

401(k)s: The Competitive Advantage

An attractive benefit plan can play a fundamental role in recruiting and retaining qualified staff. And, when trying to save for the future, a **401(k)** retirement savings plan can help employees attain their retirement objectives on a tax-advantaged basis. Named for the section of the Internal Revenue Code (IRC) that created it, a 401(k) plan may be one of the most popular and valuable fringe benefits available. Although the technical aspects of 401(k)s can be complex, the advantages can be far-reaching. Consider the following:

- o Plan participants receive a **tax deferral** for earnings on the contributions they make to their specific accounts under the plan, as well as for those made by employers on their behalf.
- o Some employers offer **matching contributions** up to a certain percentage. This provides the plan participant with the opportunity to further enhance the tax-deferred accumulation of his or her plan assets.
- o Plan participants may select from a variety of funding options. In addition, plans may allow employees to change their funding options over time to reflect their individual requirements.
- o Because plan contributions are typically made on a *pre-tax* basis (subject to certain limitations), money going into the plan is deducted from the employee's salary before Federal income taxes. Consequently, by lowering taxable salary, participants are able to lower their Federal income tax each year they participate in the plan.
- o Some plans may also allow employees to make *after-tax* contributions (again, subject to certain limitations). While these contributions do not lower the current year's income tax, as do pre-tax contributions, after-tax contributions also accumulate earnings on a tax-deferred basis.

How They Work

401(k) plans are commonly referred to as **defined contribution** plans because each plan participant has a separate account to which a specific or "defined" contribution is made. Employees determine how much they wish to contribute (not to exceed contribution limitations) and are able to choose among a variety of funding options offered by the plan.

In addition, employers may also contribute to employee accounts by matching a percentage of employee contributions. For instance, an employer may contribute \$1 for every \$2 an employee contributes. The advantage of matching contributions generally depends on the *level* of the match and the employer's "**vesting**" requirements. Vesting refers to the employee's entitlement to the funds in the plan. An employee's contributions—and the earnings on those contributions—are fully vested from his or her start in the plan. On the other hand, an employer's matching contributions may vest according to the employee's length of service. Thus, an employer can arrange his or her contributions to follow a vesting schedule that rewards loyalty by fully vesting plan participants after a specified number of years (for example, after six years).

Plan Restrictions

As with all retirement plans, 401(k) plans have certain restrictions. For instance, the contributions of highly compensated employees (HCEs) may be limited if lower paid employees do not contribute a sufficient amount. Every year, plan administrators must perform "**top-heavy**" tests to determine the maximum amount highly compensated employees may contribute.

Another restriction involves taxes. Plan participants are subject to income taxes for *pre-tax* contributions and earnings when they withdraw the funds. (*After-tax* contributions are not subject to further taxation when withdrawn.) Withdrawals usually occur at retirement, when plan participants are more likely to be in a lower tax bracket. Withdrawals prior to age 59½ are only available under certain circumstances and, when available, may be subject to a 10% Federal income tax penalty. The distribution penalty, however, does not apply to participants who are separated from service and who are age 55 or older.

The best employees seek out employers with the best opportunities. Tax-deferred saving through an employer-sponsored 401(k) plan can be a highly desirable way for a highly valued employee to build retirement savings. When combined with income from other sources, such as a pension, Social Security, and personal savings, plan participants may be able to achieve their retirement objectives.