Are you right on the money to retire?

Readiness surveys show many workers underestimate longevity.

BY MILTON ZALL

Workers who calculate how much they will need to save for retirement appear to be doing a good job of preparing for retirement. But according to the recent Retirement Confidence Survey sponsored by the Employee Benefit Research Institute (EBRI; Washington, DC), their efforts may fall short because they often underestimate how long they will live.

The survey indicates that workers today are more confident of having enough money for retirement than they were in 1993. Workers' confidence in the ability of Social Security to maintain current benefit levels bottomed out in 1995 at 19% and is now rising. Today, 28% of workers express confidence in Social Security, with the majority—71%—remaining not confident.

Other findings weaken these positive trends, however. The amounts that workers have accumulated for retirement are generally low, and many people appear to be falsely confident about their retirement security. Workers may also find that their retirement planning has been inadequate because they hold false expectations about the age at which they will be eligible for full Social Security retirement benefits, the age they will retire, the length of their retirement, and the sources of their retirement income. Nearly 20% of workers believe their retirement will last 10 years or less, and an additional 15% believe it will last 11–19 years. However, a man retiring today at age 65 can expect to live, on average, until 81, and a woman can expect to live until 84, according to the survey. In addition, 28% of the respondents who indicate they have tried to do a retirement-needs calculation are unable to state the amount they will need to save.

The survey also produced a Retirement Readiness Rating that is designed to indicate how well individual workers are preparing for retirement. The rating scale is 0–25, with those scoring 25 apparently doing the best job of preparation. The items used to compute the score for each worker include saving for retirement, completing a savings-needs calculation, establishing an investing or savings strategy for retirement, and attitudes toward various aspects of preparing for retirement. Based on the results of this scale, fewer than 1 in 10 American workers are doing a very good job of preparing for retirement; 35%, with a score of 16–20, appear to be doing a good job; and 28% appear to be doing an adequate job. Nineteen percent seem to be doing a poor job, with a score of 6–10, and 9% seem to be doing a very poor job, with a score of 0–5.

ILLUSTRATION: TONY FERNANDEZ

Not surprisingly, those with household incomes of $75,000 or more were more likely to score highly, but those who are married, who receive retirement savings information from an employer, and who expect to rely primarily on personal savings (either through a retirement plan at work or outside of work) or employer-funded plans also score highly.

"The fastest-growing segment of the population is the over-85 segment," says EBRI chief Dallas Salisbury. EBRI sponsored the survey together with the American Savings Education Council and Mathew Greenwald & Associates, a Washington, DC-based market research firm. "People need to make sure their money lasts a lifetime," says Salisbury. Fortunately, the fraction of workers saving for retirement has been rising, and 80% of households now report that they have begun to save. Currently, 53% of all workers have tried to calculate how much money they will need to save for retirement, compared with 35% in 1993. When workers were asked if they made any changes as a result of doing a retirement calculation, 54% said they started saving more and 26% said they changed their asset allocation.

Plan withdrawals

Once you have reached your retirement date and start drawing on your savings and/or pension, you need to be well versed in the U.S. Internal Revenue Service (IRS) rules to avoid possible tax penalties. To make the most of your retirement dollars, plan ahead and know the answers to the basic questions that follow.

When must I begin to take distributions from my retirement plan(s)? After you retire, you must withdraw a minimum amount from qualified tax-advantaged plans such as a 401(k) or 403(b). Such distributions must start no later than April 1 of the year after you turn 70½. You can take penalty-free distributions earlier if you wish (age 55 when retired, age 59½ if still working).

How is the required minimum distribution calculated? The amount of your minimum distribution is based on IRS life expectancy tables for you and your oldest primary beneficiary. The amount is calculated by dividing your plan balance by your life expectance factor, which may or may not be recalculated every year depending on how you choose to base your calculations. The decision whether to recalculate annually, made at the start of distributions, cannot be changed later.

What is the penalty if I do not take the minimum distribution? If you do not take the minimum at the required time, you may have to pay a penalty equal to 50% of the difference between your minimum and the amount, if any, you withdrew. Furthermore, you must still withdraw the correct amount and pay taxes on it.

What is the largest distribution I can take in a single year? You can withdraw your entire retirement plan account; however, remember that the entire amount becomes taxable in that year.

IRA beneficiaries get break

The IRS recently ruled that the beneficiary of an individual retirement account (IRA) can take required minimum distributions over his or her life expectancy, even though the original IRA holder received distributions, based on life expectancy, which were recalculated annually.

The general rule is that if you own an IRA, you must withdraw the entire balance in your IRA or start receiving periodic distributions from your IRA by April 1 of the year following the year in which you reach age 70½. If you do not withdraw the entire balance in your IRA by that date, you must start to withdraw periodic distributions. These withdrawals may follow either (a) a period that does not extend beyond your life expectancy, or (b) a period that does not extend beyond the joint life and last survivor expectancy of you and your designated beneficiary. If the IRA owner does not make any withdrawals, or doesn't withdraw enough, there is a 50% excise tax on the amount that was not withdrawn as required.

The idea is that by forcing the IRA owner to take annual distributions that are based on the owner's life expectancy, the IRS will get to tax these distributions. For example, an IRA owner who is 75 and has a life expectancy of 10 years (he is expected to live to age 85) must withdraw 10% of the money in his IRA. Because the money in an IRA is not taxed until the owner starts taking money out of the IRA, the IRS understandably wants withdrawals to begin so they can be taxed.

The case recently ruled on involved a father who had an IRA and withdrew the mandatory annual distribution amount after age 70½ that was calculated on the basis of his life expectancy. The amount he had to withdraw was recalculated annually. After his death, his daughter, who was the IRA's beneficiary, asked the IRS whether she could withdraw money from the IRA based on her life expectancy.

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Because the father designated his daughter as his beneficiary, the IRS reasoned that he could have taken annual distributions that were based on his and his daughter's joint life expectancy (option b above). Thus, the IRS concluded that his election to accelerate distributions during his life should not preclude his daughter from using her life expectancy to compute the distributions after his death.

This ruling stretches out the tax deferral period for the inherited IRA because the daughter has a considerably longer life expectancy than her father had. That means that even though she will be taking annual distributions based on her life expectancy, the money that remains in the IRA will continue to grow on a tax-deferred basis.

IRS allows disability policy in 401(k) plan

A recent IRS ruling permits employers to offer a disability income feature inside a 401(k) plan. This adds a new and valuable investment option that progressive employers can offer employees.

In its ruling, the IRS said that the purchase of a long-term disability insurance policy within a 401(k) plan did not violate any provisions of the tax law. The IRS also said that the employer or employees who elected such coverage would not lose any of the tax-favored treatment of plan contributions used for premiums on the policy.

Like most 401(k) plans, this plan provided for pretax salary contributions by employees and an employer match. What the employer wanted to do was come up with a way to guarantee that an employee's retirement savings accumulation would continue even if the employee became disabled. The employer offered employees the option of using a portion of their 401(k) contribution to purchase a long-term disability insurance policy. The way the policy worked, each employee who participated in the disability insurance coverage told the 401(k) plan trustee to allocate a portion of his or her salary deferrals for the purchase of the disability insurance policy. The plan, not individual employees, purchased the insurance policy.

If a plan participant became disabled, the policy would pay monthly benefits to the plan (not the employee) in an amount equal to one-twelfth of the plan participant's contributions plus the employer's matching contributions that were made to the plan in the year preceding disability. The plan would treat any policy payments as investment earnings, which would be allocated to the account of the plan participant who purchased the disability insurance coverage. In other words, disabled employees could continue to accumulate assets in their 401(k) plan as if they had remained working. Disabled employees who were having payments made to their account by the insurance company would be able to direct the investment of these amounts just as if they were still on the job.

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