The 411 on 401(k)

Understanding the basics of your 401(k) plan can help in providing for your financial future.

What is a 401(k)?

- A 401(k) plan is a company-sponsored retirement account where both employees and employers can contribute. 401(k) plans were created when Congress passed the Revenue Act of 1978, which included a provision that was added to the Internal Revenue Code — Section 401(k) — that allowed employees to avoid being taxed on deferred compensation.
- In 1980, benefits consultant,Ted Benna referred to Section 401(k) while researching ways to design more tax-friendly retirement programs for a client. He came up with the idea to allow employees to save pre-tax money into a retirement plan while receiving an employer match. His client rejected the idea, so Benna's own company, The Johnson Companies, became the first company to provide a 401(k) plan to its workers.
- In 1981, the IRS issued new rules that allowed employees to fund their 401(k) through payroll deductions, which kick started the 401(k)'s popularity. Within two years, nearly half of all big companies were offering 401(k) options or were considering it, according to the Employee Benefits Research Institute.

How do I start a 401(k)?

- For many people, their first steps in investing begins with signing up for their company's 401(k) plan. This can be the easiest point of entry for many workers and the process of signing up is made simple by most employers.
- It starts with a conversation with someone in your human resources department to get instructions on how to enroll. Your HR representative should be able to answer any questions you have as you go through the process.
- Once you're signed up, you can arrange to make automatic contributions to the retirement plan each pay period. These contributions will come directly out of your paycheck before you ever see the money.
- The result over time is a retirement nest egg, built without too much thought or effort.

401(k) Options

- There are two basic types of 401(k) plans, which are the Traditional 401(k) plan and Roth 401(k) plan. First, check with your employer to see if each of these are available. When selecting your investment this part might seem complicated, but it does not have to be. Listed below are the details of each product.

Traditional 401(k) Plan

- A Traditional 401(k) is an employer-sponsored investment savings account that gives employees the opportunity to save for retirement with pre-tax money. Contributions to the plan are not considered taxable income for the contributing year. Taxes for contributions are counted in the year you draw from your plan. Any earnings from dividends and capital gains grow tax-free during the plan period.
  - Ex. If you were to contribute to a Traditional 401(k), the contributions would be pre-taxed dollars, which could lower your annual reported income. This could potentially lower your current tax bracket/tax rate.

Roth 401(k)

- A Roth 401(k) is an employer-sponsored investment savings account that gives employees the opportunity to save for retirement with after-tax money. Contributions to the plan are considered taxable income for the contributing year. Since taxes have already been paid, these amounts are tax free in the year you draw. Earnings from dividends and capital gains are tax-free after 59½.

Contributions

- Contributions, also known as deposits, have a limit set by the IRS for each year. The contribution limit for 2020 was $19,500, which is $500 higher from the limit for 2019. Employees and employers can contribute up to this limit. Employee contributions are usually made as a percentage from their paycheck.
- Some employers offer contribution "matching" up to a set percentage of employee contributions. Matching can be as high as 100% of employee contributions and are typically capped between 2% - 5% of the employees salary/paycheck. Employer matching = FREE MONEY for retirement.
  - Ex. Employee Salary: $50,000;
    Employer Match: 100% of
    contributions up to 3% salary
    3% of salary: $1,500.

    If the employee contributes at least 3% to their 401(k) annually, her company will contribute $1,500 of their own money to her 401(k) every year!

Mutual Funds

- Most employer sponsored retirement plans, like your 401(k), go into mutual funds. Mutual funds are investments that pool your money together with other investors to purchase shares of a collection of stocks, bonds, or other securities, referred to as a portfolio, that might be difficult to recreate on your own. A portfolio manager typically oversees mutual funds. Mutual funds generally are placed into one of three categories:
  - Equity Type – Stocks
  - Fixed Income – Bonds
  - Money Market – Short-term debt and cash equivalents

Distributions

- Distributions, also known as withdrawals, have restrictive rules based on age and employment status. Taking a distribution before retirement age could prompt penalties, with certain exceptions such as death or disability. Generally, if you take a distribution from a 401(k) before the age of 59 1/2, you will owe a 10% early withdrawal penalty on top of any taxes you would have normally owed.
- The age 59½ distribution rule says any 401(k) participant may begin to withdraw money from his or her plan after reaching the age of 59½ without having to pay a 10% early withdrawal penalty.
- We always recommend speaking to your HR representative and/or your 401(k) administrator to determine the most cost-effective options for distribution.

PRO TIPS TO CONSIDER

Work With Someone

- Have a relationship with your 401(k) manager/financial advisor. These professionals can help with understanding and decision making, considering things like risk tolerance, security types, and investment sectors.

Catch-Up Contributions

- A catch-up contribution allows people aged 50 or older to make additional contributions to their 401(k) for accelerated savings. The IRS can adjust maximums yearly and in 2020, catch-up contributions were capped at $6,500.

Vesting

- Some employers require employees to complete a "vesting period" to take full advantage of benefits, like employer matching. Typical vesting periods can limit employer matching to 25% or 33% of the full matching benefit in the first year of employment, or require that employees remain employed for a number of years to earn full matching benefits. Once an employee is fully vested, the money earned through employer matching is theirs to keep.

401(k) Loans

- Some 401(k) participants choose to take loans against their 401(k) savings when they're in need, as opposed to higher interest rate loans. Many employers have strict restrictions including (not limited to):
  - Minimum loan amounts
  - Married participants may have to have spousal consent
  - Usually a maximum loan amount of 50 % of your vested amount
  - There is still interest accrued even though you're borrowing from yourself
  - Rate is typically Prime plus 1% or 2%
- Ask your Human Resources Department or 401(k) Plan Administrator for more details if you are considering taking a loan from your 401(k).

Moving your 401(k)

- Before moving retirement savings, you'll want to make sure that your requests are being executed correctly to prevent additional penalties/taxes. If errors are made in how checks are written or checks are not received into the correct account types, the IRS could subject you to 20% tax withholdings and 10% early withdrawal penalties. We recommend that you speak with a Financial Advisor or tax professional before authorizing transactions.

Resources

- www.irs.gov
- www.benefitscheckup.org
- www.medicare.gov
- www.benefits.va.gov
- www.ssa.gov/retire
- www.nia.nih.gov

A 401(k) is an amazing savings tool that often gives you free money from your employer. You should speak with your HR representative and/or 401(k) administrator to understand your options better.

For additional 401(k) resources and answers to your more general retirement planning questions, make an appointment with a CFS* Financial Advisor at Truliant Federal Credit Union today!

Truliant Financial Advisors

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