IN THIS ISSUE

Retirement planning

Caution needed on pension buyouts

Consistency pays off

How to maximize Social Security benefits

Tax Currents

Arbitration eliminated

Solar array okayed

Snow day as a legal holiday

Trust UPDATE

October 2015

Caution needed on pension buyouts

More and more companies are offering or planning to offer lump sum distributions to former employees, sometimes referred to as "pension buyouts," according to a September report in *The Wall Street Journal*. A number of factors were cited for the trend:

- Low interest rates and shrinking market returns have enlarged the gap between pension assets on hand and obligations to plan participants. According to Standard & Poor's, the gap grew from $224.5 billion at the end of 2013 to $389.1 billion at the beginning of this year.
- Premiums paid to the Pension Benefit Guaranty Corporation are ratcheting up, increasing 30% from last year to next year.
- When a participant accepts a buyout, the longevity risk (the chance that the participant will outlive his or her life expectancy) shifts from the employer to the participant.
- New IRS tables reflecting greater longevity won't go into effect until 2017.

That last point is what gives the issue great urgency. Longer life expectancies mean larger lump sum distributions, so companies have a great incentive to make these offers this year and next. However, low interest rates also lead to larger lump sums. As interest rates go up, the actuarial calculations converting a stream of future payments to a single payment today lead to smaller numbers. Thus, the optimal strategy for a company is to offer lump sums after interest rates go up (possibly later this year?) and before 2017.

The optimal strategy for those who may receive lump sums is something else.

GAO has concerns

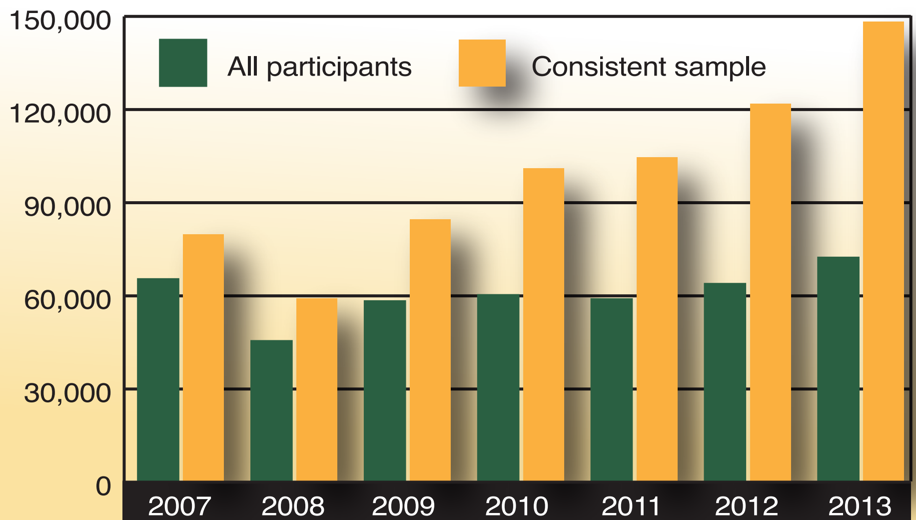
Last February the Government Accountability Office released a study, *Participants Need Better Information When Offered Lump Sums That Replace Their Lifetime Benefits*. The highlights and summary of recommendations may be found at http://www.gao.gov/products/GAO-15-74, as well as a link to a PDF of the full study.

Continued on next page

Consistency pays off

A study of 401(k) participant data by the Employee Benefit Research Institute (EBRI) reveals the importance of consistent plan participation to building a significant retirement resource. A group of 4.2 million participants who made consistent plan contributions was compared to a universe of 21.8 million participants for the period from 2007 through 2013. That includes the difficult year of 2008, when the average 401(k) plan balance fell more than 25%.

As one would expect, those who made consistent contributions did far better than average in building their retirement accounts, by a factor of two.



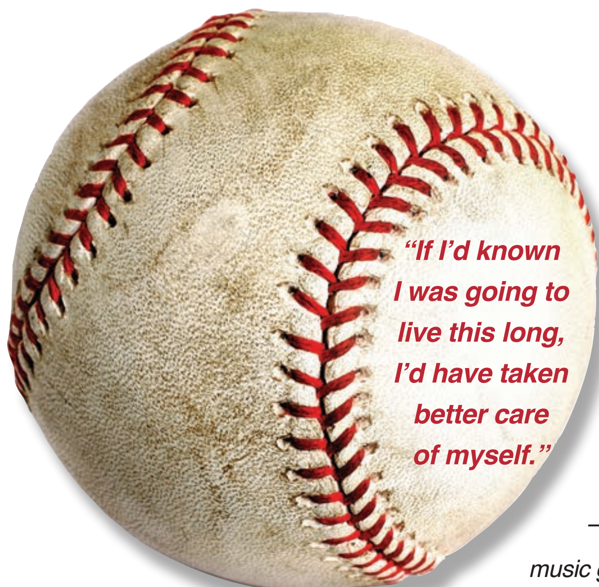
Source: http://www.ebri.org/pdf/briefspdf/EBRI_IB_418.Sept15.Longit-Ks.pdf

Both groups have roughly two-thirds of their accounts invested in equities, so asset allocation does not explain the difference in accumulations. Those who make consistent contributions buy more stocks when prices fall, and therefore they are in a better position to profit when prices rise once again.

***Caution** . . . continued*

As the title of the study suggests, the GAO is concerned about decisions based upon inadequate information. ERISA requires that the lump sum be actuarially equivalent, but that does not mean each choice is equally appropriate. Plan participants may not fully appreciate all the implications of accepting a lump sum.

Tax implications. Unless the lump sum is rolled over into an IRA, the entire amount is immediately taxable. Those under age 59½ also must pay a 10% penalty. The information packets reviewed by the GAO all had the legally mandated language informing the participants of potential tax consequences, but the eyes may glaze over at the legalese.



—Attributed to baseball great Mickey Mantle, and also to music great Eubie Blake. It is engraved on Blake's tombstone.

Investment implications. In making the offer of a pension buyout, the employer is shedding responsibility for managing the funds. That's understandable, because it is difficult work. Is the participant prepared to develop an investment strategy for the money? Can he or she implement the strategy and monitor the funds in the long term? What rate of return will the participant need to achieve in order to create a retirement income stream that is comparable to the pension? Is that return realistically achievable?

Longevity risks. One advantage of taking a lump sum is the possibility of leaving something for one's heirs. If one doesn't need the money right away, it may continue to grow tax deferred if it has been rolled into an IRA, resulting in an even more secure retirement in later years. But the flip side is the risk of outliving the money if one lives "too long." The pension promise does not expire until death.

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How to maximize Social Security benefits

Single people have two strategies available for maximizing their Social Security benefits: earn more during the working years and/or delay benefits. Working while delaying benefits may further boost the earnings record upon which benefits will be based.

Recent studies suggest that more and more people are delaying their Social Security start date. Of the men born between 1930 and 1934, 57% began taking their benefits at age 62, their first opportunity. That figure fell to 45% for men born in 1943 and 1944, according to a study by the Urban Institute of census data. Half of the women born in those years claimed at age 62. Only 19% of the men and 13% of the women born in those years were able to wait until their normal retirement age of 66 to receive their full benefits. The table below, *Benefit Calculator,* shows the percentage reduction for early retirement and the effect of the 8% credit given for each year in delaying benefits.

Married couples have more strategies available.

Benefit calculator

For those born from 1943 through 1954, the normal retirement age is 66. This table shows the effect of both the reduction for early retirement and the 8% credit for delayed retirement for this group.

Age	62	63	64	65	66	67	70
Benefit, as a percentage of primary benefit amount	75%	80%	86⅔%	93⅓%	100%	108%	132%

Source: http://www.socialsecurity.gov/OACT/ProgData/ar_drc.html

File and suspend

Spousal Social Security benefits are based upon the work record of a living spouse or ex-spouse. They are generally 50% of the worker's benefit. Survivor benefits, based upon the work record of a deceased spouse or ex-spouse, are 100% of the deceased worker's last benefit.

When a husband and wife each have work records, each has the choice between taking a spousal benefit or the regular benefit. The choice does not have to be permanent. Some affluent couples have explored a strategy called "file and suspend" to maximize their joint Social Security benefits.

Example: Harold and Ann would like to maximize their benefits by waiting to age 70 to begin collecting. Harold, who had the higher income, files for his benefit upon reaching normal retirement age, and then suspends the benefit to gain the additional delayed retirement credits. Ann can go ahead and claim her spousal benefit, collecting it until she reaches age 70, when she'll switch to her own benefit, including the full credit for delay.

This maneuver is allowed only once per couple, however. The Social Security Administration provides details on the strategy at http://www.socialsecurity.gov/retire2/suspend.htm. ☐

SOCIAL SECURITY TRIVIA

To celebrate the 80th anniversary of the creation of Social Security, the Social Security Administration has created a trivia quiz. Among the nuggets of information:

Since it began in 1935, Social Security has collected $18.0 trillion (largely from Social Security taxes paid by workers and employers) and paid out $15.2 trillion for benefits and administrative costs.

For one out of every three recipients, Social Security is all, or almost all (90% or more), of his or her income. Two in three elderly beneficiaries rely on Social Security for half or more of their total income.

The first enrollees in the Medicare system were former President Harry S Truman and his wife, Bess.

The first baby boomer, who was born one second after midnight on January 1, 1946, filed her claim for Social Security retirement benefits online on October 15, 2007. Today more than half of all retirement claims are filed online.

Beginning in 1998, Social Security has published an annual list of the most popular baby names based on the names from Social Security card applications for newborns. The page is the most popular one on the Social Security Web site, with almost 3 million visits in 2014. In the 1990s, when the list began, the most popular boy's name was Michael, and the most popular girl's name was Jessica.

Additional trivia may be found at **www.socialsecurity.gov/80thanniversary/trivia.html**

Arbitration eliminated

In 2000 the IRS began a pilot program for arbitration of disputes with taxpayers. The program was mandated by "The Internal Revenue Service Restructuring and Reform Act of 1998," and it was expected to reduce the burdens on the Tax Court, which is where such conflicts otherwise would get resolved. The program was made permanent in 2006. Under the program, issues of fact may be submitted to an arbitrator, whose conclusions will be binding on both the taxpayer and the IRS.

In September the IRS announced that the arbitration program will be dropped, because no one wants to use it. During its entire 14-year existence, only two cases were settled by arbitration. Just 16 taxpayers even began the arbitration process. The cost of setting up and maintaining the program for all that time was not included in the announcement.

Alternative dispute resolution programs will be continued, such as Post Appeals Mediation and Fast Track Settlement, in which taxpayers have shown interest.

Solar array okayed

Taxpayers are permitted a 30% tax credit for residential installations of a variety of devices promoting energy efficiency, including solar electric panels, solar water heating, fuel cells and geothermal heat pumps. Recently, the IRS allowed the purchaser of an ownership interest in community-shared solar panels to claim the individual residential tax credit. The array will transmit electricity to the taxpayer's power company, which will credit the taxpayer's share of electricity received from the array against the taxpayer's electric bill.

The 30% tax credit expires at the end of 2016, unless Congress takes action to renew it.

Snow day as a legal holiday

Taxpayer was nearing the 30-day deadline for filing an appeal with the Tax Court. Because the paperwork absolutely, positively had to be there the next day, Taxpayer used FedEx to send it. Apparently, he was unaware that a timely postmark would have satisfied the deadline.

As it happened, the next day (the filing deadline date) it snowed in Washington, D.C., and all federal offices were closed. The paperwork arrived the day after, one day late. When the IRS objected to the late filing, the Tax Court held that because it had itself been closed, the day should be treated the same as a legal holiday. Accordingly, the filing was not late.

Practitioners were surprised by the expansiveness of the Court's preliminary ruling. Will a similar rule apply in the event of a future temporary government shutdown? That was not the case in October 2013, when the federal government (including the Tax Court) was closed for 16 days. ☐

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