IRA vs. 401(k): Which is Better for You?

By Donna Fuscaldo / Published October 29, 2012 / FOXBusiness

When it comes to retirement planning, you have choices when it comes to picking what savings vehicle best fits your lifestyle. While most people will simply go with the 401(k) plan offered by their employer, there are other options like the Roth IRA.

When deciding which tool will house your nest egg, experts advise taking into consideration your discipline, income and tax goals.

With a company-sponsored 401(k) plan, employees can contribute pre-tax dollars from each pay check, which lowers their taxable income at the end of the year. In some cases the employer will match a portion of the contributions, effectively giving the employee free money. When it comes time to cash out of the plan, when you reach 59 ½, you would have to pay taxes on the distributions.

An Individual Retirement Arrangement (Roth IRA) is another retirement savings tool. The money you put this account can't be written off on taxes, but money grows tax free and you don't pay taxes on the money when you take it out as long as you are over 59 ½ and have had the Roth IRA open for at least five years.

Which is Better for You?

According to financial experts, the 401(k) is attractive to many people because the money is automatically taken out of their pay check—there's no effort to save. "The onus is on the employer," says Tisa Silver-Canady, assistant director at the office of Financial Education and Wellness at the University of Maryland. "It makes sense for people that don't want to worry about doing it themselves."

The amount you can contribute to a 401(k) each year is higher

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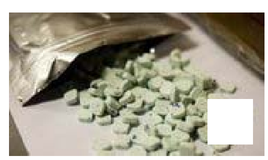

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than a Roth IRA at $17,000 for people under 50 and $22,500 for those over 50.

The possibility of an employer match with a 401(k) also makes it attractive. “It might be that the employer matches the first 6% at 50 cents on every dollar and that’s an immediate 50% return,” says David Ning, owner and operator of personal finance blog Moneyning.com, noting that since the money is taken out before you get the pay check it helps people sock away money for retirement. “Studies show it really works. If you don’t see it you don’t miss it,” he says.

There are also downsides to 401(k) plans. The plan choices can be limited. For instance, your employer may only give you two or three fund choices to invest in, limiting your options and preventing the highest return on your money. In addition, the fees associated with the plans could lower your investment dollars.

Before deciding on a 401(k)plan, Ning suggests checking for a company matching program, assessing the plan options and the fees.

In the case of the Roth IRA, Adam Bergman, a tax attorney with the IRA Financial Group, says the biggest advantage of this investment form is that your money grows tax free. With income tax rates expected to increase in the future, Bergman says this could be “potentially tax efficient.”

In addition to a Roth IRA giving you a tax benefit when you cash out, its self-directed nature puts you in the driver’s seat when it comes to choosing the funds. However, there are limits to have much you can invest each year: People under 50 can only invest $5,000 while people over 50 can invest $6,000.

If you make more than $183,000 jointly you won’t be eligible to invest in a traditional Roth IRA. Bergman notes that since 2011 there are no income restrictions for a Roth conversion, which means you can make a traditional IRA contribution a nd then convert the funds to a Roth IRA, which would be subject to tax.

Not to mention that since the money invested isn’t pretax, it doesn’t lower your taxable income. If your Roth IRA lost all its money because of a bad investment, you would have nothing to show for it, explains Bergman, but if you chose a 401k() and lost all your money, you would have at least lowered your taxable income.

Although deciding whether to go with a 401(k) or Roth IRA is a personal decision, there’s nothing stopping you from investing with both. “In a perfect world you would do both,” says Silver. You would have a 401(k) from your job and something you were in control of with an IRA.”

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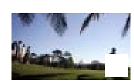

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