

Saving for Retirement

Many companies used to provide employees with a pension; those days are gone. Instead, we all have to figure out how to save up enough money to supplement social security. Social security can be a critical piece of retirement income, but you don't want it to be your sole source; on average it only replaces about 40% of income.

The best way to save for retirement is to start young. All else being equal, you could have \$500,000 by age 65 if you started saving \$190 per month at the age of 25, \$410 per month at 35, \$960 per month at 45 and a whopping \$2,889 per month at 55! When it comes to saving and investing for retirement, time is your best friend.

Your other friend is *tax deferral*; tax deferral means that income tax on money building the account (contributions or earnings) is postponed until you take money *out* of the account. While \$10,000 in a tax deferred account could grow to about \$110,000 over 35 years, the same amount and assumptions would lead to only about \$70,000 in a taxable account for someone in the 28% bracket. When saving for retirement, tax deferred accounts will help your savings grow faster.

If you are working, chances are that you have some tax-deferred opportunities to save. Many employers offer 401(k) or 403(b) plans. Under these plans you defer part of your salary into your own account. The amount that you defer does not get counted as income for tax purposes, so you save on current year taxes. And, you don't pay taxes on the earnings each year – all taxes are *deferred* until you take money *out* of the account. Some employers also contribute to these plans, or *match* a portion of your contribution. If your employer provides a match, and you do not defer enough of your salary to get the maximum match, you are literally leaving money on the table – telling your employer that you don't want money they are offering you for retirement.

Some people get overwhelmed by the investment choices they have with their work retirement plans, and that keeps them from deferring salary into their account. Or, they don't like the investment choices. Even investing in mediocre or poorly performing funds in a 401(k) or 403(b) is likely to help you save more for retirement than *not* taking advantage of the opportunity to defer salary each month into a tax-deferred account over many years.

If your employer does not offer any retirement savings plans, or you are self-employed, you can still save in tax-deferred accounts (if you do not earn more than the eligibility limits). You can contribute \$5,000 (\$6,000 if you are over 50) per year to an Individual Retirement Account (traditional IRA); your contribution is tax-deductible *and* you don't pay taxes on the earnings as the account grows. Taxes are paid when you take money out of the IRA (called *distributions*), and you are required to begin taking distributions

when you turn 70.5. If you are self-employed you can set up a Simplified Employee Pension (SEP) IRA which allows you to contribute more than the limits on the traditional IRA, depending on your business profit.

Another IRA option is a Roth IRA. A Roth also has certain eligibility requirements and is different from a traditional IRA in a few key ways. First, you do not get to deduct the contributions you make to your Roth (so contributions will not reduce your taxes in the current year). Like a traditional IRA though, you do not have to pay tax on the earnings as the account grows. Unlike a traditional IRA, you do *not* have to begin taking distributions at age 70.5 and, even more importantly, you do *not* pay income taxes on distributions. It is also possible to *convert* a traditional IRA to a Roth IRA, although you have to pay taxes at the time of the conversion so this only makes sense in certain situations.

One thing to keep in mind with all of these accounts is that there are many rules you need to follow to preserve their tax advantages. There may be penalties for taking money out early, or if you move your account incorrectly it may be considered a taxable distribution. Also, if you inherit an IRA you need to make sure you manage it carefully to preserve its tax advantages.

Most importantly, the only way for any of these accounts to help you in retirement is for you to contribute to them consistently over as long a period of time as possible!

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