

RETIREMENT Plan Trends



A benefits update

Volume 53, Number 6

Health Care Reform Provisions For Retirees

Besides provisions affecting the nation's health insurance and delivery systems, the recently enacted health care reform legislation also includes provisions that will affect retirees and others who are saving for retirement. While the new legislation will not have an impact on contributions to or distributions from 401(k) and other qualified plans, it does include a tax on distributions for high-income taxpayers who purchase non-qualified annuities, changes to Medicare Part D, and a new long-term care program.

The Patient Protection and Affordable Care Act of 2010 (Patient Protection Act) was signed into law by President Barack Obama on March 23. One week later, on March 30, the President signed into law the Health Care and Education Reconciliation

Act of 2010 (Reconciliation Act). Under the Patient Protection Act, as amended by the Reconciliation Act, starting in 2014, all legal U.S. residents not covered by employer-provided insurance or Federal programs like Medicare or Medicaid will be required to obtain health care coverage or pay a penalty, unless certain exemptions apply. Families and individuals with incomes below

specified levels will be offered assistance from the Federal government in paying for their premiums, and businesses will be required to pay tax penalties if employees qualify for a health insurance premium subsidy.

To help raise revenue to cover the costs of providing subsidies, the new law will broaden the Medicare tax base for higher-income taxpayers starting in 2013. This includes levying an additional Hospital Insurance tax rate of 0.9% on earned income in excess of \$200,000 for individuals and \$250,000 for married couples filing jointly, as well as a 3.8% unearned income Medicare contributions tax on higher-income taxpayers on the lesser of net investment income or the excess of modified adjusted gross income (AGI) over the same threshold

Also In This Issue

- Dynamic Investment Strategies For 401(k) Savings
- Small Business Owners And Retirement Saving

**Furr &
Associates**
Insurance and Investment Services

5575-C Garden Village Way
Suite 102
Greensboro, NC 27410

(336) 852-4554
(336) 698-3180 *fax*
(877) 273-7755

www.furrandassociates.com

Securities and investment Advisory Services offered through Woodbury Financial Services, Inc. Member FINRA/SIPC, and Registered Investment Advisor, PO Box 64284, St. Paul, MN 55164 (800) 800-2000



In addition, the legislation introduces a long-term care savings program under the Community Living Assistance Services and Supports Act (CLASS Act).

amounts. Some trusts and estates will also be liable for this 3.8% tax.

These tax provisions will not apply to elective contributions or to investment earnings in 401(k)s, IRAs, pensions, and other qualified plans. However, the 3.8% unearned income tax on higher-income taxpayers will apply to net investment income, including interest, dividends, capital gains, rents, royalties, and distributions from non-qualified annuities.

Certain insurance industry groups have expressed opposition to this new tax on higher-income taxpayers who purchase annuities. Following passage of the legislation in the House, Tom Currey, president of the National Association of Insurance and Financial Advisors (NAIFA), said, "We need to encourage people to put at least some of their retirement funds into lifetime annuities—not discourage them. This proposal will certainly do the latter."

The health care reform package contains several other provisions that will affect retirees. Under the new law, the so-called "doughnut hole" in Medicare Part D prescription drug coverage will be closed over the next several years, and beneficiaries who fall through this coverage gap qualify for a \$250 rebate in 2010. Starting in 2013, the legislation also eliminates the deduction of employer subsidies for maintaining prescription drug coverage for retirees who are eligible for Medicare.

In addition, the legislation introduces a long-term care savings program under the Community Living Assistance Services and Supports Act (CLASS Act). While the CLASS Act provision goes into effect in 2011, the details of the program are expected to be developed by the U.S. Department of Health and Human Services (HHS) over the next several years. It is intended to be a self-funded, voluntary program through which individuals pay a monthly premium in exchange for receiving cash benefits to cover their long-term care needs in case of disability following at least five years of participation. When the program is in place, workers will

have the option of participating through payroll deduction.

Dynamic Investment Strategies For 401(k) Savings

Defined contribution plans, such as 401(k)s, are effective vehicles for retirement savings, but more dynamic investment strategies involving frequent adjustments to portfolios, based on both market conditions and the individual circumstances of participants, may help workers achieve a steady income in retirement, according to a study published by the National Center for Policy Analysis.

The policy report, "Preparing for Retirement in an Uncertain World," was written by Liquan Liu, Andrew J. Rettenmaier, and Thomas R. Saving. The authors observed that defined contribution plans are inherently risky, especially given the investment strategies most commonly used in association with these plans. Because of the volatility of equities, a participant with investments in equities risks receiving lower retirement income if he or she retires in a year when the stock market is down. On the other hand, a participant who invests in a no-risk government bond fund faces low interest rates and may have to save a greater amount to meet retirement savings goals. Although conventional lifecycle investment strategies are intended to reduce the risks of volatile stock prices by gradually shifting the mix of investments from stocks to bonds as an individual ages, they often produce significantly lower returns than investments in equities.

A better investment strategy, according to the authors, would take into account any additional sources of retirement income the worker may have, including expected wage income in retirement, Social Security benefits, and income from trusts and pensions. "This strategy is

based on the idea that at any given point in time an individual's wealth consists of the capitalized value of future wage earnings, the capitalized value of Social Security benefits and other private retirement income, and the amount accumulated in one's defined contribution account," the authors explained.

Specifically, researchers asserted, workers whose expected future labor earnings, Social Security benefits, and pension benefits are large relative to their 401(k) savings can afford to take more risks with their 401(k) funds, and workers with more certain expected wage income may be more willing to invest more heavily in stocks than workers whose wages are more volatile.

Taking these factors into account, the authors recommended that workers save using a "dynamic lifecycle strategy," that involves the creation of individualized portfolios that are adjusted and updated annually, based on prevailing market conditions, changing investor expectations about future earnings, and changes in the investment horizon. This strategy, the authors said, "is responsive to market conditions that affect the current value of the investor's retirement account."

For example, during a bull market, the ratio of 401(k) assets to total wealth would rise, and a move toward lower stock holdings would be advisable. On the other hand, during a bear market, a shift in the opposite direction would be advisable. In a dynamic account, the authors said, these shifts in asset allocation would occur over a shorter time span than with a conventional static lifecycle account.

Using the earnings profiles assumed in the 2009 Social Security Trustees Report, the study simulates how these portfolios would work, assuming a constant 10% in annual earnings and a replacement rate equal to the ratio of the annuitized value of wealth at retirement divided by average real lifetime earnings. Meanwhile, the level of risk is measured by a "coefficient of variation."

The simulated portfolios show that, on average, dynamic lifecycle portfolios have a higher replacement rate than

conventional lifecycle strategies at every risk level. For example, the dynamic average replacement rate is 14% higher, and its relative variation lower, than a portfolio that is constantly invested 60% in stocks and 40% in bonds. The dynamic account produces a 21% higher average replacement rate than an aggressive static lifecycle account, which is weighted more toward equities, but displays only slightly higher relative variation.

On average, as a percentage of lifetime wages, an account invested 100% in equities offers the highest wage replacement rate, or 197%, but the coefficient of variation, or risk level, is 27%. At the other end of the spectrum, an account invested 100% in bonds was shown to offer a replacement rate of 62%, while the coefficient of variation in replacement rates is 6%.

Meanwhile, an account invested using a dynamic lifecycle strategy was found to offer a wage replacement rate of 182%, or close to the rate of the all-stock portfolio, but with a coefficient of variation of only 18%. The analysis also showed that a baseline dynamic lifecycle account, which is designed for participants who want to minimize their risk, offers a 145% replacement rate and a coefficient of variation of just 8%.

Thus, the authors concluded, an appropriately chosen lifecycle investment strategy can enable workers to take advantage of the average higher returns offered by the stock market, while shielding them from high levels of risk. They therefore recommended a change in public policy that would allow employers offering 401(k)s to default their employees into a dynamic lifecycle fund.



A "dynamic lifecycle strategy" involves the creation of individualized portfolios that are adjusted and updated annually, based on prevailing market conditions, changing investor expectations about future earnings, and changes in the investment horizon.

Small Business Owners And Retirement Saving

While many small business owners and self-employed individuals are saving for retirement, a significant number of

entrepreneurs, especially those with the smallest businesses, women, and members of minority groups, may not be doing enough to plan for their retirement security, according to a study by the U.S. Small Business Administration (SBA).

The working paper, "Saving for Retirement: A Look at Small Business Owners," was written by Jules H. Lichtenstein of the Office of Advocacy of the SBA. The study's findings are based on data from the U.S. Bureau of the Census' Survey of Income and Program Participation (SIPP) for a four-month period in 2006.

The study divided business owners into two groups based on number of employees: "micro-business" owners, who have fewer than 10 workers, and owners of larger businesses who employ 10 or more workers. Of the 4,922 business owners in the nationally representative sample studied, over 91% were owners of micro-businesses.

"Business owners are likely to own multiple accounts, indicating that many of them have a taste for saving, as well as owning and investing in their own business," Lichtenstein said. However, he continued, many business owners are failing to save adequately for retirement.

Overall, the analysis showed that retirement account ownership, contribution rates, and participation rates for all business owners are low. Results showed that the IRA ownership rate for business owners is only about 36%, and only one-third of business owners with an IRA contributed in the 2005 tax year. Further, less than 2% of business owners own a Keogh plan, and only around 18% participate in a 401(k)/Thrift plan.

The study also found that the characteristics of the business owner and of the business itself, along with asset accumulation, significantly influence retirement savings behavior. For example, business owners are more likely to own

an IRA and participate in a 401(k)/Thrift plan if they own a home and participate in other retirement savings accounts, and they are more likely to own an individual IRA if they are older, female, white, non-Hispanic, more educated, and married. However, while women business owners are more likely to own an IRA than their male counterparts, there is no evidence that they have higher contribution rates.

Owners of larger and more profitable businesses and those who have more than one business were also shown to be more likely to contribute to retirement accounts. While business size was found to be related to 401(k)/Thrift plan participation, no correlation was seen between business size and IRA or Keogh ownership, or IRA contributions.

There are many policy implications of the study's findings, according to Lichtenstein: "These include developing ways that help the owners of the smallest businesses, especially home-based sole proprietorships, increase their retirement savings." He also recommended that policy makers take steps to help minority, especially Hispanic, business owners increase their retirement savings, possibly through more bilingual information about retirement plans.

In addition, Lichtenstein observed that better coordination of employer-based retirement accounts with individual-based accounts, like IRAs, are needed, and plans should be made less complex and burdensome for business owners, especially for owners of micro-businesses. Finally, the study's findings highlight the need to help employers provide retirement savings options to their employees in a fair and equitable way by expanding "safe harbor" provisions, which reduce frequent non-discrimination testing when there are changes in a very small pool of retirement plan participants.



Results showed that the IRA ownership rate for business owners is only about 36%, and only one-third of business owners with an IRA contributed in the 2005 tax year.