



## YOUR MONEY:

### Could Your 401(k) Be Short-Changing You Of Retirement Savings Opportunities?

October 2007, By Guy McPhail

**Picking the right 401(k) plan can help you improve retirement savings strategies for yourself and employees.**

Retirement may seem like a distant dream, but that doesn't mean that planning can wait. In fact, a recent Hartford Business Owner's survey found that 73 percent of entrepreneurs worry about having enough money to fund their retirement and most wish they had more time for personal financial planning.

In my last article I examined the [potential perks of defined benefit plans](#). Now, let's look at defined contribution plans and specifically 401(k) plans. They may offer more opportunity for you than you realize. This is the type of retirement plan that most of you will be familiar with, and there is a chance you may even have one of these in place already.

The 401(k) plan falls into the category of defined contribution plans because Congress sets the limits on what can be contributed to these plans each year. In 2006, a person could defer \$15,000 of her salary as a contribution into a 401(k) plan. If she was 50 or older she could defer an additional \$5,000 "catch up" contribution for a \$20,000 total annual contribution. For 2007, the contribution ceiling has been increased to \$15,500, while the catch up contribution remains the same. These set limits are a key part of what distinguishes a 401(k) plan from a defined benefit plan, which uses age and salary as a major component for the calculation of the contribution.

#### **Deferral Portion Contributions**

It is important that you distinguish the deferral of salary compared to the amount put into the plan by the employer. The deferral portion is the amount that the employee defers into the investment plan and doesn't have to pay taxes on currently. For example, if the employee had a gross salary of \$47,000 and put \$5,000 of that into the 401(k) plan her W-2 at the end of the year would show \$42,000 and she would not have to pay taxes on the \$5,000 deferred. At retirement the deferred amount is taxed when withdrawn. This salary deferral doesn't cost the business any additional funds because it's taken from the employees' salaries. Offering a 401(k) plan to employees is proven to be a welcome perk and boost loyalty.

#### **Matching Plans and Safe Harbor 401(k)s**

When employees and their employers contribute to a worker's plan it's commonly referred to as matching. With matching plans, small business owners have the ability to contribute a much larger portion from their business to themselves than to their employees. This can be done by using a Safe Harbor 401(k) plan. If the small business owner contributes the amount equal to 3 percent of the salary for the employees — known as the Safe Harbor contribution — the law then allows the owner to put a larger percentage into his or her own 401(k). In my example below you'll see that by making the 3 percent Safe Harbor contribution and an additional 2 percent Profit Sharing contribution, the small business owner can put in the maximum \$29,000 allowable by the IRS for 2006.

## Sample 401(k) Contributions:

Employees	Ages	Annual Compensation	Deferral Of Salary	3% Safe Harbor Contribution made by Employer	Profit Sharing Contribution by Employer	Total Plan Contribution	% Of This Year's Total Plan Contribution
Owner	59	\$220,000	\$20,000	\$6,600	\$22,400	\$49,000	86.1%
Employee 1	39	\$47,000		\$1,410	\$940	\$2,350	4.1%
Employee 2	34	\$42,000		\$1,260	\$840	\$2,100	3.7%
Employee 3	29	\$37,000		\$1,110	\$740	\$1,850	3.3%
Employee 4	24	\$32,000		\$960	\$640	\$1,600	2.8%
Total Contribution			\$20,000	\$11,340	\$25,560	\$56,900	100.0%

### SUMMARY OF TAX SAVINGS

Total Contribution for Small Business Owner		\$49,000
Total Contributions & Tax Deduction for the Business and Owner	\$56,900	
Less: INCOME TAX SAVINGS (Assuming a Federal and State Rate of 45%)	\$25,605	
Net Cash Paid Out	\$31,295	\$31,295
Portion Of The Owner's Net Contribution Funded by the TAX SAVINGS		\$17,705

In this example you, the owner, are deferring \$20,000 in salary, the company is contributing \$36,900 (\$11,340 + \$25,560) and you are getting \$49,000 of retirement plan benefit.

On your W-2 you are deferring \$20,000 and not paying taxes on that, while the \$36,900 is an expense that you get to deduct from your revenues on your business tax return. If your business is a Partnership, LLC or S-Corporation the tax savings would be around \$25,000 as the example shows.

### Employee Salary Deferrals

What would happen if the other employees also made deferred salary contributions into the 401(k) plan? They could contribute the maximum and it would not have any effect on the small business owner. This can be accomplished because of the contributions you made for your employees. Also note that this plan usually has vesting, but it works a little differently than the defined benefit plan. The amount in the Safe Harbor column in the illustration above immediately vests to the employee, as does their salary deferral contribution, if any, as well. However, the amount where we gave the employee the additional matching contribution 2 percent in profit sharing is subject to vesting. So, for example, if Employee 1 left after two years he would get all of his safe harbor contributions that she made but only around 40 percent of the amount of the profit sharing part of the contributions made for her. The 60 percent of the amount of her profit sharing forfeiture — monies to which she is not entitled — would go back in the plan for later distribution among the other participants, or to reduce the business owner's funding requirements for future years.

## Some Final Considerations

These strategies are somewhat similar to those I used in my previous column about defined benefit plans, but on a smaller scale. In this example you can put away \$49,000 in a pension plan for yourself and have the government “pay” \$17,705 of that as a result of your tax savings. Importantly, this is \$17,705 of profits you created without having to generate more sales or work more hours. The 401(k) plan is less costly to administer than the defined benefit plan—and the administration costs are also tax deductible.

Some of you may say, “I have a 401(k) now but I am not able to put away nearly as much as this illustration.” That may be due to a problem I’ve mentioned before: You may have gotten yourself a “canned” plan. Off-the-shelf or prototype plans are massed produced. They are not tailored to your individual business. So, you’ll need to find yourself a good 401(k) administrator who can tailor this type of plan for your business so you can get the maximum deduction as illustrated.

Keep in mind that if you are planning to start a new plan or enhance one you have established, you need talk to a plan administrator regarding IRS deadlines so you can take advantage of tax deductions for the current or following year.

Find yourself a great CPA to run your numbers and see what type of retirement plan is right for your business. Get a sophisticated plan administrator who can structure a plan tailored for your specific needs. Then find an investment advisor who can help you put that money to work in the most efficient matter for prudent growth.

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