401(k) Plans And Your Retirement

Any sensible retirement planning strategy starts with a target number. This number is how much you need to have saved for living comfortably and independently throughout your retirement. A good rule of thumb is to take your current living expenses and multiply that by 400. That's how much you'd need to have to sustain yourself on a 4% return.

That looks like a wildly intimidating number. You might be thinking to yourself that there's no way you could possibly save that much out of your paycheck. The good news is it doesn't all have to come from one place.

You've probably already seen information on Individual Retirement Accounts (IRAs) that you can set up at MembersAlliance Credit Union. That's money you have to save and invest yourself. A great way to expand your retirement options is with a 401(k) that is set up by your employer. Since the beginning of the year is a great time to make changes to your payroll information, let's take a look at a few common questions about 401(k) programs and what you can do if your employer doesn't offer one.

1.) What's a 401(k)?

A 401(k) program is a retirement account named for the section of the tax code governing it (section 401(k)). It is an alternative to traditional pension plans that puts the responsibility of saving for retirement on the shoulders of the employee. Instead of the company holding a pension fund and paying retired employees each month, employees make contributions to a tax-deferred account they can invest in stocks, mutual funds and other instruments. Once they retire, they can start taking money out of the account to pay for living expenses.

The account is "tax-deferred" – meaning contributions get subtracted from your taxable income. Withdrawals are taxed as ordinary income. For people in their peak earning years, this usually results in a considerable tax savings. There are, as usual, limits on how much can be contributed annually. For 2015, the maximum contribution is $18,000. If you're 50 or older, you can make a "catch-up" contribution of an additional $6,000.

Many employers also include special incentives for contributing. They may provide "matching" funds, where the company will match an employee's contribution dollar-for-dollar, up to a percentage of the employee's income. For instance, if you make $50,000 per year and your employer offers 3% matching funds, they will contribute up to $1,500.

401(k) programs are a really popular destination for retirement accounts. In 2015, the average 401(k) account was valued at just over $90,000, up 30% from 2011. Part of that growth is the

gains made by the stock market (which grows 10% on average per year), but a larger part is the larger number of people getting involved.

2.) What do I need to do to get involved?

You'll need to speak to someone in HR or payroll at your work to find out what options exist with your current employer. You'll need to fill out a form for elective contributions, or the amount you want to have come out of your paycheck. This might mean adjusting your budget to accommodate a slightly lower take-home pay. Remember, though, this isn't a dollar-for-dollar reduction since the elective contributions you're making are pre-tax.

As far as how much you should contribute, you should at least maximize your employer's contribution. If they match 3% of your income, contributing less than that is leaving "free" money on the table.

You'll need to pick an investment vehicle to use for your 401(k) account. It makes sense to choose one with relatively low risk, since this will represent a significant chunk of your retirement savings. Also, pay attention to the fees charged by the account. The difference between a .5% fee and a .05% fee could be tens of thousands of dollars over the course of your account.

If you've held 401(k) plans at previous jobs, it might make sense to roll over those accounts to your new employer program. This is a simple process that your HR representative can walk you through. Doing so will help you to manage your retirement accounts all in one place while avoiding extra administrative fees.

If you need access to that money to buy a house or pay for college, you can make early withdrawals. Otherwise, resist the urge to cash out those accounts. You'll pay a steep penalty – 10% of what you withdraw plus taxes on the withdrawal as if it were newly earned income.

3.) What can I do if my employer doesn't offer a 401(k) plan?

Investigate Simplified Employee Pension (SEP) IRA plans. These are programs designed for employees of small businesses and the self-employed. They work like 401(k) programs, except all contributions are made by the account-holder. The annual limits are much higher than an IRA account, as much as $18,000 in 2015, with similar catch-up contributions possible for workers over age 50.

For larger contributions, consider an individual 401(k) program, sometimes called a solo k or a uni-k. These programs require considerably more paperwork. They may also include start-up charges (a few hundred dollars) and annual fees (between $20 and $150, depending upon the provider). The limits are much higher: 25% of income for workers and another 25% for small business owners and sole proprietors.

These options won't have the matching funds of a traditional 401(k) program. However, they provide the same tax benefits as those other programs. They can be a workable alternative for retirement savings for people who don't have another option.

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