

# Saving Beyond a 401(k)

## Schwab Center for Financial Research

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### Key Takeaways

- Once you've set up a financial plan that includes a foundation of emergency savings and debt reduction, we believe investors should save as much as possible in tax-advantaged accounts, due to the tax efficiency these accounts offer over time.
- Consider strategies beyond traditional 401(k) contributions when looking for ways to maximize your savings to meet your retirement goals.
- The numerous account types and saving strategies can be overwhelming, which is why we propose a suggested priority ranking to consider.

### Overview

We believe one of the best ways to help achieve your savings and retirement goals is to consider and take advantage of contributions to the tax-advantaged accounts available to you. As outlined in [Schwab's Savings Fundamentals](#), the first step to saving for retirement is to contribute enough to your workplace retirement plan to get the full company match, if one is available. Then, pay off nondeductible, high-interest rate debt like credit cards, and fill up an emergency fund with at least three months of essential living expenses.

Once you've built a strong financial foundation and have saved for any other goals – such as a home purchase or a child's college education – consider prioritizing savings in tax-advantaged accounts. The decision as to which accounts to contribute to can be deceptively complex since each account type has distinct benefits and limitations. On page 2, we propose a priority ranking to consider of the most common accounts to help you maximize your savings, while also taking into consideration the tax efficiency of each option.

#### I. Maximize Health Savings Account (HSA) contributions (if available)

If you have a high-deductible health plan, consider saving the maximum within your HSA. A HSA can be a powerful saving tool because it offers a triple tax benefit. You get a tax deduction for contributions, the investments can grow tax-free, and you can use the money for qualified medical expenses at any time penalty and tax-free.

If you're fortunate enough to not need the money for medical expenses, a HSA can be used like a traditional IRA once you reach age 65. Any distributions for non-medical purposes will be taxable, but

they won't be subject to a penalty. Learn more about the potential long-term benefits of investing your HSA in [this article](#).

#### II. Max out your employer-sponsored plan (ESP) retirement contributions

Maximizing contributions to an ESP (including 401(k), Roth 401(k), 403(b), and 457(b) plan) can allow your investments to benefit from tax-free compound growth. Consider contributing to an ESP over an IRA, because ESPs offer higher contribution limits and lack the income limitations of IRAs.

ESPs may offer traditional tax-deferred and/or Roth contribution options, depending on your specific ESP.

To learn more about which type of ESP may be better for you, refer to Schwab’s [Roth IRA vs Traditional IRA comparison](#), which can be applied to IRAs or ESPs.

ESPs come with a few unique features unavailable to IRAs, including the ability to take loans out against balances or to take distributions if there is a hardship. ESPs also come with the ability to take distributions without penalty if you retire from your current employer at age 55, making an ESP a great option for those considering an early retirement.

However, ESPs can have a few downsides, such as limited investment options or the potential for higher fees.

### III. Consider traditional or Roth IRA contributions

Though ESPs offer higher contribution limits than IRAs, almost everyone can save in an IRA if you have earned income. However, if you or your spouse is part of an ESP, your tax deduction for contributions to a traditional IRA could be limited. And if your income is over certain limits, you may not be able to directly contribute to a Roth IRA (refer to the IRS for more information on [IRA contribution limits](#)). However, almost anyone can make after-tax contributions to a traditional IRA account (see the following sections IV and V).

IRAs can offer some benefits not found in ESPs, including more investment options and, in some cases, lower fees.

### IV. Consider a Roth conversion on after-tax contributions

Once you’ve maxed out the normal contributions to tax-deferred or Roth accounts, you may still be able to make contributions to tax-deferred IRA and/or ESP accounts, however, those contributions will have to be with after-tax dollars. The downside of after-tax contributions is you don’t get an upfront tax deduction, but once the assets are in one of these tax-advantaged accounts, they have the potential to grow tax-free. Once you are in retirement, the portion of a withdrawal related to the after-tax contributions (the original principal) is tax-free and any appreciation or income on the after-tax assets is taxable.

Often, the benefits of tax-free growth can be well worth making after-tax contributions (see section V on page 4), but to make these contributions even more tax efficient, you may want to consider rolling over these assets to a Roth account. Doing a Roth conversion means any appreciation or income from the after-tax

Priority for Tax-Efficient Retirement Savings		
Savings Priority	Annual Limit	Catch-Up Age and Limit***
<b>I.</b> If available, maximize <b>Heath Savings Account (HSA)</b> contributions	\$4,150 for self \$8,300 for family	Age 55 and over +\$1,000
<b>II.</b> Max out your <b>employer-sponsored plan (ESP)</b> contributions, like a 401(k)*	\$23,000	Age 50 and over +\$7,500
<b>III.</b> If you qualify, consider <b>Traditional IRA or Roth IRA</b> contributions	\$7,000*	Age 50 and over +\$1,000
<b>IV. Consider a Roth conversion on after-tax contributions to...</b>		
• <b>Employer-sponsored plan (ESP)</b> or...	\$69,000**	Age 50 and over +\$7,500
• <b>Individual retirement account (IRA)</b>	\$7,000*	Age 50 and over +\$1,000
<b>V. Save after-tax dollars in...</b>		
• <b>Employer-sponsored plan (ESP)</b> or...	\$69,000**	Age 50 and over +\$7,500
• <b>Traditional IRA</b> or...	\$7,000*	Age 50 and over +\$1,000
• <b>Annuities</b> or...	No limit	N/A
• <b>Taxable brokerage account</b>	No limit	N/A

Source: Schwab Center for Financial Research. Reflective of 2024 annual limits. \*The IRA contribution limit is inclusive of all traditional and Roth IRAs. \*\*Includes 401(k), Roth 401(k), 403(b), and 457(b) plans. The limit is inclusive of all employer and employee contributions but excludes 457(b) plans. \*\*\*The plan must allow catch-up contributions.

contributions could be taken out tax-free in retirement. But remember, although there is no tax on the after-tax portion of a conversion, any appreciation or income rolled over is taxable.

The three main options for after-tax contributions along with a Roth conversion are:

**Backdoor Roth in an IRA:** This strategy is available to anyone who has earned income and a traditional and a Roth IRA. The backdoor Roth works by first making after-tax contributions to a traditional IRA, then converting those assets to a Roth IRA. Be aware that the pro-rata rule applies here, which means any IRAs in your name are taken into account when determining the taxable versus non-taxable portion of a Roth conversion. See [this article](#) for more information.

**In-plan Roth conversion in an ESP:** For this strategy to work, your ESP must allow after-tax contributions, in-plan rollovers, and have a designated Roth account option. This strategy works by first maxing out your normal contributions to an ESP (either to a tax-deferred or a Roth account), then you make after-tax contributions to the plan up to the maximum limit of \$69,000 in 2024 including contributions by you and your employer. Finally, you take the after-tax contributions and roll them over to a designated Roth account.

**Mega-backdoor Roth conversion in an ESP:** This strategy requires that your ESP allow after-tax

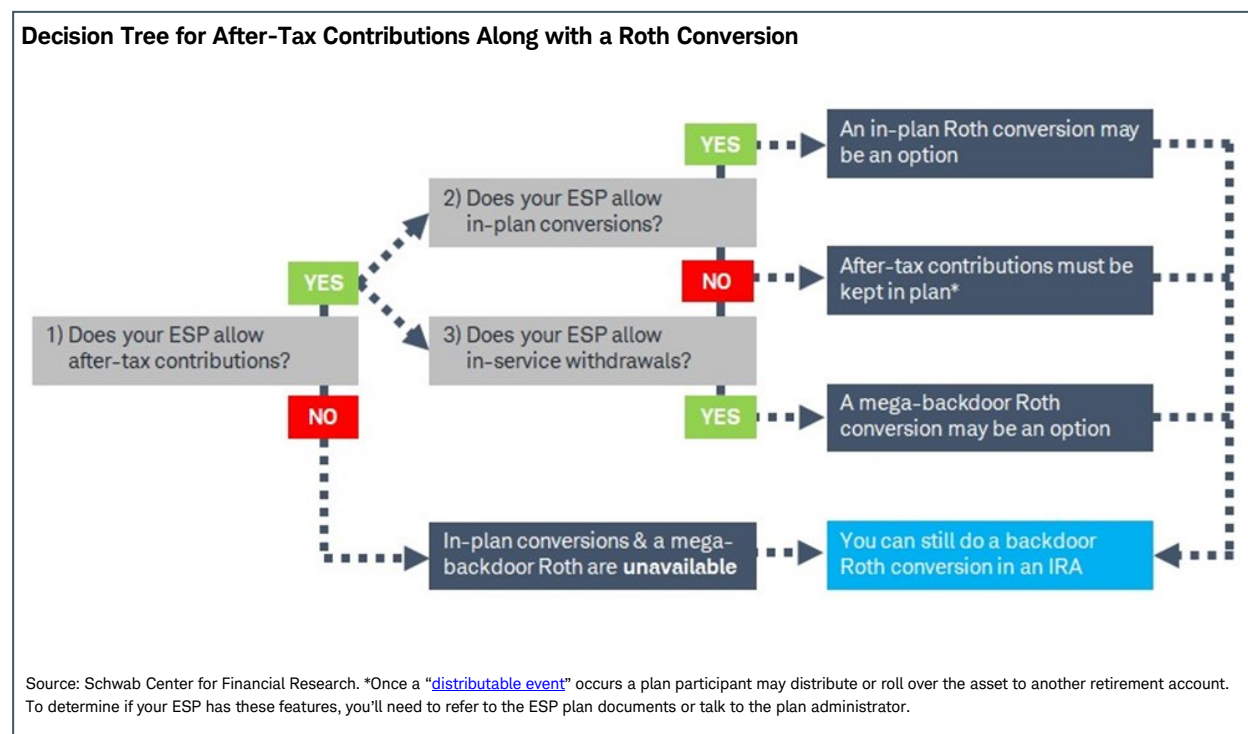
contributions and in-service withdrawals (or you must have a “[distributable event](#)” occur). If your plan does not offer in-plan rollovers, the mega-backdoor Roth may be a strategy to consider.

The process works by first maxing out your normal contributions to an ESP (either to a tax-deferred or Roth account), then you make after-tax contributions to the plan up to the maximum limit of \$69,000 in 2024. Finally, you roll over the ESP asset to an IRA (known as an in-service withdrawal).

During the rollover to the IRA, the IRS allows all after-tax assets to be moved to a Roth IRA, and all the pre-tax assets can be moved to a traditional IRA. Any income or appreciation on the after-tax assets rolled over to a Roth IRA will be taxable. However, there is no tax on the pre-tax assets rolled over to a traditional IRA, nor is there tax on the Roth assets that are rolled over to a Roth IRA.

Use the flowchart below to help determine which options are available to you.

**Note:** The rules that govern after-tax contributions and Roth conversions are complex and can result in significant tax liabilities, which is why we recommend working with a wealth advisor and tax professional before attempting these strategies.



## V. Save after-tax dollars

There are three primary options to save and invest after-tax dollars if a Roth conversion is not the best option for you:

**After-tax savings in an ESP or traditional IRA:** If you're able to make after-tax contributions to your ESP but it doesn't offer the ability for an in-plan Roth conversion or in-service withdrawals, you may still benefit by sheltering the after-tax contributions from taxes on earnings. If your ESP does not offer after-tax contributions, you could also consider after-tax contributions to a traditional IRA. The earnings will be taxed as ordinary income when a withdrawal is taken, but the initial contribution can be taken out tax-free. Be aware, you may not be able to access the money without penalty until you meet the withdrawal requirements for these accounts.

**Consider an annuity:** Annuities may fit your retirement strategy if you're looking for tax-deferred growth and guaranteed income. With an annuity, you're allowed to contribute as much as you like but only with after-tax dollars. Once the annuity is funded, earnings are tax-deferred during the accumulation phase, which means you do not pay taxes on any earnings each year; you only pay taxes on earnings when you withdraw.

The downside is that annuities may have higher fees, and they can be less flexible than some other saving options. For more information on how you might complement retirement savings with a low-cost income annuity, refer to [this article](#).

**Save after-tax dollars in a taxable account:** Although the taxable account does not inherently have many of the benefits offered by a tax-advantaged account, that doesn't mean it's not a good option for saving and investing. Saving in a taxable brokerage account offers flexibility that other accounts lack, since there is no savings limit, almost no restrictions on the assets you can own, and you can sell assets at any time to meet your spending needs.

The downside is that taxable accounts are subject to annual taxation, which can act as a drag on returns. However, by implementing a few simple tax strategies, such as [tax-loss harvesting](#), [asset location](#), utilizing [municipal bonds](#), and [managing your holding period](#), you can make the taxable brokerage account quite tax efficient.

### Bottom line

For most investors, we believe it's a good practice to consider and take advantage of contributions to tax-advantaged accounts before moving on to other available saving options. For many savers, the numerous account types and saving strategies can be overwhelming, which is why we suggest considering Schwab's priority list proposed in the table on page 2. In addition, we recommend meeting with a wealth advisor and tax professional to help you target the most tax-efficient ways to save and invest for your specific situation and goals.

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Investing involves risk including loss of principal.

Roth IRA conversions require a 5-year holding period before earnings can be withdrawn tax free and subsequent conversions will require their own 5-year holding period. In addition, earnings distributions prior to age 59 1/2 are subject to an early withdrawal penalty.

In-plan Roth rollovers are not subject to a 10% additional tax on early distributions, provided no part of the in-plan Roth rollover is distributed before the 5-taxable-year period is met. The measuring period begins on January 1st of the year of the in-plan Roth rollover. All in-plan Roth rollovers made within the same calendar year are subject to the same 5-year time period. Each individual's tax situation is different, take the time to consider all of the facts and consult a qualified tax advisor to discuss your specific situation before initiating an In-Plan Roth Rollover.

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