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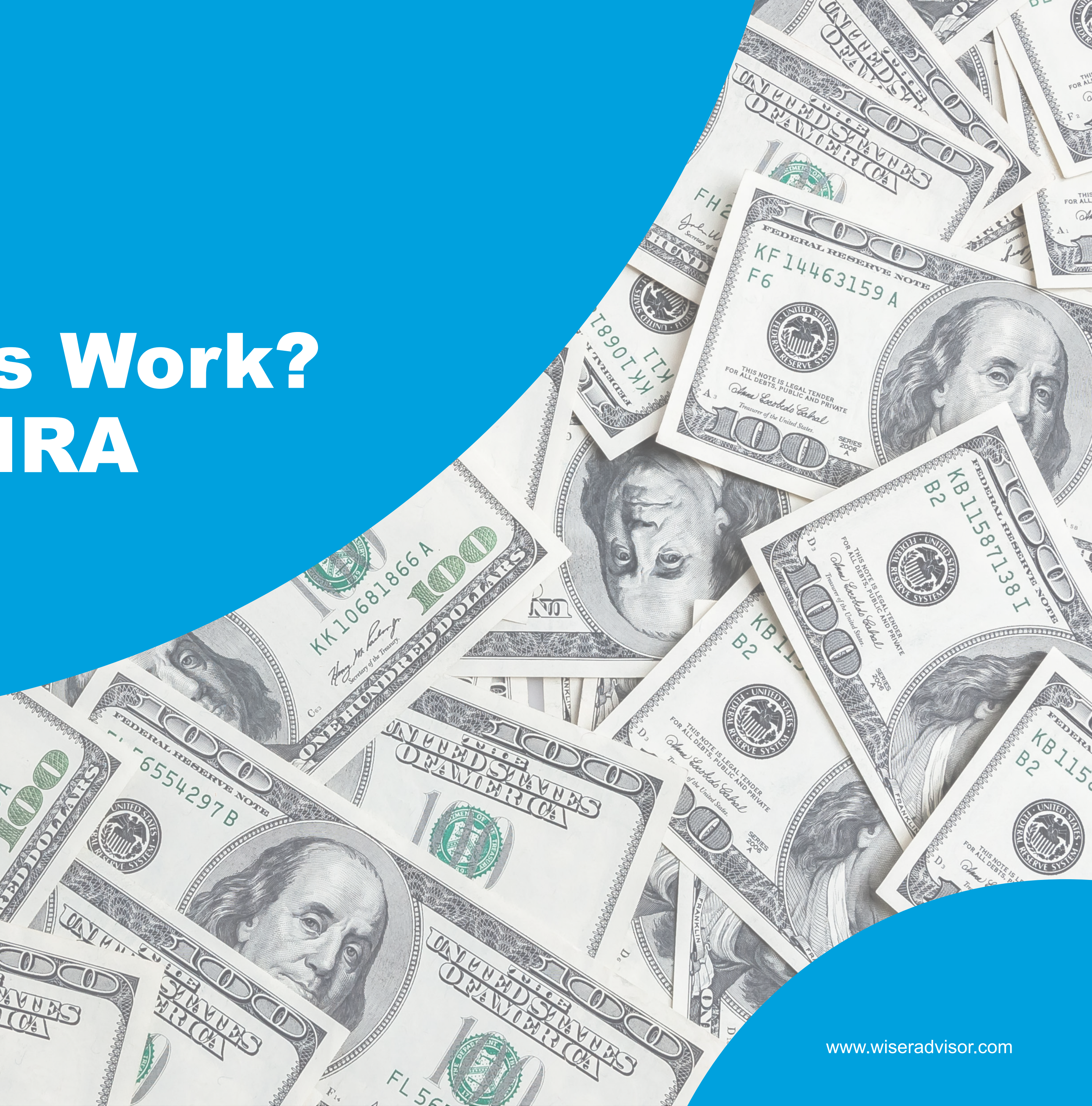
How IRAs Work? 401k Vs IRA



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A sound financial plan must include retirement planning as one of its cornerstones. A small amount of time and effort invested in planning for the sunset of life, ensures you don't have to compromise on anything then. The payout from social security and other employer pension benefits may not be enough for your retirement needs. As such, saving a portion of your income right from a young age is a prudent step and goes a long way in contributing to the necessary retirement income. You have several options while planning for retirement like the employer-driven 401k account or the individual-driven IRA account. Wondering how are these two different? Read on.

What is an IRA?

An Individual Retirement Account (IRA), as the name suggests, is a type of account that individuals can operate to generate a steady retirement income. Such IRA accounts typically include tax benefits that help you save for retirement expenses. These are designed to encourage you to save for retirement and discourage any withdrawal before a certain predefined period. You can open an IRA at any financial institution including banks and investment firms. The money you channel in an IRA is invested across several types of financial instruments, including stocks, bonds, mutual funds, savings certificates or index funds. There are some IRA accounts that are offered by employers to their employees.

IRAs are primarily of two types – Traditional IRA and Roth IRA. A traditional IRA provides tax-deferred growth, with your annual contribution being tax-free and the lump sum withdrawal being taxed. On the other hand, contributions to a Roth IRA are taxable, but grow tax-free thereafter, thus allowing you to build a retirement corpus free from tax at withdrawal. The other types of IRAs include SEPs (Simplified Employee Pension) and SIMPLEs (Savings Incentive Match Plan for Employees) which are employer-driven and offer retirement planning for self-employed professionals or small businesses.

What is a 401k plan?

A 401k plan is an employer-driven retirement savings account for employees. It is characterized by tax-deferred savings and as such, allows you to lower your taxable income. Your contribution to the account is typically matched by your employer and the amount accrues and compounds tax-free. The amount is invested in various predefined instruments like stocks and bonds. The withdrawals at maturity are taxable as per the income tax laws. A 401k plan is administered by employers and they decide your eligibility criteria, employer contributions (not mandatory), investment options and withdrawal regulations. You have the right to decide whether you want to participate in the plan or not. You also get to decide your contribution amount. Under a 401k plan, the total employer-employee contributions are held in a single plan trust, while every employee account balance is tracked separately.

The different types of 401k plans include traditional 401k plans, safe harbor 401k plans, SIMPLE 401k plans, solo 401k plans, and Roth 401k plans. While a traditional 401k plan allows tax-deferred investment, contributions to a Roth 401k plan are done using after-tax income. A safe harbor 401k plan is for small businesses to avoid compliance tests. SIMPLE 401k plans are for small businesses under 100 employees. On the other hand, 401k plans are for business owners without any employees.

401k vs IRA : How do they differ from each other?

Both 401k and IRA are financial instruments with a similar intent of incentivizing retirement planning. You may invest in both accounts for retirement planning. While a 401k plan is provided by employers, an IRA is opened by individuals on their own accord. A comparison of the various features, eligibility requirements, withdrawal criteria helps you decide which account is best suited for your retirement needs. The various ways in which these plans are different are enumerated below:

1. Contribution amount
2. Tax benefits
3. Eligibility criteria

Contribution amount

In a 401k plan, you may contribute up to $19,000 if you are under 50 years of age, and a further $6000 if you are above 50 years of age, in 2019. This is up from $18,500 in the year 2018. In a traditional and a Roth IRA, you can contribute $6000 combined if you are under 50 years of age and a further $1000 as a catch-up contribution if you are above 50. This is up from $5500 in the year 2018, while the catch-up contribution remains unchanged. Further, a 401k plan can have employer matching contributions with the combined amount limit up to $56,000 in the year 2019, up from $55,000 in 2018. As such, the 401k plan has a higher annual contribution limit.

Tax benefits

In a 401k plan, your contributions are tax deductible. As such, your taxable income reduces for the annual year. The amount on maturity is taxable as per income tax law. Thus, your contributions grow tax-deferred in a 401k. A Roth 401k plan allows your contributions to grow tax-free. Your contributions in the present year, though, are after tax. A traditional IRA account allows you to grow your investments in a tax-deferred manner. Further, the contributions are tax-deductible but are limited by an income ceiling and contributions to an employer retirement account like 401k. A Roth IRA allows tax-free investment growth of income that is already taxed as per income tax laws.

Eligibility criteria

401k plans are employer-administered and you are eligible for it if you are above 21 years of age and have served the company for at least a year. Further, your contributions to the plan are capped at $62,000, including $6000 catch-up contribution if you are above 50 years of age. You may open an IRA account of your own accord provided you earn income that is taxable and you are under 701/2 years of age. In a Roth IRA, your contributions are limited by an annual gross income of $1,22,000 if filing individually and $1,93,000 if filing together with your spouse. Further, an annual gross income greater than $1,37,000 or $2,03,000 when filing separately or together with spouse respectively, make you ineligible to contribute to a Roth IRA. In a traditional IRA, whether your contributions are tax-deductible depends on the contributions made to a workplace retirement plan like 401k. The various limits also vary based on whether you are filing separately or with a spouse.

Withdrawal

Funds withdrawn from a 401k plan are taxable as ordinary income. A Roth 401k fund offers you tax-free withdrawal. You may withdraw amount only after 59 1/2 years of age Withdrawing before the age limit, make you liable to a 10% penalty. A traditional IRA account fund is taxable on withdrawal and early withdrawals are also taxable and are accompanied by a 10% penalty. There are exceptions where-in the penalty might be waived. A Roth IRA allows tax-free withdrawals after 5 years of account opening. Again, taxes and a 10% penalty are levied for early withdrawal, unless you meet certain exceptions like funding a home purchase.

Investment options

A 401k plan offers up to a dozen avenues for you to invest in. These include mutual funds, company stock options, variable annuities, government bonds, money market funds, to name a few. You may choose to invest in a combination of two or more of these options based on your risk profile and tolerance. The different types of investment options available are typically pre-defined by your employer in the policy document. An IRA account allows you to invest in all types of financial instruments as serviced by your account provider. These include a combination of mutual funds, stocks, ETF's, bonds and US treasuries, annuities, etc.

Summary

Like it is said, retirement is wonderful if you have two essentials – much to live on and much to live for. Planning for retirement individually or through employer accounts helps you maintain your standard of living even after you retire.

Still have questions regarding these two retirement accounts? Feel free to approach financial advisors. They are not only equipped to address your queries, but they also possess the necessary expertise to help you plan your retirement better.

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