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 pretax 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
- Minimize your life insurance costs to maximize your retirement contributions
- 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 a 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 in 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 money in a retirement plan over saving money 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, interest, and 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 take a look.

MINI CASE STUDY 1.1

The Clear Advantage of Pretax 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; 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.).

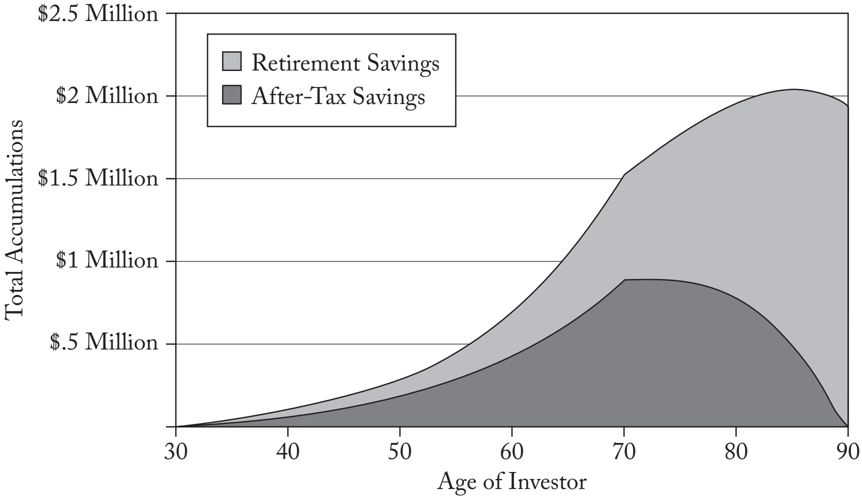
Both men begin investing at age 30.

- In 2008, they start saving $5,000 per year, 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 deductible 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 percent income tax is paid, he has only 75 percent 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 in the accumulations over time.

Figure 1.1

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



The assumptions for this graph include the following:

1. Investment rate of return is 7 percent including 70 percent capital appreciation, with 15 percent portfolio turnover rate, 15 percent dividend income, and 15 percent interest income.
2. Mr. Pay Taxes Later makes retirement savings contributions of $5,000 per year. Mr. Pay Taxes Now invests 25 percent less due to taxes. Both amounts are indexed for 2.5 percent 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 (MRDs) from Mr. Pay Taxes Later's retirement plan less related income taxes.
4. Mr. Pay Taxes Later withdraws only the minimum required distribution (MRD), pays the 25 percent income tax due on his distribution, and spends the rest. Mr. Pay Taxes Now spends the same amount plus he pays income taxes due on his interest, dividends, and realized capital gains.
5. Ordinary tax rates are 25 percent.

6. Capital gains tax rates are 15 percent for 2008 to 2010 and 19 percent thereafter.
7. Dividends are taxed as capital gains during 2008 to 2010 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 percent 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 whereas 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.

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 until 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 your 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. Promise yourself that it will motivate you to take action—take the critical steps that will put you and your family in a much more secure position than you are in today.

Make Those Nonmatched Contributions to Retirement

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 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 pretax investment that grows tax-deferred. There are no federal income taxes on the wages contributed.

Some taxpayers look at it as a deduction. Whichever 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. Furthermore, once the contribution is made, you do not 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.

By not paying the taxes up front on the wages earned, you reap the harvest of compounding interest, dividends, and capital gains 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 it builds in the discipline of contributing to your retirement plan with every paycheck. The example above is assuming that if you don't put the money in your retirement plan, you are saving and investing an amount that would be 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?

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The idea of paying taxes later and contributing the maximum to your retirement plan(s) is something that I have preached in my practice 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 in a 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 on a dollar-for-dollar basis, it offers a *100 percent 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. With few exceptions, all those reasons come down to two words: *ignorance* and *neglect*. If you didn't know that before, you know it 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 401(k), 403(b), and 457 plans. Many eligible 403(b) plan participants also may have access to a 457. 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 agreement may provide that the employer contribute 50 cents for every dollar up to the first 6 percent of salary you contribute. Keep in mind: This is free money!

Many eligible 403(b) plan participants also may have access to a 457. 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 percent 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 $5,000 to his retirement account. Bill is fortunate because his employer matches his contribution 100 percent. Thus $10,000 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 on only $70,000.

  ($75,000 income – $5,000 tax-deferred)

  (25% × $70,000 = $17,500 tax)
- He now has $57,500 ($75,000 income – $17,500 taxes).
- He makes his plan contribution of $5,000, leaving him with $52,500 outside the plan.
- His employer matches the $5,000 (also tax-deferred).
- He now has $10,000 in his retirement plan (growing tax-deferred).
- He spends $50,000 per year.
- He is left with $2,500 in cash.

Which scenario strikes you as more favorable: Scenario 2 with $10,000 in a retirement plan and $2,500 in cash, or Scenario 1 with no retirement plan and $6,250 in cash? The extreme cynic can figure out situations when 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	$2,500
Retirement plan balance	0	$10,000
Tax on retirement plan balance	0	($2,500)
Early withdrawal penalty	0	($1,000)
Total purchasing power	$6,250	$9,000

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 percent. 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 $3,750 ($6,250 – $2,500).

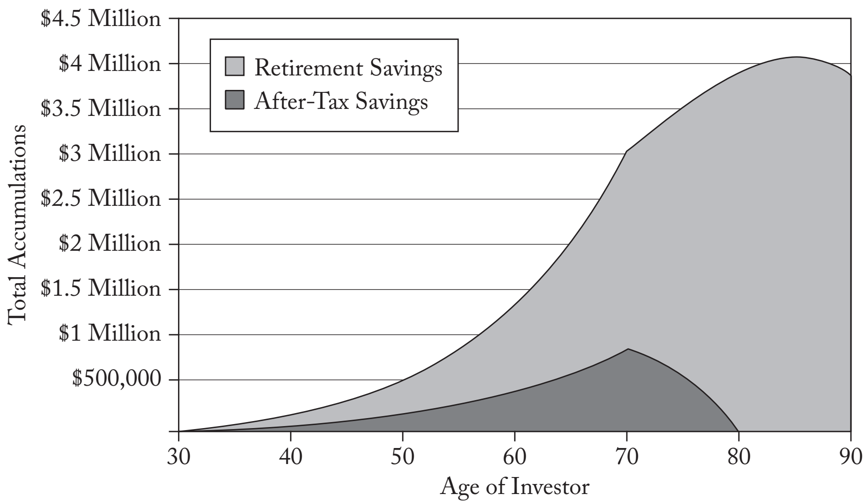
For your $3,750 gift, your adult child would end up with $10,000 in his retirement plan. That is an example of a leveraged gift. Lots of bang for your gifted buck.

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 percent employer match of annual contributions, Figure 1.2 compares stubborn Bill who refuses to use the retirement plan versus compliant Bob who contributes to his retirement plan:

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 Bob's matched retirement savings has $3,908,093 remaining, and despite the

Figure 1.2

Retirement Assets Plus an Employer Match vs. After-Tax Accumulations



large distributions being made after age 80, compliant Bob'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. Beg, borrow, or steal to find the money to contribute to an employer-matching plan.

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), 403(b), and 457 plans. 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, however, have no idea how much their plan is worth.

A growing number of employers offer the Roth 401(k) and 403(b) plans. Both are new options for defined-contribution plans that provide 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 (or even my new idea for the "self-employed formerly retired"), consider the relatively new, one-man Super-K, which is basically a one-person 401(k) plan on steroids. More detailed descriptions of these plans appear below.

At retirement or service termination, my most frequent recommendation for retirees used to be "Transfer your funds from defined-contribution plans to an individual retirement account (IRA)." Now, however, since the new law permits beneficiaries of an inherited 401(k) to make a Roth IRA conversion, but (at least while this book was being written) it does not permit nonspouse beneficiaries of IRAs to make a Roth IRA conversion of an inherited IRA, the advice becomes more complicated.

My favorite new strategy is for retirees to set up a personal 401(k) plan. Then retirees should consider rolling their 401(k) plan from their primary place of employment, and even their IRA, to their new personal 401(k) plan. This offers the following benefits:

- There are extremely flexible investment choices.
- Upon the retiree's death, his or her beneficiaries would still be able to make a Roth IRA conversion of the inherited 401(k).
- New Roth IRA conversions are possible.
- There is better protection from creditors than with traditional IRAs.

The flaw of this strategy is that to set up your one-person 401(k) plan, you must have earned income. If you don't have earned income or the possibility of having earned income, then the strategy doesn't work. Therefore, one of the things I love to see my retired clients do is earn a little self-employment income. Perhaps they do a little consulting in their field, or perhaps they take a postretirement job working at the golf course or doing some part-time teaching. Some retirees will even charge people for services they used to perform for free. For example, a retiree could consult with his self-employed child and the self-employed child could pay the parent for consulting. That earned income could be the basis of the new 401(k). On the downside there may be some administrative expenses in setting up and maintaining the plan, but this might amount to only several hundred dollars a year, at the most.

That is not to say that having a lot of money in a company 401(k) or even an IRA is bad, but having it in a one-person 401(k) plan that is completely under the retiree's control is a better strategy for many.

Common Defined-Contribution Plans

Defined-contribution plan accounts often become substantial and are frequently the largest asset in the estate. Typically they are rolled into an IRA at retirement (although, as mentioned above, this strategy must now be evaluated on a case-by-case basis). 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, such as Pennsylvania, 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 which is $22,000 in 2009 for someone 50 or older and $16,500 under age 50, (it was $20,500 in 2008 for someone 50 or older, $15,500 under 50) with higher inflation adjusted amounts in future years. The company—that is, the employer—is responsible for providing the employee with investment choices, typically six to ten 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.

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 and most common 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 prefer the Roth 403(b) over the traditional 403(b).

457 Plans: After 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 police officers, firefighters, teachers, and other municipal workers.

An interesting side note is that many eligible 457 plan participants don't even know they are eligible to make a 457 plan contribution. 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. A perfect candidate for using both plans would be a married teacher whose spouse has income and the two of them have more than sufficient income for their needs. If they have substantial savings and if they are aged 50 or older in 2009, the teacher could contribute $22,000 to her 403(b) and $22,000 to her 457 plan. By doing that, the couple reduced their taxable income by $44,000.

Roth 401(k) and 403(b) Plans: These plans are discussed more fully in Chapter 3. If your company adopts one of these plans, you will have the option of contributing either into your traditional deductible 401(k) or 403(b) or your nondeductible but tax-free Roth 401(k) or Roth 403(b). Many employers began implementing Roth 401(k) plans beginning in 2006. The new Roth 401(k) combines the features of a Roth IRA and a 401(k). When given a choice, I usually prefer the Roth option for the same reasons that I prefer a Roth IRA to a traditional IRA. At retirement, the Roth 401(k) and 403(b) accounts 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 are put into a traditional 401(k) or 403(b) 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 percent 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 percent of what most self-employed people think is compensation.)

Super-K or One-Person 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 $22,000 in 2009 (it was $20,500 in 2008) for someone 50 or older with higher inflation-adjusted amounts for later years plus the 25 percent 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. Please note this is the type of plan I like for the new self-employed retiree. These Super-K plans can also contain the Roth option as mentioned above under Roth 401(k) and 403(b) plans. Again, when given a choice, I usually prefer the Roth feature for the deferral portion.

Deferral Contribution Limits

As a result of a series of tax law changes starting with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 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 for 2008 and 2009 (and methods for changes in 2010) are shown in Table 1.1. (The maximum contributions for individuals younger than 50 are in the regular font and the maximum contributions for those 50 and older are in italics.)

Table 1.1: Maximum Deferral Contribution Limits for 2008–2010

	2008	2009	2010*
SIMPLE Plans[b]	$10,500	$11,500	$11,500[a]
50 and older	*13,000*	*14,000*	*14,000*[a]
401(k), 403(b), 457[c]	$15,500	$16,500	$16,500[a]
50 and older	*20,500*	*22,000*	*22,000*[a]
Roth 401(k) + Roth 403(b)	$15,500	$16,500	$16,500[a]
50 and older	*20,500*	*22,000*	*22,000*[a]
SEP, Super-K[d]	$46,000	$49,000	$49,000[e]
50 and older	*51,000*	*54,500*	54,500[e]

*At the time of publication, we did not have conclusive numbers for 2010. As soon as we have the information, which should be in late 2009, we will post it to www.retiresecure.com. Please visit the web site for updates and additional information.

[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] Overall plan limits for business owners include total of all contributions by the employer (self-owned business), employee (self), and any forfeitures.

[e] Plus amounts for inflation-related adjustments.

Please note that with the exception of the Roth 401(k) and Roth 403(b) discussed more fully in Chapter 3, 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 on the dividends, interest, and capital gains 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, such as California and New York, will give you a state income tax deduction for a contribution, but will require you to pay income tax on the distribution, which presumably over time would mean more revenue for the state because the distributions would include appreciation.

In many respects, an employee's contributions to Roth 401(k) or Roth 403(b) plans are treated similarly to Roth IRA contributions. Just as with a Roth IRA, the participant does not receive a tax deduction on his or her contributions to the plan. Instead, the employee pays the federal and state taxes up front and all investments grow tax-free. As long as the employee does not make a withdrawal during the first five years and until age 59½, there will be no taxes to pay when the money, including growth, is withdrawn. Unlike a Roth IRA, there are MRDs 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 pretax dollars (the traditional 401[k], etc.), 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 the employer's 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 percent per year that an employee remains with the company until five years have passed. At that point, the employee is 100 percent 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 percent vesting 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 the employee's distribution.

At retirement, the employee is often given a wide range of choices of how to collect his or her 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; maybe it is guaranteed for the life of the longest living spouse, or perhaps for a 10-year term regardless of when you die or your wife dies. (A further discussion of annuities can be found in Chapter 8.)

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 suffered serious reductions in their pension income. Many other plans have been frozen, meaning that you will get the benefit accrued up to the frozen date, but you don't get credit for more years of service or increases in pay.

If you are a participant in such a plan, you have some important options to consider at the time of your retirement. For example, let's assume that you are in good health and want the highest annuity income for your life. That often seems like the best option. However, when you die, your surviving spouse is out of luck. It might make more sense to receive reduced payments, but guarantee the payments over the lives of both the husband and wife.

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 annual payment and his or her surviving spouse will receive a fraction, perhaps half or two-thirds throughout his or her life.

But there is another option to consider. The most prudent course might be to take a one-life (not two-life) annuity and use some of the 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 to get insurance, if you are still insurable. In other words, if you are retired and are now concerned that by taking a one-life annuity with the highest monthly payment you did not sufficiently provide for your surviving spouse, you could still purchase life insurance.

In many, if not most, situations it is often simplest and best to choose a two-life option ensuring full income to you and your spouse.

Defined-benefit plans were far more popular 20 years ago than they are 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 inflexible and insignificant.

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 a defined-contribution plan. 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 increasingly mobile workforce in the United States. Employees may take their cash balance plans with them to a new employer when they change jobs or roll them into an IRA.

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

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

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 allowable. Tom earns $46,000 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 her Schedule C, Form U.S. 1040, 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 $17,200 per year. What is the maximum that Tom and Judy and Bill can contribute to their retirement plans for calendar year 2008?

Tom: Calculating Maximum Contributions to Multiple Plans

Under EGTRRA, Tom could contribute $20,500 to his 403(b) plan in 2008 ($15,500 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 percent of his earnings as it would have been under prior law. Under a special rule specifically relating to 457 plans, he could also contribute another $20,500 to the plan in 2008 (same $15,500 plus $5,000). In addition, he could also contribute $6,000 in 2008 to a Roth IRA ($5,000 per year limit plus $1,000 because he is over age 50) by using the remaining $5,000 of his income (his income is $46,000 less $20,500 for the 403(b) less $20,500 for the 457, which leaves $5,000) and using $1,000 of Judy's income. (Roth IRAs are discussed in more detail in Chapter 2.) Please note the new law allows contributions to all three plans—something not previously permitted. Tom was able to contribute

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*We have used 2008 amounts for this example. As shown in Table 1.1, the retirement plan contribution limits for 2009 are even higher. It is likely that the contribution amounts will increase in future years as well. As soon as we have the information we will post it to www.retiresecure.com. Please visit www.retiresecure.com for updates and additional information.

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 2008.

Judy: Calculating Maximum Contribution to a Super-K

After rejecting a more complicated and more expensive defined-benefit plan, Judy chooses the newly introduced one-person 401(k) plan, or the Super-K plan. Judy could contribute as much as $35,370 into her 401(k) plan. This amount comes from two components. If you were an employee with a 401(k) plan, there would be an employer share and an employee share. Since you are self employed, the plan for self employed taxpayers has the equivalent of an employee and employer share. The first component is the 401(k) elective deferral amount that is limited to $20,500 (the same limits as Tom's 403[b] plan). This $20,500 is the equivalent of the employee's share. Most Super Ks are set up so that you can deduct this $20,500 on your tax return and have this portion taxed like a regular 401(k). If you want this portion to be taxed like a Roth IRA, like we generally recommend, you can set up a Roth Super K, and elect to put this $20,500 into the Roth Super 401(k). Please note this $20,500 could be invested in a traditional Super 401(k) or in the new Roth Super 401(k). Please see Chapter 3 for a detailed comparison of a Roth 401(k) vs. a traditional 401(k).

The second component is a $14,870 discretionary profit-sharing contribution. This is like the employer contribution. Please note that just like a traditional 401(k) plan, the employer portion may not be a Roth. To arrive at the $14,870, Judy's net self-employed income of $80,000 must be reduced by half of her computed self-employment tax, which is $80,000 × 92.35% × 15.3% = $11,304 × 50%, or $5,652. The $74,348 ($80,000 – $5,652) is multiplied by the 20 percent contribution rate limit (for self-employed individuals, and equal to 25 percent of earnings net of the contribution itself) to compute the maximum profit-sharing contribution amount of $14,870. Judy also can make an additional $6,000 contribution to her Roth IRA.

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

Although Bill is young, if he can afford it, he should use his $17,200 income to begin making contributions to his retirement plan. Bill will owe $2,430 of self-employment tax, half of which is deductible, so his net earned income for the purposes of retirement plan contributions is $15,985.

Bill could open up a SIMPLE plan and contribute $10,500, plus a 3 percent SIMPLE matching contribution, which is $477 (3% of $17,200 × .9235). The net earned income less these amounts is $5,008, which is enough to fully fund his Roth IRA with $5,000. If he already spent some of the $5,000, 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 are so important to a child during his or her lifetime that some parents who have sufficient funds are willing to fund their child's retirement plan. This is a wonderful idea. However, in order to fund a retirement plan or IRA, the child must have earned income. Some parents 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 had to say that in case the IRS reads this. In all seriousness, however, there are also nonfinancial benefits in having a child do legitimate work to receive money.)

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 their retirement plan contributions. Even though Tom and Judy earned only $126,000 and Bill earned only $17,200, the family could contribute over $104,000 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 and Bill 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, however, to review this case study to help with choosing and implementing a new plan.

How to Minimize Your Life Insurance Costs to Maximize Your Retirement Contributions

Often, our younger clients will complain that they cannot maximize their retirement plan contributions because of the cost of their life insurance. Although whole life or guaranteed universal life can be a great vehicle for high income earners to save more money, term insurance is often a better solution for individuals whose budgets don't stretch to afford both the high whole life insurance premiums and maximized retirement plan contributions.

The objective of term life insurance is to protect a family from the financial devastation that can ensue from the untimely death of the primary bread winner(s). It is also important to insure the value of the services of a stay-at-home parent. It is critically important insurance, but it is also to your advantage to try to get the appropriate level of coverage for the most reasonable price. The following section, though by no means complete, presents my favorite idea for many young families to protect themselves in the event of an early, unexpected death, but to do so relatively cheaply. I am working from the premise that I do not like to see people underinsured, but I also want everyone to be thinking ahead to retirement.

One of the most common mistakes my younger clients make is not having sufficient term insurance. Most healthy young people survive until retirement and paying for term insurance is not something anyone really wants to do. In my practice, however, I have known young healthy people who died much too early. In my experience, it is rarely the result of a catastrophic car or plane accident, but more frequently because of the sudden onset of cancer or some other fatal disease.

Most people, however, also have this vague sense that the responsible thing to do is to purchase insurance to protect their families. Some people seek out an insurance provider and initiate a policy; others do something when they are approached by a life insurance professional. In either case they usually end up with some kind of policy. The key is to find a policy that balances adequate insurance and minimum premiums. I don't like to see people, especially younger people, who are working on a limited budget pay high life insurance premiums.

It isn't my intention to present a detailed prescription for determining your life insurance needs. For my purposes here, I will ask you to think about "How much income will your survivors require to live comfortably?" Let's say that after some analysis you decide that an appropriate income is

$60,000 per year in today's dollars. Please note I did not derive this number as a multiple of current salary; it is based purely on projected need.

I am not going to delve into the intricacies of calculating a safe withdrawal rate—that is to say, how much as a percentage of principal you can withdraw and have the money last for a lifetime—but I would say for young people with a long life expectancy, 4 percent would probably be on the high side for a safe withdrawal rate. This means if there is no other source of income, an individual will need at least $1,500,000 of life insurance ($1,500,000 × 4% = $60,000).

First, I hope I didn't just bum you out and make you realize you are vastly underinsured because $60,000 of income doesn't sound that high and you don't have anywhere near $1,500,000 of insurance.

Admittedly, whatever resources you have can be used to reduce the need for life insurance. If both spouses work, the income of the survivor can certainly be factored in. If you have significant investments or savings, they can also be used to reduce the need.

But to keep things simple, let's assume there aren't significant additional resources and the need is $1,500,000. Also, in this basic example I am not factoring in the additional money that would be required for living expenses and education if there were young children involved.

Let's also assume that at least one member of the couple is working and he or she receives some life insurance as a job benefit. For discussion's sake, we will assume the salary is $100,000 and the insurance benefit is equal to three times the salary. You might say, "Well, that's a start. Now I only need $1,200,000 more."

Sorry, that's the wrong answer. What if you get sick and can't perform your job? You lose your job, you lose your insurance, and because you are sick, you can't get life insurance. (Hopefully, you either have disability insurance through work or you have your own policy, but that is something I don't cover in this book). Whereas group insurance at work is a blessing for people who are uninsurable and can't get life insurance on the open market for a reasonable rate, there are two problems with group life insurance. The first, I just mentioned: If you lose your job, you lose your insurance. The second is that if you are healthy, you can almost always get insurance more economically on the open market.

For young people with cash flow problems, keeping the premiums affordable is critical. Many insurance professionals make a convincing case for permanent insurance, which is a type of policy that ultimately has a cash value. There is a payout when you die, or sometimes upon reaching a certain age. Term insurance, on the other hand, is not designed to pay out if you reach a normal life expectancy. It is designed to pay if you don't survive to a normal life expectancy.

Permanent insurance is expensive. The insurance company will ultimately have to write a check to your beneficiaries, so it costs more. Many of my young working clients come in with some measure of permanent insurance—in some ways it feels better to them. They are paying money into insurance, but they know there will be a payback. However, since it is so much more expensive, many of these same young people are significantly underinsured. If you have permanent insurance of even $500,000, you are still $1,000,000 underinsured even though you have a big premium every year. I would rather see the money going toward sufficient term insurance so the surviving spouse and other family members are protected.

Let's assume that you have a good job and marketable skills. You are prudent and thrifty, putting money into your retirement plan at work and maxing out your Roth IRAs. You do projections and determine that you will have sufficient money to retire at 60 (assuming you are 30 now). You might logically think "Okay, I need a 30-year level term policy (premiums are guaranteed never to go up) for $1,500,000."

Well, that is a reasonable start, but you are likely to find that the guaranteed premium for a level term policy for 30 years for $1,500,000 is more than you want to pay for insurance. Well, are you really going to need that much coverage for the whole time? Perhaps not. If you work and save for 10 years, you may only need $1,000,000 at that point in time. Perhaps in the 10 years beyond that, your need may drop to $500,000. I am trying to keep it simple to make a point. As you change, your insurance needs will change, and thinking within this more flexible framework offers some new options.

Since I am being frugal with your insurance budget, consider the following set of policies, assuming the above situation.

- Get a 30-year term policy for $500,000 coverage
- Get a 20-year term policy for $500,000 coverage
- Get a 10-year term policy for $500,000 coverage

If you die between the date the policy is issued and year 10, your heirs get $1,500,000, which is what we determined was the needed amount. At the end of 10 years, the first policy ends and you will only have $1,000,000 of coverage. That is okay. By this point you should have $500,000 in retirement plans and savings. In addition, the need for insurance will be down a little bit because your heirs will have a shorter life expectancy.

After 20 years the second policy ends and you will only have $500,000 of coverage remaining. That is okay because by this time you should have $1,000,000 of retirement and savings, and your need will only be $500,000. At the end of 30 years, you will have no coverage, but again, that is okay because hopefully by then you will have accrued sufficient resources for your surviving spouse.

Of course in the above example I have kept things really simple. I have not included relevant factors like inflation, children's needs, the ability of the surviving spouse to work, and so forth.

But you get the idea. We have helped a number of our clients reach their goal of adequate coverage through this layered system. Frequently, a 30-year level term policy costs more than individuals might want to pay or can afford, so they compromise by not getting the insurance coverage they really need. I would prefer to see you get the coverage you need using some variation of the layered approach that I have suggested. Remember, the goal was sufficient coverage for a reasonable cost.

In all fairness, I didn't invent this layered approach. I learned it from Tom Hall, an excellent broker I work with in Pittsburgh. This brings up another point. After you decide to get the insurance you need, I recommend purchasing your insurance through an ethical insurance broker (someone who can purchase insurance from many different companies). In our experience, working with a broker is the way to get the best policies at the best rates. (For more on working with brokers and qualifying for the best insurance rates, read Chapter 12.) If you don't have or know an appropriate insurance broker, please see the back of the book.

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

Maybe now I have helped you rethink your insurance-retirement savings quandary. But you still feel you 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 limiting your contributing to 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.

Maybe now I have helped you rethink your insurance-retirement savings quandary. But you still feel you 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.

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 pretax retirement plan contributions should be withdrawn from your savings (money that has already been taxed). Over time this process, that is, 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 pretax environment. Ultimately it results in more money for you and your heirs.

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. Instead, Joe should increase his retirement plan contribution to the maximum. In addition, he should start making Roth IRA contributions (see Chapter 2). (This solid advice freaked out a real estate investor after he read it in the first edition. He thought the money should have been used to invest in real estate. Being that aggressive, however, is a risky strategy, unsuitable for many, if not most, investors.)

Assuming Joe maintains his preinheritance 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 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 pay personal expenses or even to liquidate debt.

A Key Lesson from This Chapter

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