The 5-Year Countdown to Retirement Guide

Presented by:

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Ready to retire? A review of your financial health five years or so prior to your planned retirement may help you check to see whether you're on the right track -- and if you're not, there is still time to make some adjustments.

This guide help you learn to:

- Understand the financial impact of the timing of your retirement
- Review your sources of retirement income
- Assess cash flow needs in retirement
- Evaluate distribution options
- Prepare yourself and your loved ones for retirement

Plan for the lifestyle aspects of retirement.

Think of your retirement in terms of early years, middle years, and late years. Each phase may be as different from the other as they are from the earlier stages of your life. First, ask yourself what your goals are for each of these three phases. Expect to have different goals, unique activities, varying income needs, and fluctuating levels of energy and physical stamina for each phase. Ask yourself these questions and if applicable, include your spouse or partner in the discussion:

- What do I plan to do?
- What will my lifestyle be?
- What are my spending goals?
- What income-producing activities will I undertake, if any?
- What career management do I need to prepare myself?

Consider the timing of your retirement in relation to your goals.

The timing of your retirement determines:

- How long your current lifestyle will be supported by your paycheck
- How many more years you will be able to save
- How long, given your life expectancy, your assets may support your post-retirement lifestyle

Because it affects both the amount of money you will have and the amount you will need, the timing of your retirement has a dramatic impact on your ability to make ends meet and live the retirement lifestyle you want. Retiring early requires substantially more money to support a given lifestyle; retiring later means you may need substantially less. For example, if you retire at age 60, it will take about $1.1 million to generate an $80,000 annual income through age 85, assuming a 6 percent investment return. By retiring at 65, you would need $972,000 to generate the same income through age 85, while retiring at 70 would require only $824,000.

How many years will you be in retirement? In essence, this asks, how long do you expect to live? Insurance companies, pension administrators, and the IRS have sophisticated means of estimating life expectancy based on historical data, but they don't necessarily take into account current advances in medical technology or healthy lifestyles. Therefore, to decrease the chance that you'll outlive your savings, consider using a life expectancy of age 90. If longevity runs in your family, you might want to plan for an even longer retirement.

Estimate the annual income you'll need to support your lifestyle.

You will likely need at least 70 to 80 percent of your pre- retirement income to maintain your standard of living in retirement. Your requirements may be more or less for several reasons:

Savings - You will no longer be saving for retirement, so the share of your previous income that went to retirement savings won't be needed.

Spending - Employment-related costs such as commuting, union dues, clothing for work, and other such expenses will disappear. In addition, you will no longer be paying into the Social Security and Medicare tax systems if you do not have earned income. However, don't assume a big drop in the amount you will spend for current consumption after you retire. Medical and prescription costs, in particular, may be greater.

Debt - By retirement, your mortgage may be paid off and your monthly housing costs may drop significantly as a result. You may also have paid off other outstanding debt such as credit cards and personal loans.

Understand what you have through your employer plan.

Some types of employer retirement plans include:

Defined Contribution Plan - With a defined contribution plan, you or your company -- or you and your company -- contribute a set amount annually (for example, 10 percent of your salary). The amount you receive when you retire depends not only on the amount that was put away each year but also on how those dollars were invested. If you leave your job, you can usually take your benefits with you. (Note that you can take vested benefits with you. If your employer makes contributions on your behalf, you may or may not be vested depending upon your employer's plan.) Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans.

Defined Benefit Plan - A defined benefit plan is a retirement plan that pays a fixed monthly income at retirement based on your salary and years of service. Employers set up these plans, make contributions to a trust, and commit to paying employees a percentage of salary for life, regardless of how much money the company put away or how their plan investment performed in the long run. Under most traditional defined benefit plans, only the company makes contributions toward your retirement, although some so-called contributory plans allow you to make supplemental contributions. A defined benefit plan is obligated to pay you a benefit even if plan investments perform poorly, because your payment is determined by a formula, not by the balance in your particular plan account.

Cash Balance Plan - A cash balance plan is technically a defined benefit plan, but has some features resembling defined contribution plans. Benefits are calculated by a formula, but the benefits are expressed as an "account balance" rather than a monthly or annual benefit. Employees don't really own these accounts and may not make their own investment decisions.

Money Purchase Pension Plan - A money purchase pension plan is a plan that requires fixed annual contributions from the employer to the employee's individual account. The company has a fixed obligation under the plan to make contributions whether or not it posts a profit. The amount an employer contributes to a money purchase plan is based on a percentage of the compensation of all participants. But the most a company may contribute is 25 percent of the earnings of employees who participate in all the employer's defined contribution plans.

Understand your payout options, if applicable.

If you have a pension from your current or a previous employer, keep in mind that many pension plan benefits provided by employers are reduced if you commence the benefit prior to normal retirement age. To determine an estimate of your monthly pension, ask your employer:

- What is the normal retirement age of the plan?
- What is the earliest age that I can commence my pension?
- By what percentage will my pension benefit be reduced if I commence my pension prior to normal retirement age?
- Will there be a reduction in my pension amount once I begin collecting Social Security?
- What are the payout options associated with the pension?

The most common payout options available in pension plans include the single life annuity, which pays on the employee's life only, and the joint and survivor annuity which reduces the employee's amount but leaves a benefit behind to the spouse or other beneficiary.

Several financial issues may influence your decision on payout options, including:

- Your marital status
- Your health and the health of your spouse or other beneficiary
- Your age and the age of your spouse or other beneficiary
- Your current cash flow situation
- The financial resources available to your survivor

Consider the single life annuity, which typically gives you the highest payout, if:

- your spouse is likely to die before you
- you have cash flow needs
- your survivor has a pension or other retirement income of his or her own and will not need your annuity
- you also have life insurance or other assets to support your survivor

Consider the joint and survivor annuity, which pays you a reduced amount but reserves a benefit for your spouse in the event of your death, if:

- you believe that you will predecease your spouse
- your cash flow needs are manageable

You may have the option of receiving your funds in a lump sum or in a monthly annuity. Whichever you choose will impact your cash flow, tax and investment planning. Consider these issues:

If you're in poor health: Consider a lump sum. Your spouse will receive the full lump sum rather than a reduced monthly pension over his or her lifetime. Note that some plans require a physical examination to get a lump sum.

If simplicity and peace of mind are your goals:
Consider the annuity. Tax and investment decisions will be easier.

If you don't want to manage the money or you're in debt: Consider the annuity.
The monthly payments can provide lifetime security whereas once the lump sum is exhausted, it is gone.

If you don't need the income right now: Consider taking the lump sum and investing it in an IRA to continue the tax-deferred growth of the funds. Note that only qualified pensions can be rolled over into IRAs.

Check your Social Security benefits.

Estimate your benefits via the Social Security Administration.

At what age can you collect Social Security benefits? Eligibility begins at age 62, but there's a price to pay (reduction in benefits) for taking Social Security benefits before the normal retirement age. The normal retirement age (or FRA, full retirement age) ranges from age 65 to age 67, depending on the year of your birth and is age 67 for those born in 1960 or later.

Starting with the month you reach FRA, you will get your benefits with no limit on your earnings. If you start taking benefits before your FRA, earned income may reduce the amount of benefits you receive.

A Social Security Statement is a concise personal record of the earnings on which you have paid Social Security taxes during your working years, and a summary of the estimated benefits you and your family may receive as a result of those earnings. You can request a statement from the Social Security Administration.

Understand the impact of inflation.

A discussion about retirement planning is not complete without considering the impact of inflation. Inflation behaves like a tax on savings and investments. Unless you incorporate the cost of inflation into your retirement plan, you may be faced with a surprising financial shortfall. To avoid an unexpected deficit, it helps to understand that rising prices will impact both your future spending needs and future financial resources. The average inflation rate in the U.S. has been close to 3 percent. That means prices have increased an average of about 3 percent each year. When calculating your retirement needs, you may want to consider using a conservative assumption about inflation.

Inflation and retirement spending - To illustrate the effect of inflation, imagine your retirement spending goal is $50,000 annually in today's dollars and you plan to retire in 30 years. If you assume 4 percent inflation, you will need an estimated $162,000 the first year of retirement and an additional 4 percent each subsequent year of retirement.

Inflation and investments - To plan for inflation and the loss of purchasing power, consider the "real" return that you will receive on your investments. For example, if your return is 7 percent and inflation is 3 percent, remember that your "real" rate of return is only 4 percent.

Inflation and pension plans - If you're fortunate enough to have a pension plan from your current or previous employer, keep in mind that most pension payouts are not indexed for inflation. This means that even though the dollar amount may be fixed each month, the purchasing power of those payments will decline with inflation.

Consider how taxes may impact your retirement plan distributions.

From tax deferred retirement plans - In general, distributions from tax-deferred retirement plans, such as 401(k) plans, 403(b) plans, and IRAs are taxable at ordinary income tax rates. Any distribution has a mandatory 20% withholding applied. This is not a penalty, but rather a pre-payment of ordinary income tax. In addition there may be a 10% early withdrawal penalty if you remove funds prior to age 59.5. If the funds are rolled over to a rollover IRA, there is not a mandatory 20% withholding and no penalties.

From personal accounts - If you plan to withdraw funds from taxable accounts, or non-retirement accounts, withdrawals may result in ordinary income or capital gains taxes (on the growth of the asset, not on the original investment).

From pension plans - Distributions from pension plans, when in the form of a lump sum or annuity, will be taxed as ordinary income. If a lump sum is chosen, you have the opportunity to roll the funds over to a rollover IRA to continue the tax-deferred growth on the funds. The rollover would not result in a taxable event. Note that only qualified pensions can be rolled over into IRAs.

Review last-minute planning tips.

What if retirement is just around the corner and you haven't saved enough?
Here are some tips for last- minute planning:

- Sock it away. Pump everything you can into your tax-sheltered retirement plans and personal savings.
- Reduce expenses. Funnel the savings into your nest egg.
- Take a second job or work extra hours if you can accrue overtime pay.
- Look carefully at your investments. Diversify your holdings and keep an eye on fees. But don't take risks you can't afford.
- Retire later. You may not need to work full time beyond your planned retirement age. Part-time may be enough.
- Refine your goal. You may have to live a less expensive lifestyle in retirement.
- Delay taking Social Security. Benefits will be higher if you start taking them later.
- Make use of your home. Rent out a room or move to a less expensive home and save the profits.
- If you're self-employed, consider selling your business when you retire.
- Sell assets that are not producing much income or growth, such as undeveloped land or a vacation home, and invest in income-producing assets.

Quick Tip!

If you are at least 59 1/2, check to see if your employer allows in-service withdrawals. In-service withdrawals allow you to take a distribution from a qualified, employer-sponsored retirement plan, such as a 401(k) account, while still being employed at the company. The distribution can be used to invest in other options that might be more suitable to you. Typically, the in-service withdrawal rolls over to a previously existing 401(k) account or a new traditional IRA account.

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