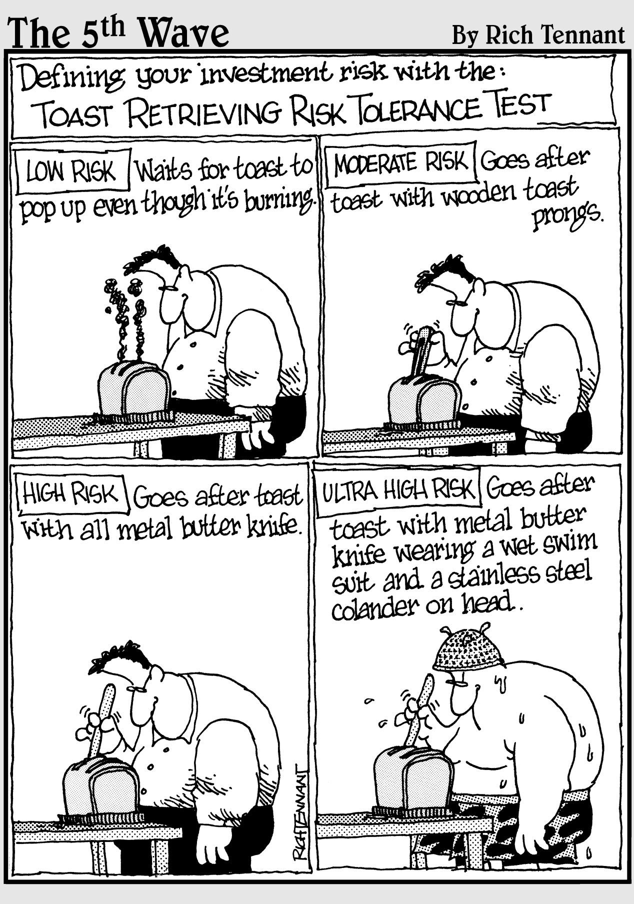
Part VI
The Part of Tens



In this part . . .

You can find out a lot from other people's questions — and from their mistakes. This part answers real-life questions from employers and 401(k) participants, boosts your confidence by warning you about common mistakes people make with their retirement plans, and shoots down any excuses you may be tempted to make for not saving in a retirement account.

Chapter 14

Ten Questions Participants Frequently Ask

In This Chapter

- Resolving tricky contribution situations
- Keeping track of your 401(k) if your company is acquired or goes bankrupt
- Questions about loans and rollovers
- Figuring out where to get help
- Dividing a 401(k) in a divorce
- Finding something good about company stock

Questions about 401(k) plans seem to be as numerous as the 42 million people who use them. So, we chose a few real-life questions to answer in this chapter. Even though this section of the book is called the Part of Tens, we convinced the publisher to let us include a few more than ten (but less than 42 million).

Contributions

I left my employer and then came back six months later. I participated in the 401(k) plan before I left. Do I have to wait one year before I can contribute to the 401(k) again?

Your employer can't require you to satisfy the plan's eligibility requirements a second time if your break in service is less than one year — even though you left and came back to the company.

I can't afford to contribute to my plan now. If I don't join my plan as soon as I'm eligible, do I lose my right to contribute later?

If contributions are out of the question now, you can join the plan later, whenever your plan's rules permit new enrollments. You may be able to enroll at any pay period, or on specific entry dates. However, unless contributing is totally impossible, you should try to do it — even if you start with only 1 percent of your pay. You can increase your contribution a little bit each time that you get a raise.

I changed jobs last year and contributed to two 401(k)s. When I got my W-2s, I saw that I contributed $900 more than the maximum allowed. What do I do?

You can leave the extra money in the plans, but you'll be taxed on it twice — once in the year you contributed it, and once in the year you withdraw it. You'll be taxed on it only once if you notify your employers and withdraw the excess money by April 15 of the year after the year in which you contributed too much.

First decide which plan to withdraw the money from. In general, you can take it all from either plan, or you can split the withdrawal between the two plans. However, some plans won't make *corrective distributions* (distributions to correct this type of error), so find out whether both plans do. If they do, figure out which plan to withdraw the excess from to achieve the best financial result. Look at the employer matching contribution that you received in both plans. Any matching contributions on the excess amount will be taken away when your excess is returned. So, your first preference should be to withdraw from the plan that didn't match your contributions or matched them at a lower rate. Also, look at the vesting schedule of both plans. If the employer matching contributions to your prior plan are fully vested (yours to keep), consider whether you're likely to be with your current employer long enough for that match to vest. (You can read more about vesting in Chapter 2.)

When and how often may I change the amount I contribute?

Your employer sets these rules. It can permit a lot of flexibility or be very restrictive. The most flexible approach is to permit changes each pay period. The most restrictive is to permit changes only at the beginning of the plan year, so that whatever contribution level you choose applies for the entire year.

I recently changed jobs, and my new employer doesn't offer a retirement plan. Can I continue to make contributions to my old 401(k)?

You can't make additional contributions to your old 401(k) account, because you're no longer an employee of your former company. However, you can make contributions to an IRA. The contribution limit is lower than for a 401(k), but it's better than nothing. Whether your IRA contributions are tax-deductible depends on your income level and the kind of IRA you choose. (See Chapter 8 for more on IRAs.)

Should I stop contributing after I contribute enough to get the full employer match?

Your goal is to have enough money when you retire. This may require contributing more than the amount that your employer matches. Keep in mind that you continue to get the full tax breaks for the amount you contribute above the match level.

My company isn't doing well, and it just announced that it's stopping the 401(k) matching contribution. Is this legal?

Your employer can change the match at any time, unless it has a contractual obligation, such as a collective bargaining agreement that requires a specific matching contribution. The plan document may permit your employer to change the match without notice. Most companies will tell you in advance if they're going to make a change in your matching contributions.

My employer just started a new 401(k) plan, but participants aren't able to choose their investments. Is this legal and fair? I was able to pick from 16 different funds in my old plan.

Surprising as it may seem, employers aren't required to let you choose your own investments. The employer is permitted to determine, with the plan trustees, how the money will be invested. It's unusual for employers to choose how to invest employees' money, but it's legal.

Employers sometimes choose investments for their employees because it makes the plan easier and less expensive to administer and eliminates the need to educate employees about different types of investments. Also, your employer may think most of your co-workers aren't capable of making informed choices.

However, most plans give employees the opportunity to split their contributions among a number of different funds. This allows each participant to structure an appropriate investment allocation among stocks and bonds, based on their time horizon and risk tolerance. (We discuss these concepts in more detail in Chapters 5 and 6.)

Mergers and Bankruptcy

My employer was recently sold. The new company told us our money will be transferred into its plan. I don't like the investments for the new plan. Why can't I leave my money in the old plan or transfer it to an IRA?

This situation is common when a company is sold. The buyer typically wants all employees in the same plan with the same investments. This is usually accomplished by forcing the participants of the acquired company to move their money into the new company's plan and investments.

The terms of the purchase agreement between the two companies is a key factor in governing what happens to the old 401(k). The purchase agreement will frequently provide for an automatic transfer of the 401(k) money from the old plan to the new plan. Depending upon the circumstances, your employer may not be able to give you the opportunity to take your money from the plan as a result of the sale of the company. Also, a single transfer to the new plan is much easier for your old employer than having to process a lot of individual benefit payments or IRA transfers. Your old and/or new employer may also want to avoid making these funds available, out of fear that employees will have the opportunity to blow their retirement savings.

The company I work for appears to be in serious financial trouble. I'm concerned about what will happen to my money if it shuts down.

Your employer is legally required to put your contributions into the plan no later than 15 business days after the end of the month in which the money was deducted from your pay. Unfortunately, some employers who are in serious financial trouble abuse this area of the law.

Your money should be safe from the company's creditors when it's deposited into the plan. In this case, the money is considered to be a plan asset, but it can take you a while to get it.

For this reason, and especially if your employer is having financial troubles, you should keep a close watch on when the contributions are deposited into your plan account. Your ability to do so depends on the administrative structure of your plan. For example, it will be easy to tell when money is added if you have daily Web or voice response access to the current value of your account.

Consider stopping your contributions if the administrative structure of your plan doesn't let you track when money is being added to your account, and you think that there's a strong likelihood your company will go out of business.

My employer went out of business six months ago, and I'm still waiting to get my money out of the plan. The former plan administrators are no longer around. The service provider tells me that they can't pay my money to me. What can I do?

Your experience is rather common when a company goes out of business. It is usually a difficult time for everyone, including the former owners. Many creditors and others probably want to find them. The good news is that if your money has actually been deposited into the plan, it should all be safe from the company's creditors. Your payment is probably delayed because, legally, the service provider can distribute benefits only with instructions from a plan representative. This authorization can't be provided if the plan representatives have all disappeared.

The courts should appoint someone to liquidate the business, including shutting down the 401(k). You'll get your money, but it may take a while. Ask the Department of Labor for help through its local office, which you can find listed on its Web site at `www.dol.gov`. The offices of your senators or congresspeople are other potential sources of help.

Loans and Rollovers

My husband and I both contribute to a 401(k). We plan to borrow 401(k) money to buy our first home. Does it matter from which plan we borrow?

Two primary issues come to mind with this question. The first is the potential that either of you will change jobs during the repayment period. If this happens, you'll have to repay the outstanding balance in a lump sum in order to avoid paying taxes. To resolve this issue, borrow from the plan of whoever plans to stay longest at his or her job.

The other issue involves your ability to handle the loan repayment, the mortgage payments, and continued plan contributions. If you have to reduce your contributions so much that you'll lose out on the employer matching contribution, consider which plan has the larger match. Make sure that contributions to that plan continue up to the full amount that's matched. The other spouse should then contribute whatever additional amount you can afford to his or her plan.

I have more than $70,000 in my 401(k) account. Can I transfer this much money to an IRA even though it exceeds the IRA limit?

The various limits that apply to personal IRA contributions don't apply to rollovers from employer plans. The amount you can roll over from an employer plan into an IRA isn't limited. You can roll over the entire $70,000.

I'm about to retire and roll my 401(k) into my IRA. My 401(k) account includes both pre-tax and after-tax contributions. What can I roll over?

You can roll over the entire amount, including your after-tax contributions. This wasn't possible before the law changed, effective in 2002.

Getting Help at Retirement

I'd like someone to help me decide what to do financially when I retire next year. How can I find a good adviser?

You face a mind-boggling combination of tax, estate planning, and investment decisions. Getting help from someone who is well versed in these issues is advisable, but finding the right person can be challenging. Two good resources for finding an adviser are the National Association of Personal Financial Advisors (`www.napfa.org`) 1-800-366-2732, and the Financial Planners' Association (`www.fpa-net.org`) 1-800-647-6340. Another is Dalbar's Advisor Finder (`http://moneycentral.msn.com/investor/dalbar/main.asp`). You can also ask friends and co-workers for recommendations in your area.

REMEMBER

Early on, establish how the adviser will be paid. Choose an adviser who's paid a flat fee rather than a commission. An adviser paid solely by commissions has to sell you products, some of which may not be in your best interest, to get paid.

Although consulting an adviser is often a good idea, totally placing your future in someone else's hands *isn't.* You should have enough knowledge to know whether the advice you're getting makes sense. Reading this book and consulting some of the resources we recommend is a good start.

Divorce

I'm getting a divorce, and my spouse has a 401(k). How can I make sure that I get my fair share? Will I have to pay tax on it?

The 401(k) should be split through a valid qualified domestic relations order (QDRO). A *QDRO* is a court order that allows a portion of your spouse's 401(k) money to go to you. If it's drafted correctly, neither you nor your spouse pays a 10 percent early withdrawal penalty on your portion, even if you're both younger than 59½. (See Chapter 2 for more about this penalty.) Your options for what to do with the money may include leaving it in the 401(k) in a separate account managed by you, or rolling it into an IRA or your own employer-sponsored retirement plan. Either option would keep the money tax-deferred until you withdraw it. You may also be able to withdraw the money right away, but you have to pay income tax on the amount. Your plans for the money must be spelled out in the QDRO; contact your spouse's employer or 401(k) plan administrator to find out what your options are. QDROs are tricky to draft, so hire a divorce attorney who has experience in this field. Some people also hire a certified divorce planner — a financial planner trained to analyze long-term implications of financial decisions made during a divorce.

I haven't seen my spouse for more than two years. I have no idea where he is. When I tried to change my 401(k) beneficiary to my children, I was told that I needed his approval. Why can't I name whomever I want as my beneficiary?

The law requires consent from your spouse in order for you to name someone else as your primary beneficiary. This provision was added to the law years ago to protect the rights of women, but it works both ways. The provision creates a serious problem in situations like yours (until you're able to get a divorce or find your spouse to get his consent). If you change your beneficiary to your children without your spouse's approval, and your employer pays the benefit to your children upon your death, your spouse could, in theory, sue your employer. That's probably why you were told that you needed your spouse's approval. However, not all employers are that strict. If your employer lets you name your children without your spouse's approval, you should do it, because you have nothing to lose.

My husband and I are getting a divorce. He wants half my 401(k) account. This is bad enough, but I don't want his girlfriend to get the money if he dies. Can this money go to my children instead?

Your spouse has a legal right to claim a portion of your 401(k) account; however, the exact details should be resolved during the divorce proceedings and become part of the final agreement. If he is willing, the agreement could give you the right to control who will get this money in the event of his death. However, this right may be workable only while the money remains in the 401(k), because it will be virtually impossible to track after he withdraws money from the plan and mixes it with other money.

I was recently given half my ex-spouse's 401(k) money. When can I get it? Who pays tax on it?

The divorce agreement should specify when you can take the money out of the plan. The agreement may not permit you to take your benefit until your ex-spouse takes his or her benefit. If this point isn't covered by the divorce agreement, you can take the benefit on the earliest retirement date provided under your ex-spouse's plan. You'll have to get this date from the employer. You'll be responsible for paying tax on the money that you receive unless you roll it over.

Company Stock Advantage

I own company stock in my 401(k). Because I'm about to retire and request a distribution, I'd like to know more about the special tax breaks I've heard about that apply to company stock.

Company stock is taxed differently when it's distributed to you from the plan. Any other amount you receive is fully taxable as additional income. With company stock, you pay taxes on the value of the stock at the time that you acquired it through the plan — not the value at the time that it's distributed to you. (This only works if you *do not* roll over the shares into an IRA.)

Assume that you have $50,000 of company stock that originally cost $20,000 when you invested in it. At the time of your distribution, you'll receive $50,000 worth of stock, but you'll pay tax on only $20,000. Later, when you sell the stock, your investment gain will be taxed as a capital gain, which is a lower rate than the regular income tax.

Chapter 15

Ten Questions Employers Frequently Ask

In This Chapter

- ▶ Understanding specifics of employer and employee contributions
- ▶ Helping employees with investment choices
- ▶ Figuring out nondiscrimination tests
- ▶ Handling distributions and loans
- ▶ Dealing with various and sundry legal questions

Even employers who know 401(k) rules like the backs of their hands may be confused when it comes to applying them. This chapter provides answers to some tricky real-life questions from employers. We promise ten questions, but you'll notice that we throw in a few more for good measure.

Contributions

I run the 401(k) at my company. Can you explain how I should calculate matching contributions?

Don't feel bad if you're confused, because employers frequently mess up matching contributions. You can either match contributions only during pay periods when employees contribute, or match them based on employees' contributions for the whole year.

For example, assume that you match 50 percent of the first 5 percent of pay contributed. This means that the maximum you'll contribute is 2.5 percent of pay. The question is whether you match 2.5 percent of annual pay or 2.5 percent of the amount paid each pay period.

If you compute the match for each pay period, the employer contribution should be equal to 50 percent of the employee's contribution, if the employee contributes less than 5 percent of pay. If the employee contributes 5 percent of pay or more, the employer contribution should be equal to 2.5 percent of the employee's pay for that period.

If you determine the match on an annual basis, you compute the amount based on the employee's year-to-date pay. Say an employee contributes nothing for six months and then contributes 20 percent of pay during the last six months. Or, say an employee contributes his year-end bonus to the plan in December. In these instances, the entire amount contributed should be matched, as long as the year-to-date match doesn't exceed 2.5 percent of year-to-date pay. This is the case even though the match for the current pay period will exceed 2.5 percent of current pay.

The method you select must be applied uniformly for all participants and should be consistent with the provisions of your plan document.

What's the difference between a variable matching contribution and a profit-sharing contribution?

Profit-sharing contributions are determined at the end of the year, based on the company's financial results. Typically, all eligible employees get a portion of a profit-sharing contribution without having to contribute to the plan. A profit-sharing contribution is usually divided among eligible employees in proportion to total earnings.

Variable matching contributions may be based on the company's financial results, as well, but they only go to employees who contribute to the 401(k).

How can you decide which type of contribution to offer? Consider this story about two workers, Phil and Dave. Phil is married, with three children. He's a great worker, but he can't afford to contribute to the 401(k). Dave is single and a marginal employee, but he contributes 8 percent of his pay to the plan. Both employees will receive a profit-sharing contribution, but only Dave will get a share of the variable matching contribution. This may cause a morale problem for Phil if he sees his less committed co-worker receiving more financial benefits. You need to decide which employees you want to receive any additional contributions as an incentive.

Investment Choices

We're considering offering a mutual fund window in our 401(k) plan that will enable participants to choose from thousands of funds. How will this impact our liability?

Opinions vary on this subject. Some argue that a mutual fund window increases liability, because participants who invest badly and lose money may then sue the employer for not preventing the calamity. Another concern is that employers, in order to get the limited fiduciary protection under *404(c) regulations,* must provide sufficient information for employees to make informed investment decisions. (We discuss 404(c) in Chapter 1, and brokerage windows in Chapter 6.)

You may be able to reduce your risk by requiring the participant to sign a waiver. The waiver should require participants to

- Acknowledge that they consider themselves to be knowledgeable investors
- Waive their right to sue if the investment results are bad
- Acknowledge that they're assuming the full responsibility to secure whatever information is needed to make investment decisions

We're thinking about offering investment advice to our participants, because many are having trouble deciding how to invest. What's the best way to provide advice without increasing our liability?

Opinions vary on this question, too. We believe that investment advice will reduce your liability if it's done right, because providing this additional level of help for your participants is better than letting them decide how to invest on their own. Education is often not enough — all the educational materials in the world haven't turned amateurs into professional investors. Adding investment advice to your plan should bring better results.

We believe that the best way to offer advice is to hire an investment advisor who doesn't have a financial stake in how your participants invest their money. The advisor should be paid a flat amount per participant. Use the same care when you select the investment advisor that you use when you select other service providers for your plan.

Nondiscrimination Tests

When determining which employees are highly compensated (HCEs), should I look at rate of pay or actual pay?

You look at the actual pay. This may give HCEs who are hired during the year a break. For example, an employee hired on Sept. 12, 2003, at a $200,000 salary will earn approximately $60,000 for the year 2003. This employee won't be considered an HCE in 2003, because his actual earnings are less than the $90,000 limit. He won't be considered an HCE in 2004, either, because the determination is based on the previous year's salary at the company. However, regardless of salary, the employee is an HCE if he owns more than 5 percent of the company in either year.

Which employees must be included in the nondiscrimination tests for our plan?

You include all employees who were eligible for any portion of the year that's being tested. An employee who doesn't contribute to the plan may still be eligible.

Take your total number of employees and subtract those who weren't eligible to contribute at any time of the year. The remaining employees are those who should be included in the nondiscrimination tests for your plan.

My company is having trouble passing the nondiscrimination tests. We have to give money back to some of the HCEs every year. How can we better manage this process?

When you do the nondiscrimination test for the current year, you're allowed to use the average percentage the non-HCEs contributed during the *prior* year if you have selected prior-year testing in your plan document. With prior-year testing, you shouldn't fail the test, because you know before the year begins exactly how much the HCEs can contribute.

If you must use *current year* non-HCE results, you should regularly monitor contributions made by both groups — and take action to limit HCE contributions as necessary — to avoid a failure.

Distributions and Loans

How are distributions reported to the IRS, and who's responsible for reporting them?

Distributions from a 401(k) plan must be reported to the IRS on Form 1099-R. The employer is responsible for reporting distributions, but most employers have a service provider handle it. Codes need to be entered on the Form 1099-R to show what type of distribution it is (hardship withdrawal, excess contribution refund, and so on). Make sure that the correct code is entered, otherwise it creates a hassle for you and the participant receiving the distribution.

We're considering adding a loan feature to our 401(k). What do we need to know?

You should consider a number of things. The most significant are the legal requirements for loans and the administrative procedures that are needed for operations.

You'll also need a lot of help from the organization that manages your plan. Ask for a checklist of decisions you need to make when you set up loans, and another checklist of the operating requirements. One of the most important operating issues you'll have to consider is how many loans a participant may have at one time. It's easy to say that you will only permit one at a time, but this can present problems for participants who want to use this money to help with educational expenses. An alternative to multiple loans is to restructure a new loan into one larger combined loan — but there are serious compliance issues associated with this solution. We discuss loans in Chapter 7.

We're considering terminating our 401(k) plan. Are there any special requirements?

Yes. You probably need to formally amend the plan to bring it into compliance with all changes in the law prior to its termination. Also, all contributions become fully vested when a plan is terminated, regardless of years of service and other vesting requirements. The plan trustee(s) and the plan administrator must continue to operate the plan with the frozen assets in accordance with the plan documents and solely for the benefit of participants and their beneficiaries, until all assets are distributed. Typically, benefits are paid to the participants shortly after the plan is terminated or the assets are transferred to another plan. You should contact your advisor to find out any other considerations for your plan.

Assorted Legal Questions

I'm helping my wife start a business. Can I use my 401(k) as collateral for a business loan to help her get started?

You can include your 401(k) balance as an asset when you submit your financial statement to the bank, but you're legally prohibited from assigning the account as collateral. This protects your 401(k) and other retirement benefits from the claims of creditors.

The lender may still be willing to give some consideration to your 401(k) when making its decision on the loan. The lender can't get at your retirement money if you default, but it may bet that you will access your retirement money rather than default on the loan.

What reports must be filed with the government for our 401(k) plan, and who is responsible for filing them?

In addition to reporting distributions using Form 1099-R, the employer must file an annual financial report, Form 5500, with the IRS each year. The filing deadline is seven months after the end of the plan year, unless the employer gets a filing extension. Employers usually have a service provider fill out the form, but the employer signs it and files it.

A couple of participants in our plan may be getting divorced. I've heard that handling those situations can be tough. Where can I get help?

Properly handling a *qualified domestic relations order (QDRO)*, which governs how the 401(k) assets are split, is difficult. You should probably establish policies and procedures for your plan in advance. Divorce attorneys usually aren't familiar with retirement plans. As a result, they often draft QDROs that contain some specific terms that are impossible for employers to comply with. Some employers have a QDRO kit that they give to both parties in the divorce to help them deal with this issue.

You should get professional help from an ERISA attorney who has experience with QDROs. Your service provider should also be able to help. One firm that specializes in this field is QDRO Consultants Company. (Its phone number is 1-800-527-8481.)

I've read that our company can be sued if we pay a benefit to a beneficiary other than a spouse, even if the beneficiary is named by the participant. With constant marital changes, how can we be expected to keep track?

Keeping track of employees' personal lives is difficult. For this reason, you should remind employees to keep their beneficiary designations up to date.

Your company can indeed be sued if it pays benefits to someone other than the employee's spouse without the spouse's consent.

The following are some things you can do to reduce your risk:

- Require a notary (rather than a company employee) to witness the spousal waiver.
- Watch for changes in marital status that may show up elsewhere, such as medical coverage and group life insurance beneficiary changes.
- Inform all participants about the spousal waiver requirements and remind them to keep their named beneficiaries current at least annually.
- Take reasonable steps to make certain that a deceased employee didn't have a spouse before you pay benefits from the 401(k) or other retirement plan to another beneficiary.

Chapter 16

Ten (or So) 401(k) Mistakes to Avoid

In This Chapter

- ▶ Avoiding participation pitfalls
- ▶ Countering contribution calamities
- ▶ Investing appropriately for you
- ▶ Filling out paperwork
- ▶ Curbing company stock

Some things are impossible to avoid, such as bad airplane coffee or a nosy next-door neighbor. But other things *are* avoidable and worth keeping away from. The following 401(k) mistakes are common, but we hope that after reading this chapter, you'll know enough not to make them.

Not Participating

If you don't participate in your 401(k) plan, you're cheating yourself. First, you lose out on the tax break that you'd get if you did contribute. Every dollar you put into a 401(k) as a pre-tax contribution reduces your taxes for that year. Also, the money in the account grows tax-free until you withdraw it. That's a great deal.

But perhaps even more important is that you're cheating yourself out of choices in the future. The more money you save for retirement, the more flexibility you'll have when you get there.

After all, where will your income come from when you no longer have a paycheck? Social Security will provide some, but it won't be (and isn't meant to be) enough. A traditional pension from your employer will also help, if you have one. But after that, it's up to you.

Chapter 17 looks at bad reasons people give for not participating and also examines why these reasons are bad. Read Chapter 17 if you still don't think it's worth saving for retirement.

Not Contributing Enough to Get the Full Employer Match

If your employer offers a matching contribution, make sure that you contribute enough to get the maximum amount possible. Would you walk past a 50 dollar bill lying on the sidewalk? We hope not! You shouldn't walk away from your employer's contribution, either.

For example, say you earn $50,000 and your employer matches 50¢ for every dollar you contribute, up to 6 percent of your salary. Six percent of $50,000 is $3,000. If you contribute $3,000 or more to your 401(k), your employer will deposit a matching contribution of $1,500 (50¢ on the dollar). If you contribute less, say $2,000, your employer will only put in $1,000. You leave $500 on that proverbial sidewalk.

Check out Chapter 3 for information on getting the largest possible matching contribution.

Taking a Loan or Hardship Withdrawal Unnecessarily

Removing money from your retirement accounts before you retire is not something to do lightly. Taking money out of your retirement account for another purpose can set you back in taxes, penalties, and lost compounding. It can be difficult — if not impossible — to make up the money.

Explore other alternatives first. If you need the money for a child's education, consider a less expensive school or have your student find part-time work to help pay the bills. If you want to buy a home, consider one that's less expensive or give yourself another year or two to save for the down payment. In other words, plan ahead or scale down your goals so that you can live within your means and keep your retirement savings intact.

Of course, we recognize that you may find yourself in an emergency situation where your 401(k) is your last resort. In that case, use our analysis in Chapter 7 to decide between a loan or hardship withdrawal.

Defaulting on a Loan

If you take a loan on your 401(k), don't default on it. You generally have five years to pay back a loan, with payments deducted from your paycheck. In most plans, if you leave your job (voluntarily or not), you can't continue paying back the loan, so the entire unpaid balance comes due. If you don't pay the entire loan back, the amount counts as an early distribution, and you owe income tax, as well as a 10 percent early withdrawal penalty if you're under 55 when you leave your job.

Contributing Too Much

The federal maximum contribution limits for 401(k)s apply to all contributions you make to all 401(k)s in one year. You don't start over at zero each time you have a new employer. Also, if you work for two employers at the same time, and both offer 401(k)s, the limits apply to both plans combined. See Table 2-1 in Chapter 2 for the limits.

If you go over the limit, you need to withdraw the excess contributions by April 15 of the year following the year you contributed too much. If you don't, you'll have to pay tax twice on those contributions — once for the year you made them, and again when you withdraw money from the plan.

Investing Too Conservatively or Too Aggressively

This issue is tricky, because "too conservative" for one person may be "too aggressive" for another. As we explain in Chapters 5 and 6, how you invest depends on factors that are unique to you — namely, investment goals, length of time until you need your money, and personal risk preferences.

If you invest in a way that's too conservative for you, your money may not grow enough to offset inflation. Even though you earn some return, prices may rise even faster (inflation), leaving you with less spending power in your retirement years.

Investing too aggressively can give you sleepless nights and sweaty palms. The ups and downs may be too much for you to stand, and you may be tempted to sell your investments when they're down (which is exactly the wrong time to sell them).

Failing to Rebalance

When you invest 401(k) money, you first decide on an *asset allocation*, that is, how to divide your money among different types of investments (asset classes), such as stocks, bonds, and cash equivalents. To take a simple example, your asset allocation may be 80 percent stocks and 20 percent bonds. (You can break these into smaller categories, but we want to keep things simple.)

Say bonds do really well for a year, and your stock investments slump. You could end up with a portfolio that's 70 percent stocks and 30 percent bonds. But that's not what you want — you decided that an 80/20 split was a better allocation for you. What do you do? Leaving more money in bonds is tempting, because they're doing well, but that's not the right move. You want to sell the extra 10 percent you have in bonds, now, while the price is high, and use the money to buy stocks, which are low. In so doing, you *rebalance* your account. We recommend looking at your account every year and rebalancing it if necessary.

Day Trading

Day trading may have gone the way of the dodo in the slumping stock market of the early 2000s, but it bears mentioning. *Day trading* means buying and selling stocks daily in an attempt to make large gains. Your long-term retirement accounts are no place for attempts at short-term gains.

TIP

Take it from us — the least stressful and most successful way to invest for retirement is by choosing a solid portfolio of diversified investments, putting your money into those investments, rebalancing annually, and getting on with your life.

Failing to Name a Beneficiary

401(k)s are *beneficiary-designated assets,* which means that your will can't direct where the money goes if you die. You have to fill out a 401(k) beneficiary form with your employer.

If you don't fill out a form, federal law provides that the money goes to your spouse if you die. If you don't have a spouse, the beneficiary default provisions of your plan, which establish a beneficiary priority, will apply. The 401(k) may go to your estate, and whoever inherits your estate will get the money. However, having the money pass through your estate is not as good a deal for the heir as inheriting the 401(k) directly. More may be taken out in taxes and legal fees if it goes through the estate. Worse yet, it may go to someone you don't even like.

Read more about beneficiaries in Chapter 3.

Cashing Out Instead of Rolling Over

When you change jobs, you have a choice of rolling your money over into a new tax-deferred retirement account, which keeps your retirement savings intact, or withdrawing the money and paying income tax (and a 10 percent early withdrawal penalty if you're under 55). You may also choose to leave the money in your former employer's plan. A lot of people make the mistake of cashing out, particularly young workers with low 401(k) balances. They figure it won't matter if they withdraw the money, because it's such a small amount.

They're wrong. A small amount — say $5,000 — can grow to $157,047 over 40 years or $102,070 over 35 years, assuming a 9 percent interest rate. That's quite a chunk of change. Is it really worth giving that up for whatever it is you think you need now?

Loading Up on Company Stock

Some participants end up with a lot of company stock in their 401(k), inadvertently or not, a la Enron. This situation can happen if the employer makes matching contributions in the form of company stock and also lets employees invest their own contributions in company stock.

WARNING!

Loading up on company stock is a bad idea, as we explain in Chapters 5 and 6. Tying your retirement account to the fortunes of one company — no matter how great you think the company is — is dangerous.

TIP

If your employer matches your contributions with company stock, take all that your employer gives you. But don't invest your own 401(k) contributions in company stock. Diversify your account as much as you can.

Chapter 17

Ten Bad Excuses People Give for Not Participating (And Why They're Bad)

In This Chapter

- Soothing stock market and corporate bankruptcy worries
- Determining saving priorities if you're a single parent
- Convincing yourself that it's not too soon, or too late, to save
- Answering other fears and concerns

Some people have an excuse for everything. They rear-end another car and then blame the other driver for stopping. Or, they can't fit into their favorite jeans after too many late-night pizzas, so they blame the dryer for shrinking them.

Making excuses is sometimes okay if it makes you feel better (even though it can be annoying to the rest of us), but one area where you shouldn't make excuses is your retirement savings. Most people have absolutely no reason not to save for retirement — especially if their employer makes it easy by offering a 401(k) or similar plan.

This chapter takes a closer look at bad excuses people give for not saving in a 401(k), and why those excuses are bad. To paraphrase a familiar big-screen character: Save or save not. There is no try.

I'm Afraid of the Stock Market

Many of the investors burned by the stock market tumble of the early 2000s may be reluctant to put their hard-earned dollars into stocks. Although a reluctance to invest in stocks is understandable, it's not a good reason to ignore your 401(k). Even if your 401(k) investments don't produce spectacular results, you'll still be a lot better off in your retirement years if you save in a 401(k) than if you spend all the money now.

401(k)s often offer some investments that aren't stocks. If you're really stock-shy, you may have this alternative available to you. However, remember that historically (on average), stocks have provided the highest return of the different types of investments and have done the best job of beating inflation, so you should consider including them in your investment portfolio.

The first step to conquering fear is finding out more about what you're afraid of. Part 3 of this book is a good place to start educating yourself about investment basics.

I'm Afraid I'll Lose My Money if My Employer Goes Bankrupt

The money you contribute to a 401(k) is placed in a trust. The assets of the trust don't belong to the company, so they shouldn't be at risk in a bankruptcy. If your employer goes bankrupt, you should eventually get your 401(k) money — although it may take a while. Of course, if you hold company stock in your 401(k), it will be worthless if the company goes out of business.

You could lose contributions that have been deducted from your paycheck but not yet deposited into the 401(k) by your employer. Employers are supposed to deposit contributions into the plan fairly quickly, but some employers violate this requirement. One month's worth of contributions is the most you'd be likely to lose if your employer is making deposits on time.

I Can't Afford It

Oh yes you can. Most people can find $10 a week if they really try — that's about $500 a year. Invest $500 a year for 40 years, at a 9 percent annual return, and you end up with $169,000. That's certainly better than nothing — and you'll probably be able to afford to save a larger amount sooner than you think.

Don't make the common mistake of expecting it to get easier to save after you start making more money. It never gets easier, so start now. Most people can find ways to reduce expenses without feeling any pain. See Chapter 4 for some of our suggestions. Also, an extra tax deduction is available to retirement plan participants with low and moderate incomes. Details are in Chapter 3.

I'm a Single Parent, and I Have to Save for My Child's Education

This excuse often comes from women, and it is a tough one to refute. Your child's college bills are probably going to be due before you retire, so it may seem logical to save for college first and retirement later. What's more, surveys indicate that women tend to put everyone else's needs ahead of their own.

Note, too, that women, on average, live longer than men, so they need more money to see them through retirement. Statistics show that women end up impoverished in retirement more often than men.

TIP

Rather than ignore your retirement savings, put some of the money you'd normally save toward education into a tax-deferred retirement account. Investigate less expensive colleges, encourage your child to get a part-time job, apply for financial aid, and ask other relatives for help paying college costs. After all, what's the point of putting Junior through an expensive college if he's going to have to support you when he gets out?

I Don't Like My Plan

This concern may be valid if you think something fishy is going on with your plan administration; for example, if your contributions aren't deposited into the 401(k) on time, and your company's treasurer just left for an extended holiday in Hawaii. But be sure that your concern is justified before you use this as an excuse.

TIP

If you don't like your plan because you think that the fees are too high or the investment selection is inadequate, don't simply throw in the towel and not participate. One strategy you can try is to contribute only enough to get the full company match. (If your employer contributes 50¢ for every dollar you contribute, that's a 50 percent return on your money right there.) Then contribute the maximum to an IRA, as well, to boost your retirement savings. You may not get a tax deduction for the IRA contribution, depending on your salary, but you may be able to contribute to a Roth IRA, which allows tax-free withdrawals. See Chapter 8 for more details about IRAs. Also, try to convince your employer to improve the plan, as we explain in Chapter 2.

I'll Probably Change Jobs Soon

You may be hesitant to join your 401(k) because you're thinking of changing jobs. Well, unless you have a firm job offer to start next week, we have news for you — things don't always go the way you plan. You may be at your job longer than you think. And when you do change jobs, you can roll over your 401(k) money into your new 401(k) or an IRA. Take advantage of the opportunity to save for retirement at your current employer, even if it's only for a few more months.

I Hate Paperwork

Paperwork ranks up there with Mondays and housework when it comes to things most people hate. To make matters worse, you generally receive 401(k) enrollment forms at the same time that you're trying to get used to a new job. The only reason some employees don't participate in their 401(k) is that they just never get around to completing the paperwork. They keep putting it off — sometimes for years.

The key is to remember that your 401(k) enrollment isn't useless paperwork — it's part of a strategy to help you achieve a goal of retiring at a certain age and having flexibility to do what you want.

It's Too Hard to Get My Money Out

This concern is understandable, but it's not a good reason to ignore your 401(k).

You can't withdraw money from a 401(k) like you can from, say, a bank savings account. But remember that you get special tax breaks for contributing to a 401(k). The reason Uncle Sam allows these tax breaks is that he wants to encourage you to save for retirement; that's why the amount you can take out, and the reasons for taking it out, are restricted. This money is supposed to be for retirement!

Most plans permit "hardship withdrawals" and/or loans from your 401(k) for approved purposes, such as higher education expenses, buying a home, or financial hardship. We explain the rules in detail in Chapter 7.

Consider saving for other purposes in different types of accounts. For example, keep an emergency fund in something easy to access, such as a money market fund. Save for your children's college in a tax-advantaged college savings fund. Then put retirement money into your 401(k).

I Don't Need Anything More than Social Security and My Pension

Social Security benefits received during retirement generally replace about 20 to 40 percent of pre-retirement income for someone who retires at Social Security's "normal retirement age." (The higher your pre-retirement income, the lower the percentage replaced by Social Security.) But financial planners estimate that you'll need 80 to 100 percent of your pre-retirement income to have a comfortable retirement.

If you don't get a pension, you're left with a gap of 60 to 80 percent. A pension benefit, if you have one, may provide an additional 15 to 25 percent, reducing the gap. How do you fill this gap? Unless you have certain wealth from another source, you need to save on your own. The more you save in a 401(k) or other retirement account, the better off you'll be.

I'm Too Young (It's Too Soon)

Unfortunately, most young people — even those in their 20s — don't spend a lot of time thinking about retirement. Why start planning now (and deprive oneself of cash every month) for something that's 30 or 40 years away?

To that we answer, c*ompounding.* Small amounts of money saved regularly over time can grow to large sums, especially in an account like a 401(k) that lets you save without paying taxes on your investment gain each year. Invest $1,000 a year from age 20 until age 65, with a 9 percent average return, and you end up with $525,000. Start saving five years later, at age 25, and you'll only have about $338,000. See how much better off you are if you start early?

You don't have to start big, either. Just $10 a week adds up to about $500 a year. As you move up in your profession and your salary increases, you can increase your contributions, as well — especially if you're already in the habit of saving.

Chapter 4 gives tips for developing a savings plan, and examples of the benefits of starting young.

I'm Too Old (It's Too Late)

Some people in their 50s and 60s worry that they're starting the retirement savings game too late. If you're just beginning to save at that age, indeed, you have some catching up to do. But guess what? Congress passed laws in 2001 that are aimed at helping you save more. The age-50 catch-up contribution and increasing federal contribution limits that we discuss in Chapter 2 were conceived to help baby boomers who hadn't saved enough for retirement save more.

Don't berate yourself if you're in this situation. The retirement landscape has changed dramatically in the last 10 to 20 years, and many people were caught unawares by the increased need to save for retirement rather than depend on Social Security and a company pension.

It's never too late to save in a 401(k). For as long as you work, even if you're older than 70½, you're allowed to contribute to your employer's 401(k). The important thing is to have a plan. Life goes on whether you're ready or not, so be prepared.