Are 401(k)s Worth It?

Weigh the potential drawbacks and benefits as you consider how to save for the future.

While 401(k) plans typically come with benefits that promote long-term saving, you might find some drawbacks as well. Understanding the potential downsides of 401(k)s, along with how to resolve or work around them, can help you better plan for your financial future.

Some of the common disadvantages of 401(k)s include:

- A small or nonexistent company match.
- High fees associated with the account.
- Few investment opportunities for your funds.

- A wait until you can keep company contributions.
- Difficulty accessing funds early.
- Tax implications for withdrawals.

Here is a look at some of the problems associated with 401(k)s and what you may be able to do to make up for each downside.

The 401(k) Match Is Minimum

Some employers offer to match up to a certain amount of your contributions to the plan. For instance, your employer might offer to contribute 50 cents for every dollar you save in the plan up to 5% of your salary. If you earn $50,000 a year and contribute $2,500 into the account, your employer will contribute $1,250.

Not all employers offer a 401(k) match, and even if they do, the match might not seem like much. A match of 50% of your contributions up to $500 would indicate that if you contribute $2,500 to the account, the employer would add $500.

If you're unsure whether your company provides a match, you can check with your employer. If there is a match, it is generally worthwhile to contribute enough to get the maximum match. "That's free money for you," says Rafael Rubio, president of Stable Retirement Planners in Southfield, Michigan. If there is no match, you can still easily save throughout the year by having funds automatically taken from each paycheck.

You're allowed to make 401(k) contributions of up to $19,500 of your own salary in 2021, and if you're 50 or older, you can put an additional $6,500 into the plan. The amount you contribute will be deducted from your salary and will not be considered taxable income until it is withdrawn from the account. This could give you a tax break for every year you make contributions to the account.

High 401(k) Fees

401(k) plans typically come with a number of expenses which might include management fees and recordkeeping fees. "Plans are required to distribute fee disclosures annually," says Julian Schubach, vice president of wealth management at ODI Financial in Lynbrook, New York. Still, it can be difficult to find these communications. "Most participants have no idea what fees they are paying," Schubach says.

To learn about the costs involved with your 401(k), you can ask the HR department or plan sponsor to help you decipher the fine print. You could also compare the fees to the match: If your employer offers a high match, those contributions might outweigh the costs of the account.

Few 401(k) Investment Opportunities

When you place funds into the 401(k) account, you'll have the option of purchasing different types of investments. However, you might find that the selection is limited. "Plan sponsors traditionally put together a list of 20 to 25 mutual funds, half of which are target-date funds," says Chris Gure, an investment consultant at Fortress Financial Partners in Raleigh, North

Carolina. A target-date fund is a collection of investments designed to grow more conservative over a time frame until a set date in the future. Target-date funds usually coincide with the year that an individual expects to retire.

Take care to compare all the investment options that are available in your 401(k) plan. You may be able to find a selection that suits your financial needs. You might also consider investing some funds in a separate account, such as a Roth IRA, which could provide additional investment choices.

A Wait Until You Can Keep Company Contributions

If your employer contributes funds to your 401(k), the funds might not immediately belong to you. Companies often have vesting schedules, which refers to the length of time you need to stay at a given job until you own the company contributions. If you leave your job before the funds are vested, you won't receive the money that still belongs to your employer. When funds are fully vested, they will remain in your account even if you switch to a different company.

Difficulties Accessing 401(k) Funds

When money is placed into your 401(k) account, the plan is designed for the funds to remain there for a long time. "In most circumstances, distributions from a 401(k) plan prior to age 59 1/2 are subject to early withdrawal penalties of 10% plus federal and state income taxes," says Chance Burroughs, a financial advisor at Manske Wealth Management in Houston, Texas. Certain plans allow for a 401(k) loan or hardship withdrawals if you run into a financial emergency. However, if you borrow from the account, you'll usually have to pay the amount back plus interest within five years.

401(k) Tax Implications

When you contribute money to your 401(k) plan, the amount is deducted from your salary and you won't be taxed on it during the year you make the contribution. However, you will have to pay income tax on your contributions and the investment gains when you withdraw funds from the account. "Without knowing for certain how your 401(k) will perform or what the taxes will be in the future, your 401(k) can be a ticking tax time bomb," Rubio says.

To lower your risk of high taxes, it can be helpful to monitor the account and forecast your upcoming income. Think about your required minimum distributions, which are withdrawals you'll need to start taking at age 72. "Calculate what your RMD will be at the age of 72," Rubio says. "This will allow you to estimate what tax implications you will have." The exercise may also allow you to determine whether to invest more in other vehicles like a Roth IRA, which taxes the contributions in the year you make the deposit but not when you withdraw the funds later.

Reduce Your Tax Bill by Saving for Retirement