SAVINGS VS. INCOME

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A 401(k) is for building retirement funds, while an annuity is a contract that provides protected lifetime income. They can work together in securing your retirement.

401(K) OR ANNUITY? WHAT'S THE DIFFERENCE?

If you already have a 401(k) for your retirement savings, do you need an annuity? It's a question that many have asked.

Although both are financial tools that can help you save for retirement and allow for tax-deferred growth, the two are very different. At the most basic level, a 401(k) is a type of retirement account – a container if you will – that holds different financial products, while an annuity is itself a financial product. A 401(k) is an employer-sponsored retirement account where you can contribute money to be invested in various financial products such as mutual funds, stocks, bonds or money market funds. An annuity is a financial product provided by an insurance company, that can allow you to save, while ensuring you'll receive a stream of protected income in retirement.

One good way to grasp the difference between a 401(k) and annuity is to understand how people use them. People use their 401(k) to accumulate and hopefully grow their money for retirement (i.e., long-term savings), while an annuity is used more frequently to turn savings into a guaranteed income stream once you've retired (i.e., long-term income).

Let's break down each starting with a 401(k), which in most cases deducts money before taxes from your paycheck (some employees have similar but alternative types of accounts, such as Roth 401(k), 403(b) or 457 plan). This means that the amount you add to your account is exempt from current federal income tax and won't be taxed until you withdraw it. The money in your 401(k) can accumulate and grow over time because you are not only adding money from your paycheck, you're also investing that money within your 401(k).

- There are tax advantages to having a 401(k). Money pulled from your paycheck and put into a 401(k) lowers your taxable income so you may see the total amount of taxes you pay go down.

- Because there are tax advantages, there are also limits on how much you can contribute to your 401(k). For 2020, you may contribute up to $19,500, with an extra $6,500 in catchup funds if you're over 50.

- Employers may also contribute matching funds to your 401(k).

- When you reach 59.5 years of age and retire, you're eligible to begin withdrawing money from your 401(k). You control withdrawals and take what you need to supplement your Social Security and your pension (if you have one). But once those savings are depleted, they're gone, and so is any income you could generate from that account.

- If there is money remaining in your 401(k) when you pass away, your heirs can inherit it.

An annuity, on the other hand, is a contract with an insurance company that typically combines elements of investment and insurance. You can contribute a lump sum or make payments over time (IRS contributions limits on non-qualified annuities do not apply), and your earnings grow tax deferred.

- Annuities are offered in many varieties, allowing you to choose the type that works best for you. At the most basic level, there are three primary categories of annuities. A fixed annuity guarantees a rate of return; a variable annuity allows you to participate in the stock market; and an index annuity is tied to the performance of a market index, like the S&P 500.

- You typically use after-tax dollars to make the purchase, so you don't owe taxes on the principal when you use it for income. And any earnings on your investment grow tax-deferred, which allows you to get a boost, while in the growth phase of the annuity – that is the period when your money is earning interest and you are not receiving any income payments. When you decide to start receiving payments, you enter the annuitization phase and your money no longer grows.

- Your annuity can be one of the three sources of protected lifetime income (a pension and Social Security being the other two) that can provide you with guaranteed payments, usually monthly, for as long as you live. So even when your account balance is exhausted, you continue to receive payments.

- Any money remaining in the annuity after you pass away can go to your family – depending on the type of annuity – and there are optional family benefits you can purchase.

Many people use both annuities and a 401(k) because they can complement one another and can allow you to generate income for your retirement. That complementary relationship is one reason the U.S. Congress passed a new law last year – the SECURE Act – that makes it easier for employers to offer an annuity as part of their 401(k) plans.

An annuity's ability to generate income for your retirement is especially important when you consider the prospect of outliving your savings. An annuity can create an income stream that lasts as long as you're alive, alleviating those fears.

Some people also choose to roll over their 401(k) balance into an IRA when they retire, putting some of their assets into an IRA annuity to be sure that it will provide income for as long as they live.

Still have questions? The best thing to do is talk to a financial professional who can sit with you, calculate the numbers for what you'll need versus want, and figure out what's best.

Learn more about Choosing an Annuity That's Right for You as well as learning how to calculate how much money you'll need in retirement.