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RETIREMENT INCOME

Quick Guide

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Retirement Income

If you are five years or less away from retirement, you're close enough to calculate approximate income and expenses. Your goal is to have enough money to live on comfortably and not outlive your assets. You need to match your expected lifestyle expenditures with your projected cash flow and provide for contingencies, such as extended illness, rapid inflation, and losses in your investments. Cash flow planning is an important part of retirement planning.

Are there other regions of the country where opportunities are better for continued employment or leisure activities? Are you concerned about living in an area where there are better local services (transportation, medical facilities)? How about more

affordable housing and senior citizen communities? Make sure you list your priorities and start acting now.

Review Your Sources of Retirement Income

As we mentioned, people generally have three sources of retirement income:

- Social Security
- Employer pension plans
- Personal savings

Your Social Security Benefits

Will You Qualify for Social Security Retirement Benefits?

To be eligible for Social Security retirement benefits, you must have earned 40 credits (typically 10 years of work). You earn credits based on the amount of earnings you have in one calendar year. You can earn no more than 4 credits in any calendar year. The credits make you eligible, but it is your history of earnings and age that determines your actual benefits.

If you are eligible, you can begin receiving benefits at age 62. But if you receive benefits prior to full retirement age (approximately age 66 in 2016) (see the section *When Can You Collect Full Social Security Retirement Benefits?*), you will receive a smaller monthly benefit. (Any subsequent cost-of-living increases will still be applied to your reduced benefit.) Get an estimate of your Social Security benefit by reviewing your Social Security Statement, which is sent to you annually.

SUGGESTION: If you are not already receiving Social Security benefits, the Social Security Administration will automatically send you an annual Social Security Statement. If you have not received this statement, call Social Security at 1-800-772-1213 and ask for Form SSA-7004, Request for Social Security Statement. It can be requested via the Internet at www.ssa.gov.

If you continue to work after you begin receiving benefits, your benefits may be reduced. Also,

depending on your adjusted gross income, a portion of your Social Security benefits may be taxable. See the section *Social Security—How Much Can You Earn Without Reducing Your Benefits?*

When Can You Collect Full Social Security Retirement Benefits?

If you were born before 1938, you'll be able to receive full benefits at age 65—the full retirement age. The retirement age has been gradually increased to 67 for covered workers born after 1937. Depending on your income level, a portion of your benefits may be subject to income taxes. If you were born during or after 1938, look at the table below to see when you'll be eligible.

Age for Full Social Security Benefits

Year of Birth	Age for Full Benefits
1937 or earlier	65 years
1938	65 years, 2 months
1939	65 years, 4 months
1940	65 years, 6 months
1941	65 years, 8 months
1942	65 years, 10 months
1943-1954	66 years
1955	66 years, 2 months
1956	66 years, 4 months
1957	66 years, 6 months
1958	66 years, 8 months
1959	66 years, 10 months
1960 or later	67 years

How Much Will You Collect?

Your actual retirement benefit is based on your average adjusted earnings over your working lifetime. Social Security adjusts your earnings for inflation and the number of years worked and then uses a specific formula to determine your actual benefit. The formula is weighted to favor low-income workers since they have had less opportunity to save over the years.

The best way to find out what you can expect is to review your Social Security Statement.

What Can Your Spouse Expect to Receive?

Your working spouse will receive the higher of his or her own benefit or the non-working spouse's benefit, but not both. The non-working spouse's benefit equals 50% of your benefit. If your spouse never worked, he or she is still entitled to 50% of your benefit. Your spouse (either working or non-working) is eligible to receive that benefit when he or she reaches full retirement age. A non-working spouse can receive a reduced benefit as early as age 62, but he or she can start receiving the benefit only after you begin to receive your benefit.

You will also need to understand the financial consequences if you elect to receive benefits early, as well as how much you can earn without reducing your benefits. You can increase your benefit amount by postponing collecting benefits beyond your full retirement age. You should look into how Social Security compensates for the effects of inflation, and the extent to which your benefits will be taxable.

The Social Security Administration will send you a yearly Social Security Statement, which will help you plan when you will start receiving benefits.

Will Your Social Security Benefits be Taxable?

For some taxpayers, up to 50% of their Social Security benefits will be taxed, while for others, up to 85% will be taxed:

- If your total income (including tax-exempt interest and one-half of your Social Security benefits) less certain adjustments (refer to IRS Publication 915 for more information), exceeds \$32,000 for a married couple filing a joint return (\$0 if married filing separately and you lived with your spouse at any time during the current year) or \$25,000 for everyone else, up to 50% of your Social Security benefits will be taxed.
- If your total income (including tax-exempt interest and one-half of your Social Security benefits) less certain adjustments (refer to IRS Publication 915 for more information), is over \$44,000 on a married filing joint return (\$0 if married filing separately and you lived with your spouse at any time during the current year), or \$34,000 for everyone else, up to 85% of your benefits will be taxed.

If your income falls below the above limits, none of your Social Security will be taxed.

IMPORTANT NOTE: When deciding between investing in taxable or tax-exempt investments, keep in mind that tax-exempt interest is added back to income when determining how much of your Social Security benefits are taxable. So, if your tax-exempt interest causes your Social Security benefits to be taxable, this effectively lowers the after-tax yield of your investments—something you should consider when you make your investment decisions.

Pension Plans

If you are vested in a pension plan, your future well-being requires that you understand the details of your plan. How would another year or two of work affect your retirement benefits? Will Social Security benefits be reduced because of your earnings? What survivor options are available and how do they affect your monthly benefit?

What withdrawal options does your plan offer? You may have to choose between a variety of payout options. Your choice will have a significant impact on your financial future.

Your employer is required to give you information about your plan. Also, your human resources department can explain the plan to you and give you an estimate of your pension benefit. You will need this information to determine how much more you may need to save and to start analyzing your payout options.

Deciding on a Payout Option

The payout option you elect is probably one of the most important decisions you'll ever make. That's because your decision is irrevocable. Understanding your distribution options is crucial to your planning. With a defined-benefit plan, your employer may give you a choice of a fixed monthly payout known as an annuity, a lump-sum, or a combination of both. With

a defined contribution plan, you may be able to exercise these options:

- Annuitize your total investment and receive a fixed monthly income.
- Leave your money in the plan until you need it, or until the age that minimum distributions must begin (generally age 70½).
- Take it as a lump sum distribution and report it as taxable income in the current year, or defer taxes by either rolling it over to a traditional IRA, or by rolling it over to a new employer's plan within 60 days. You may be able to postpone distributions from your current employer's retirement if you are still employed even if you are older than 70½. (This doesn't apply if you are a 5% owner, that is, you own more than 5% of the company.) Distributions from a Roth IRA can be postponed beyond age 70½, whether you are employed or not.

SUGGESTION: If you have both a defined-benefit plan and a defined-contribution plan and don't need all the income at once, consider taking an annuity payout from your defined-benefit plan and investing your money tax-deferred in the defined-contribution plan.

Personal Savings

Your personal savings include amounts in qualified employer retirement plans, such as your 401(k) plan, lump-sum defined-benefit pension distribution, IRAs, and other savings you have earmarked for retirement. Make sure you won't be tapping your personal savings for other needs before including them in your retirement savings calculation.

IMPORTANT NOTE: In addition to your investment holdings, you should establish an emergency fund of approximately three to six months of living expenses.

IMPORTANT NOTE: While diversification is an important risk management tool, it cannot guarantee profit or protect against loss.

SUGGESTION: You can time certain investments by using a strategy called laddering. Using fixed-income investments with fixed maturity dates, such as Treasuries, certificates of deposit*, or bonds, you divide your investable dollars into equal amounts (say five). Then put one-fifth into instruments maturing in each of five years. If interest rates go up when the first maturity date comes, you reinvest at the higher rate. If rates have declined, only one-fifth of your portfolio has to be reinvested at this lower rate, while the rest continue to grow at the higher rates. Spreading maturities in this manner should increase your yield over time, and produces a steady flow of income.

*NOTE: certificate of deposits are FDIC insured when issued by your bank or depository institution

Generating Monthly Income

In retirement, most of your expenses occur on a monthly basis. Thus, most retirees prefer their income on a monthly basis. Income includes interest and dividends, and in some cases return of principal. Investment vehicles that provide monthly income include mutual funds, government mortgage-backed securities, and fixed annuities. Other income-producing investments, although not monthly, include certificates of deposit, Treasury notes, and Treasury bonds.

Annuities

The income from these investments helps cover day-to-day expenses. Since the payments are typically made regularly, investors plan on them, but need to be aware that there is no assurance or guarantee that income will be generated or maintained. However, you also need growth in your portfolio to combat inflation. As investments with growth potential increase in value, you can make withdrawals without decreasing your original principal. The key is to have a well-rounded portfolio of both income-producing investments and investments that can outperform inflation. Diversification is another key element in managing your portfolio.

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IMPORTANT NOTE: Annuities are long-term investments. If you begin distributions before age 59½, you may be subject to a 10% penalty on the portion of the withdrawal that represents accumulated earnings. In addition, the earnings are subject to ordinary income tax. Finally, the annuity may impose surrender charges on withdrawals that exceed a certain amount (usually 10%) during the early years of the contract.

*CDs are FDIC-insured up to \$250,000 and offer a fixed rate of return if held to maturity.

The Effects of Inflation

Currently, we are enjoying a relatively moderate annual inflation rate. However, over time, inflation adds up. For example, assuming an inflation rate of 3%, in January of 1998 an item that cost \$10 in 1968 would have cost \$24. In January of 2015, that same item would have cost \$40.

What's the bottom line? In order to keep up with inflation, your investments (overall) must earn at least the inflation rate. In order to get ahead, you need to earn more than the inflation rate.

SUGGESTION: Preserving purchasing power should be one of your main investment objectives.

Types of Annuities

Annuities can be *single premium* annuities or *flexible premium* annuities.

Single premium annuities accept only an initial deposit into the contract. There is a minimum premium amount. If the deposit comes from qualified money (a distribution from a company retirement plan), the minimum premium may be lower. If you want to deposit more money later, you have to fund a new contract. At the time of deposit, you request a maturity date at which time the accumulated funds can either be distributed to you in a lump-sum settlement or can be annuitized (distributed in systematic payouts). You must choose a maturity date by a maximum age set by the company, usually at least age 85.

Flexible premium annuities allow you to make periodic deposits (premium payments) into the contract. You can elect to have automatic monthly withdrawals made from your checking account or make contributions whenever you like. With these annuities, you can take advantage of *dollar-cost averaging*: When you invest an equal amount of dollars in the annuity on a regular schedule, you purchase more units when the price is lower, and over time end up paying on average less per unit. Dollar cost averaging involves continuous investment in securities regardless of fluctuation in price levels of such securities. An investor should consider their ability to continue purchasing through fluctuating price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

Both single and flexible types can be either fixed or variable annuities:

- *Fixed Annuities* offer you a guaranteed rate of return* and guaranteed periodic payments, for either a fixed period of time, or an indefinite period

of time, such as your lifetime or the lifetime of your spouse. If it is a fixed period, at the end of the period, the company will declare a renewal rate, which may be lower than the initial rate but guaranteed not to fall below a minimum guaranteed amount. Rates declared may be based on current market rates, tied to certain indicators, or tied to the company's investment portfolio.

**Guaranteed by the claims-paying ability of the insurance company.*

IMPORTANT NOTE: Beware of annuities offering higher initial guaranteed rates than most similar type annuities. This sometimes means high risk, signaling that a company is headed for trouble. The company may be sacrificing the quality of their investments, which increases your risk.

- *Variable Annuities* shift the burden of investment risk from the insurance company over to you. Rather than receiving a fixed rate based on the company's portfolio, your deposits go into one or more separate accounts called "sub-accounts." You have a variety of investment choices ranging from money market funds to stock and bond funds, similar to mutual funds. Your principal investment may be guaranteed*(for an additional fee), but your rate of return depends on the performance of your investment selection(s).

As with mutual funds, it is a good idea to diversify your investment among different types of variable annuity sub-accounts, in a process called "asset allocation." Variable annuities allow you to change your asset allocation, in response to market trends or personal circumstances, by making tax-free transfers between sub-accounts. Asset allocation does not ensure a profit or protect against a loss.

Variable annuities are considered securities under federal law, and can be offered only by agents who are licensed and who have passed specific securities exams.

**Guarantees are subject to the claims paying ability of the issuing insurance company.*

Individual Retirement Annuities

A variable annuity is a contract between the investor and the insurance company, under which the insurer agrees to make periodic payments, beginning either immediately or at some future date.

Annuities can be an important part of a comprehensive financial plan for the purpose of tax-deferred growth. However, a comprehensive financial plan should start with retirement savings plan on a pre-tax or tax-free basis. Ask yourself these questions:

- Have you contributed the pre-tax maximum to company retirement plans?
- Has your spouse contributed the pre-tax maximum to company retirement plans?
- Are you participating in a Keogh or SEP, if available to you?
- Have you put money into a traditional or Roth IRA?
- Are you sure you won't need the money before age 59½?

If the answer to all of these questions is yes, then you may want to consider an annuity.

IMPORTANT NOTE: As an investment vehicle, annuities are primarily for individuals in higher tax brackets, such as a federal marginal income tax rate of 25% or higher. The tax-deferred savings are less beneficial at lower tax rates.

IMPORTANT NOTE: If you plan to put your retirement investments in growth stocks and they appreciate, you will recognize capital gains when you sell them in the future. Assuming you are in the middle tax bracket and the investments are held for more than one year, these capital gains will be taxed at the preferential income tax rate of 15%. But if these assets are within an annuity, all of your investment profits are taxed as ordinary income upon withdrawal. If you hold an annuity until you retire, however, you may be in a lower tax bracket and the capital gain vs. ordinary income tax differences may be minimized. ♦

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For others who have maximized other forms of pre-tax or tax-free retirement savings, such as traditional or Roth IRAs, an annuity offers another way to save on a tax-deferred basis.

Unlike IRAs and qualified plans, there are no limits on the amount that can be invested in annuities (unless they are qualified annuities, such as individual retirement annuities).

Annuities come in two basic types - fixed annuities that offer investors a fixed return for certain periods, and variable annuities, which allow contract holders to allocate their money among a variety of subaccounts. You can also set up an individual retirement annuity, which provides for retirement saving on a tax-deferred basis. Before setting up an annuity, make sure you understand the fees. When selecting an annuity, conduct a careful evaluation of the annuity and the insurance company that stands behind it.
