Personal Finance: Another Perspective

Retirement 3: Employer Qualified Plans

Updated 2020/03/17

Objectives

A. Understand Employer Qualified Retirement Plans

B. Understand Defined Benefit Plans

C. Understand Defined Contribution Plans

D. Understand Plans and Strategies for Employer Qualified Plans

Case Study

Data

- Bill, married with two kids, will be graduating in April with his bachelors degree, and has two similar offers from companies both located in San Francisco, California. Both companies are companies he would be content to stay with for 30 years. Company A has a 401k with a 100% match up to 4% of his salary. Company B has a 401k with no match, but a Defined Benefit Plan with the formula based on average salary, a factor of 1.5%, and years of service up to 30 years.

Calculations/Application:

- A. Assuming the salary is $50,000 for either firm, which has the more attractive retirement package for Bill?
- B. Can Bill participate in other retirement plans?

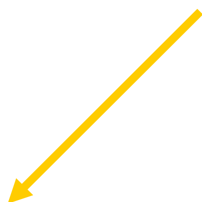
A. Understand Employer Qualified Retirement Plans

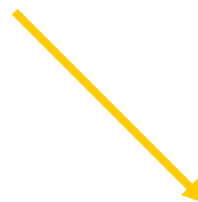
- Why do companies set up retirement plans?
  - Competition
  - Tax shelters
  - Personal retirement for the owners
  - Personal retirement for the employees
  - Other reasons
- What are the requirements for setting up retirement plans?
  - Generally stable and available cash flow
  - Willingness to fulfill financial reporting

Employer Qualified Plans (continued)

Two Kinds of

Employer Qualified Plans (EQPs)





Employer Funded Pension Plans

(Defined Benefit Plans)

Employer Sponsored Retirement Plans

(Defined Contribution Plans)

Employer Qualified Plans (continued)

Characteristics:	Defined Benefit	Defined Contribution
Employers contribution:	Actuarially determined	Specified by formula
Benefit amount:	Certain	Uncertain
IRC* limits apply:	Maximum benefits funded	Contributions
Types of Plans:	Defined Benefit Pension	Profit Sharing
		ESOP
	Cash Balance Pension	Stock Bonus
		Target Benefit
		Money Purchase
		Employee Contribution

IRC = Internal Revenue Code

Employer Qualified Plans: Business Forms

	Defined Benefit Plans		Defined Contribution Plans								
			Discretionary Contribution			Fixed Contribution		Employee Contribution			
Entity	Defined Benefit	Cash Balance	Profit Sharing	Stock Bonus ESOP	Money Purchase	Targt Benefit	Thrift Savings	Section 401k Provisions	TSA 403B	457 Plan	SIMPLE and SEP-IRA
C Corp.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
S Corp.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Prof. Corp.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Partnership	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	No	Yes
Sole Prop.	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	No	Yes
Tax-exempt	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Public School	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes	Yes	Yes
S/L Govt.	Yes	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	Yes

Employer Qualified Plans (continued)

- Funding limits are set in IRS Code 415 which limits the maximum individual funded benefit in 2020

IRS Limits :	Defined Benefit	Defined Contribution
Participant	100% or $230,000 (indexed) if less	100% or $57,000 (indexed) if less
Employer	Amount Necessary to Fund Compensation	25% of all Participants Compensation

Employer Qualified Plans (continued)

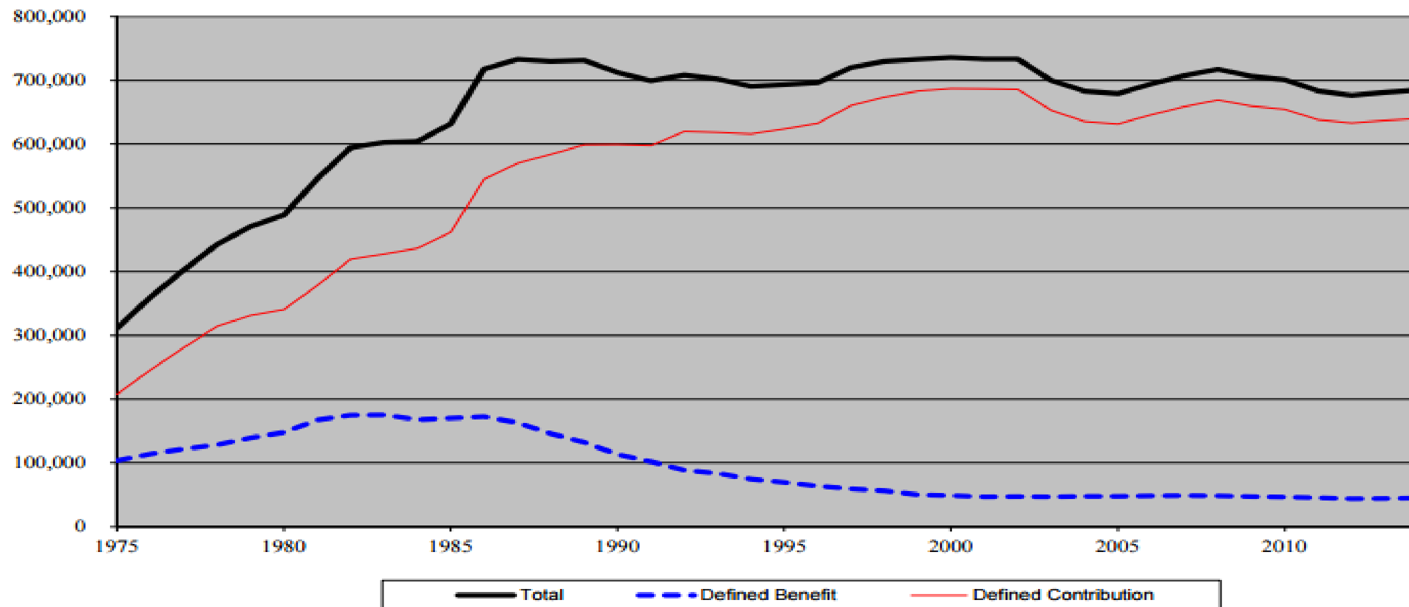
- There has been a shift in EQPs
  - With defined benefit plans, the risk of funding a specific amount each year is with the company
  - With defined contribution plans, the risk of funding a specific amount each year is with the employee
- We are seeing fewer defined benefit plans as well as a reduction in the benefits from these plans
  - Defined benefit plans have dropped from a high of 175,000 plans in 1983 to less than 44,867 in 2014
  - Risk has been essentially shifted from the company to the employee

Employer Qualified Plans (continued)

- Key benefits to EQPs
  - Employer contributions are tax-deductible to the employer and are not taxable to the employee in the year given
  - Earnings are tax deferred to the participant until retirement

Employer Qualified Plans (continued)

- What are the numbers of the different Qualified Retirement Plans?



- Source: Private Pension Plan Bulleting Historical Table and Graphs 1975-2014, Employee Benefits Security Administration, Dept. of Labor. "https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf

B. Understand Defined Benefit Plans

- What is a defined benefit plan (DBP)?
  - A retirement plan funded entirely by the employer in which the payout amount is guaranteed. Benefits are based on: a benefit formula, the definition of compensation, and full retirement age
- What are the characteristics of a DBP?
  - Employees do not contribute and bear no risk
  - Employees receive a "promise" of a defined payout at retirement, which is based on a benefit formula
- What are the main types of DBP?
  - Defined Benefit Pension Plan
  - Cash Balance Plan

Defined Benefit Pension Plans

- A Defined Benefit Pension Plan is a DBP where payments are based on a benefit payout formula
  - This formula is based on your salary, years worked and a company determined factor to calculate how much you will get each year
- Example for XYZ corporation:
  - Calculate average of five highest annual salaries within the last ten years
  - Multiply final "average" salary by a company determined factor of 1.5%, and
  - Multiple this by years in service (to a max of 33)
    - For XYZ Corporation: $60,000 x .015 x 25 years = $22,500 or 37.5% of final salary

Defined Benefit Pension Plans (continued)

- Advantages
  - Employees do not contribute and bear no risk
  - Benefits may be extended to spouse
  - Some plans provide 30% to 70% of final salary
- Disadvantages
  - Benefits are considered taxable income
  - Firms can change policies even after you retire
  - Vesting is required and a lack of portability
  - Most do not provide for inflation (no COLA)
  - Many plans are unfunded, meaning payments are made out of current company earnings

Cash-Balance Plans

- What are Cash-Balance plans?
  - A type of DBP in which provides specific annual employer contribution (generally 4-7%) each year, plus a low but guaranteed rate of investment earnings
- How is this different from a DCP?
  - Accounts grow at a predetermined rate, regardless of how much is in the account
  - Employees do not make any investment decisions

Cash-Balance Plans (continued)

- Advantages
  - Employees do not contribute, benefits are easier to track, and maximum benefit is the lesser of 100% of compensation or $230,000 in 2020
  - The investment rate of return is low but constant
  - Plans are portable, and cheaper for the company
  - Plans may be used to eliminate a traditional defined benefit plan by an employer
- Disadvantages
  - Actual payouts may be less than the basic defined benefit plans
  - Costly for employers to maintain this type of plan

Defined Benefit Plan: Distribution/Payout Options

(Example: BYU Defined Benefit Plan)

- Distribution relates to how long you will receive benefits, whether and how much your spouse receives after you die, and the guaranteed period for which you will receive benefits. There are 4 main distribution options:

1. Life Annuities (guaranteed for the "certain" period)
    - Life annuity
    - 10 year Certain & Life, 15 year Certain & Life, 20 year Certain & Life
2. Joint and Survivor Annuities (percent relates to the amount the spouse receives
    - Joint & Survivor 100 percent Annuity (10 year certain)
    - Joint & Survivor 75 percent Annuity (10 year certain)
    - Joint & Survivor 50 percent Annuity (10 year certain)

Distribution/Payout Options

3. Special Joint and Survivor Annuity (if there is a death in the marriage the benefit decreases)
   - Special Joint & Survivor two-thirds annuity (10 year certain)
4. Qualified Joint & Survivor Annuity (same as the 50% option with no term certain)
   - Qualified Joint & Survivor Annuity (50% and no term certain)

- Note that if you choose options that have certain payments for longer periods of time, the amount received each month will be less.
  - If an employee dies prior to retirement, generally the surviving spouse is restricted to QJSA option.

Important Questions to ask when Considering Defined Benefit Plans

- What questions should you ask?
  - What salary is your pension based: average compensation, final year's salary, or some other amount?
  - What is the vesting period?
  - What is the formula for calculating benefits?
  - What's the normal retirement age? What happens to your pension amount if you retire sooner?
  - Is there any advantage to working past age 65?
  - Is there a cost of living adjustment (COLA) for inflation?

Questions

- Do you understand Defined Benefit Plans?

C. Understand Defined Contribution Plans

- What is a Defined Contribution Plan (DCP)?
  - A retirement plan where the employer contributes a specific amount to the employee's retirement funds while the employee is working and then has no responsibilities once the employee retires
- What are the characteristics of a DCP?
  - Employer contributes to a fund, and then has no additional obligation when the employee retires
  - Employee may also contribute to the fund
  - Pension is determined by how much is invested by both the employer and employee, and how fast it grows

Defined Contribution Plans (continued)

- Defined Contribution plans may be three types:
  - 1. Discretionary contribution plans
    - Contributions are at employer discretion
      - Profit Sharing Plan
      - Stock Bonus or ESOP Plan
      - Money Purchase plan
  - 2. Fixed contribution plans
    - Contributions are fixed by the employer. Examples are:
      - Thrift and Savings plans
      - Target benefit plan
  - 3. Employee contribution plans (salary reduction)

Defined Contribution Plans (continued)

- Different types of defined contribution plans?
- 1. Discretionary Contribution Plans
  - Profit Sharing Plans
    - Plan where employer contributions vary year-to-year depending on firm profitability (it may be zero if the firm is not profitable in that year)
  - Stock Bonus Plan
    - Plan where employer contributions are made with employer shares of stock. Employee stock ownership plans (ESOPs) and leveraged ESOPs (LESOPs) are the most common

Defined Contribution Plans (continued)

- Money Purchase Plans
  - Plan where employer contributes a percentage of employee salary each year, not dependent on company profits
  - Employees do not contribute

Defined Contribution Plans (continued)

2. Fixed Contribution Plans

- Thrift /Savings Plans (TSP)
  - Plan where employer matches a percentage of employee contributions to a specific amount (i.e., free money). This program is for employees of federal civil service
- Target Benefit Plan
  - Defined contribution plans that establish a required contribution level to meet a specific target level of benefits at retirement

Defined Contribution Plans (continued)

- 3. Employee Contribution or Salary Reduction Plans
  - Employees contribute before tax dollars reducing their taxable income
  - Earnings accumulate tax deferred
  - 74 million active employees and 89 million total participate in defined contribution (401k, 403b,etc.) plans in 2010
  - 95% of 401(k) plans have matching contributions in 2012

- See http://www.americanbenefitscouncil.org/pub/e613e1b6-f57b-1368-c1fb-966598903769

Defined Contribution Plans (continued)

- Types of Employee or Salary Reduction Plans
  - 401k Plans or Roth 401k Plans
    - Plan where employees contribute a percent of salary up to a specified amount ($19,500 in 2020). Employers may contribute a matching amount (free money) to encourage participation
  - 403b Plans or Roth 403(b) Plans (also called Tax Sheltered Annuities)
    - Same as 401k but for non-profit tax-exempt companies and institutions (i.e., schools)
  - 457 Plans
    - Same as 401k but for state and municipal workers and tax-exempt organizations

Defined Contribution Plans (continued)

- What are the differences between Roth 401k/403b Plans and traditional salary reduction plans?
  - Roth Plans are after tax, with no tax deferral
  - Distributions of contributions can be made without penalty and without tax after 5 years
  - Roth plans do not have mandatory distributions (if they are rolled over into Roth IRAs at retirement)
  - Matching employer contributions with Roth plans go into traditional plans (not Roth plans)
  - Roth plans allow you to save more money for retirement (taxes are paid outside the vehicle)

Defined Contribution Plans (continued)

- Salary Reduction Plans
  - Employees direct the funds into different financial asset options including:
    - Mutual funds, index funds, fixed income, equities, money market funds, and GICs (guaranteed investment contracts)
      - Companies have their list of approved investment assets
        - Employees choose where to invest their assets subject to the company list
        - Employees are not allowed to invest outside of approved investment assets

Defined Contribution Plans (continued)

- Advantages to Employees
  - Offer strong growth potential, greater sense of control and portability, and tax advantages from tax deferred contribution/earnings or tax-elimination with Roth Plans
- Disadvantages to employees
  - No guarantee of actual amounts available at retirement as risk is shifted from the employer to the employee
- Advantages to Employers
  - Easier to administer, less government regulation, greater investment choice, and shifts investment decisions to employee
- Disadvantages
  - Takes time and resources to administer

Type of Plans:	Defined Benefit		Defined Contribution: Discretionary and Employee			
	Defined Benefit	Cash Balance	Profit Sharing	Money Purchase	Roth/Trad. 403(b)	Roth/Trad. 401(k)
Plan Features	Plan funded by employer and payout is a "promise." There is no funding by the employee. Payout is a function of the company factor, years of service, and average salary	Employer contributes 4-7% each year which grows at a predetermined rate. There is no contribution by the employee	Employer funded and generally based on firm profitability. Allows employer restricted coverage and control over when the money will be withdrawn	Employer funds a percentage of salary each year regardless of firm profitability. Allows employer restricted coverage and control over when the money will be withdrawn	Employee funded with possible company match. Traditional has employees contribute pre-tax dollars which reduce current taxable income, while Roth employees contribute after-tax dollars. Traditional converts LT capital gains to ordinary income	Employee funded with possible company match. Traditional has employees contribute pre-tax dollars which reduce current taxable income, while Roth employees contribute after-tax dollars. Traditional converts LT capital gains to ordinary income
Contribution limits	No contribution by the employee. Employer IRS contribution limits apply	No contribution by the employee. Employer IRS contribution limits apply	Employer may contribute 25% of compensation up to $55,000. Contributions are discretionary by the employer within IRS limits	Employer may contribute 25% of compensation up to $55,000. Employer contributions are percentage of annual salary determined in plan documents	Employees can defer up to $18,500 of annual salary, with a $6,000 catch up if over age 50	Employees can defer up to $18,500 of annual salary, with a $6,000 catch up if over age 50
Who contributes	Employer	Employer	Employer	Employer	Employer and employee	Employer and employee
Vesting	No vesting unless stay with the company until retirement		Vesting schedules allowed	Vesting schedules allowed	100% for employee contributions, and vesting schedule allowed for employer contributions	100% for employee contributions, and vesting schedule allowed for employer contributions
Loan Privileges	No	No	No	No	Yes	Yes
Distributions	No distributions until retirement	No distributions until retirement	Distributions before age 59.5 subject to a 10% penalty tax, and ordinary income. Required min. distributions at age 70.5	Distributions before age 59.5 subject to a 10% penalty tax, and ordinary income. Required min. distributions at age 70.5	Distributions before age 59.5 subject to a 10% penalty tax, and ordinary income. Required min. distributions at age 70.5 for traditional plans	Distributions before age 59.5 subject to a 10% penalty tax, and ordinary income. Required min. distributions at age 70.5 for traditional plans

Defined Contribution Plans (continued)

- Thoughts on Defined Benefit/Contribution Plans
  - 75% of plan balances are invested in equities
  - Mutual funds still provide bulk of investment opportunities, although some firms are forming brokerage links for stocks
    - Most plans typically provide 10+ options
  - Important questions to ask:
    - What are annual or administration expenses?
    - Are there any transfer fees to go from one fund to another?
    - How often can I reallocate my assets? Costs?

Defined Contribution Plans (continued)

- What is vesting?
  - Vesting is the process whereby funds contributed by the employer actually become the property of the employee.
- What is the vesting schedule of most plans?
  - 100% of employee contributions/deferrals are vested immediately
  - Generally vesting schedules apply only to employer contributions, i.e., 60% after 2 years, 80% after 3 years, and 100% after 4 years

Defined Contribution Plans (continued)

- Matching contribution must vest according to the respective cliff or graded schedules:

	401k Vesting		403b Vesting	
Year	Cliff	Graded	Cliff	Graded
1.	0%	0%	0	0
2.	0	20	0	0
3.	100	40	0	20
4.	100	60	0	40
5.	100	80	100	60
6.	100	100	100	80
7.	100%	100%	100%	100%

Tax Considerations

- What are the tax considerations of DCPs?
  - All retirement income, including capital gains, are taxed as ordinary income when distributed
  - 10% penalty rule applies for early withdrawals before 59½, with some exceptions
  - There is a 20% withholding requirement
  - Certain loan provisions may apply
  - Mandatory annual distributions begins after age 70½

Defined Contribution Plans (continued)

- Required minimum distributions must begin by April 1st of the year following age 70½.
  - The distribution is the account balance on Dec. 31 of the previous year (age 69) divided by the life expectancy from the table below. There is a 50% penalty on minimum distributions not taken.

Uniform Table

Age	Life Expectancy (LE)	Age	LE
70	27.4	75	22.9
71	26.5	76	22.0
72	25.6	77	21.2
73	24.7	78	20.3
74	23.8	79	19.5

Payout/Distribution Options?

- What are my four payout or distribution options for defined contribution plans?
  - Payout/distribution options are ways the employee can receive your money at retirement
- 1. Lump Sum Distribution or as Needed
  - Benefits
    - Take the money out as you need it
    - Can invest/gift/use it elsewhere
  - Risks
    - Plans only allow distributions every 3 months
    - Taxes are incurred immediately
    - If not plan well, may not have sufficient money for retirement

Payout/Distribution Options (continued)

- 2. Purchase of an Immediate Annuity
  - Use DCP to purchase an immediate annuity (You can purchase this contract either from your retirement Plan provider or from others outside the Plan)
  - Benefits
    - Stable payments usually for life
    - Useful for planning and tax purposes
  - Risks
    - Generally no cost of living adjustment
    - Tax is due on amount received each year

Payout/Distribution Options (continued)

- 3. Take Periodic Payments
  - Benefits
    - Can plan for regular payments at regular intervals. Can ensure that payments are available for a specific period of time
    - Payments may be large
  - Risks
    - No assurance of lifetime income
    - Tax rate may be high due to the amount of money withdrawn

Payout/Distribution Options (continued)

- 4. Roll it into an IRA Rollover (Be careful and don't touch the funds)
  - Benefits
    - You can defer taxes until you withdraw the funds
    - You can direct investment to different assets and asset classes
    - You can continue to enjoy tax-deferred growth
  - Risks
    - There is no guarantee that funds will last a lifetime
    - You must begin withdrawals at 70½ or 50% penalty is incurred

Important Questions to ask when Considering Defined Contribution Plans

- Questions for Defined Contribution Plans?
  - Do you have a match?
  - How much is it?
  - How soon until I can contribute to get the match?
  - What is the vesting period for the match?
  - What is the normal retirement age?
  - Is there any advantage to working past age 65?

Questions

- Do you understand Defined Contribution Plans?

D. Understand some Plans and Strategies for Employer Qualified Plans

- As you put your Retirement Plan together, it is important to think through some plans and strategies. Examples include:

Plans and Strategies for EQPs (continued)

- Plans and Strategies

  Accumulation

  - Live on a budget, save 20%, always get the company match
  - Save 20% of every dollar, 15% into your Roth 401k, 3% for other goals, and 2% for children's mission and education
  - Invest in Roth accounts while young and when rates are low. Use these to target your tax rate in retirement (to a low level)
  - Even though you don't know future tax rates, maximize investments in Roth's as you are saving more for retirement

Plans and Strategies for EQPs (continued)

- Plans and Strategies

  Retirement

  - Calculate a *minimum level of retirement income*, and annuitize that amount (if you have sufficient assets). The process is:
    - a. Calc. Social Security and defined benefit plan(s)
    - b. Determine *minimum amount* needed to live on
    - c. Take a percentage of EQP assets to purchase an ***immediate*** annuity to give you the minimum amount needed to have your acceptable level of income
  - Have both Roth and traditional retirement assets so you can target your tax rates in retirement
  - Donate assets from your traditional 401k/403b to pay tithes and offerings to eliminate your capital gains

Plans and Strategies for EQPs (continued)

- Plans and Strategies

  Distribution

  - Have taxable (tax now), Roth (rarely taxed) and traditional (taxes later) to target tax rate in retirement
  - Set a target tax rate, then pull traditional assets up to that amount, then Roth assets afterwards to reduce taxes
  - Make sure to pay your Required Minimum Distributions
  - During your later years, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts. Use this time to move assets into Roth accounts with as little tax consequences as possible
  - After age 70.5, donate assets from your traditional 401k/403b to pay tithes and offerings, to eliminate your capital gains and to fulfill your RMD amounts

Review of Objectives

A. Do you understand Employer Qualified Retirement Plans?

B. Do you understand Defined Benefit Plans?

C. Do you understand Defined Contribution Plans?

D. Do you understand plans and strategies for employer qualified plans?

Case Study #1

Data

- Bill, married with two kids, will be graduating in April with his bachelors degree, and has two similar offers from companies both located in San Francisco, California. Both companies are companies he would be content to stay with for 30 years. Company A has a 401k with a 100% match up to 4% of his salary. Company B has a 401k with no match, but a Defined Benefit Plan with the formula based on average salary, a factor of 1.5%, and years of service up to 30 years.

Calculations/Application:

- A. Assuming the salary is $50,000 for either firm, which has the more attractive retirement package for Bill?
- B. Can Bill participate in other retirement plans?

Case Study #1 Answer

Calculations/Applications:

- A. This is a difficult question to answer, and which depends on : 1. Bill, 2. Bill's forecast for the company, and 3. Bill's view of company policy.
- 1. Bill. How long is he planning to be with either company? Is he going back to graduate school soon? How portable is the defined benefit plan? The answer to this question is really based on the assumptions that Bill has regarding how long he plans to stay with either company. Since a defined benefit plan generally requires you to stay for an extended period, that benefit will only be valuable if Bill is committed for a long period of time.

Case Study #1 Answer

- 2. Bill's forecast for the company. Is the company viable, particularly company B? Will company B be around for as long as Bill wants them to? Are the products of both companies viable?
- 3. Bill's view of company policy. Will either company change its retirement policies after Bill retires? Have the companies historically taken good care of their employees? Are the plans consistent with similar companies? What is Company B's defined benefit formula? If Bill stays until retirement at B, what is the annual benefit? Assuming a reasonable interest rate, what is the present value of the annual benefit to Bill? What is the value of the company match over the same period?

Case Study #1 Answer

- B. Bill can have other plans, as long as his salary is below specific IRS determined limits. Based on the information provided, he could also invest in either a Roth or traditional IRA, or if he had a small business, he may be able to invest in a small business plan such as a SEP-IRA.

Case Study #2

Data:

- Greg is 50 years old and has been working for 10 years with a company that has a defined benefit plan. The formula is the five highest annual salary years within the last ten years multiplied by a company determined factor of 1.5%, times years in service (to a maximum of 33). Assuming Greg stays with the company until his retirement at age 65, an assuming his highest five years annual salaries average $60,000.

Calculations:

- A. How much can Greg expect to receive annually at retirement?
- B. What is the percent of his final 5 year average salary?

Case Study #2 Answer

- A. Greg can expect to receive:
  - $60,000 x .015 x 25 years = $22,500
- B. This is $22,500/$60,000 or 37.5% of his final salary

Case Study #3

Data:

- Bill is 55 and plans to retire in 10 years. He is working for a company with a Tax Sheltered Annuity (TSA or 403b Plan).

Calculations

- A. How much can he contribute into his company's Roth 403b plan in 2020?
- B. If is company has a matching program, what impact will that have on Bill's contribution?

Case Study #3 Answer

- A. Contribution limits for the 401(k), Roth 401(k), 403(b), Roth 403(b), and 457 Plan annual contribution limits are:

Year	Contribution Limit	Catch Up Contr.
2018	18,500	6,000
2019	19,000	6,000
2020	19,500	6,500

Since Bill is over 50 years old, he could contribute $19,500 plus a $6,500 catch up contribution in 2020 for a total of $26,000

B. The company match will have no impact on the amount that Bill can contribute

Case Study #4

Data:

- Bill retired on his 60th birthday and did not use any of his traditional IRA balances. On December 31st of his 69th year, he had $450,000 in his 401k plan.

Calculations:

- A. How much would he be required to take out of his account the next year, i.e. the year he turns 70 1/2? (use the table below)
- B. How much would he be required to take out if this was a Roth 401k?

Age	Life Expectancy (LE)	Age	LE
70	27.4	71	26.5
72	25.6	73	24.7

Case Study #4 Answers

- A. From the table, his life expectance is at age 70 is 27.4. Bill will be required to take a distribution of his 401k plan of $450,000 / 27.4 or:
  - $16,423 the next year.
- B. If this was a Roth 401k, he would still have to take the required distributions. However, if once he retired, he rolled his Roth 401k over to a Roth IRA, there would be no required distributions
  - The tax rules have yet to catch up with the retirement vehicles

Case Study #5

Data:

- Sam just got out of school and has already begun his retirement program. He has invested enough in his 401k plan to the match, and has found out that the company has a Roth 401k plan as an option. He is discussing with a friend the benefits of the Roth 401k versus the Traditional 401k.

Application:

a. Which vehicle, the Roth or traditional 401k should Sam select and why?

b. What are Sam's assumptions that would impact his choice of retirement vehicle?

See Roth versus Traditional – Which is Better (LT28)

Case Study #5 Answers

a. Which vehicle Sam chooses should be based on his vision, goals, objectives, and assumptions for the future

b. His assumptions should relate to 8 key areas:

1. Does he need the tax break now?

- If the reduction in AGI is important for him to reduce his current tax bill, then he would likely choose the traditional

2. Does he have the money to pay the taxes now?

- If he has additional money to invest for retirement, you can invest more in the Roth than the traditional. That is because he pays taxes on the Roth money outside of your retirement account.

Case Study #5 Answers

<u>3. Does he have a possible need for principle?</u>

- If he may need money in the account (just in case), with the Roth he can take out principle after 5 years without penalty or taxes, as principle has already been taxed. He cannot, however, take out earnings and interest without penalty.

<u>4. Does he expect your tax rates to rise in retirement?</u>

- If he expects tax rate to be higher (lower) in retirement, the Roth (traditional) is preferred. Make sure he takes into account his child tax and other credits when determining his current tax rates.

Case Study #5 Answers

- 5. Does he want to have more saved at retirement?
  - If he wants more money at retirement, use the Roth since he pays retirement taxes with non-retirement money, i.e., he is saving more for retirement

  6. Does he want to avoid RMDs (required minimum distributions)?
  - With tax-deferred accounts, he is required to take out a required minimum distribution each year after age 69. If not, her penalty is 50% of the RMDs

  7. Does he want to leave money to heirs without major tax or other problems?
  - With Roth's' the taxes are already paid so it is much easier from a tax basis to leave these to heirs.

Case Study #5 Answers

- 8. Does he want to be able to target his tax rate in retirement. If he wants to target his tax rate in retirement, he should have a balance of his assets in tax-now accounts (brokerage, banks, and mutual fund companies), tax-deferred accounts (traditional 401k, 403b and IRA accounts), and tax-never accounts (Roth IRA and Roth 401k accounts). This way he can pull out assets from his tax-now and tax-deferred accounts up to his targeted tax rate, and anything beyond, he takes from his tax-never accounts, enabling him to target his tax rate in retirement..