ANSWERS TO COMMON AND NOT-SO-COMMON 401(K) QUESTIONS

The 401(k) is one of the most popular retirement plan accounts; what is it all about?

Question 1: What can I do with company stock in my 401(k)?

Answer: Companies will often incentivize employees by allowing them to purchase stock in the company through their 401(k). This has the mutual benefit of allowing the employee to have ownership in the company, while also allowing any appreciation of the stock to occur tax deferred. Typically, when an employee decides to take proceeds from their 401(k) it is taxed at ordinary income rates since the contributions were made to the plan using pre-tax dollars (basically, they haven't been taxed yet).

What is unique about company stock, however, is that employees have an added option to utilize what is known as Net Unrealized Appreciation to potentially liquidate the company stock and receive those proceeds at a lower tax rate. This is achieved by first transferring the shares of company stock to a taxable brokerage account, paying income tax on the cost-basis of the stock, then selling the stock and paying capital gains tax on any appreciation, rather than regular income tax rates. While the original cost-basis of the stock is considered ordinary income in this situation, any added value the stock has achieved is taxed at long-term capital gains rates.

For example, if an individual transferred $200,000 of company stock from a 401(k) to a brokerage account that originally had a cost basis of $50,000, the individual would have $50,000 of ordinary income once the stock is transferred to the brokerage account. If they sold the stock, they would recognize $150,000 of long-term capital gains. If the stock had instead been sold within the 401(k), proceeds transferred to an IRA, then distributed as cash, the full $200,000 would be taxable at ordinary income tax rates.

Question 2: Should I borrow against my 401(k)?

Answer: Most 401(k) providers allow plan participants to take out loans against their 401(k) based on the total market value of the account at any given time. While this can be a valid option for some employees, there are a few considerations to consider prior to borrowing funds using a 401(k) as collateral. First, the interest rates for loans against a 401(k) may vary and should be carefully considered when determining if the employee will be able to make the required payments on the loan. Be sure to look at other types of personal loans to determine if rates may be better.

Secondly, interest and principal payments on the loan are made with after-tax dollars, defeating much of the purpose of having a tax-deferred account for retirement. Third, and most importantly, repayment rules are strict. If an employee is fired from their job or laid off, the loan will need to be repaid within sixty days. If the employee leaves voluntarily, the full loan balance may become due immediately!

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If the full balance of the loan can't be paid in either scenario, then any amount due will come out of the 401(k) account, which is then not only considered taxable income to the employee, but also subject to a 10 percent penalty if the employee is under 59½. You really can't have your cake and eat it too.

Question 3: What happens to my 401(k) when I move jobs? Or when I retire?

Answer: When an employee decides to change companies or retires, they have a few different options for their 401(k) plan. First, the employee may elect to keep their money in the former employer's plan, but there may be limitations based on the plan's rules as to whether an account balance is large enough, how the funds are invested, and if additional funds may be added. Second, moving the 401(k) to a new employer's 401(k) may be an option by "rolling it over". Again, this may be subject to limitations or rules of the new plan.

Third, the old 401(k) plan may be moved to an IRA or a Roth IRA via a rollover. As previously noted, IRA and Roth IRA accounts have different rules on the taxability of distributions, so talking to an advisor about those ramifications is important. Lastly, there is the option of distributing the balance of the 401(k) in cash. While this option has the benefit of providing the employee with liquidity, it has several downsides. Distributions may not only be considered taxable income, but they will also be subject to a 10 percent penalty if the employee is less than 59½ years old.

Question 4: What are some limitations of a 401(k) I should know about?

Answer: While the tax deferred benefits of a 401(k) plan and any matching employer contributions can be beneficial, there are a few limitations about these kinds of plans that should be noted. First, the maximum amount each year that can be contributed to a 401(k) in 2018 is $18,500 and that amount increases to $24,500 for individuals over the age of 50. Secondly, in the event an employee leaves their work or retires, and elects to rollover their 401(k), they have 60 days from the time they receive the distribution to the date they deposit the funds in the new account. If proceeds are not deposited in time, they will be considered taxable income to the employee. Finally, remember that 401(k) proceeds can only be moved via a rollover once a year, so if an employee leaves their company and wants to move their funds, they can only do so at one time during the calendar year.

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