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Working Longer To Fix The Retirement Mess

Are you willing to postpone retirement by two to four years? If you want to enjoy a secure, prosperous retirement, delaying it may be the best way to get there, according to a new book published by the Brookings Institution Press. *Working Longer: The Solution to the Retirement Income Challenge* offers a sobering yet hopeful message to Americans approaching retirement age at a time of soaring health care costs, declining pensions, severely weakened retirement accounts, and shaky prospects for Social Security.

Authors Alicia H. Munnell, professor of management sciences at Boston College, and Steven A. Sass, associate director of the Center for Retirement Research at Boston College, argue that raising the average retirement age from 63 to 66 would solve many of the financial problems retirees are facing. "The key is to avoid drawing on your Social Security benefits or 401(k) plan until age 67," says Sass. Allowing your retirement assets to grow just a few years longer can significantly boost your assets, and delaying retirement means a shorter period during which you'll have to depend on retirement savings.

The nice thing about this strategy is that it won't necessarily mean enjoying fewer years of post-work life. Because life expectancy has soared while the average age of retirement has fallen, merely moving back the start could still afford you decades of doing whatever you have planned. Consider these numbers:

- The average life expectancy for a 55-year-old man in 1965 was 20 years; by 2005, it had risen to 25 years.
- For women at 55, life expectancy rose from 25 years in 1965 to 29 years in 2005.
- About 19% of men and 33% of women who survive to age 65 today will live to age 90 or older.

Meanwhile, the average retirement age for Americans fell from 65 in the mid-1960s to 63 in the 1980s, where it remains today. A major reason is that workers may start receiving Social Security benefits at age 62, even though beginning then, rather than waiting until full retirement age, reduces the amount of the monthly payments you'll receive. And while Social Security's official retirement age is gradually rising from 66 to 67, the government has opted to leave the earliest eligibility age (EEA) at 62. Sass and Munnell believe the government should push back the EEA to age 64 to encourage people to remain in the work force longer.

The declining U.S. savings rate is another strong argument for staying on the job a few additional years, suggests Sass. "For baby boomers, it's getting a little late to save," he says. "They don't have that much money in their 401(k) plans. Working longer is probably the best option."

Sass notes that the amount of your Social Security benefit is calculated using the 35 highest-paid years of your working life. "By delaying retirement, very often you'll replace a zero- or low-earnings year and actually increase your benefit level," he says. Moreover, each year you wait before starting Social Security payments will boost the amount. Work four years longer, Sass estimates, and you'll increase your monthly check by a third.

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There May Be A Check In That Junk Mail!

Over the years, you may have noticed a handful of settlement checks that arrive, unannounced, looking like junk mail. Don't be so quick to toss them; it could mean money in your pocket.

These settlement checks stem from class action suits brought forth years ago. This is nothing that you, FSA, or Schwab has done, but rather stems from particular trading practices within various mutual funds that we've purchased in your account. No, it's not a Madoff situation, but either way, you may be entitled to "damages." As much as we would hope to inform you when these are arriving, we find out when you do; because there is no warning, you need to be careful you're not throwing away money!

Speaking of Madoff, we've included an article in this issue that speaks directly to the warning signs that things were not right with his business. This is good information to know as there will undoubtedly be another "Madoff" around the corner. When it sounds too good to be true, it usually is.

This issue also rounds the bases on business planning. Whether you're looking for tax breaks or ways to transition your business through estate planning, this issue provides some great ideas. Also, what have we learned from this recent market crisis? Read about what we've learned from past problems, and what typically follows.

Enjoy your summer!

Jim Joseph, CFP®
Vice President

Red Flags Raised By Madoff's Scheme

The recent revelations concerning Bernard Madoff's "Ponzi scheme" have put the fear of fraud in investors. Even if you never came anywhere near Madoff Securities, you may sympathize with those who reportedly were bilked out of billions of dollars. And you'll probably wonder whether something similar could happen to you.

According to Madoff's indictment, his truly was a scandal for the rich and famous, who were drawn in not by a chance to make a quick killing but by rock-steady annual returns of 10% to 12% regardless of the state of the markets. Although there are no guarantees that any financial manager is on the up-and-up, a closer examination of Madoff's operation would have revealed several "red flags," giving investors pause.

The mere fact that he had an unwavering track record should have been the first and biggest warning sign. Normally, even the best-diversified portfolios will rise and fall with the markets; the hope is merely for a smoother-than-normal ride and better-than-average results. In addition, Madoff took the unusual step of assuming full custody of client assets, rather than using a nationally recognized custodian. That, too, should have set off alarm bells. But there were also other problems.

Madoff's books were audited by a little-known accounting firm. That's extremely unusual for such a major investment company. Normally, big investment managers use a Big Four national accountant or at least a prominent regional firm—and investors thinking about entrusting Madoff with millions of dollars in assets should have been wary.

The lack of information on Madoff's website and in his brochures was telling. There was nothing about the qualifications or designations of the firm's money managers, and scant information about Madoff's process for managing assets. If investors had compared these marketing materials to those of other, more forthcoming investment firms, they might have been more inclined to question Madoff's apparently remarkable results. Those who did try to decipher how Madoff worked his magic found they couldn't replicate his results—it just seemed impossible to deliver that kind of performance. It was.

There was no evidence of diversification. The kind of astonishingly steady returns Madoff used to attract investors, if feasible at all, should require broadly spreading assets over many kinds of investments and regularly rebalancing to keep investment risks under control.

As more details about Madoff's dealings emerge, investors may get a clearer picture of what went wrong. In the meantime, the scandal reminds everyone that there are no shortcuts to investment success, and that when results seem too good to be true, they almost always are. ●

Four Charitable Tax Breaks For Businesses

The federal financial rescue plan enacted in October 2008 included a number of high-profile extensions of temporary tax breaks, such as the tuition deduction for individual taxpayers. But it also reinstated several less-publicized tax incentives for small business owners. Among the latter are three extensions that encourage companies to give particular kinds of charitable gifts and one that applies to all gifts by S corporations. All four provisions are now in effect through the 2009 tax year.

1. Donations of food. Ordinarily, tax deductions are based on the value of the gift on the date of the contribution. But the 2006 pension law approved an enhanced tax advantage for gifts of surplus food for care of the ill, the needy, or infants. The deduction, which takes into account what the food might have fetched if it had been sold, is equal to the lesser of the donated item's original cost basis plus one-half the appreciation in its value—its retail price, in other words—or two times the basis. This tax break is available to the full range of business entities—C corporations, S corporations, partnerships, and sole proprietorships.

2. Donations of computers. For charitable contributions of property by a corporation, the deduction is generally limited to the basis in the property and can't exceed 10% of the company's taxable income. But C corporations that donate computer equipment to elementary or secondary schools may claim an enhanced deduction equal to the basis plus one-half of the ordinary income that would have been realized had the computers been sold. The ceiling for this deduction is twice the basis of the property.

3. Donations of books. Under a special exception to the tax laws, C corporations can claim an enhanced deduction for property they donate to

What Happens After Economic Crises?

What if U.S. home prices dropped by more than a third, and didn't recover for six years? Or if stocks slid by 56% in a three-year bear market? Consider what would happen if the unemployment rate rose by seven percentage points, or per capita economic output fell more than 9%, and didn't recover for two years.

While parts of that scenario may seem extreme, in fact it's just average for almost a score of banking-led financial crises around the world since World War II. In a recent paper, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University put the current U.S. downturn in global and historical perspective. They considered 18 postwar financial crises around the world, including what they dub the big five: Spain in 1977, Norway in 1987, Finland and Sweden, both in 1991, and Japan in 1992. Add to that group the U.S. upheaval that began in 2007—which is "now beyond contention...severe by any metric," they write. They also factored in famous emerging market crises, including Asia in 1997-1998, Colombia in 1998, and Argentina in 2001, and incorporated data from the Great Depression. In all of these cases, banking system meltdowns triggered major recessions. The Reinhart-Rogoff paper maps the fallout in several areas and charts how long it took before conditions improved.

By late 2008, when the paper was written, U.S. real housing prices had fallen by almost 28% from their peak—more than twice the decline during the Great Depression. And though many countries have suffered much worse setbacks, including drops of more than 50% in Finland, Columbia, the Philippines, and Hong Kong, the U.S. retreat has approached the 35.5% average noted by Reinhart and Rogoff, who found that the average recovery time for home prices is almost six years.

The U.S. stock market retreated further since Reinhart and Rogoff compiled their data, and prices dipped close to the 55.9% average loss noted in their paper. Here, too, some equity markets have fared much worse, with stock prices in Iceland collapsing by more than 90% during the current crisis and Thai equities sliding about 85% after 1997. Though the average recovery time has been 3.4 years, several markets have taken more than half a decade to bounce back.

Job losses always come with recessions, but when banking crises lead to downturns, the rise in unemployment rates tend to be particularly jarring. The worst was a more than 20 percentage point increase during the Great Depression, a catastrophic result that no postwar recession has approached. Still, the seven percentage point average spike in unemployment that Reinhart and Rogoff observed amounts to an enormous drag on any economy, and the 9.5% U.S. rate in June 2009 was already more than five points above the low recorded in March 2007. On average, it has taken nearly five years for employment to rebound to pre-crisis levels.

The bottom-line impact of a recession is the decline in a nation's economic output, and by that measure, banking-led crises have also been unusually severe, according to Reinhart and Rogoff. Emerging economies have suffered most, probably because they depend on external credit sources that may dry up when times get tough. Per capita gross domestic product (GDP) dropped by more than 20% in Argentina after 2001 and by almost 15% in Indonesia after the 1997 financial crisis. Much worse, of course, was the nearly 30% plunge during the U.S. Great Depression. But developed countries have also seen economic output drop sharply in more recent times, and on average, recovery takes almost two years.

And the cost to governments of trying to coax their economies back to life? The average rise in public debt during the three years following banking crises has been 86%, according to Reinhart and Rogoff. "Even recessions sparked by financial crises do eventually end, albeit almost invariably accompanied by massive increases in government debt," they write.

It's not certain, of course, that the current crisis will follow the pattern of past upheavals, and the authors note that some central banks have been particularly aggressive this time in promoting economic recovery. Still, they write, "one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion." They hardly needed to add that the limits of that hypothesis have become painfully clear. ●

charity for the use of the ill, the needy, or infants. A similar exception applies for property donated to colleges and tax-exempt scientific organizations for use in research, and earlier legislation had temporarily expanded the enhanced deduction to include gifts of books to public schools. The new law revives this tax break for donations of books. Note, though, that this enhanced deduction is available only to C corporations.

4. Basis adjustments of S corporations. A pension law enacted in 2006 modified the rules for adjusting the basis of S corporation stock when property is donated to charity. Under the modification, the basis reduction equaled each shareholder's pro rata share of the basis of the donated property. That enabled shareholders to benefit from a deduction for the property's fair market value without being taxed on the property's appreciation in value. Though that tax provision had expired after 2007, the 2008 law revived it and extended it through 2009. ●

A Better Estate Plan For Business Owners

If you own a small business, you're likely working around the clock to build your company. But you still need to find time for estate planning. Despite recent tax-law changes, federal estate tax remains a prime concern for successful business owners. For someone who dies in 2009, the federal estate exemption can shield from tax up to $3.5 million in assets going to non-spouse beneficiaries (up from $2 million for 2008). But any excess is taxed at the top 45% estate tax rate.

While the estate tax is scheduled to vanish in 2010, it is likely that Congress will not let that happen, as current legislation proposes retaining the current $3.5 million exemption, with a maximum tax of 45 percent. And whereas heirs currently can "step up" the tax basis of assets for capital gains purposes—calculating subsequent gains or losses based on the assets' value on the date of death of the person who bequeathed them—that provision is due to change in 2010, at which point there will be a limited step up in basis.

However, estate tax minimization is only one aspect of estate planning. Financial planners offer many other services to help clients meet their estate planning goals. Here are four estate-planning tools a business owner might put to good use.

Buy-sell agreement. This legal document can establish the value of your business for estate tax purposes while ensuring there will be cash for your family upon your death. A buy-sell agreement spells out arrangements for purchasing shares from a deceased co-owner or partner. Typically, the buyout is funded with life insurance on the owners or partners.

Section 303 stock redemption. Under Section 303 of the tax code, your family can remove cash from the business with little or no tax liability by redeeming company stock. This special provision may provide funds to pay funeral costs, estate and administrative expenses, and federal and state estate taxes. To be eligible, the value of the company stock held by the estate must exceed 35% of the estate's total value.

GRATs. With a grantor retained annuity trust (GRAT), you transfer company stock to a trust that pays out annual income for a specific term, with the assets ultimately going to the beneficiaries you designate. This planning technique enables you to freeze the current value of the business in your estate. The amount of associated gift tax depends on the value of the stock transferred, the term of the GRAT, and the Section 7520 interest rate at the time of the transfer.

Installment payments. Another tax code provision allows your executor to spread out estate tax payments over 15 years. Among other requirements, the business interest again must comprise more than 35% of your overall estate.

Of course, every business owner's situation is different. One important thing to remember is to always ensure liquidity or these techniques will not be successful. Therefore, adequate life insurance is essential. We can work with you to discuss strategies to best address your unique planning needs. ●

Fix The Retirement Mess

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Consider a man who made an average of $150,000 a year during his highest-paid 35 years at work. If, rather than retiring at age 62, he keeps going four more years at that same average salary, his benefits will go up more than 30% compared with what he would have received at 62, not taking inflation into account, Sass says.

If the same man had earned an average of $150,000 but had worked only 31 years, his 35-year Social Security average would be lower. (The exact figure is calculated based on the Social Security wage base limit, which changes annually and stands at $106,800 in 2009.) Retiring at age 66 instead of 62 would add four more years to the average (at the wage base limit), thus increasing his benefits somewhat more than the automatic 30%.

For a person earning an average salary of $40,000 a year, adding four more years to a 31-year average would make the increase in benefits rise from 30% to 45%, according to Sass. For higher earners to receive a similar extra boost, the wage base limit would have to be increased significantly above the $106,800 level.

The recent meltdown in the stock market just adds one more reason to think about delaying retirement by a few years. Most nest eggs have suffered, and to begin withdrawals from a beaten-down retirement account may sharply reduce the size of annual distributions that can be taken without depleting the account during a long retirement. We can revisit your retirement plan with you and help you choose a retirement age that will support your goal of a long and comfortable life after work. ●

Be Prepared

How to get ready to delay your retirement.

- Make sure your skills are in demand and you're in an industry that is healthy.
- Remain flexible and responsive on the job; "think young."
- Stay healthy by adopting good habits such as eating well and exercising regularly.
- Make sure your employer knows your target retirement date.
- If you're thinking about working longer, stay up to date in your field.
- Consider changing careers. You could choose something related to personal passions—for example, if you like fishing, you might work at a boat shop or a resort.

Source: ***Working Longer: The Solution to the Retirement Income Challenge***