Mariner
WEALTH ADVISORS

Answers to 401(k) Questions

Here are a few answers to less-common questions about 401(k) retirement accounts.

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 his or her 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 the employee then sold the stock, he or she would recognize $150,000 of long-term capital gains. If the stock had instead been sold within the 401(k) and the proceeds transferred to an IRA and then distributed as cash, the full $200,000 would be taxable at ordinary income tax rates. Keep in mind that individuals under the age of 59½ will be subject to a 10% early withdrawal penalty on distributions from an IRA.

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 be aware of 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.

Second, 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 can be strict. If an employee leaves for any reason (voluntarily or involuntarily), the loan may need to be repaid immediately. Some companies give plan participants up to 60 days to repay their loans and others may allow them to set up loan payments outside of their 401(k).

If the full balance of the loan can't be paid, 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% penalty if the employee is under age 59½.

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, there are a few different options for his or her 401(k) plan. First, the employee may elect to keep 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 whether 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. IRAs and Roth IRAs have different rules on the taxability of distributions, so talking to an advisor about those ramifications is important.

Finally, there is the option of taking a distribution of the 401(k) balance in cash. While this option has the benefit of providing the employee with liquidity, it has several downsides. Distributions may be considered taxable income and may be subject to a 10% 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 with plans that should be noted. First, the maximum amount that can be contributed to a 401(k) in 2023 is $22,500 and that amount increases to $30,000 for individuals over the age of 50 ($7,500 in catch-up contributions allowed for those age 50 or older).

Second, in the event that an employee leaves work or retires and elects to roll over a 401(k), he or she has 60 days from the date of the distribution to deposit the funds in a 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 a company and wants to roll over his or her funds, he or she can only do so at one time during the calendar year.

For more information visit: marinerwealthadvisors.com

"7 Things You Need to Know if You're Considering a 401(k) Loan," fool.com

"Rolling Over Company Stock," Investopedia

"Retirement Topics-Contributions," irs.gov

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