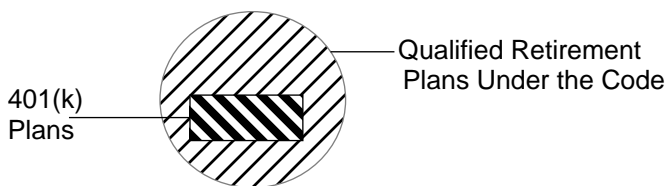


Laws Governing 401(k) Plans. Even though we try not to use citations in this short course, occasionally we refer to the two primary laws that govern 401(k) plans. They are:

- *The Code.* The Internal Revenue Code of 1986 (the Code) is the law that authorizes qualified retirement plans, including 401(k) plans, and provides for their tax benefits. It is the source of many of the technical requirements discussed in this short course.
- *ERISA.* The Employee Retirement Income Security Act of 1974 (ERISA) 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 issues such as fiduciary responsibility, reporting, and participants' rights to disclosure.

C. What Is a 401(k) Plan and Why Have One?

A 401(k) plan is a specific type of qualified retirement plan.



1. What Is a Qualified Retirement Plan?

A “qualified retirement plan” with its accompanying trust is a plan authorized under Code § 401(a) to provide retirement benefits to employees. Qualified retirement plans provide special tax benefits for both employers and employees, but they must satisfy rigorous tax requirements, many of which are discussed in this short course.

2. What Is a 401(k) Plan?

The phrase “401(k) plan” refers to a specific type of qualified retirement plan that permits contributions authorized under Code § 401(k). Code § 401(k) allows eligible employees to elect to make pre-tax contributions from their compensation to a qualified retirement plan if certain requirements relating to contributions, vesting, nondiscrimination, and distributions are satisfied. Because a 401(k) plan is a type of qualified retirement plan, it must satisfy the requirements of both Code § 401(a) and Code § 401(k).

“Pre-tax” means that contributions are not subject to federal income tax when they are made. They are, however, subject to FICA tax. The pre-tax contribution amounts, plus earnings, are subject to federal income tax at the time they are distributed from the plan.

A 401(k) plan may provide for matching contributions, which are subject to specific requirements under the Code, and also may include other contributions such as profit-sharing contributions, which are subject to their own special rules. The features of a 401(k) plan also may be associated with an

employee stock ownership plan (ESOP), in which case special ESOP rules also must be followed.

Design-based “safe harbor” and SIMPLE plans are special types of 401(k) plans that avoid some of the nondiscrimination testing requirements in exchange for meeting certain plan design requirements. These types of plans also are discussed in this short course.

3. *Why Have a 401(k) Plan?*

The tax benefits of having a 401(k) plan (or other type of qualified retirement plan) include the following:

- participants are not taxed 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;
- trust income is not taxed to the trust;
- participants are allowed rollovers and other special tax treatment on distributions;
- small employers can claim a tax credit for *qualified start-up 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 protected from creditors of both the employer and the participant.

Sample 401(k) Plan. In this short course, we include examples showing how a hypothetical employer, Acme, Inc., has designed its 401(k) plan and how those design features work. The Acme 401(k) Plan is a profit-sharing plan that allows employees to make pre-tax contributions.

D. Employers Eligible to Adopt a 401(k) Plan

Most employers, including corporations and other for-profit employers, tax-exempt employers, and Native American tribal governments and their related entities, can establish or “adopt” a 401(k) plan.

State or local governments, including their political subdivisions, agencies, and instrumentalities, however, cannot establish new 401(k) plans. Nevertheless, a state or local government can continue to maintain a 401(k) plan if the plan was established before May 7, 1986.

E. Eligibility Requirements

Who is eligible to participate in a 401(k) plan? The employer decides which employees are eligible when it establishes its plan. An employer can design its plan’s eligibility requirements to meet the employer’s own business needs, so long as the plan requirements do not violate any of the Code’s restrictions. Generally, an employee who has satisfied a 401(k) plan’s eligibility requirements is considered to be a “participant” in the plan.