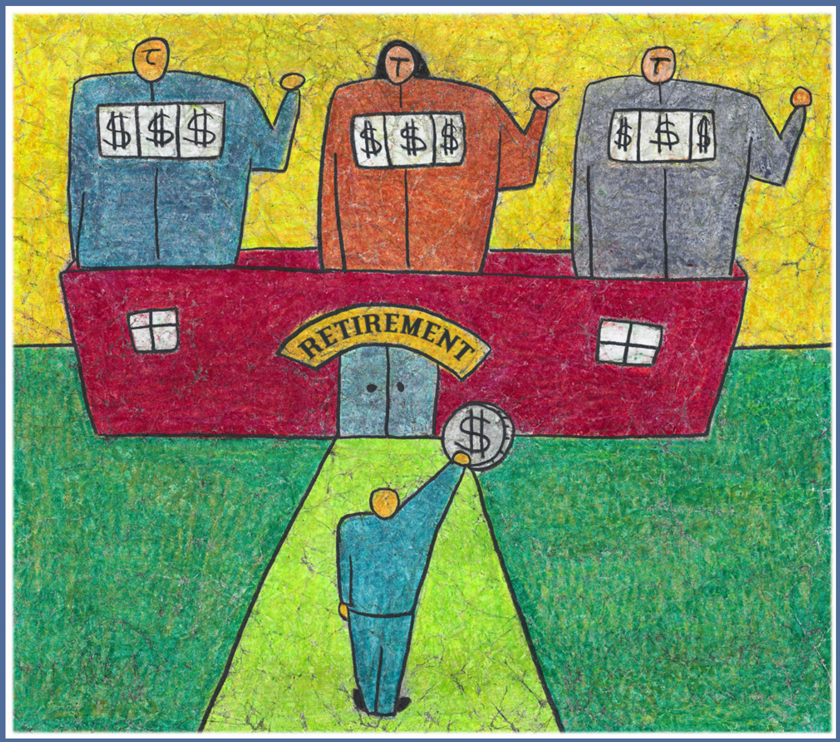
A SOUND MIND INVESTING
SPECIAL REPORT



IRAs, 401(k)s, and Social Security

A Retirement Planning Primer

BY MARK BILLER AND JOSEPH SLIFE

Introduction

The number of people joining the ranks of the "retired" is increasing at twice the rate of the overall population. By the year 2030, the post-WWII "baby boomers" will raise the prime-timer population to 73 million — one out of every five Americans.

And, on the whole, we'll be living longer than previous generations. Life expectancy continues to make remarkable gains because of improvements in health care, nutrition, and physical fitness.

Of course, living longer costs money — and one fundamental fact of retirement life is that you don't want your *money* to run out before *you* do!

For a reasonable guess as to how long you'll live in retirement, consider the case of 65-year-old males as shown in the table at right. On average, a man who lives to age 65 goes on to live another 19 years. (Roughly half of this age 65 group will live more than 19 years and half will live less. To be on the safe side, financially speaking, you have to assume you'll be in the surviving group.)

LIFE EXPECTANCIES

Age	Men	Women
30	52 more years	56 more years
35	47 more years	51 more years
40	42 more years	46 more years
45	37 more years	40 more years
50	32 more years	36 more years
55	28 more years	31 more years
60	23 more years	26 more years
65	19 more years	22 more years
70	15 more years	17 more years
75	12 more years	14 more years
80	9 more years	10 more years
85	6 more years	7 more years
90	4 more years	5 more years
95	3 more years	4 more years

If you make it to age 85, your expected life span is increased another 6 years. This means, in the absence of health reasons to the contrary, your goal should be to have *enough money to support yourself (and your spouse, if married) into your 90s.*

If that seems a bit overwhelming, given your current financial situation, don't despair. By reading this report, you are taking the first step toward overcoming three of the four most common elements of financial failure:

- **A failure to inquire.** Many are ignorant of the serious financial implications of our changing society and how they will be affected.
- **A failure to learn.** Once made aware, they may still lack the know-how needed to begin putting their financial house in order.
- **A failure to plan.** Even informed, knowledgeable people can let years go by without formulating goals and a strategy for achieving them.

But after we inform you of the seriousness of the situation, teach you the basics of survival, and lead you through the planning process, there's still one element only *you* can overcome:

- **A failure to act.** Procrastination can be the greatest deterrent to reaching your financial goals. Commit yourself now to making the sacrifices needed to put your family's finances on a solid foundation.

Where is the money coming from?

Your retirement income rests on what has been referred to as a three-legged stool:

Social Security has traditionally been regarded as the first of the three legs; however, Social Security's long-term funding problems (described below) make it impossible to project with confidence the level of benefits that will be available 20 years or more into the future. Historically, the program has provided 35%-45% of retirees' monthly income; to be on the conservative side, investors under the age of 50 should use a lower assumption to reflect the uncertainty.

Private employer-sponsored retirement plans (such as company pensions and 401(k) plans) are the second leg and provide about 15%-20% of retirees' monthly income on average, according to the Social Security Administration. But there's a lot of room for variation here.

The third leg? **Personal savings and retirement funds**, such as money invested in an Individual Retirement Account (IRA). It is this leg over which individuals have the most control. Given Social Security's long-range uncertainties and the fact that 401(k)-type accounts are connected to specific and continuing employment, personal savings is likely to play an increasingly important role in providing adequate retirement incomes in the years ahead.

Your retirement income rests on what has been referred to as a three-legged stool: Social Security, a private employer-sponsored retirement plan, and your personal savings.

Social Security

From the founding of our country until the 20th century, most Americans believed that caring for the elderly was a family matter. While Christian charities, churches, and state-and-local governments often assisted those with special needs, the *basic responsibility* remained with the individual and his or her extended family.

This changed with the passage of the Social Security Act of 1935. For the first time, it became morally acceptable for the government to take money from one group of citizens for the sole purpose of giving it to another group of citizens. *Responsibility for the elderly was transferred, at least in part, from the individual/family to society at large through a special tax designed specifically for that purpose.*

To disguise the fact that Social Security is actually a wealth-transfer program, the government named it "Old Age and Survivors Insurance." After all, buying insurance is a prudent financial step every family should take. But Social Security isn't like real insurance at all; "premiums" paid into the system have little direct correlation to one's ultimate benefits.

In his book, *Beyond Our Means*, former *Wall Street Journal* editor Alfred Malabre shares a compelling scenario:

> *Consider a worker who began paying into the system in 1937, when it was launched, and worked until 1982. If he had paid the maximum in Social Security taxes each of the 45 working years, his payments would have totaled $12,828. His benefits would have begun at $734 a month.*
>
> *If he were married, his wife would collect half of his benefit, or an additional $367 monthly, bringing their total first-year benefit to $13,217, or more than he had paid in the 45 years of employment.*

Malabre goes on to show that if that same couple live out normal life expectancies, their lifetime benefits would amount to some $375,000! (You may wonder how all this lavish generosity is possible. We'll take that up shortly.)

The government has led people to believe that Congress is obligated to honor the financial commitments made as part of the Social Security program. That's not the case. Congress can change the rules anytime it wants, as it did in 1983 when a law was passed that began gradually raising the "retirement age" from 65 to 67. What many people had been promised for half their working lives (full benefits at age 65) was changed at the stroke of a pen.

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"Well," you might think, "at least I can count on the money being there to pay my benefits because it's being held in a trust fund." But that's not the way it works. The Social Security program hasn't set aside any money for future benefits, and never has.

Remember the examples we gave earlier about the people receiving huge sums in relation to what they put in? Their withholdings couldn't possibly have grown that much purely from investments, so how was it possible?

It's simple. From the millions of dollars of "contributions" coming into Social Security from younger workers, Social Security took what was needed to pay the generous "benefits" to older retired workers, transferring the money from one group of people to another.

Because there was money left over, the Social Security Administration "invested" it in Treasury bonds. Here's what that means: Social Security lent the leftover money to the Treasury Department so the federal government could spend it on whatever it wanted. That money is long gone! What the Social Security Administration holds "in trust" is trillions of dollars in Treasury Department IOUs. No one can tell you where the government will get the money to pay back Social Security so that future benefits can be paid.

Still, if you are planning to retire in the next 10-15 years, you're probably in pretty good shape when it comes to Social Security. There may be minor benefit adjustments along the way, but the congressional failure to face up to the system's monumental problems will probably go on for at least another decade. But eventually there will be a day of reckoning, and the rest of us are probably going to be pretty unhappy about whatever "fix" Congress finally comes up with (and the younger you are now, the unhappier you're likely to be!).

In light of the uncertainties surrounding the level of Social Security benefits, *private* retirement plans are all the more critical. A basic understanding of the strengths and weaknesses of such plans is essential if you are to plan realistically.

Employer-sponsored retirement plans

There are two kinds of employer-sponsored retirement plans. One is known as a **"defined-*benefit*" plan.** With this type of plan, an employer promises to pay you a certain dollar amount each month when you retire — for as long as you live. It is up your employer to set money aside for the purpose of funding your retirement. The employer also carries the burden of where that money is invested and how well the investments perform between now and your retirement.

If your company has a defined-benefit plan, you can find out more about it by requesting information from your company's human resources department (your employer is required by law to give you a summary of the plan written in layman's terms). This "summary plan description" will explain such matters as eligibility, benefit formulas, survivors' benefits, and more.

> There are two kinds of employer-sponsored retirement plans: the "defined-benefit" plan and the "defined-contribution" plan.

Many companies also provide — once a year — a personalized "employee benefit statement" that explains the amount of benefits you've earned to date and provides an estimate of how much your monthly retirement check will be. Other items you're entitled to receive upon request include: the "summary annual report" (your plan's balance sheet), the Form 5500 (your plan's tax return and an excellent source of information concerning its financial health), and the retirement plan document itself (in case you happen to enjoy digging through page after page of mind-numbing legalese).

The second major category of employer-sponsored retirement plans are **"defined-*contribution*" plans**, and are known by designations such as 401(k) and 403(b). With this kind of plan, you elect how much you want to contribute to the plan from your payroll earnings (and, depending on company policy, your employer may kick in an additional contribution). No promises are made, however, regarding how much your account will be worth when you retire.

The advantage to employers of the defined-contribution approach is that *you* bear the investment risk between now and retirement rather than your company. If your investments do great, you'll have a healthy amount in the plan at retirement; if they perform poorly, you must make do with a lesser amount.

This shift of investment risk from employer to employee is significant; no longer can you count on having a specific monthly income in retirement. At first, this may seem like a much worse deal than a defined-benefit plan. But actually, having access to a defined-contribution plan gives you an opportunity to shape a balanced long-term portfolio that is *personalized* to your specific goals and risk tolerance.

The most popular type of defined-contribution plan is the aforementioned **401(k) —** named after section 401(k) of the tax code. 403(b) plans are similar but are for employees of not-for-profit organizations and institutions. About 75% of companies with 100 or more employees sponsor a 401(k) plan.

Here are the primary features of traditional 401(k) plans (note: the features of the "Roth"401(k) are different; they will be explained shortly):

- **Contributions are tax-deductible in the year they are made.** *However*, limits are imposed that affect the maximum amount you can contribute. According to IRS guidelines for 2017, the most a 401(k) plan can permit you to contribute is $18,000, plus an extra $6,000 "catch-up" contribution if you're at least 50 years old. (Your employer can elect to apply more stringent limitations than those set forth by the IRS.)

- **Employees control how their money is invested.** *However*, usually they must choose from among a lineup of stock, bond, and money-market funds *selected by the employer*. This limits the flexibility of the employee to invest in the funds or securities of his or her choice. (To offset this drawback, some plans offer a "self-directed" option which allows employees to enter buying and selling instructions through a broker, thus opening up a vast range of investment choices.)

- **All investment income and capital gains in the account grow tax-deferred.** *However*, withdrawals are taxed at ordinary income tax rates in the year they're made. Thus, capital gains ultimately lose their advantageous tax status when occurring within a 401(k) account.

- **Payroll deduction provides a disciplined, consistent approach to saving for retirement.** *However*, once you put the money in, you normally can't get it out before age 59½ without paying a 10% early withdrawal penalty (plus the normal income taxes due on plan withdrawals as mentioned above). Even so, many plans allow employees to *borrow* from their 401(k) accounts. (Warning: borrowing from a 401(k) is likely to have a negative impact on your retirement savings.)

• **Most employers with 401(k) plans match their employee's contributions to some degree.** For example, a company might contribute 50 cents for every $1 the employee puts in. *This is the feature that makes 401(k)s so attractive;* the employer match provides an automatic and immediate profit on your contribution.

However, employers who offer matching programs put a ceiling on the amount they will match, say up to 6% of the employee's income. Thus, money contributed above the ceiling will not be matched. Furthermore, many plans require employees to remain with the employer for a certain number of years before the matching contributions *vest*, that is, become the property of the employee. (They do this to discourage employee turnover.)

The 401(k) is becoming the bedrock of our private pension system. In 2017, 401(k) accounts (and similar retirement accounts) held an estimated $5.0 trillion. According to a study by the Plan Sponsor Council of America, nearly 88% of those eligible to participate in a 401(k) do so. Yet, it's been estimated that only 12% of those who participate in a 401(k) plan contribute the maximum amount allowed.

Participate in your company's 401(k) plan at least to the point of where you take full advantage of any employer-matching funds.

If possible, we encourage you to participate in your company's 401(k) plan at least to the point where you *take full advantage of any employer-matching funds*. If you're still working on getting your consumer debt paid off and/or building your emergency fund, that may not be possible immediately, but it should become one of your intermediate-term financial goals.

If your 401(k) plan doesn't offer a matching feature, or if you can afford to contribute beyond the maximum-matching percentage, you will want to weigh the remaining advantages of 401(k)s versus the pros and cons of IRAs before deciding which should have the priority in your retirement planning.

Roth 401(k)

Before discussing IRAs, here are details about two other common employer-based retirement plans. The first is the **"Roth" 401(k)**, a retirement-plan option introduced in 2006. It differs from the "traditional" 401(k) in a very important aspect.

The tax benefit of investing in a traditional 401(k) is *immediate*. You're allowed to reduce your taxable income by an amount equal to what you invest. (You pay the income tax when you withdraw money from your account in retirement.)

The Roth 401(k) works the other way around. There is no tax break up front, but later you *can withdraw your contributions, plus all the earnings accumulated over the years, tax-free*. This makes the Roth 401(k) an especially attractive option for young investors who have many years to accumulate earnings.

As with traditional 401(k)s, employers may offer to match worker contributions. But with the Roth 401(k), matching money is treated differently under tax law than employee contributions. Employer-matching amounts are made with pre-tax dollars, which means any matching contributions will be subject to income tax when withdrawals are made (in other words, not all distributions from a Roth account may actually be tax-free).

The trickiest part of figuring out whether to use the traditional 401(k) or the Roth 401(k) has to do with tax *rates* — specifically your current rate vs. what you expect to pay in retirement.

Most people today expect that, given the government's financial condition and debt load, tax rates will generally be higher in the future. This would seem to make a strong case for using the Roth, which allows you to pay taxes on contributions now at the lower rates, and take your distributions later tax-free when rates are likely to be higher across the board.

But this overlooks an important point regarding retirement-account taxation: your marginal (highest) rate isn't the only rate that matters. As noted above, with a traditional 401(k), you receive a tax deduction based on your level of contribution. That deduction reduces your final income, saving you tax at your highest tax rate now. But when you retire and start withdrawing money from your account, unless you have significant other income sources (which most retirees don't), your withdrawals won't immediately be taxed at the highest tax rates. Rather, they will start filling in the tax brackets from the bottom up because of the progressive nature of the tax code.

2017 Tax Rate	Retirement Income Increments[1]	Total Retirement Income
39.6%	All additional income	
35%	Next $53,600	$466,950
33%	Next $181,900	$413,450
28%	Next $79,550	$231,450
25%	Next $76,600	$151,900
15%	Next $56,750	$75,300
10%	First $18,550	$18,550

[1]Assumes married, filing jointly status and use of the standard deduction.

Consider the nearby table, which shows the tax rate applied to retiree income. (Read this table from the bottom up.) It shows that a retired married-filing-jointly couple who take the standard deduction would pay 10% tax on their first $18,550 of income, then would pay 15% on their next $56,750, and so on.

What the table demonstrates is that while someone may end up, for example, with a marginal tax rate of 25% in retirement, their first $75,300 of taxable retirement income will be taxed at significantly lower rates.

This is a strong argument for many workers in favor of using the traditional 401(k) rather than the Roth. The traditional 401(k) allows you to take your tax deduction today at your highest tax rate, then likely pay tax at lower average rates in retirement. The Roth 401(k), in contrast, turns this on its head, causing you to pay tax now in the higher brackets while saving you tax later in the lower brackets.

So should everyone use the traditional 401(k) instead of the Roth? No. Some people are likely to benefit from the Roth. Super savers are the first group that should use the Roth 401(k). If you contribute the maximum to your 401(k) and also fully fund IRAs each year, you'll likely come out ahead using the Roth.

Also, anyone who is likely to see significantly higher pay in the future than they earn now should consider the Roth. If you can pay tax today at relatively low rates, it probably makes sense to do it, especially if you expect to hit the higher tax brackets in retirement. This is why many financial advisers encourage young people to use Roth IRAs and Roth 401(k)s.

Thrift Savings Plan

Another widely used plan is available only to federal workers: the **Thrift Savings Plan**. The TSP — which offers both "traditional" and Roth options — has a generous employer-matching component that makes it an extremely attractive retirement plan. First, the government automatically contributes an amount equal to 1% of salary. Second, for every dollar employees contribute up to 3% of their salary, the government matches it with a dollar. Third, for every dollar employees contribute above 3% of salary (up to 5%), the government puts in 50 cents. By contributing 5%, therefore, employees have doubled their money just by virtue of the government's matching funds.

When you leave your job with the government, you can roll your Thrift account assets into a personal IRA. If you keep your TSP account all the way to retirement, money withdrawn from a traditional TSP account will be taxed as ordinary income, just as with a traditional 401(k). In contrast, Roth TSP withdrawals are tax-free — if certain age and timeline requirements are met. (*Matching* contributions, however, will be taxed on withdrawal because they were not taxed initially.)

The Ins and Outs of IRAs

As we talk now about Individual Retirement Accounts, some of the terminology will sound familiar because it mirrors our 401(k) discussion. There are "traditional" IRAs and "Roth" IRAs.

The IRA first appeared on the financial scene in the 1970s, but they didn't really grow to prominence until 1981 when Congress voted to allow wage earners to put away up to $2,000 a year for retirement and deduct the contribution on their federal income tax return. The IRA became one of the best tax breaks available to the middle class, second only to the deductibility of home-mortgage interest.

The Roth IRA came about in 1997, named for Sen. William Roth, a consistent supporter of IRAs (Sen. Roth's name also adorns the Roth 401(k) mentioned earlier). The Roth IRA differs from the traditional (or "Deductible") IRA primarily in the way taxes are handled — do you want to pay them now or pay them later?

In a traditional IRA — as with a traditional 401(k) — you receive a tax deduction for the amount you contribute (save on taxes now). You pay income tax on all contributions and gains down the road when money is taken out (pay taxes later). With a Roth IRA — as with a Roth 401(k) — your current contributions are not deductible at all (no tax savings now) but your future withdrawals, even your investment gains, are tax-free (no taxes to pay later, ever).

How to Choose

Three questions will help you decide what's best when choosing between a traditional IRA and a Roth.

The first question to consider is: *Do you expect to be in a lower tax bracket when you retire than you are now?* If so, choose a traditional (deductible) IRA. You get a tax benefit now while your rates are higher, and pay tax later when they're lower. Conversely, if you anticipate a higher bracket in retirement, take your tax lumps now and put the money in a Roth. It'll sure feel good coming out tax-free in the future.

> The future-tax-rates question isn't as simple as it may seem.

Unfortunately, as noted in the discussion of Roth 401(k), this future-tax-rates question isn't as simple as it may seem. That's because, with a traditional IRA, the tax dollars you save now are coming off the "top" of your income, i.e., at your highest marginal tax rate. But when you retire, you may not have much income other than what is being withdrawn from your retirement accounts.

This means that a good deal of the money coming out of your IRA will likely "fill in" the lower tax brackets, being taxed at those lower rates, even if the last dollars you withdraw in any given year are in relatively high brackets (similar, perhaps, to the maximum rate you are paying now).

This is a potentially strong argument for sticking with a traditional IRA if you qualify for deductible contributions. Even if marginal tax rates rise in the future, as many expect, it's possible that for many retirees, their *average* tax rate in retirement will be lower than their *marginal* (highest) tax rate now. And that's really the key comparison to make for this particular decision.

Another question to consider when making the traditional-vs.-Roth decision is this: *Would you like to postpone withdrawals beyond age 70½ (or possibly leave the IRA intact for your heirs)?* If so, opt for the Roth, which has no mandatory withdrawal requirements.

The final question is: *Can you afford to contribute the maximum allowable amount into a Roth* (currently $5,500 if you're under age 50, $6,500 if you're older)? Remember, these are after-tax dollars. Assuming you're in the 25% tax bracket, you'd have to actually set aside $7,334 to make a $5,000 contribution —$5,500 for your Roth and $1,834 for federal taxes.

If you are considering a traditional IRA, be aware of two particular drawbacks. One is that it turns lower-taxed capital gains into higher-taxed ordinary income. That's because, under current law, when you begin taking your money back out, it *all* gets taxed the same way—as ordinary income— even though a sizeable portion of your growth may come in the form of capital gains (which usually are taxed at a lower rate).

Another drawback is that there are rules governing how much you *must* take out each year (once you reach age 70½). If you run afoul of these "required distribution" rules, the penalties are incredible.

One other thing to keep in mind is that Roth IRAs offer more flexibility than traditional IRAs if you face a cash crunch. With a Roth IRA, you always have access to the *principal* you've contributed without further income taxes or penalties.

In addition, *earnings* (i.e., investment gains on your contributions) generally can be withdrawn early without penalty if the distributions are related to death or disability, high medical expenses, qualified higher-education expenses for you, a spouse, child or grandchild, or first time home buyer expenses. Naturally there are many nitty-gritty details to each of these exceptions, so you'll have to do some research to find out specifics, but generally you can get away with just paying income taxes on the earnings and incur no penalties.

With traditional IRAs, however, if you touch any of your money early you will pay dearly.

Other considerations: Should a 401(k) or an IRA have the priority?

If you can't afford to contribute to both a 401(k) and an IRA, you obviously have a choice to make — but there is no one-size-fits-all answer. A lot depends on your specific situation.

Two advantages of the IRA are that you have *greater control* (for example, you choose the financial institution your IRA is with) and you're likely to have a *greater range of investment choices* (if you have opened your IRA with a mutual-fund broker). A major advantage of the 401(k), however, is that you are generally allowed to contribute more annually — up to $18,000 in 2017 — than you can to an IRA. With special "catch-up" contributions, people age 50 or above can add an additional $6,000 for a total of $24,000. Compare that with the maximum $5,500 contribution allowed for an IRA (with a $1,000 additional catch-up for those 50 and above). If you have serious saving to do, 401(k)s offer a clear advantage.

As mentioned before, the trump card of the 401(k) is employer matching. If your employer's 401(k) plan has any type of matching, try to contribute at least enough to take full advantage of the matching provision. Only after you've reached the matching ceiling should you consider an IRA alternative. (Also, make sure you understand any vesting rules that may apply to the matching funds in your 401(k).)

The "IRA or 401(k)" decision doesn't necessarily have to be an all-or-nothing proposition. For those who can afford it, we suggest contributing to your 401(k) up to the matching limit, then funding an IRA. Both types of accounts are excellent tools to help you reach your retirement goals.

Practical matters: Opening an IRA

All the major banking, brokerage, and mutual-fund institutions offer self-directed IRA accounts. Self-directed means you decide how to invest the money you put in the account.

The competition for your IRA business is fierce, as can be seen by the willingness of firms to waive or reduce their standard annual fees for IRA accounts. Many discount brokers charge no annual fees for IRAs. They often offer huge numbers of mutual funds — many as no-transaction-fee options, thus saving you even more money. (The "deals" offered change frequently, so check with the leading no-load fund organizations for their current policies.)

Investors are fee-sensitive, of course, as evidenced by the fact that financial organizations give such great emphasis to their low fees in their advertising. However, we would suggest you give greater weight to having a large number of investment alternatives from which to choose. After all, what good are low fees if you have only a few average-performing funds to select from?

Fees are an important consideration, but give greater weight to having a larger number of investment alternatives from which to choose.

Moving money: How to roll your 401(k) into an IRA

If you've recently left an employer where you had a 401(k) (or other retirement plan), chances are you'll want to roll that money into an IRA. True, sometimes you can leave it in the old plan. But unless you're perfectly content with the investment options in your old plan, you'll likely want to gain the additional control that rolling into an IRA provides. Another option, if allowed, is rolling the money into your new employer's 401(k), but again, an IRA will give you more control and probably many more choices as to how the money is invested.

Rollovers are usually simple to complete. First, open a new IRA account with a brokerage firm or mutual-fund company. Usually, you indicate on the new account forms that this account will be for a "rollover IRA."

Once your account is setup, tell your old employer to roll the money *directly* into your new IRA. You'll probably need to complete a specific form to accomplish this, so check with the HR department of your old employer. By having the money sent directly to your new account — in what is called a "trustee-to-trustee transfer" — you avoid potential tax problems associated with you handling the rollover yourself.

For most people, that's all there is to it. When the new money arrives in your IRA account, you're ready to pick your new investments.

One word of caution: If you have appreciated company stock in your plan, it may be to your advantage to *not* roll it into an IRA. Because of the potential difference between the capital-gains tax rate and your ordinary income tax rate, you could come out ahead by taking the actual stock and foregoing the IRA. This decision requires some number crunching. See Chapter 20 of the *Sound Mind Investing Handbook* for details.

Staying up-to-date

For recent articles and a list of resources related to financial planning for retirement, 401(k)s, IRAs, and giving, visit the SMI website at www.SoundMindInvesting.com.