

20 Ways to Build Your Retirement Fund

- **How Much Do I Have Now?**
- **How Much More Will I Add?**
- **What Will I Have at Retirement?**
- **What Will I Need?**
- **How Long Will It Last?**
- **How Much More Do I Need?**
- **What Can I Do to Make Up the Difference?**

Includes Retirement Cash Flow Model

Primary Goals

- Forecast total retirement savings and income, estimate annual retirement expenses, project years in retirement, and calculate the deficit.
- Review all of the available alternatives to increase your retirement fund and make up that deficit.
- Use your company today *and* after you retire to increase your overall retirement fund as well as your annual retirement income.
- Take advantage of all tax-saving options to maximize retirement savings.
- Elect the settlement option to receive your retirement money that results in the greatest income to both you and your spouse and the lowest tax liability.
- Convert illiquid assets to cash and consider options to reduce post-retirement expenses.

You want to increase your retirement savings, extend the length of time it grows tax-free, and make up projected deficits while you're still working.

20 Ways to Build Your Retirement Fund

You want to increase your retirement fund, extend the length of time it grows tax-free, make up any deficits between what you've saved and what you will need, and pay the least amount of taxes when you eventually withdraw the money.

Recent survey: 66% of people aged 51 to 62 have not determined how much money they need for retirement.

The critical questions that need to be answered, particularly for business owners and individuals who have a second income from a business:

- How much money do I have now, how much more will I put in before I retire, what will it grow to, and how long will it last?
- If my calculations indicate I have less retirement money than I will need, what can I do *today* to make up the deficits?
- How do I use my company today *and* after I retire to accumulate more retirement savings and increase my annual retirement income?
- How do I sell all or part of my personal ownership position in the business to obtain more retirement money?
- How do I provide for my spouse and children if I die before or after I retire?

Business owners have special income and retirement options and decision-making powers that are not available to individuals and executives in larger corporations. You need to be more informed on retirement planning because, as the owner, you have control over how the retirement plan is funded and taxed. *Here's the evidence:* You structure the company's retirement or pension plan and determine its annual funding...you set the salary and bonuses paid to you each year...you do the tax balancing act between business deductions and higher personal income and bonuses...and, overall, you decide how best to use your company's assets and profits to provide for your retirement.

*That's what this **Resource Report** is all about.* It presents 20 ways to build your retirement fund and income. Of particular importance are the ideas to help business owners.

The key for business owners is better use of their companies' resources today to fund their future retirement needs.

Start your work by computing how much money you need for retirement. (Use the *Retirement Cash Flow Model* on pages 12 and 13 to guide you in your calculations.) The main questions you are going to answer:

- #1. How much money do I have set aside now for retirement?
- #2. How much *more* money will I set aside each year between now and retirement?
- #3. What other sources of income will I have (e.g., rental income, consulting, etc.)? Don't forget to include Social Security benefits. Review carefully the estimated monthly benefit you and your spouse will be receiving at age 62, 65, or later; it is sent annually by the Social Security Administration. For a listing of *free* retirement booklets from the IRS and Social Security Administration, see page 16.
- #4. How much total money will I have at age 65 (or whatever retirement age I am planning)? This will include both #1 and #2 amounts above plus whatever investment return those amounts will have earned at various annual rates of return between now and retirement, e.g., compute for 4%, 6%, and 8%.
- #5. Based on my total retirement fund, how much money will I be able to withdraw annually over 10, 15, and 20 years?
- #6. When will all of the money be depleted? At age 70, 75, 80?
- #7. How much more money do I need to set aside before retirement to support both me and/or my spouse if we live to, say, age 85, 90 or 95?

Don't let the math intimidate you. Your accountant can help you set up a program to automatically collect and update your retirement fund information on a regular basis once you've made the initial calculations. *The goal:* To know at any given point in time how much retirement money you have, how much it is earning,

what it will grow to, and how much you and your spouse can withdraw annually during your retirement years.

The number you are looking for in this review is the dollar deficit — the difference between your projected annual retirement expenses and your projected annual retirement income. Keep in mind that your fixed expenses after retirement should be lower than during your working years. Hopefully, you are not supporting your children, your mortgage is paid off, children's college education expenses are no longer a financial burden, and some or all of your life insurance is paid up or the coverage can be reduced.

Remember that the more years you have to implement the ideas, the greater the impact on the total amount you and your spouse will have to live on during retirement.

Plan Ahead to Make Up Retirement Deficits

Once you have calculated the shortfall between what you will have and what you will need, get to work with your advisers to decide how you can make up that difference. In many cases, a combination of strategies should be used to accomplish your goals.

Here is a checklist of ideas to get you started. To assist you in reviewing them with your advisers, we have indicated the applicable Internal Revenue Code (IRC) sections. Although some of the ideas apply only to business owners, all individuals considering retirement in the near or distant future will find many of the strategies applicable to them.

#1 — Set up a deferred compensation plan with your company to pay you “x” dollars a year for a certain number of future years, say, 10 to 15 years. These deferred salary payments are not taxable income to you until received, can be paid to you on your disability or retirement, and can continue after your death with the remaining payments made to your spouse. The company receives a tax deduction when the deferred salary is paid (IRC 404).

The financial burden is not great if your company starts setting aside money early. For example, if you are age 55 and want to collect \$50,000 a year for 10 years after retirement, your business needs to set aside annually only \$23,159 for the next

10 years. This assumes an annual return of 8%.

If your company doesn't have the cash to set aside the money today or make the deferred salary payments in future years and your concern is to provide for dependents, there are life insurance policies designed to fund the payments to your spouse and family after your death. Call your insurance broker to obtain sample illustrations.

#2 — Increase your salary today, particularly if your personal tax rate and the company's are near each other or the same. Try to shelter from taxation some of that salary increase by taking advantage of the retirement plan options discussed in this report.

#3 — Work part-time as a consultant during your early retirement years or postpone retirement for a year or two. If the consulting arrangement is with your own company, you still can effect the deferred compensation plan explained in #1 on the prior page.

#4 — Choose the settlement option carefully. You can receive your distribution from retirement accounts using any one of the following methods: (a) total (lump-sum) distribution, (b) distribution over a specific period (e.g., ten years), (c) purchase of an annuity contract that gives you a specified annual income, (d) according to distribution methods provided by an insurance annuity contract held under your plan, or (e) according to IRS life expectancy tables.

There are many considerations involved in deciding whether you want monthly, annual, or one-time income payments and whether you want them in your first 10 or 20 years of retirement or until your death. Your decision will be affected by your lifestyle in retirement, your planned spending, your outstanding financial obligations (e.g., a mortgage), as well as your health. You also should consider the tax bill. For example, receipt of a lump-sum payment is immediately taxable so it's a large tax bill but then you're done with it; annuity payments are taxed as you receive the income each year. Also protect your spouse in case she or he outlives you. *One way:* You may want to select monthly annuity payments for the lives of *both* you and your spouse even though the monthly amount is less than when paid over one person's life.

Note: If both you and your spouse are in poor health, consider a lump-sum distribution payable in its entirety at retirement; if just one of you is in poor health, consider a monthly annuity over the healthier spouse's life expectancy only.

#5 — Consider taxes in planning your withdrawals. For example, you usually withdraw first from your nontaxable savings and investments rather than from taxable retirement money. That would mean tapping first your voluntary, non-deductible IRAs, including the Roth IRA, and 401(k) contributions since part or all of the amounts can be withdrawn tax-free.

#6 — Lower post-retirement living expenses by moving to an area with a lower cost of living, say, from New York to New Hampshire, or to a state with lower taxes. But be sure to check out all the state taxes thoroughly before making the move. Some states with lower property or no income taxes have higher taxes in other areas, e.g., a tax on an individual's total assets or net worth.

#7 — Sell your home, use your exemption of \$250,000/\$500,000 on the capital gain, and buy or rent a less expensive home, co-op, or condominium. If you take this approach, don't forget to include the annual rental expense and cash proceeds from the home sale in your retirement projections.

#8 — Convert illiquid assets to cash by refinancing the equity in your home, borrowing on the cash value of your life insurance policies, selling a second or vacation home, or selling part or all of your business ownership (the methods are explained later in #15 through #18).

#9 — Make IRA and 401(k) retirement contributions even if they're not tax deductible.

The power of tax-sheltered compounding: As shown in the chart on the next page, if you contribute \$4,000 each year for 20 years to an IRA and earn an 8% average annual return, your IRA would grow to \$197,700. That same \$4,000 annual investment over 20 years earning the same return would be worth only \$151,700 outside an IRA after taking into account an average federal and state tax rate of 28%.

That's \$46,000 more value — **30% more cash for your retirement** — if you save within an IRA instead of outside one. Double the value to \$92,000 if *both* you

and your spouse annually invest \$4,000 in IRAs.

<u>Years</u>	<u>Value Within an IRA</u>	<u>Value Outside an IRA</u>	<u>The IRA Advantage</u>
10	\$ 62,600	\$ 55,100	\$ 7,500
15	\$117,300	\$ 96,700	\$ 20,600
20	\$197,700	\$151,700	\$ 46,000
25	\$315,800	\$224,400	\$ 91,400
30	\$489,400	\$320,600	\$186,800

#10 — Make *all* retirement contributions early in the year, rather than when you file your tax return the following year. The extra 15 months of compounded growth is very significant; in fact, the early contributions can increase your retirement money by up to 33%.

#11 — Consider a *reverse annuity mortgage*, also referred to as a RAM, that accomplishes three objectives: (a) frees up the equity you've accumulated in your home, (b) allows you to continue living there, and (c) pays you a monthly income. Your bank can give you more information.

#12 — Work hard to increase the annual return on your retirement money. As illustrated in *Exhibit 2* on page 14, if you can earn just one percentage point more on a \$100,000 retirement position, you will have \$47,031 (47%) more money at the end of 15 years and \$94,345 (94%) more at the end of 20 years.

#13 — Reduce or eliminate certain life insurance costs on both business and personal policies by analyzing your current and post-retirement situation. *Examples:* The amount of personal life insurance you carry *after* retirement should primarily be for your spouse's protection, to pay potential estate taxes, and to take care of special needs, e.g., a disabled family member or elderly parent. Also, you may no longer need key-executive business life insurance after retirement and your overall need for life insurance to pay federal and state estate taxes may be reduced by the unlimited marital deduction and the lifetime exemption of \$2.0 million per taxpayer for 2008.

If estate taxes are still a potential problem, consider buying *second-to-die life insurance* on your and your spouse's lives; the cost is substantially less than buying

two whole life policies.

#14 — Employ your spouse in the company, even if only part-time for more retirement savings. In addition to qualifying him or her for the company's pension plan and other benefits, his or her employment should increase the amount of Social Security the two of you receive each month after retirement.

#15 — Sell some of your shares in the company to key executives or to your children via a family (private) annuity, which pays you a sum of money every month for as long as either you or your spouse live (IRC Section 2036).

Also consider sale of your stock to the company (IRC Section 302), a stock redemption to pay estate taxes (IRC Section 303), and an employee stock ownership plan [IRC Section 4975(e)(7)].

#16 — Effect a buy-sell agreement with other company owners or key executives. Fund it with life insurance to provide liquidity and additional money to your family. To lower the total premium cost for insurance on each owner's life, look into *first-to-die life insurance*, which pays the insurance proceeds on the first death of an owner. *Important:* The buy-sell agreement can be structured to take effect on a business owner's disability or retirement in addition to his or her death.

#17 — Effect a preferred stock recapitalization to split your common stock ownership and the company's value into both common and preferred stock. *Example:* Your company's total value of \$1,000,000 is divided into \$100,000 common stock and \$900,000 of 10% preferred stock. The preferred stock can pay a dividend of 10% and can be redeemed by the company through annual payments to you, e.g., \$60,000 a year for 15 years.

A recapitalization also accomplishes the following: (a) establishes the value of your stock ownership (i.e., \$100,000 common stock and \$900,000 preferred stock), (b) sets a value on the ownership for estate and gift tax purposes (i.e., \$1 million total), (c) provides income through a dividend on the preferred stock, and (d) enables you to sell (or transfer) the preferred or common stock to make gifts and/or to obtain needed cash for your retirement and other purposes (IRC 2701).

#18 — Sell the entire business now. Don't wait until you're age 60 to 65 and forced to make a sale. Again, planning is critical. The more time you have to sell the business, the more time for window-dressing your company for sale, the more potential buyers you can approach, and the more flexibility you have in negotiations. *You never want to be in a position where you're forced to sell; that always results in a lower price.*

#19 — Set up a defined benefit plan. It's particularly appropriate for older business owners who haven't accumulated a lot of retirement money. Basically, your company can contribute each year an amount of money to fund an annual retirement benefit to you of the *lesser* of \$185,000 or 100% of your average taxable compensation for the highest three consecutive years during which you were a participant in the plan. Thus, the annual contribution needed to pay you an annual retirement benefit of \$185,000 can greatly exceed the usual \$46,000 annual limit. Of course, as with most pension plans, there are other factors to consider, e.g., nondiscrimination, vesting, optional vs. mandatory contributions, and the overall cost to the company vs. your personal benefit.

#20 — Change form of business. If your company is a C corporation, it pays its own taxes on the profits and all dividends distributed to the owners are taxable at 15%. That's double taxation.

In contrast, if your company is an S corporation, partnership, or limited liability company, all company profits *pass through* directly to the owners and are taxed to them individually. Even though you personally pay taxes on the profits, **you pay only once** and at tax rates of 10% to 35%, so you may be able to generate more cash for retirement by changing your business form to an S corporation, partnership, or limited liability company and taking your percentage share of the profits each year. *Caution:* There are many other considerations in changing a company's form of business and taxation so get good advice before doing so.

* * *

You maximize the value of your retirement money by knowing your options and planning well in advance. It's not an easy area, but the money you have earmarked for retirement is important and deserves special attention. Now is the time to meet with your advisers to determine the amount of retirement money you will need, how

much you have now, how much will be added, what it will grow to, how and when it will be received, and what the projected tax bill will be on withdrawal.

References:

Exhibit 1: Retirement Cash Flow Model — page 12

Exhibit 2: What a Difference a Percentage Point Makes! — page 14

Exhibit 3: Free Information to Help in Your Retirement Planning — page 16

Retirement Cash Flow Model: **How to Project Your Retirement Money**

Shown on the next page is a sample *Worksheet* for projecting your retirement income *and* the money (withdrawals) needed to meet your annual cash needs. To simplify the mathematics and the *Worksheet*, we have made the following assumptions:

- You are now age 64 and plan to retire at the end of 2008.
- Your annual cash need is \$40,000, which will grow by 3% a year. (The \$40,000 includes living expenses and income taxes. If you wish, you can separate and set up another column for income taxes.)
- Your liquid assets are projected at \$250,000 (\$150,000 retirement money and \$100,000 personal funds).
- Your after-tax return on the \$250,000 assets will be 8%. (Remember, your \$150,000 retirement money continues to grow tax-free until withdrawn.)
- Social Security income is projected at \$12,000 annually, which will grow by 3% a year. (Add your spouse's income if applicable.)
- No other income or cash was assumed, such as continued part-time employment, salary paid under a deferred compensation arrangement, or money received from refinancing your home.

In the projections, we intentionally have not considered other personal assets which can be converted to cash, such as the equity in your home and life insurance policies. All we wanted to do is illustrate how to perform cash inflow and outflow analysis. The *Worksheet* will help you do your own Retirement Model. See the *Deficit* column, which is the amount of money you need to withdraw from your retirement money each year.

Beginning Retirement Position is \$250,000. For our readers who are not ready to retire, determine where you are today and project how much money you will have at retirement. Then build your Retirement Model.

Projected Cash Inflow and Outflow Worksheet

<u>Year (Age)</u>	<u>Income at 8%⁽¹⁾</u>	+	<u>Social Security</u>	-	<u>Living Expenses</u>	=	<u>Deficit⁽²⁾</u>	<u>Ending Cash Position</u>
2009 (65)	\$19,667		\$12,000		\$40,000		\$ 8,333	\$241,667
2010 (66)	18,937		12,360		41,200		9,903	231,764
2011 (67)	18,076		12,731		42,436		11,629	220,135
2012 (68)	17,070		13,113		43,709		13,526	206,608
2013 (69)	15,904		13,506		45,020		15,610	190,998
2014 (70)	\$14,564		\$13,911		\$46,371		\$17,896	\$173,103
2015 (71)	13,032		14,329		47,762		20,401	152,701
2016 (72)	11,290		14,758		49,195		23,146	129,555
2017 (73)	9,318		15,201		50,671		26,152	103,403
2018 (74)	7,095		15,657		52,191		29,439	73,964
2019 (75)	\$ 4,596		\$16,127		\$53,757		\$33,034	\$ 40,930
2020 (76)	1,796		16,611		55,369		36,962	3,968
2021 (77)	159		17,109		57,030		39,762	-35,794

⁽¹⁾ We computed the 8% return on the average beginning and ending cash balances.

⁽²⁾ *Deficit Column:* This is the amount you must withdraw annually to meet your living expenses.

* * *

Summary. Your \$250,000 is fully depleted in the thirteenth year after retirement, at age 77. The cash position at the end of year 2021 is a deficit of \$35,794. *For ways to make up this deficit,* please see pages 3 through 11. □

What a Difference A Percentage Point Makes!

Work especially hard to increase the annual return on your retirement fund. *Reasons:* The huge impact of even small additional annual earnings because of the long-term nature of the investment and the tax deferral on its growth.

Here is the proof. In the Table below, we've shown the impact of different added returns for different time periods (one point equals one percent). *Note:* An 8% return was assumed as a starting point on the investment, but it's the added return (percentage points) that should be analyzed.

— Added Return per \$100,000 —			
<u>Growth Period</u>	<u>1 Point</u>	<u>2 Points</u>	<u>3 Points</u>
5 Years	\$ 6,929	\$ 14,119	\$ 21,537
10 Years	20,844	43,482	68,050
15 Years	47,031	100,508	161,242
20 Years	94,345	206,654	340,135
25 Years	177,461	398,624	673,700

As shown above, if you can earn just one percentage point more on a \$100,000 beginning retirement position, you will have \$20,844 extra money at the end of 10 years. *That's an increase of 21%* on the \$100,000 beginning investment. If you can post that additional percentage point in earnings over 20 years, the added money is \$94,345 or a **94% increase** in the initial investment of \$100,000.

How to adjust for your own fund: To apply the Table above to your own retirement money, simply *set up a ratio between your money and \$100,000*. For example, let's say you have \$85,000. Multiply all of the numbers above by 0.85 to project the value of the added return. *Example:* Using the one-point column for 15 years (\$47,031), your \$85,000 will provide you with \$39,976 additional money (0.85 times \$47,031) if you can earn just one percent more. Earn two percentage points more over 15 years and your added income is \$85,432 (85% times \$100,508).

That's why prudent investing with advice from several investment experts is essential to protecting and building your retirement fund. And, the larger your portfolio, the greater the need to have more than one investment adviser. □

Increase your annual return on \$100,000 by *only* one percentage point and your retirement money increases by \$47,031 in 15 years.

Free Information to Help You in Your Retirement Planning

To help in your retirement planning, you may want to obtain copies of the following *free* booklets from the IRS:

<u>No.</u>	<u>Title of Publication</u>
525	Taxable and Nontaxable Income
530	Tax Information for First-Time Homeowners
552	Recordkeeping for Individuals
554	Tax Information for Older Americans
560	Retirement Plans for Small Business
575	Pension and Annuity Income
590	Individual Retirement Arrangements
915	Social Security Benefits

How to order: Call 800-TAX-FORM, or visit the IRS website at www.irs.gov.

From the Social Security Administration:

- Understanding Social Security (No. 05-10024)
- Supplemental Security Income (No. 05-11000)
- Disability (No. 05-10029)
- Retirement (No. 05-10035)
- How You Earn Credits for Social Security (No. 05-10072)

How to order: These publications can be obtained *free* at any Social Security office or by calling 800-772-1213 or by visiting www.ssa.gov.

Important: If you visit the website above, the Home Page will have a comprehensive listing and automatic access to all of the Social Security and Medicare booklets. **Click** Publications.

Verification of income: To verify the income credited to your Social Security account, review Form SSA 7004, *Request for Social Security Statement of Earnings*, which is automatically sent to you each year. *Important:* If you find errors in the income amount listed, which is indicated by year, you will need your W-2 forms from the years in which the errors were made in order to have them corrected.

Recordkeeping: If you haven't kept your W-2 forms, check your tax returns. A copy of your W-2 is usually attached to it. If you don't have a Social Security file yet, set one up now to keep track of all Social Security correspondence and copies of the benefits and checks you receive. □

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **29** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

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