# WEALTH BUILDING and COLLEGE SAVINGS

# CH 3

## What do other high school students know about wealth building?

We asked high school students what they would do with an extra $5,000.

> I'd either **buy a used car** or put it in the bank so it can **grow.**
>
> Junior, Michigan

"I would put half in long term-savings, $2,000 in a college fund, and spend $500."

Senior, Wyoming

"I would save it until I was 18, then put a down payment on a house and rent it for profit."

Senior, Texas

"I'd put half in a mutual fund, $1,000 in savings, $1,000 in a money market, and buy a gaming system with the rest."

Senior, Missouri

"Save $3,500 and shop with the rest."

Junior, Alabama



### LEARNING OUTCOMES

Explain what is meant by "tax-favored dollars."

List the different types of retirement plans.

Differentiate between a traditional and Roth IRA.

Illustrate how a 401(k)company match works and prioritize money into various investments.

Describe how pre-tax and after-tax investments work.

### KEY TERMS

401(k)
ESA
IRA
Pre-Tax
Rollover
Roth IRA
Tax-Favored Dollars

# BEFORE YOU BEGIN

### What do you know about Wealth Building and College Savings?

Before you watch the lesson on Wealth Building and College Savings, think about what you already know. The word bank below contains some of the bigger concepts that you will learn in this lesson. Complete the first two columns before watching Dave's lesson as you work through the chapter. Fill in the last column with the details you learned.

| | I think I know: | I want to know: | What I learned: |
|---|---|---|---|
| 401(k) | | | |
| Roth IRA | | | |
| ESA | | | |
| UTMA/UGMA | | | |
| Before Tax | | | |
| After Tax | | | |
| Rule of 72 | | | |
| Pension | | | |

# CH 3 WEALTH BUILDING and COLLEGE SAVINGS

## Retirement and College Funding

Once the emergency fund is in place, you should begin retirement and college funding, which falls within long-term investing for ____________ ________________.

Baby Step 1 is ____________ in the bank.

Baby Step 2 is ____________ ________________.

Baby Step 3 is ______ months of expenses in an emergency fund.

BABY STEP 4 Baby Step 4 is investing 15% of your household income into Roth IRAs and pre-tax retirement plans.

Invest _____% of your household income into Roth IRAs and pre-tax retirement plans.

Tax-favored means that the investment is in a ___________ __________ or has a special tax treatment.

### MORE INFO

**The Federal Deposit Insurance Corporation (FDIC)** is responsible for insuring or guaranteeing deposits in banks and savings institutions up to $250,000. It was created in 1933 to restore public confidence after thousands of banks failed.

**The Federal Reserve**—sometimes called "The Fed"—is the central banking system of the United States and has four main duties:

1. It carries out the nation's monetary policies by managing the supply of money.
2. It supervises and regulates banking institutions.
3. It maintains the stability of the financial system.
4. It provides financial services to banks.

## STUPID TAX

"I paid over $200 for a snowboard because I loved the design. I never even used it once because it turned out to be too small."

Senior, Wyoming

"I bought a guitar when I should have paid for my speeding ticket."

Senior, Florida

"I saved up to buy an expensive hair straightener only to find my old, cheap straightener worked way better."

Junior, Missouri

## Qualified Plans

- Individual Retirement Arrangement (________)
- Simplified Employee Pension Plan (_________)
- 401(k), 403(b), 457

## Individual Retirement Arrangements

When it comes to IRAs, everyone with an ____________ income is eligible.

The maximum annual contribution for income earners is $_____________ as of 2008.

Remember: IRA is not a type of ____________ at a bank. It is the tax treatment on virtually any type of investment.

## Roth IRA

The Roth IRA is an ______-tax IRA that grows tax _______.

## MONEY FACTS

The Roth IRA is named for Senator William Roth of Delaware, who authored this section of the Taxpayer Relief Act of 1997.

## Why the Roth IRA?

The Roth IRA has more _____________.

Higher ____________ at retirement.

Investing $5,000 pre-tax is different than investing $5,000 _______ tax. It takes more than $5,000 to get home with $5,000 after tax. It would take $____________.

There are no taxes when you cash it out, so it forces you to _________________ more.

It has tons of _________________.

## Who Is Eligible:

- Singles—100% contribution with income less than $95,000. Phase out between $95,000-$110,000. Not eligible above $110,000.
- Married filed jointly—100% contribution with income less than $150,000. Phase out between $150,000-$160,000. Not eligible over $160,000.

## Flexibility of a Roth IRA:

- Tax-free and penalty-free withdrawals at any time equal to contributions. After the emergency fund is depleted, you have a fall back.
- After five years, you can make tax-free, penalty-free withdrawals for 100% under these conditions:
  1. Over 59 and a half years old

### MONEY FACTS

The average graduate of a four-year college has student loan debt of **$19,237.** Graduate students pile on even more student loan debt, ranging up to **$114,000.**

*Miles To Go*

Nearly **half** of all Americans (46%) have less than **$10,000** saved for retirement.

*Miles To Go*

**37%** of teens notice their parents being concerned about retirement.

Charles Schwab Survey

Only **13%** of teens know what a 401 (k) plan is.

Charles Schwab Survey

**29%** of teens feel knowledgeable about knowing how to pay for college.

Charles Schwab Survey

**49%** of teens say they're concerned their parents/guardians will not be able to support them financially if they attend college.

Charles Schwab Survey

2. Because of death or disability
3. First-time home purchase
   (max $10,000)

END OF VIDEO PART 1

## Simplified Employee Pension Plan (SEPP)

A __________-employed person may deduct up to ______% of their net profit on the business by investing in a SEPP.

- The maximum deductible amount is $45,000 (as of 2007) and all employees who have been with the firm more than three of the last five years must receive the same percentage of their pay into a retirement plan.

**REAL LIFE**

Winning the lottery does not guarantee peace of mind when it comes to your financial future. In fact, Ellen Goodstein of bankrate.com reported that just the opposite happened to some lottery winners—they went broke.

Saving and investing have nothing to do with the amount of money you make or get. It is about making it a priority and being smart with your money.

**William Post won $16.2 million from the Pennsylvania Lottery in 1988**

- His former girlfriend sued him and won a share of his winnings.
- His brother was arrested for hiring a hit man to kill him, hoping to inherit the winnings.
- His other siblings harassed him until he invested in a car business and restaurant, both of which failed.
- He was $1 million in debt just one year later.
- Ultimately, he declared bankruptcy and now lives on food stamps.

**Willie Hurt won $3.1 million from the Michigan Lottery in 1989**

- He spent his money on a divorce and crack cocaine.
- Two years later, he was broke and facing murder charges.

**Suzanne Mullins won $4.2 million from the Virginia Lottery in 1993**

- She borrowed $197,746, using her lottery winnings as collateral.
- She stopped making payments on the loan after she collected the rest of her winnings in a lump sum.
- The company Suzanne borrowed the money from won a judgment against her for $154,147, but has never seen a dime.
- Today, she has no assets.

## 401(k), 403(b) & 457 Retirement Plans

Most companies have completely done away with traditional ________________ plans.

It has been replaced by self-____________ and ___________ plans, like the 401(k).

- The 401(k) is yours, unlike the pension plan which was an asset of the company. If the company went broke, you most likely lost your pension.
- If you don't put money into a 401(k) there will be nothing in the fund. A pension, however, is funded automatically by your company.

The 403(b) is found in non-profit organizations such as churches, hospitals and schools.

The 457 is ______________ compensation, which means you are deferring or putting off compensation. Usually this is available for government employees.

Do not use a ______________ Investment Contract (GIC) or bond funds to fund your plan.

- This is like a C.D. inside of your 401(k). You will only make about 3-4% and it will not help you win long-term.

You should be funding your plan whether your company ___________ or not.

### MONEY FACTS

The **Rule of 72** is a quick way to do compound interest problems in your head. It isn't exact, but it will give you a quick benchmark to see how long it will take to double your money at a given interest rate.

The **Rule of 72** says that by dividing the interest rate into 72, it will tell you approximately how many years it will take to double your money.

**Example:** How long will it take to double your money at 12%?

72/12 = 6 years

What interest rate do I need to earn if I want my money to double in 7 years?

72/7=10.28%

## $ MONEY FACTS

Imagine if a couple, who are both 30 years old, funds a Roth IRA ($500 per month) at 12% interest. At 70 years old they will have... $5,882,386.26, tax free!

Imagine if that same couple made $40,000 and saved 15% in a 401 (k) (that's $500 per month or $6,000 per year) at 12% interest. At 70 years old they will have... $5,882,386.26, tax free!

By the time they retire at age 65, that couple's $1,000 per month savings in IRAs and 401(k)s will grow to: $11,764,772.51

## Rollovers

You should always ________ over retirement plans to an ________ when you leave the company.

Don't bring the money home, instead, move it straight into an IRA by a _____________ ______________.

## Roll to a Roth Only If:

1. You will have over $700,000 by age 65.
2. You can afford to pay the ________ separately, not from the IRA.
3. You understand all _______will become due on the rollover amount.

END OF VIDEO PART 2

## Retirement Loans

Never ______________ on your retirement plan. NEVER!

## Federal Thrift Plan

For federal government workers who have the standard thrift plan, we recommend 60% in the C fund, 20% in the S fund, and 20% in the I fund.

## Baby Step 4

Invest 15% of household income into Roth IRAs and pre-tax retirement.

1. Fund 401(k) or other employer plan up to the ______________. (If applicable)
2. Above the match, fund ___________IRAs. If there is no match, start with Roth IRAs.
3. Complete 15% of income by going back to your ______ or other company plans.

END OF VIDEO PART 3

*There are no fill-in-the-blanks for Part 4.*

END OF VIDEO PART 4

## College Funding

BABY STEP 5

Save for your children's education using tax-favored plans.

**First...**

Save for college by first using Educational Savings Accounts (ESA), nicknamed "Education __________."

You may save $2,000 (after tax) per year, per child, that grows tax free! So, if you start when your child is born and save $2,000 a year for 18 years, you would only invest a total of $36,000. However, at 12% growth, your child would have $126,000 for college—TAX FREE!

### REAL LIFE

Scholarships aren't just for the highest scorers on the ACT or SAT. Schools and foundations have broadened their criteria to include community involvement, after-school work and financial status in addition to the traditional athletics and diversity scholarships. Don't avoid the scholarship applications requiring essays. It is a good way to improve your writing skills while earning scholarships. Here are some additional resources to look into.

**1.** Talk to your guidance counselor.

**2.** Explore your state's website.

**3.** Many businesses have scholarships for employee's children. Ask your parents to check at their place of employment.

**4.** Explore the federal government's website at studentaid.ed.gov

**5.** Check out the big college organizations for information (collegeboard.com, petersons.com).

**6.** Apply for scholarships with local organizations such as Rotary Clubs.

## Q&A

**"I am 22 and I've been thinking about going back to school. My employer is willing to pay for nine credit hours per semester, but if I take more than nine hours they won't pay anything. My parents think we should get student loans. What do you think?"**

**DAVE'S ANSWER:** I'm sure your parents are good people. And I know they don't mean any real harm. They're just being normal, but in today's culture normal is broke. They've probably been around student loans, car payments and credit cards all their lives, and that's sad.

Go for it! You have a great opportunity staring at you. I mean, how many times does someone offer to pay for your degree with no financial strings attached? You couldn't take much more than nine hours per semester and still work a full-time job anyway.

**Above that...**

If you want to save more or if you don't meet the income limits for an ESA, use a certain type of __________ plan.

Never buy a plan that:

1. __________________ your options.
2. Automatically changes your investments based on the _________ of the child.

**Only then...**

Move to an __________________ or _________________ plan.

- While this is one way to save with reduced taxes, it is _____________ as good as the other options.
- UTMA/UGMA stands for Uniform _______________ / Gift to _______________ Act.

- The account is __________ in the child's name and a __________ is named, usually the parent or grandparent. This person is the manager until the child reaches age 21. At age 21 (age 18 for UGMA), they can do with it what they please.

## Three "Nevers" of College Savings

Never save for college using ____________.

Never save for college using ________ bonds. (Only earns 5-6%)

Never save for college using ____________ tuition.

**An ESA is *not* the right savings vehicle if you need the money within five years. Use a money market mutual fund.**

END OF VIDEO PART 5

## Recap and Review

Save long-term in tax favored plans—a Roth IRA grows tax-free.

Contribute to your 401(k), especially when a match is offered.

Do not sign up for investment plans that you don't understand.

NEVER borrow on your retirement plan.

You do not have to get a student loan to go to college!

### REAL LIFE

You don't *have* to get a student loan to go to college. There are many other ways to pay for higher education besides going into debt. Consider these options instead:

- Work while going through school
- Get a job on campus
- Join the military
- Find a job where they will pay for your schooling (ie: UPS)
- Go to school in-state as opposed to out-of-state
- Go to a public school instead of a private school
- Get your core classes at a local community college, then go to a 4-year institution
- Live at home while going to college
- Get a degree in a field that will help pay for your college (ie: teachers might qualify for tuition grants as long as they agree to teach for 3 or more years)

# CHAPTER 3: MONEY IN REVIEW

## Vocabulary

401(k)
403(b)
457 Plan
529 Plan
Custodian
Direct Transfer
ESA
IRA
Pre-Paid Tuition
Rollover
Roth IRA
SEPP
Tax-Favored Dollars
UGMA
UTMA

## Matching

a. ESA
b. 403(b)
c. 401(k)
d. Roth IRA
e. SEPP

___ 1. Retirement plan for self-employed people

___ 2. Grows tax-free

___ 3. The typical retirement plan found in most corporations

___ 4. Used for college savings

___ 5. The typical retirement plan found in non-profit groups such as schools and hospitals

## True/False

___ 6. Pre-tax means the government is letting you invest money before taxes have been taken out.

___ 7. Savings bonds are a good way to save for college.

___ 8. Never borrow money from your retirement plan.

___ 9. When you leave a company, don't move your money from the retirement account.

___ 10. An IRA is a specific type of investment.

## Multiple Choice

11. The________IRA grows tax-free.
- ☐ a. Roth
- ☐ b. traditional
- ☐ c. original
- ☐ d. life insurance

12. An Educational Savings Account (ESA) is used for _______________ .
- ☐ a. retirement
- ☐ b. college
- ☐ c. an emergency fund
- ☐ d. a new car

13. Which of the following is not a retirement plan?
- ☐ a. 529
- ☐ b. 401(k)
- ☐ c. 403(b)
- ☐ d. 457

14. Which is not a benefit of the Roth IRA?
   - ☐ a. grows tax-free
   - ☐ b. unlimited contributions
   - ☐ c. provides penalty-free withdrawals under certain circumstances
   - ☐ d. more choices

15. If your company provides a 100% match up to 6%, how much should you personally contribute to your 401(k) if you earn $35,000 (not including the money the company contributed)?
   - ☐ a. $1,750
   - ☐ b. $2,100
   - ☐ c. $3,500
   - ☐ d. $5,250

16. If you contribute $2,300 to your 401(k) and your company matches up to 3%, how much is in the account (assume you have not gone over the 3% match)?
   - ☐ a. $1,150
   - ☐ b. $2,300
   - ☐ c. $4,600
   - ☐ d. $6,900

17. What should you do with your retirement accounts when you leave a company?
   - ☐ a. cash them out
   - ☐ b. fund deposit
   - ☐ c. fund shift
   - ☐ d. direct transfer

18. Never save for college using:
   - ☐ a. pre-tax dollars
   - ☐ b. pre-paid tuition
   - ☐ c. savings bonds
   - ☐ d. both b and c

19. Baby Step 5 is:
   - ☐ a. 3-6 months of expenses saved
   - ☐ b. college funding
   - ☐ c. 15% of household income into retirement plans
   - ☐ d. the debt snowball

20. If Carol and Joe are debt free, how much should they be investing in retirement plans if their combined income is $145,000?
   - ☐ a. $14,500
   - ☐ b. $21,000
   - ☐ c. $21,750
   - ☐ d. $43,500

## Short Answer

21. What are the advantages of a Roth IRA?

22. What is Baby Step 4 and why does your emergency fund have to be fully funded before you begin this step?

23. List some ways you can avoid student loan debt if you do not have a college fund.

24. Why should you take a 401(k) match (if a company offers one) before you start a Roth IRA?

25. Explain what is meant by tax-favored dollars.

26. Why worry about retirement when every worker pays into Social Security?

27. Explain how the rule of 72 works.

## Case Studies

28. Courtney and Joe have been saving for their two son's college (age 17 & 15) and now have $16,000 in each account. However, the money is in a savings account. They recently started listening to Dave and realized that is not where their money should be. Does Dave advise them to move the money and if so, where?

29. Jane makes $85,000 at her current job. Her company matches 100% up to 3% and 50% up to 6%. Jane is currently funding her 401(k) at only 10% although she is completely debt free. What does Dave tell her to do for retirement? (Break it down in terms of how much she should be investing total, what the company is matching, and where to put her investments.)

30. Austin and Kayla have $35,000 in debt (student loan, credit cards, car loan) but have cut up all of their credit cards and started their debt snowball. Austin just got a substantial raise and their household income is now $125,000 ($3,500 more per month, net). Should he cash out his 401(k) which has about $25,000, pay off his debt, and start again from square one? Explain your answer.