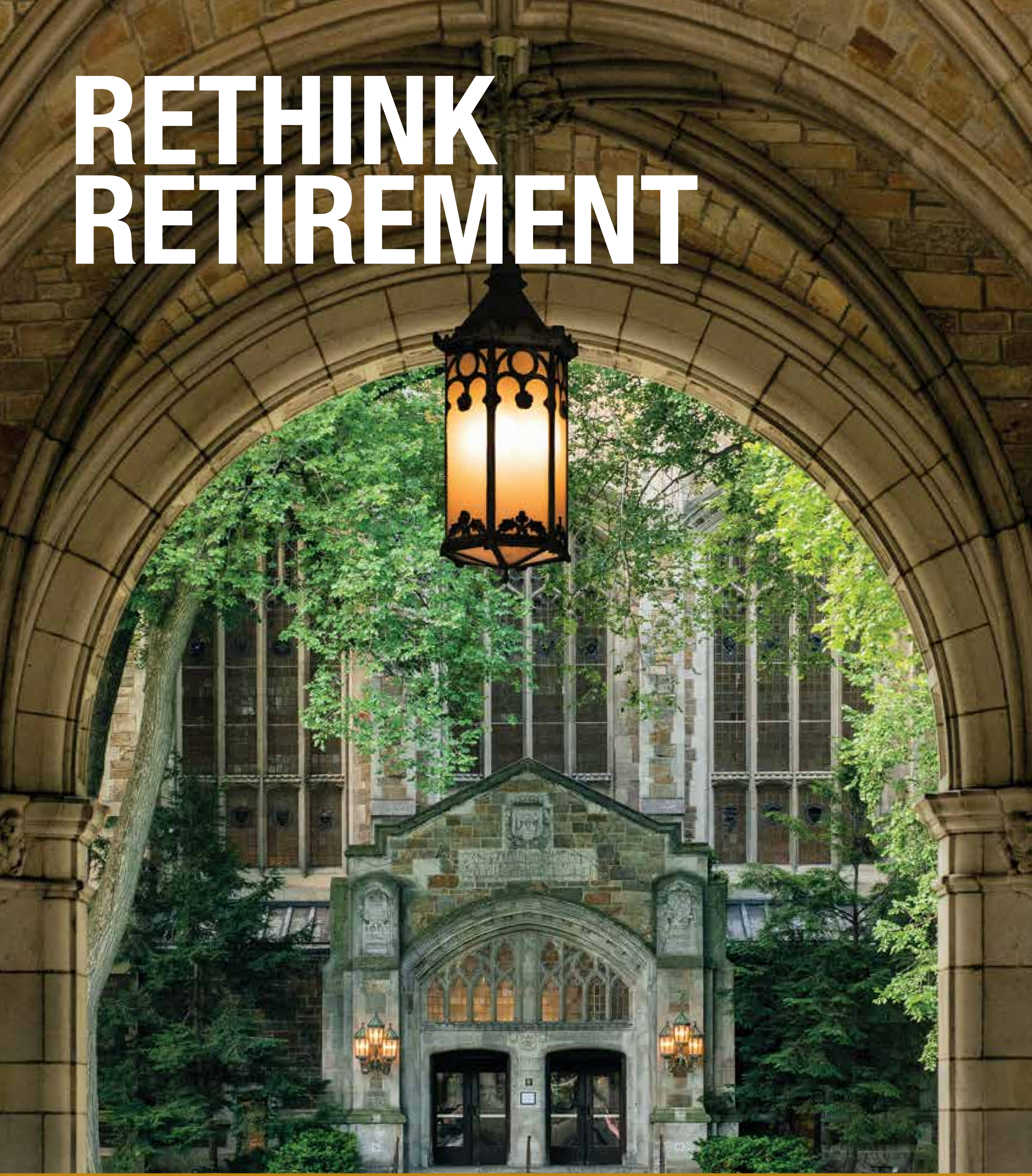
RETHINK RETIREMENT



VOLUME 2

FINANCIAL INSIGHTS FOR TODAY'S RETIREE

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CHAPTER 1

RETIREMENT INCOME SOURCES

INCOME AFTER RETIREMENT: WHERE THE CASH COMES FROM

Once the paychecks stop, retirees still will need cash for living expenses. Some seniors can count on pensions from former employers—that's especially true for those with careers in the public sector. Most retirees won't receive pensions, however, and even those who do probably will need extra sources of income for their desired lifestyle. Knowing what's available can help retirees fund a desirable retirement that may last for several decades.

SOCIAL SECURITY'S GROUND RULES

For more than 80 years, the federal government has offered Social Security retirement benefits.[1] Those benefits alone will likely be insufficient to support a luxurious retirement, but they can play a valuable role in retirees' finances.

Social Security retirement benefits typically are computed according to average indexed monthly earnings.

Social Security retirement benefits aren't only for retirees. Individuals who are semi-retired or working full-time can collect Social Security retirement benefits, if they meet certain requirements. The same may be true for people who never had earned income, if they were married to a qualified worker. Generally, a minimum of 10 years of work is needed to qualify for Social Security retirement benefits. Work, in this context, means an occupation where at least a certain amount of taxes were paid into the Social Security system. (In 2020, $5,640 is needed to qualify for a full year's credit.)[2]

The longer an individual has worked and the more someone has paid into Social Security, the higher the expected retirement benefit. Social Security retirement benefits typically are computed according to average indexed monthly earnings. This average includes up to 35 years of a worker's covered earnings, indexed to adjust for changes in general wage levels over those years. [3]

Spouses and ex-spouses who had modest or no covered earnings also may get Social Security benefits, if they are or were married to a qualified worker. (A divorced spouse can get benefits if the marriage lasted at least 10 years, is age 62 or older, and unmarried.) Social Security spousal benefits depend on the amount the higher-earning spouse paid into Social Security.[4]

HOW MUCH CAN SENIORS RECEIVE FROM SOCIAL SECURITY?[5]

ESTIMATED AVERAGE MONTHLY SOCIAL SECURITY BENEFITS PAYABLE IN JANUARY 2020	
All Retired Workers	$1,503
Aged Couple, Both Receiving Benefits	$2,531
Aged Widow(er) Alone	$1,422
Maximum Social Security Benefit, 2020, Worker Retiring At Full Retirement Age (66)	***$3,011/mo.***

As noted, receiving $1,503 a month—or even $3,011 a month—from Social Security probably won't deliver a lavish retirement. However, such income should not be dismissed.

TOPPING TREASURIES

As of this writing, the yield on 10-Year Treasury notes was 2.56%.[6] Thus, someone holding $1 million worth of Treasuries would receive $25,600 a year in interest. The average Social Security payment of $1,503 a month produces $18,036 of annual cash flow: almost as much as the interest income from $1 million of Treasuries. The average couple receiving $2,531 a month from Social Security, or $30,372 a year, gets more cash flow than $1.25 million of Treasuries would generate. ***Social Security checks are extremely welcome in these times of low-yield bonds and bank accounts***.

MIXING WORK WITH SOCIAL SECURITY

Planning for Social Security begins with a knowledge of *"full retirement age"* (FRA), which can vary among individuals. FRA is the date when an individual can start to receive retirement benefits, without any penalty for starting too soon. Here is the FRA list, by year of birth:

AGE TO RECEIVE FULL SOCIAL SECURITY BENEFITS[7]

YEAR OF BIRTH*	FULL RETIREMENT AGE
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

*Individuals born on January 1st of any year should refer to the previous year.

FRA is important for planning for several reasons. For one, benefits will be reduced if taken under FRA and earning above a certain threshold until FRA is attained. Here are the numbers for 2020:

RETIREMENT EARNINGS TEST EXEMPT AMOUNTS[5]	2020
Under full retirement age *NOTE: One dollar in benefits will be withheld for every $2 in earnings above the limit.*	$18,240/yr* ($1,520/mo)
The year an individual reaches full retirement age *NOTE: Applies only to earnings for months prior to attaining full retirement age. One dollar in benefits will be withheld for every $3 in earnings above the limit. There is no limit on earnings beginning the month an individual attains full retirement age.*	$48,600/yr* ($4,050/mo)

HYPOTHETICAL EXAMPLE. Kay Mathews was born in March 1955, so she will reach FRA in May 2021, when she reaches age 66 and 2 months. In 2020, at age 65, Kay starts to receive Social Security retirement benefits.

Suppose Kay earns $1,000 a month from working in 2020. That's under the allowance of $1,520 a month, so Kay's benefits won't be reduced. However, suppose Kay earns $2,000 a month from working in 2020. That would put her $480 a month over the limit. In the latter case, $1 in benefits will be withheld for every $2 in earnings above the limit. Thus, Kay's Social Security checks would be reduce by $240 a month: $480 divided by 2.

Note that any benefits withheld before FRA are not really *"lost."* Starting at FRA, monthly benefits will be increased to make up for any benefits withheld. ***Nevertheless, retirees with substantial earnings might want to wait until FRA or later to start Social Security benefits.***

Once people reach FRA, they can earn any amount and still receive their full Social Security benefits. Moreover, other retirement income sources such as dividends and interest won't trigger a benefit reduction, regardless of age or the amount involved.

STARTING EARLY...

As mentioned, any reduction imposed before FRA due to working while receiving benefits will not permanently reduce Social Security benefits, due to deferred makeup amounts. However, receiving retirement benefits before FRA will permanently reduce Social Security benefits:

RETIREMENT BENEFITS, STARTING AT AGE 62[8]
(based on a $1,000 benefit at full retirement age)

Year of Birth[a]	*Normal Retirement Age*	*Number of Reduction Months*[b]	*Primary*	
			Amount	*Percent Reduction*[c]
1937 or earlier	65	36	$800	20.00%
1938	65 and 2 months	38	791	20.83%
1939	65 and 4 months	40	783	21.67%
1940	65 and 6 months	42	775	22.50%
1941	65 and 8 months	44	766	23.33%
1942	65 and 10 months	46	758	24.17%
1943-1954	66	48	750	25.00%
1955	66 and 2 months	50	741	25.83%
1956	66 and 4 months	52	733	26.67%
1957	66 and 6 months	54	725	27.50%
1958	66 and 8 months	56	716	28.33%
1959	66 and 10 months	58	708	29.17%
1960 and later	67	60	700	30.00%

a If you are born on January 1, use the prior year of birth.

b Applies only if you are born on the 2nd of the month; otherwise the number of reduction months is one less than the number shown.

c The percentage reduction is 5/9 of 1% per month for the first 36 months and 5/12 of 1% for each additional month.

HYPOTHETICAL EXAMPLE. Go back to Kay Mathews, born in 1954. Her FRA is 66. Suppose that Kay's benefit, if she started at 66, would be $2,000 a month. Instead, Kay starts at age 62, and gets a 25% reduction. Kay would receive $1,500 (75% of $2,000) a year from Social Security for the rest of her life, plus any cost-of-living adjustments (COLAs) help address inflation.

As explained above, Kay could earn $1,000 a month this year and still receive her $1,500 monthly benefit from Social Security. However, if she earns $2,000 a month, that would trigger a reduction of $240 a month, dropping her monthly benefits to $1,260.

The reduction of $240 a month would be returned to Kay in the future, through higher monthly benefits. That's not the case, though, with the $500 a month that Kay has relinquished by electing to receive benefits at age 62, rather than at 66.

The reduction in monthly Social Security benefits from starting before FRA is typically permanent.

...OR STARTING LATER

Just as starting early will reduce monthly Social Security benefits, starting later will increase those benefits. Past FRA, monthly benefits now increase by 8% for every year of delay up to age 70. ***An 8% annual increase, guaranteed by the federal government, compares very favorably to other reliable sources of retirement income.*** This 8% annual increase is more generous than the increase offered to older individuals when they retired:

BENEFIT, AS A PERCENTAGE OF FRA AMOUNT, PAYABLE AT AGES 62-67 AND AGE 70[9]

Year of Birth[a]	*Normal Retirement Age (NRA)*	*Credit for Each Year of Delayed Retirement After NRA (Percent)*	*Benefit, as a Percentage of FRA Amount, Beginning at Age—*						
			62	*63*	*64*	*65*	*66*	*67*	*70*
1924	65	3	80	86⅔	93⅓	100	103	106	115
1925-26	65	3½	80	86⅔	93⅓	100	103½	107	117½
1927-28	65	4	80	86⅔	93⅓	100	104	108	120
1929-30	65	4½	80	86⅔	93⅓	100	104½	109	122½
1931-32	65	5	80	86⅔	93⅓	100	105	110	125
1933-34	65	5½	80	86⅔	93⅓	100	105½	111	127½
1935-36	65	6	80	86⅔	93⅓	100	106	112	130
1937	65	6½	80	86⅔	93⅓	100	106½	113	132½
1938	65, 2 mo.	6½	79⅙	85 5/9	92 2/9	98 8/9	105 5/12	111 11/12	131 5/12
1939	65, 4 mo.	7	78⅓	84 4/9	91⅑	97 7/9	104⅔	111⅔	132⅔
1940	65, 6 mo.	7	77½	83⅓	90	96⅔	103½	110½	131½
1941	65, 8 mo.	7½	76⅔	82 2/9	88 8/9	95 5/9	102½	110	132½
1942	65, 10 mo.	7½	75⅚	81⅑	87 7/9	94 4/9	101¼	108¾	131¼
1943-54	66	8	75	80	86⅔	93⅓	100	108	132
1955	66, 2 mo.	8	74⅙	79⅙	85 5/9	92 2/9	98 8/9	106⅔	130⅔
1956	66, 4 mo.	8	73⅓	78⅓	84 4/9	91⅑	97 7/9	105⅓	129⅓
1957	66, 6 mo.	8	72½	77½	83⅓	90	96⅔	104	128

[a] *Individuals born on January 1st of any year should refer to the previous year.*

HYPOTHETICAL EXAMPLE. To provide some hard numbers, let's go back to Kay Matthews, whose FRA (age 66) benefit from Social Security is $2,000. If Kay were to start at age 64, her monthly benefit would be only 86⅔% of $2,000, or $1,733 a month. However, by waiting to start until age 70, Kay's monthly benefit would be 132% of $2,000, or $2,640 a month. The delayed retirement credits only go through age 70. There's no financial benefit to wait for Social Security beyond that birthday.

Planning for Social Security income involves several factors, including deciding whether to start early or later. Another factor also may be important: the potential taxation of Social Security benefits.

THE KEY is *"combined income"* (CI), as defined by the Social Security Administration. ***The CI calculation includes interest income from tax-exempt municipal bonds and tax-exempt bond funds.***

CI = Adjusted gross income (AGI)
+ Nontaxable interest
+ ½ of Social Security benefits

"COMBINED INCOME"

HYPOTHETICAL EXAMPLE. Bert and Clara West collect a total of $30,000 in Social Security benefits this year. They also have $27,000 of AGI and $4,000 of nontaxable interest from municipal bonds. Thus, the Wests' CI is $27,000 + $4,000 + ½ of $30,000: $27,000 + $4,000 +15,000. The total is $46,000.

Once CI is determined, it's compared to various thresholds. The first threshold is $25,000 for single taxpayers and $32,000 for married couples filing joint returns. If CI is below the relevant threshold, go no further. Social Security benefits won't be taxed.

In our example, the Wests have $46,000 of CI, so they're over the $32,000 threshold. Over this threshold, the amount of Social Security benefits is gradually subject to income tax. This continues until 50% of Social Security benefits are taxed.

The next set of thresholds takes effect at CI of $34,001 (for single filers) and $44,001 (for married couples). If CI is over the relevant threshold, the amount of Social Security benefits subject to tax continues to increase.

Up to 85% of Social Security benefits may be subject to federal income tax.

TAXATION OF SOCIAL SECURITY BENEFITS[10]

% TAXED	*Combined Income Threshold*	*Filing Status**
0%	Under $25,000	Individual
	Under $32,000	Joint
UP TO 50%	$25,000 - $34,000	Individual
	$32,000 - $44,000	Joint
UP TO 85%	$34,000 +	Individual
	$44,000 +	Joint

*Married couples filing separate returns will likely pay taxes on their own benefits.

For example, if a single individual receives $24,000 in Social Security and has combined income in excess of $34,000, as much as $20,400 (85% of $24,000) could be subject to income tax.

TAX PLANNING

With these rules for the taxation of Social Security benefits, tax planning falls into three categories:

- **Taxpayers with CI below $25,000 (single) or $32,000 (joint).**
  No planning is necessary for this purpose. Social Security benefits won't be taxed.
- **Taxpayers with CI far above $34,000 (single) or $44,000 (joint).**
  Planning probably won't help. Expect to have 85% of Social Security benefits taxed.
- **Taxpayers with CI just below or moderately above $34,000 (single) or $44,000 (joint).**
  Planning may be able to help by lowering CI.

In our example, suppose the Wests can reduce their CI by even a few thousand dollars, from $46,000 to, say, $43,000 or even $40,000. They'll go from the range where Social Security benefits are taxed up to 85% to the range where up to 50% of benefits might be taxed.

Various tax planning ideas might help, such as taking capital losses or timing charitable contributions. Social Security recipients with moderate levels of CI may benefit greatly from working with a skilled advisor and/or CPA. ***Retirees with moderate levels of CI may get a double advantage from tax planning, reducing the tax on Social Security benefits as well as the normal tax savings from income reduction.***

MIXING IRAs AND SOCIAL SECURITY

The tax treatment of Social Security also may affect the decision on when to start benefits. That's because of the CI formula, explained above. In this formula, Social Security benefits are included at 50 cents on the dollar. All other income, even interest from municipal bonds, is included at 100 cents on the dollar. ***Therefore, structuring retirement income so that more comes from Social Security and less comes from other sources can help reduce CI, lowering or even eliminating the tax on Social Security benefits.***

One approach, then, would be to defer starting Social Security retirement benefits as long as possible, to age 70. This will increase the amount of monthly benefits and possibly reduce the need to pick up additional income. If necessary, retirees might tap other financial resources, even IRAs, to help fund their retirement lifestyle until age 70. Again, a skilled advisor can crunch the numbers to see if it makes sense to take taxable IRA distributions in your 60s in order to increase the Social Security benefits through delayed retirement credits up to age 70.

GRANDFATHERED LOOPHOLE

Recent changes in federal law have abolished some sophisticated tactics, known as *"claiming strategies."* That is, timing strategies on collecting Social Security retirement benefits, when to suspend them, and when to start again in order to help boost lifetime collections. (The so-called *"file-and-suspend"* strategy still works, for retirees who already had begun this maneuver before the law became effective in May 2016.)

Some opportunities still exist, though. For instance, *"restricted applications for spousal benefits"* are still allowed for people who reached age 62 on or before January 1, 2016. Here, an eligible retiree applies for Social Security retirement benefits but only for a spousal benefit, on the other spouse's work record. Such an application can be made at FRA, which is age 66 for those covered.[11]

HYPOTHETICAL EXAMPLE. Louise Jensen contributed more to the Social Security system than her husband Phil, so Louise will receive a larger benefit. Louise, now age 64, can file a restricted application to get a spousal benefit at her FRA. A restricted application by one spouse requires the other spouse to be receiving Social Security. Thus, if Phil is receiving benefits, Louise's spousal benefit could equal 50% of Phil's benefit.

Meanwhile, Louise (who has the larger benefit, in this example) won't be taking her own benefit, which can continue to grow. Louise can wait until age 70, to bolster delayed retirement credits then collect monthly checks that are 132% of her FRA benefit, plus any COLAs in the interim.

Alternatively, the lower-earning spouse could use a restricted application to start spousal benefits while the higher earning spouse begins collecting on his or her own record. Number crunching can indicate which approach is better, if both spouses meet the age requirement.

OTHER OPPORTUNITIES

At any age, some planning opportunities still exist for married couples who want to coordinate claiming strategies for collecting Social Security retirement benefits. One spouse might claim benefits as early as age 62, if cash is needed, while the other spouse delays as long as practical, for larger monthly checks in the future.

HYPOTHETICAL EXAMPLE. Suppose that Louise and Phil Jensen are age 60 and 61, so they can't use a restricted application. Phil might start collecting benefits at age 62 while Louise waits until age 70 for Social Security retirement benefits. Assuming that Phil has already retired, and thus not subject to any reductions to benefits due to earnings thresholds, he would get checks from age 62, to help pay the bills. Eventually, when Louise reaches age 70, she'll start to receive her higher monthly retirement benefit.

In another situation, suppose that it had been Phil who had been the primary breadwinner while Louise had modest covered earnings. Phil might start his benefits at FRA, which would allow Louise to start as well. ***Louise's spousal benefit could be as large as 50% of Phil's FRA benefit, potentially giving the couple greater combined Social Security checks in retirement.***

BASICS FOR BENEFITS

Astute claiming strategies can help increase the retirement benefits from Social Security. Still, the primary concerns shouldn't be overlooked.

CONSIDERATIONS FOR ELECTING BENEFITS EARLY

If retirees need cash to cover essential living expenses, they should start as early as possible, perhaps at age 62. The same may be true for people who have a relatively short life expectancy or who urgently wish to get a return from Social Security, after years of paying into the system. Any strategy that involves waiting means giving up currently available cash flow, in hopes of a higher payback in the future.

HYPOTHETICAL EXAMPLE. Art Payne will have a $2,000 monthly Social Security benefit, if he starts at age 66. By starting at age 62, Art would collect only $1,500 a month; by starting at age 70, he would get $2,640 a month, as explained above. (These numbers don't include any COLAs.)

Every year that Art waits, beyond age 62, he forgoes $18,000 from Social Security: $1,500 times 12 monthly checks. That adds up to $72,000 at age 66, and $144,000 at age 70. Thus, Art would have to live until his late 70s or 80s just to break even, not including any time value from receiving the money early.

CONSIDERATIONS FOR ELECTING BENEFITS LATER

This could be worthwhile for retirees who don't need the cash flow in their 60s, and who have an extended life expectancy. The idea of receiving a benefit increase of around 8% a year, backed by the federal government, can be appealing in these low yield times. The higher payout can help address inflationary concerns, which is the chance of reduction in future purchasing power due to rising costs of goods and services.

Moreover, married couples might want to have one spouse wait as long as possible to start benefits. That's because the surviving spouse will get only one Social Security check each month, after the other spouse dies. The one check for the widow(er) will be the larger of the two checks received by the two spouses. As a result, waiting for a larger benefit can help provide a higher benefit for the survivor, if the spouse collecting the larger check is the first to die.

INCOME FROM IRAs

As sources of retirement income, IRAs come in two varieties.

TRADITIONAL IRAs

This is the term commonly used to describe the original IRAs. These accounts usually are funded mainly or entirely with money that was never subject to income tax. For the purpose of this discussion, traditional IRAs will also include SIMPLE and SEP IRAs. ***Often, large traditional IRAs are created when a retiree rolls untaxed dollars from a plan such as a 401(k) to an IRA, maintaining the tax deferral.***

Traditional IRAs typically contain pretax dollars. Therefore, withdrawals usually are subject to income tax. Before age 59½, withdrawals from traditional IRAs also are subject to an additional 10 percent tax. However, several exceptions apply to this additional tax requirement.

ROTH IRAs

These accounts, named for the late Senator William Roth of Delaware, are always funded with after-tax dollars. ***If they qualify, Roth IRA withdrawals may be entirely tax-free.*** To qualify for tax-free distributions, a Roth IRA must pass two tests:

1. The taxpayer's first Roth IRA contribution must be at least five years old; and
2. The Roth IRA owner must be age 59½ or older.

Note: Amounts contributed come out of a Roth IRA first, and can be withdrawn without tax or additional federal taxes required due to distributions prior to age 59½.

In addition, the two types of IRAs differ in one vital respect: ***Traditional IRAs have required minimum distributions (RMDs) during the owner's lifetime, but Roth IRA owners never have RMDs.*** After age 72, traditional IRA owners must take at least certain amounts from their accounts each year, even if the money is not needed. Those RMDs typically are taxable, at the IRA owner's marginal income tax rate. Any RMD shortfall faces a 50% penalty! Larger distributions are permitted, but smaller-than-RMD amounts trigger the penalty.

HYPOTHETICAL EXAMPLE. Nancy Grant, a widow who has not remarried, will be 80 years old in 2017. At the end of 2016, Nancy has $200,000 in her IRA. On the IRS Uniform Lifetime Table, used by most IRA owners, the "distribution period" for someone age 80 is 18.7. Thus, Nancy divides her $200,000 year-end IRA balance by 18.7 and determines that her RMD in 2017 is $10,696. If she withdraws only, say, $2,000 from her IRA in 2017, the $8,696 shortfall will result in a penalty of $4,348, at 50%.

ROTH IRA CONVERSIONS

With the possibility of tax-free distributions and freedom from RMDs, Roth IRAs are considered by many to be better for retirement income than traditional IRAs. What's more, the tax code permits traditional IRA owners to convert their accounts to Roth IRAs. ***Traditional IRA owners may convert some or all of their IRA account balances to one or more Roth IRAs. Usually the entire amount converted is taxed to the account owner in the year of conversion.***

HYPOTHETICAL EXAMPLE. Ivan Madison has $500,000 in his traditional IRA, all from pretax contributions and untaxed investment earnings inside the account. Ivan can convert all $500,000 to a Roth, or he can convert a smaller amount. Any amount he converts is taxable.

Here, Ivan would add $500,000 to his taxable income for the year with a full conversion. That could put him in the highest income tax bracket and add $200,000 or more to his tax bill for the year. Instead of a full conversion, Ivan opts to convert $50,000 of his traditional IRA to a Roth this year. If Ivan is in a 25% tax bracket, that conversion might be taxed at only $12,500: 25% of $50,000.

A series of partial Roth IRA conversions, over multiple years, might move money from the traditional to the Roth side, at an acceptable tax cost. Each partial conversion has two benefits:

- Money moves from tax-deferred territory, inside a traditional IRA, where all future investment earnings are shared with the IRS on withdrawal. After the conversion, and paying the tax, the money in a Roth IRA is in potentially tax-free territory, including investment earnings.
- Each partial conversion reduces the amount held in traditional IRAs. This reduces future RMDs, which may be taxed.

Reducing future RMDs can help reduce the potential future tax on Social Security benefits. Taking tax-free withdrawals from Roth IRAs won't increase combined income, so that cash flow won't trigger tax on Social Security income.

Reducing future RMDs can help reduce the potential future tax on Social Security benefits.

ROTH IRAs FOR RETIREES

Roth IRA conversions can benefit retirees by reducing RMDs and providing a source of tax-free income, once the five-year and age 59½ tests are passed. What's more, the ability to recharacterize Roth IRA conversions makes this strategy especially attractive.

After a Roth IRA conversion, the account owner can use recharacterization to fine-tune the end result. A partial recharacterization can help address the concern of moving into a high tax bracket while also addressing the concern of generating too much income, which can lead to taxation of Social Security benefits. Nevertheless, IRA owners should work with knowledgeable advisors in executing Roth conversions, recharacterizations, and re-conversions. Mistakes can result in unwelcome tax consequences.

REGARDING RMDs

Roth IRAs have their appeal but many retirees will rely largely upon income from traditional IRAs. Ideally, the income taxes due on traditional IRA distributions will be modest if retirees have relatively low income, with little or no earnings from work.

Whether there is a need or not, retirees will have income after age 72, from RMDs. An IRA owner must start taking RMDs by April 1 of the year after turning age 72. Subsequently, each RMD must be taken by December 31, every year. Traditional IRA owners never get too old for RMDs, as long as there is money in the account.

HYPOTHETICAL EXAMPLE. Jan Cole was born in September 1950, so she'll reach age 72 in September 2022. Jan can postpone RMDs until April 1, 2023. However, Jan will have to take her second RMD by December 31, 2023. Taking two RMDs in one year might increase Jan's income enough to put her into a higher tax bracket.

Many retirees take their first year's RMD in the year of turning 72, to reduce the tax bill. Going forward, Jan must take an RMD by December 31, each year. Even if she lives to age 100, Jan will still have to withdraw about 16% of the money in the account for the rest of her life or until the funds are exhausted.

NUTS AND BOLTS OF RMDs

The amount of the RMD will depend on the December 31 IRA balance, the previous year. For Jan, the balance on December 31, 2021, will determine the RMD for April 1, 2023, and the IRA balance on December 31, 2022, will determine the RMD for December 31, 2023.

Retirees with multiple traditional IRAs can find the RMD for each one, calculate the total, and take the total RMD from one or more IRAs by the deadline. Generally, the IRA custodian (the financial firm holding the IRA) will tell the IRA owner the RMD amount each year. Often, this information can be obtained by going to the custodian's website.

If the custodian is not helpful, IRA owners can calculate their own RMD, using information available online. RMDs are calculated by dividing the IRA balance on December 31 of the previous year by the distribution period for each IRA. For most people the IRS Uniform Lifetime Table provides the distribution period amount needed to calculate the RMD:

UNIFORM LIFETIME TABLE			
Age	*Distribution Period*	*Age*	*Distribution Period*
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and over	1.9

HYPOTHETICAL EXAMPLE. Jan has $400,000 in her IRA on December 31, 2021. For her 2022 RMD, when she'll be age 72, Jan divides her $400,000 IRA balance by 25.6, the distribution period for age 72. The result—$15,625—is the least Jan can withdraw from her IRA in 2022 (or until April 1, 2023), in order to avoid a 50% penalty. Jan will repeat the same process every year, with an updated IRA balance and the appropriate distribution period.

Most people will use this table. However, an IRA owner with a spouse who is (a) at least 10 years younger and (b) the sole IRA beneficiary may use an alternate table, which yields smaller RMDs.

PICKING THE PAYOUT

Many IRA custodians will do more than merely inform IRA owners of their RMD each year. Often, IRA custodians will allow IRA owners to choose a schedule for direct deposit of RMDs into a checking account.

- **IRA owners who want steady cash flow** can arrange for automatic monthly transfers from their IRAs. Each month, 1/12 of the annual RMD will go into a designated checking account. Income tax withholding can be arranged, to pre-pay the income tax associated with the RMDs.
- **IRA owners who don't need the RMDs** for living expenses can opt for one annual direct deposit, near year-end. This will leave the money in investment accounts for a longer period of possible earnings.

For added flexibility, retirees also can decide how much, if any, of their IRA RMDs to donate to charity. Such direct contributions, up to $100,000 per donor per year, count toward satisfying the retiree's IRA RMD obligation if all conditions are met. ***These "qualified charitable distributions (QCDs)" count as RMDs yet will not add to the IRA owner's income, which may save money in various tax return areas.***

QCDs taken directly from IRAs may help reduce taxable income for retirees who don't itemize deductions.

QCDs taken directly from IRAs may help reduce taxable income for retirees who don't itemize deductions. Non-itemizers can't deduct charitable donations but they still will get a direct tax benefit from a reduction in taxable RMDs. Thus, unneeded RMDs can be directed to charitable donations, for retirees with philanthropic intent. Such contributions may save tax by reducing income from RMDs. Furthermore, a QCD doesn't get added to a taxpayer's adjusted gross income—so a QCD might ease the potential income tax on Social Security benefits.

Beyond charitable contributions, RMDs that retirees don't need can be used for multiple purposes. They might be used for family gifts or for buying a vacation home, just to mention some possibilities.

TAX-EFFICIENT WITHDRAWAL STRATEGIES

Many retirees have done most of their savings in employer plans such as 401(k)s. At retirement, they've rolled over the balance to a traditional IRA. For such retirees, their traditional IRA has become their retirement fund. That's where they plan to go for spending money.

Other retirees have both a tax-deferred traditional IRA and a taxable investment account. Then, decisions must be made. For retirement cash flow, should the IRA or the other account be tapped? There are many factors to take into account in making the annual decisions.

- [ ] **At first, it seems logical to spend down the taxable account.** Investment earnings inside the traditional IRA can continue to grow, tax-deferred. However, a larger traditional IRA means larger RMDs, after age 72. ***Those RMDs could push IRA owners into higher tax brackets, forcing the IRA owners to pay steep tax rates on money they don't even need.***

Another plan might be to tap traditional IRAs first, to reduce future RMDs. However, that would generate higher current tax bills and sacrifice valuable tax-free compounding of investment returns, inside the IRA. Keep in mind that a traditional IRA may be eligible for conversion to a Roth. In some situations however, tapping into a traditional IRA could be an ideal way to order withdrawals from diverse accounts:

- [ ] **Take some money from tax-deferred traditional IRAs.** In retirement, these withdrawals will be taxable, but the tax rate may be low. ***Before age 72, take out enough money to fill up a low tax bracket, if that's possible.***

HYPOTHETICAL EXAMPLE. Retirees Kevin and Bonnie Walsh had taxable income (after deductions) of $50,000 last year. They expect this year's income to be about the same. In 2018, the 12% tax bracket goes up to $77,400 of taxable income, for couples filing joint tax returns. As a result, this couple could consider withdrawing, say, an extra $25,000 from their IRAs. The extra withdrawal would still keep them in the 12% tax bracket, but might help them manage their future RMD obligations. Of course, other factors, such as their need for cash flow, must be considered.

- [ ] **Also consider taking some money from taxable accounts.** If all the money in a particular account is after-tax, such as a CD, mere withdrawals won't add more tax. If money is invested in a capital asset—such as a mutual fund account—it can generally be accessed only by selling the underlying asset. Selling the asset will likely generate capital gains. Capital gains may be offset with capital losses, if they can be realized in the same year. ***Even if long-term capital gains end up being taxed, favorable tax rates probably will apply.*** Altogether, the tax bite on money taken from the capital gains account might be lightly taxed. That's especially true for retirees with little or no earned income.
- [ ] **Use some or all of the money withdrawn from the IRA for a Roth IRA conversion.** In our example, Kevin and Bonnie Walsh withdraw $25,000 in excess of their RMD obligation from their traditional IRAs. They calculate that they only need $5,000 of that excess for living expenses, considering their other income. Therefore, Bonnie and Kevin convert $20,000 of their traditional IRA distribution into their Roth IRAs.

BOTTOM LINE. Make intentional choices regarding the timing of distributions from IRAs and taxable accounts to maximize retiree cash flow—both now and later. Consider making Roth conversions to minimize future RMD obligations and taxable income.

STRETCHING IRA DISTRIBUTIONS

The beneficiaries of a traditional or Roth IRA have RMD obligations. Their nature of their choices depend on the timing of the account owner's death and the relationship between the account owner and beneficiary. In general, beneficiaries have at least some choice over the timing of distributions from an inherited account. Having an account beneficiary delay distributions to the extent allowed by law is often referred to as "stretch." Beneficiaries who fail to take RMDs when required are subject to the 50% failure to take RMD penalty tax.

Amounts distributed from a traditional IRA to the account beneficiary are generally income taxable. Roth IRA distributions paid to a beneficiary after the death of the account owner are typically income tax-free.

HYPOTHETICAL EXAMPLE. Here's how a stretch IRA might work:

1. Henry Johnson retires from work and rolls his 401(k) account to a traditional IRA. Starting at age 72, Henry takes only RMDs from this IRA.
2. At Henry's death, his IRA passes to his wife Irene, the sole beneficiary. As the surviving spouse, Irene has a unique opportunity. Irene can roll Henry's IRA into her own IRA. Thus, the inherited IRA will become Irene's own, so she can name new beneficiaries and start a new RMD schedule. ***Note: If the surviving spouse is younger than the deceased IRA owner, which is frequently the case, the new RMD schedule may defer withdrawals and increase tax-deferred buildup.***
3. Continuing our example, Irene takes only the RMDs from what has become her IRA. Irene names the couple's children, Jack and Jill, as the beneficiaries of her IRA.
4. At Irene's death, the IRA that started with Henry's 401(k) will pass from Irene to Jack and Jill. As non-spouses, the children do not have the ability to roll the funds into their own IRAs. Jack and Jill must take out all funds as taxable distributions within 10 years of Irene's death. There is no required pattern of these distributions.

IRA owners should always make certain the account's beneficiary form is up to date. When an IRA owner dies, the beneficiary designation will determine where the money goes, even if the decedent's will, trust, or divorce decree says something else. (The Estate Planning section of this course will have detailed information on the importance of beneficiary designations.)

STRETCHING BY DISCLAIMING

In some cases, an IRA will be left to a beneficiary who doesn't need the money. That person may pass the IRA on to contingent beneficiaries named by the deceased IRA owner, using a strategy known as disclaiming. ***Disclaiming also may be appealing if the designated beneficiary has substantial net worth and wants to keep the IRA money out of his or her taxable estate.***

A disclaimer must be made within nine months of the IRA owner's death and before taking possession of the IRA assets and must satisfy certain other technical requirements. After the primary beneficiary disclaims the inheritance, the account will pass to the contingent or successor beneficiaries named by the IRA owner. Both partial and complete disclaimers are permitted. Non spousal IRA beneficiaries generally must take taxable distributions of all funds within 10 years of death of the account owner whom they inherited it from.

HYPOTHETICAL EXAMPLE. Mel Franklin dies with a $500,000 IRA. His wife Leila is the sole beneficiary and their daughter Vicky is the contingent beneficiary. Leila decides that she can live comfortably with $200,000 from Mel's IRA, so Leila disclaims $300,000 of the IRA, which passes to Vicky. Vicky must withdraw and pay income tax on all funds within 10 years of Leila's death.

KEYS TO DEFERRING INCOME TAXES ON IRAS FOR AS LONG AS POSSIBLE

- [ ] **Take only RMDs, if practical.**
- [ ] **Be sure to designate beneficiaries.**
- [ ] **Inform a spouse beneficiary of options.** (Choosing an inherited IRA rather than an immediate rollover may be desirable if the spouse will need cash flow before age 59½.)
- [ ] **Inform non-spouse beneficiaries of vital deadlines.** (Separating accounts may offer more tax deferral choices for younger beneficiaries.)
- [ ] **Name a trust as IRA beneficiary if asset protection is a concern.** (A knowledgeable attorney may be able to draft the trust to maintain income deferral for as long as possible while also meeting asset protection objectives.)

THE SPLIT BENEFIT IRA:
ROLLOVER TO SPOUSE AND SPLIT APPROACH

The hypothetical example below is a multi-generational approach for continuing distributions.

2016

BOB'S IRA

IRA Value Now (2016):	$200,000
Distributions Start (age 70):	$277,384
Death Assumed (age 70):	$288,711

Distributions during Bob's lifetime: **$10,123**

2021

AT BOB'S DEATH

Sally rolls over the value at Bob's death. Distributions are based on the Uniform Lifetime Table.

Value of Sally's IRA in 2021: $288,711

Distributions during Sally's lifetime: **$17,535**

2026

AT SALLY'S DEATH

IRA splits into separate shares at Sally's death. Distributions are based on the life expectancy of each named beneficiary.

Total Distributions to Bruce: $2,812,466

Total distributions during lives of Bob, Sally and beneficiaries: $2,840,124

Beginning Account Balance October 19, 2016: $200,000

Year	Client Age	Spouse Age	Life Exp.[a]	Earnings & Contributions[b]	Actual Distributions[c]	ALLOCATION OF DISTRIBUTIONS: Income Taxes Paid[d]	Prem. & Non-Prem. Gifts	Spend-ing	Reinvested Distributions[e]	Total of All Other Assets[f]	Account Balance
2016	65	60		3,885	0	0	0	0	0	0	203,885
2017	66	61		16,311	0	0	0	0	0	0	220,196
2018	67	62		17,616	0	0	0	0	0	0	237,812
2019	68	63		19,025	0	0	0	0	0	0	256,837
2020	69	64		20,547	0	0	0	0	0	0	277,384
2021	70	65	27.4	21,451	10,123	0	0	0	10,123	10,123	288,711

Bob dies and Sally does an IRA rollover.

Year	Spouse Age	Life Exp.[a]	Earnings & Contributions[b]	Actual Distributions[c]	ALLOCATION OF DISTRIBUTIONS: Income Taxes Paid[d]	Prem. & Non-Prem. Gifts	Spend-ing	Reinvested Distributions[e]	Total of All Other Assets[f]	Account Balance
2022	66		22,912	2,531	2,531	0	0	0	10,427	309,092
2023	67		24,681	633	633	0	0	0	10,740	333,140
2024	68		26,640	158	158	0	0	0	11,062	359,622
2025	69		28,767	40	40	0	0	0	11,394	388,349
2026	70	27.4	30,032	14,173	3,553	0	0	10,620	22,382	404,208

Total distributions during Sally's lifetime are $17,535.

[a] Bob's death is assumed to occur in 2021. Sally is named beneficiary. For Traditional IRA, 403(b) or other Qualified Plans, Bob takes required minimum distributions (RMDs) at age 70½ and calculates life expectancy annually based on the Uniform Lifetime Table.

[b] Assumes qualified plan earns 8.000% interest. Also includes contributions, if any.

[c] For Traditional IRA, 403(b) or other Qualified Plans, Actual Distributions is the greater of distribution required to generate the Desired Distribution (see Assumptions pages) or RMD.

[d] Taxes and any applicable penalties are paid at the start of the calendar year following the tax liability. Distributions from Traditional IRA, 403(b) or other Qualified Plans are taxable. See the Assumptions pages for information on distributions from a Traditional IRA with an original after-tax amount of $0.

[e] Actual Distributions less Taxes and Penalties, Premium and Non-Premium Gifts and Spending.

[f] All Other Assets and Cumulative Reinvested Distributions are assumed to earn 4.000% interest and are taxed at a 25.00% income tax rate. Does not include the death benefit of life insurance.

THE TWO FACES OF 401(k)s

Just as IRAs come in two flavors, traditional and Roth, the same is true for 401(k) plans. The older version, now called a traditional 401(k), has been joined by the Roth 401(k). ***The pair of 401(k) plans is a mirror of paired IRAs, in many ways.***

Traditional 401(k) plans are largely funded with pretax dollars: employee and perhaps employer contributions. Roth 401(k)s are funded with aftertax money. Withdrawals from traditional 401(k) plans are typically subject to income tax, and perhaps an additional 10% federal tax before age 59½. Roth 401(k)s can provide income tax-free distributions, after five years and age 59½. Given those differences, how do the two types of 401(k) function as a source of retirement income?

TRADITIONAL TACTICS

Retirees often roll their 401(k) funds into an IRA. Done properly, the account will remain untaxed until money is withdrawn. However, not everyone wants to execute a rollover. Some retirees have little inclination to manage their own retirement fund—they may be quite happy with the costs and investment selection of the company's 401(k)—despite the fact that the management of their money is out of their direct control.

These factors support the strategy of leaving money in the 401(k) account instead of rolling it over into an IRA.

Employer-sponsored plans may have more creditor protection than IRAs. A 401(k) is sheltered by federal ERISA law while creditor protection for IRAs may rely more upon state law, which varies. That's another reason a retiree—especially those who are concerned about possible lawsuits—may choose to keep retirement funds inside their 401(k), until needed.

For retirees who keep money in their 401(k), tapping the account for income generally isn't a problem. Distributions usually are permitted after a participant leaves the company, for retirement or other reasons. Distributions are taxable, but the tax rate in retirement may be low. Moreover, early retirees with money in a 401(k) get a break when it comes to the 10% penalty on premature distributions. ***If money is in an employer-sponsored plan such as a 401(k), distributions made after the participant has separated from service with the employer won't trigger the 10% early withdrawal penalty if the separation occurred in or after the year of reaching age 55.***

HYPOTHETICAL EXAMPLE. Paul Thomas retires from work at age 56. He knows he'll have to tap his retirement fund for living expenses. If Paul rolls his 401(k) money to an IRA, distributions will be subject to income tax and an additional 10% federal tax for years, until he reaches age 59½. On the other hand, 56-year-old Paul can take distributions from his 401(k) and owe tax, but not the additional 10% federal tax. When he reaches age 59½, Paul can decide whether to leave the money in his 401(k) or roll the funds to an IRA. By then, IRA withdrawals won't trigger the additional taxation.

If a 401(k) plan allows loans, there may be no tax to the participant. The possibility of borrowing may be another reason to keep money in a 401(k). A company sponsoring a 401(k) plan can choose to allow loans, but borrowing from an IRA is prohibited.

If loans are permitted, participants usually may borrow up to 50% of their vested account balance, with a cap of $50,000. Plan loans won't trigger tax or an early withdrawal additional taxation before age 59½. ***However, 401(k) loans have drawbacks, too.*** These loans must be repaid on a set schedule, with terms usually calling for repayment within five years. Failure to abide by the loan terms can trigger income tax on the outstanding balance and perhaps the 10% early withdrawal taxation.

RULES FOR THE ROTH 401(k)

An employer offering a traditional 401(k) may choose to offer a Roth 401(k) as well. A Roth 401(k) plan is officially a Designated Roth Account, so it also may be known as a DRAC. Contribution limits to a DRAC are the same as the limits to a traditional 401(k). As of 2017, employees may split their contributions between the traditional and the Roth side but the total can't exceed the one-plan limit: $18,000 a year now, or $24,000 at age 50 or older. As mentioned, DRACs are funded with aftertax dollars. Inside a DRAC, investment earnings are untaxed.

A Roth 401(k) plan is officially a Designated Roth Account, so it also may be known as a DRAC.

Although some companies with DRACs allow hardship and non-hardship in-service distributions, that's not always the case. For in-service and post-service DRAC distributions, the tax rules are similar in some ways to the tax treatment of Roth IRAs. After five years and age 59½, all withdrawals are tax-free. At retirement, a DRAC may be rolled into a Roth IRA, without triggering income tax. However, subsequent distributions from the Roth IRA may not be tax-free.

The Reason: A DRAC rollover may start a new five-year waiting period. However, rolling to a pre-established Roth IRA includes the DRAC funds in the existing schedule for tax-free withdrawals.

HYPOTHETICAL EXAMPLE: THE FIVE-YEAR HITCH

Rose Sawyer retires at age 65 and rolls her DRAC account into a new Roth IRA. Rose has never had a Roth IRA before, but she has had the DRAC for more than five years. Rose must wait another five years before she can take tax-free withdrawals from her Roth IRA.

On the other hand, Tom Williams retires at age 65 and rolls his DRAC account into a Roth IRA. Tom has had the DRAC for more than five years, and he had established and contributed to his first Roth IRA more than five years earlier. Tom can take tax-free withdrawals from his Roth IRA immediately because he passes the five-year test.

For such a reason, some people without prior Roth IRA experience might prefer to keep their DRAC in place after retirement, for a faster path to tax-free withdrawals.

SPECIAL GOVERNMENT AND NONPROFIT RETIREMENT PLANS

Today, 401(k) plans are by far the most popular employer-sponsored retirement plans, especially in the private sector.[12] Government and nonprofit workers may have access to special kinds of retirement plans. The special kinds of plans are generally similar to 401(k)s, with upfront tax deferral on some earned income and taxable withdrawals in retirement, when they may be taxed in a lower bracket.

- [ ] **403(b) plans.** These are typically offered to educators and to workers at nonprofit organizations.
- [ ] **457(b) plans.** State and local government workers may participate in these plans.
- [ ] **Thrift Savings Plan.** This retirement plan is offered to federal employees, including those in the military.

Note: Many participants in these types of plans also stand to receive pensions, after lengthy service in these fields. The 403(b), 457, and Thrift Savings plans can provide supplemental retirement income. Although 403(b), 457, and Thrift Savings Plans are similar to 401(k)s, and may also offer a Roth version (a DRAC), there are differences among them as the chart to the |right highlights.

	401(k)	403(b)	457(b)
Who is eligible?	Employees whose employers offer the plan (private employers, some nonprofit employers)	Employees of nonprofits such as public schools and some hospitals, charitable organizations	State and local government employees
Pre-tax contributions?	Yes*	Yes*	Yes*
Limits on employee contributions (2020)	Up to $19,500	Up to $19,500	Up to $19,500
Age 50+ catch-up contributions	$6,500	$6,500	$6,500
Other catch-up	No	Yes – 15-year rule**	Yes – final 3-year provision***†
Distributions while still employed , if plan permits (in-service distributions) [13]	Only on hardship if under age 59½w	Only on hardship if under age 59½	Only on account of unforeseeable emergency
Distributions without tax penalties	• Retirement after age 55 ‡ • Death or disability • Payments after age 59½ • Lifetime annuity or installments • Rollover to other qualified plan or IRA	• Retirement after age 55 • Death or disability • Payments after age 59½ • Lifetime annuity or installments • Rollover to other qualified plan or IRA	Distributions from governmental 457(b) plans not subject to the 10% additional tax on early distributions.[14] §
Required minimum distributions [15]	April 1 following the latter of the year participant reaches age 72 or retires, if allowed by plan	April 1 following the latter of the year participant reaches age 72 or retires, if allowed by plan	April 1 following the latter of the year participant reaches age 72 or retires, if allowed by plan
Tax treatment of distributions	Ordinary income tax ; tax free if qualified distribution from a designated Roth account	Ordinary income tax ; tax free if qualified distribution from a designated Roth account	Ordinary income tax ; tax free if qualified distribution from a designated Roth account
Rollovers allowed to other plans	• Yes – to 401(k), 403(b) or 457 plan (allowed but not required) • Yes – to IRA	• Yes – to 401(k), 403(b) or 457 plan (allowed but not required) • Yes – to IRA	• Yes – to 401(k), 403(b) or 457 plan (allowed but not required)† • Yes – to IRA†

*If the plan permits, a designated Roth account may be elected for employee contributions. These contributions are not pre-tax contributions but eligible distributions (including earnings) are generally tax-free when withdrawn.[16]

**Eligible employees with 15 or more years of full-time service may be able to contribute up to $3,000 more for five years, or a maximum of $15,000.

***May be eligible to defer up to two times the contribution limit in effect for the final three years of service. Employees cannot participate in the 3-year catch-up and the 457 plan age 50+ catch-up during the same tax year.

†Nonprofit employees may be eligible for a special kind of 457(b) plan that doesn't have the same kind of special catch-up or rollover ability as a governmental plan. The plan document must be consulted to determine whether in-service distributions are allowed.

‡An eligible employee must separate from service during or after the year the employee attains age 55 (age 50 for public certain public safety officials).[15]

§Rollovers from other qualified plans into a 457(b) plan, where applicable, would be subject to the 10% additional tax when withdrawn unless an exception to the penalty otherwise exists.

OTHER TYPES OF RETIREMENT PLANS

Some other types of retirement plans are favored by small companies. These small-company plans are IRA-based, meaning that an employer can help employees to set up and fund their IRAs, for future retirement income. These plans are relatively simple to establish and maintain, with few paperwork requirements. Popular small business plans include:

- **SEP.** A Simplified Employee Pension (SEP) plan may be used by a self-employed individual. In addition, other employers may find that such plans provide a way to make contributions toward their employees' retirement or the owner/employee's own retirement. Contributions are made directly to an IRA set up for each employee (a SEP-IRA).

- **SIMPLE IRA.** A Savings Incentive Match Plan for Employees (SIMPLE) plan may be appealing to small companies because employees help to fund their own retirement, if they choose to make salary reduction contributions. The employer may make either matching or non-elective contributions. Again, contributions are made directly to an IRA set up for each employee (a SIMPLE-IRA).

Refer to the chart on the right for more details on these plans.

Self-employed individuals may be able to contribute even more to a Solo 401(k). Eligible businesses are those without any employees, other than the owner or owners and a spouse or spouses who are on the payroll. In some cases, tax-deductible contributions can be greater than they are with a SEP, but there's also more paperwork.

DEFINED CONTRIBUTION VS. DEFINED BENEFIT PLANS

The retirement plans described above are known as "defined contribution" (DC) plans. With DC plans, a retiree's ultimate payout (the benefit) is not known. Instead, the contribution is defined: there is a limit to what can be put into the plan. The benefit from these plans—the amount retirees can receive after work stops—will be determined by the amount that has been contributed and how well those contributions grow over the years.

Traditional lifelong pension plans are known as "defined benefit" (DB) plans. With a DB plan, the benefit (the payout in retirement) is determined by the amount the employee earned and the number of years he or she worked for that employer. That type of pension, combined with Social Security benefits, can provide lifelong cash flow to replace a large portion of a retiree's former earned income. Today, many public service employees continue to participate in a DB plan, so they'll receive a pension if they work long enough to qualify.

With a DB plan, the benefit (the payout in retirement) is determined by the amount the employee earned and the number of years he or she worked for that employer.

	SEP	SIMPLE IRA
Key Advantage	Easy to set up and maintain.	Easy to set up and maintain.
Employer Eligibility	Any employer with one or more employees.	Any employer with 100 or fewer employees that does not currently maintain another retirement plan.
Employer's Role	May use IRS Form 5305-SEP to set up the plan. No annual filing requirement for employer	May use IRS Form 5304-SIMPLE or 5305-SIMPLE to set-up the plan. No annual filing requirement for employer. Bank or financial institution handles most of the paperwork.
Contributors to the Plan	Employer contributions only.	Employee salary reduction contributions and employer contributions.
Maximum Annual Contribution (per participant)	Up to 25% of compensation, but no more than $57,000 for 2020.*	Employee: $13,500 in 2020. Participants age 50 or over can make additional contributions up to $3,000 for 2020. Employer: Either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any 2 out of 5 yrs.); or contribute 2% of each eligible employee's compensation.**
Contributor's Options	Employer can decide whether to make contributions year-to-year.	Employee can decide how much to contribute. Employer must make matching contributions or contribute 2% of each employee's compensation.
Minimum Employee Coverage Requirements	Must be offered to all employees who are at least 21 years old, employed by the employer for 3 of the last 5 years and had compensation of $600 (in 2016-2020).	Must be offered to all employees who have compensation of at least $5,000 in any prior 2 years, and are reasonably expected to earn at least $5,000 in the current year.
Withdrawals, Loans & Payments	Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to an additional tax. Participants cannot take loans from their SEP–IRAs.	Withdrawals permitted anytime subject to federal income taxes; early withdrawals subject to an additional tax. Participants cannot take loans from their SIMPLE IRAs. Distributions taken from a Simple IRA in the first 2 years are subject to a 25% (instead of the otherwise 10%) fee.
Vesting	Contributions are immediately 100% vested.	Contributions are immediately 100% vested.

Source: California Teachers Association

*Maximum compensation on which contributions can be based is $285,000 for 2020.
**Maximum compensation on which employer 2% contributions can be based is $285,000 for 2020.

DB PLANS FOR SMALL FIRMS

Some medium-sized and large companies still offer DB plans to employees. Moreover, DB plans may be a good fit for very small enterprises. The best candidates for small-firm DB plans may be companies with one or two older, highly compensated individuals and a few, much younger employees. In order to provide the older individuals with an appropriate retirement benefit, in keeping with their compensation and years of service, very large contributions must be made to the plan.

Some DB plans may call for the company to make a deductible contribution in six figures, most of which will ultimately be paid to the owner or co-owners. Such plans include 412(i) plans which, like 401(k)s, are named for the relevant section of the Internal Revenue Code. With these plans, offered by insurance companies, small businesses and professional practices make large tax-deductible contributions. The funds are invested in permanent life insurance policies and deferred annuities. The defined benefit that will eventually be paid, primarily to the employer's principals, are guaranteed by the issuing insurer. For these and other specialized retirement plans, employers may incur steep startup and administrative costs. Nevertheless, the tax benefits to key personnel can far outweigh these outlays.

Business owners, professionals, and self-employed individuals may discover unexpected retirement planning opportunities by meeting with a knowledgeable financial advisor.

...discover unexpected retirement planning opportunities by meeting with a knowledgeable financial advisor.

PENSIONS VS. LUMP-SUMS

As mentioned, some retirees will qualify for a pension, after participating in a DB plan. Generally, a retiree will be offered X dollars a month, for as long as he or she lives; a married couple probably will be offered a smaller monthly amount, to be paid as long as either spouse is alive. ***A married retiree taking a single life pension likely will need his or her spouse's consent.*** Some employees who retire after participating in a DB plan may be offered a lump-sum of cash up-front, instead of monthly checks.

HYPOTHETICAL EXAMPLE. Lon Roberts retires at age 65 and qualifies for a $50,000 annual pension. Alternatively, Lon is offered a $600,000 lump-sum, which he can collect right away and spend or invest as he pleases.

PROS AND CONS

The advantage of the pension is security. Assuming the employer is in good financial condition, Lon can count on cash flow for as long as he lives, without having to manage investments and without regard to market turmoil.

The disadvantage of choosing the pension is lack of control. If Lon takes the pension he won't be able to select how the money will be invested, so he relinquishes the opportunity for higher returns; he lacks access to the money, beyond the monthly check; and he won't be able to leave money to heirs in case of his untimely death. ***Choosing the pension addresses longevity risk, as it offers lifelong cash flow, but this choice may reduce the potential inheritance for loved ones.***

HOW TO CHOOSE

There are two ways to make the choice between a pension and a lump-sum. One way is to select the arrangement that *"feels"* better. A retiree who is concerned about lifelong security probably will feel more comfortable with the pension. Conversely, a retiree who desires more control over his or her finances may wish to receive a large lump-sum, for ongoing money management. The second way is to make this choice is by the numbers. Compare the lump-sum offered with the pension payout.

HYPOTHETICAL EXAMPLE. Above, Lon Roberts, 65, can get $50,000 a year or $600,000 in cash. Not counting the time value of money, Lon's *"breakeven"* is 12 years: the $600,000 promised payout divided by the $50,000 annual pension. Thus, if Lon believes he can live for many years beyond age 77, because of his current health and family history, the pension may be appealing. Otherwise, Lon might choose the lump-sum.

Note: Lon's choice would be different if the lump-sum offered was, say, $750,000. Then Lon wouldn't break even until age 80, after 15 years of $50,000 payments from the pension, so he might be more interested in the lump-sum. The comparison can become more complex if the time value of money is taken into account. A financial advisor can help retirees calculate a realistic "hurdle rate": the investment return on the cash payout needed to make taking the lump-sum an attractive option.

USING PERMANENT LIFE INSURANCE TO HELP ENHANCE RETIREMENT

Another potential source of retirement income is a life insurance policy. That possibility does not come from term life insurance: basic policies that offer only death benefits for a stated period of time. However, permanent insurance might generate cash value. The policy owner may be able to convert some or all of that cash value into cash flow. In that way, a consumer will pay more for a permanent policy, but in return may get extra features that can include access to supplemental retirement income.

Permanent life insurance policies come with different names, including whole life, universal life, and variable life. By any name, these policies are versions of the same concept. ***Permanent life insurance is designed to be in place indefinitely as long as policy premiums are paid, or at least for many years.***

With permanent life insurance policies, consumers usually pay level premiums, which are higher than term premiums in the early years. Part of the early premiums go into a savings fund, which often is called the *"cash value."* Over the years, this savings fund may increase. When policy owners grow older, the cash value can help to make sure the policy stays in force.

All life insurance policies—whether term or permanent—usually pay an income tax free benefit at the insured's death. Beyond that tax benefit, permanent life insurance policies have two unique tax-saving characteristics:

- **Tax-free accumulation.** If the balance in the policy's cash value grows, the earnings won't be taxed. Over decades, the untaxed buildup may be substantial.
- **Tax-free distributions.*** The owner of a non-MEC permanent life insurance policy can receive cash flow via withdrawals up to basis and policy loans thereafter without paying income tax, provided the policy stays in force until the insured's death.

Thus, permanent life insurance can be a potential source of tax-free cash to the policy owner. With regards to policy loans and withdrawals, keep in mind they will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. We'll cover more considerations around policy loans and withdrawals when we discuss accessing any cash value accumulation later in this chapter.

DISTINGUISHING FEATURES

There are different types of permanent life insurance policies, including:

- **Whole life insurance.** This is the basic form of permanent life insurance, and some people use the term *"whole life"* to refer to all types of permanent life insurance. Premiums are level, and there are usually guarantees regarding the death benefit and the cash value.
- **Universal life insurance.** Universal life generally offers some flexibility to policyholders, who may be able to change certain elements of the policies, such as scheduled premiums or face amounts of the policy. Any such changes will have an impact on the projected performance of the underlying policy—including the cash accumulation feature. Due to this flexibility, universal life policies—and their specific variants—have become popular over the past few decades.
- **Variable life insurance.** In these policies, the unlimited potential for cash value accumulation is pegged to certain external results, such as the performance of designated investments. Thus, the cash value and death benefit amounts can fluctuate with these policies due to stock market volatility.

* Depending on the total amount of premiums paid, the policy may be treated as a Modified Endowment Contract (MEC) under federal tax laws. If a policy is treated as a MEC due to overfunding, then surrenders, partial surrenders, and loans will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½, a 10% federal additional tax may be imposed. A tax adviser should be consulted regarding policy-related tax matters.

HYPOTHETICAL EXAMPLE. Kim Lawson has a variable life insurance policy with $100,000 worth of cash value. In her particular policy, Kim can choose among certain investment choices, which include "*subaccounts*" that resemble mutual funds. Kim might, for example, allocate 40% to a domestic stock subaccount, 30% to a high-quality bond subaccount, and 30% to a foreign bond subaccount. Within limits, Kim can shift her allocation among the subaccounts, inside her variable life insurance policy. ***The growth of cash value and the policy's death benefit will depend on the success of the investment choices.*** Variable life insurance policies generally have few guarantees. However, there probably will be a guaranteed minimum death benefit if certain premiums are paid.

- **Variable universal life insurance (VUL).** These policies combine the attributes of universal and variable life insurance. Policyholders have flexibility in their ability to adjust premium payments, as long as the cost of insurance is covered, while they can allocate their cash value among multiple investment choices. VUL, like straight variable life insurance, might be considered a high-risk, potentially high-reward form of life insurance. Policyholders often allocate their cash value heavily towards the equity subaccounts.

  Over the long term, assuming stock market performance in the future is similar to what it has been in the past, policyholders may have large amounts of cash value and substantial death benefits, compared to the premiums they have paid. However, equity subaccounts can tumble if stock markets crash, as they did in 2000-2002 and 2007-2009. In bear markets, variable life and variable universal life insurance policies that are heavily allocated to equity subaccounts may face serious difficulties.

- **Indexed universal life insurance (IUL).** These policies are another form of universal life, so they may have some flexibility in premium payments. IUL insurance is different from standard universal life insurance, though, in the way earnings are credited to the cash value. The *"I"* in *"IUL"* indicates that the crediting rate is pegged to an index. Typically, one or more major market indexes, such as the Standard & Poor's 500 Index, are used in the calculation.

HYPOTHETICAL EXAMPLE. Mitch Nixon buys an IUL insurance policy with 100% participation in the S&P 500. That index goes up 5% in a year, so Mitch's cash value increases by 5%. ***In reality, IUL insurance policies don't always perform that way.*** Generally, there is a cap on the amount Mitch can earn. If the S&P 500 rises by, say, 25% in a given 12 months, Mitch's cash value increase might be capped at 10% or 12% or 15% or some other amount, depending on the specific policy. In some IUL insurance policies, Mitch's participation rate might be less than 100%. Again, this effectively puts a cap on any increase in cash value.

Mitch might accept a cap on his policy's cash value growth potential, in order to get protection against declines in cash value. IUL insurance policies have many different features and limitations, from one insurance company to another, but the basic structure is that the cash value won't go down due to the performance of the underlying index or indexes, although other factors may affect the available cash value and death benefit amounts. Over time, the protection against market volatility loss may outweigh any sacrificed upside potential. Long-term, such an IUL insurance policy might provide substantial cash value growth with protection against year-to-year volatility.

CASH FLOW POTENTIAL FROM LIFE INSURANCE

How can these permanent life insurance policies provide supplemental funds during retirement? Through policy withdrawals and through loans against the cash value.

HYPOTHETICAL EXAMPLE. Suppose that Todd Quinn bought life insurance at age 45, when he had young children. He paid $10,000 annual premiums for 20 years, until he was ready to retire. Because Todd bought permanent life insurance, a portion of the premium that he paid each year went into the policy's cash value. As a result, now that Todd has stopped working he won't be limited to Social Security and a portfolio drawdown for retirement income. Todd also will be able to tap his life insurance policy's cash value. What's more, the money he receives can be free of income tax, but access to tax-free cash withdrawals is limited to the basis in his contract.

Suppose Todd has $350,000 of cash value when he retires at age 65 and stops paying premiums. Depending on the policy details, Todd might be able to take $20,000 or more from his insurance policy each year of his retirement, tax-free. In addition, Todd's beneficiary eventually will collect a death benefit, minus any policy loans, even after many years of tax-free payouts to Todd. This strategy works best after someone had the policy for a while, to build up the cash value.

ACCESSING CASH VALUE

One way to tap a permanent life insurance policy for cash is to take withdrawals from the cash value. Generally, withdrawals up the basis in the policy (usually the amount paid in premiums) are income tax-free. All of this information presupposes the contract is not a Modified Endowment Contract (MEC). In our hypothetical example, Todd Quinn has paid $200,000 in premiums. Thus, he probably can withdraw up to $200,000 in retirement, without owing income tax. ***The downside is that withdrawals reduce the policy's cash value, which can jeopardize the viability of the policy.*** A policyholder who takes withdrawals might have to pay extra premiums to keep the policy in force. Taking withdrawals also will reduce the policy's death benefit.

Instead of withdrawals, policyholders also can get cash from life insurance via loans. There will be no tax on the money received, just as no income tax is owed when using a loan to pay for a home or an auto purchase. A life insurance policy loan generally uses the cash value as collateral. Policyholders don't have to qualify for the loan by showing a good credit score or ample earned income. Little or no paperwork is involved. Thus, taking a life insurance loan is a relatively easy way to obtain untaxed source of funds, once there's a sufficient amount of cash value in the policy.

Borrowers will be charged interest on a life insurance loan. Interest rates vary, from company to company. However, the interest rate on policy loans usually is higher than the rate on a home mortgage but lower than the rate on credit card debt. In many cases, borrowers don't have to pay the interest on a policy loan. If people choose not to pay, the interest will accrue and increase the loan balance. The bottom line is that borrowing against a permanent life insurance policy can result in cash flow without outlays for either interest or income tax.

The bottom line is that borrowing against a permanent life insurance policy can result in cash flow without outlays for either interest or income tax.

Besides benefits, life insurance policy loans have drawbacks. The amount borrowed, along with the accrued interest, will reduce the policy's death benefit. A reduction in death benefits may not be a huge concern for retirees without dependents. In addition, the loan balance will reduce the cash value. In some permanent life policies, reducing the cash value below a certain level will cause the policy to lapse, which may trigger income tax on any untaxed earnings that have accumulated inside the policy, over the years. While loans on a non-MEC are not considered taxable distributions at all, that presupposes the contract is staying in force until death. A lapse will generate a big phantom income result.

Consequently, retirees should borrow carefully from a permanent life insurance policy if they want to use it as a supplemental source of income in retirement. If loans are used in moderation, the life insurance will remain in-force. Working with a knowledgeable insurance professional can help retirees receive untaxed cash flow yet still leave a significant income tax-free death benefit to their beneficiaries.

BORROW LOW, EARN HIGH

Consumers should evaluate the loan provisions of a permanent life insurance policy if they hope to eventually tap it as an additional retirement income source. Ideally, a policy should include a low fixed rate on policy loans, guaranteed for the life of the policy. A variable loan rate might increase in the future, considering how low interest rates are now. Some insurers currently offer fixed rates of around 5% on policy loans.

HYPOTHETICAL EXAMPLE. Alice Burns has $300,000 in cash value when she retires, at age 65. That $300,000 might be considered Alice's *"cash bucket,"* from which she can borrow money. If Alice takes a $30,000 policy loan in Year One of her retirement, her cash bucket drops by $30,000, to $270,000. Now suppose that Alice's cash value earns 10% that same year. That 10% return ($27,000 on $270,000) brings her cash bucket up to $297,000. At the same time, Alice's $30,000 loan goes into what she considers her *"loan bucket."*

In our example, Alice is paying 5% loan interest but her 10% cash value earnings exceeds the interest rate. Alice pays no interest on the loan that year, so Alice's loan bucket remains at $30,000. With 5% interest owed and 10% earnings on the cash value, Alice gains by the 5% spread. That 5% spread also goes into the cash bucket. On a $30,000 loan, the 5% a spread is $1,500, so the cash bucket increases from $297,000 to $298,500.

Altogether, Alice has taken a $30,000 tax-free loan but owes no net interest while her cash bucket has declined only slightly. She's getting that 10% return on both buckets, minus the interest owed on the loan bucket.

If there is a positive spread, a life insurance loan will produce more earnings than debt service so sizable loans can continue, without jeopardizing the life insurance policy. Realistically, no insurance policy will have a cash value that earns 10% every year. Nevertheless, permanent life insurance policies are meant to be long-term commitments, and market indexes have hovered around 9% annualized returns for many decades.[17] Finding a way to tie cash value growth to long-term market index performance might yield, say, annualized growth of 7% or 8% or so. With such success, and a 5% fixed loan rate, permanent life insurance has the potential to keep cash flowing in retirement.

Something else to consider in terms of finding an income source may be negative interest rates, where a lender pays the borrower money for said borrower to take out a loan. Unusual, yes, but it has been done before and provides a positive incentive to borrow funds.

Another strategy to take into consideration is the idea of arbitrage. The basic idea here is, given the right conditions, you make a profit from purchasing from one market index and immediately selling on another. This is only profitable of course in the rare situation that pricing of an investment is slightly varied from one market index to another.

RETIREMENT INCOME FROM ANNUITIES

The course section on *"Types of Financial Products"* described annuities. Indeed, annuities can be a prime source of income for retirees.

To quickly recap, retirees may receive income from immediate annuities. Someone gives money to an insurance company and receives a stream of income, which can last a lifetime. The benefit to getting income from an immediate annuity is security. More people are spending more years in retirement, due largely to extended life expectancies, so an assured source of lifelong income can be desirable.

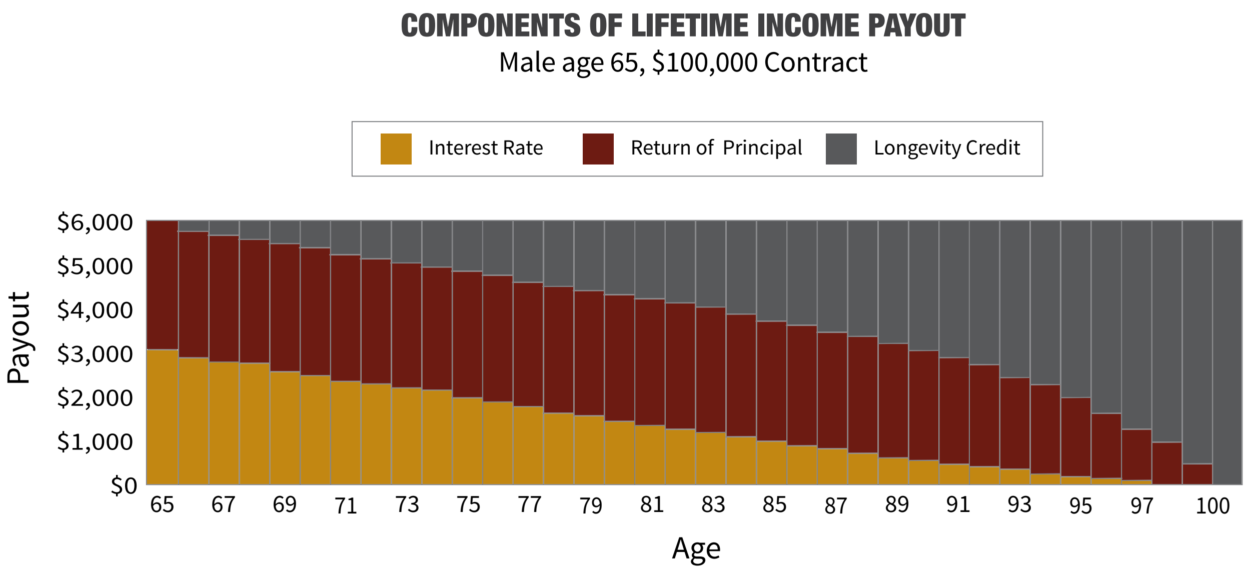
However, immediate annuities have their drawbacks. The negatives include low current yields, lack of access to one's own money, and lack of a payout to heirs after the death of the person receiving the annuity. ***Insurers have added features to immediate annuities to address these concerns.*** Consumers now can get some beneficiary payouts from immediate annuities and perhaps some access to their premiums paid. However, these features drive down payout rates even lower. Therefore, immediate annuities are a reliable source of retirement income, but they may be best suited for people willing to accept a relatively low yield in return for long-term security.

DIGGING DEEPER INTO IMMEDIATE ANNUITIES

Today, bank accounts and money market funds have scant yields. However, a 65-year-old paying $100,000 for a lifetime annuity might get $500 a month, or $6,000 a year, for a 6% payout. (That's a hypothetical amount, reflecting current payouts on some annuities, with certain features.) Some specific features of single premium income annuities (SPIAs), if chosen by the taxpayer, may affect the actual SPIA payout. In today's world, how can a 6% payout be considered low-yield? Because that 6% payout is actually composed of three forms of cash flow.

- **Flow 1: return of principal.** One flow is a return of the $100,000 principal, in this example. With a basic lifetime annuity, the premium used to purchase the contract is returned to the annuitant in monthly installments.
- **Flow 2: interest rate.** Besides a return of principal, the second cash flow is the interest rate on the contract. In today's environment, that rate is relatively low.

Flow 3: longevity credits. The third income stream of an immediate annuity, which can help boost the payout percentage, comes from *"longevity credits,"* also called *"mortality credits."* Here, the insurer adds a certain amount to the promised payments to account for the presumed early death of some immediate annuity buyers.



SURVIVOR'S SURFEIT

As an illustration of mortality credits, assume that five retirees take an annual fishing trip; each year they fund the next year's outing. Say that each one puts $1,000 into a tackle box and they tape the box shut until the next year.

In our scenario, these five retirees agree that if one of them dies, the other four can spend the money in the tackle box. Suppose that one year later, one of the friends has died and the four remaining retirees discover that there's still $5,000 in the box. The money didn't grow by one penny but now the four survivors each can spend $1,250, if they choose. They each received a 25% return—from a $1,000 outlay to $1,250 available—which is a mortality credit, due to one contributor's death.

Repeat the same story, year after year. The three survivors will have access to $1,667 apiece, then the two survivors will have access to $2,500 apiece, and the last one standing would pocket $5,000 for a $1,000 outlay.

This is an example of an annuity's mortality credit because those who die early fund those who live longer. Only an insurance company can do this. Including a return of principal, interest income, and a mortality credit, an immediate annuity can offer a payout that might be attractive, to some people in some circumstances.

In addition, as explained previously, the tax treatment of an immediate annuity held in a taxable account may be extremely favorable. For many years, only a portion of each payment will be taxed, as most of the cash flow is treated as a tax-free return of the contract owner's own money.

DEFERRED ANNUITIES

Even with mortality credits, immediate annuities are not for everyone. In fact, relatively few consumers purchase them, as the idea of losing heavily in case of an untimely death is not appealing. Instead, more consumers choose deferred annuities. As explained in the previous section, there is usually growth potential before the contract is tapped for cash flow in retirement.

A deferred annuity can be annuitized: converted to an immediate annuity for lifelong cash flow. Most contract owners don't do this, however. If that's the case, why is a deferred annuity considered a source of retirement cash flow? Because these products can be tapped via withdrawals.

Generally, deferred annuities are designed to offer living benefits, especially lifetime withdrawals. Living benefits vary, from issuer to issuer and from contract to contract, but the basic idea is to provide the option of accessing cash flow to consumers. Often, that's done by offering a guaranteed minimum withdrawal benefit (GMWB), which can be purchased with a deferred annuity. The guarantee might be based on the return of a consumer's investment amount over time.

Fixed index annuities (FIAs) may have relatively generous guaranteed income provisions, known as income riders. In many cases, FIA income riders guarantee a certain level of income, if it's taken in the way prescribed by the contract. Eventually, FIA holders can begin taking guaranteed penalty-free lifetime withdrawals.

ASSET ALLOCATION VS. INCOME ALLOCATION

When it comes to putting together a portfolio, some advisors advocate asset allocation, also known as modern portfolio theory. The idea behind this theory is that all investments can be grouped into certain asset classes. ***Stocks (or equities) are considered an asset class, for example.*** The equity asset class might be divided into large-caps (for market capitalization, the value of the outstanding shares), mid-caps and small-caps. Bonds (known as fixed income), real estate, commodities, and precious metals (primarily gold) also may be considered asset classes. Other asset classes might be included as well.

When the bells and whistles are stripped away, the main tenet of asset allocation is that investors should hold some combination of high-potential assets, mainly stocks, and some low-risk assets, mainly bonds. Various asset classes aren't *"correlated,"* so they won't all move in the same direction at the same time. Thus, investors expect to receive high long-term returns from stocks while their bonds will act to dampen overall portfolio volatility. Long-term, the ideology is that the right mix will produce an acceptable level of growth as well as tolerable downturns when stocks hit a rough patch.

However, severe bear markets have harmed investors who relied too heavily on asset allocation. Those within the first 5 years either before or after retirement have been hit the hardest. Younger people, still in the workforce and earning money, could look at bear markets as buying opportunities. Then, they prospered in the following bull markets. But that hasn't been true for retirees. Without earned income, investment opportunities are limited. In fact, retirees are spending down their portfolio. Thus, they have less to reinvest with each successive bear-and-bull cycle.

Asset allocation may work for investors in a growth mode, but retirees who need sustainable portfolio income probably will be better served with an Income Allocation strategy. With Income Allocation, the idea is for retirees to devote enough money to a vehicle that delivers an adequate amount of predictable, guaranteed income. The balance of a portfolio can be invested in stocks or other assets with growth potential. How much income do people need for a comfortable retirement? This answer depends on several factors, thus it is important to sit down with an experienced financial advisor to help you determine your specific needs.

HYPOTHETICAL EXAMPLE. If Brad and Wendy Baker spend $100,000 a year while they are working, their retirement goal might be having enough income to spend $100,000 a year. Assuming this hypothetical couple expects to receive a total of $60,000 a year from their Social Security benefits and from Wendy's pension from her years as a federal employee, they would need $40,000 a year from their retirement fund. Currently, the Bakers have $1 million in investable assets, in this example. Following the Income Allocation strategy, they might put half of their liquid assets ($500,000) into a fixed index annuity offered by a long-established, financially sound U.S. insurance company.

Here's how such a contract might work. In return for purchasing the contract and waiting seven years, the Bakers might be promised nearly $40,000 in cash flow each year for the rest of their lives, no matter how well or how poorly the chosen market index(es) perform. This strategy would be implemented to generate the desired $40,000 or even more each year. The payments would continue as long as either Brad or Wendy is alive.

In this Income Allocation example, the Bakers have purchased a fixed index annuity (FIA) with an income rider. This FIA's income rider offers immediate withdrawal opportunities to the Bakers. However, this withdrawal would be a small percentage of their purchase premium, enough to get them about halfway to their $40,000-per-year goal. That amount would be helpful, but the Bakers want the full $40,000 a year in retirement. In this example, the Bakers' initial $500,000 balance can increase through index-linked growth. Thus, the Bakers' FIA balance should increase over the years, if the linked market indexes show positive performance. Even modest growth could increase their $500,000 investment to $600,000 or more.

Moreover, the Bakers' FIA income rider increases the withdrawal percentage annually. If the Bakers wait, say, seven years and begin to take payouts in Year Eight, the payout percentage would be much higher than it is in Year One. ***Even with no growth in the FIA contract value, the higher withdrawal percentage could bring the Bakers close to their desired withdrawal amount.*** What's more, the higher withdrawal percentage in Year Eight, combined with even modest credited interest, could bring permitted withdrawals over $40,000 a year. Credited interest growth potential matching historic norms could generate even more retirement income, after this seven-year (surrender charge period) wait to begin withdrawals. ***In other words, with this Income Allocation strategy and a well-chosen vehicle, the Bakers need only a small financial market success, not a home run, to achieve their retirement income goal.***

OTHER RETIREMENT INCOME SOURCES

A comfortable retirement can be funded from multiple sources. These sources might include Social Security, a pension, a retirement plan such as an IRA or a 401(k), personal savings, annuities, and permanent life insurance. What's more, the list needn't stop there. Retirees can look for cash flow in other places, such as the following sources.

FREELANCE OR PART-TIME WORK

Freelance or part-time work can provide more than extra pocket money. Working also can help retirees remain healthy, physically and mentally and emotionally. Plus, other benefits may come from working after leaving a full-time job.

- **For early retirees.** People who retire before age 65 may lose employer-provided health insurance, yet they can't qualify for Medicare. If no coverage is available from a still-working spouse's employer, part-time work might include participation in a health plan. Meanwhile, freelancing could make health insurance premiums tax-deductible.

- **For retirees already collecting Social Security.** Additional work experience, covered by the Social Security system, could increase Social Security checks. Benefits are based on a worker's 35 highest-earnings years, adjusted to reflect rising costs. Earned income in, say, 2017 or 2018 might crowd out a low-paid year from the 20th century. If a worker doesn't have 35 calendar years of contributing to Social Security, any additional work could boost ongoing benefits.

  On the other hand, working for substantial income before full retirement age (now 66) might result in a deferral of Social Security benefits to future years. Once someone reaches full retirement age, earned income won't interfere with benefits, regardless of the amount involved.

REVERSE MORTGAGES

Retirees who own a residence may be able to tap their home equity for cash flow. The term *"reverse mortgage"* means that the lender is providing money rather than collecting mortgage payments from a homeowner. With a reverse mortgage, a homeowner might get a lump-sum, a line of credit, or regular monthly income. The amount borrowed will be secured by the home, so reverse mortgages are for homeowners with little or no debt on their home.

Most reverse mortgages are Home Equity Conversion Mortgages (HECMs), offered by private lenders to qualified borrowers age 62 or older, with the debt insured by the Federal Housing Administration. The amount a borrower might receive is determined by current interest rates, the borrower's age, and the amount of home equity. The older the borrower and the greater the amount of home equity, the more that can be borrowed on a reverse mortgage.

Many reverse mortgage calculators can be found online. Such a calculator might indicate that a married couple aged 68 could receive about $1,000 a month if they had a debt-free home valued at $325,000. Increase the ages to 78 and that couple might be able to get around $1,250 a month. (With older borrowers, it's likely that the lender will be repaid sooner.)

> *The [HECM loan] typically becomes due when the owner moves, sells the home, or stops using it as a primary residence.*

A HECM doesn't require any debt repayment while the owner lives in the home, no matter how large the loan balance becomes. The debt typically becomes due when the owner moves, sells the home, or stops using it as a primary residence.

A reverse mortgage borrower continues to bear the responsibilities of home ownership. For example, HECM borrowers still own their home, so they still must pay homeowners insurance premiums, property taxes, and any association dues. They must maintain the home so it can eventually be sold.

A recent change in federal rules requires reverse mortgage applicants to undergo a financial assessment in order to qualify for a loan. If borrowers are unlikely to be make all required ongoing payments, based on their assets and cash flow, the applicants may have to put money into escrow or they might be rejected for a HECM.

Reverse mortgages are considered loan advances and not income, so the amount received is not taxable. While reverse mortgage inflows are not taxable, any unpaid interest accrued on a reverse mortgage is not tax-deductible until the interest is actually paid, which is usually after a sale by the borrower, or after the borrower's death. The eventual deduction may be limited by the rules on home equity debt.

RENTAL PROPERTY

Yet another potential source of retirement income is rental property. A retiree with the time and the inclination might buy a home, a small apartment building, a strip shopping center, or some other type of real estate and rent it to tenants. ***Cash flow from rental property may be partially or fully sheltered from income tax.*** The rules regarding taxes and cash flow from rental property can be quite complicated, and it is important to have an experienced CPA as part of your team if you are going to do this.

As is the case with any type of real estate, location is the key to a good buy. Retirees may be able to carefully research a property, discover the amount a tenant is likely to pay, and negotiate an attractive price. Professional assistance can help retirees avoid missteps. It's best to work with a well-recommended real estate agent as well as an attorney experienced in this area. Rental property ownership is considered to be a *"passive activity,"* for tax purposes. Reported losses may or may not be currently tax-deductible.

HYPOTHETICAL EXAMPLE. Chris Johnson buys investment property for $250,000 and collects $1,200 in monthly rent: $14,400 a year. Chris pays $8,000 a year in cash for mortgage interest, insurance, and property maintenance, so his cash profit is $6,400 a year. Suppose that Chris also can claim $10,000 of depreciation deductions (which require no cash outlay). With $14,400 of rental property income and $18,000 ($8,000 plus $10,000) of tax-deductible expenses from the property, Chris has a net loss of $3,600 from this venture.

With a reported loss, a property owner won't owe tax on the rental income received. For Chris, that would mean be $6,400 of tax-free cash flow. The deal would be even better if Chris also can deduct his reported $3,600 loss from his other income. Generally, the ability to deduct such a loss depends on the property owner's adjusted gross income (AGI). A taxpayer can deduct losses up to $25,000 per year, but that opportunity phases out as AGI rises from $100,000 to $150,000.

HYPOTHETICAL EXAMPLE. If Chris Johnson has AGI of $99,000, he can deduct up to $25,000 of passive losses. Thus, he can deduct his $3,600 loss in full. Now suppose that Chris has $145,000 of AGI. That's 90% through the $100,000-$150,000 phaseout range, so his tax deduction would be limited to $2,500: 10% of the $25,000 maximum.

With AGI over $150,000, no passive activity losses from rental property can be deducted. Fortunately, rental property losses that can't be deducted currently are carried forward to future years. When the property ultimately is sold, all of the unused losses may be available to offset any tax due on the sale.

Another condition of deducting losses from a rental property relates to the taxpayer's role in managing the property. To deduct the loss, the property owner must "actively participate" in pursuing rental income. That doesn't mean the property owner has to answer midnight calls from tenants with leaking pipes. An active role, for this purpose, can mean making or approving decisions involving the property's operation and management.

Buying the right property at the right price can bring retirees a substantial source of monthly cash flow from tenants' rents, tax-free because of depreciation deductions. With income under $150,000 in retirement, tax deductions may make a good deal even better.

CHAPTER 1
CHECK FOR UNDERSTANDING QUIZ

1. ***The estimated average monthly Social Security benefit in 2020 is:***
   - **a.** $1,200
   - **b.** $1,461
   - **c.** $1,503
   - **d.** $1,660

2. ***Depending on your total combined income, up to 85% of your Social Security benefit may be subject to income tax.***
   - **a.** True
   - **b.** False

3. ***Required minimum distributions (RMDs) are required to be taken from both traditional IRAs and Roth IRAs.***
   - **a.** True
   - **b.** False

4. ***A stretch IRA can provide income for multiple generations after the death of the owner by using what process/strategy?***
   - **a.** Disclaiming
   - **b.** Converting
   - **c.** Relinquishing
   - **d.** Denying

5. ***Permanent life insurance such as whole life or universal life, in addition to a death benefit, offer living benefits that have the potential to offer tax-free distributions to supplement retirement income.***
   - **a.** True
   - **b.** False

6. ***Income can be generated from annuities by:***
   - **a.** Annuitization
   - **b.** Penalty free withdrawals
   - **c.** Guaranteed minimum withdrawal benefits (GMWB)
   - **d.** All of the above

ANSWERS. **1** - c. $1,503 **2** - a. True **3** - b. False **4** - a. Disclaiming **5** - a. True **6** - d. All of the above.

CHAPTER 2

RISK MANAGEMENT

RISK MANAGEMENT FOR RETIREES

Previous sections have focused on investments, and other financial products and strategies designed to provide income to retirees. As retirees have learned all too well, investments carry risks as well as potential rewards. Stocks can reduce dividends, or stop paying them altogether. Bonds may default. In a worldwide economic challenge, such as the one that crested in 2008, many types of investments can lose a large part of their value.

As explained, there are ways to reduce financial risk. Retirees may hold a diversified selection of assets, or invest through funds that hold many types of assets. Some financial products have federal guarantees against default. Others offer guaranteed cash flow, backed by established companies.

However, retirees face many other types of risks, beyond their savings and portfolio holdings. Broadly, retirees have health risks, for themselves and for their loved ones. They also have property risks, which might require costly repairs or replacement or paying damages to injured parties. Identifying and addressing non-investment risks can lead to a less stressful, more comfortable retirement. There are four ways to manage such risks: retain, reduce, avoid, or transfer them.

- **Risk retention.** Suppose, for example, that Julie Brown lives in the foothills of New Jersey, far from any significant body of water. Julie may decide not to purchase flood insurance, as the chance for flooding is so scant that she sees no need to purchase flood insurance. Similarly, Julie chooses not to buy a new car each year. She bears the risk that her 10-year-old car will break down, and will force her to buy a new one—meanwhile, Julie's existing car still runs well, and she's comfortable driving it.
- **Risk reduction.** Julie has her car checked every year, and has any flaws repaired. Replacing the tires periodically reduces the risk of an inconvenient—or even dangerous—blowout. Julie also abstains from drinking alcohol if she expects to be driving soon, which is another form of risk reduction.
- **Risk avoidance.** Julie has decided against having an in-ground pool in her backyard, avoiding the risk of accidents that could hurt herself, her guests, and any unwelcome visitors. And she looks both ways when she crosses the street! Julie also avoids smoking to avoid the health risks and possible unpleasant outcomes that might result.
- **Risk transfer.** Julie doesn't wish to retain, reduce, or avoid all risks. She wants to live in a house she owns, and she wants to drive a car. There are risks involved with these and other activities, so Julie transfers these risks by buying insurance. She pays premiums to insurance companies, for various coverages, and the insurer agrees to pay if certain events occur. ***Risk transfer is often combined with some other form of risk management.***

Julie's auto and homeowner's insurance policies have deductibles, which Julie will pay before coverage takes effect. Thus, Julie has retained some risk—the amount of the deductible—while transferring most of the risk to the insurance company, which will pay for excess damages. ***The higher a consumer's insurance deductible, and the risk borne by that consumer, the lower the premiums that consumer will pay.*** Therefore, the methods of managing risk described above are not mutually exclusive. Some risks may be partially transferred, partially retained or reduced.

HYPOTHETICAL EXAMPLE. Julie buys auto insurance and chooses a $1,000 deductible. Thus, she retains the risk of spending $1,000 a year if her car is dinged but transfers the risk of more expensive repairs to an insurance company. As mentioned, Julie does not drink and drive, which reduces both her risk of owing the $1,000 deductible and the insurer's risk of paying for expensive repairs. By walking rather than driving to nearby stores and friends' homes, Julie avoids the risk of driving her car on those outings. ***Julie would pay lower premiums with a $2,000 deductible, higher premiums with a $500 deductible.***

With any form of insurance, raising the deductible means the arrangement is closer is to pure insurance: protection against catastrophic expense. Someone choosing a high deductible should be ready to pay for minor damages as a necessary cost of owning a home, say, or a car. Meanwhile, the lower premiums are easier on the budget. Conversely, a low deductible locks in outlays for damages. Someone with a $500 deductible will pay the higher premium but know that further outlays are limited to $500, if a claim is filed.

Here are some basic coverages that most retirees will need, to manage common risks:

AUTO INSURANCE

Retirees who buy or lease a car will need auto insurance. This coverage can be purchased online or through an agent. ***An agent who helps with auto insurance probably will handle homeowners insurance as well, perhaps offering a discount for buying both policies from the same insurer.***

Auto insurance terminology can be confusing. A policy often will mention bodily damage liability, property damage liability, collision, comprehensive, personal injury protection, and underinsured motorist coverage. If retirees are not familiar with auto insurance, an agent can provide any needed explanation.

With auto insurance, liability coverage is vital, to protect drivers from lawsuits in case of an accident. Some states might require only $25,000 for liability coverage. However, industry and consumer groups may recommend bodily injury protection of at least $100,000 per person and $300,000 per accident. In addition to liability coverage, collision coverage pays for damages to the insured individual's car. Comprehensive coverage may provide reimbursement for theft or non-collision damages, such as repairs after a hurricane or after running over a coyote.

Considering the cost of cars these days, retirees probably will want insurance to protect their financial interests due to repairs and/or replacement expenses.

HOME INSURANCE

Retirees who own a home (including a condo or co-op apartment) should have homeowners insurance. Otherwise, renters' insurance is a good idea.

Buy enough coverage to provide the cost of rebuilding the home after a disaster. Don't worry about insurance for the cost of the land, which is unlikely to be destroyed. ***For an idea of how much insurance is needed, start by calling a local real estate agent or appraiser for data on building costs in the area.*** Then, estimate the amount of homeowner insurance that's needed by multiplying the home's total square footage by local building costs per square foot. With a 2,000-sq. ft. home, for instance, and local building costs for similar houses at $100 a square foot, $200,000 of home insurance might be sufficient.

Buy enough coverage to provide the cost of rebuilding the home after a disaster.

Standard homeowners' policies provide coverage for fire, lightning, hail, explosions and theft. However, these standard policies don't cover floods or earthquakes. ***Again, working with an agent can be helpful if you want those kinds of specialized coverage for a variety of natural disasters.***

Besides covering the house itself, retirees probably will want to cover what's on the inside. Standard homeowners' policies will cover losses if personal property is stolen or destroyed in a disaster. ***Special coverage may be needed to adequately cover special items such as jewelry, silverware, furs, and other collectibles.***

Again, homeowners will need liability coverage for any injuries sustained by other people on their property. Many homeowners' policies provide $100,000 worth of liability insurance but coverage of least $300,000 may be necessary in today's litigious atmosphere. ***Beyond auto and home liability coverage, excess liability (umbrella) policies generally provide much greater protection for a modest annual charge.***

HEALTH INSURANCE

Most people get their health insurance from work. After retirement, that can be a problem, unless the former employer offers continued coverage. ***Retirees age 65 or older typically can qualify for Medicare, which is discussed below.*** The years between retirement and age 65 can pose a problem for health insurance. Some retirees will have a spouse who still works at a firm that offers a family health plan. In that situation, retirees may get coverage through the spouse's employer until reaching 65. Even at age 65, when Medicare is available, an employer's health plan might be more desirable.

Without access to an employer's health plan, retirees younger than 65 will have to shop for coverage. One option is to look for coverage on the Affordable Care Act (ACA) exchanges. As of this writing, the ACA enrollment period runs from November 1 to December 15, for coverage in the following calendar year. Subsidies to help with premium payments may be available to retirees with low and moderate incomes.

Besides the government exchanges, there are private exchanges for health insurance. Retirees who don't qualify for ACA subsidies might find coverage there, at a reasonable price. Again, choosing among health insurance policies can be daunting. Some life insurance agents can help with policy selection, while there also are agents who specialize in health insurance.

CHOICES FOR CARE

As retirees may know from their days in the workforce, health plans often have a provider network. Retirees who are choosing among policies should pick one that includes their own doctors. Health insurance shoppers also can choose among high-deductible and low-deductible plans. As is the case with auto and health insurance, higher deductibles mean lower premiums but also greater exposure to various out-of-pocket costs.

MEDICARE

When seniors reach age 65, they usually become eligible for Medicare, the federal government's health care plan. Often, Medicare is a welcome choice for retirees who can't get coverage from an employer-sponsored plan. For new participants, open enrollment for Medicare starts three months prior to the individual's 65th birthday and stays open until three months after that birthday. Seniors should apply for Medicare as soon as they are eligible, as waiting may permanently increase the cost of monthly Medicare premiums.

Medicare Part A, which covers hospital insurance, is included when applying for Medicare. However, Medicare Part B, which covers medical services or supplies that are needed to treat medical conditions as well as preventative services, is a separate enrollment process. There are also other Medicare decisions that need to be made. For instance, Medicare enrollees might choose original Medicare. They also might feel the need to buy a "Medigap" supplemental plan. Otherwise, Medicare participants can elect a Medicare Advantage plan. With Medicare Advantage, the cost of a Medigap insurance policy can be avoided.

With original Medicare, ***seniors get to choose their doctors and hospitals that accept Medicare.*** However, original Medicare has coverage gaps. Enrollees in original Medicare typically will be responsible for 20% of the Medicare-approved amount for expenses such as doctors' charges and outpatient procedures; they'll also be responsible for the costs of prescription drugs. Such costs might reach thousands of dollars a year. To fill the gaps, retirees can turn to Medigap policies as well as to Medicare Part D prescription drug plans, both offered by private insurance companies.

Medicare Advantage plans, sometimes known as Medicare Part C, also come from private companies. These plans usually cover Medicare Part B charges, such as doctors' bills and other outpatient services; they also may include prescription drug coverage under Part D. ***Medicare Advantage fees and features vary widely, so shopping around can pay off.*** Typically, the overall cost of a Medicare Advantage plan will be lower than the cost of buying a Medigap policy, if a patient stays in the plan network. However, overall costs of a Medicare Advantage plan (including copays and any monthly charge) should be compared with the local costs of Medigap.

Some people choose original Medicare and a Medigap policy because their area lacks a good, affordable Medicare Advantage plan. Medigap policies range from Plan A to Plan N.

2020 MEDICARE COSTS AT A GLANCE[18]	
Part A Premium	Most people don't pay a monthly premium for Part A (sometimes called *"premium-free Part A"*). If you buy Part A, you'll pay up to $458 each month. If you paid Medicare taxes for less than 30 quarters, the standard Part A premium is $458. If you paid Medicare taxes for 30-39 quarters, the standard Part A premium is $252.
Part A Hospital Inpatient Deductible and Coinsurance	You pay: • $1,408 deductible for each benefit period • **Days 1-60:** $0 coinsurance for each benefit period • **Days 61-90:** $352 coinsurance per day of each benefit period • **Days 91 and beyond:** $704 coinsurance per each *"lifetime reserve day"* after day 90 for each benefit period (up to 60 days over your lifetime) • **Beyond lifetime reserve days:** all costs
Part B Premium	The standard Part B premium amount is $144.60 (or higher depending on your income). However, most people who get Social Security benefits will pay less than this amount ($130 on average).
Part B Deductible and Coinsurance	$198 in 2020. After your deductible is met, you typically pay 20% of the Medicare-approved amount for most doctor services (including most doctor services while you're a hospital inpatient), outpatient therapy, and durable medical equipment.
Part C Premium	The Part C monthly premium varies by plan.
Part D Premium	The Part D monthly premium varies by plan (higher-income consumers may pay more).

MEDIGAP PLANS

The chart below shows basic information about the different benefits Medigap policies cover.

Yes = the plan covers 100% of this benefit
No = the policy doesn't cover that benefit
% = the plan covers that percentage of this benefit
N/A = not applicable

MEDIGAP BENEFITS	MEDIGAP PLANS[19]									
	A	B	C	D	F*	G	K	L	M	N
Part A coinsurance and hospital costs up to an additional 365 days after Medicare benefits are used up	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Part B coinsurance or copayment	Yes	Yes	Yes	Yes	Yes	Yes	50%	75%	Yes	Yes***
Blood (first 3 pints)	Yes	Yes	Yes	Yes	Yes	Yes	50%	75%	Yes	Yes
Part A hospice care coinsurance or copayment	Yes	Yes	Yes	Yes	Yes	Yes	50%	75%	Yes	Yes
Skilled nursing facility care coinsurance	No	No	Yes	Yes	Yes	Yes	50%	75%	Yes	Yes
Part A deductible	No	Yes	Yes	Yes	Yes	Yes	50%	75%	50%	Yes
Part B deductible	No	No	Yes	No	Yes	No	No	No	No	No
Part B excess charge	No	No	No	No	Yes	Yes	No	No	No	No
Foreign travel exchange (up to plan limits)	No	No	80%	80%	80%	80%	No	No	80%	80%
*Out-of-pocket limit***	N/A	N/A	N/A	N/A	N/A	N/A	$5,120	$2,560	N/A	N/A

*Plan F also offers a high-deductible plan. If you choose this option, this means you must pay for Medicare-covered costs up to the deductible amount of $2,200 in 2017 before your Medigap plan pays anything.

**After you meet your out-of-pocket yearly limit and your yearly Part B deductible, the Medigap plan pays 100% of covered services for the rest of the calendar year.

***Plan N pays 100% of the Part B coinsurance, except for a copayment of up to $20 for some office visits and up to a $50 copayment for emergency room visits that don't result in inpatient admission.

(In Massachusetts, Minnesota, or Wisconsin, Medigap policies are standardized in a different way.)

Some Medigap policies, such as Plans L and N, include some cost-sharing: lower premiums for consumers, along with more exposure to medical bills. These plans might work well for people who don't use many expensive medical services. Otherwise, comprehensive Medigap plans, such as Plans F and C, have been popular. Medigap policies are lettered so that all insurers offering Plan C, for example, will provide the same list of features.

The need for Medicare decisions does not vanish. Seniors who are already enrolled in Medicare should review their coverage at the start of Medicare's annual open enrollment period (OEP). Currently, the OEP is from October 15 to December 7 each year. During the seven-week OEP, seniors can move to and from original Medicare, Medicare Advantage, and Part D drug plans for the following calendar year. Changing medical plans might result in a lower cost or a more appealing provider network. Similarly, changing Part D coverage might deliver lower costs for specific prescription drugs.

At medicare.gov/find-a-plan/questions/home.aspx, a *"Medicare Plan Finder"* helps seniors review and compare plans available in their area.

PAYING A PREMIUM

Another issue for seniors to address is the amount they pay for Medicare Part B, which covers medical costs other than hospital stays. In 2020, the *"standard"* premium is $144.60 a month. ***However, many enrollees pay less—an average of $130 a month, for seniors whose Medicare Part B premiums are deducted from their Social Security checks—because of technicalities in the Medicare rules.*** Additionally, some seniors pay anywhere from $202.40 to $491.60 a month, depending on income levels.

IF YOUR YEARLY INCOME IN 2018 WAS (FOR WHAT YOU PAY IN 2020)[18]			YOU PAY EACH MONTH (IN 2020)
File Individual Tax Return	*File Joint Tax Return*	*File Married & Separate Tax Return*	
$87,000 or less	$174,000 or less	$87,000 or less	$144.60
Above $87,000 up to $109,000	Above $174,000 up to $218,000	Not applicable	$202.40
Above $109,000 up to $136,000	Above $218,000 up to $272,000	Not applicable	$289.20
Above $136,000 up to $163,000	Above $272,000 up to $326,000	Not applicable	$376.00
Above $163,000 and less than $500,000	Above $326,000 and less than $750,000	Above $87,000 and less than $413,000	$462.70
$500,000 and above	$750,000 and above	$413,000 and above	$491.60

Those are per-person premiums. A married couple with joint income just over $174,000 in 2020 would pay a total of $404.80 a month ($4,857.60 a year) for Part B, if both are Medicare enrollees. Their neighbors, with income just under $174,000, might pay about $3,470 a year for the same Part B coverage. For Part B premiums, *"income"* has a special calculation. *"Tax-exempt"* income from municipal bonds and muni funds will be included in MAGI (Modified Adjusted Gross Income), for the purpose of calculating Medicare Part B premiums.

Income-boosting activities such as Roth IRA conversions and taking capital gains may also increase Part B premium expenses. The bill for higher Part B premiums will appear two years in the future: income reported on a 2020 tax return, for example, will determine Part B premiums in 2022. ***Therefore, planning for Part B premiums can be added to income tax planning for high-income seniors.***

HYPOTHETICAL EXAMPLE. Mike Roberts will receive a severance package when he retires from his long-time employer. Working with his financial advisor, Mike negotiates an arrangement to receive that income across several years, so he can stay below the income threshold for higher Part B premiums.

Whereas, Mike's neighbor, Jill Harris, has built up a Roth IRA over many years. In retirement, Jill takes tax-free cash from her Roth IRA in years where other income would push up her Part B premiums; Jill takes taxable income from her traditional IRA in years when her income is low enough to avoid the Part B surcharge.

Medicare Part D (prescription drug coverage) premiums also are income-tested. As a result, holding down income through savvy planning can save money on Part D as well as on Part B premiums.

LONG-TERM CARE INSURANCE

As the average life expectancy increases, so do the chances that retirees will need what's known as long-term care (LTC). Such care might take place at home, in an assisted living facility, or in a nursing institution.

HYPOTHETICAL EXAMPLE. Linda Martin is 90 years old. She may very well reach 95 or 100, and each year will increase the likelihood that someone will have to care for her. Such care might mean help with common activities of daily living (ADLs): bathing, dressing, eating, moving around, and using the bathroom. Even if Linda is physically able to do all of these ADLs, she still might need care because she could develop Alzheimer's or some other form of dementia. What's more, such care may be needed for many years. If that's the case, Linda will need LTC, and LTC can be expensive.

The Genworth 2016 Cost of Care Survey found that the median cost of homemakers and home health aides was $20 an hour. That's $240 for a 12-hour day, or twice as much for a full 24 hours of care. Even at $240 a day, that's nearly $88,000 a year.

If Linda no longer can stay in her home and must go to a nursing home, the national median cost for a private room is $253 a day, over $92,000 a year, and costs are escalating more rapidly than the general inflation rate.

No government program will pay those costs. Medicare covers medical bills, not LTC. The same limitation applies to the Affordable Care Act, known as Obamacare. It's true that Medicaid, a federal-state program, will pay nursing home bills, but Linda must have virtually no assets in order to qualify. In recent years, Medicaid has stepped up its efforts to keep people with assets from gaming the system to cover nursing home costs.

Our example uses 90-year-old Linda as someone who is likely to need LTC, but the extremely elderly are not the only ones who might be affected. Even the most athletic 60-year-old retiree can wind up incapacitated after a boating accident, for instance, so there's no age limit on vulnerability to paying the costs of LTC. When a retiree needs LTC, the total cost could potentially run into hundreds of thousands of dollars. Without proper coverage, individuals and couples could potentially run through all of their assets, wind up living frugally, and pass on little or nothing to their heirs.

Long-term care insurance coverage can come up short. One possible solution is to buy LTC insurance. Consumers pay a premium, just as they pay for auto or home insurance, and the insurance company would for any needed LTC. That was the concept, but the reality has proven to be disappointing. Insurers have discovered that they had been pricing LTC policies too low, so many companies stopped selling LTC insurance while those that stayed in the market have raised prices sharply, on new as well as existing LTC policies.

The average cost of an LTC insurance policy purchased at age 70 is nearly $3,000 a year. Such a policy might pay $150 a day, if LTC is needed. As mentioned, the national median charge for a private room in a nursing home is $253 a day. Residents with this typical $150-a-day LTC policy would have to make up the difference out of their own pocket, in an average nursing home. What's more, the policy offered for that price might pay benefits for up to four years. Someone with a longer need for care would then be paying for everything out-of-pocket, perhaps until running out of money and having to apply for Medicaid to get the LTC that's still necessary.

The average cost of an LTC insurance policy purchased at age 70 is nearly $3,000 a year. Such a policy might pay $150 a day, if LTC is needed. As mentioned, the national median charge for a private room in a nursing home is $253 a day.

Also, that $3,000 annual premium probably won't buy a policy that includes any inflation protection. That is, the benefit will remain at $150 a day. Thus, someone could buy this policy at age 70, pay $3,000 for 10 years ($30,000 in all) and go into a nursing home at age 80, when the median cost is, say, $350 a day. In that case, the nursing home resident would have to pay $200 a day, out of pocket, in addition to the $150 a day from the LTC insurance policy.

Yes, LTC insurance policies with inflation riders are available. That $150 daily benefit might increase to $160, $180, $200 per day, and so on. ***However, such policies are much more expensive, and could cost $3,500 or $4,000 a year, rather than $3,000, depending on the terms of the inflation rider.*** Paying $3,000 a year for 10 years might prove to be a good bargain if a retiree knew there would be a benefit from that policy. A one-year stay in a nursing home would trigger about $57,000 of insurance benefits, at $150 a day from the LTC policy.

If the insured individual needs care at some point, paying $30,000 in premiums over 10 years for $57,000 in benefits in Year 11 would be worthwhile, especially considering the benefits might be paid for four years. However, there is no way of knowing that someone will ever need LTC, so the policyholder might never collect any benefits. The same could be true for purchasing a LTC insurance policy with an inflation rider at a higher premium rate. There is no guarantee the LTC coverage will be needed.

The 70-year-old in our example could pay $3,000 a year in premiums for 10 or 20 years or longer and never need LTC, so there would be no benefits collected from the policy. A married couple could pay for two LTC insurance policies over a long time period and get little or nothing in return. Many retired couples might balk at paying about $6,000 a year or more for this chancy coverage.

HYBRID LTC INSURANCE

Instead of a standalone LTC insurance policy, many people prefer a *"combo"* product that includes an LTC rider. Here are two hypothetical illustrations of how a combo product might work:

- **Illustration 1.** Nora and Art Newton are retirees who still own significant portions of a family business. They hold permanent insurance policies on their lives, to fund buy-sell agreements. Their policies both have LTC riders. If either Nora or Art needs LTC, that individual's life insurance policy will provide a benefit to help pay for the cost of care. Regardless of whether that LTC benefit is used, those life insurance policies will pay a death benefit to the beneficiary at the insured individual's death.

- **Illustration 2.** Molly and Brett Oliver are retirees who are trying to balance their portfolios to find a mix of income, stability, and growth potential. They are leery of the bond market because of low yields and the risk of loss, if interest rates rise, so they put some of their money into a deferred annuity instead. Again, the deferred annuity has an LTC rider. Going forward, the annuity's rider will pay cash if either Molly or Brett needs LTC. In addition, Molly and Brett can tap the annuity for cash flow, if necessary. They also can leave that annuity to a beneficiary, who can realize any remaining value in the contract.

In both of these scenarios, there is no *"use-it-or-lose-it"* risk. These couples have acquired a valuable financial product, with the assistance of a knowledgeable financial professional. The selected hybrid products will pay out something in return for the premium paid. The purchasers will get some combination of retirement cash flow, LTC coverage, and death benefits, depending on what happens in their lives. ***Such combo products can be complex, so retirees should know what to look for.***

For retirees who are focused on life insurance, index universal life (IUL) insurance policies may offer attractive features. An appealing combo product might have a rider that allows access to a percentage of the policy's death benefit every month that LTC is needed. Coverage should be available if the care takes place in a nursing home, in an assisted living facility, or in a personal residence. Premiums should be guaranteed to age 90 or to a later age, so retirees won't have to worry about the premium increases that have been imposed on people with traditional standalone LTC insurance policies.

Alternatively, seniors might decide to fund a deferred annuity as part of their retirement planning. Couples could choose a fixed index annuity (FIA), with returns pegged to a major stock market index. Besides the FIA's guaranteed cash flow, as explained in the Retirement Income section, a combo FIA might have a rider that permits either spouse to tap the FIA contract for a multiple of the premium that was paid, if LTC is needed. ***Thus, this couple could get the retirement income they bargained for when they bought the FIA, plus even more cash if they need LTC.*** Naturally, retirees will pay for LTC protection in addition to life insurance or income from a deferred annuity. Nevertheless, the cost for such a benefit need not be onerous—the purchasers may be able to use a portion of the growth of the contract to pay the premiums.

With a well-chosen combo product, retirees might avoid portfolio depletion and lifestyle reduction while trimming exposure to LTC costs, which can shrivel bequests to heirs. Meanwhile, consumers may have either life insurance, to provide for surviving loved ones, or an annuity that can deliver ongoing cash flow over an extended retirement.

MANAGING RISK WITH LIFE INSURANCE

Life insurance plays a specific role in risk management: to reduce the risk—the consequences—of someone's death. To address that risk, the insurance policy will provide a substantial amount of cash to a named beneficiary or beneficiaries at the insured individual's death. Often, the need for life insurance begins when a child is born. Parents of young children, for example, will need life insurance if the death of a breadwinner will remove vital income from the family. ***That need may expire, when the children finish school and become independent, but other life insurance needs might still exist.***

For example, the co-owners of a small business might insure each other's lives so that the survivor will have enough money to buy company shares from the heirs of the first owner to die. In some cases, a loved one might have special needs, and life insurance can help provide for that person's well-being.

What about retirees? Do they really need life insurance? Perhaps.

Life insurance might provide ready cash to a new widow or widower, generating some time for a thoughtful transition to a new lifestyle. As mentioned previously in this course, some forms of life insurance can provide a source of untaxed cash flow in retirement. ***In some cases, life insurance might offer a plan for legacy equalization.***

HYPOTHETICAL EXAMPLE. Sandra Carson is a widow whose assets include a beach house in a prime real estate area. This home is valued well into six figures. Sandra would like to leave this beach house to her daughter Ruth, who lives nearby. Ruth's family goes to the beach house frequently However, this plan would deprive Sandra's son Phil, who lives across the country, of part of his inheritance. Sandra doesn't want to leave the beach house equally to her two children, as this would cause practical difficulties. Therefore, Sandra buys an insurance policy on her own life, payable to Phil. At Sandra's death, the insurance payout would compensate Phil for not receiving his share of the family vacation home.

TYPES OF POLICIES

Life insurance policies fall into two basic categories: group versus individual coverage. The former is often provided by employers as an employee benefit.

Many companies will pay the premiums for group life insurance, with little or no payment obligation for employees. Group life insurance usually has no health screening, so this may be an especially welcome benefit for someone with a medical condition that would generate high premiums, outside of the group.

At retirement, however, employees probably won't maintain group life insurance. Some employers offer retirees some options, such as retaining a certain amount of coverage or converting to an individual policy. Without such a choice, many retirees who want life insurance must buy their own policies as individuals. Such policies often are underwritten, meaning that the person to be insured must take a physical exam so the insurance company can get an idea of that individual's life expectancy. ***The premiums will be a function of age and health, with lower premiums for longer life expectancy.***

A MATTER OF TIME

When buying life insurance, one option is a term policy—a policy that is effective for a specific time period. Once that term expires, the insured individual may be able to renew the coverage or buy a different policy. ***Premiums probably will increase with the buyer's age.*** Historically, many people bought term insurance with annual premium increases. In recent years, multi-year term has gained popularity.

HYPOTHETICAL EXAMPLE. Someone might buy, say, 20-year term life insurance, with fixed premiums for the next 20 years. Realistically, retirees might not be able to buy term life for more than 20 years. With a need for insurance that's expected to last for a specific time, term insurance might be worth considering However, a retiree's life insurance needs might not have an expiration date. If so, term insurance may not be an astute choice.

LIFELONG COVERAGE

While term insurance might be considered basic insurance, *"permanent"* life insurance has other features. As mentioned in previous sections, these policies (whole life, universal life, and variable life) are designed to be in place indefinitely, or at least for many years. Permanent life policies usually have level premiums, which are higher than term premiums in the early years. Part of those early premiums go into savings, often called the cash value. At some point in the future, the actual life insurance cost will exceed the premiums paid. Then the cash value can be tapped to make up the shortfall, keeping the policy in force.

TAX TREATMENT

All life insurance policies—term and permanent—offer one tax break. The death benefit payout usually is not subject to income tax.

HYPOTHETICAL EXAMPLE. Dan Taylor buys a policy on his own life with a face value of $250,000. Over the years, Dan pays $20,000 in premiums, and then he dies. Dan's wife Barbara, his beneficiary, will collect the $250,000 death benefit and owe no income tax, even though there has been a $230,000 gain. (That $250,000 will be in Dan's estate, subject to estate tax, but current estate tax law makes it unlikely that any tax will be due.)

Beyond that tax benefit, permanent life insurance policies have two other tax breaks:

As mentioned in the course section on Retirement Income Sources, permanent life policies offer the potential for tax-free buildup, inside the cash value account. Within limits, policyholders can tap the cash value for tax-free cash flow, from withdrawals and policy loans. Therefore, permanent life insurance may be source of tax-free cash flow to retirees. In addition, these policies typically will deliver tax-free cash to the policy beneficiary, after the death of the insured individual.

Anyone considering permanent life insurance should be in for the long haul. Such policies have upfront costs, so it is vital to keep the insurance policy in force for years in order to make it worthwhile to pay those charges. Holding such a policy for 10 or 20 or more years will increase the likelihood of benefiting from tax-free accumulation and distributions.

In addition, someone buying any type of life insurance policy should feel confident that the insurer will be able to make the promised payments, perhaps many years in the future. Such caution is especially important with a permanent policy, as it should be kept in force for many years, perhaps offering access to the cash value in retirement. Therefore, buying a policy from a financially sound insurer is critical. Several ratings companies evaluate the financial strength of insurance companies. ***By working with a knowledgeable insurance professional, retirees can obtain a policy from a strong insurer and feel more confident the company will live up to its promises.***

DOUBLE PLAY

One variation of permanent life insurance is survivorship life, usually structured as whole life or universal life insurance. This coverage is known as second-to-die insurance because it insures two people, usually a married couple, and pays a death benefit after the second insured individual dies.

HYPOTHETICAL EXAMPLE. Lon and Sue Morgan buy a survivorship life policy. If Lon dies first, there will be no insurance payout. After Sue's death, then a death benefit will be paid to the couple's children.

Why would retirees want this type of life insurance? Possible reasons include:

- **Estate tax protection.** Very wealthy couples may owe substantial amounts of estate tax, typically after the second death. A life insurance payout then might help to cover the estate tax bill, so other estate assets can remain intact. The policy may be held in an irrevocable trust, so the death benefit won't be reduced by estate tax
- **Special needs.** A couple with a special needs dependent may want to provide for that disabled loved one, after they no longer can do so. An insurance payout might go to a trust, which would provide for the special needs individual.
- **Poor health.** A retiree might not qualify for life insurance, or be required to pay huge premiums, because of a short life expectancy. If that retiree has a healthier spouse, survivorship life coverage on both spouses might be available, with affordable premiums.

Generally, a retiree wishing to provide cash for beneficiaries other than a surviving spouse might consider survivorship coverage.

MAXIMIZING A PENSION WITH LIFE INSURANCE

It's true that traditional *"defined benefit"* pensions are becoming less common. Nevertheless, some retirees will still have defined benefit choices, especially if they have worked in the public sector. In many cases, a retiree who is married will have two payout options. One, he or she can take a monthly pension that lasts for the rest of the retiree's life. The second option will be a joint pension, one that will pay as long as either the retiree or the spouse is alive. The joint pension, though, will have a lower payout.

HYPOTHETICAL EXAMPLE. Mike Fowler retires and is offered a pension of $4,200 a month. Alternatively, he can get a joint pension that would provide monthly income as long as either he or his wife Diane is alive, but would pay only $3,500 a month.

In a "pension max" strategy, Mike would choose the higher single life pension and buy insurance on his life to protect Diane. With this plan, Mike and Diane would get the maximum pension payout as long as Mike is alive. If Diane dies first, Mike could cancel the life insurance (or change the beneficiary) and keep collecting his single-life pension. If Mike dies first, the single-life pension would stop. However, Diane would collect the life insurance death benefit, which she could tap for future cash flow.

Some of the excess cash flow from Mike's large pension can be used to pay the premiums for the insurance policy on Mike's life. Assuming Diane is the surviving spouse, she would get the policy's death benefit, probably free of income tax.

Pension maximization strategies may work well for some retirees, not so well for others. If the pensioner is relatively healthy, a substantial amount of insurance might be purchased for a reasonable amount. Also, the chances would be increased that the pensioner could live for decades, so the plump payout would flow in for many years. Conversely, a retiree in poor health might not be a good candidate for this strategy. In any case, some guesswork is involved.

How long will the pensioner live, collecting the maximum amount? If the pensioner is the first to die and the surviving spouse collects life insurance, how much ongoing cash flow would be available to the survivor then, from the purchase of an immediate annuity?

Retirees should review the details and any projections carefully before implementing a pension maximization strategy. Health insurance also should be considered. If the surviving spouse would lose attractive retiree medical coverage after the death of the single-life pensioner, choosing this strategy may not be a good choice.

CHAPTER 2
CHECK FOR UNDERSTANDING QUIZ

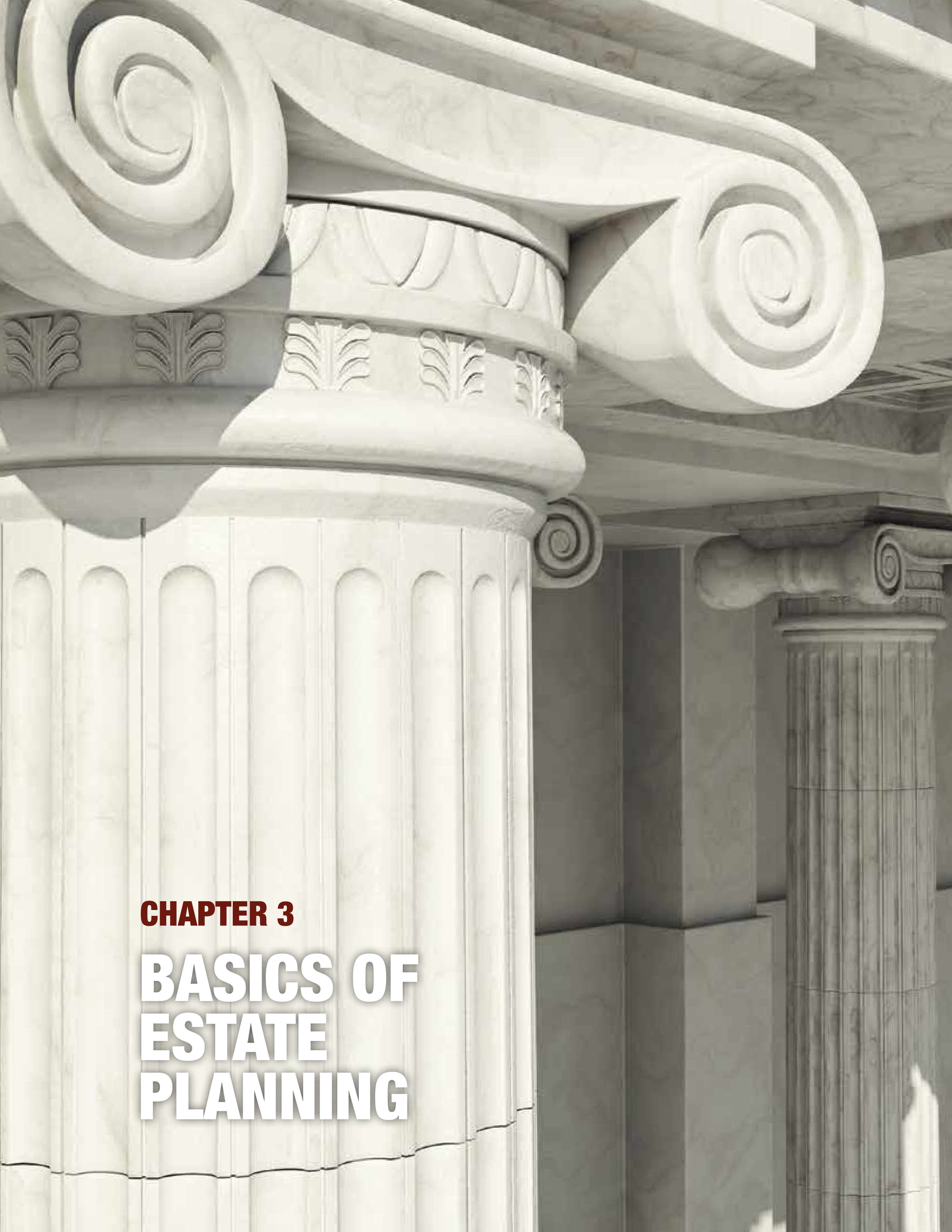
1. ***Medicare is the federal government's health care plan and offers coverage for long-term care expenses.***
   - **a.** True
   - **b.** False

2. ***Standard homeowner's insurance policies cover all of the following except:***
   - **a.** Fire
   - **b.** Theft
   - **c.** Flooding
   - **d.** Hail Damage

3. ***The current Medicare open enrollment period is from October 15 to December 7 each year.***
   - **a.** True
   - **b.** False

4. ***Death benefit proceeds from life insurance policies are:***
   - **a.** Taxed as capital gains
   - **b.** Taxed as ordinary income
   - **c.** Income tax free
   - **d.** Taxed only at the federal level

ANSWERS. **1** - b. False **2** - c. Flooding **3** - a. True **4** - c. Income tax free



CHAPTER 3

BASICS OF ESTATE PLANNING

LEAVING A LEGACY

The *"Die Broke"* phenomenon seems to be catching on. Entering the phrase on Google results in more than 100,000 hits. One recent survey found that 30% of American male retirees (and 17% of their female peers) plan to *"spend it all"* rather than pass wealth down to future generations.[20] The idea seems to be that retirees should live their life to the fullest, spending freely and supporting favoring causes, rather than *"spoiling"* their children and grandchildren with ample bequests.

One recent survey found that 30% of American male retirees (and 17% of their female peers) plan to *"spend it all"* rather than pass wealth down to future generations.[20]

WHY ESTATE PLANNING IS IMPORTANT

It may be an entertaining idea, but the truth is that few successful people will deplete all of their wealth before they depart. Most retirees want to save some money so they don't run short of cash, and they also want to leave substantial assets to their loved ones. ***Retirees may feel a sense of accomplishment in knowing that they have done all they could to wealth transfer to loved ones as easy as possible if that is their ultimate goal when they pass.***

In short, many retirees may want to leave a legacy behind them. Besides leaving significant assets, they tend to want those assets to go to their chosen relatives, friends, and chosen charities. Moreover, this group of retirees likely prefers the transfer to heirs to go as smoothly as possible. Ideally, survivors will value their bequests and avoid squabbling over possessions. ***And, not least of all, people who die with what might be considered wealth also want to avoid saddling their loved ones with steep taxes and legal bills.***

KEY CONSIDERATIONS

An effective estate plan begins with an idea of where assets should go, after death. To put the plan in place, valid legal documents are vital. Perhaps the most important:

A WILL

A surprising number of people with significant assets die *"intestate,"* meaning that they leave no will. When that happens, the decedent's assets will be distributed according to state law, and those provisions probably won't be exactly what the decedent had in mind. Therefore, retirees should have a formal will, drafted by an experienced attorney. After major life events (marriage, divorce, birth of a child or grandchild, death of an heir named in the will), individuals should revisit the will and make any necessary changes.

Among the provisions of a well-drafted will, an executor (or personal representative) should be named. This person will be responsible for handling the actual transfer of assets after the death and dealing with any legal issues, such as filing tax returns. The person named should be well-organized and good with paperwork. Most of all, he or she must be willing to serve, so it's vital to get a prospective executor's consent before naming someone in the will, and name a backup just in case something unexpected happens in the future.

IN CASE OF INCAPACITY

A will drives someone's estate plan at death. Perhaps just as important in an estate plan are precautions taken to protect assets against the possibility of an occurrence that will lead to financial incompetence.

Many retirees are living longer now, but they're not always living better. Through illness or injury, it's possible that someone might not be able to live independently. Consequently, incapacity planning has become part of estate planning. Someone whose net worth is diminished by poor health or poor decisions may leave a lot less wealth to loved ones.

A person making plans for incapacity should consider creating a revocable trust, a financial power of attorney and a medical power of attorney.

REVOCABLE TRUST.

In recent years, a common estate planning technique has emerged: the transfer of assets to a revocable trust. Such trusts, also known as *"living trusts,"* may be used as a partial will substitute.

HYPOTHETICAL EXAMPLE. Rick Lane creates a revocable trust and transfers his investment accounts, bank accounts, annuities, real estate, small business interests, and valued possessions to the trust. The trust is structured so that Rick can manage the trust assets and receive distributions from the trust. If Rick becomes unhappy with this arrangement, he can revoke the trust (that's why this is called a revocable trust) and bring the trust assets back into his own possession. Assuming Rick dies with the trust still in place, the trust assets will go to beneficiaries designated in the trust documents.

What does this accomplish? At Rick's death, all of the trust assets will pass directly to the beneficiaries he has named in the trust. There will be no probate, which is a legal process that may be expensive and time-consuming. In addition, moving assets into a revocable trust provides Rick with some incapacity protection. In case he become ill or injured, unable to manage his own finances, a co-trustee or successor trustee can take over the management of trust assets; that individual will have a legal responsibility to manage the assets to serve Rick's best interests.

Even though many assets can go into a revocable trust, everything can't go in there. IRAs, for instance, can't be transferred into a trust without triggering the deferred income tax. Thus, even if retirees have a revocable trust, they still need to periodically check the beneficiary designations for other assets that will pass to beneficiaries.

What's more, it's likely that all of an individual's assets won't go into a revocable trust. Even with such a trust, retirees also should have a *"pour-over"* will, which will make sure that any assets still hold outright, in an individual's own name, can go into the trust at death. Then those assets also will be distributed, as per the terms of the revocable trust. Thus, people who create revocable trusts may have a head start on incapacity planning. The assets held in such a trust can be managed by a reliable person who has been named in advance, if the trust creator no longer can be responsible for making astute decisions.

Regardless of whether retirees have a revocable trust, they should consider adding these items to their incapacity plan:

FINANCIAL POWERS OF ATTORNEY

With a financial power of attorney, an individual appoints someone else to act as his or her agent. This *"attorney-in-fact"* can enter into financial transactions on behalf of the person who created the power. With a financial power of attorney, the designated agent can pay bills, handle investments and so on.

A *"durable"* power of attorney is designed to be effective immediately, and to stay in effect in the event of the individual's incapacity. Naturally, retirees will their agent to be someone who can be trusted to do what's best. If a senior is reluctant to have a durable power of attorney in place while he or she is in good health, an alternative is a *"springing"* power of attorney. This document will become valid only after certain events have occurred. A springing power might go into effect only after two doctors have formally stated that the principal is no longer capable of handling personal financial matters.

The "attorney-in-fact" can enter into financial transactions on behalf of the person who created the power.

MEDICAL POWER OF ATTORNEY

Also known as a health care proxy, this may be a separate document from a financial power of attorney; the medical power is concerned only with the principal's health care. This document enables someone who has been named to make decisions about medical treatment, if the principal can't do so. A related document is a *"living will,"* which has no direct bearing on financial decisions. A living will specifies someone's preferences about whether or not life-sustaining measures are to be used, in dire circumstances.

A retiree's doctors and close relatives should know if that individual has executed these medical documents and, if so, where they are kept. At Internet sites such as caringinfo.org, retirees can download the forms and instructions for their state's advance directives, as these medical documents sometimes are known.

DISTRIBUTING ASSETS AFTER DEATH

It's true that having a will is vital for effective asset distribution after death. However, some types of assets aren't covered by a will. These asset types include:

DIRECT TRANSFER ASSETS

Many assets will go to beneficiaries named elsewhere, no matter what it says in the will.

HYPOTHETICAL EXAMPLE. Alice Perkins filled out a beneficiary form when she first opened her IRA, naming Alice's brother as the beneficiary. Over the years, Alice has accumulated substantial worth and drafted a will saying that everything should go to her daughter. If Alice has never changed that beneficiary designation, her IRA will go to her brother, despite what it says in Alice's will. The same principle applies to other assets such as life insurance, annuities, payable-on-death bank accounts and transfer-on-death investment accounts.

For a truly solid asset transfer plan, retirees should check beneficiary designations periodically, to make sure these designations reflect their current estate planning intentions.

JOINTLY HELD ASSETS

Some people plan for incapacity by having someone become a co-owner of a senior's bank or investment accounts. If that senior should become incapacitated, the co-owner can write checks to pay bills, sell assets, and generally handle those accounts as the original sole owner would have done. ***However, adding someone to bank and investment accounts as co-owners can jeopardize an asset transfer plan.*** It's true that such an arrangement can be a handy way to anticipate possible incapacity.

There are two common legal types of co-ownership—tenancy in common (TIC) and joint tenancy with right of survivorship (JTWROS). Each type has its own purpose and characteristics. Most people who add a co-owner end up choosing JTWROS—either by default or intentionally. The often-overlooked effect of such a change is that the new co-owner may inherit the entire account, no matter what it might say in the original owner's will.

HYPOTHETICAL EXAMPLE. Todd Williams, who has no children, intends to leave his assets equally among his nieces and nephews. However, Todd names his niece Debbie, who lives nearby, as a JTWROS co-owner of all his bank and investment accounts, so Debbie can handle Todd's finances, if necessary. With this arrangement, Debbie will inherit all of those accounts at Todd's death. The other nieces and nephews won't get any of those assets.

In such a situation, retirees might want to limit co-ownership to a relatively small checking account, which can be used for paying bills. ***Real estate and other assets that are owned JTWROS will go to the surviving co-owner, regardless of what's in a will.***

TRUST-WORTHY TACTICS

Revocable trusts can help a person deal with possible incapacity. Here's an incomplete list of other types of trusts and how they might be used:

- [ ] **Testamentary trust to protect minor children.** Created by a will. Provides temporary supervision of money intended for the benefit of a minor, but can last past majority.
- [ ] **Irrevocable life insurance trust.** Allows the grantor to provide liquidity for taxes, without subjecting the proceeds to taxes. Grantor should not act as trustee. Can also be useful if heirs might be irresponsible with proceeds or there is a need for detailed distributions with multiple beneficiaries.
- [ ] **Asset protection trust.** Used to limit liability exposure for assets within the trust from the grantor's creditors. Must be irrevocable, for the discretionary use of the grantor, and ultimate use of the grantor's family
- [ ] **Special needs trust.** Used for individuals with special needs that qualify for government benefits. When properly drafted SNT's provide benefits that do not add to the individuals countable assets.
- [ ] **Charitable trusts.** Used to provide funds to a charity, usually in the form of a charitable remainder trust (CRT). Donor usually receives the income interest for life or a set number of years, after their death the remainder goes to the charity. Provide income tax benefits. No capital gains on assets inside the CRT, immediate charitable deduction equal to the value of the donation minus the present value of the income stream, and the donor's estate receives a deduction

A knowledgeable financial professional may be able to help you put all of these pieces together, including LTC insurance. A complete plan covering possible incapacity as well as death, with the proper insurance in place, can help retirees feel more confident about their future.

AVOIDING PROBATE

The asset distribution techniques described in this section fall into two broad categories. Assets transferred under a will are known as probate assets, because they go through a legal process that can be costly and time-consuming. That's not the case with assets passing to named beneficiaries, assets held jointly with right of survivorship, and assets passed to a trust during the owner's lifetime. Such assets are either out of the decedent's possession already, or they pass directly to a new owner without going through probate.

Here's how probate assets, passing through a will, compare with assets held in trust:

COMPARISON CHART: WILLS, TRUSTS, LIVING WILLS, AND POWER OF ATTORNEY

	LAST WILL	LIVING TRUST	LIVING WILL	POWER OF ATTORNEY
Also Known As:	Will, or Last Will and Testament	"Inter Vivos" Trust	Advance Directive, or Health Care Directive	Durable Power of Attorney
Specify your last wishes and appoint someone to carry them out.	X	X		
Transfer your assets to beneficiaries after your death	X	X		
Transfer your assets into a trust while you're alive so they pass to beneficiaries once you're gone.		X		
Name guardians for minor children.	X	X		
Avoid probate.		X		
Make decisions about life support and organ donation in advance.			X	
Name someone to handle your financial and legal affairs.				X
Name someone to manage your healthcare.			X	

ESTATE TAX PLANNING BASICS

By the time people retire, they probably know quite a bit about federal income tax. Retirees might not know as much about federal estate tax, and misconceptions may be prevalent.

In brief, when someone dies, all of his or her assets must be tallied. If those assets reach certain amounts, the estate will owe federal estate tax. ***Many exemptions reduce the reach of federal estate tax.*** Bequests to recognized charities are not included in a decedent's taxable estate. The same is true for assets left to a spouse who is a U.S. citizen.

HYPOTHETICAL EXAMPLE. Wayne Jordan dies with a $2 million net worth. He leaves $200,000 to various charities and the balance to his wife Valerie. Wayne's estate owes no federal estate tax, as he has a zero taxable estate. The same would be true if Wayne died with a $20 million net worth, or $200 million, assuming all of his assets go to charity and to his spouse.

Leaving assets to a spouse essentially defers estate tax, as a widow(er) who dies while unmarried may have a large taxable estate. However, not all assets are left to a spouse or to charity. Other assets also may be shielded from federal estate tax with a tax exemption. The federal estate tax exemption for deaths in 2020 is $11.58 million. Married couples may be able to pass twice that amount—$23.16 million—to their heirs without triggering estate tax.

2020 Annual Gift Tax Exclusion	$15,000
2020 Estate Tax/Lifetime Gift Exemption	$11,580,000 – 40% top tax rate

TAXABLE ESTATE[21]	TAX RATE
$0 – $10,000	18%
$10,001 – $20,000	20%
$20,001 – $40,000	22%
$40,001 – $60,000	24%
$60,001 – $80,000	26%
$80,001 – $100,000	28%
$100,001 – $150,000	30%
$150,001 – $250,000	32%
$250,001 – $500,000	34%
$500,001 – $750,000	37%
$750,001 – $1,000,000	39%
$1,000,001 +	40%

A relatively recent addition to the tax code, commonly known as portability, can make it easier for married couples to get the full tax benefit.

HOW THINGS USED TO WORK

Historically, married couples may have created special trusts to reduce estate taxation. They also may have shifted assets between spouses, so that the plan would be helpful, no matter which spouse would be the first to die.

HYPOTHETICAL EXAMPLE. Harry Gordon dies in 2020 with an $12 million estate, including his real estate, retirement plans, investments, and business interests. If Harry leaves everything to his wife Fran, no estate tax will be due. Suppose that Fran dies a few years later. With the assets she inherited from Harry and her own holdings, Fran dies with a net worth of $18 million. If the federal estate tax exemption for the year of Fran's death has risen to, say, $12.5 million, Fran's $18 million estate would be $5.5 million over the exemption amount then in effect.

Assuming the current 40% estate tax rate on nonexempt assets is still in effect, Fran's estate would owe $2.2 million in federal estate tax (40% of $5.5 million). The Gordons' children, who are Fran's heirs, might have to sell some assets at distress prices in order to raise the $2.2 million to pay the tax bill. In order to avoid such a tax, the Gordons might have set up trusts, such as the A and B trusts, to receive some assets at the first spouse's death. Their plan might have called for the bequests to the trusts to be covered by the estate tax exemption. Harry also might have given some assets to Fran, so that assets would move into the trusts, no matter whether Harry or Fran would be the first to die

USING PORTABILITY

As mentioned, estate tax exemption portability is now available to married couples. Trusts and asset transfers may not be needed.

HYPOTHETICAL EXAMPLE. Planning to use portability, Harry Gordon does not put trusts into his estate plan. Instead, Harry leaves his $12 million estate outright to Fran. ***In addition, at Harry's death in 2020, the executor of Harry's estate files a federal estate tax return, IRS Form 706, electing to transfer the deceased spouse's unused exclusion (DSUE) amount to Fran, as the surviving spouse.***

If Harry has not made any gifts in excess of the annual gift tax exclusion amount (explained below), his entire $11.58 million DSUE will be transferred to Fran. If Fran dies in a year when the exemption amount is $12.52 million, she will have a $24.1 million federal estate tax exemption: her own $12.52 million plus $11.58 million from Harry. (Again, this assumes that neither Harry nor Fran made any taxable gifts.)

If Fran dies with $18 million in net worth, her $24.1 million exemption will allow all of her assets to go to their children. If Fran were to die with $24.11 million in net worth, her $24.1 million exemption would allow almost all of her assets to go to their children with scant estate tax. Fran's estate would be .01 over the limit and would owe just $4,000 in estate tax (the 40% estate tax rate times the $10,000 that Fran's estate would be over the limit), with portability.

WEIGHING PORTABILITY

Besides estate tax savings, portability may offer income tax advantages. Appreciated assets held by Harry can be passed to Fran with a basis step-up to current value.

Years later, at Fran's death, those assets may get another basis step-up. Then their children would owe no capital gains tax on a sale at the date-of-death price. ***This type of double basis step-up wouldn't be available to the Gordons' heirs with a traditional A-B trust strategy.***

Nevertheless, there can be reasons to use trusts rather than rely on portability. Leaving assets outright to Fran might not be advisable, say, if she is starting to show signs of dementia. An experienced advisor and an estate planning attorney can help retirees decide whether to use portability, use traditional trusts, or use some combination of both approaches.

QTIP TRUSTS FOR REMARRIAGES

As described, portability may offer estate tax planning opportunities for retirees. Things might look different, though, for retirees who are in a second (or even a third!) marriage.

In the above examples, Harry Gordon leaves his assets to his wife Fran. But what if Harry is reluctant to do so, because Fran may not pass on those assets to Harry's children from a prior marriage?

One solution for remarried retirees is to use a qualified terminable interest property (QTIP) trust. A QTIP trust allows the grantor to (1) provide funds for a surviving spouse and (2) name the ultimate trust beneficiaries. Often—but not always—the second beneficiaries are children of the first spouse to die.

HYPOTHETICAL EXAMPLE. Eric Duncan's will creates a QTIP trust, to be funded with most of Eric's assets. Eric's second (and current) wife Lois will receive all of the income from the QTIP trust, for as long as she lives. At Lois' death, any assets remaining in the trust will go to Eric's children from a prior marriage. Thus, Eric provides for his widow without disinheriting his own children.

Although Lois will be assured of cash flow for the rest of her life, she won't be able to direct the QTIP trust assets to her own children, from her first marriage. Eric will be assured that his children will receive whatever is left in the QTIP trust after Lois dies. Of course, Lois can have her own QTIP trust, with lifelong income to Eric and the remaining trust assets going to her children.

TAX TREATMENT

Assets left to a properly structured marital trust—one that benefits the surviving spouse—may be exempt from estate tax, the same as an outright bequest to a spouse. Thus, assets passing to a well-drafted QTIP trust will be exempt from estate tax, regardless of the amount involved.

Any estate tax would be due at the death of the second spouse.

Because the federal estate tax exemption is now up to almost $22.36 million, with portability, federal estate tax deferral is no longer vital to most retirees. That said, there can be other reasons for married couples—even those in a first marriage—to use a QTIP trust. For one, deferring state estate tax might be desirable. Many states have their own estate tax or inheritance tax, with smaller exemptions. A couple with combined net worth of $3 million might owe hundreds of thousands of dollars in state estate tax, depending on where they live ***In some states, then, deferring estate tax through a QTIP trust could be worthwhile.*** In addition, there also may be income tax advantages to using a QTIP trust.

HYPOTHETICAL EXAMPLE. Nick and Olivia Landis have been married for many years. Now they're both retired, with grown children. Assume that Nick dies first and Olivia dies a few years later. When the QTIP assets pass to their children, those assets will include some that have appreciated. The children will inherit with a basis step-up to current value, reducing or eliminating income tax on a future sale.

When their children inherit QTIP trust assets from retirees, the heirs may be established in their careers, in high income tax brackets. By reducing or eliminating taxable gains at what could be steep future tax rates, the QTIP structure could offer significant tax savings.

PROPERTY PROTECTION

QTIP trusts, like many types of irrevocable trusts, can offer asset protection. Maintaining assets left to a widow or widower might be more valuable than tax deferral.

Continuing the above example, assume that both Nick and Olivia have estate plans that will move their assets into QTIP trusts when they die. Whoever dies first, the surviving spouse will get all the trust income.

With both trusts, a local bank will act as trustee, charged with seeing that the surviving spouse has necessary cash flow. Funds left over ultimately will go to their children. With this plan, it won't matter if, say, Nick dies first and Olivia remarries. Their children won't see Nick's assets going to a stepfather or stepsiblings. ***Control of QTIP assets by the trustee will reduce the chance of poor investments, unwise spending, or other squandering by the surviving spouse.***

TRUSTEES MUST TREAD CAREFULLY

One possible issue with QTIP trusts is the conflict of interest between the surviving spouse and the secondary beneficiaries. The former probably will want maximum income, even if it means holding assets with low growth potential, and may want to get extra cash from the trust, for certain expenses. Meanwhile, the ultimate beneficiaries will want more growth from the trust investments, even if that means less current income. In addition, children from a first marriage might chafe at the idea of waiting for years—even decades—for the surviving spouse to die before receiving an inheritance. ***Therefore, retirees planning on using QTIP trusts should devote time and effort to supporting the trust.***

- ☐ The trustee should be told about the grantor's investment wishes, which might be a mix between generating income for the surviving spouse and trying to provide a substantial amount of trust assets to the ultimate beneficiaries.
- ☐ Also, the secondary beneficiaries' near-term financial concerns should be addressed, perhaps through life insurance or through a bequest of assets beyond those left in the trust.

DON'T OVERLOOK THE GIFT TAX

Federal estate tax is *"unified"* with a gift tax. That is, making gifts may impact future estate tax. In 2020, the annual gift tax exclusion amount is $15,000. In other words, every individual can give away up to $15,000 worth of assets, with no tax consequences, to any number of recipients. ***As long as gifts stay under the limit, there is no need to file a gift tax return.*** Married couples can give up to $30,000 per recipient, from a joint account. They also can split gifts, meaning one spouse can use the other spouse's $15,000 exclusion, but some paperwork will be involved.

HYPOTHETICAL EXAMPLE. Al and Eve Hart have two grandchildren. In 2020, Al can give $15,000 worth of assets to their grandson Ivan and $15,000 to their granddaughter Gina. Eve can do the same, moving a total of $60,000 from their taxable estate. Alternatively, Al can give the grandchildren $60,000 of his own assets. Then the couple must file a gift tax return, to demonstrate that Eve agrees to this use of her annual gift tax exclusion. ***Larger gifts can have tax consequences.*** Gifts in excess of $15,000 also require a gift tax return. They also reduce the giver's estate tax exemption, which is how estate and gift taxes are unified.

HYPOTHETICAL EXAMPLE. George Morris makes total lifetime gifts of $500,000 in excess of his annual exclusion allowances. If George dies when the federal estate tax exemption is $6.2 million, his estate's exemption will drop by $500,000, from $6.2 million to $5.7 million.

Typically, people won't have to pay gift tax. There's a lifetime gift tax exemption to match the estate tax exemption: $11.58 in 2020. ***Gifts over the exemption amount are taxed at 40%...with the tax paid by the giver.***

The annual gift tax exclusion is *"use it or lose it."* If someone fails to make $15,000 annual exclusion gifts in 2020, he or she can't double up with a $30,000 exclusion gift in 2021. What's more, checks must be cashed by December 31 in order for a gift to qualify in that taxable year. Therefore, retirees shouldn't wait until the last minute to make annual exclusion gifts.

LIFETIME VS. ESTATE PLANNING FOR CHARITY

When people are alive, donating appreciated assets to charity can save tax. If the donated assets were held for more than one year, the donor will get a deduction for the assets' current value and the appreciated assets won't generate income tax.

HYPOTHETICAL EXAMPLE. Bonnie Carson wants to donate $20,000 to her favorite charity. Instead of writing a check for $20,000, Bonnie donates $20,000 of stock that she bought years ago for $8,000. Bonnie receives a $20,000 tax deduction for the donation and the $12,000 gain is never taxed. Meanwhile, Bonnie leaves her traditional IRA untouched, so investment income inside the account will go untaxed. That's a savvy strategy for now, but when Bonnie prepares her estate plan, she reverses course. Bonnie wants to make a large bequest to her favorite charity, and this is her plan:

- Rather than use appreciated assets for this bequest, Bonnie decides to donate money from her IRA.
- While Bonnie earmarks IRA dollars for this substantial donation from her estate, she plans to retain some of her highly appreciated assets.

Either way, a charitable bequest will remove the amount donated from her taxable estate. If that's the case, why donate IRA money at her death, instead of appreciated assets?

HYPOTHETICAL EXAMPLE. To understand her reasoning, suppose that Bonnie dies with a $400,000 net worth. Her only assets are a $200,000 traditional IRA and $200,000 in highly appreciated securities. Suppose that Bonnie follows her lifetime path and leaves her $200,000 traditional IRA to her daughter Karen and her $200,000 of appreciated assets to charity. After Karen inherits the traditional IRA, she will have to pay income tax on all distributions from that retirement account. ***If Karen's effective income tax rate is 45%, her net inheritance will be only $110,000 (55% of the $200,000 IRA), aftertax.***

HYPOTHETICAL EXAMPLE. This time around, follow Bonnie's actual estate plan. She leaves her $200,000 traditional IRA to charity and the $200,000 of appreciated assets to Karen. ***The charitable recipient can withdraw the $200,000 from Bonne's IRA and owe no income tax, as a tax-exempt charity***. Thus, the source of the bequest makes no difference to the charity. Karen, on the other hand, will come out ahead if she inherits the appreciated assets.

Under current law, the appreciated assets would get a basis step-up to the fair market value on the date of Bonnie's death. Karen could sell the appreciated assets for their $200,000 market value and owe no tax, as her basis (cost for tax purposes) would be the $200,000 date-of-death value.

The key to this strategy is the principle that leaving a tax-deferred retirement account to a human beneficiary means leaving a built-in tax obligation as well. Making charitable bequests from an IRA is a better idea, because a charity won't owe the deferred income tax. If practical, holding onto appreciated assets and low basis assets such as depreciated property until death is tax-efficient. Heirs will get a basis step-up so capital gains tax during the decedent's lifetime can be avoided.

CHAPTER 3

CHECK FOR UNDERSTANDING QUIZ

1. ***Intestate is used to describe a person who has died without having made a will.***

   a. True
   b. False

2. ***Irrevocable trusts are typically designed to provide:***

   a. Protection from creditors
   b. Protection from assets being squandered by beneficiaries
   c. Various tax benefits
   d. All of the above

3. ***In 2020, the federal estate tax exemption per individual is:***

   a. $4.5 million
   b. $5.49 million
   c. $11.58 million
   d. $12.29 million

ANSWERS. **1** - a. True **2** - d. All of the above **3** - c. $11.58 million

NOTES

GLOSSARY

TERM	DEFINITION
12B-1 FEES	A 12b-1 fee is an annual marketing or distribution fee on a mutual fund. The 12b-1 fee is considered to be an operational expense and, as such, is included in a fund's expense ratio. It is generally between 0.25 and 1% (the maximum allowed) of a fund's net assets. The fee gets its name from a section of the Investment Company Act of 1940.
401(K)	A 401(k) plan is a qualified employer-established plan to which eligible employees may make salary deferral (salary reduction) contributions on a post-tax and/or pretax basis. Employers offering a 401(k) plan may make matching or non-elective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings in a 401(k) plan accrue on a tax-deferred basis.
403(B)	A 403(b) plan is a retirement plan for specific employees of public schools, tax-exempt organizations and certain ministers. These plans can invest in either annuities or mutual funds. A 403(b) plan is another name for a tax-sheltered annuity (TSA) plan. The features of a 403(b) plan are comparable to those found in a 401(k) plan.
457 PLAN	A 457 plan is a non-qualified, deferred compensation plan established by state and local governments and tax-exempt governments and tax-exempt employers. Eligible employees are allowed to make salary deferral contributions to the 457 plan. Earnings grow on a tax-deferred basis and contributions are not taxed until the assets are distributed from the plan.
ADDITIONAL 10% FEDERAL TAX	Early distributions, prior to age 59 1/2, from qualified accounts, such as traditional IRAs or 401(k)s, generally incur an additional federal tax equal to 10% of the taxable amount. There are some exceptions to this rule. Consult your tax professional for more details.
ANNUITIZATION	Annuitization is the process of converting an annuity contract into a series of periodic income payments. Annuities may be annuitized for a specific period of time or for the life of the annuitant. Annuity payments may only be made to the annuitant or to the annuitant and a surviving spouse in a joint life arrangement. Annuitants can arrange for beneficiaries to receive a portion of the annuity balance upon their death.
ANNUITY	An annuity is a contractual financial product sold by insurance companies that is designed to accept and grow funds from an individual and then, upon annuitization, or through an income rider (either offered for an additional cost, or built into the product) pay out a stream of payments to the individual either immediately or at a later point in time. The period of time when an annuity is being funded and before payouts begin is referred to as the accumulation phase.

TERM	DEFINITION
BEAR MARKET	A bear market is a condition in which securities prices fall and widespread pessimism causes the stock market's downward spiral to be self-sustaining. Investors anticipate losses as pessimism and selling increases. Although figures vary, a downturn of 20% or more from a peak in multiple broad market indexes, such as the Dow Jones Industrial Average (DJIA) or Standard & Poor's 500 Index (S&P 500), over a two-month period is considered an entry into a bear market.
BENEFICIARY	In the financial world, a beneficiary typically refers to someone who is designated to receive distributions from a trust, will, annuity, life insurance policy or other financial vehicle. Beneficiaries are either named specifically in these documents or have met the stipulations that make them eligible for whatever distribution is specified.
BONDS	A bond is a debt investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds are used by companies, municipalities, states and sovereign governments to raise money and finance a variety of projects and activities. Owners of bonds are debtholders, or creditors, of the issuer.
BULL MARKET	A bull market is a financial market of a group of securities in which prices are rising or are expected to rise. The term *"bull market"* is most often used to refer to the stock market but can be applied to anything that is traded, such as bonds, currencies and commodities.
CAPITAL GAINS	Capital gain is an increase in the value of a capital asset (investment or real estate) that gives it a higher worth than the purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.
CAPITAL LOSSES	A capital loss is the loss incurred when a capital asset, such as an investment or real estate, decreases in value; this loss is not realized until the asset is sold for a price that is lower than the original purchase price. A capital loss is essentially the difference between the purchase price and the price at which the asset is sold, where the sale price is lower than the purchase price. For example, if an investor bought a house for $250,000 and sold the house five years later for $200,000, the investor realizes a capital loss of $50,000.
CERTIFICATE OF DEPOSIT	A certificate of deposit (CD) is a savings certificate with a fixed maturity date, specified fixed interest rate and can be issued in any denomination aside from minimum investment requirements. A CD restricts access to the funds until the maturity date of the investment. CDs are generally issued by commercial banks and are insured by the FDIC up to $250,000 per individual.

TERM	DEFINITION
CHARITABLE REMAINDER TRUST (CRT)	A tax-exempt irrevocable trust which generates a charitable tax deduction for the donor. A CRT first pays income to the beneficiaries of the trust for a specified period of time and then distributes the remainder of the trust to the designated charity.
COST-OF-LIVING ADJUSTMENT COLA	An adjustment made to Social Security income benefits and other Supplemental Income sources to counteract the effects of inflation. Cost-of-living adjustments (COLAs) are generally equal to the percentage increase in the consumer price index for urban wage earners and clerical workers (CPI-W) for a specific period.
DEFERRED ANNUITY	A deferred annuity is a type of annuity contract that delays payments of income, installments or lump sums until the investor elects to receive them. This type of annuity has two main phases: the savings phase in which money is deposited into the contract with growth potential, and the income phase during which distributions are received. A deferred annuity can be variable, indexed or fixed.
DEFINED-BENEFIT PLAN	A defined-benefit plan is a retirement plan that an employer sponsors, where employee benefits are computed using a formula that considers factors, such as length of employment and salary history. The company administers portfolio management and investment risk for the plan. There are also restrictions on when and by what method an employee can withdraw funds without penalties.
DEFINED-CONTRIBUTION PLAN	A defined-contribution plan is a retirement plan in which a certain amount or percentage of money is set aside each year by a company for the benefit of each of its employees. The defined-contribution plan places restrictions that control when and how each employee can withdraw these funds without penalties.
DIVIDEND	A dividend is a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. Dividends can be issued as cash payments, as shares of stock, or other property.
DOLLAR-COST AVERAGING	Dollar-cost averaging (DCA) is an investment technique of buying a fixed dollar amount of a particular investment on a regular schedule, regardless of the share price. The investor purchases more shares when prices are low and fewer shares when prices are high. The premise is that DCA lowers the average share cost over time, increasing the opportunity to profit. The DCA technique does not guarantee that an investor won't lose money on investments. Rather, it is meant to allow investment over time instead of investment as a lump sum.

TERM	DEFINITION
ESTATE TAX	A federal estate tax is levied on a decedant's estate (or the property they own) at death if the value of the estate exceeds an exemption limit set by law ($11.18 million in 2018). The estate tax is mostly imposed on assets left to non-spousal heirs, but it does not apply to the transfer of assets to a surviving spouse. The right of spouses to leave any amount to one another is known as the unlimited marital deduction, but when the surviving spouse who inherited an estate dies, the beneficiaries may then owe estate taxes if the estate exceeds the exemption limit. In addition to the federal government, a state may impose its own estate tax.
EXCHANGE-TRADED FUNDS ETFS	An ETF, or exchange traded fund, is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold. ETFs typically have higher daily liquidity and lower fees than mutual fund shares, making them an attractive alternative for individual investors.
EXCLUSION RATIO	The portion of the return on investments that is income tax exempt. It represents a payback of initial investments rather than capital gains.
FEDERAL DEPOSIT INSURANCE CORPORATION FDIC	The Federal Deposit Insurance Corporation (FDIC) is the U.S. corporation insuring deposits in the United States against bank failure. The FDIC was created in 1933 to maintain public confidence and encourage stability in the financial system through the promotion of sound banking practices. The FDIC insures deposits of up to $250,000 per institution, as of 2016, as long as the bank is a member firm.
FIXED ANNUITY	A fixed annuity is a type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. In exchange for a lump sum of capital, a life insurance company credits the annuity account with a guaranteed fixed rate of interest while guaranteeing the principal purchase payment. A fixed annuity can be annuitized to provide the annuitant with a guaranteed income payout for a specified term or for life. Any guarantees are backed by the financial strength and claims-paying ability of the issuer.
FIXED INDEX ANNUITY	A fixed index annuity is another type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. However, it is a special class of annuities that can receive credited interest when the chosen external index has a positive change. These annuities are purchased from an insurance company, and similar to other types of annuities, the terms and conditions associated with payouts depend on what is stated in the original annuity contract. Any guarantees are backed by the financial strength and claims-paying ability of the issuer.
FIXED-INDEX UNIVERSAL LIFE INSURANCE	A permanent life insurance policy that allows policyholders to tie cash value accumulation values to positive performance of a stock market index. Fixed-index universal life insurance policies typically contain a minimum guaranteed fixed interest rate component along with the potential of additional credited interest. Indexed policies give policyholders the security of fixed universal life insurance with the growth potential of a policy linked to positive index performance.

TERM	DEFINITION
FULL RETIREMENT AGE	Full retirement age generally refers to the age you must reach to be eligible to receive full benefits from Social Security. Depending on when you were born, this age can vary. The Social Security Administration has been slowly increasing this age as life expectancies lengthen. Early retirees receive a reduced benefit. For individuals born prior to 1938, full retirement age is 65, while those born between 1938 and 1960 are on a graduated scale up to age 67.
IMMEDIATE ANNUITY	An immediate annuity is an annuity contract that is purchased with a single lump-sum payment and in exchange, pays a guaranteed income for a specified period of time or lifetime based on life expectancy, in which the payment starts almost immediately.
INTESTATE	The act of dying without a legal will. Determining the distribution of the deceased's assets then becomes the responsibility of a probate court, using the guidelines established by state law.
IRREVOCABLE LIFE INSURANCE TRUST (ILIT)	An ILIT is an irrevocable trust created for the purpose of owning a life insurance policy. Most ILITs are designed to keep the life insurance death benefit from inflating the value of the insured's estate for estate tax purposes. The insurance trust is a contract between a grantor and a trustee to administer an insurance contract for the benefit of the named beneficiaries. The ILIT cannot generally be rescinded, amended or modified in any way after it is created. Once the grantor contributes property to the trust, the grantor cannot later reclaim ownership of the property.
IRREVOCABLE TRUST	An irrevocable trust can't generally be modified or terminated without the permission of the beneficiaries and trustees. The grantor, having transferred assets into the trust, effectively removes all of his rights of ownership to the assets and the trust. This is the opposite of a revocable trust, which allows the grantor to modify and potentially control the trust and its assets.
LIFE INSURANCE	Life insurance is a protection against financial loss that would result from the premature death of an insured. The named beneficiary receives the proceeds and is thereby financially protected up to the death benefit amount from the financial impact of the death of the insured. The death benefit is paid by a life insurer in consideration for premium payments made by the insured.
LIVING BENEFITS	Living benefit riders, usually available for an additional cost, allow for benefits to paid when applicable during the life of an annuity owner or life insurance policyholder. Typically, life insurance policies only pay a death benefit and annuities only pay living benefits, however riders attached to either can allow for living benefits in life insurance policies and can add death benefits to annuities.

TERM	DEFINITION
LONG-TERM CARE INSURANCE	Coverage that provides nursing-home care, home-health care, personal or adult day care or other limited benefits for individuals with a chronic or disabling condition. LTC insurance offers more flexibility and options than many public assistance programs.
LONGEVITY RISK	Longevity Risk is any potential risk attached to the increasing average life expectancy, specifically the risk of potentially outliving one's assets during retirement.
MEDICAID	Medicaid is a health care program that assists low-income families or individuals in paying for long-term medical and custodial care costs. Medicaid is a joint program, funded primarily by the federal government and run at the state level, where coverage may vary. Medicaid is available only to individuals and families that meet specified criteria. Recipients must be legal permanent residents or citizens of the United States and may include adults with low income, their dependents and people with specified disabilities.
MEDICARE	Medicare is a U.S. federal health program that subsidizes people who meet one of the following criteria: 1. An individual age 65 or older who has been a U.S. citizen or permanent legal resident for five years. 2. An individual who is disabled and has collected Social Security for a minimum of two years. 3. An individual who is undergoing dialysis for kidney failure or who is in need of a kidney transplant. 4. An individual who has Amyotrophic Lateral Sclerosis (Lou Gehrig's disease). Medicare helps out people at a time in their lives when they may have serious health problems but lack the funding for treatment.
MORTALITY CREDITS	With a participating lifetime annuity, premiums paid by those who die earlier than expected that contribute to gains of the overall pool and provide a higher yield or credit to survivors than could be achieved through individual contributions outside of the pool. The mortality credit increases significantly with age and hedges longevity risk, often creating a return that would be impossible to match in the broader financial markets.
MUTUAL FUND CLASS A SHARES	Class-A shares charge a front-end load that is taken off your initial investment.

TERM	DEFINITION
MUTUAL FUND CLASS B SHARES	These shares are classified by their back-end or contingent deferred sales charge. These shares are typically good for investors with little investment cash and a long investment horizon.
MUTUAL FUND CLASS C SHARES	Class C shares are a type of level-load fund. This class works well for individuals who will be redeeming shares in the short term.
MUTUAL FUNDS	A mutual fund is an investment vehicle made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. Mutual funds are operated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.
PENSION PLAN	A pension plan is a retirement plan that requires an employer to make contributions into a pool of funds set aside for a worker's future benefit. The pool of funds is invested on the employee's behalf, and the earnings on the investments generate income to the worker upon retirement.
PERMANENT LIFE INSURANCE	A universal term for life insurance policies that do not expire (unlike term life insurance) and combine the primary focus of life insurance, the death benefit with a potential for cash value accumulation. This savings portion can build a cash value—against which the policy owner can borrow funds, or in some instances, the owner can withdraw the cash value to help meet future goals, such as paying for a child's college education. The two main types of permanent life insurance are whole and universal life insurance policies.
POWER OF ATTORNEY (POA)	A power of attorney is a legal document giving one person (called an "agent" or "attorney- in-fact") the power to act for another person (the “principal” or “grantor”). The agent can have broad legal authority or limited authority to make legal decisions about the principal's, health care, property and finance. The power of attorney is frequently used in the event of a principal's illness or disability, or when the principal can't be present to sign necessary legal documents for financial transactions. A POA can be durable, meaning it persists through an individual’s incapacity, or springing, meaning a condition must be met before the POA can be exercised by the agent.

TERM	DEFINITION
PRICE TO EARNINGS RATIOS P/E	The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price-earnings ratio can be calculated as: (Market Value per Share / Earnings per Share). For example, suppose that a company is currently trading at $43 a share and its earnings over the last 12 months were $1.95 per share. The P/E ratio for the stock could then be calculated as 43/1.95, or 22.05.
PROBATE	Probate is the legal process through which a court supervises the transfer of a decedent's assets. Probate can occur when the decedent dies intestate (see page 82), or when the decedent passes away with a will. If the decedent had a will, the probate process determine whether it is valid and authentic. The court appoints either an executor named in the will (or an administrator if there is no will) to administer the process of collecting the assets of the deceased person, paying any liabilities remaining on the person's estate and finally distributing the assets of the estate to beneficiaries named in the will or determined as such by the executor.
QUALIFIED DISCLAIMER	A refusal to accept property that meets with provisions set forth in Section 2518 of the Internal Revenue Code, allowing for the property or interest in property to be refused by the heir, beneficiary or successor owner. These types of refusals can be used to avoid federal estate tax and gift tax, and to create legal inter-generational transfers which avoid taxation, provided they meet the following set of requirements: 1. The disclaimer must be made in writing and signed by the disclaiming party. 2. The disclaimer must identify the property, or interest in property that is being disclaimed. 3. The disclaimer must be delivered, in writing, to the person or entity charged with the obligation of transferring assets from the giver to the receiver(s). 4. The disclaimer must be written less than nine months after the date the property was transferred. In the case of a disclaimant aged under 21, the disclaimer must be written less than nine months after the disclaimant reaches 21.
QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST	A qualified terminable interest property (QTIP) trust is a type of trust that enables the grantor to provide for a surviving spouse, and also to maintain control of how the trust's assets are distributed once the surviving spouse dies. Income, and sometimes principal, generated from the trust is given to the surviving spouse to ensure that the spouse is taken care of for the rest of her life. Properly drafted, a QTIP trust qualifies for the unlimited marital deduction against federal estate taxes.
REAL ESTATE INVESTMENT TRUST REITS	A REIT is a type of security that invests in real estate through property or mortgages and often trades on major exchanges like a stock. REITs provide investors with an extremely liquid stake in real estate. They receive special tax considerations and typically offer high dividend yields.

TERM	DEFINITION
REQUIRED MINIMUM DISTRIBUTION (RMD)	A required minimum distribution (RMD) is the amount that traditional, SEP or SIMPLE IRA owners must begin distributing from their retirement accounts by April 1 following the year they reach age 72. Qualified employer plan participants may be able to defer RMDs until April 1 of the calendar year following the year in which they retire. RMD amounts must then be distributed by December 31 of year following the year in which they reach age 72 based on the current RMD distribution calculation amounts.
REVERSE MORTGAGE	A type of mortgage in which a homeowner can borrow money against the value of his or her home. No repayment of the mortgage (principal or interest) is required until the borrower dies or the home is sold. After accounting for the initial mortgage amount, the rate at which interest accrues, the length of the loan and rate of home price appreciation, the transaction is structured so that the loan amount will not exceed the value of the home over the life of the loan.
REVOCABLE TRUST	A revocable trust is a trust whereby provisions can be altered or canceled dependent on the grantor. During the life of the trust, the principal and income earned is usually available to the grantor, and only after death does property transfer to the beneficiaries. This type of agreement provides flexibility and income to the living grantor; He is able to adjust the provisions of the trust and earn income, all the while knowing that the estate will be transferred upon death. The revocable trust is used primarily as a tool to avoid probate.
ROTH IRA	Named for Delaware Senator William Roth and established by the Taxpayer Relief Act of 1997, a Roth IRA is an individual retirement plan (a type of qualified retirement plan) that bears many similarities to the traditional IRA. The biggest distinction between the two is how they're taxed. Since traditional IRAs contributions are made with pretax dollars, you pay income tax when you withdraw the money from the account during retirement. Conversely, Roth IRAs are funded with after-tax dollars; the contributions are not tax deductible. Qualified distributions—those taken after the taxpayer is older than 59.5 and five years after the first Roth contribution—are tax free.
RULE OF 100/110/120	According to a traditional rule of thumb, the percentage of stock allocation should be equal to 100 minus your age with the remaining percentage allocated to a bond portfolio. So if your age is 25, then 75% of the portfolio should be allocated toward stocks and 25% allocated to a bond portfolio. With increased longevity, you can use 110 or even 120 minus your age to determine your asset mix.
SEP IRA	A SEP IRA is a type of traditional IRA for self-employed individuals or small business owners. (SEP stands for Simplified Employee Pension.) Any business owner with one or more employees, or anyone who has business income (as opposed to employment income), can establish a SEP.

TERM	DEFINITION
SEQUENCE RISK	Sequence risk, also called sequence-of-returns risk, is the risk of receiving lower or negative returns early in a period when withdrawals are made from an individual's underlying investments. The order or the sequence of investment returns is a primary concern for retirees who are living off the income and capital of their investments.
SIMPLE IRA	A SIMPLE IRA is a retirement plan that may be established by employers, including self-employed individuals (sole proprietorships and partnerships). The SIMPLE IRA allows eligible employees to contribute part of their pretax compensation to the plan. This means the tax on the money is deferred until it is distributed.
SOCIAL SECURITY	Established by the United States federal government in 1935, Social Security is the commonly used term to describe the Old-Age, Survivors, and Disability Insurance (OASDI) program. OASDI is a social insurance and federal welfare program that provides benefits to retired workers, disabled workers and survivors of deceased workers as well as eligible spouses and dependents.
STOCK CLASS A SHARES	Class A shares refers to a classification of common stock that is accompanied by more voting rights than Class B shares, usually given to a company's management team. For example, one Class A share may be accompanied by five voting rights, while one Class B share may be accompanied by only one right to vote. A detailed description of a company's different classes of stock is included in the company's bylaws and charter.
STOCK CLASS B SHARES	Class B shares are a classification of common stock that may be accompanied by more or fewer voting rights than Class A shares. Although Class A shares are often thought to carry more voting rights than Class B shares, this is not always the case: Companies will often try to disguise the disadvantages associated with owning shares with fewer voting rights by naming those shares "*Class A*" and those with more voting rights *"Class B."* A detailed description of a company's different classes of stock is included in the company's bylaws and charter.
STOCKS	A stock is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. There are two main types of stock: common and preferred. Common stock usually entitles the owner to vote at shareholders' meetings and to receive dividends. Preferred stock generally does not have voting rights, but has a higher claim on assets and earnings than the common shares. For example, owners of preferred stock receive dividends before common shareholders and have priority in the event that a company goes bankrupt and is liquidated. Also known as *"shares"* or *"equity."*

TERM	DEFINITION
STRETCH IRA	A tax planning concept that is applied to defer the distribution—and accompanying income tax—of a qualified employer account or an Individual Retirement Account (IRA) to a beneficiary or beneficiaries. A stretch IRA strategy allows the original owner of an IRA to distribute assets to a designated beneficiary. By using this strategy, the IRA can be passed on while beneficiaries enjoy tax-deferred growth as long as possible. Non spousal IRA beneficiaries generally take taxable distributions of all funds within 10 years of death of the account owner whom they inherited it from. The term "stretch" does not represent a specific type of IRA; rather it is a financial strategy that allows people to stretch out the life—and therefore the tax advantages—of an IRA.
TERM LIFE INSURANCE	Term life insurance is a policy with a set duration limit on the coverage period. Once the policy is expired, it is up to the policy owner to decide whether to renew the term life insurance policy or to let the coverage end. This type of insurance policy contrasts with permanent life insurance, in which duration extends until the policy owner reaches 100 years of age (i.e. death) or lapses due to insufficient funds.
THRIFT SAVINGS PLAN	A retirement savings plan created by the Federal Employee's Retirement System Act of 1986 for current or retired employees of the federal civil service. The thrift savings plan is a defined-contribution plan designed to give federal employees the same retirement savings related benefits that workers in the private sector enjoy with 401(k) plans. Contributions to the plan are automatically deducted from each paycheck.
TRADITIONAL IRA	A traditional individual retirement account (IRA) allows individuals to direct pretax income towards investments that can grow tax-deferred; no capital gains or dividend income is taxed until it is withdrawn. Individual taxpayers are allowed to contribute 100% of any earned compensation up to a specified maximum dollar amount. Contributions to a traditional IRA may be tax-deductible depending on the taxpayer's income, tax-filing status and other factors.
TRUST	A trust is a fiduciary relationship in which one party, known as a trustor, gives another party, the trustee, the right to hold title to property or assets for the benefit of a third party, the beneficiary.
UNIT INVESTMENT TRUST (UIT)	A unit investment trust (UIT) is an investment company that offers a fixed portfolio, generally of stocks and bonds, as redeemable units to investors for a specific period of time. It is designed to provide capital appreciation and/or dividend income. Unit investment trusts, along with mutual funds and closed-end funds, are defined as investment companies.

TERM	DEFINITION
UNIVERSAL LIFE INSURANCE	Universal life insurance is type of flexible permanent life insurance offering the low-cost protection of term life insurance as well as a savings element (like whole life insurance), which is positioned to provide potential cash value accumulation. The death benefit, savings component and premiums can be reviewed and altered as a policyholder's circumstances change. Unlike whole life insurance, universal life insurance allows the policyholder to use the interest from his accumulated savings to help pay premiums over time.
VARIABLE ANNUITY	A variable annuity is a type of annuity contract that allows for the accumulation of capital on a tax-deferred basis. As opposed to a fixed annuity that offers a guaranteed interest rate and a minimum payment at annuitization, variable annuities offer investors the opportunity to generate higher rates of returns by investing in equity and bond subaccounts. If a variable annuity is annuitized for income, the income payments can vary based on the performance of the subaccounts.
VARIABLE LIFE INSURANCE	A variable life insurance policy is a form of permanent life insurance. Variable life insurance provides permanent protection to the beneficiary upon the death of the policyholder. This type of insurance is generally more expensive than term insurance because it allows the insured to allocate a portion of the premium dollars to a separate account comprised of various instruments and investment funds within the insurance company's portfolio, such as stocks, bonds, equity funds, money market funds and bond funds.
WHOLE LIFE INSURANCE	Whole life insurance is a policy with premiums that includes insurance and investment components. The insurance component pays a predetermined amount when the insured individual dies. The growth component has the potential to build an accumulated cash value the insured individual can borrow against or withdraw. Policy loans with withdrawals will reduce available cash values and death benefits, and may cause the policy to lapse or affect any guarantees against lapse. This is the most basic type of cash-value life insurance.
WILL	A will, also known as a Last Will and Testament, is a legally enforceable declaration of how a person wants his property or assets to be distributed after death.
YIELD	The yield is the income return on an investment, such as the interest or dividends received from holding a particular security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value or face value. Yields may be considered known or anticipated depending on the security in question as certain securities may experience fluctuations in value.

APPENDIX

[1] Social Security Administration: History, FAQs, April 2017

[2] Social Security Administration: Publication No. 05-10072 - How Your Earn Credits, January 2019

[3] Social Security Administration: Publication No. 05-10070 / ICN 467100 - Your Retirement Benefit - How It's Figured, January 2017

[4] Social Security Administration: Publication No. 05-10035 / ICN 457500 - Retirement Benefits, January 2017

[5] Social Security Administration - Fact Sheet: 2020 Social Security Changes

[6] U.S. Department of the Treasury, Daily Treasury Yield Curve Rates, January 2020

[7] Social Security Administration: Retirement Planner - Full Retirement Age, April 2017

[8] Social Security Administration: Social Security Benefits - Benefit Reduction for Early Retirement, April 2017

[9] Social Security Administration: Effect of Early or Delayed Retirement on Retirement Benefits, April 2017

[10] Social Security Administration: Benefits Planner - Income Taxes And Your Social Security Benefits, April 2017

[11] Social Security Administration: Emergency Message - Processing of Voluntary Suspension Requests, August 2016

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[15] Internal Revenue Service - Retirement Topics - Required Minimum Distributions (RMDs), February 2017

[16] Internal Revenue Service - Retirement Plans FAQs on Designated Roth Accounts, February 2017

[17] Marketplace Watch - Understanding Performance: The S&P 500 Index, by Paul A. Merriman, February 18, 2015

[18] Medicare: 2020 Costs at a Glance, January 2020

[19] Medicare: How to Compare Medigap Policies, April 2017

[20] HSBC: The Future of Retirement Choices for Later Life, 2015

[21] Internal Revenue Service - Instructions for Form 706, November 2016

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