401(k)nowhow™

An Insider's Guide to Retirement Plan Options

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CHAPTER 3

Details That Make a Difference

All 401(k) plans are subject to federal regulation, so in some instances, the plans are similar. But the plans are also defined by each participating company's plan document, so plans often differ quite a bit based on company contributions, matching rules, the vesting schedule, what constitutes a hardship, and other details. Government regulations are not negotiable, but employers have many options regarding other details about the 401(k) programs they establish for employees.

It can be confusing because an employer you used to work for might administer its 401(k) plan a little differently than your current employer. Do not assume that all 401(k) plans are exactly alike. The first place to look for details of the plan is in the Summary Plan Description, or SPD. This document is available from your company's Human Resources Department. The SPD governs issues regarding your contributions, your employer's contributions, the vesting schedule, and whether or not 401(k) loans or hardship distributions are allowed.

In this chapter, I address those topics, as well as common questions employees have about the money they have invested in 401(k) accounts. Many of these questions revolve around how to get money out of their 401(k) accounts. Keep in mind, though, that your focus should be leaving your money in the account until retirement.

Your Contributions

Employee contributions are categorized as employee deferrals, and the tax status of those deferrals is considered to be either traditional 401(k) deferrals or Roth 401(k) deferrals. The only differences between the two are the taxability on that money when it comes out of the paycheck and when the money is paid out at retirement.

With a traditional 401(k), you contribute income pre-tax and then pay taxes on the money you withdraw. With a Roth 401(k), you pay the taxes up front so that you can make withdrawals free from federal income taxes during retirement. Here is a comparison of the tax implications of contributing to a traditional 401(k) and a Roth 401(k):

A 401(k) contribution receives a tax deduction from each paycheck. So if you put in $30 per paycheck, you will get a tax deduction on a $30 deferral. It saves you roughly 15 to 40 percent, depending on your tax bracket, on every single deposit you make—at the time the money is taken out of your paycheck. A $30 deduction might impact your take-home pay by only $20 to $25, with the difference being the tax savings. The trade-off is that, through retirement, the money builds up tax-deferred, and you must pay the tax when you pull out the money from your 401(k) account.

A Roth 401(k) contribution is different. If you put in $30, there is no immediate tax break on that contribution. A $30 contribution costs $30 from your paycheck, and then you will enjoy tax-favored withdrawals when you retire. Both the contributions and the growth on those contributions come out free from federal income taxes under current law.

The three factors that make the most impact on your decision about which 401(k) deferral is best are your age, current tax rate, and future earning potential.

For both types of plans, federal law currently caps contributions at $18,000 ($24,000 for people who are fifty or older) as of 2016.

The three factors that make the most impact on your decision about which 401(k) deferral is best are your age, current tax rate, and future earning potential.

For a young investor, a Roth account is ideal because his contributions will have a lot of time—decades—to grow free of federal income taxes. Also, a younger person is likely to increase his salary as he progresses in his career. That means the taxes he pays now are probably lower than those he will pay once he retires. Although choosing a Roth account will probably mean you will take a bigger hit on taxes now, you will receive the tax breaks at retirement. To avoid the tax hit now, many people split their contributions between a traditional 401(k) and a Roth 401(k).

Your Employer's Contributions

The Employee Retirement Income Security Act (ERISA) is a federal law that sets standards to protect individuals in private-sector retirement plans. Enacted in 1974, ERISA also sets rules regarding the federal income tax effects of transactions associated with employee benefit plans. Three government organizations share responsibility for interpreting and enforcing ERISA: the Department of Labor, the Department of the Treasury (particularly the Internal Revenue Service), and the Pension Benefit Guaranty Corporation, which deals mainly with pension plans. One of the functions of ERISA is to set the vesting schedule, which has remained the same for 401(k) plans since 2002. In the early 1990s, employers could vest benefits over a period of ten years instead of six. Then, in the late 1990s, the law changed that time period to seven years. Now employees can be fully vested within six years.

Earlier I focused on the employee contributions and the reasons why contributing is a wise idea. Now we will go through the other side of the 401(k) plan and one of the biggest benefits available: the employer contribution. An employer contribution is an investment in its employees, just the same as investing in machinery in the plant. A contribution to an employee's retirement account can be the reason employees stay or leave, and turnover is an expensive proposition for an employer. When they do make contributions, the intent is often to try to keep the best employees until retirement.

Employer contributions can be in the form of a flat dollar amount, a percentage of an employee's salary, or a "match"—a dollar amount that matches the employee's contribution. For example, a company might match 50 cents for every dollar an employee contributes, so a $20 per week contribution would receive a $10 match. If the employee puts in nothing, then there will be no employer contribution. As I mentioned earlier, these contributions are meant to keep employees for the long term, so they are not free and often come with strings attached. This is called "vesting." Many people hear the term and are often confused about what it means and why their retirement funds might be subject to it.

The Vesting Schedule

In law, "vesting" is to give an immediately secured right of present or future use. A person has a vested right to an employer contribution that the employer cannot take away, even though she may not possess the full balance yet. When the employer contribution can be transferred to the employee, it is termed a "vested interest."

Being "fully vested" means you have worked for the company long enough (six years in many organizations) that you are entitled to take 100 percent of your employer's contributions with you, along with 100 percent of your own contributions, when you leave the company.

401(k) plans give companies a competitive edge when recruiting employees through creative contribution and match formulas. It also encourages employees to stay in their jobs longer through a vesting schedule. The longer they stay employed, the more of the employer contribution they are entitled to keep if they leave or retire.

The length of vesting schedules has varied over the years, but early plan designs often started at ten years and vested 10 percent per year. Each additional year an employee stayed, he or she would get 10 percent more of the employer's contribution, eventually becoming 100 percent vested in the tenth year. A subsequent tax-law change reduced the period to seven years, with the first two years of employment being 0 percent and then 20 percent vesting for each year the employee stayed, until she was 100 percent vested in the seventh year. Today, employees typically receive 20 percent of an employer's match each year in the job and can be fully vested in six years, although some plans offer quicker vesting options.

Plans that are considered "safe harbor" allow for 100 percent immediate vesting on a portion of the employer contribution. Please check your plan provisions for complete details on your vesting schedule. These are also included in your employer's Summary Plan Description.

A sample vesting schedule is shown in the following chart. As you can see, you must work for a company for a full year before you are eligible to receive any percentage of your employer's contribution. That is pretty standard—a one-year wait and then an accumulation of 20 percent per year toward full vesting. Again, you can take 100 percent of the money you contribute, regardless of how long you stay with the company.

3-Year Cliff	
Year 1	0%
Year 2	0%
Year 3	100%

6-Year Graded	
Year 1	0%
Year 2	20%
Year 3	40%
Year 4	60%
Year 5	80%
Year 6	100%

Forfeitures—What Happens to the Unvested Money Employees Leave Behind

When an employee leaves a company before being "fully vested," or eligible to receive 100 percent of his employer's contributions, the remaining amount of the employer contribution will be reallocated to the other plan participants or used to reduce the employer contributions. Both are completely legal, and which option the company uses is determined by the plan document.

Contribute It and Leave It: Early Withdrawal Is Costly

It requires education and a mind-set shift to understand that a 401(k) plan is a long-term investment account, not a short-term savings account.

I have come across many employees who think of a 401(k) contribution as more of an easily accessible savings account than a retirement account. It requires education and a mind-set shift to understand that a 401(k) plan is a long-term investment account, not a short-term savings account. It is a retirement plan, so the contributions made to the plan are intended for retirement.

Upon termination of employment, you have the right to withdraw your own contributions and the portion of your employer's contributions you qualify for based on your years of service, but I strongly advise against it. The income taxes and penalties associated with early withdrawal are steep. Because of the tax deductions you and your employer receive, the government imposes stiff penalties if you take the money out before you retire.

If you withdraw money before you are 59½ years old, you will face three costly consequences:

1. First, you will be taxed on the amount you withdrew immediately. So the entire amount you withdraw will be added to your taxable income for the year.
2. Plus, you will pay a 10 percent penalty.
3. More importantly, you will lose the benefit of growth, or compound interest, your money could accumulate over time if you had left it in your account.

If you are in the 15 percent tax bracket and take $10,000 out of your 401(k) plan, it will be subject to income tax at 15 percent, plus a 10 percent penalty. The tax and penalty combined will be 25 percent of the amount you withdrew, or $2,500. If you are in the 20 percent tax bracket and withdraw $100,000, that might shift you into the higher 30 percent tax bracket, so you will have to pay more income tax than you would have otherwise. Plus, you will pay the 10 percent penalty, $10,000. So the total tax on your withdrawal would be $40,000. It's just not worth it!

The first two consequences are extremely costly, but the third one is the direst—the amount of growth you miss out on over time because you withdrew money early. What is extremely troubling to me is that I see many people withdrawing money from their accounts to spend on depreciating assets like a car, RV, or other consumer item.

When Can I Retire, and How Can I Avoid the 10 Percent Penalty?

You can retire at any time, assuming that your employer's plan document allows for early retirement. If it does, you could retire and take your money out to use for retirement, even at an age well before 59½. Federal rules say that if you withdraw your money and roll it into an IRA, you may avoid the immediate taxes. Under certain circumstances, you could start an income stream on that money at any time under Rule 72(t). You might also avoid the penalty if you leave the company after age fifty-five.

Rule 72(t)

We discussed the rule of 72 earlier when we discussed the rule that governs how quickly money compounds and grows. Rule 72(t) is an IRS rule that allows you to avoid paying the 10 percent penalty, but you have to roll your account to an IRA and then withdraw your money under equal and consistent period payments. The rule requires that, to take penalty-free early withdrawals, you must take at least five "substantially equal periodic payments" (SEPPs).

At age forty, that would amount to about a twenty-five- to thirty-year income stream. If you take your money out monthly for the rest of your life, you will not have to pay the 10 percent penalty. Income tax is still due on that money, but not the 10 percent penalty. This rule allows people to retire maybe at age fifty, live the lifestyle they want, and then do something with their retirement savings.

If You Quit

If you quit your job and withdraw money from your 401(k) plan, there is an alternative to paying income taxes and the penalty. You have three options:

1. You can roll the money into an individual IRA at a financial institution.
2. You can transfer your 401(k) account to your new employer's 401(k) plan, if it has one and if it allows rollovers.
3. If you have a balance of $5,000 or more in your employer's 401(k) account, you can leave the money in the plan as long as you choose.

In most situations, I advise people to transfer their 401(k) funds into their new employer's plan or, if that is not an option, to roll the balance into an IRA.

It is rarely advisable to leave your money with your previous employer's 401(k) plan.

When you leave money in a former employer's plan, that employer could make changes to the plan, or you might forget to give the former employer your new address if you move. Unless you keep in constant contact with them, there is a good chance that you can become disconnected from that 401(k) and possibly lose your money forever. The burden of proof to go back and claim the money lies on you, the employee. The IRS and Department of Labor have a process to help people match up and connect with their 401(k) plans that they have left, but it is shoddy at best. Some plans have a provision stating that an employee will forfeit his or her money to the state after a number of years. Newer regulations encourage employers to establish an IRA for these lost employees, but the burden to track down the money still lies with the employee. So regardless of the situation—even if your new employer's plan is not as modern or broad in its provisions as your previous employer's plan—it is rarely advisable to leave your money with your previous employer's 401(k) plan.

A recent Government Accounting Office (GAO) study found that only 10 to 15 percent of 401(k) plan participants who switched jobs moved their retirement savings to their new employer's 401(k) plans. That's far too few, in my opinion, because most of these people simply cashed out their balance and paid the penalties and taxes. Many employees do not weigh the cost to their retirement of doing this versus the benefit of letting the money grow. Immediate needs tend to outweigh future needs, and that is a costly approach.

Are 401(k) Plans Safe if the Employer Goes Bankrupt?

If your company goes bankrupt, your money is protected under state and federal bankruptcy laws. Once payroll contributions are deposited into the 401(k) plan, it is not subject to the creditors of the bankrupt company. The only time bankruptcy would impact a 401(k) participant is if that employer offered employees company stock as an investment option in the 401(k) plan. A lot of larger publicly traded corporations, in addition to a wide variety of mutual funds, might offer stock in that company. For example, if you work for Walmart, you could buy Walmart stock in your 401(k) plan. If that's the case, a bankruptcy of that company would impact your other account balance only because of the shares you owned. Think Enron here! But it would not impact your side-account balance if your employer goes under. Those assets are completely segregated and receive some of the most beneficial asset protections in the country.

What Should I Do when I Retire?

In most situations, when you retire, it is often advisable for you to roll your money into an IRA. Why? Because of provisions in a retirement plan that relate to beneficiary designations. For example, if I wanted to leave my proceeds to my kids over multiple generations—children, grandchildren, and great-grandchildren—I could not do that in any 401(k) plans. I can do that only through an IRA beneficiary designation because of the way current laws are written and the way most 401(k) plan documents and IRA trust agreements are written. The more money you have and the longer you want to leave the money in a qualified setting for future generations, the more favorable an IRA rollover is for you.

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Can My Spouse Contribute to My Plan?

We get this question a lot from participants. A participant will ask, for example, if his wife can roll her IRA into his 401(k) account. The answer is no. Just like an IRA—individual retirement account—is intended for one individual, a 401(k) retirement account is also owned by the individual participant. Retirement plan assets and IRA assets are generally segregated assets, meaning they belong to the participant only. There is no way to move IRAs or 401(k) plans from one spouse to another. If a participant dies, however, and his wife is the beneficiary, then she will receive the money from his account or could maintain a "spousal account" in the plan.

Most of the people who provide retirement plans believe employees should never borrow against their retirement plan money. I am on the other team and think loans can be a great tool if used properly.

401(k) Loans: A Controversial Topic

Borrowing against your 401(k) account is one of the more controversial topics when it comes to 401(k) plans. Many have put forth the reasons why employees should not borrow against their 401(k) accounts, but few are in favor of using retirement plan loans. The industry has tried to curb the amount of loans and imposed "loan origination fees" to help restrict access to loans.

So if most of the people who provide retirement plans believe employees should not borrow against their retirement plan money, why are loans still allowed? Because they allow access for employees needing money. I have seen the good and bad sides of loans, but I am firmly on the other team when it comes to loans. I think loans can be a great tool, if used properly. There are very good reasons to borrow money from a 401(k) plan, and I have advised clients to do so on many occasions. In my opinion, a 401(k) loan can make sense for many reasons, but especially in two primary scenarios:

1. For big, long-term purchases such as a business venture, a new car, or the down payment on a house
2. To pay off bad debt, such as credit cards with high interest rates

It makes perfect sense, in many cases, to take out a loan on your 401(k) plan instead of borrowing money from banks and credit card companies. If you have enough money in your 401(k) account and the provisions in the plan are favorable to the loan, you could save tens of thousands of dollars in interest that you otherwise would pay a financial institution.

When deciding whether or not to use a 401(k) loan versus a bank loan, be sure to also factor in the earnings you may lose as a result of the loan amount not being invested in your account. You will also need to consider if a loan will impact your ability to make contributions and receive the full employer matching contribution.

How Does a 401(k) Loan Work?

An employer can set up the company plan to allow employees to borrow from their accounts. Employees must have a minimum account balance before they are allowed to establish a loan. A common loan provision allows an employee the ability to borrow 50 percent of her account balance, up to a maximum of $50,000. The minimum loan under most plans is $1,000, but again, that is determined by the employer's plan documents. The loan can be paid back in weekly or monthly installments withheld from the employee's paychecks. The payback period can be as short as six months to as long as five years. However, the loan must be paid back in full if the employee terminates employment. The interest rate you will pay on the loan is determined by the plan document and is usually tied to an index of bank rates or the prime rate plus a certain percentage. This is often quite reasonable and lower than commercial rates. The best part is that the interest is paid back into your own account. You are, in effect, borrowing from yourself.

The Upside of a 401(k) Loan

Let's say you have a balance of $20,000 in your 401(k) account. You could borrow up to $10,000 from your plan. An employee with $100,000 could borrow up to the maximum of $50,000. An employee with more than $100,000 in the plan could borrow only the maximum of $50,000 as well.

The beauty of a planned participant loan is that the money is paid back to your account. The interest paid on that loan is paid to you, just like earnings. It is not paid to a bank, to the employer, or to the insurance company or mutual fund that holds the assets. Best of all, the loan is not reported to credit agencies and, if used to pay off credit cards, may even help increase credit scores, allowing you to borrow less expensively for other major purchases.

Many times, when working with employees who say they are not able to contribute to their 401(k) plan, we find that these employees often have large credit card balances. If an employee is paying a 25 percent interest rate on a credit card and has $10,000 in credit card debt, that is a huge drain on his or her finances. Many of them also pay late fees because they are behind and are not able to make their payments on time. Sometimes we find that the interest rates on these loans are as high as 25 to 30 percent. A $10,000 loan might cost the participant up to $3,000 a year to carry the credit card balance, plus late fees and other charges. A payday loan from a payroll lending company or a pawn-shop loan are often worse than the credit card companies. We have seen interest charges in excess of 50 percent with late fees and penalties.

And all too often, these same people make only the minimum payment on their credit cards, which is not enough to cover even the interest. They are making a very small dent in their debt, which makes credit card companies a lot of money. In these situations, we highly recommend that employees take a loan from their 401(k) plan to pay off the balance and then cut up the credit cards.

The following example shows how much money you could save by doing so. Let's say that you have $20,000 of credit card debt at 20 percent interest and you are making minimum payments. After ten years, your monthly payment would be $386.51, for a total of $26,381.36 of interest. If you paid it off over five years, the payments would be $529.88 per month and $11,792.66 of interest. However, if you were to have a large enough balance that you could borrow $20,000 from your 401(k) plan at a rate of 4.5 percent, your monthly payments would be $372.54. Your total interest would be only $2,371.62, and you would have paid it back into your *own* 401(k) account, not a bank!

The Downside of a 401(k) Loan

How much will a loan cost you in the long run? A $20,000 401(k) loan paid back over five years could mean you're missing out on more than $7,000 in potential earnings, according to TIAA-CREF calculations. (That's assuming that the borrower is forty years old and has twenty-five years left until retirement. It also assumes that it's a five-year loan with 6 percent loan interest and that there would have been an 8 percent return on funds over the next twenty-five years if the loan had not been taken.) [12]

That "opportunity cost" can lead to regrets. According to the National Institute of Pension Administrators (NIPA), nearly half (44 percent) of employees who took out a loan from their workplace retirement accounts later said they regretted the decision, according to TIAA-CREF's "Borrowing against Your Future" survey. An additional 23 percent of employees who took out a loan don't regret it but say they wouldn't do it again.[13]

What if an employee takes out a loan on a 401(k) account, agrees to pay it back in sixty months (five years), and then leaves the company? It is practically impossible for an employee to back out of that employee deduction, and employees rarely have the money available to pay off the loan. It is then considered an early distribution and is subject to income taxes and penalties. This is the worst-case example but unfortunately happens all too often.

Let's go back to our example of the employee who has $100,000 in his 401(k) account and takes out a $50,000 loan, the maximum amount allowed, to buy a new house. A month later, he is terminated from his job. He doesn't have the cash available to pay back the loan because he has invested all of the money in his house. That loan will be considered in default and treated as a $50,000 distribution. If his tax rate is 30 percent, he will pay that amount of tax (30 percent of $50,000 is $15,000) plus the 10 percent penalty ($5,000). That $50,000 loan has just cost the employee $20,000 in taxes and penalties. That $20,000 will be deducted from the employee's remaining $50,000. However, the $20,000 needed to pay the tax on the $50,000 loan will also be taxable. An additional $6,000 will be needed to pay this tax. This will likely leave $20,000 to $25,000 to roll over out of the original $100,000. He would still have his equity in the house, so the entire amount wouldn't be lost. However, it would still be extremely inefficient.

Unfortunately, it happens all too often.

When I counsel people about borrowing from their retirement plan, I advise them to follow three guidelines:

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12 "401(k) Loan Regrets, National Institute of Pension Administrators blog post, July 7, 2014, http://www.nipa.org/blogpost/891501/News-from-NIPA.

13 Ibid.

1. Use 401(k) loans sparingly.
2. Use them only if you plan to be employed at that company for the entire term of the loan so that you have a paycheck from which to pay back the loan. (Of course, a layoff is beyond your control, but quitting is.)
3. Take out a loan only if you intend to follow the rules associated with it and use it to pay off what I consider to be bad debt.

I mentioned earlier that this is a controversial subject, and often I am at odds with many other advisors and plan providers about 401(k) loans. Most other providers contend that when you take out a loan on your 401(k) plan, you will lose the growth that the money could be experiencing in the market while you are paying it back. You would be taking money out of a stock market investment that could be earning a much higher rate of return. However, they often do not show the other side of the costs associated with borrowing money and the toll it might take on a family budget.

Most plans offer online loan calculators. They show that if you borrow a certain amount of money, you are anticipated to lose a certain amount of dollars in retirement income or retirement assets because you are taking that money out of the stock market. My argument is that this may or may not be the case. It really depends on a lot of other outside factors like whether the employee could actually earn that much return on the asset, whether or not there were other loans that would cause the employee to go bankrupt as a result of not being able to pay off that money, and also the higher interest and borrowing costs associated with a bad credit score.

Car Loans: Maybe

A lot of clients ask us if they should take out a 401(k) loan to buy a new car or borrow that money from a bank. Generally, if they are looking at paying more than 6 percent interest to a bank, it often makes sense to consider using a 401(k) loan for the purchase. If their bank loan will be 5 percent or less, it almost never makes sense to use a 401(k) loan.

> ***If you plan to buy a new car and the bank is going to charge you more than 8 percent interest, it often makes sense to consider using a 401(k) loan for the purchase.***

Lifestyle Loans: Rarely

It is usually not a good idea to take out a 401(k) loan to fund a lifestyle choice, such as buying a hot tub, recreational vehicle, or motorcycle. I dislike that idea because it shows that people are viewing their 401(k) plan as a savings account, not as a retirement account. Capital purchases like houses are investments that can increase in value over time, while consumer purchases often depreciate in value over time.

Hardship Distributions

A retirement plan may, but is not required to, provide for hardship distributions that allow employees to withdraw money to take care of an economic emergency. Many plans that provide for elective deferrals also provide for hardship distributions. Some 401(k) plans, 403(b) plans, and 457(b) plans permit hardship distributions.

If a 401(k) plan provides for hardship distributions, it must provide the specific criteria used to determine what constitutes a hardship. For example, an employer's plan might stipulate that a distribution can be made only for medical or funeral expenses but not for the purchase of a principal residence or for payment of tuition and education expenses.

The IRS defines a hardship as follows:

> For a distribution from a 401(k) plan to be on account of hardship, it must be made on account of an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse or dependent.
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> Whether a need is immediate and heavy depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including: (1) certain medical expenses; (2) costs relating to the purchase of a principal residence; (3) tuition and related educational fees and expenses; (4) payments necessary to prevent eviction from, or foreclosure on, a principal residence; (5) burial or funeral expenses; and (6) certain expenses for the repair of damage to the employee's principal residence. Expenses for the purchase of a boat or television would generally not qualify for a hardship distribution. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.[14]

Your primary focus should be on leaving your money in your 401(k) plan, not trying to get your money out of the plan!

Other Ways to Access Your Money

We have discussed the primary ways you can get money out of your 401(k) account: by leaving your job and taking a cash distribution instead of rolling the money over into an IRA or a new employer's 401(k) plan and by taking out a loan against your 401(k) account.

There are very few additional ways to access money from a 401(k) plan. There have been special provisions for Iraqi war veterans. In the past, veterans of war have been able to access funds for hardships that were

14 "Retirement Plans FAQs Regarding Hardship Distributions," IRS website, http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Hardship-Distributions#2.

caused by overseas deployment. There also have been instances in which people who have been affected by major hurricanes or other major storm events have been given regional exemptions to the hardship rules to allow them to access their 401(k) account for either a direct distribution or a taxable distribution, or through loan provisions that have been expanded from $75,000 up to as much as $100,000. That is usually handled by an act of Congress, and it is usually a one-time situation in which the government makes a special provision through the IRS to allow people to access their money.

Although the focus of this chapter has been on getting your money out of your 401(k) plan, I want to stress, again, that your primary focus should be on leaving your money in your 401(k) plan! It requires a mind-set shift to recognize that it is a long-term savings plan for retirement, not a savings account. Avoiding the temptation to borrow against your account or cash it out can make the difference between a comfortable retirement and a substandard quality of life once you are no longer receiving a paycheck. Remember, the decisions you make now about your 401(k) plan will affect you for the rest of your life.

Chapter 3 Summary: Key Points to Remember

1. Do not assume that all 401(k) plans are exactly alike. The first place to look for details of your employer's plan is in the Summary Plan Description, or SPD.

2. With a traditional 401(k), you contribute income pre-tax and then pay taxes on the money when you withdraw it. With a Roth 401(k), you pay the taxes up front so that you can make withdrawals tax-free during retirement.

3. For both traditional and Roth 401(k) plans, federal law currently caps contributions at $18,000 ($24,000 for people who are fifty or older).

4. The three factors that make the most impact on your decision about which 401(k) deferral (pre-tax or Roth) is best are your age, current tax rate, and future earning potential.

5. Employer contributions can be in the form of a flat dollar amount, a percentage of an employee's salary, or a "match"—a dollar amount that matches the employee's contribution.

6. Being "fully vested" means you have worked for the company long enough (six years in many organizations) that you are entitled to take 100 percent of your employer's contributions with you, along with 100 percent of your own contributions.

7. If you withdraw money before you are 59½ years old, you will face three costly consequences. The third one is the direst. First, you will be taxed on the amount you withdrew immediately. So the entire amount you withdraw will be added to your taxable income for the year. Plus, you will pay a 10 percent penalty. More importantly, you will lose the benefit of growth, or compound interest, your money could accumulate over time if you had left it in your account. Leaving the company after age fifty-five is a way to avoid the penalty as well.

8. Rule 72(t) is an IRS rule that allows you to avoid paying the 10 percent penalty, but you have to roll your account to an IRA and then withdraw your money under equal and consistent period payments. The rule requires that, to take penalty-free early withdrawals, you must take at least five "substantially equal periodic payments" (SEPPs).

9. In most situations, when you retire, it is often advisable for you to roll your money into an IRA. If you want to leave your proceeds to your kids over multiple generations—children, grandchildren, and great-grandchildren—you can do that only with an IRA, not with any 401(k) plans.

10. Although many financial experts advise against taking out 401(k) loans, they can make sense for many reasons, but especially in two primary scenarios: (1) for big, long-term purchases such as a business venture, a new car, or the down payment on a house and (2) to pay off bad debt, such as credit cards with high interest rates.