

## Understanding 401(k) Plans

Many of us are familiar with or participate in an employer-sponsored 401(k) plan, but what is it and how does it work?

A 401(k) plan is a type of defined contribution plan known as a profit sharing plan. The profit sharing plan, in addition to allowing employer contributions, has a 401(k) feature that allows eligible participants to defer a portion of compensation into an investment account. These employee contributions, also called salary deferrals or elective contributions, reduce the employee's current federal income tax, and in most states, state income tax. The taxes on elective contributions are deferred until distribution. The employee contribution does not reduce compensation for the purpose of social security taxes (FICA) or federal unemployment taxes (FUTA.)

Employees can contribute up to 100 percent of compensation to the individual maximum. The individual maximum for 2004 is \$13,000 per participant. For participants who will be age 50 or older by the end of 2004, a \$3,000 catch-up contribution may also be made. These limits are adjusted or indexed annually for cost-of-living increases..

If the employer chooses, it can also match a portion of its participants' elective contributions to reward those employees who are participating in the 401(k) plan. This is usually quoted as a percent of the contribution up to a stated maximum. For example, the employer might match 25 percent of elective contributions up to the first three percent of compensation.

401(k) plans must satisfy complex, nondiscrimination testing to be considered a qualified plan. The salary deferrals are subject to the Actual Deferral Percentage (ADP.) This test compares the percentage of salary deferrals for non-highly compensated employees to the percentage deferred by highly compensated employees. If those percents are in proportion to each other according to pre-determined guidelines, the plan will pass testing. If not, the plan fails the ADP test and must take corrective measures. The matching contributions, if applicable, are subject to a similar test called the Actual Contribution Percentage (ACP) test.

Salary deferrals are always 100 percent vested and are typically invested at the participant's direction.

Employer profit sharing and employer matching contributions are subject to the vesting schedule stated in the plan document. The employer may choose to direct the investments of these funds or it can leave that responsibility to its employees.

401(k) plans, if handled properly, make a nice addition to an employer's profit sharing plan. To find out more about how a 401(k) plan can benefit your business, contact your Lafayette Life representative today.

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