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401k Retirement Plan

Begin Providing for Your Future

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Anyone familiar with the time value of money[1] knows that even small amounts, when compounded over long periods, can result in thousands, or even millions, of dollars in additional wealth[2]. This simple truth is one of the reasons many financial planners recommend tax-advantaged accounts and investments such as traditional[3] / Roth IRA's[4] and municipal bonds[5]. In the past, these decisions were not as crucial because of the prevalence of defined-benefit pension plans. Today, those old-world pensions are going by the wayside at many U.S. firms; instead, most of today's workforce is likely to find their retirement years funded by the proceeds of their 401k retirement plan[6].

What is a 401k retirement plan?

A 401k retirement plan is a special type of account funded through pre-tax payroll deductions. The funds in the account can be invested in a number of different stocks[7], bonds[8], mutual funds[9] or other assets, and are not taxed on any capital gains[10], dividends[11], or interest until they are withdrawn. The retirement savings vehicle was created by Congress in 1981 and gets its name from the section of the Internal Revenue Code that describes it; you guess it - section 401k.

What are the benefits of a 401k retirement plan?

There are five key benefits that make investing through a 401k retirement plan particularly attractive. They are:

- Tax advantage
- Employer match programs
- Investment customization and flexibility
- Portability
- Loan and hardship withdrawals

Tax advantage of 401k retirement plans

As touched on in the introduction, the primary benefit of a 401k retirement plan is the favorable tax treatment it receives from Uncle Sam. Dividend, interest, and capital gains are not taxed until they are disbursed; in the mean time, they can compound tax-deferred inside the account. In the case of a young worker with three or four decades ahead of them, this can mean can mean the difference between living at the Plaza Hotel or the Budget 8.

Employer match for 401k retirement plans

Many employers, in an effort to attract and retain talent, offer to match a certain percentage of the employee's contribution. According to Starbucks' "Total Pay Package" brochure, for example, the company will match a percentage of the first 4% of pay the employee contributes to their 401(k) retirement plan. Employees at the company for less than 36 months receive a 25% match; 36 to 60 months receive a 50% match; 60 to 120 months receive a 75% match; 120 or more months receive a 150% match.

In other words, an employee working at the coffee giant for over ten years earning $100,000 that contributed $4,000 to their 401(k) would receive a $6,000 deposit in the account directly from the company (150% match on $4,000 contribution.) Anything the employee deposited above the 4% threshold would not receive a match.

Even if you have high-interest credit card debt, it is preferable, in almost all cases, to contribute the maximum amount your company will match! The reason is simple math: If you are paying 20% on a credit card[12] and your company is matching you dollar-for-dollar (a 100% return), you are going to end up poorer by paying off the debt[13]. Factor in the tax-deferred gains generated by the 401(k) plan, and the disparity becomes even larger. For more information on this topic, I suggest you read the work of Suze Orman[14].

Although the topic will be discussed in further detail later in this article, be aware that employer matching contributions up to six-percent of an employee's pre-tax salary are not included in the annual limit. For example, if you qualified, you could make a 401k contribution of $16,500 in 2009 and have your employer still match the first six-percent of your salary; that match would be deposited above and beyond the $16,500 you contributed directly.

Investment customization and flexibility

401k retirement plans give employees a range of choices as to how their assets are invested. An individual that knows he or she does not have a high tolerance for risk could opt for a higher asset allocation[15] in low-risk investments such as short-term bonds; likewise, a young professional interested in building long-term wealth could place a heavier emphasis on equities. Many businesses allow employees to acquire company stock for their 401k retirement plan at a discount although many financial advisors recommend against holding a substantial portion of your 401k in the shares of your employer in light of the Enron and Worldcom scandals[16]. You can get more information by reading Investing in Your Employer's Stock - Good Idea or Disaster Waiting to Happen?[17].

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