401(k) Basics

As you earn the income that pays for your current needs and at least some of the things that you enjoy, you may also be thinking about what you'll be able to afford when you retire. One way to ensure you'll have at least some of the income you need is to participate in an employer-sponsored retirement savings plan, the most common being the 401(k).

What is a 401(k) Plan?

Named for the section of the tax code where they are described, 401(k) plans are a type of salary-deferral plan set up by a private-sector employer. Similar salary-deferral retirement plans include 457 plans (for public-sector employees) and 403(b) plans (for nonprofit-sector employees). Salary-deferral plans are generally self-directed. This means you are responsible for deciding how to invest the money that accumulates in your account. Usually you must choose among a list of investments the plan offers. The advantage of self-direction is that you can select investments that you believe will help you achieve your long-term goals. But, of course, it also means added responsibility for choosing wisely. Your employer may also contribute to your account, most commonly through a match of some portion of the amount you contributes. When you participate in a traditional 401(k) plan, the taxable salary that your employer reports to the IRS is reduced by the amount that you defer to your account. This means income taxes on that money are postponed until you withdraw from your account, usually after you retire. If you participate in a Roth 401(k), though, the amount you defer doesn't reduce your taxable income or your current income taxes. But when you withdraw after you retire, the amounts you take out are tax-free, provided you're at least 59½ and your account has been open at least five years. Participating in a 401(k) plan gives you a head start on your long-term financial security. A 401(k) not only provides a mechanism for saving. It also allows the money in your account to compound tax-deferred. That means that the earlier you begin to participate and the more you contribute, the greater chance you'll have of amassing a substantial retirement account.

401(k) Sponsorship:

An Employer's Role Each 401(k) plan has a sponsor, usually your employer. The sponsor decides which factors determine your eligibility, what percentage of your salary you can contribute to your plan, whether to match your contributions and which investments will be available within your plan. The plan administrator keeps track of the company's 401(k), handling management details and making sure that the plan runs smoothly. Your sponsor also chooses your plan provider, typically a financial services company that offers investment products, plan administration and record-keeping services. Some provisions of your 401(k) plan are dictated by ERISA, the federal law that governs qualified retirement plans. For example, plans must cover all eligible employees and treat them equitably. Other details are specific to each individual plan. That's why, if you move from one job to another, each with a 401(k), some things will seem familiar and others different. 401(k) plans are largely self-directed. You decide how much you would like to contribute to your plan, how you would like to invest—or reinvest—those contributions within the limits of your plan's investment menu, and eventually how you would like to handle withdrawals from your account. The federal government caps the amount you can contribute to your account each year. See the Annual Contribution Limits table for current caps, which can change from year to year. You are also responsible for the investment results you achieve, though your employer has the obligation to offer appropriate investment alternatives. With many employers, you have to sign up before you can contribute part of your earnings to your plan account. You have to choose how much to put away. And you decide where to invest your contributions, selecting among the investment choices offered in the plan. But a growing number of employers automatically enroll eligible employees. In that case, your employer chooses an automatic contribution rate, known as the default rate, and an automatic investment alternative, known as the default investment, for plan participants.

Tax Benefits

Any earnings your tax-deferred contributions produce during the time they remain in your account are also tax deferred. This means the combined amount has the opportunity to compound at a faster rate, since everything is being reinvested and no money is being taken out to pay taxes. And no matter how many times you sell investments that have increased in value, you won't owe capital gains tax on any profit you may make. Instead, you can reinvest the entire amount, although there may be transaction fees for your trades. Of course, if you sell investments that have lost value, you can't claim your capital losses either. The tax you eventually pay depends on your income tax rate at the time of the withdrawal. Although there's no way of predicting what your income tax rate will be when you withdraw from your account, many people have less income in retirement than they did when they were working, and so pay tax at a lower rate.

Vesting

Any money you contribute to a salary-deferral plan and the earnings those contributions produce always belong to you—though you usually must change jobs or retire to withdraw or move the balance. In contrast, you don't have a right to the money your employer contributes to your account (or the earnings made from those contributions), or makes to any other retirement account for you, until you are fully vested, or have full legal rights to your account. Vesting is determined by time on the job. Federal regulations set guidelines for vesting, but your employer determines which of various vesting schedules to use: vesting could be immediate, gradual over a period of time, or all at once when you have worked a certain number of years.

Eligibility

You must be eligible to participate before you can enroll in a 401(k) plan. But that's not a problem. Federal law requires that when an employer sponsors a plan, all employees must have an equal opportunity to save for retirement. Your employer can impose two restrictions: that you must work for a full year—usually at least 1,000 hours over 12 months—and be at least 21 years old before you enroll. But not all employers make you wait. One of the questions you'll want to ask when you're considering a new job is when you'll be eligible to contribute to a 401(k). Once you're eligible, though, you might not be able to enroll immediately. Plans often have specific start dates for new participants, such as once a quarter or twice a year, or during an open enrollment season. In any year you're not eligible to contribute to your employer's plan, you may be eligible to make a tax-deductible contribution to a traditional individual retirement plan (IRA). Or, you may qualify to put retirement money into a nondeductible but tax-free Roth IRA. Check with your tax adviser to determine if you're eligible and which may be smarter for you.