# The 401K guide

**A comprehensive resource for retirement planning**

SINCE 1986

BLACKTOWER

FINANCIAL MANAGEMENT GROUP

# INDEX



# About Us

The Blacktower Group was formed in 1986 to provide independent wealth management advice and a bespoke service for both individual and corporate clients around the world.

Having celebrated over 35 years in business, our independent financial advisers continually keep pace with the changing needs of our customers, regulations and legislation. They are led by our Chairman, John Westwood, one of the founders of the firm.

In 2000, Blacktower expanded offshore and opened its first office in the Algarve, Portugal, with Blacktower Financial Management (International) Ltd (BFMI) being established shortly after in 2003. Today, the Blacktower Group has offices in Europe, Gibraltar, the UK, the US, Switzerland, Australia, and Cayman and is continuing to expand its regulatory footprint.

The world of investment and financial planning services is complex, even if you are financially aware, and finding the right products is time consuming. That's why we are here. With our knowledge and expertise we can save you time, money and bring you peace of mind.

We want to help you achieve your financial aspirations, and realise some dreams. So, we're there for you at all the key moments in your life. We believe our role is to listen and understand your needs. Then we use our experience to find the right products for your circumstances, personal or business, home or abroad.

We guarantee, whatever financial planning services you require, you'll get the same high level of professionalism and attention. We also have Consultants throughout our offices in Europe who as well as speaking English, also speak Spanish, Swedish, Danish, Norwegian, French and Italian.

"Renowned globally for our comprehensive wealth management expertise, we offer holistic financial planning services tailored to secure and enhance your financial wellbeing, no matter your location worldwide."

– John Westwood, Group Chairman

Planning for retirement is a critical aspect of financial well-being, and a 401(K) plan can play a significant role in helping to building a secure future. Whether you're just starting your career or nearing retirement, understanding the ins and outs of a 401(K) is crucial for making informed decisions about your financial goals.

This guide aims to provide you overview of 401(K) plans, offering valuable insights into topics such as contribution limits, investment options, rollovers, and withdrawal strategies. We'll explore the benefits of a 401(K) and examine various considerations to help you potentially increaseyour savings potential.

Additionally, we'll delve into common questions and concerns, such as whether to withdraw early from your 401(K) and the importance of diversifying your retirement portfolio beyond your employer-sponsored plan.

No matter your level of financial expertise, this guide is designed to empower you with the knowledge needed to make informed choices regarding your 401(K) plan. Remember, securing a comfortable retirement requires careful planning and informed decision-making. So let's embark on this journey together, unlocking the potential of your 401(K) and paving the way towards a financially secure future.

# What is a 401(K) Plan?

A 401(K) plan is a retirement savings plan provided by many employers in the United States that offers tax advantages for savers. It is named after a specific section of the U.S. Internal Revenue Code (IRC).

When an employee enrolls in a 401(K) plan, a percentage of their paycheck is automatically deducted and deposited into an investment account. In some cases, the employer may also contribute a portion or match the employee's contribution. The employee has the flexibility to choose from various investment options, typically mutual funds.

# How do 401(K) Plans Work?

The purpose of 401(K) plans, established by the U.S. Congress, is to encourage Americans to save for retirement while providing tax benefits. There are two primary types of 401(K) plans, each offering distinct tax advantages.

**Traditional 401(K)**

In a traditional 401(K), the employee's contributions are deducted from their gross income. This means that the money is taken out of the paycheck before income taxes are applied. As a result, the employee's taxable income is reduced by the total amount of contributions made during the year. These contributions can be reported as a tax deduction for that specific tax year. Neither the contributed money nor the investment earnings are taxed until the funds are withdrawn, typically during retirement.

**Roth 401(K)**

In a Roth 401(K), contributions are made with after-tax income. This means that the contributions are deducted from the employee's paycheck after income taxes have been withheld. As a result, there is no tax deduction for the year of contribution. However, during retirement, when the funds are withdrawn, neither the contributed amount nor the investment earnings are subject to additional taxes.

Please note that early withdrawals from a Roth or Traditional 401(K) before the age of 59 1/2 may trigger tax consequences. It is advisable to consult an accountant or qualified financial advisor before making any withdrawals.

It's important to mention that not all employers offer the option of a Roth account. If a Roth 401(K) is available, employees can choose between a traditional and Roth 401(K), or contribute to both up to the annual contribution limit.

# Contributing to a 401(K) Plan

A 401(K) plan operates as a defined contribution plan, allowing both employees and employers to make contributions to the account within the limits established by the Internal Revenue Service (IRS).

Unlike traditional pension plans, which provide a predetermined amount of retirement income, 401(K) plans have gained popularity, with traditional pensions becoming less common. This shift transfers the responsibility and risk of saving for retirement from employers to employees.

Within a 401(K) plan, employees have the responsibility of selecting specific investments from a range of options provided by their employer. These options typically include various stock and bond mutual funds, target-date funds designed to minimize investment risks as retirement approaches, and sometimes guaranteed investment contracts (GICs) issued by insurance companies or the employer's own stock.

### Contribution Limits

The maximum annual contribution limits for a 401(K) plan are periodically adjusted to account for inflation. In 2022, employees under the age of 50 could contribute up to $20,500 per year, with an additional catch-up contribution of $6,500 allowed for those aged 50 and over. For 2023, the limits have increased to $22,500 per year for employees under 50 and an additional catch-up contribution of $7,500 for those aged 50 and over.

If an employer also makes contributions or if an employee opts for additional after-tax contributions to their traditional 401(K) account, there is a total limit for employee and employer contributions each year. In 2022, the limit was $61,000 per year for workers under 50 and $67,500 with catch-up contributions. In 2023, the limit has increased to $66,000 per year for workers under 50 and $73,500 with catch-up contributions.

### Employer Matching

Employers offering 401(K) plans often provide matching contributions based on specific formulas. For example, an employer may match 50 cents for every dollar the employee contributes, up to a certain percentage of their salary. Financial advisors commonly recommend that employees contribute enough to their 401(K) plans to receive the full employer match.

### Contributing to Both Traditional and Roth 401(K)

If an employer offers both traditional and Roth 401(K) plans, employees have the option to split their contributions between the two. However, the total contribution to both accounts cannot exceed the limit set for one account (such as $20,500 for individuals under 50 in 2022 or $22,500 in 2023). Employer contributions can be made to both a traditional and a Roth 401(K), with withdrawals from the former subject to taxation and qualifying withdrawals from the latter being tax-free.

# How Does a 401(K) Generate Returns?

The money you contribute to your 401(K) account is invested based on your chosen options from the selection provided by your employer. These options usually include various stock and bond mutual funds, as well as target-date funds designed to minimize investment losses as you approach retirement.

The growth of your 401(K) account depends on several factors, including the amount you contribute annually, whether your company matches your contributions, the investments you choose, their returns, and the number of years until your retirement. All these elements collectively determine the rate and extent to which your money will grow.

As long as you don't withdraw funds from your account, you won't have to pay taxes on investment gains, interest, or dividends until you make withdrawals after retirement (unless you have a Roth 401(K), in which case you won't have to pay taxes on qualified withdrawals in retirement).

Moreover, if you start a 401(K) at a young age, it has the potential to earn more money for you due to the power of compounding. Compounding means that the returns generated by your savings can be reinvested back into the account, leading to additional returns over time.

Over many years, the compounded earnings on your 401(K) account can actually exceed the contributions you've made. Consequently, by consistently contributing to your 401(K), it has the potential to grow into a substantial sum of money over time.

Since you are investing in securities that will fluctuate, you will experience market fluctuations, periods of negative returns, and loss of principal. A 401(K) does not protect against investment loss.

# Withdrawals From A 401(K)

Once money is deposited into a 401(K), it becomes challenging to withdraw it without incurring taxes on the withdrawal amounts.

It's essential to ensure that you continue saving enough outside of your 401(K) for emergencies and expenses you may have before retirement. Avoid putting all your savings into your 401(K) where accessing it easily may be difficult, if necessary.

The earnings in a traditional 401(K) account are tax-deferred, while those in a Roth 401(K) are tax-free. Traditional 401(K) owners will be taxed as ordinary income when they make withdrawals since the money they withdraw has never been taxed. In contrast, Roth account owners have already paid income tax on their contributions, so they won't owe any tax on their withdrawals as long as specific requirements are met.

Both traditional and Roth 401(K) owners must be at least 59½ years old (or meet other IRS criteria, such as being totally and permanently disabled) when they start making withdrawals to avoid a penalty. This penalty typically amounts to an additional 10% early distribution tax on top of any other taxes owed.

Some employers allow employees to take out loans against their 401(K) contributions. Essentially, the employee borrows from their own account. If you take out a 401(K) loan and leave your job before repaying it, you'll need to repay it in a lump sum or face the 10% penalty for an early withdrawal.

# Required Minimum Distributions (RMDs)

Traditional 401(K) account holders are subject to required minimum distributions (RMDs) once they reach a certain age. These distributions, often referred to as withdrawals, must be taken by account owners who have retired starting at age 73, beginning from January 1, 2023. The size of the RMD is calculated based on the account owner's life expectancy at that time. Previously, the RMD age was 70½ years old, which was updated to 72 before being further adjusted to age 73 in the omnibus spending bill H.R. 2617 in 2022.

It's important to note that distributions from a traditional 401(K) are taxable, while qualified withdrawals from a Roth401(K) are not. Unlike Roth 401(K)s, Roth IRAs are not subject to RMDs during the owner's lifetime.

# Traditional 401(K) vs. Roth 401(K)

When 401(K) plans were introduced in 1978, employees and companies only had the option of a traditional 401(K). However, in 2006, Roth 401(K)s were introduced. The name “Roth” comes from former U.S. Senator William Roth of Delaware, the primary sponsor of the 1997 legislation that made the Roth IRA possible.

While it took some time for Roth 401(K)s to gain popularity, many employers now offer them. Therefore, the initial decision for employees often involves choosing between a Roth and a traditional 401(K).

As a general rule, if you anticipate being in a lower tax bracket after retirement, opting for a traditional 401(K) and taking advantage of the immediate tax break might be advantageous. On the other hand, if you expect to be in a higher tax bracket after retiring, choosing a Roth 401(K) would allow you to avoid taxes on your savings later. Additionally, especially if the Roth account has many years to grow, the fact that all the earnings on the contributions are tax-free makes it an attractive option.

Practically speaking, a Roth 401(K) reduces your immediate spending power more than a traditional 401(K) plan, which could be a consideration if you have a tight budget.

Since it’s impossible to predict tax rates decades in advance, neither type of 401(K) offers a guaranteed advantage. For this reason, many financial advisors recommend diversifying and allocating funds to both types of accounts as a way to hedge against uncertainty.

# When You Quit Your Job

Leaving your employment at a company and having a 401(K) plan entails several options to consider:

**Cash Withdrawal**

Withdrawing the funds from your 401(K) is generally not recommended unless you have an urgent need for the money. The withdrawn amount will be subject to taxation in the year of withdrawal. Additionally, if you are under 59½ years old, you will also face a 10% early distribution tax unless you meet certain exceptions outlined by the IRS, such as being permanently disabled or meeting specific criteria.

If you have a Roth 401(K), you can withdraw your contributions (excluding any profits) tax-free and without penalties as long as your account has been active for at least five years. However, keep in mind that withdrawing from your retirement savings will reduce the amount you have saved for the future, which may have negative consequences later on.

**Roll Over Your 401(K) Into an IRA**

By transferring your funds into an Individual Retirement Account (IRA) at a brokerage firm, mutual fund company, or bank, you can defer taxes and maintain the tax advantages of your account. Moreover, you gain access to a broader range of investment options compared to your employer's plan.

It's important to be aware of the IRS rules regarding rollovers as they must be conducted correctly to avoid costly mistakes. The financial institution receiving the funds will typically assist you in the rollover process to ensure compliance.

To avoid taxes and penalties, any withdrawn funds from your 401(K) must be rolled over to another retirement account within 60 days.

**Leave Your 401(K) With Your Former Employer**

In many cases, employers allow departing employees to keep their 401(K) account in the old plan indefinitely, provided the account holds a minimum value of $5,000. However, you won't be able to make further contributions to this account. If your account is below the minimum threshold, your employer may require you to move the funds elsewhere.

Leaving your 401(K) with your previous employer can be a viable option if their plan is well-managed and offers satisfactory investment choices. However, the risk lies in accumulating multiple old 401(K) accounts over the course of your career, which you may forget about. Furthermore, your heirs might be unaware of the existence of these accounts.

**Transfer Your 401(K) To Your New Employer**

In most cases, you can transfer your 401(K) balance to your new employer's plan. This transfer, similar to an IRA rollover, maintains the tax-deferred status of the account and avoids immediate taxes.

Transferring your funds to a new employer's plan may be a wise decision if you prefer to rely on the plan administrator to handle investment decisions rather than managing a rollover IRA yourself.

# How To Start A 401(K)?

The easiest way to begin a 401(K) plan is through your employer. Many companies offer 401(K) plans, and some even match a portion of your contributions. When you join such a company, the necessary paperwork and payments for your 401(K) will be handled during the onboarding process.

If you're self-employed or run a small business with your spouse, you may qualify for a solo 401(K) plan, also known as an independent 401(K). These retirement plans allow freelancers and independent contractors to save for retirement, even without being employed by another company. Solo 401(K) plans can be established through most online brokers.

# What Is The Maximum Contribution To A 401(K)?

For most individuals, the maximum contribution to a 401(K) plan is $20,500 in 2022 and $22,500 in 2023. If you are aged 50 or older, you can make an additional catch-up contribution of $6,500 in 2022 (for a total of $27,000) and $7,500 in 2023 (for a total of $30,000). There are also limitations on the employer's matching contribution. The combined contributions from the employer and employee cannot exceed $61,000 in 2022 (or $67,500 for employees over 50 years old) and $66,000 in 2023 (or $73,500 for employees over 50 years old).

# Is Taking Early Withdrawals From Your 401(K) A Good Idea?

There are few advantages to taking an early withdrawal from a 401(K) plan. If you withdraw funds before reaching the age of 59½, you will face a 10% penalty in addition to any taxes owed. However, some employers allow hardship withdrawals for sudden financial needs, such as medical costs, funeral expenses, or purchasing a home. While this may help you avoid the early withdrawal penalty, you will still be subject to taxes on the amount withdrawn.

# What Is the Main Benefit Of A 401(K)?

A 401(K) plan offers the advantage of reducing your tax burden while saving for retirement. Not only do you benefit from tax-deferred gains, but the process is also convenient as contributions are automatically deducted from your paycheck. Additionally, many employers provide matching contributions to their employees' 401(K) plans, effectively boosting their retirement savings for free.

A 401(K) plan is a retirement plan provided by employers that allows you to make annual contributions up to a specific limit and invest that money for your post-employment years. There are two types of 401(K) plans: traditional and Roth. The traditional 401(K) involves pre-tax contributions that provide a tax break but require ordinary income tax payment upon withdrawal. The Roth 401(K) involves after-tax contributions with no upfront tax benefit, but withdrawals in retirement are tax-free. Both types allow for employer contributions, which can further enhance your savings.

For professional advice on setting up and managing your 401(K) to get the most from your money, and safeguard your retirement, get in touch. One of our advisers will walk you through the options and help you find the best options that the advisor believes aligns with your investment objectives..

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