

# What is a 401(k) plan? Here Is A Quick Overview

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Employer-sponsored retirement plans are generally grouped into two major categories: defined benefit (DB) and defined contribution (DC). In a DB plan, the employer promises to pay a defined amount to retirees who meet certain eligibility criteria. In other words, the plan defines the benefit to be received. In its most typical form, a DB plan pays a lifetime monthly benefit to retirees who fulfill specific age and service requirements. Benefits are usually linked to the amount of service and based on final average salary. Employees can reasonably rely on a known and expected benefit level; although protection against post-separation inflation is usually limited and/or uncertain. The plan sponsor may also provide an alternative lump-sum "cash-out" of the benefit entitlement. Until relatively recent times, the DB was the dominant form of employer-sponsored retirement program.

In DC plans, the plan defines the contributions that an employer can make, not the benefit that will be received at retirement. The terminating employee receives the proceeds in a current or deferred lump sum or annuity. Since the benefit is not defined, the retirement outcomes are not known in advance.

In 1978, section 401k of the Internal Revenue Code authorized the use of a new type of defined contribution plan that allows for the employee to make pre-tax contributions to the plan.

## How It Works

Employee 401k contribution are automatically deducted from their paycheck each pay period. This money is taken out before the employees paycheck is taxed. The contributions are invested at the employees direction into one or more funds provided in the plan. Employers often "match" employee contributions, but are not required to do so. While the investments grow in the employees 401k account, they do not pay any taxes on it.

## Advantages and Benefits

401k plans offer many benefits including the following:

- Any business, whether a C Corporation, S Corporation, partnership, sole proprietorship, self-employed can establish Plan.
- The company sets the eligibility requirements, within certain guidelines, at the time the plan is established.
- Employer can restrict individuals with less than one year service, union members, non US citizens, part-time workers, etc., from being eligible for the plan.
- Contributions to plan can come from voluntary employee salary reduction or from employer, or both.
- Each individual employee can defer in 2007 up to \$15,500 or 100% of compensation, whichever is less.
- Participants age 50 and over can make additional "catch-up" contributions of \$5,000 in 2007.
- Employees are immediately 100% vested with their own salary reduction tax deferred contributions.
- Employee withdrawals before age 59 1/2 may be subject to 10% penalty.
- Employees who retire any time during the calendar year in which they turn 55, or later, are not subject to the 10% penalty.
- Employers can establish a vesting schedule, within certain guidelines, for the contribution the company makes to the 401k.
- Employers are not required nor obligated to make any contribution to the 401k, although employer may have some obligation to contribute if plan is deemed top heavy.
- Turnkey and Internet based plans are available.
- Excellent range of investment options available for the plan sponsor to offer within the plan.
- The investment choices in most plans range from 8 to 20 options. The average plan has about 15.
- 401k plans may permit "self-directed investment accounts" and company stock purchase within the plan.
- Employee contributions to the plan are not subject to federal income taxes until a distribution from the plan is made. Any investment gains and earnings also enjoy tax deferral until distribution.
- This type of plan can permit loans and hardship withdrawals.
- Participants can start, stop contribution during course of year, as determined by the company.
- The employer can receive certain tax benefits for contributions.
- Plans are subject to top heavy testing and discrimination testing.
- Typically the amount the owners and highly compensated individuals can contribute to a 401k is a function of the contributions of the other employers.
- 401k plans are subject to IRS 5500 filings.
- Generally, the vendor selected by the plan sponsor does all accounting, participant reporting, testing, and files 5500 reports with the IRS.

401k plans have proven to be popular with employees for several reasons. The tax deferral is obviously high on this list of reasons. Others include the increased portability of this plan, employer matching contributions, and the increased control associated with self-direction of investments.

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