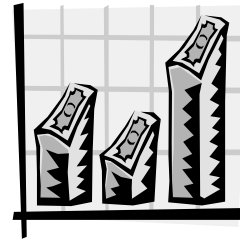


LIGHTHOUSE CPA SOCIAL SCIENCES DEPARTMENT

ECONOMICS - PERSONAL FINANCE WORKSHOPS

11 - PLANNING FOR YOUR FUTURE



*Vocabulary Keys : Words that are in **bold** = are terms that appear in one of the chapters , Words that are underlined = supplemental vocabulary . Ask questions about these words if you are not familiar with them !*

TOP THINGS TO KNOW

1. *Save as much as you can as early as you can.*

Though it's never too late to start, the sooner you begin saving, the more time your money has to grow. Gains each year build on the prior year's -- that's the power of compounding (Rule of 70), and the best way to accumulate wealth.

2. *Set realistic goals.*

Project your retirement expenses based on your needs, not rules of thumb. Be honest about how you want to live in retirement and how much it will cost. Then calculate how much you must save to supplement Social Security and other sources of retirement income.

3. *A **401(k)** is one of the easiest and best ways to save for retirement.*

Contributing money to a 401(k) gives you an immediate tax deduction, tax-deferred growth on your savings, and -- usually -- a matching contribution from your company.

4. *An **IRA** also can give your savings a tax-advantaged boost.*

Like a 401(k), IRAs offer huge tax breaks. There are two types: a traditional IRA offers tax-deferred growth, meaning you pay taxes on your investment gains only when you make withdrawals, and, if you qualify, your contributions may be deductible; a Roth IRA, by contrast, doesn't allow for deductible contributions but offers tax-free growth, meaning you owe no tax when you make withdrawals.

5. *Focus on your asset allocation more than on individual picks.*

How you divide your portfolio between stocks and bonds will have a big impact on your long-term returns.

6. Stocks are best for long-term growth.

Stocks have the best chance of achieving high returns over long periods. A healthy dose will help ensure that your savings grows faster than inflation, increasing the purchasing power of your nest egg.

7. Don't move too heavily into bonds, even in retirement.

Many retirees stash most of their portfolio in bonds for the income. Unfortunately, over 10 to 15 years, inflation easily can erode the purchasing power of bonds' interest payments.

8. Making tax-efficient withdrawals can stretch the life of your nest egg.

Once you're retired, your assets can last several more years if you draw on money from taxable accounts first and let tax-advantaged accounts compound for as long as possible.

9. Working part-time in retirement can help in more ways than one.

Working keeps you socially engaged and reduces the amount of your nest egg you must withdraw annually once you retire.

10. There are other creative ways to get more mileage out of retirement assets.

For instance, you might consider relocating to an area with lower living expenses, or transforming the equity in your home into income by taking out a reverse mortgage.

What should I do first?

The path to a successful retirement starts with creating an overall plan.

To live well in retirement, you no longer can rely solely on a pension plan or Social Security. Instead, you will have to depend on how skillfully you plan and invest, and whether you make good use of tax-advantaged savings plans such as 401(k)s and IRAs.

First, estimate how much you will need. One rule of thumb is that you'll need 70% of your annual pre-retirement income to live comfortably. That might be enough if you've paid off your mortgage and are in excellent health when you kiss the office goodbye.

But if you plan to build your dream house, trot around the globe, or get that Ph.D. in philosophy you've always wanted, you may need 100% of your income or more.

Remember, too, that your health care expenses are likely to go up in retirement, if only because you'll be paying more for insurance, especially if you retired prior to being eligible for Medicare. Some employees who retire before 62 don't realize how much their employers contribute to health care. This has led some to consider retiring after 65.

Second, figure out how you'll meet those expenses. There are three main sources of retirement income: Social Security, pensions and annuities, and your savings. Start by determining your estimated Social Security benefits. If you haven't already received a statement in the mail, you can order one online or use an online calculator to make estimates based on expected earnings.

Next, add in any annual payouts you expect from an annuity or company pension.

If it's not enough, it's time to think about where that money will come from. Count on needing at least \$15 to \$20 in investment savings to cover each dollar of that shortfall. If your projected retirement expenses exceed Social Security and pensions by, say, \$20,000 a year, that means you'll need a nest egg of \$300,000 to \$400,000 to bridge the gap.

CNN / Money's Retirement Savings Planner can help you come up with an estimate of how large a nest egg you'll need. CNN / Money's asset allocation tool will help you find the right mix of stocks and bonds to help you build it.

How should you invest?

*Your retirement savings are sacred, so you don't want to take crazy risks. That doesn't mean you should rely solely on safe investments such as bank **CDs** and **money-market funds**.*

To build a nest egg large enough to see you through retirement, which may last 30 years or more, you'll need the growth that stocks provide.

From 1926 through 2009, stocks -- broadly speaking, using the S&P 500 index as a measure -- have posted an average annual return of 9.8% versus just 5.4% for bonds .

Given stocks' superior long-term returns, some financial advisers recommend that investors whose retirement is still 20 years or more away put the lion's share of their portfolio in stocks and stock funds.

Of course, a 100% stock portfolio can give you some hair-raising moments (or years). In the 1973-74 bear market, for example, U.S. stocks lost 43% of their value and took three-and-a-half years just to get back to where they started.

Moreover, those whose stock portfolios are concentrated may suffer even more dramatic ups and downs.

If you don't have the stomach for steep downturns, a more prudent course is to throw some bonds into the mix. Putting 70% of your portfolio into stocks and 30% into bonds, for example, will let you capture most of the long-term growth of stocks while sheltering your investments somewhat during meltdowns.

As you approach retirement age, the idea is to shift more into bonds. But even in retirement, which can last a few decades, it pays to maintain a healthy dose of stocks (maybe upwards of 50% in your 70s, and up to 30% in your 80s).

Take care, however, to understand the kind of companies you're investing in. More volatile stocks may not be appropriate for you at this stage in your life.

For help on finding the right allocation for you, try CNN / Money's Asset Allocation Tool.

The virtues of the 401(k) :

Uncle Sam doesn't offer many gifts. This is one. The upside is free money .

If someone offered you free money, would you refuse it? Probably not. But that's just what you're doing if you don't contribute to your 401(k).

The more you contribute, the more free money you get. Here's why.

Contributing part of your salary to a 401(k) gives you three compelling benefits:

- 1. You get an immediate tax break, because contributions come out of your paycheck before taxes are withheld, thereby lowering your taxable income.*
- 2. The possibility of a matching contribution from your employer -- most commonly 50 cents on the dollar for the first 6% you save.*
- 3. You get tax-deferred growth -- meaning you don't pay taxes each year on capital gains, dividends, and other distributions*

Thanks to the Tax Relief Reconciliation Act of 2001, there are a few changes to 401(k)s that may be of even greater benefit to you.

For starters, the federal limit on annual contributions is set at \$16,500 for the 2010 tax year.

The Tax Relief Act also offers catch-up provisions for workers 50 and older. That is, those 50 and older now may contribute an additional amount, now set at \$5,500, above the maximum allowable 401(k) contribution.

Keep in mind, however, while federal law sets the guidelines for what's permissible in 401(k) plans, your employer may set tighter restrictions. Plus, it may take time for the administrators of your plan to implement the changes.

What's more, there are other federal non-discrimination tests a 401(k) plan must meet, one of which applies to "highly compensated" employees. So if you make more than \$110,000 in 2010 (the limit rises each year), you may not be permitted to contribute as high a percentage of your salary as some of your lower paid colleagues.

For all its tax advantages, the 401(k) is not a penalty-free ride. Pull out money from your account before age 59-1/2, and with few exceptions, you'll owe income taxes on the amount withdrawn plus an additional 10% penalty.

Also, be aware of your plan's vesting schedule -- the time you're required to be at the company before you're allowed to walk away with 100% of your employer matches. Of course, any money you contribute to a 401(k) is yours.

The IRA advantage :

Even if you've got a 401(k), an IRA can give your savings a big boost .

Whether you have a 401(k) or other tax-advantaged savings plan at work, consider investing in an IRA to augment your retirement savings plan.

As with a 401(k), you don't pay taxes each year on capital gains, dividends, and other distributions from securities held in your IRA. Beyond that, there are different tax advantages, depending on which type of IRA you open.

There are two types: a traditional IRA offers tax-deferred growth, meaning you pay taxes on your investment gains only when you make withdrawals in retirement, and, if you qualify, your contributions may be deductible.

A Roth IRA, by contrast, doesn't allow for deductible contributions but offers tax-free growth, meaning you owe no tax when you make withdrawals in retirement.

A traditional IRA comes in two flavors: deductible and nondeductible. To see if you qualify for a deductible IRA, which lets you deduct all or part of your contributions from your taxable income, use the following guidelines:

- *If you have no retirement plan at work and you're under 70-1/2, you can invest in a deductible IRA and deduct the entire amount from your taxes.*
- *If you have a 401(k) or other retirement plan at work, you may fully or partially deduct your contribution only if your adjusted gross income (AGI) qualifies. The deductions are phased out entirely for singles earning over \$66,000 or couples earning over \$109,000.*
- *If you're not covered by a retirement plan, but your spouse is, you may qualify for a full or partial deduction if you file jointly and your AGI is below \$177,000 for the 2010 tax year. The same rule applies if you're a non-working spouse of someone covered by a retirement plan at work.*

If you're not eligible to contribute to a deductible IRA, you may be eligible to contribute to a Roth IRA if your AGI is below \$120,000 if you're single or \$177,000 if you're married and filing jointly. If you are age 50 the maximum IRA contribution limit for 2010 is \$6,000; otherwise, the max is \$5,000.

If you make too much to qualify for a Roth IRA and are not eligible for a deductible IRA, a nondeductible IRA is a valid option. Your contribution won't be deductible, but at least your savings will grow tax-deferred.

So which IRA is best for you? The nondeductible is the least attractive, so open one only if you don't qualify for the other two. If you have a traditional IRA, you may want to consider converting it to a Roth in 2010, especially if you made non-deductible contributions.

The Tax Increase Prevention and Reconciliation Act of 2005 permanently removes the \$100,000 income ceiling for Roth conversion eligibility. For conversions in 2010, 50% of the income is taxed in 2011, and 50% in 2012, a one time opportunity.

The choice between a deductible and a Roth is more difficult, but generally you're better off in a Roth if you expect to be in a higher tax bracket when you retire.

Plus, the Roth offers more flexibility: You are not required to make mandatory withdrawals from your account when you turn 70 1/2 -- as you are with other IRAs -- making the Roth a great way to leave money to your heirs.

Further, if you need the money before retirement, there are more opportunities for penalty-free withdrawals.

What to do when you switch jobs ?

Don't let the IRS siphon your savings

When you change employers, you must decide what to do with your 401(k) money from your old job. You have three choices:

- Cash out. This is the financial equivalent of shooting yourself in the foot, since you pay income taxes plus a 10% penalty if you're under 59-1/2, and you diminish your retirement savings.*
- Move your money into your new 401(k) or a rollover IRA.*
- Leave your money where it is. Your old employer has to allow this if you have more than \$5,000 in the plan.*

If you decide to move it, make sure to do so as a trustee-to-trustee transfer. That means you never touch the money. You simply direct the company housing your new account to arrange the transfer with your old employer.

That method lets you avoid the costly traps involved in a "rollover," where your old employer writes a check to you, which you then must deposit in the new account within 60 days.

Sounds easy, but your former employer automatically will withhold 20% of your money for income taxes. You get it back the next time you file your income taxes, but you are required to rollover the full amount within 60 days, leaving you to come up with the missing 20% yourself in the short-term.

If you fail to roll over the full amount within the time limit, the Internal Revenue Service deems the shortfall a taxable withdrawal and imposes income taxes plus a 10% penalty.

Completing 401(k) distribution forms can sometimes be confusing. Be careful to ensure the form is completed in a manner consistent with your intentions. Sometimes people will check off the rollover option thinking they're transferring it. It's really ugly when that happens, because it's next to impossible to reverse.

Getting the most out of retirement money :

These strategies can help you get more mileage out of your assets in retirement

Once you hit retirement, you get to kick back and enjoy your savings. But you'll enjoy them a lot more and a lot longer if you manage your withdrawals smartly. To give yourself the best chance of outliving your money, financial experts recommend you withdraw no more than 4% to 5% of your total nest egg every year.

You also want to minimize your tax bite. Generally speaking, the more money you leave tax-deferred in a 401(k) or IRA, the more your nest egg will grow, because a large

balance can compound faster without the drag of taxes. But taxes will eventually come due on that money.

The key is to manage your money so that you pay the lowest possible tax rates on your withdrawals. That's why experts suggest in the early years of retirement you draw some of your income from your taxable accounts and some of it from your tax-deferred accounts.

You might stretch your money even further if you convert your traditional IRA to a Roth and tap it only after depleting your taxable accounts. Remember, too, if you have a traditional IRA, you must start taking minimum required distributions when you turn 70-1/2. There are no such withdrawal requirements for a Roth.

If you find your nest egg isn't quite large enough when you retire, there are still things you can do to stretch the assets you have accumulated. For instance, you might:

- Take a job in retirement. Imagine taking a part-time job that reduces your withdrawals from an IRA by \$15,000 a year for 10 years. By letting that money grow tax-deferred longer, after 10 years you would have almost \$220,000 that you otherwise wouldn't have had, assuming you earn an 8% annual return.*
- Get money from your home. If you are age 62 or older, you can convert your home equity into tax-free retirement income by taking a reverse mortgage.*
- Move to a less expensive area. Doing so could stretch your retirement income by 15% or more.*
- Reduce or eliminate high interest-rate debt like credit cards.*