



# The basics of a 401(k) plan

**Resource: Fidelity Investment**

## What is a 401(k)?

A 401(k) is a type of retirement plan that allows employees to save and invest for their own retirement. Through a 401(k), you can authorize your employer to deduct a certain amount of money from your paycheck before taxes are calculated, and to invest it in the 401(k) plan. Your money is invested in investment options that you choose from the ones offered through your company's plan. The federal government established the 401(k) in 1981 with special tax advantages, to encourage people to prepare for retirement. They get their catchy name from the section of the Internal Revenue Code which established them (you guessed it, section 401(k)).

## How does a 401(k) plan work?

You decide how much money you want deducted from your paycheck and invested during each pay period, up to the legal maximum (the IRS sets an annual dollar limit each year). You also decide how to invest that money, choosing from your plan's different investment options. The money you contribute to your 401(k) account is deducted from your pay before income taxes are taken out. This means that by contributing to a 401(k), you can actually lower the amount you pay each pay period in current taxes. For example, if you earn \$1,000 each paycheck, and you contribute, say 5% (\$50), you are only taxed on \$950. You don't owe income taxes on the money until you withdraw it from the plan, when you could be in a lower tax bracket.

## What's the difference between saving money in my company's retirement plan and putting money into a mutual fund or bank account?

Taxes, taxes, taxes! An ordinary savings account or mutual fund doesn't allow you to save on a tax-deferred basis. So in an ordinary savings account, you're saving money that has already been taxed, and you continue to pay tax annually on the earnings of that account, too. The money you contribute to your company's 401(k) retirement plan, however, comes out of your paycheck before taxes are taken out. Plus, you don't pay income tax on the money you contribute to your 401(k) account or on any earnings until you take it out, which is usually at retirement, when you may be in a lower tax bracket. The bottom line: More of your money is working for you instead of going toward taxes. Keep in mind, however, that investing in your company's retirement plan is only a part of a sound retirement saving plan. It is still important to have personal savings aside from your retirement savings, too.

## When I invest through my workplace plan, do sales charges apply to me?

No. Fidelity waives sales fees (also called "loads") on investments made through most retirement plans.\* This waiver applies only to investments you make within your plan, however. Call your plan's toll-free retirement benefits line for more details. \*Short-term trading fees still apply.



### **What's the difference between a 401(k) plan and my company's profit sharing plan?**

A "profit sharing plan" is a type of retirement plan. It allows an employer to share profits of the company with employees by contributing a percentage of the company's annual profits to the plan. The amount of the contribution can change each year, or may not be made at all, depending on the company's circumstances. A 401(k) plan is a feature of a profit sharing plan or a stock bonus plan. Unlike a profit sharing plan, however, employees can contribute a percentage of their own salaries (up to certain limits) to the plan for retirement savings. 401(k)s also allow employers to contribute money to its employees' accounts in the form of "company match" contributions, usually as an incentive to get employees to participate in the plan. Current income taxes are deferred on both employer and employee contributions and all investment earnings, until the money is withdrawn from the plan. The maximum pre-tax amount that you can contribute to a 401(k) in 2007 is \$15,500. Cost of living adjustments, applied in \$500 increments, may increase standard limits in future years.

### **What if my company goes bankrupt? How is my 401(k) money protected?**

The Employee Retirement Income Security Act (ERISA) of 1974 established guidelines for how money in 401(k) plans is maintained. The upshot of it is that your 401(k) plan account is not considered an asset of your employer-it is held in trust in a separate account for you. This means that your plan money (which includes all your own contributions and all vested company contributions) is not commingled with your company's money. And, your company cannot access your plan money for any purpose related to maintaining its business.

401k.com provided by



Copyright © 1996-2008 FMR Corp. All rights reserved.