401(k) Plan

What is it?

The "401(k) plan," has become one of the most popular types of employer-sponsored retirement plans.

With a 401(k) plan, an employee can elect either to receive cash payments (wages) from his or her employer immediately, or to defer receipt of a portion of that income to the plan. The amount deferred (called an "elective deferral" or "elective contribution" or "pre-tax contribution") isn't currently includable in the employee's income; it's made with pre-tax dollars.

Consequently, the employee's federal taxable income (and federal income tax) that year is reduced. The deferred portion is taxed to the employee when it's withdrawn or distributed.

> Assume Melissa is employed by a department store. She earns $30,000 annually. Melissa defers $5,000 of her earnings to the store's 401(k) plan. As a result, Melissa's taxable income is now $25,000. She isn't taxed on the deferred money ($5,000) until she receives a distribution or makes a withdrawal*.
>
> ***State tax laws may differ from federal law. Consult your pension advisor for the tax impact in your particular state.***

Roth 401(k)s

A 401(k) plan can allow employees to designate all or part of their elective deferrals as qualified Roth 401(k) contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. Unlike pre-tax contributions to a 401(k) plan, there's no up-front tax benefit, but if certain conditions are met, employees' Roth contributions and earnings are entirely free from federal income tax when distributed from the plan.

Separate accounts must be established within a 401(k) plan (the "Roth accounts") to track each employee's Roth contributions and any gains or losses on those contributions. The taxation of distributions from the Roth account is also determined separately from any other 401(k) plan dollars. (Note: Employers don't have to allow Roth contributions to their 401(k) plans.)

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*This is a hypothetical example and is not representative of any specific investment. Your results may vary.

Contributions

Whether an employee elects to make pre-tax contributions or Roth after-tax contributions to the 401(k) plan, careful attention must be paid to the elective deferral limits.

The IRS elective deferral limit for 2023 is $22,500. This limit applies to the traditional (tax-deferred) and Roth contributions made by an employee during the calendar year. The combined total of traditional (tax-deferred) and Roth contributions made during the calendar year cannot exceed the elective deferral limit. The IRS catch-up contribution limit for 2023 is $7,500. Participants are no longer required to make separate catch-up contribution elections. Amounts beyond the elective deferral or annual additions limit automatically spill over toward the catch-up limit for those who are 50 or older and for those turning 50 in the calendar year.

Employer contributions

To encourage employee participation, some employers offer to "match" employee contributions under a specific formula. For example, you might decide to match 50 cents on every dollar contributed by employees up to a maximum of 10% of each employee's salary. As an employer, you also have the option of making discretionary contributions ("nonelective contributions") to the employees' accounts. These contributions are subject to specific tests to ensure that they don't discriminate in favor of highly compensated employees.

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