Back to Basics: Your 401k

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Most of us fill out 401k paperwork when we begin a new job and don't give it much thought thereafter, other than to keep an occasional eye on the balance. Much has happened with 401k plans in the past several years. Employees have more tools and information that can make retirement savings more effective. Let's begin with the basics.

Signing up and Contributing. Enrolling in a 401k plan used to be an affirmative act. At many businesses, it still is. More and more, it happens automatically—you are enrolled, contributing from three to five percent of your salary, unless you affirmatively choose something else.

You can contribute as much as $18,000 to your 401k; $24,000 if you are at least 50 years old. Those numbers adjust with inflation, in increments of $500. Expect increased contribution levels next year. These contributions are excluded from your gross income, reducing your tax bill. For example, if you are in the 28 percent bracket for federal taxes, each dollar you contribute costs you only 72 cents (even less if your state also has an income tax).

Most financial planners recommend that between you and your employer (see below), you contribute fifteen percent of your salary annually—far more than happens on an auto-enroll plan. If that's currently beyond your budget, begin with what you can afford and commit to increasing your contribution every time you receive a raise, until you get to fifteen percent. Recall that every dollar you contribute is always 100 percent vested—you own it.

Your employer may offer you flexibility—you may be able to contribute a set dollar amount rather than a percentage of salary. You may be able to make some or all of your contribution out of a bonus payment. Ask.

Your employer's contribution can vary. At smaller, closely-held businesses, the employer often must contribute at least three percent of salary on behalf of employees earning less than $120,000 annually—otherwise, the owners cannot receive contributions that year. That three percent is always fully vested. Larger employers typically match contributions, for example contributing half of what you do, up to six percent of your salary (sometimes more). Not contributing enough to get the full employer match is like leaving salary on the table. Just be aware that matching employer contributions vest over time—you may have to remain in your job at least six years to get the full benefit. Some employers have chosen not to match 401k contributions at all. Even if that is the case at your workplace, you should still contribute as much as you can.

Many plans also offer the ability to make Roth contributions. This is particularly useful if you earn too much to contribute to a Roth IRA—there are no income limits here. As is the case with a Roth IRA, you cannot deduct a Roth contribution to a 401k plan. You don't need to. Roth accounts are great; all earnings are off the tax grid forever. It probably doesn't make sense to pile into a Roth in your high-earning, high-tax years. Still, you should get the Roth going—a Roth has to be around for at least five years to get all the benefits. Thus, designate some small amount to go into the Roth 401k to begin the five-year clock running. You can make large contributions or convert an existing traditional IRA later on, in a low-tax year.

Investing. Your 401k should be integrated with your overall investment portfolio, with fixed income concentrated in retirement accounts (a Roth 401k is more likely to hold equities). That's because all taxes on a 401k plan are deferred until you take distributions. Holding fixed income allows you to avoid paying the most taxes currently. Most plans push participants into retirement date funds; those funds invest as though they are the only investment you own. Don't settle for them. Instead, choose high-quality, low cost index funds in percentages that fit in with your global asset allocation.

Quarterly or so, you should rebalance your assets, including your 401k. Many websites now have a rebalance function, simplifying the process.

Withdrawing. Don't forget your 401k when you change jobs or retire. Rolling the account out into your IRA gives you the most flexibility and investment options. Plan administrators really don't want to be in the business of tracking down former employees to ensure they take their required distributions. Further, should you die before you turn 70, the 401k plan may offer your beneficiaries fewer—and less tax-friendly—distribution choices than would an IRA.

Should you leave your 401k in place, then you must begin taking distributions the year you turn 70-1/2. At that point, the plan pays out as an annuity. If you are married, the default is a joint and 50 percent survivor annuity—if you die first, your spouse gets half your payout. This is often not the ideal choice.

Your retirement plan is not an ATM. Still, many 401k plans also provide for loans or hardship withdrawals. No plan is required to do so. Taking money out of your retirement account prematurely is truly cheating yourself. Sometimes, it's the best bad choice.

The plan can determine loan rules. Typically, the interest rate is a percent or two above banks' prime rate, with fixed payments deducted from your paycheck for five years (longer if the loan is to buy a house). There is no way to prepay, other than in full. That low interest rate may help your immediate cash flow, but it means you are effectively earning that low rate on your retirement savings. Further, the interest is not deductible, even if you use the loan to buy a house. If you leave your job while the loan is outstanding, you must pay it back in full or have the balance treated as a premature distribution (fully taxable plus a ten percent penalty).

Hardship withdrawals are subject to very strict rules—they can only be for true financial emergencies (such as unreimbursed medical costs or to prevent you from losing your home) for which you have no other way to pay. Distributions are fully taxable and often subject to a ten percent penalty for early distributions. If you take one of these withdrawals, you are prevented from making 401k contributions for six months.

The bottom line? Despite the tweaks in recent years, the decades-long advice remains the same. Contribute as much as you can to your 401k. Invest it as part of your overall portfolio. Keep your hands off the account until you retire, but roll it into an IRA when you leave your job.