PART 5:
LIFE CYCLE ISSUES

Chapter 16

Retirement Planning

Learning Objectives

- Understand the changing nature of retirement planning.
- Set up a retirement plan.
- Contribute to a tax-favored retirement plan to help fund your retirement.
- Choose how your retirement benefits are paid out to you.
- Put together a retirement plan and effectively monitor it.

Financing Social Security

- When paying Social Security, you are purchasing mandatory insurance for you and your family in the event of death, disability, health problems, or retirement.
- These benefits provide a base level of protection.
- Your payment appears as the FICA deduction on your pay stub.

Financing Social Security

- FICA taxes paid today are providing benefits for today's retirees.
- The money you pay is not being saved up for your retirement.
- Changes will be necessary, possibly increasing the retirement age or limiting benefits for the wealthy.

Eligibility

- 95% of Americans are covered by Social Security.
- Receive Social Security credits as you pay into the system.
- In 2005, earned 1 credit for each $920 in earnings up to a maximum of 4 credits per year.
- To qualify for benefits, you need 40 credits.

Retirement Benefits

- Retirement Benefits – size is determined by:
  - Number of earnings years
  - Average level of earnings
  - Adjustments for inflation
- Born prior to 1937 – receive full benefits at age 65.
  - Those born after 1960 must be 67 years old.
- Benefits decrease for early retirement and increase for delayed retirement.

Defined-Benefit Plans

- You receive a promised or “defined” payout at retirement.
- Usually noncontributory retirement plans, where you do not need to pay into them.
- Payout is based on age at retirement, salary level, and years of service.

Defined-Benefit Plans

- Employer bears investment risk – you’re guaranteed the same amount regardless of how the stock or bond markets perform.
- Plans lack portability – cannot take the plan with you when you leave.
- Not all are funded pension plans, with unfunded plans paid out of firm’s earnings.

Cash Balance Plans

- Workers are credited with a percentage of their pay each year, plus a predetermined rate of investment earning or interest.
- Account grows at a set rate, regardless of how much is actually earned.
- They are easier to track and benefits build up earlier.
- If you leave, take your cash balance with you.

Pay Now, Retire Later

Step 1: Set Goals

- Figure out what you want to do when you retire.
  - How costly a lifestyle will you lead?
  - Do you want to live like a king?
  - Do you have costly medical conditions?
  - Will you relocate or travel?
- Decide on the time frame for achieving your goals.

Pay Now, Retire Later

Step 2: Estimate How Much You Will Need

- Turn your goals into dollars by estimating how much you will need.
- Begin with living expenses, calculate the cost to support yourself, and don't forget about paying taxes.

Pay Now, Retire Later

Step 3: Estimate Income at Retirement

- Once you know how much you need, figure out how much you'll have.
- Estimate Social Security benefits and determine what your pension will pay.

Pay Now, Retire Later

Step 4: Calculate the Inflation-Adjusted Shortfall

- Compare the retirement income needed with the retirement income you'll have.

Pay Now, Retire Later

Step 5: Calculate How Much You Need to Cover This Shortfall

- Know your annual shortfall.
- Decide how much must be saved by retirement to fund this shortfall.

Pay Now, Retire Later

Step 6: Determine How Much You Must Save Annually Between Now and Retirement

- Put money away little by little, year by year.
- Cannot make up the shortcoming in all at once.

Pay Now, Retire Later

What Plan Is Best For You?

- Many options are available.
- Most plans are tax-deferred, earnings go untaxed until removed at retirement.
- Advantages of tax-deferred plans:
  - Contribute more because they may be untaxed.
  - Earn money on money that would have gone to the IRS.

Defined-Contribution Plan

- Your employer alone, or in conjunction with you, contributes directly to an individual account set aside for you.
- It is like a personal savings account but your eventual payments are not guaranteed.
- What you receive depends on how well the account performs.

Defined-Contribution Plan

- Profit-Sharing Plans – employer contributions vary based on firm's performance and employee's salary.
- Money Purchase Plans – employer contributes a set percentage of employees' salaries to their retirement plans annually. Provides a guaranteed contribution.

Defined-Contribution Plan

- Employee Stock Ownership Plan – company’s contribution is made in stock. This is the riskiest, as the company may go bankrupt.
- 401 (k) Plans – a do-it-yourself variation of profit sharing/thrift plan.
  - A tax-deferred retirement plan where employee’s contributions and the earnings are deferred until withdrawals are made.

Retirement Plan for the Self-Employed and Small Business Employees

- Keogh Plans were introduced in 1962 to allow tax-deductible payments into a retirement plan.
- Set up the plan and decide if it will be:
  - Defined-contribution
  - Defined-benefit Keogh plan

Simplified Employee Pension Plan

- Used by small business owners with no or few employees.
- Works like a defined-contribution Keogh plan.
- For 2005, the deduction limit is 25% of salary or $42,000, whichever is less.

Savings Incentive Match Plan for Employees

- A SIMPLE plan can be established by small employers.
- May be set up by employers with less than 100 employees earning $5000 or more, covering all employees, as part of a 401(k).

Individual Retirement Arrangements (IRAs)

- There are 3 types of IRAs to choose from:
  - Traditional IRA
  - Roth IRA
  - Cloverdell Education Savings Account (known as Education IRA)

Traditional IRAs

- Personal savings plans, providing tax advantages for saving for retirement.
- Contributions may be tax deductible – in whole or in part.
- No taxes on earnings until they are distributed.
  - In 2005-2007, contributions set at $4000; in 2008, it climbs to $5000.

The Roth IRA

- Contributions are not tax deductible.
- Distributions are distributed on an after-tax basis.
- To avoid taxes, your money must be kept in the Roth IRA for 5 years.
- Can withdraw your original investment without a tax penalty.

Traditional Versus Roth IRA: Which is Best for You?

- You end up with the same amount to spend at retirement, if both are taxed at the same rate.
- Choose the Roth IRA if you can pay your taxes ahead of time.

Saving for College: The Cloverdell Education Savings Accounts (ESA)

- Works like a Roth IRA, except contributions are limited to $2000 annually per child under 18.
- Income limits beginning at $95,000 for singles, and $190,000 for couples.
- Earnings are tax-free and no taxes on withdrawals to pay for education.

Saving for College: 529 Plans

- Tax-advantaged savings plan used for college and graduate school.
- Contribute up to $250,000, grows tax-free.
- Plans are sponsored by individual states, open to all applicants regardless of where they reside.

Facing Retirement – The Payout

- Your distribution or payout decision affects:
  - How much you receive
  - How it is taxed
  - Whether you are protected against inflation
  - Whether you might outlive your retirement funds

An Annuity or Lifetime Payments

- Single Life Annuity – receive a set monthly payment for your entire life.
- Annuity for Life or a “Certain Period” – receive payments for life. If you die before the “certain period,” your beneficiary receives payment until that “certain period.”

An Annuity or Lifetime Payments

- Joint and Survivor Annuity – provides payments over the lives of you and your spouse.
- Options:
  - 50% survivor benefit – pays 50% of original annuity to surviving spouse.
  - 100% survivor benefit – continues to benefit the surviving spouse at the same level.

Annuity

Advantages

- Receive benefits regardless of how long you live.
- May pay medical benefits while payout is being received.

Disadvantages

- No inflation protection.
- Not flexible in the case of an emergency.
- Difficult to leave money to heirs.

A Lump-Sum Payment

- Receive benefits in one single payment.
- You must make the money last for your lifetime, and for your beneficiaries after you are gone.
- You can invest the money as you choose.

Tax Treatment of Distributions

- Annuity payouts are generally taxed as normal income.
- Can have the distribution “rolled over” into an IRA or other qualified plan.
  - Avoid paying taxes on the distribution while the funds continue to grow on a tax-deferred basis.

Putting a Plan Together and Monitoring It

- Most individuals will not have a single source of retirement income.
- Investment strategy should reflect investment time horizon.
- As retirement nears, switch to less risky investments.
- Monitor before and after retirement.

Possible Complications

Checklist 16.2

- Changes in inflation can have drastic effects on your retirement.
- Once you retire, you may live for a long time.
- Monitor your progress and monitor your company.
- Don’t neglect insurance coverage.
- An investment planning program may make things easier.