401(K)/ Savings Plans

401(K)/ savings plans are qualified under the US Internal Revenue Code to receive favorable tax treatments. The employer and employee contributions are tax deductible, and the investment returns are tax deferred. When withdrawals are made from the accumulated account balance at retirement, disability or death, the recipient will be taxed. It is likely that the withdrawals at retirement will be taxed at a lower rate than the person's current income tax rate.

401(K)/ savings plans are effective financial programs for attracting, retaining and rewarding employees. Some of the common plan features are:

1. Most plans have an age 21 and service (6 months to 1 year) requirement before an employee can start plan participation and make contributions.
2. Employees can make tax and non-tax deductible, if allow by the plan, contributions.
3. Employer contributions to a participant's account are usually provided by a matching formula to the employee's pre-tax (may also include after- tax) contributions (e.g. 50% match on the employee's pre-tax or total contributions up to 5% of salary).
4. Depending on the plan design, a participating employee may require to work five years to gain full vesting (right) to the employer contributions. Some plans use a graded vesting schedule of three years of service for 20% to seven years 100% vesting.
5. Employer and employee contributions are credited to the participant's account and invested based on the investment funds selected by the employee.
6. At retirement, disability, death or termination of employment, the employee is entitled to withdraw his/ her account balance (employee and vested employer contributions plus the corresponding investment returns).

Related to item 4., some 401(K)/ savings plans have a separate employer contribution formula designed, within the regulatory rules, to provide different levels of contributions according to the service and compensation of the employees. Such formula may require special testing to comply with IRS regulations. With the 2002 regulatory changes, the contribution limits have been liberalized to offer greater value to employees (especially to key senior persons) and plan sponsors.

The 2003 IRS contribution limits are as follows:

- Maximum pretax contribution by employees to 401(k) plans $12,000
- Catch-up contribution for employees age 50 and over $ 2,000
- Overall defined contribution maximum amount $40,000

Most 401(K)/savings plans allow employee to access the accumulated account balance through loans and hardship withdrawals. Loans are usually restricted to 50% of the employee's vested account balance up to $50,000. The employee is required to make regular loan repayment back to his/ her account.

To meet immediate and heavy financial needs, hardship withdrawals are allowed for:

- Certain medical expenses for the employee, spouse or dependents
- Purchase of a primary residence (excluding mortgage payment)
- Payments of certain post-secondary education expenses for the next year for the employee, spouse or dependents
- To prevent eviction from or foreclosure on the primary home

Since 401(K)/savings plans are established under IRS regulations to encourage retirement savings, early withdrawals before age 59 1/2 are subject to 10% penalty plus federal, state and local tax. There is also the requirement that plan participation must be suspended for at least six months. Therefore, hardship withdrawals should be used as the last resort after plan loans.

This booklet attempts to provide a realistic summary of the major plan design and operational features of 401(K)/savings plans. If you have any questions or would like to discuss the establishment of a 401(K)/savings plan, please contact us at (858)538-3566 or email us at jgeng@act-ben.com.