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Saving for Your Retirement

Major considerations

How much will you need in retirement?

When do you plan to retire? What kind of lifestyle do you desire? How much do you have right now that you can count on for your retirement? What about Social Security; do you know what kind of benefits you can expect? These are all factors you will need to consider when you determine how much you'll need.

Know how much you have

Take an honest look at your present net worth. If you're like most people, you've got a long way to go before you can afford to retire. Knowing how much you currently have earmarked for retirement will assist you in saving for your retirement.

Implement a savings plan

Take an honest look at your current spending. Just as in planning for other financial goals, you need to implement a savings plan. Think about establishing a long-term systematic savings plan to put aside funds for retirement. If you haven't already done so, consider the benefits of establishing and sticking to a spending plan.

Decide where to put your dollars

You've freed up some cash, and you want to put it where it will do the most good. You need to consider some options:

- Take advantage of employer-sponsored retirement plans
- Utilize IRAs
- Evaluate other investment alternatives

Take full advantage of employer-sponsored retirement plans

Taking advantage of retirement plans in general

Does your employer offer a retirement plan? If so, be sure that you're taking full advantage of it. If your employer has a defined benefit plan (a traditional pension plan, with pension benefits typically based on the number of years you work and your level of compensation), make yourself familiar with the details of the plan. Although most aspects of such a plan are beyond your control (e.g., you can't make contributions), you should know how your plan works. How long do you have to work before you have rights under the plan (the plan's vesting schedule)? When are you entitled to a full pension? This information is vital if you're considering leaving your employment.

If your employer offers a defined contribution plan (such as a 401(k) plan, to which contributions can be made by employer and/or employee), much depends upon the specific type of plan. The one feature that these plans have in common is that the contributed funds grow tax deferred. This is significant, because investments in these plans can grow more rapidly than identical investments that don't grow tax deferred. Depending upon the type of plan that you have, you may be able to make voluntary contributions.

Maximize employer-matching contributions

Some retirement savings plans, such as 401(k) plans, 403(b) plans (tax-sheltered annuity plans for employees of public schools and certain tax-exempt organizations), and thrift savings plans (plans to which you generally make after-tax contributions), allow employers to match contributions that you make up to a specified level. Since this is basically free money (once you're vested in those employer dollars), consider taking advantage of it. Contribute enough to the plan so that your employer contributes the maximum matching amount. For more information, refer to the specific plan in which you participate.

Self-employed individuals should consider establishing their own retirement plans

If you're self-employed, seriously consider establishing a retirement plan for yourself. For example, a simplified employee pension (SEP) plan is relatively easy to implement (it's really not much more than a big IRA), and it allows you to save significant funds for retirement or you might consider an individual 401(k) plan. If you're a business owner with employees, you should think about setting up an employer-sponsored retirement plan. There are a variety of retirement plans that are appropriate for sole proprietors and partnerships, corporations, and tax-exempt organizations.

If you do contract work for a tax-exempt organization or a state or local government

If you perform services as an independent contractor for a state or local government or a tax-exempt organization that sponsors a Section 457(b) plan (a specific type of deferred compensation plan), you may be able to participate in that plan. If you can participate, you can defer a significant portion of your compensation to the plan.

Individual retirement accounts (IRAs)

Contribute to an IRA each year

IRAs offer significant tax incentives to encourage you to save money for retirement. You can contribute up to $5,000 to your IRA in 2012 (and 2011) ($6,000 if you're age 50 or older), as long as you have at least that amount in compensation for the year. The types of IRAs that you can use (and the corresponding tax advantages) depend upon your income level, filing status, and whether or not you're covered by an employer-sponsored retirement plan.

If your spouse does not have compensation, contribute to an IRA for your spouse

You may be able to set up and contribute to an IRA for your spouse, even if he or she received little or no compensation for the year. To contribute to a spousal IRA, you must meet the following four conditions:

1. You must be married at the end of the tax year
2. You must file a joint federal tax return for the tax year
3. You must have taxable compensation for the year
4. Your spouse's taxable compensation for the year must be less than yours

Choosing investments within your retirement plan

It's important to understand that the earnings potential offered by a retirement plan (e.g., 401(k) or IRA) is not generated by the plan per se, but by the investments held by the plan (e.g., stocks, bonds, mutual funds). Choosing the right mix of investments within your plan is just as important as choosing the right plan itself. When making your choices, many factors should be considered including your time horizon, your tolerance for risk, and the tax implications. For example, it may not make sense to hold tax-exempt securities within a plan that is tax deferred.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act) complicates matters further. The 2003 Tax Act reduces capital gains tax rates and the tax rates on qualifying dividends. However, investments held in retirement plans will not benefit from these lower tax rates. Thus, holding investments that generate income subject to these lower rates in a tax-deferred plan is now less appealing. This does not mean that such investments are inappropriate for retirement plans, only that you should consider carefully your overall investment portfolio in deciding what investments to hold within, and outside of, a retirement plan.

> **Caution:** The reduced tax rates on capital gains and qualifying dividends introduced by the 2003 Tax Act were scheduled to expire after 2010. However, these rates were extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Evaluate nonqualified investment programs

Annuities and retirement

Annuities, which are funded with after-tax dollars, grow tax deferred. When you retire, if you're over age 59½, you may make withdrawals or begin taking payments that will continue as long as you live. The tax-deferred earnings portion of these withdrawals or payments will then be taxed as ordinary income. Keep in mind that, as with IRAs, if you withdraw any money from an annuity before you're 59½, you'll generally have to pay an additional 10 percent penalty tax.)

Life insurance and retirement

Some life insurance has certain tax advantages, such as the tax-deferred growth of the cash value of permanent life insurance. This type of life insurance can be a supplementary source of retirement income, in addition to providing financial protection to your beneficiaries.

Review other investments

You should consider carefully your current investment portfolio. Are you putting your money in appropriate investments?

Other considerations

Does your employer offer or are you in a position to take advantage of any of the following?

- Nonqualified deferred compensation plans
- Stock plans
- Other employee benefits

Choose the right strategy to save for your retirement

You know that you should be taking advantage of employer-sponsored retirement plans, making yearly contributions to IRAs, and considering all of your other options, but how do you decide which to do first? If you have the cash, you should probably be doing all three. If not, conventional wisdom says you should always consider taking advantage of any employer-matching contributions within an employer-sponsored retirement plan. Contribute at least enough to capture the full match offered by your employer.

Beyond that level of savings, you have to think about whether it's better to make additional voluntary contributions to your employer-sponsored retirement plan or put those dollars into an IRA or elsewhere. Annuities and life insurance, for example, play an important role in many peoples' retirement planning.

Certainly, if you have not reached the pretax contribution limit at work, funneling more dollars into your 401(k) or other employer-sponsored plan probably makes the most sense. The ability to make systematic contributions straight from your paycheck is a huge practical plus for most individuals, and the power of tax-deferred savings can be great. Although the traditional IRA also provides tax-deferred growth, the ability to deduct contributions is phased out for high- and middle-income taxpayers also participating in qualified retirement plans. If you earn too much to make a deductible IRA contribution, you should probably fully fund your employer-sponsored retirement plan before making nondeductible contributions to a traditional IRA.

The Roth IRA and Roth 401(k) /403(b) offer yet more options. With these arrangements, you invest after-tax dollars, but you don't pay income tax on the earnings for qualified withdrawals. Tax-free earnings are even better than tax-deferred earnings because tax-deferred earnings will eventually be taxed when you start taking distributions. In deciding between a Roth IRA and a traditional IRA or other alternative, or between pre-tax and Roth 401(k)/403(b) contributions, you should consult a financial professional who can make some planning assumptions and crunch the numbers to see what makes the most sense.