The Basics of the 401(k)

Thoughts from a financial advisor

Most often, the first question a prospective employee will ask is about your company's benefit program. And in my experience, the two most often-asked questions are about health insurance and an employer-sponsored retirement program. Let's examine the most common employer-sponsored retirement program that exists today – the 401(k) plan.

Background

401(k) plans were named for the section of the Internal Revenue Code in which they are described. They allow employees to contribute their own pre-tax money into a retirement account, often by way of automatic payroll deduction, which is a very powerful tool to help bring discipline to investing for retirement. By investing *pre-tax* dollars, employees are then able to lower their income taxes in the years they contribute to a 401(k).

In addition to lowering their current year income taxes, employees will not pay taxes on their 401(k) earnings until they withdraw them, usually at retirement.

Because contributions are made on a pre-tax basis, participants generally pay income taxes on their contributions when withdrawals are made – again, this is usually at retirement when they may be in a lower tax bracket. Withdrawals prior to age 59½ may be limited, and if available, may be subject to a 10% early withdrawal penalty. Withdrawals of after-tax contributions will not be taxed.

But is there a match?

The question that prospective employees really want to ask is this: does the company contribute to my personal 401(k) at all?

As an employer, you have the option to match some, or all, of your employee's contributions – which further enhances the employee's tax-deferred accumulations.

Additional Benefits

There are of course many other features that make 401(k) plans attractive. One example is the ability of plan participants (employees) to diversify their contributions in a variety of investment options offered under the plan. These investment options usually include a menu of mutual funds – equity funds, fixed-income funds, balanced funds, money market funds, etc. In addition, most plans allow employees to change how their assets are allocated among the various investment options, giving them the opportunity to create an individualized investment mix that is more in tune with their risk profile.

For example, a 24 year-old employee might choose to invest entirely in equity funds, because he has 30+ years to retirement; whereas a 50-year old employee might opt for a larger allocation to fixed-income funds.

In addition, many plans allow employees to make after-tax contributions (subject to certain limitations). While these contributions would not lower their current year's income tax, like pre-tax contributions, the employee's after-tax contributions will still accumulate investment earnings on a tax-deferred basis.

Flexibility: A Part of Every 401(k) Plan

A 401(k) approach could be right for your employees (and your business) if you don't want to be locked into funding a ***traditional* defined benefit program**, which provides a pre-determined benefit when an employee retires.

A 401(k) – in very technical terms – is called a **defined *contribution* plan**. This means the plan's ultimate payout depends on how much the participating employee and your business (if your business so chooses) have paid into the employee's 401(k) account, in addition to investment income. In other words, a 401(k) enables employees to contribute to their own retirement, while giving *your business* the flexibility to determine if, and how much, you want it to participate in their plan.

While offering a 401(k) program is a great tool for attracting prospective employees, it can also be used to reward employee loyalty. More specifically, you can establish a "vesting" schedule that specifies when your employees own your employer matching contributions. For example, you might decide that employees will be fully vested after a certain number of years – say 20% per year over five years. Of course employees are always fully vested for their own contributions and investment earnings.

What are the Limitations?

As with all retirement plans, there are certain limitations and they change every year. Also, the contributions of highly compensated employees (HCEs) may be limited if lower paid employees do not contribute a sufficient amount. Each plan year, plan administrators must perform "top-heavy" testing to determine the maximum allowable contribution amount for key employees. So, if you start up a 401(k) plan, make sure you have a strong buy-in from all of your employees.

Summary

Although the rules change from year to year and there is an administrative burden in establishing a 401(k) plan for your employees, it is not that difficult. Make sure you find a qualified financial advisor who can help determine whether a 401(k) plan is right for your business.

Your employees will appreciate that you are helping them save for their retirement.