FINANCIAL WELLNESS

USING EMPLOYER-BASED RETIREMENT PLANS

Does your employer provide a retirement plan? If so, retirement experts say that you should take advantage of it. Employer-based plans are the most effective way to save for your future, and also offer certain tax benefits. Employer-based plans come in one of two varieties: defined benefit and defined contribution.

Defined Benefit Plans

These plans pay a lump sum upon retirement or a guaranteed monthly benefit. The amount of payout is typically based on a set formula, such as the number of years you have worked for the employer multiplied by a percentage of your highest earnings on the job. Usually the employer funds the plan—commonly called a traditional pension plan—though in some plans employees also contribute. Most defined benefit plans are insured by the federal government.

Defined Contribution Plans

Unlike a defined benefit plan, defined contribution plans do not guarantee a specified amount for retirement. Instead, the amount you have available in the plan to help fund your retirement will depend on how long you participate in the plan, how much is invested and how well the investments do over the years. The federal government does not guarantee how much you accumulate in your account, but does protect the account assets from misuse by your employer.

In the past 20 years, defined contribution plans have become more common than traditional pension plans. Employers fund most types of defined contribution plans, though the amount of their contributions is not necessarily guaranteed.

In many defined contribution plans, you are offered a choice of investment options, and you must decide where to invest your contributions. This shifts much of the responsibility for retirement planning onto employees. Thus, it is critical that you choose to contribute to the plan as soon as you become eligible and that you choose your investments wisely.

Tax Breaks

Even though you are typically responsible for funding a defined contribution plan, you receive important tax breaks. The money you invest in the plan and the earnings on those contributions are deferred from income tax until you withdraw the money. Why is that important? Because postponing taxes on what you earn allows your nest egg to grow faster. The larger the amount you have to compound, the faster it grows. Even after the withdrawals are taxed, you typically come out ahead.

The tax deduction also means the decline in your take-home pay after your contribution won't be as large as you might think. For example, let's assume you are thinking about putting $100 into a retirement plan each month and that the rate you pay on income taxes is 15%. If you don't put that $100 into a retirement plan, you'll pay $15 in taxes on it. If you invest the $100 in your plan, you postpone the taxes. Thus your $100 retirement plan contribution would actually reduce your take-home pay by only $85. If you're in the 25% tax bracket, the cost of the $100 contribution is only $75. This is like buying your retirement at a discount.

Vesting Rules

Any money you put into a retirement plan out of your pay, and earnings on those contributions, will always belong to you. However, contrary to popular belief, employees don't always have immediate access to the money their employer puts into their pension fund or their defined contribution plan. Under some plans, such as a traditional pension plan or 401(k), you have to work for a certain number of years before you become "vested" and can receive benefits. Some plans vest in stages. Other defined contribution plans, such as the SEP and the SIMPLE IRA, vest immediately. You have access to the employer's contributions the day the money is deposited. No employer can require you to work longer than seven years before you become vested in your pension benefit. Be aware of the vesting rules in your employer's plan so you know when you are vested. Changing jobs too quickly can mean losing part or all of your pension plan benefits or your employer's matching contributions.

Article adapted from the U.S. Department of Labor publication of the same title. www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/savings-fitness.pdf

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