Imagine that you just landed your first real job with a great salary. On your first day of work, you meet with the head of human resources to go over your benefits and make some choices. After reviewing your vacation and health benefits, the discussion changes to retirement plans and which one you want to enroll in.

Retirement?! Who cares about that! You just *started* working!

Well you should care because the choices you make now could have a big impact on your life down the road.

Let's take a look at some of the different retirement plans your employer might offer or that you might enroll in on your own.

Tax Incentives

Tax-Deferred Plans

- Any contributions you make are excluded from your taxable income until you withdraw money
- Retirement balance increases until time of withdrawal (preferably at retirement age)
- Benefits taxed at a lower rate when you start to withdraw if you're in a lower tax bracket

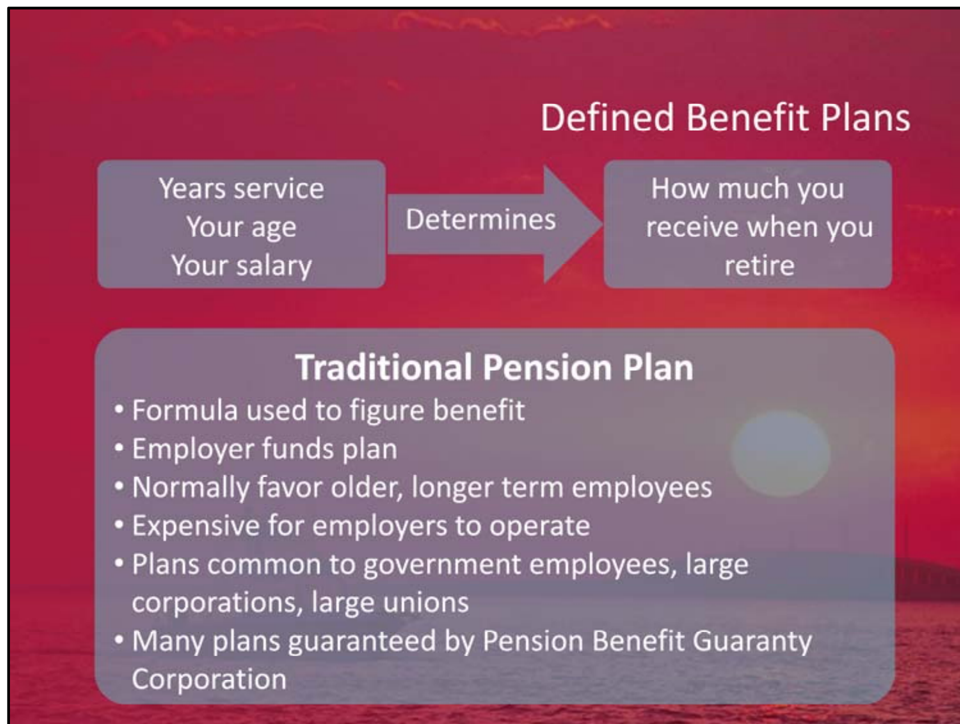
There is a **penalty** for withdrawing funds from tax deferred savings plans before the age of 59 ½ .

While we've talked about how Social Security may not cover a large amount of your retirement needs, the good news is that the federal government has set up a number of different plans that provide tax incentives for you to save money for the future. The biggest incentive is that you don't have to pay tax on any income that you contribute to some retirement plans until you withdraw the money. These are called tax-deferred plans. Since your contributions aren't taxed, you'll have more money to contribute to your plan, which will increase the returns on your investments.

Eventually, you will have to pay tax on the income when you start to withdraw funds from the account after you retire. When you do, you may be in a lower income tax bracket since you won't be working anymore, so you might pay a lower tax on this money than you would have at the time you earned it.

Because these tax incentives are provided for you to save for retirement, currently you'll pay a penalty if you withdraw funds from these plans before the age of fifty-nine and a half.

These tax incentives are mostly associated with defined-contribution retirement plans, which are retirement plans that are funded by the employees, with or without contributions from their employers.



The options for retirement plans used to be a lot simpler. Many people worked for one company for the majority of their working lives and many companies set up pension plans to pay for their employees' retirement. How much money you received when you retired usually depended upon how long you worked for the company, how old you were when you retired, and how much you made.

Some jobs still have these types of retirement plans known as defined benefit plans. As long as the plan remains the same, employees under these plans can predict exactly how much they will receive in retirement. They are still common with many government jobs and some large corporations, although increasingly less so.

Defined benefit plans offer employees a number of benefits, for example, employees often can choose to get a set monthly payment until death, which may continue in some amount if their spouse outlives them. Benefits are set in advance and aren't determined by the how well the underlying investments perform. Also, employees don't have to contribute money, although that is changing for many plans. Many plans are guaranteed up to a certain annual maximum by the federal government through the Pension Benefit Guaranty Corporation (PBGC).

There are some drawbacks for employees because they may have to work for the company for a number of years before they can get any pension, and if they leave before that time, they often won't get anything. Since the pensions are predefined, there's no possibility that the retirement benefit will be any higher, even if the company does extremely well.

Because these plans are expensive for employers to operate, defined benefit plans are becoming less common in private industry, although they're still common for public employees.

Defined Contribution Plans

- Less expensive to operate
- Funded mostly by the employee
- Returns are based on how much and how long you invest, and what the returns were
- Favor workers who might change jobs or careers
- Money in the account belongs to the employee
- Example: 401 K Plan

Biggest Difference
You have more control and more responsibility.

As pensions become less common, defined contribution plans are quickly becoming the norm. Businesses like them because they are less expensive to operate, and reduce the number of financial obligations they have on their balance sheet, which can be good for their stock price, among other things.

There are some large differences with defined benefit plans. For one, unlike pensions, these plans are funded mostly by the employee with some employers making contributions. Instead of a guaranteed return based on a formula, your retirement benefit depends on how much and how long you invested, and what the returns were. This means that your benefits may run out if you don’t save enough, or if your investments don’t perform well.

There are some benefits, however. If you’re like the majority of Americans, you’ll probably work for a number of companies during your career. Any retirement contributions are yours to keep, so you don’t have to worry about losing them like you might under a pension plan. Since these accounts usually offer different investment options, you have greater control over where you invest your money, so there’s a chance that you’ll make a higher return on your money. If you’re good at saving, you may be able to contribute quite a bit more each year to your account which will increase your final retirement savings, however, since these plans can offer tax deferral advantages, the government, and possibly your employer can limit your annual contributions.

As you can see, the biggest difference between defined benefit and defined contribution plans is that with defined contribution plans, you have more control over your retirement money, but you’re also entirely responsible for making sure you save and invest well.

You're not obligated to take part in a defined contribution plan: they are optional. You'll find that many employers that contribute to these plans as part of your benefits will only do so if you contribute. In fact, many employers will match your contributions, which means you'll double every dollar that you save for retirement. If you don't contribute, you don't get any of that free money. It's your choice and your responsibility.

Let's look at an example of how employer contributions can make a big difference in your retirement savings.

Effect of Employer Contributions

Question 1 of 1 | Point Value: **10**

Jeff and Parker work at the same company and each earns $40,000 per year.

Their employer offers a 50% match on their contributions to their 401 K Plan - up to 5% of their salary.

- Jeff contributes $2,000.00 (5% of his salary) this year
- Parker contributes $1,000.00 (2.5 % of his salary) this year

How much more money did Jeff get from the company this year in retirement contributions by contributing the maximum amount?
Enter the amount in the box and select **Submit**.

	Jeff	Parker
Annual Salary	$40,000	$40,000
% pay contributed	5%	2.5%
Employee contribution	$2,000	$1,000

PROPERTIES

On passing, 'Finish' button:	Goes to Next Slide
On failing, 'Finish' button:	Goes to Next Slide
Allow user to leave quiz:	After user has completed quiz
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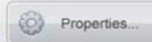
User may attempt quiz:	Unlimited times



Employer-Defined Contribution Plans

401K – Private Company Employees

403 b –Tax Exempt Organizations Public Education, Healthcare and Non-Profit Organization Employees

457 – Government Employees

Tax-deferred plans which allow people to contribute money to their retirement plans before tax is taken out.

Let’s look at the different types of defined contribution plans that your employer may offer. These vary based on the type of employer you work for.

Private companies offer 401k plans, while tax exempt organizations such as universities, healthcare institutions, and some non-profit organizations offer 403b plans. 403(b) tax-sheltered annuity plans are related plans offered by public schools and some tax exempt organizations. Government employees at all the local, state, and national level have the option of joining 457 plans.

While they go by different names, they function in much the same way. They are plans which allow people to contribute money to their retirement plans before tax is taken out. In other words, people defer paying taxes until they start withdrawing the money.

Let’s look at some other features of these plans.

Plan Features

- Tax Deferred
- Different investment options in each plan
- Employer contributions
- You can rollover your balance into a new account
- Can contribute up to $16,500 (2010 limit) per year
- Employees over the age of 50 can also make “catch-up contributions” above the maximum limit
- Plans allow you to withdraw or borrow against the account before retirement age for specified circumstances

As mentioned, these are all tax deferred retirement accounts where your contribution is deducted from your paycheck before it is taxed, which lowers your taxable income. Each employer offers different investment options so that the employee can choose investment products that match their own goals and needs.

Many employers will match all or a portion of an employee’s contribution to the plan. Unlike pension plans, if you change jobs, you can transfer or rollover your account balance into another qualified retirement plan at your new job.

Unless otherwise limited by your employer, you can currently contribute up to $16,500 per year, however, those employees over the age of 50 may be able to make an additional “catch-up contribution” of up to $5,500 dollars. These amounts change frequently, and are subject to employer restrictions.

Finally, many plans allow you to borrow against the account for certain circumstances, but doing so may reduce your final retirement fund. In addition, you may have to pay tax penalties if you don’t pay the loan back on time.

Even though you're in one plan, things might change at your company, and you need to be aware of how it affects you. Watch the short video clip that talks about how one man's retirement expectations quickly changed when his company was sold and they changed from a defined benefit to a defined contribution plan.

Traditional Individual Retirement Account (IRA)

- Tax-deferred - Can be established at banks, investment brokerages, or insurance companies
- Currently limited to annual contributions of $5,000 up to 49 years old and $6,000 over 50
- You choose your investments
- Must be under 70 ½ years old to be eligible, no minimum age

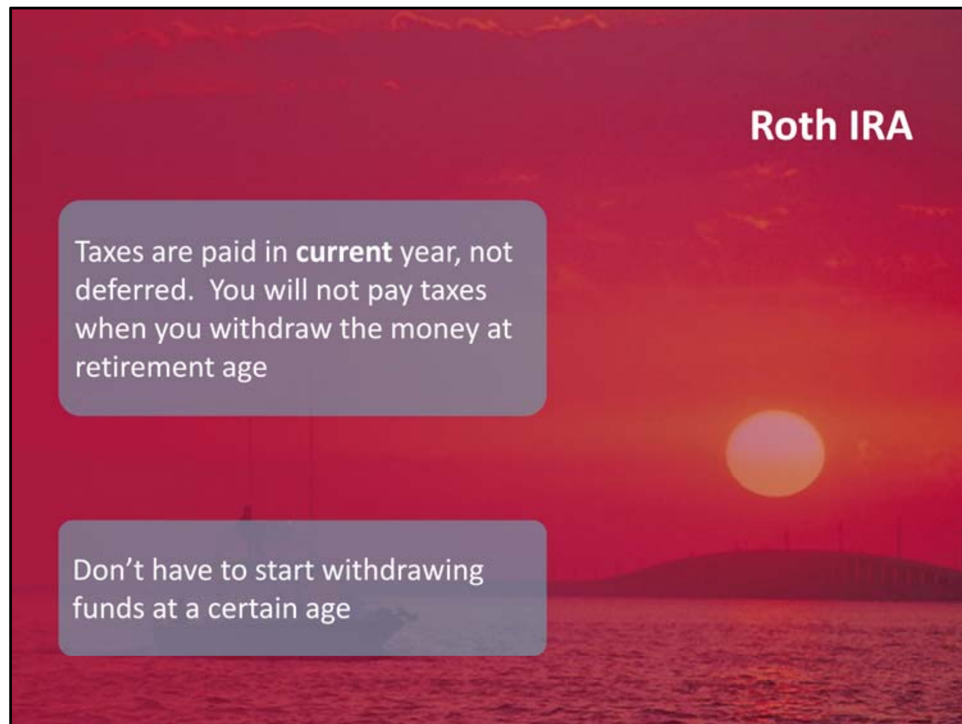
Even if your employer doesn't sponsor a retirement plan, or if you would just like to supplement your plan, you can open an individual retirement account (IRA). The most common types are traditional and Roth IRAs. Let's look at the traditional IRA first.

Like the other defined contribution plans we just discussed, these accounts are tax-deferred, up to certain income limits. There are strict limits on how much you can put in the account every year, currently five thousand dollars up to forty nine, and six thousand dollars if you are over fifty. These numbers change over time and are affected by your income and other retirement accounts.

Unlike employer plans, since you pick where you're going to establish your account, you can invest in anything that these institutions offer. This gives you greater flexibility in managing your account.

You can contribute to these plans at any age up until you are seventy-and-a-half years old, after which you have to start withdrawing money or face penalties. This is the same for 401k plans.

Finally, you can't take money out of the account unless you are transferring it to another qualified retirement plan, otherwise, you will pay a penalty and the money will be taxed.



Roth IRAs are very similar to traditional IRAs with a couple of key differences. The main difference is that a Roth IRA is not tax deferred, meaning that the money that you put into the account is taxed in the year it was earned, and you pay no tax when you withdraw it at retirement. Why would you want to pay taxes on the money now? There may be many reasons, but here are a couple.

If you think you'll be in a higher tax bracket when you retire, then you will be paying less tax on the money now than you would in the future.

Since you don't know what your tax situation will be when you retire, or what tax policy will be, paying the tax now can be part of your retirement tax strategy.

Another big difference is that with a Roth IRA, unlike with traditional IRAs or employer-sponsored plans, you aren't required to start withdrawing money when you turn seventy-and-a-half years old. This can be a big benefit depending on your retirement or estate planning needs.

Both the traditional and Roth IRAs have similar limits on how much you can put in the account every year, currently five thousand dollars up to forty-nine years old, and six thousand dollars if you are over fifty. You can have both types of accounts and split the amount you contribute to both, but the combined contribution has the same limits as the individual accounts.

These numbers change over time and are affected by your income and other retirement accounts. See the IRS website for the most current information.

Self-Employment Retirement Plans

Keogh Plan

- Defined benefit or defined contribution plan
- Tax deferred
- Small business and self employed individuals who own their own business – limited to 10 employees
- More administrative requirements
- If self employed, you can contribute up to $49,000/ year to the plans

SEP-IRA

- Simplified Employee Pension – Individual Retirement Account
- Allows small business employer to contribute to owner's and employees' retirement funds
- Tax deferred
- Easy to set up and maintain
- Can contribute 25% of income, not to exceed $49,000/year

IRS.gov

Now let's talk about a couple of self employment retirement plans that are designed for self-employed individuals and small business owners.

The Keogh plan can be set up as a defined contribution, or a defined benefit plan. It is not an IRA. These plans are limited to businesses with ten or fewer employees. Because they are difficult to set up and expensive to administer, they are best suited for high income small businesses.

The simplified employee pension individual retirement account, or SEP IRA, is an IRA designed for small business owners to fund their retirement accounts as well as their employees. It's much easier to set up and maintain this type of account, so it is better suited to small businesses that don't have high incomes. Since these are IRAs, you can invest just like an IRA, your contributions are tax exempt, and you cannot withdraw funds until you are fifty-nine-and-a-half. The rules for contributions by self employed workers are slightly more complicated.

See the IRS website for more information.

Annuities

Annuities/Annuity Contracts

Most common are contracts between a person and a business, usually a life insurance company, whereby someone pays a premium for a set number of years, most likely until they retire. The person then receives a guaranteed amount on a regular basis until they die, or whatever the contract states.

Finally, one type of retirement instrument that used to be more common are annuities, or annuity contracts.

The most common are contracts between a person and a business, usually a life insurance company, whereby someone pays a premium for a set number of years, most likely until they retire. The person then receives a guaranteed amount on a regular basis until they die, or whatever the contract states. If this sounds a lot like a pension, it is, except the person receiving the check paid the money for the contract rather than the employer.

There are many different types of annuities available, which may or may not function like this example. Some of these annuities have tax-deferred characteristics similar to other retirement plans we've looked at. Annuities are more likely to be a part of a more comprehensive retirement plan for someone who already has many of the other retirement accounts covered and is looking to address specific needs.

Pick the Retirement Plan

Question 1 of 1

Point Value: 10

Drag the description to the retirement plan that it describes and select **Submit**.

Roth IRA	Plan for private companies
403 b	Plan contributions taxed in for current year
401 K	Plan for small businesses and self employed
Traditional IRA	Plan for universities, healthcare organizations, and non-profits
SEP-IRA	Plan contributions are tax deferred

PROPERTIES

On passing, 'Finish' button:	Goes to Next Slide
On failing, 'Finish' button:	Goes to Next Slide
Allow user to leave quiz:	After user has completed quiz
User may view slides after quiz:	At any time
User may attempt quiz:	Unlimited times

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If there’s anything you should take away from this lesson is that more and more, you are responsible for your retirement: both saving for it, and managing your investments. While employers may contribute money to your retirement, some more than others, the majority of the burden is on you.

There’s only one way to make sure that you have enough to live comfortably in retirement: to save enough. Time is a great advantage that you have because the longer you save, the more your investments are likely to grow. Check out the 401k calculator link at the 401k Planning website which can give you an idea of the affect of time on your investments. Try varying the inflation rate and the rate of return and see how it affects the outcome.

Remember that these types of calculators are only rough predictions of how your retirement accounts will perform. Just like with your other long term investments, you’ll have to adjust course along the way to make sure you meet your goals.

It’s hard to think of saving for retirement when it seems so far away, but every contribution helps, especially the younger you are. When you do start working, make sure you look closely at any plans your employer offers to see what’s right for you and whatever your dreams hold down the road.