Unit 8: Planning for Retirement

Topics:

- Retirement planning
- Social Security
- Employer sponsored programs
- IRAs
- Annuities

Retirement Planning

We all look forward to the day when we can throw the alarm clock out the window, bask in the sun on the beach, and just do whatever we want. Now is the time to set your goals and put together a plan that will enable you to do what you want to do at retirement. Today, people are living longer healthier lives and are spending more years in retirement than ever before.

According to the Social Security Administration's projections (2011):

- Women tend to live longer than men
- The typical 65-year old today will live to age 83
- One in four 65-year olds will live to age 90
- One in ten 65-year olds will live to age 95

Given longer life expectancies, people need to have enough money to support them in their golden years. For this you must have a plan in place that will amass the money you will need to be self-sufficient and allow you to live comfortably.

Once again, you will need to set financial goals—this time for your retirement. At what age would you like to retire? What will be your future expenses? What income will you need to live the way you want to live? When estimating your income, you will need to know what funds will be available to you. Some of the sources of income are Social Security payments, retirement accounts and employer pensions. An excellent way to help you answer these questions is to complete a forecasting retirement income work sheet. You will need to estimate your annual retirement living expenses, your annual income at retirement as well as the additional money that may be needed to afford the lifestyle you would like to enjoy. If your calculations indicate that you will not have sufficient funds to cover all your expenses, it is the time to figure out what additional savings you will need and how you are going to attain your savings objective. This may be accomplished by contributing more money towards your retirement accounts or by opening an IRA account.

The Social Security Administration provides a calculator that can be used to determine how much more money you may need to live comfortably during retirement. It is another tool that is at your disposal in your planning for retirement. You can find this tool at http://www.socialsecurity.gov/estimator/

Social Security

Social Security payroll taxes are deducted from your paycheck each pay period. Your employer(s) also pays a portion toward funding your Social Security account on the same schedule. These contributions made to your Social Security retirement account are called “FICA” taxes.

The current requirements to receive social security benefits are as follows:

- The normal retirement age is 67 (if you were born in 1960 or later)
- You must have paid FICA taxes for at least 40 quarters (10 years)
- If you retire earlier than age 67, you will receive less social security benefits per month
- The later you retire, the higher the monthly benefits you will receive

You qualify for Social Security benefits by earning Social Security credits when you work in a job and pay Social Security taxes. As of January 2011, SSA Publication No. 05-10072 provides the following information:

> The credits are based on the amount of your earnings. We use your work history to determine your eligibility for retirement or disability benefits or your family’s eligibility for survivor’s benefits when you die. In 2011, you receive one credit for each $1,120 of earnings, up to the maximum of four credits per year. Each year the amount of earnings needed for credits goes up slightly as average earnings levels increase. The credits you earn remain on your Social Security record even if you change jobs or have no earnings for a while.

However, it should be remembered that Social Security benefits are affected by the performance of the national economy, the national deficit and inflation. Therefore, they may not be sufficient to support you once you retire. Social Security benefits should be only one part of a financial retirement plan.

To learn more, or for updated information, you can go to the Social Security Administration website at www.ssa.gov.

Employer Sponsored Programs

A salary reduction plan, or 401(k), is an agreement by which part of a covered employee’s pay is withheld and invested; taxes on the contributions and the account earnings are deferred until the funds are withdrawn. The 401(k) gives employees the option to divert part of their salary to a company sponsored, tax-sheltered account. This money accumulates until you start drawing funds at retirement; it is at that point that the money is taxed. The Internal Revenue Code regulates the government limit for tax-free contributions. For further clarification of contribution limits you can use Publication 560 at: http://www.irs.gov/publications/p560/ch02.html#en_US_publink10008830

There are other salary reduction plans, such as 403(b) and 457 plans, which are similar to the 401(k). The 403(b) is a plan that is available to employees of public, non-profit organizations, including public schools colleges, hospitals, and state and local governments.

Many of these plans have an *employer matching provision*, which means that your employer will contribute a percentage of every dollar you put in your account. It is a win-win situation for you because you can save pre-tax dollars in your salary reduction plan and, at the same time, reduce your payroll taxes. This is an excellent way for you to build your retirement savings.

A **defined benefit contribution** is an employer-sponsored retirement plan in which employee benefits are determined based on a formula, using factors such as salary history and duration of employment. Investment risk and portfolio management are entirely under the control of the company. There are also restrictions on when and how you can withdraw these funds without penalties. It is also known as “qualified benefit plan” or “non-qualified benefit plan” (Defined benefit, 2011).

A **defined contribution plan** is a pension plan that specifies the contributions that both employer and employee must make; it makes no promises concerning the size of the benefits at retirement (Defined contribution, 2011).

A profit sharing plan is an arrangement by which the employees of a firm participate in the company’s earnings. To be a qualified plan, a pre-determined formula must be used to determine contributions to the plan and benefits to be distributed, once a participant attains a specified age, becomes ill or disabled, severs employment, retires, or dies. When a profit sharing plan is first implemented, employees with considerable past service usually do not receive credit (Rubin, 1987, p. 257). The contributions are invested in stocks, bonds, and the securities of the company. When an organization is doing well, it is a great option for employees. However, if the company is failing, employees risk losing profit sharing and their jobs as well.

Self-directed retirement plans

Due to uncertainty concerning how much Social Security funding will be available in future years, as well as the cost of inflation, many people are opening their own retirement accounts to supplement their Social Security benefits. Many Americans do not have employer-sponsored programs, or are self-employed, which makes it all the more important for them to contribute to their own retirement plans. The most popular of self-funding accounts are IRAs and Keogh plans.

Individual Retirement Arrangement (IRA)

From the IRS Publication 590, IRA rules and a description of benefits follow:

> An individual retirement account is a trust or custodial account set up in the United States for the exclusive benefit of you or your beneficiaries. The account is created by a written document. The document must show that the account meets all of the following requirements.

- The trustee or custodian must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the IRS to act as trustee or custodian.
- The trustee or custodian generally cannot accept contributions of more than the deductible amount for the year. However, rollover contributions and employer contributions to a simplified employee pension (SEP) can be more than this amount.
- Contributions, except for rollover contributions, must be in cash.
- You must have a non-forfeitable right to the amount at all times.
- Money in your account cannot be used to buy a life insurance policy.
- Assets in your account cannot be combined with other property, except in a common trust fund or common investment fund.
- You must start receiving distributions by April 1 of the year following the year in which you reach age 70-½. (Feb 3, 2011, p. 9)

An **Individual Retirement Arrangement (IRA)** is a retirement plan that is open to any working American, to which a person may contribute a specified amount each year. A person can contribute a portion of their income using pre-tax dollars. The taxes on principal and interest are not paid until the money is withdrawn from the account. Under the Tax Reform Act of 1986, any individual employee can contribute up to the government specified amount each year. However, income level and eligibility for an employee pension plan determine whether or not the employee's contribution or percentage is tax deductible. The amounts of contributions each year and the circumstances of contribution to an IRA and the tax consequences under the current law can be found at: http://www.irs.gov/retirement/participant/article/0,,id=211358,00.html

A **traditional IRA** allows you to make you to make annual contributions until age 70 ½. An individual who qualifies, one who is reaching retirement age can make tax-deductible contributions in larger amounts per year to their accounts as governed by the U.S. government; a tax-deductible contribution can also be made on behalf of a non-working spouse of an equal amount. Whether the contribution is taxable or not depends on your tax filing status. It is also dependent on whether you are enrolled in an employer supported retirement plan. It is important to remember that any withdrawal made on a regular IRA before the age 59 ½may be subject to a ten percent penalty. All earnings grow tax free until the funds are withdrawn and are then taxed at the individual's tax rate. After age 59 ½ money can be withdrawn without penalty as long as the account has been open for at least five years.

Non-Deductible (after-tax) IRA is open to anyone with no wage limit or consideration to an employer based plan. Contributions can be made up to $5,000 a year for this type of account, but after-tax dollars are used. Earnings on this account accrue tax-free until they are withdrawn. When the money is withdrawn, only the earnings are taxed at current tax rate. As with the traditional IRA, the non-deductible IRA allows you to withdraw money without penalty at age 59 ½. Early withdrawals are subject to the ten percent penalty.

The **Roth IRA** allows for contributions up to $5,000 annually, which are not tax deductible, but the earnings after five years are tax-free. The funds in a Roth IRA can be withdrawn without penalty before age 59 ½ if the account owner is determined by a physician to be disabled. Also, for you, your spouse, your children, your grandchildren, you parent, or another ancestor you may withdraw up to $10,000.00 to purchase, rebuild, or build your first home. The maximum lifetime withdrawal for this reason is $10,000. One additional way that you can withdraw without penalty is to cover medical expenses greater that 7.5% of your adjusted gross income.

A **Keogh Plan** is an account to which self-employed persons and their employees may make specified payments that may be deducted from taxable income; earnings also accrue on a tax-deferred basis. The Keogh Plan Act first passed in 1962. This plan permits self-employed individuals to establish a retirement plan on their own. Keogh Plans are attractive because the maximum contribution levels may be high. A Keogh Plan can be set up as either a defined-benefit or defined-contribution plan, although most plans are defined contribution. The contribution limit for an account depends on the employee's participation in other retirement plans, however contributions are generally tax deductible up to 25% of annual income with a limit of $49,000 (as of 2010). Keogh Plan types include money-purchase plans (used by high-income earners), defined-benefit plans (which have high annual minimums) and profit-sharing plans (which offer annual flexibility based on profits) (Rubin, 1987, p. 164).

Keogh Plans can be opened at banks, mutual funds, and other financial institutions. All funds in the Keogh Plan must remain in the account until the individual reaches 59 ½ years old. Withdrawals are then taxed as ordinary income.

Annuities

An annuity is a tax-sheltered investment vehicle that is created, sold and administered by a life insurance company. An **annuity** pays a regular income benefit (monthly, quarterly, etc.), for a specified period of time. The contract can include more than one person. While the basic purpose of life insurance is to provide an income for a beneficiary at the death of the insured, an annuity is intended to provide an income for the life for the annuitant (Rubin, 1987, p. 17). The **accumulation period** of an annuity is the period during which premiums are paid for the purchase of an annuity. It can consist of one lump sum payment or a series of payments. The **distribution period** is the period during which annuity payments are made to an annuitant. These are scheduled payments to begin at a specified age, such as 65.

The benefits of an annuity consist of three parts: the principal, the interest, and the survivorship benefits. The principal is the amount the annuitant pays into the annuity during the accumulation period. Interest is the money that is earned on those funds until they are distributed. “Survivorship” in an annuity contract denotes the portion of premiums and interest that has not been returned to the annuitant before his or her death.

Annuities are not subject to contribution limitations, as are IRAs and other retirement savings accounts. When you purchase an annuity the interest on the principal, as well as the interest compounded on the interest is free from current income tax. Only when the money is distributed is it taxed at your current tax rate. If you should die during the accumulation period, your beneficiaries will receive at least the amount invested.

Classification of annuities

A **single premium annuity** is purchased with a lump-sum payment, whereas an **installment premium annuity** sets up payments (monthly, quarterly, or annually) at regular intervals over an extended period of time. The installment annuities are usually initially set up with one large payment, followed by smaller payments. An advantage of making premium payments is your ability to use tax-free dollars.

A **fixed annuity** states that the annuitant (the person who is to receive the annuity) will receive a fixed amount of income over a certain period or for life. With a **variable annuity,** the monthly payment varies because it is based on the income received from stocks and bonds or other investments.

Summary of Annuities from the Securities and Exchange Commission

Annuities

An annuity is a contract between you and an insurance company, under which you make a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to you beginning immediately or at some future date. Annuities typically offer tax-deferred growth of earnings and may include a death benefit that will pay your beneficiary a guaranteed minimum amount, such as your total purchase payments.

There are generally two types of annuities—fixed and variable. In a fixed annuity, the insurance company guarantees that you will earn a minimum rate of interest during the time that your account is growing. The insurance company also guarantees that the periodic payments will be a guaranteed amount per dollar in your account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as your lifetime or the lifetime of you and your spouse.

In a variable annuity by contrast, you can choose to invest your purchase payments from among a range of different investment options, typically mutual funds. The rate of return on your purchase payments, and the amount of the periodic payments you will eventually receive, will vary depending on the performance of the investment options you have selected.

An equity-indexed annuity is a special type of annuity. During the accumulation period – when you make either a lump sum payment or a series of payments – the insurance company credits you with a return that is based on changes in an equity index, such as the S&P 500 Composite Stock Price Index. The insurance company typically guarantees a minimum return. Guaranteed minimum return rates vary. After the accumulation period, the insurance company will make periodic payments to you under the terms of your contract, unless you choose to receive your contract value in a lump sum.

Variable annuities are securities regulated by the SEC. Fixed annuities are not securities and are not regulated by the SEC. Equity-indexed annuities combine features of traditional insurance products (guaranteed minimum return) and traditional securities (return linked to equity markets). Depending on the mix of features, an equity-indexed annuity may or may not be a security. The typical equity-indexed annuity is not registered with the SEC.

Source: Security and Exchange Commission: http://www.sec.gov/answers/annuity.htm

Resources

U. S. Social Security: www.socialsecurity.gov

To use the Social Security Retirement Estimator: www.socialsecurity.gov/estimator

Department of Labor, *Taking the Mystery Out Of Retirement Planning*
(This information is valuable to everyone, but the booklet, which includes worksheets, is specifically designed to help those who are about a decade from retirement.):
http://www.dol.gov/ebsa/publications/nearretirement.html

To better understand how Social Security benefits are calculated:
http://www.socialsecurity.gov/pubs/10072.html

Glossary

Accumulation period

The period during which premiums are paid for the purchase of an annuity

Annuity

An investment product created by life insurance companies that provides a series of payments over time

Annuity certain

An annuity that provides a specified monthly income for a stated number of years without consideration of any life contingency

Contributory pension plan

A pension plan in which the employee bears part of the cost of the benefits

Deferred annuity

An annuity in which benefit payments are deferred for a certain number of years

Defined contribution plan

A pension plan specifying the contributions that both employer and employee must make; it makes no promises concerning the size of the benefits at retirement

Distribution period

The period during which annuity payments are made to an annuitant

Employee Retirement Income Security Act (ERISA)

A law passed in 1974 to ensure that workers eligible for pensions actually receive such benefits; ERISA also permits uncovered workers to establish individual tax-sheltered retirement plans

Fixed-rate annuity

An annuity in which the insurance company agrees to pay a guaranteed rate of interest on invested money

Guaranteed-minimum annuity (life annuity with refund)

An annuity that provides a guaranteed minimum distribution of benefits

Individual retirement arrangement (IRA)

A retirement plan, available to any working American, to which a person may contribute a specified amount each year

Installment premium annuity contract

An annuity contract purchased through periodic payments made over time

Keogh Plan

An account to which self-employed persons may make specified payments that may be deducted from taxable income; earnings also accrue on a tax-deferred basis

Noncontributory pension plan

A pension plan in which the employer pays the total cost of the benefits

Pension Protection Act

A federal law passed in 2006 intended to shore up the financial integrity of private traditional (defined benefit) plans and, at the same time, to encourage employees to make greater use of salary reduction (defined contribution) plans

Profit-sharing plan

An arrangement in which the employees of a firm participate in the company's earnings

Qualified pension plan

A pension plan that meets specified criteria established by the Internal Revenue Code

Salary reduction, or 401(k), plan

An agreement by which part of a covered employee's pay is withheld and invested in some form of investment vehicle; taxes on the contributions and the account earnings are deferred until the funds are withdrawn

Single premium annuity contract

An annuity contract purchased with a lump-sum payment

Survivorship benefit

In an annuity contract, the portion of premiums and interest that has not been returned to the annuitant before his or her death

Variable annuity

An annuity in which the monthly income provided by the policy varies as a function of the insurer's actual investment experience

Vested rights

Employees' non-forfeitable rights to receive benefits in a pension plan based on their own and their employer's contributions

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