CHAPTER 15
Retirement and Estate Planning

What You’ll Learn

When you have completed this chapter, you will be able to:

Section 15.1
- Explain the importance of retirement planning.
- Identify retirement living costs and housing needs.

Section 15.2
- Describe the role of Social Security in planning for retirement.
- Discuss the benefits offered by employer pension plans.
- Explain various personal retirement plans.

Section 15.3
- Identify various types of wills.
- Discuss several types of trusts.
- Describe common characteristics of estates.
- Identify the types of taxes that affect estates.

Reading Strategies

To get the most out of your reading:

Predict what you will learn in this chapter.
Relate what you read to your own life.
Question what you are reading to be sure you understand.
React to what you have read.
In the **Real** World . . .

Every summer, Shelly Garfield visits her grandparents, who live in a retirement community designed with swimming pools and recreation rooms. Her grandparents decided to move there after Shelly’s grandmother broke her hip. They liked the idea of having a full medical staff on duty. Shelly’s grandparents had saved enough money so they could afford to move there. As the elderly population increases, Social Security, Medicare, and pensions will be stretched, and may not cover many retirees’ total expenses. Shelly is a high school senior, but it is not too early for her to start thinking about retirement. By estimating retirement costs and housing needs now, she can save for retirement on her own terms.

*As You Read*  Consider why it is wise to begin a retirement plan early.

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**Will Power**

*Q:* My parents do not have a lot of money, so is it really that important for them to write up a will?

*A:* Even if your parents do not have a lot of money, they should have a will. If they die without a will, their state of residence will step in and control how their estate is distributed. It costs somewhere between $200 and $350 to have an attorney draft a will. The peace of mind it will provide your parents will be worth the cost.

**Ask Yourself**  If you had to write up a will right now, how would you want your possessions and money distributed?

@  Go to [finance07.glencoe.com](http://finance07.glencoe.com) to complete the Standard & Poor’s Financial Focus activity.
Retirement Planning

Planning for Retirement

What factors should you consider when planning for retirement?

A recent poll from Harris Interactive reported that 95 percent of people ages 55 to 64 years old plan to do at least some work after they have retired. Another survey reported that future retirees expected to continue to learn, try new things, and pursue new hobbies and interests. Someday, when you retire, you too may desire an active life.

Your retirement years may seem a long way off right now. You are still in high school, and after you graduate, you will probably work for many years. However, it is never too early to start planning for retirement. Planning can help you cope with sudden changes that may occur in your life, and it can give you a sense of control over your future. Planning can also help make the retirement years more comfortable.

If you have not done any research on the subject of retirement, you may have some misconceptions about the “golden years.” Here are some myths about retirement:

- You have plenty of time to start saving for retirement.
- Saving a small amount of money will not help.
- You will spend less money when you retire.
- Your retirement will last about 15 years.
- You can depend on Social Security and a company pension plan to pay your basic living expenses.
- Your pension benefits will increase to keep pace with inflation.
- Your employer’s health insurance plan and Medicare will cover all your medical expenses.

Some of these statements may have been true in the past, but they are no longer true today. You may live for many years after you retire. If you want your retirement to be a happy and comfortable time of your life, you will need enough money to suit your lifestyle. That is why you should start planning and saving as early as possible. It is never too late to start saving for retirement, but the sooner you start, the better off you will be.

Suppose that you want to have at least $1 million when you retire at age 65. If you start saving at age 25, you can meet that goal by putting about $127 per month into investment funds that grow at a rate of about 11 percent each year. If you wait to begin saving until age 50, the monthly amount to achieve that goal skyrockets to $2,244.
Setting Long-Range Goals

As you think about your retirement years, consider your long-range goals. What does retirement mean to you? Maybe it will be a time to stop working and to relax. Perhaps you imagine traveling the world, developing a hobby, or starting a second career. Ask yourself: Where do you want to live after you retire? What type of lifestyle would you like to have? Then analyze your current financial situation to determine what you need to do to reach your long-range goals.

Conducting a Financial Analysis

The checklist in Figure 15.1 is an example of how you might analyze your financial assets and liabilities. As you learned in Chapter 3, an asset is any item of value that you own, including cash, property, personal possessions, and investments. This includes cash in checking and savings accounts, a house, a car, a television, and so on. It also includes the current value of any stocks, bonds, other investments, life insurance policies, and pension funds.

Your liabilities are the debts you owe, including the balance on an automobile loan, credit card balances, other loans, and unpaid taxes. If you subtract your liabilities from your assets, you get your net worth. Ideally, your net worth should increase each year.

**Figure 15.1 Assets, Liabilities, and Net Worth**

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash:</td>
<td>Current unpaid bills: $600</td>
</tr>
<tr>
<td>Checking account: $800</td>
<td>Home mortgage: $9,700</td>
</tr>
<tr>
<td>Savings account: $4,500</td>
<td>(remaining balance)</td>
</tr>
<tr>
<td>Investments:</td>
<td>Auto loan: $1,200</td>
</tr>
<tr>
<td>U.S. Savings Bonds: $5,000</td>
<td>Property taxes: $1,100</td>
</tr>
<tr>
<td>Stocks, mutual funds: $4,500</td>
<td>Home improvement loan: $3,700</td>
</tr>
<tr>
<td>Life insurance:</td>
<td>Total liabilities: $16,300</td>
</tr>
<tr>
<td>Cash value, accumulated</td>
<td></td>
</tr>
<tr>
<td>dividends: $10,000</td>
<td></td>
</tr>
<tr>
<td>Company pension rights:</td>
<td></td>
</tr>
<tr>
<td>Accrued pension benefit: $20,000</td>
<td></td>
</tr>
<tr>
<td>Property:</td>
<td></td>
</tr>
<tr>
<td>House (resale value): $50,000</td>
<td></td>
</tr>
<tr>
<td>Furniture and appliances: $8,000</td>
<td></td>
</tr>
<tr>
<td>Collections and jewelry: $2,000</td>
<td></td>
</tr>
<tr>
<td>Automobile: $3,000</td>
<td></td>
</tr>
<tr>
<td>Other:</td>
<td></td>
</tr>
<tr>
<td>Loan to brother: $1,000</td>
<td></td>
</tr>
<tr>
<td>Gross assets: $108,800</td>
<td></td>
</tr>
</tbody>
</table>

Net worth:

\[ \text{Assets} - \text{Liabilities} = \text{Net Worth} \]

\[ \text{Net Worth} = \text{Assets} - \text{Liabilities} = \$108,800 - \$16,300 = \$92,500 \]

**Calculating Net Worth**

Assets are everything that you own, while liabilities are everything you owe. How can you determine your net worth?
Reviewing Assets

Review your assets on a regular basis. You may need to make adjustments in your saving, spending, and investments to stay on track with your goal. As you review your assets, consider the following factors: housing, life insurance, savings, and investments. Each asset will have an important effect on your retirement income.

**Housing** A house can be your most valuable asset. However, if you buy a home with large mortgage payments, you may be unable to save money for retirement. In that case, you might consider buying a smaller, less expensive place to live. A smaller house is usually easier and less expensive to maintain. You can use the money you save by having lower payments to increase your retirement fund.

**Life Insurance** At some point in the future, you might buy life insurance to provide for your loved ones. If you have children, life insurance can provide financial support in case you die while they are still young. As you near retirement, though, your children will probably be self-sufficient. When that time comes, you might reduce your premium payments by decreasing your life insurance coverage. This would give you extra money for living expenses or investments.

▲ **LIVING THE GOOD LIFE** When you retire you may not be able to afford to take lavish vacations or buy many expensive items. What are some of the decisions you will have to make now to ensure a comfortable retirement?

**As You Read**

**QUESTION**

Does planning for your retirement alter today’s investment strategies?
**Other Investments**  When you review your assets, also evaluate any other investments you have. When you originally chose those investments, you may have been more interested in making your money grow over time than in getting a quick return. When you are ready to retire, you may want to use the income from those investments to cover living expenses.

**Retirement Living Expenses**

What living expenses should you consider when planning for retirement?

When planning for retirement, estimate how much money you will need to live comfortably during your retirement years. You cannot predict exactly how much money you will need, but you can estimate the expense of your basic needs. To do this, think about how your spending patterns and living situation might change.

For example, when you are retired, you may spend more money on recreation, health insurance, and medical care than you will as a young adult. At the same time, you may spend less money on transportation and clothing. Your federal income taxes may be lower as well. Also, some income from various retirement plans may be taxed at a lower rate or not at all. Figure 15.2 provides an example of retirement expenses.

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**Figure 15.2** Expenses for Older Households (65+ years)

- Food—15.4%
- Transportation—16.3%
- Housing—32.5%
- Medical care—11.3%
- Clothing and personal care—6.2%
- Contributions—5.7%
- Reading, education, and entertainment—4.9%
- Personal insurance and pensions—3.9%
- Other—3.8%

*Source: U.S. Bureau of Labor Statistics*

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**Spending More or Less?**

The amount of money you spend during retirement will vary, depending on many different factors.

Calculate how much money an older household with an annual income of $16,000 spends on food each year.
Remember to take inflation into account. Estimate high when calculating how much the prices of goods and services will rise by the time you retire. (See Figure 15.3.) Even a 3 percent rate of inflation will cause prices to double every 24 years. Also, plan for emergencies as you consider future retirement living expenses.

**Retirement Housing**

*What factors should you consider regarding housing needs during retirement?*

The place where you live can have a significant impact on your financial needs. In the years before retirement, use vacations to explore areas and cities where you might want to settle. If you find a place you like, go there at different times of the year. That way, you will be able to experience the climate and environment. Meet people who live in the area and learn about activities, transportation, and taxes.

**Retirement Relocation Pitfalls**

Consider the downside of moving to a new location. People sometimes find themselves stuck in a place they really do not like. Some retirees find they miss their children, grandchildren, and friends and relatives left behind. Other retired people move to the location of their dreams and discover they have made a mistake financially.
Researching Locations Here are some tips from specialists on how to research taxes and other costs before moving to a new area:

- Contact the local chamber of commerce for details on area property taxes and the local economy.
- Contact the state tax department to research income, sales, inheritance taxes, and exemptions for retirees.
- Read the Sunday edition of the local newspaper of the town or city you are considering.
- Check with local utility companies to estimate energy costs.
- Visit the area in different seasons and talk to local residents about the cost of living there.
- If you plan to buy a home, take time and rent a home first.

Types of Housing

Even if you do not move to a new location, housing needs may change during retirement. Many retirees want a home that is easy and inexpensive to maintain, such as a smaller house, a condominium, or an apartment. Having access to public transportation, stores, and recreation areas is also important. Figure 15.4 presents several housing options.

Careers in Finance

Paul Francisco
Choate, Hall & Stewart

Paul has very strong organizational and communication skills, which are essential in his work as an estate administrator. Under the direction of the attorney responsible for estate administration, Paul handles all phases of estate execution. He determines and informs the parties of procedural and tax deadlines and ensures compliance with the deadlines. He also calculates debts, expenses, taxes, and cash needs. In his role as an estate administrator, Paul may need to develop and implement steps to uncover and reconcile conflicts between beneficiaries or family members.

SKILLS: Writing, communication, organizational, problem-solving, analytical, and multitasking skills

PERSONAL TRAITS: Discreet, good judgment, likes working with people and numbers, tactful, and quick thinking

EDUCATION: High school diploma or equivalent; bachelor’s degree in finance or related field or equivalent work experience

ANALYZE How might planning for retirement affect your will?

To learn more about career paths for estate administrators, visit finance07.glencoe.com.
Protecting Your Finances

For retired people with disabilities, a universal design home built with special features, such as extra-wide doors, lower appliances, and automatic faucets, can be both appealing and practical. These homes help people with disabilities to maintain their independence.

Housing options for retirement are based on personal, financial, and medical factors. The goal of most retirees is to have comfortable and affordable housing that meets their particular needs.

Most retired people decide to remain where they are and continue living in their own homes.

Living with grown children and young grandchildren can be a choice for some elderly retired people and their families.
A great majority of people prefer to grow old in their own homes in their own communities. Recognizing this trend, building suppliers offer everything from lever door handles to faucets that turn on automatically when you put your hand beneath the spout. Remodeling to accommodate aging homeowners is creating a demand for these products. In addition, contractors are building universal design homes from scratch that can accommodate people who use wheelchairs and walkers or those who simply want more convenience.

Many elderly people move into assisted-living facilities during their retirement years. An assisted-living facility (ALF) is a residence complex that provides personal and medical services for the elderly. Assisted-living facilities offer everything from minimal services to full, continuous nursing care. They may vary greatly in quality, but ALFs are increasingly popular with elderly retirees, some of whom are no longer able to live alone and care for themselves.

Section 15.1 Assessment

QUICK CHECK
1. What are several reasons that early retirement planning is important?
2. What factors should you consider when estimating your retirement living expenses?
3. What are some features and benefits of an assisted-living facility?

THINK CRITICALLY
4. Imagine that you are 20 years away from retirement and you are thinking of spending a large portion of your income to purchase an expensive home. Discuss the advantages and disadvantages of this plan.

USE COMMUNICATION SKILLS
5. Free at Last! Enrique and his wife, Maribel, have both been working at the same company for almost 35 years and are nearing retirement. They have been looking forward to the time when they will be free to do almost anything they want. They already have a long list of places they would like to visit, things they would like to do, and ways they would like to spend their time after they retire.

Present Imagine the type of life you would like to have when you retire. Combine pictures and words to create a collage that expresses your thoughts and feelings about your retirement dreams.

SOLVE MONEY PROBLEMS
6. Changing Lifestyles Jeff and Maureen McBride have been retired for a couple of years. Although their income is lower than when they were working, they continue to live as they did before retirement. They have a three-bedroom house in New Jersey. Twice a year, they travel to California to visit their children and grandchildren. Unfortunately, they now find themselves in a financial pinch. They need to cut back on their expenses and have a plan to live more economically without giving up many of the activities they enjoy.

Analyze Help Jeff and Maureen by discussing various options they might have for saving money.
Planning Retirement Income

**Public Pension Plans**

**Who receives benefits under Social Security?**

You learned in Chapter 2 that a pension plan is a retirement plan that is funded, at least in part, by an employer. Public pension plans are established by states and municipalities. Social Security is a public pension plan established by the United States government in 1935. The government agency that manages the program is called the Social Security Administration.

**Social Security**

Social Security is an important source of retirement income for many Americans. The program covers 97 percent of all workers, and almost one out of every six Americans currently collects some form of Social Security benefit. Social Security is a package of protection that provides benefits to retirees, survivors, and disabled persons. You should not rely on Social Security to cover all of your retirement expenses. Social Security was not designed to provide 100 percent of retirement income. In addition, current and future revisions to the program may reduce retirement benefits in years to come.

**Who Is Eligible**

The amount of Social Security retirement benefits you receive is based on your earnings over the years. The more you earn, the greater your benefits will be, up to a maximum amount.

Each year the Social Security Administration will send you a history of your earnings and an estimate of your future monthly benefits. The statement includes an estimate, in today’s dollars, of how much you would get each month if you retired at different ages. For example, your statement might list benefits for retirement at age 62, 67, and 70, based on the year you were born, your earnings to date, and your projected future earnings.

To qualify for retirement benefits, you must earn a certain number of credits. These credits are based on the length of time you work and pay Social Security tax, or contributions, on your earnings. Your credits are calculated on a quarterly basis. The number of quarters needed to qualify depends on your year of birth. For example, people born after 1928 need at least 40 quarters to qualify for benefits.

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**Read to Learn**
- How to describe the role of Social Security in planning for retirement.
- How to discuss the benefits offered by employer pension plans.
- How to explain various personal retirement plans.

**Main Idea**
Various types of retirement plans are suited to different financial situations and personal needs.

**Key Terms**
- defined-contribution plan
- 401(k) plan
- vesting
- defined-benefit plan
- individual retirement account (IRA)
- Keogh plan
- annuity (insurance)
- heirs
Dependent Eligibility  Certain dependents of a worker may also receive benefits under the Social Security program. They include a spouse age 62 or older; unmarried children under 18 (or under 19 if they are full-time students no higher than grade 12); and unmarried individuals with disabilities aged 18 or older. Widows and widowers can receive Social Security benefits before age 62.

Social Security Retirement Benefits  Most people can begin collecting Social Security retirement benefits at age 62. However, the monthly amount at age 62 is less than it would be if the person waited until full retirement age. This initial amount becomes the permanent base amount.

In the past people could receive full retirement benefits at age 65. However, the full retirement age is being increased in gradual steps. For people born in 1960 and later, the full retirement age is 67. If you postpone applying for benefits when you are eligible, your monthly payment amount will increase slightly for each year you wait, but only up to age 70.

Social Security Information  For more information about Social Security, you can visit the Social Security Web site. It provides access to forms and publications and gives links to other valuable information. To learn more about the taxability of Social Security benefits, contact the Internal Revenue Service (IRS) and ask for Publication 554, Older Americans’ Tax Guide, and Publication 915, Social Security and Equivalent Railroad Retirement Benefits. These publications can also be found on the IRS Web site.

As You Read

If you currently hold a job, look at a recent paycheck stub. Are you paying into Social Security?
Other Public Pension Plans

Besides Social Security, the federal government provides other special retirement plans for federal government workers and railroad employees. These employees are not covered by Social Security. The Veterans Administration provides pensions for survivors of people who died while serving in the armed forces. It also offers disability pensions for eligible veterans. In addition, many state and local governments provide retirement plans for their employees.

Employer Pension Plans

What is one of the benefits of having an employer pension plan?

Another possible source of retirement income is an employer pension plan offered by the company for which you work. With this type of plan, your employer contributes to your retirement benefits, and sometimes you contribute, too. These contributions and their earnings remain tax-deferred until you withdraw them during retirement.

Private employer pension plans vary. If the company you work for offers one, find out what benefits you will receive and when you will become eligible to receive those benefits. Most employer plans are one of two basic types: defined-contribution plans or defined-benefit plans.

Defined-Contribution Plan

A defined-contribution plan, sometimes called an individual account plan, is an individual account for each employee. The employer contributes a specific amount to the account annually. This type of retirement plan does not guarantee any particular benefit. When you retire and become eligible for benefits, you receive the total amount of funds (including investment earnings) that is in your account. Several types of defined-contribution plans exist.

Money-Purchase Plans With a money-purchase plan, your employer promises to set aside a certain amount of money for you each year. That amount may be a percentage of your earnings.

Stock Bonus Plans Under a stock bonus plan, your employer’s contribution is used to buy stock in the company for you. The stock is held in trust until you retire. Then you can keep your shares or sell them.

Profit-Sharing Plans Under a profit-sharing plan, your employer’s contribution depends on the company’s profits each year.

401(k) Plans A 401(k) plan, or salary-reduction plan, is a type of retirement savings plan funded by a portion of your salary that is deducted from your gross paycheck and placed in a special account. Many employers match their employees’ 401(k) contributions up to a specific dollar amount or percentage of salary.

TechByte

Calculate Your Benefits It is never too early to start thinking about how you will fund your retirement. One source of retirement income will probably be your Social Security benefits. The Social Security administration will help you calculate how much your Social Security benefits will be. A good way to start planning for your retirement is to make some reasonable guesses about what your yearly earnings will be when you are in your mid-20s.

Use the Social Security Administration’s special calculator to plug in your best guesses and see how much you could receive upon your retirement through finance07.glencoe.com.
The funds in 401(k) plans can be invested in stocks, bonds, and mutual funds. As a result, you can accumulate a significant amount of money in this type of account if you begin contributing to it early in your career. In addition, the money that accumulates in your 401(k) plan is tax-deferred, which means that you do not have to pay taxes on it until you withdraw it.

403(b) Plans If you are employed by a tax-exempt institution, such as a hospital or a nonprofit organization, the salary-reduction plan is called a Section 403(b) plan. The funds in this plan are also tax-deferred. The 401(k) and 403(b) plans are known as tax-sheltered annuity (TSA) plans. The amount that can be contributed each year to 401(k) and 403(b) plans is limited by law, as is the amount of contributions to other types of defined-contribution plans.

Vesting Employee contributions to a pension plan belong to you, the employee, regardless of the amount of time that you are with a particular employer. But what happens to the contributions that the employer has made to your account if you change jobs and move to another company? One of the most important aspects of these plans is vesting. **Vesting** is the right of an employee to keep the company’s contributions from company-sponsored plans, such as pensions, even if the employee no longer works for that employer. Vesting occurs at different points in time, depending on company policy. After a certain number of years with a company, you become fully vested, or entitled to receive 100 percent of the company’s contributions to the plan on your behalf. Under some plans, vesting may occur in stages. For example, you might become eligible to receive 20 percent of your benefits after three years and gain another 20 percent each year until you are fully vested.

**Defined-Benefit Plan**

A defined-benefit plan is a retirement plan that specifies the benefits an employee will receive at retirement age, based on total earnings and years on the job. The plan does not specify how much the employer must contribute each year. Instead, your employer’s contributions are based on how much money the fund will need for each participant in the plan who retires. If the fund is inadequate, the employer will have to make additional contributions.

**Moving to Another Plan**

Some pension plans allow “portability,” which means that you can carry earned benefits from one pension plan to another when you change jobs. Workers are also protected by the Employee Retirement Income Security Act of 1974 (ERISA), which sets minimum standards for pension plans. Under this act, the federal government insures part of the payments promised by defined-benefit plans.
Personal Retirement Plans

What is the biggest benefit of an IRA?

In addition to public and employer retirement plans, many people choose to set up personal retirement plans. Such plans are especially important to self-employed people and other workers who are not covered by employer pension plans. Among the most popular personal retirement plans are individual retirement accounts (IRAs) and Keogh accounts.

Individual Retirement Accounts

An individual retirement account (IRA) is a special account in which a person saves a portion of income for retirement. Figure 15.5 on page 492 summarizes the various types of IRAs.

Regular IRA  A regular IRA, which is a traditional or classic IRA, allows you to make annual contributions until age 70½. In the year 2004, you could contribute up to $3,000 per year. From 2005 to 2007, the limit was set at $4,000. From 2008 and on, you can contribute up to $5,000 per year. Depending on your tax filing status and income, the contribution may be fully or partially tax-deductible. The tax deductibility of a traditional IRA also depends on whether you belong to an employer-provided retirement plan.

Roth IRA  Annual contributions to a Roth IRA are not tax-deductible, but the earnings are tax-free. You may contribute the same amounts as allowed for a regular IRA if you are a single taxpayer with an adjusted gross income (AGI) of less than $95,000. For married couples, the combined AGI must be less than $150,000.

You can continue to make annual contributions to a Roth IRA even after age 70½. If you have a Roth IRA, you can withdraw money from the account without paying taxes or penalties after five years if you are at least 59½ years old or if you are using the money to help buy your first home. You may convert a regular IRA to a Roth IRA. Depending on your situation, one type of account may be better for you than the other.

Simplified Employee Pension (SEP) Plan  A Simplified Employee Pension (SEP) plan, also known as a SEP-IRA, is an individual retirement account that is ideal for small businesses or for self-employed individuals. For a small-business SEP-IRA, each employee sets up an IRA account at a bank or other financial institution. Then the employer makes an annual contribution up to a maximum set by law. The employees’ contributions, which can vary from year to year, are fully tax-deductible, and earnings are tax-deferred. The SEP-IRA for a self-employed individual works much the same way. An individual could contribute up to $42,000 a year in 2005. The limits increase yearly until 2010.
Spousal IRA  You can make contributions to a Spousal IRA on behalf of your nonworking spouse if you file a joint tax return. The contributions are the same as for the traditional and Roth IRAs. This contribution may be fully or partially tax-deductible.

Rollover IRA  A rollover IRA is a traditional IRA that allows roll over, or transfer of, all or a portion of your taxable distribution from one retirement plan to another IRA without paying taxes on it.

Standard and Poor’s publishes the globally recognized S&P 500® financial index. It also gathers financial statistics, information, and news, and analyzes this data for international businesses, governments, and individuals to help them guide their financial decisions.

**MEXICO**

According to the U.S. Embassy, a growing number of American citizens are finding Mexico an attractive place to spend their golden years. Americans are drawn to Mexico’s warm climate, easygoing lifestyle, and lower cost of living. Since the average Social Security benefit is only about $1,000 a month, many retirees cannot afford to stay in the United States. In Mexico, however, they can live comfortably. San Miguel is a favorite place for many of the older generation. The city is designated as a national monument and offers culture, fine restaurants, and an easy drive to the warm waters of the Gulf of Mexico.
An Education IRA, also known as a Coverdell Education Savings Account, is a special IRA with certain restrictions. It allows individuals to contribute up to $2,000 per year toward the education of any individual under age 18. The contributions are not tax-deductible, but they do provide tax-free distributions for education expenses.

Even if you are covered by another type of pension plan, you can make IRA contributions that are not tax-deductible. All of the income your IRA earns will compound, tax-deferred, until you begin making withdrawals. Remember, the biggest benefit of an IRA lies in its tax-deferred earnings growth. (See Figure 15.6.)
IRA Withdrawals When you retire, you can withdraw the money from your IRA by one of several methods. You can take out all of the money at one time, but the entire amount will be taxed as income. If you decide to withdraw the money from your IRA in installments, you will have to pay tax only on the amount that you withdraw. You might also place the money that you withdraw in an annuity that guarantees payments over your lifetime. See the discussion on annuities later in this section for further information about this option.

Keogh Plans

A Keogh plan, which is also an H.R.10 plan or a self-employed retirement plan, is a retirement plan specially designed for self-employed people and their employees. Keogh plans have various restrictions, including limits on the amount of annual tax-deductible contributions you can make. You should get professional tax advice before using this type of personal retirement plan.

Limits on Retirement Plans

When must you begin to withdraw your money?

With the exception of Roth IRAs, you cannot keep money in most tax-deferred retirement plans forever. When you retire, or by age 70½ at the latest, you must begin to receive “minimum lifetime distributions.” These are withdrawals from the funds you have accumulated through your plan. The amount of the distributions, or withdrawals, is based on your life expectancy at the time the distributions begin. If you do not withdraw the minimum distributions from a retirement account, the IRS will charge you a penalty.

![Figure 15.6](image)

**Benefits of Starting a Retirement Plan Early**

<table>
<thead>
<tr>
<th>Age</th>
<th>Contributions</th>
<th>Net earnings* (excluding contributions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>Saver A $2,000/year for 9 years</td>
<td>$525,344</td>
</tr>
<tr>
<td>35</td>
<td>no contributions</td>
<td>$290,427</td>
</tr>
<tr>
<td>45</td>
<td>no contributions</td>
<td>$290,427</td>
</tr>
<tr>
<td>55</td>
<td>Saver B $2,000/year for 30 years</td>
<td>$290,427</td>
</tr>
<tr>
<td>65</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Assumes 9 percent fixed rate of return, compounded monthly, with no change in the principle.

**Start Early**

If you start investing in them early, tax-deferred investments, such as IRAs, can grow considerably by the time you retire.

**In this figure, which person contributed more money to the retirement plan? Which one earned more by age 65? Why?**
Learn to identify and understand the standard financial documents you will use in the real world.

**Investigate: A Projected Retirement Budget Worksheet**

A projected retirement budget worksheet contains the following information:
- Your current annual income and projected income
- Your current annual expenses and projected expenses

**Your Motive:** The best time to plan for your retirement is when you are young. You will need to save money each month during your working career to provide you with enough money to live on when you stop working.

### Projected Retirement Budget Worksheet — Robert & Emily Rathcliff

<table>
<thead>
<tr>
<th>Annual Income</th>
<th>Annual Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current</strong></td>
<td><strong>Retirement</strong></td>
</tr>
<tr>
<td>Wages</td>
<td>$85,000</td>
</tr>
<tr>
<td>Pension</td>
<td>0</td>
</tr>
<tr>
<td>Social Security</td>
<td>0</td>
</tr>
<tr>
<td>Rental income</td>
<td>0</td>
</tr>
<tr>
<td>IRAs</td>
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<tr>
<td>Annuities</td>
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<tr>
<td>Bond interest</td>
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<tr>
<td>Stock dividends</td>
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<tr>
<td>Mutual fund dividends</td>
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<tr>
<td>Money market interest</td>
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<tr>
<td><strong>Total Income</strong></td>
<td><strong>$85,250</strong></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Current</strong></th>
<th><strong>Retirement</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage/rent</td>
<td>$27,600</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>4,700</td>
</tr>
<tr>
<td>Homeowner's insurance</td>
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<tr>
<td>Income and Social Security taxes</td>
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<tr>
<td>Contributions to savings</td>
<td>5,000</td>
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<tr>
<td>Utilities</td>
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<tr>
<td>Food</td>
<td>1,000</td>
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<tr>
<td>Medical expenses insurance</td>
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<tr>
<td>Life insurance</td>
<td>850</td>
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<td>Vehicle payments</td>
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<td>Vehicle insurance</td>
<td>1,400</td>
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<tr>
<td>Vehicle maintenance and gasoline</td>
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</tr>
<tr>
<td>Charitable contributions</td>
<td>1,000</td>
</tr>
<tr>
<td>Gifts</td>
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</tr>
<tr>
<td>Travel/entertainment</td>
<td>15,000</td>
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<tr>
<td>Loans/credit cards</td>
<td>1,200</td>
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<tr>
<td>Other</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td><strong>$44,700</strong></td>
</tr>
</tbody>
</table>

**Total Income Minus Expenses** | $50 \$6,010

**Key Points:** A Projected Retirement Budget Worksheet helps you calculate the difference between your projected retirement income and your projected expenses. This worksheet will help you determine how much money you will need to save for retirement years.

**Find the Solutions**

1. What are the current annual expenses?
2. Why would they not list a mortgage or rent payment as an expense in retirement?
3. Why might food and vehicle expenses go down when they retire?
4. Why might the Rathcliffs not have a life insurance expense in retirement?
5. Do they have enough projected income?
Annuities

Why do people purchase annuities in addition to other retirement plans?

What do you do if you have funded your 401(k), 403(b), Keogh, or profit-sharing plans up to the allowable limits and you want to put away more money for retirement? The answer may be an annuity. An annuity is a contract purchased from an insurance company that guarantees a future fixed or variable payment to the purchaser for a certain number of years or for life.

You might also want to purchase an annuity with the money you receive from an IRA or company pension. You can buy an annuity to supplement the income you will receive from these other types of retirement plans. You can choose to purchase an annuity that has a single payment or installment payments. You will also need to decide whether you want the insurance company to send the income from your annuity to you immediately or begin sending it to you at a later date. The payments you receive from an annuity are taxed as ordinary income. However, the interest you earn from the annuity accumulates tax-free until payments begin.

GOLDEN TIME With continuing revisions in the Social Security system, many people are thinking ahead and making arrangements for supplemental income in their golden years. What advantage does an annuity offer?
Types of Annuities

Annuities may be fixed or variable. Fixed annuities provide a certain amount of income for life. Variable annuities provide payments guaranteed above a minimum amount, depending on the rate of return on your investment. Either way, the rate of return on an annuity is usually tied to overall interest rates.

Immediate Annuities  People approaching retirement age can purchase immediate annuities. These annuities provide income payments at once. They are usually purchased with a lump-sum payment. When you are 65, you may no longer need all of your life insurance coverage—especially if you have grown children. You may decide to convert the cash value of your insurance policy into a lump-sum payment for an immediate annuity.

Deferred Annuities  With deferred annuities, income payments start at some future date. Meanwhile, interest accumulates on the money you deposit. Younger people often buy such annuities to save money toward retirement. A deferred annuity purchased with a lump-sum payment is known as a single-premium deferred annuity. A “premium” is the payment you make. These annuities are popular because of the greater potential for tax-free growth. If you are buying a deferred annuity on an installment basis, you may want one that allows flexible premiums, or payments. That means that your contributions can vary from year to year.

Costs of Annuities

There are various choices regarding the type of annuity and the annuity income it will generate. The costs, fees, and other features of annuities differ from policy to policy, so you should discuss all of the possible options with an insurance agent. Ask about charges, fees, and interest-rate guarantees. Also, be sure to check the financial health of the insurance company that offers the annuity.

Living on Retirement Income

What are some things you can do to stretch retirement income farther?

As you plan for retirement, you will estimate a budget or spending plan. When the time to retire arrives, however, you may find that your expenses are higher than you had expected. If that is the case, you will have to make some adjustments.

First, make sure that you are getting all the income to which you are entitled. Are there other programs or benefits for which you might qualify? You will also need to think about any assets or valuables you might be able to convert to cash or into other sources of income.
In addition, retirees can re-examine the trade-off between spending and saving. For example, instead of taking an expensive vacation, they can take advantage of free and low-cost recreation opportunities, such as public parks, museums, libraries, and fairs, which are enjoyable options. Retirees can also receive special discounts at movie theaters, restaurants, stores, and more.

**Working During Retirement**

Retirees can use their skills and time instead of spending money. Some people decide to work part-time after they retire. Some even take new full-time jobs. Many people prefer to keep active and pursue new careers. Work can provide a person with a greater sense of usefulness, involvement, and self-worth. It is also a good source of supplementary retirement income.

▲ RETIREMENT INCOME The income needed during retirement can come from various sources. *What are some possible sources of income you might find?*
Using Your Nest Egg

When should you take money out of your “nest egg,” or savings, during retirement? The answer depends on your financial circumstances, your age, and how much you want to leave to your heirs. Your heirs are the people who will have the legal right to your assets when you die. Your savings may be large enough to allow you to live comfortably on just the interest earned by your savings. On the other hand, you may need to make regular withdrawals to help finance your retirement. However, do so with caution.

If you dip into your retirement funds, you should consider: how long your savings will last if you make regular withdrawals? For example, if you have $10,000 in savings that earns 5.5 percent interest, compounded quarterly, you could take out $68 every month for 20 years before reducing those savings to zero. Whatever your situation, you should try to conserve your retirement fund to make it last.

Section 15.2 Assessment

QUICK CHECK
1. What are the eligibility requirements to receive Social Security retirement benefits?
2. What is the difference between defined-contribution plans and defined-benefit plans?
3. What is the difference between regular IRAs and Roth IRAs?

THINK CRITICALLY
4. Describe the trade-offs that you would need to consider if you reached retirement age and realized that your expenses were higher than you could afford.

USE MATH SKILLS
5. Growing a Nest Egg When Jamal graduated from college recently, his parents gave him $1,000 and told him to use it wisely. Jamal decided to use the money to start a retirement account. After doing some research about different options, he put the entire amount into a tax-deferred IRA that pays 11 percent interest, compounded annually.

Calculate How much money will Jamal have in his IRA at the end of ten years, assuming that the interest rate remains the same and that he does not deposit any additional money? Show your calculations in the form of a chart.

SOLVE MONEY PROBLEMS
6. Making Decisions Mike Johnson has worked for the same company for 45 years. Now, at age 67, he is about to retire. When he does, he will be entitled to receive the $600,000 that has accumulated in his 401(k) plan. Now Mike has to decide what to do with the money. If he manages it wisely, it can help make his retirement years comfortable and rewarding.

Analyze Use what you have learned in this section to help Mike decide what to do with his 401(k) funds. Consider the options available to him, such as rollover IRAs and annuities. Explain why your recommendation would make the best use of Mike’s money.
The Importance of Estate Planning

Why is it important to have an estate plan?

Many people think of estates as belonging only to the rich or elderly. However, the fact is that everyone has an estate. An estate is all property and assets owned by an individual or group. During your working years, your financial goal is to build your estate by acquiring and accumulating money for your current and future needs. However, as you grow older, your point of view will change. Instead of working to acquire assets, you will start to think about what will happen to your hard-earned wealth after you die. In most cases, people want to pass that wealth along to their loved ones. That is why estate planning becomes important.

What Is Estate Planning?

Estate planning is the process of creating a detailed plan for managing personal assets to make the most of them while you are alive and to ensure that they are distributed wisely after your death. It is not pleasant to think about your own death, but doing so is a necessary part of estate planning. Without a good estate plan, the assets you accumulate during your lifetime might be greatly reduced by various taxes when you die.

Estate planning is an essential part of retirement planning and financial planning. It has two stages. The first stage involves building your estate through savings, investments, and insurance. The second stage consists of making sure that your estate will be distributed as you wish at the time of your death. If you get married, your estate planning should take into account the needs of your spouse and children, if you have any. If you are single, your financial affairs should be in order for your beneficiaries. A beneficiary (estate) is a person who is named to receive a portion of someone’s estate.

When you die, your surviving spouse, children, relatives, and/or friends will face a period of grief. One or more of these people will probably be responsible for settling your affairs. This will be a difficult time, and so your estate plan should be clear and well-organized.

Focus on Reading

Read to Learn
- How to identify various types of wills.
- How to discuss several types of trusts.
- How to describe common characteristics of estates.
- How to identify the types of taxes that affect estates.

Main Idea
Different types of wills and trusts protect your financial interests and those of your family. Applying strategies for paying estate taxes can help limit expenses for your heirs.

Key Terms
- estate
- estate planning
- beneficiary (estate)
- will
- intestate
- trust
- probate
- executor
- guardian
- codicil
- living will
- power of attorney

Before You Read
What is your definition of a will?
Otherwise, the people you have left behind may encounter problems settling your estate, and your intentions may not be carried out according to your wishes. One way to avoid these problems is to make sure that important documents are accessible, understandable, and legal.

**Legal Documents**

An estate plan involves various legal documents such as a will, which is a legal declaration of a person’s wishes regarding disposal of his or her estate after death. When you die, the person who is responsible for handling your affairs will need access to your will and other important documents. The documents must be reviewed and verified before your heirs can receive the money and other assets to which they are entitled. If no one can find the necessary documents, your heirs may experience difficult delays. They could even lose a portion of their inheritance as a result.

You should collect and organize various important papers:

- Birth certificates for you, your spouse, and your children
- Marriage certificates and divorce papers
- Legal name changes (especially important for protecting adopted children)
- Military service records
- Social Security documents
- Veteran’s documents
- Insurance policies
- Transfer records of joint bank accounts
- Safe-deposit box records
- Automobile registrations
- Titles to stock and bond certificates

Have several copies of the documents needed for processing insurance claims and settling your estate. In some cases, children whose parents have died may need to have documents proving their parents’ births and marriage and/or divorce. Surviving spouses, children, and other heirs may also be required to show proof of death in the form of a death certificate.
Wills

Why is a will such an important document?

One of the most important documents that every adult should have is a written will. If you die **intestate**—which is the status of not having a valid will—your legal state of residence will step in and control the distribution of your estate without regard for your wishes. Make sure that you have a written will. An attorney with estate planning experience can draft a will, which can help your heirs avoid many difficulties. Legal fees for drafting a will vary with the size of an estate and particular family situation. A standard will costs between $200 and $500.

Types of Wills

You have several options in preparing a will. The four basic types of wills are the simple will, the traditional marital share will, the exemption trust will, and the stated dollar amount will. The differences among the types of wills can affect how your estate will be taxed.

All types of wills usually designate a beneficiary, the person who is named to receive a portion or all of an estate after your death. A beneficiary can be a spouse, relative, friend, or organization. In the following discussions, the beneficiary will be referred to as the **spouse**.

**Simple Will**  A simple will leaves everything to the spouse. Such a will is generally sufficient for people with small estates. However, for a large or complex estate, a simple will may not meet objectives. This type of will may also result in higher overall taxation, since everything left to the spouse will be taxed as part of his or her estate.

**Traditional Marital Share Will**  The traditional marital share will leaves one-half of the adjusted gross estate (the total value of the estate minus debts and costs) to the spouse. The other half of the estate may go to children or other heirs. It can also be held in trust for the family. A **trust** is an arrangement in which a designated person known as a **trustee** manages assets for the benefit of someone else. A trust can provide a spouse with a lifelong income and would not be taxed at his or her death.

**Exemption Trust Will**  With an exemption trust will, all assets go to the spouse except for a certain amount, which goes into a trust. This amount, plus any interest it earns, can provide the spouse with lifelong income that will not be taxed. In 2004 and 2005, the tax exemption amount was $1.5 million. That amount increased to $2 million for the years 2006 through 2008. In 2009, the amount increases to $3.5 million. The tax-free aspect of this type of will may become important if property values increase considerably. This type of will is beneficial for large estates.
Stated Dollar Amount Will  The stated dollar amount will allows you to pass on to your spouse any amount that satisfies your family’s financial goals. For tax purposes, you could pass on the exempted amount of $1.5 million (in 2004 and 2005). However, you might decide to pass on a stated amount related to your family’s future income needs or related to the value of personal items.

State law may dictate how much you must leave to your spouse. Most states require that the spouse receive a certain amount, usually one-half or one-third of the value of an estate. States also have laws regarding when and how portions of an estate must pass to beneficiaries.

The stated dollar amount will has one major drawback. Suppose that you leave specific dollar amounts to your listed heirs and the balance to your spouse. Although these amounts may be fair and reasonable when the will is drafted, they can soon become outdated. What if the value of the estate decreases because of a business problem or a drop in the stock market? That decrease will not affect heirs who are left specific dollar amounts, but it will affect the value of your spouse’s inheritance. For this reason, most experts recommend using percentages rather than specific amounts.

▲ PEACE OF MIND  Preparing a will can make things easier for your family and can ensure that your estate is distributed according to your wishes. What would happen if an adult were to die without preparing a will?
Wills and Probate

The type of will that is best for your particular needs depends on many factors, including the size of your estate, inflation, your age, and your objectives. No matter what type of will you choose, it is best to avoid probate. Probate is the legal procedure of proving that a will is valid or invalid. It is also the process by which your estate is managed and distributed after your death, according to the provisions of your will. A special probate court validates wills and makes sure that your debts are paid. You should avoid probate because it is expensive, lengthy, and public. As you will read later in this chapter, a living trust avoids probate and is also less expensive, quicker, and private.

Formats of Wills

Wills may be either holographic or formal. A holographic will is a handwritten will that you prepare yourself. It should be written, dated, and signed entirely in your own handwriting. No printed or typed information should appear on its pages. Some states do not recognize holographic wills as legal.

A formal will is usually prepared with the help of an attorney. It may be typed, or it may be a preprinted form that you fill out. You must sign the will in front of two witnesses; neither witness can be a beneficiary named in the will. Witnesses must sign in front of you.

A statutory will is prepared on a preprinted form, which is available from lawyers, office-supply stores, and some stationery stores. There are serious risks in using preprinted forms to prepare your will. The form may include provisions that are not in the best interests of your heirs. If you change the preprinted wording, part or all of the will may be declared invalid. Furthermore, the form may not remain up-to-date with current laws regarding wills. For these reasons, it is best to seek a lawyer’s advice when you prepare your will.

Writing Your Will

Writing a will allows you to express exactly how you want your property to be distributed to your heirs. It is the only way to make sure that all of your property will end up where you want it. Some guidelines for writing a will include:

1. Work closely with your spouse or partner to prepare your will.
2. Write your will to conform to your current wishes.
3. Do not choose a beneficiary as a witness.
4. Consider signing prenuptial agreement if you are remarrying.
5. Consider using percentages instead of dollar amounts.
6. If you are married, your spouse should also write a will.
7. Be flexible.
8. Keep your original will in a safe place and a copy at home.
9. If you alter your will, prepare a new one or add a codicil.
10. Select an executor who is willing to do the needed tasks.
**Selecting an Executor**  An **executor** is a person who is willing and able to perform the tasks involved in carrying out a will. These tasks include preparing an inventory of assets, collecting any money due, and paying off debts. An executor must also prepare and file all income and estate tax returns. In addition, he or she will be responsible for making decisions about selling or reinvesting assets to pay off debts and provide income for your family while the estate is being settled. Finally, an executor must distribute the estate and make a final accounting to beneficiaries and to the probate court. An executor can be a family member, a friend, an attorney, an accountant, or the trust department of a bank. You may also name a beneficiary as the executor. State law sets fees for executors. If you do not name an executor in your will, the court will appoint one. Naming your own executor eliminates that possibility and helps prevent unnecessary delay in the distribution of your property. It will also minimize estate taxes and settlement costs.

**Selecting a Guardian**  If you have children, your will should name a guardian to care for them in the event that you and your spouse die at the same time and the children cannot care for themselves. A **guardian** is the person who accepts the responsibility of caring for the children of the deceased and managing an estate for the children until they reach a certain age. Many states require a guardian to post a bond (several hundred dollars) with the probate court. The bonding company will reimburse the minor's estate the amount of the bond if the guardian uses the minor's property for his or her own gain. When you name a guardian for your children, choose someone you know who loves them and shares your beliefs about raising children. Of course, the person must also be capable and willing to accept the responsibilities associated with the role of being a parent.

**Altering or Rewriting Your Will**  There may be times when you wish to change the provisions of your will because of changes in your life or in the law. After you have made a will, review it frequently so that it remains current. Here are some reasons to review your will:

- You have moved to a new state that has different laws.
- You have sold property that is mentioned in the will.
- The size and composition of your estate have changed.
- You have married, divorced, or remarried.
- Potential heirs have died, or new ones have been born.

Do not make any written changes on the pages of an existing will. Additions, deletions, or erasures on a will that has been signed and witnessed can invalidate the will. If you want to make only a few minor changes, adding a codicil may be the best choice. A **codicil** is a document that explains, adds, or deletes provisions in an existing will. To be valid, it must meet the legal requirements for a will. If you want to make major changes in your will, or if you have already added a codicil, it is best to prepare a new will. In the new will, be sure to include a clause that revokes, or cancels, all earlier wills and codicils.
A Living Will

Why is it important to have a living will?

At some point in your life, you may become physically or mentally disabled and unable to act on your own behalf. If that happens, a living will can help ensure that you will be cared for according to your wishes. A **living will** is a legal document in which you state if you want to be kept alive by artificial means if you become terminally ill and are unable to make such a decision. Many states recognize living wills. **Figure 15.7** illustrates a typical living will. Sign and date the document before two witnesses. Review your living will from time to time to update your decisions.

**Figure 15.7** A Living Will

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*Living Will Declaration*

Declaration made this _____ day of _____ (month, year)

I, ________________________, being of sound mind, willfully and voluntarily make known my desire that my dying shall not be artificially prolonged under the circumstances set forth below, do hereby declare: if at any time I should have an incurable injury, disease, or illness regarded as a terminal condition by my physician and if my physician has determined that the application of life-sustaining procedures would serve only to artificially prolong the dying process and that my death will occur whether or not life-sustaining procedures are utilized, I direct that such procedures be withheld or withdrawn and that I be permitted to die with only the administration of medication or the performance of any medical procedure deemed necessary to provide me with comfort care.

In the absence of my ability to give directions regarding the use of such life-sustaining procedures, it is my intention that this declaration shall be honored by my family and physician as the final expression of my legal right to refuse medical or surgical treatment and accept the consequences from such refusal. I understand the full import of this declaration, and I am emotionally and mentally competent to make this declaration.

Signed _______________________

City, County, and State of Residence_________________________

The declarant has been personally known to me, and I believe him or her to be of sound mind.

Witness_________________________

Witness_________________________

---

Making Choices

A living will ensures that a person's preference about medical care is honored if he or she becomes terminally ill or falls into a coma.

What is the basic purpose of a living will?
You might consider writing a living will when you draw up a traditional will. Most lawyers will prepare a living will at no cost if they are already preparing a traditional will or your estate plan. You can also get the necessary forms for a living will from nonprofit groups such as Aging With Dignity.

**Power of Attorney**

A **power of attorney** is a legal document that authorizes someone to act on your behalf. If you become seriously ill or injured, you will probably need someone to take care of your needs and personal affairs. This can be done through a power of attorney.

You can assign a power of attorney to anyone you choose. You can give that person power to carry out only certain actions or transactions, or you may allow the person to act on your behalf in all matters, including your living will.

**Letter of Last Instruction**

In addition to a traditional will and a living will, it is a good idea to prepare a letter of last instruction. This document is not legally binding, but it can provide heirs with important information. It should contain preferences for funeral arrangements as well as the names of the people who are to be informed of the death. With a letter of last instruction, you can also let people know the locations of your bank accounts, safe-deposit box, and other important items.

**Trusts**

*Why is it important that trusts avoid probate?*

Basically, a trust is a legal arrangement that helps manage the assets of your estate for your benefit or that of your beneficiaries. The creator of the trust is called the **trustor**, or **grantor**. The trust is administered by the trustee, which can be a person or an institution, such as a bank. A bank charges a small fee for its services in administering a trust. The fee is usually based on the value of the assets in the trust.

Individual circumstances determine whether it makes sense to establish a trust. Some of the common reasons for setting up a trust are to:

- Reduce or provide for payment of estate taxes.
- Avoid probate and transfer your assets immediately to your beneficiaries.
- Free yourself from managing your assets while you receive a regular income from the trust.
- Provide income for a surviving spouse or other beneficiary.
- Ensure that your property serves a desired purpose after your death.
Types of Trusts

There are many types of trusts, including a credit-shelter trust, a disclaimer trust, a living trust, and a testamentary trust. Choose the type of trust that is most appropriate for your situation. An estate attorney can advise you about the right type of trust for your needs.

Trusts can be either revocable or irrevocable. A revocable trust is one in which you have the right to end the trust or change its terms during your lifetime. Revocable trusts avoid the lengthy process of probate, but they do not protect assets from federal or state estate taxes. An irrevocable trust is one that cannot be changed or ended. Irrevocable trusts avoid probate and help reduce estate taxes. However, by law you cannot remove any assets from an irrevocable trust, even if you need them at some later point in your life.

Credit-Shelter Trust A credit-shelter trust is a trust that enables the spouse of a deceased person to avoid paying federal taxes on a certain amount of assets left to him or her as part of an estate. As of 2004, the exemption amount was $1.5 million. It increased to $2 million in 2006 and continues to increase to $3.5 million in 2009. As the most common estate-planning trust, the credit-shelter trust has many other names: bypass trust, residuary trust, A/B trust, exemption equivalent trust, and family trust. A single person does not need to set up a credit-shelter trust because assets passing to someone other than a spouse automatically qualify for the estate exemption amount.
Disclaimer Trust  A disclaimer trust is appropriate for couples who do not have enough assets to need a credit-shelter trust but who may in the future. With a disclaimer trust, the surviving spouse is left everything, but he or she has the right to disclaim, or deny, some portion of the estate. Anything that is disclaimed goes into a credit-shelter trust. This approach allows the surviving spouse to protect wealth from estate taxes.

Living Trust  A living trust, also known as an inter vivos trust, is a property management arrangement that you establish. It allows you, as trustor, to receive benefits during your lifetime. To set up a living trust, you simply transfer some of your assets to a trustee. Then you give the trustee instructions for managing the trust while you are alive as well as after your death. A living trust has several advantages:

- It ensures privacy. A will is a public record; however, a trust is not a public record.
- The assets held in trust avoid probate at your death. This eliminates probate costs and delays.
- It is advantageous if you own property in more than one state.
- It enables you to review your trustee’s performance and make changes if necessary.
- It can relieve you of management responsibilities.
- It is less likely than a will to create arguments between heirs upon your death.
- It can guide your family and doctors to follow your wishes if you become terminally ill or if you become unable to make your own decisions.

Setting up a living trust costs more money than creating a will. However, depending on your particular circumstances, a living trust can be a good estate planning option.

Testamentary Trust  A testamentary trust is established by your will and becomes effective upon your death. Such a trust can be valuable if your beneficiaries are inexperienced in financial matters. It may also be the best option if you expect your estate taxes will be high. A testamentary trust provides many of the same advantages as a living trust.

Your Estate

How does the type of joint ownership affect the distribution of an estate?

As you learned earlier in this chapter, your estate consists of everything you own. Therefore, an important step in estate planning is taking inventory of your assets. Do not forget to include in your inventory jointly owned property, life insurance policies, employee retirement benefits, money owed to you by others, and all of your personal possessions.
Some states are known as community-property states. Community property is any money earned by either spouse during the marriage and any property or possessions purchased with that money. It does not include assets received as gifts or through inheritances. In community-property states, each spouse owns 50 percent of the property. Thus, half of the couple's assets are included in each spouse's estate.

In non-community-property states, property is included in the estate of the spouse who owns it. The way you own property can make a significant tax difference.

**Joint Ownership**

Joint ownership of property between spouses is very common. Joint ownership may also exist between parents and children or other relatives. Joint ownership may help avoid probate and inheritance taxes in some states. However, it does not avoid federal estate taxes. It may, in fact, increase the amount of federal estate taxes.

There are three types of joint ownership, each of which has different tax and estate-planning consequences.

1. You and your spouse may own property as “joint tenants with the right of survivorship.”
   - The property is considered to be owned 50–50 for estate tax purposes and will automatically pass to one spouse at the other's death.
   - No estate tax is paid at the first death. However, when the surviving spouse dies, more estate taxes may be due than with a traditional marital share will.

2. You and your spouse may own property as “tenants in common.”
   - Each individual is considered to own a certain share of property for tax purposes, and only your share is included in your estate.
   - Your share does not go to the other tenant in common at your death. Instead, it is included in your probate estate, and you decide who gets it.
   - Gift and estate taxes do not apply to property that belongs to spouses.

3. Married couples may own property under the form of “tenancy by the entirety.”
   - Both spouses own the property.
   - When one spouse dies, the other gets the property automatically.
   - Neither spouse may sell the property without the consent of the other.

Joint ownership is a poor substitute for a will because it provides less control over how property is distributed and taxed after death. State laws govern the types and effects of joint ownership. An attorney should be consulted on these matters.
Life Insurance and Employee Benefits

If you have life insurance, the benefits of that insurance will be counted among the assets in your estate. Life insurance benefits are free of income tax, and they do not go through probate. They are also partially exempt from most state inheritance taxes. However, they are subject to federal estate taxes under certain circumstances, such as when you change beneficiaries, surrender the policy for cash, or make loans on the policy.

Death benefits from qualified employer pension plans or Keogh plans are usually excluded from an estate. One exception is if the benefits are payable to the estate. Another exception is if the beneficiary chooses a special provision for averaging income tax in lump-sum distributions.

Lifetime Gifts and Trusts

You may give part of your estate as a gift or set up a trust for your spouse or a child. Under certain conditions, such gifts and trusts are not included as part of your estate upon your death. However, if you keep any control or use of the gift or trust, it remains part of your estate and is subject to taxes. For example, if you transfer title of your home to a child but continue to live in it, the value of the home is taxed as part of your estate. Similarly, if you put property in a trust but keep some control over the income or principal, the property is included in your estate even though you may not be able to obtain it yourself.

Taxes and Estate Planning

Which government, state or federal, imposes inheritance taxes?

Federal and state governments impose various types of taxes that you must consider in estate planning. The four major types of taxes are estate taxes, estate and trust federal income taxes, inheritance taxes, and gift taxes.

Estate Taxes

An estate tax is a federal tax collected on the value of a person’s property at the time of his or her death. The tax is based on the fair market value of the deceased person’s investments, property, and bank accounts, less an exempt amount.

As of 2006, the exempt amount was $2 million. This means that the “first” $2 million is not used to compute the estate tax. Only the amount in excess of $2 million can be considered. The exempt amount is $3.5 million in 2009. The tax rate applied to the remaining amount is 48 percent. With careful planning, federal estate taxes can be avoided for estates over $2 million.
Estate and Trust Federal Income Taxes

In addition to the federal estate tax return, owners of estates and certain trusts must file federal income tax returns with the IRS. Taxable income for estates and trusts is computed in the same manner as taxable income for individuals. Taxes must be paid quarterly on both trusts and estates.

Inheritance Taxes

Your heirs might have to pay a tax for the right to acquire the property that they have inherited. An inheritance tax is a tax collected on the property left by a person in his or her will.

Only state governments impose inheritance taxes. Most states collect an inheritance tax, but state laws differ widely as to exemptions and rates of taxation. A reasonable range for state inheritance taxes would be 4 to 10 percent of whatever the heir receives.

Gift Taxes

Both the federal and state governments impose a gift tax, a tax collected on money or property valued at more than $11,000 given by one person to another in a single year. One way to reduce the tax liability of your estate is to reduce the size of the estate while you are alive by giving away portions of it as gifts. You are free to make such gifts to your spouse, children, or anyone else at any time. However, when doing this, be careful that you do not give away assets that you may need in your retirement.
According to federal law, you may give up to $11,000 per person per year free of any gift tax. A married couple may give up to $22,000 per person per year without paying the tax. Gifts that exceed those amounts are subject to the tax. Gift tax rates are currently the same as estate tax rates, and they are called *unified transfer tax rates.* However, gifts might be considered as part of your estate and be taxed if they were given within three years of your death. Many states have other gift tax laws as well.

**Paying the Tax**

After doing everything possible to reduce your estate taxes, you may still find that taxes are due. In that case, you will have to think about the best way to help your heirs pay the taxes. The federal estate tax is due nine months after a death. State taxes, probate costs, debts, and other expenses are also usually due within that same period. These costs might result in a real financial problem for your survivors. Finding enough cash to pay taxes, debts, and other costs without causing financial hardship can be very difficult.

There are a number of ways this problem can be handled.

1. Obtain life insurance. A life insurance policy may be the best way to provide your heirs with the tax-free cash that they will need to settle your estate.
2. Save enough cash ahead of time to pay taxes and expenses when they are due. However, the cash may be subject to income tax during your lifetime and also subject to estate tax at your death.
3. Your heirs could sell assets to pay taxes. However, this could result in the loss of important sources of income.
4. Your heirs might borrow money. However, it is unusual to find a commercial lender that will lend money to pay taxes. Besides, borrowing money only prolongs the problem and adds interest costs in the process.

**FOR LIFE** Considering the expense of estate taxes can mean more money or assets for your family or heirs. *What are at least two sources of funds to pay for taxes and debts when settling an estate?*
5. If your family members or beneficiaries can show they have a reasonable cause, the IRS may allow them to make deferred or installment payments on taxes that are due. However, like borrowing, making payments may prolong the problem.

Planning for the Future

Estate planning is essential not only to ensure that your assets are distributed in the way you choose, but also to make sure that your loved ones are not left with difficult or costly problems.

Planning for your estate and taxes as well as writing a will are just a few of the steps you can take to have a secure financial future for yourself and others. In addition, planning and saving for your own retirement will help ensure that your needs are met in your later years. Remember that the trade-offs, decisions, and goals that you make for yourself today affect your personal finances, which will continue to affect your life now and in the future.

Section 15.3 Assessment

QUICK CHECK
1. What are the four basic types of wills?
2. What is a credit-shelter trust, a disclaimer trust, and a living trust?
3. What are several strategies that you might use to arrange for paying estate taxes?

THINK CRITICALLY
4. Which format of a will—holographic or formal—is the best from a legal point of view? Why?

USE MATH SKILLS
5. Too Much Money Joel and Rachel Simon are both retired. They have been married for 50 years and have amassed an estate worth $2.4 million. If either of them dies between the years 2006 and 2008, the surviving spouse can receive $2 million tax-free. The amount over that exemption will be subject to federal estate tax. The couple has no trusts or other types of tax-sheltered assets.

Analyze If Joel or Rachel dies in between 2006 and 2008, how much federal estate tax would the surviving spouse have to pay, assuming that the estate is taxed at the 48 percent rate?

SOLVE MONEY PROBLEMS
6. Cost versus Satisfaction Irving and Irma Lansing are making plans for the distribution of their assets after they die. They have wills, but they want to make sure that they are using the right type of will to maximize the benefits for the surviving spouse and their four grown children. The estimated value of their estate is currently $1.4 million. However, most of their assets are in high-risk stocks, which can vary greatly in value depending on economic conditions and the stock market.

Write About It Help Irving and Irma by writing a summary of the benefits and drawbacks of the four main types of wills. Identify which type would be best for them.
Communicating Key Terms

Imagine you are a financial planner for a company. Prepare text for a PowerPoint presentation using as many of these terms as possible to introduce the employees to estate planning.

- assisted-living facility (ALF)
- defined-contribution plan
- 401(k) plan
- vesting
- defined-benefit plan
- individual retirement account (IRA)
- Keogh plan
- annuity (insurance)
- heirs
- estate
- estate planning
- beneficiary (estate)
- will
- intestate
- trust
- probate
- executor
- guardian
- codicil
- living will
- power of attorney

Reviewing Key Concepts

1. **Identify** three ways expenses decrease at retirement.
2. **Describe** alternative living and housing arrangements for retirement.
3. **Identify** two reasons Social Security should not be a primary source of retirement funds.
4. **Define** employer-sponsored defined-contribution plans and defined-benefit plans.
5. **Explain** the advantages of the Roth IRA over a regular IRA.
6. **Explain** why creating a living will is an important part of estate planning.
7. **Describe** the major advantages of trusts.
8. **Explain** what it means to be an executor of an estate.
9. **List** some estate planning methods to reduce inheritance taxes.
**Cost of Living in Retirement**  Pretend you are in your late 60s. With careful planning, you have about $35,000 per year for living expenses after taxes. Find a Web site that compares the cost of living in different cities.

1. **Calculate** how much you would need if you lived in U.S. cities that are attractive to retirees, such as West Palm Beach, Florida; Phoenix, Arizona; and Dallas, Texas.
2. **Compute** by using spreadsheet or presentation software to develop charts and/or graphs comparing the cost of living in different cities.

**Academic Skills**  The need for retirement planning is greater in the 21st century because more people are living longer lives.


**Your Financial Figures**  Because of longer life expectancies and declining birth rates, fewer workers are currently paying into the Social Security system than previously, and more people are in retirement for more years.

1. **Research**  Find out what the American Association of Retired Persons (AARP) thinks about Social Security and various ideas to reform it.
2. **Think Critically**  Is it “fair” for younger workers to fund current retirees’ benefits? Do you believe you will receive Social Security benefits when you retire? Why or why not?

**Connect with Economics and Social Studies**

1. **Research**  Find out what the American Association of Retired Persons (AARP) thinks about Social Security and various ideas to reform it.
2. **Think Critically**  Is it “fair” for younger workers to fund current retirees’ benefits? Do you believe you will receive Social Security benefits when you retire? Why or why not?

**Science**  The need for retirement planning is greater in the 21st century because more people are living longer lives.


**Cost of Living in Retirement**  Pretend you are in your late 60s. With careful planning, you have about $35,000 per year for living expenses after taxes. Find a Web site that compares the cost of living in different cities.

1. **Calculate** how much you would need if you lived in U.S. cities that are attractive to retirees, such as West Palm Beach, Florida; Phoenix, Arizona; and Dallas, Texas.
2. **Compute** by using spreadsheet or presentation software to develop charts and/or graphs comparing the cost of living in different cities.

**Real-World Application**

1. **Research**  Find out what the American Association of Retired Persons (AARP) thinks about Social Security and various ideas to reform it.
2. **Think Critically**  Is it “fair” for younger workers to fund current retirees’ benefits? Do you believe you will receive Social Security benefits when you retire? Why or why not?

**Internet Connection**

1. **Research**  Find out what the American Association of Retired Persons (AARP) thinks about Social Security and various ideas to reform it.
2. **Think Critically**  Is it “fair” for younger workers to fund current retirees’ benefits? Do you believe you will receive Social Security benefits when you retire? Why or why not?

**Wills and Trusts**  You need a lawyer to help you draw up wills and trusts. However, you can minimize the amount of time a lawyer will have to spend preparing the will or trust by organizing your documents and doing some research on your own first.

**Log On**  Use an Internet search engine to find Web sites showing sample will and trust documents. Answer the following questions:

1. Under what circumstances is a trust essential? Do you need one currently?
2. What are some of your state’s requirements for a will or trust to be valid?

**Newsclick: Social Security Reform**  Social Security reform has been highly debated in the news for years. Many politicians aim to change the system.

**Log On**  Go to finance07.glencoe.com and open Chapter 15. Learn more about retirement saving options. Write a list of ways to help save seniors from financial hardships. Also write a list of ways to help younger people prepare for retirement.
WHAT IS YOUR PERSONALITY?

Part of the fun of planning a successful future is considering your personal preferences. The closer you can match your activities with your personality, the more likely you are to enjoy your life. Read through the following list and write your top three characteristics on a separate sheet of paper.

___ 1. I am steady and reliable.
___ 2. I tend to think a lot.
___ 3. I enjoy being by myself.
___ 4. I almost always plan before I do something.
___ 5. I am very emotional.
___ 6. I love being the center of attention.
___ 7. I enjoy drama.
___ 8. I like to express what I feel.
___ 9. I am always ready to get up and go.
___ 10. I like to participate in high-action sports.
___ 11. I am happiest when doing physical activities.
___ 12. I find it hard to keep still.

**Thinker:** If all of your selections were from numbers 1–4, consider activities that use your ability to think.

**Heartfelt/Feeler/Enthusiast:** If all of your selections were from numbers 5–8, you are probably happiest when doing something that gives you an emotional lift.

**Doer:** If all of your selections were from numbers 9–12, you enjoy being active.

**Adapter:** If your selections were from more than one of the three sections (1–4, 5–8, or 9–12), you are versatile and could choose activities that require thinking, involve emotions, or are active.

Continue to think about the different aspects of your personality and consider what types of activities you like to do. Thinking about these things now will help you better plan for your retirement years.
Saving for Retirement

Henri has become eligible to participate in his company’s 403(b) program. He can invest from 2 to 15 percent of his salary, which is $20,000 a year. The company matches the first 5 percent at a rate of 50 percent, or 50 cents for every dollar he invests. Henri has decided to save 5 percent of his salary. Based on the current investment return of 10 percent compounded annually, Henri has calculated how much he would be able to save over 10 years, including company-matching contributions.

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<th>Contributions</th>
<th>Interest</th>
<th>Total</th>
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<tbody>
<tr>
<td>Henri’s contribution of 5 percent of his $20,000 salary</td>
<td>$1,000/year</td>
<td>10%</td>
</tr>
<tr>
<td>Company contribution matching 50 percent of 5 percent of his salary</td>
<td>$500/year</td>
<td></td>
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<tr>
<td>1st Year</td>
<td>$1,500</td>
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<td>2nd Year</td>
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</tr>
<tr>
<td>Total</td>
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<td>$11,296.75</td>
</tr>
</tbody>
</table>

Calculate

On a separate sheet of paper, calculate how much you would have in ten years if you saved $2,000 a year at an annual interest rate of 10 percent, with the company contributing $500 a year.
Making Retirement Plans

Overview

Carrie and David have been working and saving for their retirement for many years. Soon it will become a reality. They are looking forward to spending time with their future grandchildren, developing hobbies, traveling, volunteering, and maybe even working part-time, without having to worry about earning full-time wages. Their goal is to retire within the next five years. They need to develop a clear and organized plan for how they will spend their days, how much money their activities will cost, and where they will live.

Procedures

Step A The Process

If you were Carrie or David, how would you spend your retirement years?

1. Write a short story (one or two pages) describing how Carrie and David will spend their retirement years. Where will they live? Will they travel? Will they work? Do they have hobbies? Use your creativity and imagination.

2. Research long-term care insurance. Then help Carrie and David decide whether they should purchase it or invest their money in another way.

3. Watch a movie or TV show about people who are retired or nearing retirement age. You might rent a video or DVD of *Grumpy Old Men*, *Cocoon*, *Space Cowboys*, or a more recent film. Make a list of the hobbies and activities of the characters. Write one or two paragraphs comparing the characters’ hobbies and activities to those of people you know who are teens or young adults.

4. In 2004, about 12 percent of the American population was 65 or older. By 2050, that number will increase to 21 percent. Many of these Americans are or will be living in retirement communities, assisted-living facilities, or nursing homes. As a service project, plan an activity for a group of senior citizens in your community. You might develop a craft project, a music festival, or a game day. Use your imagination. Then contact a local center and ask if you can present your activity there.
Create Your Portfolio

As you work through the process, save the results so that you can refer, review, and refine. Create a portfolio to showcase the information you collected in Step A.

1. Include your short story about Carrie and David's retirement years.
2. Present your recommendations and reasoning on whether or not Carrie and David should purchase long-term care insurance.
3. Write a summary of the movie or TV show you watched. Include the list of hobbies and activities you created and the comparison paragraph you wrote.
4. Present your plan for the senior citizens’ activity. If you are able to implement it, survey the participants to find out if they enjoyed the activity. Ask how you might improve it for another time.

Mathematics

Math skills are essential for managing your own finances and planning for retirement. Also, employers look for employees who have math skills. Adding, subtracting, multiplying, dividing, working with fractions and decimals, and using algebra are the basic math skills used in the workplace.

1. Create ten word problems using basic math skills to solve financial problems from this unit. For example: David’s employer matches David’s contributions to his 401(k) retirement savings plan. If David contributes $250 per month to the plan, how many years must David continue to save to accumulate $90,000 without interest? ($250 ÷ $250 = $500; $500 × 12 = $6,000; $90,000 ÷ $6,000 = 15 years)
2. Form groups of three, and as a team, solve the word problems.
3. Compile the problems and their answers into a classroom notebook. Label the notebook “Math Problems in Personal Finance.” If possible, categorize the problems according to the skill (adding, subtracting, fractions, and so on).