

RETIREMENT Plan Trends



A benefits update

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Income Levels On Roth IRA Conversions Lifted In 2010

The Roth IRA, an individual retirement account that is funded with after-tax dollars and offers tax-free earnings and tax-free distributions, has been available for more than a decade to taxpayers below certain income levels. Due to a change in the law that goes into effect in 2010, taxpayers at all income levels can now take advantage of the Roth IRA, as income limits on conversions from traditional IRAs to Roth IRAs have been eliminated.

The 2010 contribution limits for IRAs, whether traditional, Roth, or both, are \$5,000 for individuals under age 50 and \$6,000 for those aged 50 and older. While Roth IRAs are potentially attractive to higher earners, individuals with incomes above a certain level are not allowed to contribute directly to these accounts. In

2010, the modified adjusted gross income (MAGI) limits for making direct contributions to Roth IRAs are \$177,000 for married filers and \$120,000 for single filers. Prior to 2010, the MAGI limit for converting a traditional IRA to a Roth IRA was \$100,000 for both married and single filers.

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Under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the conversion income limit is removed in 2010, meaning that taxpayers at all income levels may convert from a traditional to a Roth IRA simply by paying the income tax owed on the value of assets held in the account in the year in which conversion occurs. To make conversion more attractive, TIPRA stipulates that a saver who converts in 2010 may choose to either pay the tax owed immediately or spread the tax payment over 2011 and 2012. For example, a taxpayer who converts \$50,000 in 2010 could elect to pay tax on \$25,000 in 2011 and \$25,000 in 2012. Income inclusion will, however, be accelerated if distributions are taken during these years. Taxpayers under age 59½ will be subject to an early withdrawal

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Converting to a Roth IRA allows taxpayers to lock in a tax rate, whereas those with traditional IRAs will be unable to predict changes in the law or their own circumstances that could push them into a higher tax bracket in retirement.

excise tax of 10% if IRA funds are used to cover the taxes owed on the conversion.

For taxpayers who expect to be in a comparable or higher tax bracket during retirement, the Roth IRA may offer advantages. Converting to a Roth IRA allows taxpayers to lock in a tax rate, whereas those with traditional IRAs will be unable to predict changes in the law or their own circumstances that could push them into a higher tax bracket in retirement. In addition, unlike traditional IRAs, Roth IRAs have no minimum distribution requirements at age 70½. This makes the Roth IRA particularly attractive for individuals who wish to pass on their tax-free savings to heirs, rather than draw down the funds to finance their retirement. Bear in mind that there may be estate tax implications.

Owners of traditional IRAs who are uncertain about converting to a Roth IRA may choose to convert only a portion of an account to a Roth IRA. Moreover, those who perform the conversion and then decide they wish to switch back to a traditional IRA have until the filing date for the year in which the conversion took place to do so. While taxpayers can now convert from a traditional to a Roth IRA at any time, 2010 may be a particularly advantageous time to do so because the value of their accounts may be unusually low in the wake of the economic downturn, thus minimizing the taxes owed, and because account holders who convert in 2010 have the option of spreading their tax payments over the following two years.

Decumulation Of Retirement Funds Is A Challenge

Participants in defined benefit retirement plans frequently struggle when making decisions about how best to draw down their savings after reaching retirement age, but plan sponsors can guide participants in making choices

appropriate to their circumstances, a study published by human resources consultancy Mercer has found.

In an analysis of the psychology behind plan decisions in the payout, or decumulation, phase in the lives of defined contribution plan participants, researchers observed that, depending on their region and plan type, newly retired participants may have several options for accessing retirement funds, or they may be required to draw down funds in a predetermined way. These options generally take the form of a lump-sum (single payment), programmed withdrawals (a series of fixed or variable payments), or a life annuity (a stream of payments for as long as the retiree lives that may include additional guarantees, such as continued payment to a surviving spouse).

Each of these options, researchers noted, has its own merits. For example, a life annuity provides protection against longevity risk, but does not usually provide the potential for making a bequest to heirs other than the spouse. By contrast, taking a lump sum provides flexibility and liquidity, as well as the ability to pass assets on to heirs, but it does not protect retirees against the risk of outliving their savings. Because of the pros and cons, the study's authors pointed out, plan participants may find it particularly difficult to make a decision. Thus, the analysis showed, most defined contribution plan participants in the U.S. choose to withdraw their funds in the form of a lump sum.

In examining how plan participants come to make their decumulation decisions, researchers looked at behavioral patterns that scientists have identified as typical. These decisions may be based on a number of factors, including past experience, logical processing, and emotion. While it is generally thought that people become "wiser" as they age, and can draw upon experience with other financial matters, past experience may be of little use in making decumulation decisions because the issues associated with drawdown in retirement may differ from past choices.

“Spend-down and payout decisions are extremely important and will affect the rest of one’s life,” researchers said. “Yet the average individual is very poorly prepared to manage a lump sum that must last for years. There is also an increasing chance that as people age, their ability to make appropriate decisions declines.”

For example, the authors observed, many retirees experience “myopic loss aversion,” which leads them to think only about the next few years, while failing to plan for the longer term. Others may experience “inertia,” opting to draw down funds gradually or to take a lump sum, but refusing to make the commitment required to purchase an annuity, even if it would be in their best interest. The decumulation decisions of yet another group may be too easily influenced by “framing,” or the manner in which information is presented to them by advisers, or by “choice overload,” in which the sheer number of choices leaves the retiree feeling overwhelmed.

Certain other retirees may, for example, find it difficult to leave behind the active investment decision making they engaged in during the accumulation phase prior to retirement, or they may be tempted to take on a level of risk not usually recommended for retirees in order to make up for recent losses in the bear market. These more active participants may also experience “home bias,” which leads them to maintain their relationship and investments with the financial advisor who guided them in the accumulation phase.

Although retirement plan sponsors should not make decumulation decisions on behalf of participants, the study’s authors emphasized that sponsors must take responsibility for supporting payout decisions and ensure that they meet all applicable governance and fiduciary requirements. Researchers recommended that plan sponsors decide on a basic philosophy with regard to decumulation decisions and structure their plan’s payout options according to emerging realities.

For example, at the two extremes, sponsors may offer payment as life income only, based on the philosophy that the plan was conceived as a retirement income plan, or sponsors could offer a lump sum only, based on the philosophy that retirement is an individual responsibility. As an alternative, the plan sponsor might offer a range of payout options, focusing communication on responsibility and choice, or include a default distribution system.

In addition, the authors recommended that sponsors review their communication strategies. For example, the way that account statements present information and options are explained can affect decumulation decisions. Specifically, sponsors should help participants understand the tradeoffs involved in certain options and make the decision most appropriate to their circumstances.

“The nature of modern DC plans is that they offer choice and transfer responsibility to the individual,” the authors concluded. “Plan members need to remember that decisions they make throughout their lives will define their retirement security. Choices at payout are vital for their financial security in retirement.”

For plan sponsors, they added, “there is a tremendous opportunity to assist employees rather than leaving them to their own devices: through plan design, support for retirement planning, and the creation of the appropriate context for employee decision making.”

Marriage May Affect Wealth Accumulation

With the changes in family composition over time, the number of people expected to reach retirement without the financial support of a spouse is expected to grow. However, some of the lower levels of wealth accumulation seen among divorced and single people may be



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attributable not only to marital status, but also to demographic and economic factors, according to a study published by the University of Michigan Retirement Research Center.

In her working paper, “Gain and Loss: Marriage and Wealth Changes Over Time,” Julie M. Zissimopoulos noted that, since the late 1960s, divorce rates have increased, and remarriage rates have declined. However, even though married couples are generally expected to have better prospects for wealth accumulation than single people, due to factors such as economies of scale and better health, marriage may also discourage saving behaviors by reducing risks associated with income fluctuations. Complicating the link between marriage and wealth is the finding that low-income families are more likely to experience divorce or widowhood than high-income families.

In order to investigate the relationship between wealth changes and marital status among individuals over age 50, the author looked at eight waves of panel data (spanning from 1992 to 2006) from the Health and Retirement Study, incorporating measures of current and lifetime earnings, mortality risk, and other characteristics that vary by marital status into models of wealth change. The study then measured the wealth loss and gain associated with divorce, widowhood, and remarriage, estimating the wealth change before and after marital status change in order to eliminate other factors not associated with the marital change from the estimates.

The study found, for example, that, among the birth cohort 1931–1941, 84% were married in 1992, 10% were divorced, and 6% were widowed. Over the next 14 years, 15% of this sample changed marital status, with 4% of married respondents divorcing and 10%

losing a spouse. The data showed that respondents who were married in 1992 and had no marital status changes over the next 14 years had higher mean and median wealth than married respondents who would eventually divorce or be widowed. This group of continuously married individuals had on average \$363,814 in housing and non-housing wealth (not including pension wealth), compared to \$278,365 for married respondents who later divorced and \$254,362 for married respondents who became widowed. Meanwhile, remarried respondents who remained married over the 14 years also had lower average wealth (\$281,843) than married respondents whose marital status did not change over the period.

However, the study found that, over time, the higher savings levels of stable married couples relative to those of men who were not married can be accounted for by observable differences in economic status, pensions, and mortality risk. Meanwhile, these observable differences were found to account for between one-third and one-half of the mean savings differences between married women and divorced, widowed, and partnered women, as well as for all of the differences between couples and never-married women.

Moreover, the study found, divorce is associated with wealth loss beginning two to four years prior to divorce, as well as substantially more wealth loss over the two years when the individual transitions from being married to being divorced. However, wealth recovery among divorced individuals can occur through increased savings and remarriage. “Divorce at older ages is costly and remarriage is wealth enhancing, and people appear to respond to marital status changes by changing their savings behavior,” Zissimopoulos concluded.



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