



The Basics

Build a bigger nest egg

Higher limits mean that you can tuck away a lot more money into 401(k)s and other tax-favored retirement plans, even play catch-up if you're 50 or older. Take advantage.

By Karen Hube

If you're worried whether you're saving enough for retirement, there's some good news that might take the edge off.

You can put far more into tax-favored retirement savings plans these days, thanks to big increases in contribution limits. Contribution limits to all kinds of retirement plans -- including 401(k)s and IRAs -- will keep moving up through 2008. After that, the limits will rise with inflation.

Older workers can save more on top of that with catch-up contributions.

"This is great news for people who feel they are behind in their savings. They'll be able to make much more headway," says Ron Roge, an investment adviser in Bohemia, N.Y.

For years investors and advisers complained that contribution limits were too low, says Clint Stretch, director of tax legislative affairs at Deloitte & Touche in Washington, D.C. While 401(k) limits have risen more or less in tandem with inflation, usually in \$500 increments, IRA limits of \$2,000 a year were set in 1981 weren't adjusted until recently.

The new rules

Here's how the retirement-saving environment has changed:

Individual Retirement Accounts and Roth IRAs. Contribution limits for regular IRAs and Roth IRAs rose to \$4,000 in 2005, up from \$2,000 as recently as 2002. And IRA contribution limits rise once more in 2008 to \$5,000. Plus, there are catch-up provisions that let workers 50 and older kick in an extra \$500 in 2005, and an extra \$1,000 starting in 2006. If you're skeptical about what difference an extra \$1,000 a year in savings can make per person, take a look at the numbers: If you squirrel away \$3,000 each year for 30 years and earn an average 8% annual return, you'll end up with \$339,849, Roge says. Under the old rules, investing \$2,000 a year, you would have accumulated \$226,556 in that period.

401(k) and 403(b) accounts. The maximum you can put into these hugely popular employer-sponsored retirement plans rose in 2005 is \$14,000. That limit went up another \$1,000 in 2006, and is now indexed to inflation.

SIMPLE and SEP plans. Investors in SIMPLE plans offered by employers with fewer than 100 employees can put in more, too. So can self-employed people, who can invest more in SIMPLE plans or boost their contributions with a SEP (simplified employee pension IRA).

A bonus if you're 50 or older. The biggest retirement-savings benefits go to people aged 50 and over. Thanks to so-called catch-up provisions, they can contribute more to their retirement plans than most folks. They could invest as much as \$18,000 in a 401(k) in 2005; \$14,000 plus a \$4,000 catch-up contribution. The catch-up limit rises to \$5,000 for 2006, so those 50 and over can save up to \$20,000 in a 401(k).

To get the most out of these changes, your top priority should be to invest the maximum in your 401(k) or 403(b) plan, if you are eligible for one. Contributions in 401(k)s are made with pre-tax money, and often employers will match a portion of what you put in. These benefits make a 401(k) too good to pass up.

What's more, the law accelerates the vesting of employers' matching contributions -- that is, the full rights to an employer's match. "In the past, company matches had to be fully vested after five years, or according to a phase-in schedule lasting seven years," says Bill Arnone, director of employee financial education at Ernst & Young in New York.

Now, employers must either grant 100% vesting after no more than three years or adopt this phase-in schedule: 20% after two years, 40% after three years, 60% after four years, 80% after five years and 100% after six years.

What if you don't have a 401(k)?

If you aren't eligible for a 401(k), your first priority should be to contribute whatever retirement plan your employer makes available to you -- a 403(b), SEP or SIMPLE plan.

If you're self-employed, you can invest in an SEP or SIMPLE. Like the 401(k), these plans allow pre-tax contributions, and your money grows tax deferred.

So you can pat yourself on the back if you manage to contribute the maximum to your 401(k) or a similar plan. But don't stop there.

Love that IRA

Once you have maxed out, see if you can't squeeze out some more savings for an IRA.

Your best bet is to invest in a Roth IRA, because your investments grow tax-free and you can take the money out tax-free. But there are income restrictions.

There are two kinds of regular IRAs -- deductible and non-deductible. In both cases, your money grows tax-deferred. The added benefit to the deductible IRA is that your contributions are tax-deductible.

If you (and your spouse, if you're married filing jointly) aren't eligible for another retirement savings plan, you can contribute to a deductible IRA regardless of income. But if you are eligible for an employer-sponsored plan, you can lose part or all of your deduction based on your income.

A non-deductible IRA has no income restrictions.

Even if you can't max out on IRA contributions, sock away what you can -- and don't wait until the end of the year, says Lisa Osofsky, a tax adviser at M.R. Weiser & Co. in New York. "That way you get a head start -- set it aside early and you'll get the whole year of tax-deferred growth," she says. "As long as you have the cash to invest, it'd be nuts not to get the most out of the breaks the government is handing you."

Karen Hube is a freelance writer who lives outside New York City. Her past experience includes reporting for Money magazine and The Wall Street Journal and serving as a senior editor for Family Money magazine. She also has written for such publications as Red Herring, Self, Crain's New York Business and Working Mother. She is also an occasional lyricist for musical works that have been performed in New York and in Europe.