What is a Traditional 401(k) Plan?

Although it has only been around since 1978, the 401(k) plan has quickly become the retirement plan offering of choice for most businesses today. It seems to be the only section of the Internal Revenue Code that everyone in America knows. A traditional 401(k) plan allows eligible employees to make elective deferrals through payroll deductions on a pre-tax or post-tax (Roth) basis, depending on what the plan provisions allow. The maximum amount allowed by law for calendar year 2023 is $22,500, $30,000 for individuals age 50 or older. This type of plan requires specific nondiscrimination testing on a plan year basis.

Testing Requirements: This type of plan requires an Actual Deferral Percentage Test (ADP) and an Actual Contribution Percentage test (ACP) (if employer makes matching contributions). These tests ensure that companies extend their 401(k) plans to low-paid employees. The discrimination test divides participants into two groups, Highly Compensated Employees (HCEs) and Non-Highly Compensated Employees (NHCEs). Once the groups are separated, contribution ratios are developed for salary deferrals and employer matching contributions for each participant. The ratios are averaged for both the HCE Group and NHCE Group. This creates the ADP (Actual Deferral Percentage) and the ACP (Actual Contribution Percentage), which, when compared to the table on the left determines if the plan is within passing guidelines.

ADP or ACP of the NHCE Group	Maximum ADP or ACP of the HCE Group
0% -2%	0% - 4% (i.e. x2)
2.01% - 8%	4.01% - 10% (i.e. +2)
>8%	X1.25

If the plan fails these tests there are certain options for correction which can be taken such as refunds to the HCEs or additional contributions known as Qualified Non-Elective Contributions (QNECs) or Qualified Match (QMACs) to the NHCEs.

Options for Increasing Contributions: The higher the participation from the NHCE group, the higher the contributions can be for the HCEs and the more likely that all required tests will pass. There are some incentives or plan provisions which can be added to the plan's design to increase participation in the plan.

Employer Matching Contributions: Employers can offer Matching contributions to eligible employees as an incentive to increase participation. For example, the plan can be designed so that the employer matches 50 cents on the dollar for a participant who defers under the plan up to the first 4% of salary they defer. Participants, when making the deferral percentage determinations, will usually defer at least up to the percentage the employer matches to maximize the benefits they will be receiving towards their retirement. These contributions can be on a vesting schedule which the employer decides on upon plan design. Certain requirements for eligibility for these contributions can also be added to the plan design such as a specific amount of hours which need to be worked by the employee each plan year in order to receive a contribution and/or you can require that they be employed on the last day of the plan year to receive an allocation. Also, matching contributions may be used to help meet the top-heavy requirement.

Automatic Enrollment: An employer can opt to design their plan to include automatic enrollment. This type of provisions allows for the employer to automatically enroll those employees who have not formally made an election to participate/not participate in the plan, this typically leads to a higher participation rate within the plan which helps with passing the required nondiscrimination tests.

The Saver's Credit: If a participant makes contributions to the Plan, they may be eligible for a special tax credit, called the "Saver's Credit." This credit could reduce the federal income tax they pay dollar-for-dollar. The amount of the credit they can get is based on the contributions they make and their credit rate. The credit rate can be as high as 50%, or as low as 10% of their contributions, depending on their adjusted gross income (the lower their income, the higher the credit rate). The credit rate also depends on their filing status.