Part 1

Understanding Your 401(k) Plan

What It Is, How It Works, and Why You Need One

You've heard all about them—401(k) plans are almost everywhere. The only people who don't seem to have them are professional football players and bank robbers. And you're not so sure about the football players.

But you don't know as much as you want to about your 401(k) plan. It's for retirement money. It involves investments. And that may be about it.

Exactly how it works, what you're entitled to, the dos and don'ts—it's all a blur.

And it doesn't matter whether you actually know a lot, only a little, or nothing at all.

If you're already an avid participant in your plan, you can still use help in understanding certain features and in getting a handle on whether your investments are your best possible choices.

And most people know a lot less about their plan. After all, everyone has other time-consuming responsibilities, at work and at home. It's tough enough to pay the bills without having to worry about stealing from your own paycheck to put money away for your retirement—which may be *very* far in the future. Besides, all that jargon can give most people a headache. And Wall

Street? It seems like a very private club, with its own secret rules, located far, far away from where you live and work.

Part One of *Getting Started in Rebuilding Your 401(k) Account* explains what your plan is, how it works, and how it can help you.

And *Getting Started in Rebuilding Your 401(k) Account* does this in plain English. That may be a foreign language on Wall Street. But it's what everyone speaks on Main Street, U.S.A.

Chapter 1

Basics of Your 401(k) Plan

Right here, right now, let's cut to the chase.

Question: Why is your 401(k) plan important to your future?

Answer: Because it is a free pay raise.

If you don't need money, you can stop reading. Go to the movies. Watch some TV. Walk the dog. Good-bye and good luck.

The rest of you, read on.

A 401(k) plan does indeed provide you with a free pay raise. In fact, by putting more money into your pocket up to three different ways, it gives you as many as three pay raises.

1. Your contributions can lower your taxes.
2. Your investments grow without being taxed year-by-year. You can plow those would-be taxes back into your investments.
3. Your company almost certainly matches your contribution with a bonus that goes into your account.

No other source of savings or income duplicates that triple play—not your savings, not your pension (if you've got one), not Social Security.

A 401(k) Plan versus an IRA

An individual retirement account (IRA) comes closer than savings, pensions, or Social Security to matching a 401(k). But even an IRA—whether it's a Roth, a regular deductible, or a nondeductible—lags behind a 401(k) plan account in two crucial ways:

First, the most you can contribute each year (even if you can double the amount with a spousal contribution) is much less than the amount you can put to work inside a 401(k) account under federal rules.

Second, an IRA provides no company match!

A Closer Look at Those Three Key Advantages

The edge that a 401(k) plan gives you has to do with how those three pay raises work.

Cuts Your Taxes

Money you contribute to a traditional or regular account is subtracted from your taxable current income. It is *tax-deductible "before-tax" money.* Not only do you get to invest it; it also reduces your taxable income that year. It may even put you into a lower tax bracket. Unless you are a monetary masochist who thinks bigger is better when it comes to taxes, this is a great deal!

Tax-Deductible Your traditional 401(k) contribution is what accountants call "tax-deductible." That's because you subtract your contribution from your other taxable income. The amount left over is what you figure that year's tax bill on.

Your contribution's tax-cutting power is so important that it deserves to be talked about in a little more detail.

Think about it. Your 401(k) contribution puts money back into your pocket by doing two things:

1. It reduces your taxes.
2. The money you save on taxes can be invested so it grows—along with your contribution itself. It turns a loss into a gain. This is as close as you'll ever get to the proverbial free lunch.

"Before-Tax" Money Because your contribution is made before your taxable income is calculated, your contribution is referred to as "before-tax" money.

Lowering Your Taxes

Here's how a tax-deductible contribution helps you.

A tax deduction is taken into consideration while you are figuring out your tax bill. For instance, if you are in the 28 percent bracket, when you make a $2,000 contribution to your 401(k) account, that $2,000 is not taxed. You save 28 percent of that $2,000, or $560.

Don't confuse a tax deduction with a tax credit.

If you are entitled to a tax credit, you subtract it from your tax bill. After you calculate your tax bill, for example, a $2,000 tax credit reduces your taxes by $2,000. It doesn't matter what tax bracket you're in.

Best of Both Worlds

Your contributions to your traditional 401(k) account are tax-deductible. It's as if you did not earn the money. That lowers your current tax bill.

But your contributions are counted for purposes of calculating your Social Security and Medicare taxes. A tax payment of any kind may not exactly be cause for celebration. But it means that your 401(k) contribution is included in the calculation of how large your Social Security and Medicare benefits will be later in life.

Roth 401(k) Account

Contributions to a traditional 401(k) account are with before-tax (or pretax) money. That money is not counted in that year's taxable income.

But now you can choose to use what's called a Roth 401(k) account, if your plan offers that option, either instead of or in addition to a traditional account.

A Roth 401(k) account is like a Roth IRA. Contributions are made with after-tax money. That means they're from money left over after you've paid taxes.

Once you contribute to a Roth 401(k), you won't owe tax that year or in subsequent years on whatever that contribution earns in investments. Like a traditional or regular 401(k) account, earnings are tax-deferred.

The big difference between a Roth and a regular 401(k) account is what happens when you take money out. Withdrawals from a Roth 401(k) are not taxable. That's because you already paid tax on the money before it went into the account. Withdrawals from a regular 401(k) are taxable.

Roth 401(k) accounts are discussed in detail in Chapter 10.

Additional After-Tax Account Options

Some plans let you make non-Roth after-tax contributions. Why bother? After all, they don't lower your taxable income in the current year.

But such so-called nondeductible accounts give you another way to invest money so its earnings grow on a tax-deferred basis. You'll only be liable for tax when you finally take money out. That may not happen for years or even decades, until you are retired.

Postpones Taxes on Your Investments

This is a humongous benefit. *Not . . . paying . . . taxes.* It used to be that only gangsters could pull that off. They had to send secret deposits to a numbered account in Switzerland.

Now all you have to do is join your 401(k) plan, not your local chapter of the Cosa Nostra.

This privilege is called *tax deferral.* It means that you escape current taxes on the money you invest each year. It also means you don't have to pay yearly taxes on your 401(k) account balance or its investment earnings until you withdraw funds.

> **Tax Deferral** That's the name of the tax break that applies to your money so long as it's inside your 401(k) account.

Yes—eventually Uncle Sam expects to be paid. But not until you take the money out of your account. A gangster may never worry about paying taxes. But using a 401(k) plan won't get you sent to the Leavenworth federal prison.

This benefit cannot be exaggerated.

First, the money you contribute is not treated like income by the Internal Revenue Service. The IRS ignores it when it comes to totting up your tax bill. Then, while the money is sitting inside your account, both that money and everything it earns are *tax-sheltered.*

Dividends you earn on your ordinary bank account don't enjoy that tax break. Nor does your regular income. Nor does any profit you make on the sale of stocks and bonds.

If you own a mutual fund that pays you dividends, you'll typically owe taxes on that income—unless that fund is sitting inside a tax-deferred account like a 401(k) plan.

Best of all, your money remains tax-sheltered as long as it remains cocooned inside your 401(k) account. You probably won't withdraw it until retirement, so it could remain tax-sheltered for decades.

That means your money and its earnings can continue to grow through compounding without being whittled down by taxes. That's why money inside a tax-deferred account like your 401(k) grows more than the same money outside a protected account. And it can enjoy that advantage for decades.

However, if you withdraw money before age 59½, generally whatever amount you take out will be subject to income tax plus a 10 percent penalty. Only under certain circumstances can you avoid the tax and penalty. (See Chapter 9.)

Creates Matching Contributions

Would you like a pay raise? That's what a matching contribution is.

Better yet, it is usually a pay raise that you can give to yourself. Most matches go up when your own contribution does the same.

Typically, you don't have to ask anyone's permission. You don't have to sweat through a job review. (Unless the match hinges on company profitability or your own performance.) It is commonly yours for the taking.

Technically, a matching contribution is bonus pay.

Better yet, it is a bonus that gets the same tax break as your own contribution to your account. It is not taxed as regular income. Further, this bonus—along with its earnings—remains sheltered from taxes until you withdraw it.

This tax-sheltered bonus is unique to 401(k) plans. There is nothing like it in the world of IRAs.

Its purpose is to help your employer encourage you to save and invest for retirement. The fewer retired people who end up on welfare, food stamps, and street corners selling pencils from a tin cup, the better.

A company match is usually triggered by your own investment. But sometimes it depends on your age, years of employment, or how well the company is doing.

One way or the other, 98 percent of 401(k) plans offer some matching contribution, according to benefits consultants Hewitt Associates. Figure 1.1

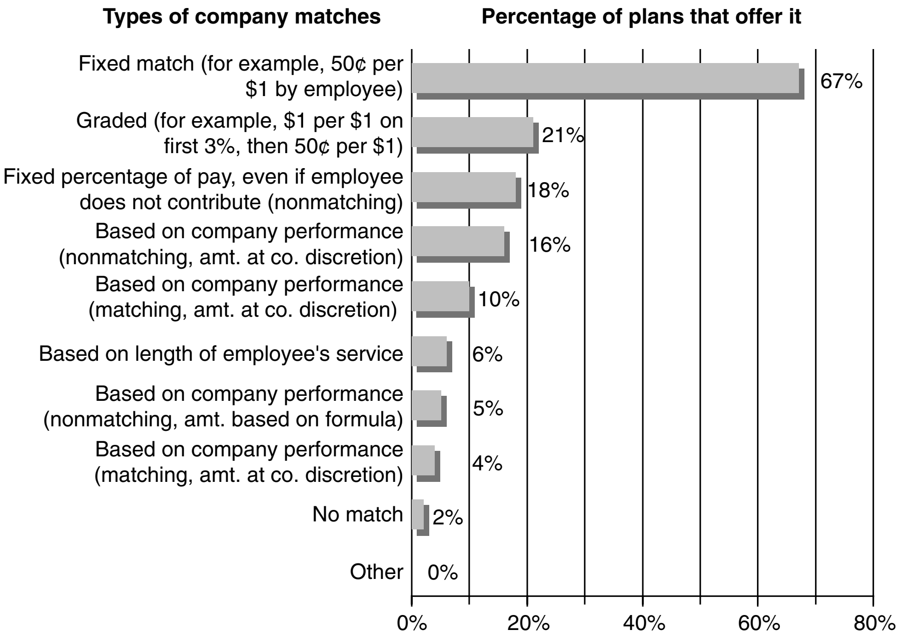

FIGURE 1.1 Types of company matches and the percentage of plans that offer each kind. By far the most common type of employer contribution is a fixed match.

Source: Hewitt Associates LLC.

Note: Nonmatching contributions are made whether or not the employee contributes to his account.

shows the types of company matches. Most simply give a set amount or percentage of your pay. That's known as a *fixed match.* Sometimes there's an upper limit to a fixed match. For instance, a company may kick in 50 cents for every $1 you contribute, but only up to 5 percent of your pay; you may be allowed to contribute, say, as much as 10 percent of your pay, but you won't get a match for anything above 5 percent.

Fixed Matches		*Percent of Plans*
All matches of less than 25 cents for each employee $1		<1%
All 25-cents-per-$1 matches		4%
25 cents per $1 of first 6%	*3%*	
All other 25-cents-per-$1 matches	*1%*	
All matches of more than 25 cents per $1 and less than 50 cents per $1		2%
All 50-cents-per-$1 matches		26%
50 cents per $1 of first 6%	*16%*	
50 cents per $1 of first 5%	*2%*	
50 cents per $1 of first 4%	*3%*	
50 cents per $1 of first 3%	*2%*	
All other 50-cents-per-$1 matches	*3%*	
All matches of more than 50 cents per $1 and less than 75 cents per $1		2%
All 75-cents-per-$1 matches		2%
All matches of more than 75 cents per $1 and less than $1 per $1		0%
All $1-per-$1 matches		24%
$1 per $1 of first 6%	*7%*	
$1 per $1 of first 5%	*4%*	
$1 per $1 of first 4%	*8%*	
$1 per $1 of first 3%	*4%*	
All other $1-per-$1 matches	*1%*	
All matches of more than $1 per $1		1%
Other fixed matches		6%

FIGURE 1.2 Fixed company matches come in many sizes. Some are more common than others. Fifty cents for each dollar contributed by an employee is the most widespread.
Source: Hewitt Associates LLC.

A *graded match* changes, rather than ends, at some specified trigger point.

The size of the employer's match can differ from company to company. Some give more. Some throw in less.

The most common fixed match is 50 cents for every $1 contributed by the employee. Dollar-for-dollar matches are the next most common. Whatever its size, the company match is virtually a pay raise that you can award to yourself. And often you can get more of it simply by increasing your own contribution.

Sure, more is better. But this is one gift horse whose mouth you should not bother looking into. Even a small match is good. That's because it is free money. It is a pay raise. And often it is a pay raise you can give to yourself. All you have to do is contribute more of your own money and—presto!—your company must pony up more (unless and until you hit any match cap there is).

Figure 1.2 shows how common each level of employer fixed match is. The table also shows categories within each level.

Figure 1.3 shows how large the most common types of graded matches are. The most widespread graded match is one in which a company antes up $1 for every $1 you contribute up to a specified limit. Then it contributes an additional amount, usually at a lower rate.

As Figure 1.1 illustrates, graded matches account for 21 percent of all the types of company matches. Figure 1.3 lists what percentage of plans offers each type of graded match.

Graded Matches	*Percent of Plans*
$1 for each employee $1 on first 3%, 50 cents per $1 on next 3%	2%
All other $1-per-$1 matches on a specified initial percent plus additional match on higher percents	2%
All 25-cent matches on a specified initial percent plus additional match on higher percents	<1%
Details of match not disclosed	1%
All other graded matches	16%

FIGURE 1.3 Some sizes of company graded matches are more widely provided than others.
Source: Hewitt Associates LLC.

More Ways a 401(k) Plan Can Help You

A yearly tax cut . . .

Tax-free growth of your money . . .

A company match . . .

If those were the only advantages conferred by your 401(k) plan, they would be more than good enough reasons for you to sign up and fork over.

But there are additional incentives as well:

- ✔ Automatic deposits.
- ✔ Flexibility.
- ✔ Control.
- ✔ Extra perks.
- ✔ Portability.
- ✔ Protection.
- ✔ Best deal.

Automatic Deposits

You don't have to write a check once a week, once a month, or once a quarter. After you choose how much you want to contribute, money is taken automatically out of your paychecks.

This has numerous advantages. First, it makes contributing pain-free. Money is diverted into your 401(k) account before it ends up in your paycheck or in your pocket. You don't miss it because you never had it.

Second, it increases the amount of money working for you. It does that by eliminating chances for you to forget to make a deposit on your own. And the more money you have invested, the bigger your nest egg.

Third, it cuts down on paperwork and administrative hassles. You only have to make arrangements once. No muss, no fuss.

Fourth, automatic investing reduces your stress while promoting better investment results. With automatic investing, you will not obsess about every contribution—especially during the stock market's inevitable rocky periods.

If you had to write a check for every contribution, you would end up playing Hamlet every time the stock market wobbles (*to pay or not to pay, that is the question*). All you would get out of that, however, is skipped contributions and more gray hairs on your head.

You'd also make the rest of your money less productive.

How? You'd play it "safe" by making more conservative investments. But those investments will lose ground to inflation and grow less than your other

Defined Contribution A 401(k) plan is known in benefits jargon as a *defined contribution* plan. That's because the amount you contribute is specified, or "defined." The size of your eventual benefit is not specified in advance. It depends on such things as how well your investments do and how much money you contribute over what length of time.

In contrast, a traditional pension plan is known as a *defined benefits* plan because the plan promises to pay you a set amount of money.

investments in the long run. We'll talk more about the crucial difference between short-term safety and long-term safety, starting in Chapter 16.

For now, what you should bear in mind is that automatic deposits help you stay the course—a more productive, less anxiety-ridden course.

Flexibility

Unlike a conventional pension plan, a 401(k) plan lets you choose the size of your contributions (up to certain limits). That gives you the freedom to boost the size of your nest egg. It gives you more influence over how much money you'll receive from your account yearly.

Control

You are usually free to select investments from a menu. You can tailor your investments to suit your own financial goals and time frame.

But . . . uh-oh. Select your own investments? If that sounds scary, don't let it frighten you off.

Chances are your choices are largely—or entirely—mutual funds, other bundled investments, and your own company's stock. Making good selections basically means choosing something in the right category. It is much easier and simpler than shopping for individual stocks out of the zillions available.

Whether your plan offers only a small number or a wide selection, I explain how to choose your investments in Part Three.

Extra Perks

Your plan may offer additional benefits, such as opportunities to borrow money from your account. (This particular option can come in handy, but you must beware of its long-run cost. See Chapter 4.)

Portability

Another major difference between a traditional pension plan and a 401(k) plan is that your 401(k) account belongs to you. If you leave your job for any reason (except extremely rare cases of criminal activity), you can take the portion of your money in which you are *vested.* You are always fully vested (100 percent ownership) in your own contributions, right from the first day. You generally gain ownership of your company's matching contributions either when you sign up or according to a timetable spelled out by your plan.

Protection

Life can bring unexpected—and unwanted—twists and turns. So it's helpful that assets in a 401(k) account are generally shielded by federal law from any creditors you may have. Your IRA assets enjoy federal protection only if you declare bankruptcy. Some, but not all, states also declare IRA assets beyond the reach of creditors.

What if your employer tumbles into bankruptcy? All your 401(k) money stays safely yours. That's not the case with traditional pension plans. Even though the Pension Benefit Guaranty Corporation can step in when a business goes bust, workers may never get the full value of their pension. Further, if your employer folds and stops sponsoring your plan, any company match you were not already fully vested in automatically becomes 100 percent yours.

Meanwhile, the money that's been in your account all along is still safe, too. The account assets are typically in the custody of outside, third-party financial institutions.

Best Deal

A 401(k) plan is routinely a better deal than other comparable retirement plans. If you take full advantage of its contribution and investment opportunities, no other plan gives you as rich a chance to reduce taxes and build up a nest egg.

Even the much-ballyhooed Roth IRA can't compare. A 401(k) plan's higher contribution ceiling lets you accumulate much more money. And, even if you contribute the *same* amount of money annually you're better off with a 401(k) plan. By the time you retire and start to withdraw funds, a 401(k) plan will put more after-tax take-home money into your pocket than a Roth IRA if, like most people, your tax bracket goes down after retirement.

Heck, if it will make you feel better, after retirement you can put your money into a *legal* Swiss bank account.