

# **Chapter 1**

## What is a 401(k) Plan?

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**Introduction and history of 401(k) retirement plans and why you should start saving now**



## **What exactly is a 401(k) plan?**

I am so glad you asked. Let's start with the basics. A 401(k) is a section of the Internal Revenue Code, 401(k). It is an employer-sponsored retirement plan that typically allows employees to contribute to the plan directly from each paycheck via payroll deduction. It allows employees to save for retirement during their working years, so they can retire with dignity when the time comes.

Depending on the plan design, employees can usually contribute on a pre-tax basis and Roth 401(k) "post-tax" basis. More on that later. Roth 401(k) contributions are becoming the golden standard within 401(k)s, so if you don't see this option in your plan, it may be time for the employer to reevaluate the current plan document.

Because a 401(k) is an employer-sponsored retirement plan, employees are not able to set up their own 401(k) at their local bank or through their advisor. You must own a business in order to establish a 401(k) plan for a company. Employees of a company offering a 401(k) plan can contribute via salary deferrals directly from their paycheck each pay period. A 401(k) is often viewed as a retirement plan benefit or perk for working at an organization.

Most 401(k) plans are considered participant-directed, which means the employee (participant) gets to choose from a menu of investment options that are usually made up of mutual funds, CITs, Target Date Funds or a mix of all of these. Some plans may also offer a self-directed brokerage account to allow employees to link their 401(k) to a brokerage account so they can invest in individual stocks, bonds, ETFs, mutual funds, and more complex investment vehicles.

## History of 401(k) Plans



On November 6, 1978, President Jimmy Carter signed the Revenue Act and the Internal Revenue Service Tax Code, 401(k), was born. It allowed employers to offer a retirement plan where employees could defer their own compensation on a tax-deferred basis into a 401(k) plan. This new method of pre-tax savings was designed to prevent profit sharing plans from only benefiting top executives.

A 401(k) plan became governed by ERISA, the Employee Retirement Income Securities Act to ensure non-discrimination between highly compensated and key employees compared to the non-highly compensated, rank-and-file employees.

Traditional pension plans that promised a certain monthly benefit to employees at retirement were becoming too expensive to maintain as they were 100% employer funded, so more and more businesses began freezing their pension plans and added a 401(k) plan to relieve some of the financial burden and create generous tax benefits to business owners and their employees. Over the next 43 years, numerous legislative rulings paved the trail for the 401(k) plans we see today.

## WHAT IS A 401(K) PLAN?

As you can see in the historical contribution chart, 401(k) contribution limits have increased tremendously over the years, even into 2024. Salary deferrals can be pre-tax and Roth up to the salary deferral limit while the Catch-Up contribution is currently pre-tax only as of the writing of this book. Catch-up contributions allow an employee an additional contribution over the salary deferral limit. A participant who is age 50 or older by the end of 2023 can contribute up to \$30,000.

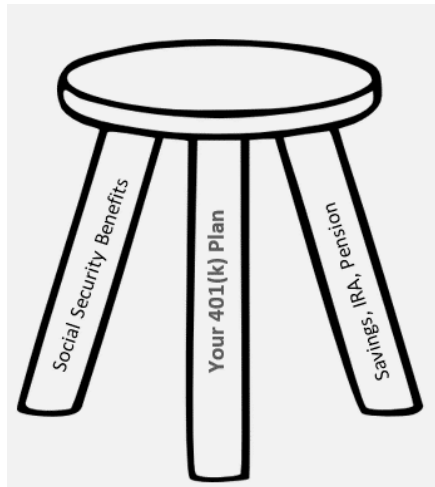
## Historical 401(k) Salary Deferral IRS Contribution Limits 1997-2024

<i>YEAR</i>	<b>SALARY DEFERRAL LIMIT</b>	<b>AGE 50+ CATCH-UP LIMIT</b>
<i>2024</i>	\$23,000	\$7,500
<i>2023</i>	\$22,500	\$7,500
<i>2022</i>	\$20,500	\$6,500
<i>2021</i>	\$19,500	\$6,500
<i>2020</i>	\$19,500	\$6,500
<i>2019</i>	\$19,000	\$6,000
<i>2018</i>	\$18,500	\$6,000
<i>2017</i>	\$18,000	\$6,000
<i>2016</i>	\$18,000	\$6,000
<i>2015</i>	\$18,000	\$6,000
<i>2014</i>	\$17,500	\$5,500
<i>2013</i>	\$17,500	\$5,500
<i>2012</i>	\$17,000	\$5,500
<i>2011</i>	\$16,500	\$5,500
<i>2010</i>	\$16,500	\$5,500
<i>2009</i>	\$16,500	\$5,500
<i>2008</i>	\$15,500	\$5,000
<i>2007</i>	\$15,500	\$5,000
<i>2006</i>	\$15,000	\$5,000
<i>2005</i>	\$14,000	\$4,000
<i>2004</i>	\$13,000	\$3,000
<i>2003</i>	\$12,000	\$2,000
<i>2002</i>	\$11,000	\$1,000
<i>2001</i>	\$10,500	
<i>2000</i>	\$10,500	
<i>1999</i>	\$10,000	
<i>1998</i>	\$10,000	
<i>1997</i>	\$9,500	

## WHAT IS A 401(K) PLAN?

Today, people are living longer and your “pot of gold” for retirement is like a three-legged stool. Your retirement income will likely come from three main sources. Social security benefits, savings, IRA or pension (if you’re lucky to get a pension), and your 401(k). The majority of your income in retirement will come from your own 401(k) if you start saving early during your working years. It is a lot harder to save when you’re not making money if you wait until retirement to start saving!

Social security benefits were never meant to be a primary source of income in retirement and there has been much debate on the political landscape over the past twenty plus years as to whether or not they will even be available when you reach retirement age. You can check out your own estimated monthly social security benefits by going to [www.ssn.gov](http://www.ssn.gov) to download a current statement based on your work history. Not all jobs pay into social security, however. For example, police officers and firefighters usually have their own pension plan, so they would not pay into the social security system.



## Why Save in a 401(k) versus a Regular Savings Account?

One of the biggest benefits of saving in a 401(k) plan compared to a regular savings account is the *tax deferred* benefit. Not only do *contributions* grow tax-free while in the account, but the *earnings* also grow tax-free year after year until you take the money out of the account, which we'll talk about later in this book. A regular savings account is *not* tax deferred. Instead, you pay taxes up front on the amount you place into a savings account and at the end of each year, you pay taxes on any earnings or interest from the savings account unlike a 401(k) plan. Let's check out a hypothetical example:

Assumes \$80k annual salary/semi-monthly paycheck/10% contribution		
	Bank Savings Account	401(k) Account
Gross pay semi-monthly	\$3,333	\$3,333
Pre-tax savings	\$0	\$333
Post-tax savings	\$333	<b>\$0</b>
Taxable income	\$3,333	<b>\$3,000</b>
FICA taxes (8.65%)	\$288	\$288
Income taxes (24%)	\$800	\$720
Total take home pay	\$1,912	<b>\$1,992</b>

\*This is not tax advice. Please consult with a CPA for specific tax guidance.

That’s an additional \$80 in your pocket each pay period or \$1,920 more per year in your pocket! Saving in a 401(k) results in less taxes being paid and more money in your pocket when compared to saving in a bank account. This of course does not mean you shouldn’t save in a bank account. It is still an excellent savings tool for short-term expenses. The cost of waiting could cost you thousands of dollars, so start saving in your 401(k) now! If that doesn’t convince you, let’s look at how the cost of waiting will impact your account balance over time.

### The Cost of Waiting



\*This scenario assumes a hypothetical 8% annual rate of return for the life of the 401(k)

In this example, we have two 401(k) investors. Eve, the early investor, saves one hundred dollars per month starting at age 25 until she retires at age 65. Lou, the late investor, waits to start saving until he’s older and making more money, so beginning at age 45, he saves \$300 per month until he is 65. Notice that Eve only had to contribute \$48,000 of her own money into the plan with her \$100 per month for 40 years,

but late Lou contributes \$72,000 of his own money into the plan over 20 years. Assuming an 8% annual rate of return in this example, look at the total savings Eve has accumulated while only putting in \$48,000. She now has a whopping \$324,000! Although Lou put in more of his own money, he lost 20 years to save and have compounding interest working for him, so he only has \$171,000 at age 65. Eve ends up with over \$152,000 more than Lou. Why is that? It's because she started saving early! Even a small amount each pay period goes a long way the sooner you begin to save.