

# Retirement Savings Vehicles

## 1. Introduction

If you ask yourself why it's important to invest, one of the answers may well be a comfortable retirement. To ensure your retirement matches or comes close to the way you want to live, you're likely to need a source of income in addition to Social Security and whatever pension a former employer might provide. Fortunately, Congress has created a variety of specialized retirement savings plans to give your efforts an added boost.

These plans are designed specifically to help you set aside money for your retirement—for basic living expenses and to pay for the things you want to do when you have the time to do them, such as traveling, learning new skills, and leaving a legacy to your loved ones or the institutions that are important to you.

The chief benefit of these retirement plans is the substantial tax advantages they offer—specifically the potential for tax-deferred or tax-free growth. Tax-deferred means you postpone taxes until you withdraw money later on. Tax-free means you owe no tax on your investment earnings at all, provided you follow the rules for withdrawing. For example, if you're using a tax-free plan to save for your retirement, you must begin withdrawing at least a certain amount of your savings by the time you reach age 70½.

In exchange for these tax benefits, there are certain restrictions. For instance, the amount you can contribute to these retirement plans each year is capped, though the limits have regularly increased to encourage savings and keep pace with living costs. In addition, you generally must reach a certain age before you can withdraw your money without penalty. And many of the plans require withdrawals once you reach a specific age—whether or not you actually need the money at the time.

Although the various plans have the same ultimate objective—helping you save money for your retirement—they are structured differently. With some plans, you must take the initiative to enroll. The best example is an individual retirement arrangement (IRA). On the other hand, your employer may offer a retirement savings plan that simply requires you to agree to participate. In fact, some employers enroll you automatically, making it easy for you to share in the benefits unless you decide to opt out.

If you work for a small company or you're self-employed, there's another set of retirement plans that makes it possible for you to invest for the future. These plans share certain characteristics of individual plans, such as a choice of investments, and some share certain features of larger employer-sponsored plans, such as matching contributions.

Regardless of the plan you're part of—and there may be more than one—participating in retirement savings plans may increasingly make the difference between a retirement that's secure and one that is not.

## **2. Individual Plans**

Individual retirement plans, as the name suggests, are accounts you open on your own, separately from a plan your employer might sponsor. With an individual plan, you decide where and how to invest. This includes decisions about your asset allocation, which means spreading your investments around among different asset classes, such as stocks, bonds, cash, and other investment categories. You must also decide how to diversify your investments within each class to help reduce investment risk, and decide when to sell one investment and buy another one.

When you're ready to stop working and start withdrawing, the value of your account depends on how much you've invested, the investments you chose, and how those investments performed. This gives you a lot of authority to make decisions, but also the responsibility for making good ones. That's one of the reasons you might decide to work with an investment professional who has the expertise to help you make these decisions.

## IRAs

Perhaps the most widely known personal retirement plan is the individual retirement arrangement (IRA). An IRA may be either an individual retirement account you establish with a financial services company, such as a bank, brokerage firm, or mutual fund company of your choice, or an individual retirement annuity that's available through an insurance company. Certain retirement plans, including a simplified employee pension (SEP) and a SIMPLE may be set up as IRAs, though they operate a little differently from those you set up yourself. There's more about them in the "Small Plans" section below and in IRS Publication 590.

Your IRA provider acts as custodian for your account, investing the money as you direct and providing a regular accounting of your account value. Once your account is open, you can select any of the investments available through the custodian. In fact, one of the things to think about in choosing a custodian is the type of investments you are planning to make.

To participate in an IRA, you must earn income, and you can contribute up to the annual limit that Congress sets. That cap is \$5,000 in 2008. In addition, if you're 50 or older, you can make an additional catch-up contribution of \$1,000 per year. However, you can't contribute more than you earn. So, for example, if your total earned income is \$2,500 for the year, that's the amount you can put into an IRA. If you're divorced, you can count alimony as earned income. And there's an exception to the earned income requirement for nonearning spouses, called a spousal IRA.

You can put money into your IRA every year you're eligible, even if you are also enrolled in another kind of retirement savings plan through your employer. If both you and your spouse earn income, each of you can contribute to your own IRA, up to the annual limit. All IRA contributions for a calendar year must be made in full by the time you file your tax return for that year—typically April 15, unless that deadline falls on a weekend. It may be smarter to spread out your contributions over the year though, on a regular schedule. That way you don't have to struggle to pull together the whole amount just before the deadline or risk putting in less than you're entitled to contribute. Another reason spreading out your contributions over the year may be smart is that it allows you to take advantage of dollar cost averaging.

When IRAs were first introduced, there was just one basic type, which was open to anyone with earned income. But since then, IRAs have evolved to include a number of variations:

- **Traditional:** There are two categories of tax-deferred traditional IRAs, deductible and nondeductible. If you qualify to deduct your contributions,

you can subtract the amount you contribute when you file your tax return for the year, reducing the income tax you owe. If you don't qualify to deduct, the contribution is made with after-tax income.

There are two ways to qualify. The first is by having a modified adjusted gross income that's lower than the limits that Congress sets for the year. The second is by not being eligible to participate in an employer-sponsored retirement savings plan, either because your employer doesn't offer one or because you haven't worked at your job long enough to join the plan. If this is your situation, you may be able to deduct your contribution no matter how much you earn.

Specifically, in 2008, you can deduct your full IRA contribution if your modified adjusted gross income is less than \$53,000 if you're single, and a decreasing percentage of the total until your modified adjusted gross income hits \$63,000. If you're married and file a joint tax return, the comparable modified adjusted gross income limits are \$85,000, and the deduction is phased out at \$105,000.

If you don't qualify to participate in an employer's plan, you can deduct your full contribution if you're single. If you're married and file a joint return, you can deduct the full amount if your combined modified adjusted gross income is less than \$159,000 and a decreasing percentage until your modified adjusted gross income reaches \$169,000. Above that amount, your contribution is no longer deductible.

Earnings on investments in a traditional IRA are tax deferred for as long as they stay in your account. When you take money out—which you can do without penalty when you turn 59 1/2, and which you are required to begin doing once you turn 70 1/2—your withdrawal is considered regular income so you'll owe income tax on the earnings at your current rate. If you deducted your contribution, tax is due on your entire withdrawal. If you didn't, tax is due only on the portion that comes from earnings.

You can't contribute any additional amounts to a traditional IRA once you turn 70, even if you're still working.

- **Roth:** Contributions to a Roth IRA are always made with after-tax income, but the earnings are tax free if you follow the rules for withdrawals: You must be at least 59 1/2 and your account must have been open at least five years. What's more, with a Roth IRA you're not required to withdraw your money at any age—you can pass the entire account on to your heirs if you choose. And you can continue to contribute to a Roth as long as you have earned income, no matter how old you are.

However, there are income restrictions associated with contributing to a Roth IRA. In 2008, if your modified adjusted gross income is less than \$99,000 and you're single, you're eligible and can contribute \$5,000. As your modified adjusted gross income increases, you can contribute a decreasing percentage of the \$5,000 until your modified adjusted gross income reaches \$114,000, when your eligibility to contribute is phased out. If you're married and file a joint return, the limits are \$156,000 for a full contribution, which is phased out entirely at \$166,000. Both you and your spouse can each establish your own Roth IRAs.

If you're eligible for a partial Roth contribution, you can put the balance of the \$5,000 in a traditional IRA, and you might qualify to deduct that portion.

### **Which Is Better: Traditional vs. Roth IRA?**

The answer to this question will vary from person to person. Assuming you're eligible for either a deductible traditional IRA or a Roth IRA, here are some factors to consider:

- **Current year tax benefits**—Depending on your income and employment, contributions to a traditional IRA may be tax deductible, which reduces your taxable income each year you contribute. But if you don't need that tax break now, a Roth IRA can give you more flexibility since you can withdraw your contributions at any time without paying taxes or fees—and you can withdraw your earnings tax-free if your account has been open at least five years and you are 59 ½ or older.
  - **Likely future tax bracket**—If you're young and likely to be in a higher tax bracket when you retire, then a Roth IRA may make more sense. But if you're likely to be in a lower tax bracket after you retire, a traditional IRA is usually the better choice. With a traditional IRA, however, you are subject to minimum required distributions when you reach age 70 ½.
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- **Spousal:** If you're married to someone who doesn't earn income, such as a parent who stays home with small children, you can contribute up to the annual limit in a separate spousal IRA in that person's name as well as putting money into your own IRA. For example, in 2008, your total contribution could be \$5,000 to your spouse's IRA and \$5,000 to your own, plus catch-up contributions if you're 50 or older.

Your spouse owns the spousal IRA, chooses the investments, and eventually makes the withdrawals. A spousal IRA can be a traditional deductible, traditional nondeductible, or a Roth IRA, as long as you qualify for the type you select.

- **Deemed or “Sidecar” IRAs:** In some cases, you can make contributions to an IRA through your employer by taking advantage of a deemed or “sidecar” IRA provision.

In this case, your employer deducts your IRA contributions from your after-tax earnings. All the rules for this account—that is, for contribution limits, withdrawal rules, and so forth—are the same as for any other IRA. If you qualify, you may be able to deduct your contribution when you file your tax return.

You might find a deemed IRA helps you to save. After all, contributions are automatic, so you don't have to remember to write a separate check to your IRA custodian and you won't be tempted to spend the money on something else. But you might also find that your choices of IRA investments are limited with this option, since they will depend on which financial services company your employer chooses as custodian or trustee of the account.

In addition, if you're not keeping accurate records of your deemed IRA contributions, you might inadvertently go over the contribution limit, which remains the same no matter how many separate IRA accounts you have. That could mean incurring penalties.

## **Taking Money Out**

One important thing is true of all IRAs: Taking out money early is discouraged. In fact, you generally cannot make IRA withdrawals before age 59 1/2 without paying an early withdrawal penalty. The penalty is 10% of the amount you withdraw.

There are exceptions, however, if you take IRA money out to meet certain medical expenses, purchase your first home, pay college tuition bills, or for certain other reasons listed in the federal tax laws. In any event, before you make any early IRA withdrawals, you should check with your tax or legal adviser to be sure you're following the rules. Even if you do not face a penalty, you will have to pay income tax on any withdrawal you make. The only exception is that you can take up to \$10,000 in earnings from your Roth IRA tax free to buy a first home for yourself or a member of your immediate family.

There is a reason why withdrawing early from your IRA is made difficult. These savings vehicles are specifically designed to help you set aside money for retirement, not for other purposes. By imposing penalties for the early use of these funds, the government hopes that most people will leave their money alone. That way, the money will have time to compound, and will be available to support you in your retirement.

You should be aware, too, that unlike certain employer plans, you're not allowed to borrow against your IRA balance.

### **Required Withdrawals**

Just as the IRA rules generally discourage you from taking your money out too early, other rules require that you begin withdrawing from a traditional IRA no later than April 1 of the year following the year in which you turn 70 1/2. And once you do start taking money out, you must take at least your minimum required distribution, or MRD, every year. You're always free to take more than the minimum, but you must take at least that amount, or risk paying a penalty.

Your MRD is calculated based on your age and your annual IRA account balance. To do the calculation, you divide the balance at the end of the year by a number you find in Table III of IRS Publication 590, called the Uniform Lifetime Table. The number you use is the one that corresponds to your age in the year you're making the withdrawal.

For example, if you have \$200,000 in your IRA on December 31, 2006, and you turn 70 1/2 in March 2007, the number you use is 27.4. That means you must take out \$7,299 ( $\$200,000 \div 27.4$ ). As long as you take out this amount before April 1 of 2008, you can do so on any schedule that works for you. Remember, though, that you'll have to make another withdrawal of \$7,299 for 2008. If you take both withdrawals the same year, you might end up owing more income tax than if you took the initial MRD by December 31, 2007.

However, if you name your spouse as the beneficiary of your IRA and he or she is more than ten years younger than you are, you can use Table II in Publication 590. You find the point in the table where your age and your spouse's age intersect and that's the number you use as the divisor. It will always be higher than the number for your age in the uniform table, which means you will be required to withdraw less each year.

For example, using the same \$200,000 account, if you were 70 and your spouse were 55, you would divide the balance by 31.8, which would mean you'd have to withdraw only \$6,289 for the year.

If you fail to keep up with your MRDs, you face a penalty that can be pretty steep: up to 50% of the amount you should have withdrawn but didn't, plus the income taxes you would have owed on that amount. Don't assume that if your IRA is invested in mutual funds, and you're receiving distributions from those funds, that you've automatically satisfied your MRD. It could happen, but you can't count on it.

However, if your IRA is an individual retirement annuity, which you would set up with an annuity provider such as an insurance company, your annuity provider assumes the responsibility for ensuring that the income you receive from your annuity meets your MRD.

## **IRA Rollovers**

There are penalties for withdrawing from your IRA before 59 1/2, but there are no penalties for transferring your account from one custodian to another. You might want to do that for several reasons: to be able to make different types of investments, to consolidate several IRAs with a single financial services company, or perhaps simply because you move across the country.

In most cases, you roll over a traditional IRA to another traditional IRA and a Roth IRA to a Roth IRA.

There are specific guidelines for handling rollovers. Normally, the easiest way is a direct rollover: You ask your current IRA custodian to transfer the money directly to another custodian where you already have an IRA—either a previously existing one or one you've just opened. Once you fill out the authorization forms, the money will be moved electronically to the investments you have selected in the new account—though not instantly. It may take days or even weeks for the transaction to take effect and you'll want to follow up to be sure that the transfer has actually been completed and the money invested as you've directed.

A direct rollover isn't the only way to handle moving your IRA assets. You can ask for a check for the amount to be rolled over and complete the transaction on your own. But you must deposit the full amount into the new IRA within 60 days. If you don't, regardless of the reason, the IRS considers the money an early withdrawal, so taxes are due as well as a potential 10% penalty if you're younger than 59 1/2. What's more, that amount can never be deposited in a tax-deferred account again.

You may also choose to roll over a traditional IRA to a Roth IRA. That's allowed if your adjusted gross income (AGI) for the year in which you make the move is \$100,000 or less, not counting the amount you're transferring. That cap is the same whether you're single or a married couple filing a joint return. You'll owe all the taxes that are due on the money you're moving—on the earnings and any tax-deferred contributions you've made in the past—in the year the rollover is completed. So if you've accumulated a substantial amount in the IRA you're moving, you could face a hefty tax bill.

Beginning in 2010, however, the \$100,000 ceiling will be lifted. Anyone will be able to roll over traditional IRA assets to a Roth IRA. Tax will be due on the earnings and any deductible contributions, though those taxes can be spread over two years. You should consult with your tax adviser if you're considering such a rollover, however, to be sure it is appropriate for you.

If you're thinking about moving your assets to a Roth IRA, you'll want to consider how much tax will be due when you make the transfer, and how the rate you'll

pay now may compare to the rate you'll have to pay when you withdraw from your traditional account in the future—which you can't know for sure. Another factor is whether you'll keep the Roth IRA open at least five years. If that doesn't seem likely, making the switch is probably not a good idea since you'll owe tax again on the withdrawals since the tax free withdrawal provisions won't apply.

### **IRA Beneficiaries**

When you open an IRA, you should name a beneficiary for your account. A beneficiary is the person you want to receive the assets you have accumulated when you die. If your IRA custodian permits it, you might also name contingent or secondary beneficiaries—essentially, back-up heirs in case something happens to your first choice, or that person chooses not to take the money. For example, you might name your spouse as primary beneficiary and your children as contingent beneficiaries.

If you want to leave IRA assets to more than one beneficiary, though, you should discuss the best way to handle your intentions both with your IRA custodian and your tax and legal advisers. One solution may be to divide your IRA assets into separate accounts, each with its own beneficiary.

### **What If You're a Beneficiary?**

If you inherit an IRA, you must take required minimum required distributions over your lifetime. When you must start withdrawing depends on whether or not you were married to the owner of the IRA, and whether or not the owner had begun taking MRDs. You can find the information you need in IRS Publication 590, and it's always a good idea to get legal and tax advice, especially if you're uncertain about the rules.

### **Tax-Deferred Annuities**

If you've contributed all you can to an IRA, you might also consider saving for retirement with a nonqualified deferred annuity. Nonqualified here simply means that you purchase the annuity on your own as opposed to selecting one that's offered in a qualified employer plan.

A tax-deferred annuity lets you postpone tax on any earnings as they accumulate and pay tax at your regular rate on withdrawals. However, since you buy the annuity with after-tax dollars, the portion of your withdrawal that comes from your premiums isn't taxed. Like IRAs, there's an early withdrawal penalty if you take money out before you reach 59 1/2—though there may be a provision in your contract allowing you to take a small percentage each year penalty free.

Unlike IRAs, however, you can contribute money from any source to a nonqualified annuity, including investment income or an inheritance. You can put

in any amount you can afford, usually up to \$1 million per contract—though few people approach that limit.

You can choose a fixed annuity, which means that the insurance company offering the contract guarantees the earnings at a specific rate, subject to the company's ability to meet its obligations. Or, if you prefer, you can choose a variable annuity. In this case, your earnings from the annuity depend on the investment performance of the underlying securities held in the investment funds (also called subaccounts) that you select from among those offered in your contract. As the term "variable" implies, the rate at which you accumulate earnings will depend the performance of the underlying investments.

One drawback to tax-deferred annuities, and variable annuities in particular, is that the annual fees for these products may be higher than those for an IRA invested in mutual funds or individual investments, such as stocks and bonds.

### **3. Employer-Sponsored Plans**

Many employers offer retirement savings plans as part of their employee benefits package. Sometimes the employer puts in all of the money that goes into these plans, but more often the employee makes the primary contribution by contributing a portion of his or her current salary.

These savings plans are known as defined contribution plans. What that means is that the amount of money going into the plan—the contribution—is determined, or defined, by a particular formula and is restricted by an annual cap. The retirement income the plan provides is determined by the amount that was contributed, how the money was invested, and the return those investments provide over time.

Defined contribution plans are increasingly replacing defined benefit plans, better known as pensions. In those plans, the employer had full responsibility for putting money into the plan—an amount typically determined by a formula—and investing that money to provide a retirement income often calculated as a percentage of your final income.

Defined contribution plans vary, not only by type of plan, but by employer. But they all share some specific characteristics.

#### **Tax Advantages**

Employer-sponsored retirement plans all have significant tax advantages. Traditional plans, which are the most common, are funded with pretax contributions. This means the money you put into the plan reduces your current taxable salary, and therefore the income tax you owe now. For instance, if your gross income is \$55,000 a year and you defer \$4,500 to a traditional 401(k), the income that your employer reports to the IRS is just \$50,500.

In addition, all the earnings in the account are also tax deferred. That applies to any capital gains you might have from selling an investment in the account that has gained in value. In fact, you don't owe any income tax until you withdraw from your account, typically after you retire. At that point, the tax is due at the same rate as you're paying on your other income. But, by then, compounding generally has allowed you to accumulate substantially more than you would have in a similarly invested taxable account if you'd had to withdraw every year to pay the income tax that was due.

For example, let's say you choose not to participate in the 401(k) but instead invest \$4,500 in a taxable account. Your income tax for the year will be higher since your reported income is still \$55,000—and not the \$50,500 that would have been reported had you contributed the \$4,500 to a 401(k). In addition, if your taxable investment account provides dividends or interest income, you'll owe tax on those amounts each year—though the rate on the dividends may be lower than your regular rate.

Some employer plans—specifically 401(k)s and 403(b)s—also offer a tax-free alternative, called a Roth 401(k) or a Roth 403(b). If you choose to participate in these plans, your contribution is not tax deferred and it doesn't reduce your current income tax. But if your account is open at least five years and you're at least 59 1/2 when you retire, all your withdrawals are tax free.

If you prefer, you can divide your contribution between a traditional and a Roth account, in whatever proportion your plan allows. The one thing you can't do is move money back and forth between a traditional and Roth 401(k).

### **Self-Direction**

When you participate in defined contribution plan such as a 401(k) or 403(b), you decide how to invest the money you're contributing. Your employer is responsible for choosing the investment alternatives that you're offered, but you're responsible for putting together your portfolio by selecting among them. That's why these plans are described as self-directed.

A plan menu is likely to include a variety of mutual funds, perhaps some exchange traded funds (ETFs), managed accounts, a real estate portfolio, a variety of fixed-income alternatives, and perhaps fixed or variable annuities. Some types of plans also offer what's known as a brokerage window, which is a brokerage account through which you can select stocks, bonds, and other investments. Finally, some corporate plans offer stock in the sponsoring company.

Once you've chosen the investments you want, you must also decide what percentage of your total contribution will go into each one each pay period. That's a process called asset allocation, and it's at least as important to the results you achieve as your choice of specific investments.

For example, if you're 25, you might allocate up to 90% of your portfolio to a combination of equity investments because your goal is growth. But if you're 55, you might allocate just 50% or 60% or even a smaller percentage of your assets to equity investments and the balance to fixed-income because you've started to think about having a source of regular retirement income.

You also want to be sure that you diversify within various asset classes, or varieties of investment. For example, if your employer offers a dozen stock funds and you choose three, you want to be sure that the funds invest in different types of stock, such as mid- and large company stock, or perhaps international stock. And if your company makes its own shares available to purchase for your 401(k) portfolio, you can stay diversified by limiting the percentage of company stock in your total portfolio.

Your plan may offer a set of target date funds as part of the investment menu. Each of these funds is designed for employees whose projected retirement date corresponds to the date in the fund's name—such as Fund 2025 or Fund 2035. The appeal of these funds is that the individual funds that are included are preselected, reducing your responsibility for allocating your assets and diversifying your portfolio. In addition, the manager gradually adjusts the allocation from investments designed for growth to investments designed to produce income as the date in the name draws closer.

### **Matching Contributions**

Some employers choose to match part of your contribution, though they're not required to do so. The exceptions are if they offer the type of plan known as a SIMPLE or a money purchase plan, both of which are discussed in the following section. In contrast, state and local government employers who offer 457 plans are not permitted to make matching contributions.

When an employer matches your contribution, the amount of the match is based on a specific formula. A typical match is 50% of the amount you contribute, up to 5% of your salary. So, if you are earning \$45,000 and contribute 5% that amount, or \$2,250, during the year, your employer would add \$1,125 to your account. If you contributed 10% of your gross salary, or \$4,500, your employer's match would still be \$1,125, or 50% of 5% of your earnings.

If your employer matches contributions, it's smart to contribute at least enough to qualify for the full match. Otherwise, you're throwing away free money, since you're not taxed on your employer's contributions or any earnings those contributions generate until you withdraw from your account. Of course, you can contribute more than the amount that will be matched. In fact, you may want to put away as much as you possibly can each year to build up your retirement account. The government cap is \$15,500 in 2008. And if you're 50 or older, you can make an additional annual catch-up contribution of \$5,000.

In some cases your employer may limit your contribution to a percentage of your salary—say 15%—which may mean putting in less than the federal cap. Your plan administrator will provide you with that information if it applies.

One thing worth noting is that if you participate in a Roth 401(k) or a Roth 403(b) and your employer matches your contribution, those contributions will go into a traditional tax-deferred account. You'll still have the right to decide how they are invested.

## **Vesting**

Vesting is the amount of time you have to work for an employer to be entitled to benefits from a retirement plan. One advantage of a retirement savings plan is that all the money you contribute to it is yours from the moment you put it in. So are any earnings those contributions generate.

However, you must stay at your job long enough to be able to benefit from the matching contributions your employer makes and the earnings those assets provide. Your plan administrator will tell you how long that period is, though the maximum is six years if vesting is gradual and five years if is not. If you're considering a new job, you may want to think about how close you are to being vested in your old one. It might pay to wait a few months to make a change if a sizeable amount of money is involved.

## **Portability**

Unlike traditional defined-benefit pensions, employer-sponsored retirement savings plans are portable. This means you can take your money with you if you leave your job. You always have the choice of rolling these assets into an IRA, where they continue to have the same tax advantages as your other IRA assets. Or you may be able to move some or all of the money in your account to a new employer's plan if the plan accepts transfers. The advantage is that you don't lose any momentum toward building your retirement account.

Rolling over your 401(k) to an IRA is very similar to moving one IRA to another. You open the account where you want the money to go and notify your plan administrator. Typically, the assets in your account are liquidated and the value is transferred electronically to your new custodian. There may be a delay, something you should ask about at the time you authorize the transfer.

You can choose to move the money yourself, by asking your plan administrator to write a check to you for the value of your account. You have 60 days to deposit the money from a 401K into your rollover IRA. However, by law, 20% of what you're moving must be withheld to pay the taxes that will be due if you don't

complete the rollover. Any amount—including the 20% that was withheld—that you don't put in the rollover IRA within the time limit is considered an early withdrawal, subject to tax and potentially subject to penalty if you're younger than 59 1/2. To avoid the tax and penalty, you'll have to use money from a savings account or other source to make the full deposit. That's why a direct transfer is often the better choice.

You also have the option of leaving your account with your old employer if its value is \$5,000 or more. You might want to do that if the plan is a good one and your new employer doesn't offer anything comparable. If your account value is between \$1,000 and \$5,000, and you haven't told your former employer how you want the account to be handled, the employer has the right to roll it into an IRA with a financial services company that it chooses. It's probably smarter to pick your own IRA custodian directly.

If your account value is less than \$1,000, your employer may cash you out by sending you a check for that amount, less 20% that must be withheld to pay the tax that's due on what counts as a withdrawal. You have the right to roll that amount into an IRA, and, if you add the missing 20% when you deposit the check you receive, the entire amount remains tax deferred.

What you probably don't want to do is take the money in your employer plan as cash when you change jobs. Not only will a percentage go to the government in taxes and, potentially, an early withdrawal penalty as well, but you'll be back to square one in setting aside money for retirement.

## **Taking Withdrawals**

You normally can't withdraw from your employer-sponsored retirement savings plan before you retire, even if you are 59 1/2 and could withdraw without a tax penalty.

Your employer will typically offer several alternatives for receiving income, and you can choose the one that you believe will work best for you. You'll receive a document explaining what your options are, and you can either consult with a retirement adviser that your employer provides, or consult one on your own. Among the alternatives are likely to be a lifetime payout, which is similar to a traditional pension, or a lump sum distribution.

You also have the right to roll over the assets in your account to an IRA, exactly as you do when you change jobs. You might make this choice if you want to postpone taking income or if you want more control over how your money is invested.

## **Potential Drawbacks of Employer-Sponsored Plans**

Along with their advantages, employer-sponsored plans have a few potential disadvantages.

- The plan provider that your employer selects may offer a more limited menu of investments than you would prefer, or the fees may be higher than from other providers.
- You may not be eligible to participate right away, as many employers require that you work at their organization for a certain amount of time, such as one year, before you are eligible to enroll.
- Some plans might require you to pay some of the administrative costs of 401(k) participation.

Still, the clear-cut benefits of employer-sponsored plans spur many people to participate in them—in fact, some employers even automatically enroll their eligible employees, although those workers can always opt out of participating.

## **Specific Plans**

Employers may sponsor different types of retirement plans, though they normally share many of the same characteristics.

### **401(k) Plans**

Corporations and nonprofit organizations can sponsor 401(k) plans. An employer may offer just a traditional plan or both a traditional 401(k) and a Roth 401(k). Each employer's plan differs in some ways from other plans, but the basic elements are essentially the same. Among the most important are that contributions are deducted directly from your earnings and deposited into your account, you select the investments from the menu your plan provides, and you enjoy tax benefits for participating.

Some employers now offer plans with automatic features, including enrollment at pre-set contribution levels into a pre-selected fund. These features can help increase participation rates and allow companies to better help their employees save for retirement. Although automatic features change the defaults so that a new hire doesn't have to remember to sign up, an employee who does not wish to contribute can choose to opt out.

### **403(b) Plans**

Nonprofit employers, including educational institutions, hospitals, museums, and foundations, may offer 403(b) plans to their employees. Traditional 403(b)s are tax-deferred salary reduction plans and Roth 403(b)s are tax-free plans to which you contribute after-tax income. These plans resemble 401(k)s in many respects though they may allow larger catch-up contributions, are less likely to offer matching contributions, and their investment menus are typically limited to annuities and mutual funds.

### **457 Plans**

State and local governments may offer 457 plans to their employees. For the most part, these savings vehicles work very much like traditional 401(k)s—they allow you to set aside pretax income in a tax-deferred account. However, there's no Roth version of a 457 plan, and employers do not match contributions. If you're 50 or older, you may have more generous catch-up provisions if you're within three years of the plan's retirement age. Plus, with a 457, you are permitted to make penalty-free withdrawals any time after you retire from your government job, even before you're 59 1/2.

You're able to roll over assets that you accumulate in one type of plan to another. For example, you can move your traditional 401(k) or 403(b) assets to a 457 plan, or vice versa. Your combined assets are subject to the rules of the plan that they're in.

## **Thrift Savings Plan**

If you work for the federal government as a civilian or military employee, you can save for retirement through a Thrift Savings Plan, usually abbreviated as TSP, as part of either the Federal Employees' Retirement System (FERS) or the Civil Service Retirement System (CSRS).

The federal TSP resembles traditional 401(k) plans in many ways. You contribute pretax income through payroll deductions, and your TSP assets grow tax-deferred until retirement, when you start making withdrawals. At that point, you pay taxes at your regular rate on the amounts you withdraw. Your TSP plan assets are portable, your contributions are always 100% vested, and if you leave your job you can roll over the money to an IRA.

Similarly, you face withdrawal restrictions. If you're younger than 59 1/2 when you leave your job, you cannot withdraw your TSP balance without paying a 10% penalty. Income taxes are due unless you qualify for one of the exceptions.

You can set aside any percentage of your salary you choose, up to 100%, as long as you don't go over the maximum contribution of \$15,500 per year in 2008—the same maximum dollar amount as with 401(k) plans. If you are a member of the U.S. armed forces and contribute tax-exempt income, separate rules apply, permitting you to put in up to \$45,000 in 2008. In either case, you can also make additional annual TSP catch-up contributions of up to \$5,000 per year if you're 50 or older.

If you're a FERS employee, your agency will automatically put 1% of your basic pay into your TSP account, and will match up to 5% of the pay you contribute. The match is dollar-for-dollar on the first 3% and 50% of the next 2%. There is no matching for CSRS employees, though their defined benefit plan provides more income than FERS employees receive from their comparable plan.

The major difference between the TSP and a 401(k) is in the type of investments you can make. Customarily, 401(k) plans offer as many investment options as the plan provider chooses to make available—often a dozen or more mutual funds plus fixed-income and other options. Some 401(k) plans even let their participants invest in individual stocks and other securities through a brokerage account, often called a brokerage window, which the participant opens within the plan.

In contrast, TSP participants can allocate their assets among five index fund options, each one identified by a letter, or choose a lifecycle fund, also known as a target date fund. The index fund choices are a U.S. Treasury bond fund (the “G” Fund), common stock fund (“C” fund), fixed-income fund (“F” fund), international stock fund (“I” fund), and small-capitalization stock fund (“S” fund).

The lifecycle funds, or L Funds, are funds of funds that combine the five index funds in different mixes to make them appropriate for people whose projected retirement date corresponds most closely to 2010, 2020, 2030, or 2040. There’s also an income fund. The combination of funds in each lifecycle fund is adjusted regularly, shifting gradually from seeking growth to providing income.

Another difference between the TSP and a 401(k) is the fees that investors typically pay. Few, if any 401(k) plans offer investment options with lower fees than comparable options available in the TSP.

## **4. Small Business Plans**

If you work for a small company, you may have fewer opportunities to participate in an employer-sponsored retirement plan. In fact, some studies have shown that fewer than 30% of full-time workers at small businesses are covered by a retirement plan. But there are some plans that the government has created specifically for these employers.

### **SIMPLEs**

The Savings Incentive Match Plan for Employees, usually called a SIMPLE, is available to companies that employ fewer than 100 people. If your employer offers a SIMPLE and you earn \$5,000 or more, you must be included in the plan. Also, your employer must contribute to your account following one of two formulas—either by matching 3% of the amount each participating employee contributes or by contributing 2% of each eligible employee's compensation whether they participate or not.

There are two variations of SIMPLEs, the standard SIMPLE IRA and the SIMPLE 401(k). With a SIMPLE-IRA, all of the contributions are vested and belong to you from the beginning, so if you leave your job, you can take the money with you. You must, however, wait two years before you can move your account or withdraw any money, or you face a 25% penalty on whatever you transfer or take out, which is much steeper than the 10% that applies to other employer plans. As the name implies, the SIMPLE 401(k) is set up as a 401(k). So your contributions go into an account that's part of the plan, rather than to an IRA.

In 2008, the contribution limit for both a SIMPLE IRA and SIMPLE 401(k) is \$10,500, plus a catch-up contribution of \$2,500 if you're 50 or older.

### **SEPs**

If your employer has 25 or fewer employees, your retirement plan may be a Simplified Employee Pension, or SEP, which is an IRA in your name. You're 100% vested in all money in your account and you choose the investments from among those offered by the plan provider your employer selects.

You don't contribute. Your employer makes the entire contribution, though the amount may vary from year to year. The limit is much higher than in 401(k)s or similar plans—up to 25% of your salary, or \$46,000 in 2008, whichever is less. But each eligible employee must be treated the same way. If 25% of the boss's salary is added to his or her SEP-IRA, then 25% of your salary must be added to your account.

Rules on SEP-IRA distributions are similar to those for traditional IRAs. Anyone with a SEP is required to start required minimum distributions by age 70 1/2. As with an IRA, you cannot borrow against your account balance. And if you make a SEP withdrawal before age 59 1/2, you'll face a 10% penalty and regular income taxes on both the contributions to the account and your investment earnings—just as with a traditional IRA.

### **Profit Sharing and Money Purchase Plans**

If your employer has chosen a profit sharing or money purchase plan, which are sometimes described as varieties of a Keogh plan, your employer can contribute the full amount to your account, up to 25% of your salary, or \$46,000 in 2008, whichever is less.

In a profit sharing plan, the amount your employer adds each year depends on how well the company has done. The amount could range from \$0 to the maximum, but an employer has to contribute to all employees' accounts at the same rate. If the boss gets 25% of salary, so do you. If the boss gets 10%, you get 10%. In a money purchase plan, your employer is committed to adding a certain percentage of your salary each year—say 5%—and can contribute more if it has been a good year.

Distribution rules for these plans are standard. There are penalties for withdrawals before 59 1/2 and mandatory minimum requirements after 70 1/2. You have some flexibility when it comes to account rollovers. For example, you can roll money from other pensions or employer-sponsored retirement accounts into a Keogh. Or, as with a SEP, you can roll the Keogh itself into an IRA, without penalty. And, unlike SEP-IRAs and other IRAs, most Keoghs let you borrow from the balance in your account.