Creative

wealth maximization strategies*

Wealth Design Group
3040 Post Oak Blvd. Suite 400
Houston, Texas 77056
281.220.2700 • 713.622.1440

Rick Ray
rickray@wealthdesigngroup.net

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In 1989, American singer-songwriter Billy Joel released a song "*We Didn't Start the Fire*." The lyrics were a rapid-fire recitation of people and events from the previous 40 years, beginning with "Harry Truman/ Doris Day/ Red China/ Johnnie Ray…" and ending with "Rock and roller cola wars/ I can't take it anymore." Joel, born in 1949, is a Baby Boomer, and the song was a condensation of his generation's life and times thus far. Interspersed between the verses was a refrain that articulated both the idealism and failures of the Baby Boomers.

We didn't start the fire/ It was always burning/ Since the world's been turning

We didn't start the fire/ No we didn't light it/ But we tried to fight it

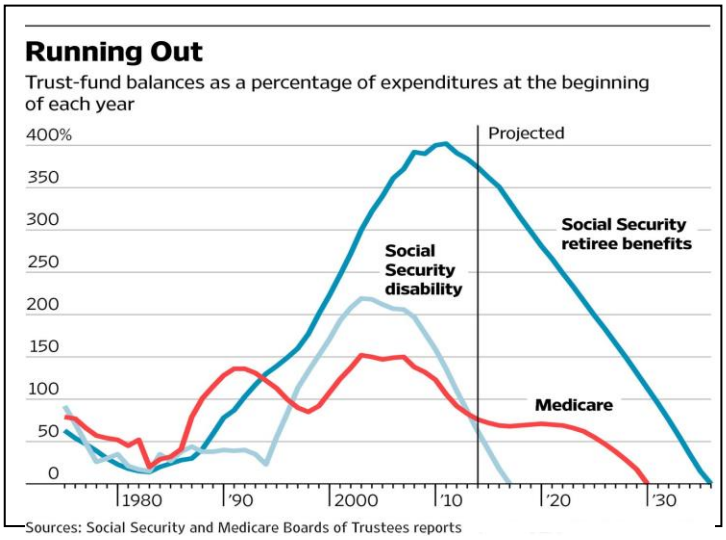
Fast forward to 2015. Joel is 66, and just married his fourth wife, 33-year-old Alexis Roderick, who is expecting. Going beyond typical celebrity gossip, Investment News writer Mary Beth Franklin, in a July 2015 article, makes an interesting observation on the May-December relationship. Noting that Mr. Joel has reached his full retirement age for Social Security, **"…he can file and suspend his Social Security benefits, triggering a monthly payment for his minor child worth 50% of his full retirement age amount. In the meantime, Mr. Joel's own retirement benefit will continue to grow, earning delayed retirement credits of 8% per year up to age 70."**

Since minor children are entitled to dependent benefits until they turn 18, Ms. Franklin recommends: "Put that money in a 529 college savings plan, and you'll have paid for Harvard."

Mr. Joel's personal circumstances are a bit unusual, but they encapsulate many of the factors that challenge the solvency of the Social Security system. Boomers are living longer, having children later in life, and generally stretching the parameters of retirement. The benefits of Social Security were designed for a different, pre-World War II era, with different norms. And while American Boomers didn't "light the fire" of Social Security's financial crisis, their sheer numbers make it an uphill fight to keep these programs from going broke.

Is Pay-As-You-Go Going, Going, *Gone*?

The 2015 annual report from the Social Security Administration (SSA), released in July, documents both benefits paid, and the ability to make future payments for three distinct programs: retirement, disability and Medicare. The SSA report provided this graph, showing the anticipated levels of solvency for each plan.



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The SSA oversees pay-as-you-go plans; benefits are funded by on-going payroll tax collections. Anticipating larger benefit obligations in the future – primarily because of the retiring Boomers – the SSA attempted to accumulate surpluses for each program by collecting more than was needed for current payments. But after several decades of surpluses, each of the plans administered by SSA is currently running an annual deficit – more benefits are being distributed than collected in tax revenues. This is reflected by the downward slope of each plan on the graph.

Using current projections of benefits owed and anticipated revenues, the disability plan is expected to exhaust its reserves late in 2016, while Medicare can continue full benefit payments until 2030, with Social Security retirement benefits projected to last to 2035.

If (or when) the trust fund balances for each program are exhausted, benefits will be reduced to what can be paid from current revenues. In the case of the disability program, it is estimated that this condition would result in a 19 percent reduction in monthly benefits.

Because other branches of the US government have borrowed against Social Security surpluses, and not yet repaid these loans, some financial analysts believe these projections are too optimistic. David Stockman, a former director of the Office of Management and Budget, wrote in a July 31, 2015, article that Social Security could exhaust its reserves as early as 2026, resulting in a 33 percent reduction in retirement benefits.

This is sobering stuff. If you are 50 today, you will be 70 in 2035, and perhaps retired, or on the cusp of doing so. It's a bit disturbing to consider that either a few years into retirement, or just as you're about to start, Social Security benefits might be reduced or eliminated. And the feelings aren't any better if you're younger, knowing a portion of every paycheck is funding programs on a failure trajectory.

Social Security might best be viewed as a supplemental piece of the retirement puzzle instead of an essential one.

More Taxes, Less Benefits: This is a Solution?

In the early 1980s, SSA programs were also on the edge of collapse. Congress responded by increasing taxes and extending the age for full retirement benefits to 67 from 65. These measures resulted in a sharp uptick in surpluses over the next two decades.

Unfortunately, the sheer size of the aging Baby Boomer demographic rapidly eroded this turnaround. Since 2010, 10,000 Americans turn 65 ***each day,*** and SSA expects this volume to continue for the next 16 years. As a July 24, 2014, *Washington Post* article summarized, "The impact of baby boom retirements will certainly put pressure on the Social Security and Medicare systems."

As before, increased taxes and later eligibility dates have been proposed. In this year's report, SSA trustees said the Social Security retirement fund could remain solvent for 75 years (to 2090) if the payroll tax was upped to 15.2 percent (it is currently 12.4 percent), or benefits were reduced by 16.4 percent. Another possibility: maintain benefit levels for current recipients, but reduce benefits by almost 20 percent for those who become eligible in 2015 or later.

Higher taxes for fewer benefits is a tough sell. Is it possible that these programs could just shut down? Not a chance, at least according to professor Jamie Hopkins, associate director at the American College of Financial Services.

There are 10,000 Americans who turn turn 65 every day.

"We have an unsustainable course with Social Security. But as a society, we've set up the way we retire and our personal finances to rely on Social Security. We're not a nation that lets people starve in retirement. We take care of the elderly. We take care of the poor. Social Security provides over one-third of retirees' entire retirement income. It can't just go away, and not just for baby boomers, but for the next generation. We're not seeing higher savings from the next generation to offset the assumption that Social Security won't be important in the future."

In this can't-live-with-it/can't-live-without-it scenario, there aren't many good choices, just tough ones. As journalist David Friedman puts it, "We're entering an era where being in politics is going to be, more than anything else, about taking things away from people."

Two likely "taking" scenarios: incremental tax increases on everyone, and means-testing to eliminate some Americans from eligibility. Tolerance for financial discomfort is relative; taxpayers may accommodate small doses of pain, as long as it doesn't cross an absolute threshold. And if someone accumulates enough assets to get by without Social Security, why not reallocate those benefits to those who haven't been as fortunate? Why should Billy Joel's kid receive Social Security benefits to attend Harvard, right?

There Might Be a Light at the End of the Tunnel … 20 Years from Now.

Against this bleak outlook, there are a few points of optimism. The challenges for Social Security solvency have always been population-driven; the Boomer generation warped the math. If the generational US population could stabilize, Social Security might do the same.

In a January 2015 article titled "Nature Rebounds", Jesse Ausubel writes at length about a global trend toward a revival of natural resources; less farmland is producing more food, continents are being reforested, the air is getting cleaner, etc. One of the contributing factors: a slowdown in population growth. Ausubel cites studies showing that new births peaked globally at 130 million in 1990, and have stayed around that number; in the past 25 years, population growth is mostly due to increased life expectancies. Once the Baby Boomers get through retirement, government programs like Social Security could become more stable and affordable.

But Social Security's current condition presents Americans over 50 with some challenging decisions. Anticipating diminished or eliminated benefits might prompt some to claim benefits as soon as possible, even before full retirement age. *(Better to get something now than a lower benefit - or nothing – later.)* And if a means-test is implemented, those with modest retirement assets (but not enough to replace Social Security), may discover additional saving will reduce benefits. When

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taking smaller benefits and not saving seem prudent, Americans are facing some unusual financial circumstances.

So if it isn't going away, but has to change, the near-term outlook suggests Social Security might best be seen as a supplemental piece of the retirement puzzle instead of an essential one. This shift in perspective may require personal assets be allocated to purposes beyond simple accumulation. A new retirement "safety net," for end-of-life medical expenses, survivor benefits, and the like has to be considered. But assuming current benefits can be sustained is simply not rational.

IS YOUR CURRENT RETIREMENT PROGRAM DEPENDENT ON SOCIAL SECURITY STAYING THE SAME?

SINCE IT ALMOST CERTAINLY WILL CHANGE, SHOULD YOU? ❖

In Practice, this Theory Doesn't Work.

Research says the real-world performance doesn't deliver.

In financial circles, perhaps no debate generates more heat than permanent life insurance (PLI) versus buying term and investing the difference (BTID). It may be more of a Coke-vs-Pepsi discussion for consumers, but experts can really get worked up. So when an *Investment News* article titled, "New Life Insurance Study Debunks 'Buy Term, Invest the Difference' " was posted on July 28, 2015, the comments section was perhaps more interesting than the article. Here's what it sounds like when insurance experts 'trash talk':

"Anyone that looks at this as a 'study,' and not a piece of marketing propaganda, is an absolute idiot."

"If the public actually knew how powerful, specially-designed whole life insurance policies were, they wouldn't put their money in the market. The market is for suckers."

"In an article on life insurance for the general public, there really should be no mention of permanent insurance. Regardless its claimed virtues, it is complicated and confusing and is one reason so many people don't get any life insurance at all."

"Term and permanent life insurance are substitutes as much as milk and beer are."

*Okaaayyy…*passionate opinions, but probably not the basis for a reality show. However:

The article, referencing a study from David Babbel and Oliver Hahl published in the May 2015 issue of *Journal of Financial Service Professionals*, has some interesting observations, not so much about the two approaches, but about human behavior. Titled "Buy Term and Invest the Difference Revisited," the article says that while BTID might be theoretically plausible, it doesn't deliver in the real world. A little context:

The premium for a $1 million whole life policy on a healthy 45-year-old male non-smoker from a highly-rated carrier is about $20,000/yr. This premium is guaranteed to remain the same for one's lifetime, and includes an accumulation component, i.e., the cash value.

In contrast, the premium for a $1 million 20-year level term policy for the same applicant is about $2,000/yr. In a BTID comparison, this leaves $18,000/yr. to be invested for 20 years to replace the insurance benefit that will terminate.

Historically, certain investment strategies have produced accumulations that exceed the actual performance of some whole life policies. But the results of any PLI/BTID comparison tend to **hinge on the assumptions used**. Rates of return, tax treatment, and length of time can all be manipulated to produce a favorable result – for either strategy.

While either approach is theoretically valid, Babbel and Hahl's research tends to say the real-world performance of a BTID approach doesn't deliver. Babbel provides this succinct summary:

"People don't buy term and invest the difference. They most likely rent the term, lapse it, and spend the difference. Our study sheds light on Wall Street guidance that has been taken as an article of faith, but that clearly underperforms for many who follow it."

Babbel's pronouncements reflect two real-world challenges to the successful execution of BTID.

Practically, the desire to leave a lifetime financial legacy to a surviving spouse, children, or other beneficiaries is an expensive undertaking. In the example referenced earlier, the 45-year-old male, who we might assume has a stable career path and emotional motivation to provide for a family, has to allocate $20,000/yr. to provide a $1 million legacy. It might also be reasonable to assume he needs to save for retirement and would like to help with the college education of his children. It would take a sizable chunk of savings to adequately address each of these objectives.

So no matter how it's configured – as BTID or PLI – many Americans, especially early in their financial lives, don't have the money for a fully-funded permanent insurance benefit. They buy term because they believe it's all they can afford, given other savings objectives. And eventually, when the term gets too expensive, they let it go.

There are psychological hiccups in the BTID approach as well. When term is presented as a shortcut to a "cheaper" permanent life insurance benefit, the same thinking says it is possible to shortcut the accumulation process as well.

Remember, the principal argument for BTID is that the individual can achieve an equal or better return with the

Buy Term & Invest the Difference (BTID) permits the individual the illusion of believing they don't have to invest the difference. So they don't.

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difference. Support for this belief involves a projection of future returns, and projections can be manipulated to meet objectives. So if you don't have the difference to invest, just use a lower amount with a higher projected rate of return. Or assume you will "catch up" by increasing deposits in the later years. BTID permits the individual the illusion of believing they don't have to invest the difference, just something, maybe, when they can. So they don't.

In a whole life policy, the cash values represent the equity in an insurance benefit owned by the policyholder. Withdrawing or borrowing against this equity impacts the insurance benefit, both immediately and long term. Psychologically, every premium payment (which includes the part of the premium allocated to cash values) is part of the insurance benefit.

But with BTID, the insurance and accumulation are two distinct components, and tend not be seen as connected to one another. As one commenter put it, "My experience has been that no one actually invests the difference and leaves their hands off it until death."

The twist: BTID "successes" end up with PLI?

There are people who have the practical and psychological profile to make BTID work: diligent savers. People with good saving habits often have both the resources and motivation to establish and maintain a financial legacy in their financial program.

But ironically, these very same people may also often end up choosing permanent life insurance – not only because they can afford it, but because they value other benefits that are part of a whole life insurance policy, such as guarantees*, loan provisions, tax advantages, creditor protection, etc. Several commenters in the *IN* article referenced their experiences with older, wealthier individuals who decided to purchase permanent life insurance late in life; they understood the value, were healthy enough to be approved, and could afford it.

A practical starting point – for everyone

Too often for consumers, the BTID/PLI debate gets presented as an irrevocable, either-or decision, typically in one of their first encounters with a financial professional. But at the beginning of our financial journey, how many of us are truly able to make an informed decision about life insurance for the rest of our lives? At the same time, many younger households would suffer significant financial harm if a breadwinner died unexpectedly. Term or permanent, many households have an immediate need for life insurance.

Given these realities, a practical starting point is obtaining as much convertible term life insurance as possible. This provides financial protection today, as well as the option to incrementally transition to permanent life insurance at a later date, regardless of future health. As good savers come to realize the value of permanent life insurance, convertible term makes sure they can maximize this strategy. As your savings accumulate and perspectives mature, the option of transitioning to a permanent life insurance program could be a valuable legacy asset.

Have you maximized your insurability with convertible term insurance? ❖

*All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company.

401(k) Options When You Change Employers

The Bureau of Labor and Statistics reported in 2012 that U.S. workers have an average job tenure of 4.6 years, and will work for seven different employers during their lifetime. At least once or twice, many Americans will have to decide what to do with a 401(k) balance held with a previous employer.

If you switch jobs before retirement, these are the typical options for a 401(k):

- leave the money in your former employer's plan
- transfer the money to your new employer's plan (if the plan accepts transfers)
- transfer the money into an individual retirement account (IRA)

Because both 401(k)s and IRAs allow pre-tax contributions and tax-free accumulations, with distributions in retirement taxed as regular income, Americans may see the two plans as essentially the same. And many workers transfer old 401(k) balances to an IRA to preserve the tax status of their accumulations when they end an employer relationship. But for all their similarities, IRAs and 401(k)s also differ at several points.

Note: Besides 401(k)s, these provisions apply to all ERISA-qualified, employer-established defined contribution plans, which includes 403(b), 501(a), TSAs and others, including the federal TSP. For this article, the term 401(k) stands for all these plans.

Details, Details

The regulations governing a qualified retirement plan proscribe three distinct activities: contributing, accumulating and distributing. When deciding to keep a 401(k) with a former employer or transfer to an IRA, the key differences involve accumulation options and distribution choices, before and during retirement.

Accumulation Options

In a 401(k), the investment options are limited to those selected by an employer. These offerings may be quite diverse, but also may be changed by management. You have options, but the employer selects the menu. With IRAs, the investment choices are much broader, and the final say-so lies with the individual. For some, the opportunity to self-direct one's retirement account is a major incentive to transfer a 401(k) balance to an IRA.

IRA assets can also be consolidated or divided according to individual preference. Consolidations may simplify organization

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The opportunity to self-direct one's retirement account can be a major incentive to transfer a 401(k) balance to an IRA.

and decrease management fees. But one can also hold an unlimited number of IRA accounts, which may be advantageous.

For example, one might use funds from one IRA to initiate a 72(t) distribution, while other accounts continue growing. (A 72(t) permits early distribution of funds without penalty as long as the withdrawals are in the form of a stream of substantially equal periodic payments consistent with IRS guidelines.)

A 401(k) cannot be divided into two accounts with the same employer.

Pre-Retirement Distributions

♦ **72(t):** IRAs can be used for 72(t) distributions under any circumstance, at any time; 401(k)s really don't allow 72(t) distributions. Per the IRS: "If 72(t) distributions are from a qualified plan, not an IRA, you must separate from service with the employer maintaining the plan before the payments begin for this exception to apply."

♦ **Loans:** If the employer's plan permits them, a portion of 401(k) balances can be accessed as loans. The maximum amount a plan can permit as a loan is (1) the greater of $10,000 or 50% of your vested account balance, or (2) $50,000, whichever is less. With some exceptions, loans must be repaid on a regular schedule within five years. (If you terminate employment, unpaid balances are due immediately, or become taxable and subject to penalty.) IRA accounts do not have loan provisions.

♦ **Early Partial Withdrawals:** While IRAs have no loan provisions, there is no limit on early withdrawal amounts (although income tax and early-withdrawal penalties will apply); 401(k)s do not permit partial withdrawals, although unpaid loans end up with the same tax consequences.

Regular Retirement Distributions

♦ **At 59½:** For IRAs, the standard retirement age (the age at which funds can be withdrawn without penalty) is 59½. Some hardship provisions may exempt pre-59½ distributions from penalties.

♦ **At 55:** Under certain conditions, a 401(k) plan may allow penalty-free withdrawals if you leave your job at age 55 or later. (For some occupations, the penalty-free age is 50.) This provision applies only to a 401(k) balance with your last employer. If you have a 401(k) balance with a former employer and weren't at least age 55 when you left, you must wait until age 59½ to take withdrawals from those accounts without penalty.

The age 55 provision could prompt early retirees to transfer previous 401(k)s to their current 401(k) plan (if the new plan allows it) ***before*** retiring from their current job. This makes all funds penalty-free after 55 but before 59½.

♦ **RMDs:** Once you reach age 70½, you must begin required minimum distributions from all IRAs. However, you don't have to take required minimum distributions from a 401(k) as long as you are still working. RMDs from 401(k)s can be deferred until April 1 of the year after you retire.

Decisions, Decisions

Will a lot of American workers face a transfer decision about a 401(k) with a former employer? Probably. Will they know (or remember) these differences between transferring to another 401(k) or an IRA? Maybe, but probably not. There are a lot of details to keep track of.

This is a decision that begs for professional assistance. Before you transfer, get the facts, as well as some strategies that work best with your unique financial objectives. ❖

For all the benefits that can be accomplished with life insurance, great ideas can be undone by sloppy execution. A recurring error is improper designation of the three parties of interest for every life insurance transaction. When these relationships are incorrectly designated, intended benefits can be needlessly diminished, or undone.

Every life insurance policy has three crucial players. The **policy owner** is the person or entity that pays the premiums and has the authority to make changes to the policy. The **insured** is the person whose life is covered by the policy. The **beneficiary** is the person or the entity designated to receive the insurance benefit when the insured dies.

Standard insurance practice says two of the three parties of interest should be the same person or entity. Some examples: In a family insurance scenario, the owner and insured will typically be the same; the insured owns the policy on his/her life, and names the spouse as beneficiary. If a business wants to insure a key employee, the business will usually be both owner and beneficiary.

However, if three different persons or entities play the roles of policy owner, insured, and beneficiary, adverse tax consequences may be incurred. This condition is often referred to as a "Goodman Triangle," in reference to a 1946 court case, *Goodman vs. Commissioner of the Internal Revenue Service*. The main thrust of the Goodman case was that the owner of the policy was making gifts to non-owner beneficiaries upon the death of the insured. The tax logic behind this determination is convoluted, but some examples are instructive.

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Example 1: A father owns a life insurance policy on his adult son (the insured), and the son's wife is the named beneficiary. If the son dies, his wife will receive the insurance proceeds tax free. But the way the IRS sees it, the wife has received a gift from her husband's father, the owner of the policy. This triggers a gift tax assessment against the father.

Example 2: Three shareholders in a C-corporation have a buy-sell agreement drafted. The corporation, as owner, purchases three insurance policies, naming the other two shareholders as beneficiaries for each insured's policy. Since the three parties are different, the owner (the corporation) is deemed to have made a taxable gift to the beneficiaries (the surviving shareholders) upon an insured's death. Instead of assessing a gift tax against the corporation, the IRS considers the insurance proceeds as a distribution from the business to shareholders, on which the recipients now owe income tax.

Example 3: Even a partially incorrect designation can result in a Goodman Triangle. A man obtains a policy on his life, naming his spouse as beneficiary. As his faculties begin to diminish, a decision is made to make the spouse the owner, giving her authority to make changes. So far, so good. But to assist in managing her affairs, the spouse adds the insured's eldest son as a co-owner. With the addition of the son as co-owner, the owner (spouse and son) is now different than the beneficiary (spouse only).

There may be occasions when the rule of thumb that two of the three parties in a life insurance transaction should be the same doesn't appear workable. These instances call for professional input, and sometimes, the establishment of a new entity, like a trust, to serve as either owner and/or beneficiary to satisfy the Goodman Triangle rules. Referencing Example 3, problems can arise also when the passage of time results in ownership or beneficiary changes. A Goodman Triangle assessment should be part of every life insurance review.

Great ideas fail because of faulty execution. Make sure you, and your financial professionals, tend to the details. ❖

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Rick Ray
Wealth Design Group
3040 Post Oak Blvd. Suite 400
Houston, Texas 77056
280.220.2700
rickray@glic.com

Registered Representative and Financial Advisor of Park Avenue Securities LLC (PAS).
OSJ: 3040 Post Oak Blvd., Suite 400 Houston, Texas 77056, 713-622-0192.
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