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401(k) Plans: What Are They, How They Work

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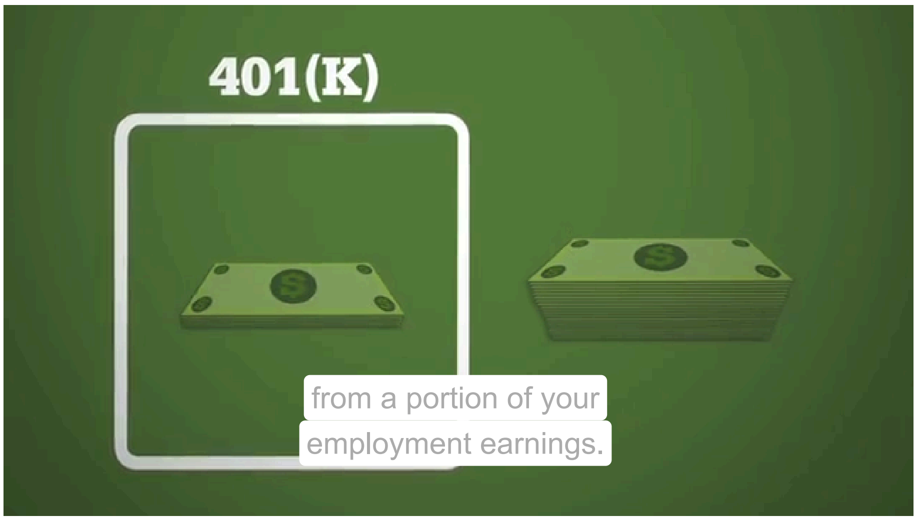
Part of the Series
401(k) Plans: The Complete Guide



DEFINITION:

A 401(k) plan is a tax-advantaged retirement savings plan.

What Is a 401(k) Plan?

A 401(k) plan is a tax-advantaged retirement savings plan. Named after a section of the U.S. Internal Revenue Code, the 401(k) is a defined-contribution plan provided by an employer.[1] The employer may match employee contributions; with some plans, the match is mandatory.

There are two major types of 401(k): traditional and Roth. With a traditional 401(k), employee contributions are pretax, meaning they reduce taxable income, but withdrawals in retirement are taxed. With a Roth 401(k), employee contributions are made with after-tax income. There's no tax deduction in the contribution year, but withdrawals—qualified distributions—are tax free.[2]

Below, you'll find detailed information on how 401(k) plans work, how to start one, and strategies for making the most of a plan.

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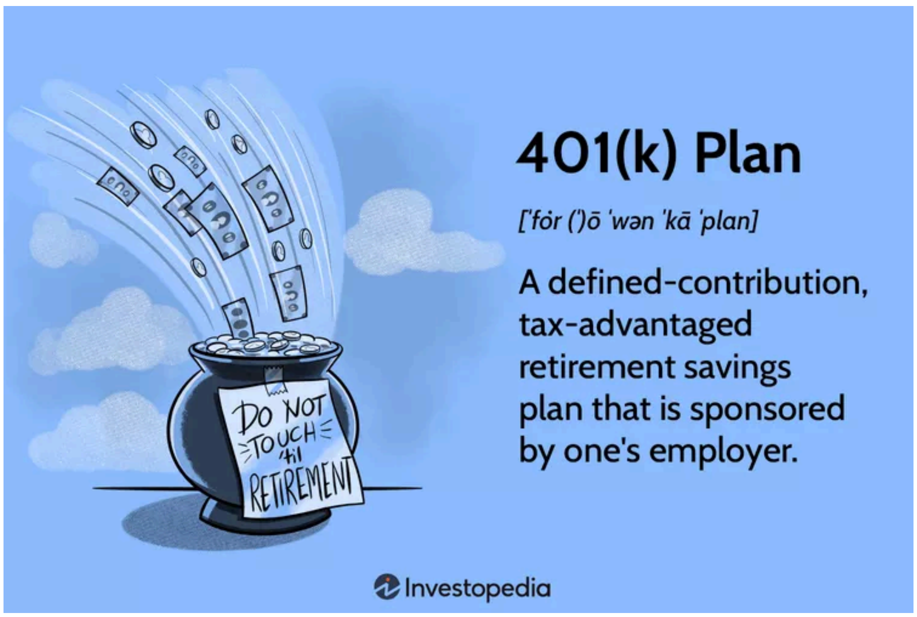
- A 401(k) plan is a company-sponsored retirement account in which employees can contribute a percentage of their income. Employers often offer to match at least some of these contributions.
- There are two basic types of 401(k)—traditional and Roth—which differ primarily in how they're taxed.
- Employer contributions can be made to both traditional and Roth 401(k) plans; solo 401(k) companies provide plans for people without employers.
- There are rules governing when you can withdraw money from a 401(k) without penalty.



Credit: Ellen Lindner / Investopedia

"The most important thing to know when making any decision about your 401(k) is to use it. In a perfect world, you put the maximum amount in it, but at a minimum, you should contribute up to the point where your company matches what you put in," said Peter Lazaroff, financial advisor and chief investment officer at Plancorp.

In 2023 (the most recent data), Americans saved an average of 7.1% of their salaries in their 401(k)s, which was higher than the overall personal savings rate that year. [3] [4] Less than 12% of working-age Americans were on track in 2023 to max out their contributions. [5]

Take the Next Step to Invest

The 401(k) employee contribution limit for 2025 is $31,000 (including "catch-up" contributions) for those 50 and older and $23,500 for those under 50. [6]

How 401(k)s Work

Traditional 401(k) plans were introduced in the early 1980s, allowing employees to make pretax contributions from their salaries up to certain limits. [7] [8]

When a worker signs up for a 401(k), they agree to deposit a percentage of each paycheck directly into an investment account. Employers often match part or all of that contribution.

Employees choose the specific investments held within their 401(k) accounts from a selection offered by their employer. Typically, investment offerings include stock and bond mutual funds and target-date funds designed to reduce the risk of losses as the employee approaches retirement. [9]

> Note
>
> *An employee's account holdings may include guaranteed investment contracts issued by insurance companies and sometimes the employer's own stock.* [10]

How Do You Start a 401(k)?

- Contact your employer. Ask if a 401(k) is available, and whether there is a company match. Some employers will make this clear when you're hired.
- If a 401(k) is available, the company will instruct you on how to sign up.
- Choose your investments. There should be a range of options, from conservative to aggressive. A popular option is the target date account, which automatically adjusts the asset mix to align with a preset retirement date. It typically becomes more conservative as you near retirement. [11]
- If you are self-employed or run a small business with your spouse, you may be eligible for a solo 401(k) plan, also known as an independent 401(k). [12]

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Traditional 401(k)s

With a traditional 401(k), employee contributions are deducted from gross income. This means the money comes from your paycheck before income taxes have been deducted.

As a result, your taxable income is reduced by the total contributions for the year and can be reported as a tax deduction for that tax year. No taxes are due on the money contributed or the investment earnings until you withdraw the money, usually in retirement. [13]

Roth 401(k)s

When 401(k) plans were first rolled out in the 1980s, companies and their employees had one choice: the traditional 401(k). [14] Roth 401(k)s didn't arrive until 2006. [15] These 401(k) plans are named for former U.S. Senator William Roth of Delaware, the primary sponsor of the 1997 legislation that made the Roth IRA possible. [16] At first, Roth 401(k)s caught on slowly, but now many employers offer them.

With a Roth 401(k), contributions are deducted from your after-tax income. This means you contribute from your pay after income taxes have been deducted. As a result, there is no tax deduction in the year of the contribution. When you withdraw the money during retirement, though, you don't have to pay any additional taxes on your contribution or on the investment earnings.

As a general rule, employees who expect to be in a lower marginal tax bracket after they retire might want to opt for a traditional 401(k) and take advantage of the immediate tax break.

Employees anticipating a higher tax bracket after retiring might choose a Roth 401(k) to avoid paying taxes on their savings later. This decision could be especially worthwhile if the Roth has many years to grow, as all the money earned by the contributions over decades will be tax free upon withdrawal.

As a practical matter, a Roth reduces your immediate spending power more than a traditional 401(k) plan—something to consider if your budget is tight.

Even though contributions to a Roth 401(k) are made with after-tax money, there are, generally speaking, tax consequences if withdrawals are made before you're 59½ years old. Always check with an accountant or qualified financial advisor before withdrawing money from either a Roth or traditional 401(k). [17]

TIP

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401(k) Plan Contribution Limits

Traditional and Roth 401(k) plans are defined contribution plans. Both the employee and employer can contribute to the account up to the dollar limits set by the Internal Revenue Service (IRS). [13]

The maximum amount an employee or employer can contribute to a 401(k) plan is adjusted periodically to account for inflation, which measures rising prices.

For 2025, the annual limit on employee contributions to a 401(k) is $23,500 for workers under age 50. Those age 50 or older can make an additional $7,500 catch-up contribution. [6]

TIP

"Even though everyone has different circumstances, in general, you should try to put in the maximum allowable amount in your 401(k)," says Peter Lazaroff, an Investopedia 100 top financial advisor.

Employer Matching

- For workers under 50 years old, the combined limit for both employee and employer contributions is $70,000 per year in 2025.
- If the catch-up contribution for those 50 or older is included, the combined limit is $77,500.

Employers who match employee contributions use various formulas to calculate that match.

An employer might match $0.50 for every $1 that the employee contributes, for example, up to a certain percentage of their salary. Vanguard estimates that about one in seven companies have 401(k) matching contributions that follow this formula on 6% of their employees' wages. [18]

Lazaroff, who hosts the investment education podcast The Long Term Investor, says that you should take advantage of your employer's matching contributions if you can. [19] It's a risk-free way to grow your money and not leave part of your compensation on the table.

"Meeting the match doesn't necessarily mean you have to sacrifice other financial goals, such as paying down debt or establishing an emergency fund,"

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How Does Your 401(k) Earn Money?

When you contribute to your 401(k) account, your money is invested according to your choices from the options your employer offers. These typically include an assortment of target-date funds and mutual funds.

Target-date funds are the way "you're least likely to make mistakes," Lazaroff said. These accounts contain a mix of stocks, bonds, and other securities that are adjusted as your chosen date approaches, generally shifting toward more conservative investments as you near retirement.

"You might be different from the average, and you might accumulate enough wealth one day where a target-date fund isn't the most appropriate. But for many people, it's one of the easier and least risky routes to take," Lazaroff says.

Several factors influence the pace and extent of your 401(k)'s growth, including the amount you contribute annually, any company matches, investment performance, and the time until you retire.

A significant benefit of a 401(k) is tax-deferred growth. With a traditional 401(k), you don't have to pay taxes on investment gains, interest, or dividends until you withdraw money from the account. However, if you have a Roth 401(k), you won't have to pay taxes on qualified withdrawals when you retire, as contributions are made with after-tax dollars. [20] [21]

Opening a 401(k) also allows your money to grow over time, thanks to the power of compounding. Compounding occurs when the returns generated by your savings are reinvested into the account, generating returns of their own. Over many years, the compounded earnings in your 401(k) account can exceed the amount you contributed. This is why, as you continue to contribute to your 401(k), it can grow quite substantially by the time you retire.

401(k) Withdrawals

Once your money goes into a 401(k), it can be difficult to withdraw it without paying taxes on the amount. [20]

"Make sure that you still save enough on the outside for emergencies and expenses you may have before retirement," says Dan Stewart, the head of Dallas-based Revere Asset Management. "Do not put all of your savings into your 401(k) where you cannot easily access it, if necessary."

For emergency funds, consider putting some of your savings into a high-yield savings account, where you can access it easily while still earning a decent interest rate. And for money you won't need for a while, look at the best available CDs to lock in a strong rate for months or years at a time.

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money (which has never been taxed) will be taxed as ordinary income. With a Roth, you've already paid income tax on the money you contributed, so you won't owe taxes on withdrawals if you satisfy specific requirements.[22][21]

You must be at least 59½—or meet IRS criteria for a hardship withdrawal—when you start making withdrawals, or you will face a 10% early withdrawal penalty on top of any other income tax you owe.[20][17]

FAST FACT

Some employers allow employees to take out a loan against their 401(k) plan contributions, essentially borrowing from themselves.[23]

Required Minimum Distributions

Traditional 401(k) account holders have required minimum distributions (RMDs) after reaching a certain age or face an IRS penalty. (Withdrawals are called distributions in IRS parlance.)[24]

Investors who have retired must start taking RMDs from their 401(k) plans at age 73. The amount of the RMD is calculated based on your life expectancy at the time. Before 2020, the RMD age was 70½. After that, it was changed to 72.[25] And it was updated to age 73 in the omnibus spending bill H.R. 2617 in 2022.[26]

What Are the Pros and Cons of a 401(k)?

Pros

- Traditional 401(k) plans let you reduce your tax burden while saving for retirement.
- With Roth 401(k)s, qualifying withdrawals are tax free.
- Tax-deferred gains
- Hassle-free because contributions are automatically subtracted from your paycheck
- Employer might provide a match, boosting your retirement savings

Cons

- 401(k)s can come with fees—though they're typically modest.
- Traditional (not Roth) accounts are subject to required minimum distributions (RMDs).
- There are penalties for withdrawing funds early—if you're younger than 59½ and you don't qualify for a hardship withdrawal, you'll need to pay a 10% penalty to the IRS.
- A 401(k) might not be enough on its own to sustain you in retirement, depending on your goals and circumstances. Consider talking to a financial

TIP

Since it's difficult to predict what tax rates will be decades from now, many financial advisors suggest putting money into both Roth and traditional 401(k) accounts.

History of the 401(k)

The United States has undergone a significant shift in how Americans save for retirement, as illustrated below by our chart comparing the number of Americans (in millions) in defined benefit and defined contribution plans, along with the total for both.

Defined contribution plans, most of which are 401(k)s, are an alternative to the traditional pension, known as a defined benefit plan. With a pension, the employer is committed to providing a specific amount of money to the employee for life during retirement.[27] In recent decades, as the chart below shows, defined contribution plans like 401(k)s have become far more common, and traditional pensions have become rare as employers have shifted the responsibility and risk of saving for retirement to employees.[28] [29]

Comparing the Number of Americans in Defined Benefit vs. Defined Contribution Plans

Chart of Americans in defined contribution vs. defined benefit plans

Congressional Research Service.
Credit: Investopedia

Above, the number of Americans in defined benefit and defined contribution plans, along with the total of both, in millions.[28]

Initially offered by employers to supplement other employee benefits, 401(k)s have become the most common private employer-sponsored retirement program in the U.S. About a third of working-age Americans have a 401(k), according to U.S. Census data, compared with one in nine who have a defined benefit pension plan. Meanwhile, as many as 4 in 10 baby boomers and half of millennials have no retirement account at all.[8]

Still, the 401(k) plan was designed to encourage Americans to save for retirement. Among its benefits are tax savings. If your employer offers both types of 401(k) plans, you can split your contributions, putting some money into a traditional 401(k) and some into a Roth 401(k).[17]

401(k)s vs. Brokerage Accounts

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brokerage account can be used for various financial goals and often offers more control over the investments.

A 401(k) is a type of qualified retirement plan. Within it, you can choose from a menu of investment options (generally mutual funds) where your money grows in a tax-advantaged manner.

A brokerage account, meanwhile, is a private account where you can buy, sell, and hold whatever securities your broker has access to, including mutual funds, stocks, bonds, and exchange-traded funds (ETFs). Brokerage accounts are taxable, meaning your capital gains and dividends are subject to tax in the current period. There are also no contribution limits, early withdrawal considerations, or minimum distributions.

401(k)s vs. Brokerage Accounts

401(k)	Brokerage Account
Retirement account	Can be used for anything
Employer-sponsored	Self-sponsored
Limited menu of investment options	Can buy or sell any investment
Tax-deferred	Taxable
Annual contribution limits	No contribution limits
Early withdrawal penalties	No withdrawal penalties
RMDs	No RMDs
Potential for employer matching	No employer matching

What Happens to Your 401(k) When You Leave a Job?

When you leave a company where you've been employed and you have a 401(k) plan, you generally have four options:

1. Withdraw the Money

Withdrawing the money is usually a bad idea unless you urgently need it. The money will be taxable for the year it's withdrawn. You will be hit with the

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With a Roth 401(k), you can withdraw your contributions (but not any earnings) tax-free and without penalty if you have had the account for at least five years or meet the IRS criteria mentioned previously. [17] However, you're still decreasing your retirement savings, which you may regret later.

2. Roll Your 401(k) Into an IRA

Moving the money into an individual retirement account (IRA) at a brokerage firm or a bank means avoiding immediate taxes and maintaining the account's tax-advantaged status. What's more, you can choose from among a wider range of investment choices than you had with your employer's plan. [30]

The IRS has relatively strict rules on IRA rollovers and how they need to be accomplished. Not following them is costly. [31] Typically, the financial institution in line to receive the money will help with the process to prevent any missteps.

> **WARNING**
>
> Funds withdrawn from your 401(k) must be rolled over to another retirement account within 60 days to avoid taxes and penalties. [31]

3. Leave Your 401(k) With Your Former Employer

In many cases, employers permit a departing employee to keep a 401(k) account indefinitely in their old plan, though the employee can't contribute further. This generally applies to accounts worth at least $5,000. For smaller accounts, an employer may give the employee no choice but to move the money elsewhere. [30]

Leaving the money where it is makes sense if the former employer's plan is well-managed and you are satisfied with its investment choices. The danger is that employees who change jobs throughout their careers can leave a trail of old 401(k) plans and may forget about one or more of them. Their heirs might also be unaware of the existence of the accounts.

Capitalize, an investment platform specializing in rolling over forgotten or left-behind 401(k) accounts, estimates that in 2023, there were almost 30 million such accounts in the U.S., holding about a quarter of Americans' total assets in 401(k) plans. [32]

4. Move Your 401(k) to Your New Employer

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immediate taxes.

If you aren't comfortable with managing a rollover, you can leave some of the work to the new plan's administrator.

Frequently Asked Questions (FAQs)

What Is the Maximum Contribution to a 401(k)?

The maximum contribution to a 401(k) plan is $23,500 in 2025 if you are younger than 50 years old. If you are 50 years old or older, you can make an additional catch-up contribution of $7,500. There are also limitations on the employer's matching contribution: The combined employer-employee contributions cannot exceed $70,000 in 2025 for employees under 50 (or $77,500 for employees 50 or older). [33] [34]

Is It a Good Idea to Take Early Withdrawals From Your 401(k)?

Typically, no. There are few advantages to taking an early withdrawal from a 401(k) plan. If you withdraw before age 59½, you will face a 10% penalty in addition to any taxes you owe. However, some employers allow hardship withdrawals for sudden financial needs, such as certain medical costs, funeral costs, or buying a home. [35] This can help you avoid the early withdrawal penalty, but you will still have to pay taxes on the withdrawal.

How Can a Stock Sell-Off Impact Your 401(k)?

A plunging stock market may seem worrisome, but it's almost always the right move to stay the course. Amid a big stock sell-off (a bear market), stocks are essentially on discount, if you can weather some big emotions and ignore external pressures. Though the value of your 401(k) will dip as the market dips, it's likely that it won't forever—or even for too long.

The Bottom Line

A 401(k) plan is a workplace retirement plan that allows you to make annual contributions up to a specific limit, investing that money for your later years.

There are two major types of 401(k) plans: traditional and Roth. The traditional 401(k) involves pretax contributions that give you a tax break when you make them and reduce your taxable income. However, you pay ordinary income tax on your withdrawals. The Roth 401(k) involves after-tax contributions and no upfront tax break, but you won't pay taxes on your withdrawals in retirement. Both accounts allow employer contributions that can increase your savings.

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