What is a 401(k) Plan?

A 401(k) plan is a company-sponsored retirement plan that offers tax advantages to both employer and employee. Employees can contribute part of their salary to the plan on a tax-deferred basis. That means they don't pay taxes on the amount they contribute or any investment returns until they make a withdrawal. An employer will often match a certain percentage of what the employee contributes, which in also provides a tax savings for the company.

The name comes from a specific section of the tax code – section 401(k) – that established this kind of retirement plan in 1978. 401(k) plans are tax-qualified plans which means that they're governed by regulations under the Employee Retirement Income Security Act of 1974 (ERISA).

Types of Contributions

A 401(k) plan can be funded by one or more contribution types: salary deferrals including Roth, discretionary match, discretionary profit-sharing, and safe harbor. Safe harbor contributions have their own rules and will be covered later. The types of contributions allowed and the necessary formulas must be written into the plan document. There's a limit on how much can be contributed, and the IRS sets the maximum contribution limits each year for cost-of-living purposes.

EMPLOYEE CONTRIBUTIONS

Employees simply defer a portion of their salary (pre-tax or after-tax) into the plan.

Traditional 401(k), or pre-tax. A great perk for 401(k) plan participants is the tax savings. Contributions to a traditional 401(k) plan are made from an employee's salary before income taxes are deducted. This lowers the employee's taxable income for the year. The IRS determines the maximum salary deferral limit each year and employees can choose to contribute up to that limit. Employees who are age 50 or older can also make "catch-up" contributions in addition to the annual maximum contribution.

Roth 401(k), or after-tax. Contributions can also be made on an after-tax basis as Roth contributions. Contributions are taxed, but investment returns grow tax-free. If a Roth account is held five years or longer, investment returns can be withdrawn tax-free.

EMPLOYER CONTRIBUTIONS

Matching. The employer may choose to match contributions which can be either a percentage of employee contributions or dollar-for-dollar up to a certain dollar amount. Matching contributions are made only to those employees – or participants – who are contributing to the plan.

Profit-Sharing. Profit-sharing contributions are also discretionary and are made to all eligible employees regardless of whether they contribute to the plan. The company can make a profit-sharing contribution regardless of whether the company actually generates a profit. Profit-sharing contributions can be a flat dollar amount per employee or a fixed dollar amount that's allocated on a pro-rata basis based on employee compensation.

Plan Funding

Employee salary deferrals are made on a payroll-per-payroll basis and deposited into participant investments as soon as administratively possible, which is generally within 3-4 days. Employer matching and safe harbor contributions can either be made on a payroll-per-payroll basis or annually at the end of the plan year, according to the plan document. Profit-sharing contributions can be made up until the time the company files a tax return, plus any extensions, depending on how the plan document is written.

Plan Asset Investing

The company that sponsors the 401(k) plan selects a menu of investment options from which participants can choose. Included investments fall into one or more of the following:

- Stock funds
- Bond funds
- Index funds
- Target-date funds
- Money market funds

Investment selection and monitoring are specified in the company's Investment Policy Statement.

Vesting

Vesting is simply another word for ownership. 401(k) participants are always 100% vested in their deferrals and Roth contributions in the plan. Company matching and profit-sharing contributions, however, may have vesting schedules that specify what percent of the company's contributions the employee owns, based on years of service with the company. If a participant leaves the company before being 100% vested in employer contributions, they may lose a portion of the employer contributions.

The IRS has rules on how long an employer can make a participant wait until they're 100% vested by mandating that an employer use one of two vesting schedules:

- **Graded vesting**, where the participant's vested percent increases the longer he's with the company; the vested percent increases 20% every year until he's 100% vested after six years of service.
- **Cliff vesting**, where the participant isn't 100% vested until after three years of service.

Eligibility for Participation

Employees are not always eligible to participate when they're first hired. A company can have a waiting period of up to one year of service and an age 21 requirement.

Accepting Rollovers

A 401(k) plan can allow participants to "roll in" money from certain other qualified retirement plans such as another 401(k) plan or an IRA, if, of course, it's written into the plan document.

Loans

401(k) plans can allow participants to take out personal loans from their 401(k) account if the employer allows it and writes it into the plan document. The maximum loan amount is 50% of a participant's vested account balance with a maximum of $50,000. The maximum length of a loan is five years unless it's for a home mortgage and then it can be increased to 25 years. The interest rate must be comparable to the rate charged by a lending or other financial institution.

If a participant terminates employment before the loan is paid off, the unpaid balance will be treated as a premature distribution and income taxes and penalties will apply. Most plans only allow participants to have one loan outstanding at any one time, but multiple loans can be allowed if it's written into the plan document.

Safe harbor 401(k) Plans

Safe harbor plans are a popular 401(k) design because they're exempt from certain 401(k) nondiscrimination tests. This allows highly compensated employees to maximize their contributions without causing the plan to fail these tests. There are four different 401(k) safe harbor design options:

- **Nonelective.** The employer contributes 3% of compensation to all eligible employees, whether they choose to make 401(k) deferral contributions.
- **Basic Match.** The employer matches 100% of employees' deferrals, up to 3% of compensation, plus 50% on deferrals between 3% and 5%, for a total match of 4%.
- **Enhanced Match.** The employer matches 4% employees' deferrals.
- **401(k) Match with Auto Enrollment (QACA).** All employees are automatically enrolled in the 401(k) plan; then the employer matches 50% of employees' deferrals between 2% and 5%, for a total match of 3.5%.

Employer nonelective contributions and basic and enhanced matching contributions are 100% immediately vested. Employer contributions to the auto-enrollment match must be 100% immediately vested after two years of service.

We're Here to Help

There are a lot of moving parts to a 401(k) plan that can make it seem complex. Laws and regulations for retirement plans can change frequently, which may complicate your efforts to keep the plan compliant. Partnering with a third-party administrator (TPA) is one way a company can manage their retirement plan benefits. In fact, 79% of employers choose a TPA instead of relying solely on in-house resources.[1]

If you're ready to continue the conversation about 401(k) plans or explore what's involved in outsourcing administrative work to a TPA, call Definiti at 1-888-912-3653, email mailto:sales@definiti-llc.com or visit definiti.com.

[1] Society of Professional Benefits Administrators.