Choosing the right retirement plans for you.

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The most significant financial goal many people have is saving for retirement. Unfortunately, with the disappearance of pensions and worries over the stability of Social Security, many people find themselves wholly responsible for their own retirement plan, and very few have the knowledge or tools to tackle this complex task. In this article, we'll review the basic types of retirement plans so you'll have a foundation for your planning.

Types of Retirement Plans

It's often best practice to have a combination of retirement plans for tax planning purposes. For example, qualified retirement plans reduce your taxes now, but you'll pay ordinary income tax on withdrawals from the account. Conversely, a Roth IRA lets your money grow tax-free forever, but you pay income tax on the money as you earn it. A brokerage account, which is outside of all retirement plans, doesn't give you a tax break when you earn the money, and you don't pay ordinary income tax when you withdraw. But you'll pay tax on the interest, dividends, and capital gains distributions every year, and you may pay tax on the capital gains when you sell the funds in the account. A good combination of these accounts lets you reap tax rewards now and in the future.

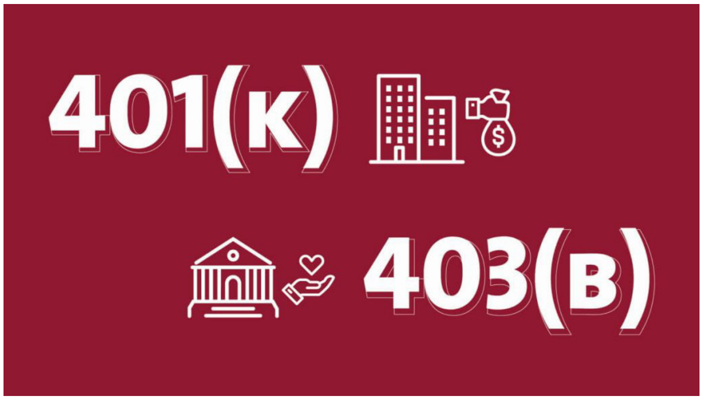
Qualified Plans

A qualified retirement plan is set by an employer and designed to provide retirement income for employees and their beneficiaries. A qualified plan means you have earned income you haven't paid income tax on because you put it into one of these plans. But there are limits to how much you can contribute to these plans each year, and, in the case of IRAs, earned income above a certain amount may make you ineligible to contribute at all.

While these plans are a boon to anyone saving for retirement, they come with a few caveats:

- If you withdraw money from these accounts before age 59 ½, you'll pay both income taxes and steep penalties, with a few exceptions. Don't withdraw funds before retirement to avoid penalties and ensure your retirement plan is fully funded.
- You must start taking money out of these accounts by age 72. These are called Required Minimum Distributions (RMDs). The amount you must withdraw is determined by your age. These can be significant withdrawals for people with large, qualified accounts, and since the entire withdrawal is taxed as ordinary income, RMDs can significantly impact your tax able income.
- There are also RMDs for beneficiaries of qualified accounts. If you pass away and someone besides your spouse inherits the account, they have 10 years to withdraw all the money.

401(k) & 403(b) Accounts



Named after the sections of the IRS code that created them, employer-sponsored 401(k) and 403(b) plans let you contribute part of your earned income into a retirement account without paying income tax on the contributions. The account grows tax-deferred, which means you don't pay income tax on any interest, dividends, or capital gains while the money is still in the account. You'll pay ordinary income tax rates on withdrawals.

If you work for a nonprofit or tax-exempt organization, you may be eligible for a 403(b), which is similar to a 401(k).

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Either plan allows you to contribute up to $19,500 in 2021. If you're 50 or older, you can set aside up to $26,000. Earnings grow tax-free until withdrawal.

These plans let employers make contributions to the accounts. While some employers contribute zero, others contribute an amount equal to what you contribute, up to a limit. Some employers even contribute to the account regardless of whether employees do.

Action Items:

- **Always contribute at least the amount that your employer will match to the account.** If not, you're missing out on free money. If, for example, the employer matches up to 4% of your salary, you'll get the entire match as long as you contribute at least 4%.
- **Name at least one primary beneficiary and at least one contingent beneficiary.** Beneficiaries on the account supersede any beneficiaries named in a will.
- **Invest your contributions to your 401(k).** You don't want the money to be sitting in cash, earning little interest. Be sure to select investment funds for your contributions.

IRAs

An Individual Retirement Account, or IRA, allows you to save for retirement outside of any employer plans. Like a 401(k) or 403(b), an IRA account grows tax-deferred until you withdraw money, at which time the entire withdrawal is treated as ordinary income. Also, like a 401(k) or 403(b), contributions to an Individual Retirement Account reduce your taxable income by the amount you put into the account.

There are notable differences between IRAs and 401(k)s. The amount you can contribute to an IRA is much lower than the employer plan limit. You may be ineligible to contribute to an IRA, or income thresholds may reduce the amount you can contribute if your income is above certain levels.

The contribution limit for an IRA is $6,000 in 2021, or $7,000 for those 50+.

You have more choice in your investment options in an IRA. In a 401(k) or 403(b), the employer determines where the retirement plan is held (such as Fidelity, TIAA-CREF, etc.) and which funds you can choose in your account. In an IRA, you decide where to open the account. You can also choose from a much more comprehensive array of stocks, bonds, and mutual funds.

Action items:

- **Contribute by April 15 of the following year.** For example, you have until April 15, 2022. to contribute for the 2021 tax year.
- **Always contribute at least the amount your employer will match to 401(k) or 403(b) accounts, then contribute extra funds into an IRA.** You may prefer to contribute to your IRA because you can choose from a more extensive list of investment options, but first take advantage of your company match.
- **Combine multiple old retirement plans into one IRA.** Many people find that they have retirement plans from every place they ever worked, and it can be challenging to keep track. You can open an IRA and roll over those old 401(k)s and 403(b)s into one account, making it easier to manage your investments and giving you more choices. And if you open an Individual Retirement Account with a CERTIFIED FINANCIAL PLANNER™ professional at Allegheny Financial Group, you'll benefit from personalized investment management.

Self-Employed Plans

If you're self-employed, the relatively low contribution limits of an IRA aren't your only choice. We typically recommend two options for our clients.

SEP IRA

As the IRS site says, "The Simplified Employee Pension Plan (SEP) lets employers contribute to traditional IRAs (SEP-IRAs) set up for employees. A business of any size, even self-employed, can establish a SEP." Basically, a SEP allows employees to make tax-favored contributions to individual retirement accounts (IRAs) owned by employees.

Note that only **employers** can make contributions, so the calculations are only for the employer.

The other caveat is the contribution limit. If you're eligible for a SEP IRA, you can set aside up to either 25% of your compensation or $58,000 in 2021, whichever is less. You won't pay taxes on the amount contributed, but the funds withdrawn will be subject to taxes.

This compensation number can be pretty low, as it is the net earnings from self-employment, less half your self-employment tax, and less the contribution to your SEP-IRA. These deductions may not let you contribute enough to fully fund your retirement.

Solo 401(k)

Also known as a one-participant 401(k) plan, a solo 401(k) is intended for individual business owners with zero employees. The Solo 401(k) may let you contribute much more to your retirement savings. But unlike SEP IRAs, the Solo 401(k) is only for the self-employed. A Solo 401(k) can't be used to provide benefits to employees as well as yourself.

There are two types of Solo 401(k) contributions: employer and employee. Together, those two are capped at $58,000 in 2021. As an employee, you can contribute up to $19,500 (plus a $6,500 catch-up contribution for those over 50) in 2021. The Solo 401(k) employer contribution limits are the same as for SEP IRAs. So, you

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could potentially contribute up to $26,000 more in a Solo 401(k) than in a SEP IRA.

Another difference: a Solo 401(k) can also be a Roth account; a SEP IRA can't.

Action Items:

- **Don't over-contribute**. If your self-employment income is in addition to a full-time job with an employer-provided plan, employee 401(k) contribution limits apply per person, not per plan.
- **Proceed with caution**. This short description only scratches the surface of self-employed plans, so consult with your tax adviser or CERTIFIED FINANCIAL PLANNER™ professional before you set up either plan.

Roth Accounts

You'll have to pay income taxes at some point; the question is when. We often refer to 401(k)s and IRAs now as "traditional" accounts to distinguish them from their Roth cousins. Roth accounts are similar to traditional retirement accounts, but the taxation is the opposite. While a traditional 401(k) or IRA lets you avoid paying taxes on earned income now, the Roth equivalents let you avoid paying in the future.

In a previous article, we outlined how to determine if a Roth account is right for you. Ready to create a personalized plan? Contact Allegheny Financial Group to get started.

Roth IRA

With a Roth IRA, you don't pay income tax on withdrawals, and there are no RMDs at age 72 as with traditional IRAs. That makes Roth IRAs a great way to diversify and a fantastic estate planning tool. Since you don't have to take RMDs, you can let the account keep growing for your heirs, who'll have ten years to withdraw the money, just as they would with a traditional account, without paying taxes. They can leave the money in the account for the entire ten years, growing tax-free.

There are two other differences between traditional and Roth IRAs. One, you can withdraw contributions made to a Roth IRA without paying taxes or penalties.

Two, the income phaseouts to qualify to contribute to a Roth IRA are higher than for a traditional IRA. So, if you make too much to contribute to a traditional account, you may be eligible for contributions to a Roth IRA.

You can contribute up to $6,000 to a Roth IRA in 2021, or $7,000 if you're 50 or older. Unlike an IRA, you'll pay taxes on the funds you contribute to a Roth IRA.

Roth 401(k) and Roth 403(b)

Many employees now have the option of allocating part or all of their employer plan to a Roth 401(k) or 403(b). Contact your benefits office to see if you have a Roth option at work—you may have access and don't know it. Consult your tax advisor or your CERTIFIED FINANCIAL PLANNER™ professional for this complex analysis to determine how much to put into each type of plan.

Non-Retirement Plans: Brokerage Accounts

One-size-fits-all advice would have you believe all your retirement savings should go into tax-advantaged plans. Unfortunately, while qualified and Roth IRA accounts play an important role in retirement planning, conventional wisdom often omits accounts outside of retirement plans.

Leveraging Taxation With Brokerage Accounts

All the retirement accounts discussed assume you have taxable income to invest and that you'll pay ordinary income tax on that taxable income. Those taxes are paid either when you earn it (like Roth IRA accounts) or when you withdraw it (like traditional qualified accounts). Ordinary income tax rates are usually higher than capital gains tax rates, which you pay on the growth of assets in a non-qualified account.

By incorporating a taxable account into your retirement plan, you can diversify your income streams and usually pay less taxes.

Increase Financial Flexibility

The main advantage of a taxable brokerage account is flexibility. There are no income limits or annual funding limitations. And unlike individual retirement accounts, the assets in a brokerage account can be used for any purpose at any time.

Make Your Money Work for You

Having an emergency fund equal to three to six months of living expenses is essential. But if you have excess cash in a savings or money market account, you know it's paying virtually nothing. Cash is a fine holding place for money you'll need shortly but having too much money in cash risks that inflation will eat away at your spending power.

Diversification, Personalization, & Planning Are Key

A retirement plan changes over the course of a lifetime, and tax laws will also change during that time. Whatever your stage of life, there are always opportunities to plan for your retirement, and tax diversification and your individual needs should be part of that process.

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