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Deciding Between a 401(k) Plan and a Roth IRA

If you have limited funds to invest for retirement, you may be wondering whether to fund your 401(k) plan or a Roth individual retirement account (IRA). Before deciding, make sure you understand the basics.

You can contribute up to $17,500 in 2014 and $18,000 in 2015 to a 401(k) plan. If you are age 50 or older and your plan permits, you can make an additional catch-up contribution of $5,500 in 2014 and $6,000 in 2015. Those contributions are deducted from your gross pay, so you don't pay current income taxes on them (you must still pay Social Security and Medicare taxes). Earnings and capital gains grow tax deferred until withdrawn. When funds are withdrawn, you generally pay ordinary income tax rates on the contributions and earnings (a 10% penalty tax may also apply if withdrawals are made before age 59½). Additionally, many employers match some portion of an employee's contribution.

While contributions to a Roth IRA are not tax deductible, earnings on qualified distributions are taken on a tax-free basis. A qualified distribution is one made (a) after age 59½ or for a qualifying first-time home purchase (up to $10,000 lifetime maximum), due to a qualifying disability, or distributed to beneficiaries upon the IRA owner's death; and (b) at least five tax years after your first contribution (regular, rollover, or conversion contribution) to any Roth IRA you hold as the owner. The maximum contribution in 2014 and 2015 is the lesser of $5,500 ($11,000 total for married couples with separately established IRAs) or earned income. Additional catch-up contributions of $1,000 can be made by individuals age 50 and older. Eligibility to make contributions is phased out at modified adjusted gross income levels in 2014 between $114,000 and $129,000 for single taxpayers and $181,000 and $191,000 for married taxpayers filing jointly. Contributions can be made even if you contribute to a 401(k) plan.

So which alternative is better? If your employer matches contributions in your 401(k) plan, you should probably first contribute enough to take advantage of all matching contributions. The matching can substantially

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Borrow Wisely

- ✔ Use debt only for items that have the potential to increase in value, such as a home, college education, or home remodeling. Avoid incurring debt on items like clothing, vacations, or other luxuries.
- ✔ Consider a shorter term when applying for loans. Even though your monthly payment will be higher, you will incur much less interest over the life of the loan.
- ✔ Make as large a down payment as you can afford. If you can make prepayments without incurring a penalty, this can also significantly reduce the interest paid.
- ✔ Consolidate high-interest-rate debts with lower-rate options. It is typically fairly easy to transfer balances from higher-rate to lower-rate credit cards. Another option is to obtain a home-equity loan.
- ✔ Compare loan terms with several lenders, since interest rates can vary significantly. Negotiate with the lender.
- ✔ Review your credit report before applying for a loan. You then have an opportunity to correct any errors on the report. ❍❍❍

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Deciding Between

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boost your retirement savings. After that, you can decide whether to continue contributing to your 401(k) plan or to a Roth IRA. Some items to consider include:

Will you need the funds before age 59½? Funds from a 401(k) plan can only be withdrawn in certain limited circumstances and typically result in the payment of ordinary income taxes and a 10% federal income tax penalty for distributions before age 59½. As an alternative, many plans have loan provisions allowing you to take a loan equal to the lesser of half your account's value or $50,000. With a Roth IRA, you can withdraw your contributions at any time generally with no tax consequences. In addition, after the five-year holding period, earnings can be withdrawn with no tax consequences on or after age 59½ or due to death, disability, or to pay up to $10,000 of first-time home buying expenses. Earnings can also be withdrawn to pay qualified higher-education expenses, paying normal income taxes but no federal income tax penalty. Nonqualified withdrawals of IRA earnings for other purposes are subject to ordinary income taxes and a 10% federal income tax penalty (unless exception to the penalty tax applies).

Are you satisfied with the investment options offered by your 401(k) plan? Contributions to a 401(k) plan must be invested in one of the options offered by the plan. While some plans offer numerous options, others offer only a limited selection. You can generally invest your Roth IRA contributions in a wide variety of investment alternatives.

Will you need the funds for retirement? Generally, withdrawals must start to be made from a 401(k) plan by the later of age 70½ or when you retire. With a Roth IRA, you aren't required to make withdrawals during your lifetime (but after your death, your beneficiaries must take required withdrawals in accordance with federal tax rules). Thus, it can be a good tax-advantaged way to transfer funds to heirs.

Please call if you'd like to discuss this is more detail. ❍❍❍

Muni Bonds: What You Need to Know

Municipal bonds are critical financing tools for state and local government entities. But are they the right place for you to invest?

In addition to the income stream that municipal bonds generate, they are also tax-advantaged. For the vast majority of municipal bonds, interest received is not subject to federal tax. Munis are the only security with that tax benefit (even Treasury securities are typically subject to federal tax). And in most cases, if you live in the state or city issuing the bond, you may be exempt from state and/or city taxes as well.

Do the tax advantages of munis outweigh the often-lower yields they generate? Would it be better to invest in a corporate bond with taxable interest? Here's a quick formula to answer that question:

- ✔ Add your federal, state, and any local income tax rates.
- ✔ Subtract that total from 1.00.
- ✔ Divide the remainder into the municipal bond's current yield (if you're buying it in the secondary market) or coupon (if it's a new issue) to find the taxable equivalent yield.
- ✔ Compare the bond's taxable equivalent yield to the current yield or coupon of the taxable bond you're comparing.

What to Be Aware Of

✔ **Call risk** — When a muni is callable, the issuer has the right to retire a bond before its maturity date. The issuer might do that if the interest rate falls below a certain point (in effect refinancing the muni). Many municipal bonds are callable. If you're looking to hold a bond to maturity, check out the call/redemption provisions listed in the bond's official statement.

✔ **Liquidity risk** — Municipal securities are typically less liquid than Treasuries. While there is a secondary market for munis, it is typically more difficult to sell a municipal bond before its maturity, as most muni investors plan to hold the bond until maturity.

✔ **Credit risk** — As with any bond, municipal bonds return your principal at maturity — but only if the issuer remains solvent. Local government defaults are rare, but they do happen. The city of Detroit, for example, filed for bankruptcy protection in 2013. In 2008, Jefferson County, Alabama, defaulted on payments on $3.8 billion of sewer bonds.

Credit risk can be mitigated in two ways: First, invest in bonds with high credit ratings. All three major credit rating agencies — Standard & Poor's, Moody's, and Fitch — rate municipal bonds. While the scales differ slightly among rating agencies, triple-A is the highest-rated muni bond, determined to be the least risky. C-rated munis are deemed to be relatively high credit risks.

The second way to mitigate the risk of a default is to diversify your municipal bond holdings across regions. While it's generally true that when the national economy is doing well or poorly, state and local economies are, too, there are different patterns in regional business cycles. Take advantage of those by diversifying across regions. ❍❍❍

Pump Up Your Retirement Savings

Don't give up on your retirement goals if you find you've entered middle age with little to no retirement savings. Sure, it may be harder to reach your retirement goals than if you had started in your 20s or 30s, but here are some strategies to consider:

✔ **Reanalyze your retirement goals.** First, thoroughly analyze your situation, calculating how much you need for retirement, what income sources will be available, how much you have saved, and how much you need to save annually to reach you goals. If you can't save that amount, it may be time to change your goals. Consider postponing retirement for a few years so you have more time to accumulate savings as well as delay withdrawals from those savings. Think about working after retirement on at least a part-time basis. Even a modest amount of income after retirement can substantially reduce the amount you need to save for retirement. Look at lowering your expectations, possibly traveling less or moving to a less-expensive city or a smaller home.

✔ **Contribute the maximum to your 401(k) plan.** Your contributions, up to a maximum of $17,500 in 2014 and $18,000 in 2015, are deducted from your current-year gross income. If you are age 50 or older, your plan may allow an additional catch-up contribution of $5,500 in 2014 and $6,000 in 2015. Find out if your employer offers a Roth 401(k) option. Even though you won't get a current-year tax deduction for your contributions, qualified withdrawals can be taken free of income taxes. If your employer matches contributions, you are essentially losing money when you don't contribute enough to receive the maximum matching contribution. Matching contributions can help significantly with your retirement savings. For example, assume your employer matches 50 cents on every dollar you contribute, up to a maximum of 6% of your pay. If you earn $75,000 and contribute 6% of your pay, you would contribute $4,500 and your employer would put in an additional $2,250.

✔ **Look into individual retirement accounts (IRAs).** In 2014 and 2015, you can contribute a maximum of $5,500 to an IRA, plus an additional $1,000 catch-up contribution if you are age 50 or older. Even if you participate in a company-sponsored retirement plan, you can make contributions to an IRA, provided your adjusted gross income does not exceed certain limits. However, the tax deductibility of contributions to a traditional IRA may be be limited.

✔ **Reduce your preretirement expenses.** Typically, you'll want a retirement lifestyle similar to your lifestyle before retirement. Become a big saver now and you enjoy two advantages. First, you save significant sums for your retirement. Second, you're living on much less than you're earning, so you'll need less for retirement. For instance, if you live on 100% of your income, you'll have nothing left to save toward retirement. At retirement, you'll probably need close to 100% of your income to continue your current lifestyle. With savings of 10% of your income, you're living on 90% of your income. At retirement, you'll probably be able to maintain your standard of living with 90% of your current income.

✔ **Move to a smaller home.** As part of your efforts to reduce your preretirement lifestyle, consider selling your home and moving to a smaller one, especially if you have significant equity in your home. If you've lived in your home for at least two of the previous five years, you can exclude $250,000 of gain if you are a single taxpayer and $500,000 of gain if you are married filing jointly (Source: Internal Revenue Service, 2014). At a minimum, this strategy will reduce your living expenses so you can save more. If you have significant equity in your home, you may be able to use some of the proceeds for savings.

✔ **Substantially increase your savings as you approach retirement.** Typically, your last years of employment are your peak earning years. Instead of increasing your lifestyle as your pay increases, save all pay raises. Anytime you pay off a major bill, such as an auto loan or your child's college tuition, take the money that was going toward that bill and put it in your retirement savings.

✔ **Restructure your debt.** Check whether refinancing will reduce your monthly mortgage payment. Find less-costly options for consumer debts, including credit cards with high interest rates. Systematically pay down your debts. And most important — don't incur any new debt. If you can't pay cash for something, don't buy it.

✔ **Stay committed to your goals.** At this age, it's imperative to maintain your commitment to saving. Please call if you'd like help reviewing your retirement savings program. ❍❍❍

Debt and Your Retirement

Most people's vision of retirement not only involves freedom from work but also freedom from debt. A debt-free retirement is a laudable goal, but it's one that has become increasingly difficult for many to achieve: two-thirds of people between the ages of 65 and 74 have some form of debt (Source: University of Michigan Retirement Research Center, September 2013).

The Debt-Free Retirement Goal — When you retire, you stop actively earning income and start living on your savings. If you're still paying off debt, those payments will be another fixed expense. By going into retirement debt free, you'll lower your living expenses.

Reducing Debt before Retirement — If at all possible, you'll want to eliminate your debt before you retire. Of course, some types of debt are worse than others. High-interest credit card debt can be a significant burden, so you'll want to eliminate it as quickly as possible.

Getting debt-free before retirement may mean aligning your mortgage pay-off date with your retirement date. Often, retirees want the peace of mind that comes with knowing they'll own their home when they retire. But that accelerated pay-off plan might not be right for everyone. If you have a relatively low-interest mortgage, no other debt, and are already maxing out your retirement savings, you may feel comfortable sticking with your standard repayment plan.

One thing you shouldn't do: take money out of your retirement accounts to pay off credit card or mortgage debt. If you focus all your financial resources on paying off your loans, you run the risk of retiring with inadequate savings. Another potential misstep: prioritizing debt payoff over saving. While you don't want to be saddled with excessive debt, you also don't want to end up cash poor in retirement.

Debt in Retirement — Unfortunately, many people still end up nearing retirement holding a significant amount of debt. If that's your situation, you have several options. One is to delay retirement for a few years while you concentrate on paying off debt.

If you must enter retirement with debt, you may need to pare down your lifestyle to reduce debt and minimize the risk of outliving your retirement savings. You could also continue to work part-time or as a consultant. That can bring in extra income, and many people enjoy a more gradual transition to full retirement. ❍❍❍

Avoid Cosigning Loans

To keep your credit rating high, avoid cosigning a loan for someone else. This can be difficult to enforce, since the request typically comes from a family member or friend. However, the reason this favor is typically needed is to satisfy a creditor who does not consider the person a good credit risk and wants additional assurance before granting the loan.

When you cosign a loan, you sign a legal document accepting responsibility for the entire debt. If the primary borrower falls behind in payments, the creditor can come to you immediately looking for payment.

Additionally, the primary borrower's late payment history is likely to appear on your credit report. The debt is also listed as your debt on your credit report, which may impair your ability to obtain another loan.

If you are a cosigner on a loan that the primary borrower can't repay, call the creditor immediately and try to negotiate. The creditor may agree to settle for a lesser amount to avoid legal or collection fees. ❍❍❍

Financial Thoughts

Approximately 46% of senior citizens in the United States have less than $10,000 in financial assets at the end of their lifetimes (Source: MetLife, 2014).

Less than 20% of new mothers under the age of 30 have life insurance, compared to 35% of fathers between the ages of 18 and 30 (Source: *InsuranceNewsNet Magazine*, July 2014).

In a recent survey, half of all workers indicated that they guess at their retirement savings needs. Approximately 22% have estimated this goal based on current living expenses, 11% used an Internet calculator, and 5% had the amount calculated by a financial advisor. Only 2 in 3 baby boomers have factored in ongoing living expenses, and half have factored in health care costs. Even fewer have factored in inflation and tax, estate, and long-term care planning. While 62% of baby boomers have a retirement strategy, only 14% have a written plan (Source: Transamerica Center for Retirement Studies, 2014).

The combined federal, state, and local motor fuel (gasoline) taxes paid by the average driver in the United States is 40.89 cents per gallon (Source: American Petroleum Institute, 2014). ❍❍❍