restrict 401(k) plans in their original tax reform package by limiting an employee’s annual elective contribution to $8,000, it now appears that Rep. Dan Rostenkowski’s (D-IL) Ways and Means Committee will preserve them—at least for employees of all private sector corporations. Elective contributions would continue to count as employer contributions against the annual contribution and benefit limits for tax-favored plans.