

401(k) Retirement Savings Programs

Overview

What you need to know about 401(k) plans.

- How 401(k) plans work
- Benefits of 401(k) plans
- Understanding your own employer's plan
- If you leave your current employer before retirement
- Early withdrawals and loans from your 401(k) account
- What to do with your 401(k) when you retire

A 401(k) plan is a retirement savings program established by your employer that lets you set aside a percentage of your pay. The money you set aside, which comes out of pretax income, is placed in a professionally managed fund. Within that fund, you can choose where to invest your 401(k) money. Many employers even pay an additional “company match” into each participating employee’s 401(k) account. The money in your 401(k) grows tax-deferred. Because of recent federal laws, you can contribute larger amounts than ever before and even more after age 50 -- and all through pretax contributions.

How 401(k) plans work

A 401(k) plan is a retirement savings program provided by your employer that gives you tax advantages for saving for retirement. Your contributions to a 401(k) come out of your pretax salary through automatic payroll deduction. Your paycheck or pay stub will reflect that some of your pay -- an amount that *you* have determined, subject to certain limitations -- has already been taken out and deposited into your 401(k) account. When it’s time to pay income tax, you won’t be taxed on the amount that was withheld from your pay and deposited into the 401(k) account.

Each company’s 401(k) plan is personalized by that company, within government guidelines. The following plan elements may vary depending on the employers’ options:

- *Contribution limits.* The amount you can contribute to a 401(k) may vary, depending on the rules set by your employer. The Internal Revenue Service (IRS) also sets an annual limit on the amount of pretax dollars you can contribute to employer-sponsored plans. For 2008, for example, your combined pretax contributions may not exceed \$15,500. In addition, if you are age 50 or over at the end of a tax year, you may contribute an extra “catch-up” amount -- the allowable “catch-up” amount is \$5,000 through 2008 (adding up to a total permissible contribution of \$20,500 in 2008).
- *Eligibility.* Eligibility to take part in your employer’s 401(k) plan is usually tied to the length of time you’ve been employed at the company. It’s common for employers to require that employees be working for them for one year, and for a minimum number of hours a week, to join the 401(k) plan.

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- *Employer matching contributions.* Your employer may elect to contribute a certain amount for every dollar that you contribute to your 401(k) account, generally up to a certain dollar amount or percentage of your pay. Match formulas vary, as do company policies on how long you must have worked for the company before your employer will pay into your account. The timing of the match may also vary. Some employers pay their company match at the time the employee contribution is paid into the 401(k). Others pay the match at regular intervals, such as monthly, quarterly, or annually.
- *Vesting.* Vesting refers to how much of the contributions made by your employer, and the earnings on those contributions, belongs to you based on how much time you have been with the organization. Even though your company's contributions are deposited into your account, they are not entirely yours until you have been employed at the company for a period of time determined by your employer. Some employers set up plans by which a percentage of their contributions become yours each year. Others provide for full vesting of each company contribution after a certain length of service following the employer's contribution date. For instance, if a company match is made in January, you might become vested in that contribution in February of the following year, after you have worked there for a full 12 months after the match date.

Benefits of 401(k) plans

Experts agree that 401(k) plans are one of the best “safety nets” for retirement savings. Here are some of the many benefits of contributing to your company's 401(k) plan:

- *Income tax deferral.* The money you contribute comes out of your pay before income taxes are calculated. This lowers your taxable income, so you'll pay less in taxes, leaving more of your money to work for you, rather than for Uncle Sam. You don't pay income tax on your 401(k) contributions or any earnings on those contributions until you withdraw them from the plan.
- *Automatic payroll deduction makes it easy to save.* You don't see the money, so you're less likely to miss it.
- *Your money is protected.* As with any investment, there's no guarantee that your 401(k) investment choices will lead to a high return. But federal regulations do ensure that those who administer your company's 401(k) program will be held to certain professional and ethical standards. Your employer must file an annual report on its 401(k) program with the federal government, and government agencies may audit the program to make sure it's in compliance. And money that's invested in a 401(k) account is also safe from most debt collection, even for those who have declared bankruptcy.
- *With a company match, your account can grow faster, and larger, than another type of account.* Matching contributions put you on a fast track to money growth. In addition to whatever interest and dividends your own contribution earns, your

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money increases even more by the addition of company contributions and the earnings on those.

- *You can control the amount you set aside.* With a 401(k), you can save the amount that's right for *you*. You might choose to set aside just a little each month, such as 1 percent of your pay, or you could save the maximum that's allowed by law. Many people opt to contribute the maximum amount that's matched by their employer to get the most benefit from their company match. And as your circumstances and needs change, you can adjust your contribution amount.
- *You can control your investments.* You can choose among investment options. Most 401(k) plans offer a number of investment options for your money, such as stocks, bonds, and money market options, each involving a different degree of risk. You can apportion your 401(k) among several investment accounts or focus on just one account. When choosing among your investment options, don't lose sight of the big picture; make sure that, between the 401(k) and your other investments, your total investment portfolio is diversified. It's a good idea to discuss your 401(k) investment choices with your personal financial adviser.
- *If you're 50 or over, you may be able to save even more with "catch-up contributions."* If your employer's plan allows (and most do), you can make additional annual "catch-up contributions" to your 401(k) account, starting on January 1 of the year you will turn 50. This enables you to save even more for retirement.

Understanding your own employer's plan

To find out the rules of your company's 401(k) program, read through the Summary Plan Description (SPD). This is a government-required communication from your employer that describes the features of its 401(k) program. Employers must disclose the following information in the SPD:

- general information about the plan, including the name and contact information of the plan administrator
- eligibility and vesting requirements
- summary of benefits
- claims procedures
- plan contributions and other funding information, such as how, and how often, your contributions and the company match will be deposited
- explanation of your legal rights

You should receive a copy of your company's SPD when you join the plan or shortly thereafter. You can also get a copy anytime upon request. Check with your human resources office for more information.

If you leave your current employer before retirement

One of the best things about a 401(k) account is that you can take it with you -- or choose not to -- when you leave your job. You can roll over your 401(k) into an individual retirement account (IRA), or into a new employer's 401(k) plan, if the new plan's rules allow contributions from other plans. And if your total vested amount in your former employer's 401(k) plan is more than \$5,000, you can often choose to leave your money in that plan, even though you've changed employers. Just remember, once you leave a job, you will probably not be able to continue to contribute to your former employer's plan or to borrow from it.

Early withdrawals and loans from your 401(k) account

The purpose of a 401(k) plan is to set money aside for retirement. Still, you may find that you need to access your savings before then because of financial hardship or other personal circumstances. You may have one or two options that enable you to do so, under your employer's 401(k) rules.

- *Hardship withdrawals.* Most plans allow employees to withdraw 401(k) funds only in the case of a financial hardship. This is in keeping with IRS guidelines that allow for withdrawals if there is an immediate and a heavy financial need relating to a very limited set of circumstances: certain medical expenses, purchase of a primary residence, payments of certain postsecondary education expenses, and prevention of eviction from or foreclosure on your primary home. Withdrawals to meet these types of situations should be viewed as a last resort. You will have to pay income tax on the money you withdraw and, depending on your situation, a possible 10 percent early withdrawal penalty if you are under age 59½. State and local taxes may also apply. And under most employers' rules, you will likely be suspended from contributing to your account for at least six months after the withdrawal. So be sure to consult with a financial or tax adviser about your particular situation if you are considering a withdrawal from your 401(k) account.
- *Borrowing from your own 401(k) account.* Many plans have loan features that let you withdraw money as a "loan to yourself." You pay the loan back automatically, through payroll deduction, into your own 401(k) account, and the interest you pay goes into your own account, too. Usually, contributions to a 401(k) account must be suspended while a loan is outstanding, and the loan must be paid back in its entirety when you leave the company.

What to do with your 401(k) when you retire

Upon retirement, you'll have several options regarding your 401(k) account. These include the following:

- *Leaving it in your employer's plan.* This avoids current taxes and penalties, and your assets in the 401(k) account are protected from most creditors. Your employer's plan, however, may offer fewer benefits to retirees. For example, you won't be able to borrow from your account, and you may be charged a fee for plan features

that are free to active employees. So be sure to review your employer's SPD before making this decision.

- *Moving your eligible distribution to a rollover IRA, an income annuity, or both.* Rollover IRAs are designed specifically so that eligible distributions coming from an employer-sponsored plan can remain invested on a tax-deferred basis. An income annuity is a popular choice among retirees who are concerned about outliving their savings and income. Managed by an insurance company, an income annuity converts some or all of your 401(k) savings into a regular, fixed stream of income payments. Once payments begin, no withdrawals can be made from the annuity account.
- *Taking your distribution in cash.* Most people do not choose to take their distribution in cash because it may lead to undesirable taxes and penalties. A portion of this cash distribution will be automatically deducted as a federal withholding tax, and the sum that you receive after withholding is subject to federal income tax and probably state and local taxes as well. And if you're not yet 59½, you may also be assessed a 10 percent penalty.

Your age is another consideration in deciding how to treat your 401(k) account when you retire. You must start withdrawing your money from your 401(k) account by April 1 of the year following the year in which you reach age 70½, and each year you must withdraw a required minimum distribution or face a penalty. The IRS provides formulas for calculating this required amount. Your employer's plan will probably help lead you through these calculations and will offer automatic withdrawal options to help you meet these minimums.

Remember that the sooner you invest in your 401(k), the larger your account will grow and the sooner you'll be on your way to a comfortable retirement. Talk with a financial adviser about making the choices that are right for you as you decide how much of your paycheck to set aside, how to invest your account assets, and whether and when to withdraw your funds.

Written with the help of licensed psychologist Jonathan Hefner, M.A. Mr. Hefner specializes in financial and legal counseling and is the manager of legal and financial services at Ceridian Corporation.