Getting an "A" in 401(k)

In the past, traditional retirement income sources were symbolized by a sturdy three-legged stool. One leg represented pension income, one Social Security income, and one personal savings income. For past generations of retirees, this retirement-income stool image was a reassuring visual of a balanced and stable retirement-income plan. Today, the three-legged retirement-income stool ideal has become unstable and cannot bear the weight of those who sit upon it expecting a three-to-four-decade retirement period.

A closer look at the traditional retirement-income stool reveals that the pension leg is disappearing, the Social Security leg is cracked, and the personal savings leg is most likely underfunded by most folks who are hoping to replace the missing pension leg.

Retirement is no longer a predetermined destination where all you need to do is show up at your retirement age (usually sixty-five) and collect vested lifetime guaranteed entitlements for a relatively short retirement life span.

To get a leg up (so to speak), today's retirement hopefuls seeking financial independence must create a new retirement-income stool to compensate for the epic changes in traditional retirement-income sources. The new design consists of maximizing Social Security benefits, fully funding voluntary retirement savings accounts—for instance, 401(k) and IRA accounts—and building other assets that are convertible to future income, such as a business that can be sold or real estate that can be sold or leased or tapping primary home equity that can be converted to income through a reverse mortgage post age 62.

I'll Just Keep Working

Continuing to work past the traditional retirement age is a frequent default option utilized by many who fail to build their retirement-savings resources during younger working years. Employment income alone is not a suitable substitute for the retirement-income stool since the whole intent of retirement financial independence is to create income from resources independent of wages because at some point you might become involuntarily unemployable. Working seniors who are doing so out of financial necessity and not merely the desire to continue to work for pleasure may find their retirement-income stool pulled out from under them if unplanned changes occur. Factors that affect continued employment include changes in health (yours or that of a family member) and/or labor force supply-and-demand shifts.

Empowerment Replaces Entitlement

Topping the list of valuable tools to create your own empowered retirement lifestyle is the 401(k) account. It's surprising that this vital retirement-income producer that has been around since 1978 is not fully utilized by every participant who is eligible to contribute to one. Recent statistics reveal that out of every two eligible employees reading this article, only one is contributing to a 401(k) account.

> Financial independence is not affected as much by what you know as by what you do with what you learn.

Give yourself an "A" if you are eligible to participate in your company's 401(k) plan *and* are actively contributing. If not eligible, give yourself an "A" if you are actively contributing to an alternative 401(k) plan by using a combination of a traditional IRA, Roth IRA, SIMPLE IRA, Simplified Employee Pension (SEP) IRA, and/or tax-deferred annuities to reinforce your teetering retirement-income stool.

Getting an "A" in 401(k) means you have mastered the "whats" and "whys" about 401(k) investing. But even more important is acting on this knowledge. You can ace the knowledge portion of a retirement-planning quiz, but if you fail to act accordingly, knowledge alone may not keep the lights on during your retirement twilight hours. Financial independence isn't affected as much by what you know as by what you do with what you learn. An empowerment attitude is defined by what you do with what you've got.

Determine Your Ultimate 401(k) Purpose and Invest Accordingly

Why are you participating in a 401(k) plan? Tax deductibility of contributions and tax-deferred compounding are common responses. Collecting the employer matching contributions, if available, is also a great reason to contribute at least enough to get the full match. But surprisingly, free money in the form of an employer match is not the ultimate reason to participate. The primary reason for contributing a percentage of your wages to your employer-provided 401(k) retirement plan is to replace as best you can the disappearing pension leg of the retirement-income stool discussed earlier. Employers offer 401(k) retirement accounts and, in some cases, include matching contributions as a viable substitute for the disappearing defined-benefit plan know as a “pension.” But unlike a vesting pension benefit, your participation in the 401(k) pension replacement program is 100 percent voluntary. If you snooze, you lose.

If the primary purpose for contributing to your retirement account is to create a future income supplement, and you are at least five years away from requesting income payments from your plan, choosing an investment that provides inflation protection through capital growth is most prudent. Yet research continues to reveal that a high percentage of those participants who have many years left until retirement income is needed elect short-term, stable-value, non-inflation-protected investments such as short-term bonds and money market funds as their primary investment choice. The motivating reason is rooted in human nature. Given a choice, most people will choose certainty in the short-term (principal protection) versus certainty later on (inflation-adjusted income protection).

Investing for long-term growth of future income means you must accept some short-term account fluctuations along the way. If your investment plan is well diversified, these short-term value gyrations are temporary and not impactful to your later-on retirement aspirations. Paradoxically, what most investors fear the most, periodic financial market value declines (short-term uncertainty) actually can add additional value for the disciplined long-term saver. For those who continue to invest during such declines, additional shares are automatically purchased when shares prices are lower. This assumes, of course, that you continue to add systematic contributions to your account during all market conditions and that financial markets recover from any value decline experienced. Occasional down-market periods along the way could end up improving your future income prospects when you begin income distributions down the road.

Give yourself an "A" if your ultimate 401(k) purpose is certainty of future retirement income purchasing protection (capital growth) versus certainty of current value (stable value) and if that purpose is prevalent in your 401(k) investment choices. Give yourself another "A" if you are an all-weather (all market values) 401(k) contributor.

Make Maximum Annual 401(k) Contributions; Enjoy Maximum Tax Deductions

Some income tax deductions phase out at certain taxable income levels. Contributions to your 401(k) account are deductible dollar for dollar up to the maximum allowable contribution limit in the year of contribution.

If you are under age fifty and your employer's plan allows it, you can contribute up to $18,500 (2018) and fully deduct the total 401(k) contributions from federal taxable income each calendar year. Participants age fifty and over can contribute and deduct an additional $6,000 (2018). There is no reduction to your annual tax deduction up to the amount of your actual contribution amount. Some plans may limit your total annual contribution percentage, but each dollar you contribute is 100 percent tax deductible. Check with the plan sponsor for more details.

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Are you maximizing retirement-plan contributions each year and reducing your tax liability dollar for dollar? If you answer yes, give yourself an "A."

401(k) Accounts Help All Income Earners

Do you think the 401(k) income tax deduction savings only benefits higher-income earners? If you answered yes, reconsider. Although it is true that higher taxable income earners trigger higher marginal income tax brackets and can benefit from greater tax savings with each dollar of deductible contribution to their 401(k) plan, lower-income earners can also benefit. If your adjusted gross income in 2018 is $31,500 or under as a single earner or $63,000 or less as a joint-income-tax filer, you might qualify for the Saver's Tax Credit on your federal income tax return. This credit can be worth from 10 percent to 50 percent of your contribution amount up to $2,000 for single tax filers and $4,000 for joint filers. What's great about the Saver's Tax Credit is that it is an actual tax credit—not a tax deduction. A tax deduction subtracts the value of the deduction amount from your taxable income, and you pay taxes on the remaining amount. A tax credit gives the tax filer the entire dollar value of the credit back or subtracts the value from the taxes you owe—making it far more valuable monetarily than a deduction. The Saver's Tax Credit is nonrefundable, meaning it can reduce taxes owed dollar for dollar down to zero but can't be refunded to you directly. In addition to 401(k) contributions, the Saver's Tax Credit is available for other types of retirement plans, including IRA, 403(b), and 457(b) plans. Currently only about 12 percent of eligible participants are taking advantage of this credit. Why? They are not aware of it or are not contributing to an eligible retirement plan account.

Now that you know, give yourself an "A" if you can utilize this valuable tax credit. If you aren't eligible due to taxable income limitations, maximize your annual tax-deferred, retirement-plan contribution and pass the Saver's Tax Credit information on to someone you know who can use it to save money on taxes.

Are the Investment Choices in Your 401(k) Plan Diversified?

Some participants mistakenly believe that they are properly diversified because they own several investment funds within their 401(k) account. Owning multiple funds with the same investment objective is not a diversified portfolio.

How does this occur? Most 401(k) plans offer participants a plethora of investment choices to select from. Usually this list includes several funds that share the same investment objective but have different names. A common example is a "capital growth" fund and an "S&P 500 Index" fund. Although the capital growth fund is most likely actively managed and the S&P 500 Index is not, they tend to own the same parts of the stock market over time.

Unguided participants tend to choose the short-term winners for their investment allocation. In other words, they often pick the investment funds with the best short-term performance returns. Because similar funds will tend to have the same performance over the same periods, they end up selecting what they think are different investment objectives, but in reality, they are different in name only.

Diversifying across not only investment objectives (growth, income, and cash) but also companies, industries, and even countries can lessen your risk. When one component isn't performing well, your whole account is not having the same experience.

Give yourself an "A" if your ultimate investment purpose is funded with several investment choices that have different investment objectives and collectively serve your lifetime retirement-income distribution needs, which is the ultimate purpose of your 401(k).

Employer Matching Funds Are the Traditional Pension-Fund Substitute for the Modern Retirement Hopeful

By now, most everyone knows that planning and funding a lifestyle of financial independence in retirement for a period that could last longer than all the years you have worked is a humongous task. The absence of the pension leg from the three-legged retirement-income stool puts enormous pressure on the remaining two legs—Social Security and personal savings—to accomplish this goal.

> The 401(k) employer match requires that you be employed by the firm *and* voluntarily contribute a percentage of wages to your 401(k) account that's high enough for you to receive the full match from the employer.

If your employer elects to match a percentage of your plan contribution, it is done to provide a valuable employee compensation benefit and to replace pension allotments that are most likely not going to be made on your behalf. The big difference is this: In most cases, employer-paid pension contributions only required you to be actively employed with the firm for a minimum period to vest; on the other hand, the 401(k) employer match requires that you be employed by the firm *and* voluntarily contribute a percentage of wages to your 401(k) account that's high enough for you to receive the full match from the employer. If you elect not to participate in the 401(k) or if you elect to contribute an amount that is less than the maximum necessary to receive the full match, the difference in what you didn't invest forfeited forever.

Since every dollar you contribute today will be needed to replace lost pension income tomorrow, leaving any employer's matching dollars on the table is just foolish.

Give yourself an "A" if you are contributing enough to your 401(k) account to receive 100 percent of any employer match each year.

In-Service Withdrawal—Transfer of Investment Management

Some 401(k) plans allow for the participant to transfer a portion of his or her existing 401(k) balance to a separately managed retirement account while still working for the current employer. The advantage of such a transfer is to "self-direct" the investments according to an investment policy the participant establishes rather than being captive to what the 401(k) plan sponsor document dictates for all participants.

Interested participants will need to check with the plan custodians to determine availability, costs, restrictions, and other considerations before proceeding.

You Have Left Your Current Employer. Did You Leave Something Behind?

Use the same rule for your 401(k) account as you do for your luggage at the airport—never leave it behind.

If and when you leave your employer, make an informed decision to roll your former employer's 401(k) money into a new employer plan or directly into a self-directed IRA. This transfer, when done correctly, is tax-free.

If you are under age fifty-nine and a half when you terminate your employment, be advised that rolling your 401(k) into an IRA may forfeit the ability to take distributions while under the age of fifty-nine and a half to avoid the early withdrawal 10 percent penalty tax. Ordinary income taxes will still prevail for any distributions in the years they are received.

Do you have a 401 (k) account or accounts from a former employer? If yes, your choices are as follows:

Leave the account with the former employer.

Transfer the account to a new employer's 401(k) plan.

Roll it over to an IRA.

Never take a fully taxable distribution.

Give yourself an "A" if you have a former employer's 401(k) plan and have diligently reviewed the pros and cons of its disposition, such as the following:

Investment and management costs

Tax ramifications for distributions (such as distributions before the age of fifty-nine and a half and appreciated stock holdings within the plan)

Investment choices

Ongoing financial adviser support

Just Say *No* to 401(k) Loans

Many 401(k) plans allow for employee loans to be taken against the value of the account. Although this may be a workable money solution in the short-term, 401(k) loans can create bigger issues over the long-term. Budgeting for both the repayment of the loan and continued new contributions to your retirement account may be unrealistic given other competing monthly obligations. Altering your contributions while paying back the loan could affect future employer match amounts and can cause you to undercontribute to your ultimate retirement planning goal. Additionally, if you terminate employment before the loan is repaid, the unpaid balance will be taxable and could include tax penalties if you are under age fifty-nine and a half.

Give yourself an “A” if you just say *no* to the loan dough.

Who Gets What You’ve Got When You’re Gone?

401(k) plans allow for direct beneficiary designations. If you don’t survive to spend these hard-earned dollars yourself, who you name as direct beneficiary of your account will determine how distributions are paid and over what period of time they will be received. It is important to review your estate wishes with a professional who is qualified and experienced in these matters. Estate laws can be complex. Don’t rely solely on a customer service representative employed by the plan custodian.

Some 401(k) plans limit distribution options for nonspouse beneficiaries if proceeds are not first rolled into a beneficiary IRA. Don’t take the chance of a costly mistake.

Give yourself an “A” if you have reviewed your estate wishes with a professional who is qualified to advise you on your retirement account estate and tax planning matters.

Getting an “A” on a 401(k) Report Card

Action Grading: Yes = A No = Incomplete

Eligible to participate and contributing	
Receiving 100 percent of employer match each year	
Contributing maximum amount each year plus catch-up when eligible	
Use Saver’s Tax Credit and/or, if not eligible, tell someone who is	
Ultimate purpose is to provide inflation-protected retirement income	
Investment portfolio objective: growth now; income later	
Investment portfolio is broadly diversified	
In-service transfer options reviewed	
No former 401(k) left behind	
Just say *no* to 401(k) loans	
Beneficiary review	

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