

The

LEAP Letter

Lifetime Economic Acceleration Process

Retirement Income Planning

In our society many people consider money as the lifeblood of our daily lives. Simply put, we need money to live. We need it for food, shelter, health care, insurance protection, travel, leisure, entertainment and more. The less money we have the less possible our lives may be fulfilled. The less access and control over our money that we have, the more our lives may be adversely affected.

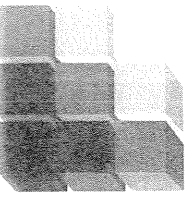
Basically, there are only two ways to produce income: *People at work* and/or *Dollars at work*. Younger people ordinarily have fewer *dollars at work* since they have not had the time or opportunity to save. As people grow older, money and other assets are accumulated through saving or investing, thus starting the process of *dollars at work*.

Generally, retirement is nothing more than an individual's conversion from *people at work* to *dollars at work*. If one lacks sufficient *dollars at work*, retirement may have to be postponed, supplemented with part-time work, or compromised by a reduction in lifestyle. That is why retirement income planning should be an important part of each person's ongoing financial life.



Many people do not completely understand all facets of retirement planning and fall short of their true retirement income potential. People often view retirement as a "slowing down" period or as a time to decrease current lifestyle. Unfortunately, they may only envision their retirement income as being only what they will "need," rather than what they really would want and enjoy. It is also common to hear people in the financial community promoting retirement planning methods based solely on establishing income "needs" at retirement. This is unfortunate because no person should be left to only have income based solely upon what they "need" while having foregone the

continued on page 2



LEAP®

Adding Money to Life

Volume 5, Number 1

much greater potential of what was possible. The reason why consumers rarely have enough retirement income is because too many people, including their advisors, ask the wrong questions when first developing a retirement plan. Examples of such questions are: “How much income will you need at retirement?” and “How long do you think you will need this retirement income?”

These restrictive questions set up a ceiling or boundary that may result in answers that are limiting as well. Some typical responses may sound like this: “I’ll be in a lower income tax bracket when I’m retired,” or “We won’t need as much money at retirement because our children will not be living with us any more,” or “My mortgage will be paid off and I won’t need as much money to live on.” Without being fully aware of it, people are potentially “limiting” themselves out of income they could have had.

In order to help avoid an unfavorable outcome for retirement planning purposes, the use of realistic, non-limiting questions is fundamentally important. Such questions as . . . “What would you really want to

“The reason why consumers rarely have enough retirement income is because too many people, including their advisors, ask the wrong questions when first developing a retirement plan.”

happen when you retire?” Or, “If you could have it your way, how much income would you want when you retire?” Or, “Given an ideal world, would you rather have more income than you earn today or less?” Or, “What tax bracket would you like to be in?” The answers to these questions may result in a different outcome.

The consideration of non-limiting questions may lead to responses like these:

- “I want at least 100% of my highest working year’s income.”
- “I want to maintain the best possible lifestyle for me and my family.”
- “I want as much income as possible, in case I decide to stop working due to advancing age, job loss, declining occupational skills, or decreased health.”
- “I want to receive my income when I want it.”
- “My income should last the rest of my life, for as long as I live.”
- “I want to receive my income from a variety of sources.”
- “My income must be protected against any asset decline or loss, and be insulated against income taxes as best possible.”
- “I want my spouse, children, heirs, charities, and others to receive the full value of my estate after I die.”

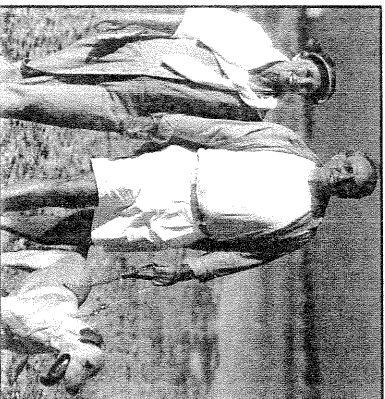
Placing a “fixed target” on retirement income of only what a person thinks they need may direct retirement planning toward an unfulfilled need. This type of deficiency planning may not allow for the full potential of one’s wealth to be realized. If the targeted retirement income is inappropriate, the plan may not meet the individual’s goals and objectives. The focus of a retirement plan should be on efficiency planning to help improve the effective use of your money and maximize its full potential.

Once the right questions are asked and the use of efficiency planning begins, there are a couple of other issues to be considered. Although saving

continued from page 2

money for retirement (*accumulation* phase) is an important element in successful retirement planning, it only represents one third of the effort.

The other two important phases are the *distribution* phase and the *conservation* phase. The latter two phases are major deciding factors in determining the ultimate success of a retirement plan. Even if the accumulation phase met quantitative expectations, it is unlikely a retirement program would be completely successful without the careful and proper consideration of the *distribution* and *conservation* phases.



The *distribution* phase concerns when and how your retirement income will be received. The *conservation* phase has to do with the safety of retirement dollars against losses due to

income taxes, inflation, market fluctuation, creditors, estate taxes, probate fees, accounting costs, and many other factors. Unless retirement or inheritance dollars are received when they are wanted without penalty, without tax, and without risk, individuals are vulnerable to eroding factors.

Many people reach retirement without adequate money due to these eroding factors and their stories are often recounted in the media as reminders of what can occur. The main reason that these people suffered such unfortunate circumstances is that they did not have a sound strategy for the *distribution* or *conservation* phase of their retirement plan. It is a necessity to have proper

planning in all three phases in order to help bring about a successful retirement outcome.

The following hypothetical situation shows why the *distribution* and *conservation* phases are of critical importance to a successful retirement plan.

Suppose a 35-year-old decides to join their employer's pre-tax qualified retirement plan. The employee contributes \$12,000 into the program and the employer contributes another \$6,000. Assume that the employee and employer continue to make these deposits every year until the employee's age 65 and that the account earned an 8% average annual rate-of-return* during all of those years. In this hypothetical example, the 35-year-old person would have accumulated \$2,202,225 by age 65 or the end of the *accumulation* phase.

What problems might there be for this employee if there were no planning for the *distribution* phase?

It is important to note that the pre-tax qualified retirement plan is subject to government regulation. That means that the government has complete control over when income may be received from the account without penalty. For instance, suppose the government decides to push back the earliest age of distribution on qualified retirement plans to age 70, or sometime later than the current minimum age of 59½. If this were to happen, the employee might not be able to retire at the desired age of 65. Retirement may have to be delayed for another five or ten years. It is difficult, if not impossible to predict what factors the government will use to determine the minimum age of distribution. The purpose of this example is to illustrate how having all of one's "eggs in one basket" may have serious consequences that may negatively impact the ability to retire successfully.

continued on page 4

*The 8% hypothetical rate of return is for illustrative purposes and does not represent past or future performance of any particular investment. Investment performance and principal value will fluctuate with market conditions.

continued from page 3

What problems might there be for this employee if there were no planning for the conservation phase?

How would the employee's retirement income be taxed? Very few people have an "exit strategy" for receiving their retirement income that would help to avoid or reduce the income tax burden. If the employee takes a lump-sum distribution from the retirement account, it would most likely elevate the employee into the highest income tax bracket possible. If that highest income tax bracket in any future year amounted to 50% or more (combined federal and state) that would cut the account value in half to \$1,101,112. In addition, assuming an average annual inflation rate of 3%, the remaining qualified plan account value would be eroded by another \$647,469 leaving the remaining purchasing power to be only \$453,643.

If the employee intended to purchase a retirement home with the income from this account, the value of the home, in today's dollars, would be only \$187,000. This is an astounding fact given all of the contributions that the employee and the employer made to the retirement plan over the thirty-year period. Not only can income taxes and inflation have a negative impact on the retirement account's value in the future, but it may continue to erode the growth of the account if the money is not withdrawn.

Another *conservation* phase problem, often disregarded by many people and their advisors, is the potential estate taxes on a qualified tax-deferred account at death. There is not only an income tax burden to the heirs, but there may be a death or estate tax as well. Suppose the employee died at age 65 with \$2,202,222 in the qualified account and the entire amount was income and estate taxable to the heirs. If the estate tax and the income tax rate were both 50% in the year of death, then the heirs would receive only \$550,555 and inflation would lower the purchasing power to about \$275,000.

In order to avoid the initial impact of income taxes, many people decide to forego taking a lump-sum distribution from their retirement accounts. Instead, the account is usually rolled over into a traditional IRA and allowed to continue to accumulate tax-deferred. The intended outcome of this option, to avoid current income taxes and pass on the account to an heir, has many problems as well. The end result may be that the enjoyment and use of the money is delayed and the same taxes will still be due at some point. Taxes are actually not avoided; they are only delayed and it remains to be seen whether this will create a higher or lower income tax consequence pending other variables. There is also a government minimum distribution regulation that requires an amount to be withdrawn from the account each year. The amount rises with age. Therefore, income taxes will still be paid each year even during the deferral period.

What then is the solution for effective retirement planning?

A complete and well-orchestrated strategy that addresses all three phases — *accumulation, distribution, and conservation* — is necessary to help reach an effective and successful retirement income program. One must envision what they would "want" their retirement income to be and not just accept an amount that is perceived to be a "needed" amount. Limiting goals may lead to having less retirement income than what is possible and desired.

Having a plan that can provide for greater efficiency of asset use, increased access to one's own money, more control, and maintaining flexibility over retirement capital and income is essential to avoiding many of the retirement planning pitfalls. A comprehensive strategy that includes a professional and that is committed to helping you identify your full retirement issues and concerns is important for sound retirement planning.