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Building Your Nest Egg with an IRA

Steps to Do It Right

David Bach

There is no getting around it. If you don't work for a company that offers a 401(k) plan, you must get yourself an IRA and "max it out"— meaning that you make the maximum allowable annual contribution. Thanks to the miracle of compound interest—plus the huge advantage you get from not paying any taxes on your IRA contributions until you start withdrawing them—even a relatively modest savings of a few thousand dollars a year can be transformed huge nest egg.

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What's shocking to me is that, according to the IRS, only about 10 percent of those eligible to contribute to an Independent Retirement Account actually do so. Why do so few people take advantage of this great opportunity? In most cases, it's probably because they think they can't afford to. In fact, if you look at the numbers—and consider how little you're going to get from Social Security (for most of us, the equivalent of roughly $13,000 a year)—you'll realize that if you're not participating in some other kind of tax-deferred retirement plan, you can't afford *not* to have an IRA.

IRAs come in five flavors but all have one thing in common: They give you tax breaks that make it much easier to save for retirement. Here's how they differ:

- **Traditional deductible IRA.** Your contributions may be fully or partially deductible and your savings grow tax-deferred, but your withdrawals are taxable.
- **Traditional nondeductible IRA.** Your contributions aren't deductible, but they grow tax-deferred and only part of your withdrawals are taxable.
- **Roth IRA.** Your contributions aren't deductible, but if you follow the rules, they grow tax-deferred and all your withdrawals are tax-free.
- **Spousal IRA.** If you're unemployed or retired but your spouse is still working, you can contribute to a spousal IRA, as long as your spouse has enough earned income to cover the contribution and you file a joint return. As long as your joint adjusted gross income is less than $166,000, your contribution is fully deductible.
- **IRAs for the self-employed.** Includes the SEP IRA, the solo 401(k), the SIMPLE IRA and the Defined Benefit Plan.

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Goal Setting

How do you set goals?

- I write out my life goals.
- I write out my life goals and daily goals with deadlines.
- I have goals I want to achieve, but I don't write them down.
- I think setting goals is too limiting. Life happens.
- I don't have any goals.

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In short, anyone who earns a taxable income or files a joint return with a spouse who earns an income can contribute to an IRA. But if you earn too much, you can't contribute to a Roth IRA or deduct a contribution to a traditional IRA. (In 2009, your eligibility to contribute to a Roth IRA phases out for couples with a combined gross income [AGI] between $166,000 and $176,000, and for single filers with an AGI between $105,000 and $120,000.)

As long as you're eligible, you can have as many IRAs as you want—though there is a limit on how much you can contribute in total. In 2009, the maximum is $5,000 a year, plus an extra $1,000 "catch-up contribution" for people 50 or older. In 2010 and beyond, the limits rise with inflation in $500 increments.

Some people think that $5,000 or $6,000 a year is not enough to really amount to anything. In fact, if you do it right, even a relatively modest contribution of a few thousand dollars a year can grow into a nest egg worth hundreds of thousands—even millions—of dollars.

Here's how to do it right:

Start Early, Start Now—Save Until You Retire

How much you'll have in your IRA at retirement depends mainly on three things: how much you contribute, how much your investments earn, and how many years your money has the chance to compound. It's never too late to start, but the earlier you start, the better.

Suppose you contribute $5,000 a year to an IRA, earn an 8 percent annual return, and want to retire at 65. If you were to start at age 55, you'd contribute a total of $50,000 in the 10 years before you retire, at which point your account would be worth $72,433. By contrast, if you started at 25, you'd contribute $200,000 over the next 40 years, and by the time you retired, your account would be worth $1.3 million. In other words, by starting at 25, you'd wind up contributing four times as much as you would have if you'd started at 55, but when you retired, you'd have more than 17 times as much money. In fact, if you started at 25 and contributed the $5,000 a year for only the first 10 years and then never contributed another dime, you'd still have more than 10 times what you'd have if you'd started at 55—nearly $729,000 in all. That's what 30 extra years of compounding can do.

Invest Wisely

One of the great things about an IRA is that you can invest the proceeds pretty much any way you want, not just in the choices your employer provides through a 401(k). As is the case with 401(k) plans, your goal should be to diversify your investments with a variety of mutual funds that give you wide exposure to the stock and bond markets, both in the United States and internationally. If all this seems confusing (and it should), ask your bank or broker about "target date" or life cycle funds. These are funds specifically designed for retirement savings. You pick a target date close to when you plan to retire, and the fund automatically ensures that you will have the appropriate mix of investments for someone your age—more aggressive when you're younger, gradually becoming more conservative as you approach retirement.

While there is no one "right" investment for an IRA, there are some types of investments that are clearly not appropriate. Some, like life insurance and antiques, are not allowed. Others are just bad ideas. For example, take tax-deferred investments such as municipal bonds or annuities. Because of their tax advantages, investors pay a premium for these kinds of investments in the form of reduced yields or higher fees. But any investment you put in your IRA is automatically tax-deferred, so you'd be paying this premium for an advantage you already have.

You should also think long and hard before you put investments in an IRA that cannot be easily valued and sold, such as real estate, limited partnerships or business partnerships, especially if you are getting close to the age of 70 ½, when you are required to start making withdrawals. These kinds of assets generally have to be appraised, which will cost you money, and if they can't be broken up easily, you may find yourself forced to withdraw the entire investment in order to meet minimum distribution requirements.

Know When to Start Withdrawing

The law permits you to start taking distributions from your IRA when you're 59 ½. But that doesn't mean you have to start then. When you begin withdrawing your funds depends on your circumstances.

If you're in a high tax bracket, you should postpone taxable IRA withdrawals as long as possible. On the other hand, if you're in a low bracket, you might want to immediately start taking out as much as you can without bumping yourself into a higher bracket. If you don't need to spend the money, you can pay the income taxes on it and then put it into a Roth IRA.

Remember that just about everyone is eligible for some type of IRA and even a few thousand dollars a year in contributions can make a big difference in your quality of life down the line. S

David Bach is the author of nine national bestsellers, including Start Late, Finish Rich *and* The Automatic Millionaire. *His latest book is* Fight for Your Money: How to Stop Getting Ripped Off and Save a Fortune. *Founder and chairman of FinishRich Media, Bach is regularly featured on radio and in newspapers and magazines nationwide. Visit his Web site at FinishRich.com.*

Web Exclusive from David Bach: How to Choose the right IRA for you?

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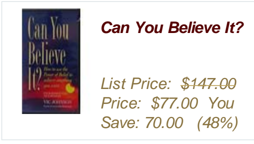

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