The IRA and the 401(k)

Comparing their features, merits, and demerits.

How do you save for retirement? Two options probably come to mind right away: the IRA and the 401(k). Both offer you relatively easy ways to build a retirement fund. Here is a look at the features, merits, and demerits of each account, starting with what they have in common.

Taxes are deferred on money held within IRAs and 401(k)s.
That opens the door for tax-free compounding of those invested dollars — a major plus for any retirement saver.[1]

IRAs and 401(k)s also offer you another big tax break.
It varies depending on whether the account is traditional or Roth in nature. When you have a traditional IRA or 401(k), your account contributions are tax deductible, but when you eventually withdraw the money for retirement, it will be taxed as regular income. When you have a Roth IRA or 401(k), your account contributions are not tax deductible, but if you follow IRS rules, your withdrawals from the account in retirement are tax free.[1]

Generally, the IRS penalizes withdrawals from these accounts before age 59½.
Distributions from traditional IRAs and 401(k)s prior to that age usually trigger a 10 percent federal tax penalty, on top of income tax on the withdrawn amount. Roth IRAs and Roth 401(k)s allow you to withdraw a sum equivalent to your account contributions at any time without taxes or penalties, but early distributions of the account earnings are taxable and may also be hit with the 10 percent early withdrawal penalty.[1]

You must make annual withdrawals from 401(k)s and traditional IRAs after age 70½.
Annual withdrawals from a Roth IRA are not required during the owner's lifetime, only after his or her death. Even Roth 401(k)s require annual withdrawals after age 70½.[2]

Now, on to the major differences.

Annual contribution limits for IRAs and 401(k)s differ greatly.
You may direct up to $18,500 into a 401(k) in 2018; $24,500, if you are 50 or older. In contrast, the maximum 2018 IRA contribution is $5,500; $6,500, if you are 50 or older.[1]

Your employer may provide you with matching 401(k) contributions.
This is free money coming your way. The match is usually partial, but certainly nothing to disregard — it might be a portion of the dollars you contribute up to 6 percent of your annual salary, for example. Do these employer contributions count toward your personal yearly 401(k) contribution limit? No, they do not. Contribute enough to get the match if your company offers you one.[1]

An IRA permits a wide variety of investments, in contrast to a 401(k).
The typical 401(k) offers only about 20 investment options, and you have no control over what investments are chosen. With an IRA, you have a vast range of potential investment choices.[1,3]

You can contribute to a 401(k) no matter how much you earn.

Your income may limit your eligibility to contribute to a Roth IRA; at certain income levels, you may be prohibited from contributing the full amount, or any amount.[1]

If you leave your job, you cannot take your 401(k) with you.
It stays in the hands of the retirement plan administrator that your employer has selected. The money remains invested, but you may have less control over it than you once did. You do have choices: You can withdraw the money from the old 401(k), which will likely result in a tax penalty; you can leave it where it is; you can possibly transfer it to a 401(k) at your new job; or, you can roll it over into an IRA.[4,5]

You cannot control 401(k) fees.
Some 401(k)s have high annual account and administrative fees that effectively eat into their annual investment returns. The plan administrator sets such costs. The annual fees on your IRA may not nearly be so expensive.[1]

All this said, contributing to an IRA or a 401(k) is an excellent idea.
In fact, many pre-retirees contribute to both 401(k)s and IRAs at once. Today, investing in these accounts seems all but necessary to pursue retirement savings and income goals.

Contact us for help in financial planning.

Citations.

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