401(k) Plans

Perhaps the most popular retirement plan being elected today, a 401(k) retirement plan is a type of plan to which the employee can contribute from his or her paycheck before or after taxes are taken out. The contributions go into a 401(k) account, with the employee often choosing the investments based on options provided under the plan. In some plans, the employer also makes contributions, matching the employee's contributions up to a certain percentage.

There are two types of 401(k) plans. In a **traditional 401(k) plan**, employees are allowed to make contributions from their paychecks on a **pre-tax basis**. Thus, employees can avoid paying taxes on this income until it is distributed from the account at retirement. The contributions also grow tax-free until distribution. In a **Roth 401(k) plan**, employees are allowed to make contributions from their paychecks on a **post-tax basis** (i.e., after taxes are taken out). Roth 401(k) contributions and investment assets grow tax-free, and because the employee paid taxes on the contributions up front as ordinary income, distributions at retirement are generally tax-free.

Participation Rules

Typically, a plan includes a mix of rank-and-file employees, managers, and owners. However, some employees may be excluded from a 401(k) plan if they:

- Have not attained age 21;
- Have not completed a year of service during which they work at least 1,000 hours*; or
- Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good-faith bargaining.

*Beginning in 2021, employers must permit part-time workers who work for at least 500 hours over three consecutive years to contribute to 401(k) plans.

Contribution Rules

The maximum amount an employee can contribute to a 401(k) plan in 2023 is $22,500 (up from $20,500 in 2022). However, employees aged 50 or older are generally permitted to make additional "catch-up" contributions of $7,500 in 2023 (up from $6,500 in 2022).

Withdrawal Rules

Withdrawals from a 401(k) account directed by employees who are not yet 59.5 years old are generally subject to an additional 10% tax, on top of any income tax owed on the withdrawal amount. **However, certain exceptions do apply**. Click here for more information.

In addition, holders of traditional 401(k) accounts generally must make **required minimum distributions** upon turning 72 years old or, if later, upon retirement.

Nondiscrimination Rules

Traditional 401(k) plans are subject to annual testing to assure that the amount of contributions made on behalf of rank-and-file employees is proportional to contributions made on behalf of so-called highly compensated employees. For more information, contact the Internal Revenue Service.

Vesting Rules

Employee contributions are immediately 100% vested—that is, the money cannot be forfeited. When an employee leaves employment, he/she is entitled to those funds, plus any investment gains (or minus losses) they have incurred.

Additional requirements apply. Click here for more information.