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401(k)s Explained: Everything You Need to Know

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Tags: Investing | Retirement | Tax Benefits | Employer-Sponsored Plan

Introduction to the 401(k)

A 401(k) plan, sometimes referred to as a "Traditional" 401(k), is an employer-sponsored, defined-contribution investment account, often backed by larger private businesses, that helps employees save and prepare for retirement. The 401(k) plan as we know it today was formed by the Revenue Act of 1978, and has since helped millions of people achieve their long-term financial objectives. This retirement account type is a popular method of long-term planning, mainly due to the significant tax benefits it offers.

Why Should I Invest in a 401(k)?

If managed properly, a 401(k) could help you attain your financial goals in the long-run. A 401(k) account has distinct tax advantages over a standard brokerage account, specifically as it relates to the deferral of capital gains (i.e., tax-deferred growth) and tax deductibility of contributions. Further, employers who have set up a 401(k) plan on behalf of employees may choose to contribute directly to the employees' 401(k) plans themselves, by either a contribution "match" or a flat contribution amount.

Tax-Deferred Growth

There are two major tax-related benefits associated with investing in a 401(k), the first of which is **tax-deferred growth**.

When you invest in a standard brokerage account, you pay tax on all investment gains in the year you realize those gains. This means that if you buy $1,000 worth of stock today and sell that same stock for $1,500 in the future, you will incur a tax liability on that $500 gain in the year you sell. Then, if you choose to reinvest the balance, you won't have the full $1,500 to invest with (you will have less) since some of your gain goes to paying capital gains tax.

If you invest in a 401(k), however, you won't incur any tax liability until you take withdrawals in retirement! In other words, you keep 100% of your investment gains until you begin taking withdrawals on the account, at which point the withdrawals are taxed as ordinary income. The impact of this **tax-deferred growth** is massive in the long-term. For example, $10,000 invested in a tax-deferred account (such as a 401(k)) over 40 years could be worth $30,000 more than that same amount invested in a standard brokerage account.[1]

Tax Deductibility of Contributions

The second major tax benefit of investing in a 401(k) relates to the **deductibility** of contributions from your annual taxes. While certain rules apply (more on this below), many individuals can reduce their taxable income on a dollar-for-dollar basis by contributing to a 401(k). If an

individual making a $100,000 salary is fortunate enough to be able to contribute the full $23,000 to a 401(k), taxable income for the year could be reduced to $77,000, saving thousands of dollars in taxes.[2]

Employer Contributions

Since a 401(k) is an employer-sponsored retirement plan, 401(k) account owners may have the benefit of receiving contributions to their account by their employer. Although employer contributions to 401(k) plans are not required, many employers offer this as an incentive to work and stay with the company. These contributions experience the same tax-deferred growth as employee contributions, and are taxed upon withdrawal.

The most common method of employer contributions is the 401(k) "match", which stipulates a variable employer contribution based on how much the employee contributes to their own 401(k). Employers may choose to match an employee's contributions one-for-one (a 100% match), or may match at a different rate (such as $1 for every $2 the employee contributes). Other times, an employer will contribute a flat dollar amount or a percentage of total employee compensation each year, regardless of whether the employee contributes to the account.

Employer contributions are usually capped at a certain amount or percentage of total employee compensation (3-6% of total comp is standard). Additionally, employer contributions to 401(k) accounts are often subject to a vesting schedule that requires the employee to remain at the company for a certain period of time before fully earning the employer's contribution. You can request information about your employer's 401(k) contributions by contacting the HR department.

Who Can Own and Contribute to a 401(k)?

Only employees of private employers that offer 401(k) plans can contribute to a 401(k) plan. Employees of companies without 401(k) plans cannot create and contribute to their own 401(k)s (although other retirement account options, such as IRAs, do exist).

In order to be eligible, the employee must also meet all of the requirements of the employer, which can include minimum age, tenure, and number of hours worked throughout the year (applicable mainly to part-time employees). Employer requirements must be applied uniformly across all employees.

There are no age limits for contributing to a 401(k)—people of all ages can contribute—and no income restrictions either.

How Much Money Can I Contribute to a 401(k)?

In 2024, the maximum contribution an employee can make to a 401(k) plan is $23,000. When combined with employer contributions, the maximum contribution to any one 401(k) account in a given year is $69,000 (the split between employee and employer contributions does not matter).

Those who are at least 50 years old are eligible for an additional "catch-up" contribution of up to $7,500, increasing their contribution limit to $30,500 for employees and $76,500 when combined

with employers. These employee limit, employee plus employer limit, and catch-up contribution amount are occasionally revised in order to adjust for cost of living and inflation.

Additionally, 401(k) contributions are restricted to the income earned with a given employer, only. Income generated outside the compensation of your employer (such as investments or a second job) cannot be contributed to a 401(k).

Can I Deduct My Contribution to a 401(k)?

As mentioned earlier, one of the benefits of a 401(k) is that you can reduce your taxable income on a dollar-for-dollar basis with your contributions today. The deadline for claiming the deduction on your tax return is generally December 31 of each year. In other words, to reduce taxes for your 2024 filing, you must contribute to a 401(k) during 2024.

The tax deductibility of 401(k) contributions is not dependent on factors such as income level and tax filing status (single, married filing jointly, etc.). All contributions are tax deductible assuming you have income to offset.

What are the Withdrawal Rules of a 401(k)?

401(k) plans are subject to specific withdrawal rules that, when not followed, could result in a substantial penalty. Starting at age 59½, you may take distributions from your 401(k) at any time and in any amount without incurring a penalty. These distributions are included in your taxable income for the year in which you take them.

Those who withdraw funds before age 59½ are subject to penalty in an amount of 10% of the distribution, unless the distribution qualifies for an exception. The most common exceptions include distributions related to birth or adoption expenses (up to $5,000 per child), emergency personal expenses (up to $1,000 per year), federally declared disasters (up to $22,000), certain unreimbursed medical expenses, death or disability of the 401(k) account owner and separation from service for those aged 55 and older.

Separately, 401(k) account owners must abide by **required minimum distribution (RMD)** rules. Starting at age 73, account owners are required to withdraw a certain amount from their account each year to avoid a penalty (up to 25% of the value) on the missed RMD. The amount of the RMD is calculated based on life expectancy and account balance.

What Types of Assets Can I Invest in with a 401(k)?

A 401(k) allows its account owner to invest in a fairly broad spectrum of assets. Stocks, exchange-traded funds (ETFs), mutual funds, bonds, money market funds, and certificates of deposit (CDs) are all permitted assets in an 401(k). Examples of investments that are prohibited in a 401(k) include life insurance, artwork and collectibles, S corporation stock, and real estate for personal use, among others.

However, the actual investment options any 401(k) plan offers is dependent on the choices of the 401(k) plan administrator. It is not uncommon for 401(k) plans to have a limited set of preselected stock and bond funds that participants can invest in. The limited investment options of a 401(k)

is one reason employees who move on from an employer often consider a 401(k) rollover into an IRA.

It is important to establish an allocation of assets in your 401(k) that best matches your financial objectives and risk tolerance. A dynamic portfolio that evolves over time can help you meet your financial needs, wants, and wishes.

Are There Other Types of 401(k)s?

Yes, there are other forms of 401(k)s that may have specific use cases. These include:

- Roth 401(k) – A post-tax 401(k) that allows tax-free growth and withdrawals.
- Solo 401(k) – A 401(k) for self-employed individuals that allows for higher contribution limits.
- Roth Solo 401(k) – A 401(k) that combines the benefits of both a Roth 401(k) and Solo 401(k).
- Safe Harbor 401(k) – A 401(k) that avoids the regulation requirements and expenses of Traditional 401(k)s and specifies that all employer contributions are immediately vested.
- Savings Incentive Match Plan for Employees (SIMPLE) 401(k) – A 401(k) plan with special perks for self-employed individuals or small business owners.

How Can I Start Investing in a 401(k)?

If your employer offers a 401(k) plan, it is often a great idea to participate in that plan, especially if the employer conducts some form of contribution matching. If you would like assistance in choosing which investments to select for your 401(k), reach out to us at **FreeMind Financial Advisory** and we would be happy to provide a **free strategy session** personalized for you. We can help you maximize your benefits by choosing the best contribution rate, and selection, for you.

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Footnotes

[1] Assumptions include (a) 8.0% annual return on portfolio, (b) 25% annual rebalancing of the total portfolio, and (c) 20% long-term capital gains tax rate.

[2] Although 401(k) contributions may be deductible in the year of contribution, those contributions will be taxable as income when withdrawn in the future. Lifetime tax savings are subject to numerous factors, primarily (a) current and future tax rates and (b) current and future income.