Maximizing Retirement Savings Outside of Earnings

Maximizing contributions to retirement savings plans is a priority with which few people would disagree. When money is needed for life's more immediate necessities or deemed necessities, however, retirement savings for that "distant future" may get squeezed out – at least temporarily.

But even during those times when every dollar of salary may be called upon to satisfy an immediate need (or if salary itself is in short supply), tax-preferred retirement savings do not necessarily need to grind to a halt. Through gifts from one family member to another, or through moving regular savings into retirement savings, tax-preferred retirement savings opportunities need not be lost.

One general principle to remember when planning to maximize retirement contributions is that Internal Revenue Code-imposed contribution limits apply on an annual basis. Once the year is up (whether measured to December 31 or extended until the filing date for that year), there is no going back to "make up the payment."

"Catch-up contributions" for those 50 years old or older are a misnomer; even catch up of "catch-up" contributions are not allowed, and no need to catch up needs to be present to make "catch-up" payments.

- **Opportunity No. 1: Children who earn a limited amount while students.** The maximum contribution limit to an individual retirement account for the year of 2007 is 100 percent of earned income or $4,000; for the year of 2008 it rises to $5,000. Yet it is the rare student who wants to sock away 100 percent of their earnings for retirement. A parent, grandparent or other relative who "matched" those earning as a gift that is put into an IRA will likely be remembered for their generosity years from now as the account grows.

Since earned income is not taxed at the "Kiddie Tax" rates, contributing to a Roth IRA, rather than a traditional IRA that allows for a deduction at the cost of a deferral of tax, generally makes more sense. This is particular true now, with the Kiddie Tax age limit rising to age 24 for full-time students next year.

- **Opportunity No. 2: The student who works several years after college before starting grad school.** In this situation, the college grad could contribute to a traditional IRA while working in order to be entitled to the contribution deduction, and then convert to a Roth IRA while once again a low-income individual while in graduate school. Using regular savings or a gift to bankroll the tax on the conversion would maximize this strategy.

- **Opportunity No. 3: Employers that match 401 (k) contributions.** At any age, retirement savings contributions should be maximized at least to the extent that an employer matched them under a plan. Clients should be shown the incremental value that their 401 (k) account balance will enjoy if their contributions, employer matching, and the tax-deferred earnings are compounded each year. Only with that data can they measure the true cost of their discretionary purchases in lieu of maximizing 401 (k) contributions.

- **Opportunity No**. **4: Use of regular savings to maximize retirement savings.** Employees 50 years of age and over who are "maxed out" on everyday obligations may not be able to contribute not only the additional 55-and-over retirement contribution, but also the rising maximum for 401(k)s. For 2007, those amounts are $15,500 and $5,000, for a total of $20,500. One solution to not letting this opportunity pass them by is to have them withdraw from their regular savings accounts to maximize contributions.

Those within 10 years of retirement, whether or not pinched for cash for daily living, usually have managed to build up some sort of regular nest egg outside of a formal retirement account. Transferring some of those regular savings or investment accounts into tax-preferred savings accounts is one way to "convert" part of a regular savings account into a deductible account or Roth IRA account. Being closer to retirement, too, the risk surrounding locking funds into an account in which a 10 percent early withdrawal penalty would be assessed is significantly lower.

One procedural note: For those who are using this strategy through an employer-sponsored 401(k), the "transfer" from regular savings to the 401(k) must be in the form of using savings to replace take-home pay that will be reduced my maximizing withholding for employee contributions.

- **Opportunity No. 5 Pass up withdrawals.** A penny saved from withdrawal from a retirement plan is a contribution earned, to borrow from Ben Franklin's wisdom. Once money that was once contributed to an account is withdrawn, it cannot be re-contributed back into the account (with the limited exception of certain re-contributions within the same taxable year or 60-day period).

The fact that a withdrawal may be penalty-free does not mean that there is no economic penalty. Lost forever is the chance to have those funds continue to accumulate tax-deferred or tax-free until withdrawn during retirement.

True, the early-withdrawal penalty of 10 percent, on top of recognizing income on the withdrawal in case of a deferred account, does not apply under the Tax Code when used to a limited extent for first-time housing, education or emergency needs. However, clients should be reminded that these "special-needs" withdrawals are not free money from the government. Rather, it is the client's money – money that otherwise would, in fact, have amounted to some free money through the magic of tax deferral had the amount remained in the account.

Conclusions

Workers are increasingly left on their own to save for retirement, with defined-benefit plans fewer each year and automatic employer contributions to defined-contribution plans not nearly enough to make up the difference. The need to maximize contributions becomes critical, and that need increasingly must be emphasized by employers and tax advisors. No single strategy is the solution, but the combined use of several – none of which should cause the client much sacrifice can add up gradually but steadily to a more adequate fund on which to retire.