The 401(k) Profit Sharing Plan

MANNING & NAPIER

Suitability Profile

- Profits are predictable and consistent
- Each owner able to take W2 salary of $150,000+ annually
- Each owner's S-Corp distribution is substantial and growing
- Employer can commit to a 3% of payroll benefit cost
- Appropriate for businesses of any size
    - Owner-only businesses
- Owners seek to maximize allocations while controlling the benefit cost of non-owners.

Disadvantages

The biggest disadvantage of the 401(k) is the impact to the business in terms of time and cost. While the employer that sponsors a 401(k) as technically the plan's administrator, it must usually hire a service providers known as the Third Party Administrator (TPA) and the Recordkeeper, much in the same way an accountant or attorney is hired. The fees charged by service providers are in two forms:

- Hard-dollar fees that are billed directly to the employer and,

- Asset-based fees that are levied against the plan assets.

Hard-dollar fees paid by the business will approach $3,000-$5,000 per year depending on plan size and complexity. Asset-based fees will range between .5% and 2% of plan assets. The all-in (hard dollar and asset-based fees combined) fee will depend on the type of investments and range of services needed to best meet the Plan objectives.

The 401(k) plan will present a procedural burden that will impact the employer's day-to-day operations, especially during the year-end administrative cycle. For simple arrangements, this impact is easily managed but not without attention to detail. Also, the 401(k) sponsor assumes certain regulatory and fiduciary obligations that must be acknowledged. Here again, in simple arrangements for closely held businesses, these obligations can be effectively managed.

Advantages

The single greatest advantage of the 401(k) plan over the SEP is that it is a more robust plan with larger limits for employees. Employers sponsoring a 401(k) will typically need to make a minimum contribution — usually 3% of eligible payroll. After this initial safe harbor contribution, the 401(k) sponsor has great flexibility to maximize owner allocations while controlling the cost of allocations to non-owners, especially as the owners age. This safe harbor contribution pulls triple-duty because it will also satisfy two important non-discrimination tests known as the top-heavy and gateway tests.

There is a tax credit for new plans equal to:

- 100% of administrative fees per year for 3 years, up to $5,000 per year, for employers with up to 50 employees

- 50% of administrative fees per year for 3 years up to $5,000 per year for employer with 51-100 employees.

Additional credits are also available, making the net effect of starting a 401(k) plan "no or low-cost" for many small employers. Unfortunately, the credits do not apply to owner-only plans. Beyond any available tax credits, most hard-dollar fees paid by the business can be deducted as ordinary and reasonable business expenses. Regardless, for many small employers the advantages of a 401(k) far outweigh the disadvantages.

401(k) Profit Sharing Plan

Limits

The 401(k) plan allows both employer and employee contributions. The maximum annual contribution limit for an employer in any year is 25% of eligible payroll. The maximum annual contribution by an employee is 100% of pay up to a specific dollar amount that is indexed every year. Employees aged 50 or more years are allowed an additional catch-up contribution. The maximum amount of employer and employee contributions that can be allocated to any one individual is again, 100% of compensation up to a specific dollar amount that is indexed every year.

2023 401(k) Limits	
Employee Maximum	$66,000
Employee 401(k)	$22,500
Employee Catch-Up	$7,500

401(k) Allocations

As alluded to above, the 401(k) typically works best when the employer commits to annual contribution equal to 3% of eligible pay. Often called Safe Harbor 401(k) plans, this 3% contribution allows the business owners to make maximum salary deferrals under the employee limit above without concern for failing complex regulatory testing. For the business owner who can comfortably take a salary of $100,000 to $150,000, this sort of design is ideal. For the business owner who can take even more salary, additional allocations are possible for minimal, or at least controllable, allocations for non-owners.

A 401(k) Case Study

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To illustrate how a 401(k) plan works, we examine a sample employer with the following characteristics:

- S-Corporation
- Two owners
- Owner ages range from 20s to 50s
    - Take low W2 salary to minimize their own self-employment taxes
    - Receive earnings distributions in addition to salary
    - Total owner compensation is relatively consistent and predictable
- Five non-owners
- Business earnings are relatively consistent and predictable
- Willing to commit to a 3% of eligible pay contribution annually, at a minimum

The 401(k) Plan

Position	Age	W2 Pay	ER 3%Safe Harbor	EE 401(k)	Total
Owner A	**20s-40s**	**$150,000**	**$4,500**	**$22,500**	**$27,000**
Owner B	**20s-40s**	**$150,000**	**$4,500**	**$22,500**	**$27,000**
Staff 1	50	$65,000	$1,950	$0	$1,950
Staff 2	55	$40,000	$1,200	$0	$1,200
Staff 3	35	$30,000	$900	$0	$900
Staff 4	30	$25,000	$750	$0	$750
Staff 5	25	$20,000	$600	$0	$600

Owners	**$54,000**
Non-Owners	$5,400
Total	$59,400
% to Owners	**91%**

For illustrative purposes only.

ER 3% Safe Harbor = Employer's Safe Harbor contribution equals 3% of pay.

EE 401(k) = Employee's voluntary salary deferral contribution.

The Safe Harbor

Here, the employer chooses to make a 3% of pay safe harbor contribution ("ER 3% Safe Harbor"). We assume the owners each take a salary of $150,000 annually. Now we begin to see how the 401(k) plan can maximize owner allocations while controlling the cost of allocations to non-owners. Stated above, this arrangement allows the owners to make maximum salary deferrals in addition to the safe harbor.

A 401(k) Case Study

Getting Older?

Older owners can use additional profit-sharing contributions — over and above the 3% safe harbor — to further increase their own allocations. As the average of the owners over the non-owners increases, there is more flexibility under the non-discrimination tests to give different percent-of-pay profit sharing allocations to different employee groups, like owners and non-owners, for example.

In the example to the left, we assume the owners are a bit older and take each take a slightly higher salary. The plan still provides the 3% safe harbor to everyone. But the owners are now able to leverage an additional 2% of pay allocation for non-owners into much higher percent of pay allocations for themselves. Best of all, ninety-three cents of every dollar contributed attributes to the owners.

Now you begin to see how a 401(k) plan can adapt as the business grows and the owners' age.

The 401(k) Plan

Position	Age	W2 Pay	ER 3% Safe Harbor	EE 401(k)	EE Catch-Up	ER PS %	ER PS $	Total
Owner A	**55**	**$175,000**	**$5,250**	**$22,500**	**$7,500**	**11.6%**	**$20,269**	**$55,519**
Owner B	**50**	**$175,000**	**$5,250**	**$22,500**	**$7,500**	**11.6%**	**$20,269**	**$55,519**
Staff 1	50	$65,000	$1,950	$0	$0	2.0%	$1,300	$3,250
Staff 2	55	$40,000	$1,200	$0	$0	2.0%	$800	$2,000
Staff 3	35	$30,000	$900	$0	$0	2.0%	$600	$1,500
Staff 4	30	$25,000	$750	$0	$0	2.0%	$500	$1,250
Staff 5	25	$20,000	$600	$0	$0	2.0%	$400	$1,000

Owners	**$111,038**
Non-Owners	$9,000
Total	$120,038
% to Owners	**93%**

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ER 3% Safe Harbor = Employer's Safe Harbor contribution equals 3% of pay.

EE 401(k) = Employee's voluntary salary deferral contribution.

EE Catch-Up= Employee's voluntary salary deferral contribution if age 50+.

ER PS % = Employer's discretionary profit-sharing contribution expressed as a percent of pay.

ER PS $= Employer's discretionary profit-sharing contribution expressed as a dollar amount.

A 401(k) Case Study

Want to max out?

But wait, there's more! Each owner still has room under the individual 401(k) plan allocation limit; so what combination of owner salary and profit sharing percent will get them to the maximum?

In our example, each owner can maximize profit sharing allocations under the non-discrimination testing by increasing salary to the amount shown in the chart. Recall from Simplified Employee Pension blog, the amount of salary needed to reach the maximum allocation for each owner, and the non-owner cost of allocations was much higher! Clearly the 401k plan is better at leveraging as low an owner salary as possible into maximum plan allocations for the owners.

The 401(k) Plan

Position	Age	W2 Pay	ER 3% Safe Harbor	EE 401(k)	EE Catch-Up	ER PS %	ER PS $	Total
Owner A	**55**	**$235,000**	**$7,050**	**$22,500**	**$7,500**	**15.5%**	**$36,450**	**$73,500**
Owner B	**50**	**$235,000**	**$7,050**	**$22,500**	**$7,500**	**15.5%**	**$36,450**	**$73,500**
Staff 1	50	$65,000	$1,950	$0	$0	2.0%	$1,300	$3,250
Staff 2	55	$40,000	$1,200	$0	$0	2.0%	$800	$2,000
Staff 3	35	$30,000	$900	$0	$0	2.0%	$600	$1,500
Staff 4	30	$25,000	$750	$0	$0	2.0%	$500	$1,250
Staff 5	25	$20,000	$600	$0	$0	2.0%	$400	$1,000

Owners	**$147,000**
Non-Owners	$9,000
Total	$156,000
% to Owners	**94%**

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EE 401(k) = Employee's voluntary salary deferral contribution.

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ER PS % = Employer's discretionary profit-sharing contribution expressed as a percent of pay.

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Outgrowing the 401(k)

What if our two owners never adopted a plan before the ripe old ages of 55 and 50? Perhaps they suddenly realize that retirement is much closer than graduation. Instead of prioritizing retirement savings over the years, they've poured every available dollar back into the business. They need to squeeze 20 years of retirement savings into 10; and even the 401(k) plan maximums are just not enough. What can they do?

Owners in this situation typically turn to a second plan — a Defined Benefit (DB) pension known as a Cash Balance Plan.

A 401(k) Case Study

Conclusion

The Profit Sharing 401(k) Plan (“401(k)”) allows the employer to make annual contributions of up to 25% of pay on a discretionary basis; and allows employees to contribute through pre-tax payroll deferrals. The 401(k) is appropriate for established businesses with consistently predictable earnings and can commit to a minimum 3% of eligible payroll annually as a contribution; as well as absorb typical hard-dollar plan costs. The 401(k) allows the employer to leverage reasonable plan allocations for non-owners into maximized allocations to owners through the use of discretionary profit-sharing contributions.

Businesses outgrow or need more than a 401(k) when owners want annual allocations that exceed the annual 401(k) plan limits, and approach $100,000 or more. For these situations, businesses often turn to a second plan, which you can learn about here (link to CB4k blog).

If you’re considering or need help with a qualified retirement plan, Manning & Napier has professionals on staff with decades of experience evaluating and implementing a wide range of plan designs. Contact your Manning & Napier representative today to learn more.