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21st century retirement

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Social Security: Is Your Age a Retirement Numbers Game?

When preparing for your retirement, think about how much income you may need each year to fund the lifestyle you want. To help maintain your living standard, you may need to save enough money to supplement other sources of retirement income, such as a company pension and/or Social Security. It is also important to be aware of how your *age* factors into your retirement decisions. Here are some important age milestones to consider:

Age 55. If you take an early retirement, quit, or are otherwise terminated from employment, you can generally withdraw money from **401(k)**, **403(b)**, and **profit-sharing plans** without being subject to a 10% Federal income tax penalty for early withdrawals. As specified in IRS *Publication 575*, the following apply: you must reach age 55 by December 31 of the year you leave the workforce; money must be distributed to you from your employer's plan and cannot be transferred to an **Individual Retirement Account (IRA)**; early withdrawals are subject to the plan's provisions; and only money from your last employer's plan qualifies (not funds from previous employers). You may take early distributions from a traditional IRA without penalty, provided you receive "substantially equal periodic payments." Since certain rules govern this provision, be sure to consult a qualified tax professional.

Age 59½. Generally, you can withdraw money from traditional IRAs and qualified retirement plans after the age of 59½ without being subject to the 10% tax penalty, if plan-specific qualifications are met. Ordinary income tax is due if your contributions were tax deductible. No income tax or penalty applies to distributions from a **Roth IRA**, provided you have reached age 59½ and have owned the account for at least five tax years.

Age 60. Widows and widowers may be eligible for Social Security benefits. For the most up-to-date information, visit the Social Security Administration's website at www.ssa.gov.

Age 62. Some companies may allow retirement at 62 with full pension plan benefits. This is also the earliest age for receiving regular Social Security benefits, but the benefit amount is permanently lower than its potential maximum.

Ages 62–64. For those who are working and collecting Social Security benefits while younger than full retirement age—the age at which an individual is eligible to receive full Social Security benefits—the earnings threshold is $17,640 for 2019. One dollar in benefits is withheld (a "give back") for every $2 earned above that amount. A portion of benefits may also be taxed as income based on a complex formula that includes wages and tax-exempt income.

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It's Later Than You Think: Do You Know Your IRA Basis?

With the rising popularity of **Individual Retirement Accounts (IRAs)**, many people may have been making yearly contributions without giving much thought to what will happen from a *tax standpoint* when they start taking money out of their traditional IRAs. This oversight is understandable, since many IRA contributors may be years away from retirement, and *contributions*, not withdrawals, are usually the primary focus.

However, when you begin taking distributions from a traditional IRA, a variety of tax issues could arise. In general, your distributions are included in your gross income. Withdrawals made before the age of 59½ are subject to a 10% penalty, in addition to ordinary income tax. This process is relatively straightforward for those who have made only deductible contributions to their IRAs, but taxation is more complicated for nondeductible contributions.

IRA Tax Basis

If all of your contributions to a traditional IRA were deductible, then you have no **basis** in your IRA, and your distributions are fully taxable. Basis represents the after-tax balance in your account. If you made nondeductible contributions to your IRA, the amount of your contributions equals your basis, and this money is not subject to tax upon distribution.

Deductible Contribution Limits

Prior to 1987, all wage earners could make a deductible contribution of up to $2,000 annually. But, the Tax Reform Act of 1986 limits deductible contributions for employees who are active participants in qualified employer-sponsored retirement plans with **adjusted gross income (AGI)**—subject to certain modifications—exceeding specified amounts based on filing status. ($64,000–$74,000 for single filers; and $103,000–$123,000 for married joint filers in 2019).

Nondeductible Contributions

While some people were aware that a nondeductible contribution was permitted without regard to active participation in an employer-sponsored plan, many who made such nondeductible contributions failed to account for them by filing Form 8606 with their annual tax returns. Form 8606 properly tracks nondeductible IRA contributions in both *current* and *prior* tax years, and is the only official record of after-tax contributions (i.e., IRA basis).

Without having filed Form 8606 for years in which nondeductible contributions were made, a taxpayer will be exposed to double taxation of contributions when withdrawals are made. According to the IRS, without the proper historical record, no distinction is made between contributions made with *before*- and *after*-tax dollars, and all withdrawals are subject to taxation. In addition, there is a $50 penalty for failing to file Form 8606 for any year in which nondeductible contributions were made.

Also, consider state taxation of IRA withdrawals. Many states do not permit deductions for IRA contributions and, consequently, provide for a tax-free "return of basis." This means that contributions are not taxed when withdrawn, but that

part of the IRA account, consisting of accrued interest and dividends, is then taxed as received. However, this "return of basis" works only if the individual has kept accurate records and knows what his or her IRA basis is.

Recordkeeping

One way to determine your total deductible and nondeductible contributions is to examine your tax returns over the entire period of IRA funding. If your recordkeeping has been less than ideal, account trustees (insurance companies, banks, mutual fund companies, brokerage firms) may be able to help you reconstruct your total contributions over the years. However, be advised that such trustees usually have no record of whether your contributions were deductible or nondeductible.

If you find yourself in "IRA limbo" with respect to your IRA basis, you may want to enlist the help of a qualified professional. Remember, it is important to keep organized records of your contributions and to file the appropriate forms. However, to help avoid a tax mishap at the time of withdrawal that could undo some of the annual benefits you have enjoyed from tax-deferred savings, be sure to consult your tax professional about your unique circumstances. ■

Updating Your Will Can Contribute to a Relaxing Retirement

Whether you are decades or months away from retirement, it may be prudent to review your will whenever there is a significant change in your family circumstances or finances. To stay current, revisit your will at least once every five years to help ensure your estate tax strategies are on track, and that your assets will be distributed according to your wishes.

Seek Counsel

Legally, you could draft a will on your own. However, it is recommended that a will be drawn up by a lawyer. The reasons include the inherent complexity of estate planning and that states have different standards and often require specific language for a will to be deemed valid. If you draft your own, have your will *reviewed* by a lawyer so you can be assured that all statutory requirements are met.

A married couple may draft a will jointly or separately as individuals. Separate wills may help specify *who* owns *what* property. The portion of your estate covered by a will includes *tangible* assets, such as your home or car, as well as *intangible* assets, such as savings accounts held in your name. (Property owned jointly with right of survivorship will pass directly to the surviving owner, while other assets, such as life insurance death benefits, will automatically pass to your designated beneficiaries.)

Be Thorough

Whenever you update your will, the new document should include the date, a statement revoking all previous wills, provisions for trusts (if any), names of guardians and alternates for minor children (if necessary), and specific bequests. A specific bequest calls for the transfer of *a particular piece* of property to a named beneficiary, while a general bequest does not specify from which part of an estate the property is to be taken. Be sure that the updated and signed document also includes your full name, a statement that the document is a will, and the names of the executor and substitute executor.

Once you have reviewed and updated your will, make copies for yourself and family members, or others who may need the information. Be sure the original is kept in a secure place, such as a bank safe-deposit box or lawyer's office. Also, make sure your family and friends know where the will is located. Once these tasks are completed, you can feel confident, knowing that your wishes will ultimately be fulfilled. ■

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Age 65. Many company pension plans provide full benefits at this age. However, the age may vary by the company plan. **Medicare** eligibility also generally begins at age 65.

Ages 65–67 (or the year in which full retirement age is attained). Traditionally, full retirement age was 65. However, for those born between 1938 and 1959, full retirement age has been rising incrementally, and for those born in 1960 or later, the age for receiving full benefits is 67. The lower earnings threshold amount still applies for years prior to full retirement age, and a second earnings threshold rule applies for the year in which full retirement age is attained.

For those who are working and receiving Social Security benefits, there is a benefit give-back in 2019 of $1 for every $3 over $46,920 earned in the months prior to attaining full retirement. Once full retirement age is attained, the earnings threshold no longer applies, and a portion of benefits may be taxed as income based on a complex formula that includes wages and tax-exempt income.

Age 70½. Required minimum distributions (RMDs) from qualified retirement plans, such as a 401(k) or IRA, must generally begin by April 1 of the calendar year following the year in which you reach age 70½. Roth IRAs, however, are not subject to the age 70½ mandatory distribution rules.

You have worked many decades to accumulate assets to prepare for enjoyable "golden years." Be sure to consult with qualified tax and financial professionals to help you stay on the track to achieving your retirement goals. ■

Monitoring Retirement Fund Menus Can Improve Performance

The monitoring of defined contribution (DC) retirement plan menus by plan sponsors in order to identify underperforming funds and replace them with more attractive funds can provide value to plan participants, according to new research published by Morningstar Investment Management.

In a white paper entitled "Change Is Good," released on April 15, researchers observed that when retirement plan sponsors evaluate the quality of mutual fund investments offered to plan participants, they may occasionally decide to replace one fund with another. The authors noted that previous studies of plan sponsor replacement decisions have suggested that the decision to replace funds is frequently motivated by historical performance data relative to a benchmark that does not predict future performance. They pointed out, however, that even though this monitoring activity is an important function of investment fiduciaries, little is currently known about whether adding and removing mutual funds from a plan menu is valuable for participants.

To investigate the monitoring value provided by plan sponsors, researchers analyzed a unique longitudinal dataset of plan menus from January 2010 to November 2018 that includes 3,478 fund replacements across 678 DC plans. For each plan, the analysis compared the menus for two different periods, employing a matching criterion to determine when a fund was replaced. A fund was deemed to have been replaced if it did not exist in the later menu, and a new fund was added in that later menu that was of the same investment style, such as bond or equity.

The results indicated that, on average, the replacement funds had better historical performance and lower expense ratios, as well as more favorable comprehensive metrics based on star and quantitative ratings, than the funds they replaced. The analysis also showed that the largest performance difference between the replacement and replaced funds was for the five-year historical returns. According to researchers, this finding suggests that the five-year historical reference period is the one that carries the most weight among plan sponsors.

In addition, the analysis revealed that the future performance of the replacement fund was better than the fund being replaced at both the future one-year and three-year time periods. The authors emphasized that this outperformance persisted even after controlling for expense ratios, momentum, style exposures, and other metrics commonly used by plan sponsors to evaluate funds, such as the star rating and the quantitative rating. "Our findings suggest that monitoring plan menus can have a positive impact on performance," the authors concluded.

Researchers cautioned, however, that while they were able to analyze certain factors related to the outperformance of replacement funds—such as the type of fund, lower expense ratios, higher recent historical performance, and various ratings—the primary drivers of the outperformance remain unclear, because the dataset provided no information about the decision-making process plan sponsors use to determine whether a fund should be replaced, or about other salient factors, like the relative importance of the fund being replaced or how long the fund has been in the plan.

Thus, the study's authors added, although the analysis suggests that monitoring fund menus can improve performance, "more research on why this effect occurs is warranted." ■