Lesson 3: Retirement Accounts

Student Guide Pages: 78-82

Lesson Objectives: By the end of this lesson, your students should be able to:

- explain the importance of investing through retirement accounts
- explain the two main types of retirement accounts
- explain the difference between a Roth retirement account and a non-Roth retirement account

Lesson Summary:

One of the simplest things investors can do to make more money is pay very close attention to taxes and fees, as these costs dig directly into your profits. In the last lesson, we discussed how index mutual funds have lower fees, since they don't require a manager. Because of this simple fact, index funds often outperform the majority of funds that use a manager.

One of the easiest ways to avoid taxes is to invest in a *retirement account*, tax shelters the government set up to encourage people to save for their own retirement. These protect your investments from taxes until you turn 59 ½. Since taxes are essentially a fee, and a large fee at that, retirement accounts are worth considering.

There are two types of retirement accounts:

- **Employer-sponsored accounts:** These are the 401(k), the Roth 401(k), the 403(b) (for nonprofit companies), the TSP (for government employees), and the SEP or simple (for small business employees).
- **Individually sponsored accounts:** These include the individual retirement arrangement (IRA), or the Roth IRA.

One way that retirement accounts differ is by who manages them. Is it you or the company you work for?

The other distinction has to do with *Roth*. If an account, sponsored by the employer or individual, has Roth in its title, this simply means you get the tax break *later*. If it doesn't, you get the tax break *now*.

To set up an employer-sponsored plan, ask your boss or the head of Human Resources what plans are available. If you work for a for-profit company, you will most likely be offered a 401(k) or Roth 401(k).

If nothing is available, consider setting up an IRA. You can do this at a local bank or nearly any financial company. Just ask about IRAs vs. Roth IRAs, though the Roth is ideal for most young people.

There is one final thing to keep in mind about retirement accounts: You must have *earned income* to enroll in one of these plans. In other words, if you are a full-time student, living off your parents or student loans, you'll have to wait until you have a job. Be patient. You'll get there! Remember: You need to know this stuff *before* you need to know this stuff.

Review Questions:

- Why is a Roth IRA the best bet for most young people?
  Answer: Most young people don't need a tax break now but will *later.* When young Americans enter the workforce, their income is at a lifetime low. Low income means low taxes, so there is not the urgency yet for a tax break now. However, if they save and invest, their net worth will grow to a huge amount when they retire, and tax breaks will become important. The Roth IRA provides the tax break upon the withdrawal of money, not upon contribution of money.

- Can you have both an individual retirement plan and an employer-sponsored retirement plan?

Answer: Yes, but there may be some restrictions. Start with the employer plan, then move on to the individual plan. You may have to ask your tax advisor about the restrictions, which are based on income. See? You *need* a tax advisor.

- Who can help you open an individual plan?

  Answer: Your bank or any brokerage company can. Consult Scottrade, E*TRADE, or Edward Jones but don't get too hung up on picking the ideal company. You can always switch later.

- Once you start an individual or employer-sponsored plan, are you committed to anything?

  Answer: No! You can lower your contributions or stop if you wish. However, some employers only allow changes once a month or once per quarter, so be sure to ask. You can stop contributing for five years in a row, then start again if you like. In short, there is no excuse not to do it!

Homework Assignment:

Ask your students to research retirement plans. If they already have one, ask them to learn where their money is invested. If they don't have one but are employed, ask them to talk to their employer or call a brokerage company and interview them. Use the sheet in the Resources section.

Class Activity:

Students are often hesitant about investing for retirement. It seems too far away, and there are far more urgent things to address. As a class, discuss everyone's concerns. What can be done about those concerns? Is anyone in class already investing in a retirement account? Students learn from and by sharing.

Additional Information:

www.FACScourse.com: There are great online calculators on this website to help you determine long-term retirement account investing.

www.etrade.com
www.fidelity.com
www.vanguard.com
www.scottrade.com
www.edwardjones.com
www.troweprice.com

All these companies can help your students with Roth IRAs, and you might want to note that we receive no compensation or referral fee for mentioning them here.

www.irs.gov: The IRS website is surprisingly easy to use. Students can search for 401(k) or Roth IRA and read about them.

Fun Facts:

The Roth IRA was named after its creator, Senator William Roth.

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Six Questions to Ask Your Employer and/or Financial Company About Retirement Accounts

- ***How much can I contribute to the plan?***
  Amounts vary from company to company and can depend on your salary. For IRAs, the IRS sets a limit every year; this is also sometimes tied to salary. Ask a financial company.

- ***When can I start contributing?***
  Some companies may want you to work for them for a little while before taking advantage of the plan. If they won't allow you to start right away, you may want to go with the IRA.

- ***What type of investments can I invest in?***
  A typical 401(k) allows you to invest in just about anything, like stocks, bonds, and mutual funds. IRAs allow that as well. If your employer has a very limited plan that does not contain index mutual funds, an IRA may be the better way to go.

- ***Do you offer matching contributions****?*
  Hopefully, the answer is yes. *Matching funds* are when your employer contributes money based on how much you contribute. It's free money, so if your employer offers matching contributions, go with their plan over an IRA. IRAs don't offer matching, since you are the sponsor.

- ***What is the speed velocity of a swallow?***
  This depends on whether or not it is an African or Australian swallow, and this question is only here to see if you are paying attention.

- ***What happens if I am fired or leave the company?***
  This is important. Sometimes you can leave your 401(k) with that company and just let it grow on its own. Other times, you can transfer it into your new 401(k) with your new company or into an IRA using a *direct rollover*: a) the one trick you can never get your dog to do or b) how you move money from one retirement account to another. Direct means you do not take possession of the money before moving it into the new account, so you won't have to pay taxes and penalties on it. Of course, since an IRA is an individual plan, it is not affected when you change jobs.

Different Types of Retirement Accounts:

- **Traditional IRA:** This is an account sponsored by you. In most cases, you get a tax break for putting money in, but the money is taxed as income when you take it out. You must leave the money in the account until you turn 59 ½. You can set a traditional IRA up at a brokerage company such as Edward Jones, Merrill Lynch, E*TRADE, Scottrade, etc. Remember that you must have earned income to open one of these accounts.

- **Roth IRA:** This is an account sponsored by you. You do not get a tax break for putting money in, but the money is not taxed when you take it out. You must leave the money in the account until you turn 59 ½. You can set one up at a brokerage company, such as Edward Jones, Merrill Lynch, E*TRADE, Scottrade, etc. Remember, you must have earned income to open one of these accounts.

- **401(k) (for profit) 403(b) (nonprofit):** These employer-sponsored accounts work the same. They just have different titles, depending on whether you work for a for-profit company or a nonprofit company, such as a school. You get a tax break for putting money in, but the money is taxed as income when you take it out. You must leave the money in the account until you turn 59 ½. Your Human Resources Department can explain more about these plans. Sometimes, employers match your contributions to these plans with money of their own.

- **Roth 401(k):** This is an employer-sponsored account. You do not get a tax break for putting money in, but the money is not taxed when you take it out. You must leave the money in the account until you turn 59 ½. Your Human Resources Department can explain more about these plans. Sometimes, employers match your contributions to these plans with money of their own.

- **SEP-IRA or Simple:** These are retirement plans for self-employed people. They work like a traditional IRA, but you may need the help of a professional to set them up.