

- what plan design issues should an employer consider when adopting a plan;
- how a plan is adopted and submitted to the IRS; and
- what basic plan administration issues need to be addressed.

**Laws Governing 401(k) Plans.** As promised, we use only a few citations in this short course. These citations refer to the two primary laws that govern 401(k) plans:

- *The Code.* The Internal Revenue Code of 1986 is the law that authorizes qualified retirement plans, including 401(k) plans, and provides for certain tax benefits. It is the source of many technical requirements that apply to 401(k) plans.
- *ERISA.* The Employee Retirement Income Security Act of 1974 is the law designed primarily to protect participants and beneficiaries. It contains many of the same requirements found in the Code, and it also addresses fiduciary responsibility, participants' rights to plan disclosures, and reporting requirements.

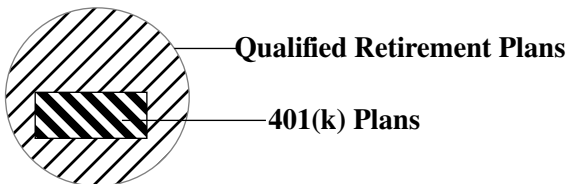
## C. What Is a 401(k) Plan?

A 401(k) plan is a type of qualified retirement plan. A “qualified retirement plan,” along with its accompanying trust, is authorized under Code § 401(a) to provide certain tax benefits to both employers and employees in exchange for employers’ providing retirement benefits to employees. Retirement plans must satisfy rigorous tax requirements in order to “qualify” for the tax benefits offered under Code § 401(a). These rigorous tax requirements, known as qualification requirements, are highlighted in this short course and are discussed in detail in the our comprehensive *401(k) Plans* manual.

Qualified retirement plans must meet all qualification requirements, both in the written form of the plan document and in the operation of the plan. For this reason, it is helpful to think of a plan’s qualification in two parts—form and operation.

### 1. A 401(k) Plan Is a Specific Type of Qualified Retirement Plan

The phrase “401(k) plan” refers to a specific type of qualified retirement plan authorized under Code § 401(k). This means that a 401(k) plan must satisfy not only the qualification requirements under Code § 401(a) but also additional requirements under Code § 401(k). The following diagram illustrates how 401(k) plans fit into the qualified retirement plan framework:



Code § 401(k) allows eligible employees to elect to make contributions from their pay to a qualified retirement plan if certain requirements relating to

eligibility, contributions, vesting, distribution, and nondiscrimination are satisfied. This elective feature is referred to as a cash or deferred arrangement (CODA) because the employee has the choice of taking the amount in cash (as part of the employee's regular pay) or deferring the amount into the plan as a contribution. Usually these contributions are made on a pre-tax basis, which means that the employee's contributions are not subject to federal income tax when they are made. Instead, the contributions, plus earnings, are subject to federal income tax at the time they are distributed from the plan. The contributions are, however, subject to FICA tax at the time that they are made. Design-based "safe harbor" plans are special types of 401(k) plans that avoid certain nondiscrimination testing requirements because they meet certain plan design requirements.

A 401(k) plan may provide for matching contributions, which are subject to specific requirements under the Code, and also may provide for other contributions (for example, profit-sharing contributions), which are subject to their own special rules. Sometimes, the features of a 401(k) plan may be associated with an employee stock ownership plan (ESOP), in which case the ESOP rules also must be followed.

## ***2. Tax Benefits of a 401(k) Plan***

Among the reasons that motivate employers to set up 401(k) plans (or other types of qualified retirement plans) are the following tax benefits:

- participants can defer taxation of their contributions until they actually receive the funds—contributions and earnings—from the trust;
- employers can claim a tax deduction for the year for which the contributions are made;
- the trust income is not taxed to the trust;
- participants are permitted to continue to defer taxation of their contributions by taking rollover distributions when they terminate their employment;
- small employers can claim a tax credit for qualified costs incurred in connection with establishing a new qualified retirement plan; and
- certain low-income participants can claim a tax credit for contributing to a qualified retirement plan.

In addition, qualified retirement plan assets are required to be held in a trust and are protected from creditors of both the employer and the participant.

## **D. Who Can Sponsor a 401(k) Plan?**

Most employers are eligible to sponsor (that is, set up and maintain) a 401(k) plan. In addition to corporations and other for-profit employers, tax-exempt employers and Indian tribal governments (including related entities) can sponsor 401(k) plans.

State or local governments, including their political subdivisions, agencies, and instrumentalities, however, cannot set up new 401(k) plans. This prohibition, however, does not extend to the federal government and its agencies. Under a