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Understanding your 401(k) plan

by Steven Podnos, Md, Mba, Cfp • Aug. 27, 2015 • 1 min read • original

I encounter a great deal of confusion about the most common retirement plan in the country. Most of you reading this are probably enrolled in a 401(k) plan and maybe you have some of the same questions as others.

First, understand that there are two sides of a 401(k) plan. The side that involves the biggest decision is the salary deferral side. It is here that every participant has the choice to defer some of his salary into the plan rather than take it as taxable income (note that this deferred income is still subject to self-employment taxes, just not state or federal income tax). In 2015, the upper limit to salary deferral is $18,000 (with an additional $6,000 ″catch up″ for participants 50 years or older). Any salary deferred into the plan is immediately vested —meaning you would take both that money and any future earnings on it with you, if you leave the plan.

The other side of the 401(k) plan all comes from the employer, and is not modified by your behavior. The employer side of the plan is called a ″match″ or a ″non-elective contribution″ or ″profit sharing.″

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The government regulation of 401(k) plans favors lower-income participants. It rigidly restricts the ability of higher-income participants to make salary deferrals if lower-income participants do not. This is called discrimination testing. So if a company has only a simple salary deferral plan in which few low-income employees participate, the higher-income participants will be markedly constrained and will not be able to come close to the otherwise allowable limits ($18,000/$24,000).

There are two ways in which employers try to overcome this problem. One solution is to offer a ″match.″ The employer agrees to give a contribution based on the amount that an employee contributes in salary deferral. A typical match might read, ″The company will match employee salary deferrals dollar for dollar up to 3 percent of compensation.″ So, an employee who makes $20,000 could get a $600 match (3 percent x $20,000) if they deferred the same amount to the plan. Recognize that this is a 100 percent return for the year on the $600 salary deferral.

A second way that employers try to maximize salary deferrals for participants who wish to do so (especially key employees) is to make an immediately vested contribution on the

employer side, which is called a "safe harbor" contribution. The government regulations state that if such a safe harbor contribution is made, all participants may make full salary deferrals without any discrimination testing.

Some 401(k) plans go further and provide participants with an additional profit-sharing contribution subject to vesting (meaning you would get all this money only if you remain employed for a certain period of time).

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