American Association of Individual Investors
presents
Financial Planning Workshop

Retirement Planning

Fred Smith
Email: fred@fredsmithfinance.com
Webcast details at www.siliconvalleyaaii.org

Financial Planning Workshops

- Fundamentals of Investing
- Building a Diversified Portfolio
- Introduction to Computerized Investing
- Active versus Passive Investment Strategies
- >>> Retirement Planning
- Managing your Cash Flow in Retirement
- Safe Withdrawal Rates from your Retirement Portfolio
- Social Security and Medicare
- Estate Planning

Today we will cover …

- Retirement Planning
  - The accumulation phase
  - Reasons to start early
- Various types of accounts
  - Traditional and Roth IRAs
  - 401(k) plans, etc.
- How to manage your retirement accounts
  - Asset location
- Estate planning issues with retirement accounts

Disclaimer

- I am not a Certified Public Accountant, Enrolled Agent, Attorney, etc., etc.
- These topics are complicated and errors can have far-reaching consequences
- Please seek professional help before making any major decisions.

Graduation Day

- Meet Alan, a bright young twenty-something
- Just graduated from Prestige U.
  - Advanced degree in artificial intelligence
- Starts work shortly at Giggle
  - Starting salary $100k per annum

Retirement Day

- Fast forward 50 years
- Alan is now seventy-something
- Looking forward to a long and comfortable retirement

Goal of Retirement Planning

- Accumulate enough assets between Graduation Day and Retirement Day (Accumulation phase)
- To live comfortably after Retirement Day (Distribution phase)

Expenses during Distribution Phase

- Normal living expenses
- Increased medical expenses ?
- Long term care ?
- Rule-of-thumb: 80% of final salary
  - No contributions to retirement plan
  - No daily commute expenses
  - No Social Security taxes, Lower income taxes ?
- Assume $80k pa in today's dollars

Sources of Income for Distribution Phase

- The traditional 3-legged stool
  - Social Security
  - Pension
  - Retirement Portfolio
- Assume Social Security = $30k per annum

  and assume Giggle does not provide a corporate pension
- Therefore Alan's retirement portfolio needs to fund the remaining $50k per annum

Assets needed on Retirement Day

- Assume initially that Bengen's 4% rule of thumb applies
  - Then Alan's retirement portfolio should be $50k/0.04 = $1.25M
- But Bengen's 4% rule is probably optimistic
  - Derived in the 1990s bull market
  - Assumes portfolio only needs to last 35 years
- Since Alan may live another 50 years we should be conservative and use a 2% withdrawal rate.
  - Therefore Alan should plan for a portfolio of $2.5M

Accumulation Phase

- How do we get from $0 on Graduation Day to the $2.5M required in the retirement portfolio on Retirement Day?
- Assume Alan starts saving for retirement at age 35 and continues contributing to his portfolio until age 70, i.e. for 36 years

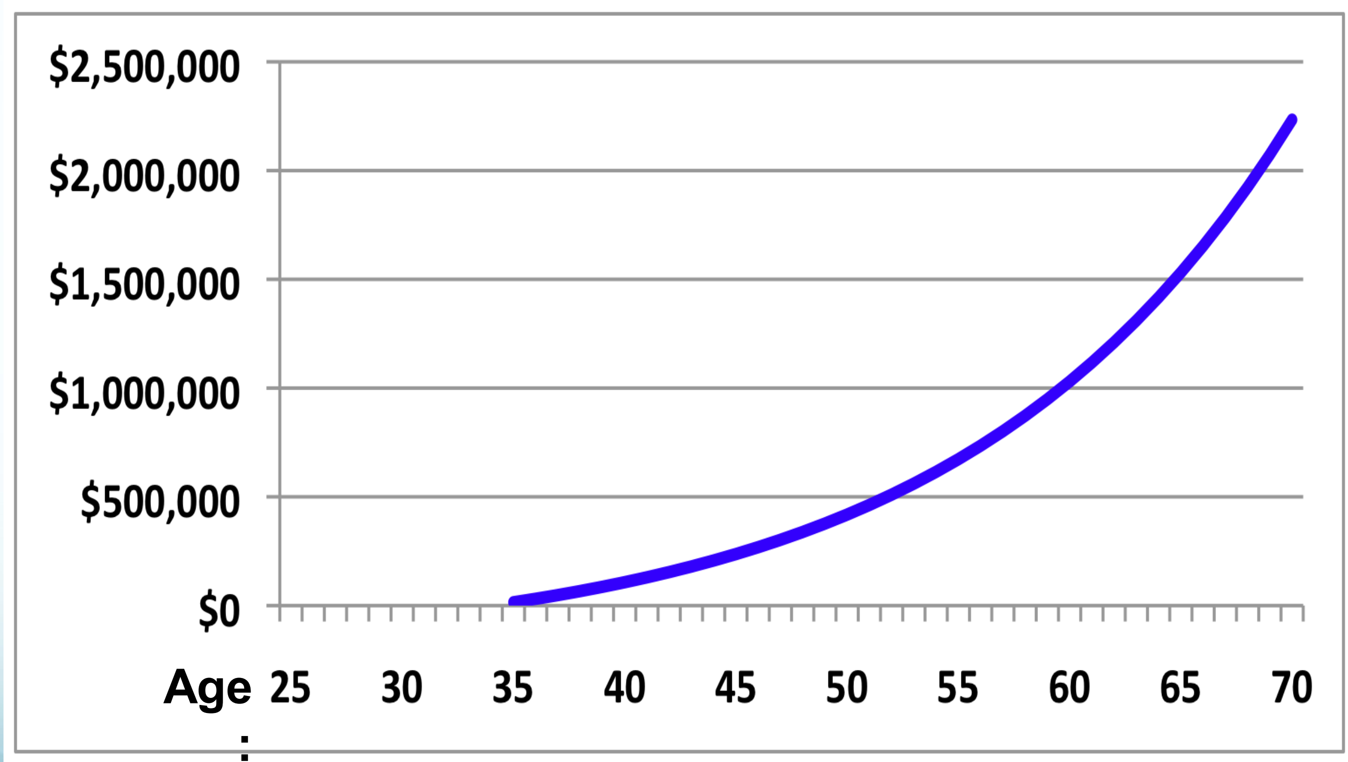
Alan's Retirement Plan

Age	Contribution	Portfolio
35	$15,000	$15,000
36	$15,000	$31,050
37	$15,000	$48,224
-	-	-
69	$15,000	$2,073,553
70	$15,000	$2,233,702

Total of 36 contributions = $540,000

Assume 7% pa growth rate

Alan's Retirement Portfolio



Meet Betty

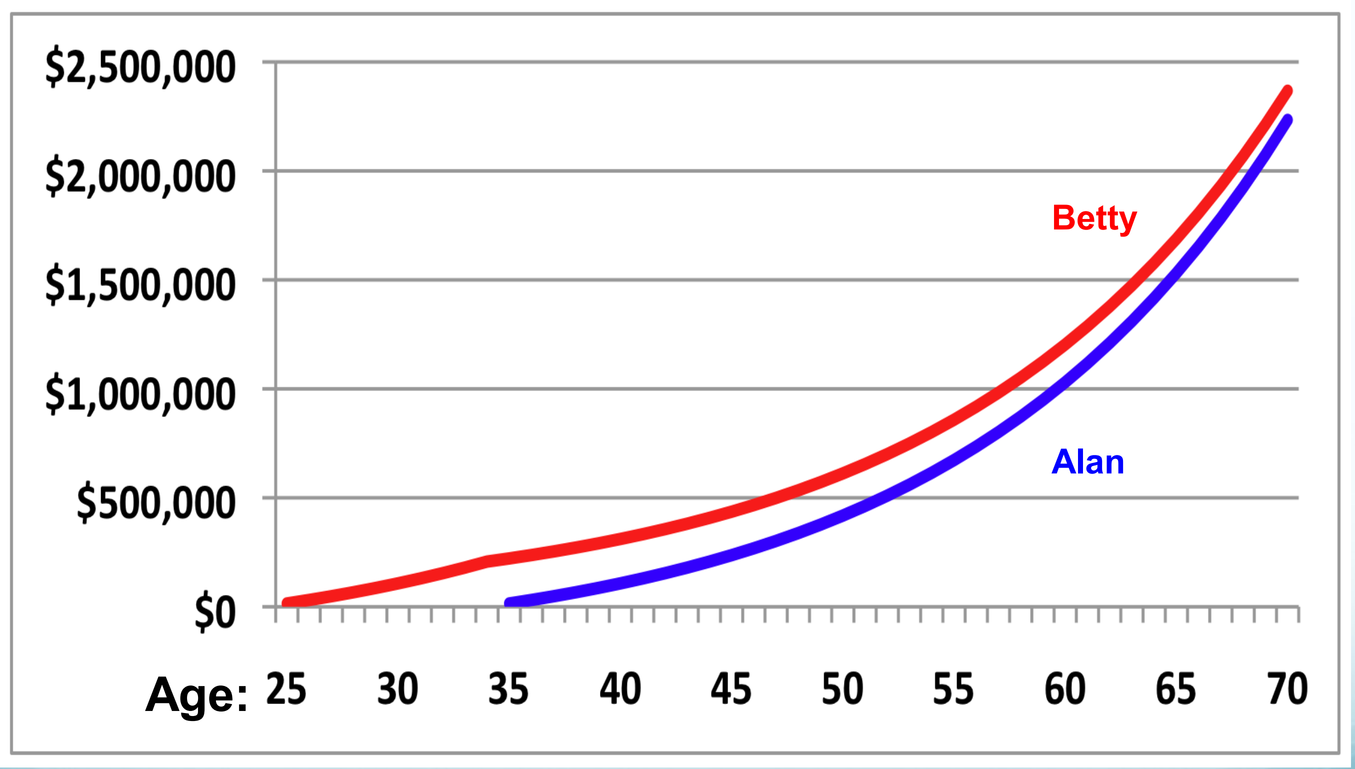
- Betty is the same age as Alan, and graduated the same year
- She also works at Giggle and earns the same salary as Alan
- However she starts saving for retirement at age 25
- But she drops out of the workforce at age 35, and no longer contributes to her retirement portfolio.

Betty's Retirement Plan

Age	Contribution	Portfolio
25	$15,000	$15,000
26	$15,000	$31,050
-	-	-
34	$15,000	$207,247
35	$0	$221,754
-	-	-
69	$0	$2,212,686
70	$0	$2,367,575

Total of 10 contributions = $150,000   7% pa growth rate

Betty's Retirement Portfolio



Meet Charlie

- Charlie was a classmate of Alan and Betty and started with them at Giggle
- Charlie started contributing to his retirement plan at age 25, and continued making contributions to   age 70

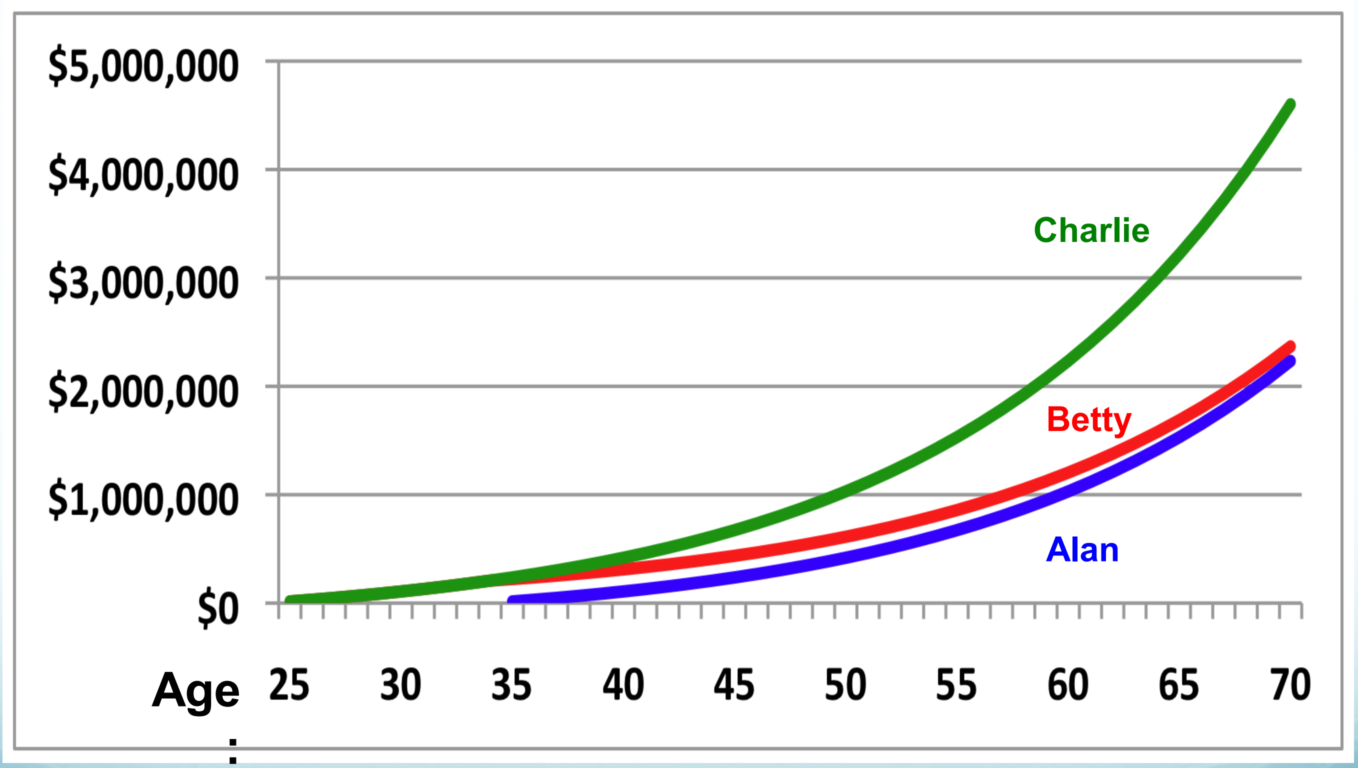
Charlie's Retirement Plan

Age	Contribution	Portfolio
25	$15,000	$15,000
26	$15,000	$31,050
27	$15,000	$48,224
-	-	-
69	$15,000	$4,286,240
70	$15,000	$4,601,276

Total of 46 contributions = $690,000

Assume 7% pa growth rate

Let's Compare The Three Plans



Are You On Track For Retirement?

- Recommendations from T. Rowe Price

If you are		Aim to have	
If you are	30	Aim to have	0.5x salary saved
	35		1x
	40		2x
	45		4x
	50		6x
	55		8x
	60		10x

FS opinion: 65 Need 15x-20x-25x for 4% withdrawal pa

- Save at least 15% of your current gross salary
- Michael Kitces: Avoid "lifestyle creep"
  - Goal: 30x current lifestyle expenses for 3.3% withdrawal

Tax Diversification

- Tax Advantaged Retirement Plans
  - Traditional IRA
  - Spousal IRA
  - Non-deductible IRA
  - Roth IRA
  - myRA
  - 401(k) and 403(b) plans
  - 401(k) and 403(b) Roth plans
  - SIMPLE
  - SEP
  - Individual 401(k) plans
  - Non-Qualified Deferred Compensation Plans
- Taxable accounts

Traditional IRA

- **Must have reportable income**
- **Must be younger than 70.5 at the end of the year**
- **Who is eligible to contribute to a deductible IRA?**

  Modified Adjusted Gross Income, MAGI, in 2017

  < $62,000 - $72,000 for singles

  < $99,000 - $119,000 for married filing jointly
- **Maximum contribution for 2017:**

  $5,500 pa, plus extra $1000 pa catch-up if age 50 or over

Tax Characteristics for a Traditional IRA

- Contributions are deductible from 1040 income
- Growth within the plan is tax-deferred
- Withdrawals after age 59.5 are taxed as ordinary income
- Withdrawals before age 59.5 are also assessed a 10% penalty (some exceptions)
- Required minimum withdrawals (RMD) start at age 70.5
- Failure to take RMD triggers 50% penalty

IRA Rollovers

- Individuals can withdraw funds tax-free from a traditional IRA if they are deposited within 60 days to another IRA
- IRS allows only 1 personal rollover per person per annum regardless of the number of IRAs owned
- Solution is to do a trustee-to-trustee transfer
  - No limit on the number of these rollovers allowed

Required Minimum Distributions, RMDs

- Must start withdrawals after age 70.5
- RMD is based on age and life expectancy

  e.g. at age 72 joint life expectancy used by the IRS is 25.6 years

  RMD = 1/25.6 = 3.9% of account value at end of previous year
- Draconian penalty for missed RMD
  - Penalty is 50% of RMD not taken

IRS RMD Tables

- Table I: Single Life Expectancy
  - For use by beneficiaries
- Table II: Joint Life and Last Survivor Expectancy
  - IRA owner
  - Married and spouse is the sole beneficiary
    and is more than 10 years younger
- Table III: Uniform Lifetime
  - IRA Owner
  - Unmarried
  - or Married and Spouse is not the sole beneficiary
    or is not more than 10 years younger

IRS RMD Table III Uniform Lifetime

Age	Years	RMD		Age	Years	RMD
70	27.4	3.6%		86	14.1	7.1%
71	26.5	3.8%		87	13.4	7.5%
72	25.6	3.9%		88	12.7	7.9%
73	24.7	4.0%		89	12.0	8.3%
74	23.8	4.2%		90	11.6	8.8%
75	22.9	4.4%		91	10.8	9.3%
76	22.0	4.5%		92	10.2	9.8%
77	21.2	4.7%		93	9.6	10.4%
78	20.3	4.9%		94	9.1	11.0%
79	19.5	5.1%		95	8.6	11.6%
80	18.7	5.3%		96	8.1	12.3%
81	17.9	5.6%		97	7.6	13.2%
82	17.1	5.8%		98	7.1	14.1%
83	16.3	6.1%		99	6.7	14.9%
84	15.5	6.5%		100	6.3	15.9%
85	14.8	6.8%		-	-	-

Spousal IRA

- Similar to a traditional IRA
  for a spouse with little or no income
- Contribution limits = $5500 / $6500
- Can roll into an old 401(k)

Non-Deductible IRA

- Available to those who do not meet the MAGI limit
- Same contribution limits as the traditional IRA

  but contributions are not deductible on 1040
- Earnings on account grow tax-deferred
- After-tax contributions are withdrawn tax free
- Earnings are taxed as ordinary income on withdrawal

Roth IRA

- Great for millennials!
- Who can contribute in 2017?
  - Income limits

    $118,000 - $133,000 for single taxpayers

    $186,000 - $196,000 married filing jointly
- Contribution limits same as for traditional IRA
  - $5,500 pa plus $1,000 catch-up for age 50 or older

Tax Characteristics for a Roth IRA

- Contributions are <u>not</u> deductible
  - Growth within the plan is tax-free
  - Can withdraw contributions any time for any reason
- Qualified withdrawals of earnings are tax-free
  - After age 59.5
  - Original plan must be > 5 tax years old
  - Otherwise there is a 10% penalty

    except $10,000 for first home purchase

    education expenses, medical expenses, etc.

Major Differences Between Traditional and Roth IRAs

- Contributions to the Roth IRA are not deductible
- Withdrawals from a Roth IRA are tax-free
- The RMDs do not apply to Roth IRAs
- Roth IRA's can be bequeathed efficiently to the next generation; good estate-planning tool
  - Continue to grow tax free for heirs
  - Withdrawals are tax free

Roth Conversions

- **Convert traditional IRA account to a Roth IRA**

  Will owe taxes on deductible portion of contributions and the earnings

- **Consider splitting the new Roth assets into two or more accounts, each with a different asset class**

  e.g. Fixed income Roth account (say 30%)

  Domestic equity account (say 40%)

  International equity account (say 30%)

- **Can "recharacterize" any/all accounts as late as tax filing date next year (Oct 15 with extension) and roll the remaining accounts into a single Roth account**

Recharacterizing a Roth Conversion

- If a new Roth account has fallen in value you may wish to save on the taxes owed by undoing the conversion, i.e. “recharacterizing” the conversion.
- May wish to recharacterize to stay below a given tax bracket
- A Roth conversion can be recharacterized, as late as tax filing date the following year (Oct 15 with extension)
- This allows a maximum of 21 months to determine which accounts (if any) to recharacterize.
- Recharacterized accounts revert back to the original traditional IRA as if the conversion had never happened, and can be reconverted later (after 30 days) if desired.

The "Backdoor" Roth

- Can be used when AGI exceeds Roth limits
- Make a non-deductible contribution to regular IRA
- Then convert the non-deductible IRA to your Roth IRA
- IRS "pro-rata rule" requires total of all IRAs be used to compute the tax owed on conversion
  - Best when there are no other IRAs
  - Beware the pitfall of rolling old 401(k) plans into an IRA when changing jobs
  - Move all pre-tax dollars to 401(k) or 403(b) plans

    Not included in computation for Roth conversion
  - Convert all after-tax contributions to the Roth IRA

myRA

- New type of federally sponsored “starter” Roth IRA
- Eligibility: Income < $133,000 single, $196,000 mfj
- After-tax contribution: payroll deductions, checking a/c
  - Limits of $5500 pa, $6500 for age 50 or higher
- Contribution principal can be withdrawn anytime with no tax penalty
- Portable from one job to another
- Only invests in US Treasury retirement savings bond
  - Won’t decline in value; pays floating interest rate
- Must roll over to Roth IRA before assets reach $15,000

Traditional 401(k) Plan

- Employer sponsored pension plan allowing employees to defer pre-tax salary
- Employer may require up to 1 year of service before eligible
- 2017 limits = $18,000 + $6,000 for age 50 or over
- Sponsor must do Average Deferral Test (ADP) to limit benefits for Highly Compensated Employees (HCEs)
- Employer matching contribution typically 4% of salary
  - Vesting schedule (up to 6 yrs) for employer contributions
  - Employee contributions always fully vested
- Participant loans allowed by some plans (Beware !)

Tax Characteristics for a Traditional 401(k) Plan

- Tax implications same as for traditional IRA
  - Pre-tax contributions
  - Earnings grow tax-deferred
  - Distributions taxed as ordinary income
  - 10% penalty for early withdrawal < age 59.5
  - RMDs start at age 70.5; Missed RMD = 50% penalty
- Employer may allow additional after-tax contributions

  IRS limits =$54,000 + $6,000 catch-up for age 50 or over
- When changing jobs
  - Roll pre-tax contributions plus earnings into an IRA (?)
  - Use after-tax contributions to “super-fund” a backdoor Roth

Responsibilities of 401(k) Plan Sponsor

- The plan sponsor has a fiduciary duty to act in the best interest of the plan's participants
  - Selection and ongoing monitoring of service providers
  - Understand where all the fees are hidden
  - Provide a diverse selection of low cost funds, and benchmark these regularly regarding performance, fees
- If the plan sponsor does not offer an acceptable plan, and live up to its fiduciary obligations, the employee should
  - Discuss the problem with the sponsor and/or HR dept
  - Try to add a few index funds and/or a brokerage window
  - Document problems, perhaps signed by fellow employees
  - Consider legal action

    c.f. Boeing $57M and Lockheed Martin $62M settlements

403(b) Plan

- Usually sponsored by not-for-profit organizations, educational groups, local governments, etc. for the benefit of their employees
  - Teachers, Police, Firemen, etc.
- Similar to a traditional 401(k) plan in most respects

Roth 401(k) and Roth 403(b) Plans

- Similar to traditional 401(k) and 403)(b) plans except
  - Contributions are <u>not</u> tax deductible
  - No taxes are due on plan earnings
  - No taxes are due on withdrawals
- RMDs apply at age 70.5 unless still working for the employer offering the plan

Savings Incentive Match Plan SIMPLE IRA

- Usually set up by small employers
  - Must be 100 or fewer employees

- Employee contributions are optional
  - Limits for 2016 and 2017

    $12,500 pa + $3,000 catch-up if age 50 or older

- Employer matches employee contribution $ for $
  - Up to 3% of employee compensation
  - Or fixed 2% for <u>all</u> employees above $5000 pa, even if some employees choose not to participate
    - Limit $5,300 for 2016, $5,400 for 2017

Simplified Employee Pension Plan (SEP) IRA

- For use by small business owner or if you have self-employed income from consulting work, etc.
- Works well for married couple in a family business
- 2017 limits = lesser of 25% of income or $54,000
- Contribution limits are not affected by participation in traditional or Roth 401(k) plans
- Distributions are taxed as ordinary income
- Can convert to a backdoor Roth year after year

Individual 401(k) Plan

- Suitable for sole proprietors or partners
  - No common-law employees
  - Can contribute as employer and/or employee
- No age or income restrictions
- Employee pre-tax or Roth contributions
  - Limits for 2016 and 2017
  - $18,000 + $6,000 catch-up if age 50 or older
- Employer contributions
  - Limit $53,000 for 2016 $54,000 for 2017
- Limits on total contributions
  - $59,000 for 2016 $60,000 for 2017 for age >50

Non-Qualified Deferred Compensation Plans (NQDC Plans)

- Set up by company to benefit well-paid non-owner employees, i.e. officers, executives, managers
- Company owners cannot receive favorable tax treatment
- No Internal Revenue Code limit on deferral amount, but plan may impose limits
- No Internal Revenue Code limit on withdrawal time, but plan may impose limits; “Golden handcuffs”
- Distributions are taxable on receipt
  - Cannot be rolled over to a traditional or Roth IRA
- Risk: NQDC remains in company’s general assets
  - Not protected in bankruptcy, even in a “rabbi trust”

Which Retirement Plan Should I Fund First?

1. Fund traditional 401(k) or 403(b) up to match limit first (free money!)
2. Then contribute to Roth IRA up to limit
3. Back-door Roth IRA
4. Complete post-match funding of 401(k), 403(b)
5. SEP IRA
6. Traditional IRA
7. Taxable brokerage account

The 529 Tuition Plan

- Similar to a Roth IRA but withdrawals can only be used for qualified higher educational expenses for self or others
  - No income or age limits for contributions
  - Tax-free growth and withdrawals if requirements are met
- Sponsored by various states
  - OK to use another state's plan, but may forfeit some state tax advantages
- Often used as a gift by grand-parents

Should I fund my Retirement Plan or Tuition Plan First?

- When was the last time you applied for a loan to fund your retirement? How did that work out for you?
- No guarantee that your child will go to college but you probably will want to retire some day
- Bottom line:
  1. Emergency fund; 3 to 6 months expenses min.
  2. Retirement plan; at least 15% of gross salary
  3. College savings; There are numerous options available to fund college, e.g. student loans, scholarships, community college / 4 year school.

Asset Location

- Tax-efficient products
  - Muni bonds, ETFs, index funds, collectibles

    Generate qualified dividends

    and long-term capital gains

    These are best in taxable accounts

- Tax-inefficient products
  - Corporate bonds and bond funds, zero-coupon bonds, active funds

    Generate interest and non-qualified dividends

    and short-term capital gains

    These are best in tax-advantaged accounts

    such as IRAs, Roth IRAs, 401(k) accounts

Rebalancing Issues

- Difficult to rebalance diversified portfolios with all the tax-efficient assets in taxable accounts and inefficient products in tax-advantaged accounts
- Conflict: Each individual account should be sufficiently diversified to accommodate rebalancing

A Practical Compromise for Rebalancing

- Assume Investment Policy Statement calls for
  40% Fixed income / 60% stocks
- For tax-deferred accounts
  - Overweight the fixed income allocation
    e.g. 60% fixed income / 40% stocks
- For taxable accounts
  - Overweight the equity allocation
    e.g. 20% fixed income / 80% stocks
- Rebalance appropriately within each account

Rebalancing at the Household Portfolio Level

- Morningstar location optimization strategy
  - Can improve after-tax return by up to 1%
  - Should review performance at household level rather than account by account
- Taxable Accounts
  - Tax efficient investments, US equities
- Tax-free accounts: Roth IRAs, Roth 401(k)s, etc.
  - High return investments, Emerging market equities
- Tax-deferred accounts: IRAs, 401(k)s, etc.
  - Tax inefficient investments, Lower returns, Bonds

Estate Planning Issues

- **Federal estate tax exemption = $5.49M in 2017**
- **Be careful with <u>income tax</u> efficiency:**
  - **Roth accounts are best**

    No taxes owed.
  - **Taxable accounts are good**

    Step-up in basis; no tax if sold immediately
  - **Tax deferred IRA accounts are worst**

    Unfavorable tax treatment; no step-up in basis

      Owe ordinary income tax on distributions

    Spouse can assume an IRA at death; Stretch RMDs

    Consider leaving to charity:

      Qualified Charitable Distributions count as RMD
- **Talk to your estate planning attorney!**

Inheriting IRA Assets: The "Stretch IRA"

- **Only a spouse can roll over the assets into an IRA in his/her own name**
  - **Must take RMDs at age 70.5**
  - **Can name own beneficiaries; continue the "stretch"**
- **Children/grandchildren can use the assets to fund an Inherited IRA**
  - **RMDs start in year following owner's death and are based on age of oldest beneficiary**
  - **May want to consider splitting the original IRA into separate accounts while still alive**
  - **No early withdrawal penalties**
- **Important to educate heirs now about options**
- **Talk to your estate planning attorney!**

Important to Review Beneficiary Forms Regularly

- Have there been any …..
  - Births, Deaths
  - Marriages, Divorces
  - Beneficiaries reaching the age of majority
- Most retirement accounts pass by contract and not by will or trust
- The beneficiary forms govern, regardless of the will or trust
- Talk to your estate-planning attorney!

In Summary

- Today we covered planning for retirement
  - The accumulation phase
  - The distribution phase
  - Various tax-deferred, tax-free and taxable retirement plans
  - Managing your retirement accounts and the importance of asset location
  - Estate planning issues with retirement accounts
- All slides are available at www.siliconvalleyaaii.org

Next Month We will Cover …..

- Managing your cash flow in retirement
  - The three-legged stool
    - Social Security, Pension, Retirement portfolio
  - Other tools
    - Reverse mortgages
    - Immediate and deferred annuities
  - Protecting your retirement plan
    - Long-term care
    - Umbrella insurance policies

Before Next Month's Workshop …..

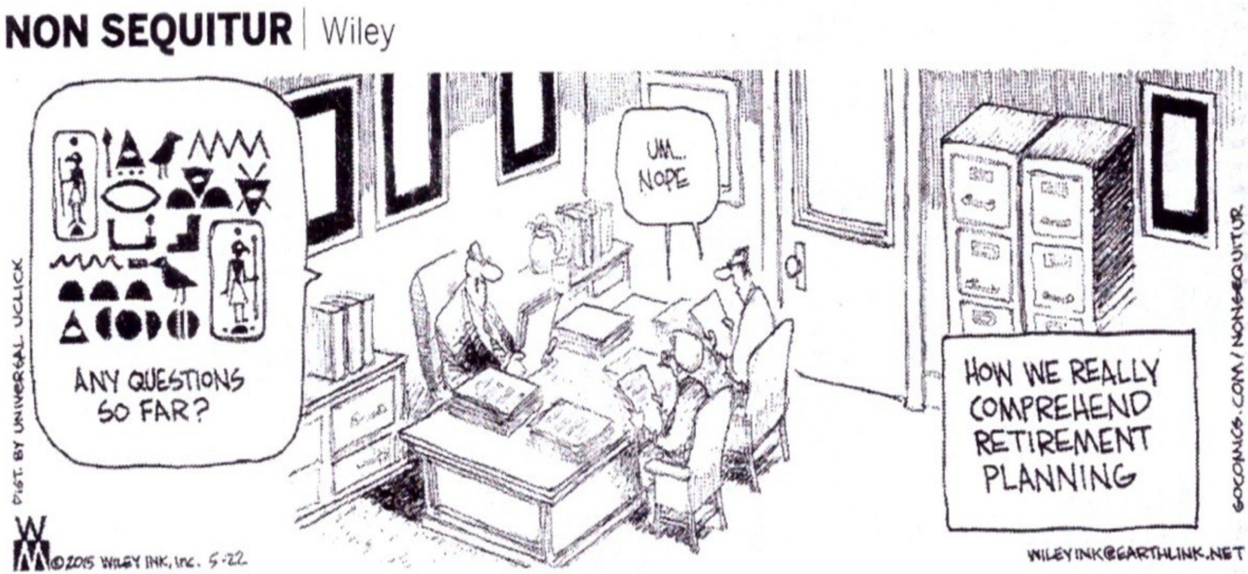
- Review your current retirement plan
  - Are you saving enough? Are you on track?
  - Do you have adequate tax diversification?
  - Would a Roth conversion make sense?
  - Have you taken asset location into account?
  - Have you checked your beneficiary forms recently?

To Probe Further

- An In-Depth Look at the Tax Consequences of Asset Location, Kevin Trout, AAII Journal, March 2013
- The Tax Consequences of Investing, AAII Journal, July 2014
- Converting to a Roth IRA Can Minimize RMDs, Judith Ward, AAII Journal, March 2015
- Shifting Into Reverse, Donald Jay Corn, Financial Planning, January 2016
- How to Make Your Money Last, Jane Bryant Quinn, AARP Bulletin, January/February 2016
- Uncover Long-Term Tax Savings with Location Optimization, Sheryl Rowling, Morningstar white paper, December 2016
- IRS Publication 590
- Guidance on the Allocation of After-Tax Amounts to Rollovers, Notice 2014-54, Internal Revenue Service, September 2014

Useful Websites

- www.aaii.com Broad selection of material including retirement planning
- www.siliconvalleyaaii.org Previous presentations on various topics
- www.santaclaracountylib.org/Adults/Business & Money
- www.vanguard.com   Numerous articles on Retirement Planning/Calculators
- www.troweprice.com ”
- www.fidelity.com ”
- www.schwab.com ”
- www.personalcapital.com/financiaL-software/retirement-planner
- www.choosetosave.org/ballpark Online calculator
- www.retirementoptions.com
- www.caniretireyet.com/the-best-retirement-calculators/ Darrow Kirkpatrick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