



JENNINGS LAW FIRM

memorandum

October 22, 2002

ADDING 401K TO YOUR DEFINED BENEFIT PENSION PLANS

Many businesses, particularly closely held businesses, have adopted defined benefit plans as a way to obtain higher deductible contributions than are often available from other kinds of retirement plans such as profit sharing plans and 401k plans.

In the past, contributions to profit sharing plans and 401k plans were not permitted if the employer was making contributions to a defined benefit plan that exceeded 25% of covered payroll. Congress has changed the deduction rules so that beginning in 2002, an employer may offer a 401k plan to its employees even if they are already making contributions to a defined benefit plan.

How do the new deduction rules work?

Beginning in 2002, 401k contributions are deductible without limit. This means that a company that presently makes contributions to a defined benefit plan can permit all employees, including the company's owners, to make 401k contributions.

It gets better. If you are age 50 or older by December 31st, you can make an additional 401k contribution called a "catch-up" contribution. Your catch-up contribution is also deductible without limit.

What if my company only employs the owner and his family?

No problem. An employee can make a 401k contribution whether or not he or she is the owner or related to the owner. An employee has to be receiving wages, however, in order to make a contribution.

In the case of sole proprietorships and partnerships, the owners have to be receiving earned income.

It gets better. If you are age 50 or older by December 31st, you can make an additional 401k contribution called a "catch-up" contribution. Your catch-up contribution is also deductible without limit.

How much can each employee contribute to a 401k plan?

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The dollar limits on your annual 401k contributions are as follows:

Year	401k Limit	Catch-up Limit	Total Limit
2002	\$11,000	\$1,000	\$12,000
2003	\$12,000	\$2,000	\$14,000
2004	\$13,000	\$3,000	\$16,000
2005	\$14,000	\$4,000	\$18,000
2006	\$15,000	\$5,000	\$20,000

After 2006, both the 401k contribution limit and the catch-up contribution limit are increased for changes in the cost of living.

Here's an example: let's say Joe maintains a defined benefit plan for his business. The plan covers Joe and his spouse, Mary, who are the only employees of the business, and both are over age 50. No matter how much the business is already contributing to the defined benefit plan, Joe and Mary can contribute another \$12,000 EACH in 2002 to a 401k plan. By 2006, Joe and Mary can contribute another \$20,000 EACH to the plan, AND this is on top of what ever the business is contributing for them to the defined benefit plan.

There has to be a catch here, right?

No! Congress loves 401k plans and wants all employees to participate in them.

What do I have to do to set up and maintain a 401k plan?

Like any other retirement plan, certain requirements have to be satisfied. These are basically the same requirements, however, that the company is already satisfying for its existing defined benefit plan. For example, the company has to adopt a plan document and give each eligible employee the opportunity to make a 401k contribution. Also, a Form 5500 has to be filed each year with the US Dept of Labor.

Are there any deadlines I need to be aware of if I want to set up a 401k plan?

A 401k plan has to be established before the end of the company's tax year. If the company files its tax returns on a calendar year basis, the plan has to be established by December 31st. Also, since all contributions have to come out of wages, the plan has to be established before all of the employees' wages have been paid.

The best advice is to set up the plan as soon as possible. This would allow enough time to get everything done correctly.

What Services Can Dana Consulting Group Provide?

We can prepare the plan documents you will need to set up your 401k plan. Alternatively, you can use any proto-type document offered by your local bank or by any of the mutual funds or insurance companies.

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We can also prepare your annual Form 5500. If our firm is already assisting you with administering your defined benefit plan, we can prepare the 401k plan's Form 5500 at the same time we prepare the return for your defined benefit plan.

How do I learn more about this?

If you would like additional information about tax qualified retirement plans, please call Lee T. Jennings in our office.

Our web site also has information about retirement plans at www.danacongroup.com

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