



Stockton Peer Financial Education Program 401(k) Plans



You're in college. Retirement may seem like something you don't need to worry about right now but the earlier you start planning for your retirement, the better off you will be in the long run.

It is important to talk with prospective employers about the type of retirement plan they offer. Employers may offer one of two basic types of retirement plans.

- **A defined contribution pension plan:** a retirement plan, like a traditional 401(k) where the employee and/or employer make contributions to the employee's account. The employer's contribution, if any, can be based on factors such as the employee's wages and the employee's own contribution to the account. The employee's retirement benefit will be based on the amount contributed and investment earnings over time.
- **A defined benefit plan:** a retirement plan where an employer promises a specified monthly benefit to the employee at retirement. The benefit is based the employee's earnings, age at retirement, number of years of service, and other factors.

Today, more employers offer defined contribution pension plans.

A Traditional 401(k) plan, what is it?

A traditional 401(k) plan is a private sector employer-sponsored savings plan that allows employees to contribute a portion of their earnings to a retirement account and to defer income taxes on that savings until money is withdrawn. You can begin to withdraw from your traditional 401(k) at age 59 and ½. These withdrawals are subject to income taxes. If you withdraw the funds earlier, except under certain defined hardships, there is a 10% additional tax (penalty) applied. The maximum amount you can contribute to a 401(k) in 2013, for those under 50, is the lesser of your earnings or \$17,500.

Some benefits of using Traditional 401(k) plans

- ✓ Tax advantages
The money you put into the traditional 401(k) and the amount it earns isn't taxed until you take it out. The money you put into your traditional 401(k) is deducted from your pay before income taxes are taken out.
- ✓ Employer match programs
Some employers will match the amount you put into your traditional 401(k).
For example – Your employer matches your contribution up to 3% of your salary. If your salary is \$40,000 per year and you put 3% of your earnings in your 401(k) account, your employer will contribute \$1,200. If you don't participate in the plan, you lose the match.
- ✓ Investment customization and flexibility
You can choose high risk or low risk investments. Also you can choose between short and long term investments. You will be limited to the investment choices that your employer's plan offers.
- ✓ Portability
If you change jobs you don't lose what you have invested, you can take it with you.
- ✓ Loan and hardship withdraws
Certain amounts can be withdrawn for major occurrences, such as your first home purchase or a medical emergency, e.g. an unexpected illness, injury or accident.

Risks of Traditional 401(k) plans

- ☒ Account holders do not have full control
 - Your employer can make changes within the parameters of the law.
- ☒ The type of investments available will depend on what your employer offers in their specific plan.
 - The company may not offer every type of investment you want.
- ☒ Some employers don't match what you put into the account.
 - You should ask your employer if, and how much, they will contribute to the traditional 401(k).
- ☒ Your money is not insured unless you invest in insured products like bank CDs.
 - You could end up losing money.

Start saving early, an example:

If you start your traditional 401(k) saving with your job at the age of 24 and contribute 3% of your \$40,000 salary each year, your employer matches that, and you earn 5% on your 401(k) investments, by the time you are 60 and retired, you have saved approximately **\$230,007**. The websites below have calculators that can be used to calculate this.

Roth 401(k), another type of 401(k) plan

Another type of 401(k) plan that may be offered by some employers, the Roth 401(k) plan allows employees to contribute on an after-tax basis. This means that employee contributions are made with funds that have been taxed in the year it is saved, so this plan does not enjoy the same tax-deferral benefit of the Traditional 401(k). However, the appreciations to the Roth account and the distributions taken from the Roth 401(k) after the age of 59 and ½ are not subject to income tax.

Some Helpful Websites

- www.401K.org
- www.irs.gov/retirement
- www.Bloomberg.com
- www.MyCalculators.com
- www.aarp.org

References:

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For further information about Peer Financial Education, contact:
Dr. Deborah M. Figart, Professor of Education and Economics
Director, Stockton Center for Economic & Financial Literacy
Deb.Figart@stockton.edu