

Joining Your 401(k) Plan

Chapter

Five

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I occasionally get letters and calls from individuals who want to open a 401(k) account. Unlike an IRA that you can do on your own, the 401(k) is available only through an employer.

Employers are not required to have any retirement plan. Employers that do have plans must establish the rules within the guidelines of existing laws and regulations. Congress writes the laws, and administrative agencies such as the Treasury Department and the Department of Labor issue the regulations. Tax laws governing plans like the 401(k) provide the general legal framework. Regulations provide the detail and there's no shortage of that. The regulations are typically much more voluminous than the actual laws.

The fact that your employer offers a 401(k) doesn't mean that you are eligible to contribute. You must meet your employer's eligibility requirements before you can join the plan. Your employer is permitted to exclude those who have been employed for less than one year and/or who are under age 21. In addition, employees who have satisfied the plan's eligibility requirements can be required to wait a maximum of an additional six months until a plan entry date. The entry date is the first date you can actually enter the plan after satisfying the eligibility requirements.

For example, assume you joined your company on January 14, 2002 and your employer requires one year of service before plan eligibility. Further assume the plan has two entry dates: January 1st and July 1st. You will complete one year of service on January 14, 2003. You will

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have missed the January 1, 2003 entry date so you will have to wait until July 1, 2003 before you can begin contributing. This is almost eighteen months after you started with your employer. As I mentioned previously, the trend has been to move away from these long delays so that newly hired employees can join the plan immediately or within 30 to 90 days of the first pay period.

Full-time and part-time status is another issue that may affect eligibility. The employer is permitted to exclude all employees who have not worked at least 1,000 hours during any year. The following are other categories of employees who may be excluded:

- employees who are covered by a collective bargaining agreement (union),
- non-resident aliens,
- leased employees, and
- a specific category of employees.

Leased employees include those who work for a company on a temporary basis placed through an agency such as Manpower. An employer may also exclude a specific category such as hourly or salaried employees or the employees of a specific business unit, as long as the rest of those covered by the plan satisfy applicable legal standards. For example, your company's 401(k) may be available to only salaried employees if the coverage rules of the Internal Revenue Code can otherwise be satisfied.

Some companies that own many different businesses prefer to let each business unit have their own benefit programs. For example, one of my clients owned a business unit that hired rocket scientists and other business units that hired low-skilled factory workers. The units with low-skilled workers could not afford the same benefit programs that were needed to attract rocket scientists. As a result, each business unit maintains its own plans that qualify under IRS separate line of business rules.

There is a lot of confusion related to the exclusion of union employees. Labor laws pro-

hibit employers from offering any retirement or other benefit plan (including a 401(k) that is funded solely by employee contributions) outside the collective bargaining process. The labor laws require union employees who want a 401(k) to include this in their contract demands. Union managers continue to prefer defined benefit pension plans, which is the primary reason why 401(k) coverage is lower among union employees. It also is the reason why 401(k) plans for union employees typically don't include an employer matching contribution.

Getting Started

Probably the most important decision you will make regarding your 401(k) plan is simply to join. Everything else is irrelevant if you don't start contributing to the plan. If money is tight, you will be tempted to wait and to start saving in a couple of years when you might be earning more or have less debt. One of the biggest myths for younger employees is that it will get easier to save in the future. The fact is that it never gets easier. I know because I have been there. Saving is easy for some people and seemingly impossible for others.

You might think that it doesn't really matter if you wait to join the plan for a couple of years. But you lose a lot of potential savings when you wait. Take a look at the difference in Ken, Rasheed and Lisa's account balances after 30 years. Ken, Rasheed and Lisa all earn \$25,000 each year and decide to contribute 5% of pay or \$1,250 to their 401(k) plan.

Ken waits eight years to begin saving. In years nine through thirty, he contributes \$27,500 to the plan and his account balance grows to \$71,827. Rasheed starts saving right away, but stops after eight years. He has only contributed \$10,000 to the plan but he ends up with \$74,897, over \$3,000 more in his account than Ken. This surprising difference is due to the magic of compounded earnings over a thirty-year period.

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

Year	A KEN waits 8 years to start saving		B RASHEED starts saving early, quits after 8 yrs.		C LISA starts saving early and keeps at it!		WHAT YOU INVEST AND WHAT YOU EARN
	Annual Investment	Year end value @ 8%	Annual Investment	Year end value @ 8%	Annual Investment	Year end value @ 8%	
1	\$0	\$0	\$1,250	\$1,295	\$1,250	\$1,295	A - started late 22 yrs. @ \$1,250 Total saved \$71,827 Amount invested 27,500 Investment return 44,327
2	0	0	1,250	2,694	1,250	2,694	
3	0	0	1,250	4,205	1,250	4,205	
4	0	0	1,250	5,836	1,250	5,836	
5	0	0	1,250	7,598	1,250	7,598	
6	0	0	1,250	9,501	1,250	9,501	B - stopped early 8 yrs. @ \$1,250 Total saved \$74,897 Amount invested 10,000 Investment return 64,897
7	0	0	1,250	11,557	1,250	11,557	
8	0	0	1,250	13,777	1,250	13,777	
9	1,250	1,295	0	14,879	1,250	16,174	
10	1,250	2,694	0	16,069	1,250	18,763	C - started early & continued 30 yrs. @ \$1,250 Total saved \$146,724 Amount invested 37,500 Investment return 109,224
15	1,250	11,557	0	23,611	1,250	35,167	
20	1,250	24,579	0	34,692	1,250	59,271	
25	1,250	43,713	0	50,973	1,250	94,687	
30	1,250	71,827	0	74,897	1,250	146,724	

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

Lisa saves for the entire thirty years. She has contributed only \$10,000 more than Ken, but her account has grown to \$146,724—twice that of Ken's. You can see that it pays to start saving early and to keep saving.

This may be old stuff to those of you who are older, but you can help a younger fellow employee, a child or grandchild learn the importance of developing the savings habit early. One great lesson I've learned is that it's truly how we manage the income we receive rather than how much income we earn. I know this is very difficult for some of you to believe, but I have seen many examples. I have met individuals with incomes in excess of \$300,000 who have a huge amount of debt and no savings. I have also met individuals who have built substantial savings and carry little or no debt—despite modest incomes.

The Department of Labor hosts an event annually to celebrate the efforts that have been

made by both the public and private sector to encourage savings. I was able to attend the year 2000 celebration. One of the highlights of this event is to honor an individual of modest means who has accumulated significant savings. Earl Crawley, a parking attendant who worked for a bank for many years, was the 2000 honoree.

The fact that Mr. Crawley saved so much money in a low paying job shows that just about anyone can build an adequate nest egg. It's a matter of turning spenders into savers.

I have found that spenders will always spend what they have or more, regardless of how much they earn. A spender who gets a substantial increase in income adjusts his spending habits to the new level within a very short period of time. This is why if you are a spender, you should take a portion of any pay increase and put it into a 401(k) or similar forced savings vehicle before you get used to having it in your hot little hands.

Otherwise you will never break the spender cycle.

Some Easy Ways to Save

I have stated before that 401(k), 403(b) and 457 plans don't work well for most individuals with incomes below \$20,000. Many different types of employees fall into this category, including high school and college students, seasonal workers, seniors and other part-time workers who have little interest in saving for retirement. There are also many employees working full-time earning only enough to cover basic necessities.

Even though I know that everyone has to save as early as they can, it's not right to condemn those who have trouble eking out any extra money. But sometimes people don't realize that there are easy ways to save. I'm not suggesting that you give up many of the things that you enjoy in life—but often a few minor spending adjustments can free up money for savings.

It all boils down to making choices. Each of the things on the following list are not necessities—and cutting one or two out or reducing the cost of a few items could begin your savings program.

- \$1 each day or week for a lottery ticket
- \$25 for a carton of cigarettes
- \$3 a day for an alcoholic beverage
- \$3 a day for various other beverages of choice (bottled water, soda, coffee, etc.)
- \$10 a day for lunch
- a \$400 monthly car payment vs. a \$250 payment
- a \$250,000 home vs. a \$150,000 home
- \$20 per week for entertainment
- a \$500 vacation vs. a \$1,000 vacation.

Each of these small expenditures adds up over time. Drinking regular old water with lemon every time you eat out will save \$1 to \$3. Assume you eat out five times a week or 260 times per year. Your annual savings will range from \$260 to \$780 depending upon the cost of the beverage you normally select. Next, assume you reduce

your non-mealtime beverage consumption by one drink per day. That's one less beer, Starbucks' coffee, bottle of water, etc. This will generate another \$260 to \$780 of annual savings. Just cutting back on beverages alone could bring you close to \$1,500 a year in savings—and in 30 years that savings could add up to \$204,450 (assuming a 9% investment return).

Cars are another item that prevent many people from saving. It can cost a lot to own and operate a car, regardless of whether you buy or lease it. If you have a new car, it costs you around \$13.00 for a 40-mile roundtrip to the mall—when you consider all operating costs and amortize the purchase price. Sure, you need a reliable car for commuting to work, but there are many good and affordable used cars that are not an embarrassment to drive. Ideally, you should always buy whatever car you can afford with cash. But if this isn't possible, a \$250 monthly car payment instead of \$400 payment gives you \$150 more per month to invest for retirement.

You may be asking if all this nickel and diming is really worth it. I can hear some people saying, "Hey, you only live once, and I want to have all the extras I can afford." I understand this way of thinking, but I also think that giving up a few non-essentials today is far better than struggling without necessities during your retirement years. The fact is that I've never met any 401(k) participants who claim that they've saved too much. I've also never heard participants say that they

Help your children or grandchildren catch the savings habit with a "401kid" match. Add \$.25 or \$.50 to the amount your child or grandchild saves. The advantages of saving can and should be learned at an early age.

wished they had spent more money. Instead, what many older participants tell me is that they wish they had started saving sooner.

Getting started is the issue. And sometimes the best way to get started is to save a very small amount such as \$10 per week or \$520 per year. Due to the tax savings the 401(k) offers, your take-home pay is reduced by only about \$8 per week when you save \$10. I think that just about anyone who is earning more than \$20,000 could find a way to save \$8 a week. If you keep a record of your non-essential spending for just one week, you would see how easy it is to eliminate one or two things.

Remember that even a small savings makes a big difference over time. Only \$10 per week invested for 35 years with a 9% return will eventually be worth \$112,320. Any employer matching contribution will increase this amount. Roughly \$100,000 won't be enough money to live on during all your retirement years, but it certainly will be a big help.

How Much Should You Save?

After you get started, your goal should be to increase your savings rate each year. Perhaps the easiest way to accomplish this is to boost your savings rate each time you receive an increase in pay. Assume you start by contributing 1% of your pay and you receive a 4% pay increase. Take at least 1% of the raise to increase your contribution rate to 2%. Keep doing this each time you receive a raise until you reach a point where your savings plus any employer contribution is likely to provide an adequate level of retirement income. Don't miss any opportunity to get your retirement planning on track.

When you consider how much you need to save, don't forget about any employer contribution. Employers usually match only a portion of the amount you contribute—so it makes sense to contribute the amount necessary to get the entire match. There are many different ways the match-

ing contribution can be structured, but the most common is for the employer to match the first 4 to 6% of pay that you contribute.

Assume you are earning \$30,000 and your employer matches the first 5% of pay you contribute. This means the employer will match the first \$1,500 (5% of \$30,000) you contribute. You should attempt to contribute the full percentage that is matched by your employer so that you can get as much “free” money as possible. If you can't afford to do so now, start with a lower percentage and increase your contribution rate to the maximum employer level as soon as possible. Remember, you're leaving money on the table when you contribute less than the percentage that is matched by your employer.

One other important point: even though in this example, you will not receive a match for any contributions you make in excess of 5%, you still get a tax break for your entire contribution. It always makes sense to personally contribute as much as you possibly can.

If you are married, you and your spouse should each contribute the maximum amount required to get the full employer match. If you can't afford to do so, then see which plan has the higher match and decide who is likely to stay long enough to get the vested employer contributions. You may also want to consider which plan has the better investment options—and which one permits loans if you expect to tap your 401(k) plan resources in the future.

How the Matching Contribution Boosts Your Savings

Both employees and employers have trouble understanding exactly how the match works. Most importantly, you need to know how to structure your contributions so you don't lose a portion of the match. When you join the plan,

clear up any confusion and make sure that you're maximizing your employer contribution.

The matching contribution rate is set by each employer, and a match is not required. The amount may be as little as \$.10 for each \$1.00 you contribute or as much as \$1.00 for each \$1.00. The most common matching rates are \$.25 and \$.50 to the dollar. A few employers match more than \$1.00 per \$1.00. The highest matching rate I've seen is \$4.00 for each \$1.00 of employee contributions. I would tell you the name of the employer so you could apply for a job, but they don't want publicity.

Beware of the fact that some employers match only during the pay periods that you also contribute to the plan. Suppose you want to make several large contributions early in the year so that you're sure you've contributed the maximum permissible amount (\$11,000 in 2002).

The problem is that your employer may match a fixed percentage of your pay in each pay period—they will not front-end their employer contribution the same way that you do. If your employer uses this contribution method, it means that once you stop contributing, your employer does as well. But at the point you stop, the employer has not yet matched the full percentage of your total salary that you will receive throughout the year. By front-loading your own contribution, you then forfeit some of your employer's contribution.

Assume you earn \$80,000 and you decide to contribute 20% of your pay. You will be forced to stop contributing when you reach the \$11,000 limit. Matching contributions will also stop at that point if your employer matches only during payroll periods when you're contributing. It makes

See more detail on contribution limits in Chapter 4.

more sense to reduce your contribution rate so you will be contributing for the entire year and still hit the \$11,000 limit. In this

instance, 13.75% would be the applicable percentage for each pay period. Otherwise you would be forced to stop contributing when you have earned \$55,000.

Assume your employer matches the first 6% of pay you contribute and the matching rate is 50%. You should receive an employer contribution equal to 3% of your \$80,000 pay or \$2,400—if you contribute at least the 6% required to receive the full employer contribution.

However, if your employer match is made only when you are contributing, you would receive only \$1,650 of matching contributions in this example (3% of \$55,000). You would lose \$750 of employer contributions. This arrangement is unfair to employees who don't spread their contributions over an entire year, but it's common practice because it's easier to compute the matching contribution for each pay period that you actually contribute.

You will also need to know how your contributions will be calculated if you receive variable pay due to overtime, commissions, bonuses, etc. Most employers will permit you to have contributions deducted from your entire gross pay, but some will limit contributions to only your base pay. For example, assume your gross base pay is \$1,000 per pay period and you want to contribute 5%. Your contribution would be \$50 per pay period. Further assume you earn an additional \$100 of overtime. Your contribution will be increased to \$55 if contributions are deducted from your gross pay including the overtime. If your employer doesn't deduct contributions from gross pay, your contribution will be \$50 each pay period regardless of the amount of overtime you earn.

Some employees also like to make larger than normal contributions when they receive a bonus, a large commission or other form of variable pay. For example, you may contribute 4% of your regular pay but you may want to contribute 30% of a special bonus you receive during December.

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Naming a Beneficiary

One of the things you will be asked to do when you join the plan is to name a beneficiary who will receive the money that is in your account in the event of your death.

Before you name any beneficiaries you need to understand that by law your spouse automatically receives your 401(k) benefit when you die, regardless of whom you have named as your beneficiary. This is the case unless your spouse signs a benefit waiver that is witnessed by a notary or a plan representative. This provision was added to the law to protect the rights of female spouses, but it works both ways. For example, a married female employee who has children from a prior marriage must obtain an acceptable spousal benefit waiver from her husband before she can name her children as beneficiary.

You will probably be able to name both a primary and a secondary beneficiary. The primary beneficiary will receive your 401(k) money if he/she is living at the time of your death. Your secondary beneficiary will receive your money if your primary beneficiary dies. You should also be able to name more than one primary and/or secondary beneficiary. In this instance, you will need to specify the percentage that each will receive.

You may want to use a more generic secondary beneficiary if additional children are a future possibility. You could specify that all your children are to share equally or you could name a trust as the beneficiary. A trust is advisable if there are minor children, or if you have a large account and you do not want your children to get the money when they reach age 18. Related tax issues are covered in Chapter 10.

You need to know that the beneficiary form you have filed with your employer is the primary instrument that will determine who receives your plan benefit. The provisions of the plan document will determine what happens to your 401(k) money if you haven't named a beneficiary or if the beneficiary you named isn't living. I have met people who have written wills and trusts that they think will control the distribution of their 401(k) assets.

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

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

Another question I have been asked is whether a waiver that is part of a pre-nuptial agreement will suffice. There isn't a clear answer. The law states that the waiver must be signed by the spouse. An individual is not a spouse prior to actual marriage. As a result, the spouse could contest the pre-nuptial waiver.

