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Guide to Workplace Retirement Plans

What to know before you sign up for your 401(k)

Workplace retirement plans are the backbone of retirement savings for most Americans and should be taken advantage of whenever possible. For many years, it was commonplace to participate in a defined benefit plan, or as many of you know it, a pension plan, but today many of those plans are not available and most employers offer defined contribution plans such as 401(k)s and 403(b)s instead.

Much of the workforce in the U.S. will derive their retirement income from these workplace retirement plans. Planning for retirement is truly a lifelong process that often begins when you start working. Here's what to know to begin on a solid retirement savings path.

DEFINED BENEFIT PLANS VS. DEFINED CONTRIBUTION PLANS

There are important differences between defined benefit plans – which start off with a defined benefit plan or the promise of a specified benefit at retirement – and the more common defined contribution plans.

A defined benefit plan may state a promised benefit as an exact dollar amount, such as $100 per month at retirement, or it may calculate a benefit through a formula that considers factors such as years of service and/or compensation. The common example of a defined benefit plan is a pension plan where it is required that one sets aside money, along with the employer, into a fund for growth and withdrawal at a certain future date. The benefits in most traditional defined benefit plans are protected, within certain limitations, by federal insurance.

The more common workplace retirement plans are defined contribution plans, which are funded by the employee and oftentimes a combination of both the employee and the employer, in the form of an employer-match.

The most well-known contribution plans are:

- 401(k)s offered by private-sector employers
- 403(b) plans that are offered by charitable or educational organizations such as schools and hospitals
- 457 plans for employees of state and municipal governments.

FREQUENTLY ASKED QUESTIONS ABOUT DEFINED CONTRIBUTION PLANS

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How do I fund my 401(k)?

To fund a defined contribution plan, the contribution amount you select comes out of your paycheck without any taxes assessed. In some companies, employers will match a portion of your contributions.

By making this pre-tax contribution, your taxable income is reduced, up to a certain amount, by the sum of your contributions. Any gains that take place within the account then grow tax deferred. During retirement, you pay taxes on the funds withdrawn from these accounts.

There are annual limits to how much you can contribute to these plans and financial penalties if account holders take money out of the plan before set retirement ages.

? How much should I contribute?

We advise clients that even if you cannot afford to contribute the maximum amount each year, make sure you at least contribute enough to get the full amount of your employer's match.

? Are there other plans my employer may offer?

Many employers will offer a Roth 401(k) option as well. These are funded by the employee with after-tax dollars and the distributions, or withdrawals from these plans during retirement, are tax-free. Any employer matches that are contributed to your Roth 401(k) will be made pre-tax, therefore, you will have to pay income taxes on the match and any growth from those funds when you withdraw funds in retirement.[1]

These accounts often depend on various factors such as age, tax bracket, etc. so you should consult your advisor or accountant before making any decisions.

If your employer offers both, you can elect to contribute to both a Roth 401(k) and a traditional 401(k). The annual contribution limit, which is set by the federal government, would apply across both accounts.

? How is the money invested?

Defined contribution plans offer a variety of investment options, although they tend not to have a significant number of choices. It is up to the employee to select among these options and/or make any changes they see fit.

Two distinct options for managing investments within a retirement plan are target date funds and DIY (do it yourself) investing.

- Target date funds adjust their asset allocation automatically over time based on the investor's expected retirement date. The funds typically begin with more aggressive stocks and over time gradually leans toward more conservative investments like bonds and cash. These are attractive for investors who want to set the strategy once.
- DIY investing involves choosing and managing individual investments within a retirement plan account and requires choosing specific stocks or bonds or mutual funds based on your own research and decisions. This type of investing offers the most customization, but also requires more time, effort, and knowledge to manage the account effectively.

? What if I change jobs?

These plans can be moved if you change jobs or retire. You can roll them into your next employer's plan, or you can roll them into another type of retirement savings tool, such as an Individual Retirement Account. Due to the limited investment options within these plans, and at times, heavy fees, we often recommend that clients roll them into an IRA with more flexibility.

Can I join the plan on my first day?

One caveat around these plans is you often need to be employed for a certain amount of time before you can access them, say six months or a year. In addition, a vesting schedule is usually in place for company matching contributions, meaning you may have to remain employed with the company for a certain time period before you would be able to leave and keep 100% of the funds the employer contributed in the account. For example, the vesting schedule could be 25% of employer contributions a year for four years. Once you're fully vested, the employer's contributions are fully yours.

How do I sign up?

Here are some important directions to follow when signing up for your defined contribution plan.

1. Your company will likely provide a guide on how to enroll, adjust your elections and choose the investments.
2. Always make sure that you add your beneficiaries. If you are married, you will need your spouse to sign a waiver if that spouse is not identified as your beneficiary.
3. Contribution limits for employees who participate in 401(k), 403(b) and most 457 plans, as well as the federal government's Thrift Savings Plan, is $23,000 for 2024, with an additional $7,500 catch-up contribution for those aged 50 and up.

Finally, many sponsors of retirement plans also have tools and calculators available on their web sites to help with certain tasks like managing cash flow, planning for retirement and assisting with other financial evaluations.

If you have any further questions about these plans or something similar, please feel free to reach out.

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[1] Grady Williams, "The Little-known Tax on Roth 401(k) distributions."