Make the Most of Your Company's 401(k) Plan

Companies-be they technology corporations, manufacturing plants, or law offices-are all distinctly different. Each company's 401(k) plan has been designed to meet the specific needs of that company and its unique work force. Your plan may be designed to have a generous employer matching contribution, it may have a small match but include a profit sharing contribution option, or it may have no match but your company may offer a defined benefit plan as well as a 401(k) plan.

Other differences in plans include the time it takes for you to own the money contributed in your account by your employer (called vesting), or the number and types of investment options offered by your employer. The key is to know your particular plan so you can make it work for you. This chapter suggests some fundamental ways you can make the most of your company's plan.

Participation

Everyone knows that participation is basic to making your 401(k) plan work for you. However, many do not realize that knowing if you can participate is just as critical. Do not assume when you start a new job that you do not meet the requirements for 401(k) plan participation simply because you are new to the company or work part-time. Ask about 401(k) participation when you start your new position. Do not wait to be told. If you want to make the most of your company's plan, you need to take responsibility for knowing how it works. That starts with knowing if and when you can participate.

Start Saving Now

In a 401(k) plan, your money starts to grow the instant you con tribute to the plan. So make the most of your plan and join as soonas possible! Different companies have different starting dates. Find out when you can start saving, complete your enrollment forms, and return them right away. It is easy to procrastinate and suddenly find your initial eligibility date has passed. By getting your paperwork in early you will start saving as soon as you are eligible to participate.

Also, if you are eligible to join your plan a year down the line, don't depend on your employer to remind you when it is time to par ticipate. Mark your calendar, then be sure to complete your enrollment forms and turn them in on time, or ahead of time, if allowed.

Get That Company Match

Some companies make matching employer contributions to their 401(k) plans. Typically, an employer match is a percentage of what you contribute to the plan up to a maximum amount-for example, 50 cents for every dollar up to 6 percent of your salary. Employers provide this as an incentive to you to save for retirement. It doesn't matter if your company's match is a generous $1 for $1 contribution or just a few pennies. A company match is a risk-free addition to your savings that requires no work and is not taxed as income. If a bank was willing to deposit money into your account based on how much you deposited, what would you do? In other words, this is free money from your employer, so don't pass it up!

Likewise, be sure you get the entire match. If your employer matches up to 6 percent of pay, make sure you contribute 6 percent of pay. If your employer matches up to 10 percent of pay, meet that amount. Even if it means cutting back somewhere else, contribute enough to your 401(k) to get the full company match. Remember, what you contribute now will be worth many times more to you later.

Companies do not determine their matching contributions in the same way or contribute their match at the same time. Some contribute the company match when they deposit your own contribution into the plan, which may be as frequently as every pay period. Others contribute the match after a period of time, typically on an annual basis. It is important to be aware of the timing of your company's match. This will ensure that you know what to expect and can contribute in a way that will maximize your employer's matching contribution.

If your plan provides the match at the end of the year, you can contribute different amounts throughout the year and still receive the full match. But you must be aware of other rules. For example, if you leave the company before the day of the match-even one day before the match will be put into the plan-you may not receive the matching contribution. If you decide to change jobs, you should consider the timing of the employer matching contribution when you pick your termination date.

Different rules apply at companies that match at the same time your own contributions are deposited. For example, if you must contribute 6 percent of your pay to get the full match, you may have to contribute 6 percent of each paycheck you receive during the year. This means if you want to reduce your contributions for half of the year then make up the difference with large contributions for the rest of the year, you may not receive the full match. Some companies do go back at the end of the year, calculate the total you contributed, and make an additional matching contribution to make sure you get the full match allowed. The key is to know what your plan will allow.

Start Early

What you save earlier in your career has a longer time to earn for you. This reduces how much you may have to save later as illustrated in Figure 4.1 someone who saves consistently for 11 years between ages 24 and 35, and then stops saving but keeps the money invested until retirement, will have approximately as much money as someone who waits until age 35 to start saving and then saves for 30 years.

For example, Pat is making $25,000 at age 24 when he begins participating in his company's 401(k). He contributes 6 percent of pay and the company makes a 50 percent match on that amount. If Pat gets an 8 percent rate of return and receives salary increases of 2.5 percent every year, he will have $43,238 in his account when he is 35. He stops contributing at that time but keeps his money in his 401(k), where he earns an 8 percent return on that money, when he is 65, he will have $435,092 without having made another contribution for 30 years.

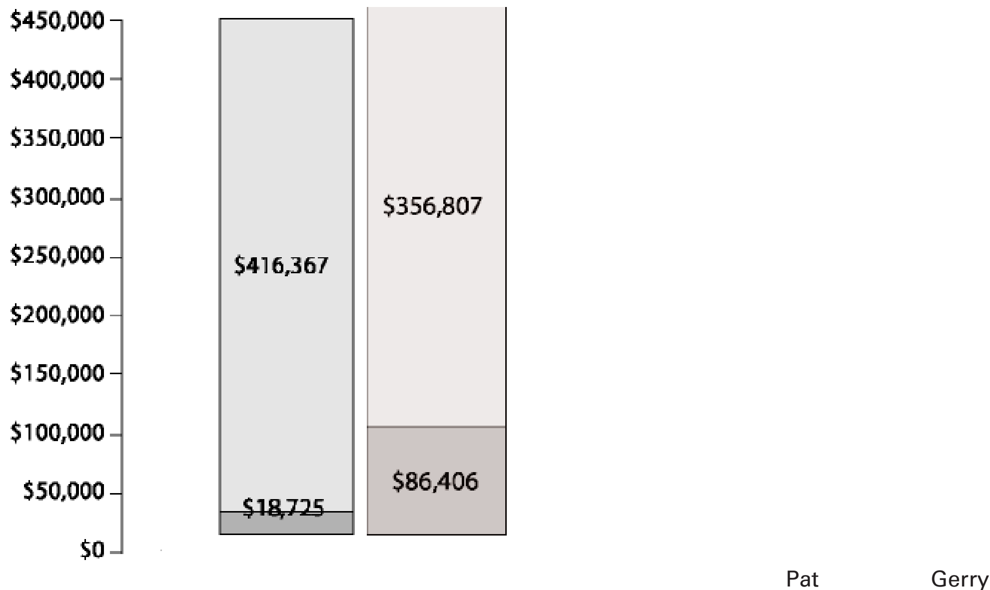
Gerry, on the other hand, does not start saving until she is 35. At age 24 she was making the same as Pat ($25,000), and at her current age she is making $32,800, thanks to a 2.5 percent salary increase every year. Like Pat, Gerry now contributes 6 percent of pay, and the company matches 50 percent of that amount. Also, Gerry earns an 8 percent rate of return and continues to receive the 2.5 percent salary increase. When she retires at age 65 after 30 years of contributions and earnings, she will have $443,213, only $8,121 more than Pat. However, Pat will have contributed less than $20,000, while Gerry will have contributed over four times as much to

reach the same amount. Of course, you can be smarter than both Pat and Gerry by starting early and consistently saving inyour 401(k) year after year.

Figure 4.1 The Benefits of Saving Early

Assumptions:

Pat Contributes from Age 24 to 35 Gerry Contributes from Age 35 to 65
Both In Plan With-50 cent match up to 6 percent of pay
Starting salary: $25,000 year Contribution: 6 percent of pay
Rate of return: 8 percent Salary increase: 2.5 percent per year



Maximize Your Contribution

Can you imagine complaining that you have too much saved for retirement? Making the most of your 401(k) plan means contributing the most that you can when you can. Why set your contribution level low? Find out what the maximum contribution for your plan is. Then save as close to the maximum as you can. You may not always be able to save as much as you can now, and it is good to get ahead.

The beauty of a higher contribution level is that you can always cut back in the future. You may be able to easily change your contribution rate on a quarterly, monthly, or even daily basis, depending on your plan. Perhaps for one year you can contribute the maximum, while for another you may only be able to put the minimum into your plan.

You can also stop contributing entirely at any time, but find how your plan works before you do. In some cases, if you choose to quit saving completely you may be locked out of contributing to your plan for an entire year. Remember, your tax benefit is not just abouta future date

when you retire-your tax savings begin the day you begin to participate in your plan. Any money you contribute to your plan not only postpones your taxes, it can often lower your tax bracket as well, reducing your overall income tax rate.

If you cannot make the maximum contribution right away, gradually increase your 401(k) contribution over time. For example, if initially you can only save 5 percent of your pay, increase the amount you save by 1 percent of pay each time you get a raise. Sooner than you know it, you will be at your plan's maximum.

Once you have set your contribution at your plan's maximum amount, the payroll deductions become automatic. You will most likely adjust to that level of income and never think about it again, all the while reaping the benefit of those tax-free dollars going straight into your account. However, make sure to increase your contribution amount every year to meet the contribution limit increases provided by law. When you reach the age of 50, remember to make additional catch-up contributions over the legal limit, if they are allowed in your plan.

Another opportunity for maximizing the value of your contribution is the low-income and moderate-income saver credit on your income tax, described in detail in Chapter 2. If you are eligible, this credit provides as much as 50 percent back on a contribution of up to $2,000, or a credit of $1,000 on your income taxes. If your company match provides 50 cents on the dollar for your contribution and the saver's credit provides 50 cents on the dollar as well, your entire contribution has been repaid.

If you are seeking to contribute the absolute maximum amount possible, some plans allow additional after-tax contributions. This money will not reduce your taxable income now, but at the end of the road when you withdraw your funds for retirement, you will not have to pay taxes on these after-tax contributions. Any earnings on your after-tax contribution investment will not be taxed until you withdraw them from the plan.