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401(k) Plans

Qualified cash or deferred arrangements (CODAs) permitted under Section 401(k) of the Internal Revenue Code, commonly referred to as "401(k) plans," have become one of the most popular types of employer-sponsored retirement plans.

How does a 401(k) plan work?

With a 401(k) plan, you elect either to receive cash payments (wages) from your employer immediately, or defer receipt of a portion of that income to the plan. The amount you defer (called an "elective deferral" or "pretax contribution") isn't currently included in your income; it's made with pretax dollars. Consequently, your federal taxable income (and federal income tax) that year is reduced. And the deferred portion (along with any investment earnings) isn't taxed to you until you receive payments from the plan.

Example: *Melissa earns $30,000 annually. She contributes $4,500 of her pay to her employer's 401(k) plan on a pretax basis. As a result, Melissa's taxable income is $25,500. She isn't taxed on the deferred money ($4,500), or any investment earnings, until she receives a distribution from the plan.*

You may also be able to make Roth contributions to your 401(k) plan. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. Unlike pretax contributions to a 401(k) plan, there's no up-front tax benefit, but qualified distributions from a Roth 401(k) account are entirely free from federal income tax.

When can I contribute?

You can contribute to your employer's 401(k) plan as soon as you're eligible to participate under the terms of the plan. In general, a 401(k) plan can make you wait up to a year before you're eligible to contribute. But many plans don't have a waiting period at all, allowing you to contribute beginning with your first paycheck.

Some 401(k) plans provide for automatic enrollment once you've satisfied the plan's eligibility requirements. For example, the plan might provide that you'll be automatically enrolled at a 3% pretax contribution rate (or some other percentage) unless you elect a different deferral percentage, or choose not to participate in the plan. This is sometimes called a "negative enrollment" because you haven't affirmatively elected to participate--instead you must affirmatively act to change or stop contributions. If you've been automatically enrolled in your 401(k) plan, make sure to check that your assigned contribution rate and investments are appropriate for your circumstances.

How much can I contribute?

There's an overall cap on your combined pretax and Roth 401(k) contributions. You can contribute up to $17,500 of your pay ($23,000 if you're age 50 or older) to a 401(k) plan in 2014. If your plan allows Roth 401(k) contributions, you can split your contribution between pretax and Roth contributions any way you wish. For example, you can make $10,000 of Roth contributions and $7,500 of pretax 401(k) contributions. It's up to you.

But keep in mind that if you also contribute to another employer's 401(k), 403(b), SIMPLE, or SAR-SEP plan, your total contributions to all of these plans--both pretax and Roth--can't exceed $17,500 ($23,000 if you're age 50 or older). It's up to you to make sure you don't exceed these limits if you contribute to plans of more than one employer.

Can I also contribute to an IRA?

Yes. Your participation in a 401(k) plan has no impact on your ability to contribute to an IRA (Roth or traditional). You can contribute up to $5,500 to an IRA in 2014, $6,500 if you're age 50 or older (or, if less, 100% of your taxable compensation). But, depending on your salary level, your ability to make deductible contributions to a traditional IRA may be limited if you participate in a 401(k) plan.

Make sure you contribute as much as necessary to get the maximum matching contribution from your employer. This is essentially free money that can help you reach your retirement goals that much sooner.

**When considering a rollover, to either an IRA or to another employer's retirement plan, you should consider carefully the investment options, fees and expenses, services, ability to make penalty-free withdrawals, degree of creditor protection, and distribution requirements associated with each option.*

What are the income tax consequences?

When you make pretax 401(k) contributions, you don't pay current income taxes on those dollars (which means more take-home pay compared to an after-tax Roth contribution of the same amount). But your contributions and investment earnings are fully taxable when you receive a distribution from the plan.

In contrast, Roth 401(k) contributions are subject to income taxes up front, but qualified distributions of your contributions and earnings are entirely free from federal income tax. In general, a distribution from your Roth 401(k) account is qualified only if it satisfies both of the following requirements:

- It's made after the end of a five-year waiting period
- The payment is made after you turn 59½, become disabled, or die

The five-year waiting period for qualified distributions starts with the year you make your first Roth contribution to the 401(k) plan. For example, if you make your first Roth contribution to your employer's 401(k) plan in December 2014, your five-year waiting period begins January 1, 2014, and ends on December 31, 2018. Each nonqualified distribution is deemed to consist of a pro-rata portion of your tax-free contributions and taxable earnings.

What about employer contributions?

Many employers will match all or part of your contributions. Your employer can match your Roth contributions, your pretax contributions, or both. But your employer's contributions are always made on a pretax basis, even if they match your Roth contributions. That is, your employer's contributions, and investment earnings on those contributions, are always taxable to you when you receive a distribution from the plan.

Should I make pretax or Roth contributions?

Assuming your 401(k) plan allows you to make Roth 401(k) contributions, which option should you choose? It depends on your personal situation. If you think you'll be in a similar or higher tax bracket when you retire, Roth 401(k) contributions may be more appealing, since you'll effectively lock in today's lower tax rates. However, if you think you'll be in a lower tax bracket when you retire, pretax 401(k) contributions may be more appropriate. Your investment horizon and projected investment results are also important factors. A financial professional can help you determine which course is best for you.

Whichever you decide--Roth or pretax--make sure you contribute as much as necessary to get the maximum matching contribution from your employer. This is essentially free money that can help you reach your retirement goals that much sooner.

What happens when I terminate employment?

Generally, you forfeit all contributions that haven't vested. "Vesting" means that you own the contributions. Your contributions, pretax and Roth, are always 100% vested. But your 401(k) plan may generally require up to six years of service before you fully vest in employer matching contributions (although some plans have a much faster vesting schedule).

When you terminate employment, you can generally leave your money in your 401(k) plan until the plan's normal retirement age (typically age 65), or you can roll your dollars over tax free to an IRA or to another employer's retirement plan.*

What else do I need to know?

- Saving for retirement is easier when your contributions automatically come out of each paycheck
- You may be eligible to borrow up to one-half of your vested 401(k) account (to a maximum of $50,000) if you need the money
- You may be able to make a hardship withdrawal if you have an immediate and heavy financial need. But this should be a last resort--hardship distributions are taxable events (except for Roth qualified distributions), and you may be suspended from plan participation for six months or more
- If you receive a distribution from your 401(k) plan before you turn 59½, (55 in certain cases), the taxable portion may be subject to a 10% early distribution penalty unless an exception applies
- Depending on your income, you may be eligible for an income tax credit of up to $1,000 for amounts contributed to the 401(k) plan
- Your assets are generally fully protected from creditors in the event of your, or your employer's, bankruptcy