

Why Employees Benefit from the 401(k)

Chapter Three

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Retirement as we know it is a relatively new phenomenon. The first formal retirement system was established in Germany during the mid-18th century by Bismarck. The normal retirement age for this program was 65. Life expectancy was only age 45. At the time, funding the benefits of those who survived until retirement age wasn't too difficult.

Our Social Security system originated at a time when most workers were males— many of whom were employed in jobs that involved hard labor. Those who survived to retire at age 65 lived an average of about 10 additional years.

Even a few decades ago the biggest retirement-related decision for many workers was whether to take a reduced pension benefit so that payments from the employer-funded plan would continue after death to a surviving spouse. Only a modest amount of personal savings was needed to provide a financially secure retirement. My parents, aunts and uncles were average members of the middle class. The combination of Social Security, an employer-funded pension and personal savings enabled all of them to live into their 90s in reasonable comfort. They didn't have to sit around at family gatherings when they were in their 30s and 40s talking about how much they were saving for retirement and how they were investing their savings.

Fewer workers are expected to spend their careers with one employer in the future—and even if they do, a shrinking number of these employers will offer an employer-funded pension plan that guarantees a lifetime income benefit. Employers will continue to shift to plans such

as a cash balance pension and defined contribution plans where the employer contributes only a percentage of pay each year. Approximately 40% of employees work for employers that do not provide any retirement plan at all.

The retirement picture is very different today. Regardless of where you work, the bottom line is that planning for retirement is your responsibility. You can't rely on the government, an employer or anyone else to do it for you.

Many employees retire well before age 65 and a large number survive for an additional 20 to 30 years. These additional years of retirement require much larger retirement nest eggs than were needed a generation or two ago. It's not a simple matter of tripling the amount of money that participants once needed. Inflation has to be factored into the "how much is enough" equation.

At a modest 3% inflation rate, it will take 2.42 times as much income after 30 years to buy what you can buy during your *first year* of retirement. In your 30th year of retirement, you will need \$84,700 to buy what \$35,000 will buy today. This sobering fact is one of the reasons why I plan to keep working as long as I am able. Continuing to earn an income is the best hedge against inflation.

Financial security during retirement requires income from a variety of sources. I am shocked

See Chapter 6 for more details on how to determine how much you need to save for retirement and how inflation affects your planning.

when I still encounter people who are not aware that Social Security isn't enough to cover your retirement needs. This has little to do with the current Social Security problems—the system was never intended to be the sole source of retirement income. Social Security will provide only about

40% of the average worker's income at a normal retirement age.

The percentage of your pre-retirement income that you will need in retirement depends upon many personal factors. Most professional advisors recommend an annual income equal to 70 to 80% of your pre-retirement income. There is no standard percentage—the right amount is whatever you will need to fund the retirement lifestyle you want.

Your Social Security Resource

You are not entitled to receive any Social Security benefits before you reach age 62. So if you are considering early retirement, you need to make up for this resource. The other problem with Social Security is that an even smaller portion of your pre-retirement income is provided by Social Security as your income increases. For example, the amount payable at your normal retirement age is only 25% or less if your income exceeds \$75,000.

Social Security will provide 30 to 40% of your pre-retirement income if you earn \$30,000 to \$50,000 per year and retire at your Social Security normal retirement age. A defined benefit plan normally provides 20 to 30% of pre-retirement pay for a long-term employee who retires at normal retirement age. This benefit, plus the 30 to 40% provided by Social Security, can provide a survivable level of retirement income.

Personal savings must provide the difference between Social Security and any defined benefit resources. If you earn \$75,000 or more, and you're entitled to lower Social Security benefits as a percentage of pay, you have to save even more—enough to replace about 50% of your pre-retirement income. Hopefully, your employer will help you save by providing and contributing to one or more retirement plans. The ideal scenario is to spend most of your career with the same employer. This employer would fund a defined benefit plan that guarantees you an income for

life and provide a 401(k) or similar plan for you to make pre-tax contributions.

The Future of Social Security

Each time we have a national election, attention is focused on Social Security. Political debates over what to do with Social Security and Medicare will continue for at least the next three decades. One does not have to possess great intellect to come to this conclusion.

As the Baby Boomers transition to their retirement years, our country will experience great financial strain. The aging of America will continue to be a major focus of the first three decades of the 21st century.

In the early and mid 1990s politicians were split over whether there was actually a Social Security crisis. Democratic candidates contended the system was financially sound, and they assured us there wasn't any reason for concern. Then President Clinton also told us not to worry after the Social Security Summit held during the first year of his presidency.

On the other side, Republican candidates were challenging the financial soundness of the system and proposing changes. By the late 90s, candidates from both parties finally reached agreement that the program is in trouble. The debate shifted at this point to who had the best solution. Nothing was ever resolved, and it is no small wonder that most Americans remain confused.

The real question is how big is the problem and when will it actually become a crisis? I was attending a board meeting of a benefits industry trade group in 1998 shortly after a special commission had submitted its recommendations for preserving the Social Security system.

The commission included highly respected members of both parties and the public and private sector. A Democratic Senator reported the commission's findings and recommendations to our group. The commission's major finding was that the Social Security system would run out of

money by 2029 unless drastic changes were made.

After many years of listening to people deny that there is a problem, I was encouraged. I only quarrel with the commission's time estimate: the fact is that cash flows for the Social Security system will become negative around 2014.

Currently, Social Security taxes collected each year exceed benefits that are paid by around \$150 billion. Sometime around 2014, annual benefits paid will exceed payroll taxes collected. This is a known fact—not my theory.

Those who contend that we won't have a problem until 2029 say that the extra money needed to cover benefits will be taken from the Social Security trust fund. They ignore the fact that there isn't any money in this fund because the government has already spent it for other purposes.

Suppose that by the time you reach retirement age you have borrowed all the money out of your retirement account and used it for other purposes. Instead of having \$100,000 invested in a variety of funds, the only asset your retirement account has is your IOU for \$100,000. The loan obviously won't provide retirement income to you.

"I'm 26 years old and have been contributing 10% of my salary for three years. In these three years I've managed to save \$9,000. My wife has saved \$30,000 in her 401(k) account in 9 years. Our goal is to save \$1.2 million by the time we retire. Already, the \$39,000 we've both saved will be worth almost \$800,000 in 35 years (assuming a 9% return). That's without additional contributions—and we plan to keep saving!"

—Neal Kennedy
Wyoming, OH

Likewise, the excess Social Security taxes we have been paying should have been retained in the Social Security trust fund, and then invested and preserved to provide retirement benefits to the Baby Boomers. The loans the Social Security trust fund holds can't be converted into retirement benefits either but our elected officials want us to believe they can.

I had planned to keep my mouth shut while the Senator spoke, but I was not successful. During the question and answer session, I told him that although I am not an actuary or economist, I believe that the problem will occur around 2014. He sputtered for a while and finally responded by saying, "We are committed to this system. We will keep our promise to pay benefits even if we have to print money." Needless to say, I was neither impressed nor comforted by this response. By the way, in my opinion both parties are equally guilty of playing political games with the Social Security system.

As a semi-amusing side note, one fairly recent presidential candidate advocated using some of the money in the Social Security trust for other social needs. The money had already been spent for other purposes so either he didn't know better or he wanted to double spend the money that is supposed to be used solely to provide retirement benefits.

Unfortunately, Social Security will continue to be a political football. There will be mounting pressure for candidates to provide supposedly painless solutions. This will be impossible unless we continue to be blessed with strong economic growth that can generate sufficient general budget surpluses to cover the Social Security shortfall. All or most of the budget surpluses we have heard so much about during the last few years are really due to the fact that Social Security taxes collected each year currently exceed benefits that are paid.

Once Social Security becomes a budget deficit around 2014 something has to give. Rather

painful changes will eventually be needed unless tax revenue from other sources can make up the difference. Reduced Social Security benefits or increased Social Security taxes—or a combination of the two—is inevitable. The longer we go without facing this very real problem, the more severe the changes will be.

How bad can it get? Again, the facts are quite simple. A dollar in revenue must be collected by the government to pay a dollar of benefits. This is because Social Security is in fact a transfer system rather than an insurance or funded retirement system. The taxes you and I pay are used to pay benefits first and whatever is left is spent on other government programs or used to reduce the national debt.

Many people think they have actual retirement accounts at the Social Security Administration, but there is nothing more than a central computer that keeps records of how much we contribute. These contributions don't grow because they are not invested. As a result, we obviously don't have an option to withdraw our money from this account.

When I begin to collect Social Security benefits, I won't be drawing money out of an account. I will instead be receiving taxes paid by you and other workers. The Social Security taxes that are deducted from each paycheck for your retirement benefits amount to 5.3% of your pay. An equal amount is paid by your employer.

In 1945 there were 41.9 workers for every retiree. The ratio dropped to 3.4 workers for each retiree in 1999. By about 2030 the ratio is expected to drop to two workers for every retiree. The current taxes that two workers pay cannot cover the Social Security benefits for one retiree. In order to provide sufficient future benefits, Social Security taxes must at least double.

It was no problem when the taxes paid by 41.9 workers and their employers covered the benefits for each retiree. But today it's a different story. The average monthly benefit per retired

worker was \$804 in 2000 or \$9,648 annually. Assume the average taxable salary for those who are contributing to Social Security is \$35,000. The total taxable income for the 3.4 workers that are supporting each retiree is \$119,000. The tax needed to pay each retiree's benefit is 8.1% (\$9,648 divided by \$119,000). This tax is split between you and your employer and your share is 4.05%.

Now assume that the worker/retiree ratio is 2 to 1 rather than 3.4 to 1. The taxable wage base per retiree would be only \$70,000 (\$35,000 times 2). The tax required to pay this retiree's benefit would be equal to 13.8% (\$9,648 divided by \$70,000). This is 70% more in taxes than what is needed today (13.8% divided by 8.1%).

The Medicare Dilemma

Once you start talking about Social Security, you also have to think about Medicare. It's impor-

"My 401(k) plan has really helped my husband and I save for retirement...and I'm only 36. My husband and I decided we need \$3.5 million to maintain our current lifestyle in retirement, and the 401(k)'s automatic saving feature is helping us get there.

When I was 22, my Mom gave me that old chart that shows the benefits of saving early. We're planning to have \$100,000 of inflation-adjusted income per year for 40 years. And because we started early, we think we can reach our goal when we're in our 50s."

*Beth Prickett
San Diego, CA*

tant to realize that Medicare is in worse financial condition than Social Security. Solutions will be even more difficult to find on the Medicare front.

Most people fail to consider health care a retirement issue, but it is an important one. For starters, if you or a dependent is under age 65 when you retire, access to health care and the related costs is a big problem. This is because Medicare isn't available until age 65.

The future financial demands on Medicare are huge. The greatly expanded number of participants is one reason. Another reason relates to our high expectations. There are many procedures available today to extend life that didn't exist a generation ago. Other procedures can make this extended life more comfortable. It is great that knees and hips can be replaced to relieve the pain of 80-year-olds, but in the next couple of decades we will unfortunately be forced to determine a level of health care the nation can afford.

Medicare doesn't cover all medical expenses, which is why most participants buy supplemental coverage. Prescription drugs and extended care are the other major expenses for many retirees. Many seniors are spending thousands of dollars per year for prescription drugs. The pressure for the government to help will increase. But is it likely that already heavily taxed workers be willing to pay even more taxes to provide further assistance to seniors? I wouldn't count on it.

We all need to realize that the government can't make health care less expensive for some without increasing taxes for others. For example, government subsidized prescription and/or long-term care benefits at less than market rates that I receive will increase the tax burden placed upon my children and grandchildren. But their tax burden is already heavy, and I don't want additional burdens imposed on them for my benefit. Senior members of our society must face the fact that this is what they are doing when they push the government for additional help.

Taxes, Taxes and More Taxes

The fact is that you and other workers are already over-taxed. FICA (Social Security) taxes take a big chunk out of your paycheck. You currently lose a total of 7.65% of your pay to FICA taxes (an acronym for the Federal Insurance Contributions Act). These FICA taxes are paid for various reasons: 5.3% are imposed for your retirement benefits, 1.45% for your Medicare benefits and 0.9% for disability and survivor benefits. The employer pays an equal amount which totals 15.3% of your pay. In 2001 these taxes were paid on the first \$80,400 of your income. You and your employer each paid an astounding \$6,151 in FICA taxes in 2001 if you earned at least \$80,400.

The maximum FICA wage base is increased annually and it has mushroomed since 1977. The maximum FICA wage level was only \$16,500 in 1977 and the tax rate was 5.85%. The combined employee/employer FICA maximum has increased from \$1,931 to \$12,302 since 1977. This is an increase of 637% or an average of 8% per year. If this pace continues, in 2025 the combined employee/employer FICA tax will exceed \$78,000 for those who earn the maximum wage base. The 1.45% Medicare portion of this tax applies to all earned income and results in a 2.9% combined employee/employer tax.

To make matters even worse, we must also pay Federal, state and local income/wage taxes on the FICA taxes we pay. This means that we must pay tax on the tax! How painful is this double tax burden? Assume you have a gross income of \$60,000 and your combined Federal, state and local income/wage taxes are equal to 20% of your income. The FICA tax you must pay is 7.65% of 60,000 (\$4,590), but you have to first pay income tax on the entire \$60,000.

Let's do the math so you can grasp the full impact of the double tax. You pay \$4,590 of FICA taxes (7.65% of \$60,000), but you also pay income/wage taxes on these FICA taxes. This

means that you pay a tax on the \$4,590 tax! Assuming a 20% tax rate, you will pay an additional \$918 of tax. In addition, you must of course pay income/wage taxes on your remaining income of \$55,410 (\$60,000 minus the FICA tax of \$4,590), as well as many other taxes, such as sales taxes, gasoline, real estate, occupational taxes—the list goes on and on.

The tax burden is even worse for those who own small businesses because they personally have to pay both the employee and employer portion of the FICA tax. A small business owner who earns \$60,000 of W-2 income must pay the entire 15.3% of FICA taxes (\$9,180) plus income and other payroll taxes. I occasionally bump into people who think they want to be independent contractors rather than employees. Any perception that being a contractor is better than being an employee is erased when I explain the situation with Social Security taxes.

With the eventual decline of Social Security, employer-sponsored plans such as the 401(k) that include employee pre-tax contributions will play an increasingly important role in helping workers save for retirement. As I've illustrated above, the taxes we pay are a big financial drain. It's virtually impossible to save for retirement without tax breaks. Contributions you and your employer put into a tax-qualified retirement plan are not taxable until they are withdrawn. All investment income and gains are also sheltered from tax until they are withdrawn. I encourage employees who are entering the work force to save 10% of their incomes for retirement as early a stage as possible—and the combination of employee and employer contributions make this a realistic goal.

The Positive Side of Taxes

I've talked about the negative side of taxes, but there's also a flip side. Saving for retirement is so important that the government provides big tax breaks to help you achieve your retirement

goals. Tax breaks are provided to avoid having a country full of senior citizens who are financially dependent on others.

As you know, the money you contribute to a 401(k) comes from your pre-tax “gross” income. This is a significant point because you pay three different types of income or wage taxes. Federal taxes increase as your income increases. The top tax rate is 38.6%, but the tax rate for most workers is either 15 or 27%. Many states also impose their own income tax and many local and municipal governments have wage taxes. Not all states and local governments follow the Federal tax code.

Some things that are deductible when you pay your Federal income tax are not deductible when you pay your state and local taxes. Employee pre-tax contributions to 401(k) plans are one of these exceptions. You don’t have to pay Federal income tax on your 401(k) contributions, but you may have to pay state and local taxes. Your contributions to a 401(k) are also subject to Social Security taxes.

I know this is all very confusing, so let me try to clarify it with an example. Assume the following:

- Your gross pay is \$2,000 each pay period.
- You live in a state that has an income tax equal to 2% of your income.
- Your wages are subject to a 1% local wage tax.
- Contributions you make to a 401(k) plan are exempt from state and local tax.

Next assume you do not contribute to a retirement plan. The following illustrates the difference between your gross and net pay:

Gross pay	.....\$2,000
Federal income tax	.....350
State income tax	.....40
Local wage tax	.....20
FICA tax	.....153
Net pay	.....\$1,437

Now assume you contribute 6% or \$120 per paycheck to a 401(k) plan. The impact on your net pay is as follows:

Gross pay	..... \$2,000
Federal income tax	..... 329
State income tax	..... 38
Local wage tax	..... 19
FICA tax	..... 153
After tax pay	..... \$1,461
Retirement contribution	.... 120
Net pay	..... \$1,341

The reduction in take-home pay is only \$96 but you have invested \$120 for your retirement.

Next assume your employer contributes \$.25 for each \$1.00 you invest. No taxes are paid on the employer contributions at the time they are contributed. This additional \$30 (\$120 times 25%) increases the amount invested into your retirement account each pay period to \$150. This is 56% more than the reduction in your take-home pay.

With a 401(k) plan, you not only reduce your tax bill, you also save faster. Without a 401(k) plan, taxes eat away the money you could save. Assume you work for an employer that doesn’t have any retirement plan and your total tax rate is 37.65% (FICA taxes of 7.65% plus 27% Federal income tax plus 2% state and 1% local wage taxes.) It will take almost 16% of your pre-tax income to have 10% left to invest for retirement after paying these taxes.

See Chapter 4 for more information on the employer contribution.

Assume you earn \$50,000 and your goal is to save 10% or \$5,000. The results are as follows:

Pre-tax earnings required to get \$5,000 after paying taxes

.....	\$8,017
FICA taxes	613
Federal income tax	2,164
State/local wage tax (3%) . . .	240
Amount left	\$5,000

You are able to avoid the \$2,164 of Federal income tax and probably the \$240 of state and local wage taxes with a 401(k) plan's pre-tax savings. Remember, employee contributions to a 401(k) are subject to FICA taxes. Without a 401(k) plan, it takes you \$8,017 in pre-tax income to save \$5,000. When you avoid paying \$2,164 in Federal, state and local taxes, it only takes \$5,613 in pre-tax income to save the same \$5,000.

How the Employer Match Reduces Your Tax Bill Even More

Your tax situation gets even better if your 401(k) has a matching employer contribution. Assume all the facts are the same except the employee contributions are also based on your pre-tax income. Also assume that your employer will contribute 3% of your pay via a \$.50 per \$1.00 match limited to the first 6% of pay you contribute. You need to contribute 7% to achieve your 10% savings goal. There are no taxes on the 3% employer contribution before it is contributed. Your total savings are as follows:

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

The first advantage is that the employer contribution makes it possible to save the same

\$5,000 through only a \$3,500 personal contribution. In order to make that \$3,500 contribution, you must earn \$3,790 in pre-tax dollars to cover the \$290 in FICA taxes. If you were not in the 401(k) plan it would take \$8,017 of your gross, pre-tax earnings to save this \$5,000. As you can see, the help you get from the 401(k) tax breaks and employer contribution is huge.

Benefits of Tax-Deferred Investing in a 401(k)

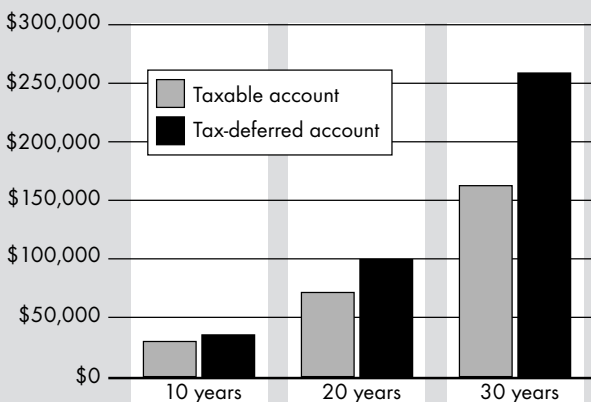


Chart compares the rate of return over 30 years for a taxable account and a tax-deferred account. (Assumes 8% annual return and 25% combined state and Federal tax bracket.) Earnings will vary according to your own tax bracket and annual rate of return.

I hope these two comparisons really grab your attention if you haven't previously thought about how important it is to work for an employer that offers a 401(k) or similar plan with an employer contribution. The advantage becomes very clear when you consider how much faster tax-sheltered money can grow.

A 401(k) or similar plan offers yet another tax-related advantage. The actual reduction in your take-home pay is less than the amount you put into the plan due to the immediate tax savings. For example, if you contribute \$1, your take-home pay is reduced only by about 70 cents.

As you consider the benefits of a 401(k), you may wonder why you need a company plan to invest your money. The first reason is that it's difficult to start investing a small amount of money on your own due to minimum requirements that

apply to most investment vehicles. When you contribute to a 401(k), your contributions are combined with those of your fellow employees, giving you access to investments that would not otherwise be available. And in many instances, the fees you pay in a 401(k) are less than those you would pay for the same investments outside the plan. This is particularly true if you have a small amount invested.

See Chapter 7 for more detail on investment risk.

The second major reason that you should think carefully about going solo relates to diversification—the first key investment concept. If your investments are diversified, they are not all invested in

the same thing. Spreading your money into a number of different investments reduces risk. It is very difficult to diversify small amounts of money on your own. With a 401(k) your investments are immediately diversified—usually through mutual funds that in turn invest your money in a variety of stocks and/or bonds. It's also no small matter that investing through your 401(k) plan gives you access to investment pros who manage billions of dollars.

It's obvious that I think 401(k)s have many more pros than cons. When I'm asked to name the single most important benefit of the 401(k), my answer is *semi-forced savings*. With a 401(k), savings becomes the first rather than the last priority. Very few employees can achieve long-term saving goals on their own.

Tips on the Benefits of the 401(k)

- *Plan for an annual income equal to 70 to 80% of your pre-retirement income.*
- *Factor inflation into your retirement plan. At a modest 3% inflation rate, you will need 2.42 times as much income after 30 years to buy what you can buy during the first year of your retirement.*
- *Remember that Social Security will provide only a portion of the retirement income you will need.*
- *Factor access to affordable health care into your retirement planning because Medicare is not available to you or your spouse until age 65.*
- *Don't forget that Medicare doesn't cover many medical expenses-including prescription drugs and extended care.*
- *Take advantage of the semi-forced savings accomplished through the 401(k) payroll deduction feature. Make saving your first, rather than your last, priority.*



