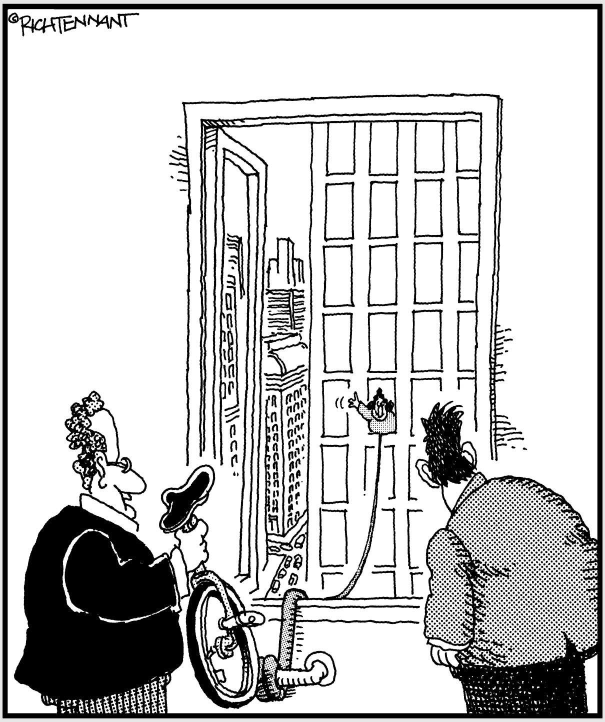
Part I

Getting Started

The 5th Wave By Rich Tennant



"Oh, her? That's Ms. Lamont, our plan administrator. She's going to help me determine your eligibility in our 401(k) plan."

In this part . . .

Saving in a 401(k) is potentially one of the best deals that you'll ever get. 401(k) plans offer significant tax breaks and other advantages, and very few drawbacks. But you have to know what you're doing in order to get the full benefit from your plan. This part explains how 401(k) plans work, how to evaluate the plan your employer offers, and what to do when you sign up for your plan.

Chapter 1

Benefiting from Your 401(k)

In This Chapter

- Understanding how a 401(k) plan works
- Getting the most tax savings, extra money, and other advantages
- Improving your chances for an ideal retirement

Not too long ago, many people would ask, "What the heck is a 401(k)?" Today, however, 401(k) is a household word. People discuss their 401(k) investments at social gatherings. These once-obscure plans are in the national media nearly every day.

401(k) plans have helped more than 40 million workers save for retirement. Because Social Security alone won't provide adequate retirement income, and fewer companies offer a traditional pension plan, 401(k)s have become an essential part of the average worker's future plans.

Even young people, for whom retirement would normally be low on the priority list, have jumped on the retirement savings bandwagon. They're the smart ones, because in some respects, *how long* you save is more important than *how much* you save.

Unfortunately, the stock market nosedive and corporate scandals in the early 2000s caused 401(k) plans to come under some fire. Many workers who made bad investment choices saw large drops in the value of their accounts. Some blamed the 401(k) itself, but that's like blaming the messenger who brings you bad news. If you take the time to understand and follow basic investing principles (see Chapters 5 and 6), your 401(k) can grow into a nest egg that can help you retire comfortably.

The beauty of a 401(k) is that it makes saving easy and automatic, and you probably won't even miss the money that you save.

Defining What a 401(k) Does for You

A 401(k) plan lets you put some of your income away *now* to use *later*, presumably when you're retired and not earning a paycheck. This procedure may not appeal to everyone; human nature being what it is, many people would rather spend their money now and worry about later when later comes. That's why the federal government approved tax breaks for 401(k) participants to enjoy now. Uncle Sam knows that your individual savings are going to be an essential part of your retirement, and wants to give you an incentive to participate.

When you sign up for a 401(k) plan, you agree to let your employer deposit some of your paycheck into the plan as a *pre-tax contribution*, instead of paying it to you. Your employer may even throw in some extra money known as a *matching contribution* (see Chapter 2). You don't pay federal income tax on any of this money until you withdraw it.

Of course, there's a catch. Some 401(k) plans may not allow you to withdraw money while you're still working. Even if yours does allow you to withdraw money while working, if you're under 59½ years old, withdrawals can be difficult and costly. Check out Part III for a full explanation of these rules and regulations.

How much your 401(k) will be worth when you retire depends on a number of factors, such as what investments you choose, what return you get on those investments, whether your employer makes a contribution, and whether you withdraw money early. The next few sections take a look at the benefits of participating in a 401(k).

Lowers how much tax you pay

A 401(k) lets you pay less income tax in the following two ways:

- **Lower taxable income:** You don't have to pay federal income tax on the money you contribute pre-tax to your 401(k) plan until you withdraw it from the plan.
- **Tax deferral:** You don't pay tax on your 401(k) investment earnings each year — only when you make withdrawals.

The government provides these big tax breaks in an attempt to avoid having a country full of senior citizens who can't make ends meet. (Nice to know the government's on top of things, huh?)

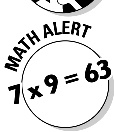
Lower taxable income

The money that you contribute to a 401(k) reduces your *gross income,* or *taxable income* (your pay before tax and any other deductions). When you have lower taxable income, you pay fewer of the following income or wage taxes:

- **Federal taxes:** These taxes increase as your income increases — for 2002, the rate for most workers is either 15 or 27 percent, and the top tax rate is 38.6 percent.
- **State taxes:** Many states impose their own income or wage taxes, ranging from less than 1 percent to as much as 12 percent in 2002, depending on the state.
- **Local/municipal government taxes:** Many local and municipal governments also have income or wage taxes.

In most states, you aren't required to pay state or local taxes on contributions to your 401(k). However, a few states may require you to list all or part of the money that you contribute to a 401(k) as taxable income on your state tax return. You still get the federal tax break, however. Check with your state and local tax authorities if you're not sure what the rules are where you live.

Taxes that you don't avoid, because everybody has to pay them on gross income (including 401(k) contributions), are Social Security/Medicare (FICA) and unemployment (FUTA).



Here's an example of how you save money when you contribute some of your pay pre-tax to a 401(k). Assume that:

- Your gross pay is $2,000 each pay period.
- You're in the 27 percent federal tax bracket.
- Your state income tax is 2 percent, local income tax is 1 percent, and your FICA/FUTA taxes are 7.65 percent.
- Contributions you make to a 401(k) plan are exempt from state and local tax.

Say you don't contribute to a retirement plan. Look what happens to your income after you pay all those taxes:

Gross pay	$2,000
Federal income tax	–$350
State income tax	–$40
Local wage tax	–$20
FICA/FUTA taxes	–$153
Take-home pay	$1,437

Now assume that you contribute 6 percent, or $120, per paycheck to a 401(k) plan. Your FICA/FUTA taxes will be the same, but the other taxes are lower because they're based on a lower income (your gross income minus your retirement contribution). Here's how it breaks down:

Gross pay	$2,000
Retirement contribution	–$120
Federal income tax	–$329
State income tax	–$38
Local wage tax	–$19
FICA/FUTA taxes	–$153
Take-home pay	$1,341

You invested $120 for your retirement, but your take-home pay is reduced by only $96. For the time being, you're up $24 that would otherwise have gone to the government. You don't have to pay these taxes until you withdraw your money from the plan. As a general rule in this tax bracket, if you contribute $1, your take-home pay is reduced only by about 70 to 80¢.

Here's another way of looking at it. Without a 401(k) plan, taxes eat away the money that you could save. Assume that your employer doesn't offer a 401(k) or other retirement plan, and your total tax rate is 37.65 percent (7.65 percent FICA/FUTA, 27 percent federal income tax, 2 percent state income tax, and 1 percent local wage taxes). After paying these taxes, it takes almost 16 percent of your gross income to have 10 percent left to invest for retirement. The following example shows how this works.

Assume that you earn $50,000 a year, and your goal is to save 10 percent, or $5,000. You would have to earn $8,017 in order to have $5,000 left "after-tax."

Pre-tax earnings required	$8,017
Federal income tax	–$2,164
State/local wage tax	–$240
FICA/FUTA taxes	–$613
Amount left to save	$5,000

Now assume that your employer offers a 401(k) plan, and you can save the $5,000 in your 401(k) account. In this case, the only tax you have to pay at the time you make the contribution is FICA/FUTA. As a result, you need to earn only $5,414 in order to be able to contribute $5,000 to the 401(k) plan.

Pre-tax earnings required	$5,414
Federal income tax	–$0
State/local wage tax	–$0
FICA/FUTA taxes	–414
Amount left to save	$5,000

REMEMBER

Without a 401(k) plan, it takes you $8,017 in pre-tax income to save $5,000 after taxes. When you can save pre-tax money in your 401(k), it only takes $5,414 to save the same $5,000. In other words, with a 401(k), it will cost you less of your current earnings to save the same amount. Pretty good deal, don't you think?

TIP

Some plans allow you to make *after-tax* contributions. You don't get the initial tax break of lower taxable income, but you do benefit from deferring taxes on your investment earnings.

Tax deferral

In addition to the income tax savings on your contributions, you also save when it comes to paying tax on your investment earnings.

The gains in your 401(k) aren't taxed annually, as they would be in a regular *taxable* bank savings account, a personal mutual fund account, or a brokerage account (which you may use to buy and sell stocks and other investments). With a 401(k), you defer paying taxes on your investment earnings until you withdraw the money.

Figure 1-1 shows how tax-deferred compounding lets your money grow faster than it would in a taxable account. It compares the results of investing $5,000 at a 9 percent return in a tax-deferred account with investing $3,750 in a taxable account ($3,750 = $5,000 less income tax) at a 9 percent return, taxed each year at a 25 percent tax rate.

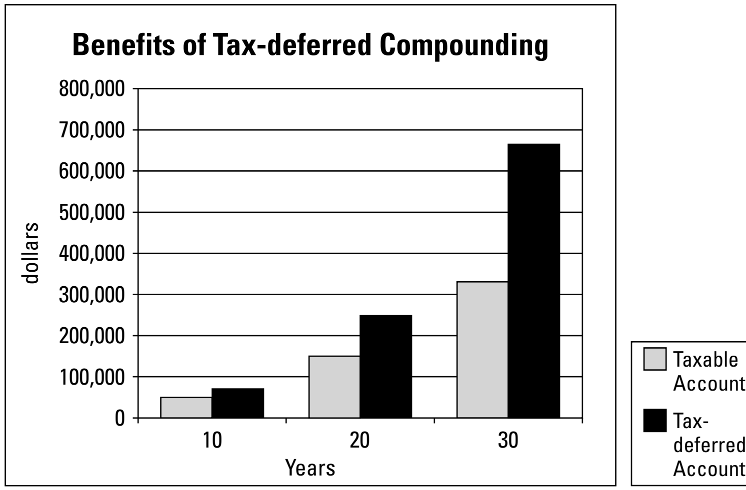


Figure 1-1: Positive impact of tax-deferred compounding.

Gets you something extra from your employer

Whoever said there's no such thing as a free lunch didn't know about *employer matching contributions* — money that your employer will contribute to your 401(k) if you contribute to the plan. (Not all employers make this type of contribution, but many do.)

The most common formula is for the employer to put in 50¢ for every dollar you contribute up to 6 percent of your salary. Because 50¢ is half of one dollar, the most your employer will contribute is half of 6 percent, or 3 percent of your salary. You get this full 3 percent only if you contribute 6 percent of your salary. Chapter 2 gives examples of how this matching contribution works.

REMEMBER

The employer matching contribution can be the single most important feature of your 401(k) plan. The more you get from your employer, the less you have to save out of your own paycheck to achieve an adequate level of retirement income. In fact, if your employer offers a matching contribution, make sure that you contribute enough to your plan to get it all. If you don't, this money will be lost to you.

How 401(k) became a household "word"

The 401(k) is named after the section of the IRS "rulebook" (the Internal Revenue Code, or IRC) that governs how it works.

Section 401 applies to many different tax-qualified retirement plans — those with special tax advantages for you and your employer. It begins with paragraph (a) and includes paragraph (k), which was added when Congress enacted the Tax Reform Act of 1978.

Paragraph (k) was one of those special interest paragraphs added to the bill in the 11th hour. Its original objective was to cover a specific type of Section 401 plan that was sponsored by banks for their own employees.

It was only a couple of years later, when Ted was designing a retirement plan for a company, that he realized that paragraph (k) offered additional possibilities. The result was the first 401(k) savings plan with employer matching contributions and employee pre-tax contributions made through payroll deductions. It wasn't universally accepted at first, but after the Treasury Department okayed it in 1981, it began to catch on.

And the rest, as they say, is history.

TIP

You may have to stay with your company for a minimum length of time before the employer contributions *vest,* or belong to you, a topic we discuss in more detail in Chapter 2. But if you can meet that requirement, the money's yours, as well as any return it's earned in the meantime.

Saving Without Tears

A big benefit of signing up for your 401(k) plan is that you don't have to think about the fact that you're saving. "Out of sight, out of mind" is what happens to most people — they don't even miss the money, because it's taken out of their paycheck before they have a chance to spend it.

This semi-forced savings is one of the most valuable benefits of 401(k) plans. The payroll deduction has the power to convert spenders into savers. Most people are unable to save over a long period of time if they have to physically write the check or make the deposit each pay period. Saving becomes the last, not the first, priority. Many participants have said that the 401(k) has helped them save thousands of dollars that they otherwise would have spent carelessly.

It's a good idea to increase your 401(k) contributions if you get a raise or a bonus. In fact, do it right away so that you don't get used to spending the extra money.

Taking Your Savings with You When You Change Jobs

When you change jobs, you can take your 401(k) money with you — and keep the tax advantages — by putting it into your new employer's 401(k), 403(b), or 457 plan, or into an IRA (Individual Retirement Account).

Transferring your money to a new employer's plan or an IRA is known as a *rollover* or *trustee-to-trustee transfer.* See Chapter 8 for more on rolling your money into an IRA; see Chapter 10 for details about 403(b)s, and Chapter 11 for information about 457 plans.

Many employers require you to work for a minimum number of years before the employer contributions are yours to keep (known as *vesting*). See Chapter 2 for more details on vesting procedures.

Because your 401(k) is "portable," you can build up a retirement nest egg even if you change jobs fairly frequently. This beats the traditional defined-benefit pension plan (in which you receive a set amount from your employer each month in retirement, if you qualify). With those plans, you can lose *all* retirement benefits if you don't work at the company for the minimum vesting period — this can be at least five years, or even longer at some companies.

Letting the Pros Work for You

Have you ever wished that you could hire a professional money manager to handle your investments? A 401(k) lets you take a step in that direction by offering *mutual funds.*

Mutual funds are investments that let you pool your money with the money of hundreds or thousands of other investors. An investment expert called the *fund manager* decides how to invest all this money, trying to get the best return on your investment based on the fund's *investment objective.* Because the fund manager invests your money along with the money contributed by other investors in the fund, she has more money to invest and can spread it around to different companies or sectors of the economy. This *diversification* helps reduce the amount of risk that you take with your investments. (We explain more about selecting investments, including mutual funds, in Chapter 6.)

What does this mean for you? If you choose your fund carefully, you benefit from a professional money manager who's seeking the best return for the fund's investors, based on the fund's investment objectives.

In most cases, your employer is responsible for choosing the mutual funds (and any other investments) offered by your 401(k) plan. More than 8,000 mutual funds are registered in the United States. If your employer does a good job of narrowing the offering down to a handful, it can save you a lot of time.

Rather than rely on choices made by their employer, however, some investors prefer to choose their own investments, such as individual stocks, mutual funds, or other investments that aren't included in their plans. Some 401(k) plans now offer a *brokerage window* that allows you to choose your own investments. But you generally pay an extra fee if you use this feature. Chapter 6 has more details on brokerage windows.

Buying More When Prices Are Low

When you invest a specified amount at regular intervals, as you do with automatic 401(k) contributions from your paycheck, you are using an investment strategy called *dollar cost averaging.* (You didn't know you were that smart, did you?) This investment strategy may lower the average price that you pay for your investments. How? Because you're spending the same amount each time you invest, you end up buying more shares of your investments when prices are low and fewer shares when prices are high. By averaging high and low prices, you reduce the risk that you will buy more shares when prices are high.

Of course, if stock prices only go up for the entire time you invest, this strategy won't work. But if you contribute to a 401(k) over a long period of time, there will likely be periods when prices go down.

Improving Your Chances of an Ideal Retirement

Investing in a 401(k) gives you a chance at extra savings for your retirement years. The additional savings can mean the difference between merely surviving retirement and actually living it up.

Did you ever stop to think how much money you'll need in retirement to keep up your current lifestyle? Most financial planners suggest that you'll need at least 70 to 80 percent of your pre-retirement income. But many people may need closer to 100 percent, or more.

Some people think that their Social Security benefits alone will be enough to cover their retirement needs. The unfortunate fact is, you shouldn't rely on Social Security to finance your retirement. Financial security during retirement requires income from a variety of sources. Social Security's current problems are serious, but the system was never intended to be the sole source of retirement income for Americans.

Try to estimate how big a retirement account you'll need, and develop a savings plan to try to accumulate that amount. When you retire, you'll have to manage your nest egg so that you don't run out of money before you die. Chapter 4 explains why and how to set up a savings plan for your 401(k) during your working years, and Chapter 9 looks at ways to make this money last after you retire.

Protecting Your Money

Investing money always involves some risks, but money in a 401(k) plan is protected in some ways that money in an ordinary savings account, brokerage account, or IRA isn't.

Meeting minimum standards

401(k) plans are governed by a federal law called *ERISA* — the Employee Retirement Income Security Act. Passed in 1974, ERISA sets minimum standards for retirement plans offered by private-sector companies. (Some nonprofits also follow ERISA rules, but local, state, and federal government retirement plans, as well as church plans, don't have to.)

ERISA requirements include:

- Providing information to you about plan features on a regular basis, including a *summary plan description* outlining the plan's main rules, when you enroll in the plan and periodically thereafter
- Defining how long you may be required to work before being able to sign up for the plan or before employer contributions to the plan are yours to keep if you leave your job
- Detailing requirements for the *plan fiduciary*, essentially including anyone at your company or the plan provider who has control over the investment choices in the plan (A fiduciary who breaks the rules may be sued by participants.)

This last point, *fiduciary responsibility*, is important to understand. Essentially, it means that anyone who has a decision-making role in your 401(k) plan's investments is legally bound to make those decisions in the best interests of the plan participants (you and your co-workers), and *not* in the best interest of the company, the plan provider, or the fiduciary's cousin Joe. For example, the committee in charge of choosing a 401(k) provider shouldn't choose Bank XYZ just because the company president's cousin runs the bank.

But this doesn't necessarily mean that you can sue your employer if your 401(k) doesn't do well. (Keep in mind that lawsuits are often costly and won't endear you to your employer.) If you lose most of your money because you make bad investment decisions or the stock market takes a nosedive, but your employer has followed ERISA rules, your employer is off the hook. Your employer may gain limited protection through something called *404(c)*. Without going into too much detail, Section 404(c) of ERISA requires your employer to provide you with specific information about your plan, including information about the investment options, and to allow you to make changes in your investments frequently enough to respond to ups and downs in the market. In return, *you* assume liability for your investment results.

Plan operation was a critical point in the case of Enron, the Houston-based energy trading company that declared bankruptcy in late 2001. Many employees suffered huge losses in their 401(k)s because they had invested heavily in Enron stock based on the rosy picture that was painted by senior management about the company's fortunes. When that rosy picture turned out to be a fake, employees hollered that they wouldn't have invested so much in Enron stock (one of their 401(k) investment options) if they had known the truth.

Avoiding losses in bankruptcy

Many people wonder whether their 401(k) money is at risk if their employer goes belly-up. The answer is usually no, with a few caveats:

- If the money is in investments that are tied to your employer, such as company stock, and the employer goes bankrupt, you may lose your money. (This is a compelling argument for you to limit the amount of your 401(k) that you invest in a single stock.)
- In the case of fraud or wrongdoing by your employer or the trustee of the 401(k) account, your money may be at risk. (The trustee would be personally liable to return your money, but that's no help if he has disappeared.) These situations are rare; what's more, your employer is required to buy a type of insurance — a *fidelity bond* — when it sets up the plan, that may enable you to recoup at least some of your money in the event of dishonesty. (Fidelity bonds generally cover 10 percent of the amount in the entire plan, or $500,000, whichever amount is smaller.)
- Part of your money may be lost if your employer goes out of business or declares bankruptcy before depositing your contributions into the trust fund that receives the 401(k) money that is deducted from your paycheck.

Federal law says that if you declare personal bankruptcy, your creditors generally can't touch your 401(k). They may be able to get at your other savings, but your 401(k) should be protected. Exceptions include if you owe money to the IRS or if a court has ordered you to give the money to your ex-spouse as part of a divorce settlement. In both of those cases, your 401(k) money is vulnerable.

Watching Out for Potential Pitfalls

The tax advantages you get with a 401(k) have a flip side: rules. Rules about when you can take your money out, and whether you'll have to pay a penalty, and even what you can invest in. All of these are out of your control after you decide to contribute to a 401(k) plan. This section tells you what pitfalls to watch out for.

Withdrawing money while you're working is difficult

It can be difficult, if not downright impossible, to make a withdrawal from your 401(k) while you're working for the company that sponsors the plan.

Many employers permit you to borrow money from your 401(k), but not necessarily for any old reason. Many plans permit *hardship withdrawals,* which are withdrawals from your account to pay expenses when you're in financial difficulty. Your employer may permit withdrawals only for reasons approved by the IRS. (Check out Chapter 7 for a more detailed discussion of loans and hardship withdrawals.)

People often think that they're automatically allowed to withdraw money from a 401(k) for higher education expenses or for buying a home, and that they won't owe an early withdrawal penalty on the amount. This is false. Your plan *may* allow you to make a withdrawal for these reasons, but it doesn't *have* to.

When you leave your employer, either to retire or to change jobs, you generally have a window of opportunity to get your money. In most cases, you can receive payment of your account or transfer the money into an IRA or another employer's retirement plan (see Chapter 8). We highly recommend transferring the money to another plan or IRA, or leaving the money in the plan, to avoid a high tax bill (see the following section).

Taking money out before 59½ costs more

If you do manage to withdraw your money using a hardship withdrawal before you turn 59½, you'll be heavily taxed. Not only will you owe federal and perhaps state and local income tax on the amount withdrawn, you'll also owe a 10 percent federal early withdrawal penalty on the entire amount. Some states may also impose additional early withdrawal penalties of a few percent. All of these combined could mean that you pay more than 50 percent of your withdrawal in taxes and penalties, depending on your tax bracket.

Taking out a loan lets you avoid these penalties; however, other costs are involved. We explain these costs in Chapter 7.

Earning more may mean contributing less

If you earn enough to qualify as a highly compensated employee, your contributions to your 401(k) plan may be limited to only a few percent of your salary. Many 401(k) plans are required to pass *nondiscrimination tests* each year to make sure that highly paid employees as a group aren't contributing a lot more to the plan than their lower-paid colleagues. In requiring these tests, Congress is looking out for the little guy (and gal). Chapter 3 explains how these tests work, and who qualifies as "highly compensated."

Being at the mercy of your plan

A well-administered, well-chosen, flexible 401(k) plan can be a wonderful benefit. A poorly administered plan with bad investment choices and little flexibility can be a nightmare. We've heard stories of companies that don't invest employee contributions on time or that take money from the plan, companies that don't let employees contribute the maximum permitted, or companies where employees pay useless fees for a plan because the managers who set it up were incompetent, uninformed, or even criminals.

In most cases, the tax benefit of a 401(k) is a good enough reason to take advantage of the plan offered by your employer. However, if the investments offered by the plan are truly bad, the fees charged are exorbitant, or the administration of the plan is questionable, you may be better off investing your retirement money elsewhere until you have a better 401(k).

We talk more about understanding your 401(k) plan's features in Chapter 2. We also provide suggestions for how you can try to improve your plan if it falls short.

Telling the Employer's Point of View

For employers, setting up and running a retirement plan is no cakewalk. An employer has to select a plan, decide how to administer it, find a company to provide the investments, comply with paperwork and other regulations, possibly contribute money to employees' accounts, and so on. Small-business owners may find that 401(k)s don't meet their needs. Chapter 12 gives information on retirement plans for small-business owners, and guidelines for choosing one. Chapter 13 provides tips for larger employers on running a 401(k) in the best interests of their participants.

Chapter 2

Understanding the Important Features of Your 401(k)

In This Chapter

- Measuring your employer's contribution
- Calculating your contributions and catch-up contributions
- Timing when your employer's contribution belongs to you
- Finding out when you can start participating
- Breaking open your 401(k) piggy bank while you're working
- Understanding what investments you can choose
- Determining how much you pay in fees
- Getting extra help and services
- Trying to get your plan changed

401(k) plans are like snowflakes — each one is unique. Federal laws govern many aspects of 401(k) plans, but employers are allowed to be more *restrictive* with their plan rules (for example, they may limit your contributions to a lower level than what Uncle Sam permits). If you're looking for a standard 401(k) plan, be aware that there's no such animal. Each company creates its own plan, and some are better than others.

If you want to get the most out of your 401(k) plan, you have to understand how it works. This chapter covers questions to ask yourself, your employer, or your plan provider when evaluating a 401(k) plan.

How Much Your Employer Contributes

An employer contribution is the single most important feature of any retirement plan. The more you get from your employer, the less you have to save on your own.

Employers aren't required to offer a retirement plan, nor are they required to contribute to a 401(k) plan. Employers that help you save for retirement demonstrate a commitment to your future.

We don't want to get too technical, but at this point it'll be helpful to explain the two broad categories of retirement plans that employers can choose from:

- *Defined benefit plans* are traditional pension plans in which the amount you receive (the benefit) is "defined" up front based on factors such as your salary in your final year (or years) of your career with the company. Your employer is responsible for making sure that there's enough money in the plan to pay this benefit. Your grandfather probably had this kind of plan, but fewer and fewer of these critters are available today.
- *Defined contribution plans* include 401(k)s and similar plans in which the *contributions* to your account are "defined" by you and your employer. Your eventual benefit depends on how much is contributed and how well your investments do. Many different types of defined contribution (or "DC") plans are available, including the following:
    - 401(k)
    - 403(b) (see Chapter 10)
    - 457 "deferred comp" (see Chapter 11)
    - Defined contribution/money purchase pension
    - Employee stock ownership plan (ESOP)
    - Stock bonus plan
    - Simplified Employee Pension (SEP) (see Chapter 12)
    - Profit-sharing (see Chapter 12)
    - SIMPLE IRA (see Chapter 12)

That's a lot of names; we include them so that you'll know what you have if your employer offers one of them. Your employer may make a contribution to one or more of these types of accounts.

In some cases, you get the employer contribution only if *you* contribute (matching contribution). In others, you get the employer contribution no matter what (non-matching contribution). We explain more about matching and non-matching contributions in just a minute.

Employers can choose their own schedule for depositing contributions into your account. Some may do this every pay period, while others may deposit a year's worth in one shot. The contributions can be deposited at any time until the tax-filing deadline for that year, including extensions (September 15 for an employer with a December 31 fiscal year-end). So the employer contribution for one year may not show up in your account until the following year.

The match game: Employer matching contribution

The key to employer matching contributions is that *you* have to contribute money to the plan in order to get the employer's contribution. If you don't contribute to the plan, you don't get the employer's money.

Employers use different formulas for calculating their match. A common formula is 50¢ on the dollar up to 6 percent of salary. What does that mean? For every dollar you contribute to your 401(k) plan up to 6 percent of your salary, your employer will contribute 50¢.

Here's a concrete example. Say you earn $50,000 a year. Six percent of your salary is $3,000. For every dollar you contribute to your 401(k) plan up to $3,000, your employer will contribute an additional 50¢. If you contribute $3,000, your employer will contribute an additional $1,500. You end up with $4,500 after only contributing $3,000 of your own money. However, if you contribute only $1,000, your employer will contribute an additional $500, and you'll miss out on $1,000 in potential employer contributions.

How much will your employer contribute if you put in $4,000? If you answered $2,000, or 50 percent of your contribution, you're wrong. If you contribute $4,000, your employer will still only contribute an additional $1,500 because the match only applies to $3,000, or 6 percent of your salary. (We admit that was a bit of a trick question, but we just want to keep you on your toes!)

Here's another way of looking at it. Suppose that you earn $50,000, and you want to put aside 10 percent in your 401(k). If your employer contributes up to 3 percent of salary as a match, you need to contribute only 7 percent of your salary to achieve your 10 percent savings goal. There are no taxes on the 3 percent employer contribution until it is withdrawn from the 401(k). Your total savings are as follows:

Employer contribution of 3 percent:	$1,500
Employee contribution of 7 percent:	$3,500
Total contribution:	$5,000

An employer matching contribution gives you an incentive to save, and it can give your savings a powerful boost. It makes sense for you to contribute at least the full amount that your employer will match. Employers may make higher (dollar-for-dollar, for example) or lower (25¢ on the dollar, for example) matching contributions and may match higher or lower percentages of salary. There's no set rule, and some employers are more generous than others. But after an employer sets the formula for the matching contribution, it must meet the commitment until it amends the *plan document* (the official document detailing the plan's rules) with a new formula.

You typically have to work for your employer for a certain period of time before you can leave the company without forfeiting (losing) your employer's contributions. We discuss this rule, known as *vesting*, in the "Vesting: When Your Employer's Contribution Is Yours to Keep" section later in this chapter.

Looking at the whole picture

If you're trying to judge whether your employer (or a prospective employer) offers good retirement benefits, don't make the common mistake of focusing only on the 401(k) and overlooking the many other types of retirement plans and employee benefits. Be sure to look at the total package of compensation, retirement plan contributions, and employee benefits.

For example, if your employer contributes 5 percent of your pay to a cash balance pension plan (a type of defined-benefit plan), it may be better than a 3 percent employer matching contribution in a 401(k) plan. An employer contribution equal to 10 percent of pay in a profit-sharing plan is generally better than a 401(k), even if it includes an employer matching contribution. In fact, if your employer contributes 10 percent or more of pay to a retirement program, you don't need to make any comparisons — it's a great retirement program.

Some employers make what's called a *variable or discretionary matching contribution* — a hybrid of profit-sharing and matching contributions. You have to contribute to your 401(k) to get it, as with an ordinary matching contribution, but the amount of the contribution varies at the discretion of your company. For example, the amount of your matching contribution may depend on the success of your company from one year to the next.

A little something extra: Employer non-matching contribution

Some employers contribute to their employees' 401(k) accounts (or to another plan) whether the employee contributes or not. This is called a *non-matching contribution*. For example, your employer may deposit a profit-sharing contribution into the 401(k) on your behalf, either alone or in addition to a matching contribution. In a good year, for example, your employer may contribute 5 percent of each eligible employee's pay as a profit-sharing contribution, plus a 25 or 50¢ matching contribution. You get the 5 percent no matter what, but you only get the additional matching contribution if you put some of your salary into the plan. In a bad year, the company may only make the matching contribution and forgo the profit-sharing contribution, or it may even forgo both contributions!

A company may also make *a non-matching employer contribution* that's *not* based on its financial results. The employer may contribute a specific percentage of your pay each year — typically between 3 and 5 percent — regardless of whether the company does well. A non-matching employer contribution is frequently used when a company has discontinued a defined-benefit pension plan (described earlier in this section) in favor of a defined-contribution arrangement.

Automatic contributions may also be made in what's called a *Safe Harbor 401(k)*. This type of plan doesn't have to pass certain federal nondiscrimination tests that are part of the law governing 401(k)s (we explain more about these tests in Chapter 12).

How Much You Can Contribute

"How much can I contribute to my 401(k) plan?" seems like a fairly simple question to answer. Not necessarily. There *are* federal limits on contributions, but your plan is allowed to be more restrictive. Also, high-income earners may have their contribution levels capped due to special restrictions required by law. (We explain rules for highly compensated employees in more detail in Chapter 3.)

What Uncle Sam allows (he's extra generous if you're 50 or older)

Table 2-1 shows the maximum pre-tax contributions that you can make under federal law. (*Pre-tax contribution* refers to money taken out of your paycheck before you pay federal income taxes — it reduces your taxable income so that you pay less federal income tax for the year.)

The limits apply only to your pre-tax contributions and do not include contributions from your employer. The same limits apply for 403(b) plans (see Chapter 10) and 457 plans (see Chapter 11). However, with a 457 plan, the employer contribution *does* count toward these limits.

The *regular limit* in the table applies if you're under 50. In the year that you hit the big 5-0 and every year thereafter, you may make an additional pre-tax contribution, known as a *catch-up contribution*, which raises your total possible contribution to the amount listed in the column on the far right. Why the special tax break? We like to think that it's because Uncle Sam is well over 50 himself (look at his white hair, after all). In reality, Congress approved this extra tax break to help workers who may not have contributed much to their own retirement savings early on, particularly women who may have stepped out of the work force to raise children or care for ailing relatives.

There's a catch, though — even though federal law allows this type of contribution, your plan has to change its rules to specifically allow catch-up contributions before you can actually make them. Your plan isn't required to allow these contributions. The law only changed in 2002, and some plans may be slow to adopt this change. Ask your employer or plan provider whether your plan allows catch-up contributions. If it doesn't, keep after your employer or plan provider to amend the plan.

Table 2-1 Annual Contribution Limits

Year	*Regular Limit*	*Age-50 Catch-up Limit*	*Maximum Total Limit for 50 and over*
2002	$11,000	$1,000	$12,000
2003	$12,000	$2,000	$14,000
2004	$13,000	$3,000	$16,000

Year	*Regular Limit*	*Age-50 Catch-up Limit*	*Maximum Total Limit for 50 and over*
2005	$14,000	$4,000	$18,000
2006 and beyond	$15,000	$5,000	$20,000

TIP

A small number of 401(k) plans allow you to make "after-tax" contributions. You can't deduct these contributions from your income tax, but you can benefit from them in another way — the gain on your investment isn't taxed every year. It grows *tax deferred,* and you pay income tax only on the investment gains when you withdraw them. However, you may be able to achieve a better result by investing in a *Roth IRA,* especially if your employer doesn't match after-tax contributions. You also make after-tax contributions to a Roth, but you pay *no* income tax when you withdraw the money at retirement. (Read more about Roth IRAs in Chapter 8.) The limit on after-tax contributions is part of the "percent of pay" limit we explain in the next section.

REMEMBER

A few small businesses (under 100 employees) may offer what's known as a SIMPLE 401(k) plan. These plans have fewer administrative requirements for the employer, but the tradeoff is lower contribution limits than those outlined in Table 2-1. With the introduction of Safe Harbor 401(k) plans in the late 1990s, which also have fewer administrative requirements for the employer but allow the higher 401(k) contribution limits presented here, most employers have switched away from the SIMPLE 401(k). By the way, SIMPLE stands for *Savings Incentive Match Plan for Employees.* Another plan, called a SIMPLE IRA, is still used fairly often, particularly by companies with fewer than 10 employees. We explain Safe Harbor 401(k)s and SIMPLE IRAs in Chapter 12. We agree, the existence of so many types of plans is confusing!

Percent-of-pay limit

So far, so good. But you need to be aware of another limit that can cap your contributions. Before the new tax law went into effect in 2002 (EGTRRA — the Economic Growth and Tax Relief Reconciliation Act, not the newest gourmet breakfast item), your contributions (pre-tax and after-tax) combined with your employer's contributions couldn't be more than 25 percent of your pay or more than $35,000, whichever figure was smaller. As a result, employers had to limit the percentage of pay that you could contribute. For example, you may have been limited to a maximum of 20 percent of your pay if your employer contributed 5 percent.

The good news is that, under the new federal tax laws, the combined employee/employer limit is 100 percent of pay with a $40,000 maximum. (Just to complicate matters, the age-50 catch-up contribution can be made in addition to the $40,000 maximum, but not on top of the 100 percent of pay limit.) However, your employer must modify its plan before you can contribute this higher percentage.

In reality, you can't contribute a full 100 percent even if your employer doesn't make a contribution, because you must pay Social Security taxes, and possibly state and local taxes, on your income before making your 401(k) contributions. (Chapter 1 explains these taxes in more detail in the section "Defining What a 401(k) Does for You." You may also have other pre-401(k) pay deductions for medical coverage or contributions to a Section 125 flexible benefits plan.

But, if you can afford to do so, you may be able to contribute quite a chunk of your pay as long as you remain under the limit. If you're a lower-income saver, or if you start a second career after earning a military, police, or other pension, being able to contribute the higher percentage can be a real plus for you. For example, if you retired from the military with a pension that covered most or all of your everyday expenses, but you became bored and decided to go back to work part-time earning $14,000, you could contribute $11,000 of this amount to a 401(k) in 2002 (or possibly $12,000 if you were eligible to make a catch-up contribution).

The only fly in the ointment would be if your employer still has the old limit of 25 percent of pay written into your plan. In that case, you could only contribute $3,500, which is 25 percent of $14,000.

Vesting: When Your Employer's Contribution Is Yours to Keep

When your employer puts money into your 401(k) plan, that money doesn't necessarily belong to you right away. Most companies require that you stay employed with them for a certain amount of time before the contributions *vest,* or are yours to keep if you leave your job. They use this requirement to encourage you to stay on the job.

The employer contributions are generally deposited in the account right away, earning a return on your behalf even before they vest. If you leave your job before the employer contributions vest, you forfeit those contributions plus any earnings on them.

The contributions you make from your salary are always yours to keep, and you can take them with you when you leave. This section refers only to contributions made by your employer.

Your employer can't make you wait forever to vest. There are maximum lengths of time for matching and non-matching contributions. What are they? Keep reading to find out.

Vesting of matching contributions

Employer matching contributions must generally become yours to keep either

- All at once on a specified date within three years
- Gradually over six years

The first method is known as *cliff vesting.* With this method, you must go from 0 to 100 percent vested after you have earned three years of service, at the most (the period can be shorter). The second is called *graded vesting*, or *graduated vesting*. With this method, you must go from 0 to 100 percent vested by increases of 20 percent over a period of six years, at the most.

Table 2-2 shows a comparison of the two vesting schedules, looking at the maximum number of years of service that an employer can generally require.

Table 2-2 Longest Allowed 401(k) Matching Contribution Vesting Schedules

Years of Service	*Cliff*	*Graduated*
Less than 2	0%	0%
2 but less than 3	0%	20%
3 but less than 4	100%	40%
4 but less than 5	100%	60%
5 but less than 6	100%	80%
6 or more	100%	100%

An employer may choose a faster vesting schedule (and may even choose to have your matching contributions 100 percent vested at all times) but probably not a longer one. (Some technical exceptions exist, but they're rare.) According to the Profit-Sharing/401(k) Council of America, a little more than one-third of plans have *immediate vesting* (you don't have to wait at all), and a similar number have graduated vesting. A little more than one-quarter of plans offer cliff vesting.

Vesting of non-matching contributions

All employer contributions that are not matching contributions, such as profit-sharing or automatic contributions, may take longer to vest. The maximum requirement for cliff vesting is five years, and the maximum requirement for graded vesting is seven years.

Why are the rules different for matching and non-matching contributions? You'll have to ask Congress. The new laws Congress passed containing the shorter vesting schedule refer only to employer matching contributions. Non-matching contributions still fall under the old (pre-2002) rules.

Exceptions (You knew this was coming, right?)

A few other situations may cause immediate vesting of matching and non-matching employer contributions, no matter how many years you may have worked at the company. These situations are

- If your employer terminates your 401(k) plan
- If you reach "normal retirement age" (This is defined by the plan, but it is usually age 65.)
- If you die before you leave the company
- If you become disabled, as defined in the plan
- If you're among a "substantial portion" (such as more than 20 percent) of plan participants who are laid off due to the closing of a plant or division, or are otherwise part of a large layoff

To find out which rules apply to you, check your summary plan description.

When You Can Start Participating

Sarah is a top-notch worker who's being wooed by two companies. The job offers are identical in every way except one: Company A will let her start participating in the 401(k) plan right away, while Company L (for "loser") will let her join only after she's worked there for one year. Which employer will nab Sarah? If Sarah is smart, it's Company A.

Why does it matter if she has to wait a year to join? One year is the maximum length of time that an employer can make you wait. Employers that impose this limit usually require you to wait until the next entry date after fulfilling the year of service — for example, the first day of each quarter (such as January 1, April 1, July 1, and October 1).

What does this mean for Sarah? If she were hired on January 12, 2002, she wouldn't be able to start contributing to the plan until April 1, 2003 — Company L's first entry date after completing one year of service if it uses the schedule outlined in the previous paragraph. If she changed jobs more than five times during her working life and had to wait one year each time to join a plan, she could lose out on at least five years of retirement benefits, seriously reducing her long-term savings.

Until the late 1990s, it was common to make new employees wait one year before they could join a 401(k) plan. But plan eligibility periods have been shrinking. New employees are now often eligible to join the plan within 90 days or less. Quarterly entry dates are being replaced by immediate or monthly entry dates. Keep this in mind when you're evaluating a potential employer's 401(k) plan.

Accessing Your 401(k) Plan Money While Working

The tax breaks you get with a 401(k) plan come with a price. It can be very costly to take your money out of the plan before you retire, if you can even do it at all.

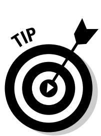
Don't wait for an emergency, or any other reason to access your 401(k) money, before checking on the rules of your plan. You may find that you can't make a withdrawal or that you will lose about half the value in taxes and penalties if you do make a withdrawal.

Federal law allows three ways to get money out of your 401(k) while you're working for the employer sponsoring the plan. But keep in mind that your employer isn't *required* to allow these features, so they may not be available in your plan. (We discuss these features in detail in Chapter 7.) The three ways to obtain money from your 401(k) are

- **Unrestricted access to plan assets after you reach age 59½.** The amount withdrawn becomes part of your taxable income for that year.
- **Withdrawals for financial hardships as defined by law and IRS regulations.** *Hardship withdrawals*, as they're known, are fully taxable and are usually also subject to an additional 10 percent federal early withdrawal penalty (and possibly additional state and local penalties, as well).
- **Plan loans.** These are subject to numerous restrictions. (You may get a plan loan to pay for excessive medical expenses, but you shouldn't assume that you'll get one to buy a yacht.)

The first two options listed are known as *in-service withdrawals,* because you make them while you're "in the service of" your employer.

Strangely enough, federal law makes it theoretically easier to withdraw your employer's contributions than your own pre-tax deferrals while you're working. Your employer may allow you to take the employer contributions out for any reason. But most employers place restrictions on withdrawals of their contributions because they want you to use the money for retirement, so you probably won't be able to use those to buy your yacht, either.



Loans and in-service withdrawals are a mixed blessing because, while they give you some flexibility with your money, they'll likely reduce the ultimate value of your retirement nest egg. But being able to withdraw these savings can be an important plan feature if you think that you may need your money before reaching age 59½. This is particularly true for younger employees who have a long way to go until retirement.

What Investments You Can Choose

When it comes to your 401(k) investment choices, you're at the mercy of your employer. Your employer chooses the investment options that will be offered by the plan. Generally, these are mutual funds and, possibly, stock in your employer's company. Some companies offer a *brokerage window*, which lets you invest in individual stocks and bonds in addition to the mutual funds offered by the plan. (Think of it as a "window" to a larger universe of stocks, bonds, and mutual funds.)

Most plans let you decide how to invest your money among the options offered. A very small number of plans do *not* let you choose how the money is invested — the employer decides for you. In this case, the employer has greater fiduciary liability for the account's investment performance.

Many 401(k) plans offer at least ten investment choices. Your plan may have more than this, or not as many. More important than the number, though, is the *quality* and *range* of the investments offered. Although not required, at a minimum your plan should ideally offer

- A large-company stock fund
- A small-company stock fund
- A bond or other fixed-income fund
- A money market (cash) fund
- A mutual fund that invests in international stocks and/or bonds

These different categories, or classes, of investments are called *asset classes*. (We discuss asset classes and investing in more detail in Chapter 6.)

When judging the quality of funds offered in your plan, remember that it's impossible for employers (or anyone else, for that matter) to pick consistently top-performing fund options in each category. What's more, funds that can boast top short-term performance records may not even be the best choices for long-term investors in a 401(k) plan. You need to use appropriate criteria for judging a mutual fund's performance.

How Much You Pay for Plan Expenses

A 401(k) plan provides a service to you, and it's not free. You're charged various fees and expenses for the administration of the plan, your account, and your investments inside the account. These charges aren't unusual, but you want to assess whether you're paying a reasonable amount.

Figuring out whether you're paying a reasonable amount can be harder than it sounds. You won't get a bill that lists exactly how much you're paying in fees. Nor will you necessarily see an entry on your 401(k) statement that reports all fees deducted. Instead, you have to do some detective work to find out what you're paying.

It's worth the effort. In most cases, fees are deducted from your *investment return* — the money being earned by your investments. The higher the fees, the more they'll reduce your eventual balance.

For example: Say you and your spouse each contribute $5,000 a year to 401(k) plans from age 30 to age 65. You both earn an average 8 percent return on your investment (before fees). Your spouse's plan charges 1 percent in fees annually. Your plan charges 2 percent. Do you think this 1 percentage point will make a big difference in the end value of your accounts? You bet it will. Your spouse will have $641,000. Assuming everything else is equal, you'll have $521,000 — around $120,000 less!

There's no "right" amount of fees to pay — although, if you're paying more than 1 percent of your account balance, you're probably paying too much. As with just about everything in investing, you have tradeoffs to consider; if your plan charges relatively high fees but provides many useful services, you may be satisfied.

If you think that your plan fees are too high, you don't necessarily have to abandon your 401(k), especially if your alternative is not saving for retirement at all. At least contribute enough to get the employer matching contribution, and explore other ways to save for retirement, such as an IRA. (Read Chapter 8 for more information about IRAs.)

401(k) fees can be tricky to understand because of the way plans are put together. Generally, you have a fixed administrative cost and variable costs associated with individual investment choices. Many plans are administered by financial companies that combine some or all of these fees and charge all participants' accounts the same percentage fee. (In this case, the higher your account balance, the higher the dollar amount you'll pay.)

Most 401(k) fees are expressed in *basis points*. One hundred basis points equals 1 percent. How much is 150 basis points? If you said 1.5 percent, you're right. Fifty basis points equals 0.5 percent.

There are four common types of services, for which fees may be charged, that you are likely to receive in your 401(k):

- Recordkeeping and other administrative functions
- Investment management
- Benefit transactions
- Education and advice

Administrative functions

401(k) plans involve a lot of number crunching and recordkeeping. Someone has to keep track of how much money is in each person's account and where the money is invested. Someone also has to roduce your monthly, quarterly, or annual account statement. The plan needs to carry out federally required testing and reporting. These administrative functions need to be paid for.

Most employers hire an outside firm to handle these administration functions. In many cases, the *plan provider* (the financial company that offers your plan's investments, such as Fidelity or Vanguard) also handles the administration. But your employer may also hire separate companies — one to provide the investments, and the other to handle the administration of the plan.

REMEMBER

Administration fees may be as much as $100 a year (or more) per participant. This fee may also be a fixed cost, regardless of how much money is in each participant's account. When it comes to administrative costs, the key question is: Who pays — you or your employer.

The best scenario is that your employer pays, which is usually what happens during the first few years after starting a plan.

Employers commonly shift payment of the administrative fees to you, the participant, as the plan matures. But when they do this, they won't necessarily charge each participant $100. They will likely charge it as a percentage of everyone's account. For example, say your plan has 100 participants. The total administrative fee is $10,000 (100 × $100). If all participant accounts added together are worth $5,000,000, with some people having $200,000 in their accounts and others having $10,000, the plan fee is 0.2 percent of each person's account. (The $10,000 administrative fee is 0.2 percent of $5,000,000.) The people with a $200,000 balance pay $400, while the people with $10,000 balances pay $20.

WARNING!

You may not realize that you're paying administrative fees. The expense may be clearly shown on your statement, or it may be hidden and simply reduce your investment return.

Investment management

The 401(k) plan set up by your employer provides you with choices for how to invest your money. Most 401(k) plans limit these choices to mutual funds. (We talk more about mutual funds and 401(k) investing in Part II.) What's important to know here is that most, if not all, mutual funds charge some kind of investment fee to pay for the expense of managing the fund. These fees range from very low to pretty high, depending on the type of mutual fund. Each mutual fund that you invest in will likely charge this type of fee.

Managers come with a price tag

Generally, a mutual fund with a fund manager who constantly buys and sells stocks to try to improve the fund's return (an *actively managed fund*) will have a higher investment fee than an index fund that doesn't involve a manager who picks the investments. (We explain index funds and other investments in Chapter 6.)

The annual fee for an actively managed stock fund is usually in the 1 to 1.5 percent range, compared to 0.20 to 0.40 percent for an index fund. These fees are usually referred to as the fund's *expense ratio.* The fees may also be expressed as *basis points* (100 to 150 basis points for the managed fund, compared to 20 to 40 basis points for the index fund).

Retail mutual funds (available to the average individual investor) are likely to be more expensive in a 401(k) plan than *institutional* funds (geared toward traditional pension plans or other entities with large amounts to invest). Retail mutual funds are preferred by many participants due to brand-name comfort and because the funds can be readily tracked in the daily papers and other publications. You won't find daily performance results of institutional investment managers in the financial section of your paper, but the lower fees may make them a better deal than the higher-cost retail funds. Some large companies use institutional funds to help keep fees, including administrative and investment costs, low.

Factoring in wrap fees

Sometimes a 401(k) plan provider charges what's known as a *wrap fee.* Small plans with fewer than 100 participants are most often charged this fee, which is likely to be anywhere between 0.5 and 1.5 percent of the total assets in the plan (everybody's accounts combined). The wrap fee is added to the normal fund management fee and the administrative fees.

An insurance company, bank, or brokerage firm may charge this wrap fee if it offers funds managed by a number of different mutual fund companies, including ones the provider owns. For example, the provider may offer the well-known Fidelity Magellan fund but add an additional 100-to-150-basis-point annual fee to the standard fee charged by Fidelity.

TIP

The wrap fee explains why the return that you see printed in the newspaper for the funds you invest in may be different from what you see on your 401(k) statement. If the wrap fee is 1.5 percent, for example, your returns will be reduced by 1.5 percent each year, as compared with what's in the newspaper. This may not sound like much, but a 1.5 percent additional wrap fee reduces your 30-year savings by 30 percent!

Getting the 411 on investment fees

Looking at a fund's prospectus will generally help you see what fees are charged. The *prospectus* is a document that tells you things such as what companies the mutual fund invests in, how often the manager buys and sells stocks within the fund, and what the manager is trying to achieve (the fund *objective*). It also tells you the expense ratio. But it doesn't include information about a wrap fee charged by the 401(k) provider. Getting this information is often difficult because providers who charge wrap fees are often reluctant to disclose their fees. A prospectus should be available from your employer, the plan provider, or the fund company that runs the fund (try the company's Web site or request one by phone).

Some mutual funds that aren't sold to the general public aren't required to provide a fund prospectus. Getting straight answers on fees for these funds can be very difficult. Ask the plan provider for fee information, and get your employer involved, too.

TIP

The United States Department of Labor Web site (`www.dol.gov/pwba/pension.htm`) has a free brochure for 401(k) plan participants that explains how plan fees work. (A separate brochure has information for employers.)

You should find out what your plan charges in fees, and then tell your employer if you think it's too high. There may be a good reason for the fees charged by your plan (such as extra services, which we discuss in a minute), or there may not be.

Benefit transactions

If your plan offers special services, such as loans or hardship withdrawals, you'll probably have to pay a fee when you take advantage of them. For example, you may be charged one fee when you take the loan, and a separate annual fee for each year that it takes you to repay it. You may even have to pay a fee for the privilege of taking your money out of the plan when you change jobs or retire. These fees are commonly in the $50 to $100 range.

You usually have to pay these fees yourself, because you trigger the transactions.

Education and advice

It's not enough for your employer to simply offer a 401(k) plan. You need help understanding how to use and manage it. At a minimum, your employer can and should provide additional support that includes

- A retirement calculator to help you determine how much you'll need when you retire and how much to invest to reach your goals
- Information about the various types of mutual funds to help you understand your investments
- Account statements (at least quarterly) and other tools to help you measure your progress
- On-site educational seminars about investing, goal-setting, and taking advantage of a 401(k)

Additional features, which are being offered by more and more 401(k) plans, can include

- An 800-number to call for assistance in managing your plan investments
- Internet access to detailed information about your plan investments (including fee information and historical investment results)
- The ability to make changes at any time, such as moving money from one investment to another or changing your contribution amount
- Investment advice and financial planning assistance

All of these support services are designed to help participants understand the plan and manage their investments, and they involve additional expenses that must be paid. The added value you receive from these services may warrant higher fees. Chapter 6 tells you where to find advice, education, and retirement calculators if your employer doesn't offer them.

What — no fees?

Some representatives of financial organizations tell employees who have 401(k) plans that they do not pay any fees. If someone tells you this, don't believe it. No organization that runs a 401(k) plan does so for free. The question is *how* participants pay the fee — not whether they pay one. You don't actually write a check to pay a fee, but the reduction in your investment return is a powerful form of payment.

A move toward lower-cost investment alternatives began a few years ago, and it will continue. Previously, when the stock market was strong throughout the 1990s, participants were indifferent to fees. It was hard to get worked up about an extra 0.5 percent in fees when net investment returns were 15 percent or higher. In a down market, that half a percentage point looks a lot more important.

Trying to Improve Shortcomings in Your Plan

If you don't think your plan is up to snuff, you can try to convince your employer to change it. Don't get your hopes up too high, though. Making a change to a 401(k) plan is complicated for the employer, so there has to be a really good reason for doing so.

For example, many small employers simply can't afford to make a matching contribution. You can petition them until the cows come home, but, for economic reasons, they won't budge.

TIP

For information about what other plans nationwide offer, contact the Profit-Sharing/401(k) Council of America through its Web site (`www.psca.org`) or by phone at 312-441-8559.

Employers often need to be reminded that the 401(k) helps to attract and retain employees. Armed with information about competitive plans, employers may be able to shape a plan that attracts more top-quality employees. The top three complaints employees have about their 401(k) plans are

- Poor investment performance
- Lack of available information (especially about fees)
- Not enough funds offered, or not the right types of funds

Here's a look at each complaint in more detail, as well as what you may be able to do about them.

Poor investment performance

If you have a caring employer, and if your investments really are performing poorly, you may be able to make a change.

Sometimes participants ask the employer to replace one fund with another that they think is performing better. This change may seem like a no-brainer, but it's not. The employer needs to look not only at the fund's recent performance, but also at long-term returns and other measures. Comparing the fund's performance with that of similar funds is also important. If similar funds are also going through a bad spell, and the fund itself is solid and makes sense as part of the plan, a couple of years of less-than-ideal performance isn't necessarily reason to boot it out of the plan completely.

JARGON ALERT

401(k) plans are governed by a law known as ERISA — the Employee Retirement Income Security Act. ERISA lays out minimum standards for 401(k)s and other types of pension plans. One thing ERISA says is that your employer has a responsibility (known as *fiduciary responsibility*) to make sure that the plan is operated in the best interest of the participants. (Anyone else who exercises control over plan assets or management — which may include the plan trustee or the plan provider — is also considered to have fiduciary responsibility.) This responsibility covers a number of issues, including what mutual funds you can invest in. Your employer must be able to show that it acted responsibly in choosing funds to offer in the plan. Changing funds every few years on a whim would probably not qualify as responsible. ERISA allows plan participants to sue *fiduciaries* (those who have control over the plan assets) for breaching their responsibilities. (We discuss ERISA in more detail in Chapter 1.)

Lack of available information

Timely access to investment information is another big issue. Managing a retirement account in the best of circumstances is hard, but it's almost impossible when important information isn't available.

Employees are often shocked to discover that employers are required (by ERISA) to provide to them only three pieces of information about their 401(k):

- **A summary plan description (or SPD).** The plan description explains the general terms of the plan — who is eligible and when, the types of contributions permitted, vesting, withdrawal rules, and so on. Although it's useful when you need to know your plan's rules, the information about plan investments is typically limited to generic fund descriptions. Some SPDs don't even give fund descriptions; they say only that participants can split their contributions among various funds selected by the employer.

- **A summary annual report (or SAR).** The annual report isn't exactly what you'd call useful up-to-date information. The SAR is pulled from a form that your employer has to file with the Department of Labor within seven months after the plan year ends. But the information on the form is for the previous year, ending December 31 (if the plan year ends on December 31), so the information is dated by the time you receive it. The summary annual report lists general financial results for the year for the entire plan, including total contributions, interest, dividends, realized and unrealized gains, and benefit distributions. None of this information helps you decide how to invest your money.
- **An annual statement of their account.** This statement doesn't have to include detailed information on the actual return and expenses for each participant's investments. It may be limited to the beginning balance, contributions, withdrawals, investment gains or losses, and ending balance. Still, a growing number of service providers are reporting a lot more information, including each participant's specific *rate of return* (the percentage by which your own investments grew, or shrank, over the year). These voluntary efforts are to be applauded (and you should point them out to your employer as a good example of what to do — if your plan doesn't offer them yet).

However, notice that none of these documents are required to explain how much you pay in fees.

So, now that we've told you what isn't very useful, here's what *is* useful: services and information that your employer isn't required to provide. These include

- Sending statements every quarter (every three months) instead of only once a year
- Providing a toll-free number that you can call to ask investment and other plan account questions
- Giving you Internet access to plan information

TIP

Many employers offer these services. If your employer doesn't offer these services, you should request them.

Investment advice: More than 5¢, but well worth it

A growing number of employers offer their employees the opportunity to receive investment advice from independent companies such as mPower, Financial Engines, and Morningstar. These online companies recommend how to invest money in your 401(k) plan so that you have a better chance of meeting your retirement goals. You can pay a fee individually to access one of these services over the Internet if your employer doesn't offer one. (We explain more about advice in Chapter 6.)

A number of employers don't yet offer advice services, because they worry that employees who aren't happy with the advice they receive may sue. Although the Department of Labor has ruled that it's okay for employers to make independent advice available to their employees, many companies are still concerned about potential liability exposure. At the time of writing, several members of Congress had proposed laws permitting, even encouraging, employers to provide advice. You can expect to see a lot of movement in this area over the next few years, following the Enron, WorldCom, and similar debacles, and the stock market downturn. We believe that letting employees invest on their own, without advice, creates greater risk than providing good investment advice.

The bottom line is that most participants probably don't get enough information to manage their 401(k)s wisely. What can you do? You can consider signing up for an advice service. Your employer may offer one as a benefit, or you can sign up on your own. (We tell you how in Chapter 6.)

Some funds offered by 401(k) plans are special funds created by the provider, and they aren't available to the general public. In this case, you need to ask the provider or your employer for information about the fund. Written requests are usually the most effective.

Here's a sample letter asking for more information about plan fees:

> Dear 401(k) Plan Representative:
>
> Planning for my retirement is a serious matter. I want to do everything I can to be sure that I have an adequate income during my retirement years.
>
> Unfortunately, I haven't been able to make informed investment decisions, because I can't get adequate information about the fees that I pay. I called the service center at the Outback Investment Company, and their representative told me that I don't pay any fees. Perhaps I should consider this wonderful news, but I'm not dumb enough to believe that it's true.

> As a result, I'm requesting a written explanation of all the fees that I pay, including the ones deducted from plan assets by the organizations that invest and manage the plan, and that reduce the net investment return I receive.
>
> Sincerely,
>
> 401(k) Plan Participant

Not enough funds or not the right funds

You may be convinced that your plan needs to offer more or better mutual funds. In some cases, you may be right; in others, you may not be. In any case, you have a better chance of getting your plan sponsor to listen and take action if you submit detailed written complaints. Generic complaints that simply state that a plan's investment options stink aren't very useful. It's best to explain why, specifically, you're dissatisfied. It may be the fact that a particular type of fund isn't offered, or it may be generally due to high fees or poor performance.

Here's a sample letter that may get the attention of a plan sponsor:

> Dear 401(k) Plan Representative:
>
> I take 401(k) investing very seriously, because I want to do everything I can to be sure that I have an adequate income when I retire. As you know, investment return has a major impact on the savings that I, and other participants, will accumulate.
>
> I am very dissatisfied with the return of our large-cap stock fund, the Outback Super Stock Fund. In the past year, the return for this fund was 2.4% less than the S&P 500 index. During the last three years, the fund returned an average of 2.6% less than the S&P. This fund has also ranked in the bottom quartile for three years, and it only has a two-star Morningstar rating.
>
> It would clearly be in the best interest of all participants to replace this fund with a similar fund that has a better track record and rating.
>
> Sincerely,
>
> 401(k) Plan Participant

Keeping it all in perspective

401(k) plans today may have problems, but they've come a long way, baby.

In the early days, all administrative activity was paper-based, labor intensive, and slow. Participant accounts were generally updated on specific *valuation dates* (dates when the value of the account was calculated and recorded) only once or twice a year. The really advanced plans updated participant accounts quarterly — four times a year. If you wanted to change your investments or take a distribution (withdrawal), you could do so only on these valuation dates. Because of cumbersome administration, you usually had to wait six to eight weeks *after* the valuation date for the transaction to be completed.

Today, the administration of 401(k)s has moved from cumbersome paper-based processing to electronic processing. Most participants can get information about their accounts and investments all day and every day, from anywhere in the world. You should be able to change investments and make other transactions just as easily.

Participant education didn't even exist in the early days of 401(k) plans. Now, more and more employers offer good education programs, although unfortunately not all of them do. Individuals can also find investment education in special retirement planning sections of many financial Web sites. Some Web sites, such as mPower Cafe (`www.mpowercafe.com`), are entirely devoted to retirement investment education.

This letter contains specific reasons for the dissatisfaction of the fund. The reasons are supported by Morningstar ratings, an independent source. The letter also properly identifies the type of fund and compares its performance with the *S&P index*, an appropriate benchmark for this type of fund. (Chapter 6 has more information about S&P and other indexes.) Gathering this information may appear to be very difficult, but it isn't. The Morningstar.com Web site (or other similar fund resources we mention in Chapter 6) provides all of this information.

TIP

Consider your company culture before you attack the 401(k). You don't want to be labeled a troublemaker if this is how your employer views people who complain. At your company, a casual remark at the water cooler followed up by an e-mail with "just the facts" may be enough to spur someone in a position of authority to consider a change.

If you fail to get the information you need, consider writing to the United States Department of Labor. Explain what efforts you've made to get the information and the responses you received. Letters should be addressed to: The Assistant Secretary of Labor, Pension and Welfare Benefits Administration, 200 Constitution Ave., N.W., Washington, D.C. 20210-1111. You can go to the United States Department of Labor's Pension and Welfare Benefits Administration Web site at `http://askpwba.dol.gov/` and click on Postal Mail/National Office for up-to-date information.

In the end, as you evaluate your 401(k) plan, you're really evaluating the corporate citizenship of your employer. If your employer realizes the importance of having a strong 401(k) plan, that's a good sign.

Chapter 3

Signing Up for Your 401(k)

In This Chapter

- Understanding the rules for participating
- Seeing how much you can save if you're highly paid, low-paid, or somewhere in between
- Filling out the paperwork
- Deciding who gets your money if you die

We occasionally hear from individuals who are self-employed or whose employers don't offer a retirement plan, who want to know how they can "open a 401(k) account." Unfortunately, it's not that simple. Unlike an IRA that you can open on your own, a 401(k) is only available through your employer.

Companies aren't required to offer 401(k) plans (or any retirement plan, for that matter). The fact that your employer offers a 401(k) doesn't mean that you're automatically eligible to contribute, though. Before joining your employer's 401(k) plan, you must fulfill your employer's eligibility requirements.

After you qualify to join the 401(k), you'll have some decisions to make. How much will you contribute from each paycheck? How will your contributions be invested? Who should inherit the account if you die?

Reading this chapter can help you understand the paperwork you need to fill out when you sign up for your 401(k) plan. It also explains how much you're allowed to contribute, whether you're just signing up or whether you've been participating for years.

Figuring Out Whether You're Eligible

Your employer isn't required to let all employees join the 401(k) plan immediately. What's more, certain groups of employees can be excluded altogether. When interviewing for a job, be sure to ask what the rules are for that company's 401(k) plan.

Sometimes you play a waiting game

As a new hire, you may be able to participate immediately, you may have to wait up to one year before you're eligible to join the plan, or you may never be eligible to participate in the plan. After you meet the requirements, you have to wait until the plan's *next entry date* to actually begin contributing to the account. The entry date is the first date you can actually contribute to the plan after satisfying the eligibility requirements. Some employers have a plan entry date every pay period, while others may have only a few during the year. As a new hire, you're better off with a company that lets you join the plan shortly after you begin your employment. You can find out why in Chapter 2.

If your plan requires you to work for one year before becoming eligible for the 401(k) plan, different definitions of "year" are possible. For example, a year can mean

- 12 months of employment
- At least 1,000 hours of work during the course of 12 months of employment (working 20 hours a week for 50 weeks, for example)

Ask your human resources department for more information.

TIP

If you have to work 1,000 hours in one year to become eligible for the plan, you generally don't need to work 1,000 hours in subsequent years to *remain in the plan*. However, the number of hours you work in subsequent years may affect your eligibility to receive employer contributions. It may also affect how soon those contributions *vest,* or become your property. (See Chapter 2 for more on matching contributions and vesting.)

Sometimes you can't join at all

Employers are allowed to exclude certain employees from participating in the 401(k) plan. These employees include

- **Union employees covered by a collective bargaining agreement.** Federal law prohibits employers from offering *any* retirement or other benefit plan to union members that hasn't been agreed on through collective bargaining. This includes 401(k) plans — even those funded entirely by employee contributions. Labor laws require union employees who want a 401(k) to include it in their contract demands.

  Union managers often prefer traditional defined-benefit pension plans (see Chapter 2), which guarantee benefits at retirement. This is the main reason that 401(k) coverage is lower among union employees. It's also why 401(k) plans for union employees typically don't include an employer matching contribution — the employer is already contributing to the defined-benefit plan.
- **Nonresident aliens.** Employers are allowed to exclude employees who live outside the United States and aren't U.S. citizens from participating in the plan. However, employees who are residents of the United States (including green card holders) but are not U.S. citizens can't be excluded simply because they're not U.S. citizens.
- **Leased employees.** Leased employees are people who work for a company temporarily, often placed through an agency.
- **Specific categories of employees.** Under certain circumstances, an employer may exclude a specific category of employees, such as hourly workers or the employees of a specific business unit, from participating in the 401(k) plan. Generally, an employer can legally exclude a group if it makes up less than 30 percent of all employees. For example, your plan may permit only salaried workers to participate, and exclude hourly wage earners, if the hourly workers account for only 10 percent of the staff. However, even if the 30 percent test isn't satisfied, a variety of other exceptions may apply. Determining the categories of employees that may be excluded can be very complicated.

  Finally, you may be excluded if you're under 21. The exclusion would have to apply to all employees under 21, though; an employer couldn't permit some to participate and not others.

Sometimes you're automatically in

A small number of 401(k) plans use what's called *automatic enrollment.* Eligible employees are automatically signed up for the plan unless they refuse in writing. A percentage of salary is deferred into the plan for automatically enrolled employees, and often is deposited in the most conservative investment option.

If your plan has automatic enrollment, don't be lazy — be sure to come up with an investment plan to diversify your money among different investments. Also, consider contributing more than the amount your employer automatically deducts, which is likely to be too small to build up a sufficient nest egg.

Determining How Much of Your Salary to Put Aside

When you enroll in your 401(k) plan, you'll need to fill out a *salary deferral* agreement. Salary deferral refers to the amount of your pay that you want your employer to put in the 401(k) plan rather than in your paycheck.

The form you have to fill out may require you to select a percentage of salary to defer, or it may ask for a dollar amount. In fact, it may even give you a choice, such as the one shown in Figure 3-1. What's the difference? Take a look:

- The percentage of salary is easy because it's the same no matter how many pay periods you have. If you want to contribute 10 percent of your pay, you simply list "10%" on the form.
- For a dollar amount, you need to figure out the total amount you want to contribute for the year and then divide it by the number of pay periods. Say you get paid twice a month. If you earn $30,000 and you want to put $3,000 a year into your 401(k), you list $125 a pay period as a dollar amount ($3,000 divided by 24 equals $125). If you're paid once a month, you need to put down $250 a pay period.

If you work irregular hours or earn variable pay such as overtime, bonuses, or commissions, contributing a percentage of pay usually works better. If your gross pay varies from one pay period to another, you may not earn enough in some pay periods to cover the fixed contribution you've chosen.

SECTION I - Salary Deferral Election

Participant should complete A or B.

A. ☐ **I elect to contribute** the following pay to the Plan each pay period:

☐ ______________% **OR** ☐ $______________

B. ☐ **I elect NOT to contribute** to the Plan.

SECTION II - Salary Deferral Election of Bonuses and Commissions

I elect ☐ **to apply** ☐ **not to apply** the percentage or fixed dollar amount specified in Section I(A) above to any bonuses and/or commissions I may receive as compensation.

Figure 3-1: Sample 401(k) salary deferral form.

Some employers won't let you include overtime or other forms of non-base pay as compensation for the purposes of contributing to a 401(k). In this case, contributions may be based only on your base pay or something less than your total compensation.

How do you decide what percentage or dollar amount to put aside? To begin with, you need to consider several factors:

- The government's restrictions
- Your own plan's restrictions
- Your budget's limitations
- The amount you need to get the full employer matching contribution

Also, remember that the most important thing is to start contributing as soon as you're eligible. Even if you only contribute 1 percent of your salary to begin with, it's a start. After you're in the habit of saving, it gets easier and easier. But if you put it off, it only gets harder.

Gauging the limits of the law

The *federal dollar limit for pre-tax salary deferrals* is probably the best-known 401(k) limit (not to mention a mouthful to say!). Despite its scary title, this limit is easy to understand. It's the cap on how much income you can have your employer put into the 401(k) rather than into your paycheck. In 2002, the limit is $11,000, plus an additional $1,000 "catch-up contribution" if you're age 50 or older. Limits rise each year through 2006; see Table 2-1 in Chapter 2 for details.

The tax legislation that created these limits is due to expire at the end of 2010. If Congress doesn't extend the tax legislation, in 2011 we'll revert to the limits that existed in 2001 ($10,500 in pre-tax contributions and no catch-up contributions).

Another federal limit to be aware of is the *percentage-of-pay limit.* This limit applies to all contributions made to your 401(k) by you and your employer, as well as to all contributions to other defined contribution plans, such as profit-sharing plans or 403(b) plans. Beginning in 2002, these contributions can't total more than 100 percent of your pay, or $40,000, whichever is less. The $40,000 limit is expected to rise periodically with inflation.

The 100-percent-of-pay limit includes catch-up contributions, but the $40,000 dollar limit does not. The pre-tax contribution limits discussed in Chapter 2 don't include the catch-up contribution either.

Measuring your plan's maximums

Your 401(k) plan isn't allowed to let you contribute *more* than the federal limits discussed in the previous section, but it can restrict you to *less.*

Old-fashioned limits

Your employer may be behind the times. Previously, through 2001, contributions to your 401(k) by you and your employer were limited to 25 percent of your pay. Because of this rule, many employers limited employee pre-tax contributions to 15 or 20 percent of salary. Beginning in 2002, however, the limit was raised to 100 percent of salary, so employers have no need to cap contributions at 20 percent, although your employer may still do so. Ted suggests that plans raise the limit specified in the plan document to around 80 percent, which gives everyone plenty of flexibility.

"Highly compensated employee" rule

Under federal law, employers must test their plans each year to ensure that no "discrimination" exists in favor of highly paid employees. As an example, the contribution percentages of highly paid employees are added up as one group, and the contribution percentages of lower-paid employees are added up as a second group. The average contribution percentage of the highly paid employees can't be more than 2 percentage points above those of the lower-paid group. For example, if lower-paid employees as a group contribute an average of 4 percent of salary to the 401(k), highly paid employees can only contribute 6 percent. (The formula is actually more complex, but this example gives you the basic idea.)

The *Safe Harbor 401(k)* used by some employers doesn't require the nondiscrimination test. You can read more about Safe Harbor plans in Chapter 12.

Highly compensated employees are often referred to as *HCEs,* while lower-paid workers are referred to as *non-HCEs.* We mention these terms so that you'll be familiar with them should you encounter them. However, we try to spare you from having to wade through too many acronyms in this book.

The key question is: How much do you have to earn to qualify as "highly compensated"? The rules are pretty tricky. If you earn less than $85,000 and you don't own more than 5 percent of your company (and you aren't related to, or married to, anyone who does), you aren't highly compensated. If that's the case for you, feel free to skip this section. Otherwise, keep reading — but do a few jumping jacks first to make sure that you're fully alert.

You're considered highly compensated in a given year if you own more than 5 percent of your company in that year or the previous year. You may also be considered highly compensated in a given year if you earned more than a specified salary in the previous year. Here's a concrete example. You'd be considered an HCE in 2002 if you owned more than 5 percent of your company in either 2001 or 2002. Also, you *may* be considered an HCE in 2002 if your salary in 2001 was more than $85,000. (We say "may" because a possible exception exists for the salary rule. See the "Exception to highly paid dollar limit" sidebar in this chapter for details.) For 2003, the dollar limit goes up. You'll be an HCE in 2003 if you own more than 5 percent of your company in 2002 or 2003, and you *may* be an HCE in 2003 if you earn more than $90,000 in 2002. (Hey, we never said this stuff was easy.)

Exception to highly paid dollar limit

If you earn more than the HCE salary limit, you still may not be considered an HCE even if your company has a lot of highly paid employees. A company is allowed to limit its designated HCEs to only the top 20 percent of employees. So, for example, if 40 percent of employees at your company earned more than the $90,000 dollar limit in 2002, your company could choose to designate only the top-paid 20 percent of non-excludable employees as HCEs who may have their contributions capped or receive refunds in 2003. This flexibility doesn't exist with the ownership rule, though. If you own more than 5 percent of the company in 2002 or 2003, you'll be considered an HCE for 2003.

Calculating an HCE refund

If your plan fails the nondiscrimination test during any year, refunds will probably be made. The system for determining who gets a refund, and how much it is, is somewhat complicated. First the plan has to determine how far the highly compensated employees were over the limit. Say the lower-paid employees in the plan contributed 4 percent on average, and there are three highly compensated employees in the plan. One of the highly compensated employees contributed 8 percent, one contributed 7 percent, and one contributed 6 percent. Their average contribution is 7 percent, which is 1 percent too high. (Because the lower-paid employees contributed 4 percent, the highly compensated employees are limited to 6 percent.)

The HCE who contributed the largest dollar amount (rather than highest percentage of pay) is the first to get a refund. This rule can cause tension among highly compensated employees, because the one who caused the plan to fail by contributing 8 percent isn't the one who has to take a refund.

If you're highly compensated, your contributions will likely be limited to bring your combined contributions down to an acceptable level (in other words, in line with lower-compensated employees).

Say you're highly compensated and you want to contribute 10 percent for a year in which HCE contributions have to be capped at 6 percent. If your plan is on the ball, you'll find out about the problem early and have your contributions capped at 6 percent.

By the way, there's another way your employer can resolve this problem. Your employer can give an extra contribution to some or all of the lower-paid employees to make up for the discrepancy. This contribution is called a *QMAC (qualified matching contribution)* or *QNEC (qualified nonelective contribution).* If you receive one of these contributions, it must be vested right away. This option is less popular among employers, because it costs them extra and it's complicated. (Go figure, right?)

There's another limit that may come into play (if you're our one reader who earns more than $200,000). You're not allowed to make 401(k) contributions or receive employer contributions based on more than $200,000 in compensation for 2002. So, if you earn $220,000 and contribute 5 percent of salary, your contributions have to stop at $10,000 (5 percent of $200,000) instead of $11,000 (5 percent of $220,000). Any employer match would apply to the $10,000, as well.

Estimating what your budget can afford

Talking about how much you're allowed to put into the plan is fine, but what about how much you can *afford* to put into the plan? If money is tight, you may be tempted to wait and start saving "in a couple of years" when you're earning more or have less debt. The problem with that strategy is that the longer you wait to start saving, the harder it gets psychologically. You get used to spending the money you have. Also, by waiting to participate, you lose a lot of potential savings.

The following example (also illustrated in Figure 3-2) shows how you can cheat yourself big time by waiting just a few years to start saving.

Ken, Rasheed, and Lisa all earn $25,000 a year. They all decide to contribute 5 percent of their salary, or $1,250, to their 401(k) plans, but over different periods of time. Assuming that each has an average *annual return* (how much the money increases in value when it's invested) of 8 percent, look at the surprising results:

- Ken waits eight years to begin saving. In years 9 through 30, he contributes a total of $27,500 to the plan ($1,250 × 22 years), and his account balance grows to $71,827. (The extra comes from his 8 percent return, which is reinvested in the account each year without being taxed.)
- Rasheed starts saving right away, but he stops after eight years. He contributes only $10,000 to the plan ($1,250 × 8 years), but because he started earlier, his money has more time to grow through the magic of compounding. He ends up with $74,897 — $3,000 more than Ken after 30 years.
- Lisa saves for the entire 30 years. She contributes only $10,000 more than Ken, in total (over the eight years when Ken doesn't contribute), but her $37,500 contribution grows to $146,724 — twice that of Ken's, because her money benefited from compounding for a longer period of time.

You can see that it pays to start saving early and to keep saving. In this example, each person is saving a little more than $100 per month. If that seems like too much for you now, consider contributing a smaller amount. Sometimes that's the best way to get started. For example, consider saving $10 per week, or $520 a year. You can save $10 while only reducing your take-home pay by about $8 per week, because you save the $10 before paying taxes, while you get your take-home pay after paying taxes. Just about anyone who's earning more than $20,000 can probably find a way to save $8 a week. If you keep a record of your nonessential spending for just one week, you may find that eliminating one or two things is easy. (In Chapter 4, we suggest ways to "find" money to save if you're on a tight budget.)

Remember that even a small amount of savings makes a big difference over time. That $10 per week invested for 35 years with an 8 percent return will eventually be worth about $90,000! Any employer matching contribution will increase this amount (see the section "Getting the most from your employer matching contribution" later in this chapter for more info). This amount probably won't be enough to live on during all of your retirement years, but it will certainly be a big help.

TIP

After you start saving, your goal should be to increase your savings rate each year. Perhaps the easiest way to do this is to save more each time you get a raise. Assume that you start by contributing 1 percent of your pay, and you receive a 4 percent pay increase. Use part of the raise to increase your 401(k) contribution rate to 2 percent. Keep doing this each time you get a raise, until you reach a point where your savings plus any employer contribution is likely to provide an adequate level of retirement income. (We give guidelines in Chapter 4.)

Advantages of Starting to Save Early Through a 401(k) Plan

	A) KEN waits 8 years to start saving		**B)** RASHEED starts saving early, quits after 8 years		**C)** LISA starts saving early and keeps at it!	
Year	Annual Investment	Year end value @ 8%	Annual Investment	Year end value @ 8%	Annual Investment	Year end value @ 8%
1	$0	$0	$1,250	$1,295	$1,250	$1,295
2	0	0	1,250	2,694	1,250	2,694
3	0	0	1,250	4,205	1,250	4,205
4	0	0	1,250	5,836	1,250	5,836
5	0	0	1,250	7,598	1,250	7,598
6	0	0	1,250	9,501	1,250	9,501
7	0	0	1,250	11,557	1,250	11,557
8	0	0	1,250	13,777	1,250	13,777
9	1,250	1,295	0	14,879	1,250	16,174
10	1,250	2,694	0	16,069	1,250	18,763
15	1,250	11,557	0	23,611	1,250	35,167
20	1,250	24,579	0	34,692	1,250	59,271
25	1,250	43,713	0	50,973	1,250	94,687
30	1,250	71,827	0	74,897	1,250	146,724

What you invest and what you earn

A – started late 22 years @ $1,250	
Total saved	$71,827
Amount invested	27,500
Investment return	44,327
B – started early 8 years @ $1,250	
Total saved	$71,827
Amount invested	27,500
Investment return	44,327
C – started early & continued 30 years @ $1,250	
Total saved	$71,827
Amount invested	27,500
Investment return	44,327

The figures indicated reflect employee contributions only. In this example, investment return is calculated at 8%. Your own 401(k) investment return may be higher or lower, depending on the performance of the funds offered and how you invested the money in your account.

Figure 3-2: Payoffs of saving early in a 401(k).

Bonus for low- and moderate-income savers

Congress approved an extra tax break to encourage low- and moderate-income earners to save with 401(k)s and other retirement accounts. This tax credit is available in tax years starting with 2002 and continuing through (including) 2006. You may qualify if you're single and have taxable income of $25,000 or less, or if you're married and have joint taxable income of $50,000 or less. If this applies to you, you can claim a *non-refundable tax credit* for your contributions up to a certain amount. What does that mean? You can subtract a percentage of your contribution to your 401(k) from your tax bill, as well as lower your taxable income, by making the contribution. (Contributions to an IRA, 403(b), or 457 may also qualify for this tax credit.)

Here are the limits for the tax credit.

If you're single and have an adjusted gross income (AGI) of . . .	Or married filing jointly with an AGI of . . .	Subtract this percent of your contribution (up to $2,000) from your tax bill
$0–$15,000	$0–$30,000	50%
$15,001–$16,250	$30,001–$32,500	20%
$16,251–$25,000	$32,501–$50,000	10%

Your *adjusted gross income (AGI)* is your gross income minus deductions that you're allowed to list before you take off your itemized or standard personal deduction (for example, deductible IRA contributions, student loan interest payments, and so on). It is clearly marked at the bottom of the first page of your tax form.

The actual calculation of the tax credit has a few more rules that apply. Also, the amount of your tax credit may be further reduced by any plan withdrawals you (or your spouse) may receive (or have received in the past two years).

REMEMBER

Joining is probably the most important decision you'll make regarding your 401(k) plan. Everything else is irrelevant if you don't start contributing to the plan.

Getting the most from your employer matching contribution

When you consider how much you need to save, don't forget about your employer's matching contribution. (See Chapter 2 for details on employer matching contributions and when they vest, or become yours to keep.) The amount of money you receive from your employer depends on how much you contribute, so it makes sense to contribute enough to get the most possible.

Timing is everything

How you time your contributions is important. Some people like to contribute more to their 401(k) early in the year to ensure that they reach the maximum before, say, having to think about buying holiday gifts at the end of the year. This is sometimes referred to as *front-loading* the 401(k). The potential problem with this strategy is that it can cause you to lose some of your employer match. Before you decide to go with this strategy, ask your employer about its timing for depositing matching contributions. Many employers only make these deposits during the pay periods when you contribute to the plan because it's easier for them. If this is how your plan works, you'll lose out by front-loading.

For example, say your employer matches 50¢ on the dollar, up to 6 percent of your salary. If you earn $80,000, and you contribute at least $4,800 (6 percent of your salary), you should receive an employer match of $2,400.

Now, say you want to contribute the full $12,000 permitted in 2003, and you want to do it early in the year. You fill out your form indicating that you want to contribute 20 percent of your pay every pay period. You're not allowed to contribute $16,000 to a 401(k), so you'll be forced to stop contributing partway through the year when you reach the $12,000 limit. (You'll get there after you've earned $60,000, because 20 percent of $60,000 is $12,000.) Say your employer stops making matching contributions then, because you're no longer making contributions at that time. You will have received only 3 percent of $60,000 in matching contributions, or $1,800, which is lower than the $2,400 you would've received if you had spread out your contributions evenly over the year. By using this strategy, you lose $600 of employer contributions.

In this case, it makes more sense to reduce your contribution rate so that you contribute for the entire year and still hit the $12,000 limit. In this instance, 15 percent would be the percentage to use (15 percent of $80,000 equals $12,000).

See how important it is to find out how your employer makes the matching contribution and to ask if you're receiving the greatest amount of matching contributions on what you contribute?

Your employer sets the rate at which it will match your contributions, along with the limit for how much it will match and the vesting schedule for the employer contributions. The match rate may be as little as 10¢ (or less) for each dollar you contribute, or as much as one dollar for each dollar you contribute, up to a percentage of your salary. The most common matching rates are 25¢ and 50¢ for each dollar you contribute, usually up to 6 percent of your salary. Some employers match dollar-for-dollar, and a few have even higher matches.

If you can't afford to contribute the full amount matched by your employer now, start with a lower percentage and increase your contribution rate as soon as possible to reach the full amount. You don't have to stop there, either. It always makes sense to contribute as much as you possibly can.

If you're married, you and your spouse should each contribute the maximum amount required to get the full match in your plans. If you can't afford to do so, you may want to see which plan has the higher match and best vesting schedule. You can then decide who's likely to stay long enough to qualify for the vested employer contributions and consider pooling your contributions to that plan to get the full match. You may also want to consider which plan has better investment options, and, if you expect to tap your 401(k) plan resources in the future, which one permits in-service withdrawals or loans. (Read more about these options in Chapter 7.) You can then contribute more to the plan that offers the best options.

There's no delicate way to put this, so we'll be blunt. If you think there's a chance that you won't stay married, you may be better off continuing to fund your own 401(k) to the extent possible rather than putting some of your money toward your spouse's 401(k) plan. Divvying up retirement accounts after a divorce can be tricky.

Deciding How to Invest Your Money

After you decide how much to invest, you need to decide where to invest your money. Your enrollment papers will likely include something called an *investment election form* (see Figure 3-3), which lists the investment options offered by your 401(k) plan. You need to specify what percentage of your contribution should go into each option you choose.

The percentages on your investment election form must add up to 100 percent.

If you're not sure right away what to invest in, don't use that as an excuse to put off signing up for the plan. At a minimum, find out if your plan offers a money market fund. A *money market fund* generally earns some interest and is the least likely to lose value, so it's a good short-term investment, but it doesn't have as good a potential for long-term growth as stocks or bonds. Until you decide on a plan for investing your money, you can have your contributions deposited into a money market option. (You can read more about how to select investments in Chapter 6.)

SECTION III - Investment Election

I choose to invest all contributions to my account in **whole percentages totaling 100%** as follows:

Investment Option	Investment %
Short-term bond fund	
All-bond index fund	
S&P 500 stock index fund	
Wilshire 5000 stock index fund	
Large-cap growth stock fund	
Large-cap value stock fund	
Mid-cap blended stock fund	
Small-cap stock index fund	
Small -cap blended fund (growth and value blend)	
Emerging markets growth stock fund (growth oriented)	
Emerging markets value stock fund	
International stock index fund	
International large-cap blended stock fund	
Money market fund	
Total	**100%**

Figure 3-3: Sample 401(k) investment election form.

Ask your employer how often you can change your fund elections. After you do your research, decide on an investment plan and then fill out a form to change your fund elections the next time it's possible.

Naming a Beneficiary

Another form you have to fill out is the *beneficiary designation.* This is where you list the person or people whom you wish to receive the money in your account if you die.

WARNING!

The 401(k) beneficiary form that you file with your employer is the primary instrument that determines who receives your plan benefit if you die. A will or trust won't control distribution of the 401(k). If you don't name a beneficiary, or the beneficiary you name isn't living when you die, the provisions in the plan document determine who gets the money. This may not be the person you intended the money to go to. Therefore, filling out the beneficiary form and keeping it up-to-date is very important.

You'll probably be able to name both a primary and a secondary beneficiary (or beneficiaries). The primary beneficiary will receive your 401(k) money if he or she is living at the time of your death. If not, your secondary beneficiary receives the money. You should be able to name more than one primary and/or secondary beneficiary. If you do name more than one, you have to specify what percentage of the account each should receive. Figure 3-4 shows what this form may look like.

SECTION I - Beneficiary Designation

Participant SHOULD complete A and B below to designate specific beneficiary(ies).

A. **Beneficiary Designation (Please Print)**

Primary Beneficiary(ies) - In the event of my death, I hereby designate as my primary beneficiary(ies):

Beneficiary Name	Social Security No.	Date of Birth	Relationship	% Share
			Total	100%

Secondary Beneficiary(ies) - In the event my primary beneficiary(ies) should predecease me, I designate as my secondary beneficiary(ies):

Secondary Beneficiary Name	Social Security No.	Date of Birth	Relationship	% Share
			Total	100%

Signed ______________________________ Date of this designation: ________

Participant

Figure 3-4: Sample 401(k) beneficiary designation form.

Your spouse: The go-to person

By law, your spouse automatically receives your 401(k) benefit when you die, regardless of whom you named as your beneficiary, unless your spouse signs a *benefit waiver* that is witnessed by a notary or a plan representative. (This benefit waiver form should also be in your enrollment packet.)

One of the questions Ted has received regarding the spousal waiver is what to do if you're legally married but your spouse is nowhere to be found. If you're in this situation, name your children or someone else as your beneficiary — but be aware that your spouse still has legal rights to claim your 401(k) benefit.

Another question is whether a waiver that's part of a pre-nuptial agreement will suffice. The answer isn't clear. By law, the waiver must be signed by the spouse. An individual is not a spouse before actually getting married. As a result, the spouse (*after* the wedding ceremony) can contest the prenuptial waiver (that he or she signed *before* the wedding ceremony). Ain't love grand?

Your children

If you have minor children whom you want to name as beneficiaries or secondary beneficiaries, consider naming a trust instead, for their benefit. Doing so can help avoid the legal complications that may arise when money is left directly to minor children.

A *trust* will hold the money until the date you've established for it to be distributed. The trustee will be responsible for overseeing the trust assets, including investing the funds until they're distributed. If you have minor children and have a will, it probably includes trust provisions that can be used for this purpose. A trust may also be advisable if you have a large account and don't want your children to get all the money when they reach age 18.

Payment can be made directly to adult children.

Reviewing your choices

Whenever your marital status changes, you need to review your beneficiary designation. For example, you may be single when you join the plan. If you marry, your new spouse automatically becomes your beneficiary, regardless of who's named on the form you previously filed with your employer. This is fine if you want your spouse to receive the benefit, but it isn't if you want someone else, such as your children, to receive the benefit. Remember that your new spouse remains as the primary beneficiary unless he or she signs a spousal waiver.