RETIREMENT FINANCIAL PLANNING

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CURRENT PRACTICE

As a Senior Vice President and Wealth Strategist at U.S. Trust, Bank of America Private Wealth Management, Toby coordinates the delivery of complex estate planning, financial consulting, and tax services to high net worth individuals and families. He also works closely with clients and their outside advisors to provide specialized wealth management and fiduciary services.

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I. INTRODUCTION

A. Purpose and Scope

Planning for retirement can seem like a daunting task, especially when you consider the many complex issues you have to navigate when developing your plan. How does Social Security work, and how much can I expect to receive? What type of retirement account is best for me? Should I be thinking about long-term care insurance? How much do I need to save before I can retire? These and other issues can leave people feeling overwhelmed, leading many to inaction.

The purpose of this article is not to provide comprehensive answers to the complex issues involved in retirement but rather to outline the issues most people face when planning for retirement and to provide some general information and guidance. While this article leaves out many details that may be relevant to your own planning, it is intended to provide a solid understanding of each topic discussed, enabling you to avoid inaction and to move with confidence towards a comprehensive plan the meets your objectives. My hope is that the article will inform you and point you in the right direction so you will be equipped to ask the right questions of your financial advisors.

It must be noted that the article is limited to retirement *financial* planning and does not address every issue you may encounter when you retire. So, for example, virtually nothing is said about estate planning or business succession planning, nor is there much discussion at all about such "softer" topics as the stresses and opportunities that can accompany such major life transitions as retiring. These and many other topics are well beyond the scope of this article.

B. No Substitutes For Saving and Planning

It is never too early to begin planning for retirement, even if you are just beginning your career. Starting early is perhaps the most important factor for achieving your retirement goals. The power of compounding by itself makes starting to save for retirement early in your career a wise decision. When you add in the income tax deferral features of retirement accounts and, if available, the matching retirement contributions made by your employer, it really is a no brainer. If you can be disciplined enough to put away 10% or more of your earnings in a retirement account beginning early in your career, you will certainly be rewarded handsomely later on.

Even if you did not begin saving early, it is (almost) never too late to begin planning for retirement. While failing to plan early in your career can limit your options later on, there are helpful steps you can take no matter what age you are.

Retirement planning is much more than simply putting away savings, and there is a lot you can and should do to plan for retirement, whether you began saving early or not. Retirement planning really begins with self-education and developing a written plan. Whether you work with a financial advisor or go it alone, there is simply no substitute for a solid understanding of retirement planning principles and no shortcuts for developing a written plan. Simply calculating what you will need in retirement and developing a written plan for how to get there greatly increases your odds of success. Failing to spend the time to educate yourself and develop a written plan will most likely leave you unable to retire on your own terms, or perhaps to retire at all.

After discussing sources of income available during your retirement years and how to think about expenditures during retirement, the remainder of the article will discuss in greater detail those particular issues and ideas most people need to consider as part of a comprehensive retirement financial plan.

II. SOURCES OF INCOME

A. Social Security

While few people can rely exclusively on Social Security for their retirement needs, it is a helpful and much-needed source of income for many people. Knowing how much to expect and the rules that can dramatically affect your benefits is crucial. A broad overview and summary of the applicable rules is provided in the section below, entitled "Social Security – Basic Rules and Strategies."

B. Continuing to Work

Many people continue to work beyond their full retirement age (i.e., age 66 or 67 under current Social Security rules) in order to supplement their Social Security and other post-retirement income. The extra income can make a hug difference: an extra $20,000 per year from employment is equivalent to a 4% annual withdrawal from $500,000 of savings.

Beware, though. Planning on significant employment income during retirement years may be unrealistic due to such factors as tight job markets or poor health.

1. <u>Remain in Current Job</u>

Some simply decide to remain in their current position beyond age 65 in order to accumulate enough savings to retire comfortably.

Others would like to stay with their current employer but no longer wish to work full-time. Increasingly, employers are accommodating requests from older workers for continued employment but with a more flexible schedule, in a part-time position, or even on a seasonal basis. It never hurts to ask if this is something you would like to do.

2. Reduced Work Schedule in the Same Field

Many older employees find their employers do not or cannot accommodate their requests for a reduced work schedule, so they are forced to look elsewhere. Some employers are thrilled to hire more experienced workers on a part-time, contract, or consulting basis, particularly as they have temporary, project-based, or seasonal needs. Many workers are thus able to find work in their same field but with a different employer, a contracting agency, or even by starting their own consulting business.

3. New Pursuits

Retirement has traditionally been synonymous with ceasing to work at age 65. However, with many people living healthy and active lives well into their 80's and 90's, it may be time to re-think the nature of retirement. A full-time life of leisure after a long, hard career sounds appealing, but most people become bored with it after a short while. Recent research has shown that being actively engaged in productive work, even if only part-time, is necessary to maintain a sense of meaning and purpose. Also, many people who cease working effectively loose an important source of social interaction they may not otherwise have outside of the office.

Many people are therefore choosing "post-retirement" jobs or "encore careers". While many such jobs or careers do provide money, their main purpose typically is not to acquire more money but rather something more meaningful: pursuing a lifelong dream, serious pursuit of a hobby or passion, leaving a legacy, changing the world, or even simply maintaining social ties.

Once people feel they have sufficient assets, they are freed to retire from working for financial gain and instead consider spending their time pursuing more meaningful work. In this way of thinking, the central concept of retirement is not simply achieving the ability to cease working altogether but rather achieving sufficient financial independence to transition to more meaningful and typically less stressful work, chosen independently of the financial compensation it provides.

When financial independence (and not simply ceasing to work) becomes the goal of saving and investing, people tend to look forward not simply to rest and leisure but instead to new pursuits. Following this way of thinking, many people are finding they do not need to stay in their high-income earning careers until age 65. Even if they are not fully financially independent at age 50 or 55, they may have saved enough by then to leave the high-income career for a more meaningful lower-income career they plan to pursue into their 70's or 80's.

C. Income Producing Assets

One of the biggest sources of income for most people during retirement comes from the money they saved during their working years. Typically, such savings are invested in balanced portfolios consisting primarily of stocks, bonds, and cash, though many people do put a portion of their savings into other income generating investments such as rental real estate, oil and gas, etc.

Many planners suggest arranging for guaranteed income to met your required expenses so that only income for discretionary expenses can be affected by market fluctuations. In addition to Social Security benefits, such guaranteed income typically comes from annuities, pensions (if you are one of the few these days who has one), rental real estate, ladder bond strategies, or other fixed income strategies.

1. Retirement Plan Accounts

The best way for most people to accumulate assets that will produce income during retirement is through disciplined savings in retirement plan accounts over the course of their careers. The power of compounding over the years is tremendous, and it is super-charged when that compounding occurs within tax-advantaged retirement accounts.

There are many different tax-favored retirement plan accounts, and choosing the right one or ones for you can be confusing. Regardless of which plan or plans may be available to you, it is almost always best to contribute as much as you can to a retirement account.

Most employers offer 401(k)'s or 403(b)'s, which are defined contribution plans available through for-profit employers and non-profit employers respectively. These accounts allow for annual contributions by you and usually your employer, with no guarantees regarding the benefits you will receive during retirement. Current law allows you to contribute $17,500 per year to a 401(k) or a 403(b) account, with an ability to contribute an extra $5,500 if you are age 50 or older. Such contributions are subtracted from your taxable income on your W-2.

Many employers match a portion of your contributions. A common example is an employer that matches your contribution dollar-for-dollar up to 3% of your salary. The account funds are invested tax-free until you begin taking distributions in retirement (age 59½ or older), which distributions are taxable as ordinary income. You are not required to take any distributions until age 70½, when you must begin taking minimum distributions based on your life expectancy.

If your employer does not offer a 401(k) or 403(b), you may be eligible to make non-taxable contributions to a traditional IRA. Current law allows you to contribute $5,500 per year, with an ability to contribute an extra $1,000 if you are age 50 or older. You are allowed a deduction for such contributions if neither you nor your spouse can contribute to a 401(k) or 403(b). If either you or your spouse can contribute to a 401(k) or 403(b), the rules get a little complicated and you may not be able to take a deduction (or perhaps only a partial deduction).

Even if you cannot claim a deduction for contributions to a traditional IRA, you should strongly consider making a *nondeductible* contribution to a traditional IRA (if you are able to save more after fully funding your 401(k) or 403(b)). Although you will not save taxes in the year of contribution, the contribution will grow tax-free in the same manner as non-taxable contributions. Also, you will have basis equal to the amount of the taxable contribution, and that basis can be used to offset the recognition of income when distributions are made from the IRA.

You may also be able to make contributions to a Roth IRA (assuming your income is not too high), and you should always consider making such contributions if you can. Roth IRA's provide many tremendous advantages over other retirement accounts. See the more detailed discussion of Roth IRA's below under Part IV of this outline.

There are other retirement plan accounts available for smaller employers and for the self-employed, including SEP IRA's and SIMPLE plans. Special advice from your tax adviser is strongly encouraged if you are in one of these situations.

With so many saving options, it is often difficult to decide which retirement plan may be best for you. If your employer offers a 401(k) or 403(b), you should always contribute enough to receive the maximum employer match possible, and you really should contribute as much as you can to that account. If a Roth 401(k) or Roth 403(b) option is available, you should strongly consider that option for a portion or all of your contributions. Next, you should contribute to a Roth IRA if you are able, then to tax-deductible IRA's if you are able, and then finally to non-deductible IRA's. If you are self-employed, you should work with your tax adviser to determine your best options.

2. <u>Pension Plans</u>

Some employers today still offer pension plans, though these are much less common than they used to be. Pension plans are defined benefit plans, meaning that you will have guaranteed benefits upon retirement. Contrast these with defined contribution plans (such as 401(k)'s or IRA's) which have set amounts you can contribute during your working years but leave you with uncertain benefits during retirement due to the uncertainties of how your investments perform over the years.

While pension plans may not have the same downside potential as defined contribution plans, neither do they have the same upside potential. Your pension benefits are determined by a formula based on years of service and compensation levels, giving you much greater certainty regarding your retirement income. Accordingly, pension plans can make retirement planning much easier.

3. <u>Annuities</u>

Most people today are not able to participate in pension plans (because such plans are not offered by their employers). They can however effectively create their own "pension" through the purchase of a fixed annuity.

The easiest way to do so is to purchase a single premium annuity that begins payments immediately upon acquisition (i.e., purchase it at retirement when you are ready to begin receiving fixed income payments). Such annuities usually are not indexed for inflation, and they are even less attractive in today's low interest rate environment (which means you can expect a lower payout rate for the purchase price). As many investors know, fixed income is hard to find these days due to low interest rates, so the "price" of acquiring guaranteed income through fixed a fixed annuity may currently be too steep for many retirees.

You could consider an annuity ladder as a way to avoid locking in currently low interest rates while still achieving guaranteed income. Under this strategy, you buy fixed annuities every few years rather than all at once. Assuming interest rates go up, your payouts will increase with the newer annuities. You will also receive higher payouts because you are older (i.e., because of your shorter life expectancy).

Regardless of when you purchase an annuity (or annuities in a ladder strategy), your payouts will be highest if you choose a life-only annuity. These annuities pay until you die, but then payments stop. Just like with life insurance, your annuity is more valuable if you live beyond your life expectancy but less valuable if you die early.

If you are married, you can hedge against the risk of dying prematurely by purchasing a joint and survivor annuity that keeps paying until the second death of you and your spouse. To hedge that risk even more, you can purchase an annuity with guaranteed payments (to you, your spouse, or your heirs) for a fixed term of years. Obviously, the less risk you take, the more risk the insurance company takes, meaning your annuity payments will be lower (or you will pay more for the same annuity payments).

Many people are more worried about outliving their retirement savings as a result of poor market performance in their investment account and/or living many years past their life expectancy. For these people, a deferred annuity that delays payments until their 70's or 80's can be a good option. The longer you defer the payments, the higher the annual payout will be when payments begin. Most people who purchase such annuities choose a cash refund option that guarantees their heirs will get at least as much as they invested in the annuity regardless of when they die. Of course, such "insurance" comes with a cost, but most people find that cost a necessary one when purchasing a deferred annuity.

4. Taxable Investment Accounts

Having assets in a taxable investment account provides a ready source of cash flow during retirement. As discussed below, you can plan to withdraw both the income and a portion of the account assets themselves during retirement as a way to help pay for expenses.

Because of the tax-savings available through retirement accounts, you annual savings amount should first go into your retirement accounts before adding funds to taxable investment accounts. Of course, in the event you need to access your savings before you retire, there is no penalty (and no additional tax) if you withdraw from a taxable investment account, unlike most retirement accounts. So, you must balance the tax benefits of retirement accounts against the easy access of taxable investment accounts.

Note however that a Roth IRA gives you the ability to access your contributions before retirement (though earnings are not as easily available), making Roth IRA's very attractive. See the separate discussion of Roth IRA's below.

5. Other Assets

There are other classes of income producing assets to consider, though they are not nearly as popular as the types discussed above. One more common type of asset is rental real estate which many people find to be a great way to obtain a steady flow of income during retirement without significant depreciation risk. Of course, recent years have shown that the real estate market can decline significantly, but some markets are certainly more susceptible than others, and many people do still believe real estate is one of the safest long-term investments you can hold.

While oil and gas investments are by nature usually very risky, a portfolio of producing wells can provide a very nice stream of income. Market prices for oil and for gas can affect annual income substantially, and acquiring producing wells is tricky. So, counting on oil and gas investments for retirement income is not the best strategy for most people. If during your working years you have some extra savings you can take significant risks with, investing in oil and gas properties could make sense. If they payoff, the difference it makes to your retirement could mean you eat at nice restaurants most nights of the week rather than only occasionally, or that you can retire early rather than waiting until age 65 or 70. Unless you already hold producing properties, your primary savings plan should not revolve around oil and gas investments.

D. Focus on Cash Flow

Unless you want to leave a substantial sum to your heirs or to charities, the real goal of saving for retirement is not merely to have assets that will generate sufficient *income* to help meet living expenses but rather assets that will generate sufficient *cash flow* to meet those expenses. In other words, you should plan to spend down the wealth accumulated during your pre-retirement years throughout your retirement years. The focus should be on cash flow, not on income.

With that understanding in mind, how big of a "nest egg" do you need? There are several factors to keep in mind.

1. Life Expectancy

Average life expectancy in the United States is just under 79 years. Of course, that means many people live much longer. Based on your own family history, you may have a good idea whether you are likely to live into your 80's, 90's, or even 100's. In any case, you should err on the side of caution so you do not have to cut back on your expenses to avoid running out of money.

2. Withdrawal Rate

For several years, many advisors have recommended a 4% rule, which is a plan to withdraw an amount equal to 4% of your investment assets in your first year of retirement and then increase that amount each year for inflation. This 4% rule was developed in 1994 based on a financial analysis of average 30-year returns with an assumed portfolio allocation of 50% stocks and 50% bonds. Given the increased volatility we have seen since the late 90's and the dramatically lower interest rates we have seen in recent years, many planners are now suggesting a lower withdrawal rate starting with 2.5% or 3% and then growing for inflation. Another nuanced change to the 4% rule is to withdraw less than the scheduled amount in years when your assets are not performing well and withdraw more when they are.

Few suggest taking more than 4% or less than 2.5%, so you are probably safe assuming a withdrawal rate within that range when planning for retirement. Regardless of which rate you choose, you should be aware that it can have a material impact on your plan.

3. Asset Allocation

As people near retirement, they tend to put a smaller portion of their investments into equities, and rightfully so. However, some people make the mistake of getting completely out of equities when they retire based on the thought that they do not want to take any risks during retirement. This can have a dramatic effect on a retirement lasting 15 or 20 years, greatly reducing the power of your assets to produce cash flow long-term. You need to take some amount of risk if you are going to beat inflation over your retirement years. Somewhere between 20% and 40% in equities is right for most investors. Only the most conservative of investors, who have more than they need (even if their investments lag behind inflation), get out of equities altogether. The key point here is that your asset allocation during retirement can greatly impact your available cash flow in your later years of retirement, so you should be very cautious about holding too little in equities.

4. Residence and Other Nonfinancial Assets

Depending on your plan for your residence after retirement, you may want to count the equity in your residence towards your total nest egg. See the separate section below entitled "What to Do With Your Homestead" for a more complete discussion. Likewise, if you have a second home or other nonfinancial assets you plan to liquidate before or during retirement, those liquidation values should be added to the total. Be sure not to overestimate the value of those assets – a common mistake.

III. EXPENDITURES

A large part of developing a written retirement plan is determining how much you will need during your retirement years. Some people use a rule of thumb to estimate their retirement expenditures, which can be helpful particularly if you are just starting your career and have very little idea about what your retirement budget might look. The better practice, if at all possible, is to prepare a detailed budget. Below is some guidance for both approaches.

A. Rule of Thumb

By nature, rules of thumb are inexact substitutes for detailed thinking and planning. While detailed budgets do have limitations due to the need to build in assumptions, there really is no substitute for them. Nevertheless, rules of thumb can give some general guidance and can serve to give a level of comfort (or motivation) when you consider the state of your own retirement planning.

Perhaps the most prevalent rule of thumb is that you should expect to need between 70% and 85% of your pre-retirement annual expenses. In most cases, certain costs will simply disappear when you stop working full-time or simply stop working at your high-income producing job. Payroll-taxes, work-related expenses, business clothing, retirement savings contributions, lunches, tolls, gas, insurance, etc. can also decrease significantly.

Other costs will increase for most people during their retirement years. Vacation and travel (including dream trips and trips to visit kids, grandkids, or old friends) tend to increase. Hobby expenses also can increase when you have more time on your hands. Hobbies such as woodworking, art, cars, etc. can lead to increased spending for new tools and supplies. For many people, more free time means more time on the golf course, which of course is not cheap.

Charitable giving also tends to increase for many people, particularly if they are spending more time volunteering for their favorite charities. Education expenses can also be significant for those taking up an "encore" career.

Depending on how well off your parents are, you may need to help support them in their later years. Likewise, in the past several years, many grown children have needed help as they faced a difficult job market and sky-high college debt, an unwelcomed surprise to their parents who had not planned on such added expenses during their early retirement years. The need to raise grandchildren (e.g., when your child is unable or unwilling to provide for his/her own children) can also easily bust a retirement budget.

Keep in mind that costs for each category can change dramatically through your retirement years. More may be spent on travel during your early years when you are healthy and mobile; more may be spent on health care later on.

B. Prepare a Budget

Given all of the variables that can affect your projected retirement budget, there really is no substitute for actually developing a written plan tailored to your particular circumstances and objectives. Rather than relying on a rule of thumb, the better approach is to use a budget worksheet and then grow for inflation.

Make sure your budget is realistic and conservative in its assumptions. Spending too little time to develop a realistic budget or being too optimistic about how little you might be able to spend during retirement can be dangerous.

Be sure your retirement budget includes taxes during retirement. While these most likely will go down substantially for most retirees, they likely will not disappear entirely. See the separate section below entitled Income Taxes During Retirement for a more detailed discussion.

Do not forget occasional large expenditures. Many people overlook major home repairs such as a new roof or new HVAC unit. Many people who spend more time at home after retirement end up remodeling their kitchen or bathroom or perhaps converting a bedroom into a study, so be sure to plan for these possibilities. Also, be sure to include the cost of new cars into your retirement budget – if your retirement years last 15 or 20 years, you might not want to drive the same car you were driving when you retired.

IV. SOCIAL SECURITY – BASIC RULES AND STRATEGIES

A. Basic Rules

1. Qualifications

Anyone who has paid into Social Security will be eligible to receive Social Security retirement benefits beginning as early as age 62. The monthly benefits you are entitled to receive are greatly affected by a number of factors.

Full retirement age ("FRA") for Social Security retirement benefit purposes is currently between age 66 and 67, depending on your birth date. Claiming benefits at age 62 (rather than waiting until your FRA) will result in lower monthly benefits, just as waiting until age 70 will result in higher monthly benefits. A number of studies have revealed that living to age 80 will result in the same overall amount of benefits regardless of when you begin taking benefits. This means that if you die before age 80, then beginning your benefits earlier would have been better, and if you live longer than age 80, then waiting until age 70 to begin taking benefits would have been better. Of course, you will not have the benefit of hindsight when you make the decision to begin taking benefits, but these facts can help you evaluate the risks of waiting longer to take benefits.

Your monthly benefit is also greatly impacted by your average monthly wages or self-employment income, based on your highest 35 years of earnings. So, working fewer than 35 years will lower your Social Security retirement benefits. Lower earnings early in your career can also impact your benefits if you do not have enough higher earning years later on. The maximum annual earnings in each of the 35 years counted for purposes of this calculation is limited to the maximum amount of earnings in those years that were subject to Social Security withholding taxes ($117,000 in 2014).

You must work at least 40 covered quarters (i.e., a quarter during which you work a job covered by Social Security and earn a minimum amount of income) in order to claim any Social Security retirement benefits.

2. Impact of Working

Earned income (from wages and self-employment) during any period you are receiving Social Security benefits but before your full retirement age (i.e., after age 62 but before age 66 or 67 [depending on your birth date]) can reduce the amount of your monthly retirement benefit. For every $2 of earned income over the annual limit ($15,480 in 2014), your Social Security benefit is reduced by $1.

These reductions in your Social Security benefits due to excess earned income are not permanently lost. Instead, when you reach your full retirement age, your monthly retirement benefit will be recalculated. The recalculation simply counts the months of benefits lost and adds that number of months to your actual retirement date. So, for example, assuming you retired at age 62 and began taking benefits but then had 12 months of excess earned income causing you to lose 12 months of benefits, when you reach age 66 (assuming that is your full retirement age), you monthly benefits will be recalculated going forward as if you had actually retired 12 months later (i.e., at age 63).

3. Spousal Retirement Benefits

In addition to you own retirement benefits based on your own earnings, you can also receive a retirement benefit based on your spouse's earnings if you meet certain criteria: you have been married at least 1 year, your spouse has filed for Social Security retirement benefits, and you are at least age 62. Assuming you meet these criteria, your spousal retirement benefit is equal to 50% of your spouse's benefit, reduced by the amount of your own benefit. Your spousal benefit is then added on top of your own benefit. If you claim spousal retirement benefits before your full retirement age, those benefits will be reduced (by the same percentage as your own benefits would be reduced if you claimed Social Security for yourself before your full retirement age). So, you and your spouse might each be eligible for your own retirement benefits plus a spousal retirement benefit.

B. Basic Strategies

Whether you are single, married, divorced, or widowed, determining when to claim Social Security retirement benefits can be difficult to determine. Things are even more complex if you are married, given the additional strategies available to married couples.

1. Delay Benefits

Almost three quarters of all retirees claim Social Security retirement benefits prior to their full retirement age, and approximately 40% claim them at age 62. Though many of these people have little or no choice (i.e., they need the money), many others fail to appreciate the long-term consequences of taking benefits early. While age 62 may be right for many people, undoubtedly too many people are claiming at age 62 when they would be better off waiting until full retirement age, or even age 70.

If you need the money at age 62, then the choice is simple – claim benefits at age 62. Generally, the longer you wait to begin taking benefits, the more total benefits you will receive over your lifetime, assuming you live long enough. The most basic strategy for maximizing benefits, then, is simply to run the numbers to determine if you can defer taking benefits, as long as you are healthy and have no reason to believe you have a shortened life expectancy.

2. File and Restrict

If you file for benefits before your full retirement age and you qualify for both your own retirement benefits and spousal benefits, you are irrevocably deemed to have filed for both benefits (even if one of them is $0). However, if you wait to file for benefits until your full retirement age, then you can restrict the benefits claimed to less than all of the benefits you are entitled to receive. This would allow you to claim spousal retirement benefits (assuming you are otherwise eligible for them) without also claiming your own retirement benefits. You could also claim your own retirement benefits but not spousal retirement benefits, so that your spouse could claim spousal retirement benefits.

3. File and Suspend

You can wait until your full retirement age to file for benefits, and then you also have the option to suspend those benefits. For example, upon reaching full retirement age, you could file for your own retirement benefits (which allows your spouse to claim spousal benefits) and then immediately suspend your own benefits. Because you would not receive any of your own benefits, your retirement benefits would accrue "delayed retirement credits". Delayed retirement credits are entitled to an 8% annual increase until age 70 (a very good return without any risk).

After you file and suspend, you can unsuspend your benefits and collect, retroactively, all the benefits you had foregone since your full retirement age. In other words, you do not have to wait until age 70 to collect the suspended payments. However, any "back pay" collected does not receive the 8% annual increase. This option is particularly helpful if you file and suspend and then later learn you have a shortened life expectancy.

You also do not have to wait until age 70 to begin taking monthly benefits. You can unsuspend and begin collecting monthly benefits at any time. In this scenario, you do keep the 8% increase from full retirement age through the date you unsuspend. If you choose to take any "back pay", however, the above rule applies and you do not get the 8% annual increase on the back pay.

C. Projected Amounts

Every year, the Social Security Administration sends out a statement showing your Social Security earnings history. The statement will also give you an estimate of your future monthly retirement benefits at certain ages, based on assumptions about your future earnings. You can get an estimate of your future monthly retirement benefits online through a handful of helpful Social Security administration estimators at www.ssa.gov/planners/benefitcalculators.htm.

V. WHAT TO DO WITH YOUR HOMESTEAD

While many people plan to pay off their mortgage so they can own their home "free and clear" during retirement, there are other options worth exploring. The continued costs and time commitment related to maintaining a larger home that may no longer be needed convince many people to consider downsizing to a smaller home or even renting. What follows is a brief summary of the main options available with respect to the homestead.

A. Payoff the Mortgage

For those that want to remain in the same home and eliminate their monthly mortgage payments, planning to fully pay off their mortgage before retirement is a great option. Many people love the peace of mind that comes from knowing they own their own home and are debt free. Knowing the equity in their home is protected from creditors also provides great comfort. Despite recent turmoil in real estate markets, many people still feel having money in their homes will provide a safer investment over the years than other investments.

Despite these advantages, many people find it would be better to take the equity from their homes and invest it in a balanced portfolio. Also, many attorneys and other professionals rely on homestead protection during their working years when they are more susceptible to lawsuits and then plan to access their equity for living expenses during retirement. While many retirees are nostalgic when it comes to their family home, others love the idea of creating new memories in a newer home that better fits their needs during retirement.

B. Reverse Mortgage

An increasingly popular way to remain in your home during retirement while also accessing the equity in your home is through a reverse mortgage. Anyone age 62 or older who meets certain federal requirements can convert a portion of their home equity (up to $625,500) into cash, which can then be used to help pay monthly expenses or generally be used for any purpose.

Your house must be your primary residence, and you must pay off any current mortgage with the proceeds from the reverse mortgage. There are no monthly mortgage payments, but you must also be able to pay ongoing property taxes, utilities, and hazard and flood insurance premiums. You must also continue to live in the home.

You can take the loan proceeds upfront or in monthly payments to you for the rest of your life. You can also elect to receive a line-of-credit you can access at any time.

Typically, you pay a one-time, upfront mortgage insurance premium of 0.5% of the loan amount plus annual insurance premiums of 1.25% of the loan balance each year. These insurance premiums ensure the lender will be reimbursed by the government if the house ultimately sells for less than the loan balance. Consequently, the loan is non-recourse debt, meaning you (or your heirs) will never owe more than the home is worth.

If you sell the home during your lifetime, the loan balance is paid off and you keep any remaining proceeds from sale. If the loan balance exceeds the sales price, the Federal Housing Administration reimburses the lender for the difference – this is what the mortgage insurance premiums are for. If you die while still owning the home, the same results will apply for your heirs.

C. Downsize

Many people plan to sell their homes shortly after retirement and purchase a new home. Some do so in order to be able to purchase a smaller home that better fits their needs during their retirement years. Others want a newer, more efficient home. Still others may simply want to move near grandkids or go on a new adventure (whether out of state or simply in another part of the same town). Some even choose to purchase a condo in the city with less space and less maintenance hassles, even if the condo is more expensive than their current home.

Whatever the reasons, downsizing can result in lower property taxes, utilities, and insurance. Also, as with a reverse mortgage, you can effectively cash out of your existing home and then put only a portion of those cash proceeds towards the down payment on the new home, leaving cash in your pocket to meet living expenses or invest in a balanced portfolio. Downsizing also enables those who perhaps cannot afford to pay off their mortgage on their existing home to purchase a more affordable home entirely from the cash proceeds from the sale of their existing home, leaving them with the peace of mind of having no mortgage.

D. Rent

Cashing out of the home and renting can be a very attractive option as well. It enables you to access cash for living expenses and investment purposes while also minimizing maintenance hassles. Overall monthly costs are typically less than owning a home, though of course no part of the payment goes towards equity.

Renting does not necessarily mean a small apartment or condo. Many people rent luxury townhomes or houses. If you do not feel the need to remain in the same location year round, you could even consider renting multiple homes throughout the year in different locations. With internet sites like www.vrbo.com, www.homeaway.com, and many others like them, you could rent houses, condos, or townhomes homes in different locations throughout the country or abroad for several months at a time. Whether to live with different family members at different times of the year or simply to enjoy mild winters and summers, renting can be a great way to enjoy a portion or all of your retirement years.

VI. ROTH IRA'S

Roth IRA's are arguably the most versatile and valuable accounts you can have. While Roth IRA's are similar to traditional IRA's in many respects, there are some key differences between the two accounts that tend to make Roth IRA's the more favored retirement vehicle.

Though their primary purpose is for retirement savings, Roth IRA's also allow you to access assets pre-retirement for a variety of other purposes without incurring taxes or penalties. Because these accounts are so valuable, and because of a significant policy change in 2010, Roth IRA's deserve special attention in this outline.

A. Basic Rules

Contributions to Roth IRA's are non-deductible. Withdrawals from Roth IRA of *contributions* are tax-free and can be taken at any time. Withdrawals of *earnings* are tax-free if made after age 59½ and you have had a Roth IRA for at least 5 years. There are no required minimum distributions from Roth IRA's, meaning the tax-free build-up of earnings and growth can continue much longer than for traditional IRA's.

As with traditional IRA's, you can contribute $5,500 per year to a Roth IRA, with an ability to contribute an extra $1,000 if you are age 50 or older. Unlike with a traditional IRA, you are not able to contribute to Roth IRA's if your modified AGI exceeds $191,000 for a married couple or $129,000 for a single person. Even if your modified AGI exceeds these limits, you may still have other ways to establish a Roth IRA – see subsections C and D below.

While the stated contribution limits are the same for traditional and Roth IRA's, you actually get a bigger benefit from making contributions to a Roth IRA. Every dollar contributed to a Roth IRA belongs to you because that dollar (and any growth or income while in the Roth IRA) will never be subject to federal income tax. By contrast, a portion of every dollar contributed to a traditional IRA effectively belongs to the federal government because distributions from a traditional IRA will be one day taxed. If, for example, you will be in the 25% tax bracket during retirement, then 25% of your traditional IRA is earmarked for taxes, while 0% of your Roth IRA will go to taxes. So, a $5,500 contribution to a Roth IRA would be equivalent (in this example) to a $7,333 contribution to a traditional IRA. Put the other way, a $5,500 contribution to a traditional IRA would be equivalent to a $4,125 contribution to Roth IRA – but you get to contribute $5,500 to the Roth IRA! The take-home point is that a full contribution to a Roth IRA enables you to have more of your own money working for you tax-free inside the account than if you made a full contribution to a traditional IRA.

B. Other Advantages of Roth IRA's

In addition to withdrawals of your contributions and of earnings after age 59½ (assuming you have had a Roth IRA for at least 5 years), other tax-free and/or penalty-free withdrawals are permitted. Withdrawals of earnings to pay for college expenses are subject to income tax, but the 10% penalty for early withdrawal (i.e., before age 59½) does not apply. You can also withdraw up to $10,000 of earnings for the purchase of a first-time home without any taxes or the 10% penalty for early withdrawal. You can also withdraw for certain unreimbursed medical expenses tax-free and without a penalty.

As an estate planning vehicle, Roth IRA's have very beneficial rules. Because there are no required minimum distributions from Roth IRA's during your own lifetime, you can allow your Roth IRA to grow tax-free over your lifetime (assuming you have other sufficient resources to fund your retirement costs). After your death, your heirs must take required minimum distributions over their lifetimes, but they can leave excess amounts in the account to grow tax-free over their own lifetimes. And, any distributions to your heirs are free of income tax.

C. Overcoming AGI Limitations Via Conversion

Because of certain limitations initially imposed on Roth IRA's, high income earners were unable to create Roth IRA's due to the modified AGI limitations cited above as well as certain AGI limitations on the ability to convert a traditional IRA to a Roth IRA. In 2010, those conversion limitations were eliminated. So, while contribution limits still apply, anyone can effectively create a Roth IRA through a conversion.

Under current law, you can convert a traditional IRA into a Roth IRA regardless of your AGI. A particularly attractive strategy is to make *nondeductible* contributions to a traditional IRA (meaning with after-tax dollars, just as a normal Roth IRA contribution is with after tax dollars) and then convert that traditional IRA to a Roth IRA. When a traditional IRA is converted, you do have to pay income tax on the *deductible* contributions plus any earnings or growth on those contributions, but you do not have to pay income tax on *nondeductible* contributions. *Nondeductible* contributions give you basis in the traditional IRA, and you get to deduct that basis when you convert the traditional IRA to a Roth IRA. <u>Caution</u>: When converting, current law requires you to aggregate all of your traditional IRA's together and then allocate a pro rata share of your basis in the aggregate amount of the IRA's to the converted IRA.

D. Roth 401(k) vs. Regular 401(k)

Many employers are now offering Roth 401(k) plans, which follow the same contribution rules as traditional 401(k)'s but allow you to make nondeductible contributions to a Roth account. The stated contribution limits are the same for traditional 401(k) and Roth 401(k) accounts – $17,500 with an ability to contribute an extra $5,500 if you are age 50 or older. However, putting $17,500 of pre-tax dollars into a 401(k) account is not that same as putting $17,500 of post-tax dollars into a Roth 401(k) account (see similar discussion above at Section IV.A). Therefore, a Roth 401(k) account can offer the ability to put more after-tax wealth into a tax-deferred retirement fund.

Contributions to Roth 401(k)'s are typically eligible for the same matching funds your employer offers for traditional 401(k) accounts, though the employer matching funds will be contributed to a traditional 401(k) account. You can also split your 401(k) contributions between a Roth 401(k) and a traditional 401(k).

The law does allow you to convert some or all of the money in your traditional 401(k) to a Roth 401(k), as long as your employer's plan allows for it.

Contributions to Roth 401(k)'s are not subject to the AGI limitations that apply to Roth IRA's. and, when you retire from your job, you can simply rollover your Roth 401(k) into a Roth IRA. This is another way that high income earners can take Roth IRA's into retirement (conversions being the other).

VII. HEALTH CARE COSTS

A. Expected Costs

The average 65 year old couple needs $220,000 for health care costs for 20 years of retirement. Most of that amount comes from the cost of insurance premiums, deductibles, and coinsurance requirements. Yet, few people realize the types and amounts of health care costs they can expect, setting them up for a very care costs and may have a rude awakening in their golden years.

The $220,000 amount does <u>not</u> include any costs associated with nursing-home care and applies only to those with Medicare insurance. Also, some people will simply have more health problems, and other will live beyond age 85. $220,000 may therefore be a low number for you, particularly if you have ongoing health issues or if you expect to live into your late 80's or your 90's.

B. Medicare

1. Qualifications

Most people will qualify for Medicare at age 65. If the individual or the individual's spouse worked at least 10 years and paid into Medicare, then the individual qualifies for Medicare.

2. Covered Expenses

Medicare consists of 4 parts: Parts A, B, C, and D. Part A provides for hospital care, skilled nursing facility care, certain nursing home care, hospice, and home health services. Part B provides for non-hospital medically necessary services and for certain preventative services. Part D provides prescription drug coverage. Part C (also known as Medicare Advantage plans) refers to private HMO or PPO plans provided by companies who contract with Medicare and provide plans that combine Parts A, B, and/or D.

Most people do not pay premiums for Part A insurance because they already paid for it through their payroll taxes when working. There are premiums for Parts B and D as well as for plans under Part C. Also, all 4 parts require deductibles and coinsurance payments.

Examples of expenses not covered by Medicare include long-term care, most dental care, eye examinations related to prescribing glasses, dentures, cosmetic surgery, acupuncture, hearing aids and exams for fitting them, and routine foot care.

3. Medicare Gap Coverage

When people talk about "Medicare gap coverage," they mean ways you can cover the out-of-pocket costs not covered under Parts A & B. These "gap" costs include costs for prescriptions drugs, deductibles, co-payments, and other non-covered costs (described above).

There are 3 basic ways to cover these gap costs: (1) retiree health insurance provided through your employer (rare today), (2) a medigap policy coupled with Part D prescription drug coverage, or (3) a private Medicare Advantage plan (i.e., Part C).

Medigap policies are offered by private insurers, but each plan must meet standardized coverage requirements set forth by the government. There are several types of plans, each with its own set of standardized required features and a letter designation to indicate what type of plan it is (A, B, C, etc. – not to be confused with Medicare Parts A-D) . While every medigap plan with the same letter will have the same exact coverage, premiums can vary significantly by provider. If you purchase a medigap plan, you will also need a separate Part D prescription drug policy.

Instead of purchasing a Medigap policy and a separate Part D prescription drug policy, you could simply sign up with a Medicare Advantage plan which provides comprehensive coverage from a private insurer. These plans have lower monthly premiums but also have fewer providers and higher out-of-pocket costs.

C. Insurance For Early Retirement

Prior to the Affordable Care Act, if you retired before age 65 or if you began an "encore career" that does not provide health insurance, finding affordable health insurance until you were eligible for Medicare (at age 65) was a challenge. Now, however, health insurers may no longer reject you or charge you higher rates due to your health.

Assuming your former employer does not provide retiree health benefits, you should acquire insurance through COBRA, individually offered policies, or policies offered on state exchanges. While insurance may seem costly during these reduced income years, you simply do not want to take a chance that your retirement savings could be wiped out be unexpected health care costs.

D. Long-Term Care Insurance

Long-term care refers to the assistance a person needs with "activities of daily living", such as walking, getting out of a chair or bed, eating, bathing, and going to the bathroom. For a person age 65, the chances of needing long-term care by age 75 is about 15%, increasing to about 50% by age 85 and 75% by age 90. Long-term care includes home health care, assisted living, and nursing care. When care is needed, the average annual cost is $84,000 and the average length of care is about 2.2 years for men and 3.7 years for women.

Many people plan to save sufficient assets to meet the financial risks of long-term care, and often those savings are enough. When those funds are not enough, Medicaid is available (you essentially have to be out of money to qualify) to cover costs for a *portion* of the necessary care, leaving family members with the burden of covering the rest of such care. In fact, 70% of long-term care services are provided by family members, frequently resulting in very negative effects on the care providers' own finances, career, and health.

Long-term care insurance ("LTCI") policies provide a great way to help manage the financial risks of long-term care. You do not need LTCI to cover 100% of your long-term care; instead, you really only need enough to protect your retirement savings (particularly for your spouse) and to supplement the savings you set aside and designated for long-term care. Typically, LTCI covering about 50% of the financial risk of long-term care is sufficient and hits a sweet spot for premiums. However, you should consider sufficient LTCI to cover the gap between what you could afford to pay from your savings and the projected possible cost of care.

Initially, LTCI policies had few options. Today, many insurers offer discounts for couples buying policies simultaneously, a shared benefit policy (where a 3-year benefit period for each of you instead becomes a 6-year benefit that can be split between you as you each may need it), and different inflation adjustment options (e.g., 3%, 4%, or 5%). Some providers offer policies that combine long-term care and life insurance so that if you die before needing any long-term care, your heirs will get a death benefit.

E. HSA's

If you are eligible to open and fund a Health Savings Account ("HSA"), it can be one of your smartest retirement moves. HSA's are designed to allow for tax-advantaged savings to pay current or future health care costs. But, if the HSA funds are never used to pay medical costs, the account functions very much like a traditional IRA, allowing tax-free contributions during your saving years with income taxes due on distributions taken after age 65.

1. Eligibility

You can only contribute to an HSA if you are covered by a high deductible health plan ("HDHP"), which is defined as a health plan with a minimum deductible and a maximum out-of-pocket limit. For 2014, the minimum deductible is $1,250 for a single person and $2,500 for a family; the maximum out-of-pocket is $6,350 for a single person and $12,700 for a family. These limits are adjusted annually for inflation. Even if covered by a HDHP, you are not eligible to contribute to an HSA if you are covered by your spouse's health insurance, you have a separate prescription drug plan, or if you have certain flexible spending accounts or health reimbursement accounts.

2. Contribution Limits

For 2014, the maximum annual contribution to an HSA is $3,300 for a single person and $6,550 for a family, with an extra $1,000 contribution allowed for those who are age 55 and older.

3. Withdrawals

You can withdraw funds from an HSA at any time for qualified medical expenses, defined generally as the same expenses that can be deducted as an itemized deduction for federal income tax purposes. Qualified medical expenses can be incurred by you, your spouse, or a dependent.

Withdrawals for qualified medical expenses are not subject to income tax as long as the medical expenses are incurred after the HSA is established, are not otherwise reimbursed, and are not claimed as itemized deductions. Withdrawals to pay the following health insurance premiums are likewise not subject to income tax: Medicare Parts A and B (but only if age 65), COBRA coverage, qualified long-term care insurance, and health insurance while receiving unemployment compensation.

Withdrawals not used for qualified medical expenses or for the health insurance premiums listed above are generally subject to both federal income tax and a 20% penalty. The 20% penalty does not apply to withdrawals made after your 65th birthday or withdrawals made due to disability or death.

You can name a designated beneficiary of your HSA. If your spouse is the designated beneficiary, he or she can then treat the HSA as his or her own HSA (with continued favorable income tax treatment, as described above). If your estate or any other individual besides your spouse is the designated beneficiary, the fair market value of the HSA assets must be reported as income in the year of your death (either on your final return if your estate is the designated beneficiary or on the individual's own return if that individual is the designated beneficiary).

4. An Ideal Account

Given their tax-favored status, HSA's provide an ideal way to save for expected health care costs during retirement. HSA's are also great vehicles for making additional tax-deferred contributions to retirement accounts after maximum contributions to your 401k and IRA accounts have been made. While you do have to wait until age 65 to be able to make withdrawals (for non-medical purposes) without incurring a penalty (as compared to age 59½ for IRA's and 401k's), there are no required minimum distributions for HSA's (unlike traditional IRA's and 401k's).

VIII. INCOME TAXES AFTER RETIREMENT

1. Taxation of Social Security Benefits

A portion of your Social Security benefits (up to 85%) could be subject to federal income tax, based on a convoluted formula that is difficult to summarize. In very broad stokes, if your AGI + tax-exempt interest + ½ of Social Security benefits is greater than $25,000 ($32,000 for married filing jointly), then a portion of your Social Security benefits will be includible in your taxable income. Essentially, if the amount is over $25,000 (or $32,000 if married), then up to 50% of your benefits may be subject to income tax; if the amount is over $34,000 (or $44,000 if married), then up to 85% of your benefits may be subject to income tax. There is no requirement that income tax be withheld from your Social Security benefits.

The 3.8% Medicare surtax imposed on net investment income does not apply to Social Security benefits because those benefits do not count as net investment income.

Most states do not tax Social Security benefits either because they exempt such benefits from taxation or because they do not have a state income tax. However, some states do tax Social Security benefits, and these states are not your typical list of "tax happy" states (such as California, Illinois, and New York). The states that do tax Social Security benefits generally have exemptions for lower income earners. You can visit the website www.taxfoundation.org to see a map showing the taxation of Social Security benefits by state.

2. Certain Retirement Income Exempt From State Taxation

Under federal law, states are prohibited from taxing a non-resident on income resulting from distributions from qualified retirement plans, including 401(k)'s, 403(b)'s, IRA's, and certain annuities (generally, tax-sheltered annuities for school teachers and employees of charities). One planning idea then is to change your residency to a state that does not have a state income tax, generally by establishing the new state as your domicile before you recognize retirement income.

3. Reducing Overall Taxable Income During Your Retirement Years

Having taxable, tax-deferred, and tax-free accounts can help you manage your income taxes from year to year. After determining your overall asset allocation strategy (taking all of your investment accounts together), you can then decide which accounts should hold which particular assets.

Your taxable accounts should generally hold investments you plan to qualify for long-term capital gains treatment or for tax-free treatment, including growth stocks, tax-efficient mutual funds, tax-efficient ETF's, municipal bonds, or municipal bond funds. Assets that generate ordinary income (such as dividends and taxable interest, as well as corporate bonds, bond funds, real estate investment trusts, preferred stocks, and common stocks where short-term gains are expected) should be held in tax-deferred accounts. Withdrawals from tax-deferred accounts (such as 401(k)'s and traditional IRA's) will be taxed as ordinary income, regardless of the type of income generated by the account assets..

Withdrawals from Roth IRA's are never subject to income tax (assuming you are age 59½ and have owned a Roth for at least five years), and you never have required minimum distributions from Roth IRA's. Thus, the same types of assets appropriate for 401(k)'s and traditional IRA's are appropriate for Roth IRA's. However, your more aggressive, longer-term investments should be held in Roth IRA's because you'll never be required to pay income tax on withdrawals from Roth IRA's (giving you more time to invest in the long-term strategies).

Generally speaking, you should take withdrawals from your taxable accounts first, then from your tax-deferred accounts (401(k) and traditional IRA), and finally from your tax-free account (i.e., Roth IRA).

You should however monitor your tax-deferred accounts (i.e., 401(k) or traditional IRA) to make sure your required minimum distributions will not be too big when you are required to start taking minimum distributions (at age 70½). If it looks like required minimum distributions may push you into a higher tax bracket, you may want to consider taking earlier distributions from those accounts to avoid the higher tax brackets later on. Before you must take required minimum distributions, you should withdraw just enough from tax-deferred accounts to remain within the 15% tax bracket (after considering income and capital gains from taxable accounts, Social Security benefits, etc.). Any additional expenses for that year can be covered by principal distributions from your taxable accounts, followed by distributions from your Roth IRA.

IX. CONCLUSION

While I hope this article does provide helpful guidance to those thinking about their retirement planning, it is certainly far from comprehensive. At the very least, I hope it gives you enough understanding to make retirement planning seem less daunting. My best advice is to hire a competent financial advisor to help you develop a comprehensive, written plan for your retirement. If this article helps prepare you for those meetings and enables you to ask the right questions, then this article will have achieved its purpose.