The Road to Retire Well

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Individually, many financial decisions seem too small to have much impact. Indeed, few single decisions have the potential to make you a millionaire or send you into bankruptcy. But many small decisions added together could turn a so-so retirement into one that is comfortable and financially secure. This workshop will show you how to make those smart choices and put yourself on the road to Retire Well.

Retirement Plan Basics

Everyone who is employed or runs a business, receives alimony, or is *married* to someone who works or runs a business can have a tax-advantaged retirement plan. For the fortunate employee, a retirement plan is set up by the employer. For the worker whose employer doesn't offer a plan, IRAs can offer some of the same benefits although with lower **contribution limits**. A self-employed person can set up any one of several types of retirement plans for themselves and their employees.

Retirement plans can be broken down into two categories: **defined benefit** plans and **defined contribution** plans. Perhaps you have a traditional pension plan, with a formula that determines what percent of your salary you'll get as a retirement benefit. That's a defined benefit plan: you can calculate how much you'll get per month in retirement.

More likely, you have a plan to which you or your employer, or both, contribute money—but there's no benefit formula. You choose where to invest the money and how much to contribute. The lump sum that accumulates is yours to draw on in retirement. These are defined contribution plans—the amounts of the deposits are known, but the final value of the account will depend on many variables. Examples of defined contribution plans include 401(k) in the private sector and 403(b) and 457 plans for government, education, or non-profit organizations.

Getting the Most from Your Employer Plan

Make these small, smart decisions to get the greatest benefit from your employer's retirement plan.

- If your employer doesn't automatically enroll you, sign up and start contributing to your retirement plan as soon as possible.
- If your employer matches your contributions to the plan, contribute enough to get the full match. Not contributing enough to get the maximum match from your employer is like saying "No thanks" to a raise.

Example #1: Matching

Max and Julie each earn $50,000. Their employer offers a 50% match on contributions up to 6% of pay. Max contributes $3000 this year—6% of his pay. The company pitches in another 3%, or $1500. Julie contributes only $1500, or 3% of her paycheck. Her employer match is 1.5%, or $750. For both of them, it's like an automatic 50% return on their contributions. But Julie could have pocketed another $750 from her employer by increasing her contribution to 6%.

	Max	**Julie**
Annual salary	$50,000	$50,000
% of pay contributed	6%	3%
Employee contribution	$3000	$1500
Employer matching	$1500	$750
Missed matching $ (as % of income)	-- --	$750 (1.5%)

- Work for your employer long enough to be **vested,** meaning that you get to keep the employer's contributions when you leave. Vesting applies to both defined benefit plans and defined contribution plans.
  - Every employer plan has a vesting schedule that shows the percentage of the employer's contribution (or employer-paid benefit, in defined benefit plans) to which you are entitled when you reach certain years of service.
  - You may become vested all at once, called cliff vesting. Or it may be a graded vesting schedule, starting at 20% and increasing each year until you're fully vested.
  - Since 2006, the maximum vesting periods allowed by law in defined contribution plans are 3 years under cliff vesting and 6 years for graded vesting.
  - In some small business plans including SEP, SIMPLE IRA and SIMPLE 401(k) plans, the law requires that you be immediately 100% vested.

Example #2: Vesting

John and Linda started at ABC Company at the same time. Both earn $50,000 and contribute 6% of their incomes to the 401(k) plan. The company matches $1 for every $2 the employee contributes, up to 6% of pay. The vesting schedule is 3-year cliff, so they will be 100% vested at the end of 3 years of service, but 0% until then.

John leaves ABC Company after 2 years and 11 months, and loses all of the company match. Linda leaves after 3 years, and keeps all of the company matching money.

	John	**Linda**
Length of employment	2 years, 11 months	3 years

% of pay contributed	6%	6%
Employee contribution	$3000 per year, $8750 total	$3000 per year, $9000 total
Employer matching	$1500 per year, $4375 total	$1500 per year, $4500 total
Vested employer matching	0%	100%
Total retirement savings	$8750 (plus investment returns)	$13,500 (plus investment returns)

- If you have a **defined benefit** plan, know the plan's formula and make it work for you.

  Defined benefit plans typically calculate your retirement benefit based on your years of service and your average pay during the last few years of work, or the years in which your salary was the highest. The formulas favor the most senior workers and those who have large pay increases several years before retirement. If you get a major promotion or a large raise, you might increase your retirement benefit substantially for each additional year you continue to work at that higher salary.

Example #3: Benefit Formulas

Rachel and Jack are the same age. They've earned the same pay and were promoted at the same time. Their last promotions included substantial raises. Rachel retired one year after that promotion, at age 57. Jack retired 5 years later, at age 62.

Pension formula: 2% of final average salary, based on last 5 years of work with a 6% reduction for each year younger than age 60.

	Rachel	**Jack**
Years of service	10 years	15 years
Final five years salary		
Final year	$50,000 (promoted at end of previous year)	$53,000
Previous year -1	$44,000	$52,400
Previous year -2	$43,200	$51,500
Previous year -3	$42,700	$50,900
Previous year -4	$42,000	$50,000 (promoted at end of previous year)
Final average salary	$44,380	$51,560
Normal annual retirement benefit (yrs. of service x 2% x final avg. pay)	$8876	$15,468
Reduction for retirement before age 60	($1598) (-18%)	--

	Rachel	Jack
Actual annual benefit	$7278, just 47% of Jack's	$15,468

Make Use of IRAs

Anyone receiving earned income or alimony, or whose spouse receives it is eligible to contribute to at least one type of IRA. Consider contributing to an IRA if:

- Your employer doesn't offer a retirement plan.
- You don't have any earned income or alimony but your spouse does.
- You're already contributing the maximum to your employer plan but want to save more.
- Your employer plan has high expenses or poor investment choices.
- You'd prefer a Roth account, but your employer doesn't offer that option.
- You're self employed and haven't set up another type of retirement plan.
- It's after December 31 and you wish you'd put more of last year's income into a retirement plan. You can make a contribution to an IRA for last year until April 15.

You can open an IRA account at almost any type of financial institution, such as a mutual fund company, a brokerage, or a bank. You can purchase nearly any type of investment in the IRA account. You can contribute up to $5000 (2008, indexed for inflation) or the amount you earned, whichever is less. You can contribute an extra $1000 each year if you are aged 50 or older.

There are three options for IRA contributions:

Roth IRA

Eligibility: You can contribute to a Roth IRA unless your income is above certain limits.[1] The amount of your contribution may be limited if your income is in the phase-out range.

Tax benefits: You get no tax deduction now, but you will owe no taxes on the growth in the account when you take your distributions according to the rules.

Deductible contributions to a traditional IRA

Eligibility: You can deduct your contribution if you are under age 70½ and you have no retirement plan at work. If you or your spouse have a retirement plan, the amount you can deduct may be limited if your income is above certain limits.[2]

Tax Benefits: Taxes on both the contribution and the earnings in the account are delayed until you take the money out.

Non-deductible contributions to a traditional IRA

Eligibility: Anyone with earned income or alimony, or a spouse with earned income or alimony can make a non-deductible contribution.

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[1] Adjusted gross income. Single filers $101,000 to $116,000; joint filers $159,000 to $169,000; married filing separately $0 to $10,000 (2008, indexed for inflation annually).

[2] Adjusted gross income. If you have a retirement plan: single filers $53,000 to $63,000; joint filers $85,000 to $105,000; married filing separately $0 to $10,000 (2008, adjusted gross income, indexed for inflation annually). If only your spouse has a retirement plan, $159,000 to $169,000.

Tax benefits: You will defer taxes on the growth in the account, but you get no tax benefit on your contributions.

Tax Benefits of Employer Plans and IRAs

Tax savings are the most appealing reason to contribute to retirement plans. There are two types of tax benefits: deferral of income taxes and tax-free earnings. Tax-deferral is offered by the traditional forms of retirement plans (IRAs, 403(b) and 401(k) plans, 457 plans, etc.). Tax-free earnings are offered by the Roth versions: Roth IRAs, Roth 403(b) plans, and Roth 401(k) plans.

With tax deferred accounts, you are not taxed on the amount you contribute to the retirement plan or on the earnings in the plan until you withdraw the money. With tax free earnings, you pay taxes now on the contributions but the earnings will be distributed tax free. The two types of tax benefits are mathematically equal if your tax rate remains constant. Which is best for you depends on your circumstances and expectations about the future.

Tax Deferral

Advantages

- Reduces current income taxes (except non-deductible IRA contributions).
- No taxes on earnings until withdrawal.
- If your income drops when you retire, you could be in a lower tax bracket and pay less in taxes when you take the money out.
- Pay taxes with dollars that are worth less because of inflation.
- Lower current adjusted gross income increases eligibility for other tax deductions and income-based programs (i.e., retirement Saver's Credit, education tax breaks, medical or miscellaneous itemized deductions).
- Illinois residents: Even though you will pay federal income tax on distributions from employer plans, Illinois does not currently tax those distributions—making those contributions and earnings state income tax free. You lose this benefit with Roth accounts, since you pay both state and federal tax on those contributions.

Disadvantages

- Tax rates might go up by the time you retire.
- Compared to investments in non-retirement accounts, you'll pay regular income tax rates on your withdrawals instead of capital gains rates.
- Your heirs will owe income tax on all distributions from tax deferred accounts. Heirs would owe tax on investments held in regular accounts only when they sold the investment, and only on the increase in value since the date of death.
- There are penalties for early withdrawal.
- If you already owe no income tax, you will get no benefit from contributions to your employer plan or a deductible contribution to an IRA.

Tax Free Earnings (Roth)

Advantages

- You lock in tax-free distributions on all future growth in the account.

- Hedge against possible higher income rates in retirement.
- Your heirs will also receive distributions tax-free.
- In years when your income is low, Roth accounts allow you to pay taxes now and take advantage of the lower tax rates. Low-income years might be in the early years of your career, or when you work only part of a year, switch temporarily to part-time work, or leave work to start a business that is not yet profitable.
- Roth accounts reduce taxable income in retirement and may therefore lower taxes on Social Security benefits or help you qualify for other benefits and services that are based on income.
- Roth accounts offer the flexibility to take larger distributions when needed in retirement to meet large expenses, without increasing taxable income.
- *Roth IRAs only*: These accounts offer additional flexibility:
    - You can take some tax-free distributions even before retirement, because distributions are treated as coming first from contributions.
    - There are no required minimum distributions for the account owner, although there are for beneficiaries.

Disadvantages

- You pay tax now on your contributions.
- You might be in a higher tax bracket now than you will be in retirement.
- Loss of eligibility for other tax breaks due to higher current adjusted gross income.

Maximize Your Tax Benefits

When you change jobs, transfer the money from your retirement plan to an IRA or to your new employer's plan, or leave it with your previous employer. *DON'T* ***just take the money out and spend it.***

This is one of the most common mistakes people make. If you withdraw the money, you'll owe income tax on the entire amount plus a possible 10% penalty if you're under age 59½. It could also increase your tax bite by pushing you into a higher tax bracket. That's a very expensive way to get your hands on some spending money. And, you've just set yourself back on saving for retirement by several years.

Be smart. Leave the money alone or do a rollover. For more details, see *Rules for Taking Distributions from Tax-Deferred Retirement Plans,* at **http://www.ace.uiuc.edu/cfe/retirement/takingdistributions2007.PDF**.

Example #4: Rollover

Remember John and Linda? Now meet Miguel. They all started at ABC Company at the same time, earned $50,000, and contributed 6% of their incomes to the 401(k) plan. The company matched $1 for every $2 the employee contributed, up to 6% of pay. The vesting schedule is 3-year cliff, so they were 100% vested at the end of 3 years of service, but 0% until then.

John left ABC Company after 2 years and 11 months, and lost all of the company match. Linda left after 3 years, but took the money out and used it to move to her new job. Miguel left after 3 years and rolled his money over to an IRA.

	John	**Linda**	**Miguel**
Length of employment	2 years, 11 months	3 years	3 years
% of pay contributed	6%	6%	6%
Employee contribution	$3000 per year $8750 total	$3000 per year $9000 total	$3000 per year $9000 total
Employer matching	$1500 per year $4375 total	$1500 per year $4500 total	$1500 per year $4500 total
Vested employer matching	0%	100%	100%
Total in 401(k) account	$8750	$13,500	$13,500
Decision at leaving employment	Leave at old employer	Take out	Rollover to IRA
Regular income taxes (25% federal, 3% state)	0	$3780	0
Penalty tax	0	$1350	0
Total taxes	0	$5130	0
Balance	$8750	$8370	$13,500

More ways to maximize your tax benefits

- Contribute the maximum to your plan or IRA.
- If you're 50 or over, use the **catch-up provisions** which allow you to contribute amounts over and above the usual annual limits to IRAs and employer plans.[3]
- Your contribution to an IRA or retirement plan could earn you a **Saver's Credit** of up to $1000 on your income taxes if your income qualifies[4]
- Set up an IRA for a non-working spouse.
- Leave the money in an employer plan or IRA until you are at least 59½ to avoid possible early withdrawal penalties.[5]
- When you're approaching retirement, consider getting professional advice to help you make the best decisions about handling your retirement account, especially if you have appreciated company stock in your retirement plan.

[3] IRAs: $1000 per year. 401(k), 403(b) and 457 plans: $5000 (2008, indexed for inflation). SIMPLE IRA and SIMPLE 401(k) plans: $2500 (2008, indexed for inflation).
[4] Adjusted gross income not more than $53,000 for married filing jointly, $39,750 for heads of household, and $26,500 for single filers (2008, indexed for inflation annually).
[5] Age 55 for employer plans if you separate from service.

What about Annuities?

Commercial annuities[6] are touted as investments with great tax benefits and guarantees that supposedly make them safer and more tax-advantaged than regular mutual funds or individual stocks and bonds. While certain types of annuities may make sense for the retiree who is looking to create a guaranteed stream of income that will last until they die, annuities are less likely to be the best choice as an "accumulation" or investment vehicle—especially when compared to retirement plans and IRAs. Employer retirement plans and IRAs have much better tax benefits than annuities.

Annuities are funded with dollars on which you have already paid taxes. Taxes on the growth in the account are deferred until paid out. At withdrawal, the principal (your investment) will be repaid without taxes, and you will owe income taxes at your marginal tax rate on the part of the payment that represents earnings in the account.

Compare that with regular retirement accounts and IRAs, which give you tax deferral on both the contribution *and* the earnings. Or, Roth accounts on which you pay the taxes now on the money you contribute (just like an annuity) but the Roth accounts allow you to receive all the earnings tax-free. With the annuity, you're taxed at your marginal tax rate, perhaps 28% or higher, on the earnings. Retirement plans, with their stronger tax advantages, win easily over annuities.

Before even considering an annuity, contribute the maximum to your employer plan and to an IRA, including catch-up contributions if you're 50 or older. If you still have money to invest, compare all your investment options carefully, including their costs. Almost all annuities[7] pay hefty commissions to the salesperson and have significantly higher annual expenses than mutual funds. Once you're invested, annuities charge surrender fees if you want to get out of it in less than 7 to 10 years. Distributions before age 59 ½ will carry a 10% early distribution penalty, just like retirement plans. The value of your annuity could also depend on the insurance company remaining solvent—its bankruptcy could cost you your investment.

Annuities are extremely complex products that should be investigated thoroughly before investing. Consider paying for a couple of hours with a **fee-only** financial planner for objective advice to help you evaluate your options.

Attention: Government Workers

[6] This information refers to annuities purchased from commercial providers. It does not apply to charitable annuities or to 403(b) plans (Tax Sheltered Annuities or Tax Deferred Annuities), a retirement plan provided to teachers and certain other groups. 403(b) plans may offer both annuities and mutual funds as investment choices. Mutual funds may be the better choice; the account is tax-deferred and no tax benefit is gained from the added costs of an annuity.

[7] Exceptions are no-load or low-load annuities sold directly to the consumer. According to Motley Fool.com, examples are Vanguard, Fidelity, and T. Rowe Price (**http://www.fool.com/personal-finance/insurance/2007/01/08/are-annuities-too-cheap-part-2.aspx**).

If you worked in a government position where your earnings were not subject to Social Security, the amount of Social Security you can receive either on your own work record or from your spouse's work may be reduced. The benefit estimate in your annual Social Security Statement is not accurate for your situation. For details, get *Government Pension Offset* (SSA Publication #05-10007) and *Windfall Elimination Provision* (#05-10045) from the Social Security Administration. Go to **www.socialsecurity.gov** or call 1-800-772-1213.

If you worked as a government employee and only paid into Social Security for part of your working life, use Social Security's *WEP Online Calculator* or download the *Detailed Calculator* at **http://www.ssa.gov/planners/calculators.htm** to calculate your benefit. You can see the effect of the Windfall Elimination Provision and run scenarios to see whether a few more years in a Social Security-covered job might either qualify you for Social Security or boost your benefit. For the impact of the Government Pension Offset, use the fact sheet to make a calculation using your spouse's Social Security benefit amount and your pension amount. Before making decisions, call and talk with a Social Security representative at 1-800-772-1213.

Get Help If You Need It.

- For questions about your employer's retirement plan, talk with your Human Resources Office or the provider of the plan.
- Educate yourself about investing. Look for reliable and unbiased sources of information.
  - You may be eligible for assistance at little or no cost from the provider of your employer's retirement plan or a mutual fund where you have substantial assets or where you are transferring assets, perhaps by rolling over an IRA or 401(k) plan.
  - University of Illinois Extension's web site, *Plan Well-Retire Well*, includes an audio presentation with PowerPoint slides about investing. Register at **www.RetireWell.uiuc.edu** and go to *Choose Investments*.
- Many financial experts suggest using a **fee-only** financial planner for investment advice. Fee-only means that the person sells no investment products and receives no commission or other payment based on what you buy. To locate a fee-only adviser, contact:
  - The National Association of Personal Financial Advisers 1-888-FEE-ONLY or **www.NAPFA.org**.
  - The Garrett Planning Network at **www.garrettplanningnetwork.com**.
- For more information about choosing an investment adviser or financial planner, see *Choosing a Financial Professional* at **http://www.ace.uiuc.edu/cfe/retirement/**.

Action Steps

What actions will put you on the road to Retire Well? What issues do you need to investigate? What financial steps should you take? Check the items you'd like to accomplish:

___ Learn more about my retirement plan at work (i.e., about enrollment, vesting, matching contributions, or pension plan formulas)

What I will do:

___ Sign up and start saving—in an employer plan or IRA.

What I will do:

___ Increase the amount I am saving.

What I will do:

___ Plan how to handle employer retirement accounts when I change jobs or retire.

What I will do:

___ Get help if I need it.

What I will do:

___ Other:____

What I will do:

Additional Resources from University of Illinois Extension

- A guide to *Choosing a Financial Professional* is available on-line at **http://www.ace.uiuc.edu/cfe/cfp/**.
- *Rules for Taking Distributions from Tax-Deferred Retirement Savings Plans* explains rollovers, taxes and penalties, when you must begin taking distributions, and rules for beneficiaries of retirement accounts. It is available on-line at **http://www.ace.uiuc.edu/cfe/retirement/takingdistributions2007.PDF**.
- The interactive *Plan Well, Retire Well* web site offers numerous tools to help you with retirement and investing questions at **www.RetireWell.uiuc.edu**. Register and then explore the site. You may find these sections especially helpful:
    - *How Much do I Need to Save Each Month* calculator: go to *Goal Setting* and then *Plan of Action*.
    - *Informed Investing*, an audio presentation with PowerPoint slides: go to *Choose Investments*.
- *Is Your Financial Security at Risk?* is an interactive site that will help you develop your personal risk management plan, identify ways to handle risks, and decide what types of insurance you need. **http://www.urbanext.uiuc.edu/risk/** .
- *Your Retirement Checklist* ($19.99) is a print publication available from **www.PublicationsPlus.uiuc.edu** or 1-800-345-6087. Eight checklists give step-by-step guidance to help you stay on track as you develop your retirement plan and update it over the years.
- *IRA Basics* details the differences between traditional and Roth IRAs. It is available at **http://www.ace.uiuc.edu/cfe/retirement/**.

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