COOPERATIVE EXTENSION SERVICE
UNIVERSITY OF MARYLAND, COLLEGE PARK
UNIVERSITY OF MARYLAND EASTERN SHORE

FACT SHEET

Retirement Planning

Investing in 401(k) Tax Deferred Retirement Plans

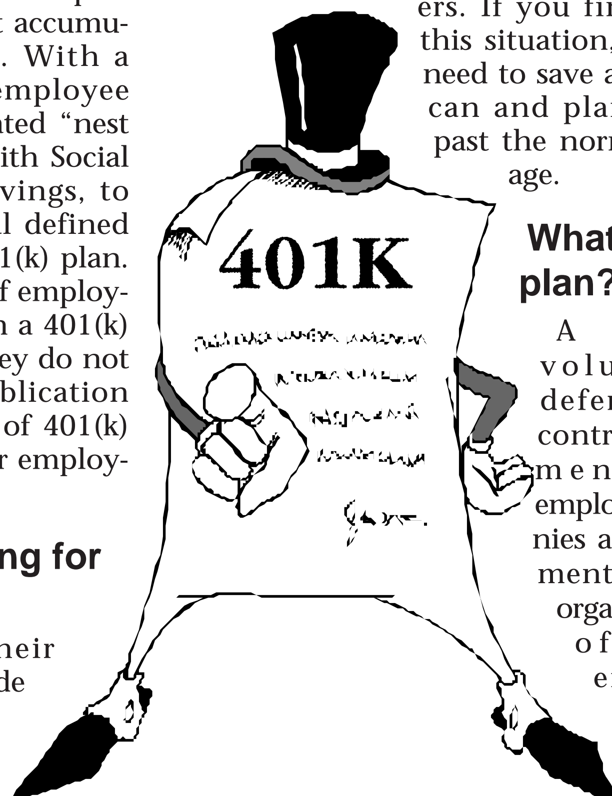
Fact Sheet 716

Patricia M. Tengel
family resource management specialist
Extension Family and Consumer Sciences

Over the last 10 years the types of retirement plans offered by companies have changed. The old defined benefit plans that guaranteed a stated benefit if one worked for the company for many years are rapidly disappearing. In their place, companies are offering defined contribution plans that provide a benefit based on the amount accumulated in the plan at retirement. With a defined contribution plan, the employee assumes the risk that the accumulated "nest egg" will be large enough, along with Social Security and other retirement savings, to fund a secure retirement. A typical defined contribution plan is an optional 401(k) plan. Research indicates that 25 percent of employees who are eligible to participate in a 401(k) plan do not do so, often because they do not understand the benefits. This publication shows you how to make the most of 401(k) plans when they are offered by your employer.

When should one start saving for retirement?

More and more people in their midtwenties see the need to put aside funds for retirement. The numbers tell us that this is a good age to begin because if one starts this early, he or she needs to save only 5 percent of pay to fund a financially secure retirement. Because these funds have many years to compound, they will produce a sufficient balance by retirement age. Waiting until the midthirties increases the amount needed to 9 percent or almost double, and waiting until the midforties increases the amount needed to 18 percent, or double again, simply to accumulate the same amount as those starting earlier. Those in their fifties need to save 43 percent, an amount that is not possible for most workers. If you find yourself in this situation, you probably need to save as much as you can and plan on working past the normal retirement age.



What is a 401(k) plan?

A 401(k) is a voluntary, tax-deferred defined contribution retirement plan for employees of companies and nongovernmental tax-exempt organizations. State of Maryland employees are also eligible to participate in

Local Governments • U.S. Department of Agriculture Cooperating

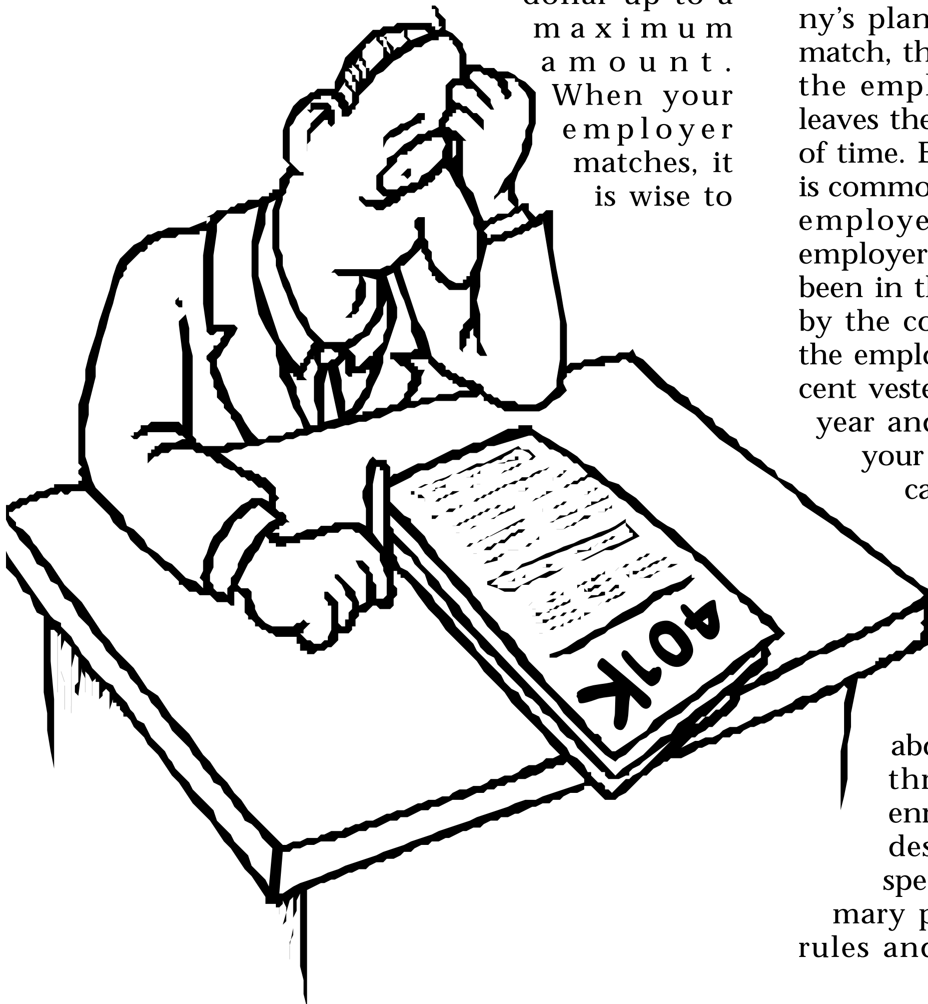
The University of Maryland is equal opportunity. The University's policies, programs, and activities are in conformance with pertinent Federal and State laws and regulations on nondiscrimination regarding race, color, religion, age, national origin, sex, and disability. Inquiries regarding compliance with Title VI of the Civil Rights Act of 1964, as amended; Title IX of the Educational Amendments; Section 504 of the Rehabilitation Act of 1973; and the Americans With Disabilities Act of 1990; or related legal requirements should be directed to the Director of Personnel/Human Relations, Office of the Dean, College of

a 401(k) plan. The term 401(k) stands for a section in the Internal Revenue Code, which explains the tax advantages.

How does a 401(k) plan work?

Employees who enroll in the plan designate the amount they want to contribute on a pretax basis. Because your contribution is deducted from your income before income taxes are calculated, you will pay fewer taxes. For example, in a 28 percent tax bracket, for every $100 contributed only $72 will come out of your paycheck. The remaining $28 is your current tax savings. Your employer will tell you the maximum percentage of your salary you can contribute, often as much as 6 percent. Regardless of the percentage, the maximum dollar amount you can contribute is $9,500 annually. This amount will be adjusted for inflation periodically.

While a matching contribution from the employer is not required, most companies match at least 25 cents of every dollar you contribute. Some employers match dollar for dollar up to a maximum amount. When your employer matches, it is wise to contribute enough to receive the full match because this is "free" money. State of Maryland employees receive no match. The funds that both you and your employer contribute grow untaxed until you retire many years from now. Your contribution is deducted directly from your paycheck so you are not likely to miss the funds.



However, if you are making minimum payments on your credit cards or will have to increase the amount of credit you use to contribute the maximum to a 401(k), consider contributing only the amount your employer will match until you get your spending and debts under control. It makes little sense to borrow at 18 percent, a common credit card rate, when contributions over the employer's match do not earn that much. A strategy to reach the maximum is to increase contributions up to the employer's match as rapidly as possible, then as you receive raises, save one-half your raises and pay off debt with the rest.

Whether the employer's match is vested immediately or not depends on the company's plan. If a company defers vesting the match, the employee does not have access to the employer's contribution if he or she leaves the company before a specified period of time. Either cliff vesting or graded vesting is commonly used. *Cliff vesting* means that an employee does not have access to the employer's contribution until he or she has been in the plan for 5 years while employed by the company. *Graded vesting* means that the employer's contribution becomes 20 percent vested each year starting with the third year and ending with the seventh year. If your company is generous, contributions can vest more rapidly. Employees can start a 401(k) at age 21 or after 1 year of service.

Investing in a 401(k) plan

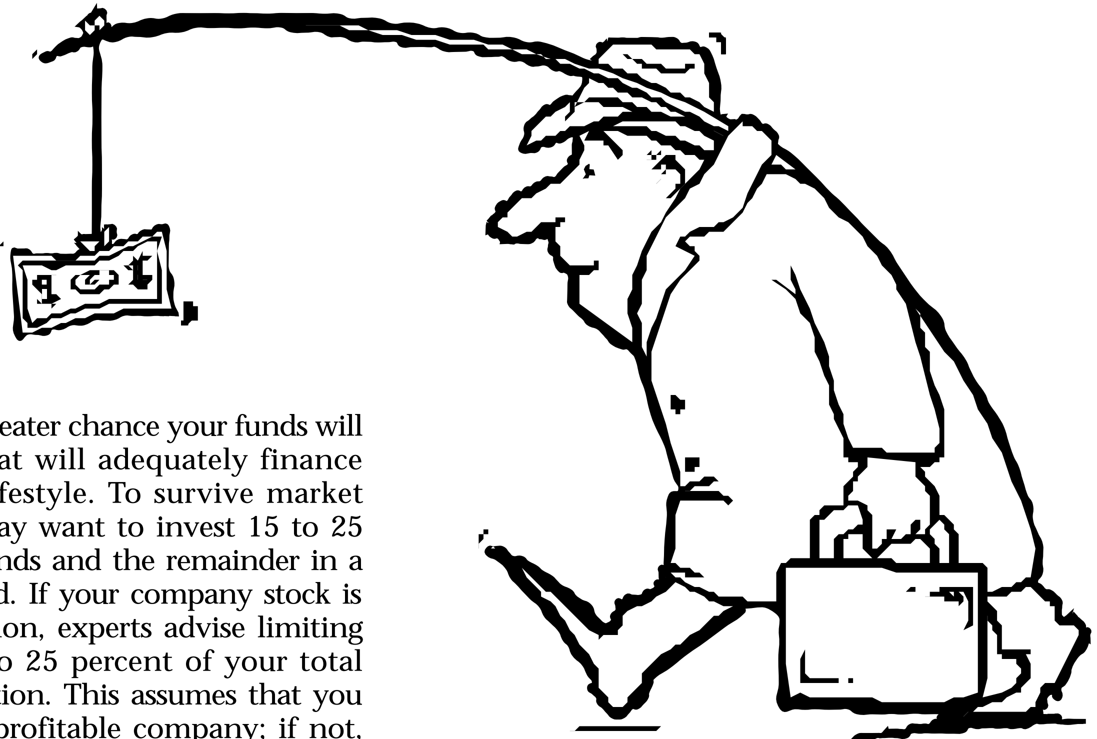
Once you request information about a 401(k) plan, you will be given three pieces of information: (1) an enrollment form, (2) a summary plan description, and (3) information on specific investment options. The summary plan description details the plan's rules and regulations including amounts

employees can contribute, employer matches, vesting rules for employer contributions, distribution rules, and grievance procedures. The information on investment options may be a short description of each option or a prospectus if mutual funds are offered.

Where to put tax-deferred funds

Once you decide on the amount to invest, the next step is to elect a place to put this money. Since January 1, 1994, companies offering 401(k) plans have been relieved of much of their fiduciary duties if they offer at least three asset classes, such as a money market fund, bond fund, and stock fund. Some companies offer a whole menu of mutual fund types, along with company stock and a Guaranteed Investment Contract (GIC), which has a guaranteed interest rate. Most companies have at least six choices.

Be aware that tax-deferred plans are long-term investments. This means you can afford to take greater risks. Consider investing the major portion of your funds in stocks, since historically they have out-performed other investment options. The portion invested in stocks may change over your working life. Those in their twenties might consider investing 75 to 80 percent in the stock market, in their thirties and forties, 70 percent, in their fifties, 60 percent, and in their sixties, 50 percent. While you may think this is a risky strategy, the longer you hold on to stocks, the less risk of loss of principal and the greater chance your funds will grow to a level that will adequately finance your retirement lifestyle. To survive market downturns, you may want to invest 15 to 25 percent in bond funds and the remainder in a money market fund. If your company stock is an investment option, experts advise limiting your investment to 25 percent of your total 401(k) stock allocation. This assumes that you are working for a profitable company; if not, limit the percentage even further.



Equity mutual funds

Many plans offer mutual funds with a variety of objectives and risks. Your choice of mutual fund depends on the amount of risk you want to assume. The following types of funds are commonly offered by companies. *Growth funds* invest in both small and large companies that pay few or no dividends. *Socially conscious funds* invest in companies that do not harm health or the environment. *Value funds* buy undervalued stocks. *Growth and income funds* invest in dividend paying stocks. A *balanced fund* invests in stocks and bonds. An *index fund* invests in stocks found in a particular stock index, such as the Standard and Poor's 500 (S&P 500) stock index. An S&P 500 index fund provides the approximate return of the stock market as a whole. The prospectus for each of these types of funds explains the risks. Depending on your risk tolerance, you may want to vary the proportion of funds you put into several of these options.

Fixed income alternatives

A Guaranteed Investment Contract is a contract between an insurance company and the tax-deferred plan. The interest on the account is guaranteed for a specific period of time, however, the funds themselves are not. The funds are invested in mortgages and bonds, which mature at the same time as the contract. In addition to GIC's, tax-deferred plans frequently offer a series of bond funds. Some common examples are corporate bond mutual funds, and U.S. Treasury Agency bond mutual funds with various maturity lengths. When purchasing a bond fund, remember to check the maturity of bonds held in the portfolio. A fund containing bonds that will reach maturity in 5 to 10 years is common and not as risky as a fund containing longer term bonds. In addition, most 401(k) plans offer a money market mutual fund with a maximum maturity of only 90 days. For additional information on mutual funds, request Fact Sheet 656, "Mutual Funds," from your local Cooperative Extension office.

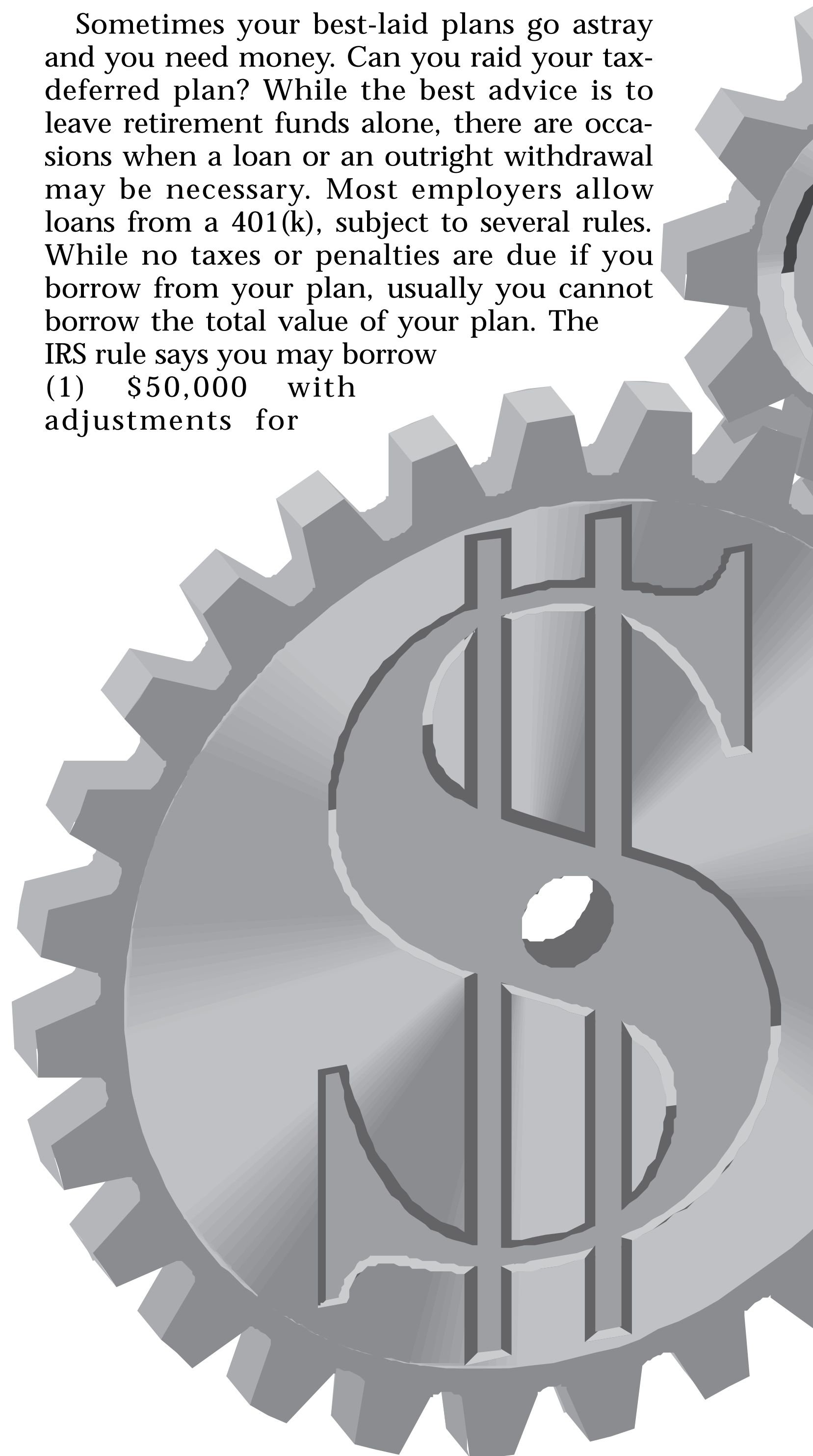
Information on how your 401(k) investments are performing

Within 6 weeks of the end of each quarter, the company managing your 401(k) plan will send you a statement of your account. This quarterly statement contains an itemized account of contributions, beginning balances, ending balances, loans (if any), income earned, and capital gains and losses. Review these statements carefully for accuracy. Compare the contributions with the amounts on your pay stubs. If your employer makes a match into the same funds you are investing in, the two contributions may be combined. If this is the case, you may want to note the amount of your contributions on your statement because your contribution vests immediately while your employer's may not. This information will become valuable should you decide to leave the company. You may need to stay a little longer if the employer's contributions are about to vest.

In addition to statements, you will also receive periodic reports on investment options. If this report is only a summary and you are offered a more detailed report, be sure to request the detailed report and review it carefully. Remember, your tax-deferred plan is like any other investment. You may need to adjust your 401(k) portfolio from time to time to keep your desired allocation between stocks and fixed income investments in the desired balance.

Taking money out of a 401(k) plan in an emergency

Sometimes your best-laid plans go astray and you need money. Can you raid your tax-deferred plan? While the best advice is to leave retirement funds alone, there are occasions when a loan or an outright withdrawal may be necessary. Most employers allow loans from a 401(k), subject to several rules. While no taxes or penalties are due if you borrow from your plan, usually you cannot borrow the total value of your plan. The IRS rule says you may borrow (1) $50,000 with adjustments for



any outstanding loans, or (2) one-half of your vested total. For example, if your account value was $80,000, you could borrow $40,000. If the account value was $150,000, you could borrow $50,000. However, if the vested balance in your account is $10,000 or less, you can borrow the total even though it is more than half. For example, if you have an $11,000 vested account, you could borrow $10,000 of it. Because you are borrowing more than 50 percent in this case, your employer could require you to put up some collateral. When you only borrow 50 percent, no collateral is required because the other half serves as the collateral.

When borrowing from your plan, you must repay the loan within 5 years unless you have borrowed the money for the purchase of a primary residence. You must pay the money (principal and interest) back in approximately equal installments at least quarterly over the term of your loan (5 years). The interest you pay on your loan is credited to your account. When you finally withdraw the interest in retirement you will need to pay taxes on it. In addition, the interest you pay cannot be taken as an itemized deduction for tax purposes unless it is home mortgage interest and you have not made salary reduction (before tax) contributions to your 401(k). The requirement that salary reductions not be taken probably restricts most 401(k) home mortgage borrowers from deducting the interest.

If your employer does not allow you to borrow, another option is a "hardship" withdrawal. The only advantage of a "hardship" withdrawal is that you are not required to leave your job to get to your money. However, getting to these retirement savings will be expensive. You will need to pay income taxes on the amount withdrawn and, if you are under age 59 ½, you will be assessed a 10 percent penalty. In a 28 percent income tax bracket, you would lose 38 percent of the amount you withdrew. That means if you withdrew $10,000, you would actually have only $6,200. You also would have to meet two hardship conditions: (1) that the distribution is necessary in light of immediate and heavy financial need, and (2) that funds are not reasonably available from other sources. To meet the "immediate and heavy" requirement, the funds must be used for (1) payment of medical expenses for you or your dependents, (2) purchase of a principal residence, (3) payment of educational expenses for you or your dependents, or (4) payments to prevent eviction or mortgage foreclosure. The "existence of other resources" condition uses a "safe harbor" test that requires the borrower to meet two criteria: (l) the borrower can borrow only the amount needed to fund the immediate and heavy financial need, and (2) the borrower has used all available resources including borrowing at reasonable terms, using easily liquidated assets, or using insurance reimbursements. In addition to meeting these criteria, the borrower must cease to contribute to tax-deferred plans for 12 months. In other words, this is the last source for money available to the borrower. As you can see, you would have to be in dire straits to take a "hardship" withdrawal.

Leaving a job before retirement age

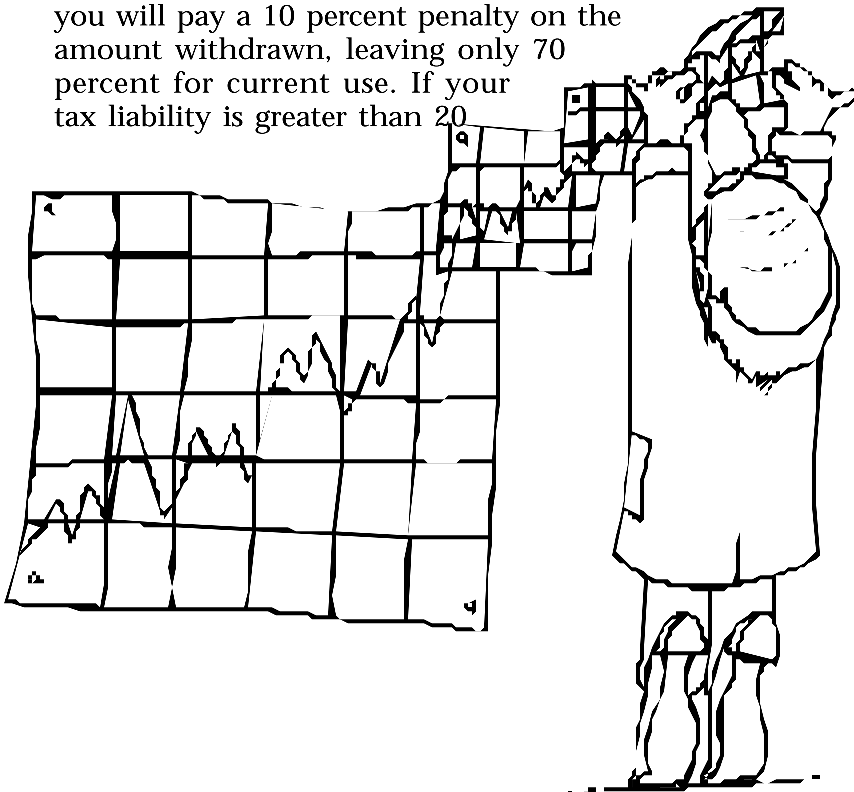
Changing jobs

If you are making a career move, you must make a decision as to what to do with your 401(k). If you are leaving your employer on amicable terms, you may want to leave your funds with that employer. This may be possible if you have more than $3,500 in the

account. Alternatives include rolling the money over into an Individual Retirement Account (IRA) or transferring your funds to your new employer's plan. In either case, make sure the funds transfer directly from one plan to another. If the check is written to you, rather than to the new plan, your previous employer is required to withhold 20 percent for the payment of income taxes. To roll over the full amount, you would need to add from personal funds the 20 percent your employer withheld, in order to avoid the 10 percent penalty mentioned in the previous paragraph. You also must roll the funds over within a 60-day time limit. In this do-it-yourself situation, you then apply for a credit of the amount withheld on your income tax form.

Layoffs, temporary illness, disability, or leaving to care for someone who is ill

If you have lost your job, are temporarily too ill to work, or must stay home to take care of a loved one, you may need your 401(k) funds for current expenses. Withdrawing these funds will be very expensive. Twenty percent will be withheld for payment of taxes and, if you are under age 59 ½, you will pay a 10 percent penalty on the amount withdrawn, leaving only 70 percent for current use. If your tax liability is greater than 20 percent, you may end up paying additional taxes as well. The message is that 401(k) money is for retirement. If at all possible, leave the money in place until you reach retirement age. Should you become permanently disabled before age 55, you can take your 401(k) money without the 10 percent penalty. If you can wait until age 55 to permanently leave the labor force, you also can take the funds without penalty. You will still have to pay income taxes on the total amount withdrawn.



If you must quit before age 55, you can avoid the penalty by taking more or less equal withdrawals for at least 5 years or until you reach age 59 ½, whichever is later. After that time you can cease withdrawals until you reach age 70 ½. There are three methods to determine the size of your payments. They can be based on your life expectancy, on a reasonable rate of interest along with your life expectancy, or on an annuity table. The younger you are, the smaller the payments. In addition, you forgo the compounding from leaving your funds in the tax-deferred account.

Removing funds from your 401(k) at retirement

Once you reach age 59 ½, you may take money from your 401(k) plan whenever you choose. The funds can be left in the employer's plan or rolled over into an IRA. You may wish to take only the amount of money you need to supplement other retirement income. Remember, the less you take out at the beginning of retirement, the more will be available later on. Let's say you need a lump sum to take a special trip or start a part-time business. This too is possible. The rest can then remain in the plan. If you decide to take a partial lump sum and roll the rest into an IRA, you must roll over at least 50 percent of the total.

Another option is to take all of the funds from your 401(k) at once. A special tax break, called 5-year forward averaging, may be

used one time by those who are at least age 59 ½. This tax break will be available only until December 31, 1999. To figure your taxes using this method, divide the lump sum by 5, check the tax rate on the single taxpayer schedule, and multiply that amount by 5. The taxes are then paid with your regular annual tax return. Those born on or before January 1, 1936, can use 10-year forward averaging, applying the tax rates in effect in 1986. Any capital gains earned by these individuals before 1974 will be taxed at the 20 percent rate that was in effect in 1986. Five-year forward averaging can save a considerable sum in taxes.

If your retirement income is adequate without your 401(k), you can leave it alone until you reach age 70 ½. In fact, your first payment can be delayed until April 1 of the year after you turn 70 ½. However, if you wait that long, you must take the second payment by December 31 of the same year. If you do not start taking your money out before you reach age 70 ½, you must make a very important decision. You must advise the administrator of your 401(k) plan which of two withdrawal methods you want to use. The withdrawal methods are called term certain and recalculation. If you fail to make a choice, the custodian will automatically choose recalculation, the method that causes the highest tax liability for your survivors. With *term certain* you take out 1/x of the balance each year. The fraction is based on your life expectancy or a joint life expectancy with your spouse or another person. Request IRS Publication 590, "Individual Retirement Arrangements," for tables based on single and joint life expectancies. At age 70 you can expect to live an additional 16 years, so if you are using only your life expectancy, the first year (at age 70) you would withdraw 1/16th, the next year at age 71, 1/15th, and so forth. For example, if you have $75,000 in your IRA, at age 70 you would need to withdraw $4,687.50 ($75,000 ÷ 16 = $4,687.50), and at age 71, you would use the remaining balance divided by 15. Using this method, your survivors can continue to take the money out using the same schedule you were using.

With the *recalculation* method, life expectancy tables decrease by less than 1 year each year, because the longer you live, the longer you can expect to live. Using the same life expectancy as above, the first year at age 70 the fraction of the balance you can take out each year would be 1/16, at age 71, 1/15.3, and at age 72, 1/14.6. Joint life expectancies with the owner at age 70 and spouse at age 67 start at 1/122. Using the recalculation method, your surviving spouse's life expectancy must be used after your death. Also, with this method, once your spouse dies, the entire balance must be distributed by the end of the year following your spouse's death, rather than on the schedule using a joint life expectancy.

As you retire, it would be wise to check your tax-deferred plans to make sure they allow the term certain method. Not all plans do. If not, you would then be able to locate and transfer funds to an IRA that allowed the term certain method.

Should you die before withdrawals begin, your spouse as beneficiary can roll the account over into his or her own account. Any other beneficiary could choose from three options: (1) take all the funds at once and pay the taxes now in a higher tax bracket, (2) take the funds over 5 years, or (3) take

the funds based on the beneficiary's life expectancy. A word of caution—not all custodians know the rule on using the beneficiary's life expectancy. For a more detailed discussion on withdrawals, request Fact Sheet 692, "Retirement Planning—Withdrawals from Individual Retirement Accounts" from your local Cooperative Extension office. The rules are the same for 401(k)s.

Because these rules are very complex, it is wise to obtain expert tax counsel before making a decision. Also remember to review your beneficiary choices from time to time to make sure they are up to date. Naming a beneficiary two generations younger than yourself could keep that money growing tax-deferred for many years after your death because the account can continue to grow with withdrawals based on the younger beneficiary's age.

Summary

Here are 12 thoughts to keep in mind:

1. Start now to plan for your retirement.
2. Your retirement income will be pooled from several sources, such as Social Security, an employer's pension, your IRA, and a 401(k) plan. All of these sources may be necessary to maintain your current lifestyle in retirement.
3. Tax-deferred savings are preferable to regular savings when saving for retirement.
4. Contribute the most you can to your 401(k), striving to reach the maximum allowed each year.
5. Your employer will probably match your contributions to your 401(k). Take advantage of this—it's like "free" money.
6. The younger you are, the more risk you can assume.
7. A substantial portion of your 401(k) investments should be in stocks rather than fixed income investments.
8. Modify the risk on your retirement savings and 401(k) by diversifying your assets in stocks, bonds, and fixed income investments.
9. Avoid removing funds from your 401(k) before retirement. In an emergency, borrowing is preferable to "hardship" withdrawals.
10. When leaving a job or retiring, if you cannot leave your 401(k) where it is, roll it over into an IRA.
11. Allow your funds to grow tax deferred for as long as possible.
12. Elect the method of withdrawal before reaching age 70. Term certain is generally the best choice.

References

Blackman, C.M., II, and K.P. McAuliffe. "Tax Law Changes and How They May Affect Your Retirement Plans." *AAII Journal*, American Association of Individual Investors, October, 1996: 28-30.

Golly, A.J., Jr., "Understanding 401(k) Mechanics: A Look at How the Plans Operate." *AAII Journal*, American Association of Individual Investors, May, 1996: 8-11.

Kaye, S.D. "A plastic poisoned retirement." *U.S. News and World Report*, November 4, 1996: 67.

Leimberg, S.R. and J.J. McFadden. 1995. *The Tools & Techniques of Employee Benefit and Retirement Planning*. Cincinnati, Ohio: The National Underwriter Company.

Miller, A.J. 1995. *Standard and Poor's 401(k) Planning Guide*. New York, New York: McGraw-Hill, Inc.