If you have a retirement plan at your job, you may have the opportunity to participate in *one* of the plans described below. The plan offered depends on the type of employer you work for.

- **401(k) plan:** Most "for-profit" companies can offer these plans to their employees.
- **403(b) plan:** Public schools, churches, and hospital organizations can offer these plans to their employees.
- **457 plan:** Frequently available to people working for certain state and local government entities—such as that friendly DMV associate.

You: What's the difference between these plans?

The differences are minor and unimportant. Remember, you can't choose *which* plan to participate in. To simplify, we will refer to all employer-sponsored retirement plans going forward as 401(k) plans, because they are the most common.

401(k) PLANS

You: Where do they get these ridiculous names? Are these number and letter combinations from failed disinfectant formulas? Cough syrups?

Earlier, I mentioned the several–thousand-page Internal Revenue Code. It's divided into numerous sections. Part *k* of the section numbered *401* describes the plan known as a 401(k) plan. That's where the name comes from.

You: For real?

Yes, not too creative, but remember tax professionals aren't known for their creative skills—and those who are have an excellent chance of being put in jail. In short, if the tax code authors had placed additional information about taxes in the IRC before they wrote about retirement plans, we could be asking each other how our 865(w) plans were doing.

You: Okay, so I get it that a 401(k) plan is a retirement plan. How does it work?

ELIGIBILITY

You must first be eligible to participate. The rules at some companies allow new employees to participate on their first day of work. Elsewhere, employees must wait a period of time, such as one year, before they can participate.

You: Okay, I've been told I'm eligible. Now what?

That's great, because at many companies no one comes around to tell you when you are eligible. You must remember when you are eligible.

This distinction is important, because eligibility alone does not usually cause participation. *Once eligible, you must usually take action to participate.*

You: What action?

Simply requesting an enrollment form from Human Resources and filling it out.

You: I got the form—that part was simple. It's the "filling it out" that is more complicated. What the heck is a contribution level?

The form can be intimidating. But only to people who don't understand how 401(k) plans work. Let's take a step back.

You: Fine by me.

When you contribute money to your 401(k) plan, you move money from your paycheck to your retirement account. *The money remains yours.*

You: Prove it.

The 401(k) account has your name on it. You receive statements detailing the money you put in and your current plan value. Most 401(k) plans allow you to check the value of your plan (your plan balance) online at any time.

Since the money you are contributing is still yours, your contribution is sometimes referred to as a **deferral.** You are simply deferring *your* income to *your* 401(k) plan for *your* eventual use in retirement.

Ultimately, a 401(k) contribution is like taking money from your right pocket—where your wallet is—and putting it in your left pocket. Actually, it's better: your contribution is not subject to the federal and state income taxes you would otherwise pay.[4]

You: Sorry to be a thorn here. I love metaphors, but I have to ask: Where exactly is my left pocket?

Your 401(k) plan is held by the plan's **custodian.**

You: Ron? The man in high school with all those keys?

No. The custodian is a company, not a guy with a mop. Your checking account has a custodian too: the bank. The 401(k) custodian provides periodic statements and brochures. You do not have to visit the custodian's office. Examples of 401(k) custodians are:

- Fidelity
- Ameriprise
- Vanguard

You: So the money is in my name but is also in a retirement account. How does that work?

Here's an example:

- Let's say you contribute $100 of each $1,000 paycheck to your 401(k) plan.
- Further, let's say your federal tax withholding rate is 25 percent.

You: Imagine I have said those things. Now what?

How much does your paycheck decrease due to your contribution?

You: $100—you just told me that.

Nope—your paycheck decreases by $75.

You: Why only $75?

Pretend you didn't contribute $100 to your 401(k) plan after all. Your taxable income would be $100 higher than if you had made the 401(k) contribution. But you aren't paid taxable income. Your paycheck is net income. Since your withholdings are 25 percent, you pay $25 of tax on the additional $100 of taxable income. Therefore, by not making a $100 contribution to your 401(k), your paycheck increases by only $75.

[4] The contribution is subject to FICA and Medicare taxes, however.

You: Gotcha. How much goes to my 401(k) plan as a result of the contribution?

I ask the questions.

You: I bought your book.

Fair point. Your 401(k) plan increases by \$100—the amount of the contribution you make.

You: Not \$75, like the amount my paycheck decreases?

No. One hundred dollars.

You: It sounds like I just made \$25.

You did, by simply putting money in your left pocket.

You: Excellent.

Absolutely. You lowered your tax by \$25. Instead of receiving (and probably spending) \$75, you save \$100. These are good things.

Figure 6-3

Effect of a 401(k) Contribution To:

Your Paycheck

	No Contribution	\$100 Contribution
Gross pay	\$ 1,000	\$ 1,000
401(k) contribution	\$ –	\$ (100)
Taxable pay	\$ 1,000	\$ 900
Taxes (at 25%)	\$ (250)	\$ (225)
Net pay	\$ 750	\$ 675

Your Wealth

	No Contribution	\$100 Contribution
Net pay	\$ 750	\$ 675
401(k) contribution	\$ –	\$ 100
Total	\$ 750	\$ 775

Furthermore, your savings should grow significantly before you retire. In addition to the tax savings from your contributions, the *growth*