

Small paycheck can pack more savings punch

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On the money

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Love that puny paycheck.

It may actually be small enough to help you save more.

You read that right. I did not say: "It may actually be large enough to help you save more."

Perhaps you struggle from month to month to pay the bills. Maybe you have had some calls from bill collectors, or overdraft charges on your checking account.

You may promise yourself that you will start saving for your future if you ever get ahead.

But the answer may be in front of you, in the tax return that's been beckoning for your attention.

I'm talking about the Credit for Retirement Savings Contributions, known as the Saver's Credit. It's a goodie found on your tax form, but ignored by many tax professionals because most of their clients are too affluent to use it. Yet it can result in a refund for singles with incomes up to \$25,000, married couples with incomes up to \$50,000, and single parents that have incomes up to \$37,500.

The maximum credit is \$1,000 for individuals or \$2,000 for couples, depending on your income and how much you save. But you have to put away money to qualify.

The result of using this savings device can be even better than it first appears. That's because of the way saving for retirement works on your taxes. Whether you put money into a 401(k) retirement savings plan at work or an individual retirement account, known as an IRA, outside of work, your savings will cut the income that Uncle Sam taxes.

That snowballs through your tax return, turning small credits for children or low-income individuals into bigger credits. And in the end it can make your refund larger than you ever imagined.

Of course, all of this depends on your income level, and details like whether you have children and how many.

To understand the possibilities, consider Sabrina, a Nashville mother of three who has been getting financial advice from financial planner Keith Newcomb of Full Life Financial in Nashville.

When Sabrina sought help about a year ago, she was drowning. With an income of \$30,000, she wasn't saving anything and was running up almost \$4,000 a year in charges for late payments on bills and overdraft charges, Newcomb said.

He helped her plan better so this would not happen. But this year he figures she could get significant help with a smarter approach to the tax system.

By putting \$4,000 into a 401(k) retirement savings plan at work, Sabrina could save for retirement and end up with the government paying for it, Newcomb said.

Uncle Sam wants people to save for their future, so it provides rewards to those who do it. Low-income people receive extra help.

In a nutshell, here's how it works: By putting \$4,000 away for retirement, Sabrina slices away \$4,000 from her income. So instead of seeing her as having \$30,000 in income, Uncle Sam sees only \$26,000.

That makes it look like Sabrina's household faces a greater financial challenge than it otherwise would. As a result, the government sees a bigger need to help Sabrina's family: With a lower income, she is entitled to larger tax credits.

For example, with a \$30,000 income, she would have been given an earned income tax credit of about \$1,750. This is a credit eligible to people with low incomes. But because her savings lowered her income to \$26,000, she gets a larger credit--about \$2,600, Newcomb said. Also, because her income is lower, an additional tax credit for her children, comes out better. Instead of about \$1,070, she qualifies for \$1,670.

The bottom line is that Sabrina's refund becomes about \$5,500--approximately \$1,400 more than she would have received without the fancy tax work, according to Newcomb's calculations.

Among other steps that help her save, Sabrina receives extra money from her employer as a reward for using the 401(k) plan at work. Not all employers do this, but hers is not unusual. The employer partially matches her contributions. So with her own money, and the money from her employer, she has a total of \$5,800 earning interest for her future.

Although the tax credits might seem like a confusing boggle of numbers, keep one thing in mind: You do not have to be a tax expert to get these credits. If your income is below \$39,000 you are eligible for free tax help in one of 12,000 centers across the country. These are called VITA centers, or Volunteer Income Tax Assistance programs, and you can find one near you at 800-829-1040. Seniors with low and moderate incomes can locate free help at 888-227-7669.

Depending on your income, people with access to the Internet also can use free tax preparation software through "Free File," found at IRS.gov. You will be asked simple questions that will help you spot credits like the Credit for Retirement Savings Contributions and the earned income tax credit, and instruct you step by step in taking advantage of them. The software does the math for you.

In VITA centers this year, people are being advised that they can split their tax refund in as many as three ways. So the government will send your refund automatically into more than one account if you want, said David Marzahl, executive director of the non-profit Center for Economic Progress.

With a \$1,500 refund, for example, you could tell the IRS to put \$500 into your checking account so you could cover bills, \$500 into a savings account so you would have money for emergencies and \$500 into an IRA. You can divide your refund any way you want, for no charge. Just fill out IRS Form 8888.

For the best interest rates on savings, search Bankrate.com. Internet banks such as HSBC Direct or ING Direct offer rates well above usual bank rates--about 5 percent rather than 1 percent or 2 percent.

If you want to open an IRA for the first time, you could do it at a bank, mutual fund company or brokerage firm. A good starter mutual fund might be a target-date fund. It would give you investments in both stocks and bonds. You would select it by telling a broker or a phone attendant at a mutual fund company the year you intend to retire. A few mutual fund companies, such as T. Rowe Price, will let you open an IRA and invest as little as \$50 a month in a mutual fund.

Newcomb found a simple way for Sabrina to put money into a 401(k) every payday. As he looked over Sabrina's tax information, he noticed that the government was withholding about \$100 in taxes from her paychecks each month. That was crimping Sabrina's pay unnecessarily. The fact that she was getting a refund showed that she was paying taxes she did not owe. And having an extra \$100 a month in her paycheck would serve her well.

His advice: Go to her benefits office at work and change her W-4 withholding form so that she would have less taken out.

Also, he suggested she fill out a W-5 form so that she would receive her earned income tax credit throughout the year--not just at the end of the year. With these actions, Newcomb said, Sabrina would have about \$260 in extra pay each month, and she could route all, or a portion, into her 401(k).

With this approach, her refund will not be as hefty as in the past. She should receive about \$2,500 instead of \$5,500.

But that doesn't mean she is ending up with less money.

In fact, it's just the opposite.

Consider what constant saving in a 401(k) will do for her. Say she saves \$4,000 a year for 30 years in mutual funds that invest in stocks and bonds, and she earns 8 percent a year on the money. She will have about \$489,000 for retirement. With her employer's free matching money it could be over \$709,000.

With just \$3,000 a year, she could still accumulate \$367,000. And with just \$1,000--or about \$85 a month tucked into a 401(k)--she could have about \$122,500.

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