What is a 401k?

Among the many retirement options is the 401(K) plan. This is a retirement plan that you can participate in if it's offerred by your employer. There are many benefits and advantages to a 401(k) plan, which we will outline here.

A 401(k) is an employer-sponsored retirement plan that allows employees to contribute a portion of their income to the plan without having to pay taxes on it. Your employer provides you with different investment options that are available to you under their 401(k) plan. From these options, you select those investments that are appropriate for your situation. Since everybody's goals are different, it's a good idea to consult a financial advisor to make sure the investments you choose will help you meet your goals. Because of the various options of a 401(k), it is considered by many to be one of the best ways to plan for retirement.

A 401(k) plan offers several advantages. The first is that contributions are taken from the paycheck before taxes are deducted. In fact, taxes needn't be paid on the money as long as no withdrawals are taken before the age of 59.5. Another advantage is that most companies will "match" a certain amount of the employee's contributions. This is essentially free money. Most plans do have some kind of "vesting" provision. This means that you have to be employed at the company for a certain amount of time before you can call the employer's contributions your own. But when vesting is complete, all the funds (and all the gains) in the plan belong to you. The two most common types of vesting schedules are graded vesting, in which a certain percentage of the money becomes yours each year, and cliff vesting, in which all the money becomes yours after a certain number of years. In 2002, these vesting schedules were reduced. The longest schedule five.

Another benefit of having a 401(k) is that many plans allow you to borrow from it. Like any other loan, though, you pay interest on the money you borrow from your 401(k). The rate is usually about a point or two higher than the Prime Rate, which is the rate that banks give to only their most creditworthy borrowers. If your plan allows you to borrow, there will be a limit, usually up to half of what's in the 401(k), but never more than $50,000. Borrowing from a 401(k) plan should only be considered as a last resort. There are several disadvantages to this. First, if you lose or change jobs before the loan is repaid, the outstanding amount would have to be repaid either before the last day on the job, or within a specified period, generally 90 days. If it is not repaid, the amount owed becomes taxable and the IRS will add an additional 10% penalty for early withdrawal of the money if you're under the age of 59.5. Another disadvantage is that you are replacing pretax money with after-tax money. For example, if you are in the 27% tax bracket, it will take $1.40 in salary to replace the $1 you withdrew from your account. Also, instead of letting the money grow on its own by earning interest on your investments, you're paying the interest out of your own pocket when you pay back the loan.

If your plan does not permit loans, the law provides for financial hardship withdrawals. The law generally permits withdrawals if you are unable to borrow from any other source and you need money for:

- A down payment on a primary residence.

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- Preventing foreclosure on, or eviction of your home.

If you leave your employer, voluntarily or otherwise, and have an account balance that is more than $5,000, you can leave your money in the plan if you choose. You can also transfer your vested balance to a new employer's qualified plan or to a rollover IRA. You usually have 60 days to do so. If you don't reinvest the money within 60 days, your account will be treated as an early withdrawal, which means you will be subject to regular income tax, plus a 10% early withdrawal penalty, providing you are under age 59.5.

BORROWING FROM YOUR 401(K)

One of the benefits of having a 401(k) is that you may be able to borrow from it. Like any other loan, though, you pay interest on the money you borrow from your 401(k). The rate is usually about a point or two higher than the Prime Rate, which is the rate that banks give to only their most creditworthy borrowers. If your plan allows you to borrow, there will be a limit, usually up to half of what is in the 401(k), but never more than $50,000.

Borrowing from a 401(k) plan should only be considered as a last resort. Although it is convenient, a 401(k) loan comes with several disadvantages. First, if you lose or change jobs before the loan is repaid, the outstanding amount would have to be repaid either before the last day on the job, or within a specified period, generally 90 days. If it is not repaid, the amount owed becomes age of 59.5. Another disadvantage is that you are replacing pretax money with after-tax money. For example, if you are in the 27% tax bracket, it will take $1.40 in salary to replace every dollar you borrowed from your account. Also, instead of letting the money grow on its own by earning interest on your investments, when you pay back the loan you are paying the interest out of your own pocket.

A 401(k) loan may be an attractive option for some people, but it is important to be aware of the potential pitfalls that come with it. As with any other loan, consumers should do their homework and ask questions before signing on the dotted line.