401(k) Basics

A 401(k) plan is an employer-sponsored retirement account in which employees may contribute a percentage of their paychecks, with the goal of providing income during their retirement. There are two types of 401(k) plans, a Traditional 401(k) and a Roth 401(k).

With a Traditional 401(k), employee contributions are deducted from your gross income before taxes. Because of this, your overall annual taxable income is reduced by the total contributions you have made for that tax year. Taxes are not due on the 401(k) contributions and earnings until you withdraw the money, usually at retirement.

With a Roth 401(k), employee contributions are deducted from your gross income after taxes. However, when you withdraw the money during retirement, you won't have to pay any additional taxes on your 401(k) contributions and earnings.

With either option, a 401(k) is an important part of the retirement planning strategy for many. The key features include:

Employee Contributions. Employees may choose to contribute a percentage of their salary into their 401(k) account, up to an annual limit set by the IRS.

Employer Contributions. Many employers offer matching contributions to employee 401(k) accounts, effectively providing "free money" towards retirement savings. Employer matches can be a significant boost to your 401(k) balance. Check with your plan administrator for details.

Automatic Saving. 401(k) contributions are automatically deducted from each paycheck, making it easier to save consistently without having to manually transfer funds.

Availability of Loans. Many 401(k) plans allow participants to take out loans against their account balance if needed, providing access to the funds in an emergency. Check with your plan administrator for specific details and eligibility to borrow from your 401(k).

It’s Portable. The money you’ve contributed to your 401(k) and its earnings belong to you, even if you change jobs. Depending on your plan type, there are different ways to keep it invested and growing. If you still have a 401(k) with an old employer, you may be able to leave it in their plan or move it somewhere else - In most cases by rolling it into an IRA or transferring it into your new employer’s 401(k) plan. Note that funds withdrawn from a 401(k) must be rolled over or transferred into another retirement account within 60 days to avoid taxes and penalties. Check with your plan administrator for details.

Early Withdrawal Penalties. Note that there are tax consequences if withdrawals are made from either type of 401(k) before you reach the age of 59½. Check with an accountant or qualified financial advisor before withdrawing money from your 401(k).

A 401(k) plan is a powerful tool for building retirement wealth over the long term. The earlier you start contributing, the more time your savings will have to grow. Remember that each employer-sponsored 401(k) plan is different, so talk to your plan administrator for all the details.