

# The Right 401(k) Can Be a Tax-Free Haven

Robin Hale

Providing the financial security of a retirement plan is an excellent way to attract and keep valuable employees. With the threatened state of Medicare and Social Security, workers are looking for corporations and small businesses who are concerned enough about their well being to offer a plan for their future needs. Businesses are meeting those needs by offering defined-contribution plans such as a 401(k).

A 401(k) plan requires employees to invest a set amount or percentage of their own earnings and also allows them to choose the type of investment plan they wish to participate in. Employers can choose to match or contribute a fixed amount to the 401(k) plan as well.

Unlike the pension plans of the past, the 401(k) allows individuals to keep their benefits should they decide to leave their place of employment. This is called a rollover and basically means that the funds in a 401(k) from one employer can be 'rolled over' directly into a new employer's plan without penalty.

If your new employer doesn't offer a retirement plan, you also have the option to roll your funds directly to your individual retirement account (IRA).

## **Choosing the Right 401(k)**

For a business owner with employees, there are four basic types of 401(k) plans to choose from. Deciding which will best fit with your organization is the first step.

**Simple** – The Simple 401(k) is a cost-effective way to provide employees with a retirement plan. It is available to companies with 100 or fewer employees who received \$5,000 or more in compensation the previous year. It is not subject to the non-discrimination testing and any contributions made by the employer are fully vested. A possible drawback of The Simple 401(k) is that it cannot be combined to receive benefits from other plans from the same employer.

**Traditional** – The Traditional 401(k) allows the employer to make or match employee contributions. A vesting schedule can also be included, which would require an employee to stay with the company a certain number of years before receiving 100% of the matched contributions. This plan also allows individuals to make pre-tax contributions through payroll deductions.

An additional feature of the Traditional 401(k) is the annual non-discrimination testing that is performed. The testing ensures that the employees are receiving comparative benefits to owners and upper management.

**Roth** – The Roth 401(k) contributions are on an after-tax basis and then grow tax-free. Withdrawals are also tax-free. The benefit of a Roth plan is the fact that your withdrawal won't be taxed at retirement, as long as you have reached 59 ½ and your Roth account is five years old.

**Safe Harbor** – A Safe Harbor 401(k) is similar to a Traditional plan, without the complex tax rules or the non-discrimination testing. Any size company is eligible for this plan, and any contributions made by the

employer are fully vested when made. Unlike the Simple plan, other benefits can be combined with the Safe Harbor 401(k).

### **No Employees? Even Better**

If you are self-employed and don't have any employees, investing in a 401(k) plan can shelter a huge portion of your income from Uncle Sam. The self-employed or solo 401(k) allows self-employed business owners to stash up to \$51,000 per year (according to 2008 tax rules) into a solo account. Contributions are tax-free and grow tax-deferred until withdrawn. Penalties apply for money taken out before the individual reaches 59 ½.

Similar to regular 401(k) plans, pre-tax contributions are capped at a certain amount that generally rises with inflation. Additional perks of this plan allow a way around the cap. The owner can contribute up to one quarter of their annual earnings in the form of profit-sharing. For those under 50, that adds up to a maximum of \$46,000 annually, while those over 50 are allowed \$51,000 in total contributions.

Every self-employed individual qualifies for this type of 401(k), regardless of ownership structure. LLC, partnerships and sole proprietors all qualify. And although this plan is limited to those without employees, partners qualify for inclusion and spouses are eligible to contribute.

### **Setting up a 401(k)**

Once you have decided on the most important aspect, which is the type of 401(k), the rest of the set up process can be broken down to four basic actions. You are free to set up the plan yourself or use the help of a financial institution. Here are four actions necessary in setting up your 401(k) plan:

**A written plan** – You will need a written document that outlines the plan's details. If an institution or professional is helping you establish your 401(k), they will provide this for you. In either case, this is a legal document, so it is wise to receive assistance with this step.

**Appoint a trustee** – In order to assure that assets are used for the benefit of the participants, a plan's assets must be held in trust. A trustee is appointed who handles contributions, distributions and investments. Choosing a reputable trustee is one of the most critical decisions in establishing your 401(k) plan.

**Record keeping** – Contributions must be properly tracked, as well as investments and beneficiary distributions. A solid record keeping system will allow all aspects of the 401(k) to run smoothly and will help with end of year tax reporting as well.

**Informing employees** – Unless you are a sole-proprietor, you must notify all eligible employees of their right to participate in the plan. All benefits, requirements and contribution details must be disclosed as well. A summary plan description (SPD) is generally used to inform employees about the details of the plan.

Regardless of the plan you choose, establishing a 401(k) is an excellent wealth building strategy that can help secure your future retirement plans, as well as those of your employees.