DOLLARS & Sense

Family Financial Education Foundation

Family Financial Education Foundation Edition 5, Volume 4

What Do All Those Numbers Mean?

Have you ever wondered what those numbers and letters mean when people talk about a 401(k) and a 529? Have you ever wondered why they are important? In this newsletter, you'll find out.

Although the answer to the first question is simple, you are rarely told what it is. Both the 401(k) and the 529 are named for the section number of an amendment that was made to the Internal Revenue Code. An amendment is made to the Internal Revenue Code when Congress decides changes are needed.

The 401(k) Savings Plan—Saving for Retirement

The 401(k) Savings Plan is a plan that allows you to save for retirement. It is a long-term savings plan instituted by an employer in which a deposit is deducted automatically from your paycheck and invested by a plan manager. This deduction is most often expressed as a percentage of the total amount of pay. For example, if you receive $1,000 per month in wages and you choose to have 2% of your wages deposited into a 401(k) retirement account, $20 of your paycheck would go to the 401(k) and you would only pay taxes on the remaining $980.

In 1978, Congress amended the Internal Revenue Code and added section 401(k). The important distinction this section made was that employees will not be taxed on income they choose to defer (deposit) to plans they will withdraw from at retirement until the withdrawal is made. The law went into effect on January 1, 1980, and by 1983 almost half of the biggest companies in the U.S. were either offering a 401(k) plan or had plans to do so.

Originally intended for executives, the section 401(k) plan became popular with workers at all levels because 1) It allowed higher yearly contribution limits than the already existing Individual Retirement Account (IRA); 2) employers frequently deposited matching funds in the employees' accounts; 3) 401(k) plans often allowed loans; and 4) employer's stock was sometimes an investment choice.

By 1984, thousands of U.S. companies were offering 401(k) plans, and Congress passed additional legislation to ensure that the plans did not discriminate in favor of highly paid employees. They did this by putting a limit on the amount of pay that could be deferred. The Tax Reform Act of 1986 tightened the nondiscrimination rules even further and reduced the maximum annual 401(k) before-tax salary deferrals by employees.

In 1998, Congress passed legislation that allowed employers to put automatic deductions in place to have all employees contribute a certain amount into a 401(k) plan unless the employee actively chooses not to contribute.

One big reason for the instant popularity of 401(k) plans with employers was that these plans are less expensive for employers to maintain than the previous pension plans for every retired worker. With a 401(k) plan, the employer only has to pay the costs of administering the plan. Matching contributions by the employer are optional, meaning that employers can choose whether or not to include matching contributions in their plans. The federal regulations do not require that matching contributions be included. Employers can also choose to contribute some years and not others. For example, in years with strong profits, employers can make matching or profit-sharing contributions, and reduce or eliminate them in poor years. Also, 401(k) plan costs are much more predictable for employers, whereas the cost

(Continued on page 2)

What Do All Those Numbers Mean?

(Continued from page 1)

of previous pension plans could vary unpredictably from year to year.

The 529 Savings Plan – Saving for College

The 529 Savings Plan is named for section 529 of the Internal Revenue Code which was added in 1996 as part of the Small Business Job Protection Act. With the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 529 Savings Plans gained their current prominence and tax advantages. The 529 Savings Plan is a plan that is intended as a way to save for future college education expenses for your children, grandchildren, or other person that you designate as a beneficiary.

The advantage of a 529 Savings Plan is that, although deposits you make are not pre-tax contributions, when the withdrawals are made for qualified higher education expenses, they are exempt from federal income tax so your designated beneficiary will not be required to pay taxes on them. There can also be matching grant and scholarship opportunities, protection from creditors for the money deposited in the plan, and often the deposited funds don't have to be included in state financial aid calculations for people who invest in 529 plans within their state of residence.

There are two types of 529 plans: Prepaid Plans and Savings Plans. Prepaid Plans are administered by states and by higher education institutions. If you choose to invest in a Prepaid Plan, the money you deposit "buys" tuition credits at the price of tuition when you deposit the money. Therefore, if the cost of tuition increases before your beneficiary is ready to withdraw the money, you do not have to pay that increase and thus, your deposit has earned the difference between the cost of tuition you paid and the cost of tuition at the time of withdrawal.

These plans are available in all 50 States through financial institutions or higher education institutions. They are not available through employers. You will need to check with your financial institution or through the school you are interested in to see what is available. The nice thing about these plans is that there are no age or income restrictions, and although the plans are offered by individual states, there is no residency restriction, which means that if you live in one state, you are allowed to participate in a plan for a school in another state. ■

Five Reasons to Start a 401(k)

If your employer offers a 401(k) plan and you are trying to decide whether or not to join, consider these important points:

1. Your contributions are automatically deducted from each of your paychecks so you save regularly and can learn to adjust your budget to accommodate the savings.

2. Your money is invested in funds that are researched by the plan manager so that investment risk is reduced. You can choose which funds within the plan you want to invest your money in or your plan manager can make the investment choices for you.

3. Your plan contributions are made before taxes are taken out of your paycheck so you don't have to pay income tax on your contributions until the money is withdrawn at retirement. Since you will probably be in a lower tax bracket when you retire, you will save more money on taxes when you withdraw the money.

4. You can choose how much money you want to contribute to your 401(k) plan based on how much you feel you can afford. You can also change the amount of your contribution as your finances change. There is a maximum amount that you are allowed to contribute each year, but this maximum amount is quite generous and increases periodically.

5. Many employers match a certain percentage of an employee's contribution to a 401(k) plan. For example, you might contribute 10% of your wages to your 401(k) plan and your employer might match the entire 10%. For another example, your employer may match your first 1% and half of the next 4%. Employer matches will change from employer to employer so find out what your employer offers.

6. If you should change jobs, your money in your 401(k) plan can be rolled over to your new employer's 401(k). Changing jobs doesn't mean you must cash in or lose your 401(k) plan. ■

Making Wise Investment Choices for Your 401(k) Plan

A 401(k) plan provides you with the option to allocate your money to the investments you want or to allow your plan manager to make the choices for you. It is certainly advisable to talk with the organization that manages the plan and discuss what your investment options are. Your employer can provide you with the contact information for your plan advisor. Stocks, mutual funds, and bonds are usually among the options. A 401(k) is usually safer than attempting to invest in the stock market on your own unless you are very knowledgeable or have a good stock broker.

The type of investments you choose for your 401(k) assets will probably be affected by:

1. **How close you are to retirement:** The closer you are to retirement, the more of your money you may want to move into stocks that are more conservative and less risky so that more of your money is preserved.
2. **How much you are willing to risk:** The more willing you are to take the risk that the value of your 401(k) assets will rise and fall with the markets, the more money you may want to invest in options like stock mutual funds. Many financial advisers suggest that when the economy is in decline, it is best to sit tight and wait it out instead of panicking and withdrawing your money from these funds.
3. **How much you have in other savings plans:** If you have other savings plans, such as an IRA, CDs, or whole life insurance, you may want to invest your 401(k) money in riskier stocks or mutual funds.

Managed funds is a package that is put together by the plan manager. This package consists of stocks and bonds in varying degrees of risk. These degrees of risk may look like this:

Aggressive model fund: Invests 20% of its assets in bonds and 80% of its assets in stocks.

Conservative to moderate model fund: Invests 28% of its assets in Money Market funds, 30% of its assets in bonds, and 42% of its assets in stocks.

Conservative model fund: Invests 40% of its assets in Money Market funds, 36% of its assets in bonds, and 24% of its assets in stocks.

Moderate model fund: Invests 40% of its assets in bonds and 60% of its assets in stocks.

If your plan manager offers a call center where you can speak to a representative who is hired by your plan and is objective, take advantage of his or her expertise. Since he or she is not trying to sell you a product, they can walk you through all the options in your 401(k), how it works, and offer you some investment advice on how to allocate your money.

Many 401(k) plan participants have more than 20% of their money tied up in their employer's stock. While the opportunity to own company stock is an important benefit, you need to ensure that the bulk of your savings are not concentrated there. It is very important to diversify your investments.

The following is a recommended breakdown of how to invest your money according to how close you are to retirement:

- **30s and younger:** 100% in stocks
- **40s:** 80% in stocks and 20% in bonds
- **50s:** 75% in stocks and 25% in bonds
- **60s:** 70% in stocks and 30% in bonds
- **70s and older:** 50% in stocks and 50% in bonds

One of the great things about investing in a 401(k) plan is that you invest money a little at a time and not all at once, which is exactly what stock brokers recommend you should be doing when the stock market is unstable. While you may not view your 401(k) as investing in the stock market, that is exactly what you are doing. It is important to remember that "bull markets," markets in which stocks are rising, always follow "bear markets," markets in which stocks are falling. History shows that once the stock market hits rock bottom in a recession, about a year later, stocks generally grow rapidly.

Financial advisers generally advise against adjusting your 401(k) allocations to favor more conservative investments in an attempt to protect your money just because the economy is in a falling market and especially advise against stopping contributions to your retirement plan or cashing it out entirely. Market fluctuations and downturns are normal. While it is important to consistently examine the types of investments in your 401(k) and how you are doing, if you are too conservative, you run the risk of outliving your money.

If you don't have a 401(k) plan, this is a great time to do a little research and get a potential allocation plan worked out. Start by deciding how much risk you are willing to take. Then figure out how much you need to save for retirement, and calculate how much to set aside each month to reach that goal based on an average annual rate of return. Knowing these things will help you select appropriate investments when you are ready to start your account. ■

Advantages of the 529 Savings Plan

There are a number of advantages to consider about 529 Savings Plans:

1. Although contributions are not pre-tax deductions when they are deposited, a prime benefit of the 529 Savings Plan is that your funds grow tax-deferred and withdrawals for the beneficiary's college costs are exempt from tax. In addition, many states provide state income tax deductions for all or part of the contributions.

2. You, as the donor, maintain control of the account. The person you have named as the beneficiary has no rights to the funds until the time you have designated. This means the funds do not affect the beneficiary's application for college financial aid as he or she does not yet own the money. Most plans even allow you to reclaim the funds for yourself any time you desire, no questions asked. You will, however, be required to pay income tax and an additional 10% penalty tax.

3. A 529 Savings Plan can provide a very easy way to save for college. Once you decide on a 529 Savings Plan, you complete a simple enrollment form and choose to make either a single contribution or regular automatic deposits. The ongoing investment of the account is handled by the plan manager, similar to a 401(k).

4. 529 Savings Plans generally have very low minimum start-up requirements and low deposit requirements. The fees, compared with other investment vehicles, are also low.

5. Everyone is eligible to take advantage of a 529 Savings Plan, and there are no income limitations or age restrictions.

6. If you want to move your investment around, you may change to a different option in a 529 Savings Plan every year (program permitting), or you may rollover your account to a different state's program provided no such rollover for your beneficiary has occurred in the previous 12 months.

The Top Ten Performing 529 Savings Plans (using a 5-year Performance Ranking)

1. START Saving Program (Louisiana)
2. T. Rowe Price College Savings Plan (Alaska)
3. Virginia Education Savings Trust (VEST)
4. Utah Educational Savings Plan (UESP) Trust
5. College Savings Plans of Maryland—College Investment Plan
6. College Savings Plan of Nebraska
7. University of Alaska College Savings Plan
8. The Vanguard 529 Savings Plan (Nevada)
9. CollegeBound Fund (Rhode Island)
10. The Upromise College Fund (Nevada) ■

We have new business hours!

Monday-Friday:
7:00 a.m.-9:00 p.m.
Saturday:
7:00 a.m.-4:00 p.m.

Questions You Should Ask about Your 401(k)

When you start a new job or anytime you want to join a 401(k) plan, there is certain information you need to make good decisions about your plan. Even if you already participate in the plan, ask your employer or plan manager for the answers and fill the answer in on the appropriate line.

1. When you will become eligible for the 401(k) or retirement plan?
2. What percentage will be deducted from each paycheck?
3. How and when can you change the amount you contribute?
4. How can you change the funds your money is invested in?
5. How and when you can stop making contributions at all if you so choose?
6. What is the vesting (employer contributions to your plan) schedule?
7. Is the matching contribution in the form of company stock or cash?
8. Can your plan be rolled over if you terminate employment?
9. What are the penalties for early withdrawal?

Family Financial Education Foundation

ACCESS EDUCATION SYSTEMS
724 Front Street, Suite 340
Evanston, WY 82930
contact: (877) 789-4175
www.ffef.org | info@ffef.org

If you know of someone who would benefit from this information, please pass this newsletter along.

This publication is the property of Family Financial Education Foundation. All rights are reserved. For more information about our services or how we can help you with your debt management program, please contact Family Financial Education Foundation at www.ffef.org.