Affordability of Maximizing Your Roth 401(k)

With the contribution limits as high as $16,500 on your Roth 401(k) and $22,000 if you are age 50 and older, not everyone who is working can afford to maximize both their Roth IRAs and their Roth 401(k). If contributing the maximum to your Roth 401(k) means you can't make ends meet, then the story is over. If you need the money for rent, mortgage, or basic living expenses, be sure to at least contribute what your employer will match. Over and above that, contribute the most you can (please see below).

The next question is whether you have any savings. If you do, you might consider contributing the maximum amount to your Roth IRA and Roth 401(k)s and living off your savings. Over time you will be replacing your after-tax savings that were growing taxable with Roth 401(k) dollars that are growing tax free. That is a good thing. The biggest downside to this strategy is you will be giving up liquidity. If you don't need the liquidity and have the savings, then it is an easy call: maximize your Roth 401(k) contribution. If you absolutely need the liquidity in the short run, then it is also an easy call: don't make the contribution.

What if you can afford to maximize your contributions, but the money you could be putting in your retirement plan could also be used in many ways?

Before I begin this section of advice for readers who are still working and are on the borderline as to whether they should contribute the maximum to their Roth 401(k)s, I should also tell you most of my estate and investment clients are older and richer. So, I don't deal with this situation every day.

On the other hand, I have quite a few tax clients who do fit this mold and I wish they would follow this advice. Let's assume you have enough money to meet your day-to-day expenses and you can afford to maximize your Roth IRA and Roth 401(k). The problem is you might be short in other financial areas that are competing with the Roth IRA and Roth 401(k). Your problem may be that you have enough money for some, but not all of these demands.

For example, let's assume you are meeting your truly required expenses and want the following things but can't afford them all:

- Money to go beyond your basic expenses because you want to have some fun
- Contributing the maximum amount for your retirement plan
- Money for life insurance
- Money for either a first house or an upgrade to your existing house
- Money for your children's college expenses

Perhaps there are many demands on your money and the question then is which of these demands should be met and which should not.

Jonathan Clements' book, ***The Little Book of Main Street Money***, has a fine discussion regarding this issue. Jonathan's theory is that if you can't afford everything, you have to prioritize. I would recommend Clements' book. I would also refer you to his discussion of this issue on my radio show. You can reach it by going to the archives at www.retiresecure.com.

Now, I will throw in my own advice.

If you have children and you are counting on your salary to support your spouse and children until they are 18, then you need life insurance. Period. For our purposes here, getting at least $500,000—and probably closer to $1,000,000—of life insurance to support your children if something happens to you is probably a starting point for most working parents.

I also like to see a certain minimum of life insurance for the benefit of your spouse even if you don't have children. Of course your spouse's earning capacity, assets, etc. are all important considerations. I will say, however, that the vast majority of the younger people I see are under-insured, even if all they can afford is cheap term life insurance.

I know this isn't a life insurance book, but I am an advisor and I can't help myself.

The next issue is: should you put money aside for retirement or just spend more now? I like to do financial projections to determine if you are on track to retire comfortably. If the projections point to an under-funded retirement plan, maybe you should contribute whatever you can afford. I usually don't like clients to spend excessively if they are not maximizing the Roth IRAs and/or Roth 401(k)s. Again, it is a question of priorities.

Let's now assume you are spending as much as is comfortable for you and you are not willing to spend less. Let's say you also have the following competing interests for your remaining funds:

- purchasing your first house or upgrading your existing housing
- funding your children's college expenses
- funding your retirement

What should you do?

Of course this is a personal choice and your priorities will ultimately dictate what you are going to do. Let me tell you my priorities for you.

You are not going to like my answer. I think you have to make sure you have a plan on being able to retire comfortably for the rest of your life before you upgrade your housing or even put away money for your children's education.

I see the disappointment in my younger clients' faces when they hear me say this. My starting point is food on the table, shelter over your head, and gas in the car no matter what. If you don't have a way to meet these minimal expenses, then you have to put away money, preferably the maximum, into your retirement plan.

Many experts will tell you how real estate, particularly your home, is the best investment there is. That certainly hasn't been true lately. I think it would be more accurate to say that if investing in real estate is your profession that is a different thing. What I don't like and I see all the time is young couples over reaching to be in homes they think they can afford—but can't. Because some banker or mortgage broker motivated by a commission he will make gives you a mortgage doesn't mean you can afford the property. Right now millions of people are losing homes that they should never have purchased in the first place. True, many are victims of losing their jobs through no fault of their own. But many just bought more house than they could afford.

This doesn't count the additional millions who aren't losing their homes but are struggling to keep them.

I will readily admit that given today's interest rates and the price of housing, it seems like a great time to buy. That might even be a reasonable risk. Some would say if you buy now at a great price and you lock in a long-term fixed mortgage at a reasonable rate, you would be doing well. They are probably right. That has to be a consideration. Getting a good price on a house at good interest rates certainly tips the scales closer to buying or upgrading than to contributing the maximum to your Roth 401(k). Personally, I would prefer that you have the option of retiring securely when you prefer. You may not be happy if you are forced to continue working because you spent too much money on a house you could not really afford. Remember! A more expensive house is more than the mortgage. There are also more expensive real estate taxes and more expensive maintenance. You also face this issue: your children are surrounded by kids whose parents have more money than you.

My parents were house poor. My Mother fell in love with a big house in a nice neighborhood right before I was born. She walked into the house and saw a foyer that was the perfect size for two parlor grand pianos. They bought the house. Even though my Mom was a college professor and my Dad was a lawyer, too much of their income went to support the house. I certainly admit it was pleasant growing up in a nice house and I live in that house today. The pressure on my father to make money and continue working beyond when he was ready to retire makes me question that decision. Had we been in a less expensive house with a lower mortgage, lower maintenance, and lower real-estate taxes, I think my parents would not have had the financial pressures they did. My Dad worked until his death at age 71. He would have preferred to retire earlier, but it wasn't an option. Too much money went into the house.

Okay, I am done with my "don't-spend-too-much-money-on housing" tirade.

My next tirade might be equally painful and will seem like a blow right to a lot of overly protective mothers' hearts. You should provide for your own retirement before your children's expensive college education. Again, this is a matter of priorities. Somehow, with loans, scholarships, or—God forbid!—your precious children actually getting jobs—your kids will survive. They will probably do better than if you give them too much too early. I grew up in a culture where my parents paid for a four-year education at a state school. Anything over and above that—a more expensive school or graduate school—was on us. My brothers and I had part-time jobs at college and worked over the summers for spending money. If we couldn't get a job, we washed cars, shoveled snow, or did whatever we could. I don't think that if money is tight, limiting what you will pay for your children's college expenses is a bad policy.

After I graduated, my father presented me with my first dentist bill. I had to get a job and I started work in a CPA firm. When I wanted to go to law school, I continued to work as a CPA. I worked in the Tax Department of Arthur Andersen (one of the old "Big 8" that is now dissolved) and later in the Tax Department for a large law firm (Buchanan Ingersoll) in Pittsburgh during the day and went to law school at night. I was a much better student when I went to law school on my own dime than as an undergraduate when I was on the family dole.

I hate to see clients jeopardize a comfortable retirement because they are pampering their children and paying for all their adult children's expenses, including paying for all of an expensive college education. One good book on the issue of teaching children to be financially fit is ***Money Doesn't Grow on Trees*** by Neale Godfrey. You can also listen to me interview Neale in the archives of my radio show found at www.retiresecure.com.

I know these issues of savings vs. housing vs. children's education are tough. I have friends who have overspent on their housing or they fund their children's college expenses before their retirement. Somehow, I suppose they will get by. I don't think they will be able to rely on their spoiled, expensively educated little darlings to provide for them when they retire. Realistically, unless they inherit money, they will probably just have to keep working longer—assuming they can keep their job.

You might be curious as to what I did with my own money. When I was 41, 13 years ago, my wife and I and our three-year-old baby moved out of our perfectly fine $500/month apartment to purchase a house that after renovations cost over $400,000. It was a lot for a house in Pittsburgh back then. We actually bought it from my Mom; it is the house I grew up in. We got a little break because there were no real-estate transfer taxes and no real-estate commissions. So, even though I got a good deal and my Mom was satisfied and the house was staying in the family, I violated my own rule. We also contributed money to our daughter's 529 plan. At the time, we did not have sufficient money nor were we on track to have a comfortable retirement. Do as I say, not as I do.

Call me a hypocrite. I am guilty.

The way I justified the decision was: I figured my business would improve and my income would grow. That has happened, in large part due to being able to attract clients by helping them with Roth IRA conversion advice. I lucked out. You may not. Subject to some exceptions, if money is tight, take care of your retirement before the big house and over spending on your children's education.

I will also freely admit most of my younger clients don't listen to me because they want the bigger house and the education funds for their kids. It really kills me when a bright child gets a full scholarship to a good university but prefers a different university that costs the parents $50,000/year. If you can afford that for your kid or kids and you want to pay for that expensive school—that is fine. But what if you can't afford it?

How many additional years of working will it take you to save that $200,000? Is it really worth it?

I have a 55-year-old client who is living in an expensive house and will fully pay for all his little darlings' expensive college expenses even after they turned down a scholarship to a perfectly fine school. Unless something out of the ordinary happens, he will have to work in a job he doesn't enjoy until he is at least 70 to reach a point. Because of his age and the current state of the job market, he will be lucky to hang on to his job. Will the bigger house and the satisfaction of knowing he paid for his children's expensive education be worth it? It is a matter of priorities.

Another thing that bothers me is paying for your adult children's living expenses when you can't really afford it. If you can afford to help out your adult children and choose to do so, fine. For estate-planning purposes, I often advocate a series of regular gifts. That is a different issue. I am talking about times when you really can't afford it but you are sending your kids money anyway.

I have a retired client who is on the border line of having a secure retirement. He has an unemployed adult child living in his house. While that isn't desirable, I really get perturbed when I see the gardener cutting his lawn, the snow service shoveling his sidewalk and driveway, and the painters coming in to paint several rooms in the house. His perfectly healthy unemployed son is too lazy to help out.

The group that I would let slide and say it is okay to fund your children's expensive college expenses when money is tight are people with really secure jobs that they love. I have over 100 college professors as clients and many—if not most—of them will work well beyond age 65 by choice, even if they don't need the money. Their jobs are solid and they love what they do. They value a good education at a top school. They typically have large balances in their retirement plans (Usually TIAA-CREF). They—and readers with similar situations—can afford to finance their children's expensive education even if money is tight. This is not the case for a reader who doesn't love his job and who has limited retirement funds.

Most of my clients today are older and are well off. They worked for a long time and they consistently put the maximum into their retirement plans at work. Most of my clients who did not contribute consistently to their retirement plans are not nearly as financially secure. Life is all about making choices, make yours wisely.