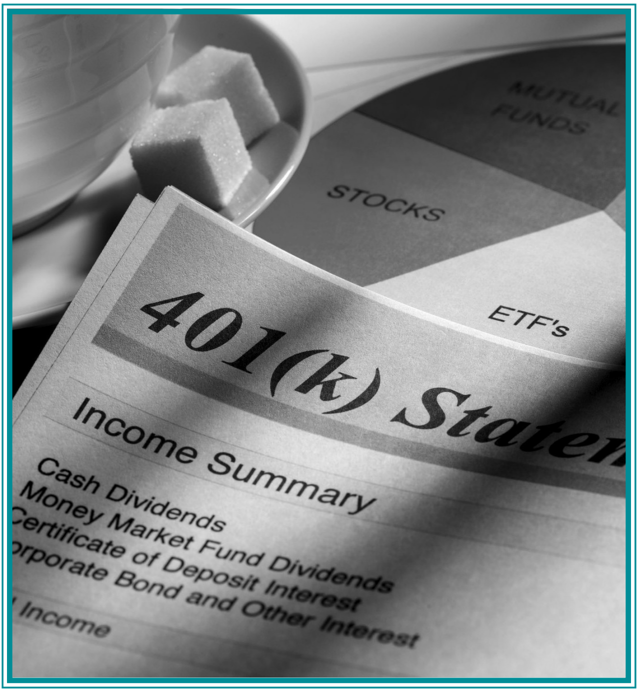
A Consumer's Guide to



401(k) Plans

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NYSUT Member Benefits wants NYSUT members to be the best-informed consumers in the state. This Consumer Guide is one of our contributions towards achieving that goal. We hope that you find it helpful and informative.

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Saving for retirement is one of the most important financial actions you will ever take. With increasing longevity, it is possible that many people today will live 30 years or more past the age of retirement. How do you prepare financially for such a long period of retirement? One of the best ways is by making regular contributions to your 401(k) plan.

What's a 401(k) plan?

A 401(k) plan is a type of qualified retirement plan designed to provide participants with a tax-favored method of accumulating savings payable upon retirement. Like a 403(b) or 457(b) plan, voluntary pre-tax contributions – in the form of employee elective deferrals – can be made.

There are other types of qualified plans to which employee elective deferrals can generally not be made, such as defined benefit pension plans and money purchase plans. However, this Consumer Guide will focus on the specific features of 401(k) plans.

How much can I contribute to my 401(k) plan?

The normal contribution limit for 401(k) plans is $19,000 in 2019. This limit is subject to indexing for inflation in future years in $500 increments. In addition to the normal contribution limit, there is a type of "catch-up" election that might enable you to contribute more. If you are over age 50 or turn age 50 any time in the calendar year, you can contribute an extra $6,000 under what is called an "age-50 catch-up" election – for a total of $25,000. This limit is also indexed for inflation in $500 increments.

This "catch-up" election is an optional plan provision; employers are not required to offer it, but most do. For those of you familiar with 403(b) plans, the additional special election for employees with at least 15 years of service that may be utilized in 403(b) plans CANNOT be used in a 401(k) plan.

It should be noted that if you make deferrals to another 401(k) or 403(b) plan (but NOT a 457(b) plan), your combined deferrals to all of these plans combined generally cannot exceed $19,000 ($25,000 if age 50 or older).

Additional limits: There are other limits that may apply if your 401(k) plan includes employer contributions. For more details, consult your plan's benefits summary.

When can I contribute to my 401(k) plan?

Many 401(k) plans permit you to make elective deferral contributions immediately upon hire. However, an employer may require you to wait until you have completed up to one year of employment in order to make elective deferrals. In addition, if the 401(k) provides for employer contributions, special rules may apply to those contributions; consult your plan's benefits summary for details.

Will my employer contribute to my 401(k) plan as well?

It is possible that your employer may contribute to your 401(k) plan; consult your plan's benefits summary for details.

If your employer contributes to your plan, it is most likely in the form of a matching contribution where the employer contributes a certain dollar amount for each dollar that you contribute to the plan, up to a certain maximum amount.

For example, if your employer contributes a dollar-for-dollar match up to 4% of compensation, this would mean that your employer would contribute an additional amount to your 401(k) plan equal to the amount that you contribute, up to 4% of pay.

If you earned $30,000 and contributed 4% of pay, or $1,200, your employer would provide a matching contribution of $1,200 for a total contribution of $2,400.

Some employers will contribute to the plan even if you do not contribute voluntarily, but this type of contribution is less common. Again, consult your plan's benefits summary for details.

Your employer may require you to complete up to two years of employment in order to receive matching contributions, but most plans will match your contributions after you complete one year of service or less.

Rollovers:

You can also roll over the money from a previous employer's retirement plan (403(b), 401(k) or governmental 457(b)) into your current 401(k) plan. Often, you can roll over funds to your new 401(k) plan immediately upon hire, although employers can impose a waiting period here as well. There are a number of advantages to rollovers, including:

- It's simpler to have your money in one place.
- It may increase the amount of the loan you are able to take if you need one.
- If you leave account balances with the plans of prior employers, you may forget that you maintained such accounts at retirement.

What are the advantages and disadvantages of 401(k) plans?

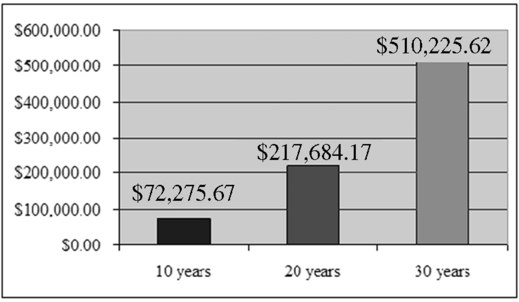
The biggest advantage is that your contributions can be made pre-tax. If your pay is $50,000 per year and you contribute 10 percent ($5,000), you are only taxed on $45,000 of income. That could save you a lot of money in taxes.

Your money also accumulates tax-deferred for as long as it remains in the account. You will not pay tax on any investment gains or interest earned until you withdraw the money.

Another advantage is that deferrals are taken automatically from your paycheck once you sign up. That makes it easy to save. And the easier it is to save, the more likely you are to do it.

The real beauty of saving money automatically is how it compounds over time. The following graph is an example.

Assumptions: Savings are $5,000 per year over 10-, 20- and 30-year periods; money is tax-deferred; contributions are made bi-weekly at the end of the period; and money grows at 7 percent per year.



Your advantages continue into retirement. The first $20,000 that you withdraw from your 401(k) plan each year after age 59½ may be exempt from New York state income taxes, depending on distributions you receive from any other retirement plans and IRA's.

Disadvantages? The money has restrictions placed on it. If you take it out early, before age 59½, you may have to pay a 10 percent excise tax. In addition, many plans restrict the ability to withdraw funds at all while employed (see "When may I receive a distribution from my 401(k) plan?" below).

Is a 401(k) plan the best way to save for retirement?

For most people, the answer is yes – for two reasons:

1) It is pre-tax.

2) Once you enroll, the payments are automatically deducted from your pay. Saving "off the top" by means of payroll reduction is the most effective way for most people to save money.

If you don't see it, you won't spend it. And, saving pre-tax means that your taxable income will be reduced in your prime earning years. That's a combination that's hard to beat.

When may I receive a distribution from my 401(k) plan?

Generally, distributions cannot be made until a "distributable event" occurs. A "distributable event" is an event that allows distribution of a participant's plan benefit and includes the following situations:

- The employee dies, becomes disabled, retires, or otherwise has a severance from employment
- The plan ends (terminates), subject to certain restrictions
- The employee reaches age 59½ or suffers a financial hardship

Please note that the plan sponsor can define a "distributable event" to be more restrictive than the rules listed.

As indicated above, your plan may permit hardship withdrawals. The IRS defines hardship as:

- Expenses for medical care previously incurred by the employee, the employee's spouse or any dependents of the employee, or necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses for the next 12 months of postsecondary education for the employee, or the employee's spouse, children or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- Funeral expenses; or
- Certain expenses relating to the repair of damage to the employee's principal residence.

Please note that 401(k) plans are not required to use these definitions of hardship, but, in practice, most do. For plans that use these definitions, it is important to note that there are NO exceptions. Credit card debt, for example, might be a hardship to you, but is not defined as a "hardship" by the IRS and thus you cannot withdraw funds from your 401(k) plan for this reason.

What are the tax consequences of a withdrawal?

As referenced above, withdrawals are subject to ordinary federal and state income taxes, with the possible New York state tax exemption described above. However, an additional 10% penalty over and above the tax paid will apply to all distributions EXCEPT those taken under the following circumstances:

- When you reach the age of 59½
- If you separate from service in or after the year you attain age 55
- If you choose to receive distributions over your life expectancy
- If you become totally and permanently disabled
- As part of a qualified domestic relations order
- To your heirs if you die
- For medical expenses that are more than 7.5 percent of your adjusted gross income

These rules can be complicated to interpret. Before you take any kind of withdrawal from a retirement plan, it makes sense to speak with a tax professional.

Also note that most distributions are subject to 20% mandatory federal tax withholding. Many people confuse this withholding with their actual tax liability. The 20% withholding is NOT a tax; it is merely money withheld in advance toward payment of taxes, much like the tax withholdings from your paycheck.

If you owe more than 20% in taxes on the distribution when you file your taxes, those additional funds are payable at that point – either increasing how much you owe to the government or reducing the amount of your tax refund.

If you roll over your distribution directly to another retirement plan or IRA, the distribution is not subject to any taxes or penalties. You can roll over most distributions except for:

- A distribution that is one of a series of payments based on life expectancy or paid over a period of 10 years or more
- A required minimum distribution (see "What happens when I retire?" on page 12)

- A corrective distribution
- A hardship distribution

May I borrow from my 401(k) plan?

If your employer's written plan and vendor contract permit it, you can take a loan. You may borrow up to 50 percent of your vested account balance, to a maximum of $50,000 (the $50,000 maximum is reduced if you have an outstanding loan from the plan).

The loan must be repaid within five years unless it is used to pay for your principal residence. A principal residence loan may be repaid over as many as 30 years depending on your vendor contract.

The loan repayments must be made in substantially level payments over the life of the loan.

Are there any disadvantages to loans?

Yes. Your money will not be invested while it's out of the plan, and you will lose out on any market gains that may occur during that time. You are also paying back pre-tax contributions with after-tax money, so if your tax rate is 25 percent, you are paying 25 percent per year to pay the loan back – in addition to the normal interest that's attached to the loan.

However, the amount of the loan itself is not taxable as long as you pay it back. If you default on the loan, the amount of the loan also becomes taxable to you as income.

What about the Roth 401(k)?

You may have the option of a Roth 401(k), depending on where you work. It is an interesting twist on the traditional 401(k) plan. Instead of putting money away pre-tax, you save after-tax; however, if you comply with its rules, you can take qualified distributions tax-free.

A qualified (tax-free) distribution is generally a distribution that is made after a five-taxable-year period of participation and that is either:

- Made on or after the date that the employee attains age 59½
- Made after the employee's death, or
- Attributable to the employee being disabled

Roth 401(k)s have the same limits on contributions as traditional 401(k)s – $19,000 in 2019 and a $6,000 catch-up if you are over age 50 or reach it in the calendar year.

The limit is combined for pre-tax and Roth contributions, which means that you may not contribute $19,000 to a regular 401(k) and $19,000 to a Roth; the combined amount that may be contributed to both plans is limited to $19,000.

However, unlike a Roth IRA, there is no limit on the amount of money you can earn and still contribute. Other rules, such as those that apply to loans, are similar for Roth and traditional 401(k)s.

Pre-tax 401(k) account balances can be converted to Roth, although income taxes must be paid on the converted funds.

A Roth may make sense for you if any or all of the following conditions apply:

- You are in a low tax bracket now
- You have many years to go until you plan to use the money
- You think you may be in a higher tax bracket at retirement
- You would like to leave some or all of your retirement plan money to your heirs

If you think a Roth 401(k) might work for you, you may wish to talk to a tax professional that can perform calculations to test the benefits of the Roth versus the regular 401(k) – given your specific situation.

What are my investment options in a 401(k) plan?

In 401(k) plans, investments typically consist of the following types:

- Short-term investments such as money market funds, stable value funds and fixed interest accounts
- Bond mutual funds
- Stock mutual funds

These three types of investments all respond differently to economic and financial market conditions. Which type is best for you? For almost everyone, the answer is all of the above. A diversified portfolio will tend to give you better returns for less risk over time.

For further assistance with investing in your 401(k) plan, you should contact your plan provider.

What are the costs of investing in my 401(k) plan?

The costs are largely invisible but still important. For mutual funds, much of the cost will be found in the expense ratios of the funds in the plan.

You see on the news that the S&P 500 index was up 15.10 percent in a particular year. You own an S&P index fund in your retirement plan. Does that mean you earned 15.10 percent last year?

No, because your fund will have an expense ratio. An expense ratio is what a fund charges you to own it. What you earn – your total return – will be the S&P 500's return less the fund's expenses.

Fund expense ratios are expressed as fractions of a percent, called basis points. One hundred basis points equal 1 percent. S&P 500 index funds can cost anywhere from 4 basis points to 148 basis points. That's a wide spread.

If you were holding the same S&P 500 index fund with a 7 basis point expense ratio, your return would have been 15.03 percent. If you were holding a fund with a 148 basis point expense ratio, or 1.48 percent, your return would have been 13.62 percent. Expressed in dollars, the difference in return would have amounted to $141 on a $10,000 account balance.

Other costs:

The funds in the plan may have loads, or sales charges, attached to them. There are many kinds of loads. They can be charged when you buy the fund (front-end loads, usually known as Class "A" shares), when you sell (back-end loads, usually known as Class "B" shares), or over the time that you own the fund (level loads, usually known as Class "C" shares). Loads are expressed as percentages or basis points. If a fund charges you a front-end load of 200 basis points, it will cost you 2 percent to buy it.

How do you know what kind of funds your vendor is offering? That information will be typically included in the name of the fund. "ABC Bond Fund A" will be the "A" (front-end load) share class of ABC Bond Fund.

It is possible, especially with "A" shares, that you will not have to pay the sales charge. Most 401(k) plans, for example, offer "A" shares that are "load-waived." They do not charge the load because they know that retirement plan money tends to stay put for a long time. Therefore, they waive the load on the fund.

How do you find this information?

When in doubt, call the plan vendor and ask.

What kind of load is best? That will depend on you. A do-it-yourselfer may prefer a fund without any load at all, known as a "no-load" fund. Loads can be used to pay for additional services for a fund and to compensate financial advisors, brokers or salespeople. If you choose a fund with a load, "A" shares may be your best option – especially if you plan to hold the fund for a long time.

Your plan or vendor contract may have other costs as well, such as administrative charges, maintenance charges or wrap fees. There can be charges for taking out a loan, for certain types of distributions, for preparing statements, or for performing retirement calculations.

It's important that you understand the total costs of investing in your plan – as well as the benefits you may derive from them – before making a decision. Ask your vendor for a schedule of all charges before you make a decision to buy.

What happens when I retire?

When you retire, you may leave your funds on deposit (if the plan permits) or receive a distribution. You may receive all of your account balance in a lump-sum payment or, if your plan permits, withdraw portions of your account balance as the need arises.

In addition, if the plan permits, you may receive periodic payments from your account such as installment payments or an annuity – which guarantees a level of income for a fixed period or your lifetime, depending on how it is structured. Distributions from your 401(k) plan are taxable unless the amounts are rolled over (see "What are the tax consequences of a withdrawal?" on page 6).

If you receive a lump-sum distribution from a 401(k) plan and were born before 1936, you may be able to elect optional methods of figuring the tax on the distribution. More information on the optional methods can be found in IRS Publication 575 Pension and Annuity Income and in IRS Form 4972 Instructions, Tax on Lump-Sum Distributions.

If you choose to leave your funds on deposit at retirement (assuming the plan/vendor permits this action), you must eventually withdraw at least a portion of your account balance by the required beginning date. The required beginning date is April 1 of the first year after the LATER of the following years:

- Calendar year in which you reach age 70½
- Calendar year in which you retire

However, a plan may require you to begin receiving distributions by April 1 of the year after you reach age 70½, even if you have not retired (this is not common).

You must start taking payments (called Required Minimum Distributions, or RMDs) by April 1 of the year following the year in which you turn age 70½ (or retire, if later). Otherwise, the amount that the IRS calculates you should have withdrawn will be subject to a 50 percent excise tax.

There are IRS tables to determine the correct withdrawal rate once you reach age 70½, but you should speak with a tax professional or financial advisor to determine the proper distribution amount.

What if I have any questions regarding this guide?

Contact NYSUT Member Benefits:

- Phone: 800-626-8101
- Website: *memberbenefits.nysut.org*