



Retirement Strategies

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Retirement Strategies

One of the most important financial issues that impacts your life is planning for your retirement. You need to ask yourself, “How much money will I need to save and invest during my working years to have enough money to support the lifestyle I want to have during my retirement?”

Although you may be thinking that you are never going to retire, the reality is that most people who have had a long and productive working life want to begin to take it easy by their late 60s or early 70s. If traditional retirement does not appeal to you, you may be the type of person who wants to embark on a new career around the time you would otherwise retire. Regardless of what type of retirement you want to have, you need to implement strategies to ensure you have enough money to live comfortably and pursue your dreams.

Comment: Pension planning is in a great state of flux. In the past few years, some of the largest companies in America abandoned their traditional pension plans, plans which had been in place for 40 or 50 years. Other large plans have gone bankrupt. Over the past three decades, the Pension Benefit Guaranty Corporation (PBGC) has taken over more than 3,600 pension plans. Over 1.3 million individuals are receiving benefits from the PBGC, which is running a deficit of roughly \$23 billion. Congress has been debating how to “fix” the pension crisis but hasn’t come up with a

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solution yet. The uncertainty makes it all the more urgent that you take personal charge of your retirement planning.

How To Begin

To implement your retirement strategy, you begin by looking into the future. You must determine:

- What your monthly expenses will be after retirement
- How much money you’ll have after retirement to pay these expenses.

Once you get a ballpark estimate, you can come up with a plan for saving and investing today to make sure that you’ll have enough to meet your expenses after retirement.

It’s helpful to use a pie chart when thinking about your retirement savings. The three pieces of the pie are:

- Social Security,
- A traditional retirement plan sponsored by your employer (or sponsored by you as the employer), and
- Savings and investments you accumulate on your own.

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Congress originally intended that Social Security would be a large part of your income during retirement. That was true 70 years ago; it's not true today.

Social Security is now only projected to be about 20 percent of the average person's retirement income needs. Although Social Security remains an important piece of the pie, it is no longer the major source of retirement income.

At the same time, the percentage of an average individual's retirement income that is derived from employer-funded retirement plans has declined.

The fact that Social Security and private pension plans make up much less of your total retirement dollars means that you need to rely more on your savings and investments. It has become strategically more advantageous from a tax perspective to plan to have a large portion of your savings and investments in tax-friendly retirement vehicles.

Our focus will be how to combine the money from Social Security and employer pension plans with investments and contributions in employer sponsored plans, such as 401(k) plans, so you can fund a comfortable and secure retirement.

Social Security

Even though most people know that Social Security won't be enough by itself after retirement, they still think of it as the foundation of their retirement savings. In many ways, it is, but you have to plan realistically and make educated decisions. While Social Security generally won't be enough to live on during retirement, it will be substantial enough that you must factor it into the equation when determining your tax and financial planning goals.

The following table shows how the age at which you can retire and receive full Social Security benefits increases depending on your year of birth.

Date of birth*	Full benefit at age
1/1/38 or earlier	65
1938	65 + 2 months
1939	65 + 4 months
1940	65 + 6 months
1941	65 + 8 months
1942	65 + 10 months
1943—1/1/55	66
1955	66 + 2 months
1956	66 + 4 months
1957	66 + 6 months
1958	66 + 8 months
1959	66 + 10 months
1960 or later	67**

* Month and date are January 2 unless otherwise shown.

** Experts fully expect the retirement age to continue to rise in future years.

Requesting an estimation of benefits. You don't have to guess what your benefits will be. The Social Security Administration (SSA) will send you an estimate of your future benefits if you complete and file Form SSA-7004 (Personal Earnings and Benefits Estimate Statement).

You can get a copy of Form SSA-7004 at your local Social Security office or by calling 1-800-772-1213. You can also go online at www.ssa.gov.

Obtaining the SSA estimate of your benefits helps you in two ways. It gives you a better idea of how much you'll need from other sources to fund the lifestyle you want to have during retirement. It allows you to check whether SSA is giving you proper credit for all of the years you worked.

Taxation of Social Security benefits

Often, Social Security benefits are taxable, at least in part. The tax is based on the other amounts of income you earn in addition to Social Security benefits. The maximum amount of benefits that can be taxed is 85 percent.

This calculation is not quite as complicated as it sounds. To make it a bit simpler, use the worksheet in the instructions to Form 1040.

Private retirement plans

There are three types of private retirement plans:

- (1) Employer funded plans;
- (2) Employer and/or worker funded plans; and
- (3) Worker funded accounts.

The first type is exclusively funded through employer contributions. You generally do not have any control over the funds until they are distributed to you. However, it is important to understand how these plans work and what they will potentially give you when you retire.

The second type allows you to exercise some control over how much money you can save for retirement. You can choose to make elective or salary reduction contributions, such as to a 401(k) plan.

The third type is the individual retirement account (IRA). Except for SIMPLE IRAs, which can be set up by employers, IRAs are exclusively employee funded.

Employer funded retirement plans

There are two types of employer funded plans: defined benefit plans and defined contribution plans.

Defined benefit plans. Under a defined benefit plan, your employer contributes an amount calculated through the use of life-expectancy tables to give you a promised monthly benefit when you retire. Your benefit is expressed as a formula, for example, 90 percent of your final average pay, payable in equal monthly installments. Receiving large benefits under a defined benefit plan today is very unusual because these plans are very expensive for employers.

If you are lucky enough to participate in this type of plan, your retirement planning becomes more straightforward. Add your monthly benefit to your monthly Social Security payment to determine the additional monthly income you'll need to meet your monthly expenses during retirement.

When your employer is providing you with a defined benefit plan, you don't have to worry about the investment performance of the plan. That's your employer's worry. Your employer has promised a benefit to you at retirement and must fund the plan to provide you with that promised benefit.

Although the benefit under this type of plan is usually expressed in terms of a monthly benefit, when you are ready to retire, there generally is a way to receive your benefits in a lump sum rather than monthly payments.

Defined contribution plans. The other type of retirement plan an employer can sponsor is a defined contribution plan. Sometimes, an employer must contribute a set percentage of your compensation annually to the plan. This type of plan is called a "money purchase pension plan." Another type of defined contribution plan is called a "profit sharing plan."

The characteristic that both types of defined contribution plans have in common is that the amount payable to you upon retirement as a participant is based strictly on the amount the employer has contributed to the plan on your behalf plus any earnings allocated to you. This type of plan does not provide a promised benefit.

Self-employed retirement plans

When you are both the employer and the employee, you can establish a defined benefit or defined contribution plan for yourself. “Keogh” plans are a special type of retirement plan for self-employed people. You don’t have to carry on a full-time business in order to be considered self-employed. If you work for a salary during the day and conduct a business from your home in the evenings, the earnings from your home business are considered self-employment income.

Your plan must provide that contributions or benefits cannot exceed certain limits. The limits differ depending on whether your Keogh plan is a defined contribution plan or a defined benefit plan. (These limits factor in inflation, so they rise a few dollars each year.) Contributions to a defined contribution plan cannot exceed the smaller of:

- (1) \$44,000 (in 2006), or
- (2) 100% of the participant’s compensation.

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The annual benefit for a participant under a defined benefit plan may not be more than the smaller of:

- (1) \$170,000 for 2006, or
- (2) 100% of the participant’s average compensation for his or her highest three consecutive years.

Employer sponsored plans accepting elective deferrals

In addition to plans funded with employer contributions made on your behalf, you may be eligible to invest your own money in your employer’s retirement plan and accumulate additional amounts for your retirement. Some employer-sponsored plans permit employees to earmark six to 15 percent of their salary to invest in the plan.

This type of contribution, generally made to a 401(k) plan, is referred to as a salary reduction contribution or elective contribution. For 2006, generally you can contribute up to \$15,000 in elective contributions to a plan. (If you are age 50 or older this year, you may also be able to make additional catch-up contributions).

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If you are thinking of making elective contributions, you should be aware that the rules are complicated. For tax planning purposes, you should know:

- How the plan operates and the limits on the amounts you may contribute;
- If the employer is also making a contribution and how your employer's contribution is computed;
- If you may direct the investment of your money;
- If you have the option of either receiving the employer's contribution in cash when it is made or letting money go into the plan;
- If you can borrow from the plan; and
- How and when you can begin withdrawing your contributions from the plan.

Individual Retirement Accounts

Establishing an individual retirement account (IRA), either a traditional IRA or a Roth IRA, is an excellent way to save at least part of the funds that you'll need during retirement.

For 2006, you may be able to contribute \$4,000 annually to a traditional IRA or a Roth IRA. You might want to put some of the money in a traditional IRA and some in a Roth IRA. Individuals age 50 and over may be eligible to make an additional catch-up contribution to their IRAs.

Traditional IRAs

If you're under age 70 ½ this year, you may be able to deduct IRA contributions up to the lesser of \$4,000 or 100 percent of compensation. The deduction is phased out if you are:

- An active participant in an employer's retirement plan for any part of a year and
- Your modified adjusted gross income (MAGI) exceeds a specific amount.

The applicable MAGI limit depends on your filing status and the limits will be increased annually over the next few years.

You are not considered an active participant in an employer-sponsored plan merely because your spouse is an active participant for any part of a plan year. This allows more people to take a full deduction for a contribution to an IRA, regardless of whether their spouse is covered under a retirement plan at work.

Roth IRAs

Since they were introduced, Roth IRAs have been enthusiastically received by many taxpayers even though Roth IRA contributions are never deductible. However, interest, dividends and appreciation accrues in your Roth IRA tax free.

Your maximum yearly contribution to a Roth IRA is limited to \$4,000. Unlike traditional IRAs, you may make contributions to a Roth IRA after you reach 70½ and you do not have to withdraw Roth IRA funds during your lifetime.

The maximum yearly contribution that can be made to a Roth IRA is phased out for single taxpayers with MAGI between \$95,000 and \$110,000, for joint filers with MAGI between \$150,000 and \$160,000, and for married individuals filing separately with MAGI between \$0 and \$10,000.

Five-year holding period. In order to receive the tax-free advantages that a Roth IRA has to offer, you generally have to keep your money in the account for five years. Savings in a Roth IRA can be accessed tax free:

- After you reach age 59½;
- If made to a beneficiary on or after your death;
- Because of disability; or
- To pay for certain first-time home buying expenses.

Rollovers from traditional IRAs to Roth IRAs

You may be eligible to roll over funds from a traditional IRA into a Roth IRA. However, the rollover is taxable. The total taxable amount is included in your income in the year the rollover takes place. Penalties will not be applied if the requirements are met. The reason for making the rollover is to convert money from a tax-deferred account into an account that is potentially tax free.

Rules for making rollovers. You will be able to make the rollover if for the year of transfer:

- (1) Your AGI does not exceed \$100,000; and
- (2) You are not married filing separately.

Factors involved in making this decision. Your decision whether to convert a traditional IRA into a Roth IRA should only be made after a careful evaluation of all the various tax and investment factors. Among these factors are:

- (1) The total income tax you will pay because of the conversion;
- (2) The costs you will incur because of the conversion (transaction fees and sales charges);
- (3) Your anticipated tax bracket when you would receive distributions from the traditional IRA;

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Planning Tip. A decision of whether to invest in a traditional IRA or a Roth IRA or in a combination of both types of IRAs should be made in consultation with your tax advisor. This professional will review your particular set of financial and tax circumstances and “run the numbers” to do a comparison study of which type of IRA best suits your specific retirement needs.

- (4) The anticipated return from the Roth and traditional IRA;
- (5) Your age at the time of conversion; and
- (6) The length of time it will take you to recoup the tax and other expenses caused by the conversion.

Roth 401(k) Plans

New for 2006, employers who offer 401(k) plans can give their employees the option of putting their 401(k) contributions into a Roth 401(k). Before this can take place, however, the employer must choose to amend the existing 401(k) plan to allow for this “designated Roth 401(k) contributions.” Once the amendment is in place, it is up to each employee to elect to have part or all of his or her 401(k) contributions considered Roth contributions. By doing so, the employee’s contribution is taxed to the employee as wages immediately, but subsequent earnings and qualified distributions are tax free. This is clearly an option worth considering.

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Deciding When To Retire

The decision when to retire encompasses many factors. One of the factors to consider is how will your monthly Social Security income be affected by the age you retire. Another factor to consider is do you want to continue working in your current job, business, or occupation. As you approach your ideal retirement age, you must review your major sources of income to see if the actual income you will be receiving will meet your retirement needs, goals and objectives.

Social Security benefits

Hopefully, you already requested and received a projection from the Social Security Administration of what your benefits will be. Some general rules to consider are that if you are under age 62 and not disabled, you cannot collect Social Security benefits. If you elect to commence benefits at age 62, then you will receive reduced benefits. If you wait to collect benefits until after age 70, generally you will receive increased benefits.

Wild cards

Situations arise that can result in a “wild card” being thrown into your planning. For example, you inherit a substantial amount of money or your employer offers you a sweetened early retirement package. To determine how to handle these circumstances, the most telling analysis will be when you “do the math.”

Inflation

Inflation itself is perhaps the greatest wildcard in retirement planning.

Fortunately, your retirement savings keep earning interest, dividends, and capital appreciation that will hopefully be at least a few points above inflation each year. If inflation is less, your earnings will be less, but presumably so will your expenses after retirement.

To protect the full amount of your retirement earnings each year – and therefore the amount you are left with after retirement – it is very important to use the tax law to your advantage.

If earnings are taxed instead of tax-deferred each year, the magic of compounding does not work nearly as well over the course of 10, 20 or 30 years. The principal benefit to be gained from saving for retirement in a qualified retirement savings vehicle, whether it is a qualified plan, a 401(k) plan, an IRA, or a combination of them, is tax-deferral of contributions and earnings (or tax-exemption of earnings in the case of a Roth IRA). Another benefit is that you will simply be more likely to save for retirement in a special account that is separately set aside for your retirement.

While your retirement savings are growing, however, remember also that the cost of living after you retire is also growing. Think back to what a typical one-bedroom apartment rented 30 years ago – maybe around \$200? The same apartment now rents for \$2,000. Sure, you may forecast that you will have a million dollars when you retire 10 years from now, but how will inflation have lowered its true value?

“...inflation does not stop on the day of retirement.”

Retirees must also keep in mind that inflation does not stop on the day of retirement. If they should live for 20 or 30 years more, prices will likely to triple, at least, during that time. Only by carefully timing the withdrawal of retirement savings and skillfully using inflation, investment acumen and tax deferral, can you come out ahead.

Post-retirement Decisions

Retirees often have a wide variety of options on how to receive benefits from their retirement plans: periodic payments, annuities, lump-sum distributions, or combinations of these. Each has its own tax consequences.

Taxation of retirement plan distributions

Distributions from employer-sponsored retirement plans and from traditional IRAs are subject to income tax at whatever rate bracket your total taxable income falls. There is an exception to this rule for amounts distributed from Roth IRAs. These amounts were taxed before they were invested in the Roth IRA and therefore are not subject to tax when distributed.

Because most of these distributions are immediately taxed, if you do not need the funds to meet immediate living expenses, you may be better off leaving the funds in the plans until you need them. However, there are rules requiring you to begin taking minimum distributions from employer-sponsored plans and traditional IRAs that must be complied with once you attain age 70 ½.

Minimum distribution rules

Although it seems that much of the focus of retirement strategy is determining whether you will have enough assets to meet living expenses, another factor comes in beginning on April 1 after you attain age 70½.

At that point, if you have not already done so, you are required to begin taking minimum distributions from any retirement plans sponsored by your employer, including 401(k) plans to which you contributed and traditional IRAs. Your tax advisor can help you determine this minimum amount that you must start withdrawing annually from these plans. A calculation must be made to determine this amount that is based on life-expectancy tables provided by the IRS.

Withholding on distributions

If you receive a lump-sum distribution from an employer-sponsored retirement plan, you generally will be subject to a 20% withholding tax. The withholding tax can be avoided only if the distribution is transferred directly to another retirement plan or IRA. This 20% withholding applies even if you meet the 60-day requirement for traditional rollovers. This means that you will have to come up with funds from another source if you want to roll over the full amount of the distribution. However, you will recover the 20% that was withheld when you file your return for the year of the distribution, either as a refund or as a payment toward your total income tax liability.

All distributions from retirement plans and traditional IRAs are subject to immediate tax. For any distribution that does not qualify as a lump-sum distribution, having taxes withheld is optional. You decide at the time of the distribution. So as not to get a big surprise at tax time, it may be advisable to opt to have taxes withheld from all retirement plan distributions, with the exception of Roth IRA distributions.

Estimated tax liability

In order to avoid any penalty for underpayment of estimated tax, you must consider the impact of any large one-time payments on your tax liability in the year of retirement. One-time payments can include severance payments or retirement benefits paid in a lump sum and not rolled over into an IRA. To determine whether any estimated tax penalties apply, withholding is treated as having been made in the amount of 25% of your estimated tax liability in each of the quarterly tax periods even if actually withheld later in the year. Also, you can rely on the safe harbor provision and pay 100% of your prior year's tax liability to avoid any penalty. However, if you are a high-income taxpayer (a taxpayer with adjusted gross income of over \$75,000 or \$150,000 on a joint return) in the prior year (referred to as the lookback year), the safe harbor percentage adjusts to 110% for 2005.



Planning tip. There is an exception from the estimated tax rules for some retirees. If you are over age 62, you can apply for relief from underpayment penalties if the underpayment results from reasonable cause and not due to willful neglect. This relief is available only in the year of retirement.

Liquidation of assets

When you retire, you may consider converting nonproductive assets to productive investments to provide sufficient cash flow to meet your income needs. Generally, the most valuable asset you have is your personal residence. There are several methods for producing income from this asset. You can sell your home and (1) rent or (2) purchase a less expensive home. If you are married you will probably be able to exclude up to \$500,000 of gain. The exclusion is \$250,000 for other taxpayers. As an alternative, you can remain in your home and obtain a reverse mortgage that will provide a monthly payment to you based on the amount of your equity.

Conclusion

The key to successful retirement planning is starting early. It's easier to save five percent of your income when you're beginning to work than a higher percentage later in life. It's also important to diversify your savings to maximize your tax savings when you retire. While this guide has reviewed some retirement planning strategies, your tax advisor can craft a plan incorporating these and other vehicles to best match your situation.