Silicon Valley Chapter
American Association of Individual Investors

Financial Planning Workshops

Retirement Planning I

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Please check us out!

- Chapter website: www.siliconvalleyaaii.org
- Meetups: www.meetup.com/AAII-Silicon-Valley-Meetup
- Facebook: www.facebook.com/sv.aa
- Slides and Recordings

  www.siliconvalleyaaii.org/financialplanning/
- AAII National website: www.aaii.com
- My email address: dstikes.svaaii@gmail.com

Our Next Event and Special Interest Group Webcasts

- Monthly Event: Saturday January 13th at 9:00am; webcast only
  - Nicholas Atkeson: How do you Make Money in World Where the Financial Experts are Always Wrong
- Financial Planning Workshop
  - Debra Stikes: Second Wednesday of each month at 6:30pm September to June
- Investing Discussion Group
  - Lynn Gillette: Fourth Monday of each month at 6:30pm except Dec.
- Computerized Investing Group
  - Don Mauer, Bill Paseman: First Thurs of each month at 6:30pm

Financial Planning Workshops

- Financial Planning … The Big Picture
- Investing 1: Modern Portfolio Theory, Building a diversified portfolio
- Investing 2: Efficient Market Hypothesis; Can you beat the market?
- Taxes: TCJA, SECURE Act, Tax diversification, Asset location, QCDs
- Retirement Planning 1: Tax-advantaged plans, RMDs
- Retirement Planning 2: Safe withdrawal rates, Bengen's 4% rule
- Risk Management/Insurance: Annuities, Long-term care, Litigation
- Social Security and Medicare: Claiming strategies, Medicare traps
- Estate Planning: Probate, Executor/trustee duties, Philanthropy
- Wrap-up: Case study reviewing previous material

Today we will cover …

- Retirement Planning
  - The accumulation phase
  - The distribution phase
- Various types of accounts
  - Traditional and Roth IRAs
  - 401(k) plans, etc.
- Estate planning issues with retirement accounts
- Stretching your retirement plan to age 100
- Financial planning software

Retirement Planning

- Typical life cycle
  - Birth ..... Graduation day ..... Retirement day ..... Death
- Goal of retirement planning
  - Accumulate enough assets between Graduation Day and Retirement Day (Accumulation phase) .....
  - ..... to live comfortably after Retirement Day (Distribution phase)
- Known Unknowns
  - Length of accumulation and distribution phases
  - Return on retirement portfolio, inflation, etc.
  - Sequence of return risk
  - Sequence of expense risk, medical expenses, LTC

Meet Alan

- Graduation Day
  - Alan, a bright young twenty-something, just graduated from Prestige U.
    - Advanced degree in computer sciences
  - Starts work shortly at Giggle Corp
    - Starting salary $100k per annum
- Fast forward 50 years to Retirement Day
  - Alan is now seventy-something
  - Looking forward to a long and comfortable retirement
  - How will Alan fund his retirement?

How Much Will Alan Need?

- Expenses in Retirement
  - Assume 80% of salary = $80,000 pa (Today's $)
- Income
  - Social Security; assume $30,000 pa
  - Pension; assume Giggle offers none
  - Retirement portfolio must fund $50,000 pa
- Retirement Portfolio
  - Need $1.25M assuming Bengen's 4% rule
  - Alan should plan for $2.5M to be safe.

Alan's Accumulation Phase

- How do we get from $0 on Graduation Day to the $2.5M required in the retirement portfolio on Retirement Day?
- Assume Alan starts saving for retirement at age 35 and continues contributing to his portfolio until age 70, i.e. for 36 years
- $15,000 pa for 36 years → $2.2M at age 70

Today's $, assuming 7% CAGR

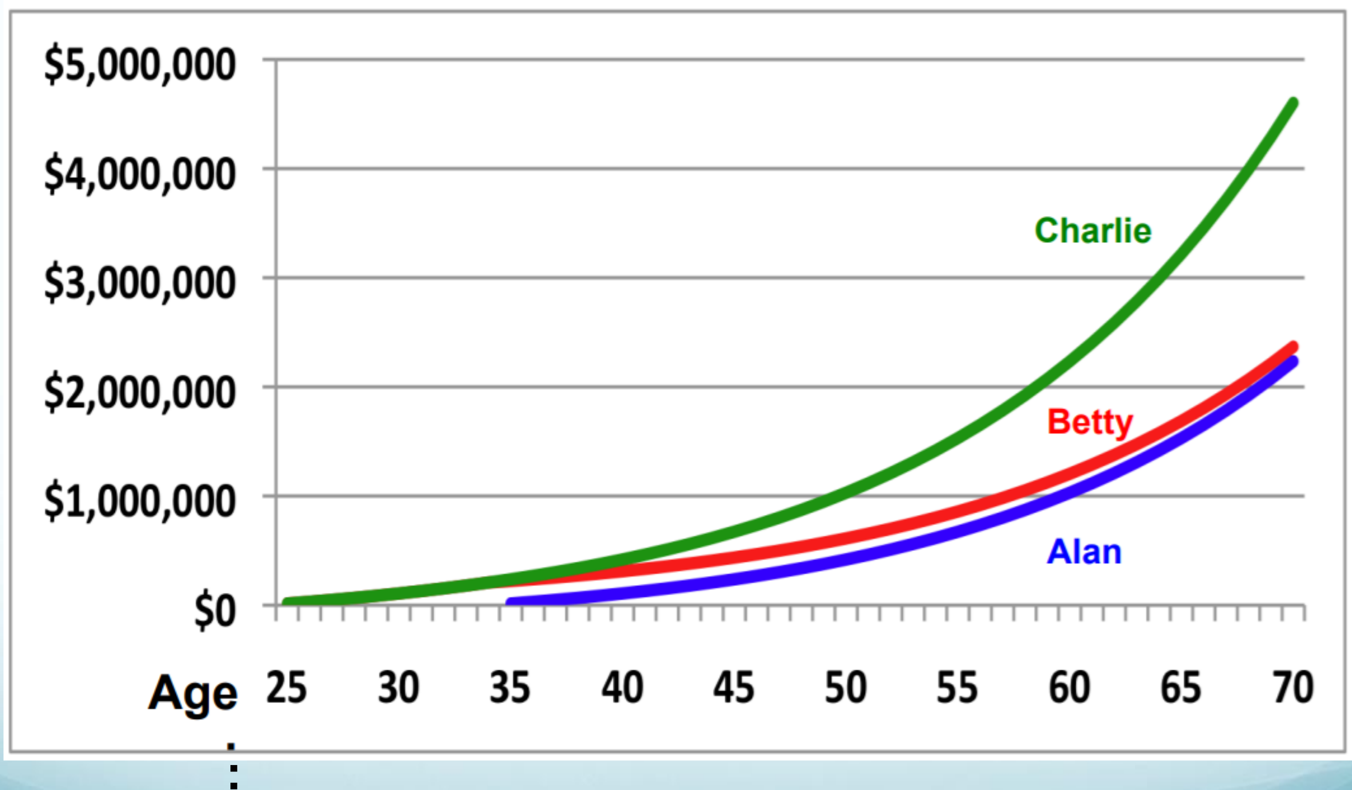
Meet Betty

- Betty is the same age as Alan, and graduated the same year
- She also works at Giggle and earns the same salary as Alan
- But she starts saving for retirement at age 25
- Then she drops out of the workforce at age 35, no longer contributes to her retirement portfolio
- $15,000pa for 10 years → $2.4M at age 70

Meet Charlie

- Charlie was a classmate of Alan and Betty and started with them at Giggle
- Charlie started contributing to his retirement plan at age 25, and continued making contributions to age 70
- $15,000pa for 46 years → $4.6M at age 70

Let’s Compare The Three Plans



Are You On Track For Retirement?

- Recommendations from T. Rowe Price

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

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

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

Tax Advantaged Retirement Plans

- Employee salary deferral plans
  - Traditional IRA, Spousal IRA, Non-deductible IRA
  - Roth IRA
- Employer sponsored plans
  - 401(k) and 403(b) plans
  - 401(k) and 403(b) Roth plans
  - SIMPLE
  - SEP
  - Solo 401(k) plans
  - Non-Qualified Deferred Compensation Plans
- Pseudo retirement plan
  - Health Savings Account, HSA

Traditional IRA

- Contributions are may be deductible from 1040 income
  - Maybe eligible for Saver's Credit
- Growth within the plan is tax-deferred
- Withdrawals after age 59.5 are taxed as ordinary income
- Withdrawals before age 59.5 are assessed a 10% federal penalty (some exceptions) and possible additional state penalty (2.5% in CA)
- Required minimum withdrawals (RMD) start at age 72
- Failure to take RMD triggers 50% penalty

Traditional IRA Limits

- Must have reportable income
- Contribution limits for 2024:

  $7,000 pa, plus extra $1000 pa catch-up if age 50 or over

- Who is eligible to deduct their IRA contribution?
  - Anyone not covered by an employer retirement plan
  - For those covered by an employer retirement plan

Modified Adjusted Gross Income, MAGI, in 2024

< $77,000 - $87,000 for singles

< $123,000 - $143,000 for married filing jointly

IRA Rollovers

- Individuals can withdraw funds tax-free from a traditional IRA if they are deposited within 60 days to another IRA
- Only 1 non-trustee-to-trustee rollover per person every 12 months regardless of the number of IRAs owned (not calendar year)
- Solution is to do a trustee-to-trustee transfer
  - No limit on the number of these rollovers allowed

Required Minimum Distributions, RMDs

- Beginning in 2023, the SECURE 2.0 Act raised the age for starting RMDs to 73
  - RMDs start in 2024 for those turning 73 in 2024

- RMD is based on age and life expectancy

	2024 Table
Uniform Lifetime Table	
Unmarried at age 73	26.5 years
RMD percent	3.77%

RMD = % of account value Dec 31st of the previous year

Required Minimum Distributions, RMDs

- Penalty for missed RMD
  - SECURE ACT 2.0 decreased the Penalty from 50% to 25%
  - Penalty is further reduced to 10% when corrected by the end of second year after the missed RMD.
  - It is routine for the IRS to forgive the penalty of a first missed RMD.

IRS RMD Tables

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

Other IRAs

- Non-deductible IRA
  - Available to those who do not meet the MAGI limit
  - Same contribution limits as the traditional IRA
    but contributions are not deductible on 1040
  - Earnings on account grow tax-deferred
  - After-tax contributions are withdrawn tax free
    - Cost basis is pro-rated
  - Earnings are taxed as ordinary income on withdrawal
- Spousal IRA
  - Similar to a traditional IRA for a spouse with little or no earned income
  - Same contribution limits and tax treatment

Roth IRA

- Contributions are not deductible
  - Growth within the plan is tax-free providing distributions are qualified
  - Contributions can be withdrawn any time for any reason
- Qualified withdrawals of earnings are tax-free
  - After age 59.5
  - Original plan must be > 5 tax years old
  - Otherwise there is a 10% fed penalty plus state penalty

    except $10,000 for first home purchase

    education expenses, medical expenses, etc
- No required minimum distributions
- Good estate planning tool

Roth IRA Limits

- Who can contribute in 2024
  - Income limits

    $146,000 - $161,000 for single taxpayers

    $230,000 - $240,000 married filing jointly
- Contribution limits same as for traditional IRA
  - Contribution limit is combined for Traditional and ROTH IRAs
  - $7,000 pa plus $1,000 catch-up for age 50 or older

Roth Conversions

- Anyone can convert a traditional IRA to a Roth IRA
  - Will owe taxes on deductible portion of contributions and the earnings
- Consider partial conversions to fill up to the top of your current tax bracket
- Can no longer recharacterize a conversion
- Must wait 5 years before withdrawing any converted balances (contributions or earnings)
  - Otherwise if under 59 ½ there is a 10% federal penalty plus state penalty on withdrawal

The "Backdoor" Roth

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

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

Traditional 401(k) Plan

- Employer sponsored pension plan allowing employees to defer pre-tax salary
- Employer may require up to 1 year of service before eligible
- Tax implications same as for traditional IRA
  - Pre-tax contributions
  - Earnings grow tax-deferred
  - Distributions taxed as ordinary income
  - 10% federal penalty plus state penalty for early withdrawal < age 59.5
  - RMDs start at age 73; Missed RMD penalty same as IRA

Traditional 401(k) Limits

- Limits: $23,000 + $7,500 for age 50 or over (2024)
- Employer matching contribution
  - Most common match 50% of first 6%
  - Vesting schedule (up to 6 yrs) for employer contributions
  - Employee contributions always fully vested
- Sponsor must do Average Deferral Test (ADP) to limit benefits for Highly Compensated Employees (HCEs)
- Employer may allow additional after-tax contributions

  IRS limits =$69,000 + $7,500 catch-up for age 50 or over
  - The plan may allow after-tax contributions to be converted to ROTH
- Catch-up is a combined limit for all 401K contributions
- Participant loans allowed by some plans (Beware!)

Responsibilities of 401(k) Plan Sponsor

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

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

403(b) Plan

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

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

- Similar to traditional 401(k) and 403)(b) plans except
  - Contributions are <u>not</u> tax deductible
  - No taxes are due on plan earnings
  - No taxes are due on withdrawals
- RMDs
  - No longer required unless already required to take RMDs

Savings Incentive Match Plan for Employees, SIMPLE IRA

- Usually set up by small employers
  - Must be 100 or fewer employees
- Employee contributions are optional
  - Limits for 2024

    $16,000 pa + $3,500 catch-up if age 50 or older
- Employer matches employee contribution $ for $
  - Up to 3% of employee compensation
  - Or fixed 2% of all employees' compensation above $5000 pa, even if some employees choose not to participate
    - Cap on compensation: $345,000 for 2024

Simplified Employee Pension Plan (SEP) IRA

- For use by small business owner or if you have self-employed income from consulting work, etc.
- Works well for married couple in a family business
- 2024 limits = lesser of 25% of income or $69,000+$7,500 catch up contribution
- Contribution limits are not affected by participation in traditional or Roth 401(k) plans
- Distributions are taxed as ordinary income
- Can convert to a backdoor Roth year after year
  - Get professional help!

Simplified Employee Pension Plan (SEP) IRA

- Contribution limits are combined for all defined contribution plans

Solo 401(k) Plan

- Suitable for sole proprietors or partners
  - No common-law employees
  - Can contribute as employer and/or employee
- No age or income restrictions
- Employee pre-tax or Roth contributions
  - Limits for 2024
  - $22,500 + $7,500 catch-up if age 50 or older
- Employer contributions
  - Limit 25% of compensation
- Limits on total contributions 2022
  - $69,000 for 2024. plus $7,500 for age 50 or older

Non-Qualified Deferred Compensation Plans (NQDC Plans)

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

Which Retirement Plan Should I Fund First?

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

Health Savings Account

- Eligibility
  - Must have a high-deductible health insurance plan
  - Cannot be on Medicare
- Triple tax benefits
  - Contributions are tax-deductible
  - Investments grow tax-free
  - Qualified medical distributions are tax-free
    - Distributions for non-medical expenses are taxed as ordinary income
- Contribute up to $4,150/person, $8,300/family plus $1,000 catch-up if age 55 or older
- Can make withdrawals after you no longer qualify for contributions

Asset Location

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

    Generate interest and non-qualified dividends

    and short-term capital gains

      These are best in tax-advantaged accounts

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

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

    Generate qualified dividends

    and long-term capital gains

      These are best in taxable accounts

QCD – Qualified Charitable Distribution

- Many IRAs are eligible – Traditional, Rollover, Inherited, SEP (inactive plans only), and SIMPLE (inactive plans only)
- IRA Owner must be over 70 ½
- Direct transfer from administrator to qualified charity
  - Donor Advised Fund is not qualified
- Counts towards RMD
  - Track to verify removed from taxable income on 1099-R
- Annual Maximum $100,000

Transfer 529 to ROTH IRA

- SECURE ACT 2.0
  - Allows lifetime rollover of $35,000 per beneficiary in unused 529 assets
  - Rollover to the beneficiary of the 529 plan
  - Plan must be held for the beneficiary for at least 15 years old
  - Transferred amount must have resided in the 529 for at least 5 years before the transfer
  - The aggregate amount transferred from 529 account and other IRA contributions for the year, must not exceed the ROTH IRA annual contribution limited applicable for the beneficiary.

Estate Planning Issues

- Federal estate tax exemption = $13.61M in 2024
  - Sunsets in December 2025
- Providing no changes expected Federal estate tax exemption in 2026 would be approximately $6.8M
- American Taxpayer Relief Act of 2012 (ATRA 2012)
  - Deceased Spouse Unused Exemption Portability
  - File an Estate Tax Return within 5 years (was 2 years)

Estate Planning Issues

- Be careful with <u>income tax</u> efficiency:
  - Roth accounts are best

    No taxes owed.
  - Taxable accounts are good

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

    Unfavorable tax treatment; no step-up in basis

    Owe ordinary income tax on distributions

    Spouse can assume an IRA at death; Stretch RMDs

    Consider leaving to charity
- Talk to your estate planning attorney!

Inheriting IRA Assets: The "Stretch IRA"

- The SECURE Act (December 2019) eliminated the Stretch IRA except for ...
  - Surviving spouse of original owner
    - Must transfer to the surviving spouse within 10 yrs
  - Minor child < age of majority
  - Person >10 years younger than the decedent
  - Disabled individuals
  - Chronically ill individuals
- For all others the account must be completely distributed within 10 years of the original owner's death, but there are no annual RMD requirements
- Important to educate heirs now about options
- Talk to your estate planning attorney!

Inheriting IRA Assets

- When a spouse inherits, the spouse should be listed as the primary beneficiary.
- A living trust which becomes irrevocable at death can be a primary or contingent beneficiary.
  - A consideration when a non-spouse inherits
  - The beneficiaries of the trust must be individuals (no charities, etc…)

Important to Review Beneficiary Forms Regularly

- Have there been any .....
  - Births, Deaths
    - Consider designating contingent beneficiaries
      - Specifying a trust is an option
  - Marriages, Divorces
    - Marriage/Remarriage often voids beneficiary designations – This is a recent change
    - Current spouse consent is often required if they are less than a 50% beneficiary
  - Beneficiaries reaching the age of majority
  - Has the beneficiary information been lost?

Important to Review Beneficiary Forms Regularly

- A spouse is the only beneficiary that can transfer a retirement account to their name
- If a spouse is to inherit the account, they should be specified as the primary beneficiary
- Specifying an estate as the beneficiary subjects the account to probate
- No beneficiary subjects the account to probate
- The administrator of the account will not notify the estate administrator or trustee the identity of the beneficiaries

Important to Review Beneficiary Forms Regularly

- TOD accounts also pass by contract and not by will or trust
- Beneficiary designations are often lost when the plan administrator changes
- DYI Estate Planning is strongly NOT recommended. Mistakes can be expensive and not correctable. Get professional help!

What If I Can't Stretch My Portfolio to Age 100?

- Possible solutions to longevity challenge
  - Start saving earlier (Talk to your kids, grand-kids!)
  - Save more during working years
  - Work longer
  - Reduce withdrawals
    Downsize home, move to a cheaper area
  - Seek higher returns (more risk)
- Other possible solutions
  - Tap into home equity; Reverse mortgage
  - Buy insurance; Annuity

FHA Reverse Mortgage for Seniors

- Home Equity Conversion Mortgage (HECM)
  - Insured by the Federal Housing Administration
- Requirements
  - Be 62 years of age or older
  - Own property outright or have significant equity
  - Occupy property as principal residence
  - Continue to pay property taxes, insurance, and maintain the property
  - Not be delinquent on any federal debt
  - Must undergo counseling, financial assessment

How Much Can I Borrow?

- Maximum loan
  - Lesser of appraised value or $1,149,825 (2024)
  - Adjusted for age of the youngest borrower and the interest rate
- Form of loan
  - Lump sum
  - Monthly payments
  - Line of credit (non-cancellable)
  - Combination of the above
- Repayment due on sale, no longer primary residence or death of owner

Costs for a HECM

- Interest, accumulates on loan
- Mortgage insurance premiums
  - Initial: Typically 0.5% of home value
  - Annual: 1.25% of outstanding loan balance
- Closing costs
  - Appraisal, title search, inspections, taxes, etc.
- Origination fee: 1% to 2% capped at $6,000
- Servicing fees: Capped at $35 per month
- Most fees rolled into loan; many waived by mortgage lender

HECM Line of Credit

- Converts home equity into easily accessible funds
- No monthly payments on principal or interest
- Lender cannot reduce or cancel line of credit
- Unused line of credit grows over time
- Non-recourse loan, i.e. can never owe more than the home is worth when the loan is repaid
- Can be converted to a monthly cash flow at any time

Uses for a HECM Line of Credit

- Defer Social Security benefits for a higher benefit
- Allows smaller short term cash bucket
  - Reduces opportunity cost of "dead money"
- Provides flexibility in long-term investment bucket
  - Reduces sequence of returns risk, i.e. need to sell assets in bear markets
- Can extend life expectancy of retirement portfolio
- Can provide living expenses if retirement portfolio is exhausted

Consider an Annuity

- Single premium immediate annuity, SPIA
  - Benefit starting immediately
    - $1900/month, i.e. $22,800 pa
  - Cost for 65 year old male: $300,000 (Jan 2024)
    - Cash flow = 7.6 per annum
- Single premium deferred annuity, SPDA
  - Benefit starting at age 85
    - $12,883/month, i.e. $154,596 pa
  - Cost for 65 year old male: $300,000 (Jan 2044)
    - Cash flow = 51.5% per annum

Retirement Planning Software

- Available free from most financial houses
  - T Rowe Price, Vanguard, Fidelity, Schwab, AARP, etc.
- Inputs
  - Marital status
  - Age, spouse's age, target retirement age, etc.
  - Income: Salary, Social Security benefits, etc.
  - Expenses: Fixed expenses, variable expenses
  - Portfolio size and return, inflation rate, etc.
- Output
  - Shortfall or surplus, required savings rate, etc.
  - Confidence level from Monte Carlo simulations
  - Remaining balance data

Problems With Retirement Planning Software

- Beware precision output to 5 significant figures
  - Garbage in … Garbage out
- Output is only as good as the input assumptions
  - Life expectancy; actuarial tables only give averages
  - Rate of return assumptions for portfolio
  - Sequence of returns risk
  - Tax rate forecast in retirement
  - Inflation estimate
- Compounding the "known unknowns" 35 years into the future is not an exact science!

"Too err is human; to really screw up you need a computer!"

Best Uses for Planning Software

- Learning tool
  - Provides a feel for how all the pieces play together
  - Guides the safety first versus lifestyle trade-off
- Scenario analysis
  - What if I work for 2 extra years?
  - What if I delay taking Social Security benefits to age 70?
- Sensitivity analysis
  - What if the return on my portfolio is 5% instead of 7%?
  - What if inflation is only 2%? How about 4%?
- Even a rough plan is much better than no plan
  - Re-evaluate the plan annually

To Probe Further

- *Want to Create a Retirement Paycheck? …*, Carrie Schwab-Pomerantz, December 2020
- *Many Retirees Limit Withdrawals to the RMD Amount*, AAII Journal, November 2020
- *Estimating the End (of Retirement)*, David Blanchett, Morningstar, April 2020
- *Converting to a Roth IRA Can Minimize RMDs*, Judith Ward, AAII Journal, March 2015
- IRS Publication 590
- *How to Invest in an Annuity*, Christine Benz, Morningstar, September 30, 2020
- *Can You Save too Much in a Health Savings Account?*, Christine Benz, Morningstar, September 25 2020

Useful Websites

- http://aaii.com Broad selection of investing material
- http://siliconvalleyaaii.org Previous presentations on various topics
- https://sccld.org/resources/business/ Business & Money
  Morningstar Research Center, S&P's NetAdvantage, Value Line
- https://portfoliovisualizer.com Free access to a wide selection of tools
- https://vanguard.com https://fidelity.com https://schwab.com
- https://www.personalcapital.com/financial-software/retirement-planner
- https://caniretireyet.com/the-best-retirement-calculators/ Darrow Kirkpatrick
- https://Livingto100.com Calculates your life expectancy
- https://Reversefunding.com FAQs on reverse mortgages
- https://Immediateannuities.com Easy annuity quotes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