Dreaming of an early retirement?

Working until at least age 65 is a common assumption when planning for retirement, but some people dream of retiring earlier. Whether early retirees hope to use that additional time to enjoy more time for travel, family, or hobbies, early retirement requires careful planning.

If you are planning to live on Social Security alone in retirement, be prepared to drastically change your lifestyle. Although Social Security benefits range from 20% for higher income earners to 50% for lower income earners, Social Security on its own will only supplement about 35% of income in retirement depending earnings and assuming benefits start at age 65. However, you can narrow the gap between income and expense by making changes now:

1. **Create a budget and increase retirement savings now**
   The sooner you start the better. Begin by creating a budget that includes your current living expenses. Reduce your annual spending, and put the savings into your retirement account. Targeting a 1% increase in your retirement savings each year can accumulate quickly. You'll be surprised by how much you can live without, and how quickly your savings add up.

   Making extra contributions to your retirement account will help, but careful budgeting is just as important. While we are working, we tend to follow a less strict budget or use credit cards to help satisfy cravings. Remember, in retirement you will have far less room for over-spending, so learning how to stick to a budget is increasingly important as retirement nears.

2. **Join your company's 401(k)/403(b) plan or open an IRA**
   Take advantage of the tax savings offered through retirement savings accounts. Contributions to a 401(k)/403(b) or traditional IRA are often tax-free, and earnings in both accounts are tax-deferred. If you put your money in a taxable account (like a traditional bank savings account) you would be paying taxes each year on your interest or capital gains. With a tax-deferred account all of the money stays invested and working for you, enabling you to defer thousands of dollars in taxes throughout your working years.

   You may be able to make Roth contributions to your 401(k)/403(b). These contributions are made on a post-tax basis and earnings grow tax-free; withdrawals in retirement are also tax-free. Roth accounts are not subject to minimum required distribution rules making them an effective way to transfer wealth upon death.

   Many 401(k)/403(b) plans offer employer matching contributions that can help your savings grow more quickly. An employer matching contribution is a deposit that your employer makes into your retirement account on your behalf so use it to save as much as you can.

   If do not have 401(k)/403(b), max out the amount you can save in an individual retirement account (IRA) or

Roth IRA. Other items to consider when looking at your savings plan:

- Explore a taxable brokerage account which allows you to save more than the permitted IRS limits each year
- Reduce your annual tax burden by avoiding income-producing securities in a brokerage account
- Minimize capital gains by buying stocks and holding them for the long-term

3. **Guaranteed sources of retirement Income**

   Early retirees may have to wait to access certain income sources. For example, individuals under age 59½ may not be able to tap into their 401(k)/403(b) retirement account without paying a 10% early withdrawal penalty (other than certain exceptions) plus any income tax on their withdrawal. In addition, individuals under age 62 cannot claim Social Security benefits, and those who claim Social Security before full retirement age (generally age 67) also receive a smaller monthly benefit for life.

   Drawing on savings earlier and for a longer duration may increase longevity risk (i.e,outliving retirement savings). To reduce this risk, early retirees often consider additional income sources such as:

   - Turning a hobby or passion into a side business for additional income
   - Pursuing part-time work in an area of interest
   - Purchasing an annuity. Early retirees could begin collecting guaranteed income right away with an immediate annuity, or use a deferred annuity to receive income on a future date of their choosing. Some annuities offer guaranteed lifetime income payments which can help protect against longevity risk. Withdrawals can be made before income payments begin, but that reduces the account value and could result in surrender charges or other fees.

4. **Reducing debt**

   Eliminating as much debt as possible before retirement frees up cash flow that can be used to cover other expenses. People considering early retirement can examine whether they can afford the same level of monthly debt payments if they have less monthly income once they stop working. People may discover they need to work longer solely to reduce or eliminate their debt.

   For those who need help reducing their debt, consider paying off higher interest credit cards first. Paying off your mortgage before retirement can also significantly reduce your monthly expenses in retirement.

5. **Coverage for medical costs**

   Healthcare planning is essential with an earlier retirement date. Many early retirees are no longer covered by employer-sponsored health insurance plans, but may be too young to qualify for Medicare. However, there are ways to help bridge potential health insurance coverage gaps.

   For those with employer-sponsored health insurance, COBRA benefits allow employees to keep their health insurance for the first 18 months after leaving a job. COBRA can be expensive, because employees must pay for all of their monthly premiums (including the employer's portion) plus a 2% administration fee.

   People who choose a high-deductible health insurance plan also might qualify for a health savings account (HSA). An HSA allows account holders to make contributions until age 65, and savings grow tax-free and allow tax-free fund withdrawals to pay for qualified medical expenses. Once HSA owners reach age 65, these funds can be used for any purpose without penalty (however, withdrawals for non-medical expenses may be subject to income taxes).

Choosing when to retire is a personal choice, but everyone can agree that the key to success involves thoughtful planning. Working with a financial advisor or tax consultant may help determine if early retirement is a viable option for you.