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Taking Advantage of Employer-Sponsored Retirement Plans

Employer-sponsored qualified retirement plans such as 401(k)s are some of the most powerful retirement savings tools available. If your employer offers such a plan and you're not participating in it, you should be. Once you're participating in a plan, try to take full advantage of it.

Understand your employer-sponsored plan

Before you can take advantage of your employer's plan, you need to understand how these plans work. Read everything you can about the plan and talk to your employer's benefits officer. You can also talk to a financial planner, a tax advisor, and other professionals. Recognize the key features that many employer-sponsored plans share:

- Your employer automatically deducts your contributions from your paycheck. You may never even miss the money--out of sight, out of mind.
- You decide what portion of your salary to contribute, up to the legal limit. And you can usually change your contribution amount on certain dates during the year.
- With 401(k), 403(b), 457(b), SARSEPs, and SIMPLE plans, you contribute to the plan on a pretax basis. Your contributions come off the top of your salary before your employer withholds income taxes.
- Your 401(k), 403(b), or 457(b) plan may let you make after-tax Roth contributions--there's no up-front tax benefit but qualified distributions are entirely tax free.
- Your employer may match all or part of your contribution up to a certain level. You typically become vested in these employer dollars through years of service with the company.
- Your funds grow tax deferred in the plan. You don't pay taxes on investment earnings until you withdraw your money from the plan.
- You'll pay income taxes and possibly an early withdrawal penalty if you withdraw your money from the plan.
- You may be able to borrow a portion of your vested balance (up to $50,000) at a reasonable interest rate.
- Your creditors cannot reach your plan funds to satisfy your debts.

Contribute as much as possible

The more you can save for retirement, the better your chances of retiring comfortably. If you can, max out your contribution up to the legal limit. If you need to free up money to do that, try to cut certain expenses.

Why put your retirement dollars in your employer's plan instead of somewhere else? One reason is that your pretax contributions to your employer's plan lower your taxable income for the year. This means you save money in taxes when you contribute to the plan--a big advantage if you're in a high tax bracket. For example, if you earn $100,000 a year and contribute $10,000 to a 401(k) plan, you'll pay income taxes on $90,000 instead of $100,000. (Roth contributions don't lower your current taxable income but qualified distributions of your contributions and earnings--that is, distributions made after you satisfy a five-year holding period and reach age 59½, become disabled, or die--are tax free.)

Another reason is the power of tax-deferred growth. Your investment earnings compound year after year and aren't taxable as long as they remain in the plan. Over the long term, this gives you the opportunity to build an impressive sum in your employer's plan. You should end up with a much larger balance than somebody who invests the same amount in taxable investments at the same rate of return.

For example, you participate in your employer's tax-deferred plan (Account A). You also have a taxable investment account (Account B). Each account earns 8 percent per year. You're in the 28 percent tax bracket and contribute $10,000 to each account at the end of every year. You pay the yearly income taxes on Account B's earnings using funds from that same account. At the end of 30 years, Account A is worth $1,132,832, while Account B is worth only $757,970. That's a difference of over $370,000. (Note: This example is for illustrative purposes only and does not represent a specific investment.)

Capture the full employer match

If you can't max out your 401(k) or other plan, you should at least try to contribute up to the limit your employer will match. Employer contributions are basically free money once you're vested in them (check with your employer to find out when vesting happens). By capturing the full benefit of your employer's match, you'll be surprised how much faster your balance grows. If you don't take advantage of your employer's generosity, you could be passing up a significant return on your money.

For example, you earn $30,000 a year and work for an employer that has a matching 401(k) plan. The match is 50 cents on the dollar up to 6 percent of your salary. Each year, you contribute 6 percent of your salary ($1,800) to the plan and receive a matching contribution of $900 from your employer.

Evaluate your investment choices carefully

Most employer-sponsored plans give you a selection of mutual funds or other investments to choose from. Make your choices carefully. The right investment mix for your employer's plan could be one of your keys to a comfortable retirement. That's because over the long term, varying rates of return can make a big difference in the size of your balance.

Research the investments available to you. How have they performed over the long term? Have they held their own during down markets? How much risk will they expose you to? Which ones are best suited for long-term goals like retirement? You may also want to get advice from a financial professional (either your own, or one provided through your plan). He or she can help you pick the right investments based on your personal goals, your attitude toward risk, how long you have until retirement, and other factors. Your financial professional can also help you coordinate your plan investments with your overall investment portfolio.

Finally, you may be able to change your investment allocations or move money between the plan's investments on specific dates during the year (e.g., at the start of every month or every quarter).

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Know your options when you leave your employer

When you leave your job, your vested balance in your former employer's retirement plan is yours to keep. You have several options at that point, including:

- Taking a lump-sum distribution. This is often a bad idea, because you'll pay income taxes and possibly a penalty on the amount you withdraw. Plus, you're giving up continued tax-deferred growth.
- Leaving your funds in the old plan, growing tax deferred (your old plan may not permit this if your balance is less than $5,000, or if you've reached the plan's normal retirement age--typically age 65). This may be a good idea if you're happy with the plan's investments or you need time to decide what to do with your money.
- Rolling your funds over to an IRA or a new employer's plan if the plan accepts rollovers. This is often a smart move because there will be no income taxes or penalties if you do the rollover properly (your old plan will withhold 20 percent for income taxes if you receive the funds before rolling them over). Plus, your funds will keep growing tax deferred in the IRA or new plan.