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Cutting or Stopping Contributions to Your Retirement Plan—A Bad Idea, Even Now

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Article Tools:

Facing a recession and a down stock market, many people are stopping or cutting back their contributions to retirement plans like 401(k)s, IRAs and SEP IRAs.

Unfortunately, they don't understand that in doing so they are both increasing their income taxes now and hurting their retirement savings for the future.

While fear of being laid off is motivating some people, more people are cutting back because they feel they'll be crimping their lifestyle by saving.

It's important to understand that the money you're putting away reduces your federal and state income taxes. I worked with one family where both spouses stopped contributing to their 401(k) plans and they couldn't understand why they were suddenly paying so much tax.

Take a married couple, filing jointly, that makes \$150,000 a year. Each spouse under age 50 can contribute a maximum of \$15,500 to a 401(k). Let's say the husband stops contributing. That increases taxable income by \$15,500, resulting in \$4,340 more in federal income tax and about \$1,085 more in state income tax if they live in Maryland, for instance.

Additionally, the 401(k) contribution also reduces your FICA tax (but not the Medicare tax). Altogether, the couple is losing nearly \$6,500 in tax benefits, so the out-of-pocket cost of putting away \$15,500 a year is only about \$9068 a year.

Many tax credits phase out or are limited for upper-income earners. Contributing to your plan may let you take full advantage of the dependent-care, dependent-child, and tuition credits. And contributing may keep your income below the level at which itemized deductions are reduced.

Equally damaging, is that by not contributing you won't have as much in your retirement plan(s) when you retire. Investments in retirement plans grow faster tax-free until they're withdrawn.

Most employers provide an employer match, and you'll lose that free money too if you don't contribute.

"But I'm Afraid of Losing My Job"

Even if you're worried about losing your job, keep contributing as much as you can afford.

You might not lose your job—and then you won't have saved anything and be paying higher taxes on top of that if you haven't contributed.

If you think you may need the money, consider contributing to a Roth IRA. While contributing to one doesn't reduce your taxes, a Roth IRA is liquid because you can take out the basis tax-free. If you socked away \$10,000 in a Roth IRA and it's now worth \$14,000, you can take out the \$10,000 anytime without paying a penny in taxes. Only the growth is taxable if withdrawn.

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