

Part III

Getting Your Hands on Your Money

The 5th Wave

By Rich Tennant



"That reminds me - I have to figure out how to save for retirement and send these two to college."

In this part . . .

Believe it or not, saving money in a 401(k) is the easy part. Taking it out is hard. You need to plan carefully to avoid squandering your hard-earned money on taxes and penalties. Uncle Sam gives you a tax advantage with these plans, but in return, he expects you to use the money to help pay for your retirement. Using it for something else can be difficult, not to mention expensive; depending on your plan, it may even be impossible. After you retire, you still need to be careful about how you manage your money to make sure it lasts.

This part explains the rules for taking money out of a 401(k) when you're working, when you change jobs, and when you retire, and how to avoid paying unnecessary taxes and penalties. It also explains basic rules for Individual Retirement Accounts (IRAs), an integral part of many retirement strategies.

Chapter 7

Putting Your Hand in the 401(k)ookie Jar

In This Chapter

- ▶ Understanding the rules for taking a loan or hardship withdrawal
 - ▶ Calculating the taxes and penalties from taking money out early
 - ▶ Using 401(k) money to buy a house
 - ▶ Deciding between a loan and hardship withdrawal (or something else)
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Life is so unpredictable. Just when you think you have everything under control . . . wham! An unexpected expense jumps out of a dark alley, bops you on the head, and runs off with your wallet. At times like that, it's nice to know that you may be able to tap your 401(k) plan funds to tide you over.

Uncle Sam permits two ways for getting money out of your 401(k) while you're still working — hardship withdrawals and loans. However, your employer isn't *required* to allow you to do either one. Before you go any farther with this chapter, check your summary plan description (summary of your plan's rules) to see what your plan allows. It may permit both loans and hardship withdrawals, only one or the other, or neither.

You're probably wondering why you can't get your money any time you want. After all, it's your money, right? Yes, it is, but remember that Uncle Sam gives you big tax breaks to help you save in a 401(k). He really wants you to use this money when you retire, so he makes it difficult to take it out earlier.

If you *are* allowed to take a loan or make a hardship withdrawal, you'll be much better off if you understand the rules and how much you may have to pay in taxes and penalties, before doing so. You may decide that it's better for your long-term future to look for another source of emergency funds first.



The rules we discuss in this chapter apply if you're still working for the employer that sponsors your 401(k) plan. The rules are different for taking money out after you leave your employer. We discuss those details in Chapter 8.

Hey, Self, Can You Spare a Dime?

Most 401(k) plans allow hardship withdrawals, but not all of them do. Why *wouldn't* a plan let you withdraw money to pay for an emergency? Your employer may want you to use the money only for retirement — period. In the rest of this section, we assume that your 401(k) plan offers a hardship withdrawal possibility.

Defining a hardship

Hardship withdrawals are only permitted if you have an *immediate and heavy financial need*. This doesn't mean that you'll be able to take a withdrawal if your yacht broke down and you need to buy another one before the spring thaw, or you need a little extra to buy the winery that you've always wanted to run as a hobby.



Two different approaches can determine immediate and heavy financial need. One is the *facts and circumstances test*, which requires you to prove that you've exhausted all other resources. You have to give your employer substantial personal financial data to prove this. In fact, the requirements are so extensive and invasive, that most employers choose the other method, called the *deemed hardship method*, in which withdrawals are limited to a list of hardship situations that have the IRS stamp of approval. These situations are

- ✓ Costs related to the purchase of your primary residence
- ✓ Payment of post-secondary tuition and related educational expenses for the next 12 months for you, your spouse, a dependent, or nondependent children
- ✓ Medical expenses for you, your spouse, or dependents not covered by insurance
- ✓ Payments necessary to prevent either eviction from your principal residence or foreclosure on the mortgage for your residence

Using the deemed hardship method, your employer doesn't have to ask you for personal financial data to show that no other resources are available. By the way, we didn't dream up these rules — the government did.



Participants who are unhappy with their 401(k) investments frequently ask whether they can take their money out of the plan as a hardship withdrawal, while they're working, and roll it into an IRA. The answer is “no.” You can only transfer your money to an IRA under the conditions explained in Chapter 8.

Withdrawing the money: How much?

You can withdraw only the amount you need to meet your hardship expense. Because you have to pay tax on a hardship withdrawal, you can include the taxes you'll owe in this amount. We provide an example in the next section, “Calculating the tax you owe,” that includes taxes.

The money you're allowed to withdraw for a hardship may be limited to the money you've contributed (excluding investment gains), or it may include vested employer contributions and money you have rolled into the plan from an IRA or another retirement plan. Your employer decides the rules. Many employers don't permit their contributions to be withdrawn for a hardship, because they want this money to stay in the plan and be used to provide retirement benefits.



If your plan lets you borrow money from your 401(k), you may be required to take a loan before taking a hardship withdrawal. It depends on your plan's rules. In this case, you take the maximum loan allowed to you, and then if you still need money, you take the rest of what you need as a hardship withdrawal. We discuss loans in more detail in the section “Both a Borrower and a Lender Be” later in this chapter.

Calculating the tax you owe

You need to pay federal income tax, and state income tax if applicable, on the amount of your hardship withdrawal. (You didn't think you'd be able to avoid taxes, now, did you?) Additionally, if you're under 59½ years old, you may have to pay a 10 percent early withdrawal penalty on the amount you take out (we list circumstances

when you don't have to pay the penalty, later in this section). Some states also impose an early withdrawal penalty of a few percentage points. In total, you'll probably have to pay 25 to 40 percent of the amount withdrawn, and you may sometimes have to pay even more.

For example, say you need \$10,000 for a down payment on a house, your federal tax rate is 27 percent, and you're under 59½. Because of your age, you'll also owe a 10 percent early withdrawal penalty. Without taking into account state and local taxes, you'll need to withdraw \$15,873 in order to have \$10,000 after paying 37 percent tax. (The extra \$5,873 is what you'll owe when you file your income tax return.)



Don't spend all the money you withdraw without first determining how much you owe in taxes! Your employer will normally withhold 10 percent of the hardship withdrawal. However, this mandatory tax withholding has no relationship to the amount of federal and state tax you'll owe — it's simply a deposit to the IRS. You'll determine the actual taxes owed when you figure your taxes for the year you receive the distribution, and you'll have to pay the difference. Determine how much tax you'll have to pay — and pay it — before you do anything else. Many participants fail to do this and end up with an unexpected, whopping tax bill.



Participants often ask us whether withdrawing money to buy a home or to pay for college expenses exempts them from the 10 percent early withdrawal penalty. The answer is “no.” The confusion arises because you *can* avoid this penalty if you withdraw money from an IRA to buy a home or pay for higher education expenses. We discuss rules for IRAs in Chapter 8.

In some situations, money withdrawn from your 401(k) while you're working won't be subject to the 10 percent early withdrawal penalty (although income tax will still be due). These situations include

- ✓ If you become disabled, as defined by the IRS
- ✓ If you owe medical expenses that equal more than 7.5 percent of your income
- ✓ If you set up a special schedule for receiving equal payments over a number of years (not all plans allow this)
- ✓ If a court order requires you to withdraw the money to give to a divorced spouse, a child, or other dependent

Wait, there's more: Anticipating longer-term consequences

As if the consequences we've talked about so far weren't enough, Uncle Sam has a few other rules you need to know about.

For one thing, if you take a hardship withdrawal using the deemed hardship approach, you have to wait six months before you're allowed to begin contributing to your 401(k) again. You also have to wait six months to contribute to all other deferred compensation plans your employer offers, including stock purchase plans.

Also, your contributions in the year following the hardship withdrawal will be limited to the federal maximum, which we explain in Chapter 2, *minus* the amount that you contributed during the year you took the hardship withdrawal. This rule is a bit tricky, so here's an example.

Assume the following:

- ✓ You take a hardship withdrawal on May 14, 2003.
- ✓ You contribute \$4,500 pre-tax during 2003, before taking the withdrawal.
- ✓ You start to contribute to the 401(k) again on January 1, 2004.



You'll be allowed to contribute only \$8,500 to your 401(k) in 2004, even though the federal maximum limit is \$13,000 for that year. Why? Because your contributions for 2004 must be reduced by the \$4,500 contributed during 2003 (the year you took the hardship withdrawal). When you figure the math, you have \$13,000 minus \$4,500 equals \$8,500.



Another consequence from hardship withdrawals is that your retirement savings will be disrupted. Say you withdrew \$15,873 in order to end up with \$10,000 after paying taxes (as in the earlier example). You wouldn't just lose the \$15,873 from your 401(k); you'd lose what this money would've been worth by the time you retire. If that money had stayed invested for 30 years with a 9 percent return, it would've been worth \$210,598. You'll have to substantially increase your contributions to make up this loss by the time you retire.

Dipping into Your 401(k) Money to Buy Your First Home

The tax bite and disruption to your retirement account are two good reasons to avoid a hardship withdrawal, unless, of course, the withdrawal is absolutely necessary. But withdrawing money to buy your first home may be a smart financial decision.



Investing in a home can bring you a good return. Assume that you take a hardship withdrawal of \$15,000 at age 35 to buy a \$180,000 home with a 30-year mortgage. Assume that the value of your home appreciates at a rate of 3 percent per year. After 30 years, your house would be worth \$435,000. Of that, \$255,000 is capital appreciation (\$435,000 – \$180,000).

If you had left the \$15,000 in your 401(k) plan and it had earned a 9 percent return until your retirement age of 65, it would've grown to \$199,000, which is less than the capital appreciation on your house. This is a simplified example to show you the potential value of home ownership.

If you're using some of your 401(k) money to purchase your first home, here's a smart approach that will either eliminate or substantially reduce your tax bite. Essentially, you need to buy your home as close to the beginning of the year as possible, as the following example shows.

Assume the following:

- ✓ Your first home costs \$180,000.
- ✓ You have to withdraw \$15,000 to help cover the initial costs.
- ✓ The property taxes are \$2,500 per year.
- ✓ The mortgage will be \$162,000 at a 6.5 percent interest rate.
- ✓ The settlement date is January 15.

In the year you buy the home, the property taxes you pay will be \$2,395, and the mortgage interest will be \$10,100, because you will have owned the home for only 11½ months. You start to receive the tax benefits of first-time home ownership by deducting the interest and taxes — \$12,495 of deductions that will largely offset the impact of having to add the \$15,000 withdrawal from your 401(k) to your total income.

But this strategy only works if you withdraw the \$15,000 during the same year that you buy the home. You get less of a benefit the later in the year that you buy the home, because you have to include the full withdrawal in your income, but you can deduct interest and tax payments only for the period that you own the home. The worst case would be to buy your home in December, because you get the tax break related to home ownership only for part of one month. In this case, you'd have a \$15,000 taxable distribution minus a \$1,000 tax break, meaning that \$14,000 is taxable income.



You may have to borrow the money, rather than withdraw it, if your plan gives you both options. Again, this is one of those crazy government things.

Both a Borrower and a Lender Be

Most 401(k) plans allow loans, but your plan may limit your ability to borrow from your 401(k). Your employer may not want you to squander your retirement money on something that's not really a necessity.

Following are general rules for loans. Keep in mind that the rules for your specific plan may differ.

Give one good reason . . .

You can take out a loan only if your 401(k) plan document allows you to borrow for the specific reason that you have in mind. Some plans permit borrowing for any reason, but another common approach is to permit loans only for the reasons included on the hardship withdrawal list that we discuss earlier in this chapter (see the section, "Defining a hardship," earlier in this chapter for more info). You can get specific details about account loans from your summary plan description or from your benefits office or 401(k) plan provider.

Figuring out how much you can borrow

The government sets the limits on how much you can borrow. Generally, you're allowed to borrow no more than 50 percent of your account value up to \$50,000 maximum. The other half stays

in the account as collateral. However (there always seems to be a “however”), government rules theoretically permit borrowing 100 percent of an account up to \$10,000. For example, if your account value is \$15,000, you may be able to borrow \$10,000, even though 50 percent of \$15,000 is only \$7,500. Most plans don’t allow this, though — they limit all loans to 50 percent of the account value for the sake of simplicity. Some plans also impose a minimum loan amount, because it’s not worth the hassle for them to administer a loan for only a few bucks.

Determining how much interest you pay

The interest that you pay on your 401(k) loan is determined by your employer and must be a level that meets IRS requirements. It’s usually the *prime rate* (the interest rate that banks charge the most creditworthy companies) plus 1 or 2 percentage points. In most plans, the interest that you pay goes back into your account, so you’re in the interesting position of being both the borrower and the lender (what would Shakespeare have said about *that?*).

Paying the piper: Repayment rules

You normally have to repay the loan within five years, but you can repay it faster if your plan permits. Also, your employer may permit a longer repayment period if the money is used for a home purchase.

Employers usually require you to repay a loan through deductions from your paycheck. The loan repayments are taken out of your paycheck after taxes, not pre-tax like your original contributions. Then, when you eventually withdraw this money in retirement, you pay tax on it again. We repeat: *You pay tax twice on money used to repay a 401(k) loan.*



The fact that most employers require you to pay back the loan with payroll deductions means that if you’re laid off or you quit your job, it becomes impossible to keep repaying the loan. What happens then? You have two choices: Either repay the entire outstanding loan balance right away, or take the amount as a taxable *distribution* (payment from the account).

If you don't have the money to repay the loan, you must declare the entire unpaid loan balance as income on your tax return. Adding insult to injury, if you're younger than 55 when you leave your job, you'll probably have to pay an early withdrawal penalty of 10 percent (or more). As we explain in the earlier section, "Calculating the tax you owe," this withdrawal penalty hurts.



TIP If you take a loan, you should be pretty sure that you're going to stay with your employer long enough to repay it. At the very least, try to have a "Plan B" in the works (other than robbing the nearest bank) to help you scrape together enough money to repay it in full if you're laid off.

To Loan or Not to Loan (to Yourself, That Is)

Although the ability to take a loan is nice in an emergency, it shouldn't be used lightly. Taking a loan from your 401(k) rather than from another source has definite disadvantages.

The most attractive feature of a loan is that it isn't taxable when you receive the money.



However, you eventually have to pay tax on the loan. You have to repay the loan and interest with after-tax deductions from your paycheck, so you simply pay tax on the loan every pay period rather than all at once. And when you withdraw money at retirement (including those repayments that were already taxed), you pay income tax again. You're taxed twice on the amount of a loan.

If you can't afford to continue making pre-tax contributions to the 401(k) at the same time that you're repaying the loan, your eventual account balance will be lower than if you hadn't taken the loan.



Say you're contributing \$1,800 a year pre-tax to your 401(k), and you receive an employer matching contribution of \$900. If you stop contributing for five years, you lose out on \$9,000 of your own contributions ($\$1,800 \times 5$) and also on \$4,500 in employer matching contributions ($\$900 \times 5$). If those amounts are invested in the 401(k) plan over 30 years, with an average return of 9 percent, they will grow to \$139,340.



If you take a loan, try to continue making pre-tax contributions to your 401(k) while you're repaying the loan. Doing so will help build up your 401(k) balance over the long run.

Deciding Whether to Take a Hardship Withdrawal or a Loan

You may come up against a situation where you're required to tap your 401(k), either by using a hardship withdrawal or a loan, because you have no alternative.

Table 7-1 compares the end result of a loan and a hardship withdrawal on the balance of a hypothetical account after five years. In this case, the person repaying the loan isn't making new contributions to the account.

Table 7-1 Impact of Loan versus Hardship Withdrawal on Account Balance

	<i>Loan</i>	<i>Hardship Withdrawal</i>
Beginning account balance	\$20,000	\$20,000
Amount borrowed or withdrawn	\$10,000 (borrowed)	\$15,873 (withdrawn to have \$10,000 left after tax)
Monthly repayment (loan) or contribution (hardship withdrawal)	\$202.76 monthly loan repayment for 60 months	\$277.75 monthly contributions for 54 months (after six-month suspension)
Annual investment return	9 percent	9 percent
Balance after five years without employer contribution	\$30,603	\$24,736
Balance after five years with employer contribution of 50¢ on the dollar	\$30,603	\$33,930

You can see that the decision whether to take a loan or hardship withdrawal isn't cut-and-dried. If your employer makes a matching contribution, the hardship withdrawal may work out better for you in the long run, because you can start benefiting from those contributions earlier. However, if you can afford to keep making pre-tax contributions to your account while paying back a loan, the loan may be a better long-term solution. A loan may also work out better if your employer doesn't make matching contributions.

Using 401 (k) Money for Other Things — Good Idea?

The bottom line is that both loans and hardship withdrawals are much less attractive than they first appear for most purposes. As a result, you should use them only when absolutely necessary rather than as a convenience.



By taking a loan or hardship withdrawal, you're most likely reducing the eventual balance of your retirement account. We explain earlier in this chapter why it may make sense to take money out of your 401(k) to buy a first home. Doing so may give you a good return on your investment. We know people who have borrowed from their 401(k)s to start businesses, also. Like buying a house, this could be a smart move if the business does well — but not if it flops.

People also often ask whether to take money out of a 401(k) to pay off credit card debts charging high interest rates. The thinking is that it's better to pay 9 percent interest to yourself (with a 401(k) loan) than 22 percent interest to a credit card company. This may be true, but the danger is that you'll simply rack up more debt, and you'll have no 401(k) to bail you out. If you do use 401(k) money to pay off credit card debt, make sure that you cut up your credit cards so that you don't dig yourself back into the same hole.

Warning for employers

Employers must administer hardship withdrawals and loans according to the plan document and the applicable regulations. Not long ago, a controller told Ted that his company permits hardship withdrawals for any reason. This approach may make some participants happy, but it will lead to big trouble if the IRS or Department of Labor (DOL) audits the company's plan. The primary penalty for violating the law is to disqualify your plan, which creates major tax problems for your company and all participants. The company loses the tax deductions it received (for the matching contributions and employee pre-tax contributions it made), and employees lose the benefits, such as the tax-deferral for investment earnings and the opportunity to roll the money over to an IRA, that come with a qualified plan. Disqualification is rare, but that doesn't mean that a company can feel comfortable in blatantly violating the law. Short of total disqualification, other fines and penalties may apply.

Both the IRS and the DOL are likely to review both your hardship withdrawal and loan procedures if they audit your plan. Here are steps you should take to protect yourself as an employer:

- ✔ Keep the application and other paperwork for each hardship withdrawal or loan on file.
- ✔ Be sure to get documentation from the participant to support the reason for the withdrawal. For example, if the participant is buying a home, be sure to get a copy of the contract.
- ✔ Make sure that all loan applications include the math showing that the amount of the loan doesn't exceed the applicable limits (for example, 50 percent of the account balance).

Many service providers offer streamlined processing for hardship withdrawals and loans. This processing makes both types of transactions faster and easier for your participants, but you're still required to follow the procedures outlined in your plan document. A few years ago, the DOL audited one of Ted's clients. The agent spent weeks on-site going through all the employer's files. Subsequently, the agent sent a letter to the company's CFO, citing a loan violation. The amount that one participant borrowed supposedly exceeded the 50 percent limit. The CFO was very upset, because the letter from the DOL made it sound like his company had committed a horrible crime. We discovered that the agent was wrong and we were right — but getting to that point was a big hassle. The agent wasn't very polite about the whole thing, either — Ted's client didn't receive an apology letter after the agent was informed of his error.

You should operate your plan with the awareness that these audits do occur and are not fun. They're exhaustive and exhausting, and they take you away from important business. Do everything you can to avoid an audit. Some audits are random, but others are triggered by red flags, such as an employer that consistently takes much longer than permitted to put employees' money into the plan.

Chapter 8

Weighing Your Options When You Leave Your Employer

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In This Chapter

- ▶ Making smart decisions about your 401(k) when you change jobs
 - ▶ Keeping your 401(k) tax advantage by doing a rollover
 - ▶ Looking at all your options
 - ▶ Understanding how to handle company stock in your 401(k) when you leave your employer
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When you stop working at the employer that sponsors your 401(k) plan, as if by magic, some restrictions on your money drop away. Except in a few extreme cases, you're allowed to withdraw your money for any reason at all (it doesn't have to be a hardship), although you still have to pay applicable taxes and penalties.

This newfound freedom makes about one-third of 401(k) participants giddy enough to do something silly — that is, take the money and run. That's a bad idea — we explain why later in the chapter. Fortunately, there's an easy way to avoid pillaging your 401(k) — do a *rollover*. You can transfer your 401(k) money directly from your former employer to an Individual Retirement Arrangement (IRA) or to your new employer's retirement plan (if it allows rollovers), without owing tax. In the new account, the money continues to grow tax-deferred, with no income tax on annual earnings.

If you don't do a rollover right away, you can most likely leave the 401(k) money in your old employer's plan while you consider your options. This chapter explains how to preserve your 401(k) tax

advantage when you change jobs and how to avoid costly mistakes with your retirement money. Chapter 9 explains your options when you retire, which may be slightly different.

A Rolling 401(k) Gathers No Taxes

When you leave your job, one of the many forms that you'll likely have to fill out is a 401(k) *distribution election form*. (*Distribution* is employee-benefit-speak for the payment to you of your vested 401(k) money.)



The most sensible thing to do with your 401(k) from a tax-management point of view is a *direct rollover* (also known as a *trustee-to-trustee transfer*) of the money. With this type of rollover, the money goes directly from your 401(k) plan into another tax-deferred account — an Individual Retirement Arrangement (IRA) or your new employer's 401(k) plan, 403(b) plan, or 457(b) plan. (We discuss 403(b) plans, generally used by educators and nonprofit employees, in Chapter 10, and 457(b) plans, generally offered by state and local governments, in Chapter 11.) By doing a direct rollover, you don't have to pay any tax on the money when it comes out of your old employer's 401(k). The money also continues to grow tax-deferred in the new account.

Instead of transferring the money directly to the new plan or IRA, your employer may give you a check for the 401(k) balance. With a direct rollover, the check should be made out to the financial institution that runs the account where you want the money to go. If the check is made out to you personally, things get complicated.



If the check is payable to you, your former employer is required to withhold 20 percent of the account value as federal withholding tax. So, if you have \$10,000 vested in your account, you'll receive a check for only \$8,000. In order to avoid paying income tax and an early withdrawal penalty, you'll have to deposit the \$8,000 check *plus* \$2,000 of your own money into an IRA or new employer's plan within 60 days of receiving the distribution. (The IRS will return the \$2,000 to you when you file your tax return if you do the rollover correctly.) The amount that you *don't* deposit in the new account will be considered a cash distribution on which you'll owe applicable tax and penalties. The IRS is firm on this 60-day limit.

Account size matters



TIP If your account balance is less than \$5,000, you may be forced to take the money out of your employer's 401(k) plan when you leave. If it's more than \$1,000 (and less than \$5,000), and you don't tell your employer what you want to do with the money, your employer can automatically roll the money into an IRA on your behalf. If the balance is \$1,000 or less, your employer can simply issue a check to you for the entire amount without giving you any alternatives, but you'll owe tax and penalties on the money. You should really let your employer know right away that you want to do a *rollover* if your balance is less than \$1,000.



TIP If your vested 401(k) balance is \$5,000 or more, and you're younger than the normal retirement age specified in the plan document (usually 65), your employer is required to let you leave your money in the 401(k) if you want to. Leaving your money in the plan can be a useful strategy, at least as a temporary measure. See the section "Never Can Say Goodbye: Leaving Money in Your Old Employer's Plan" later in this chapter for details.

Getting the skinny on IRAs

Many participants wonder whether it's better to roll their 401(k) into an IRA or into another employer's plan. It really depends on your situation. We look at those two options in the "Rolling over into an IRA" and "Rolling over into another employer's plan" sections later in this chapter. In the meantime, this section explains rules for IRA investing that you should know before making your decision.

Traditional IRAs

Most IRA holders have traditional IRAs because (as their name suggests) they've been around longer — since 1974. Roth IRAs, described in the next section, have been available only since 1998.



You can make two types of contributions to a traditional IRA:

- ✓ *Deductible*, meaning you can deduct your contributions from your income for tax purposes
- ✓ *Nondeductible*, meaning — you guessed it — you *can't* deduct your contributions (Who said this financial stuff was complicated?)

In both types of accounts, you don't pay income tax on your earnings until you withdraw money from the account. You owe income tax when you withdraw the money at retirement. With deductible contributions, you owe tax on the contributions plus the earnings. With nondeductible contributions, you owe tax only on the earnings. As you can well imagine, if you make both types of contributions to an IRA, you need to keep meticulous records in order to know what's what when you start withdrawing the money, which could be many years from now.



For more information about IRAs, we suggest that you take a look at IRS *Publication 590, Individual Retirement Arrangements*, which you can download for free from the IRS Web site at www.irs.gov/pub/irs-pdf/p590.pdf. (The IRS home page is www.irs.gov.)

The deductible IRA is a better deal because you get the extra tax break of being able to deduct your contributions from your taxable income. The catch is that if you have a 401(k) or any other employer-sponsored tax-qualified plan, you can deduct your contributions to an IRA only if your *income* is below the limits illustrated in Table 8-1. (By "income" we mean *modified adjusted gross income, MAGI*, which is your gross income minus certain deductions. This is defined in detail in IRS Publication 590.) If your income is in the ranges indicated in the table, you can deduct only a part of your contribution. If your income is above the upper limit, you can't deduct any part of your contribution. However, you can still make a nondeductible IRA contribution for the portion that you can't deduct.



If you participate in a 401(k) plan, you *are* allowed to contribute to an IRA. Every worker with earned income can contribute to an IRA, and so can their spouses (even if they don't work). The only question is whether your contributions will be deductible.

Table 8-1 **Income Limits (MAGI) for Deductible Contributions to a Traditional IRA (for 401(k) Participants)**

<i>Tax Year</i>	<i>Single Filer</i>	<i>Married Filer</i>
2002	\$34,000–\$43,999	\$54,000–\$63,999
2003	\$40,000–\$49,999	\$60,000–\$69,999
2004	\$45,000–\$54,999	\$65,000–\$74,999

<i>Tax Year</i>	<i>Single Filer</i>	<i>Married Filer</i>
2005	\$50,000–\$59,999	\$70,000–\$79,999
2006	\$50,000–\$59,999	\$75,000–\$84,999
2007	\$50,000–\$59,999	\$80,000–\$99,999

If you're married, filing jointly, and you have a 401(k), but your spouse isn't covered by a retirement plan at work, the limits in Table 8-1 apply only to you. Your spouse can make a fully deductible IRA contribution to his or her IRA if your joint taxable income (MAGI) is under \$150,000. From \$150,000 to \$159,999, a partially deductible contribution is allowed. If your income is \$160,000 or more, the contribution isn't deductible.

Roth IRA

A Roth IRA adds a new dimension. You can never deduct your contributions to a Roth, so in that sense, it's like a nondeductible traditional IRA. However, the advantage of a Roth is that you don't pay tax on your investment earnings — ever. The money grows tax-deferred in the account, and you can withdraw it tax-free at retirement, providing you follow the rules.

You may wonder why anyone would bother with a nondeductible traditional IRA, where you have to pay tax on withdrawals, when they could have a Roth IRA. Good question. The answer is that you can't contribute to a Roth IRA if your income is over a certain limit.

In order to qualify for a full Roth contribution, your MAGI (remember, that's modified adjusted gross income, not an ancient king or philosopher) must be below \$150,000 if you're married filing jointly, or below \$95,000 if you're single. You can make a partial contribution if your income is between \$150,000 and \$160,000 for married filing jointly and between \$95,000 and \$110,000 for singles.

Contribution limits for traditional and Roth IRAs

Federal law limits the amount you can contribute to an IRA (or to all your IRAs combined, if you have several) in a single year. For many years, the limit was stuck at \$2,000, but in 2002 it began rising. It will reach \$5,000 in 2008. In addition, if you're age 50 or older in any year, you may make an additional "catch-up" contribution. Table 8-2 shows the limits that apply to both traditional and Roth IRAs.

Table 8-2 Traditional or Roth IRA Contribution Limits

<i>Year</i>	<i>Regular Limit</i>	<i>Age 50+ Catch-Up</i>
2002–2004	\$3,000	\$500
2005	\$4,000	\$500
2006–2007	\$4,000	\$1,000
2008	\$5,000	\$1,000



These limits don't apply to amounts you roll over from a retirement plan. If you have a 401(k) balance of \$50,000 or \$500,000, for example, you're allowed to roll it all into an IRA when you leave your employer.

Roth conversion: No, it's not a new football play

If you have money in a traditional IRA, and you'd rather have it in a Roth, you can do what's called a *conversion* of the traditional to a Roth. You can do this only in a tax year in which your income (MAGI) is less than \$100,000. Here's one case where it doesn't pay to be married — that limit is the same whether you file a single return or you're married filing jointly. (Don't put off the nuptials just because of that, though. Believe it or not, there are more important considerations.) If you're married but file your return separately, you can't convert your traditional IRA into a Roth IRA.

A conversion is kind of like a rollover, except you have to pay tax on the amount you convert. You can either have your IRA custodian (the bank or other financial institution where you have your IRA) make a check out to you, which you deposit in the Roth within 60 days, or do a direct transfer of the money to the new Roth IRA custodian. If you're keeping the Roth IRA at the same custodian as your traditional IRA, the process is even simpler — the institution can simply transfer part or all of the traditional IRA balance into a Roth IRA. You have to pay income tax on the amount transferred, but there's no early withdrawal penalty.

Some investors do a Roth conversion because they like the idea of having tax-free income at retirement. But you take a big tax hit in the year you do the conversion. One strategy is to do a conversion in a year your IRA investments haven't done too well: The value is down, so you pay tax on a lower amount.

Rolling over into an IRA

You can roll money from your 401(k) into a traditional IRA, but not directly into a Roth IRA. (This is because a Roth IRA is treated differently for tax purposes.) What you may be able to do, however, if you really want a Roth, is convert your traditional IRA into a Roth after doing the rollover. Check out the sidebar “Roth conversion: No, it’s not a new football play” for an explanation.



When rolling over into an IRA, you can do a *partial rollover*, rolling over only part of your 401(k) while leaving the rest in your 401(k) account or cashing it out. For example, you may not want to roll over employer stock if you receive shares as part of your distribution. (We explain the details of this strategy in the “Special Company Stock Considerations” section at the end of this chapter.) Or, you may withdraw some of your 401(k) money right away to pay for an expense, but roll the remainder into an IRA to keep it working for your retirement. Likewise, you can do a partial conversion of a traditional IRA into a Roth — leaving some of the traditional IRA intact. (Because you pay income tax on the converted amount, reducing the amount you convert lowers the tax you pay for the conversion.)

If you already have a traditional IRA, you can roll your 401(k) money into that account. However, it’s probably a better idea to open a separate IRA just for your rollover money. This will make keeping track of the funds easier. This type of account is often referred to as a *conduit IRA*, because it can act as a conduit between your old 401(k) and a new employer’s plan or a *rollover IRA*. Read the sidebar, “Conduit or rollover IRAs — still necessary?” for more details.

IRAs have different rules from 401(k)s. Be aware of the following before you do a rollover:

- ✓ You aren’t allowed to take a loan from an IRA. If you roll your 401(k) into an IRA, you won’t be able to take a loan as you may be able to with a 401(k).
- ✓ You can always withdraw your money from an IRA. You don’t have to apply for a hardship withdrawal as with a 401(k). However, you will owe income tax on money you withdraw from a traditional IRA, in addition to a 10 percent early withdrawal penalty if you’re under 59½. Also, you can’t replace the money in the account like you can with a 401(k) loan. You can put in only as much as the permitted annual IRA contribution.

- ✔ You can avoid the early withdrawal penalty with an IRA if you take money out to
 - Purchase a first home (you're limited to \$10,000 over your lifetime)
 - Pay higher education expenses for you, your spouse, or relatives such as the children or grandchildren of you or your spouse
- ✔ An IRA generally offers more investment choices than a 401(k). Depending on how much choice you like to have, this can be good or bad!
- ✔ If you have money in a 401(k) plan, you can be forced to withdraw the money when you reach the plan's normal retirement age, usually 65, unless you're still working for that employer. With a traditional IRA, you're required to start taking minimum distributions only after you turn 70½. A Roth IRA never requires you to take withdrawals (unless you inherited the Roth IRA).
- ✔ Money held in a 401(k) may be more secure from your creditors than money in an IRA. IRA protection depends on state law, while 401(k)s are protected by federal law. We explain this idea in more detail in Chapter 1.



To qualify for the tax advantages, your IRA must be held by a qualified *custodian* or *trustee*. Many financial institutions — a bank, brokerage, mutual fund company, trust company, and so on — may act as qualified *trustees* for your IRA.

In choosing one, you need to decide how much investment choice and what level of service you want.



Along with brokerage firms, just about any financial organization can now sell you stocks and bonds, including banks and insurance companies. If you buy a mutual fund from a bank, keep in mind that it's *not* guaranteed or insured like other more traditional bank investments, such as certificates of deposit (CDs) or plain old savings accounts. While we were writing this book, Ted heard from a 48-year-old woman who'd taken her bank's advice and invested in two mutual funds. The investments dropped in value by more than 35 percent, and she was deeply troubled by this, because she thought banks were a safe place to invest. She didn't realize that the mutual funds weren't guaranteed investments. Keep in mind that stocks, bonds, and mutual funds involve the same level of risk whether you buy them from a bank, stockbroker, or other financial institution.

Conduit or rollover IRAs — still necessary?

Money in an IRA can come from two sources: your own contributions made directly to the IRA each year, or a rollover of money in a 401(k) or similar plan from a former employer. You can also roll money in the other direction — from an IRA into a 401(k) or other employer plan.

Now for a history lesson. Before 2002, you were allowed to do a rollover from an IRA into a 401(k) *only* if the money in the IRA came from a 401(k) at a previous employer. If any money in the IRA came from your own contributions (even if it was just one dollar!) or from a different type of plan than a 401(k), you couldn't roll it over. If you wanted to keep your options open, you had to keep it in a special IRA untainted by any other money — a conduit IRA.

Conduit IRAs seemed to become less important in 2002, because Congress eased the rules to allow you to roll *any* traditional IRA money into a 401(k), whether it comes from a former employer's 401(k), 403(b), or 457(b) plan, or from your own contributions. The problem is, you never know what those guys and gals in Congress are going to do next. The rules can change. In fact, the legislation allowing the rollover rule change and many other retirement saving changes (EGTRRA) is due to expire in 2010. Congress has to renew all these provisions. Otherwise, in 2011, we'll be back to the pre-2002 situation.

The bottom line: It's easy to open a rollover IRA, and it may save you a lot of heartache in 2011.

Rolling over into another employer's plan

You don't have to roll over your 401(k) into an IRA. You may be able to roll the money over into your new employer's plan. You may decide to do this for a number of reasons, including

- ✓ Your new employer has a terrific plan with great funds and low expenses.
- ✓ You want to consolidate all your retirement savings in one place for ease of management.
- ✓ You think you may want to take a loan someday (remember, you can't take a loan from an IRA).



Before you decide to roll over your 401(k) into the new employer’s plan, make sure that you get a copy of the new plan’s summary plan description to find out all the rules your money will be subject to. Remember, after the money is in the 401(k) plan, you may not be able to withdraw it and move it into an IRA unless you leave your job, so be certain about the rollover before you do it.



You also need to find out whether your new employer’s plan accepts rollovers. In theory, you’re allowed to roll a 401(k) plan into another 401(k) plan or into a 403(b) plan or 457(b) plan. In practice, though, not all employer plans accept rollovers. If yours doesn’t, you can leave your money in your old 401(k) or roll it into an IRA to preserve the tax advantage. (See the sections, “Getting the skinny on IRAs” and “Never Can Say Goodbye: Leaving Money in Your Old Employer’s Plan,” in this chapter for more information about these options.)



Federal law was changed in 2002 to allow rollovers from 401(k) plans directly into 403(b) and 457(b) plans, and vice versa. Previously, money could be rolled only from one type of plan into the same type of plan — for example, 403(b) to 403(b). One reason your new employer may not accept a rollover from a different type of plan is that the employer may not have adopted the new federal rules yet.

Your new plan may require you to wait until you’re eligible to participate before accepting a rollover from your old 401(k). For example, if your new employer has a waiting period of one year before you can contribute to the 401(k), you have to wait one year to roll the money into the 401(k). In that case, you can either leave your money in your former employer’s plan or move it to a conduit IRA, ready to be transferred into the new 401(k) when the time comes.

Playing the waiting game

After you decide to roll over your 401(k) money into an IRA or a new employer’s plan, the transaction may take a while to happen. We’ve heard from participants who’ve had to wait months (or in extreme cases, years) before their former employer would release their money.



Your plan is allowed to retain your money as long as it wants, but no longer than the “normal retirement age” specified in the plan document. We’ve heard of companies restricting money in this way for up to five years after an employee leaves. One reason that an employer may set up a plan this way is to help retain good employees. Delaying distributions will prevent an employee from

quitting simply to access 401(k) money. Employees in this situation usually ask us whether their former employers can legally hold on to the money. The answer is “yes.” Amazingly (and somewhat frighteningly), under federal law, a plan is only required to distribute your money when you reach retirement age. (More specifically, it must be paid no later than 60 days after the end of the plan year when you reach the plan’s normal retirement age, which is often 65.)

The good news is that most employers want to get rid of the responsibility of administering an account for someone who’s no longer an employee, so most plans provide for immediate distribution of your money.

Another rule that the employer has to follow is to treat employees in a *uniform and nondiscriminatory manner*. In other words, your former employer has to handle your benefit distribution the same way it handled those of other employees who left under similar circumstances. Benefit distributions may also be delayed for administrative reasons. Employers that make profit-sharing contributions typically do so just before filing their corporate tax return, which can be 9½ months after the end of the year.

Never Can Say Goodbye: Leaving Money in Your Old Employer’s Plan

Leaving your money in your old 401(k) plan may be a good temporary solution while you figure out your next step, but it’s probably not the best long-term solution.

Leaving the money in the 401(k) may have advantages for some investors because

- ✓ Some people don’t want to make new investment decisions. If you’re satisfied with your 401(k) investments, this strategy is fine. However, be aware that an employer can change the investments offered by the plan at any time. If your money is in your former employer’s 401(k), you have to go along with the change. During the switchover period, which can take several weeks or months, you won’t be able to access your account.
- ✓ Money in a 401(k) generally has more protection from creditors than that in an IRA should you declare personal bankruptcy.

But, here are some drawbacks to consider about leaving your money in your former employer's 401(k):

- ✔ After you leave a company and are no longer an employee, you'll be low in the pecking order for service if you request a distribution from the 401(k) plan, or if you have questions or complaints. Companies can change a lot over time, including being acquired or restructured. The level of support you receive as an ex-employee usually drops dramatically if this happens.
- ✔ While the money is in a former employer's 401(k) plan, you can't take a loan. (Remember, you have to pay these back through payroll deductions.) Taking a withdrawal will also probably be difficult.
- ✔ You can no longer contribute to the old 401(k) plan, but you can rebalance the investments.

Withdrawing the Money with a Lump (Sum) in Your Throat

We hesitate to mention this, but you need to know all your options — when you leave your employer, you may withdraw all the money in your 401(k) account. This type of withdrawal is called a *lump-sum withdrawal*. Surveys show that about one-third of participants who change jobs withdraw all the money in their 401(k) account. Often, they have small account balances and probably figure that it's just not worth it to bother with a rollover.



Unless you have a serious financial need, cashing out the money and spending it is something you should avoid. Even if your account balance is small, it's worth leaving the money alone. If you take cash, you'll have to pay income tax on it. You'll also owe the 10 percent early withdrawal penalty if you're under 55 when you leave your employer and you don't meet any of the exceptions explained in Chapter 7.

While you're still with your employer, the magic age for withdrawing money from the plan without a 10 percent early withdrawal penalty is 59½. This is also the magic age if you have an IRA. However, the IRS lets you avoid the penalty if you're at least 55 when you leave your job (the job with the employer who sponsors your 401(k) plan). The reasoning is that if you lose your job at age 55 or older, it can be particularly hard to find a new one, so you may need the money. Imagine that — for once, the IRS gives you a break.

Moving out of the country

We often receive questions from non-U.S. citizens who work for a time in the United States, build up a 401(k) balance, and then wonder whether they can transfer it overseas and preserve the tax advantage.

You should consult an international tax expert for details about your specific situation, because the answer may depend on tax treaties between the United States and the country where you want to transfer your money.

But even if you can't do the equivalent of a rollover when you depart the United States, it may still be worthwhile to save in a 401(k) while you have the chance, particularly if you will get an employer matching contribution. When you leave your employer, you can leave the money in the 401(k) or (better yet) transfer it into an IRA to preserve the tax advantage. When you reach age 59½, you can withdraw the money without a 10 percent penalty, either all at once or little by little. (If you were at least 55 when you left your employer, you don't have to pay the penalty.) In any case, you'll still owe U.S. income tax, so you should try to withdraw the money in a year, or years, when you have no other taxable U.S. income. Your tax rate should be lower then.



Some people take a cash distribution and spend the money, figuring it's such a small amount that it won't matter. This is a mistake. An amount as small as \$5,000 when you're 25 can grow to \$157,047 by the time you're 65, assuming a 9 percent rate of return. That additional income could mean puttin' up at the Ritz rather than puttin' up a tent during your retirement travels.

What's more, you wouldn't even get the full \$5,000. After paying income tax and penalties, you may just be able to afford a big-screen TV. (And you'll be working so hard trying to make up for lost time in your retirement savings that you probably won't have time to watch it!)

Special Company Stock Considerations

If you have company stock (stock in your employer's company) in your 401(k), you need to know a few things about taxation before you decide what to do with it.

One option is to convert the stock to cash and then transfer it along with your other 401(k) money into an IRA. This gives you an opportunity to diversify your investments by selling the stock (a single investment) and using the proceeds to buy a variety of investments. That's good. However, if you're willing to take on the increased risk of holding company stock outside your IRA, you can get an additional tax break on the company stock. (We discuss risk and company stock in Chapter 5.)

Here's how it works. If you take a distribution of the company stock from your 401(k), but you don't roll it over into an IRA, you'll pay tax on the value of the stock at the time you acquired it — not at the time you withdraw it from the plan. This special provision of the tax law provides your first tax break, because the stock is most likely worth more now than when you received it. (Your employer is responsible for letting you know the total taxable value of the stock when you receive the distribution.)



Assume that you have \$50,000 worth of company stock in your 401(k) when you take a distribution, but it was valued at \$20,000 when you received it. At the time of your distribution, you'll receive \$50,000 worth of stock but pay tax on only \$20,000 of it. Later, when you sell the stock, your investment gain (whatever the stock is worth over \$20,000) will be taxed as a capital gain, a lower rate than the income tax rate.

If you hang on to the stock for a long time and still own it at the time of your death, your heirs will benefit. They'll have to pay tax only on the gain that occurs after they receive the stock. Say it's worth \$100,000 when they get it, and they sell it at \$110,000. They pay tax only on \$10,000 — the difference between the value when they received it and the sale price. They never pay income tax or capital gains tax on the \$50,000 gained while you held the stock.

This is a big tax break, but it's only useful if you don't need the money during your retirement years. You must also be willing to take on the higher investment risk of having a chunk of money invested in a single stock for a number of years.

Chapter 9

Living Beyond the Gold Watch

In This Chapter

- ▶ Deciding when and how to take money out of your 401(k) after you retire
 - ▶ Figuring out how much money to withdraw from your retirement savings each year
 - ▶ Keeping taxes to a minimum when you withdraw money
 - ▶ Making sure that you have enough money to last your lifetime (and then some)
-

When you retire, your investment job isn't over. In some ways, the job's just beginning. You have to convert your account balance (your *nest egg*) into a healthy income stream that will last the rest of your life. This means that you not only have to decide how to invest your money, you also have to decide how and when to spend it.

It'd be great if you could invest the money in a way that would let you live off the investment income without touching the *principal* (the amount in your nest egg before withdrawing any money), but for most people this isn't possible. You have to slowly spend the principal, as well. Spending your account's principal is often referred to as *drawing down* your account. The trick is spending just enough to make things comfortable but not using everything up before you go to the great beyond.

This chapter helps you decide what to do with your 401(k) money when you retire from your job, and how to manage it during your retirement to give you comfort and peace of mind (and maybe even have a little something left over for your heirs).

Note: All the recommendations that we provide in this chapter are directed toward individuals, not couples. That's because both you and your spouse need to do your own retirement planning — unless

you operate on a combined income. If you and your spouse have joint accounts and a “what’s yours is mine” attitude, a combined plan is fine. But remember that, unless you have other resources, both incomes need to be replaced to maintain your lifestyle.

Decisions, Decisions: What to Do with Your 401(k) Money

One of your first decisions as a retiree will be what to do with the money in your 401(k). You’ll essentially have two choices:

- ✓ Leave it in the plan.
- ✓ Take it out of the plan.

Well, okay, the choices are a bit more complicated than that. On the first point, you can leave it in the plan if your vested balance is more than \$5,000, and you haven’t reached the plan’s normal retirement age, usually 65. Leaving your money in your former employer’s plan is probably fine if you like the 401(k) plan investments, and if you’re not going to need the money soon. However, remember that the employer can change the plan investments at any time, and you have to go along with it. Also, most plans won’t let you take installment payments, so if you need to withdraw some money from the plan, it’ll be all or nothing.

That brings us to the second option — taking it out of the plan. When you take money out of a 401(k), you have to act carefully to keep taxes and penalties in check. The amount you take out has to be added on top of your other taxable income for that year. This additional income can push you into the highest tax bracket if you have a healthy account balance that you withdraw all at once. If your plan lets you take installment payments, you can arrange to take out what you need and pay income tax only on that amount each year. (This works until you hit age 70½, when you must start taking a *required minimum distribution* each year.) We explain these distributions in the section “Paying Uncle Sam His Due: Required Withdrawals” later in the chapter.

However, most plans have an “all-or-nothing” policy — either leave it in the plan, or withdraw a *lump sum* (the entire amount). With all-or-nothing plans, the best solution is generally to transfer some or all of the money into an IRA, to preserve the tax advantage, and withdraw money periodically from the IRA as you need it. Again,

you pay income tax only on the amounts that you withdraw, which works out to be less than paying tax on the entire amount all at once. (See Chapter 8 for more on IRAs.)



What you decide to do, and when you decide to do it, should depend largely on two factors:

- ✓ Your age when you leave your employer
- ✓ When you plan to start using the money

Being older can save you money

Your age when you leave your employer is important, because it determines whether you have to pay a 10 percent early withdrawal penalty on money you withdraw from the 401(k), in addition to taxes.

If you're at least 55 years old when you leave your employer, you won't have to pay the penalty on money withdrawn from that employer's plan. You still have to pay income tax on any withdrawals, though.



The exemption from the 10 percent early withdrawal penalty doesn't apply to any 401(k) money you may still have with employers you once worked for but left before turning 55.

If you're under 55 years old when you retire, you *will* owe a 10 percent early withdrawal penalty on any 401(k) money you withdraw, in addition to taxes. (There are a few exceptions called *72(t) withdrawals*, which we explain in the following section.) When you reach age 59½, though, you can withdraw your 401(k) money without a penalty, even if you retired from your employer before age 55.



Just to complicate matters, remember that your plan can refuse to let you withdraw money until you are the plan's "normal retirement age," which is often 65. Make sure to find out the rules for your plan before you do anything drastic, like retire.

No matter how old you are, you can avoid the early withdrawal penalty tax by rolling over your 401(k) money into an IRA. Remember, though, that after it's in the IRA, you'll generally owe a 10 percent early withdrawal penalty on any money you withdraw before you turn 59½. (The mysterious *72(t) withdrawal* exception, which we explain in the following section, applies here, too.)

Foiling the dreaded early withdrawal penalty



But what if you need your money before age 55 or age 59½? Here's where the *72(t) withdrawals* (distributions) come into play — you can use them to avoid the early withdrawal penalty. These distributions are a list of exceptions to the penalty, such as being disabled or having medical expenses exceeding 7.5 percent of your income (see Chapter 7 for the complete list). However, one of the exceptions, called a *SEPP*, can be used by anyone. (SEPP stands for substantially equal periodic payments.)

When you use SEPP withdrawals, you set up a schedule of annual payments that continue for five years or until you're 59½, whichever is longer. Each year, you withdraw the same amount. (You determine the amount using an IRS formula that is based on your life expectancy. Several approved methods exist. The simplest is the same one used to determine required minimum distributions, described in the section "Paying Uncle Sam His Due: Required Withdrawals.") You can set up SEPP payments with your 401(k) if your plan allows these periodic payments. If it doesn't allow periodic payments, you can roll your 401(k) balance into an IRA and take the SEPP payments from the IRA.



Use a SEPP to avoid the 10 percent penalty tax if you retire before age 55 and start withdrawals from your 401(k) before age 59½, or if you need to make withdrawals from your IRA before age 59½.



If you move your 401(k) money into an IRA, remember to have it transferred directly. Don't accept a check made out to you personally. If your employer makes the 401(k) check out to you, your employer has to withhold 20 percent of the amount for taxes. You have to make up this difference when depositing the money in the IRA, otherwise it will count as taxable income. See Chapter 8 for more information.

Here's an example of a situation requiring SEPP withdrawals. Say you stop working at age 56 and leave your money in your 401(k). Everything's fine for two years, and then you decide you need money from your 401(k). You don't have to worry about the 10 percent early withdrawal penalty, because you were at least 55 years old when you left your employer. However, you still have to think about income tax. If you withdraw the entire 401(k) balance, you'll have a big tax hit. Your employer may allow you to take installment payments from your 401(k) in the amount of your choosing, which would solve your problem. However, if your employer lets you take only a lump sum

withdrawal, what do you have to do? (If you've read the earlier chapters, we expect you to belt out this refrain like a Broadway chorus by now.) That's right, roll over the 401(k) into an IRA to preserve the tax advantage.

There's one complication, though. (There's always something.) If you take a distribution from an IRA before you're 59½, you'll have to pay the 10 percent penalty tax. It doesn't matter that you were over 55 when you left your employer. To get the money out of the IRA without the penalty tax, you need to take a Section 72(t) distribution that must continue for at least five years — until you're 63, in this example.

An alternative is to take a partial distribution from your 401(k) for just the amount you need right away, and roll over the rest of the money into an IRA. For example, assume that you have \$200,000 in your account, and you need to use \$35,000 before you turn 59½. You can take \$35,000 (plus enough money to cover the tax) from your 401(k) plan and transfer the rest of the money directly to the IRA.



After retiring, we recommend having the bulk of your savings in an IRA, because IRAs give you greater withdrawal flexibility after age 59½ and more investment flexibility than a 401(k).

Leaving money with your former employer

If you don't need to use any of your 401(k) money for retirement income, and your account exceeds \$5,000, you can leave the money in your 401(k). Your employer can't force you to take the money out prior to your plan's normal retirement age. Participants who are comfortable with the investments they have in their 401(k) and/or who don't like making decisions are more likely to leave their money in the plan. Those who aren't thrilled with their 401(k) investments usually can't wait to get their money out of the plan and into other investments that they think are better.

There is no right or wrong decision. Either arrangement is fine if your 401(k) investments are satisfactory. One thing to remember is that money in a 401(k) may have somewhat greater protection from creditors than money in an IRA, depending on your state of residence, should you declare bankruptcy. (IRA protection depends on state law where you live, whereas 401(k) protection is afforded by federal law.)

On the other hand, an IRA offers much greater investment flexibility. An IRA also gives you greater flexibility in naming a beneficiary. (You don't have to get your spouse's approval before you can name someone else as beneficiary, as you have to with a 401(k).)



As you decide whether to leave your 401(k) money with your former employer, you should also consider the fact that the corporate landscape changes constantly. In a continuous merger-and-acquisition climate, Ted usually advises participants to get their money out of the 401(k) plan as soon as they can. Not only can former employers be elusive but they can also change your plan investments at any time. Your money can be moved from one set of investments to another without your approval.

Paying Uncle Sam His Due: Required Withdrawals

In the previous sections, we talk about when you're allowed to take money out of your 401(k). Now we switch gears and explain when you're *required* to withdraw money from your 401(k).

You must begin taking your money out of the 401(k) plan by the time you're 70½, unless you're still working for the employer that maintains the plan. (If you own more than 5 percent of the company, you must start taking distributions by age 70½, even if you're still working.) The government wants to collect tax on your money at some point, which is why you can't leave it in a 401(k) forever.



The amount that you're required to withdraw each year is called your *required minimum distribution*, or *RMD*. The first one you have to take applies to the year when you turn 70½, even though you have until April 1 of the following year to take the installment. You then have to take required distributions by December 31 of each year.



You have a few extra months to take your first required distribution (until April 1), but because that distribution is for the previous year, you still have to take a second required distribution for the current year before December 31 of that same year. Be aware that this will increase your taxable income for that year. You may want to take your first withdrawal earlier.

Here's an example. If you turn 70½ in 2003, you have to take your first RMD by when? That's right, April 1, 2004. But you can take it sooner, in 2003, if you'd like. Why would you do that? Because

you'll also have to take a distribution by December 31, 2004, for the year 2004. If you put off your 2003 distribution until 2004, you'll have a higher taxable income that year, all else being equal.

Calculating your RMD isn't terribly difficult if you have the right information available:

- ✔ **You need to know your account balance as of December 31 of the year before the one that you're taking the distribution for.** In other words, if you're calculating your 2003 distribution, you need to know your account balance as of December 31, 2002.
- ✔ **You also need to get hold of the IRS life expectancy tables that apply to you and find the correct number for your age.** You can find these tables in a supplement to Publication 590 for 2002, available at www.irs.gov/pub/irs-pdf/p590supp.pdf. Beginning in 2003, the tables should be included in Publication 590, which can be found on the IRS Web site (www.irs.gov.) Use Table III if your spouse is less than 10 years younger than you, if you're single, or if you're married but your spouse isn't your named beneficiary. Use Table II if your spouse is more than 10 years younger than you. Don't worry about Table I — it's for beneficiaries who inherit an IRA.



For example, if you're 70 and married, and your spouse is 65, you'll use Table III. On that table, the distribution period for a 70-year-old is 27.4. You divide your account balance by that number, and the result is your required minimum distribution. Say your account balance on Dec. 31, 2002, is \$500,000. Your required minimum distribution is \$18,248.18 (\$500,000 divided by 27.4). That's how much you have to take out the first year. For the following year, you do a new calculation with your updated account balance and the next distribution period number on the table.



If you think that's complicated, you should've seen the rules before the IRS simplified them in 2001! You can always ask your plan provider or IRA custodian to calculate the RMD for you. In fact, IRA custodians are required to help you calculate it, so don't be shy about asking for help.

By the way, the rules for calculating required minimum distributions are the same whether your money is in a 401(k) or an IRA. And you can always take out more than the required minimum. However, if you take out less, the IRS will fine you 50 percent of the required amount that you didn't withdraw.

Developing a Strategy to Deal with the Tax Man

It would be nice if taxes disappeared when you retired, but unfortunately they don't. The earlier sections of this chapter talk about minimizing taxes when you first move your money out of your 401(k), but you need to look at a few other situations, too.

Which comes first: Plucking the chicken or emptying the nest egg?

You most likely have some money saved in "taxable" (non-tax-advantaged) accounts as well as in your 401(k). How do you decide which money you should spend first?

Historically, many professional advisors had recommended keeping as much money as possible in a tax-deferred account, even during retirement. The rationale was that you would continue to benefit from the fact that no interest, dividends, or gains would be taxable while the money was in the account.

But the game changed when Congress revised the tax rules regarding Social Security benefits. Although this tax-deferred advantage is still true, you also have to factor in taxation of your Social Security benefits. When you start receiving Social Security, your benefits will be taxed if your income is over certain limits. Distributions from a 401(k) or traditional IRA are taxable retirement benefits that are included in the income that must be counted to determine what portion, if any, of your Social Security benefits will be taxable. So, if you take money out of your 401(k) or IRA when you start receiving Social Security benefits, you may have to pay tax on your Social Security benefits. It would be wise to do some basic planning before deciding on withdrawals. For up-to-date rules, contact a tax attorney and look at the Social Security Administration Web site at www.ssa.gov.



If you retire a few years before taking Social Security benefits, you may want to use up your tax-deferred accounts first, rather than your other savings.

Here's an example. Assume that you

- ✓ Retire at age 60
- ✓ Plan to start receiving Social Security benefits when you reach age 62

- ✓ Have \$100,000 of personal savings
- ✓ Have \$250,000 in your 401(k) account
- ✓ Will need \$35,000 of income (after taxes) each of your first two years of retirement (before Social Security kicks in)

You could either use your personal savings or withdraw approximately \$40,000 from your retirement account during each of these two years. (We're assuming that a \$40,000 withdrawal will leave you about \$35,000 after paying taxes. If you have other taxable income, your tax rate might be higher.) Withdrawing the money from your 401(k) right away will reduce the size of the taxable distributions you'll receive after you become eligible for Social Security. It reduces your taxable income after you start to collect Social Security benefits, so perhaps you won't have to pay as much, or any, tax on your benefits. This may be a better tax deal than the tax break you receive by keeping more money in your retirement account. And you'll still have your personal savings available, which has already been taxed.



You need to do some fairly complex calculations to see what's better in your situation, so we strongly encourage you to consult an experienced tax attorney or other qualified adviser who does this type of planning.

More on that darned company stock

You also need to consider taxes when you decide what to do with the company stock you may have accumulated in your 401(k) account or other employer-sponsored plan, such as an Employee Stock Ownership Plan (ESOP). As we discuss in Chapter 8, you get a special tax break when you receive company stock as a distribution. You pay tax only on the value of the stock when it was credited to your plan account, not on its current value. You pay a capital gains tax on the difference whenever you eventually sell the stock. These capital gains taxes are lower than the income taxes you would otherwise pay. Finally, if you pass the stock to your heirs when you die, they won't pay tax on any gains that occurred before it was given to them.

This type of estate planning is feasible only if you don't expect to use the stock during your retirement, and you're willing to take the risk of having a chunk of money tied to one stock for many years.



Holding stock in an individual company is much riskier than investing in a number of different investments. If you're not sure why, check out Chapters 5 and 8.

If you roll your company stock into an IRA, you can sell it and diversify into other investments. You will have to pay income tax on your eventual withdrawals. If you take your distribution of stock, you must pay tax on the value of the stock when you received it in the plan. You can then sell the company stock, paying only capital gains tax on the gain, and use the money to invest in more diversified mutual funds or a portfolio of stocks. However, returns on these “taxable” investments will be subject to income tax every year. Still, the benefits of diversification probably make either one of these strategies more palatable than holding on to the company stock, unless you really aren’t going to need the money during your lifetime.



Don’t let the tax tail wag the dog. Passing company stock on to your heirs is an instance when tax planning for them may get in the way of good investment planning for you.

Managing Your Investments in Retirement

Investing to build up an adequate retirement nest egg takes most people an entire working career. But, believe it or not, managing your investments is even more critical *during* your retirement years, because what took many years to build can go “poof” in an instant, like one of those big soap bubbles kids blow. When you’re younger, you can do some really dumb things and still have time to recover. If your investments lose 20 percent or more when you’re 30, it’s a non-event. When you’re 70, it can be a disaster.



As a retiree, you really have to pay attention to your investments so that you can convert your retirement account and other resources into an income stream that will last for the rest of your life.

As you decide how to manage your nest egg during your retirement years, we can’t emphasize enough the importance of consulting a professional. This is probably the best investment you can make for your retirement. Ask co-workers, friends, or family members for recommendations on financial professionals in your area. A couple of good resources are www.napfa.org, the Web site of the National Association of Personal Financial Advisors, or www.fpanet.org, the Web site for the Financial Planners’ Association. You can also try Dalbar, Inc.’s Advisor Finder at <http://moneycentral.msn.com/investor/dalbar/main.asp>.

Live long and prosper

Maintaining an income stream that will last for the rest of your life is more difficult now than it used to be. A generation or two ago, retirees commonly converted all their available funds into *income-producing investments*. For most retirees, this meant converting their funds into bank certificates of deposit (CDs). Those who owned stocks typically stuck to the ones that were popular for widows and orphans — in other words, stocks such as utilities that paid high dividends and had a history of steady income with low price fluctuation and modest long-term growth.

Keeping up with inflation wasn't a big deal when the average retiree lived for only 10 to 12 years after retiring. A 3 percent inflation rate reduced the amount of income a retiree could spend by only 23 percent after 10 years.

Today, if you retire during your 50s or early 60s, you need to plan for at least 30 years of retirement income. Your buying power will be reduced by 58 percent after 30 years of inflation at 3 percent. You've probably read that you have to keep some money invested in stocks during your retirement years to help offset the impact of inflation. This advice makes sense, because stocks have produced a higher level of return on average than other investments over 20- to 30-year time periods. But you also need to know how much stock, and which types of stock, to own.



When you do your retirement planning, don't expect an annual 15 percent or higher return. Unfortunately, too many 401(k) investors came to expect just that during the high-performance 1990s. But as the market plummeted in the early 2000s, these investors learned the hard way that the stock market has never produced a return in this range for more than a few years. Expect your return to average 7 percent to 9 percent per year during your retirement years — even with stock investments.

Be realistic about your expectations



In the previous section, we tell you what *not* to expect. Now, to help you plan, here are some rules about what investment return to expect. In general, stocks have produced about a 10 percent average return, and fixed income about a 6 percent average return over a 20- to 30-year period. The return for your overall portfolio will depend on your mix of stocks and bonds. For example:

- ✔ If 75 percent of your money is invested at 6 percent and 25 percent is invested at 10 percent, you can expect an average portfolio return of 7 percent.
- ✔ If your money is split 50/50, expect an average portfolio return of 8 percent.
- ✔ If 25 percent of your money is invested at 6 percent, and 75 percent is invested at 10 percent, expect an average portfolio return of 9 percent.

Remember that these are simply guidelines to help you establish realistic investment expectations for your retirement years and decide how to split your money among different types of investments. They outline *average returns* that could be expected during a *20- to 30-year period*. The year-to-year returns will vary — with even larger variances — when you have a large amount invested in stocks. You also have to consider the fact that these are average long-term expectations. You won't get these returns every year. Your return will be higher for some years and lower for other years. They may even be negative for some years.

Many professional investment advisors recommend investing less than 75 percent of your money in stocks during your retirement years. This means that you should expect an average return in the 7 to 8 percent range if you follow the most commonly recommended mix of stocks and fixed-income investments for retirees. This mix includes a stock allocation of around 40 to 60 percent, depending on your age and risk tolerance. For example, a 60 percent stock allocation may be appropriate during the early years of your retirement, but in most instances, you should reduce the percentage as you get older.

Managing Risk and Maximizing Return

Why so much talk of risk during your retirement years? After all the years you worked hard to reach your retirement goal, you probably want, and deserve, a break that's free of investment stress. We wish we could tell you how this sort of break is possible, but we can't, because it's not. At this point, you need to withdraw money from your account to live. The combination of a low or negative return for a couple of years and regular withdrawals can really disrupt your carefully laid plans.

Imagine that you have a retirement nest egg worth \$250,000. You withdraw 6 percent, or \$15,000, for living expenses the first year. The next year you withdraw \$15,450 to keep up with 3 percent inflation. Now say the value of your investments drops 10 percent the first year and another 4 percent the second year. Finally, assume that you based your plan on an 8 percent return during your retirement years.

An 8 percent return may have looked like a sure thing when you retired, but the market hasn't done well during the first two years of your retirement. Table 9-1 shows how much the value of your nest egg drops after two years of retirement, and where you are compared to your original investment plan.

Table 9-1 How Actual Results Can Differ from Your Plan

	<i>Your Plan (Assumes 8 % Return)</i>	<i>Your Results with 100 Percent Stock</i>	<i>Your Results with 50/50 Split Stocks/Bonds</i>
Beginning amount	\$250,000	\$250,000	\$250,000
Withdrawal year 1	\$15,000	\$15,000	\$15,000
Withdrawal year 2	\$15,450	\$15,450	\$15,450
Investment gain (or loss) year 1	\$19,400	-\$24,250	-\$4,850
Investment gain (or loss) year 2	\$19,734	-\$8,121	\$2,224
Ending balance year 1	\$254,400	\$210,750	\$230,150
Ending balance year 2	\$258,684	\$187,179	\$216,924

This example assumes that you withdraw money monthly. Although no one can predict when the market will go up and down, you do need a predictable stream of income during your retirement years. But withdrawing money when the value of your investments is declining can be gut-wrenching.



One way to avoid having to sell stocks when they're down is to invest about 20 percent of your nest egg in low-risk, fixed-income investments, such as a money market fund or short-term bond fund. Hold these investments in your regular IRA or in a separate

IRA. Use this money as a special cash reserve fund during down periods. You can tap this fund rather than become forced to sell stocks when their value is down.

You can reduce the risk of a loss in any retirement year by increasing the amount you invest in bonds and other fixed-income investments. In the example illustrated by Table 9-1, if you had invested 50 percent in stocks and 50 percent in bonds rather than 100 percent in stocks, the overall loss in the first year would've been only 2 percent, and you actually would've gained 1 percent in the second year. This amount would still be different from your target, but it would, nonetheless, substantially soften the blow.

We can hear you asking why you shouldn't simply put your entire account into fixed-income investments during your retirement years. The answer is that dreaded "I" word: inflation. In Chapter 4, we discuss how inflation makes things cost more over time. In the example in Table 9-1, the amount of money that you'll need to withdraw during the 20th year of your retirement will have increased from \$15,000 to \$26,300. (That's assuming a 3 percent inflation rate, which is on the low side, historically speaking.)



If you're particularly thrifty, you may think that you don't need to adjust for inflation. Don't fool yourself. You're not living on the same income now that you had 20 or 30 years ago, and you won't want to live on today's income 30 years from now. Some argue that, despite inflation, expenses decrease during retirement years. That's true for some expenses, but medical expenses usually increase, and you may ultimately need to cover the cost of an assisted-living facility. Keeping some of your investments in stock should help you make up the gap that inflation causes.

Living within Your Means for Your Lifetime

Some people think that they'll never run out of money if the amount they withdraw from their retirement account each year never exceeds their investment return. But how can you do this in years when your return is low or negative? Would you be able to live on 1 percent of your account? (Even with an account of \$500,000, that would be \$5,000 for the entire year.)

Achieving an investment return such as 8 percent is not a given every year. Stock returns can be almost nonexistent even during extended periods. Living through one of these longer-term market

funks when you're building your nest egg isn't easy — but it's much more painful when you're retired and watching your account shrink. In addition to good planning, a favorable economy during most of your retirement years will certainly help — but of course, you can't control that.

If you have a \$500,000 nest egg, a realistic amount to withdraw each year to avoid running out of money would be around \$30,000 per year (adjusted for inflation). If you find that difficult to believe, take a look at Table 9-2, which shows the effect of those annual withdrawals on the account. After 25 years, you've only got enough left for two more years. That's not a very big cushion.

Table 9-2 **Managing Your Nest Egg During Your Retirement Years**

<i>No. of Years</i>	<i>Beginning of Year Balance</i>	<i>Annual Withdrawal (Assumes 3% Inflation)</i>	<i>Investment Return (7%)</i>	<i>End-of-Year Balance</i>
1	\$500,000	\$30,000	\$33,950	\$503,950
2	\$503,950	\$30,900	\$34,195	\$507,245
3	\$507,245	\$31,827	\$34,393	\$509,811
4	\$509,811	\$32,782	\$34,539	\$511,568
5	\$511,568	\$33,765	\$34,628	\$512,431
6	\$512,431	\$34,778	\$34,653	\$512,306
7	\$512,306	\$35,822	\$34,610	\$511,094
8	\$511,094	\$36,896	\$34,485	\$508,683
9	\$508,683	\$38,003	\$34,278	\$504,958
10	\$504,958	\$39,143	\$33,977	\$499,792
11	\$499,792	\$40,317	\$33,574	\$493,049
12	\$493,049	\$41,527	\$33,060	\$484,582
13	\$484,582	\$42,773	\$32,424	\$474,233
14	\$474,233	\$44,056	\$31,654	\$461,831

(continued)

Table 9-2 (continued)

No. of Years	Beginning of Year Balance	Annual Withdrawal (Assumes 3% Inflation)	Investment Return (7%)	End-of-Year Balance
15	\$461,831	\$45,378	\$30,740	\$447,183
16	\$447,183	\$46,739	\$29,667	\$430,111
17	\$430,111	\$48,141	\$28,423	\$410,393
18	\$410,393	\$49,585	\$26,992	\$387,800
19	\$387,800	\$51,073	\$25,358	\$362,085
20	\$362,085	\$52,605	\$23,505	\$332,985
21	\$332,985	\$54,183	\$21,413	\$300,215
22	\$300,215	\$55,809	\$19,062	\$263,468
23	\$263,468	\$57,483	\$16,431	\$222,416
24	\$222,416	\$59,208	\$13,497	\$176,705
25	\$176,705	\$60,984	\$10,445	\$129,166

If that's not enough to convince you, and you want more information on this topic, you may want to look at a widely reported study by three finance professors at Trinity University in San Antonio, Texas (the "Trinity Study").

The study showed that portfolios with a stock/bond mix, rather than 100 percent stocks or 100 percent bonds, are most likely to provide an income for the longest period of time. It also found that withdrawing more than 6 to 7 percent of your retirement account per year substantially increases the chance that you will outlive your savings. Your chance of *not* running out of money is even better if you withdraw only 3 to 4 percent each year.

More detailed information about the Trinity Study appears in the book, *Retirement Bible*, by Lynn O'Shaughnessy (Wiley Publishing, Inc.). An article by the study's authors (including results tables) was also available at www.aaii.com/promo/mstar/feature.shtml at the time this book was written.

Row, Row, Row Your Boat, Gently Down the Income Stream

When you're living off your retirement accounts, you need to come up with a strategy to provide a stream of income that's as predictable as your paycheck was. You'll have expenses that need to be paid, trips you want to take, and activities you want to participate in, and they will all cost money.

You can structure your retirement account in several ways to provide a monthly stream of predictable income.

IRA withdrawals

One way to develop a monthly stream of predictable income is to take monthly withdrawals of a specific amount from mutual funds held in an IRA. You can even have the money automatically deposited directly to your checking account.



For example, assume that you have \$250,000 in your IRA, and you want to withdraw a total of 6 percent per year. This would be \$15,000, divided into monthly payments of \$1,250. If your investments are split evenly between a bond fund and a stock fund, you can ask to have \$625 transferred from each account into your checking account every month.

When you invest in mutual funds, you may receive dividends, interest, and realized capital gains (gains on stocks that the mutual fund sells). You can elect to have these amounts paid directly to you, but having them reinvested into new mutual fund shares is easier. The mutual fund company sells enough shares each month to generate the payment you've requested.



You can increase or decrease your withdrawal amount if you absolutely have to, but you should try hard to stick with your plan. Remember that your nest egg doesn't provide a guaranteed lifetime income stream: The checks stop when your account balance hits zero. For example, you can increase the amount you withdraw annually by 3 percent, or whatever inflation rate you've built into your plan; however, it's wiser to keep the withdrawal amount at the same level until you really need the additional income.



Keeping your withdrawal amount steady gives you a cushion for later. Your plan for managing your nest egg during your retirement years includes many variables, including a “guesstimate” of when you will exit your earthly existence. It’s highly unlikely that everything will happen exactly as you plan. Living somewhat more frugally during the early years of your retirement reduces the potential that you’ll outlive your nest egg.

The annuity option

Another way to get a monthly check in retirement is by purchasing an *immediate annuity*, a financial product that protects you if you live beyond a normal life expectancy. To buy an immediate annuity, you pay a lump sum (which can be rolled over from a 401(k), for example), and in return you are guaranteed income for life — no matter how long you live. How much income you receive depends on the terms of your annuity. An annuity is a good option if you have a limited amount of money that has to last you for many years.

Evaluating the pros and cons



A major disadvantage of an annuity, besides additional fees, is the fact that, depending on the terms of your annuity, the insurer may keep your money if you die sooner than expected. You can guarantee payments for a certain number of years beyond your death or for the life of another beneficiary, but doing so reduces your monthly payments while you’re alive. Financial organizations that sell annuities aren’t in the business of giving money away. To put it bluntly, annuity-holders who die early pay for those who live longer than expected.

Another risk of an annuity is that the insurer that is guaranteeing the annuity might fail. You should only buy an annuity from a company that has a top rating. Companies that rate insurers include A.M. Best (www.ambest.com), Standard & Poors (www.standardandpoors.com), and Duff & Phelps (www.duffllc.com).

A possible solution, if you like the guarantee offered by an annuity, is to split your retirement money between an annuity and other investments. This solution can be the best of both worlds for some people — they can count on a certain amount of life income from the annuity, plus a monthly withdrawal from the mutual funds or other investments that they make outside the annuity.



The July 2002 issue of *Money* magazine features an article titled “Income for Life” that’s a good reference if you want more information about topics discussed in this chapter. You should be able to find it at your local library.



After you buy an annuity, you can't change the payment structure for some unexpected need. Because of this inflexibility, you should avoid putting all of your money into an annuity. Also, make sure that you completely understand the terms of the annuity before purchasing it.

Varying your annuity

Immediate annuities exist in *fixed* or *variable* types. With a fixed annuity, the insurance company guarantees you payments of the same amount each year. Your payments don't increase to keep up with inflation. A variable annuity lets you invest in mutual funds to try to boost your payments and keep up with inflation. However, investing in these mutual funds through a variable annuity is more expensive because of the income guarantee. Plus, your payments may drop if your investments don't do well.

If you do buy a variable annuity, be sure to choose one that gives you access to mutual funds you prefer. You can buy an annuity directly from most mutual fund companies. Remember to split your annuity investment between stocks and fixed-income investments, as you do with the rest of your portfolio.



One word of caution: Consult a trusted financial planner or other professional adviser to make sure that either type of annuity is right for your situation. It's very difficult, if not impossible, to get out of an annuity after you've bought it.

Your home is your asset

When you consider financial resources to fund your retirement, you may also wonder whether you should convert your home into an income-producing asset. In some cases, this makes sense, but many people are emotionally attached to their family home and don't want to sell it. You may have to try to take a less emotional look, however, because you may need the equity from your home to achieve a comfortable level of retirement income.

It may be better to sell your home and use the proceeds to generate income, and then find a place to rent. Why rent if you own a home without a mortgage? Consider that a home is indeed an asset, but it doesn't produce money — it eats it up. It costs a lot of money to live in your home, even if you don't have a mortgage. Assume that you own a \$150,000 home. The real estate taxes are probably in the \$2,500 range. Your routine annual maintenance costs are probably in the \$2,000 range. (Check all your expenditures for a year if these estimates seem high.) You also have to factor in major periodic repairs, such as a new roof. You probably spend at least \$5,000 per

year for the privilege of owning your \$150,000 home — even with the mortgage fully paid. This additional expense is okay if you have adequate retirement income, but it's not wise if your retirement resources are limited.

You can probably find a nice place to rent for \$800 per month in the same area as your \$150,000 home. The rental will cost you \$9,600 per year compared to the \$5,000 it may cost to live in your present home. You're paying almost double for the rental, but you don't have the hassle of home ownership. Most importantly, you can reinvest the money from the sale of your home and make up the difference.



Assume that you have \$135,000 left after you sell your home and move. (Also assume that you don't owe capital gains tax.) You can reinvest this money in a 50/50 stock and fixed-income portfolio that may generate an average 8 percent investment return of \$10,800. You will need \$4,600 of this "profit" to make up the difference between the rent you pay and the housing expenses that you've eliminated. This leaves you with \$6,200 of additional annual retirement income that may enable you to do some things that would not otherwise be possible. You also have access to the \$135,000 for emergencies.

The same logic applies if you live in an area where housing costs are very high. If you have limited retirement resources, it makes sense to relocate to a lower-cost area so that you can unlock the equity in your expensive home.