The Importance of Having More Than One Retirement Account

Most of your retirement savings will likely come from an employer-sponsored plan, such as a 401(k) or a 403(b). These are great savings plans for retirement because normally an employer will also match your contributions. However, just because your employer sponsors a retirement plan, doesn't mean you should stop saving for retirement there. Having more then one investment account will offer you more flexibility for your retirement income.

Before deciding what type of account to open, you need to consider your goals and time horizon. This is very important because if you have a short time horizon, you want to pick an account that allows easy access to your funds without penalty. But if you have a long time horizon, you probably want to choose an account that focuses more on retirement, like an IRA or a Roth IRA. Having a single retirement account through your employer may be simplistic, but it does limit your ability for tax planning and even investment planning.

Let's say you have a 401K through your work, and you are looking to open an additional account specifically for retirement. Generally speaking, there are two types of accounts you could open for this goal – an IRA and a Roth IRA. When deciding which account is best for retirement savings, you need to look at your current and future tax situation. If you are a high-income earner, it's probably best to open an IRA so you can get a tax deduction for your contributions now and defer those tax payments when your income drops in retirement. If you are a low-income earner, it's best to open up a Roth IRA and pay those taxes at a lower rate now rather than at a potentially higher rate later. It's also important to remember that if money inside an IRA and Roth IRA is withdrawn before age 59.5, there is a 10% early distribution penalty. Which is why these accounts are great if you have a longer time horizon.

If we continue with the above example, let's say you are saving up for a big expense, like a down payment on a house, and you need this money in five years. In this case, an individual brokerage account would be the best option for you. Reason being you can withdraw the money whenever you want penalty free, and investments held in a brokerage account for at least a year receive favorable long term capital gains tax treatment. These tax rates are much lower then your ordinary income rate.

The main advantages of having retirement accounts outside of your employer is for tax planning and investment purposes. Typically, employer-sponsored plans do limit your investment selection which in return could limit your investment performance. Most employer plans are normally pre-tax, which means it will be hard to minimize taxes in retirement because that entire account will be taxable upon withdrawal. When you have multiple retirement accounts, you have the ability to manage your taxable income every year in retirement and reduce your tax bill. You don't want to limit yourself when you retire. You want to make sure you have given yourself options and flexibility with regards to cash flows, tax liability, and investment options. Maybe retirement is far away for you, but being selective and purposeful with your investment choices now can provide big payoffs in the future.