Best Alternatives To A 401(K)

By James Royal and Karen Roberts

A401(k) plan can be a great way to invest, giving employees the opportunity to grow their pre-tax contributions and earnings tax-deferred until retirement. About 50 percent of employers offer a cash match on contributions, according to the Bureau of Labor Statistics — providing an additional incentive to save.

Unfortunately, based on 2019 estimates from the American Retirement Association, more than 5 million employers in the U.S. did not offer a workplace retirement savings benefit (401(k), 403(b), 457 plan) leaving 28 million full-time and more than 23 million part-time workers without this opportunity to save. To increase access, Congress passed the SECURE Act in 2019 to make it easier for businesses to offer 401(k) plans. As a result, many businesses are expected to implement retirement savings plans for their employees in 2021.

If your current employers' plan does not have a match, offers only limited investment options, or the options provided come with higher than average fees, it may make more sense to take charge and save for retirement on your own.

How to invest without a 401(k)

Fortunately, you do have some alternatives if your company does not offer a 401(k) plan — or a good one. For example, anyone with earned income can access an IRA and those with their own business — even a side gig —have alternatives, too.

If your employer's retirement plan doesn't measure up, here are eight investing alternatives to consider:

- Traditional IRA
- Roth IRA
- SEP IRA
- Solo 401(k)
- Health savings account (HSA)
- Taxable brokerage account
- Real estate
- Invest in a business startup

Best alternatives to your company's 401(k)

1. Traditional IRA

A traditional IRA is one of the most popular ways a person can save for retirement, regardless of what other retirement plans they have. The traditional IRA allows a wage earner to put away money in an account that allows the money to grow tax-free. You'll pay taxes only when you withdraw the money at retirement. Plus, contributions to the account can be deducted from your taxable income, so you avoid taxes on that income today.

Key benefits: Tax-deferred growth, a tax break today on contributions and complete flexibility in investment choices.

Drawbacks: Contributions have an annual maximum: $6,000 for those under age 50 in 2021, ($7,000 for those 50 and older). There are age-related required minimum distributions (RMDs) that need to be taken. The entire contribution may not be tax-deductible based on your income. (Here's everything you need to know about an IRA.)

2. Roth IRA

A Roth IRA is another way that workers can stash some cash for retirement, and it has two key differences from the traditional IRA:

The Roth IRA allows you to grow your money tax-free, and you'll be able to withdraw any of the money at retirement completely tax-free. In exchange for this benefit, your contributions are made on an after-tax basis. In other words, you don't get any tax savings today from the Roth IRA.

A Roth IRA may be a better fit for you than a traditional IRA, but it depends on how your income and tax rate today compare to the one you're expecting to have in retirement, so be sure to check with a financial advisor.

Key benefits: Tax-free growth and withdrawals at retirement, flexibility to use the contributions for some qualified expenses (such as college expenses and first-time home purchases) without a penalty, complete flexibility in investment choices, no capital gains on asset sales and the account balance can be passed to heirs.

Drawbacks: You're giving up a tax benefit today for the promise of tax-free withdrawals after you retire. Contributions have an annual maximum, $6,000 in 2021 ($7,000 for those age 50 and older). RMDs apply here too. (Here's how to open a Roth IRA.)

3. SEP IRA

A Simplified Employee Pension IRA, or SEP, is an IRA for those who are self-employed, own a business, or have income from freelancing or side jobs. The SEP-IRA has the same investment, distribution and rollover rules as a traditional IRA. A significant difference is that instead of the traditional IRA's $6,000 limit (for those under age 50) on contributions, participants can contribute up to $58,000 in 2021 or 25 percent of eligible compensation, whichever is less.

Key benefits: Higher contribution limit than traditional IRAs, complete flexibility in investment choices, the amount contributed each year can vary, tax-deferred growth of contributions, and larger maximum contributions.

Drawbacks: Contributions are limited to 25 percent of business earnings. Any employees working for the business must receive the same contribution (although they are barred from making any elective salary deferrals or catch-up contributions), and RMDs apply.

4. Solo 401(k)

You'll need your own business to take advantage of the solo 401(k) and have no employees other than a spouse, but it's a powerful savings vehicle if you have a side gig. You're allowed to contribute as much as $58,000 for 2021, though that amount is divided into components for yourself as the employee ($19,500 for 2021) and yourself as the employer ($38,500). If you're age 50 or over, your employee limit is $26,000 for 2021, making your potential total contribution as high as $64,500.

One of the best perks of this type of plan, especially if you're earning enough money in your main job, is the ability to save 100 percent of your business-generated income up to the annual maximum contribution limit of $64,500. That could be an important advantage over a SEP-IRA, where your contribution is limited to 25 percent of your business earnings. Your contributions can be pre- or post-tax funds.

Key benefits: Can contribute substantial amounts to the plan as noted above, complete flexibility in investment choices (including the option to invest in real estate and/or cryptocurrency), contributions can be pre or post-tax.

Drawbacks: There are extra IRS rules and reporting requirements with this program. You must own a business to participate. Limits on elective deferrals are person-based, not plan-based — this is an important distinction for business owners also employed by a second company and participating in their 401(k). It can become complicated if you hire any employees.

5. Health savings account

Health savings accounts (HSAs) aren't just for health care, though they were created to help Americans with high-deductible health plans pay for their care.

HSAs offer a huge benefit for those who can accumulate a nest egg in their account until they retire and/or become covered by Medicare. You're eligible for one if your employer-provided health insurance plan is considered a high deductible health plan and has a minimum deductible of $1,400 (Individual coverage, $2,800 family coverage) and maximum out-of-pocket costs of $7,000 Individual; $14,000 family). For 2021, the plan allows individuals to contribute up to $3,600 toward an HSA and families up to $7,200. Employees age 55 and older (by the end of the tax year) can contribute an additional $1,000 as a catch-up provision.

In exchange for contributing to your HSA, you'll get a tax deduction today, and the interest or other earnings on the account are tax-free. Distributions from the account are tax-free if you use the account to pay for qualified medical expenses. But the real benefit occurs once you hit age 65. That's when you can avoid the 20 percent penalty for non-medical uses of the plan although such withdrawals/expenses are considered taxable income. Even if your employer does not offer a HSA plan, you can set one up on your own.

Key benefits: HSAs allow for flexible use of contributions, employers can contribute to the plan, IRAs can be rolled over into an HSA should a major medical need arise, you can use the funds to pay for spousal and dependent qualifying medical expenses even if they are not covered under your health plan and the entire HSA contribution is either tax-deferred or can be deducted from gross income on your tax return.

The HSA has no minimum required distribution. In most plans, investment options are available for HSA contributions once a certain account balance is achieved. If still working after age 65, funds can be used to pay for employer-sponsored health insurance. After retirement, funds can be used to pay for Medicare or Medicare Advantage plan premiums.

Drawbacks: The investment options may be limited as you'll likely want to keep a comfortable amount of your vital health care funds in safe, liquid assets. You may also exhaust all the funds if you encounter a major medical need while still employed. Once you are on Medicare you can no longer contribute to an HSA even if you are still employed, although you can continue to use accumulated funds.

6. Taxable brokerage account

If you've exhausted the other retirement savings options or they don't apply, you can always save money in a taxable brokerage account. You won't get any help from your employer here – no cash match, for example – but you can invest in what you want and you can choose the broker that works best for you. So, if you're searching for low-cost brokers or you need to trade specific funds for free, you can do that.

Key benefits: No limit on contributions, complete flexibility in investment choices, potential to access low-cost options compared to a 401(k), easy to set up, no limit on the number of accounts, can withdraw funds at any time without penalty.

Drawbacks: Realized capital gains are taxable, lack of diversification or a bear market could limit gains, contributions are after-tax. (Here is Bankrate's review of best brokers for beginners.)

7. Real estate

With real estate, investors are responsible for making sound purchase decisions and growing their returns. Investments can be made for short-term cash flow and/or long-term appreciation purposes.

Key benefits: Depreciation and other tax advantages; if a rental property, renters are building your equity, covering expenses and providing cash flow.

Drawbacks: Lack of appreciation if real estate is not in the right area or the market sours, may take time to sell the property if money is needed quickly, real estate broker fees and unexpected expenses for repairs or renovation, costly legal process to evict tenants if necessary.

8. Invest in a business startup

The thrill of funding the next big thing makes investing in a startup exciting, however, it also includes a high degree of risk. Crowdfunding or focused investment platforms are a few ways that startups reach out to both potential investors and future customers.

Key benefits: Low investment threshold, rapid growth could lead to a corporate buyout and a large financial gain.

Drawbacks: High failure rates, may take a long time for the investment to pay off and/or to liquidate the investment.

How 401(k)s work

A traditional 401(k) is a tax-advantaged vehicle designed to allow employees to save for retirement. The tax advantage is that contributions are deferred on a pre-tax basis which lowers an employee's taxable income, and funds grow tax-free until withdrawn, typically in retirement when employees are in a lower tax bracket.

Employees naturally prefer to work for employers who offer a 401(k) match (with vesting requirements) as part of their plan – typically 50 cents for every dollar the employee defers up to 3 to 4 percent of employees' annual cash compensation. Best-in-class employers may set their limits somewhere between 6 and 12 percent of annual cash compensation to better attract and retain talent.

Vesting requirements differ based on the plan an employer sponsors – vesting can be immediate or take some number of years to achieve. Vesting refers to ownership, so once you are 100 percent vested in your employers' contributions, they are yours. Before that, if you leave employment, you will forfeit any non-vested employer contributions.

For 2021, employees can defer up to $19,500 into a 401(k); employees age 50 and older can contribute an additional $6,500. Employees can manage their investment options or the plan will invest the employees' funds in balanced portfolios designed to correspond to the employees' expected date of retirement.

Most plans charge the employee for management fees that come out of the employees' account balances, so employees should familiarize themselves with their plans' investment choices and investment fees. Depending upon their plan, employees may have the option of deferring contributions as either pre-tax or post-tax (Roth).

Bottom line

The plans mentioned above were designed to encourage workers to play an active role in planning for retirement.

While having a company-sponsored 401(k) plan is great, workers have other options if their employer doesn't offer this type of retirement plan, if they have additional monies to invest from other employment or if they desire to utilize other investment vehicles that better fit their retirement goals.**Bankrate, posted on SouthFloridaReporter.com, May 12, 2021**

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