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What Is a 401(k) Plan?

A 401(k) plan is self-directed, qualified retirement plan established by an employer to provide future retirement benefits for employees. Employee contributions are made on a pre-tax basis, and employer contributions are often tax deductible. [Roth 401(k) contributions are made after-tax, but qualified withdrawals in retirement are free of federal income tax.] Many employers are now enrolling new hires automatically in 401(k) plans, allowing them to opt out later if they choose not to participate. This is done in the hope that more employees will participate and will start saving for retirement at an earlier age.

If you elect to participate in a 401(k) plan, you can allocate a percentage of your salary to your plan every month. The maximum annual contributions are $15,500 for 2008 and $16,500 for 2009. Starting in 2010, the contribution limits will be indexed for inflation. If you will be 50 or older before the end of the tax year, you can contribute an additional $5,000. Contribution limits are indexed annually for inflation. The funds in your account will accumulate tax deferred until you begin taking distributions in retirement.

Employer contributions are often subject to vesting requirements. Employers can determine their own vesting schedules, making employees partially vested over time and fully vested after a specific number of years. When an employee is fully vested, he or she is entitled to all the contributions made by the employer when separating from service.

In plans that offer loans, you may also be allowed to borrow money from your account (up to 50% of the account value or $50,000, whichever is less) with a five-year repayment period. Of course, if you leave your job, the loan may have to be repaid immediately.

The funds in a 401(k) plan are portable. When you leave your job or retire, you can move your funds or take a taxable distribution. However, if you leave a company before you are fully vested, you will be allowed to take only the funds that you contributed yourself plus any vested funds, as well as any earnings that have accumulated on those contributions.

Within certain limits, the funds in your 401(k) plan can be rolled over directly to your new employer's retirement plan without penalty. Alternatively, you can roll your funds directly to an individual retirement account (IRA) instead.

You must begin taking required minimum distributions from 401(k) plans no later than April 1 of the year after you reach age 70½. Distributions from regular 401(k) plans are taxed as ordinary income and may be subject to a 10% federal income tax penalty if withdrawn before age 59½, except in special circumstances such as disability or death.

A 401(k) plan can be a great way to save for retirement, especially if your employer offers matching contributions. If you are eligible to participate in a 401(k) plan, you should take advantage of the opportunity, even if you have to start by contributing a small percentage of your salary. This type of plan can form the basis for a sound retirement funding strategy.

For more information on how a 401(k) plan and other financial solutions can fit into your overall financial plan, contact Jason M. Woodward, J.D. today at (603) 264-7550 or financialattorney@gmail.com.