What’s The Best Way to Prepare for Retirement As A Teen?

401(k), Roth IRA, Golden Coins…? Oh, there are so many options for retirement. However, the best method of retirement investment may not be the one your parents (or even financial advisor) recommend. As a young investor, aged under 25, a “traditional” retirement savings account may not be the best option.

A Brief Overview of Retirement Savings Accounts

There are several types of retirement accounts. Before understanding what’s the best account for you, let’s review your offerings.

401(k) or 403(b) Offered By Your Employer

One of the simplest for many, a 401(k) plan through your employer. Money for the plan is withheld from your paycheck and in many cases an employer will match your contribution. Note: A 401(k) is usually offered by a for-profit company, while teachers and other employees of nonprofits may be offered a 403(b) instead

Contribution limit: you can save up to $19,000 of your pre-tax income in 2019 ($25,000 if you are 50 or older).

Solo 401(k)

An individual proprietor can set up an individual 401(k) and make contributions as both the employee and employer. With both the employer offered and solo type of 401(k) contributors pay tax they withdraw their earnings and contributions.

Contribution limit: you can save up to a total of $56,000 in 2019 (or $62,000 for someone 50 or over).

Roth 401(k)

The Roth 401(k) is similar to other 401(k) plans except you are contributing after-tax dollars, and contribution limits are lower.

Contribution limit: you can save up to a total of $19,000 in 2019 (or $25,000 for someone 50 or over).

Roth IRA

A Roth IRA allows you to stash away after-tax income, meaning when you reach retirement, 100% of the money you see in your account is yours. Keep in mind that eligibility for a Roth account depends on income – you must earn at least $122,000 but less than $137,000 per year (if you file single, joint filings are different).

Roth *contributions* can be withdrawn penalty and tax free at any time, even before age 59½.

Contribution limit: you can save up to a total of $6,000 in 2019 (or $7,000 for someone 50 or over).

Normal/Traditional IRA

A Traditional IRA allows you to stash before tax income – and worry about paying Uncle Sam later. You are still subject to the income eligibility limitations.

A big difference between the Roth and Traditional is when the savings must be withdrawn. Traditional IRAs require you to start taking required minimum distributions. These are mandatory, taxable withdrawals of a certain percentage of your funds at age 70½, whether you need the money at that point or not.

Contribution limit: you can save up to a total of $6,000 in 2019 (or $7,000 for someone 50 or over).

 Side Note: Choosing between a Roth and Traditional IRA. When choosing between a Roth and Trad, you need to consider taxes. You pay taxes now when contributing to a Roth, but you pay taxes on distribution (when you're 70 ½) with a traditional. To save the most money and choose the best IRA, you need to predict when you will have the highest taxes. If you feel like you will be in a higher tax bracket now, you should choose the Trad, and vice versa. You are effectively attempting to predict tax rate, and choose based on that prediction.

SEP IRA

A SEP IRA is a type of IRA for self-employed individuals or small business owners — anyone with one or more employees, or freelance income.

This type of plan is similar to the Traditional IRA: money in a SEP IRA is not taxable until withdrawal. It also require minimum distributions beginning at age 70½

Where it differs is the contribution limit (which is almost 10 time the Trad contribution limit). SEP IRA contributions, like the solo 401(k), cannot exceed the lesser of:

- 25% of compensation
- $56,000

We discuss this type of contribution further in the next section.

Contribution limit: $56,000

There are a few more that are less common, and probably wont apply to your situation, but if you're interested in learning about them, click here. Additionally, to keep this article at a manageable length, I didn't include all of the information on each retirement plan. To learn more about them, do a quick search on Investopedia.

What Plan Is Best For You?

Contributing to a 401(k) almost always is better than an IRA because you can stash away a lot more money. As your income grows, so can your contributions. While you're limited at $6,000 for Roth IRA's, with a self directed 401(k) the limitation is much higher.

For the many people on the journey to Millionaire By 25 and beyond, you'll be creating business, working multiple jobs, and experiencing massive variations in incomes. Because you won't be stuck at one employee, seeing varying degrees of monetary success over the years, and probably run your own company, the self directed 401(k) may be the best option for you. It provides flexibility, a high contribution limit, and simplicity.

A Solo 401(k) makes a lot of sense for sole proprietors, owners of an S Corporation, C Corporation or partnership (without employees). With the plan, you contribute *elective* and *non elective* contributions. Elective contributions come from your pay, which you choose to put into the retirement plan. Non elective contributions are from you business to your account.

The limit for elective contributions in 2019 is $19,000, or $25,000 if aged 50 or over. With non elective contributions the max contribution cannot exceed $56,000, but the actual amount will depend on the type of business you own.

If your business type is a Corporation, the maximum profit sharing contribution is 25% of gross income and still subject to the above non elective limitations.

If your business type is a Sole Proprietor/Partnership, the maximum profit sharing contribution is 20% of net income and still subject to the above non elective limitations.

It’s important to note that if you decide to take the full $19,000 for the elective contribution, you are limited to making $37,000 in non elective contributions so that your contributions *do not exceed $56,000.*

Here’s an example: Jeffery, age 23, earned $90,000 in W-2 wages from his S-Corp in 2019. He deferred the maximum amount of $19,000 in as an elective contribution to the 401(k) plan. His business contributed 25% of his compensation to the plan, $22,500. Total (an the max amount of contributions) contributions to the plan in 2019 was $41,500.

Keep in mind, you can roll many plans into others. If you end up working for a large company, you can roll your self directed plan into theirs (and vice versa). Additionally, you can have multiple retirement plans at once — just make sure you don’t exceed the contribution limit, which remains the same regardless of the number of accounts you have.

While the solo 401(k) may be the best for entrepreneurs, a Roth IRA is also quite appealing for other reasons. If you as a 20-year-old put $5,000 a year into a Roth for 10 years and then stop contributing, 10 years of Roth contributions and growth at 8% CGAR would grow to about $1,070,944 of tax-free dollars at age 65.

Retirement Strategy for Age 16-25

It’s important to review which plan would work best for you personally. I recommend the Solo 401(k) above, but each person should decide on their own what would be best for them. At this age, choosing the best plan depends on their future.

By choosing to start thinking about retirement at this age, you don’t need to work as hard as others because of the magic of compound interest. My advice is to contribute as much as possible (ie. put 100% of your earnings into the plan) at this age, while you don’t need to worry about bills, rent and payments.

If you contributed $4,000 per year into a Roth IRA starting at age 16 for 15 years, then stopped, you would not need to contribute any more money into your savings account to retire comfortably. By sacrificing in the short term now, you achieve massive long term results and comfort.

Some Hypothetical Returns (Assuming 9% CGAR)

Account Type	Average Annual Contribution	Years Of Contribution
Roth IRA	$6,000 (Max)	48 (Begin at age 20)
Total amount invested	Retirement Age	“Nest Egg”
$288,000.00	68	$4,475,193.33

This first hypothetical situation refers to a person who chooses an IRA. Note that their limit is $6,000 per year.

Account Type	Average Annual Contribution	Years Of Contribution
Solo 401(k)	$13,000	45 (Begin at age 25)

Total amount invested	Retirement Age	“Nest Egg”
$585,000.00	70	$7,451,418.08

This second hypothetical situation attempts to mirror a real estate investor. After building capital this investor purchases his first property at age 23. After building his portfolio, he begins to invest income into a Solo 401(k). As saving for retirement is a priority, this investor averages his annual contribution at $13,000 per year. When he retires, he has a full real estate portfolio, and retirement savings of $7.5 million dollars.

Account Type	Average Annual Contribution	Years Of Contribution
Solo 401(k)	$3,000	54 (Begin at age 16)
Total amount invested	Retirement Age	“Nest Egg”
$162,000.00	70	$3,777,276.23

With a focus on retiring with a large, a young investor begins a solo 401(k). Starting at 16 years old, he/she invests their entire paycheck for four years into their account. As their income increases, they continue investing only $3,000. By age 25, their retirement savings are already $42,578.80, and their fund is returning about $4,000 per year. By sacrificing their income in the first few years, compound interest is given more time to do it’s work, and the investor retires with a similar balance to the first

A 9% CGAR is on track with stock market returns in the past 100 years, but if you’re a good investor, you can achieve an even higher CGAR by investing in real estate, active higher risk stocks, or commodities.

□Keep In Mind□ The average annual contribution doesn’t equal the specific contribution that you make each year. For example, if you contribute 3218 on year one, 1495 on year two, 5102 on year three, 4259 on year four and 1868 on year five, it will still average out to be an average contribution of $3000. Practically, this means that by increasing your contribution as your salary increases will end up averaging to one of these figures (it is easier to calculate this way). However, keep in mind, if the figures deviate to much from the mean over the lifespan of the investment, your “nest egg” will differ (compound interest).