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Make the Most of Your Employer Retirement Accounts

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Your eyes may glaze over at retirement-plan numbers — 401(k), 403(b), 457 — but you want to be sure you understand yours. For most people, an employer-sponsored plan is crucial to accumulating enough for retirement.

The information here, which emphasizes the general rules rather than the exceptions, is intended to give you a basic understanding of employer retirement plans and some ways to make the most of them. Your employer can provide information on the specific provisions of your plan. Check with your financial planner and/or tax advisor on the state of current laws before making significant changes, withdrawals, and so on.

REMEMBER

You have investment risk in your retirement plan. Manage this risk by working these accounts into your overall asset allocation and paying attention to the costs and performance of your investments in the plan.

Know Your Plans

401(k), 403(b), and 457 plans are governed by three sets of rules: Internal Revenue Service Code sections, other federal laws such as ERISA (Employee Retirement Income Security Act), and an employer's optional elections. Check with your tax advisor and human resources department to be sure you understand the features of your plan.

401(k) and 403(b)

401(k) plans are established by private-sector, for-profit employers. The employer decides whether its plan allows loans, hardship distributions, and Roth 401(k) contributions. 403(b) plans are similar to 401(k) plans but are found in public educational organizations, nonprofit organizations, and some religious organizations.

457

457 plans are most commonly government or private-sector deferred-compensation plans:

- **Government:** A state or local government offers the government 457 plan. These plans received a makeover from the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Pension Protection Act, and now they work much like 401(k)s.

  The 457 plan lets government employees put away more pre-tax money to supplement their pensions and other retirement savings. It isn't subject to creditor claims of the employer, and funds must be set aside in a separate annuity or trust. The government plan may allow you to use money from your 457 account to purchase service credits to increase pension benefits. Contribution limits equal the employee deferral-contribution limits of 401(k)s ($15,500 as of this writing).
- **Private-sector:** The private-sector 457 plan serves as an additional way to defer compensation and taxes after you maximize contributions to a 401(k). To get the additional tax benefits, you have a substantial risk of forfeiture, which means you have a real risk of loss. These funds are subject to the creditor claims of the employer. If you have one of these plans, you can save more on a tax-deferred basis, even after you've deferred your maximum amount in a 401(k). You don't have a 10-percent penalty for withdrawals before age 59½. The funds are taxed as ordinary income when you receive them.

TIP

Use the government 457 plan to supplement your pension; use the private-sector 457 plan when you want to defer more than your 401(k) allows. Understand that with a private-sector 457, your money isn't as secure because it's subject to creditors' claims against your employer.

Get Money into Your Accounts

So how do you invest money in your retirement plan? You have a few options:

- You contribute the funds through salary deferrals.
- Your employer contributes the funds.
- You have investment earnings in a retirement account.
- You roll another retirement account into the plan.

Employee contributions

You usually make your employee contributions before tax. Federal, state, and local income taxes apply when the contributions are distributed to you. Social Security taxes on your contributions aren't deferred. If you make post-tax contributions, you're usually taxed only on the earnings in the account upon distribution.

Your employer may allow Roth 401(k) or 403(b) contributions. (At the time of this writing, a bill allowing government 457 Roth contributions is pending.) You make Roth contributions after tax, and the earnings on Roth contributions should be tax-free. If Roth contributions are allowed, you can make your employee contributions Roth contributions, pre-tax contributions, or some of each.

TIP

In deciding whether to make Roth contributions, consider your tax rate now and in retirement. If your marginal rate in retirement will be significantly lower, pre-tax contributions may be preferable. If you think overall rates are likely to increase significantly, consider Roth contributions.

Employer contributions

Many 401(k) plans have an employer match based on a formula or percentage. For example, perhaps an employer matches $0.50 for each $1 the employee contributes, up to a maximum of 6 percent of the employee's salary. This is free money, and you should take advantage of it. 403(b) plans may or may not have matching contributions. Employers can match contributions to a Roth account, but they must match the funds on a pre-tax basis. They can't make contributions into the designated Roth account. Here are a couple of tips:

- If your employer matches contributions, contribute at least as much as needed to get the entire employer match.
- Consider contributing enough to receive the match and then funding an IRA. Then continue contributions to the plan up to the maximum allowed, if you have enough income.

Investment earnings

The choices your employer made limit the investment options in your employer plan. Think of it as your menu. When choosing, consider the following:

- Don't put too large of a percentage of your assets into your employer's stock. Every individual stock you own is subject to company risk, which is compounded when the company is your employer.
- Look at your employer plan as part of your total portfolio. Choose plan investments that fit within your overall asset allocation and complement investments in your IRA and other accounts.
- Fees and other costs cut into your return. Look for investments with low fees and operating expenses.

Rollovers

Generally, employees can transfer employer plan account balances to another employer plan or to an IRA when they leave a job, without tax or penalty, regardless of age. However, if you don't transfer your balance as a trustee-to-trustee transfer, the plan customarily withholds 20 percent for taxes. Make sure your rollover is a trustee-to-trustee transfer if possible.

Prepare to Take Funds Out

When funds come out of employer plans, they're usually subject to ordinary income tax unless they're rolled over to an individual retirement account (IRA) or if an exception applies. (Also see Strategy #74 for more information.)

Usual distributions

Distributions are subject to ordinary income tax and can be subject to a 10-percent penalty tax unless they're qualifying distributions. You can take qualifying distributions only after age 59½ unless one of the following applies:

- Disability
- Death
- A qualified domestic relations order (divorce)
- A distribution covering medical expenses in excess of 7.5 percent of adjusted gross income (AGI)
- Separation from employment at age 55 or older
- Victim of a specific natural disaster (designated by the federal government)
- Other (check with the IRS)

NUA of employer stock in a 401(k)

If you have company stock in your plan and the stock is eligible, you may be able to take advantage of special tax rules. Basically, if the stock value has grown substantially, *net unrealized appreciation* (NUA) rules allow you to pay regular tax only on the original cost when the stock comes out of the plan and capital gains tax on the balance upon the sale of the stock. Any gain in value over your basis will be taxed at capital gains rates when you eventually sell the shares. Long-term capital gains rates are currently lower than the ordinary income tax rates for most people.

If you're eligible and if you and your tax advisor determine it's worth doing, you must take a lump-sum distribution of your retirement-plan within one calendar year. The account is split into a taxable account that receives the company stock, while the balance of the account (everything that's not employer stock) may be transferred into an IRA or other tax-deferred plan.

Withdrawals and loans in hard times

If you need money, you can explore these options to withdraw funds from your retirement plan:

- **Hardship withdrawals:** An employer may allow hardship distributions, but if it isn't a qualifying distribution, the 10-percent penalty applies.
- **Taking plan loans:** Although some plans allow loans, taking one is typically a bad idea. If you invest properly, you're likely to earn more in the account over the loan period than you'd pay in loan interest. Reducing your investment returns during the loan period can make a big difference later. You'll also be repaying the loan with post-tax money, which will ultimately be *taxed again* when you withdraw the money.

Bankruptcy protection is a critical reason not to take out a loan against plan assets. An employer retirement plan often protects your assets in the event of your bankruptcy, so if you take money out of the plan, you could be making an exempt asset nonexempt. Plans receive protection if they're covered under applicable federal statutes, such as being ERISA qualified, protected by the Bankruptcy Abuse Protection and Consumer Protection Act of 2005, or protected by the Federal Bankruptcy Code. Some states have applicable state statutes. Check with an attorney for applicability of statutes to your plan(s).

What if your company is in trouble and declares bankruptcy? Retirement funds in 401(k), 403(b), and government 457 plans are generally protected against your employer's creditors' claims. Consult with an advisor for the specifics on your plan and current laws. This doesn't protect against declines in the plan's investments.