Do You Plan to Retire?

Ways to Save For Retirement

Retirement is just around the corner, and it is important to begin planning and saving for retirement as soon as possible. In order to maximize your savings, it is important to understand the various types of tax-advantaged retirement plans available individually and offered by employers. Your employer may offer a defined benefit pension plan or a defined contribution plan. You can also contribute to an individual retirement account (IRA). Each plan offers various benefits and with knowledge, you will be able to optimally save for retirement.

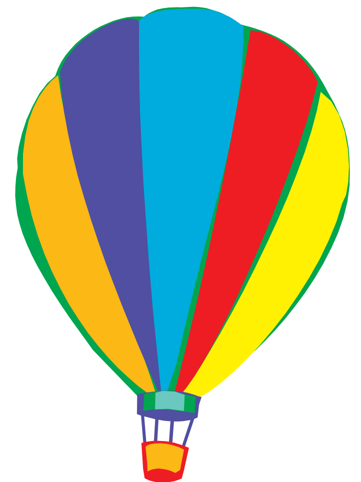
Types of Retirement Savings Plans

Defined Contribution Plans

Defined contribution plans are established by an employer (employer-sponsored) and both the employee and employer can make contributions to the plan. With these types of plans, the employee accepts the risk because the amount received at retirement is based on the amount of contributions and investment performance. A brief overview of some of the most common plans is below.

- *401(k) Plans*- 401(k) plans are established by for profit employers and allows employees to defer a portion of their current income into a retirement account. Some employers match a portion of employees' contributions which can substantially increase the employees' retirement savings. Contributions are made with pre-tax dollars, and the employee pays income taxes on contributions and investment earnings when the money is withdrawn in retirement. These plans are tax deferred for income tax purposes, but they are still subject to payroll (Social Security and Medicare) taxes. There is a maximum amount that can be contributed to each employee's account.

- *Profit Sharing Plans*- With profit sharing plans, employer contributions to employees' retirement accounts are based on the employer's profits. Employees receive a percentage of the employer's profit based on the earnings of the employer. If the employer does not make a profit, then employees do not receive contributions to the plan. With this type of plan, employees may feel a sense of ownership. The plan is designed to encourage loyalty to the company and therefore make employees want to work harder so the company will succeed. The contributions and investment earnings are not taxed until the employee withdraws the funds in retirement. There is a maximum amount that can be contributed to the plan each year.



Defined Contribution Plans (cont.)

- *Stock Bonus Plans*- Stock bonus plans, like profit sharing plans, encourage loyalty among a company's employees. Like profit sharing plans, stock bonus plans give participants a vested interest in the performance of their employer. Instead of sharing the company's profits like profit sharing plans, employers give employees stock in the company. Employees, however, have more risk in their investment portfolios because the portfolios are not diversified; their portfolios are comprised of only the employers' stock. Portfolios that are not diversified are typically more risky. Employer contributions to the plan are discretionary, so the employees' retirement accounts are somewhat dependent upon the frequency and amount contributed by the employer. The contributions and investment earnings are tax-deferred until retirement, and there are maximum annual contribution limits.

- *403(b) Plans*- 403(b) plans are retirement plans similar to 401(k) plans for employees of government organizations, schools and other educational institutions, and tax-exempt organizations (501(c)3 organizations). Like 401(k) plans, employees can contribute tax-deferred income to their plans but contributions will be subject to payroll taxes. These plans also have a maximum annual contribution limit.

- *SIMPLE IRAs*- SIMPLE IRAs are designed for small employers (fewer than 100 employees). Employees can contribute a certain amount of their earning each year to the plan. Employers can also contribute to the plan for their employees. Contributions and earnings are not taxed until withdrawn at retirement, and there is a maximum amount that can be contributed to the plan each year.

- 457 *Plans*- 457 plans are similar to 401(k) and 403(b) plans and are offered by eligible tax-exempt (501(c) 3 organizations) and governmental employers. These plans offer greater savings ability for employees who also have access to 401(k)s or 403(b)s because 457 plans have separate contribution limits from other defined contribution plans. Contributions are tax-deferred, but subject to payroll taxes.

Defined Benefit Retirement Plans

Defined benefit retirement plans are offered by employers. With these plans, participants are guaranteed a monthly amount when they retire after reaching the plan's specified retirement age regardless of investment performance. Employees are not responsible for investing the money in the plan; they don't have individual retirement accounts. Employers contribute a certain amount of money to the plan for each employee, and employers are responsible for investing the employer and employee contributions. The employer accepts all of the investment risk. Contributions to the plan are tax-deferred. The monthly benefit at retirement can be based on the number years of service with the employer, your highest salary or a highest average salary, and a percentage amount determined by the employer.

Individual Retirement Accounts (IRAs)

IRAs are individual retirement plans that allow people to save for retirement outside of their place of employment. Small businesses can also use traditional IRAs to make retirement contributions for their employees.

- *Traditional IRA*- Contributions to a traditional IRA are income tax deductible for some persons. The deductibility of the contributions is based on whether or not the

person has access to an employer-sponsored pension plan (defined benefit or defined contribution) and their income. A person may be able to deduct some, all or none of the contributions on their tax return. Any contributions that were deductible on the individual's income tax returns and investment earning are taxed when the money is withdrawn. The amount individuals can contribute to an IRA is limited to a maximum allowable contribution each year.

- Roth IRA- A Roth IRA is similar to a traditional IRA because both allow individuals to save for retirement outside of work. Contributions to a Roth IRA, however, are made with after-tax income and therefore are not income tax deductible. Therefore, contributions are tax free when withdrawn. In addition, investment earnings are income tax free if the person meets certain qualifications. Contributions to a Roth IRA are limited if the individual's income exceeds a certain amount and has access to a retirement plan through their employer, regardless of whether they contribute to the plan or not. Roth IRAs have an annual maximum allowable contribution amount.
- Simplified Employee Pensions (SEPs)- SEPs are a type of retirement plan for small businesses. These plans allow business owners to open traditional IRAs for themselves and their employees and make tax-deferred contributions to these individual accounts. The money in these plans is taxed when it is withdrawn. SEPs also have annual maximum contribution limits.

Roth 401(k) and 403(b) Plans

Roth 401(k) and Roth 403(b) plans combine features of a Roth IRA with a traditional 401(k) and 403(b) plan. With these plans, employees can choose Roth IRA type tax treatment (after tax dollars) for a portion or all of their retirement plan contributions.

Catch-up Contributions and Withdrawals

As you get closer to retirement, you may want to save more. Once you reach age 50, many plans allow you to save an additional amount for retirement to help you reach your savings goals. These additional amounts are called catch-up contributions. The catch-up contribution for each plan is different.

Retirement accounts are meant to help individuals save for retirement rather than for expenses they will have before retirement such as home down payments or children's educations. In order to ensure that these types of accounts are used primarily for retirement purposes, withdrawals can only be made after age 59½ with some exceptions. Withdrawals from retirement accounts made before you reach 59½ are subject to a 10 percent penalty unless they meet certain exceptions. Early withdrawals and withdrawals at age 59½ are also subject to income tax. Certain withdrawals can be made tax-free, and/or some can be made without a penalty. In addition, with some retirement plans, individuals have to begin making withdrawals at a certain age (usually age 70½) to avoid a penalty. Also, with most retirement plans, individuals can choose from different withdrawal options when they retire such as joint and survivor annuity option, partial or total lump sum option or rollover option.

To find the current maximum annual allowable contribution amounts, catch-up contribution amounts, and information about withdrawal limitations and options for each of the retirement plans, go to the IRS' website at www.irs.gov. These amounts change regularly, and they can be found on this website.

Sources

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