IRS

401(k) plan overview

A 401(k) plan is a qualified plan that includes a feature allowing an employee to elect to have the employer contribute a portion of the employee's wages to an individual account under the plan. The underlying plan can be a profit-sharing, stock bonus, pre-ERISA money purchase pension, or a rural cooperative plan. Generally, deferred wages (elective deferrals) are not subject to federal income tax withholding at the time of deferral, and they are not reported as taxable income on the employee's individual income tax return.

401(k) plans are permitted to allow employees to designate some or all of their elective deferrals as "Roth elective deferrals" that are generally subject to taxation under the rules applicable to Roth IRAs. Roth deferrals are included in the employee's taxable income in the year of the deferral.

Tax advantages

Two of the tax advantages of sponsoring a 401(k) plan are:

- Employer contributions are deductible on the employer's federal income tax return to the extent that the contributions do not exceed the limitations described in section 404 of the Internal Revenue Code. Refer to Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans) PDF, for more information about deduction limitations.
- Elective deferrals and investment gains are not currently taxed and enjoy tax deferral until distribution.

Types available

There are several types of 401(k) plans available to employers - traditional 401(k) plans, safe harbor 401(k) plans and SIMPLE 401(k) plans. Different rules apply to each. For tax-favored status, a plan must be operated in accordance with the applicable rules. Therefore, it is important that the employer be familiar with the special rules that apply to its plan so the plan is administered in accordance with those rules. To qualify for the tax benefits available to qualified plans, a plan must both contain language that meets certain requirements (qualification rules) of the tax law and be operated in accordance with the plan's provisions. The following is a brief overview of important qualification rules. It is not intended to be all-inclusive.

Traditional 401(k) plans

A traditional 401(k) plan allows eligible employees (i.e., employees eligible to participate in the plan) to make pre-tax elective deferrals through payroll deductions. In addition, in a traditional 401(k) plan, employers have the option of making contributions on behalf of all participants, making matching contributions based on employees' elective deferrals, or both. These employer contributions can be subject to a vesting schedule which provides that an employee's right to employer contributions becomes nonforfeitable only after a period of time, or be immediately vested. Rules relating to traditional 401(k) plans require that contributions made under the plan meet specific nondiscrimination requirements. In order to ensure that the plan satisfies these requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees.

Safe harbor 401(k) plans

A safe harbor 401(k) plan is similar to a traditional 401(k) plan, but, among other things, it must provide for employer contributions that are fully vested when made. These contributions may be employer matching contributions, limited to employees who defer, or employer contributions made on behalf of all eligible employees, regardless of whether they make elective deferrals. The safe harbor 401(k) plan is not subject to the complex annual nondiscrimination tests that apply to traditional 401(k) plans.

Safe harbor 401(k) plans that do not provide any additional contributions in a year are exempted from the top-heavy rules of section 416 of the Internal Revenue Code.

Employers sponsoring safe harbor 401(k) plans must satisfy certain notice requirements. The notice requirements are satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content and timing requirements.

In order to satisfy the content requirement, the notice must describe the safe harbor method in use, how eligible employees make elections, any other plans involved, etc. Income Tax Regulations section 1.401(k)-3(d)(2) (PDF), contains information on satisfying the content requirement using electronic media and referencing the plan's Summary Plan Description.

The timing requirement requires that the employer must provide notice within a reasonable period before each plan year. This requirement is deemed to be satisfied if the notice is provided to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year. There are special rules for employees who become eligible after the 90th day. See Income Tax Regulations section 1.401(k)-3(d)(3) (PDF).

Both the traditional and safe harbor plans are for employers of any size and can be combined with other retirement plans.

See also Mid-year amendments to safe harbor 401(k) plans and notices.

SIMPLE 401(k) plans

The SIMPLE 401(k) plan was created so that small businesses could have an effective, cost-efficient way to offer retirement benefits to their employees. A SIMPLE 401(k) plan is not subject to the annual nondiscrimination tests that apply to traditional 401(k) plans. As with a safe harbor 401(k) plan, the employer is required to make employer contributions that are fully vested. This type of 401(k) plan is available to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding calendar year. Employees who are eligible to participate in a SIMPLE 401(k) plan may not receive any contributions or benefit accruals under any other plans of the employer.

For more information on traditional, safe harbor and SIMPLE 401(k) plans, see Publication 4222, 401(k) Plans for Small Businesses PDF.

Restriction on conditions of participation

A 401(k) plan cannot require, as a condition of participation, that an employee complete more than 1 year of service.

Automatic enrollment in a 401(k) plan

A 401(k) plan can have an automatic enrollment feature. This feature permits the employer to automatically reduce the employee’s wages by a fixed percentage or amount and contribute that amount to the 401(k) plan unless the employee has affirmatively chosen not to have his or her wages reduced or has chosen to have his or her wages reduced by a different percentage. These contributions qualify as elective deferrals. This has been an effective way for many employers to increase participation in their 401(k) plans. These contributions qualify as elective deferrals. For more information about 401(k) plans with an automatic enrollment feature, refer to Income Tax Regulations section 1.401(k)-1(A)(3)(ii).

Elective deferral limits

The law, under IRC section 402(g), limits the amount that a participant can defer on a pre-tax basis each year. See the 401(k) plan contribution limits.

Elective deferrals that exceed the section 402(g) dollar limit for a year or are recharacterized as after-tax contributions as part of a correction of the Actual Deferral Percentage (nondiscrimination) test are included in the employee's gross income.

Matching contributions

If the plan document permits, the employer can make matching contributions for an employee who contributes elective deferrals to the 401(k) plan. For example, a 401(k) plan might provide that the employer will contribute 50 cents for each dollar that participating employees choose to defer under the plan. As mentioned earlier, employer matching contributions may be subject to annual tests to determine if nondiscrimination requirements are met.

Other employer contributions

If the plan document permits, the employer can make additional contributions (other than matching contributions) for participants, including participants who choose not to contribute elective deferrals to the 401(k) plan. If the 401(k) plan is top-heavy, the employer may be required to make minimum contributions on behalf of certain employees. In general, a plan is top-heavy if the account balances of key employees exceed 60% of the account balances of all employees. The rules relating to the determination of whether a plan is top-heavy are complex. Please refer to section 1.416-1 of the Income Tax Regulations for the rules describing how to determine whether a plan is top-heavy.

Employee compensation taken into account

For 2024, no more than $345,000 of an employee's compensation ($330,000 in 2023, $305,000 in 2022, $290,000 in 2021, $285,000 in 2020 and $280,000 in 2019) can be taken into account when figuring contributions. This is indexed for inflation PDF.

Vesting requirements

All employees must be fully (100%) vested in their elective deferrals. A plan may require completion of a specific number of years of service for vesting in other employer or matching contributions. For example, a plan may require that the employee complete 2 years of service for a 20% vested interest in employer contributions and additional years of service for increases in the vested percentage.

Distributions

Distribution rules govern when a plan may or must distribute benefits to participants. For more information about the treatment of retirement plan distributions, refer to Publication 575, Pension and Annuity Income PDF.

Reporting elective deferrals

The employer reports elective deferrals on the participant's Form W-2, Wage and Tax Statement PDF. Although these amounts are not treated as current income for federal income tax purposes, they are included as wages subject to social security (FICA), Medicare, and federal unemployment taxes (FUTA). Refer to Publication 525, Taxable and Nontaxable Income PDF, for more information about elective deferrals. Refer to the Form W-2 instructions PDF, for more information on how amounts should be reported.

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