Creating the next awesome, must-have social media app and then selling it to Apple or Google is one way to an early retirement. Not a programmer? Not to worry. Here are five common-sense steps to get you on the road to retiring while still young.

Five steps towards EARLY RETIREMENT

STEP 1

SAVE EARLY SAVE OFTEN

If you haven't heard of The Rule of 72, it's a fast and easy way to picture your wealth growing. It goes like this.

Take the number "72" and divide by the average rate of return that you expect to get on your investments.

The result is the number of years that it will take your money to double. For example, if I put my money in a broad-market index fund, like the S&P 500, and that fund averages 7%; then in a little over 10 years, it will double that initial investment, and in 31 years, it will have increased 7-fold.

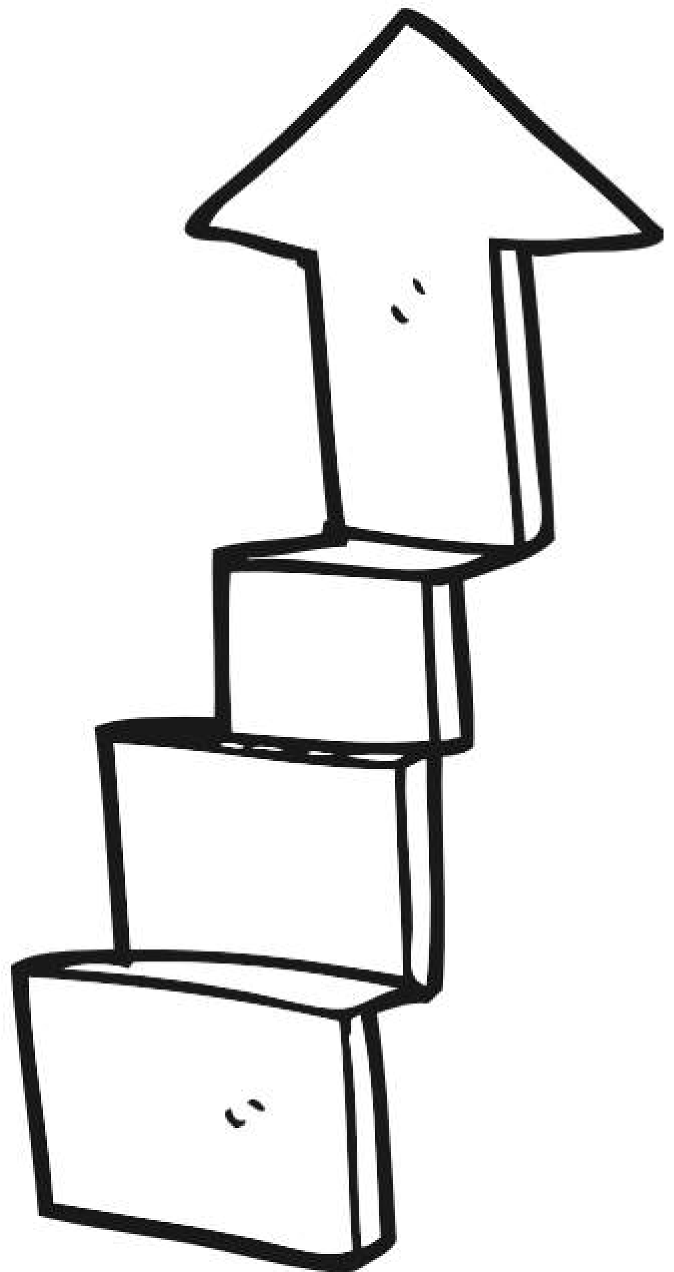
For example, if you invest $5,000 and get an average of 7% per year return on that investment, you will have over $40,000 31 years later. The stock market has returned more than 7% in the past, but knowledgeable investors (the likes of Warren Buffet) agree that 7% is reasonable in today's low-inflation environment.

RULE OF 72

72 / 7 = 10.3 (THE NUMBER OF YEARS IT WILL TAKE TO DOUBLE YOUR MONEY, ASSUMING A 7% RATE OF RETURN)

STEP 1: SAVE EARLY, SAVE OFTEN

The best place to start, if you work for someone else, is with your employer-sponsored plan. This is because many employers offer a match, which is often around 3%. So, let’s say that I am 30 years old and make $65,000 per year. I put $10,000 per year into my 401(k) and my employer contributes 3% or $1,950. In that hypothetical index fund returning 7% on average, I will have over $800,000 by the time I’m 55. Note that the maximum you, as the employee, can contribute to a 401(k) or similar employer-sponsored plan, is $19,500 per year. Once you turn 50, you can make an extra $6,500 per year of “catch up” contribution.



The tax-deferred nature of your employer-sponsored plan also has advantages. The first is that, since you save on taxes in the current year, you can afford to put a bit more in and still have enough to live on. The second is that more dollars keep working every year, since none get siphoned off to pay taxes until you take the money out in the future. Even when you start using the account, you are still only paying taxes on the amount you take out. If you work for yourself, you can still work with your tax and financial professionals to create an employer-sponsored plan for yourself.

STEP 2

GO ROTH

Employer-sponsored plans and traditional IRAs leverage tax-deferral to grow more rapidly. Eventually though, you still have to pay taxes on that growth. Your hypothetical $800,000+ discussed above? It's ALL taxable when you take it out since it all went in before you paid taxes on it. However, what if at least some of it wasn't? What if you could earn money on your money and the IRS would never take their cut? Even if it sounds too good to be true, it actually isn't—and how many times can you say that in the context of taxes?

The Roth IRA works something like the traditional IRA, except that you don't get a tax deduction for contributions as you make them. Whatever you put in your Roth this year is money on which you have already been taxed. But—and this is a big "but"—you NEVER have to pay taxes on any returns that your contribution generates.[1]

Does it make a difference? Well, let's see. Let's assume that each year between 30 and 55 you fund your IRA with $5,500. By contributing to a Roth rather than a traditional IRA, you forego $20,625 in deductions over the next 25 years if your marginal rate is 15%. With that traditional IRA, though, you will eventually pay more than $50,000 in taxes at that same marginal rate, because you will be paying taxes on not only on all contributions, but on all the growth those contributions generated.

STEP 2: GO ROTH

Of course, the ability to contribute to a Roth IRA is phased out for singles with incomes between $120,000 and $135,000 with contributions, precluded for those who make over $135,000 for 2018. For couples, the phase out is $189,000 to $199,000 for 2018. Even so, there are alternative routes to taking the Roth advantage.

If your income is too high, you can make so-called "back door" Roth contributions. The ability to contribute to a traditional IRA is not limited by income, although higher-income earners do not get a tax deduction for the contribution. Earners, who exceed the Roth thresholds above, can contribute non-deductible (after-tax) dollars to a traditional IRA and then convert amounts from that IRA to a Roth. Typically, taxes would be owed on growth at the time of conversion but if the conversion happens soon after the contribution, that growth will be minimal.

Also, some employer sponsored plans offer Roth options WITHIN the 401(k) or similar plan. Unlike with Roth IRAs, there are no income restrictions on contributing to the Roth option of your 401(k). Again, you are foregoing the tax deduction up front, but you are gaining from not having to pay tax on the growth when you withdraw the funds.

1 This has been true since Roth IRAs were established in 1997. Of course, tax laws may be subject to change.

STEP 3

WATCH EXPENSES

I'm sure most of you reading have heard the advice to give up your $5/day flavored, whipped-cream-topped coffee drink habit and invest the savings.

And yes, if you do the math, that adds up to $1,250/year in additional investment even if you still splurge while on your two-week's vacation. Beyond that, though, it is worth tracking your expenses, particularly since many banks have made the process easy to do online. Being aware of how much your lifestyle is costing you has advantages. It lets you prioritize.

For some people, it may be worth it to give up every single small luxury to push retirement forward a few years. For others, eliminating every single non-essential expenditure might leave them so depressed, they'd never make it to retirement.

If you know the relative cost, though, you can make intelligent trade-offs. Maybe you go down to three lattes a week or maybe you steel yourself to 5 days of burnt break-room coffee only and splurge on your Saturday nights out. Or maybe the best option is a Keurig® for your cubicle.

Tracking and then moderating your expenses also sets you up for a reasonable and sustainable spending pattern IN retirement. One and a half million dollars sounds like a lot to most of us, but that only provides for about a $50,000 a year retirement lifestyle (not considering ongoing investment returns or inflation, which work in opposite directions) if you retire at 55 and live to 85. Those of us who hope or expect to get a few more years would have to opt for an even more restrained lifestyle to make that money last.

STEP 4

MAXIMIZE YOUR EMPLOYEE BENEFITS

One way to manage your expenses and maximize the disposable income left for investing is to take advantage of every applicable employee benefit. If we didn't before the ACA (Affordable Care Act), all of us are sure to sign up for group health insurance now. Furthermore, most of us put at least something into our employer-sponsored plan and get the match. However, in some cases, that's just the beginning. Benefits manuals are way up there with tax forms and product-assembly instructions for reading pleasure and clarity; but taking a deep dive into what your employer offers can save you money.

Most employers offer more than one health insurance option and it can pay to compare. If you are relatively healthy, you may want to take a plan with a higher deductible and lower premiums. If your employer offers a true high-deductible plan, consider opting for that one and opening a Health Savings Account (HSA). You can contribute up to $3,550 to an HSA for yourself, and up to $7,100 for your family. Of course, once the money is in the HSA, there is a 20% penalty for any withdrawals for non-health expenses. However, contributions not used in the current year can roll over indefinitely, grow tax-deferred and be used without penalty for non-health expenses after 65 (although tax would then be owed on the growth). This allows you to pay for health care expenses with dollars that are never taxed. In addition to basic health insurance, make sure to check out vision insurance, especially if you wear glasses or contacts, and dental insurance.

STEP 4: MAXIMIZE YOUR EMPLOYEE BENEFITS

Other employer benefits that can add to your bottom line if used correctly are: accounts that collect pre-tax contributions for child- and dependent-care expenses, actual child- and dependent-care assistance, discounts for on-site child-care, tuition assistance, public transit and parking passes, expense reimbursement (buy a hand-held receipt scanner or get the app for your phone to keep track), free or reduced-cost gym membership, adoption assistance, and discounts on financial planning services. Even if your employer does not offer these benefits, talk to your tax professional to make sure that you are taking advantage of things like child- and dependent-care credits and unreimbursed employee-expense deductions.

STEP 5

SOCK AWAY UNEXPECTED INCOME OR SAVINGS

If you are watching expenses and making the most of your employee benefits, you may be spending or saving every budgeted penny in an efficient manner. Sometimes, though, you are surprised by unexpected income or savings like a larger-than-expected bonus, a small inheritance, or a larger-than-expected tax refund. Since you never “had” this money in your original budget, whisk it away immediately into savings that are designated for retirement.

This is a particularly good year to keep this in mind because of the recently enacted Tax Cuts and Jobs Act. Some people, of course, will end up paying more taxes under these new rules; but some people, particularly those at more modest income levels, may pay less. If you never itemized before and you have few or no dependents, you may get a boost from the larger standardized deductions. If you are self-employed through an LLC or partnership, you may benefit from the 20% deduction on income that “passes through” these entities. The TCJA has quite a few moving parts and you will need to work with a tax professional to sort out how it affects you. However, IF you end up paying less tax under the new rules, you can leverage the savings towards your early retirement.

Even if 60 is the new 40 and some of us like our day jobs, many of us have dreamed about being free from the constraints of employment before we qualify for Medicare. These five steps can help—even if that doggie-dating app never gains critical user mass.

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