How Retirement Accounts Work (401k, IRAs)

You might hear the term from time to time, "did you put money in your 401k this year?". "Did you max out your IRA?". Maybe you've never heard of these terms. Maybe your employer doesn't even offer you a 401k. For that reason, you absolutely should read up on what they mean!

In the United States, we pay something called "capital gains tax" on investments. Selling stocks, houses, and crypto is typically taxed at 15%. (but you have to own it for at least a year, if you sell within a year, its taxed as if its regular income).

What makes retirement accounts special is that you don't have to pay capital gains tax. The downside is you generally can't access this money until you are 59 1/2 years old. The 401k can be especially good because many employers match a part of what you put into the 401k (they'll say something like "we will add $1 for every $1 you contribute, until it hits 1% of your income. So if you make 100,000k a year, you need to contribute $1,000 dollars and then they'll add $1,000. This is money you have to take advantage of and consider with your job offers!)

The government encourages this because they don't want you to be poor when you are old. Social Security will not be enough for most old people, it should be thought of as a backup plan so you aren't completely starving. You should start when you are young. If you put in $5,000 dollars in when you are 25, the day you turn 65 that money will be worth $33,523, assuming a modest 5% a year of gains! So lets recap

1. If your employer offers 401k matching, make sure you contribute the minimum to get that money.
2. It might not make sense to put a whole lot of money in here, but try to stash away a little each year, you'll be grateful in the future.

Traditional Vs. Roth

Now comes the hard part! You have the option on making your contributions either Traditional or Roth. These accounts are tax advantaged because you don't pay capital gains on them, but you still have to pay income tax on the money you make! You just have the option of getting taxed now on the income, or getting taxed later.

Lets say you make $60,000 a year. The tax rate for income between $48,476 to $103,350 is 22%. So if you put $10,000 into a traditional 401k, your taxable income drops to $50,000 a year, and your tax bill for 2025 is reduced by $2200 a year.

To explain this write out the equation [(1 - tax rate)*income] * [(1 + return rate)^ years] show you can re arrange to income * [(1 + return rate)^ years] * [(1 - tax rate)] and it equal the same thing. And since its equal the same thing if you tax it later, it also means if you tax now, then have capital gains tax, thats still worse than taxing the whole thing with gains after 20 years.

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