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401(k) Plans: A Retirement Plan for Your Businesses

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Tags: Investing | Retirement | Tax Benefits | Employer-Sponsored Plan

Introduction to the 401(k) Plan

A 401(k) plan, sometimes referred to as a "Traditional" 401(k), is an employer-sponsored, defined-contribution investment account, often backed by larger private businesses, that helps employees save and prepare for retirement. The 401(k) plan as we know it today was formed by the Revenue Act of 1978, and has since helped millions of people achieve their long-term financial objectives. This retirement account type is a popular method of long-term planning, mainly due to the significant tax benefits it offers.

Why Should I Consider a 401(k) for My Business?

There are many reasons you should consider a 401(k) retirement plan for your business. Depending on the profile of your business, the 401(k) rules may be the most beneficial to you and your employees.

Tax-Deferred Growth for Employee Portfolios

Like other retirement account types, the 401(k) allows assets invested in the account to grow on a **tax-deferred** basis. This means account owners won't incur any tax liability until they withdraw the assets in retirement, at which point the withdrawals are taxed as ordinary income. The impact of **tax-deferred** growth is massive in the long-term.

Tax Deductibility of Contributions for Your Business and Employees

Contributions to 401(k) are **tax deductible** for both the business and the employee. Employer contributions are tax deductible for the business, while employee contributions are tax deductible to the employee.

Relatively High Contribution Limits

401(k) plans offer relatively high annual contribution limits for participants. Employees are allowed to directly contribute up to $23,500 per year, and when combined with the employer, total contributions can be as high as $70,000 per year. This type of plan gives highly-compensated employees a way to maximize contributions to tax-advantaged accounts.

Who Can Own a 401(k)?

Only employees of private employers that offer 401(k) plans can contribute to a 401(k) plan. Employees of companies without 401(k) plans cannot create and contribute to their own 401(k)s (although other retirement account options, such as IRAs, do exist).

To be eligible, the employee must also meet all of the requirements of the employer, which can include minimum age, tenure, and number of hours worked throughout the year (applicable to part-time employees). Employer requirements must be applied uniformly across all employees.

There are no age limits for contributing to a 401(k)—people of all ages can contribute—and no income restrictions either.

What are the Rules for 401(k) Contributions?

Employers and employees, alike, can contribute to a 401(k).

Employees have the option to contribute as much of their earnings as they would like to their 401(k), up to the annual limit. Contributions are typically made through payroll deductions every pay period, but if the plan allows it, employees can make a lump sum contribution.

Employer matches are not required for 401(k) plans. That said, many employers that sponsor 401(k) plans offer some type of contribution to employee accounts. Employers can make flat dollar contributions or matching contributions, and there is significant flexibility in how matching contributions are set up. Employers must ensure their contributions comply with IRS rules and regulations, including nondiscrimination testing, to ensure that benefits are fairly distributed among all employees.

All employee contributions to a 401(k) are immediately vested to the employee. Employer contributions can be made with immediate vesting, graded vesting, or cliff vesting, depending on how the plan is designed. Employers should consider designing their 401(k) plan to incentivize long-term commitment from employees.

How Much Can Be Contributed to a 401(k)?

In 2025, the maximum contribution an employee can make to a 401(k) plan is $23,500. When combined with employer contributions, the maximum contribution to any one 401(k) account each year is $70,000 (the split between employee and employer contributions does not matter).

Those who are at least 50 years old are eligible for a bonus contribution amount of $7,500, and those who are between 60 and 63 years old can contribute a bonus amount of $11,250. These "catch-up" contribution amounts increase the maximum contribution for both the employee and combined limits, alike. The employee limit, combined limit, and catch-up contribution amount are occasionally revised in order to adjust for cost of living and inflation.

Additionally, 401(k) contributions are restricted to the income earned with a given employer, only. Income generated outside the compensation of your employer (such as investments or a second job) cannot be contributed to a 401(k).

How Can My Business Deduct Contributions to 401(k) Accounts?

The deadline for taking a tax deduction on 401(k) contributions is the federal income tax return due date for your business, including any extensions. The tax document on which contributions can be deducted is dependent on how your business is legally organized.

What are the Employer Requirements for 401(k) Plans?

Businesses that offer a 401(k) plan to employees must adhere to strict rules in order to remain in good standing with the IRS. For starters, 401(k) plans are maximally covered by the Employee Retirement Income Security Act (ERISA), meaning specific fiduciary responsibilities, protection for participants, and plan management practices need to be followed.

401(k) plans must pass an **annual nondiscrimination test** to ensure that contributions do not disproportionately favor highly compensated employees (HCEs) over non-highly compensated employees (NHCEs). These tests include the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests.

Most 401(k) plans are required to file an annual **Form 5500** with the Department of Labor (DOL) and IRS to report plan activities and financial condition. Small 401(k) plans with fewer than 100 participants may be eligible to file a shorter version, Form 5500-SF.

What are the Withdrawal Rules of a 401(k)?

401(k) plans are subject to specific withdrawal rules that, when not followed, could result in a substantial penalty. Starting at age 59½, you may take distributions from your 401(k) at any time and in any amount without incurring a penalty. These distributions are included in your taxable income for the year in which you take them.

Those who withdraw funds before age 59½ are subject to penalty in an amount of 10% of the distribution, unless the distribution qualifies for an exception. The most common exceptions include distributions related to birth or adoption expenses (up to $5,000 per child), emergency personal expenses (up to $1,000 per year), federally declared disasters (up to $22,000), certain unreimbursed medical expenses, death or disability of the 401(k) account owner and separation from service for those aged 55 and older.

Separately, 401(k) account owners must abide by **required minimum distribution (RMD)** rules. Starting at age 73, account owners are required to withdraw a certain amount from their account each year to avoid a penalty (up to 25% of the value) on the missed RMD. The amount of the RMD is calculated based on life expectancy and account balance.

Can Account Owners Borrow Against the Balance of Their 401(k)?

Yes, if the plan allows loans. If loans are permitted, participants can typically borrow up to 50% of their vested account balance, with a maximum limit of $50,000. Loans must generally be repaid within five years, unless the loan is used to purchase a primary residence, in which case the repayment period may be longer.

What Types of Assets Can Be Invested in with a 401(k)?

A 401(k) allows its account owner to invest in a fairly broad spectrum of assets. Stocks, exchange-traded funds (ETFs), mutual funds, bonds, money market funds, and certificates of deposit (CDs) are all permitted assets in an 401(k). Examples of investments that are prohibited in a 401(k) include life insurance, artwork and collectibles, S corporation stock, and real estate for personal use, among others.

However, the actual investment options any 401(k) plan offers is dependent on the choices of the 401(k) plan administrator. It is not uncommon for 401(k) plans to have a limited set of preselected stock and bond funds that participants can invest in.

What Other Forms of Retirement Plans Exist for Businesses Like Mine?

There are many other forms of retirement plans that may be a fit for your business, including:

- Roth 401(k) – A post-tax 401(k) that allows tax-free growth and withdrawals.
- Solo 401(k) / Roth Solo 401(k) – A 401(k) for self-employed individuals that allows for higher contribution limits.
- Safe Harbor 401(k) – A 401(k) that avoids the regulation requirements and expenses of Traditional 401(k)s and specifies that all employer contributions are immediately vested.
- SIMPLE 401(k) – A 401(k) plan with more flexibility and less administrative burden for self-employed individuals or small business owners.
- SEP IRA – An IRA with special perks for self-employed individuals or small business owners.
- SIMPLE IRA – Another IRA with special perks for self-employed individuals or small business owners.
- Payroll Deduction IRA – The easiest retirement plan to establish with the least financial and legal requirements for the sponsoring business.

How Can I Start a 401(k) Retirement Plan for my Business?

To get started with a 401(k) retirement plan for your business, reach out to us at **FreeMind Financial Advisory** and we would be happy to provide a **free strategy session** personalized for your business. We can help determine if a 401(k) is the best retirement plan for your business, and if it is, we can assist in setting up accounts and onboarding employees.

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