

Looking Ahead to Retirement: Retirement Accounts

– Video Transcript

Retirement-specific savings accounts offer unique benefits and can help individuals save for retirement.

Individuals can save in retirement accounts on their own and, in many cases, through their employer.

There are many types of workplace retirement plans, including: 401(k) plans for private sector workers, 403 (b) plans for tax-exempt organization workers, and 457 (b) plans for government workers.

There are two ways workplace retirement plans encourage savings

The first reason is the ability to contribute to some accounts on a pre-tax basis.

This means contributions are deducted from your paycheck before taxes are calculated, so you are taxed on a lower amount. Here's an example.

Let's assume a \$2,000 paycheck and a combined 25% federal and state tax rate.

In one scenario, you contribute \$0 to your retirement account and in the other you contribute \$300.

Your \$300 contribution only "costs" you \$225 out of pocket.

The \$75 that would have been paid to taxes is now going to your retirement account.

This is potentially huge.

The second reason workplace plans can help encourage retirement savings is the possibility of employer matching contributions.

These contributions are typically limited to a partial match on a certain percentage contribution. Matching contributions are like free money for retirement and can help individuals save even more.

But there are trade-offs with using pre-tax retirement accounts.

There are typically penalties for taking early withdrawals and withdrawals are subject to income taxes.

Individuals can also save for retirement on their own with an Individual Retirement Account (IRA). There are two types: traditional and Roth.

Traditional IRAs allow individuals to make pre-tax or after-tax contributions into a tax-deferred account.

The ability to contribute pre-tax is phased out at higher income levels for people covered by a workplace retirement plan.

Funds from a pre-tax account are subject to income tax when withdrawn.

Roth IRAs allow individuals to make after-tax contributions into a tax-deferred account. Withdrawals are generally not subject to income tax in retirement.

The ability to contribute to a Roth IRA is phased out above certain income levels.

Some workplace retirement plans allow Roth (after-tax) contributions and have similar advantages to Roth IRAs.

Retirement plans can be important tools in helping individuals save for retirement.

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.

There is no guarantee that working with a financial professional will improve investment results.