401(k) PLANS

A 401(k) plan is a type of retirement savings account which takes its name from subsection 401(k) of the Internal Revenue Code (IRC). It is a qualified plan established by employers to which eligible employees may make salary deferral contributions. Employers offering a 401(k) plan may make matching or non-elective contributions to the plan on behalf of eligible employees and can also add a profit-sharing feature to the plan.

FEATURES

TYPES OF PLANS

There are two types of 401(k) plans – a traditional 401(k) and a Roth 401(k). A traditional 401(k) plan provides for pre-tax employee salary deferrals where earnings grow tax-deferred and distributions are taxable.

The Roth 401(k) plan was first introduced as a provision of the Economic Growth and Tax Relief Reconciliation Act that became effective in 2006 and offers the same benefits as Roth IRAs. Employee salary deferrals are made with after-tax dollars, earnings grow tax-deferred, and distributions can be withdrawn tax free.

CONTRIBUTIONS

Employees are limited to the amount of elective deferrals they can contribute to their traditional or Roth 401(k) plan. For 2015, the limit is $18,000 and a $6,000 "catch-up" contribution is available for those ages 50 or older. The deferrals are made through payroll deduction and if both plans are available, participants can contribute to both as long as they do not go over the maximum amount combined. For traditional 401(k) contributions, even though these are not subject to federal or state income taxes at the time of contribution, FICA taxes are still deducted. For Roth 401(k) plan contributions, federal, state and FICA taxes are deducted and the net amount is then deposited into the account.

CONTRIBUTION DEADLINE

Contributions to a 401(k) plan must be made within the calendar year.

EMPLOYER MATCHING

Some employers may match a certain percentage of employee's elective deferrals or salary, up to a specified amount and may be subject to vesting requirements. For those contributing to a 401(k) plan, any employer matching contributions will not be made into the Roth 401(k) plan. In order to preserve the tax benefits to the company of their contributions, these will instead be deposited into a traditional 401(k).

RETIREMENT OR TERMINATION OF EMPLOYEMENT

Once an employee retires or terminates their employment, they can typically choose to either keep their funds in the employer's plan (if the balance is at least $5,000) or transfer it to a Rollover IRA or Roth IRA. It is generally advised to roll their account into an IRA, as these accounts allow for greater flexibility, more investment options, and potentially lower internal fees.

NORMAL DISTRIBUTIONS

Once an employee is retired or no longer an active participant in the plan, and reaches the age of 59 ½, they are able to take distributions from the 401(k) plan. For distributions from a traditional 401(k) plan, these are subject to ordinary income taxes.

LOANS

Some 401(k) plans have a provision where the employee can take out a loan against their account balance which will avoid incurring taxes or the 10% early distribution penalty. Typically, in order for a participant to be eligible to take out a loan, their account balance must be at least $5,000 and the maximum loan amount is the lesser of 50% of the present value of the employee's vested account balance in the plan or $50,000. In most cases, the loan must be repaid over a five-year period which is done through payroll deductions in which principal and interest payments are made. In the event one is laid off, fired, chooses to retire, or to leave for another employer, the loan balance becomes due immediately. If it cannot be paid back, it is treated as ordinary income where taxes and an early withdrawal penalty will be assessed.

IN-SERVICE WITHDRAWALS

Before experiencing a triggering event such as retirement or termination from an employer, it is very difficult for an employee to withdraw funds from an active 401(k) plan aside from taking out a loan. However, there are ways to withdraw from a 401(k) plan prior to retirement, including hardship withdrawals. Additionally, some plans may permit in-service 401(k) withdrawals which allows the participant access to their plan's assets, but this type of withdrawal is treated as ordinary income, and if under age 59 ½, he or she could be subject to a 10% early withdrawal penalty.

REQUIRED MINIMUM DISTRIBUTIONS

For traditional 401(k) plans, to ensure that the funds are used for retirement income and not for estate planning purposes, participants must begin making withdrawals by April 1st of the following year they turn age 70½ (the required beginning date). The minimum amount that must be withdrawn (the required minimum distribution) from these traditional 401(k) plans is found by dividing the account balance on December 31st of the year preceding the distribution by the IRA owner's life expectancy as found in IRS Publication 590. Failure to take the required minimum distribution before December 31st results in a 50% excise tax on the amount not distributed as required. An exception to this rule is if the participant is still actively participating in a 401(k) plan, in which case, he or she is not subject to taking an RMD from this account. Active participants who would have been subject to RMD should check with their plan administrator.