Planning For Retirement

Chapter 14

Learning Goals

- **LG1** Recognize the importance of retirement planning, and identify the three biggest pitfalls to good planning.
- **LG2** Estimate your income needs in retirement and the level of retirement income you’ve estimated from various sources.
- **LG3** Explain the eligibility requirements and benefits of the Social Security program.
- **LG4** Differentiate among the types of basic and supplemental employer sponsored pension plans.
- **LG5** Describe the various types of self-directed retirement plans.
- **LG6** Choose the right type of annuity for your retirement plan.

How Will This Affect Me?

While almost everyone understands that planning for retirement is important, far too few people actually implement a comprehensive plan, much less set aside enough savings to fund their retirement adequately. This chapter discusses the importance of retirement planning and encourages action by identifying the major pitfalls that you must overcome. In order to make the process more concrete and accessible, the steps for estimating your retirement income needs and the income that your investments will support are explained. Eligibility requirements to receive Social Security benefits and their amounts are detailed, as well as the key aspects of supplemental employer-sponsored pension plans and the potential benefits of self-directed retirement programs like traditional and Roth individual retirement accounts (IRAs). In addition, the usefulness of various annuity products in retirement planning is evaluated. After reading this chapter, you should understand how to develop and implement a financial plan that will help you achieve your long-term retirement objectives.

Financial Facts or Fantasies?

- The first step in retirement planning is to set your retirement goals.
- In order to receive maximum social security retirement benefits, a worker must retire before his or her 66th birthday.
- Social security retirement benefits should be sufficient to provide retired workers and their spouses with a comfortable standard of living.
- Because participation in a company's defined benefit pension plan is mandatory, you're entitled to immediate vesting of all contributions.
- Your contributions to an IRA account may or may not be tax deductible, depending in part on your level of income.
- Since an annuity is only as good as the insurance company that stands behind it, you should check the company's financial rating before buying an annuity.

Retirement Planning

- **Start Now!**

Retirement Planning

- First step is to set retirement goals
  - Standard of living when retired
  - What income level you will need to fund that standard
  - Relocation costs
- Determine the amount you need to accumulate for retirement
- Design an investment program to build you “nest egg”

Pitfalls to Retirement Planning

- Starting too late – Many wait until they are in their 30’s or later
- Putting away too little – Tendency to spend now
- Investing too conservatively – Earlier you start, more risk you can take; low-yielding investments will build small nest eggs.

- Compounding rewards the investor who starts early

Power of Compounding

AMOUNT OF ACCUMULATED CAPITAL FROM								
	Contribution of $2,000/Year at These Average Rates of Return				Contribution of $5,000/Year at These Average Rates of Return			
Accumulation Period*	4%	6%	8%	10%	4%	6%	8%	10%
10 yrs. (55 yrs. old)	$ 24,010	$ 26,360	$ 28,970	$ 31,870	$ 60,030	$ 65,900	$ 72,440	$ 79,690
20 yrs. (45 yrs. old)	59,560	73,570	91,520	114,550	148,890	183,930	228,810	286,370
25 yrs. (40 yrs. old)	83,290	109,720	146,210	196,690	208,230	274,300	365,530	491,730
30 yrs. (35 yrs. old)	112,170	158,110	226,560	328,980	280,420	395,290	566,410	822,460
35 yrs. (30 yrs. old)	147,300	222,860	344,630	542,040	368,260	557,160	861,570	1,355,090
40 yrs. (25 yrs. old)	190,050	309,520	518,100	885,160	475,120	773,790	1,295,260	2,212,900

Determining Future Retirement Needs

- Start with current living expenses
- Estimate future as a percent of current, rule of thumb 80%
- Estimate Retirement Income
- Social Security benefits
- Company retirement benefits/pension plan
- Investments
- See Worksheet 14.1

Worksheet 14.1 Parts I & II

I. Estimated Household Expenditures in Retirement (Note 1):	
A. Approximate number of years to retirement	30
B. Current level of annual household expenditures, excluding savings	$ 56,000
C. Estimated household expenses in retirement as a *percent* of current expenses	70%
D. Estimated annual household expenditures in retirement (B × C)	$ 39,200
II. Estimated Income in Retirement :	
E. Social Security, annual income	$ 24,000
F. Company/employer pension plans, annual amounts	$ 9,000
G. Other sources, annual amounts	$ 0
H. Total annual income (E + F + G)	$ 33,000
I. Additional required income, or annual shortfall (D − H)	$ 6,200

Worksheet 14.1 Parts III & IV

III. Inflation Factor :		
J. Expected average annual rate of inflation over the period to retirement		5%
K. Inflation factor (in Appendix A): Based on 30 years to retirement (A) and an expected average annual rate of inflation (J) of 5%		4.322
L. Size of inflation-adjusted annual shortfall (I × K)	$	26,796
IV. Funding the Shortfall :		
M. Anticipated return on assets held *after* retirement		8%
N. Amount of retirement funds required—size of nest egg (L ÷ M)	$	334,950
O. Expected rate of return on investments *prior* to retirement		6%
P. Compound interest factor (in Appendix B): Based on 30 years to retirement (A) and an expected rate of return on investments of 6%		79.058
Q. Annual savings required to fund retirement nest egg (N ÷ P)	$	4,237

Note: Parts I and II are prepared in terms of current (today's) dollars.

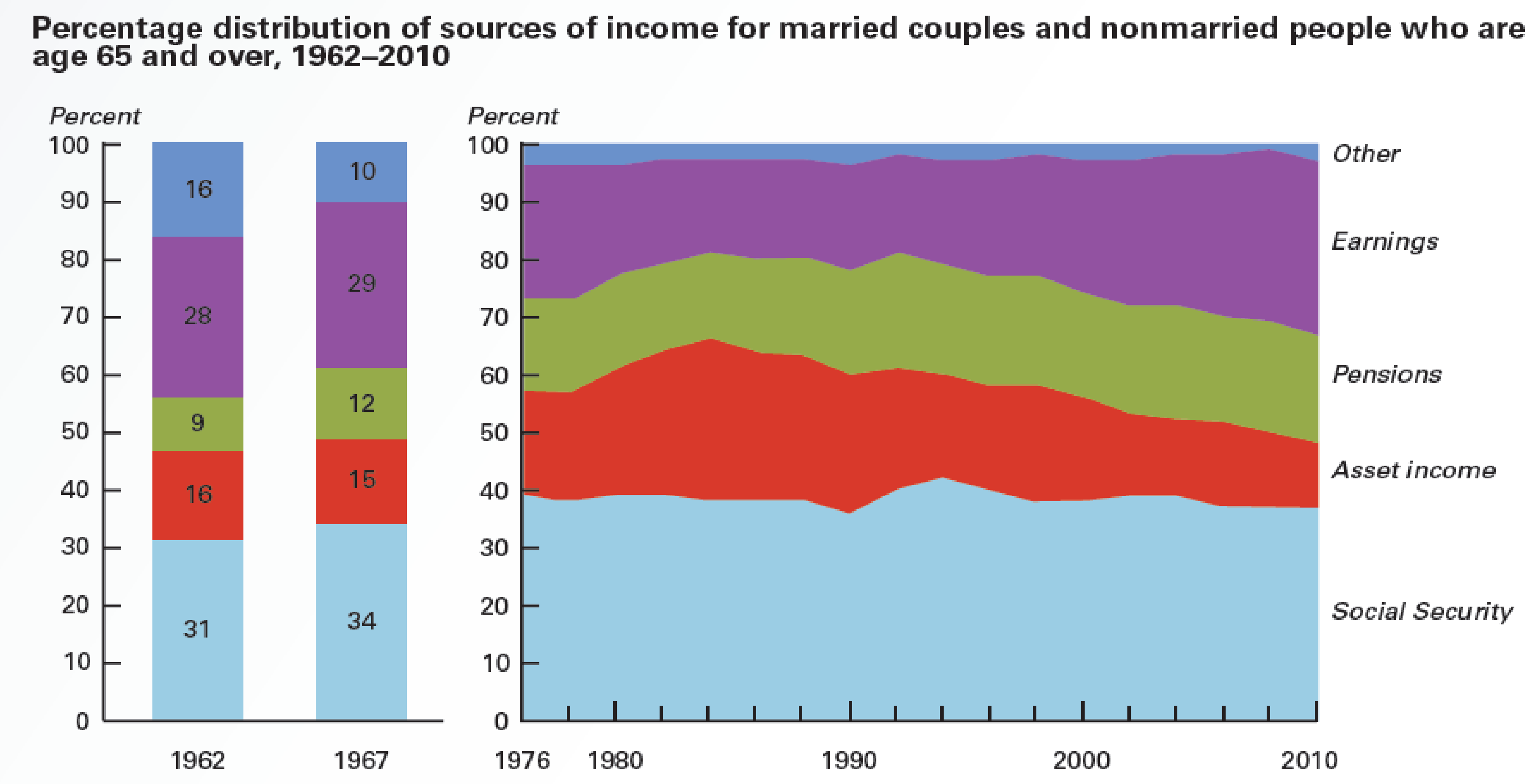
Determine Annual Savings

- Determine the total need investments for retirement
- To determine systematic saving amount needed
- Future amount divided by annuity factor from Appendix B equals annual savings needed
- Example: Additional amount needed at retirement $334,950
- Annuity factor, assuming 6% per year over 30 years, from Appendix B 79.078
- Annual saving need: $334,950 / 79.078 = $4,237

Sources of Retirement Income

- Employer pension plan
- Social Security benefits
- Income from investments
- Employment, full or part-time

Source of Retirement Income



Social Security

- Qualifications: Must worked 40 quarters or 10 years of full-time work
- For Full benefits, must meet qualifying age requirement:
- If born in 1960 or later, full retirement age is 67
- Benefits are increased by 8% per year if defer taking benefits after age 67 until you reach age 70. No addition increase after age 70
- Surviving spouse and minor children receive benefits if worker meets 40 quarters test or had 6 quarters during previous 3 years.

Social Security

- Primary funding provided by FICA tax which is 6.2% of salary and wages up to a limit that is adjusted for inflation each year. For 2015 the limit is $118,500. The employer matches the amount paid by the employee, thus a total of 12.4% of salary up to limit is paid each year. People who are self-employed must pay the total 12.4% of self-employment income, again up to the limit amount.
- The other part of FICA tax [1.45% by employee and employer] is for Medicare.

Social Security Benefits

- if you retire at full retirement age in 2015, your maximum benefit would be $2,663 per month. This amount would be reduced by Part B Medicare premiums and income tax withholding, if any. This amount assumes that you paid in the maximum in each of your 40 quarters.
- Spousal benefits if worker retired would be half of the amount received by worker.
- For middle income taxpayers, 85% of benefits are included in taxable income.

Average Social Security Benefits

Type of Beneficary	Average Monthly Benefit
Retired worker	$1,328
Retired Couple	$2,176
Disabled worker	$1,165
Dixabled worker with spouse and child	$1,976
Widow or widower	$1,274
Young widow or widower with two children	$2,680

Pension Plans

- About 40 percent of full-time workers covered by employer funded pension plans.
- Trend is increasing use of defined contribution plans funded with salary reduction agreements by employee.

Pension Plans -- Basics

- Two types of pension plans
- Defined Benefits Plan – Benefits determined by formula such as 2% or final salary for each year of service. Thus, if you worked 30 years and your final salary was $50,000, your pension would be $30,000 per year. Employer must add to pension fund an amount each year that will provide the estimated benefits for its employees. These funds are invested and subject to market risk. Employer takes the risk; not the employee.

Pension Plans -- Basics

- Defined Contribution Plan
- An amount is added to the plan each year [perhaps 10% of salary] and is invested. The amount could be paid by the employer, employee, or both.
- Benefit is based upon the amount in the plan at time of retirement. Employee bears the market risk since pension will vary based upon market return of the funds in the plan.

Pension Plans -- Basics

- Cash balance plan
- Fully funded by employer who guarantees a minimum return on the funds, e.g. 2% per year. The funds are invested for the employee's benefit. Pension is based upon the balance in fund at retirement. Pension is not related to salary at retirement.

Pension Plans -- Basics

- Participation in plan
- Must be non-discriminatory, that is cannot give greater benefits to higher income employees than lower paid.
- Plan will vest, that is belongs to the employee, either immediately when work is done, a cliff vesting no benefits for first three years then 100% vesting, or graded scheduled such as 20% vested at end of first two years, then 20% per year so fully vested at end of six years.

Supplemental Plans

- Employer may provide opportunity for employee to contribute to a supplemental plan
- Salary reduction agreements
- Funds contributed to the plan are invested and are tax deferred until withdrawn by employee, typically at retirement
- How funds invested could be decided by employer or employee.

Types of Supplemental Plans

- Profit-Sharing Plans –
- Funded by employer,
- Amount contributed depends upon profits of company, will vary each year,
- May be invested entirely in stock of the company and subject to risk of company failing
- May be invested in a portfolio of securities

Types of Supplemental Plans

- Thrift and Savings Plans
- Employer matches some portion of contributions by employee
- Funds Invested by trustee for benefit of employees in a portfolio of securities
- Employer’s contribution is tax deferred; Employee’s contribution is included in taxable income [similar to a ROTH account]

Types of Supplemental Plans

- 401(k), 403(b), or 457 plans
- Employer make contributions to plan using funds withheld from employee under a salary reduction agreement
- Employee selects where to invest funds, typically from a list of approved by employer plans, and typically invested in mutual funds
- Amount is limited and limit changes with changes in the CPI
- Limit for 2015 is $18,000 up from $17,500 in 2014. There is a $6,000 catch-up for employees over 50.

Types of Supplemental Plans

- ROTH plans
- Differ from others in that after-tax funds are contributed to plan. As a result, withdraws are not subject to tax if you are age 59.5 and the funds have been invested for five years.
- Roth plans you pay tax first then invest the net of tax proceeds.
- Traditional plans invest full amount and pay tax when withdrawn, receiving net amount.
- Advantage depends upon tax rate when contributed v tax rate when withdrawn. If rate is the same, no difference.

Types of Supplemental Plans

- Keogh and SEP plans
- Designed for small businesses and self-employed
- Maximum you can contribute is 25% of earned income or $53,000 in 2015
- If withdrawn prior to age 59.5, 10% penalty tax applies
- Normally invested in mutual funds chosen by participant of the plan

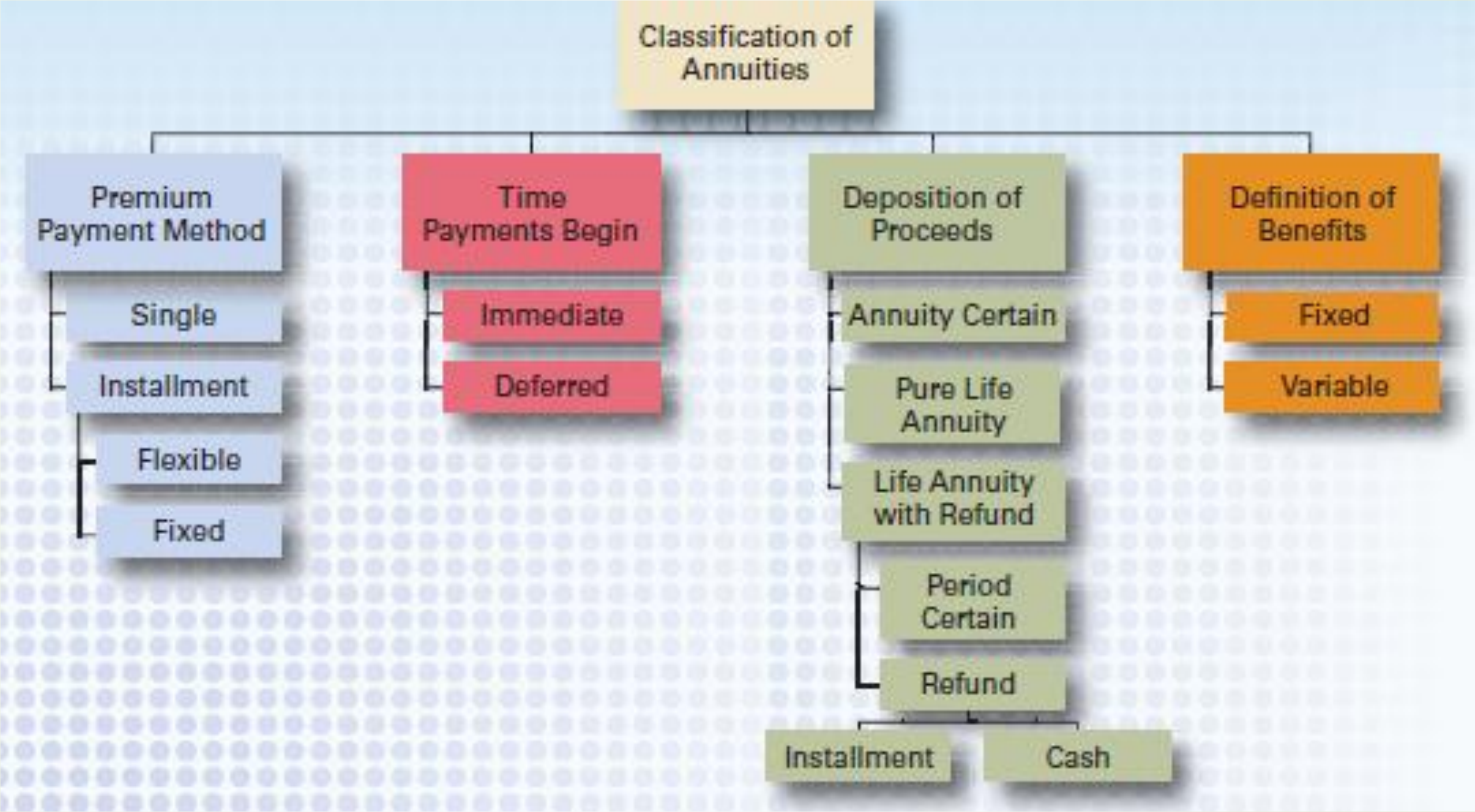
Types of Supplemental Plans

- Individual Retirement Accounts
- Traditional: before tax dollars contributed
- ROTH: After-tax dollars contributed: Must have AGI under threshold amount [$193,000 in 2015]
- Advantage depends upon comparison of tax rates now versus tax rate when retire
- Contribution of each limited to $5,500 in 2015 with an additional $1,000 if over 50 years old.
- While not for retirement, the Coverdell Education Savings Account is an IRA for education expenses – income not taxed if use for qualified education expenses [tuition, books, required fees]

Annuities

- An investment product created by life insurance companies that provides a series of payments over time.
- Distributions are part return of investment or cost and part interest income. May also have survivor benefits if annuitant has died.

Types of Annuities



Annuities Characteristics

- Contributions: Single premium or installments
- Distributions normally deferred to begin at retirement, may be immediate distributions
- May be for life or for a term certain
- May have contractual fixed return or be invested with a variable return
- May be combined with life insurance benefits

Annuities

- Useful for risk adverse retiree
- May take defined contributions amounts and purchase a fixed annuity at retirement in provide a stable retirement income
- Transaction costs are high: commission at purchase plus annual fees to continue