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Question 1 - What is an IRA?

With an IRA, you get a practical way to start or supplement your retirement savings. And it comes with tax breaks to boot.

The basic definition

An IRA (individual retirement account) is a personal, tax-deferred account the IRS created to give investors an easy way to save for retirement.

What it does

It provides an excellent opportunity for your retirement money to grow and **compound** faster than it would in a taxable account.

What you can do

You can open an IRA on your own through almost any bank, brokerage company, insurance firm, or investment company.

And you can save *your* way for *your* retirement through the wide variety of investment choices that an IRA offers.

Source:

https://investor.vanguard.com/investor-resources-education/iras/what-is-an-ira

Question 2 - 401(k) vs. IRA?

How much you save now may determine how comfortable you are in retirement. Combining 401(k)s and IRAs can make it even comfier.

If your employer offers a retirement plan, like a 401(k) or 403(b), and will match a percentage of your contributions, you should definitely take advantage of it—after all, it's free money for you. Plus you'll have a tax-deferred account that makes saving a cinch through automatic payroll deduction.

If your employer doesn't offer a plan, then an IRA can be a good start to your retirement savings and another opportunity for your earnings to grow tax-free.

Facts & figures you need to know

Column 1	401(k)	IRA
Who can participate	Anyone who works for an employer that offers a plan	Effective for 2020 contributions and later, anyone with earned income can open and contribute to a traditional or Roth IRA. For 2019 contributions and earlier, you could not make contributions to a traditional IRA after age 70½.
How much you can invest	If you're under age 50, your annual contribution limit is $20,500 for 2022 and $22,500 for 2023. If you're age 50 or older, your annual contribution limit is $27,000 for 2022 and $30,000 for 2023.	If you're under age 50, your annual contribution limit is $6,000 for 2022 and $6,500 for 2023. If you're age 50 or older, your annual contribution limit is $7,000 for 2022 and $7,500 for 2023. Get details on IRA contribution limits & deadlines
What you can invest in	Most employers limit you to a preselected list of investment choices.	You can invest in a wide variety of mutual funds, exchange-traded funds (ETFs), and individual stocks and bonds. Pick investments for your IRA
How to get started	Your employer may automatically enroll you in the plan and offer you an easy way to contribute through automatic payroll deduction.	You can open an IRA on your own through almost any bank, brokerage company, insurance firm, or investment company. Learn how to open your IRA

Eligible for both? Go for it

The good news is that you don't necessarily have to think IRA versus 401(k). You can save with both as long as you're qualified and heed contribution and income limits.

Source:

https://investor.vanguard.com/investor-resources-education/iras/401k-vs-ira

Question 3 - Roth vs. Traditional IRAs?

Start simple, with your age and income. Then compare the IRA rules and tax benefits.

IRA eligibility

Column 1	ROTH IRA	TRADITIONAL IRA
Is there an age limit?	You can contribute to a Roth IRA at any age.	As a result of changes made by the SECURE Act, you can make contributions to a traditional IRA for 2020 or later regardless of your age.
How does my income affect how much I can contribute?	The amount you can contribute to a Roth IRA: Can't exceed the amount of income you earned that year. Can't exceed the IRS-imposed limits (see below). Could be reduced—or even eliminated—based on your modified adjusted gross income (MAGI). Get details on Roth IRA income limits	The amount you can contribute to a traditional IRA: Can't exceed the amount of income you earned that year. Can't exceed the IRS-imposed limits (see below). There are no additional restrictions based on your income.
Can minors or nonworking spouses contribute to an IRA?	Minors and nonworking spouses may be able to contribute, but check the special income rules first.	Minors and nonworking spouses may be able to contribute, but check the special income rules first.

IRA contribution rules

Column 1	ROTH IRA	TRADITIONAL IRA
What are the contribution limits?	For the 2022 tax year: If you're under age 50, you can contribute up to $6,000. If you're age 50 or older, you can contribute up to $7,000. For the 2023 tax year: If you're under age 50, you can contribute up to $6,500. If you're age 50 or older, you can contribute up to $7,500. Limits could be lower based on your income. Get details on IRA contribution limits & deadlines	For the 2022 tax year: If you're under age 50, you can contribute up to $6,000. If you're age 50 or older, you can contribute up to $7,000. For the 2023 tax year: If you're under age 50, you can contribute up to $6,500. If you're age 50 or older, you can contribute up to $7,500. Limits could be lower based on your income. Get details on IRA contribution limits & deadlines
Can I claim my contribution as a deduction on my tax return?	You can't deduct your Roth IRA contribution.	You may be able to deduct some or all of your traditional IRA contributions. The deductible amount could be reduced or eliminated if you or your spouse is already covered by a retirement plan at work. Get details on IRA deductions
What's the deadline for making contributions in a given year?	The deadline is typically April 15 of the following year.	The deadline is typically April 15 of the following year.
How much money do I need to open a Vanguard IRA®?	You'll need $1,000 for any Vanguard Target Retirement Fund or for Vanguard STAR® Fund. Most other Vanguard funds require an initial investment of at least $3,000, though some have higher minimums.	You'll need $1,000 for any Vanguard Target Retirement Fund or for Vanguard STAR Fund. Most other Vanguard funds require an initial investment of at least $3,000, though some have higher minimums.

IRA withdrawal rules

Column 1	ROTH IRA	TRADITIONAL IRA
Will I pay taxes on withdrawals?	You'll never pay taxes on withdrawals of your Roth IRA contributions. And you won't pay taxes on withdrawals of your earnings as long as you take them after you've reached age 59½ and you've met the 5-year-holding-period requirement. Get details on IRA withdrawals	You'll pay ordinary income tax on withdrawals of all traditional IRA earnings and on any contributions you originally deducted on your taxes. Get details on IRA withdrawals
Is there a penalty for withdrawals taken before age 59½?	There are no penalties on withdrawals of Roth IRA contributions. But there's a 10% federal penalty tax on withdrawals of earnings. Exceptions to the penalty tax	With a traditional IRA, there's a 10% federal penalty tax on withdrawals of both contributions and earnings. Exceptions to the penalty tax
Will I have to take required minimum distributions (RMDs)?	Roth IRAs have no RMDs during your lifetime.	Due to changes to federal law that took effect on January 1, 2023, the age at which you must begin taking RMDs differs depending on when you were born. If you reached age 72 on or before December 31, 2022, you were already required to take your RMD and must continue satisfying that requirement. However, if you had not yet reached age 72 by December 31, 2022, you must take your first RMD from your traditional IRA by April 1 of the year after you reached age 73. For each subsequent year, you'll need to take your annual RMD by December 31. Get details on RMDs

Question 4 - What is an IRA Roth conversion? Should I do it?

Would converting from a traditional IRA to a Roth IRA be a smart move for you? Understand the tax implications before you decide.

The benefits of a Roth conversion

A Roth conversion refers to taking all or part of the balance of an existing traditional IRA and moving it into a Roth IRA.

Why you might convert a traditional IRA to a Roth IRA

Enjoy tax-free withdrawals in retirement

When taking withdrawals from a traditional IRA, you'd have to pay taxes on the money your investments earned—and on any contributions you originally deducted on your taxes.

With a Roth IRA, as long as you meet certain requirements, *all* of your withdrawals are tax-free.

Watch your money grow tax-free for longer

Traditional IRAs force you to take required minimum distributions (RMDs) every year after you reach age 73*, regardless of whether you actually need the money. So you lose the tax-free growth on the money you had to withdraw.

On the other hand, Roth IRAs don't have RMDs during your lifetime, so your money can stay in the account and keep growing tax-free.

*Due to changes to federal law that took effect on January 1, 2023, the age at which you must begin taking RMDs differs depending on when you were born. If you reached age 72 on or before December 31, 2022, you were already required to take your RMD and must continue satisfying that requirement. However, if you had not yet reached age 72 by December 31, 2022, you must take your first RMD from your traditional IRA by April 1 of the year after you reached age 73.

Leave a tax-free inheritance to your heirs

The people who inherit your Roth IRA will have to take RMDs, but they won't have to pay any federal income tax on their withdrawals as long as the account's been open for at least 5 years.

A conversion can get you into a Roth IRA—even if your income is too high

The conversion would be part of a 2-step process, often referred to as a "backdoor" strategy.

First, place your contribution in a *traditional* IRA—which has no income limits. Then, move the money into a *Roth* IRA using a Roth conversion.

But make sure you understand the tax consequences before using this strategy.

Other questions to consider

Deciding whether to convert to a Roth IRA hinges on issues like your tax rate now versus later, the tax bill you'll have to pay to convert, and your future plans for your estate. And remember, the conversion will be permanent—you can't revert the money back to a traditional IRA.

It's best to talk with a tax advisor before you make your decision. In the meantime, here are a few things to consider.

Will you need the money in 5 years or less?

There's a 5-year holding period on withdrawals of money that were part of a Roth conversion. So if you think you'll need the money within that time, you could end up owing the taxes you were hoping to minimize with a conversion.

Will you end up in a higher tax bracket?

All or a portion of the money you convert could be considered "reportable income" by the IRS. If you're on the cusp of the next tax bracket, there's a chance you'll get bumped up in the year you convert.

To avoid this, consider converting a *portion* of your traditional IRA. This could help you:

- Stay out of that higher tax bracket.
- Spread the taxes related to the conversion over a few years instead of getting hit with the entire bill in 1 year.

Will your tax bracket be higher now or later?

No one really knows how tax rates could change over the next 5, 15, or 25 years.

If you believe your tax rate is **lower now** than it will be when you start taking withdrawals, a conversion may look promising because you'll pay conversion taxes while you're in a lower tax bracket and enjoy tax-free Roth IRA withdrawals later (when the higher tax bracket won't matter).

But if you believe your tax rate is **higher now** than it will be when you start taking withdrawals, a conversion could cost you more in taxes now than you'd save with tax-free withdrawals later.

So what do you do? It may help to "diversify" your taxes—in other words, pay some of the taxes now (when you're still building your retirement savings) and save some for later (when you need that money to cover expenses in retirement).

Give this some thought and talk with your tax advisor about what might be best for you.

Where will you get the money to pay the conversion taxes?

Before you use money from your IRA to pay the tax bill, consider the following:

Short-term consequences

The money taken out of your IRA to pay conversion taxes would be considered a distribution. This could result in even higher taxes in the year you convert.

In addition, if you're younger than age 59½ and you withdraw money from your IRA to pay conversion-related taxes, you could also face a 10% federal penalty on that withdrawal.

Long-term consequences

You'll lose the chance for that money to **compound** and grow tax-free in your IRA—which means less money when you need it in retirement.

Question 5 - What is asset allocation?

As you decide which investments to buy, start with the big picture, not the details.

Points to know

- If you start building your portfolio by finding the right mix of asset types, you'll have more control over how risky your portfolio is.
- There are no "good" or "bad" allocations—you'll need to find the one that's right for you based on your own situation.

How investing is like the weather

Imagine you're relocating and you prefer sunny, dry weather. How will you make sure you pick a new home in a place you're going to enjoy? Just checking today's weather won't tell you much. To know whether a certain location meets your needs, you'd have to understand more about its overall climate.

Start with your climate, not your 5-day forecast

Asset allocation—the way you divide your portfolio among **asset classes**—is the first thing you should consider when getting ready to purchase investments, because it has the biggest effect on the way your **portfolio** will act.

Just like it's not a great idea to base your relocation on a current run of nice weather in a random city, choosing investments on a whim is unlikely to be a winning strategy over the long term.

Different asset classes tend to act in specific ways, kind of like the investing climate they inhabit. By choosing how to divide your portfolio, you have a certain amount of control over the experience you'll have as an investor.

There's no "best" asset allocation, just like there's no "perfect" climate for everyone—it all depends on what makes you comfortable and gives you a good shot at meeting your goals.

See more about the risks of different investment types

How important is asset allocation?

Extensive research has shown that, if you have a **diversified** portfolio, a whopping 88% of your experience (the **volatility** you encounter and the **returns** you earn) can be traced back to your asset allocation.*

In other words, your experience will be very consistent with that of any other diversified investor with the same asset allocation, no matter which specific investments they choose.

In the same way, if you move to San Diego, your overall weather will be very similar to that of someone living in Los Angeles. It won't matter very much which of those cities you choose or what month you move there—what's important is that you're living in Southern California and not New England.

Once I know my asset allocation, what's next?

Within the broad categories of **stocks** and **bonds**, there are many subtypes that have specific characteristics. Depending on your goal, you may choose to invest in some of these specific subtypes.

Use stocks to add the opportunity for growth

Use bonds for income & additional stability

Whichever investments you choose, it's important to make sure you lower your **risk** through diversification.

Question 6 - What are the risks of different investment types?

The 3 main types of assets all have different levels of risk and potential reward. You can mix them in order to lower your chance of losing money.

Points to know

- Of the 3 main asset classes, cash is the safest, followed by bonds and then stocks.
- Safer investments also have lower average returns.
- By mixing investments, you can get a balance of both stability and growth potential.

What are the 3 asset types?

Cash (short-term reserves) & money market funds

Main goal: stability. You probably won't lose money with these investments, but you won't gain much either.

Main risk: The rate at which you earn money could be lower than the rate of **inflation**.

Average return over time: 3.5% a year before inflation, 0.6% a year after inflation.*

Percentage of years with a negative return: 0%.

Find out more about cash

Bonds & bond funds

Main goals: getting a **moderate return** in exchange for a moderate amount of **risk**; getting a stream of income; offsetting the larger risk of **stock** investments.

Bonds can be domestic (from the United States) or international. Having both in your **portfolio** helps spread out your risk even more.

Main risks: Because bond prices and **interest** rates move in opposite directions, rising interest rates could push bond prices down. The bond's issuer could stop making promised payments or be unable to repay the principal.

Average return over time (for U.S. bonds): 5.5% a year before inflation, 2.5% a year after inflation.*

Percentage of years with a negative return: 16%.

Find out more about using bonds for income & stability

Stocks & stock funds

Main goal: getting a larger return in exchange for a larger amount of risk.

Stocks can also be domestic or international. As with bonds, it's smart to consider holding both.

Main risks: Stock prices could drop for a variety of reasons, including poor performance of certain companies and concern about the economy. Dips in the stock market tend to be worse than in the bond market.

Average return over time (for U.S. stocks): 10.2% a year before inflation, 7.1% a year after inflation.*

Percentage of years with a negative return: 28%.

Find out more about using stocks to add the opportunity for growth

How does mixing investments lower risk?

As you can see, stocks, on average, have the highest potential return. Adding bonds tends to shrink the range of possible outcomes you could face every year—creating a lower opportunity for returns but also a reduced risk of loss.

If you have a long timeline (10 years or more) and a very high risk tolerance, you might be fine with an all-stock portfolio. But if you need your money in less than a year or you're very **conservative**, you might need to keep your money in cash.

If you fall somewhere in the middle, your portfolio should be made up of a variety of asset types, giving you a more moderate level of portfolio risk.

Find out more about getting the right asset allocation

Adding bonds tends to lower both risk and potential return

Question 7 - When should I start saving for retirement?

Short answer: as soon as you begin working. Too late for that? Remember that saving will be easiest if you start now.

The amazing power of beginning early

Who wants to be a millionaire?

For many people, having a million dollars might seem like being elected President—a worthy but unattainable goal.

But getting to a million might not be that hard if you know the secret: time.

If you give your savings enough time to grow, you'll only need relatively small investments of money—made consistently—to wind up with a pretty big balance.

How much do you think you'd need to save each year in order to reach a goal of a million dollars? $20,000? $50,000?

In fact, if you save just under $4,500 per year over a 45-year career, you could have over $1 million by the time you retire. And if you have the opportunity to invest in a retirement plan that offers a matching contribution from your employer, your yearly investment could be as small as $2,200.

Make retirement your first priority, *especially* early on

It might seem backwards to worry about the *last* money you'll need *before* you think about meeting any other financial goals. But because **compounding** is so powerful, starting early gives you more flexibility later on in life.

Imagine you start saving at age 25 and dutifully put away $10,000 a year, including any matching contributions your employer offers. But at age 40, you need to stop saving for some reason.

Your friend starts saving at age 35 and saves the same $10,000 a year for the next 30 years, until you both retire.

At that point, all else equal, you'll have more money than your friend, despite having put away only half as much.

Starting late? Turn up the dial on your contributions

Making the most of the early years of your career is one way to hit your retirement savings goal—and probably the easiest—but it's not the only way. If you have less time to save for retirement, you'll simply need to save more each year.

For example, as we saw above, if your goal is to have $1 million at age 65 and you save just under $4,500 each year starting at age 20, there's a good chance you'd meet your goal.

If you start at age 30 instead, you'll have to save about $9,000 each year for the same chance at reaching your goal.

Beginning at age 40? You'll need to save about $18,000 a year. And if you wait until age 50, you'll need to put away over $40,000 a year to give yourself a good shot at reaching your goal.*

In other words, no matter what your current age, you'll always be better off starting *now* rather than waiting until *later*.

Question 8 - How much should I save for retirement?

Your goal amount will depend on the lifestyle and retirement date you want as well as the other sources of income you'll have.

Just getting started? Save what you can

If retirement is decades away, setting a specific goal amount is probably unnecessary. For now, focus on:

1. Immediately saving at least enough to get the full match offered by your employer plan, if you have one. This is free money—don't let it pass you by.
2. Working your way up to 12%–15% of your pay, including any employer match. For example, you could increase your savings rate 1% every year until you reach your target rate. This should get you in the ballpark of what you'll need.

Vanguard did a study that shows average retirement plan account balances by age as of 2018. For people under age 25, the average account balance was $4,773. For people age 25 to age 34, the average account balance was $24,728. For people age 35 to age 44, the average account balance was $68,935. For people age 45 to age 54, the average account balance was $129,051. For people age 55 to age 64, the average account balance was $190,505. For people age 65 and over, the average account balance was $209,984.

Source: Vanguard, *How America Saves 2018*. This study examined employer retirement plans (and their participants) managed by Vanguard. Amounts reflect the average balance per account.

Closer to retirement, narrow in on your goal

Two big factors weigh heavily on your retirement savings needs: how many years you're going to spend in retirement and how much you're going to need to withdraw each year.

Plan to spend at least 30 years in retirement—longer if you think you'll retire early. Medical advances are consistently extending the average lifespan.

Even if you don't *plan* to retire early, illness or other responsibilities could prevent you from working as long as you expected, extending your retirement on both ends.

Figuring out how much you're going to withdraw each year can also be a little tricky.

After you estimate your expected budget—which will depend on the lifestyle you expect to live in retirement—you'll need to take into account other income (like Social Security and any pensions or rental income you're expecting, for example) and calculate the difference.

Find out when you might have enough to retire

What do others do?

In 2014, the average age people expected to retire was between 66 and 67. However, the actual age at which people *did* retire was 61.

Source: Gallup Poll Social Series, May 2018.

Question 9 - What is a Required Minimum Distribution (RMD)?

Once you reach RMD age, you must withdraw at least a minimum amount—your required minimum distribution—each year from your tax-deferred retirement savings accounts. This includes your IRAs (with the exception of Roth IRAs) and any qualified retirement accounts you hold with a former employer.

Question 10 - When can I retire?

When can I retire? It's a simple question, but knowing how much you need to retire can be tricky.

Start with this rule of thumb

As you're deciding when to retire, you'll need to think about how much money you're likely to spend each year.

Financial planners often tell people to plan to spend 75%–85% of their current income once they retire. It's an estimate based on the fact that, once you retire, you should be spending less on:

- Payroll taxes.
- Debt, assuming you paid much of it off before retiring.
- Retirement savings.
- Everyday expenses like gas and clothes for work.

However, this "rule" doesn't work for everyone. Don't forget to consider any additional expenses you might be expecting, like:

- Expensive travel or other lifestyle purchases (for example, a boat or second home).
- Higher-than-average health care expenses.
- College tuition or other gifts to family members.

If you foresee any of these expenses in your future, you might need to increase your target to 100% or more of your current income.

Social Security (and potentially a pension) will give you some income, but the rest will need to come from your savings.

Question 11 - How do I plan for retirement?

You're in the homestretch! The 5 to 10 years before you retire is a critical time for planning to meet your goal.

See how you could benefit from expert advice

We believe anyone can be a successful investor by following some basic principles.

But even if you've been investing solo for decades, think about whether you might benefit from advice as you begin planning for retirement. During this time, you'll be making some very important decisions that could make or break your retirement timeline.

Get your retirement plan

How to retire

If you feel confident you can handle retirement planning on your own, here's your checklist of things to do.

See when you can realistically retire

It's not a simple question to answer, but running some numbers will give you a good idea about where you stand.

Find out when you might have enough to retire

Learn how medical care could affect your expenses

Many of your day-to-day expenses in retirement will be similar to those you have currently. But one expense you'll have to think about is your medical insurance.

Learn more about health care costs in retirement

Learn how Social Security timing will affect your income

You can start collecting Social Security payments at age 62, but that's not the whole story. See how a variety of options and strategies could affect your retirement income.

See how your retirement age affects your Social Security benefits

Make a plan to pay off your debt

You may decide to retire before all your debt—for example, your mortgage—is paid off, and that's okay. Just make sure you understand the implications and have a plan to pay it off.

See how paying off debt can affect your retirement lifestyle

Keep your plan on track

As you get closer to retiring, make sure you're doing everything you can to set your savings up for success.

Set up your savings to get you to your goal

Question 12 - Why should I save for retirement?

Consistent, dedicated saving might not be glamorous, but it will give you far more freedom and control over your lifestyle down the road.

Social Security shouldn't be your only retirement plan

Social Security was never meant to be anyone's sole source of retirement income.

In fact, a 30-year-old making $50,000 per year today—and who might realistically expect to make substantially more by the time he or she retires—can expect less than $22,000 per year from Social Security at age 67 (in today's dollars).

In the past, pensions often offered an additional source of income for retirees. But pension plans are becoming rare in today's world, and it's more important than ever to take advantage of the opportunity to save for your future.

Keep in mind:

On average, Social Security payments make up only about 33% of Americans' retirement income.

Source: Social Security Administration.

Spending now could mean you'll pay for it later

Perhaps you'd rather spend your money on other things that are more fun than saving for retirement.

But because **compounding** can enhance the value of your savings, the "pain" of each dollar you save now can be greatly outweighed by the flexibility you gain later.

Of course, we're not suggesting you'd be better off squeezing the last drop of enjoyment from your life.

But we think that knowing you'll be all set to meet your basic needs later—with enough left over to let you comfortably do the things you look forward to in retirement—is worth going without a few treats now and then.

Do the math:

Choosing to spend less on certain expenses now could make a huge impact in the long run! For example, you could spend $3,600 a year on payments for a new car during the next 5 years ... or you could watch that money grow to $80,000 over the next 40 years!*

Control what you can

In the end, the future of Social Security isn't the only thing that's out of your hands. Tax rates will almost certainly change between now and your retirement date, and inflation will continue to increase prices over time. Other government programs, like Medicare, might also change.

But there's one thing that only you can completely control: how much you save. Start now and you might be surprised at how little you notice the sacrifice.

See when you should start saving

What do others do?

Our report found that 42% of employees under age 25 were enrolled in their workplace retirement plans.

Source: Vanguard, *How America Saves 2018*. This study examined employer retirement plans (and their participants) managed by Vanguard.

Question 13 - How can I save for retirement?

Wondering how to invest for retirement? It's not hard. In general: Automate everything you can, and check in once in a while.

1. Put your savings on autopilot

If you're saving in a workplace plan, your **contributions** will likely be deducted from your paychecks.

You can automate your other retirement savings too. For example, set up automatic bank transfers to an **IRA** on a monthly or weekly basis. This has the added benefit of taking the money from your account before you have the chance to spend it!

Automatic transfers also ensure that you don't accidentally throw your savings plan off track. Forgetting a few contributions a year can have a huge impact on your retirement balance, because those contributions will miss out on **compounding**.

For example, if you planned to save $100 a month and missed two contributions every year until retirement, you could wipe almost $33,000 off your final account balance—way more than the $8,000 in missed contributions.

Step up your contributions

Look for other ways to automate your savings as well. For example, see whether your workplace plan offers "step up" contributions, which automatically increase your savings percentage once a year until you reach your target.

Since your salary will likely grow at the same time your contributions do, chances are that you won't even miss the money!

2. Resist the urge to tinker with your accounts

Because saving for retirement is so critical, you might think you should maintain a tight focus on your accounts and what they're doing.

But saving for retirement is more like a marathon than a sprint—it's going to take a while and it will occasionally be a little monotonous. The best thing you can do is settle into a good saving rhythm.

Here are some saving *don'ts:*

Don't look for shortcuts.

Once you've spent time determining the best **asset mix** for you, be careful not to veer off course.

Keep in mind that, at any given time, certain types of investments will do better than others. If you constantly change direction to take advantage, you could find yourself falling farther and farther behind.

Instead, stick with your plan and know that you'll get to the finish line in good time.

Learn more about picking an asset mix that's right for you

Don't pay too much attention to the markets.

Downturns in the market might feel like being caught outside in a storm. But if you flee for cover every time there's a little wind in your face, you'll miss out on the times when the wind is at your back.

Instead, force yourself to invest a consistent amount in the same mix of assets every week or month, no matter what's happening on Wall Street.

That way, you ensure you're buying more of an investment when its price has fallen and less of it when it's up. Buy low, sell high—sound familiar?

MAKE NO MISTAKE

Taking money from your account (or moving it to a cash investment) when your balance has dropped and then putting it back when the market has already recovered is a guaranteed way to lose money.

Don't get distracted.

At some point, other uses for your money will probably start to compete for your attention. But keep in mind that as far as financial goals go, experts agree that saving for retirement should be number one.

You might think there's no harm in putting your savings on hold for a little while, but remember that time is what makes your savings so powerful, and you'll never get that time back.

Obviously, it's also not a great idea to take money you've already saved for retirement and use it for something else. If you withdraw the money outright, you may have to pay income tax and penalties.

And even if you take a loan rather than a withdrawal, you'll hurt your retirement in the long run. The money you take as a loan won't be available to grow while it's out of your 401(k) plan. That means less money for you to retire on.

Do the math:

For every $50,000 you borrow from your 401(k), you could lose over $10,000 for your retirement, even if you repay the loan on time.*

*This hypothetical illustration does not represent the return on any particular investment and the rate is not guaranteed. Assumes you repay the loan over 5 years, your 401(k) investments earn an average of 6% annually, the interest rate on your loan is 4%, and you have 20 years from the time you pay off the loan until you retire.

3. Check in on your accounts—occasionally

Of course, you don't want to be completely in the dark about where you are on your retirement journey. At least once or twice a year, take a look at your accounts and ask yourself these questions.

What's my current asset mix and how does it compare with my target?

When you open your retirement account, you'll decide how you want your money invested. In a **diversified portfolio**, the investments you choose won't have as much impact on your account balance as your overall asset mix will. And that asset mix can change without you lifting a finger!

For example, imagine you determined that 50% stocks/50% bonds was the best asset mix for you. If 4 years go by during which stocks return an average of 8% a year and bonds 2%, you'll find that your new asset mix is more like 56% stocks/44% bonds.

Why does this happen? The values of the stocks you own are rising faster than the values of the bonds, throwing your overall mix out of whack.

Check your portfolio at least once a year, and if your mix is off by at least 5 percentage points, consider **rebalancing**. There are a couple ways you can do this:

- **Exchange money from one type of asset to another.** For example, you could exchange some money from your stock portfolio into your bond portfolio. This will immediately realign you with your target.
- **Use your contributions to buy more of one kind of asset.** In the example above, you have too much in stocks and not enough in bonds. So you could direct all of your contributions to your bond investments until you're back in balance.

MAKE IT EASY

If you choose a **target-date fund** for your retirement savings, you won't have to worry about rebalancing back to your target asset mix—it will be done automatically for you.

Am I comfortable with the amount of risk I'm taking?

You'll likely know the answer to this question even before you peek at your accounts. If market movements have made you a nervous wreck, you may want to rethink your asset mix and consider something more **conservative**.

On the other hand, if you've grown comfortable with the **risk** inherent with investing, you might think about whether your risk tolerance has become more **aggressive**.

Are my investments working as hard as they could be?

While choosing investments isn't as critical to your portfolio's performance as your asset mix, keep in mind that investment costs reduce your returns. The less you pay for your funds, the more you keep in your pocket—it's that simple.

When you're saving in an employer plan, you're restricted to choosing from the investments the plan offers. But if you've left a job and have an old 401(k) or 403(b) account sitting around, think about whether rolling it over to an IRA could be a good decision.

With an IRA, you can invest in any **mutual fund**, **ETF**, stock, or bond—giving you greater choice and a chance to lower your investment costs.

See why investing costs are so important

See whether a rollover could be right for you

Am I saving enough to reach my goal?

If you're still decades from retirement, this can be a tough question to answer (although there are some guidelines you can follow).

But as you get years of investing under your belt, you can plug some numbers into a calculator and see where you are.

If the answer is "not even close," you'll have some work to do. Strong market performance can't make up for years of paltry contributions (and you can't count on getting a streak of high **returns** anyway).

See if you'll have enough to retire

Has my goal changed?

Several ingredients go into your retirement recipe—what age you plan to retire, how long you think you'll live, how much you think you'll need to spend, what other sources of income you'll have, whether you plan to leave money to anyone...

Your personal ingredients will probably change over time. Remember to think about the effects of these changes on your retirement goal.

Question 14 - What's a rollover?

A rollover may entail a number of actions, most popularly the transfer of the holdings of one retirement plan to another without creating a taxable event.

Question 15 - Should I open a Roth IRA, traditional IRA, or both?

When it comes to IRAs, there are 2 main types to choose from—Roth and traditional. Making that choice—and knowing when and how much you can contribute—isn't always clear, so we want to provide some context around one of our most commonly researched topics. Here's more information on 2 retirement options: Roth IRAs and traditional IRAs.

Common ground

A traditional IRA allows you to contribute money that can grow tax-deferred. A Roth IRA holds after-tax money you can withdraw tax-free. They sound fundamentally different, but *both* accounts are designed to help you save for retirement. They share other similarities too:

1. Age limit
In the past, you couldn't contribute to a traditional IRA after you reached the age of 70½. However, with the passing of the Setting Every Community Up for Retirement Enhancement (SECURE) Act in 2019, you can now contribute to both a Roth IRA and a traditional IRA (provided that you are otherwise eligible to contribute), no matter your age. SECURE 2.0, signed into law in 2022, increased the required minimum distribution (RMD) age to 73* beginning in 2023 and will increase it to 75 in 2033.

2. Contribution limits
For both traditional and Roth IRAs, the annual contribution limits for the 2022 tax year are $6,000 for those younger than 50 and $7,000 for those age 50 and older. The annual contribution limits for the 2023 tax year are $6,500 for those younger than 50 and $7,500 for those age 50 and older. These are total amounts across all of your traditional and Roth IRAs; you can't contribute the maximum amount to each account separately. Depending on your income, your contribution limits may be lower.

3. Contribution deadline
Whether you're contributing to a traditional or a Roth, the deadline to contribute is the same for both accounts. In 2023 the deadline is April 18.

4. Transfer or Rollover
You can transfer your IRA account to another similarly registered IRA through a direct transfer. You can also withdraw money from your account for 60 days if you roll it back into the same (or similarly registered) IRA. You can use this **60-day rollover** option once every rolling 365 days. When you use the 60-day rollover option, taxes may be withheld from the withdrawal so you'll have to use other funds to roll over the full amount of the distribution.

Learn the differences

To better **understand the differences** between Roth and traditional IRAs, let's focus on 3 areas: deductions, taxes, and withdrawals.

Traditional IRA

With a traditional IRA, you may be able to deduct your contributions (though the deductible amount could be reduced or eliminated if you or your spouse are covered by an employer's retirement plan). When it's time to start withdrawing, your deductible contributions and earnings are taxed as ordinary income. If you don't qualify for deductible contributions, you can make a nondeductible contribution; the nondeductible portion won't be taxed upon withdrawal. Withdrawals work like this:

- If you withdraw from your traditional IRA before you've reached age 59½, you'll pay ordinary income tax on the amount that represents the pre-tax portion of the distribution as well as a 10% early distribution penalty (unless an exception applies).
- If you withdraw after you've reached 59½, you won't be penalized, but you'll still pay ordinary income tax on the amount that represents the pre-tax portion of the distribution.
- When you reach age 73*, you'll be required to start taking distributions from your traditional IRA. The amount you withdraw for your RMD is calculated based on your life expectancy and the balance of your account at the end of the previous year.

Roth IRA

Contributions you make to your Roth IRA aren't deductible. This means withdrawals of your Roth contributions (your "basis") will always come out tax- and penalty-free. Think of it like layers of a cake: When you take your first bite (or in this case, your first distribution), the topmost piece with the frosting is your basis. Beneath that layer? Your earnings. You can make tax-free withdrawals as long as you're age 59½ or older and you've owned your Roth IRA for at least 5 years.** There are no mandatory withdrawals for a Roth IRA because your contributions have already been taxed—meaning you can withdraw your savings at your leisure in retirement.

Eligibility

Any individual with earned income (or who has a spouse with earned income) can contribute to a traditional IRA. However, the amount you can contribute to a Roth IRA could be reduced—or even eliminated—based on your modified adjusted gross income (MAGI).

If you can't make the maximum Roth IRA contribution because your MAGI is nearing the upper limit of the annual income range, you may still be able to make the maximum IRA contribution by splitting your contribution between a Roth IRA and a traditional IRA.

Learn more about income limits

Summary

Whether you're eligible to contribute to a Roth, a traditional, or both, opening this type of account is a step toward a better retirement. Your eligibility may depend on your income—so if you aren't sure what to do, reach out to a tax advisor to help you make an informed decision.

Question 16 - How does employer match work?

Employer matching of your 401(k) contributions means that your employer contributes a certain amount to your retirement savings plan based on the amount of your annual contribution.

Depending on the terms of your employer's 401(k) plan, your contributions to your retirement savings may be matched by employer contributions in several ways. Typically, employers match a percentage of employee contributions up to a specific portion of the total salary. Occasionally, employers may elect to match employee contributions up to a certain dollar amount, regardless of employee compensation.[1]

KEY TAKEAWAYS

- When an employer matches your contributions, they add a certain amount to your 401(k) account in addition to what you contribute.[1]
- One way employers determine matching contributions is to match a percentage of an employee's contribution, up to a certain limit.[2]
- Most mid-to-large-sized companies offer some kind of retirement benefit.
- Employees may contribute up to $22,500 to their 401(k) in 2023.[3]
- Not taking advantage of an employer match is the equivalent of leaving free money on the table.

Matching Contributions: How Much and When

The specific terms of 401(k) plans vary widely. Other than the necessity to adhere to certain required contribution limits and withdrawal regulations dictated by the Employee Retirement Income Security Act (ERISA), the sponsoring employer determines the specific terms of each 401(k) plan.[4]

Your employer may elect to use a very generous matching formula or choose not to match employee contributions at all. Some 401(k) plans offer far more generous matches than others. Whatever the match is, it amounts to free money added to your retirement savings, so it is best to take advantage of it if offered.

Refer to the terms of your plan to verify if and when your employer makes matching contributions. Not all employer contributions to employee 401(k) plans are the result of matching. Employers may elect to make regular deferrals to employee plans regardless of employee contributions, though this is not particularly common.

Employer Matching Contribution Formulas

Most often, employers match employee contributions up to a percentage of annual income. This limit may be imposed in one of a few different ways. Your employer may elect to match 100% of your contributions up to a percentage of your total compensation or to match a percentage of contributions up to the limit. Though the total limit on employer contributions remains the same, the latter scenario requires you to contribute more to your plan to receive the maximum possible match.

Some employers may match up to a certain dollar amount, limiting their liability to highly compensated employees regardless of income. For example, an employer may elect to match only the first $5,000 of your employee contributions.

"Your employer could match 100% or even a dollar amount based upon some formula, but this can get expensive and normally owners want their employees to take some ownership of their retirement while still providing an incentive," says Dan Stewart, CFA®, president, Revere Asset Management Inc., in Dallas, TX.

The IRS requires that all 401(k) plans take a nondiscrimination test annually to ensure that highly compensated employees don’t benefit more from tax-deferred contributions.[5]

How Matching Works

Assume your employer offers a 100% match on all your contributions each year, up to a maximum of 3% of your annual income. If you earn $60,000, the maximum amount your employer would contribute each year is $1,800. To maximize this benefit, you must also contribute $1,800. If you contribute more than 3% of your salary, the additional contributions are unmatched.

A partial matching scheme with an upper limit is more common. Assume that your employer matches 50% of your contributions, equal to up to 6% of your annual salary. If you earn $60,000, your contributions equal to 6% of your salary ($3,600) are eligible for matching. However, your employer only matches 50%, meaning the total matching benefit is still capped at $1,800. Under this formula, you must contribute twice as much to your retirement to reap the full benefit of employer matching.

If your employer matches a certain dollar amount, as in the first example, you must contribute that amount to maximize benefits, regardless of what percentage of your annual income it may represent.

Contribution Limits

Employee and Employer Combined

All deferrals are subject to an annual contribution limit dictated by the Internal Revenue Service (IRS) regardless of whether contributions to your 401(k) come from you and/or from employer matching. The total contribution amount allowed for all 401(k) accounts held by the same employee (regardless of current employment status) is $66,000 in 2023 or 100% of compensation, whichever is less. That's $5,000 higher than the 2022 limit of $61,000.[6]

Employee Alone

Elective salary deferrals made by employees alone are limited to $22,500 in tax year 2023, up from $20,500 in tax year 2022.[2] A saver can contribute up to the annual salary deferral limit to their 401(k) each year, and an employer can match or contribute up to the combined IRS annual limit referred to above. The sum your employer matches does not count toward your annual salary deferral limit.

Keep in mind that these figures can be updated each year by the IRS to keep pace with inflation. The announcement of the following year's various limits is usually made in October or November.

The IRS also allows those who are age 50 and over to make catch-up contributions in addition to their normal contribution. These are designed to encourage employees nearing retirement to bulk up their savings. The catch-up contribution amount is $7,500 in 2023, up from $6,500 in 2022.[6]

Therefore, for these individuals, The individual total deferral amount for these individuals is $30,000 ($22,500 + $7,500). The combined employer/employee limit is $73,500 ($66,000 + $7,500).

You don't pay taxes on matching contributions until you withdraw them in retirement.[7]

401(k) Vesting Schedules

In addition to reviewing your 401(k) plan's matching requirements, educate yourself about your plan's vesting schedule. A vesting schedule dictates the degree of ownership you have in employer contributions based on the number of years of your employment.

Even if your employer has a very generous matching scheme, you may forfeit some or all of those contributions if your employment is terminated—either voluntarily or involuntarily—before a certain number of years has elapsed.

Any contributions you make to your 401(k) account yourself are 100% vested at all times and cannot be forfeited.[8]

"A typical schedule gives an employee a percentage of ownership that steadily increases in lock-step with the employee's tenure. According to the Bureau of Labor Statistics, the average number of years to be fully vested is five," according to Mark Hebner, founder and president of Index Fund Advisors Inc., in Irvine, Calif., and author of "The 12-Step Recovery Program for Active Investors."[9]

What Does Employer Matching Mean for My 401(k)?

It means that you can receive the enormous financial benefit of added money being deposited into your retirement savings plan at work and earning on your behalf for years. It's something you should make the most of if your company offers it. Specifically, the term "matching" refers to your employer contributing to your account a percentage of your total contribution or income, up to a certain limit.

Can My Employer Contribute to My 401(k) Even If I Don't?

Yes. Employers can make non-matching contributions to your 401(k) retirement savings account even if you don't contribute. For instance, an employer might decide to do so if a company's growth in revenue or profits for the year has been good.

Is There a Limit on the Combined Employer and Employee Contribution Amount?

The total amount for a combined employer/employee contribution is $66,000 in 2023. Catch-up contributions of $7,500 for 2023 increase the limit to $73,500 for employees who are 50 years old or over.[6]

The Bottom Line

One of the great advantages to those Americans saving for retirement through their workplace 401(k) accounts is the added money that they can accumulate by way of employer matching. Employers may or may not offer the benefit of matching. But if they do, try your best to contribute all that's needed to get as much of these additional funds as you can annually. By doing so, you can boost your savings potential for years to come.

Question 17 - What is vesting?

What Is Vesting?

A vesting schedule is an incentive program for employees that gives them benefits, usually stock options, when they have contractually fulfilled a specified term of employment with the company. The benefits can also be other assets, such as retirement funds. Vesting is a way for employers to keep top-performing employees at the company.

A vesting schedule is also commonly used in inheritance law and real estate.

Question 18 - How does vesting work?

KEY TAKEAWAYS

- When an employee is vested in employer-matching retirement funds or stock options, she has nonforfeitable rights to those assets.
- The amount in which an employee is vested often increases gradually over a period of years until the employee is 100% vested.

- A common vesting schedule is three to five years.

Understanding Vesting

In the context of retirement plan benefits, vesting gives employees rights to employer-provided assets over time, which gives the employees an incentive to perform well and remain with a company. The vesting schedule set up by a company determines when employees acquire full ownership of the asset.

Generally, nonforfeitable rights accrue based on how long an employee has worked for a company. One example of vesting is seen in how money is awarded to an employee via a 401(k) company match. Such matching dollars usually take years to vest, meaning an employee must stay with the company long enough to be eligible to receive them.

Vesting within stock bonuses offers employers a valuable employee-retention tool. For example, an employee might receive 100 restricted stock units as part of an annual bonus. To entice this valued employee to remain with the company for the next five years, the stock vests according to the following schedule: 25 units in the second year after the bonus, 25 units in year three, 25 units in year four and 25 units in year five. If the employee leaves the company after year three, only 50 units would be vested, and the other 50 would be forfeited.

For some benefits, vesting is immediate. Employees are always 100% vested in their salary-deferral contributions to their retirement plans as well as SEP and SIMPLE employer contributions. Employer contributions to an employee's 401(k) plan may vest immediately. Or they may vest after several years using either a cliff vesting schedule, which gives the employee ownership of 100% of the employer's contributions after a certain number of years or using a graded vesting schedule, which gives the employee ownership of a percentage of the employer's contribution each year.[1]

Traditional pension plans might have a five-year cliff vesting schedule or a three- to seven-year graded vesting schedule.

Just because you are fully vested in your employer's contributions to your plan does not mean you can withdraw that money whenever you want. You are still subject to the plan's rules, which generally require you to reach retirement age before making penalty-free withdrawals.

Employees are always 100% vested in their own contributions to an employer-sponsored retirement plan.[1]

Special Considerations

Vesting is common in wills and bequests and often takes the form of a set waiting period to finalize bequests following the death of the testator. This waiting period before vesting helps reduce conflicts that could arise over the exact time of death and the possibility of double-taxation if multiple heirs die after a disaster.

Startup companies often offer grants of common stock or access to an employee stock option plan to employees, service providers, vendors, board members, or other parties as part of their compensation. To encourage loyalty among employees and also keep them engaged and focused on the company's success, such grants or options usually are subject to a vesting period during which they cannot be sold. A common vesting period is three to five years.

Question 19 - What is risk tolerance and why does it matter?

What Is Risk Tolerance?

Risk tolerance is the degree of risk that an investor is willing to endure given the volatility in the value of an investment. An important component in investing, risk tolerance often determines the type and amount of investments that an individual chooses.

Greater risk tolerance is often synonymous with investment in stocks, equity funds, and exchange-traded funds (ETFs), while lower risk tolerance is often associated with the purchase of bonds, bond funds, and income funds.

KEY TAKEAWAYS

- Risk tolerance is a measure of the degree of loss an investor is willing to endure within their portfolio.
- Stock volatility, market swings, economic or political events, and regulatory, or interest rate changes affect an investor's tolerance for risk.
- Age, investment goals, and income contribute to an investor's risk tolerance.
- An aggressive investor commonly has a higher risk tolerance and is willing to risk more money for the possibility of better, yet unknown, returns.
- A conservative investor commonly has a lower risk tolerance and seeks investments with guaranteed returns.

Understanding Risk Tolerance

All investments involve some degree of risk and knowing their risk tolerance level helps investors plan their entire portfolio, determining how they invest. Based on how much risk they can tolerate, investors are classified as aggressive, moderate, and conservative.

Risk tolerance assessments are available online, including risk-related surveys or questionnaires. An investor may also want to review historical returns for different asset classes to determine the volatility of the various financial instruments.

One factor that affects risk tolerance includes the time horizon for an investor. Having a financial goal with a long time horizon, an investor may have greater returns by carefully investing in higher-risk assets, such as stocks. Conversely, lower-risk cash investments may be appropriate for short-term financial goals.[1]

An investor's future earning capacity, and the presence of other assets such as a home, pension, Social Security, or an inheritance affect risk tolerance. An investor can take greater risk with investable assets when they have other, more stable sources of funds available. Additionally, investors with a larger portfolio may be more tolerant to risk, as the percentage of loss is much less in a larger portfolio when compared to a smaller portfolio.

Aggressive Risk Tolerance

An aggressive investor, or one with a high-risk tolerance, is willing to risk losing money to get potentially better results.[1] Aggressive investors tend to be market-savvy with an understanding of the volatility of securities and follow strategies for achieving higher than average returns.

Their investments emphasize capital appreciation rather than income or preserving their principal investment. This investor's asset allocation commonly includes stocks and little or no allocation to bonds or cash.

Moderate Risk Tolerance

Moderate investors want to grow their money without losing too much. Their goal is to weigh opportunities and risks and this investor's approach is sometimes described as a “balanced” strategy.

Commonly, moderate investors develop a portfolio that includes a mixture of stocks and bonds, perhaps as a 50/50 or 60/40 structure.[2]

Conservative Risk Tolerance

Conservative investors are willing to accept little to no volatility in their investment portfolios. Retirees or those close to retirement age are often included in this category as they may be unwilling to risk a loss to their principal investment and have a short-term investment strategy.

A conservative investor targets vehicles that are guaranteed and highly liquid. Risk-averse individuals commonly opt for bank certificates of deposit (CDs), money markets, or U.S. Treasuries for income and preservation of capital.

What Is an Example of a 60/40 Portfolio Structure?

A moderate risk-tolerant investor may choose to invest in a 60/40 structure which may include a 60% investment in stocks, 30% in bonds, and 10% in cash.2

What Financial Instruments are Considered High Risk Investments?

High-risk investments include investing in options, initial public offerings (IPO), and foreign emerging markets.

How Does Risk Tolerance Compare to Risk Capacity?

While risk tolerance measures an investor's willingness to take risk, an investor's risk capacity measures their financial ability to take a risk.

Question 20 - Should I borrow from my retirement plan?

The purpose of retirement planning is to finance your post-work years, allowing you to maintain or improve upon your pre-retirement standard of living. As such, your financial/retirement planner will encourage you to save as much as you can in your qualified retirement account(s) and to defer making withdrawals for as long as is permitted under the plan.

Taking funds from your retirement account may adversely affect your retirement savings, but there are instances when doing so makes sense. Below, we'll look at some of the pros and cons of borrowing from your retirement account.

Loans vs. Withdrawals

First, let's distinguish. Taking a loan is different from making a withdrawal from a retirement account. Both reduce the assets in your portfolio, of course. If your account holds $100,000 and you take out $40,000, you will have a remaining balance of $60,000.

However, with withdrawal, you are not required to return the amount distributed from the plan, whereas a loan must be repaid to the plan in order to avoid it being considered a taxable event.1?

Diversification

Diversification is an important part of retirement planning. Retirement planners usually recommend that assets be diversified according to the risk tolerance of the individual client. While planning is based on the past and projected performance of assets, the risk must be considered, except when it comes to assets that produce a guaranteed rate of return or guaranteed interest.

One of the drawbacks of borrowing from your retirement plan is that the loan amount is no longer being invested and could thus mess up the diversification ratios until the sum is returned to the plan.

However, when you take a loan, the loan amount will be treated as an asset in the plan, as it will be replaced by your promissory note. While the amount will not be diversified, it will receive a guaranteed rate of return, which could be an average of the prime rate plus 2%.

Remember that diversification comes with risks, and the possibility exists that you could have a negative return on your investments unless some of your investments have a guaranteed rate of return. Therefore, the advantage of taking a loan from your account is that you will receive a guaranteed rate of return on the loan amount.

Double Taxation

One of the arguments against taking a loan from your retirement plan is that the amount you repay in interest will be double taxed. This is because the loan repayments, including the interest, will be made with amounts that have already been taxed and will be taxed when withdrawn from the retirement account.

"As soon as your after-tax loan repayments hit your 401(k) plan, they become pretax, and when you retire and start taking distributions, your loan repayments will be taxed again," says Michael Mezheritskiy, president, Milestone Asset Management Group, Avon, Connecticut. "Hence, double taxation."

Let's look at an example.

Assumption No. 1

- You contribute $100,000 to your retirement plan on a pretax basis.
- The $100,000 accrues $10,000 in earnings.
- You have never taken a loan from your retirement plan balance.

The $110,000 will be taxed at your income tax rate when withdrawn from your retirement account. Because the $100,000 came from pretax monies, and the earnings of $10,000 accrued on a pretax basis, the $110,000 will be taxed only when withdrawn.

Assumption No. 2

- You contribute $100,000 to your retirement plan on a pretax basis.
- The $100,000 accrues $8,500 in earnings.
- You took a loan of $20,000 from the plan, which you have repaid.
- The interest repaid on the loan is $1,500.

The $110,000 will be taxed at your income tax rate when withdrawn from your retirement account. Since the $100,000 came from pretax monies, and the $8,500 earnings accrued on a pretax basis, the $108,500 will be taxed only when withdrawn.

However, the $1,500 that came from interest repayment on the loan was repaid with amounts that were already taxed, and it will be taxed again when withdrawn from your retirement account. As a result, you will be paying taxes twice on the $1,500.

Consequences of Failing to Make Repayments

With a few narrowly defined exceptions, loans taken from your retirement account must be repaid at least quarterly, and they must be repaid in level, amortized amounts of principal and interest.[2]? Failure to meet these requirements could result in the loan being deemed a taxable transaction.[3]? It would also mean that you lose the opportunity to accrue tax-deferred earnings on the amount and to make diversified investments with it.

> “I think it is always best not to borrow from a retirement plan unless it is a last resort," says Allan Katz, president of Comprehensive Wealth Management Group, LLC, in Staten Island, New York. "Even though doing so is positioned as a tax-free way to access the capital, it doesn’t always work out that way.”

If you leave your employer before the loan is repaid, you may be required to repay the entire balance within a short period, instead of over the established schedule. If you are unable to repay the balance, the plan may treat it as a distribution (offset).

The loan would thus be treated as ordinary income unless you have available funds to replace the amount as a rollover contribution to an eligible retirement plan within 60 days after the date the offset occurs, or you are eligible to complete a direct rollover of the promissory note to another qualified plan.4? Loan balances that are treated as distributions are not only subject to income tax, but also may be subject to the 10% early-distribution penalty.3?

Why Take a Loan from Your Retirement Plan?

You should take loans from your retirement plan only if you have exhausted your other financing options, or if the loan will help to improve your finances. For instance, if you had credit card balances of $20,000 with an interest rate of 15% and you could afford to pay $400 per month, it might make good financial sense to take a loan from your retirement plan in order to pay off your credit card balances.

Let's compare the two scenarios.

Table 1

Scenario 1	Scenario 1 Costs	Scenario 2	Scenario 2 Costs
Retirement Plan Loan Amount	$20,000.00	Credit Card Balance	$20,000.00
Interest Rate	4.5%	Interest Rate	15%
Payment Frequency	Biweekly	Payment Frequency	Monthly
Payment Amount	$171.94	Payment Amount	$400.00
Repayment Period	Five Years	Repayment Period (if repayment is $400/month)	Six Years 7 Months
Total Interest	$2,351.41	Total Interest	$11,582.00

While it is true that the $2,351.41 you pay in interest on your loan amount will be double taxed, the obvious benefit is that the interest will be repaid to you, instead of to a credit card company, and the amount you pay in interest will be significantly lower.

If you do take a loan from your retirement account to pay off your credit card balance, make sure you take steps to avoid accruing new indebtedness under the credit cards. Check with your financial planner for assistance in this area—they can also help you ensure that your credit score is not adversely affected.

Another good reason for taking a loan from your retirement account is to use the loan amount to purchase a home. As industry trends show, amounts invested in your home provide a significant return on investment. Furthermore, you could also use your home to finance your retirement, whether by selling the home or by taking a reverse mortgage.

“I recommend borrowing from the retirement plan for capital expenditures such as home repairs or to start a business, and for debt consolidation in certain situations,” says Wes Shannon, CFP®, founder of SJK Financial Planning, LLC, in

Hurst, Texas. “Never borrow from a retirement plan for education expenses. The government makes easy, low-cost loans available for college, but not for your retirement.”

Check Your Plan Provisions

Not all qualified plans allow loans, and some that do will only allow them for special purposes such as purchasing, building, or rebuilding a primary residence, or paying for higher education or medical expenses. Others allow loans for any reason. Your plan administrator will be able to explain the loan provisions under your retirement account.

Replenish Your Account After You Take a Loan

If you must take a loan from your retirement account, try to continue making contributions and increase the amounts you contribute, where possible. This may be a challenge, as you will also be required to make loan repayments, and those repayments will not be considered contributions to your retirement account. However, it will help you restore your nest egg much faster.

Most plans will allow you to accelerate your loan repayments, which will help to restore your plan balance more quickly. Be sure to factor your loan repayment into your budget. This will keep you from overspending.

The Bottom Line

You should not take a loan from your retirement account unless it is an absolute necessity or it makes good financial sense. Determining whether a loan is right for you requires an assessment of your financial profile and a comparison of the loan option with other options, such as taking a loan from a financial institution (if available) or paying off credit card balances over time.

Be sure to discuss the matter with your financial planner, so that they can help you decide which option is best for you.