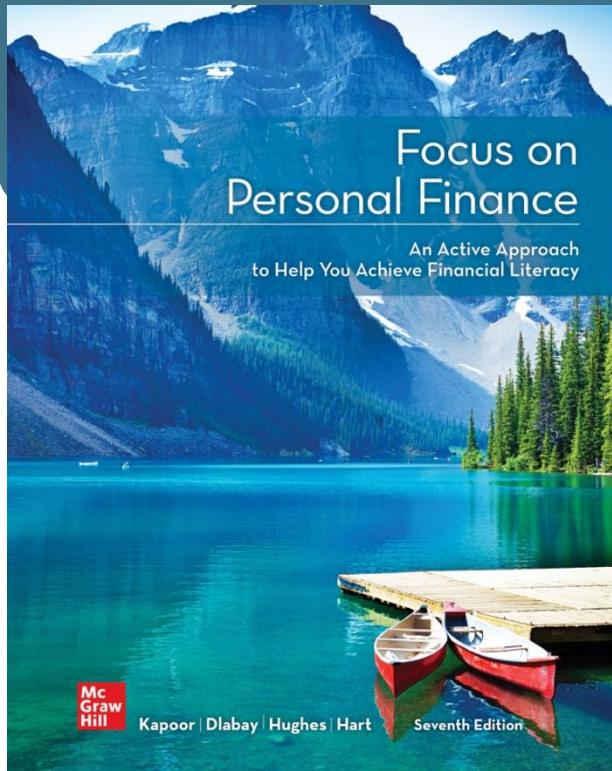


Chapter 14

Starting Early: Retirement and Estate Planning



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Starting Early: Retirement and Estate Planning

Chapter Learning Objectives

- LO14.1** Analyze your current assets and liabilities for retirement and estimate your retirement living costs.
- LO14.2** Determine your planned retirement income and develop a balanced budget based on your retirement income.
- LO14.3** Analyze the personal and legal aspects of estate planning.
- LO14.4** Distinguish among various types of wills and trusts.



Planning for Retirement: Start Early

LO14.1

- It's never too late to start saving for retirement, but the sooner you start, the better off you'll be
- Myths about retirement:
 - You have plenty of time to start saving for retirement.
 - Saving just a little bit won't help.
 - You'll spend less money when you retire.
 - Your retirement will only last about 15 years.
 - You can depend on Social Security and a company pension to pay your basic living expenses.
 - Your pension benefits will increase to keep pace with inflation.
 - Your employer's health insurance plan and Medicare will cover all your medical expenses when you retire.



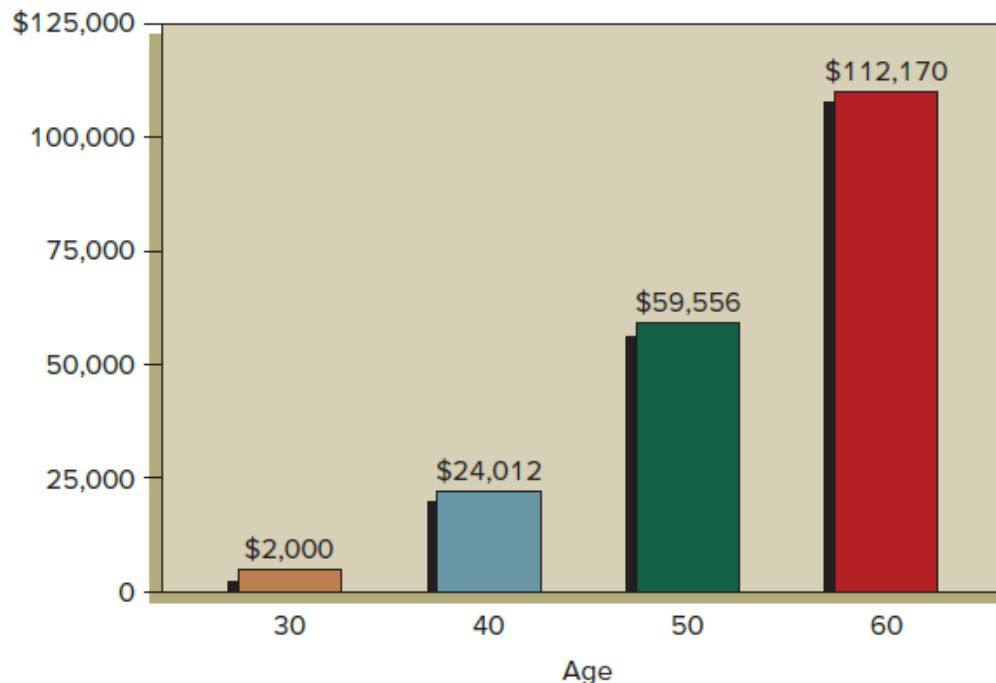
Saving Smart for Retirement: Even a Little Goes a Long Way

- Tips on how to start saving early:
 - Start Now. Don't wait. **Time is critical.**
 - Start small, if necessary.
 - Use automatic deductions from your payroll or checking account.
 - Save regularly.
 - Be realistic about investment returns.
 - If you change jobs, keep your retirement account money in your former employer's plan or roll it over into your new employer's plan or IRA.
 - Don't dip into retirement savings unless it is absolutely necessary.

Starting Early: An Example

EXAMPLE: Starting Early

Consider this: If from age 25 to 65, you invest \$300 per month and earn an average of 9 percent return a year, you'll have \$1.4 million in your retirement fund by age 65. Waiting just 10 years until age 35 to begin your \$300-a-month investing will yield about \$549,000, whereas if you wait 20 years to begin this investment, you will have only about \$200,000 at age 65. The chart in Exhibit 14–2 shows how even a \$2,000 annual investment earning just 4 percent will grow.





Conducting a Financial Analysis

- An asset is any item of value that you own
 - E.g., cash, property, personal possessions, investments, and the current value of any stocks, bonds, life insurance, or pension funds
- Liabilities are the debts you owe
 - E.g., remaining balance on mortgage or automobile loan, credit card balances, unpaid taxes, etc.
- Net worth is found by subtracting your liabilities from your assets
 - Ideally, it should increase each year as you move closer to retirement
- You should review your assets on a regular basis



Conducting a Financial Analysis

(Continued)

- **Housing**

- Likely your most valuable asset, but buying a home with a large mortgage could prevent you from saving

- **Life Insurance**

- May be purchased to provide financial support for your spouse and children in case you die while they are young
- You may reduce your premium payments by decreasing your life insurance coverage as your children become self-sufficient (and you near retirement age)

- **Other Investments**

- When you are ready to retire, you may want to use the income from these investments to help cover living expenses instead of reinvesting it



Estimating Retirement Living Expenses

- You can't predict exactly how much money you'll need when you retire, but you can estimate basic needs
 - Where you live during retirement has significant impact on your financial needs
 - You will probably spend more on recreation, health insurance, and medical care in retirement than you do now
 - You may spend less on transportation and clothing
 - Your federal income taxes may be lower in retirement
 - Some income from various retirement plans may be taxed at a lower rate or not at all
 - Remember to plan for emergencies
 - Do not forget to take inflation into account

How “Average” Older (65-74 and 75+) Households Spend Their Money

	AGE 65-74		AGE 75 & OLDER	
	Average \$ Amount	Percent	Average \$ Amount	Percent
Pretax Annual Income	\$52,366	100	\$35,467	100
Annual Expenditures	\$48,855	100	\$36,673	100
Housing	\$15,838	32.4	\$13,375	36.5
Food	\$ 6,284	12.0	\$ 4,349	11.9
Clothing	\$ 1,417	2.9	\$ 683	1.9
Transportation	\$ 8,338	17.1	\$ 5,091	13.9
Health Care	\$ 5,456	12.2	\$ 5,708	15.6
Entertainment	\$ 2,988	6.1	\$ 1,626	4.4
Pensions and Social Security	\$ 2,788	5.7	\$ 800	2.2
Other*	\$ 6,074	11.6	\$ 5,041	13.7

*Includes cash contributions, alcohol, tobacco, personal care products and services, reading, education, life and personal insurance, and miscellaneous expenses.

Source: Ann C. Foster, “A Closer Look at Spending Patterns of Older Americans,” *Beyond the Numbers: Prices and Spending*, vol. 5, no. 4 (U.S. Bureau of Labor Statistics, March 2016), <https://www.bls.gov/opub/btn/volume-5/spending-patterns-of-older-americans.htm>, accessed March 19, 2020.



Your Retirement Income

LO14.2

- Four major sources of retirement income:
 1. **Employer pension plans** are retirement plans that are funded, at least in part, by an employer
 2. **Public pension plans** are provided by a local, state, or federal government
 3. **Personal retirement plans** are set up by individuals and are especially important to self-employed people and other workers who are not covered by employer pension plans
 4. **Annuities** are contracts purchased from an insurance company that provide for a sum of money to be paid to a person at regular intervals for a certain number of years or for life



Employer Pension Plans

Defined-Contribution Plan

- Most employer plans are one of two basic types:
 1. Defined-contribution plans
 2. Defined-benefit plans
- **Defined-contribution plans** consist of an individual account for each employee to which the employer contributes a specific amount annually
 - Does not guarantee any particular benefit
- Several types of defined-contribution plans exist:
 - With a **money-purchase plan**, your employer promises to set aside a certain amount of money for you each year
 - Under a **stock bonus plan**, your employer's contribution is used to buy stock in the company for you
 - In a **profit-sharing plan**, your employer's contribution depends on the company's profits



Employer Pension Plans

Defined-Contribution Plan (Continued)

- In a **401(k) plan** (i.e., *salary-reduction plan*), you set aside a portion of your salary from each paycheck to be deducted from your gross pay and placed in a special account
 - Your employer will often match your contribution up to a specific dollar amount or percentage of your salary
 - Funds are invested in stocks, bonds, and mutual funds
 - Money that accumulated is tax-deferred, meaning you do not have to pay taxes on it until you withdraw it
 - Fees and expenses paid by your plan may substantially reduce the growth in your account
 - Referred to as *Section 403(b) plan* if employer is a tax-exempt institution, such as a hospital or nonprofit firm



Employer Pension Plans

Defined-Contribution Plan (Concluded)

- Employee contributions to a pension plan belong to you, the employee, regardless of the amount of time that you are with a particular employer
- *What happens to the contributions the employer has made to your account if you change jobs and move to another company before you retire?*
 - **Vesting** is the right to receive the employer's pension plan contributions that you've gained, even if you leave the company before retiring
 - After a certain number of years with the company, you will become *fully vested*, or entitled to receive 100 percent of the company's contributions to the plan on your behalf



Employer Pension Plans

Defined-Benefit Plan

- **Defined-benefit plans** specify the benefits you will receive at retirement age, based on your total earnings and years on the job
 - Plan does not specify how much the employer must contribute each year, but rather the employer's contributions are based on how much money will be needed in the fund as each participant in the plan retires
 - If the fund is inadequate, the employer will have to make additional contributions



Employer Pension Plans

Carrying Benefits from One Plan to Another

- Some pension plans allow *portability*, which means that you can carry earned benefits from one pension plan to another when you change jobs
- *Employee Retirement Income Security Act of 1974*
 - Sets minimum standards for pension plans
 - Federal government insured part of the payments promised by defined-benefit plans



Public Pension Plans

Social Security

- Social Security is a public pension plan established by the U.S. government in 1935
 - Government agency that manages the program is called the Social Security Administration
 - Covers 97% of all workers, and almost one out of every six Americans currently collects some form of Social Security benefit
 - Package of protection that provides benefits to retirees, survivors, and disabled persons
 - Protects you and your family while you are working and after you retire
 - Never intended to provide 100% of retirement income



Public Pension Plans

Social Security (SS) Eligibility

- Amount of retirement benefits you receive from Social Security is based on earnings over the years
 - The more you work and the higher your earnings, the greater your benefits, up to a certain maximum amount
- To qualify for benefits, you must earn a certain number of credits
 - Credits are based on the length of time you work and pay into the system through the SS tax, or contribution, on your earnings
 - You and your employer pay equal amounts of the SS tax
 - Credits are calculated on a quarterly basis
- Certain dependents of a worker may receive benefits



Public Pension Plans

Social Security (SS) Retirement Benefits

- Most people can begin collecting SS benefits at age 62
 - Monthly amount at age 62 will be less than it would be if the person waits until *full retirement age*
 - Reduction is permanent
- Full retirement age will be 67 for people born in 1960 and later
 - If you postpone applying for benefits beyond your full retirement age, your monthly payments will increase slightly for each year you wait, but only up to age 70
- When you start receiving SS benefits, certain members of your family may also qualify for benefits on your record



Public Pension Plans

Other Public Pension Plans

- Federal government provides several other special retirement plans for federal government workers and railroad employees
 - Employees covered under these plans are not covered by Social Security
- Veterans Administration provides pensions for survivors of people who died while in the armed forces
 - Also offers disability pensions for eligible veterans
- Many state and local governments provide retirement plans for their employees, as well



Personal Retirement Plans

Individual Retirement Accounts

- **Individual retirement account (IRA)** is a special account in which the employee sets aside a portion of their income; taxes are not paid on principal or interest until money is withdrawn from the account
- Several types of IRAs are available:
 - Regular IRA
 - **Roth IRA**
 - Simplified Employee Pension (SEP) Plan
 - Spousal IRA
 - Rollover IRA
 - Education IRA
- Biggest benefit of IRA is tax-deferred earnings growth

Various Types of IRAs

Exhibit 14-5

Type of IRA	IRA Features
Regular IRA	• Tax-deferred interest and earnings • Annual limit on individual contributions • Limited eligibility for tax-deductible contributions
Roth IRA	• Tax-deferred interest and earnings • Annual limit on individual contributions • Withdrawals are tax-free in specific cases • Contributions do not reduce current taxes
Simplified Employee Pension Plan (SEP IRA)	• “Pay yourself first” payroll reduction contributions • Pretax contributions • Tax-deferred interest and earnings
Spousal IRA	• Tax-deferred interest and earnings • Both working spouse and nonworking spouse can contribute up to the annual limit • Limited eligibility for tax-deductible contributions
Rollover IRA	• Traditional IRA that accepts rollovers of all or a portion of your taxable distribution from a retirement plan • You can roll over to a Roth IRA
Education IRA	• Tax-deferred interest and earnings • 10 percent early withdrawal penalty is waived when money is used for higher-education expenses • Annual limit on individual contributions • Contributions do not reduce current taxes



Personal Retirement Plans

Individual Retirement Accounts (Continued)

- **Keogh plan** is a plan in which tax-deductible contributions fund the retirement of self-employed people and their employees
 - Also called *H.R. 10 plan* or *self-employed retirement plan*
 - Limits on annual tax-deductible contributions
 - Can be complicated to administer
- *Required minimum distribution* is minimum amount you must withdraw from your account each year
 - Apart from Roth IRAs, you cannot keep money in most tax-deferred retirement plans forever
 - SECURE Act of 2019 requires that when you retire, or by age 72 at the latest, you must begin to receive “required minimum distributions” or else be charged a penalty

Timeline for Retirement Planning

Exhibit 14-6

Age	Actions to take
50	Begin making catch-up contributions, an extra amount that those over 50 can add to 401(k) and other retirement accounts. Check your Social Security statement online every year for earnings accuracy and to learn what your estimated benefits will be.
59 1/2	No more tax penalties are levied on early withdrawals from employer-provided retirement savings plans such as 401(k) plans and other individual retirement accounts, but leaving money in means more time for it to grow. Also, withdrawals will be taxed as regular income.
62	The minimum age to receive Social Security benefits, but delaying claiming means a larger monthly benefit.
65	Eligible for Medicare Sign up for Medicare and Medicare Part D.
66-70	Receive Social Security full benefits, depending on your birth year. Earn Social Security Delayed Retirement Credits, which increase monthly benefits for each month claiming is delayed between the full retirement age and age 70.
72	Start taking minimum withdrawals from most retirement accounts by this age; otherwise, you may be charged heavy penalties in the future.

Sources: U.S. Department of Labor, Social Security Administration, and Department of Health and Human Services, 2020.



Annuities

- May purchase an annuity with the money you receive from an IRA or company pension
 - You can buy an annuity to supplement the income you'll receive from either of these types of plans
- You can choose to purchase an annuity that has a *single payment or installment payments*
 - Payments received from an annuity are taxed as ordinary income, but interest earned from the annuity accumulates tax-free until payments begin



Living on Your Retirement Income

- You may find your expenses in retirement are higher than you expected, in which case you'll have some work to do
 - Are you getting all the income to which you're entitled?
 - Consider any assets or valuables you can convert to cash or sources of income
- Some people decide to work part-time after they retire, and some even take new full-time jobs
- If you dip into your retirement nest egg, consider one important question:
 - How long will your savings last if you make regular withdrawals?



Estate Planning

LO14.3

- Your **estate** consists of everything you own
- Many years from now, as you grow older, you will start to think about what will happen to your hard-earned wealth after you die
- **Estate planning** is a definite plan for the administration and disposition of one's property during one's lifetime and at one's death
 1. Build your estate through savings, investments, and insurance
 2. Ensure your estate will be distributed as you wish at the time of your death



Legal Documents

- An estate plan typically involves various legal documents, one of which is usually a will
- Important papers you need to collect and organize include:
 - Birth, marriage, and divorce documents
 - Legal name changes
 - Military service records
 - Social Security documents
 - Veteran's documents
 - Insurance policies
 - Transfer records of joint bank accounts
 - Safe-deposit box records
 - Automobile registration
 - Titles to stock and bond certificates



Legal Aspects of Estate Planning

LO14.4

- A **will** is the legal declaration of a person's mind as to the disposition of his or her property after death
 - One of the most important documents for every adult
 - Have an attorney experienced with wills and estate planning draft your will
 - Standard will costs between \$300–\$400
- If you die **intestate**—without a valid will—your legal state of residence will step in and control the distribution of your estate without regard for any wishes you may have had
- Four basic types of wills are the *simple will*, the *traditional marital share will*, the *exemption trust will*, and the *stated amount will*

Types of Wills

1. **Simple will** leaves everything to your spouse, and is generally sufficient for people with small estates
 - May not meet your objectives if you have a large or complex estate
 - May result in higher overall taxation
2. **Traditional marital share will** leaves one-half of the adjusted gross estate (the total value of the estate minus debts and costs) to the spouse and the other half to children or other heirs
 - May also be held in a trust for the family
 - **Trust** is a legal arrangement through which one's assets are held by a *trustee*



Types of Wills (Continued)

3. **Exemption trust will** passes all your assets to your spouse except for a certain amount, which goes into a trust
 - Amount in trust, plus any interest it earns, can provide lifelong income to spouse that will not be taxed
4. **Stated amount will** allows you to pass along an amount best suited for your particular needs
- **Probate** is the legal procedure of proving a valid or invalid will
 - No matter what type of will you choose, it is best to avoid probate
 - Probate is expensive, lengthy, and public

Format of Wills

- *Holographic will* is a handwritten will that you prepare yourself
 - Should be written, dated, and signed entirely in your own handwriting
 - No printed or typed information should appear on its pages
 - Some states do not recognize holographic wills as legal
- *Formal will* is usually prepared with the help of an attorney
 - May be typed, or it may be a preprinted form you fill out
 - Must sign the will in front of two witnesses; neither person can be a beneficiary named in the will
 - Witnesses must then sign the will in front of you
- *Statutory will* is prepared on a preprinted form
 - Presents serious risks



Writing Your Will

Selecting an Executor

- An **executor** is someone willing and able to perform the tasks involved in carrying out your will
 - Tasks include preparing an inventory of your assets, collecting any money due, and paying off your debts
 - Must prepare and file all income and estate tax returns
 - Responsible for making decisions about selling or reinvesting assets to pay off debt and provide income for your family while the estate is being settled
 - Must distribute the estate and make a final accounting to your beneficiaries and to the probate court



Writing Your Will

Selecting a Guardian and Altering Your Will

- A **guardian** is a person who assumes responsibility for providing children with personal care and managing the deceased's estate for them
- Sometimes you'll need to change the provisions of your will because of changes in your life or in the law
- Reasons to review your will include the following:
 - You've moved to a new state that has different laws
 - You've sold property that is mentioned in the will
 - The size and composition of your estate have changed
 - You've married, divorced, or remarried
 - Potential heirs have died, or new ones have been born
- A **codicil** is a document that modifies provisions in an existing will



A Living Will

- **Living will** is a document that enables an individual, while well, to express the intention that life be allowed to end if he or she becomes terminally ill
 - To ensure effectiveness, discuss your intention of preparing such a will with the people closest to you and your family doctor
 - Sign and date your document before two witnesses
 - Give copies of your living will to those closest to you, and have your family doctor place a copy in your medical file



Social Media or Digital Will

- If you are active online, you should consider creating a statement of how you would like your online identity to be handled
 - Review the privacy policies and the terms and conditions of each website where you have a presence
 - State how you would like your profile to be handled
 - Give the social media executor a document that lists all the websites where you have a profile, along with your usernames and passwords
 - State in your will that the online executor should have a copy of your death certificate



Power of Attorney and Letter of Last Instruction

- **Power of attorney** is a legal document authorizing someone to act on one's behalf
 - If you become seriously ill or injured, you'll probably need someone to take care of your needs and personal affairs
- *Letter of last instruction* is not legally binding, but it can provide your heirs with important information
 - Should contain your wishes for your funeral arrangements, as well as the names of the people who are to be informed of your death
 - Send one copy to your attorney or executor, attach another to your will, and keep one in a safe place at home



Trusts

- A **trust** is a legal arrangement that helps manage the assets of your estate for your benefit or that of your beneficiaries
 - Creator of trust is called the *trustor*, or *grantor*
 - *Trustee* administers the trust, and may be a person or institution
- Common reasons for setting up a trust are to:
 - Reduce or otherwise provide payment of estate taxes
 - Avoid probate; transfer assets immediately
 - Free yourself from managing assets
 - Provide income for a surviving spouse or someone else
 - Ensures property serves desired purpose after death



Types of Trusts

- All trusts are either *revocable* or *irrevocable*
 - **Revocable trust** is one in which you have the right to end the trust or change its terms during your lifetime
 - Avoid the length process of probate
 - Do not protect assets from federal or state taxed
 - **Irrevocable trust** is one that cannot be changed or ended
 - Avoid probate
 - Help reduce estate taxes
 - By law, you cannot remove any assets from an irrevocable trust, even if you need them at some later point in your life



Types of Trusts (Continued)

- **Credit-shelter trust** is one that enables the spouse of a deceased person to avoid paying federal taxes on a certain amount of assets left to him or her as part of an estate
 - Perhaps the most common estate planning trust
- **Disclaimer trust** is appropriate for couples who do not yet have enough assets to need a credit-shelter trust but may have in the future
 - Surviving spouse is left everything, but he or she has the right to disclaim, or deny, some portion of the estate
 - Disclaimed portion goes into a credit-shelter trust



Types of Trusts (Concluded)

- **Living trust** is a property management arrangement that goes into effect while you're alive
 - Allows you to receive benefits during your lifetime
 - Advantages include the following:
 - Ensures privacy, as trusts are not public record (unlike wills)
 - Assets held in trust avoid probate at your death
 - Enables you to review your trustee's performance
 - Can relieve you of management responsibilities
 - Less likely than a will to create arguments between heirs upon your death
 - Can guide your family and doctors if you become terminally ill or unable to make your own decisions
- **Testamentary trust** is one established by your will that becomes effective upon your death



Taxes and Estate Planning

- An *estate tax* is a federal tax collected on the value of a person's property at the time of his or her death
 - Based on fair market value of the deceased person's investments, property, and bank accounts, less an exempt amount of \$11.58 million (in 2020)
 - Tax is due nine months after a death
- Estates and certain trusts must file *federal income tax* returns with the IRS
 - Taxable income for estates and trusts is computed in the same manner as taxable income for individuals
 - Trusts and estates must pay quarterly estimated taxes

Taxes and Estate Planning (Continued)

- An *inheritance tax* is a tax collected on the property left by a person in his or her will
 - Only state governments impose inheritance taxes
 - Reasonable average for state inheritance taxes would be 4 to 10 percent of whatever the heir receives
- A *gift tax* is collected on money or property valued at more than \$15,000 (in 2020) given by one person to another in a single year
 - Imposed by both state and federal governments
 - One way to reduce the tax liability of your estate is to reduce the size of the estate while you're alive by giving away portions of it as gifts



Chapter Summary

LO14.1: Analyze your current assets and liabilities for retirement and estimate your retirement living costs.

- The difference between your assets and your liabilities is your net worth.
- Review your assets to ensure they are sufficient for retirement. Then estimate your living expenses.
 - Some expenses are likely to decrease while others will increase.



Chapter Summary

LO14.2: Determine your planned retirement income and develop a balanced budget based on your retirement income.

- Your possible sources of income during retirement include employer pension plans, public pension plans, personal retirement plans, and annuities.
- If your income approximates your expenses, you are in good shape; if not, determine additional income needs and sources.



Chapter Summary

LO14.3: Analyze the personal and legal aspects of estate planning.

- The personal aspects of estate planning depend on whether you are single or married.
- Never having been married does not eliminate the need to organize your financial affairs.
- Every adult should have a written will.
- A will is a way to transfer your property according to your wishes after you die.



Chapter Summary

LO14.4: Distinguish among various types of wills and trusts.

- The four basic types of wills are the simple will, the traditional marital share will, the exemption trust will, and the stated amount will.
- Types of trusts include the credit-shelter trust, the disclaimer trust, the living trust, and the testamentary trust.
- Federal and state governments impose various types of estate taxes; you can prepare a plan for paying these taxes.