A New Opportunity for Retirement Savings

IRA, 401(k) plan limits skyrocket in 2023: Can you afford to max out?

by Alexandra Armstrong, CFP®, CRPC® & Christopher Rivers, CFP®, CRPC®

Inflation grabbed headlines in 2022, as prices for homes, cars and everyday goods jumped significantly. For many, this was their first experience with pronounced inflation, as the Consumer Price Index remained above 5% for most of the year. For more experienced investors, memories of the 1970s came rushing back.

Inflation hurts consumers by increasing expenses and it hurts savers as increased costs eat into nominal investment returns. But there is a silver lining for those who are still working and have the ability to contribute to a 401(k) and/or individual retirement account.

The Internal Revenue Service increased retirement plan limits and phaseouts significantly for 2023, allowing taxpayers to save more than ever for retirement. In fact, the limits on company sponsored retirement plans have increased so much that truly "maxing out" retirement plan contributions may be out of reach for many investors.

401(k) LIMITS BALLOON THANKS TO INFLATION-RELATED ADJUSTMENTS

For 2023, the IRS bumped up contribution limits to 401(k), 403(b) and 457 plans by nearly 10%.

The maximum contribution to these plans jumped to $22,500 for 2023, up from $20,500 last year. In addition, the catch-up contribution for those over age 50 was increased by $1,000, to $7,500. As a result, investors over age 50 may now contribute up to $30,000 to their 401(k) plan for 2023.

Keep in mind, this limit does not include any employer contributions. The total limit on contributions to a 401(k) plan from both employees and employers is $66,000 for those younger than 50 in 2023 and a whopping $73,500 for those 50 and older. Thus, your employer can make matching or profit-sharing contributions of up to $43,500 on your behalf. These limits apply to both traditional and Roth 401(k) contributions.

IRA AND ROTH IRA LIMITS INCREASE AS WELL

The IRS announced similar increases to the limits on IRA and Roth IRA contributions, though the lower overall dollar limits on IRAs means the amount of the increases is more modest. For those under age 50, the maximum IRA contribution moved up to $6,500 for 2023, from $6,000 last year. Taxpayers over 50 get an additional $1,000 catch-up contribution, bringing their maximum contribution to $7,500 for 2023.

In addition, the income limits on Roth IRAs were increased, potentially opening the door for more taxpayers to make after-tax contributions. To fully contribute to a Roth IRA in 2023, your modified adjusted gross income (MAGI) must be below $138,000, up from a limit of $129,000 last year. Between $138,000 and $153,000 MAGI, you can contribute to a Roth IRA at a reduced amount, while taxpayers with more than $153,000 in MAGI are phased out entirely.

For joint taxpayers, the phase-out range MAGI is between $218,000 and $228,000. Joint taxpayers below the $218,000 threshold can each contribute the max to a Roth IRA for 2023. Note that unlike a Roth IRA, the Roth 401(k) has no income limits on contributions, making it particularly attractive for higher earners looking to make after-tax contributions.

IS MAXING OUT YOUR CONTRIBUTIONS FEASIBLE?

Given the magnitude of the increases, you may feel like reaching the maximum contribution limit is out of reach. If so, you're not alone. A 2021 study by Fidelity noted that just 9.7% of participants in Fidelity-sponsored 401(k) plans contributed the maximum amount. Similarly, a report by Vanguard found 14% of participants in their plans were reaching the maximum contribution. The majority of those maximizing in the Vanguard study were earning $150,000 or more.

As we can see, the majority of participants are not contributing the max, given how much discretionary income is needed to set aside up to $30,000 per year.

Even in a traditional 401(k) plan, where tax savings negate some of the lost cash flow, the impact is still significant. Take the example of Anne, a single 55-year-old earning $200,000 per year. After deductions Anne is in the 24% tax bracket and we will assume she pays state taxes at a rate of 5% as well. By contributing the maximum $30,000 (including the $7,500 catch-up) to her company 401(k) plan, Anne would save approximately $8,700 in taxes. Thus while she contributed $30,000, the change to her net cash flow would be $21,300. This illustrates the power of maximizing your tax savings with a traditional 401(k) plan. However, even at Anne's elevated income level, this still reduces her after-tax take-home pay by 15%.

In order to approach the maximum contribution level, you must have a clear cash-flow plan in place, giving you certainty that you have the ability to meet current living expenses from your take-home pay. In Anne's situation,

she would need to be certain that she could fund her living expenses and other goals from the remaining 85% of her take-home pay.

In addition, she should have an emergency cash reserve of at least three to six months on hand to plan for contingencies. As we experienced in 2020, circumstances can change in an instant. While you may be able to tap into your 401(k) plan in an emergency, via a loan or early withdrawal, the costs are steep. Loans must be repaid with interest, using your after-tax dollars.

Early withdrawals meanwhile are taxed at your ordinary tax rate and assessed an additional 10% early withdrawal penalty. In Anne's case, an early withdrawal of $10,000 would be reduced by a federal tax of $2,400, a state tax of $500 and an early withdrawal penalty of $1,000, leaving her with just $6,900. Clearly, a cash reserve is a better source of emergency funding than taking a loan or early withdrawal from your 401(k).

CONTRIBUTION GOALS

Nevertheless, for higher-earners or empty nesters no longer paying to feed, clothe and educate their children, reaching the max contribution limit may be within reach.

For those earlier in their careers or at lower income levels, the max can often seem unattainable. A more productive approach can be to concentrate on saving a percentage of income in your retirement plan each year. Various studies recommend a savings rate of 15% over your earning career to provide enough in assets to replace 70%-85% of your pre-retirement income.

The starting point for most should be to contribute enough to earn the maximum matching contribution from your company. From there, as cash flow frees up thanks to career progression or changing expenses, you can build towards the maximum.

Wherever you start, it is crucial you remain diligent about increasing your contributions as your career progresses. When you receive a raise or a bonus, designate a portion of this money towards increased retirement plan contributions. You'll see an increase in your bank account and you'll accelerate your retirement savings at the same time.

CONSIDER THE ENTIRE PICTURE

While maximizing your retirement plan contributions is a worthy goal in a vacuum, it is critical to frame your savings rate within your overall financial plan. At any given stage of life, you will have goals and expenses competing for your dollars. As noted above, the benefits of maxing out contributions to your retirement accounts can be negated if you need to withdraw those funds in a pinch.

In addition, housing, education and health care expenses make up a significant portion of the expenses of the average household. Working with a financial planner on a comprehensive financial plan will give you a clear view of your cash flow and expenses, as well as your household budget, and will help you lay out a plan to best direct your income towards your savings and spending goals.

Maximizing your retirement contributions is the clearest path toward building a comfortable retirement on your own terms.

CONCLUSION

If you have the ability to do so, maximizing your retirement contributions is the clearest path towards building a comfortable retirement on your own terms. But for many, it remains an aspirational goal. Until those aspirations are met, energy should be focused on contributing the maximum amount that your situation allows, habitually increasing your savings rate as your career progresses and regularly assessing your overall financial situation with a financial plan.

Alexandra Armstrong is a CERTIFIED FINANCIAL PLANNER™ professional and Chartered Retirement Planning Counselor℠ and founder and chairman emeritus of Armstrong, Fleming & Moore, Inc.. Christopher Rivers, a CERTIFIED FINANCIAL PLANNER™ professional and Chartered Retirement Planning Counselor℠ and co-author of this article is a principal of Armstrong, Fleming & Moore, Inc., located at 1800 M St. NW, Suite 1010-S, Washington, D.C. 20036-5813, 202/887-8135.