Part One

THE ACCUMULATION YEARS

The Best Way to Save for Retirement

1

Fund Retirement Plans to the Maximum

The most powerful force in the universe is compound interest.

— Albert Einstein

Main Topics

- Why contributing the maximum to a retirement plan is so valuable
- The clear advantage of pre-tax IRA and retirement plan savings
- Why you ***must*** always contribute to plans with employer-matching
- The two principal categories of retirement plans
- Eight major types of retirement plans and their contribution limits
- Running the numbers for an employer matching program
- Nonmatched contributions
- Tax-deferred accumulations versus after-tax accumulations
- Options for contributing to more than one plan
- Making contributions when you think you can't afford it

> **KEY IDEA**
>
> Every employee who has access to a retirement plan should contribute the maximum his or her employer is willing to match or even partially match. If you can afford more, make nonmatched contributions.

Why Contributing the Maximum to a Retirement Plan Is So Valuable

A trusted client of mine recently referred to me as "her guardian angel." At first I was totally taken aback—no one had ever called me their guardian angel before. She continued, "Twenty years ago you advised me to put the maximum into my retirement plan. I didn't know if it was a good idea or not but I trusted you and did what you recommended. Now I have a million dollars in my retirement plan. What should I do now?"

Her question is ultimately answered by this book. But her comment also compelled me to complete a comprehensive analysis of why it was such good advice. I wanted to be able to persuasively convince anyone who harbored the least little doubt about the advantages of saving in a retirement plan over saving outside of a retirement plan.

I set myself the challenge of evaluating the outcomes of two different scenarios:

1. You earn the money, you pay the tax, you invest the money you earned, and you pay tax on the dividends and interest, perhaps capital gains.
2. You put money in your retirement plan and you get a tax deduction. Looked at another way, you don't pay income taxes on that money when you invest it. The money grows tax deferred. You don't have to pay taxes on that money until you take it out.

The first question is: is it better to save inside the retirement plan or outside the retirement plan? The answer: it is better to save within the retirement plan. Why? This isn't a touchy-feely issue. It comes down to numbers. Let's look.

MINI CASE STUDY 1.1

The Clear Advantage of Pre-Tax IRA and Retirement Plan Savings

Mr. Pay Taxes Later and Mr. Pay Taxes Now are neighbors. Looking at them from the outside, you wouldn't be able to tell them apart. They own the same type of car; their salaries are the same; and they are in the same tax bracket. Their savings have the same investment rate of return. They even save the same percentage of their gross wages every year.

They have one big difference. Mr. Pay Taxes Later invests as much as he can afford in his tax-deferred retirement plan, his 401(k), even though his employer does not match his contributions. Mr. Pay Taxes Now feels that putting money in a retirement account makes it "not really his money," as he puts it. He doesn't want to have to pay taxes to take out his own money, or put up with the other limits to his access of "his money." Thus he contributes nothing to his retirement account at work but invests his savings in an account outside of his retirement plan. Mr. Pay Taxes Now invests the old-fashioned way: earn the money, pay the tax, invest the money, and pay the tax on the income that the invested money generates (dividends, capital gains, etc.).

Both men begin investing at age 30.

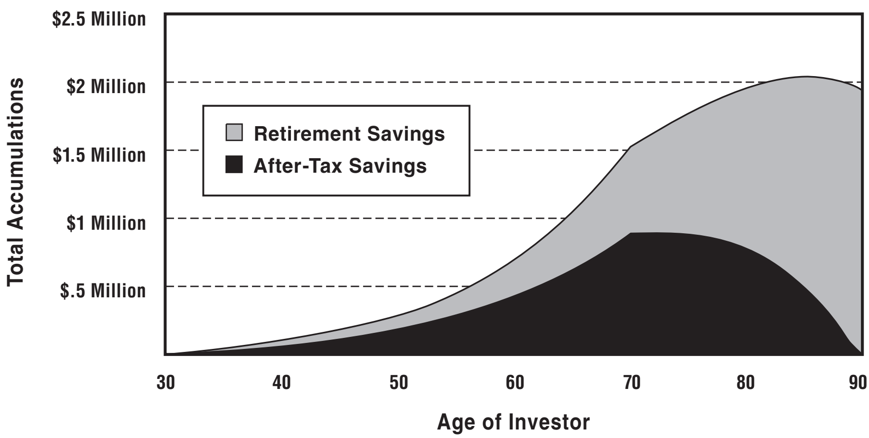
- They start saving in 2005 with $5,000 per year of their earnings, indexed for inflation.
- Mr. Pay Taxes Later has his entire $5,000 withheld from his paycheck and deposited to his tax-deferred 401(k). (The analysis would be identical if he contributed the money to a traditional IRA.)

- Mr. Pay Taxes Now chooses not to have any retirement funds withheld but rather to be paid in full. He has to pay income taxes on his full wages, including the $5,000 he chose not to contribute to his retirement plan. He has to pay income tax immediately on the $5,000. After the 25% income tax is paid, he has only 75% of the $5,000, or $3,750, left to invest.

Now, look at Figure 1.1. Mr. Pay Taxes Later's investment is represented by the gray curve, and Mr. Pay Taxes Now's by the black. Look at the dramatic difference, over time, in the accumulations.

Figure 1.1

Retirement Assets, IRAs, etc. versus After-Tax Accumulations



The assumptions for this graph include the following:

1. Investment rate of return is 7% including 70% capital appreciation, with 15% portfolio turnover rate, 15% dividend income, and 15% interest income.
2. Mr. Pay Taxes Later makes retirement savings contributions of $5,000 per year. Mr. Pay Taxes Now invests 25% less due to taxes. Both amounts are indexed for 2.5% annual raises, starting at age 30, until age 70.

3. Starting at age 71, spending from both investors' accounts is equal to the Minimum Required Distributions (MRD) from Mr. Pay Taxes Later's retirement plan.
4. Mr. Pay Taxes Later withdraws and spends only the minimum required distribution (MRD) and pays 25% income tax due on his distribution. Mr. Pay Taxes Now spends the same amount plus pays income taxes due on his interest, dividends, and realized capital gains.
5. Ordinary tax rates are 25%.
6. Capital gains tax rates are 15% for 2005 to 2008 and 19% thereafter.
7. Dividends are taxed as capital gains during 2005 to 2008 and as ordinary income thereafter.

Now, to be fair, Mr. Pay Taxes Later will have to pay the taxes eventually. When he is retired, for every dollar he wants to withdraw, he has to take out $1.33. He pockets the dollar and pays $0.33 in taxes (25% of $1.33). If Mr. Pay Taxes Now withdraws a dollar, subject to some capital gains taxes, it's all his, just as he wanted. At age 90, however, Mr. Pay Taxes Now has depleted his funds entirely while Mr. Pay Taxes Later has $1,946,949 left in his retirement plan.

… all things being equal, following the adage "don't pay taxes now—pay taxes later" can be worth almost $2 million over a lifetime.

Given reasonable assumptions and all things being equal, following the adage "don't pay taxes now—pay taxes later" can be worth almost $2 million over a lifetime.

Make Those Non-Matched Contributions to Retirement Accounts

What conclusion can we draw from Mini Case Study 1.1? Don't pay taxes now—pay taxes later. Even putting aside the additional advantage of matching contributions, you should contribute the maximum to your retirement plan, assuming you can afford

After spending your life working hard, paying the mortgage, paying the bills, raising a family, and putting your kids through college, you may never have expected to have such a substantial IRA or retirement plan and be so well off in retirement. To many of my clients, it seems like a fantasy.

A realistic and common emotional reaction is fear. It could be fear of the unknown, or fear because you're not sure what to do next. Many readers are scared they will make costly mistakes and/or mismanage their retirement money. The fear is paralyzing, so they do nothing—literally, nothing. They procrastinate, and avoid doing important planning for their IRA and retirement plan. That may have been you till now.

You have already made a great start by buying this book. Now, please read it and know that I have done everything in my power to provide you with the best information available on planning for your IRA and/or retirement plan. After all, your future and your financial security depend on you handling your retirement finances properly. After reading this book, *don't do nothing*. Promise yourself that reading this book will be more than an academic exercise, it will motivate you to take action—take the critical steps that will put you and your family in a much better position than you are in today.

it. Money contributed to a retirement plan, whether a 401(k), 403(b) SEP, SIMPLE, 457, deductible IRA, or another type of retirement plan, is a pre-tax investment that grows tax-deferred. There are no federal income taxes on the wages contributed. Some taxpayers look at it as a deduction. Either way you look at it, you are getting a tax break for the amount of the contribution multiplied by the tax rate for your tax bracket. In addition, once the contribution is made, you do not have to pay income taxes on the interest, dividends, and appreciation *until you take a distribution* (i.e., withdrawal) from the retirement plan. In other words, you pay taxes later.

In my practice the clients who usually have the most money saved at retirement are the ones that religiously contributed to a retirement plan during their long career.

By not paying the taxes up front on the wages earned, you reap the harvest of compounding interest on the money that would have gone to paying taxes—both on the amount contributed and on the growth had the money been invested outside of the retirement plan.

In the real world, not only is there a tax advantage to saving in a retirement plan, but there is the built-in discipline of contributing to your retirement plan every paycheck. The example above assumes that if you don't put the money in your retirement plan, then you will save and invest an amount equivalent to your contribution. But can you trust yourself to be a disciplined saver? Will the temptation to put it off till the next paycheck undermine your resolve? Even if it is put away for savings, knowing you have unrestricted access to the money, can you be confident that you would never invade that fund until you retire?

In my practice, the clients who usually have the most money saved at retirement are the ones who religiously contributed to a retirement plan during their long career.

The idea of paying taxes later and contributing the maximum to your retirement plan(s) is something that I have preached for over 20 years. Many of my long-standing clients took my advice 20 years ago—even if they didn't completely understand why—and now they are thanking me.

The Employer Matching Retirement Plan

With all due respect, broadly speaking, you have to be pretty "simple" (that's a nice word for "stupid") not to take advantage of a retirement plan where the employer is making a matching contribution.

The Cardinal Rule of Saving for Retirement

Money won is twice as sweet as money earned.

— Paul Newman, *The Color of Money*

If your employer offers a matching contribution to your retirement plan, the cardinal rule is: contribute whatever the employer is willing to match—even if it is only a percentage of your contribution and not a dollar for dollar match.

Imagine depositing $1,000 of your money into the bank, but instead of getting a crummy toaster, you receive an extra $1,000 to go along with your deposit. To add to the fun, imagine getting a tax deduction for your deposit and not having to pay tax on your "gift." Furthermore, both your $1,000 and the gift $1,000 grow (it is to be hoped), and you don't have to pay income tax on the interest, dividends, capital gains, or the appreciation until you withdraw the money. When you withdraw the money, you will have to pay taxes, but you will have gained interest, dividends, and appreciation in the meantime. That is what employer matching contributions to retirement plans are all about. If the employer matches the employee contribution, it offers a *100% return on the investment in one day* (assuming no early withdrawal penalties apply and the matched funds are fully vested).

Over the years, I have heard hundreds of excuses for not taking advantage of an employer-matching plan. All those reasons can be summarized in two words: ignorance and neglect. If you didn't know that before, you know now. If you are not currently taking advantage of your employer-matching plan, run—don't walk—to your plan administrator and begin the paperwork to take advantage of the employer match. Matching contributions are most commonly found within Section 401(k), 403(b), and 457 plans. Many eligible 403(b) plan participants also may have access to a 457 plan. You can, in effect, enjoy "double" the ability to tax defer earnings through participation in both the 403(b) and 457 plans. Even if your employer is only willing to make a partial match up to a cap, you should still take advantage of this opportunity. For example, a fairly common retirement plan may provide that the employer contribute 50 cents for every dollar up to the first 6% of salary you contribute. Keep in mind: this is free money!

Many eligible 403(b) plan participants also may have access to a 457 plan. You can, in effect, enjoy "double" the ability to tax defer earnings through participation in both the 403(b) and 457 plans.

Again, this isn't touchy-feely stuff. It is backed by hard numbers.

MINI CASE STUDY 1.2

Running the Numbers for Employer-Matched Retirement Plans

Scenario 1

- Bill earns $75,000 per year and is subject to a flat 25% federal income tax (for simplicity, I ignore other taxes and assume a flat federal income tax).
  25% × $75,000 = $18,750 tax

- He spends $50,000 per year.
- He doesn't use his retirement plan at work, so he has $6,250 available for investment:
  ($75,000 income – [$18,750 tax and $50,000 spending] = $6,250 available cash).

Scenario 2

Bill's dad is very wise. He bought *Retire Secure!* After reading this chapter, he advises his son Bill to contribute the maximum amount that Bill's employer is willing to match. Uncharacteristically, Bill listens to his dad and contributes $4,500 (6% times $75,000) to his retirement account. Bill is fortunate because his employer matches his contribution 100%. Thus $9,000 goes into his retirement account.

Under current tax laws, Bill will not have to pay federal income tax on his retirement plan contribution or on the amount his employer is willing to match.

By using his employer's retirement plan, Bill's picture changes for the better as follows:

- Bill pays tax only on $70,500
  ($75,000 income – $4,500 tax-deferred)
  25% × $70,500 = $17,625 tax.
- He now has $57,375 ($75,000 income – $17,625 taxes).
- He makes his 6% contribution of $4,500, leaving him with $52,875 outside the plan.
- His employer matches the $4,500 (also tax deferred).
- He now has $9,000 in his retirement plan (growing tax deferred).
- He spends $50,000 per year.
- He is left with $2,875 in cash.

Which scenario strikes you as more favorable: Scenario 2 with $9,000 in a retirement plan and $2,875 in cash, or Scenario 1 with no retirement plan and $6,250 in cash? The heckler can figure out situations why he may prefer a little extra cash and no retirement plan. For the rest of us, we will take advantage of any employer matching retirement plan.

Please remember that the money in the retirement plan will continue to grow, and you will not have to pay income taxes on the earnings, dividends, interest, or accumulations until you or your heirs withdraw your money. Even without the future deferral, at the end of the first year, assuming the employer-matched funds are fully vested, the comparative values of these two scenarios are measured by after-tax purchasing power as follows:

	Scenario 1	Scenario 2
After-tax cash available	$6,250	$2,875
Retirement plan balance	0	$9,000
Tax on retirement plan balance	0	($2,250)
Early withdrawal penalty	0	($900)
Total Purchasing Power	$6,250	$8,725

Obviously, it is better to take advantage of the retirement plan and the employer's matching contributions. Let's hope you can afford to do this and maintain the tax-deferred growth for many years, thus avoiding early withdrawal penalties altogether.

There is an interesting option if you want to see your child's retirement plan grow, but your child claims not to have sufficient cash flow to contribute to his retirement plan, even though his employer is matching 100%. You may consider making a gift to your child in the amount that your child would be out of pocket by making a contribution to his retirement plan. In this example, you could make a gift of $3,365 ($6,250 – $2,875).

For your $3,365 gift, your adult child would end up with $9,000 in his retirement plan. That is an example of a leveraged gift. Lots of bang for your gifted buck.

The long-term advantages of the employer match are even more dramatic. Using the same facts and circumstances as in Mini Case Study 1.1 with the addition of a 100% employer match of annual contributions, Figure 1.2 compares stubborn Bill who refuses to use the retirement plan versus compliant Bill who contributes to his retirement plan:

Figure 1.2

Retirement Assets Plus an Employer Match versus After-Tax Accumulations

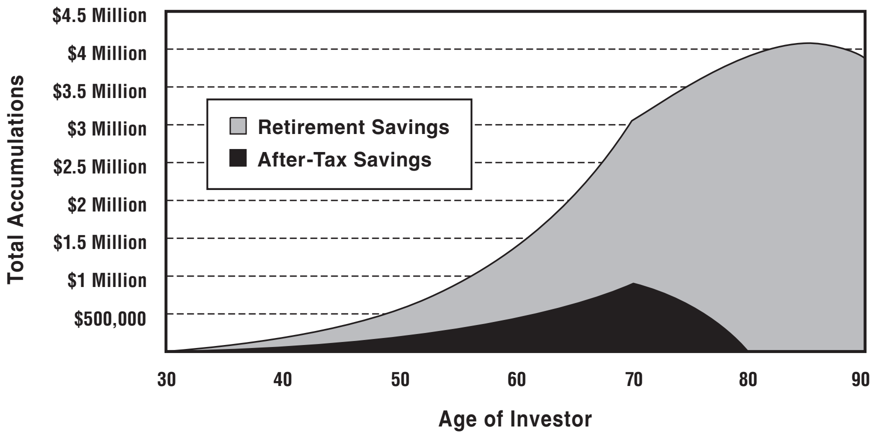


Figure 1.2 reflects higher spending from both accounts since the retirement plan's larger balance requires larger distributions. The higher distributions deplete stubborn Bill's unmatched funds even faster. He would run out at age 80 instead of 90 (in Mini Case Study 1.1), while compliant Bill' s matched retirement savings has $3,908,093 remaining, and despite the large distributions being made after age 80, compliant Bill's savings are still growing when he reaches 80. The obvious conclusion again is, if you are not already taking advantage of this, run—don't walk—to your plan administrator and begin the paperwork to take advantage of the employer match.

Occasionally, clients moan that they literally can't afford to make the contribution, even though their employer is willing to match it. I am not sympathetic. I would rather see you borrow the money to make matching contributions, especially if a home equity line of credit is available where the interest is tax deductible.

Two Categories of Retirement Plans

Generally all retirement plans in the workplace fall into two categories: defined-contribution plans and defined-benefit plans. The plan in the previous example is a defined-contribution plan.

Defined-Contribution Plans

In a defined-contribution plan, each individual employee has an account that can be funded by the employee or the employer or both. At retirement or termination of employment, subject to a few minor exceptions, the account balance represents the funds available to the employee. In a defined-contribution plan, the employee bears the investment risks. In other words, if the market takes a downturn, so does the value of your investments. Conversely if the market does well, you are rewarded with a higher balance.

The most common defined-contribution plans are 401(k) plans, 403(b) plans, and 457 plans. The Roth 401(k) and 403(b) are new options that many employees have for tax-free growth. The Simplified Employee Pension plan (more commonly known as a SEP plan) and the Savings Incentive Match Plans for Employees (more commonly known as SIMPLE plans) are attractive defined-contribution plan options for small employers or self-employed individuals. For self-employed individuals with higher incomes, consider the relatively new, one-man "Super-K," which is basically a 401(k) plan on steroids. More detailed descriptions of these plans appear below.

At retirement or service termination, I usually recommend transferring funds from defined-contribution plans to an individual retirement account (IRA).

Defined-contribution plans often offer a wide array of tax-favored investment options. Defined-contribution plans are relatively easy to understand. Most employees with defined-contribution plans usually can tell you the balance in their account—at least to the nearest $100,000. Most employees with defined-benefit plans have no idea how much their plan is worth.

Common Defined-Contribution Plans

Defined-contribution plan accounts often become substantial and are often the biggest asset in the estate. Typically they are rolled into an IRA at retirement. Therefore the planning for the defined contribution plan, or the IRA that the defined-contribution plan is eventually rolled into, becomes the most important part of the retirement and estate planning process. The following paragraphs discuss some of the more common defined contribution plans.

401(k) Plans: This type of plan usually includes both employee and employer tax-deferred contributions. No federal income taxes are paid until the money is withdrawn. Some states, however, will tax the employee's contribution in the year that the contribution is made. Employer contributions to 401(k)s are usually determined as a percentage of earnings, and the deductible employee contribution is usually limited to a prescribed amount ($20,000 in 2006 for someone 50 or older). The company—that is, the employer—is responsible for providing the employee with investment choices, typically 6 to 10 choices in either one or two families of mutual funds. The employer is also responsible for the investments and administration of a 401(k) plan. Many employers will be implementing Roth 401(k) plans beginning in 2006. The Roth 401(k) combines the features of a Roth IRA and a 401(k). When given a choice, I usually recommend the Roth 401(k).

403(b) Plans: This plan is similar to a 401(k) plan but is commonly used by certain charitable organizations and public educational institutions such as universities, colleges, and hospitals. One of the biggest differences between a 401(k) plan and a 403(b) plan is that 403(b) plans can only invest in annuities and mutual funds. TIAA-CREF is the best known 403(b) provider. The new Roth 403(b) combines the features of a Roth IRA and a 403(b). When given a choice, I usually recommend the Roth 403(b).

457 Plans: After recent changes passed with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 457 plans have become more similar to 401(k) plans. They are commonly used by state and local governmental employers and certain tax-exempt organizations. Typical 457 employees are policeofficers, firefighters, teachers, and other municipal workers.

An interesting side note is that many eligible 457 plan participants don't even know about the plan. They may have a 403(b) plan and don't know they can in effect enjoy "double" the ability to tax defer earnings through participation in both the 403(b) and 457 plans.

The New Roth 401(k) and 403(b): Starting in 2006 many employers will give employees the option of contributing either into their traditional 401(k) or 403(b) or to a new Roth 401(k) or Roth 403(b). I prefer readers take the Roth option for the same reasons that I prefer a Roth IRA to a traditional IRA. At retirement, a Roth 401(k) or 403(b) can be rolled into a Roth IRA. The Roth 401(k) and 403(b) options apply only to the employee's contribution. Any contributions made by the employer would be put into a traditional 401(k) account.

SEP: SEP is an acronym for Simplified Employee Pension. These plans are commonly used by employers with very few employees and self-employed individuals. Under a SEP, an employer makes contributions to IRAs, which are not taxable for federal income tax purposes, on behalf of employees. Contribution limits are higher with SEPs than with IRAs. Maximum contributions equal 25% of compensation. (You must be careful to look at how "compensation" is defined. After you go through the technical hoops, the contribution actually works out to about 20% of what most self-employed people think is compensation.)

Super-K or One-Man 401(k): The Super-K is commonly used by self-employed individuals (with no employees) who want to contribute the most money possible to their own retirement plan. You can contribute a deferral portion (up to $20,000 in 2006 for someone 50 or older) plus the 25% contribution amount subject to limitations. (As with a SEP plan, be careful to define compensation accurately.) For an example of the power of the Super-K and a calculation, please see Judy's example in Mini Case Study 1.3.

Deferral Contribution Limits

As a result of a series of tax law changes starting with EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001), the new deferral contribution limits for employees and owners of many of these individual and defined-contribution plans have grown substantially more generous. The government now allows us to put more money in our retirement plans and provides greater tax benefits. I recommend that we take the government up on its offer to fund our own retirement plans to the extent we can afford it.

The maximum deferral contribution limits since 2005 and through 2008 are as follows:

Maximum Contributions for Individuals Younger than 50

Maximum Contributions for Those 50 and Older (in italics)

	2005	**2006**	**2007**	**2008**
Simple Plans [b]	$10,000	$10,000	$10,000 [a]	$10,000 [a]
50 and older	*12,000*	*12,500*	*12,500* [a]	*12,500* [a]
401(k), 403(b), 457 [c]	$14,000	$15,000	$15,000 [a]	$15,000 [a]
50 and older	*18,000*	*20,000*	*20,000* [a]	*20,000* [a]
Roth 401(k) + Roth 403(b)	N/A	$15,000	$15,000 [a]	$15,000 [a]
50 and older		*20,000*	*20,000* [a]	*20,000* [a]
Super K [d]	$56,000	$59,000	$59,000 [e]	$59,000 [e]
50 and older	60,000	64,000	64,000 [e]	64,000 [e]

[a] Plus inflation adjustment in $500 increments.

[b] SIMPLE Plans are for enterprises with 100 or fewer workers.

[c] 403(b) plans are for nonprofits; 457 plans are for governments and nonprofits. In the last three years before retirement, workers in 457 plans can save double the “under age 50” contribution limit.

[d] Wages (for corporations) must be at least:

$168,000 $176,000 $176,000 [e] $176,000 [e]

or Schedule C Net income (for sole proprietors) must be at least:

$218,506 $229,163 $229,163 [e] $229,163 [e]

[e] Plus amounts for inflation related adjustments.

Please note that with the exception of the Roth 401(k) and Roth 403(b), every one of the listed retirement plans works basically the same way. Subject to limitations, the participant in each plan receives a tax deduction on the contribution to the plan. The employer's contribution is not subject to federal income taxes, nor is the employee's deferral contribution. The employee pays no federal income tax until the funds are withdrawn; funds can only be withdrawn according to specific rules and regulations. Ultimately the distributions are taxed at ordinary income tax rates. These plans offer tax-deferred growth because as the assets appreciate, taxes are deferred—or delayed—until there is a withdrawal or a distribution.

Please note that the taxation of retirement plans differs for state income tax purposes. Some states, such as Pennsylvania, will not give employees a tax deduction for the contribution to their retirement plan. On the other hand, Pennsylvania doesn't tax IRA or retirement plan distributions. Other states will give you a state income tax deduction for a contribution, but will require you to pay income tax on the distribution.

The employee's contributions to Roth 401(k) and Roth 403(b) plans are similar to Roth IRAs in many respects. Just as with a Roth IRA, the participant does not receive a tax deduction on their contributions to the plan. Instead, the employee pays the federal and state taxes up front and their investments grow tax free. As long as the employee does not make a withdrawal during the first five years, there will not be any taxes to pay when the money is withdrawn. There are restrictions similar to those of a regular 401(k) regarding when the funds can be withdrawn. Unlike a Roth IRA, there are minimum required distributions for the Roth 401(k)s and Roth 403(b)s, but transferring the money to a Roth IRA upon retirement could help you avoid these required distributions. Any matching contributions made by the employer would be made with pre-tax dollars and the federal taxes would not be paid until those funds are withdrawn.

Timing and Vesting of Defined-Contribution Plans

It is important to understand when employers are required to make their contribution and when your interest becomes "vested."

Employers must make their contributions to an employee's retirement plan by the due date of their federal tax return. As a result, if your employer is on a calendar-year-end, you might not see the match portion of your 401(k) until well after year-end. Other employers match immediately when a contribution is made.

Also, just because the money is credited to your account doesn't necessarily mean it is all yours immediately. The portion you contribute will always be yours, and if you quit tomorrow, the contribution remains your money. The employer's contribution will often become available to you only after working a certain number of years. A common vesting schedule is 20% per year that an employee remains with the company until five years have passed. At that point, the employee is 100% vested. This is called *graded vesting*. Other plans allow no vesting until the employee has worked for a certain number of years. Then, when he or she reaches that threshold, there is a 100% vest in the employer's contributions. This is called *cliff vesting*.

Defined-Benefit Plans

With a defined-benefit plan the employer contributes money according to a formula described in the company plan to provide a monthly benefit to the employee at retirement. Many people refer to these types of plans as "my pension." The amount of the benefit is determined based on a formula that considers the number of years of service, salary (perhaps an average of the highest three years) and age. Defined-benefit plans usually do not allow the employee to contribute his or her own funds into the plan, and the employer bears all of the investment risk. When it is time for the employee to collect his monthly benefit, the employer is responsible for paying the benefit—regardless of how the investments have done from the time of the employer's contribution to the time of employee's distribution.

At retirement, the employee is often given a wide range of choices of how he would like to collect his pension. Distribution options generally involve receiving a certain amount of money every month for the rest of one's life. Receiving regular payments for a specified period, usually a lifetime, is called an "annuity." (Please don't confuse this type of annuity with a tax-deferred annuity or a 403(b) plan, which is also often called an annuity.) The annuity period often runs for your lifetime and that of your spouse. Or it might be defined with a guaranteed period for successor beneficiaries, such as a guaranteed 10-year term regardless of when you die. (A further discussion of annuities can be found in Chapter 6.)

The failure of companies to make their promised payments and announcements of reduced payments has reached crisis proportions and is getting worse. For example, retirees in the airline industries and many other industries now face a likely reduction in their pension income.

There is often an important need for life insurance for many married owners of defined-benefit plans, and you have some important decisions to make at the time of your retirement. For example, let's assume that the plan owner is in good health and wants the highest annuity income for his or her life. That is often the best option. If, however, the owner dies, the spouse is out of luck. Sometimes owners choose a lower monthly payment because it will last through their life and their spouse's life. Sometimes the owner will take a large payment and his or her spouse will receive a fraction, perhaps half or two-thirds.

The most prudent course might be to take a one-life (not two-life) annuity and use the additional income to purchase life insurance on the owner's life. Should the owner die, the life insurance death benefit can go toward the surviving spouse's support. This is an important decision to be made at your retirement. In these situations, "running the numbers," that is, comparing different potential scenarios, can provide guidance in making a decision. Please note that if you have already retired and already decided to take the highest pension without a survivorship feature, it is not too late, if you are still insurable. If you are retired and are now concerned that by taking a one-life annuity with the highest monthly payment that you did not sufficiently provide for your surviving spouse, you could still purchase life insurance.

Cash Balance Plan

A relatively new and unique version of a defined benefit plan is known as a *cash balance plan*. Technically, this is a defined-benefit plan, but it has features similar to defined-contribution plans. Though on the rise, this type of plan is not common. Each employee is given an "account" to which the employer provides contributions or "pay credits," which may be a percentage of pay and an interest credit on the balance in the account. The account's investment earnings to be credited are usually defined by the plan, and the employer bears all downside risk for actual investment earning shortfalls. The increase in popularity of the cash balance plan has been spurred by the country's increasingly mobile workforce. Employees may take their cash balance plans with them to a new employer when they change jobs or roll them into an IRA.

There is a good possibility that you have the opportunity to invest more money in your retirement plan or plans than you realize.

Defined-benefit plans were far more popular 20 years ago than today. For people with defined-benefit plans there are limited opportunities to make strategic decisions, during the working years, to increase retirement benefits. It might be possible to increase the retirement benefit by deferring salary or bonuses into the final years, or working overtime to increase the calculation wage base. These opportunities, however, depend on the plan's formula, and they are often not flexible and not significant.

How Many Plans Are Available to You?

There is a good possibility that you have the opportunity to invest more money in your retirement plan or plans than you realize. For many readers who are still working, applying the lessons of this mini case study could save you thousands of dollars every year.

MINI CASE STUDY 1.3

Contributing the Maximum to Multiple Retirement Plans

Tom and his wife, Judy, both 55, want to make the maximum retirement plan contributions allowed. Tom earns $44,000 per year as a secretary for a school district that has both a 403(b) plan and a Section 457 plan. Judy is self-employed, has no employees, and shows a profit on Schedule C of $80,000 per year. Tom and Judy have a 16-year-old computer-whiz child, Bill, who works weekends and summers doing computer programming for Judy's company. Bill is a legitimate subcontractor, not an employee of Judy's company. Judy pays Bill $14,000 per year. What is the maximum that Tom and Judy and Bill can contribute to their retirement plans for calendar year 2006?

Tom: Calculating Maximum Contributions to Multiple Plans

Under EGTRRA, Tom could contribute $20,000 to his 403(b) plan in 2006 ($15,000 normal limit plus another $5,000 because he is over 50). Please note that under EGTRRA, Tom's retirement plan contribution is not limited to 15% of his earnings as it would have been under prior law. Under a special rule specifically relating to only 457 plans, assuming Tom's employer has a 457 plan, he could also contribute another $20,000 to the plan in 2006 (same $15,000, plus $5,000). In addition, he could also contribute $5,000 in 2006 to a Roth IRA ($4,000 per year limit plus $1,000 because he is over age 50) by using the remaining $4,000 of his income (his income is $44,000 less $20,000 for the 403(b) less $20,000 for the 457, which leaves $4,000) and using $1,000 of Judy's income. (Roth IRAs are discussed in more detail in the next chapter.) Please note the new law allows contributions to all three plans—something not previously allowed. Tom was able to contribute the entire amount of his income into retirement plans. In addition, he could use $1,000 of Judy's income to maximize his Roth IRA contribution for 2006.

Judy: Calculating Maximum Contribution to a "Super K"

After rejecting a more complicated defined-benefit plan, Judy chooses the newly introduced one-person 401(k) plan, or the "Super-K" plan. These plans are now available as a result of the tax law changes effective in 2002. Judy could contribute as much as \$34,870 into her 401(k) plan. This amount comes from two components. The first component is the 401(k) elective deferral amount that is limited to \$20,000 (the same limits as Tom's 403(b) plan). The second component is a \$14,870 discretionary profit-sharing contribution. To arrive at this figure, Judy's net self-employed income of \$80,000 must be reduced by one half of her computed self-employment tax, which is \$80,000 × .9235 ×.153 = 11,304 × 50%, or \$5,652. The \$74,348 (\$80,000 – \$5,652) is multiplied by the 20% contribution rate limit (for self-employed individuals, and equal to 25% of earnings net of the contribution itself) to compute the maximum profit-sharing contribution amount of \$14,870. Judy also can make an additional \$5,000 contribution to her Roth IRA.

Bill: For Parents Who Are Considering Funding Retirement Plans for Their Children

Though Bill is young, he should use his \$14,000 income to begin making contributions to his retirement plan.

Bill could open up a SIMPLE plan and contribute \$10,000. In addition, he could contribute his remaining \$4,000 of earned income to a Roth IRA. If he already spent some of the \$4,000, his parents could make him a gift of the money.

The tax-free benefit of the Roth IRA and the tax-deferred benefit of the SIMPLE plan is so important to the child during his lifetime that some parents who have sufficient funds—and who are willing to fund their child's retirement plan—will be tempted to create a sham "business" for their child or even put their child on the payroll as a sham transaction. I do not recommend this approach. I advocate that the child do legitimate work, complying with all child labor laws. All retirement plan contributions should stem from legitimate businesses and, if based on self-employed earnings, be a real business.

I have seen parents paying infants to model, characterizing the payment to the infant as “self-employed income” and making a retirement plan contribution for the infant. I think that goes too far. Any situation where a child younger than 11 years old receives employment compensation is highly suspect. Even at age 11, legitimate compensation should not be too high.

Let’s assume that Tom, Judy, and Bill “max out.” Though Tom and Judy earned only $124,000 and Bill earned only $14,000, the family could contribute over $98,000 into their retirement plans and Roth IRAs. For subsequent years, the contribution limits are even more generous. Is this a great country or what?

This example intentionally exaggerates the family’s likely contributions. The point is to show maximum contribution limits and the variety of plan options. In this particular case, Tom and Judy may choose not to maximize their contributions because they may not receive any income tax benefits beyond a certain level of contribution. It is worthwhile to review this case study to help with choosing and implementing a new plan. In addition, Bill’s Roth IRA may be considered an asset for financial aid purposes by universities that use the Institutional Method for determining financial aid.

Many people—perhaps you—feel they cannot afford to save for retirement. The truth is you may very well be able to afford to save, but you don’t realize it.

When You Think You Can’t Afford to Make the Maximum Contributions

Many people—perhaps you—feel they cannot afford to save for retirement. The truth is you may very well be able to afford to save, but you don’t realize it. That’s right. I am going to present a rationale to persuade you to contribute more than you think you can afford.

Let’s assume you have been contributing only the portion that your employer is willing to match and yet you barely have enough money to get by week to week. Does it still make sense to make nonmatched contributions assuming you do not want to reduce your spending? Maybe.

If you have substantial savings and maximizing your retirement plan contributions causes your net payroll check to be insufficient to meet your expenses, I still recommend maximizing retirement plan contributions. The shortfall for your living expenses from making increased pre-tax retirement plan contributions should be withdrawn from your savings (money that has already been taxed). Over time this process, that is to say, saving the most in a retirement plan and funding the shortfall by making after-tax withdrawals from an after-tax account, transfers money from the after-tax environment to the pre-tax environment. Ultimately it results in more money for you and your heirs. Another way to squeeze blood from a stone is to consider an interest-only mortgage. The reduced mortgage payment (in contrast to what you would be paying on a 30-year fixed rate mortgage) is deductible as a home interest expense. The additional cash flow from the reduced payment could be used to pay credit card debt or fund one or more tax favored investments. You could open a Roth IRA, make additional retirement contributions, and/or purchase a tax-favored life insurance plan. In the long run, you could be better off, often by hundreds of thousands of dollars. Of course there are risks with this strategy. I will keep coming back to the primary theme: don't pay taxes now—pay taxes later.

MINI CASE STUDY 1.4

Changing Your IRA and Retirement Plan Strategy after a Windfall or an Inheritance

Joe always had trouble making ends meet. He did, however, know enough to always contribute to his retirement plan the amount his employer was willing to match. Because he was barely making ends meet and had no savings in the after-tax environment, he never made a nonmatching retirement plan contribution. Tragedy then struck Joe's family. Joe's mother died, leaving Joe $100,000. Should Joe change his retirement plan strategy?

Yes. Joe should not blow the $100,000. If his housing situation is reasonable, he should not use the inherited money for a house—or even a down payment on a house. Many planners and people will disagree. Of course it depends on individual circumstances. Instead, Joe should increase his retirement plan contribution to the maximum. In addition, he should start making Roth IRA contributions (see Chapter 2). Many of you who live in areas that have seen huge real estate appreciation think he should use the money to invest in real estate. You may have been right yesterday. You might even be right today. It is, however, a risky strategy, unsuitable for many if not most investors.

Assuming he maintains his pre-inheritance lifestyle, between his Roth IRA contribution and the increase in his retirement plan contribution, Joe will not have enough to make ends meet without eating into his inheritance. That's okay. He should then cover the shortfall by making withdrawals from the inherited money. True, if that pattern continues long enough, Joe will eventually deplete his inheritance in its current form. But his retirement plan and Roth IRA will be so much better financed that in the long run, the tax-deferred and tax-free growth of these accounts will make Joe better off by thousands, possibly hundreds of thousands, of dollars. The only time this strategy would not make sense is if Joe needed the liquidity of the inherited money, or he preferred to use the inherited funds to improve his housing.

A Key Lesson from This Chapter

You should contribute the maximum you can afford to all the retirement plans to which you have access.