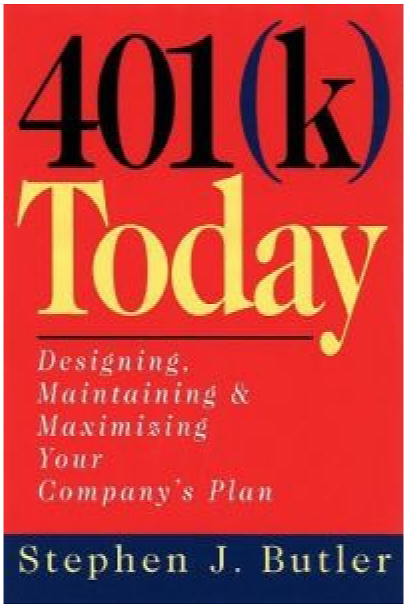

Book 401(k) Today

Designing, Maintaining & Maximizing Your Company's Plan

Stephen J. Butler
Berrett-Koehler, 1999

Recommendation

With all the political strife surrounding the impending demise of the U.S. Social Security system, it's refreshing to spend some time thinking about a retirement savings system that is an unqualified success - 401(k). This well-written book offers a clear and straightforward look at the ins and outs of 401(k) - and believe us, there are more of these than you probably know. Although author Stephen J. Butler kept the jargon minimal, this is not light summer reading, but you'll be glad you upgraded. By the time you put it down, you will understand enough to make sure your 401(k) vendor isn't pinching pennies from your nest egg. You'll know what to ask for, what to invest in, and how plans should function. *BooksInShort* recommends this book to those responsible for designing and running 401(k) plans and to those participating in one. (Applies to United States tax laws only.)

Take-Aways

- New regulations make selecting and maintaining a 401(k) plan more complex.
- Seek updated information so you are not at the mercy of a vendor's salesmanship.
- Fees to vendors can vary by as much as 600%.
- Many employees vote on vendor selection or form advisory committees that act like investment clubs.
- 401(k) plan participants enjoy five times more retirement money than they would have had otherwise.
- Be sure your 401(k) plan is structured for your benefit, not others' convenience.
- The average investment is 15% of salary. However, individuals may invest 25% or $10,000, whichever is less. The overall limit for the whole plan is 15%.
- Often plan administrators apply the 15% maximum to individuals, even when the whole plan is below the 15% average. This penalizes employees who could contribute more.
- 401(k) plan participants should review details of their plan.
- Due to tax advantages and mutual funds, you could become a "401(k) millionaire."

Summary

So You Wanna Be A Millionaire?

There's another way to become a millionaire besides convincing Regis that yes, that really is your final answer! 401(k) plans have made more millionaires than Regis ever will. With a lot of money hanging in the balance, it makes sense for you to know how to structure your retirement plan. The old reliable 401(k) has changed in several ways you should understand.

> "Short of winning the lottery, nothing triggers a thirst for investment knowledge more effectively than an ever-growing 401(k) account balance."

New laws complicate plan administration, but also create new opportunities. The new rules were supposed to make the plans easier to administer, but they accomplished the opposite. Competitive pressures have made plans that provide valuations daily (rather than quarterly) more affordable. Today, recapturing gives sponsors and participants an opportunity to negotiate lower administrative costs. Of course, the big advantage of the 401(k) is the special tax treatment. Your contributions reduce your salary, since the money you set aside goes into the plan. No state or federal taxes are paid on money deposited to a 401(k).

> "The general rationale for all pension legislation is to force or encourage company owners and top managers to offer pension plans to their employees if the owners and managers want to enjoy the benefit of these plans themselves."

The public is increasingly aware of the costs of participation in a 401(k) and now can feasibly compare the costs that different vendors pass along. Beware: Fees for services can vary by as much as 600%. With more than 50 million people now participating in 401(k) plans, it is critical to know what your plan can, and should, do for you.

The ABCs of 401(k)

One of the biggest myths is the limit on the maximum amount that you can contribute to your 401(k). If you've been told it is 15%, you should know more. Any participant can contribute up to $10,000 or 25% of annual income, whichever is lower. The limit exists for the plan as a whole: Including all participants, the average percent of payroll contribution cannot exceed 15%. That includes the participant's contribution, plus any employer payments into a profit-sharing retirement plan. However, a corporate contribution to the plan does not cut the $10,000 maximum an employee can allocate. Because most people will not approach the maximums, most likely you could safely contribute more until you reach $10,000. Check with your administrator. Your plan may have been capped at 15% merely to make it easier to administrate - and someone else's convenience could cost you big bucks.

> "Studies indicate that we will have over five times more money at retirement than would have been the case in the absence of the 401(k) phenomenon."

If you have an executive salary, you face an additional limitation. Tax law forbids the plan to discriminate against rank-and-file workers in favor of highly compensated employees (HCEs), defined as those who make more than $80,000 annually. HCEs cannot contribute at a level more than 2% above the average contribution of non-highly compensated workers (or NHCEs). So if NHCEs typically contribute 7% of their pay, the HCEs cannot contribute more than 9% of their pay, although at a high salary, the $10,000 cap may be what stops you anyway.

> "When the information from vendors can be accurately assessed, you can know, beyond a shadow of a doubt, that you have chosen the plan that best satisfies the combined interests of your company and its employees."

401(k) Constants **All 401(k)'s have common elements. They are:**

1. Retirement plan trust - This legal entity manages the assets of a 401(k) plan. These assets must be separated from the assets of the corporation that sponsors the plan.
2. Plan document - The plan document defines the plan, stating who is eligible, what matching contributions the company will make, and so forth. If this document is improperly signed, that alone can result in your plan being disqualified.
3. Summary plan description - This is the layperson's overview of the plan, other than promotional material, that prospective participants receive.

4. IRS form 5500 - This is an annual report to the government. An IRS audit always will focus on form 5500.
5. Investment choices - Generally, these are mutual funds selected by the plan trustees.
6. Sponsor - This is the business organization that offers the plan to its employees.

> "Sorting through the marketing hype contained in the stack of three-ring binders from all the vendors is next to impossible without some organization or methodology for making apples-to-apples comparison."

401(k) Advantages To 401(k), or not to 401(k)? That is the question. The answer is that most investors receive better investment performance within the confines of a 401(k) plan for several reasons:

1. Since the total amount in the 401(k) plan is substantial, it tends to get the attention of the best investment advisers. Financial planners who work with individual employees are not likely to be as skilled as the best experts.
2. The trustees are successful business owners and executives who have proven their business acumen. 401(k) money gets more care than executives' own investment decisions, because all of their colleagues will know how well their decisions paid.
3. Since the trustees' money is invested, they have a vested interest in the plan's success.
4. Contributions to the 401(k) reduce your taxable income.
5. The income from the investment is tax deferred.
6. Employees can borrow against money put in their 401(k). You can borrow up to half the value of your 401(k) account, up to a maximum of $50,000. There is no minimum on what you can borrow. Since the average participant has more than 20 years before retirement, a loan can help pay for a home or car, or a child's college tuition. The interest that you pay returns to your account. So an average $15,000 automobile purchase would result in $10,000 worth of interest payments over five years, paid back to yourself. The loan must be paid back, usually via automatic payroll deductions. In practice, about a third of participants borrow money from their 401(k) accounts.
7. You can get your money out of the 401(k) prior to retirement as a hardship distribution, but it isn't recommended. While loans can be for any reason, hardship distributions are limited to "safe harbor" situations. These include the purchase of a primary residence, educational expenses for the participant or a dependent, and un-reimbursed medical expenses. This kind of payment may become a hardship to you, given the federal tax penalty of 10%, a state penalty of 2%, and an overall increase in federal and state income tax if the additional income puts you in a higher bracket. The cost of a hardship distribution approaches about 50% for most participants - now that's a hardship!

Take Me to Your 401(k) Leader

Every 401(k) plan has an administrator who sells the plan and has specific responsibilities:

- Plan Compliance - The administrator is responsible for making sure the plan is in compliance with federal regulations. Some problems with a plan, such as an accounting error, can be easily corrected. If the plan has an under-performing mutual fund investment, the administrator can simply change to a more successful fund. However, other situations are more serious. The number of IRS investigators auditing 401(k) plans for compliance has increased fivefold since 1990. If the IRS determines, for example, that a plan favors executives and owners unfairly, it can revoke the tax-exempt status of the funds. This form of enforcement has generated an additional $200 million for the government. Thus, the responsibility for plan compliance is quite serious.
- Plan Changes - Changes in tax and employment law can call for continual adjustment of the plan. Willingness to review and update the plan is where many administrators fall short. Plan sponsors tend to focus on minimizing administrative costs instead.
- Record Keeping - The administrator keeps track of the accounts of individual participants, pooling together all funds under the 401(k) plan and jointly investing them in mutual funds. The mutual funds cannot track the accounts of the individual 401(k) plan investors, so that important task falls to the plan administrator.
- Participant Service - The 401(k) administrator has the ongoing task of educating the participants about the services available under the plan. The bottom line is that administering a plan is a demanding role, and the least-expensive administrator is unlikely to provide an adequate service level. With high maintenance being the foremost criticism of such plans, the lowest-cost provider can be more expensive in the long run.

Hidden Costs

You know how to avoid getting suckered, right? Here are some suggestions:

- Keep money management costs below 1% of total assets.
- Above-average expenses will not necessarily result in better returns.
- The costs of broker-managed firms may be higher. Brokers naturally tend to exercise more trades as a way to generate commissions.
- Watch for back-end loads, the costs of withdrawing the fund from the plan administrator. In one case, the back-end load was 20%, wiping out much of the plan's investment gain.

Beware the Shifty Vendor

Your greatest exposure stems from having the government disqualify your plan, so be sure your service contract has waiver language that shifts liability from the plan administrator to the plan sponsor. Sometimes, clever administrators use questionnaires to elicit compliance and testing information from the sponsor. If the sponsor's information is wrong, disqualification is no longer the fault of the plan administrator, who would merely take the data provided and perform qualifications. Make sure that you have reviewed the service contract before you stand up in front of employees and proudly announce the plan. At that point, you already have committed yourself. When 401(k) vendors try to persuade you of their fiduciary responsibility, direct the conversation toward compliance, and go through the service contract line by line. Review it carefully before moving on to the exciting investment options. As plan sponsor, you can protect yourself other ways. Make sure the plan administrator takes responsibility for:

- Analyzing the raw payroll data;
- Identifying company ownership, including year-to-year changes and family employment;
- Conducting an annual sweep to insure that new acquisitions haven't compromised the integrity of your plan, or altered the rules that apply to it;
- Preparing all statements, testing, and compliance, including completion of the annual 5500 reporting form.
- The service agreement also should guarantee operation of the plan in compliance with federal regulations. Demand sufficient evidence of errors and omissions insurance to make the guarantee meaningful.
- Do not assume that an annual CPA audit protects you. The CPA only looks for accounting issues, and will not assume responsibility for IRS issues.

Recapture

You can recover some of the costs associated with the plan by recapturing. Recapture involves negotiating a free service contract for maintenance and service of the plan, in return for an agreement that lets the plan administrator charge competitive expense ratios against the plan's earnings for the money management work the administrator performs. This becomes a trade-off between maintenance costs and money management costs. The goal is to avoid an aspect of administrative costs, without giving up anything in return. Vendors are willing to forego fees because of the profitability of mutual fund management. For plan participants to benefit from recapture, their company must pass along some portion of the savings in administrative fees, presumably through matching contributions.

The Path of Minimum Regret

Your goal in fashioning the ideal 401(k) plan is to forge a path of minimum regret. This means the right plan with the right administrator will offer an excellent return on investment with a minimal cost or risk. Carefully considering the opportunities and pitfalls of the 401(k) will keep you on the path to investment - and retirement - success.

About the Author

Stephen J. Butler is the founder of Pension Dynamics Corporation, a third-party pension administration firm in Northern California that specializes in implementing 401(k) plans. He also is a popular speaker who is well-known within the pension industry.