What is the Order to Fund Your Retirement Savings?

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In a previous blog post I stated that 15% is a good goal to consider when funding for retirement and to start today due to the compounding effect. Because tax deferred growth can be very powerful, I want to share an issue that many do not consider. Assume you just graduated college with a starting salary of $60,000 and the employer has a 401(k). You will be able to contribute $9,000 ($60,000 x 15%).

However, let's assume you will delay contributing until your salary is $175,000 and want to contribute 20% to make up for the earlier years. Because the 401(k) deferral for a person under age 50 in 2018 is **$18,500**, you can only contribute up to $18,500 even though you are prepared to contribute $35,000 ($175,000 x 20%). Say you want to contribute $5,500 to a Roth IRA to make up for only being able to contribute $18,500 to the 401(k), you are out of luck as a single person with income in excess $135,000 will not be able to contribute to a Roth IRA (that grows tax-free). However, a less favorable non-deductible IRA for $5,500 (that grows tax-deferred) can be made instead.

Before I get to the order of how to fund your 15% contribution, the above information is highlighting two issues:

- For 2018, the IRS limits your 401(k) funding to only $18,500. Therefore, the maximum $18,500 amount can be significantly lower than what is needed to obtain a 15% contribution of your W-2 income.
- Also, because a Roth IRA (which grows tax-free) is such a great investment to fund, the IRS does not allow you to contribute $5,500 to one if your taxable income exceeds certain income thresholds.

Therefore, due to these limitations, you will want to take full advantage and maximize these investment vehicles before they may be significantly reduced or not available to you as your income level may increase.

Back to the example where you will contribute 15% of your $60,000 salary or $9,000 for your retirement savings. Assume your employer provides a 3% match on the first 6% contributed and that the plan is a 401(k) plan only (a Roth 401(k) plan is not offered).

You may want to consider funding the $9,000 as follows:

- Contribute the first 6% of salary or $3,600 ($60,000 x 6%) to the 401(k) to receive the 3% employer match of $1,800 ($60,000 x 3%). This $1,800 is subject to a vesting schedule and when you are fully vested, you can consider this money to be yours without any employer limitations.
- Contribute the remaining amount to a Roth IRA not to exceed $5,500. In this example the amount is $5,400 ($9,000 total - $3,600 election to the 401(k) equals $5,400).

Let's assume the same facts, however, your salary is $70,000. You may want to consider funding the 15% amount or $10,500 as follows:

- Contribute the first 6% of salary or $4,200 ($70,000 x 6%) to the 401(k) to receive the 3% employer match of $2,100 ($70,000 x 3%). This $2,100 is subject to a vesting schedule and when you are fully vested, you can consider this money to be yours without any employer limitations.
- Contribute the remaining amount to a Roth IRA not to exceed $5,500. In this example the amount is $5,500 ($10,500 total - $4,200 election to the 401(k) equals $6,300).
- Contribute the additional percentage of your salary not to exceed $18,500. Because there is $800 remaining ($10,500 total - $4,200 to receive the company match - $5,500 to Roth IRA) you would increase the 6% to 7.14% (the 1.14% multiplied by $70,000 equals $800). Depending on the 401(k), you may need to round this to the nearest whole number (for example 7%).

Let's assume you can contribute 20% of your $175,000 salary or $35,000 and your employer provides a 3% match on the first 6% contributed. Here is how you would fund this amount:

- Contribute the maximum $18,500 to the 401(k) to receive the 3% employer match of $5,250 ($175,000 x 3%).
- Contribute $5,500 to a non-deductible IRA.
- Contribute the remaining $11,000 ($35,000 total - $18,500 to the 401(k) - $5,500 to a non-deductible IRA). This would be invested in a taxable account using a tax-efficient asset allocation to minimize current taxes.
