A Public Employee’s Guide to Retirement Planning

Second Edition

Kathleen Jenks Harm

Government Finance Officers Association
and
ICMA Retirement Corporation
CONTENTS

v Foreword

vii Preface

1 INTRODUCTION

3 PART ONE: What Steps Should I Take and When?

9 PART TWO: How Do I Carry Out Key Retirement Planning Activities?
    Personal Finances
    Employer-provided Benefits
    Social Security
    Your Investment Decisions
    Asset Allocation Illustrated with Sample Portfolios

25 PART THREE: Frequently Asked Questions about Retirement Programs
    Employer-provided Benefits
    Social Security
    Medicare
    Estimates of Retirement Income Needs
    Additional Retirement Savings Programs
PART FOUR: Useful Resources

Books
Newspapers/Newsletters
Magazines
Money Management Software
Organizations
Internet

APPENDIX: Retirement Savings Worksheet
FOREWORD

Long before retirement, a public employee needs to carefully map out his or her plans for ensuring a secure retirement. Governments have an obligation to assist their employees in this effort by explaining the value of the benefits they have earned. Because employer-sponsored retirement plans often represent an individual’s largest single source of savings, this task is vital to their long-term welfare. In recognition of the critical role state and local governments play in helping their employees prepare for retirement, the Government Finance Officers Association (GFOA) has joined with the ICMA Retirement Corporation to publish this revised edition of A Public Employee’s Guide to Retirement Planning.

This book serves as an easy-to-read primer on retirement arrangements. It can be seen as a starting point in a marathon run toward retirement security. Although not intended to be the sole source of information on the subject, this booklet, when used in conjunction with other materials, can assist readers in planning for their financial future. The publishers encourage local governments to include this booklet with other relevant materials when communicating benefit information to their employees.

The GFOA and ICMA Retirement Corporation wish to thank several persons involved in this publication. In particular, we would like to thank Kathleen Jenks Harm, Director of Relationship Development for the ICMA Retirement Corporation, for writing this book and Nicholas Greifer, Manager, Policy Analysis, GFOA Research & Consulting Center, who served as project
manager. Recognition is extended to Sheri Berman, Product Manager, ICMA Retirement Corporation, for reviewing the manuscript. Finally, we thank Max Patterson, Executive Director of the Houston Firefighters' Relief and Retirement Fund and GFOA Executive Board member and Jan Hawn, Director of Finance & Administration, City of Chesterfield, Missouri and GFOA Committee on Retirement and Benefits Administration member, for their reviews of the publication.

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December 2001
PREFACE

This guide is written for the state or local government employee who wants to understand how public-sector retirement programs work and how they can be used to create a more financially secure retirement. Its purpose is to provide a primer on retirement programs that accomplishes the following:

- helps employees establish their own action plan at each point in their careers;

- provides information on the most common benefits and programs (including defined benefit and defined contribution plans, Social Security, IRAs, and 401(k) and 403(b) plans);

- compares the features of retirement programs, including payment options available under various plans; and

- explains differences between public- and private-sector programs.

This guide is organized around the tasks required of a public employee to adequately prepare for the financial needs of retirement. After introducing the necessity for the retirement planning process, the guide in Part One lists the tasks appropriate at different career stages and as retirement age approaches. Where appropriate, the tasks are detailed in Part Two.
Part Three further explains various retirement programs in a question-and-answer format. Part Four lists useful resources on retirement planning issues.

The general information provided in this guide is not intended as specific tax and legal advice, which may only be obtained from an accountant or attorney trained in such matters.

This 2001 revision of the 1995 guide incorporates significant recent tax code changes: the introduction of the Roth IRA; major modifications to deferred compensation programs, including contribution limits, portability, and ownership of assets; and other changes to defined benefit and defined contribution retirement plans. The revision also reflects the fundamental ways in which public employees and, indeed, the vast majority of Americans now access information—via the Internet.

Kathleen Jenks Harm

December 2001
INTRODUCTION

A financially secure retirement is one of the most important goals for nearly everyone. Planning for a comfortable retirement has become increasingly complicated, however, because of several factors:

- Better health has extended longevity, resulting in more active retirement years and longer retirement periods;
- The structure of public employer retirement plans has become more complex, with a growing trend towards retirement benefits provided through defined contribution plans, which allow individual employees to direct the investment of their retirement assets;
- Less than one quarter of public-sector employees earn a significant pension through service of longer than 20 years with a single employer;
- The Social Security system has changed. More public employees are covered, benefits may be subject to income taxation, and many individuals will have to delay retirement longer to receive full benefits from the system;
- Much more attention is being devoted to retirement issues in the financial press, and old and new investment products are being marketed as retirement vehi-

* In the public sector, governments have traditionally offered a defined benefit pension.
cles. However, some significant differences between public- and private-sector programs are frequently not taken into account, resulting in potential misinformation regarding available options.

- The effects of inflation on the buying power of anticipated pension income can be devastating, and too often retirement planning overlooks the importance of making appropriate preparations for dealing with inflation during retirement.

This guide is intended as a practical first step in meeting these financial planning challenges. This guide is not intended as a comprehensive approach to financial planning for retirement purposes. It is important to consider other financial resources as well. The author strongly recommends that the guide be used in conjunction with a reference book containing more extensive and thorough material, such as one of the financial planning references listed in Part Four. This guide also does not deal comprehensively with non-financial retirement issues, such as social needs, retirement housing choices, health-related issues, and so forth. Several appropriate references are listed beginning on page 59.
PART ONE

What Steps Should I Take and When?

To plan for a secure retirement, public employees need to take specific steps at certain points in their careers, as well as at various ages. The following table summarizes the tasks involved in preparing for retirement and their timing. In addition, any life-changing events (divorce, death of a spouse, a child with special needs, etc.) would cause you to reevaluate financial plans.

CHECKLIST FOR RETIREMENT PLANNING

<table>
<thead>
<tr>
<th>Action to Take</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Assess financial needs and develop basic plan</td>
<td>• Right now</td>
</tr>
<tr>
<td>• Update the plan</td>
<td>• Throughout career, every 3 years</td>
</tr>
<tr>
<td>• Roll over or preserve assets</td>
<td>• Throughout career, whenever job changes</td>
</tr>
<tr>
<td>• Retirement “rehearsal”</td>
<td>• 5-10 years prior to retirement</td>
</tr>
<tr>
<td>• Begin paperwork to obtain retirement benefits</td>
<td>• 1 year prior to retirement</td>
</tr>
<tr>
<td>• Medicare sign-up</td>
<td>• Age 65</td>
</tr>
</tbody>
</table>
Right now (if you haven’t already done so)—Assess financial needs and develop basic plan

☑ Complete a net worth statement and determine which of your assets are available for retirement investing (page 9).

☑ Estimate your retirement income needs and calculate the gap (if any) between anticipated retirement income and retirement income needed (pages 43-44).

☑ Calculate the amount of retirement savings required to reach your retirement income goal (pages 67-70).

☑ Review your benefit estimate from the Social Security Administration (page 13).

☑ Start or continue your annual contributions to a Roth IRA or a deductible traditional IRA (page 51).

☑ Develop your overall investment plan if you haven’t done so before (page 16).

☑ Provide for the distribution of your assets (including retirement plan assets) on your death through the use of a will or other technique, such as a living trust.

☑ Make sure your financial information is accessible to your spouse or other individual who will need it in the event of your incapacity or death (page 11).

☑ Talk to your spouse (or partner) about retirement. What retirement programs are available to your spouse or partner; do you have the same goals about where you want to live, when you want to retire, and how active you hope to be?
☒ Find out who your employee benefits administrator is, obtain all the information available from your benefits office on retirement programs, including pension plan, deferred compensation, and retiree health benefits (page 11).

☒ Increase your contributions to your deferred compensation program or 401(k) if you are not making the maximum possible tax-advantaged contributions (page 15).

☒ Obtain and read a general reference book on financial planning (Part Four, page 59).

**Throughout your career, every three years—Update the plan**

☒ Update the estimate of your potential benefits from your employer’s pension plan (page 12).

☒ Update your retirement income needs/retirement savings assessments and make adjustments accordingly (page 67).

☒ Reassess your investment portfolio—re-examine your retirement investments in light of the balance of your overall invested assets, length of time to retirement, and ability to tolerate risk (page 16).

**Throughout your career, whenever you leave employment/change jobs—Roll over or preserve assets**

☒ Find out what pension benefits you have earned. If you are vested and have a substantial number of years
before you can begin receiving benefits, do you have the option to receive a lump sum which can be directly rolled over to an IRA to avoid early withdrawal penalties and automatic 20 percent tax withholding in order to produce additional retirement income (page 28)?

☐ Review your options for the deferred compensation program in which you have been participating. Can you transfer your balance to your new employer? Is an IRA rollover an appropriate strategy?

Five to ten years before retirement—Retirement "rehearsal"

☐ Attend your employer’s pre-retirement seminar, if available.

☐ Visit your local Social Security office and pick up copies of all applicable informational brochures. Read them!

☐ Spend some time in the location(s) you are considering for your retirement.

☐ Determine your eligibility and potential cost for retiree health care benefits (page 12).

The year before your retirement—Begin paperwork to obtain retirement benefits

☐ Plan on spending significant amounts of time preparing for your approaching retirement; this is a new part-time job!
Initiate paperwork for receiving Social Security benefits and determine when you will begin to receive them. (page 38).

Initiate paperwork for receiving benefits from your employer's qualified retirement plan.

Contact prior employers where you have earned vested retirement benefits.

Read up on the changes you will go through when you retire; get a good general reference book on retirement life issues (page 59).

Examine your part-time employment opportunities, considering the effect of earned income on Social Security benefits.

Investigate the state tax requirements for pension payments you will receive, particularly if your payments will be made when you reside in a state other than where you earned the benefits.

When you reach age 65—Medicare sign-up

Sign up for Medicare (if you are not already receiving Social Security benefits) through your Social Security office (page 41).
PART TWO

How Do I Carry Out Key Retirement Planning Activities?

Part Two provides practical information on accomplishing the important tasks highlighted in Part One. Because the financial resources needed for retirement are often compared to a three-legged stool—personal savings, employer benefits, and Social Security—this chapter focuses on these three areas. In addition, the fundamental investment decisions of (a) how much to save and (b) how to invest savings (asset allocation) are discussed.

PERSONAL FINANCES

Complete a net worth statement and determine which of your assets are available for retirement investing

The basic picture of your financial status at any given time is your net worth statement. Your net worth is:

your total assets minus your total liabilities.

Your net worth is calculated using as assets such items as the total market value of your home, cash value of life insurance policies, value of personal property, and the market value of all invested assets. Liabilities include your outstanding mortgage principal, balance on all installment or credit card loans, and other indebtedness.
Although the process of calculating your net worth may seem somewhat intimidating, if you have applied for a mortgage or mortgage refinancing recently, you probably have compiled all the information contained in a basic net worth statement. Generally, people are pleasantly surprised with the outcome of these calculations, as individuals and families frequently underestimate their net worth. Good worksheets for calculating net worth are included in two of the book resources listed in Part Four and on the Internet sites indicated.

After completing your net worth statement, you should review your assets to determine which can be earmarked for retirement investing. You should evaluate your assets and make sure that you have:

- three to six months of take-home pay available as an emergency fund, and
- investments earmarked for your other important financial goals, which might include your children’s college education or down payment for purchase of a home.

This is a good time to review your debt and see how it can be reduced or eliminated prior to retirement, if appropriate. Although you may feel that not having an outstanding mortgage is beneficial to you, careful examination may indicate that is not the case. It may more valuable to not pay off your mortgage from other (normally taxable) investments in order to take advantage of the interest deduction allowed on your income tax return.
Make sure your financial information is accessible to your spouse or other individual who will need it in the event of your incapacity or death

The information should include the location of the following: insurance policies, deeds to real property, title to automobiles and other personal property, mutual funds, stocks and bonds, certificates of deposit, savings and checking accounts, retirement accounts such as pension plans and IRAs, and military records, if applicable.

Particularly if your financial documents are in separate locations and some records are in your personal computer, it is vital to provide some means for your spouse or other responsible individual to locate all of them in the event of your incapacity or death. The inventory of documents should be readily available to the appropriate individual when needed and should include the password for any software program you use for personal financial management.

EMPLOYER-PROVIDED BENEFITS

Find out who your employee benefits administrator is

Depending on the size and complexity of your employer’s workforce, the employee benefits administrator may be an individual who is also responsible for payroll or the human resources function, or you may work for a large employer who has several individuals handling various employee benefit programs. Finding the appropriate person or office and then utilizing them as a resource can pay big dividends in information about your em-
ployer-provided benefits and the opportunity to maximize the advantages of available programs.

Obtain all the information available from your benefits office on retirement programs, including

- **Pension plan**—An employer’s pension plan is a formal plan that is designed to provide retirement income. (Further description of pension plans is found on page 25.) You should be able (1) to get a written explanation of your plan from your employee benefits administrator and (2) to initiate a request for an estimate of the benefits you could expect to receive if you stay until you reach the plan’s normal retirement age (and at both an earlier and a later age). It is not unusual for participants in some retirement systems to wait six months or more for an estimate.

- **Deferred compensation**—Most benefit offices can supply you with general descriptive material on the deferred compensation program offered through the employer and specific information on the available plan investments. If your employer uses the services of an outside plan administrator, you should be able to contact a representative of the outside administrator for the necessary information.

- **Retiree health benefits**—Since retirees spend a higher percentage of their income on health care (especially on prescription medication and long-term care) than other people, a significant consideration in determin-
ing your retirement age will be the availability of and
conditions for retiree health care. Public employers
vary widely in the degree to which they provide and
pay for retiree health coverage. About 60 percent of
governmental employers provide some continuing
coverage for medical expenses, with about half of
state plans requiring employees to contribute toward
the cost of the coverage and only a third of local gov-
ernments requiring costs to be shared by the retiree.

A growing trend is for employers to establish pro-
grams that accumulate assets in individual accounts to
be expended for retiree medical expenses. These ac-
counts may be funded with employer contributions,
employee contributions, and accumulated vacation
and sick leave, depending on the type of program uti-
lized and the program designed by the employer.

SOCIAL SECURITY

Review your Social Security record and estimate of
projected benefits

Your Social Security Statement, sent annually by the Social Security
Administration (SSA), provides two main pieces of information:

(1) Your covered earnings record, important for verifying that
you have been credited with all applicable wages. The record
also indicates whether you have met eligibility requirements for
various types of benefits. Since the Social Security Administra-
tion bases your eligibility for and amount of benefits on this re-

PART TWO ◇ 13
cord, its accuracy is important to you. You only have slightly more than three years to correct any errors in this record.

(2) An estimated benefit statement, estimating the amount of your monthly benefits for retirement at early, normal, and late retirement ages, and for your survivors in the event of your death and for disability.

Important Caution: The estimated benefits statement will not provide accurate information for some public employees. If you will be paid a pension as a result of working for a public employer that did not participate in the Social Security system and withhold taxes for you, see page 38 for additional information.

A rough estimate of monthly benefits in current dollars for you and your spouse at full retirement age, which will go up from the age of 65 to age 67 in gradual steps starting in the year 2000, can be approximated from the following table:

### MONTHLY SOCIAL SECURITY BENEFIT

<table>
<thead>
<tr>
<th>Your age in 2001</th>
<th>Your Family</th>
<th>$20,000 Earnings</th>
<th>$40,000 Earnings</th>
<th>$60,000 Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>You</td>
<td>$838</td>
<td>$1,352</td>
<td>$1,622</td>
</tr>
<tr>
<td></td>
<td>You and spouse</td>
<td>1,257</td>
<td>2,028</td>
<td>2,433</td>
</tr>
<tr>
<td>55</td>
<td>You</td>
<td>824</td>
<td>1,323</td>
<td>1,599</td>
</tr>
<tr>
<td></td>
<td>You and spouse</td>
<td>1,245</td>
<td>1,984</td>
<td>2,398</td>
</tr>
<tr>
<td>62</td>
<td>You</td>
<td>812</td>
<td>1,300</td>
<td>1,555</td>
</tr>
<tr>
<td></td>
<td>You and spouse</td>
<td>1,218</td>
<td>1,950</td>
<td>2,332</td>
</tr>
</tbody>
</table>
One of the most useful Websites on the Internet is the Social Security Administration’s at www.ssa.gov. The site presents calculators and comprehensive information on retirement, disability, and survivor’s benefits.

YOUR INVESTMENT DECISIONS

Determine how much to save toward retirement

Public employees need to estimate how much to save for retirement, at least in approximate terms. The worksheet on pages 67-70 will help you prepare such an estimate. Those seeking a more precise estimate or set of estimates may wish to use Web-based calculators (see page 64).

The following are four general guidelines for efficient savings.

1. Maximize your tax-deferred savings. Particularly appropriate for retirement purposes, the most efficient saving usually comes from tax-deferred savings programs, such as Section 457 deferred compensation plans, Section 403(b) tax-sheltered annuities, Section 401(k) salary deferral plans, and individual retirement accounts.

2. Use a payroll deduction plan to “pay yourself first.” By having a regular amount taken out of your paycheck, saving is automatic. Your employer may have a variety of options for this purpose: a credit union will make your money readily accessible; and tax-deferred
savings programs available may include 401(k), 403(b), and 457 plans.

Each time you receive a pay raise, try to increase the amount of your contributions, if possible, before your spending habits catch up.

3. **Invest a regular dollar amount each month.** This approach allows you to take advantage of an investment technique called *dollar cost averaging*, acquiring more of an investment (whether it is an individual stock or bond or a mutual fund) when the price is low. This method is particularly important when you direct your savings to a volatile investment such as a stock fund.

4. **Take advantage of the power of time.** The dollar you invest early in your career will have more time to grow due to the effect of compounding of returns (earning interest on interest) and will be worth far more than the dollar you save late in your career.

*Determine your asset allocation: Assess your investment portfolio (retirement investments in particular) taking into account your overall invested assets, length of time to retirement, and ability to tolerate risk*

In recent years, a great deal of research has shown that the most important decision any long-term investor can make is the asset allocation decision. Asset allocation is simply the task of selecting fundamental types of investments: domestic stocks, interna-
tional stocks, bonds, cash, and so forth. Pages 19-23 illustrate several examples of different asset allocations or portfolios.

In order to choose your personal asset allocation, the following are six general principles that a public employee should consider. This guide is not intended to provide comprehensive guidance on investing for retirement purposes. Several of the resources listed in Part Four (page 59) provide this information.

1. **Know your ability to tolerate risk:** to the extent you can identify your aversion to the uncertainty of return on an investment, you can select an appropriate level of risk. You should endeavor to assume as much risk as you can tolerate, consistent with other general principles of investment, in order to maximize your long-term rate of return.

2. **Anticipate inflation.** Inflation of just 3 percent per year will reduce the purchasing power of a dollar significantly; a pension of $20,000 in today’s dollars will be worth only $11,212 after 20 years. As a result, a certain portion of your portfolio probably should be invested for growth, particularly in equities (stocks).

3. **Keep an eye on your investment time horizon.** As you approach retirement, your investments will probably become more conservative. However, don’t forget that even after you retire, you may be looking to your assets to provide income for the next 25 or 30 years. A
traditional rule of thumb is that the percentage of equity investments in your portfolio should equal 100 minus your age, but usually should not go below 30 percent.

4. **Diversify your investments.** Don’t put all your eggs in one basket. It is a good idea to diversify among:

- Different asset classes (such as stocks, bonds, real estate, international stocks and bonds, and cash in deposit accounts, etc.);

- Different industries within an asset class; and

- Different investment styles/objectives (growth, value, growth and income, etc.).

A practical way to diversify is to invest in a family of mutual funds or similar vehicles which contains a variety of funds.

5. **Become an educated investor.** Develop a familiarity with common investment terms and concepts. Read the business section of your newspaper and a financial magazine on a regular basis.

6. **Don’t invest in something you don’t understand.** Ask questions of the person who is trying to get you to invest in a particular security or type of investment. If
you can’t understand it, chances are you will be uncomfortable about the investment.

*Avoid any perceived conflict of interest arising from your governmental position*

An important footnote for public employees is to avoid investments that may give even the appearance of a conflict of interest. For many employees of local governments, the only appropriate investment in local real estate may be the individual’s primary residence. Where there is a question about the propriety of an investment, there may be a state ethics board that can make a ruling. Also, if you are in a sensitive or financial management position, it may be appropriate and wise to disclose your investments to your governing board or immediate supervisor.

*ASSET ALLOCATION ILLUSTRATED WITH SAMPLE PORTFOLIOS*

To take advantage of your investments for retirement, you should endeavor to maximize your overall return in light of the amount of risk (uncertainty of the return on any investment, the volatility of return) you are willing to assume. Typically, the more risk inherent in an investment, the greater the potential for reward in the long term.

Risk includes the possibility that your savings may fail to increase in value, or will actually go down, as well as the risk that your investments will not keep pace with inflation. Risk may result from overall market conditions, from business conditions specific to a particular industry or company, and from changes
in interest rates. Risk also results from other factors, such as exposure to currency rate fluctuations when making international investments. *There is no such thing as a riskless investment!* This is why it is important to understand the types of risk intrinsic to each investment and to mitigate risk through such means as diversification of asset classes. The major investment asset classes include stocks (which are shares of ownership in a company), bonds (which constitute an entity’s debt), cash (very short-term investments), international investments, real estate, etc.

Several profiles of investors can be drawn from the risk levels they are willing to undertake, based on ability to tolerate volatility (potential loss in investments) and the length of time they have until they expect to liquidate an asset:

*Aggressive investors* are willing to accept occasional losses, which may sometimes be substantial, as a tradeoff for the potential for higher rates of return. These investors rely on more volatile investments, such as mutual funds including growth stocks, small company stocks, and international investments. Aggressive investors must be able to invest for the long term (seven to ten years or more), and preferably to invest more in down markets, as returns over the short term may be negative and sometimes sharply negative.

*Moderate investors* generally seek investments combining the objectives of generating income and possessing the potential for growth. They are willing to accept some fluctuation in the value of investments and rely on investments such as dividend-paying
stocks and investment-grade bonds. These investors typically have investment horizons that are at least five to seven years long.

*Conservative investors* typically seek steady current income and a high level of safety of principal. These investors are willing to forego the potential for significant asset growth in return for lack of fluctuation in the value of their assets. They may emphasize U.S. Treasury securities, investment contracts, and cash.

Sample portfolios for each of these investor types is shown on the next page. Note that diversification of assets through the selection of several types of investments may provide more stable returns and better long-term performance than reliance on a single type of asset. For this reason, the sample portfolio for even the conservative investor contains equity investments.

Many investment providers, including mutual funds and administrators of defined contribution and deferred compensation plans, offer as sample portfolio programs funds designated for investment purposes. Usually offering three to five investor profiles, these programs are often referred to as model portfolio programs. Some providers take the approach another step and offer these portfolios not just as guidance for investments but as actual investment options, commonly called *lifestage* or *lifestyle funds*.

Before making any investment choices, you must consider your personal needs and your personal and financial tolerance for risk. Then carefully read the prospectus and other disclosure materials and ask questions before making your investment decisions. These examples of investor types and sample portfolios
SAMPLE PORTFOLIOS

Aggressive Growth

Moderate Growth

Conservative Growth

Foreign Equity

Bonds and Cash Equivalents

U.S. Equity

22  A PUBLIC EMPLOYEE'S GUIDE TO RETIREMENT PLANNING
are for illustrative purposes only. You should always base your investment decisions on your changing circumstances.

Finally, consider your retirement investment strategy as part of your overall retirement planning. Income from the retirement investments you control may be just one part of what you receive in retirement, particularly if you expect to obtain Social Security benefits and a defined benefit pension. Social Security, your employer-provided pension, and personal investments have often been referred to as a three-legged stool that supports you during retirement.

Because Social Security and defined benefit pensions provide streams of payments similar to fixed-income investments, these should be taken into account when selecting either a moderate, aggressive, or conservative portfolio as illustrated above. In other words, Social Security and a defined benefit pension are predictable, stable sources of future retirement income that may offset the risk associated with your other investments (such as personal investments in equity funds).
PART THREE

Frequently Asked Questions about Retirement Programs

EMPLOYER-PROVIDED BENEFITS

How can I determine what type of pension plan I have?

A pension plan is an employer-provided retirement plan designed to produce retirement income. In general, pension plans must be fixed and determinable either as to benefits (defined benefit plans) or contributions (defined contribution plans). All states and most local governments have pension plans; as a result, over 95 percent of all full-time state and local government employees are covered by a pension plan.

If you are in a defined benefit plan, the type that covers 90 percent of public employees, you will be used to hearing about receiving a percentage of your final salary when you reach retirement age. If you are in a defined contribution plan, you will receive a statement of your account value on a periodic basis, such as quarterly or annually, and you will usually direct the investment of the money in your account.
Does a public employer have to provide a pension plan to all its employees?

All public employers are now required, at a minimum, to cover their full- and part-time employees and any temporary and seasonal employees under Social Security or a retirement system deemed to provide a certain level of benefits or contributions. A pension plan is only one of several means of satisfying the federal requirement.

What are qualified plans?

By meeting requirements of the Internal Revenue Code for qualified plans, most basic retirement plans provided by public employers are eligible for certain favorable tax treatment, such as tax-deferral of contributions and tax-free rollovers of distributions to IRAs and to plans of subsequent employers. The pension plans of state and local governments are normally structured as qualified plans that qualify for all available tax advantages for participants.

A Section 457 deferred compensation plan, which provides similar tax deferral advantages to public-sector employees, is not a true qualified plan but still has the most important tax advantages of a qualified plan. The same is true for a Section 403(b) plan, which is available to employees of public schools, hospitals, or universities.

What are defined benefit plans?

Defined benefit plans obligate the employer to pay you a stated benefit at the time of retirement. The benefit amount to be paid, before taking survivor benefits into account, is determined by
the plan's benefit formula. This formula normally contains factors for your years of service with the employer, your salary over specified years, and a factor which is a percentage benefit earned for each year of service.

Example: Your plan may specify 2 percent per year of service times the average salary for the three highest years. In this case, if you had 20 years of service and an annual average salary for the highest three years of $30,000, you would have an annual pension benefit of $12,000 (20 × 2 percent × $30,000).

All 50 states provide defined benefit plans in which participation is mandatory for all state employees, with several minor exceptions. Recently, many states have considered and some have enacted defined contribution plans for newly hired employees. While there is a definite move toward use of defined contribution plans, by no means are defined contribution plans expected to replace defined benefit plans as the dominant plan for state government employees in the foreseeable future.

The vast majority of local government pension plans are defined benefit plans as well, although significant numbers of local employers have begun to use defined contribution plans, particularly for new hires. States may also maintain plans that cover employees of municipalities within the state on either an optional or a mandatory basis. Examples of states that allow municipalities to choose to have defined benefits provided through state programs include California (CalPERS), Florida (FERS), Pennsylvania (PMRS), Missouri (LAGERS), and Maine (MSRS). Examples of states with mandatory coverage of local government employees are New York State (New York State and Local Retirement Systems) and Utah (USRS).
What is the standard retirement benefit from a defined benefit plan?

Benefits vary widely. However, a defined benefit system will usually pay retirement benefits monthly based on its benefits formula when a participant becomes eligible through attaining a certain age, number of years of service, or both. For example, your plan could state that you become eligible for retirement on reaching age 65 or on reaching age 62 with at least 20 years of service.

Some plans contain a cost of living adjustment (COLA), which may increase the payment amount annually based on a cost of living index, usually subject to a limitation, such as 3 percent per year.

What happens if I leave before I reach the retirement age?

If you separate from service before you have become eligible to receive a retirement benefit from the defined benefit plan, your right to receive benefits at a future time (usually retirement age) is dependent on whether or not you have become vested. Vesting refers to your ownership of the retirement benefit, based on your years of service with the employer.

The most common vesting schedule in a defined benefit plan is known as cliff vesting: a participant is 0 percent vested until he or she becomes 100 percent vested on reaching a certain number of years of service with the employer, most frequently 10 years. If you separate after working for 10 or more years with an employer that requires 10 years for vesting but have not reached retirement age, you are entitled to a deferred, vested benefit. This benefit is normally paid at retirement age and is based on the em-
employer's benefit formula, with average salary figures determined as of your separation from service. The value of the resulting benefit will be eroded by inflation during the years from the date you terminate your employment until you are eligible to collect your benefit.

Regardless of how long your service is, you will always be vested in any contributions you make to the plan. Your plan will normally require that any contributions you make remain in the plan, should you leave employment with an earned retirement benefit (either immediate or deferred). If you leave prior to having earned a deferred, vested benefit, you will generally be given the opportunity to receive any contributions you have made to the plan plus a stated rate of return determined by the defined benefit plan.

**In a defined benefit plan, does it matter how many employers I have over my career?**

Defined benefit plans favor longer-service employees because the formula generally gives you credits for all the years you have worked with the employer (think about what employees made in your job 20 years ago!) but calculates benefits on only your highest wages. Thus a series of jobs in different defined benefit plans will not produce the same level of benefit as a career with a single employer. Since fewer than 25 percent of governmental employees work for longer than 20 years with the same employer, relatively few public employees enjoy the full potential from a defined benefit plan.
Do I have to contribute towards my defined benefit plan?

Roughly 40 states and most local governments require plan contributions from the employee, generally in the range of 5 to 6 percent. These systems are referred to as *contributory* because the employee directly pays a portion of the cost. The participant contributions are payroll-deducted and the plan will specify whether they are made on a pre-tax or after-tax basis for federal and/or state income tax purposes.

What benefit payments are available from defined benefit plans?

The amount of benefit you actually receive will depend on whether you receive the highest amount possible, based on the formula, and whether you are required to take (or choose to take) a benefit based on the inclusion of survivor benefits for another individual, usually a spouse. Payments are normally made on a monthly basis.

What are spousal rights and how do they affect payments from a defined benefit pension plan?

Twenty-six states and significant numbers of local jurisdictions (sometimes as a result of provisions in state statutes, sometimes due to local plan provisions) provide standard benefits in a form which gives continuation of some level of retirement income to a surviving spouse in the event of the death of a retiree. The provision for continuing income will result in a lower payment to the employee, based in part on the age of the spouse. Plans requiring
spousal continuation benefits also frequently provide the opportunity to select another form of payment, with spousal consent.

Should I buy life insurance to protect my spouse instead of selecting the spousal payment continuation option in the plan?

You may be approached with a pension maximization or pension max program, which is sold by insurance agents as a method of providing spousal income continuation through life insurance. While it may be worth investigating, some complex calculations are necessary to determine whether pension max will actually result in more security for you and your spouse. There is a pension max worksheet in Making the Most of Your Money, listed in the resources in Part Four (page 59).

My defined benefit plan has a DROP provision. Is this a good idea for me?

Some governmental defined benefit plans have added a feature called a deferred retirement option plan (DROP). These programs generally allow participants of a certain age to be treated (for pension purposes only) as though they have retired while working an additional period of time, generally up to three or five years. The pension payments which would have been made to the individual during this time are made available to the employee on actual retirement, usually in a lump sum and including interest at either a rate determined by the pension fund or actual rates of return if the monthly payments have been accumulated in a self-directed investment account. These DROP programs

PART THREE  ◊  31
give you the chance to have access to a lump sum payment on retirement, which can be rolled over to an IRA or used for a major purchase. Whether the plan is a good idea for you will depend on a number of factors concerning both the structure of the DROP and your circumstances, including length of time of DROP participation, imputed or real rates of return, increases in salary over the final years of employment, etc. You may wish to consult a financial planner to determine whether DROP participation benefits you (see page 57.)

My defined benefit plan will allow me to "buy back" prior service credits. Is this a good deal for me?

Many defined benefit plans will allow you to have prior service (from another employer or service you cashed in when separating from the employer in the past) credited for computing the actual retirement benefits you receive. Generally this requires a payment by you to the retirement system at actuarially determined rates and will be to your benefit if you do not die before reaching your life expectancy. The Internal Revenue Code permits you to use assets in qualified plans (including a defined contribution plan) and recently added assets in Section 457 and 403(b) plans to purchase these service credits. The advantage of using these sources is that you will be making the purchase with pre-tax dollars. Your retirement system should be able to tell you whether you have any service credits available for purchase and what the cost to you would be.
What are defined contribution plans?

Defined contribution plans are retirement plans characterized by individual accounts maintained for each participant, into which contributions are made by the employer and/or by the participants. Defined contribution plans cover only about nine percent of state and local government employees. This percentage is increasing over time as public employee’s desire retirement vehicles that provide flexibility and portability and public employers seek predictability of retirement costs.

Contributions to a defined contribution plan are specified in the employer’s plan document (either in terms of a percentage of salary or as a stated dollar amount), and the retirement benefit is based solely on the value of the participant’s account. The plan usually has several investments available, normally chosen by the participant. All of the earnings on investments remain tax-deferred until the funds are withdrawn. The performance of the investments will have a major impact on the funds available at retirement.

Example: A defined contribution plan has employer and employee contributions that equal a combined 12 percent on an annual basis. Over a period of 20 years, with a starting salary of $15,000, annual salary increases of 3 percent annually and average annual return of 8 percent, a participant’s account value would be $115,000. This amount could yield 25 years of annual payments of over $10,700 at an 8 percent rate of return.
How does vesting work in a defined contribution plan?

Vesting in a defined contribution plan applies to the right to receive plan assets that result from employer contributions and tends to be at a faster rate than in a defined benefit plan, usually five years or less. Unlike defined benefit plans, which rarely give vesting credit prior to attaining 100 percent vesting status, partial vesting is frequently granted in defined contribution plans. The participant is always vested in any employee contributions to the plan.

How does the number of employers over my career affect my ultimate benefits in a defined contribution plan?

As long as you meet requirements for vesting with each employer, defined contribution plans are neutral in terms of how many employers you have during your career, as opposed to defined benefit plans, which clearly favor long service with one employer.

Do I have to contribute to a defined contribution plan?

Plans may require employee contributions, either as a condition of employment or as a condition of participation in the plan. These employee contributions are payroll deducted on either a pre-tax or after-tax basis, depending on the plan. Some plans also permit employees to make additional voluntary after-tax contributions.
Are there limits to the amounts contributed to my account?

Contributions to a defined contribution plan must be made in accordance with your employer’s plan document. Beginning in 2002, contributions may be made by the employer/employee up to the maximum level allowed by the plan, so long as this amount does not exceed 100 percent of compensation (your earnings less picked-up contributions to qualified plans) from that employer or $40,000 (periodically indexed for cost of living adjustments). There are additional, separate limits for voluntary employee pre-tax salary deferrals under Sections 401(k), 403(b) and 457, covered in this guide beginning on page 45.

What benefit payments are available from defined contribution plans?

The structure of your retirement benefits will be up to you under a defined contribution plan. Subject to certain limitations (see the information on special factors for married individuals on page 30) and dependent upon your employer’s plan, you might be able to elect to receive your account value as a single lump sum payment, monthly payments for a specified amount until the full account is withdrawn, payments over your life expectancy, payments over the joint life expectancy of you and a named beneficiary, or an annuity.

For example, for each $100,000 you have in account value at the time of your retirement, if (i) you retire at the age of 65, (ii) draw funds from your account, (iii) your spouse is three years younger than you are, and (iv) your account earns 8 percent on your
funds in retirement, you would have the following benefit payments available:

<table>
<thead>
<tr>
<th>Lump Sum</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly Payments Over:</td>
<td></td>
</tr>
<tr>
<td>Ten Years</td>
<td>$1,199</td>
</tr>
<tr>
<td>Life Expectancy (20 years)</td>
<td>819</td>
</tr>
<tr>
<td>Joint Life Expectancy (27.6 years)</td>
<td>731</td>
</tr>
</tbody>
</table>

Ask your employee benefits administrator for an estimate of what options may be available to you at retirement and what amounts you might be able to receive under these options, given an interest rate you think you can attain given the level of risk you are willing to take. (See discussion of investment considerations, page 16.)

If you have no other reliable sources of retirement income and you are concerned about the possibility that you could outlive the assets in your plan account, you should consider the possibility of purchasing an annuity, a product sold by an insurance company. An annuity will pay a series of monthly payments, usually over your lifetime (eliminating the possibility that you could outlive your assets), although other time frames may be selected. A wide and complex variety of annuity products is available. Since lump sums in a defined contribution plan may represent significant dollar values, the assistance of an independent, fee-only financial planner (one who doesn’t receive compensation based on the sale of specific insurance products) may well be appropriate (see page 57).
My employer will be offering a defined contribution plan
to new hires, and as an existing employee, I have the
choice to stay in the defined benefit plan or move to the
new plan. What decision is best for me?

Unfortunately, the only time the best decision can determined for
a particular employee is when the last benefit payment is col-
lected by that individual, which is normally at his or her death.
The factors that affect total amounts paid under each of the
plans may include: date of death, final compensation, existence
of a COLA in a defined benefit plan, rates of investment return,
and years of future service with the employer.

As a general rule, the younger the employee is, with the smallest
number of years of service with the employer, the more the indi-
vidual may profit from being covered by a defined contribution
plan, particularly if he or she does not stay with the same em-
ployer for an entire career. Conversely, an employee who has
many years of service with the employer and is close to retire-
ment age will normally have an advantage from a defined benefit
plan, unless the individual dies at a relatively younger age. Your
employer should provide basic information on how the change
could affect you financially, but in some cases, this is such a ma-
jor decision that you may wish to contact an outside financial
advisor (see page 57).
SOCIAL SECURITY

What determines Social Security eligibility?

In order to qualify for Social Security retirement benefits, you must have paid Social Security taxes (also referred to as FICA) for a specified number of quarters. Generally, if you have 10 years of employment covered by Social Security you will be eligible for benefits. (Forty quarters of credit are necessary, with a quarter of credit earned for each $830 in income (in 2001) and a maximum of four quarters credited per year.)

How is the amount of benefit payment determined?

The amount you receive from Social Security is based on your covered earnings (wages on which you paid Social Security taxes, also called FICA wages) over your working career and is calculated through a formula, based on your average earnings during your career. The formula is designed to replace a higher percentage of earnings for individuals in lower income brackets than for individuals in higher income tax brackets. Your monthly benefit amount will also be affected by your age at the time you begin receiving payments. Generally, benefits are figured based on full retirement age of 65 (which will be raised in steps to age 67 for individuals born between 1938 and 1960), with reductions if you retire early (initial eligibility at age 62) or increases due to delayed retirement.
How am I penalized in Social Security benefits if I receive a pension from work not covered by Social Security?

Two significant issues arise for employees who receive pensions from public-sector jobs not covered by Social Security: one applies to the employee’s benefits from Social Security and the other to the employee's spousal benefits.

The windfall elimination provision results in a reduction in the benefits which would otherwise be available to an employee from Social Security, based on the number of years of uncovered employment and the average earnings from those years. The effect is such that if two individuals with identical employment records covered under Social Security and one has also earned a pension from an employer not in the system, the individual with the additional pension will receive less in monthly benefit amount from Social Security. (See A Pension From Work Not Covered By Social Security, available from local SSA offices and through the toll-free number.) If you work under a defined contribution plan, the Social Security Administration will convert your available account balance into a hypothetical monthly payment amount to calculate your Social Security reduction.

If you receive a pension from a public employer that does not participate in Social Security, the Social Security benefit you would otherwise be eligible to receive as a spousal benefit may be partially or completely offset by your uncovered pension. For example, if you were not covered by Social Security and earned a pension of $800 per month and the normal benefit based on your spouse’s earnings record was $300, you would be ineligible.
to receive the spousal benefit. Another individual who earned the same pension benefit and participated in Social Security as well would be eligible to receive the $300 per month on their spouse's record. (See *Government Pension Offset*, available from SSA.)

**When are payments from Social Security treated as taxable income?**

Increasingly over the past several years, Social Security benefits have become subject to federal income tax. The current tax situation is illustrated in the following table:

<table>
<thead>
<tr>
<th>Filing Status/Income Level</th>
<th>Amount of Benefit Subject to Income Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single Person</strong></td>
<td></td>
</tr>
<tr>
<td>Under $25,000</td>
<td>0%</td>
</tr>
<tr>
<td>Between $25,000 and $34,000</td>
<td>Up to 50%</td>
</tr>
<tr>
<td>Over $34,000</td>
<td>Up to 85%</td>
</tr>
<tr>
<td><strong>Married Couple</strong></td>
<td></td>
</tr>
<tr>
<td>Under $32,000</td>
<td>0%</td>
</tr>
<tr>
<td>Between $32,000 and $44,000</td>
<td>Up to 50%</td>
</tr>
<tr>
<td>Over $44,000</td>
<td>Up to 85%</td>
</tr>
</tbody>
</table>

*Income level includes most items of reportable taxable income plus one-half of Social Security payments plus otherwise tax-free interest derived from state and municipal securities.*
If I continue to work after I start receiving my Social Security benefits, what effect will my earned income have on the amount of my Social Security benefit?

If you receive earned income while receiving Social Security benefits before you reach full retirement age (see second question in this section), there is a reduction in benefits, based on your age and the amount of earned income. If you are under full retirement age, your benefits will be reduced $1 for every $2 earned over $11,280 (2002 figure). In the year in which you reach full retirement age, for every $3 over $30,000 (2002 figure) in income, your benefits will be reduced $1 in each of the months before you reach full retirement age. However, starting with the month you reach full retirement age, you can receive full benefits with no limit on your earnings.

MEDICARE

What benefits are available from Medicare?

Medicare is the federal health insurance program for people 65 and older. There are two parts to Medicare coverage: hospital insurance (also called Part A), and medical insurance, covering some costs of physicians’ services and other medical services (Part B).

The primary gaps in Medicare coverage relate to nursing home care and prescription drugs. Since the cost of these items may be catastrophic, many insurance companies offer policies designed to fill the gaps remaining after Medicare Part A and Part B coverage (so-called Medigap policies). While the different levels of
coverage have been confusing, policies are now categorized, on an A through J basis, so that contracts for similar benefits may be compared directly to each other. Also offered to cover the benefits not covered by standard health insurance policies is long-term care insurance, designed to cover such items as extended nursing home care or in-home assistance.

**What determines Medicare eligibility?**

Medicare eligibility differs for Parts A and B. You are automatically eligible for Part A if you are eligible for Social Security benefits, if your spouse (or former spouse) is eligible for Social Security, or you have paid the Medicare portion of the Social Security tax (usually a result of your being hired by your employer after April 1, 1986). You may also buy Part A coverage. If you are a local government employee who is not automatically eligible for Part A coverage and you buy the coverage for a period of seven years, you will then have Part A coverage continued at no charge to you.

Part B is an optional program that is available for purchase by almost anyone eligible for Part A.

The Part A coverage premium for 2001 cost $300 per month for individuals with less than 30 quarters of eligibility, and $165 per month for 30 to 39 quarters of eligibility. The Part B coverage premium for 2001 cost $100.

If you are getting Social Security when you turn 65, you will automatically be enrolled in Medicare and may elect to decline Part
B coverage. If you are not signed up for Social Security when you turn 65, you should call or visit a Social Security office.

ESTIMATES OF RETIREMENT INCOME NEEDS

How much retirement income can be expected from each employer-provided source?

Recent figures (1999) indicate a median household income for persons over age 65 of $22,812. Several facts emerge from a review of statistics on retirement income:

- The percentage distribution of income from different sources emphasized the importance of Social Security:

  - Social Security 37.6%
  - Employer Benefits 18.7%
  - Earnings 20.7%
  - Investment Earnings 19.9%
  - Other 3.1%

  Source: Social Security Administration, March 2000

- Social Security makes up a larger portion of income for lower-income than for higher-income elderly

- The portion of income made up of investment income rises as retirement incomes grow

PART THREE ◊ 43
Will this be enough?

For long-range planning purposes, you may estimate your retirement income needs to be roughly 80 to 100 percent of your pre-retirement income. Those retirees whose incomes are relatively low may need close to 100 percent, while those with higher incomes may be able to get by with lesser replacement percentages. As you approach retirement, you can fine-tune your budget, based on the activities and lifestyle you will be pursuing in retirement. Excellent tools for estimating your retirement income requirements are include in several of the resources listed at the end of this guide.

For most employees, the combination of pension payments and Social Security will be insufficient to generate the 80 to 100 percent level of replacement of income considered by many to be adequate to provide a comfortable retirement. See the Appendix of this guide (page 67) for a retirement income calculator worksheet that you can use to see if the benefit levels you can expect from these sources plus income generated from other sources will reach the 80 percent level. The worksheets also help you determine how much regular additional savings will be necessary for you to reach this level.

What can I do to save more for retirement?

You should consider maximizing your use of any individual retirement savings programs offered by your employer, which may include a 457 deferred compensation plan, 403(b) tax-sheltered annuity, or 401(k) salary deferral plan. Regular con-
tributions to an IRA may allow you to set aside an additional amount annually on either a deductible or nondeductible basis. You may also save on a regular basis by payroll deduction using your employer’s credit union, which will give you greater access to your funds than these retirement-specific programs for intermediate purposes (such as a down payment on a home, college tuition, etc.). Many mutual funds have programs that permit you to have a deduction from your checking account in a stated amount each month.

**ADDITIONAL RETIREMENT SAVINGS PROGRAMS**

*What is a 401(k) plan?*

Although not frequently offered as benefits to public-sector employees, profit-sharing plans (including 401(k) plans) are very popular in the private sector and available to some state government employees, such as in Utah and North Carolina, and the employees of some local governments.

A profit-sharing plan differs from a defined contribution pension plan in that the employer contributions are not fixed in nature but may vary from year to year.

A profit-sharing plan may include a 401(k) feature, permitting employees to elect on an individual basis the amount of pre-tax voluntary contributions they will make to the plan. A profit-sharing plan with a 401(k) feature is normally called a 401(k)
plan. Effective in 1986, the federal tax code does not permit state and local governments to adopt new 401(k) plans.

The maximum employee elective deferral to a 401(k) plan is the lesser of 100% of gross wages (less picked-up contributions to qualified retirement plans) or the dollar limit shown for maximum 457 deferrals on page 48.

**What are Section 457 deferred compensation plans?**

Deferred compensation plans are a convenient and ideal way to accumulate retirement funds through tax-deferred payroll savings deductions. They are currently available to employees of all 50 states and to likely over 90 percent of the local government work force.

Deferred compensation plans under Section 457 of the Internal Revenue Code (also called 457 plans) may be set up by state and local governments or their agencies and made available for employee participation, usually on a voluntary basis, although some employers may require participation in lieu of another retirement vehicle, such as Social Security. Check with your employee benefits administrator to see if a program is available to you.

Deferred compensation plans allow eligible participants to elect to contribute to their accounts by payroll deduction on a pre-tax basis. Many employers offer employer contributions to participant accounts on a matching basis, as part of contracts with collective bargaining units or as part of employment agreements with key administrative personnel.
Funds that are set aside have the advantage of not being subject to current federal and (in most instances) state income tax. The amount saved is thus the whole amount of the payroll deduction, which includes the taxes that would normally be deducted from pay on the amount saved. The accounts are not taxed until amounts are withdrawn, normally at retirement, when the participant may be in a lower income tax bracket.

Most deferred compensation plans offer a choice of several investment options, and the funds available for withdrawal at retirement or other eligible event (separation from service with the employer, death, or unforeseeable emergency) are a function of contributions, length of time the funds have been in the account, and the earnings resulting from the investment decisions made.

Most providers of deferred compensation programs have developed communications materials that will give you the information you need to make informed decisions on how to invest your account, choose a payment schedule, and so forth.

**What is the maximum contribution permitted to a 457 plan?**

While the percentage limit for maximum contributions is 50 percent of pre-deferral taxable income (basically 100 percent of taxable wages), the schedule for maximum contributions will be increased annually according to the following table, with limits thereafter indexed to inflation in $500 increments ($1,000 increments for catch-up contributions—see below):
<table>
<thead>
<tr>
<th>Year</th>
<th>Contribution Limit</th>
<th>Catch-up Contribution Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$11,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>2003</td>
<td>$12,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>2004</td>
<td>$13,000</td>
<td>$26,000</td>
</tr>
<tr>
<td>2005</td>
<td>$14,000</td>
<td>$28,000</td>
</tr>
<tr>
<td>2006</td>
<td>$15,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Are there any special provisions about 457 plans that make them different from other retirement plans?

There are some special provisions regarding 457 plans which differ from most other tax- sheltered retirement savings programs:

- Catch-up contributions are permitted to make up for prior unused eligible deferral, in three tax years not earlier than the date on which the participate is eligible for unreduced pension benefits from the employer’s plan (see table above for maximum catch-up contributions). Catch-up contributions are permitted up to twice the dollar limit per year.

- A special “age 50” catch-up provision (not dependent on having prior unused deferrals) is available to participants who are age 50 or older and not using the standard catch-up provision (see item above.) These contributions are not included for purposes of contribution limits. The dollar limits are as follows:
<table>
<thead>
<tr>
<th>Year</th>
<th>Age 50 Catch-up Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1,000</td>
</tr>
<tr>
<td>2003</td>
<td>$2,000</td>
</tr>
<tr>
<td>2004</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005</td>
<td>$4,000</td>
</tr>
<tr>
<td>2006</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

- The 10 percent tax penalty for early withdrawal applicable to most retirement savings programs does not apply.
- Assets may be rolled to a qualified retirement plan, 403(b), or IRA but withdrawals will then be subject to the 10 percent penalty for early withdrawals.
- The assets in the plan are held in trust by the employer for the exclusive benefit of the participant and beneficiary(ies).

**What is a 403(b) plan?**

A 403(b) plan is a tax-sheltered retirement savings plan available to employees of schools, hospitals, and similar organizations. The plan may provide for employer contributions, but most commonly there are only elective employee contributions. Plan contributions (when employer contributions are included) may be made up to the lesser of 100 percent of gross wages (less picked-up contributions to qualified retirement plans) or $40,000 (indexed for inflation.) The dollar limitation for employee elective deferrals is the dollar limitation shown on page
48 as the limitation for 457 plans. The plan investments may include annuity contracts sold by insurance companies or custodial accounts invested in mutual funds.

Can I have all three types of plans: 401(k), 457, and 403(b)?

Your employer may offer more than one type of plan, and you will normally be allowed to contribute the maximum to any of those provided.

Are there any special opportunities for employees with lower income levels?

An individual who makes a contribution to a retirement plan (including 401(k), 403(b), 457, or IRA) may be eligible for a tax credit of up to $1,000. The credit is based on the first $2,000 of contributions. The amount of the credit will depend on the AGI of the individual. For example, a joint filer with combined AGI of up to $30,000 could take a 50 percent credit on his or her contribution. (If $2,000 is deferred to a 457 plan, the credit will be $1,000.) The percentage of the credit phases out from 50 percent to 0 percent, based on AGI:

<table>
<thead>
<tr>
<th>Credit</th>
<th>Individual</th>
<th>Joint</th>
<th>Head of Household</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>$0-$15,000</td>
<td>$0-$30,000</td>
<td>$0-$22,500</td>
</tr>
<tr>
<td>20%</td>
<td>$15,001-$16,250</td>
<td>$30,001-$32,500</td>
<td>$22,501-$24,375</td>
</tr>
<tr>
<td>10%</td>
<td>$16,251-$25,000</td>
<td>$32,501-$50,000</td>
<td>$24,376-$37,500</td>
</tr>
</tbody>
</table>
The amount of the contribution eligible for the credit must be reduced by certain distributions received by the individual and his/her spouse. The credit cannot lower the individual’s tax liability below zero. The credit will be available from 2002-2006.

**What is an IRA?**

IRA refers to *individual retirement arrangement*, which may be in the form of either an individual retirement account (usually a bank or mutual fund) or an individual retirement annuity (if an insurance company annuity is used to fund the IRA). There are two basic types of IRAs: *traditional IRAs*, which may have contributions that are tax-deductible or non-deductible, grow on a tax-deferred basis and are taxable on withdrawal; and *Roth IRAs*, which have non-deductible contributions that grow tax-deferred and may have tax-free withdrawals if certain circumstances are met (generally existence of the account for five taxable years and reaching age 59 ½, disability, purchase of a first home, or death.)

**What IRA contributions are permitted?**

In 2001, individuals may contribute up to $2,000 or 100 percent of earned income, whichever is less, to their IRA, either traditional or Roth. If only one of a married couple filing jointly has earned income, the couple may fund a spousal IRA, with the individual $2,000 maximum for each IRA, for a total of $4,000. These maximum contributions are scheduled to increase as follows:
<table>
<thead>
<tr>
<th>Year</th>
<th>Maximum IRA Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-2004</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005-2007</td>
<td>$4,000</td>
</tr>
<tr>
<td>2008</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Starting in 2009, these limits will be indexed for inflation and increased in $500 increments.

**Is there a catch-up provision for IRAs?**

Beginning in 2002, taxpayers age 50 and over will be able to make annual catch-up contributions of $500 for 2002-2005 and $1,000 beginning in 2006 and thereafter.

**Who can make deductible IRA contributions?**

Although Roth IRA contributions are never deductible, traditional IRAs may be. Under traditional IRAs, if you or your spouse are covered by a retirement plan at work (including pension plans, 401(k) plans, 403(b) plans, but not 457 plans), the deductibility of a traditional IRA contribution depends upon adjusted gross income (AGI). Please refer to the table below, which provides figures for 2001 (subject to change).
Eligibility for IRAs

Married Couple
- Under $53,000
- Between $53,000 and $63,000
- Over $63,000

Single Individual
- Under $33,000
- Between $33,000 and $43,000
- Over $43,000

Adjusted Gross Income
- Fully deductible
- Deductible on a pro-rata basis
- Not deductible

Are there income limitations for making a Roth IRA contribution?

If you are married filing a joint tax return, you may contribute to a Roth IRA if your adjusted gross income (AGI) is $150,000 or less, and if you are single or head of household, if your AGI is $95,000 or less. Once these income thresholds are reached, the tax break is phased out.

Can I contribute to a Roth or traditional IRA through my employer?

Employers may currently offer you the opportunity contribute to a Roth or traditional IRA through payroll deduction. Beginning in 2003, you may contribute to a Roth or traditional IRA through payroll deduction to your 401k plan, if your employer chooses to offer the option. The money contributed is subject to the IRA rules and is not counted toward the 401k contribution limit. You will not receive any immediate tax savings but would be able to realize tax deferral at the time you file your annual in-
come tax return if you are making deductible traditional IRA contribution. Payroll deduction is generally a very effective method of ensuring that you make the annual contribution in a systematic way, which also takes advantage of dollar cost averaging on your investment (see page 16.)

Are traditional non-deductible contributions worth making?

Generally only those individuals above the income limits for the Roth IRA should consider the nondeductible IRA. The earnings and gains on non-deductible contributions are tax-deferred until they are withdrawn, usually when your income may be reduced because you have retired. When capital gains taxes are at roughly the same level as the taxes on regular income, there are real advantages to making nondeductible contributions. Since capital gains currently offer substantial tax savings over regular income rates, nondeductible contributions may not provide a significant advantage over investing outside an IRA. Careful review of rate differentials will be needed to determine whether nondeductible contributions still retain their attractiveness.

However, making decisions on the basis of what the tax code may provide in the future may not be fruitful.

Is there an age at which I am required to start receiving my pension and other retirement program payments?

Unless you are in a plan that uses a special exemption for active employees, you will be required to start receiving payments from
your pension and other retirement programs no later than April 1st of the year following the year in which you reach age 70½. (Plans with the exemption require payments to begin no later than April 1st following the year of actual separation from service.) From that age on, annual payments are required.

Are there requirements for how much I take out of my retirement savings programs?

Starting with the year in which you turn 70½, you will be required to withdraw a certain amount from your defined contribution, 401(k), 457, and 403(b) plans and your IRAs. The first year’s withdrawal may be postponed until no later than April 1st of the following year, but if the first payment is delayed, there will be two required withdrawals in the year following the 70½ year.

The requirement is that the participant withdraw from each type of separate account an amount equal to the previous year’s ending balance divided by the applicable life expectancy (ALE), defined as follows:

The joint life expectancy will be with a hypothetical beneficiary who is 10 years younger.

If the spouse is the named beneficiary for the account and the spouse is more than 10 years younger, the actual joint life expectancy of the participant and spouse;
These provisions and useful examples are outlined in IRS Publication 590, available from the IRS or online from the IRS Web site. (Check to see that you have the most recent version, because the ALE definition changed in 2001.)

**What are the penalties associated with not taking enough from my retirement plans?**

If you do not withdraw at least the minimum required amount from your retirement plans, you will be subject to a tax penalty of 50 percent of the amount of the difference between the required withdrawal and the amount you actually withdrew. This 50 percent penalty is in addition to the normal tax liability you incur for withdrawals. You may aggregate your IRA accounts and withdraw the minimum amount required from any one or all of your accounts. However, you must take the minimum required distribution for each employer retirement plan from that plan.

**What are the penalties for withdrawing at too early an age?**

If you withdraw funds from your retirement accounts prior to age 59½, you may be subject to a 10 percent tax penalty for early withdrawal. This penalty is not applicable under the following circumstances: if you separate from employment at age 55 or later; if you take a series of substantially equal payments scheduled to last over a period based on your life expectancy; if you are disabled; in the event of your death. The 10 percent penalty also does not apply to 457 plans except for assets from plans subject to the 10 percent penalty which have been rolled into a 457 plan.
What tax-free transfers are available from one retirement plan to another?

You may generally transfer assets on a tax-deferred basis among retirement plans (qualified plans), Section 457 deferred compensation plans, IRAs, and 403(b)s when you are eligible for a distribution. Certain otherwise taxable distributions from employer-based plans are eligible rollover distributions. You not only may transfer them to a new employer’s plan or IRA, you will be subject to 20 percent automatic withholding of taxes if you do not transfer the assets directly from the plan to your new employer’s retirement plan or IRA. A distribution is considered an eligible rollover distribution unless it is: a required minimum distribution; any of a series of substantially equal periodic payments paid at least once a year over (1) life expectancy, (2) life expectancy of you and your beneficiary or (3) a period of 10 years or more.

Provisions still exist that permit an IRA rollover within 60 days of receiving a distribution. However, if this option is taken, the full amount of the distribution may not be readily available, as the 20 percent withholding will have been taken out.

When should I consult a financial planner?

You should consult a financial planner if you have to make a decision which has a substantial impact on your future financial well-being and you are not comfortable that you have the necessary expertise or understanding to make that decision. You should be aware of any compensation that the financial planner
may receive as a result of your making a particular investment
decision. For example, an insurance agent offering financial
planning services may receive a commission as a result of your
purchasing an insurance or annuity product. An alternative is to
utilize a fee-only financial advisor.

You may wish to consult a financial planner who has the CFP, or
certified financial planner, designation. Although not a guaran-
tee of competence, these individuals have passed a series of qual-
ifying examinations and possess a combination of education and
experience considered appropriate by the certification board.
You may get a listing of financial planners with this designation
by contacting the Financial Planning Association at (800)
322-4237. For a fee-only financial advisor, contact the National
Association of Personal Financial Advisors (NAPFA) at (800)
366-2732. Both organizations have Web sites, listed with
Internet resources on page 65.
PART FOUR

Useful Resources

Where the resource is not generally available in bookstores/newsstands, information on how to obtain it is provided.

Caution: The Internal Revenue Code has undergone substantial changes in the area of retirement plans. The information in this guide reflects changes to the Code through the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA.) This bill resulted in significant changes to qualified plans and IRAs and profound changes particularly to 457 plans. The publication dates of the references listed below, if before 2001, will indicate that some of the material contained is no longer applicable.

The books with an asterisk preceding the title contain worksheets for calculating retirement needs.

BOOKS


*Over Fifty: The Resource Book for the Better Half of Your Life*. Tom and Nancy Biracree. Harper Collins Publishers. This guide has listings of large numbers of resources in the areas of finance, taxes, health care, recreation, etc. on a state-by-state basis where appropriate.

*Personal Finance for Dummies*. Eric Tyson. Demystifies personal finance, including retirement planning. While the information is not provided in depth, the book is well organized and answers basic questions very well.

*Planning and Establishing Preretirement Education Programs*. David Amick, Ann Risdon and Sheryl Wilson. Government Fi-
nance Officers Association. Valuable planning guide for public employers designing preretirement education programs.

*Tax Facts.* National Underwriter, Cincinnati, Ohio. This annual publication is an authoritative, relatively technical, source of information on taxation of employee benefits, particularly retirement programs.


*Winning the Loser’s Game: Timeless Strategies for Successful Investing,* Charles D. Ellis. McGraw-Hill. Written initially for institutional investors and therefore somewhat technical, consumer-oriented version adds valuable insight for individual investors interested in understanding how to manage their investments.

special concern to women, particularly women’s employment patterns and resulting financial concerns.

Yes You Can; Si, Se Puede: Every Latino’s Guide to Building Family Wealth, Charles Gonzalez. Chandler House Press. Although written in English, book is designed for Latinos of all income levels.

NEWSPAPERS/NEWSLETTERS

Morningstar Mutual Funds. Widely used rating source for mutual funds. (800) 876-5006.

New York Times. General interest newspaper with strong financial focus.

USA Today. General interest newspaper with good, easy-to-read section on Money.


MAGAZINES

Money, Mutual Funds, and Smart Money. Magazines with articles of current interest on financial matters. Good retirement planning focus.
Consumer Reports. This advertising-free magazine occasionally provides articles on how mutual funds should be selected and other financial planning topics.

ORGANIZATIONS

Agencies on Aging. Coordinate delivery of many governmental programs providing assistance to older citizens. Listed in consumer pages of most phone directories.

American Association of Retired Persons (AARP). Lobby for retired Americans that provides excellent magazines (“Modern Maturity” and “My Generation”), publications, services, discounts. Full membership available to individuals over age 50. Contact AARP, 610 E Street, N.W., Washington, DC 20049. (202) 434-2277. No specific policies or products of AARP are endorsed or recommended by this author or the publication.

National Council of Senior Citizens (NCSC). NCSC’s primary goal is the continued security of Americans in their older years, which the organization promotes through its network of over 5,000 clubs across the country, its Political Action Committee, its publications (including Senior Citizens News and Retirement Newsletter), its provision of 10,000 senior employment opportunities, and through being one of the largest providers of Section 202 low-income housing for the elderly. Contact NCSC, 1331 F Street, N.W., Washington, DC 20004-1171. (202) 347-8800.
MONEY MANAGEMENT SOFTWARE

Microsoft Money and Quicken by Intuit—Comprehensive personal financial software including money management, loan calculations, insurance needs estimates, retirement income requirements calculations, net worth statements, etc. Easy to use, recommended by financial planning and accounting professionals.

INTERNET

The following Web sites are sponsored by government agencies and not-for-profit organizations. Many more commercial for-profit Web sites have useful retirement planning information or tools as well, but are not listed below. For your own state or local government benefits site, ask for the address at your benefits office or use a search engine (e.g., Yahoo.com or Google.com) and type in your employer’s name and other key words, such as “retirement” or “pension.”

aarp.org—Web site for the largest organization of individuals over 50 years of age.

benefitscheckup.org—Valuable information on available benefit programs and how to apply for them.

choosetosave.org—The public sector initiative associated with the American Savings Education Council, the site has many calculators and information on savings.

gfoa.org—Government Finance Officers Association is a definitive resource for public-sector finance information, including pensions and benefits.

icmarc.org—ICMA Retirement Corporation is a private, not-for-profit provider of retirement plans for the public sector. Website has asset allocation modeling under “Portfolio Builder” and current information on retirement programs.

Investoreducation.org—The Alliance for Investor Education operates a web-based clearinghouse specifically oriented toward investment education. The alliance is made up of several non-profit associations.

irs.gov—Source for information on federal income taxes and publications of interest, such as Publication 590 on Individual Retirement Arrangements and 575 on Pension Plans.

medicare.gov—Comprehensive information on federal health insurance program for individuals 65 and older

naic.org/1pubcat/consumer.htm—Web site of state insurance commissioners offers publications which help in the evaluation of various insurance policies, particularly valuable in area of long-term care insurance.

napfa.org—Find a fee-only financial planner on site of the National Association of Personal Financial Advisors.
ncscinc.org—Informative site of National Council of Senior Citizens.

nfcc.org—National Foundation for Credit Counseling offers tools to assist in debt management for individuals.

ssa.gov—One of the best sites on the Internet, a wealth of information on Social Security, includes calculators for determining benefit estimates, list of “top ten” questions, information about government offset and windfall elimination.

sec.gov—Aside from regulating financial institutions, the Securities and Exchange Commission (SEC) offers considerable educational information, including interactive tools and free on-line publications.

wiser.heinz.org—Women’s Institute for a Secure Retirement deals with special interests and concerns of women.
APPENDIX

Retirement Savings Worksheet

How much do I need to save for retirement?

The assumptions used in this worksheet are as follows: you work until age 65, earn 8 percent rate of return on assets before retirement and 7 percent after, inflation will be 4 percent annually and that you will schedule your payments to provide monthly income over a period of twenty-five years, five years beyond your single life expectancy (female-male average). You may find it useful to complete three of these worksheets: one for yourself, your spouse or partner, and the two of you together.

If you are within 10 years of retirement, you should prepare a more detailed analysis, such as those provided by the worksheets in the books asterisked on pages 59-62.

STEP ONE:
First figure the amount you will need (calculated in today’s dollars) from sources other than Social Security and your pension plan (or plans).

1. Total annual retirement income needed from all sources

   (In today’s dollars, you will likely need approximately 80-100 percent of your income to live comfortably.)
2. Income provided by Social Security

(Enter an approximate figure by taking your nearest age and salary from the table on page xx and multiplying by 12)

3. Annual pension income provided by employer

(Request this information from your employee benefits administrator. Include deferred vested benefits from past employers. Exclude savings from your employer's defined contribution or 401k plans (see step 7).)

4. Annual income gap in today's dollars

(Add up lines 2 and 3; then subtract from line 1.)

STEP TWO:
Now calculate the amount you will need in a lump sum at age 65 to generate the needed additional annual income from Step One.

5. Annual income gap in dollars at age 65

(Multiply line 4 by the inflation factor from the table below. If the number of years until age 65 is not given, you may approximate between the closest numbers)
6. Lump sum necessary to generate annual income in line 5 (assumes you will have payments increase annually with inflation)

   (Multiply line 5 times 17.64)

### STEP THREE:

Project how much your assets earmarked for retirement will be worth at age 65.

7. Retirement savings available now

   (Include savings from defined contribution and deferred compensation plans, IRA, or personal savings)

8. Value of these savings at age 65

   (Multiply line 7 by the factor from the table below. If the number of years until your retirement is not given, you may approximate between the closest numbers)

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**Years to Age**

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<th>7</th>
<th>10</th>
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**Appendix**
STEP FOUR:
What amount do I need to save annually in today's dollars to make up the income gap between my available assets and retirement goal?

9. Additional savings required at age 65

(Subtract line 8 from line 6)

10. Annual savings to meet retirement income goal

(Multiply line 9 by the factor from the table below. If the number of years to age not given, you may approximate between the closest numbers)

<table>
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<tr>
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<th>7</th>
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