

## Example Safe Harbor 401K

NOTE: A safe harbor 401K can bypass discrimination testing (i.e. owners & highly compensated employees using the 401K to save money). In order to bypass this test, a safe harbor 401k requires the company to match the first 3% of each employees (and owners) salary deferral dollar for dollar (i.e. 100% match) and then next 2% of each employee (and owner) salary deferral 50 cents for each dollar (i.e. 50% match). This is a maximum employer contribution of 4%. (NOTE: companies can also match the first 4% dollar for dollar).

### Example Company

Your Company has 5 full time employees eligible to participate in the 401K plan. Jen, Dan, Rick, Arielle, and Mike. Jen & Dan are the owners who pay themselves wages (or “draws” if an LLC). In this example, your Company does **payroll monthly**, and each employee has an annual salary:

- Jen (owner): \$100,000
  - Jen chooses to save the maximum allowable amount of \$19,500. Since payroll is monthly, this is \$1625 per month / payroll.
  - The Company has to match the first 3% of Jen’s deferral dollar for dollar. 3% of Jen’s annual salary is \$3000 per year, or \$250 per month/payroll.
  - The Company has to match half of the next 2% of Jen’s salary deferral. 2% of Jen’s annual salary 2,000. Half of that is \$1000, or \$83.33 per month/payroll.
  - Jen’s gross paycheck is \$8,333 per month / payroll.
    - Jen is saving \$1625 from her paycheck into her 401K.
    - The Company has to make matching contributions in the amount of \$333.33 per paycheck.
    - The Company sends \$1958.33 each payroll to the 401K plan to be deposited into Jen’s 401K account.
- Dan (owner): \$100,000
  - Dan chose to save 5% of his salary in order to maximize his Company matching contribution. 5% of Dan’s \$100K a year salary is \$5000, or \$416.66 per paycheck.
  - Since Dan is saving 5% in order to maximize the Company matching 401K contribution, the company is contributing 4% of Dan’s salary. 4% of \$100K a year is \$4000, or \$333.33 per paycheck.
  - Dan’s gross paycheck is \$8,333 per month / payroll.
    - Dan is saving \$416.66 from her paycheck into her 401K.
    - The Company has to make matching contributions in the amount of \$333.33 per paycheck.
    - The Company sends \$749.99 each payroll to the 401K plan.
- Rick: \$40,000
  - Rick chooses to save 3% of his paycheck. 3% of Rick’s salary is \$1,200... or \$100 per payroll.

- The Company has to match the first 3% dollar for dollar, so the Company is contributing \$100 per pay check.
- The Company sends \$200 each payroll to the 401K plan.
- Arielle: \$32,000
  - Arielle chooses to save 1% of her annual income, which is \$320 per year or \$26.66 per pay check.
  - The Company has to match the first 3% dollar for dollar, so the Company is fully matching Arielle's entire 401K savings at \$26.66 per pay check.
  - The Company sends \$53.33 each payroll to the 401K plan.
- Mike: \$60,000
  - Mike declines enrolling into the 401K plan

In total, Company 401K contributions total \$793.32 per payroll. Of this amount, \$666.66 was to the 2 owners. \$126.66 per payroll was to match employee contributions.

This 401K, if it was not "safe harbor", would NOT pass discrimination testing and the owners and highly compensated employees and the 401K plan would RETURN owner & highly compensated employee contributions (and Company contributions) back to the Company... leaving a good bit of accounting work to do.

Since the Shared 401K is safe harbor, this is not a problem!

## Overall True Cost

Keep in mind that 401K contributions are NOT subject to federal income taxes. So, the company could save some money on any taxes / insurance tied to the amount of federally taxable wages paid.

Total employee contributions to the 401K are \$2168.32 per payroll (i.e. month).

However, consider the tax savings that potentially occur from the 401K contributions. The company is paying \$180 each monthly payroll in matching contributions. However, at a hypothetical 20% tax rate, the group of 401k participants are saving \$433.66 in taxes!

## Profit Sharing

The Company had a great year! So, the Company has \$90,000 in profits and instead of distributing it to the owners... the owners decide to share some of the profits with employees. Let's see how this works in 2 examples. Example 1 would be sharing the ENTIRE profit. Example 2 would be sharing a portion of the profit.

### Profit Sharing Example 1: Share Entire Profit

Tax deductible 401K profit sharing is limited to 25% of annual salary (non-tax deductible profit sharing is 100% of income or \$58K per year 2021). This is a KEY limitation and unavoidable in nearly all retirement plans. Since the company is trying to share the entire \$90,000, let's see if they can do this.

- Jen: \$100,000 – 25% of this is \$25,000
- Dan: \$100,000 - 25% of this is \$25,000
- Rick: \$40,000 - 25% of this is \$10,000
- Arielle: \$32,000 - 25% of this is \$8,000
- Mike: \$60,000 - 25% of this is \$15,000
  - Note that even though Mike did NOT participate in the 401k, he must be included in the profit sharing. All ELIGIBLE employees are included in profit sharing.

This is a total of \$83,000 that goes into each employee's 401K account. Remember the tax savings associated with this! The Company did so well they cannot share the entire profit and the owners would have to figure out what to do with the remaining \$7000 profit... a nice problem to have!

## Profit Sharing Example 2: Share Some Profit

The Company decides to share some of the profit... but do it as a 5% salary bonus.

- Jen: \$100,000 – 5% of this is \$5,000
- Dan: \$100,000 - 5% of this is \$5,000
- Rick: \$40,000 - 5% of this is \$2,000
- Arielle: \$32,000 - 5% of this is \$1,600
- Mike: \$60,000 - 5% of this is \$3,000
  - Note that even though Mike did NOT participate in the 401k, he must be included in the profit sharing. All ELIGIBLE employees are included in profit sharing.

This is a total of \$16,600.