6 Benefits of a 401(k) Plan You Haven't Considered

Your company's retirement plan gives you more than just an employer match.

Payroll deductions towards a 401(k) plan make it simple to fund retirement savings.(GETTY IMAGES)

As employers phased out traditional pensions, 401(k) plans were introduced to fill the gaps. Named for the subsection of Internal Revenue Service code that allows for them, these accounts have become the primary retirement savings vehicle for many people.

"Just having one is really important," says Jodan Ledford, CEO of Smart USA, a global recordkeeper that offers pooled retirement plan solutions.

He points to data from the Employee Benefit Research Institute showing that those with access to retirement plans accrue significantly more savings. The 2020 Retirement Confidence Survey from EBRI found 51% of retirees with a retirement plan had at least $250,000 in savings and investments, while only 5% of those without a plan retired with that amount.

One reason workplace retirement plans are so valuable is that employers often will match a percentage of an employee's contributions, providing an immediate boost to retirement savings. However, there are also some lesser-known perks of 401(k) plans that may appeal to employers as well as employees.

Here are six 401(k) advantages you may have overlooked:

- Multiple options for tax benefits.
- After-tax contributions.
- Financial safeguards.
- Automatic enrollment.
- Loans and early withdrawals.
- Means to attract and retain top talent.

Multiple Options for Tax Benefits

Depending on the plans offered by their employer, workers may be able to choose whether to pay taxes on their retirement funds now or later.

Contributions of up to $19,500 to traditional 401(k) accounts are tax-deductible in 2021. Workers age 50 and older can benefit from catch-up contributions for a total of $26,000 in tax-deductible contributions this year. Money grows tax-deferred and then is subject to regular income tax when withdrawn in retirement. At age 72, retirees must begin taking required minimum distributions, also known as RMDs, regardless of whether they need the money.

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"The way I look at the tax deduction is as an IRS match," says Dan Hill, president and CEO of Hill Wealth Strategies in Richmond, Virginia. For someone in the 22% tax bracket, for instance, every dollar contributed to a traditional 401(k) could result in 22 cents of tax savings.

Many employers also offer a Roth 401(k) option. This newer version of the 401(k) plan doesn't offer deductions for contributions. After-tax money is deposited into the account, and withdrawals in retirement are then tax-free. There are no RMDs with a Roth 401(k).

Both accounts come with 401(k) tax benefits, and which you choose will depend on your personal circumstances. For younger workers who have mortgage and child deductions now and may have significant gains in their investments over the years to come, it may make sense to forego an immediate tax deduction in favor of a Roth 401(k) that could result in substantial tax savings later.

After-Tax Contributions

In addition to making deductible and Roth contributions to a 401(k), workers have the option of making what are known as after-tax contributions. This ability opens up some other savings possibilities.

The first is a strategy known as a "mega backdoor" Roth. In 2021, the government allows up to $58,000 in combined employee and employer contributions to a 401(k) for younger workers and $64,500 for those age 50 and older. Those with annual incomes lower than these amounts are limited to contributions equal to 100% of their compensation.

Assuming someone has maxed out their tax-advantaged contributions, they could make up to $38,500 in after-tax contributions to a 401(k) depending on if and how much their employer matches. Assuming it is allowed by the employer, this after-tax money can then be transferred to a Roth IRA so that future gains can be withdrawn tax-free.

There's only a small percentage of workers who have the financial means to make contributions of that size. That means the mega backdoor Roth strategy isn't going to benefit most workers, but it's a valuable tool for those who are able to use it.

However, after-tax contributions also show promise as a means for workers to conveniently build up nonretirement savings. Some plans allow workers to make automatic after-tax contributions to their 401(k) account that can be used for an emergency fund. This money can be accessed whenever needed, and any withdrawals of the principal amount can be made without having to pay taxes or penalties.

Financial Safeguards

All 401(k) plans must comply with the Employee Retirement Income Security Act, commonly called ERISA. As a result, employers have a fiduciary responsibility to create a plan based on their employees' best interests.

Plan administrators can't push investments that maximize profits. Instead, they need to ensure workers have access to stable funds with reasonable fees. They also must disclose information such as administrative expenses and historical fund performance to help employees make informed investment decisions.

Employers shouldn't let these requirements discourage them from offering a 401(k) plan though. "Online technology makes it easy to do," says Denise Stefan, agency president for Engage PEO, an organization providing human resources solutions to small and midsize businesses. Businesses can easily outsource plan administration to firms such as Engage PEO if they don't want to hassle with the paperwork themselves.

For workers, another benefit of ERISA is that it protects assets from creditors. In the event a judgment is entered against a worker, assets held in qualified funds such as 401(k) accounts cannot be garnished. However, this protection does not extend to certain government garnishments such as those for federal income taxes or criminal fines.

Automatic Enrollment

The convenience of 401(k) plans is an often overlooked benefit. Not only do payroll deductions make it simple to fund retirement savings, but many companies have also set up automatic contributions for new hires.

When investing for retirement, starting early can be important to maximizing gains. However, signing up for a 401(k) plan isn't always at the forefront of a worker's mind when starting a new job.

To keep workers from procrastinating, many companies now auto-enroll their workers in a 401(k) plan. As a result, 93% of new hires at those businesses are saving for retirement, compared to 47% at companies that don't auto-enroll, according to a 2018 study by investment firm Vanguard. Some will also automatically increase the amount of a worker's contribution every year.

Since these contributions are made via payroll deductions, it is a relatively painless way to start saving for retirement.

Loans and Early Withdrawals

Normally, withdrawing money from a 401(k) account prior to age 59 1/2 results in a 10% tax penalty. However, these plans have provisions that can turn them into a safety net during difficult financial times.

“Best practices are, obviously, to have emergency savings outside of the retirement plan,” Ledford says. But if those aren’t available, taking a loan from a 401(k) may be an option.

Typically, loans are capped at 50% of the vested balance, up to $50,000 total. Loan payments can then be paid back using convenient payroll deductions. However, if you leave your job, be aware that any outstanding balance must be paid back by the next tax filing deadline. Otherwise, the loan may become taxable and subject to the 10% penalty.

Money from a 401(k) may also be accessed through hardship withdrawals for reasons such as medical care, college tuition and funeral expenses. Early retirees are allowed to pull money from their account before age 59 1/2 as well. That means someone who leaves an employer at or after age 55 can take withdraws for any reason without penalty.

Taking a loan or an early distribution from a 401(k) account can have a negative impact on your long-term savings, so be smart about using this financial tool. "I know people who have taken loans for Harley Davidsons and pools," Hill says. Those sorts of discretionary purchases are not a good use of retirement funds.

Means to Attract and Retain Top Talent

While workplace retirement plans have clear benefits for employees, business owners may be wondering: Are 401(k)s worth it? The answer, according to some human resources experts, is yes.

“401ks are among the No. 1 thing that employees are looking for today,” Stefan says. Not only can they help a company attract qualified workers, but a good plan may keep them on the job.

New pooled plans also make it easier for smaller companies to offer retirement benefits to their employees. “The friction to set up a plan is going to be alleviated,” Ledford says. Authorized by the SECURE Act, pooled employer plans allow small firms to join together to create the economies of scale that large firms may enjoy in their retirement plans. Using a pooled plan provider may also simplify the process of setting up and administering a retirement plan.

A 401(k) plan comes with valuable tax benefits for employees as well as employers, but that isn't the only reason to love these accounts. They can also give you the tools to make smart investment decisions, build emergency savings and more.

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