Retirement Investment Options

Retirement investments give you the opportunity to choose from multiple types of investment accounts. You can choose to use several tax-advantaged retirement plans; some may have the added bonus of an employer match.

These retirement plans have been created through legislation to encourage individual saving for retirement. The plans also come with restrictions that limit access to funds for any purpose other than retirement.

Unless specified otherwise, the following benefits and restrictions apply to the plans described in this publication:

• Contributions by employer and/or employee are not included in the taxable earnings for the year; income tax on contributions and account earnings is deferred until withdrawal.
• Each type of plan has a set limit (stated as a percentage of compensation and/or a maximum dollar amount) on contributions and tax deductions.
• Catch up contributions may be allowed for those who are 50 or older.
• Funds withdrawn prior to age 59½ are subject to a 10 percent penalty tax in addition to regular income tax (certain exceptions apply; see IRS publication 590).
• Withdrawals must begin no later than April 1 following the year in which the IRA owner turns 70½.
• Qualified withdrawals are taxed as ordinary income.
• Withdrawals must follow a schedule that would deplete the account over the life expectancy of the participant—or the joint life expectancy of the participant and a spouse (see PM 1825C, Required Minimum Distributions—store.extension.iastate.edu/Product/PM1825C).
• A spouse who inherits the account may treat it as his/her own; other beneficiaries must follow IRS rules for distributions (see IRS Publication 590).

Note: For a discussion of asset allocation decisions, see PM 1821, Growing Your Nest Egg: Risk and Return—store.extension.iastate.edu/Product/PM1821. These decisions involve choosing whether to invest in bank certificates of deposit, individual stocks or bonds, mutual funds, or other assets and are influenced by your investment time horizon and your personal attitudes about risk.

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In general, retirement investment structures can be divided into two groups—employer-sponsored and individual plans. A subset of opportunities is available to people employed by small businesses (including self-employed individuals).

**Impact of Tax Deferral**

Most retirement investment plans allow you to defer payment of income taxes until you actually withdraw the money during retirement. Tax deferred retirement plans provide a double advantage. You save on your tax bill and invest for retirement at the same time. The amount you deposit is not counted as part of your taxable income for that year. Also, the earnings or growth on your investment are not taxed until you withdraw the money in retirement. This deferral allows your money to grow more rapidly, since the entire balance remains on deposit and can continue to grow.

Occasionally, investors may find themselves in a higher tax bracket during retirement, which may reduce (or less-commonly, eliminate) the financial advantages of tax deferral. Investors who anticipate this situation will generally benefit from the Roth IRA (see pages 4 and 5).

**Concept to understand**

**Vesting** refers to your right to permanently retain ownership of funds in your retirement account. Contributions you make are immediately vested; that is, you immediately have the right to keep those funds even if you leave the employer. The same is not typically true of your employer’s contributions. IRS rules, established in 2006, require that employer contributions to defined contribution plans must be fully vested to the employee within one of two timelines:

a) “cliff” vesting at three years of service, meaning that you have no rights to any of the employer’s contributions until you have completed three years of employment. Or
b) “graded” vesting over six years, with 20 percent vesting at two years, 40 percent at three years, 60 percent at four years, 80 percent at five years and 100 percent at the end of six years of employment. Be sure you read and understand the provisions of your employer’s plan, especially before considering a job change. See page 6 for information on rolling over funds when you do make a job change.

**Employer-sponsored Plans**

**Defined benefit**

**Traditional pensions** – Many large employers have offered defined-benefit pensions, also known as traditional pensions, in which the company defines (or promises) the benefits that the employee will receive after retirement. These benefits typically use a formula based on the employee’s years of service and the employee’s salary. A generous plan might provide 30 to 50 percent of pre-retirement income to a long-standing employee. Traditional pensions are becoming less common. See PM 1821 for more details.
**Defined contribution**

Through a defined contribution plan, employers maintain a separate retirement account for each employee and define (promise) what they will contribute to the retirement account. How much will be available to the employee at retirement depends on how well the selected investment performs. All employer plans must comply with federal regulations; however, specific plan provisions vary from employer to employer. Some plans are funded solely by employer contributions; others are funded by employee contributions, with or without contributions from the employer. You may or may not have a selection of investments from which to choose. Such plans may take several forms, including:

- **Profit-sharing** – the employer decides each year whether contributions will be made, usually tied to company performance.

- **Employee stock ownership plans (ESOP)** – the employer’s contributions to the worker’s retirement fund are in the form of company stock or stock options, rather than cash.

- **Money purchase** – the employer contributes a fixed annual percentage of an employee’s salary each year. In some cases, the percentage is set to fund a targeted retirement benefit, although no benefit is guaranteed because investment performance determines the actual retirement income provided.

- **Salary reduction** – voluntary pre-tax contributions by the employee, sometimes matched by the employer according to a defined formula. Three types exist, named according to the section of the tax code that authorizes them. An employer’s plan may offer several investment options (typically a selection of mutual funds) from which the employee can choose. In 2016 employee contribution is limited to $18,000 per year, a catch up contribution of $6,000 allowed for those 50 or older, with total contribution to all employer-sponsored plans limited to the lesser of $53,000 or 100 percent of compensation. Three types include:

  - **401(k) plans** – available to eligible employees of private companies that sponsor plans

  - **403(b) plans** – available to employees of certain tax-exempt employers and certain public school teachers (sometimes known as TSAs, tax shelters, and savings plans)

  - **457 plans** – available to state and municipal workers whereby they can defer up to $18,000 of their salary (known as salary reduction plans). Employer contributions are not allowed.

**Individual Retirement Savings Opportunities**

Individual Retirement Accounts (IRAs) can be established directly with a financial institution (e.g., bank, credit union, brokerage house, and mutual fund company), with or without guidance from an investment adviser. Contributions for a given year may be made until the tax filing deadline for that year (April 15 for most people).

IRA contributions are limited to $5,500 per year (2016) with an additional catch up contribution of $1,000 for those 50 or older; the individual must have earned income equal to or exceeding the amount contributed. However, a nonworking spouse may contribute up to $5,500/year to his/her own IRA if the earned income of the working spouse equals or exceeds the total contributions to both partners’ IRAs. The $5,500 limit applies to total contributions, but may be split among more than one IRA account in an individual’s name.

A 10 percent penalty is imposed for premature withdrawal (generally, prior to age 59½); however, some exceptions are allowed in cases of disability, excessive medical expenses, purchase of a first home, qualified higher education expenses, and early retirement between age 55 and 59½. IRS publication 590 offers more details.

Traditional IRAs offer the benefits of tax deferred investing and similar withdrawal regulations to the plans already described. To contribute to a traditional IRA, you must be under age 70½ at the end of the tax year in question.
Tax Deductible?
If you are covered under an employer’s pension plan, your income in combination with your tax filing status determines the deductibility of your IRA contribution, as shown in Chart 1.

Chart 1 – 2016 IRA deduction guidelines
If you are covered under an employer-sponsored retirement plan, your contribution to a traditional IRA is tax-deductible only if your income is below federal guidelines. Chart 1 identifies the income range in which the deductible contribution is reduced or eliminated.

If you are not covered by an employer retirement plan, but your spouse is, your IRA deduction is reduced or eliminated entirely depending on your filing status and modified (AGI) as shown below.

<table>
<thead>
<tr>
<th>If Your Filing Status Is...</th>
<th>And Your Modified AGI Is...</th>
<th>Then You Can Take...</th>
</tr>
</thead>
<tbody>
<tr>
<td>single or head of household</td>
<td>$61,000 or less</td>
<td>a full deduction up to the amount of your contribution limit.</td>
</tr>
<tr>
<td></td>
<td>more than $61,000 but less than $71,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$71,000 or more</td>
<td>no deduction.</td>
</tr>
<tr>
<td>married filing jointly or qualifying widow(er)</td>
<td>$98,000 or less</td>
<td>a full deduction up to the amount of your contribution limit.</td>
</tr>
<tr>
<td></td>
<td>more than $98,000 but less than $118,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$118,000 or more</td>
<td>no deduction.</td>
</tr>
<tr>
<td>married filing separately</td>
<td>less than $10,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>no deduction.</td>
</tr>
</tbody>
</table>

If you file separately and did not live with your spouse at any time during the year, your IRA deduction is determined under the “single” filing status.

* This chart refers to modified adjusted gross income (AGI), which includes your taxable earned and unearned income, and does not take into account certain deductions including student loan interest, IRA deduction, and others.

If you are not covered by an employer-sponsored pension plan, your contributions to a traditional IRA are deductible up to the contribution limits regardless of your income.
Non-deductible?

Even if your IRA contribution is not fully deductible, you may still contribute up to the $5,500 annual limit to a non-deductible IRA, in which your investment earnings grow tax-deferred until withdrawal. Distributions from a non-deductible IRA are partly taxable. The portion of distributions that represents your non-deductible contributions has already been taxed, and will not be taxed again. If you have a non-deductible IRA, it is advisable to maintain it separately from any deductible IRA account, to simplify the tax calculations at the time you withdraw your investment.

Roth IRAs

Roth IRAs offer tax advantages that are the reverse of traditional IRAs. Contributions are not tax-deductible. But qualified distributions during retirement are completely tax-free; the account earnings are never taxed. To qualify as tax-free, Roth IRA distributions must be made:
- at least 5 years after the first contribution, and
- after age 59½, or due to death or disability, or for a down-payment on a first home.

Unlike most other retirement plans, a Roth IRA has no required withdrawal schedule; you can make contributions to your Roth IRA after you reach age 70½; you may leave the funds intact past age 70½. Eligibility to contribute to a Roth IRA is dependent on income, as illustrated in Chart 2. Phase out begins at $184,000 to $194,000 MFJ; $10,000 MFS; $117,000-$132,000 Single or Head of Household (2016).

Rolling funds into a Roth IRA. Funds deposited in a Traditional IRA may be rolled over into a Roth IRA. You also may roll over funds from an employer plan if you leave that employment. However, you must pay ordinary income tax on any amount rolled over, so rollover decisions must take into account how much additional federal and state income tax you can afford to pay in the current year.

Roth 401(k) and 403(b) Plans

The Roth 401(k) and Roth 403(b) combine features of the traditional 401(k) and 403(b) with those of the Roth IRA. These plans are available only to employees whose employer elects to offer this new retirement savings option. Employee contributions are made with after-tax dollars but withdrawals at retirement are not taxed. Employer matches are made with pre-tax dollars and the match accumulates in a separate account that will be taxed as ordinary income at withdrawal. Unlike the Roth IRA, there are no income restrictions for the Roth 401(k) or 403(b). Also, an employee may contribute a larger amount to the Roth 401(k) or 403(b) ($18,000 in 2016). Note: The $18,000 limit applies to both types of 401(k) plans or 403(b) plans. One cannot save $18,000 in a 401(k) and another $18,000 in a Roth 401(k).

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**Chart 2 – Roth IRA contribution guidelines**

<table>
<thead>
<tr>
<th></th>
<th>Roth IRA contribution limit is reduced (below $5,500) if income is:</th>
<th>No Roth IRA contribution allowed if income equals or exceeds:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or Head of household</td>
<td>$117,000 - $132,000</td>
<td>$132,000</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>$184,000 - $194,000</td>
<td>$194,000</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$0 - $10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Rollovers

At the time of a job change, or perhaps a change in investment goals, it may be desirable to transfer funds from one retirement plan to another without experiencing tax ramifications. This is done by “rolling over” the funds from an employer plan to an IRA (either Roth or Traditional) or a new employer’s plan. Rollovers also occur when individuals transfer assets from one IRA investment to another IRA. The smoothest way to make this transaction is to have the funds transferred directly from the original financial institution to the new institution (trustee to trustee), so that you never have the money in your possession, and you therefore incur no tax obligation or penalty.

It is possible to receive the distribution from one fund, and make an equal deposit into a new fund within 60 days; however, the distribution from the original fund will be subject to 20 percent tax withholding. Thus if you withdraw $10,000, you will receive a check for only $8,000, because of the withholding. However, in order to avoid paying tax, you’ll need to deposit the entire $10,000 in the new account. You will receive a refund of the $2,000 tax that was withheld, but not until you file your tax return for the year. One rollover of this type will trigger a 12 month waiting period before another rollover can be completed. Therefore, it is generally preferable to arrange for a direct rollover.

When rolling funds from an employer-sponsored plan into an IRA, it is advisable to keep the “Rollover IRA” separate from other IRAs to which you have contributed over time; this separate Rollover IRA leaves you free to roll the funds into a new employer’s plan if the opportunity arises.

Note that when you leave a job, you also may have the option of leaving your retirement funds in that employer’s plan. The advantage is avoiding taxes on the distribution and the early withdrawal penalty. Maintaining records of the account and ensuring your contact information is updated is essential for your benefit and the benefit of those who are designated to receive a remainder interest upon your death.

Concept to understand

Portability can be a major attraction of defined contribution plans. Employees who change jobs may be able to move accumulated assets in their previous employer’s retirement plan to their new employer’s plan. Check with your former and new employers on provisions for releasing and accepting rollover contributions.

Note: If your funds remain in a former employer’s plan, they will continue to grow and will be available to you on retirement.
Special Options for Small Business and Self-employed Individuals

The special needs and limitations of small businesses and self-employed individuals are usually met by one of the following options. All provide the two tax advantages of tax deductible contributions plus deferral of tax on earnings. In addition, all are subject to withdrawal regulations similar to those that apply to other tax-advantaged retirement investments. Note: If you are an employee covered by a retirement plan at work, but also have part-time self-employment or small business income, you may be eligible to contribute to one of the following plans a portion of your earnings from your own business, as a supplement to your employer-sponsored plan.

SEP (Simplified Employee Pension) is, as its name denotes, a written plan that allows employers to make contributions toward their own (if they are self-employed) and their employees’ retirement without the administrative complexities of a qualified plan. Under an SEP, the employer contributes to a traditional individual retirement arrangement (called an SEP-IRA) set up by or for each eligible employee. SEP-IRAs are owned and controlled by the employee, and the employer sends contributions directly to the financial institution where the SEP-IRA is maintained. Contributions are not required every year. If contributions are made for any employee, then they must be made for all eligible employees according to a written formula that does not discriminate. In 2016, the maximum contribution is 25 percent of net earnings, or $53,000, whichever is less.

An SEP-IRA cannot be designated as a Roth IRA. Employer contributions to an SEP-IRA will not affect the amount that an individual can contribute to a Roth IRA. SEP-IRA distributions are subject to IRA distribution rules and early withdrawal penalties. An employer cannot prohibit distributions from an SEP-IRA, nor make contributions on the condition that any part of them must be kept in the account.

SIMPLE plans (Savings Incentive Match Plan for Employees) is another retirement investment option for self-employed individuals and small business. This plan can be set up as either a SIMPLE IRA or a SIMPLE 401(k) account. A SIMPLE IRA cannot be a Roth IRA. An employer is eligible to use SIMPLE plans only if it has 100 or fewer employees who earned compensation of $5,000 or more during the year.

SIMPLE plans involve both employee and employer contributions. The maximum employee contribution for 2016 is $12,500; if you are 50 or older, you are allowed an additional $3,000 catch up contribution. The annual employer match is 2 percent fixed or up to a maximum 3 percent match of employee contributions.

Some limits apply to rollovers from SIMPLE plans during the employee’s first two years of participation. In addition, premature withdrawals (prior to age 59½) that occur during the first two years of participation are subject to 25 percent penalty tax rather than the usual 10 percent penalty.

Retirement Plans for Small Businesses, publication 560 from the Internal Revenue Service, provides details on these retirement plans. www.irs.gov.

Catch-Up Contributions

Individuals age 50 and over may make additional catch-up contributions to retirement plans. In 2016, the initial contribution is limited to $6,000 for 401(k), 403(b), and 457 plans. A $1,000 catch-up contribution may be made to an IRA. An additional $3,000 may be contributed to a SIMPLE plan.
Tax Credit for Contributions

Low and middle-income taxpayers may receive a tax credit up to $1,000 per individual, $2,000 for married couples, for contributions made to an IRA, 401(k), 403(b), 457 plan, SEP, SIMPLE, or other qualified retirement plan. The applicable credit percentage is applied to retirement contributions not exceeding $2,000 for each individual.

<table>
<thead>
<tr>
<th>Credit</th>
<th>Adjusted Gross Income of Single Taxpayer</th>
<th>Adjusted Gross Income of Married Filing Jointly Taxpayer</th>
<th>Adjusted Gross Income of Head of Household Taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of contribution</td>
<td>$0–$18,500</td>
<td>$0–$37,500</td>
<td>$0–$27,750</td>
</tr>
<tr>
<td>20% of contribution</td>
<td>$18,501–$20,000</td>
<td>$37,501–$40,000</td>
<td>$27,751–$30,000</td>
</tr>
<tr>
<td>10% of contribution</td>
<td>$20,001–$30,750</td>
<td>$40,001–$61,500</td>
<td>$30,001–$46,125</td>
</tr>
</tbody>
</table>

IRS Form 8880, Credit for Qualified Retirement Savings Contributions, is used to determine the rate and amount of the credit.

RESOURCES
- www.extension.iastate.edu/humansciences/family-finances-families
- www.extension.org/personal_finance

This is one in a series of publications written to challenge your thinking and start your planning for the retirement you want. Find other Iowa State University Extension and Outreach publications that can help you secure your future by searching for “retire” at the Extension Store.

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Revised by Joyce Lash, family finance specialist. Reviewed by a team of ISU Extension and Outreach family finance specialists. Originally written by Barb Wollan, family finance specialist. Designed by Hobbs Designs, LLC.