Planning for Your Retirement

Standard 6

The student will explain and evaluate the importance of planning for retirement.

Lesson Objectives

- Identify and evaluate different retirement options.

Personal Financial Literacy Vocabulary

Annuity: A contract between an individual and an insurance company where the individual makes a series of payments that are invested by the company and repaid to the individual at a later date, generally during retirement.

401(k): A retirement plan that allows employees in private companies to make contributions of pre-tax dollars to a company pool that is then invested in stocks, bonds, or money market accounts.

Defined Benefit Plan: A company retirement plan where the retirement payments are based on the length of service to the company and the salary earned at the time of retirement.

Defined Contribution Plan: A retirement plan where the retirement payments are based on earnings invested from regular contributions from the employer and employee.

Individual Retirement Account (IRA): An account in which an individual may set aside earned income in a tax-deferred savings plan for his or her retirement.

Social Security: A federal program that requires employers and workers to make regular payments to a government fund which is used to make payments to people who have reached a certain age or unable to work because they are disabled.

Introduction

Lindzi and Lezli are twin sisters, and their grandparents are getting ready to retire. The twins are looking forward to attending all the family gatherings and retirement parties to celebrating this accomplishment.

Grandma Eliza invested in her company's 401(K) and has an emergency savings account in addition to her Social Security benefits for her retirement income. Grandpa Jess, however, decided it was better to rely solely on Social Security.

Who made the best choice: Grandma Eliza or Grandpa Jess?

Lesson

The oldest person alive in the United States today was born in 1899, and that makes her about 100 years older than you. Imagine what that would be like! If you assume she retired at age 65 (the most common retirement age in the United States), she has lived almost half of her life in retirement.

Fast forward about 50 years and think what you would want your life to be like when you retire. Would you want to live on a lake and spend your days fishing? Or how about living in a cabin in the mountains? Or maybe you would like to stay in Oklahoma and live close to your family? Regardless of what sounds good right now, you will need some kind of income to ensure you can live wherever and however you want. Unless you start planning for retirement in your younger years, you will be living your "golden years" on a limited income that may or may not provide enough money to pay your bills.

Even though retirement means different things to different people, most would agree that having some degree of financial security is an important consideration. Creating a successful retirement plan includes understanding some of the potential sources of income, such as Social Security, company retirement plans, Investment Retirement Accounts (IRAs), and annuities. Like anything else, each plan has both benefits and risks.

Sources of Retirement Income

Social Security is one of the most common retirement benefits in the United States, with almost 90 percent of the population over 65 receiving a monthly payment. The program is primarily funded with payroll taxes called FICA (Federal Insurance Contributions Act), and the average check received is about $1335. That is basically the equivalent of earning $8.35 an hour. It currently ranks as one of the largest government programs in the world and has one of the largest budgets of any program in the country.

Social Security is classified as a "pay as you go" benefit, with the money coming in today being used to pay for those currently drawing the benefits. It was originally designed to be a "supplemental" income program for people over the age of 65 to help them meet their basic needs. When the Social Security Act was signed by President Franklin Roosevelt in 1935, individuals over 65 received a one-time lump sum from the federal government. In January of 1940, the government began making monthly payments to those who turned 65.

REMINDER

Social Security is funded through payroll taxes called FICA (Federal Insurance Contribution Act). Receipts qualify for social security benefits at age 62 and full benefits at 65.

Relying only on Social Security for your retirement years will be very limiting. In fact, it may not be enough to pay for the things you want or need when you get older. Because Social Security is a government program, you have little or no control over what you will earn. And, you have little or no control over what happens to the program in the next 60 years. The amount you receive is based on the number of years you work and the amount you paid into the system. In most cases, you need to work a minimum of ten years to receive Social Security benefits, but there are several exceptions. While most recipients today qualify for partial Social Security benefits at age 62 and full benefits at age 65, future recipients will need to be a few years older to start receiving payments.

Almost every job in the United States requires employers to participate in the Social Security system, making it the most readily available retirement income. If you are self-employed, then you pay the entire amount of your FICA tax while your employer and you share the costs when you work for someone else.

Like Social Security, company retirement plans have changed through the years too. Most companies no longer offer "pension plans" to their employees, instead offering retirement plans commonly called a 401(k). With pension plans, employees received a monthly retirement check based on their length of time with the company and their annual income. These plans are called "defined benefit plans" because the benefits are spelled out for the employees. Today, most retirement accounts are "define contribution plans" because the amount the employee receives is based on the amount of money they put into the account and how much that money earns.

With the 401(k), you and your employer can both put money into a specially designed investment account. Often, your employer will match how much money you place in the account each month, but you choose

how that money is invested. Generally, money put into a 401(k) is tax-free at the time it is invested, but you pay income tax on the amount you withdraw. You can take out your money before you retire, but may face a substantial tax penalty for doing so.

An annuity is a different kind of retirement account. Annuities are based on a contract where you or your employer pay in a specific amount each month while you are working, and then you receive a guaranteed amount each month when you retire. If employer-sponsored, the amount you receive is based on the number of years you work and your annual salary. You would also pay taxes on the amount earned annually from the annuity. While annuities are a good option to consider, they tend to generate less overall earnings than a 401(k). However, their benefits are guaranteed whereas 401(k) plans have no guarantees.

IRAs provide another option for retirement planning. You may want to consider an IRA if your company does not offer a retirement plan, or you may choose to set up an IRA as a supplement to other retirement accounts. Most IRAs are invested in mutual funds which tend to have lower risk than other investment options. Before opening an IRA, you should determine exactly how your money will be invested and understand any potential fees for managing the account. Currently, there are two kinds of IRAs: a traditional IRA and a Roth IRA. You may want to get professional advice from a financial planner or other financial consultant before opening an IRA account to determine which type is most beneficial for you.

A traditional IRA allows you to contribute money to your account, deduct the contribution from your personal income taxes, and then pay the income taxes when you pull the money out of your account. Money paid into a traditional IRA is available after you turn 59 1/2 years old. You may be able to withdraw funds from your account for special purposes or emergencies; otherwise, you will pay costly penalty fees for using your money before then. Those penalties are in place as an incentive to keep your money invested for retirement purposes instead of using it like a savings account.

A Roth IRA is a little different. With a Roth, you pay personal income taxes on your earnings before placing it in your IRA account. Because you pay the taxes upfront, you will not pay any taxes when you withdraw the money at a future date. Roth IRAs also have fewer restrictions for taking the money out before retirement, but it is always advisable to be sure you understand the terms and conditions of the account.

Of course, older people may have income from other sources too. These might include rental property, inheritance, or other investments. Some retirees may even want to continue working full-time or part-time while others may earn money from their hobbies. Whatever the source of their money, most people today find it difficult to live on only one type of income. Having a plan in place to help you diversify your retirement earnings will help you have a financially security future.

Sources of Income for Individuals 65 and older	
Social Security	85%
Investments and other assets	63%
Pensions	32%
Income from employment	23%
Public Assistance/Welfare	3%
Veteran's Benefits	4%
No income	3%

Source: http://www.pensionrights.org

Conclusion

As a young person, the thoughts of retirement and investing for retirement seem rather foolish. After all, you have not even graduated from high school! Who wants to think about retiring when your whole life is ahead. You probably prefer saving for a car, a college education, a graduation trip, or a wedding. However, once you start working, you will be faced with several decisions that will determine whether or not you can live comfortably in your later years. Learning the basics now will help you make the best decisions about your future. It may also help you talk with your parents about their plans for retirement.

While most retirement accounts allow you to access your money before retiring, you have a high opportunity cost when making that decision. Remember, the purpose is to save for retirement. If you use the money now, you will not have it when you need it later on. The money you need before then should be in your savings account — not your retirement account

FINAL NOTE: Lindzi and Lezli should be proud of both grandparents. Reaching retirement is an important milestone in anyone's life. However, they made very different life choices that will impact their financial security during their retirement years. Based on what we know, Grandpa Jess will have very limited income and may not be able to achieve his goals for retirement. While Social Security provides a set income, some people find it is insufficient to cover all of their monthly expenses. Also, Social Security benefits cannot be passed along as inheritance to grandchildren like Lindzi and Lezli. On the other hand, Grandma Eliza planned for her retirement and should be able to live a more financially independent life. Also, any funds remaining in her savings or 401(k) can be left to her heirs.

Name:______________________________Class Period: ______________________________

Planning for Your Retirement Review 6.1

In the box below, write the definition of each type of retirement income.

Sources of Retirement Income
Social Security
401(k)
Annuity
Traditional IRA
Roth IRA

Name:_______________________________Class Period: ______________________________

Retirement Plans Activity 6.1A

The U. S. Department of Labor provides the information in the table on the next page about Defined Benefit and Defined Contribution retirement plans. After reading through the basic characteristics of each plans, complete the following questions and return to your teacher.

1. What are two advantages to having a Defined Benefit plan for retirement?

2. What are two advantages to having a Defined Contribution plan for retirement?

3. What is one disadvantage to having a Defined Benefit plan? Explain why it is a disadvantage.

4. What is one advantage to having a Defined Contribution plan? Explain why it is a disadvantage.

5. What, if any anything, do the two plans have in common?

Table 1
Characteristics Of Defined Benefit And Defined Contribution Plans

	Defined Benefit Plan	Defined Contribution Plan
Employer Contributions and/or Matching Contributions	Employer funded. Federal rules set amounts that employers must contribute to plans in an effort to ensure that plans have enough money to pay benefits when due. There are penalties for failing to meet these requirements.	There is no requirement that the employer contribute, except in some situations. The employer may have to contribute in certain automatic enrollment 401(k) plans. The employer may choose to match a portion of the employee's contributions or to contribute without employee contributions. In some plans, employer contributions may be in the form of employer stock.
Employee Contributions	Generally, employees do not contribute to these plans.	Many plans require the employee to contribute in order for an account to be established.
Managing the Investment	Plan officials manage the investment and the employer is responsible for ensuring that the amount it has put in the plan plus investment earnings will be enough to pay the promised benefits to the employees.	The employee often is responsible for managing the investment of his or her account, choosing from investment options offered by the plan. In some plans, plan officials are responsible for investing all the plan's assets.
Amount of Benefits Paid Upon Retirement	A promised benefit is based on a formula in the plan, often using a combination of the employee's age, years worked for the employer, and/or salary.	The benefit depends on contributions made by the employee and/or the employer, performance of the account's investments, and fees charged to the account.
Type of Retirement Benefit Payments	Traditionally, these plans pay the retiree monthly annuity payments that continue for life. Plans may offer other payment options.	The retiree may transfer the account balance into an individual retirement account (IRA) from which he or she withdraws money, or may receive it as a lump sum payment. Some plans also offer monthly payments through an annuity.
Guarantee of Benefits	The Federal Government, through the Pension Benefit Guaranty Corporation (PBGC), guarantees some amount of benefits.	No Federal guarantee of benefits.
Leaving the Company Before Retirement Age	If an employee leaves before his or her retirement age, the benefit generally stays with the plan until he or she files a claim for it at retirement. Some defined benefit plans offer early retirement options.	The employee may transfer the account balance to an individual retirement account (IRA) or, in some cases, another employer plan, where it can continue to grow. The employee also may take the balance out of the plan, but will owe taxes and possibly penalties, thus reducing retirement income. Plans may cash out small accounts.

Name:______________________________Class Period: ____________________________

Retirement Plans Activity 6.1B

Complete the following assignment and return it to your teacher.

Many employers now provide defined contribution retirement plans, primarily a 401(k). These plans tend to offer an employer/employee match, which means the company will match the amount of money you put into the plan up to a certain percentage. You have a new job with a salary of $60,000 and your employer will match your contribution to your retirement account up to 7 percent. Follow the steps below to calculate your employer's match.

Step 1. Find the maximum amount of the match. Multiply your salary by the employer's percent to find the annual total amount of the match.

$ ________ times ________ equals $ ________

Step 2. If you decide to match the maximum, what is the total amount added annually to your retirement account?

$ ________ plus $ ________ equals $ ________

Step 3. Find the monthly amount donated to your retirement account.

$ ________ divided by 12 equals $ ________

Step 4. Find the amount of your monthly contribution to your retirement account.

$ ________ divided by 2 equals $ ________

Step 5. Suppose your employer decides to raise the maximum match to 10 percent, but you leave your amount at 7 percent. What is the total amount contributions you are losing each year?

A. Find new amount contributed by your employer:

$60,000 times .10 equals $ ________

B. Subtract the total amount in Step 2 to find the total amount you are losing each year.

$ ________ minus $ ________ equals $ ________

Most people spend about 40 years in the workforce. Suppose your employer changes this percentage after you have worked there for 10 years. How much money would you miss putting in your retirement account over those 30 years? To find this amount, multiply the answer in 5B by 30. Also remember, this amount only represents the contributions made; it does not include the additional amount of interest you would be earning on those contributions