How Much Should You Contribute to a 401(k)?

Here's how to select the amount to save in your 401(k) plan.

When you start a new job and sign up for your company's 401(k) plan, you will need to decide how much to contribute to the account. This seemingly simple decision will affect how much is withheld from your paychecks, your annual income tax bill and how much money you will have in retirement. Here's how to determine the amount to save in your 401(k) plan.

Qualify for the 401(k) match. Find out how much you need to save to qualify for any 401(k) match your employer provides. The most common 401(k) match formula is 50 cents for each dollar saved, up to 6 percent of pay. Employees in this type of plan would need to contribute as least 6 percent of their salary to the 401(k) plan to get the maximum possible 401(k) match. Saving 6 percent of your pay in a 401(k) plan and earning a 3 percent 401(k) match means you are tucking away an amount equal to 9 percent of your salary each pay period for retirement. For a worker earning $50,000 per year, this means an annual 401(k) contribution of $3,000, plus another $1,500 in employer contributions. "At a minimum, employees should always contribute enough to receive their employer match," says Christina Empedocles, a certified financial planner for Insight Personal Finance in San Francisco. "Getting a 50 percent or 100 percent return on investment by capturing an employer's contribution is a powerful incentive."

Aim to save more than 10 percent. Saving enough to qualify for a 401(k) match allows you to capture valuable employer contributions, but you may need to save more than that to end up with an adequate nest egg for retirement. Only 28 percent of 401(k) plans provide a suggested savings rate to participants, according to a Plan Sponsor Council of America survey of nearly 600 401(k) and profit-sharing plans. But when a savings rate is suggested, it's typically 10 percent or more. "Our rule of thumb is to save 15 percent annually at any point throughout your career, and that includes any contribution your employer might make," says Meghan Murphy, a director at Fidelity Investments. Other 401(k) providers recommend similar savings rates. "Typically we would recommend that a person save 12 to 15 percent of their salary for retirement," says Shannon Nutter-Wiersbitzky, head of participant strategy and development at Vanguard.

However, most 401(k) participants aren't saving this much. The average 401(k) contribution was 6.2 percent of pay in 2016, according to Vanguard 401(k) plan data, but that jumps to 10.9 percent when employer contributions are included. Only 18 percent of 401(k) participants save more than 10 percent of their salary for retirement.

Increase your savings rate over time. If you can't save 10 to 15 percent of your pay at the beginning of your career, aim to gradually increase your savings rate. You can boost your 401(k) contributions each time you get a raise, which allows you to build a nest egg without reducing your take-home pay. "If you can't afford to maximize the company match, try to contribute what you can," says Allison Vanaski, a certified financial planner for Arcadia Wealth Management in New York. "As you get raises and increases in salary, make sure to bump up your savings along with it. Don't let lifestyle creep get in the way of saving for your future."

If you are automatically enrolled in the 401(k) plan at a low savings rate, such as 3 percent, you may have to actively change your contribution amount to qualify for the full 401(k) match and save enough for retirement. Some 401(k) plans have an automatic escalation feature that will periodically boost your savings rate. "They can essentially just click a box that says every year increase my savings percentage by 1 percent," Nutter-Wiersbitzky says. "Without having to do anything or think about it, a participant would automatically be setting themselves up for additional saving in the future."

Factor in your age. Saving a small amount in your 20s can grow to an impressive sum by your 60s due to the power of compound interest. However, if you don't start saving until your 40s, you will need to save a lot more each year to achieve the same result. For example, a worker who earns $50,000 per year, puts 5 percent aside for retirement beginning at age 25 and earns a 7 percent annual return will have over half a million dollars by retirement. An employee earning a similar salary who doesn't start saving until age 40 will need to save 16 percent of his pay to accumulate the same half-million-dollar nest egg by age 65. "We ask people to target saving one times their salary by the time they are age 30, save two times their salary by age 35 and four times by age 45," Murphy says. "The ultimate goal is to save 10 times your salary by the time you are 67."

Consider 401(k) contribution limits. The 401(k) contribution limit is $18,500 in 2018. Workers age 50 and older can make catch-up contributions of up to an additional $6,000 for a maximum possible 401 (k) contribution of $24,500. Retirement savers can defer paying income tax on the amount they contribute to a 401(k) plan. Maxing out your 401(k) helps you to save money on taxes while saving for retirement. A worker in the 24 percent tax bracket who saves $18,500 in a 401(k) plan will reduce his tax bill by $4,440. However, income tax will be due on traditional 401(k) withdrawals in retirement. Only 10 percent of 401(k) participants maxed out in 2016, according to Vanguard data.

How to max out your 401(k). In order to max out your 401(k), you will need to select the percentage of your pay that will add up to $18,500 if you are age 49 or younger or $24,500 if you are 50 or older. "Most employers allow you to save a percentage of your pay, so you have to back in and figure out what the $18,500 would be as a percentage," Murphy says. For example, a worker earning $100,000 would need to contribute 18.5 percent of his paychecks to a 401(k) plan to max out in 2018. However, if you set your savings rate with the intention of maxing out your 401(k), watch out for mid-year raises and bonuses. You may need to reduce your 401(k) contributions after a salary increase to avoid exceeding the 401(k) contribution limit.