The 401(k) Advantage

401(k) plans are one of the most popular and successful methods of saving for retirement, full of advantages that your employer and the government work together to provide. But for you to get the full benefit from your 401(k), you need to be aware of all the advantages and know exactly how to use them.

The 401(k) advantages break down into four basic components:

1. *Less tax pain, more gain.* The more you save and invest in your 401(k) plan, the greater your reward.

2. *Saving is easy.* 401(k) plans make saving for retirement simple and automatic.

3. *You're in control.* 401(k) plans give you control of the when, where, and how of your money.

4. *It's protected.* Both your employer and the government are responsible for making sure that your 401(k) savings are secure.

If this seems like a conspiracy to help you build a successful retirement, it is! The 401(k) plan is designed by employers and the government to help everyone get the best return on his or her investment dollar, and as a result be financially secure in retirement.

Less Tax Pain, More Gain: Pre-tax Contributions and Tax-Deferred Earnings

401(k) contributions are made pretax, which means that when your money goes into the plan it is not subject to federal income tax or most state and local income taxes. Likewise, investment earnings on your savings are not taxed until they are withdrawn from the plan. Because taxes take a large bite out of each dollar you earn, you have to save more after-tax dollars to get the same result as pretax saving. Thanks to pretax contributions, you are paying yourself rather than the government, and your assets multiply dramatically over time as investment returns compound on a larger pool of assets.

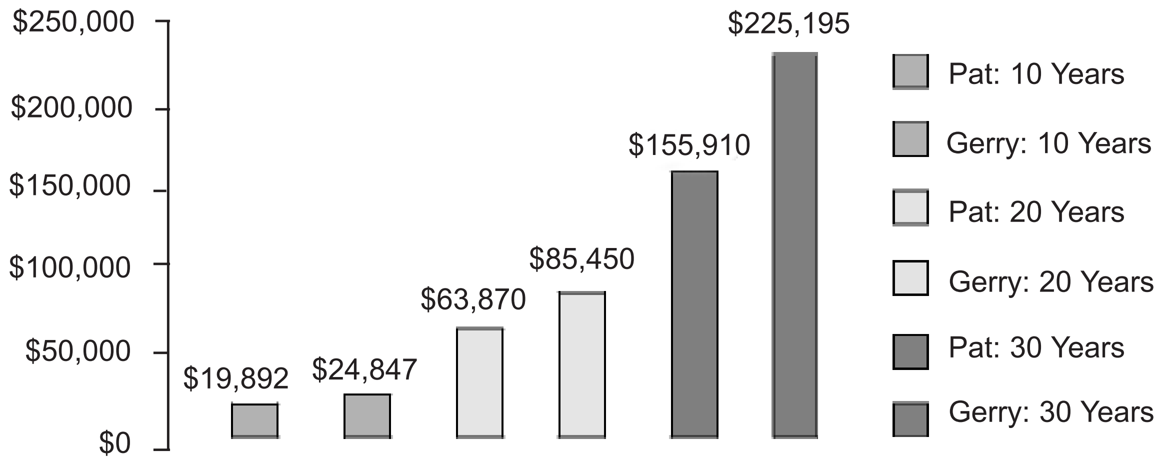
Let's assume that Pat and Gerry each start out earning $25,000 per year. Both would like to save 6 percent of their salary, or $1,500. Gerry is saving her contributions pretax in a 401(k), while Pat is saving in an after-tax vehicle, which means his $1,500 is hit by a 15 percent federal tax before it goes into his account. Both Gerry and Pat receive an 8 percent rate of return and can expect a 2.5 percent pay increase every year. At the end of 30 years, Pat would have $155,910, while Gerry would have saved $225,195-almost 50% more-as illustrated in Figure 2.1.

Figure 2.1 Difference in Pre-Tax and After-Tax Investments

Assumptions:

Gerry: Pretax Investment	Pat: After-Tax Investment
Starting salary: $25,000	Contribution: 6 percent of pay
Time span: 30 years	Rate of return: 8 percent

Salary increase: 2.5 percent per year
Tax rate on after-tax contributions and investment earnings: 15 percent



401(k) contributions lower your adjusted gross income for federal income tax purposes. Any contributions you make to your 401(k) reduce your taxable income. If you pay 15 percent of your salary in federal income taxes and you contribute $1,500 in pretax money, you save $225 on federal income taxes alone. In most cases, your 401(k) contributions also reduce the amount you have to pay in state income taxes. In addition, your contributions may drop you down into a lower tax bracket, reducing your overall tax rate as well. So be sure to use your reduced W-2 income as your taxable wages and earnings on your income tax form when tax time rolls around.

Supersized Savings

You can save a lot in your 401(k), and the level of maximum contribution is set to increase considerably over the next few years. In addition, the maximum contribution that you can make to your 401(k) is much greater than the maximum contribution to an IRA. In 2007, you can contribute at most $4,000 in an IRA ($5,000 if over age 50). However, the federal maximum contribution for 401(k) plans will be $15,500 ($20,500 if over age 50) and will be indexed to inflation by $500 increments every year thereafter.

Not only are contribution limits getting higher all the time, planimposed restrictions required by government regulations limiting the percentage of pay you can allocate to retirement savings have been eased. Under the old rules, most employees were limited to contributing no more than 15 percent of pay to their 401(k) plan. So if you earned $50,000 in 2001, you could only stash $7,500 in your company retirement plan even though the federal dollar limit was $10,500.

Only 11 percent of plan participants maxed out their 401(k) contributions in 1999, according to a study by the Employee Benefits Research Institute. More than half of those who didn't were prohibited from doing so by their plan imposed limits.

In 2007, you have a whole new story. Changes to federal law now permit employers to allow employees to contribute a higher percentage of their salary. Except for highly paid workers who face other restrictions, most employees can contribute the full dollar maximum ($15,500 in 2007) to their 401(k) plans. If you are 50 or older, you may be able to kick in an extra $5,000 per year-a welcome incentive as you approach retirement.

Tax Credit for Low-Income and Moderate-Income Savers

You may be eligible to claim a tax credit of up to $1,000 when you make contributions to your 401(k) plan, 403(b) plan, government 457 plan, SIMPLE, SEP, traditional IRA, or Roth IRA. After-tax contributions to qualified employer plans are also eligible. The tax credit for low-income and moderate-income savers (or "saver's credit") went into effect at the beginning of 2002. This credit applies only as a reduction to your income tax liability, not as cash in hand via a refund. If you owe no federal income tax, you are not eligible for a tax credit.

In order to qualify for the saver's credit you must be:

- 18 years of age or older
- Not a full-time student
- Not claimed as a dependent on someone else's return

In addition, you must meet one of the following financial criteria in 2007:

- File your taxes as single or separately with an income of $26,000 or less
- File your taxes as head of household and have an income of $39,000 or less
- File your taxes jointly with an income of $52,000 or less

Figure 2.2 Tax Credit for Different Income Levels

Adjusted Gross Income in 2007

Credit	*Single Filers*	*Head of Household*	*Joint Filers*
50% of contribution	0-$15,500	0-$23,500	0-$31,000
20% of contributions	$15,501-$17,000	$23,251-$25,500	$31,001-$34,000
10% of contributions	$17,001-$26,000	$25,501-$39,000	$34,001-$52,000
Credit not available	More than $26,000	More than $39,000	More than $52,000

Figure 2.3 Effect of Tax Credit and Matching Contribution on Net Income

	Pat	*Gerry*	*Gerry's 401(k)*
Annual Income	$15,000	$15,000	
401(k) Contribution Percent	0%	3%	
401(k) Contribution	$0	($450)	$450
Adjusted Gross Income	$15,000	$14,550	
2007 Tax Liability	($625)	($580)	
Add in the 50% tax credit	$0	$225	
Disposable Income*	$14,375	$14,195	
Employer match (50%)			$225
Net Total	$14,375	$14,195	$675

**Disregards FICA, FUTA, and state income tax*

The tax credit ranges from 10 to 50 percent of each $1 you contribute, up to the first $2,000 you put in your 401(k). If you and your spouse both contribute to a 401(k) plan, you may both be eligible to receive a credit. The amount of your tax credit depends on the amount of your adjusted gross income. The income limits and applicable credit rate allowance are as shown in Figure 2.2.

The tax credit is in addition to other favorable tax treatment of the contribution, such as the deferral of income tax on pretax contributions. The credit is reduced by the taxable distributions you or your spouse receives from any plans eligible for the credit during the year the credit is claimed.

The credit is incredibly valuable for lower-income individuals, particularly if their employer matches their 401(k) contribution. Let's compare Pat and Gerry. They are both single tax filers and earn identical salaries of $15,000. Pat declines to take advantage of his employer's 401(k) plan while Gerry elects to contribute 3 percent of her earnings. Their employer offers a 50 percent match on the first 6 percent of compensation contributed by employees. Figure 2.3 details the effects of the tax credit and matching contribution on each person's net income.

While Pat's net income exceeded Gerry's by $180, Gerry has $675 in her 401(k) plan compared to Pat's zero. How is this possible? Gerry's $450 401(k) contribution was replaced by her tax credit of $225 and her employer's match of $225. She also lowered her adjusted gross income by $450, and as a result paid $45 less in tax at the 10 percent tax rate. Gerry was required to reduce her daily spending by 49.3 cents to build a real retirement nest egg.

The government established this program because it wants to reward low-income and moderate-income workers who save for retirement. Not only do you receive up to a$1,000 deduction from the federal income taxes you owe, in many cases you will also get an employer matching contribution of 50 percent of the money you put into your plan. In other words, if you save $1, the government gives you 50 cents back and your employer puts 50 cents into your account. That's free money.