

401(k) Plans...An Overview

Description:

A 401(k) plan is a type of profit sharing plan that allows employees to choose between receiving current compensation (and being taxed on it) or deferring compensation to a 401(k) plan (and deferring tax on it) through a "cash or deferred arrangement" (CODA). Employers frequently make a matching contribution equal to some percentage of the employee's elective salary deferral. A 401(k) plan can also provide for profit sharing contributions made by the employer and allocated to the accounts of all plan participants in a uniform, non-discriminatory manner. Plan participants are usually able to allocate their 401(k) contributions among the various investment alternatives available in the plan. The amount of a participant's retirement benefit is then based on the value of the participant's account at retirement.

401(k) Plan Contributions:

Contributions to a 401(k) plan typically arise from one or more of these sources:

Salary reduction: The employee agrees to a reduction in salary (an elective salary deferral), which the employer then contributes to the plan on the employee's behalf. The employee is able to exclude the salary reduction amount from current income.

Matching employer contribution: The employer agrees to match a percentage of the employee's elective salary deferral. The match is typically a percentage match (e.g., 50%) for each dollar deferred by the employee, up to a specified maximum.

Profit sharing contribution: The employer makes a profit sharing contribution, which each employee can take in cash, defer to the 401(k) plan or some combination of the two.

Advantages:

Both employers and employees can make retirement plan contributions on a pre-tax basis.

The employee directs how his/her 401(k) account is invested and assumes the risk of investment performance.

Disadvantages:

401(k) plans are somewhat more involved to administer than some other types of qualified retirement plans.

401(k) plans tend to be more advantageous for younger employees with more time until retirement.