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Don't Invest One More Dollar Until You Know These 5 Terms

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Everyone claims to know where you should put your retirement money. Sort through all the noise by checking out these five plans...

The ending of the wildly popular HBO series "The Sopranos" is one of the most debated and analyzed TV drama endings of all time. For six seasons, the show chronicled the personal life of New Jersey mafia boss and protagonist Tony Soprano, whose insecurities, triumphs and challenges drove a fascinating lifestyle of crime, womanizing and murder.

By the last episode, which aired on June 10, 2007, Tony had a target on his head: He and a rival crime boss had put hits out on each other. So you can imagine the audience's anxiety about the final scene, in which Tony meets his family at a restaurant for an ordinary dinner.

#-ad_banner-#Tony arrives first. He watches strangers come and go. Tony's wife arrives, then his children. Nothing unusual is happening. Journey's "Don't Stop Believin'" plays.

Suddenly, a suspicious-looking man walks past Tony, then enters the bathroom. Moments later, he comes out of the bathroom. Tony looks up at the guy.

The screen goes black. The credits roll.

If you were one of the show's millions of viewers that night, you probably thought what most people thought: What the hell just happened? Did the cable go out? Are you telling me I just spent eight years watching this, and now I don't get to know how it ends?

It's a familiar tune -- putting years of your life into something only to find yourself stumped at the end. And that's how too many of us enter retirement. We turn 65 and end up sitting in front of a financial black screen, wondering what happened.

Don't create a black screen for yourself. We gleaned from our Financial Dictionary and found some of the most basic terms you should know before you put one more dollar in a retirement account.

Defined Contribution Plan and Defined Benefit Plan

In general, a defined contribution plan is a tax-deferred savings plan that people fund with their own money (rather than an employer's money) and use to save for retirement. It is the opposite of a defined benefit plan, which is typically a pension plan funded by the employer or an entity other than the person who will directly benefit from the plan.

A 401(k) plan is the most common type of defined contribution plan, though there are other types of similar plans for certain types of employees. The idea is the same, though: Contribute a portion of your pay on a pre-tax basis in your own account. Choose how much you want to save per year, up to the maximum allowed by the plan. In many cases, employers match your contributions.

The plan then invests your funds in a securities portfolio. The composition of the portfolio may vary depending on the plan and how much risk you're comfortable with. The choice is yours. When you turn 59 1/2 years old, you can begin withdrawing your money.

Keogh Plan

A product of the Self Employed Individuals Tax Retirement Act of 1962, a Keogh Plan is basically a 401(k) for self-employed individuals or unincorporated businesses. The program is named after Eugene Keogh, who spearheaded the legislative efforts.

Similar to 401(k) plans, you make tax-deductible contributions to an account and can invest that money in a wide variety of securities. Certain small businesses can set up Keogh plans for their employees as well. These contributions and their earnings are tax-free until they are withdrawn. Unlike 401(k) plans, however, you can't borrow against a Keogh plan.

Employee Stock Ownership Plan (ESOP)

Also known as a stock purchase plan, an ESOP is a defined contribution plan that invests the fund assets in the employer’s stock.

To establish an ESOP, a corporation forms a trust in which the employees are partial owners. The employees then contribute to the trust (usually through payroll deductions). The trust in turn purchases shares of the company, which it then allocates to individual employee accounts within the ESOP.

There are four major tax benefits associated with ESOPs:

1. Employers can deduct their contributions (up to a limit).
2. Employees can often defer taxes on the contributions and their earnings until they withdraw their funds (if the ESOP owns at least 30% of the company’s stock after the sale and the seller reinvests the proceeds in certain investments).
3. The employer does not pay taxes on the ESOP’s earnings and dividends while those earnings are in the fund.
4. Employees and their beneficiaries can often transfer ESOP balances into other tax-deferred vehicles, such as IRAs, to further defer taxation.

Like other defined contribution plans, the ultimate benefit to you depends on the amount contributed and the performance of the investments in the fund. ESOP participants can enjoy some unique tax advantages, but ESOPs also tend to bear more risk than other defined contribution plans, such as 401(k)s, because they generally do not diversify their holdings.

IRA

Individual retirement accounts (IRAs) are one of the most well-known ways to save for retirement. Congress established the original IRA program in 1974, but today there are several kinds of IRAs, and each one has its own requirements, restrictions, limits and tax treatments.

You can open an IRA account with a bank, brokerage firm or mutual fund company. These firms act as a fiduciary, though you're responsible for selecting the plan investments. Once the account is open, you contribute a maximum of several thousand dollars per year (the contribution limits often change annually). Participants 50 and over are often eligible to make additional "catch-up" contributions, but you usually can't make contributions to Traditional IRAs after age 70 1/2.

IRA contributions are typically deductible if the IRA is a Traditional IRA, but they're not deductible if the IRA is a Roth. Withdrawing from a Traditional IRA before age 59 1/2 almost always incurs huge penalties. (There are certain exemptions for disability, financial hardship and death, though.)

Withdrawals made at or after age 59 1/2 from a Traditional IRA are taxed, typically at ordinary income levels. Withdrawals from Roth IRAs, on the other hand, can happen any time and are completely tax-free in most circumstances. This sounds great, but remember that contributions to Roth IRAs are not deductible (as Traditional IRA contributions typically are).

Because the IRS taxes you either coming or going, one question to ask when deciding which IRA is right for you is whether your current tax bracket is higher or lower than the tax bracket you expect to be in when you retire. Another factor is income. (Roth IRAs are available only for filers who make below a certain amount, for example).

The Investing Answer: Retirement is tricky, and these terms are just the tip of the iceberg in terms of what you should know before you begin. Though you can't throw a dead cat without hitting somebody who's telling you what to do with your retirement savings, be sure you at least understand the vocabulary of retirement before you throw that dead cat.

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