Retirement and Deferred Compensation – How to be Prepared

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Agenda

• Planning for Retirement
  – Amount Needed to Retire
  – Factors to Consider
  – Sources of Income
• 457 Deferred Compensation
• After-tax Savings
• Proposed Legislation
How Do You Define Retirement?

- Leaving the job market entirely.
- Starting a new career.
- Making a business out of a hobby or vice versa.
- Doing volunteer work.
- Traveling the world.
Planning for Retirement

• How many years will you live in retirement?
  – Could be more than 30 years.

• How healthy do you expect to be?
  – Will you have health insurance? If so, at what cost?
  – Will you have long term care insurance?

• What major changes do you foresee at the time you leave your primary occupation?
  – Will your mortgage be paid off?
  – What will your tax bracket be?
How Much Money Will You Need in Retirement?

• The “$64,000” (or “$1 million”) question.
• General rule of thumb used in the past – 70% - 80% of pre-retirement income.
• More may be needed due to increased health costs and increased longevity.
• No set rule - depends upon your specific situation and the activities you intend to pursue in retirement.
Your Planned Retirement Spending

- Assess your specific situation to determine how much annual income you will need.
- What bills will be paid off?
  - Home mortgage, car loan, student loans
- Will clothing and commuting expenses be less?
- Will property taxes, utility bills, medical, travel and entertainment expenses be higher?
Other Factors to Consider

- Retired baby boomers may be financially responsible for either children or aging parents.
- Unlike earlier generations, baby boomers may carry considerable debt into retirement.
- Escalating medical costs.
- Post-retirement inflation.
Projecting Future Expenses

• Project your actual retirement expenses.
• Projection should include an inflation factor
• Run projection with several assumed rates.
  of inflation and earnings rates.
• Many calculators available on the web and
  in bookkeeping and investment software.
• You may find that you will need closer to
  90% of pre-retirement income.
Assessing Your Current Situation

- Employer sponsored pension – many in CalPERS. Ask DB sponsor for a benefit projection.
- 457 deferred compensation plan account.
- Personal IRAs, savings accounts, mutual funds, stocks, bonds, etc.
- Equity in your home – should only be factored in if you intend to sell your home and downsize, etc.
- Debts, including home mortgage, car loans, credit cards, equity line of credit, current bills.
How Much You Need to Save

• Calculate your retirement income “gap”
  – the difference between amount needed in retirement and what you expect to receive from Social Security, employee benefit plans and growth of current assets.

• Take your desired retirement income figure and factor in the number of years until retirement.
  – For example, if you need $700,000 to fill the “gap” and plan to retire in 15 years, you must save approximately $28,372 per year, earning 6% per year.
Six Primary Factors

- The amount of retirement capital already accumulated.
- The dollar amount of income needed.
- The number of years until retirement.
- The number of years you expect to be retired – should plan on living into your 90’s.
- The growth rate on invested dollars.
- The rate of inflation.
Replacement Ratio Approach

• Sum of expected sources of retirement income, divided by annual salary just prior to retirement.
• If at age 65, the payout over life expectancy would be 70%-80% of final pay, that should be enough according to conventional wisdom.
• This approach ignores post-retirement inflation and retiree medical expenses so must adjust.
• Remember, medical expenses have been rising faster than the basic inflation rates.
Replacement Ratio Approach

• Basic ratio approach also doesn’t take into account the risk of outliving one’s assets.
• May need to adjust for a number of other contingencies as well based upon your unique situation.
• Again, it may be best to strive for 90% of pre-retirement income.
Sources of Retirement Income

- Employer pension – is it a defined benefit plan that guarantees a lifetime benefit or a defined contribution plan with a fluctuating account balance dependent upon earnings?
- Social Security – there may be changes such as reduced benefits or increased costs by the time you are ready to retire.
Sources of Retirement Income

- Many people find their employer pension and social security are not enough to meet their projected retirement income needs.
- Personal savings is an increasing important and larger piece of the pie.
- Contributing to a section 457 deferred compensation plan is a great way to save.
457 Deferred Compensation

457 Deferred Compensation Plan – Great Vehicle to Enhance Personal Savings
California Municipal Treasurers Association

457 Deferred Compensation

• Economic Growth and Tax Relief Reconciliation Act of 2002 (EGTRRA) greatly improved governmental 457 deferred compensation plans.
• Final Treasury regulations have also made welcome changes.
• Governmental 457 plans are now arguably the best employer-sponsored savings plan.
Improvements to 457

• 457 plans now have many of the “bells and whistles” of 401(k) and 403(b) plans.
• EGTRRA added distribution flexibility, rollovers, QDROs, loans and increased the contribution limits.
• Still no 10% penalty on distributions prior to age 59 ½.
457 Deferred Compensation

- 457 plans allow you to save on a pre-tax basis and earnings accumulate on a tax-deferred basis.
- Special catch-up provision and new in-service transfer provision for purchase of service credit in your DB plan are invaluable retirement income planning tools.
• Contribution limits:
  – $13,000 in 2004,
  – $14,000 in 2005
  – $15,000 in 2006,
  – then indexed in $500 increments for cost of living adjustments.
Age 50 Catch-up Limits

• Participants age 50 or better may contribute additional amounts:
  – $3,000 in 2004,
  – $4,000 in 2005,
  – $5,000 in 2006,
  – then indexed for cost of living in $500 increments.
Special 457 Catch-up

• Special catch-up available during 3 years ending prior to normal retirement age.
• Normal retirement age (NRA), not severance from employment is the key.
• Participants in a DB plan have flexibility to choose their NRA.
• Special rule for qualified police and fire personnel.
Special 457 Catch-up Limits

• Special 457 catch-up amount = twice the basic limit:
  – $26,000 in 2004
  – $28,000 in 2005
  – $30,000 in 2006

• Cannot contribute special 457 catch-up and age 50 catch-up in same year, but can contribute the larger of the two.
No Coordination of 457 Limits with 401(k) or 403(b)

- As of 2002, a participant in a 457 plan and a 403(b) or a 401(k) can contribute the maximum to both plans.
- In 2004:
  - $26,000 if under age 50.
  - $32,000 if age 50 or older.
  - $42,000 if age 50 or older in 403(b) or 401(k) and eligible for special 457 catch-up.
  - $45,000 if age 50 or older and eligible for regular 403(b) catch-up plus special 457 catch-up.

California Municipal Treasurers Association
Unused Sick and Vacation Pay

• Final 457 regulations allow employees to defer unused sick and vacation pay up to the annual contribution limit.
• Election to defer and payment need to be made prior to severance from employment.
• For those who leave early in the calendar year, this can be a significant benefit.
Low to Moderate Income Savers

• Many participants cannot take advantage of the 457 maximum contribution limits.
• Important to save even a little as early as possible and to keep it in the plan.
• Waiting even one year can make a dramatic difference over time.
• Retirement Savings Credit a major plus.
Retirement Savings Tax Credit

• To encourage low and moderate income individuals to save.
• Maximum credit – 50% of contributions up to $2,000 = $1,000 or tax that would have otherwise been owed.
• Credit is claimed on individuals Form 1040.
Retirement Savings Tax Credit

• Eligibility is based upon adjusted gross income (AGI).

• % of contribution that can be claimed as a credit declines as AGI increases.

• Example: married couple filing jointly with income of $32,000 contributes $2,000 to 457 plan which reduces taxable income to $30,000. Net effect: $2,000 contribution costs only $1,000.
## Credit - AGIs

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<th>Single (Married=Double)</th>
<th>Head of Household</th>
<th>Credit Amount</th>
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<tr>
<td>$1-$15,000</td>
<td>$1 - $22,500</td>
<td>$1,000 -100%</td>
</tr>
<tr>
<td>$15,001-$16,250</td>
<td>$22,501-$24,375</td>
<td>$  400 - 20%</td>
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<td>$16,251-$25,000</td>
<td>$24,376-$37,000</td>
<td>$  200 - 10%</td>
</tr>
<tr>
<td>Over $25,000</td>
<td>Over $37,500</td>
<td>Zero</td>
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Rollovers Into 457 Plan

• You can now consolidate your assets by rolling funds from other eligible retirement plans into your 457 plan.

• Rollovers may be accepted from:
  – Qualified 401(a) and 401(k) plans
  – 403(b) tax sheltered annuities
  – Other governmental 457(b) plans
  – IRAs
Rollovers

- Rollover dollars must be separately accounted for in the 457 plan.
- Rollover dollars may be distributed prior to severance from employment if plan allows.
- Rollovers from 401(a)/(k)s, 403(b)s and IRA remain subject to the 10% premature penalty tax.
QDROs

• Prior law made it very difficult to divide plan assets in the event of divorce.
• After EGTRRA, the QDRO rules apply to 457 plans.
• Alternate Payees can receive an immediate distribution if the plan allows.
• Distributions are taxed to alternate payee.
Distribution Flexibility

• You may leave your funds in the plan after you sever employment – no distribution is required until you turn age 70 ½.

• No longer required to elect an irrevocable future distribution commencement date.

• You also have the flexibility to roll your 457 plan assets to your new employer’s plan or to an IRA at severance of employment.
Options for 457 Participants

Defined Benefit Payments versus 457 Account Balance
Analyze Impact of Additional Service Credit in DB Plan

• When projecting how much annual income you will need for retirement, your pension benefit will be essential.
• Determine whether you are allowed to buy additional service credit to increase the annual DB payments in retirement.
• If so, determine if increased DB payments for life outweigh the cost of purchasing the credit.
Purchase of Service Credit

• If you participate in a governmental defined benefit plan, such as CalPERS, you may have an option to increase your service credits under the defined benefit plan.

• 457 plan assets may now be transferred directly from your 457 plan to the defined benefit plan to purchase certain types of service credit.
California AB 55 and AB 719

- AB 55 amends Government Code relating to county employees’ retirement.
- AB 719 adds Section 20909 to Gov’t Code relating to public employees’ retirement.
- Both provisions allow members to purchase up to 5 years of “additional retirement credit” in their defined benefit plan.
Additional Retirement Credit

• For purposes of AB 55 and AB 719, “additional retirement credit” means years that don’t qualify as public service, military service, leave of absence or other service recognized for credit by CalPERS.

• Since no service is required, this type of credit is often referred to as “air time.”
Additional Retirement Credit

- It is clear that both AB 55 and AB 719 allow defined benefit plan participants to purchase “air time.”
- The issue is whether “additional retirement credit” as described in AB 55 and AB 719 may be purchased with an in-service transfer from a 457 plan.
Final 457 Regulations re: Purchase of Service Credits

• Section 1.457-10(b)(8) is entitled “Purchase of permissive past service credit by plan-to-plan transfers from an eligible governmental plan to a qualified plan.”

• The IRS has taken the position that “air time” does not meet the definition of permissive past service credit and thus in-service transfers are not available.
What is Permissive Service Credit

• Code section 415(n)(3)(A) defines “permissive service credit” as service credit:
  – Recognized by the governmental plan for purposes of calculating a participant’s benefit under the plan.
  – Which the participant has not received under such governmental plan.
  – Which the participant may receive only by making a voluntary additional contribution...
CalPERS Rules for Accepting 457 Transfers

• CalPERS held hearings and attended an attorneys’ roundtable sponsored by the California Association of Public Retirement Systems (CALAPRS).

• Question was whether to allow/accept in-service transfers from 457 plans for the purchase of “air time.”
CalPERS Decision

• CalPERS Board decided to allow in service transfers to purchase air time only if the member certifies to “corresponding service.”
  – Corresponding service means compensated employment with a non-governmental entity.

• This rule applies to transfers out of CalPERS 457 plan as well as transfers in to its DB plan.

• Other 457 plans may use CalPERS rules as a guide.
Additional Personal Savings Options

After-Tax Investments
Benefits of After-Tax Savings

- After-tax savings can help determine whether you will have enough in retirement since the tax has already been paid on your contributions.
- Mutual funds, stocks and bonds.
- Lower tax rate on dividends and capital gains.
After-Tax Savings Plans

- After-tax savings plans under current law include:
  - Traditional non-deductible IRA,
  - Roth IRA, and
  - After-tax contributions into a grandfathered 401(k).
Proposed Legislation

Increased After-Tax Savings
President Bush’s Proposal for Increased Savings

- Lifetime Savings Accounts (LSAs).
- Retirement Savings Accounts (RSAs).
- Employer Retirement Savings Accounts (ERSAs).
- Would greatly increase an individual’s annual after-tax saving opportunities.
President Bush’s Proposal for Increased Savings

• Proposed last year and generated spirited debate about tax policy.
• Had no sponsors in either House or Senate.
• President retooled the proposals to alleviate some criticism.
• All three savings schemes were introduced as part of this year’s budget.
Lifetime Savings Accounts

- Introduced on March 31, 2004 in House by Sam Johnson (R-TX) and in Senate by Craig Thomas (R-WY).
- If passed, effective for years beg. 1-1-05.
- New section 530A would be added to Code.
- LSAs held in trust, custodial or annuity.
- All contributions made with after-tax dollars and earnings accumulate tax-free.
Lifetime Savings Accounts

- Distributions can be taken at any time for any reason without taxation.
- Annual contribution limited to $5,000, indexed for cost of living in $500 increments in calendar years after 2005.
- Excess contributions not distributed before 7-1 of following year are subject to excise tax equal to 6% of excess for each taxable year it remains in the account.
Lifetime Savings Accounts

• Qualified rollovers from other LSAs of same individual or spouse allowed.

• Qualified rollovers allowed prior to 1-1-06 from qualified tuition program or Coverdell Education Savings Account if:
  – Amount rolled into LSA does exceed lesser of:
  – $50,000 or account balance as of 12-31-03, plus the lesser of $5,000 or contributions made in 2004 and the earnings thereon.
Lifetime Savings Accounts

- Major changes from President’s earlier proposal:
  - Annual contribution limit lowered from $7,500 or $5,000.
  - LSAs, as revised, do not appear to replace traditional IRA accounts. Under prior proposal, no new dollars could be contributed to a traditional IRA.
Retirement Savings Accounts

- Proposed legislation on RSAs expected to be introduced in next few weeks.
- RSAs – $5,000 annual after-tax contribution with earnings tax-free if not distributed prior to age 58.
- Can contribute maximum amount to LSA and RSA and ERSA every year.
Employer Retirement Savings Accounts

- ERSA legislation expected to be introduced in next few weeks.
- Unless new proposal has been revised, ERSAs would replace 457, 403(b) and 401(k) plans. Contributions either pre-tax or after-tax.
- After-tax contributions not subject to required minimum distribution rules.
Summary

- Take time to plan for retirement.
- Determine your required (as well as desired) annual retirement income.
- Assess current assets and project how much your pension, social security and savings will contribute to the amount required in retirement.
- Optimize your deferred compensation plan and after-tax savings opportunities.
- Plan which funds to use first (i.e., after-tax).
THANK YOU!

Questions?