

## September 2008 Issue

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## Rolling Over Pension Plan Assets to a Roth IRA

Starting January 1, 2008, the Pension Protection Act of 2006 permits proceeds from qualified retirement plans, including 401(k), 403(b), and 457 plans, to be rolled over directly to a Roth individual retirement account (IRA). In the past, the proceeds had to be rolled over to a traditional IRA and then from the traditional IRA to a Roth IRA. Guidance was recently released by the Internal Revenue Service on how to apply this provision.

The Roth conversion rules still apply to these rollovers. Thus, in 2008 and 2009, your modified adjusted gross income (AGI) cannot exceed \$100,000 to convert, not including any income resulting from the conversion. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs), but are exempt from the 10% early withdrawal penalty. Starting in 2010, all taxpayers can convert, regardless of their income.

When converting from a traditional IRA to a Roth IRA, you cannot convert just the nontaxable portion of your traditional IRA. You must assume that a pro-rata portion of both the taxable and nontaxable IRA funds are being converted. With a rollover from a qualified retirement plan to a Roth IRA, however, you do not have to use the pro-rata rule. Thus, if a portion of your plan contains nontaxable funds, you can convert only that portion to a Roth IRA, putting the taxable portion in a regular IRA (if your plan allows you to split your funds for distribution purposes). This strategy would not require the payment of any income taxes following the conversion.

If you have some nontaxable funds in your retirement plan, but the plan does not allow split distributions, you have a couple of options:

- Transfer all of the funds to a regular IRA and then convert a portion of the balance to a Roth IRA. This requires the use of the pro-rata rules, so you will owe some income taxes on the conversion.
- Request a check payable to you. You can deposit the check and then write two checks - one to the Roth IRA in the amount of your nontaxable funds and another for the balance to a regular IRA. However, the plan will be required to withhold 20% of the taxable amount for income taxes, which you will have to provide from personal funds to keep the entire balance invested. You will then get that money back when you file your tax return.

If you transfer the funds to a Roth IRA and find out that you are not eligible to do so (this would only be a concern in 2008 and 2009), you can recharacterize the funds to a traditional IRA. The funds cannot go back to the retirement plan. A recharacterization eliminates any tax consequences from converting to a Roth IRA. You can also recharacterize if you decide you do not want to pay the income taxes or your account value decreased after conversion, so that you owe income taxes on more than your account is currently worth. You have until October 15 of the year following the year of the conversion to recharacterize.

Nonspouse plan beneficiaries can also roll over inherited retirement plan balances to an inherited Roth IRA, even though they cannot roll over an inherited traditional IRA to an inherited Roth IRA. The rollover is only possible if the plan permits nonspouse beneficiary rollovers, and it must be a direct transfer to the Roth IRA. Once the assets are rolled over, the beneficiary must take required minimum distributions starting in the year following the original owner's death, even though it is a Roth IRA, since the beneficiary is not the owner or the owner's spouse. However, the distributions can be taken income-tax free. The beneficiary will have to pay income taxes on the taxable portion of the plan assets, but he/she will be entitled to the deduction for income in respect of a decedent, which will help offset some of the cost.

Typically, a Roth conversion makes the most sense when funds will not be deducted from the Roth IRA for a significant length of time. Since a nonspouse beneficiary must start taking distributions in the year following the original owner's death, he/she should carefully analyze whether it makes sense to convert. The younger the nonspouse beneficiary is, the more benefit he/she receives from the conversion, since distributions are made over the beneficiary's life expectancy.

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## **Social Security Benefits for Married Couples**

When should married couples apply for Social Security benefits? Before answering, you first need to understand the rules.

If benefits start at full retirement age, you are entitled to the larger of 100% of your benefit based on your earnings or 50% of your spouse's benefit. However, if you elect benefits before full retirement age, your spouse's benefit will be reduced by a larger percentage than your benefit was reduced. After your death, your spouse receives the larger of his/her benefit or 100% of your benefit, provided he/she is over full retirement age. If not, your spouse receives between 71.5% and 100% of your benefit. Thus, the larger your benefit is, the larger your spouse's benefit may be after your death.

For individuals turning 62 this year, full retirement age for Social Security purposes is 66. If benefits are claimed at age 62, that individual would receive 75% of full retirement benefits. For each year past age 66, benefits increase by 8% per year, for a maximum benefit at age 70 that is 132% of full retirement benefits. These amounts have been actuarially calculated, so that if you live to the average age, the benefits are approximately the same for a single individual, no matter when you start those benefits.

However, for married couples, benefits are not actuarially the same. Typically, the man is older than the woman, has higher earnings than the woman, and will not live as long as the woman. Because the surviving spouse can elect to receive 100% of the other spouse's benefit, it typically makes sense for the man to wait until age 70 to claim Social Security benefits, in order to provide his wife with the highest benefit possible after his death. On the other hand, there is usually no reason for the woman to wait beyond ages 62 to 66 to start Social Security benefits, provided she can claim benefits on her own earnings record. While the wife's benefit may be lower when her husband is alive, she will receive his higher benefit after his death.

A spouse who can't claim benefits on his/her own earnings record can claim spousal benefits, but he/she must wait until his/her spouse starts benefits or reaches full retirement age. Spousal benefits are reduced when taken at age 62, but do not continue to grow after full retirement age. However, a worker can apply for Social Security benefits at full retirement age, allowing his/her spouse to collect benefits, and then suspend his/her own benefit, reapplying at a later date.

Keep in mind that these strategies are based on individuals living an average life expectancy. If you and your spouse live well beyond that age, it will typically pay for both of you to delay benefits until age 70. However, if you both die young, it would make more sense for both of you to claim benefits at age 62.

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## Should You Pay Back Social Security Benefits?

Deciding when to start Social Security benefits is an important decision. While full retirement age for Social Security benefits is gradually increasing from age 65 to age 67, you can still start benefits at age 62. However, your benefit will be permanently reduced by 20.8% to 30%, depending on your year of birth. Wait until age 70, and your benefit will increase by 3.5% to 8% annually, again depending on your year of birth.

Thus, the amount of your benefit can change dramatically, depending on when you start drawing benefits. However, you can undo your decision by filing form 521, "Request for Withdrawal of Application," with the Social Security Administration (SSA). You must pay back any benefits you received, but you do not have to pay interest or inflation adjustments on that amount. The form asks for your reason for withdrawing your application, so that the SSA can assess whether you understand the implications of your decision.

When does it make sense to consider withdrawing your application? Suppose you retire at age 62 and decide by age 64 that you really don't enjoy retired life. You can pay back your Social Security benefits for those two years, work for six more years, and then reapply at age 70, receiving a substantially higher benefit than you received at age 62.

Or suppose you retire at age 62 with reduced benefits. You didn't consider the fact that when you die, your spouse will receive 100% of your benefit provided he/she is over full retirement age. Now that you are 70, you wish you had waited for the higher benefit, so your spouse would have more income after your death. You can file the application, repay all benefits received, and then immediately reapply for Social Security benefits, receiving a much higher benefit amount.

But does it make financial sense to repay all benefits when you have received them for several years? In essence, you are purchasing an annuity with inflation protection by doing this. One way to evaluate your decision is to first determine how much your benefit will increase, including additional income your spouse may receive after your death. Then, find out how much an annuity from a private company would cost for that incremental income. If paying back your Social Security benefits costs less than purchasing an annuity, it's worth considering.

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## What Happened to Savings in America?

Consider the following:

- America's personal savings rate - defined as savings divided by disposable income - has been falling steadily for more than two decades and is among the lowest in the industrialized world (Source: *Federal Reserve Bank of St. Louis Review*, November/December 2007).
- According to the U.S. Commerce Department's Bureau of Economic Analysis (BEA), Americans spent more than they saved in 2005, for the first time since the Great Depression (Source: Bankrate.com, March 2006).
- In a recent survey, nearly two-thirds of Americans admitted they don't save enough, and more than a third said they often (11%) or sometimes (25%) spend more than they can afford (Source: Pew Research Center Publications, January 2007).

In the mid-1980s, the savings rate stood at more than 10%. As of March of this year, it was a measly 0.4% (Source: Employee Benefit Research Institute, March 2008). These and a host of other data point to a disturbing reality: America is experiencing a savings crisis that threatens its economic future.

Savings are the source of capital investment in new products and services that increase productivity and contribute directly to economic growth. As domestic sources have dwindled, U.S. business and government alike have had to rely on foreign sources of capital, resulting in a growing outflow of billions of dollars a year in the form of interest and dividend payments. Instead of the world's banker,

the U.S. has become the world's largest debtor, with a growing trade deficit and a weakening dollar that threaten a shrinking economy, rising unemployment, and a lower standard of living.

## What's Behind It All?

Economists point to a number of factors that are driving America's shrinking savings rate, including:

**The wealth effect.** Beginning in the early 1990s, American household wealth skyrocketed as a result of booms in the stock and real estate markets. It's an economic axiom that when household assets increase rapidly, people perceive less need to save while their appetites for spending increase.

**Declining interest rates.** After peaking in 1980 to 1981, interest rates began a long decline, fueling the economy by encouraging borrowing and spending while gradually discouraging saving. The prime rate, at 21.5% in 1980, fell to 4.0% in 2003, and 30-year mortgage rates declined from an average high of 16.63% in 1981 to 5.83% in 2003 (Source: *The Wall Street Journal*, 2008). Meanwhile, rates on six-month certificates of deposit slid from a high of 17.98% in 1981 to a scant 1.02% in 2003, and even now are hovering below 3% (Source: Federal Reserve, 2008).

**Easier credit and ways to borrow.** Creative financing mechanisms, including zero-down, interest-only, and adjustable-rate mortgages, home-equity lines of credit, and the securitization of debt, made it easier for consumers to borrow money to buy anything from homes for investment to cars, vacations, jewelry, and the latest in digital consumer electronics.

These were only the latest developments in a 63-year period of virtually unbroken U.S. prosperity that has reshaped America from a nation of savers to a nation of shoppers. Even policymakers recognize that the consumer is responsible for upward of 70% of all spending in the U.S. economy and is largely responsible for fueling GDP growth since the falloff in capital spending early in this decade.

The concern, however, is that in the midst of these mechanical disincentives to save, two-plus generations of Americans have forgotten how to postpone immediate gratification. Now that we have entered an extended period where assets may no longer grow at the same rate as consumers have recently become accustomed, the fear is that the saving habit may not return to fuel needed investment in our economic future.

## What Can We Do?

Some of what needs to be done to stimulate American personal saving has recently been accomplished, but there's more to do. Some steps that would help turn the decline in personal savings around include:

**Continue to encourage automatic 401(k) enrollment.** The U.S. Pension Protection Act of 2006 made it easier for companies to enroll workers in 401(k) retirement saving plans without their prior permission. Instead of deciding to opt in to these tax-advantaged payroll savings plans, employees have the choice of opting out. Employers can determine a minimum contribution rate of up to 10% of pretax income, mandate higher contribution levels over time, and direct the investment of employee contributions. The plans are growing in popularity with employers: a survey found that 23% of 401(k) sponsors are automatically enrolling participants, compared to 14% a year earlier (Source: Deloitte Annual Benchmarking Survey, 2008).

**Publicize the split tax refund option.** IRS regulations were updated for 2007 to allow taxpayers receiving a refund via electronic deposit to target up to three different accounts, including savings and IRAs. Observers note, however, that many people still aren't aware of the opportunity, which requires filing IRS Form 8888 with their return.

**Expand the Savers' Tax Credit.** Enacted in 2001, this provision offers taxpayers who earn \$50,000 or less up to a \$2,000 tax credit for contributions to an IRA, 401(k), or other employer-sponsored retirement plan. Originally slated for extinction after 2005, the federal Savers' Tax Credit was made permanent by the 2006 Pension Protection Act. It also indexed income limits to inflation, a previous shortcoming that contributed to only five million taxpayers taking advantage of it in 2005. Advocates call for expanding the credit to create refunds for lower-income savers who don't have a tax liability.

**Create automatic payroll-based IRAs.** The Retirement Made Simpler Coalition, backed by the American Association of Retired Persons and the Financial Industry Regulatory Authority (FINRA), advocates the creation of automatic workplace IRAs for the 57% of American workers who aren't covered by a 401(k) plan (Source: *The New York Times*, April 27, 2008). As with automatic 401(k) plans, employers would enroll participants automatically, but enable them to opt out. Investment management would be contracted to private sector financial institutions, which would maintain no-frills accounts making maximum use of electronic technology. Once account balances reached a predetermined amount, participants could roll over to full-service accounts at providers of their own choice.

**Introduce government-matching contributions.** Among the most radical proposals to stimulate saving comes from The Brookings Institution, a nonprofit public policy research center, and economists from MIT. They urge the federal government to scrap tax deductions for contributions to traditional IRAs and

401(k) plans in favor of universal 30% government-matching contributions. They argue that the proposal would be tax-revenue neutral, but stimulate greater savings among low- and middle-income households, who benefit less from tax deductions than high-income taxpayers.

Americans' rapidly declining rates of savings aren't just bad for the nation's economy - they're bad for your future, too.

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## 7 Steps to a Financially Healthy Marriage

Money is one of the great battlegrounds of marriage. It's the factor responsible for the most divorces, and according to a survey by *Money* magazine, the subject married couples argue about more than any other topic except one (that honor is reserved for household chores).

Financial stress can come from many sources, but one of the most difficult is when one spouse is a spender and the other a saver. We come into marriage with attitudes toward money deeply engrained in our psyche, and they're not easily changed. But don't despair - if you find yourself engaged in a struggle with a spouse who is your opposite when it comes to saving and spending, there are steps you can take to achieve balance and harmony.

**1. Agree to be a team.** You got married to spend your lives together, so it shouldn't be difficult to start with this understanding, even if it may seem hard to reconcile with your money behavior. To be a team, you have to act like a team, and that starts by giving up individual possessiveness about money: there's no "your money" and "my money." It needs to be "our money."

**2. Agree on your goals.** Start your teamwork by articulating your long-term goals, they're the most important and the easiest to agree upon. Long-term goals might include living the lifestyle you want in retirement and educating your children. Be sure to be specific. A goal isn't a dream, like "a comfortable retirement" or "a good school for the kids." Articulating specific long-term goals involves knowing how much those dreams are going to cost and precisely when they will occur. You need dates and dollar figures.

Once you've reached an agreement on your long-term goals, try to set the same kind of specific plans for your intermediate- and short-term goals, like your next vacation and your savings and retirement account balances for the end of the year.

**3. Practice full disclosure.** Being a team means each of you is empowered to act on behalf of the other with implicit approval. That requires that each of you have full command of the facts: how much money you make, how much you owe, and how much you spend. Share the balances in any individual accounts you may hold, like checking and credit cards. You need to be completely honest with each other, even if you make a mistake now and then.

**4. Budget and pay bills together.** Create a monthly budget (spreadsheets are ideal for this) that compares the total of your bills and expected out-of-pocket expenses with every penny of incoming and available cash. Include an itemized list of your debts and scheduled payment amounts, as well as your asset accounts and their balances.

Thoroughness is a key determinant of your success, so don't overlook anything, especially significant one-time expenses like gifts or big nights out. Create a catch-all category of out-of-pocket expenses called "miscellaneous" for the little things you might forget - or those that are small and hard to pin down.

Pay your bills at the same time at the same place, and then update your budget spreadsheet as you do. This means revisiting your monthly budget at least once a month. Print out two copies and keep them somewhere you can each easily glance at whenever the need arises.

**5. Update your checkbook(s).** One way spenders rationalize their behavior is by keeping themselves in the dark - unaware - of how much they really have to spend. If you're going to be faithful to the budgeting process in Step 4, you have to keep careful track of your cash on hand, and that means being sure your checkbook entries are up to date.

**6. Agree on spending rules.** You and your spouse need to agree on how much you can spend on purchases without consulting the other. Beyond this preset amount, you should talk about the purchase in advance and adjust your budget spreadsheet accordingly.

**7. Create a financial plan.** Everybody should have a professionally prepared plan, but for couples with polarized spending and saving habits, it's especially important. Apart from the fact that a professional can provide the expertise and tools you may lack, he/she will serve as an impartial third party to help you defuse your money debates.

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