401(k) Plans: Learn the Basics

By: Benjamin Grom, CFP®

We are long past the days where the most common method of funding your retirement is through a pension plan. Many employers have now shifted to offering 401(k) plans. While millions of workers depend on 401(k)s to fund their retirement, few understand how they work. The following will provide you an overview of 401(k) plan terminology and investment options.

Employee Contributions

A 401(k) allows employees to contribute a portion of their salary to a tax-advantaged qualified investment account. Employers can also make matching or Non-Elective Safe Harbor contributions. In 2019 , the maximum deferral an employee can make to their 401(k) is $19,000; however, if the participant is 50 years of age or older, a catch-up contribution of $6,000 is allowed for a total contribution of $25,000.

Contribution Types

Most 401(k) plans allow you to choose between pre-tax, Roth, and after-tax contributions. The appropriate contribution method varies per individual, it is not a one-size-fits-all approach.

Pre-tax Contributions reduce your current year income tax burden because they are deducted from your federal taxable income. While you will not pay federal income tax on the amount that you contribute, withdrawals are fully taxable for federal income tax purposes.

Roth Contributions are after-tax contributions that grow tax-free. However, when a qualified withdrawal is made, neither the contributions nor growth is taxed.

After-Tax Contributions are similar to Roth contributions because taxable income is not reduced by the contributions made. The difference is when distributions occur, tax is due on the portion of earnings but not the contributions.

Employer Matching Contributions are made by your employer based on the amount of your contribution. The amount is usually capped and based on a formula, which is specific to the plan. The key here is the employee is required to contribute to receive the employers matching contribution.

Non-Elective Safe Harbor Contributions are mandatory contributions made by the employer to every participant's retirement account. The contribution must be at least 3% but could be more for specific plans, and it is contributed regardless of whether the employee contributes.

Investment Options

Contributions are most commonly invested in a variety of mutual funds. An increasingly common addition to 401(k) plans is target date funds. Target date funds are a model investment portfolio designed for a pre-determined time horizon, namely a retirement date. The fund continuously adjusts risk as the retirement date approaches. These funds usually entail a higher fee to compensate for the management. It is important to remember that just because the retirement date aligns with your retirement goal, the risk and investment allocation may not be appropriate for every individual. Individual mutual funds offer better flexibility because you can create a portfolio tailored to your specific goals and risk tolerance. However, you are required to manage and make your own changes to your investment allocation, which requires research and investment knowledge.

Suggested Contribution Levels

There is no rule of thumb for how much you should contribute to your 401(k). What is right for your colleagues may not be right for you. Income, living expenses, retirement age, and retirement goals are all factors that impact your desired contribution amount, all of which vary by individual. If you are financially able to, make sure you contribute at least enough to receive the employer match. Often, employers will match employee contributions up to a certain dollar amount and by not contributing that minimum dollar amount, you are missing out on "free" money.

Now that you have a better understanding of your 401(k) and how it works, it is time to get serious about saving. Remember, your financial situation is independent to you and should be tailored to your goals, not the goals of your peers. Be sure to consult with a CERTIFIED FINANCIAL PLANNER™ practitioner to determine the contribution amount, contribution type, and investment allocation that is appropriate for you.