

Financing Your Retirement Future

February 2008

Solving the Pension Payment Puzzle

If you participate in a pension plan at work, you may be offered several payout options when you retire. The form of benefit you choose could be one of the most important financial decisions you ever make.

Defined benefit plans--a crash course

In a traditional pension plan (also known as a defined benefit plan), your retirement benefit is generally an annuity, payable over your lifetime, beginning at the plan's normal retirement age (typically age 65). Many plans allow you to retire early (for example, age 55 or earlier).



However, if you choose early retirement, your pension benefit is actuarially reduced to account for the fact that payments are beginning earlier, and are payable for a longer period of time.

If you're married, the plan generally must pay your benefit as a qualified joint and survivor annuity (QJSA). A QJSA provides a monthly payment for as long as either you or your spouse is alive. The payments under a QJSA are generally smaller than under a single-life annuity because they continue until both you and your spouse have died.

Your spouse's QJSA survivor benefit is typically 50% of the amount you receive during your joint lives. However, depending on the terms of your employer's plan, you may be able to elect a spousal survivor benefit ranging from 50% to 100% of the amount you receive during your joint lives. Generally, the greater the survivor benefit you choose, the smaller the amount you will receive during your joint lives. If your spouse consents in writing, you can decline the QJSA and elect a single-life annuity instead (or another option offered under your plan).

Your plan must provide you with an explanation of your payout options prior to retirement, including an explanation of your right to waive the QJSA, and the relative values of the optional forms of benefit available to you.

Single-life annuity or QJSA?

If you're married, a QJSA provides you with the security of knowing that your spouse will receive a guaranteed monthly income after you die. Why, then, might you choose a single-life annuity instead, knowing that payments will stop at your death? The primary reason is that the single-life annuity pays a larger monthly benefit.

For example, if your spouse is in ill health and unlikely to survive you, the single-life annuity might be the better choice. If you were instead to choose the QJSA and your spouse pre-deceased you, you'd be stuck with the smaller QJSA benefit for the rest of your life. The single-life annuity might also be the better choice if your spouse has enough other retirement income available if he or she outlives you.

Your plan may offer other distribution options as well, such as period certain annuities, "pop-up" annuities that increase your QJSA benefit if your spouse dies before you, and level income options that coordinate your benefits with Social Security.

Maximizing with life insurance

One option to consider when deciding between a single-life annuity and the QJSA is "pension maximization." Under this strategy, you choose the single-life annuity, with its larger benefit, and then use the additional income to purchase life insurance with your spouse as the beneficiary, thereby providing for your spouse's financial future.

Cash balance plans

Cash balance plans are a special form of defined benefit that provide a payout option not usually offered by traditional pension plans--the ability to take a lump-sum distribution (again, with your spouse's consent if you're married).

Unlike annuity payments, a lump-sum distribution from a cash balance plan can be rolled over to an IRA or to another employer's plan that accepts rollovers. This might be an attractive alternative if you don't immediately need the income when you retire. However, if you choose this option, you'll be giving up guaranteed income for your life (and your spouse's life if you're married). You'll also assume the risk (and the potential reward) of investing the assets yourself.



Putting the pieces together

The best option for you depends on your (and your spouse's) age, health, and other financial resources. Your financial professional can help you sort out the options available to you, and help you put the pieces of this complicated puzzle together.

Don't Let This Year's Family Vacation Wreck Your Budget

With today's busy lifestyles, many people view a nice family vacation every year as an entitlement, even if it means going into debt to pay for it. They rationalize that they work hard all year and deserve it, or they become wistful after hearing about the fancy vacation plans of friends, co-workers, or neighbors. Sure, everyone needs a break, and parents naturally want their kids to have fond memories of days spent romping on the beach, but how can you prevent your vacation costs from spiraling out of control?

Can you really afford it?

First, assess honestly whether you can afford the vacation you're thinking about. If you have to borrow most of the money to pay for it, then you probably can't afford it. If you do borrow to pay for your trip, you might find yourself financially strapped later on if the roof starts leaking or one of the kids needs braces. At the very least, you'll inherit the stress that comes with trying to pay off that debt.



Think outside the vacation box

Not being able to take a dream vacation doesn't mean you can't take a vacation at all. Everyone needs time away from their job and normal family responsibilities to recharge. If you simply don't have the budget for the vacation you want, think of other creative ways to spend your time off. Here are some ideas:

- Try a few long weekends instead of one or two consecutive weeks. Perhaps you can afford a couple of nights at a hotel or bed and breakfast instead of all week. Or maybe you can camp for a few nights at a state or national park, where rates are very reasonable.
- Vacation from home. Take day trips into a nearby city and visit museums, restaurants, and other attractions. Or head out to the country for a hike, swim, and picnic. Doing things out of the ordinary, like eating breakfast three times a day or setting up a tent in the living room to play games and sleep in, can be a big hit with kids. Young kids usually just like being with their parents and are mostly happy to go along with what you have planned.

- Let older kids pick an activity. It might not be Disney World®, but what about a trip to an amusement or water park, a day or two at the beach, an afternoon canoeing or fishing, a movie and dinner outing, or a ballgame? Instead of lamenting the fact that you can't take an exotic vacation, focus on what you can do and enjoy the time with your family.
- Consider house swapping. If you're willing to trade houses with other like-minded families to save on room-and-board costs, there are several websites where you can find more information.

Plan now for next year (or the year after)

It's never too early to start thinking about next year, or the year after that. Start saving now for that future getaway by making a budget and seeing where you might be able to squeeze a few dollars. Then consider opening a separate vacation account for those funds; otherwise, the money may get "lost" in your regular savings account and used for other purposes. Where you put your money will depend on your time horizon and other factors. A financial professional can help you examine your options.

If you can contribute monthly to your vacation fund, great. If you can't, consider adding small windfalls like your tax refund, year-end bonus, or cash from birthdays and holidays. Knowing that you're setting aside money for a planned "dream" vacation can go a long way to making you feel less deprived in the years you can only afford to stay close to home.

And when it comes time to actually planning your big vacation, keep cost-cutting tips in mind. For example, you might consider less convenient flights or a night or two at a less fancy hotel.

Forget about the Joneses

It's tempting to want to take grand vacations every year when everyone else seems to be doing so. But don't fall into the trap of thinking that you or your family will somehow be scarred if you can't. The important thing is to relax in a way that you can afford, and then enjoy that time with your family. You will have taught your children an important lesson--how to live a financially sound life, without worrying about what the Joneses are doing.

Estate Tax Repeal: Ramifications and Outlook

The Economic Growth and Tax Relief Act of 2001 gradually phases out the federal estate tax until its complete repeal in 2010. However, under the same law, the estate tax is scheduled to return in 2011.

Since 2001, there have been a number of failed attempts to make the estate tax repeal permanent. In fact, there are still several bills in Congress that include provisions to eliminate this tax. While it's clear President Bush would sign such legislation, the recent changes in Congress make it less likely he'll get the chance to do so. The question remains, though: Will permanent repeal become law, and if so, what are the potential ramifications?

Good-bye estate tax, hello capital gains tax

Repeal does not mean that tax on wealth transfers from one generation to the next will disappear. While currently a tax is imposed on estates, after repeal, a tax will be imposed indirectly on inheritances in the form of capital gains tax. Here's a simplified explanation.

Under the current tax system, property that is transferred to heirs at the owner's death typically gets a "step-up" in tax basis. Generally, tax basis refers to the cost the owner paid to acquire the property, and is used to compute capital gains tax when the property is sold. For example, let's say Mr. Smith buys property for \$50,000, which becomes his tax basis, and sometime later sells the property for \$60,000. Mr. Smith's computed capital gain for tax purposes is \$10,000.

When property is transferred by gift, the recipient receives a "carryover" basis; the tax basis in the hands of the person making the gift generally becomes the recipient's tax basis. So, let's say that Mr. Smith gives the property in the above example to his son, John. Mr. Smith's \$50,000 tax basis carries over to John, and when John subsequently sells the property for \$60,000, John recognizes the \$10,000 capital gain.

However, when property is transferred because of the owner's death, the tax basis is stepped up to its current fair market value. Again using the first example, let's say that John receives the property through his father's will. John's tax basis is stepped up to \$60,000, the property's fair market value. When John subsequently sells the property for \$60,000, John recognizes no capital gain on the transaction.

According to the Center for the Study of Taxation in April of 2006, 3 out of 4 Americans want the estate tax repealed or significantly reduced.

One of the consequences of estate tax repeal in 2010 will be that the step-up in tax basis will be lost. Heirs will receive a carryover basis on inherited property, and will recognize the capital gain (or loss) when the property is sold at some point in the future.

What will this change in the tax system mean for American families? According to the IRS, estate tax affects only 2% of the most wealthy Americans. Capital gains tax, though, can affect anyone who owns capital assets. Therefore, unless the step-up in basis remains, estate tax repeal is likely to result in creating a higher tax bill for a greater percentage of less wealthy Americans. Further, repeal will create a paperwork headache for heirs who will have to determine the decedent's tax basis in the property they've inherited.

Pros and cons of permanent repeal

Proponents of permanent repeal regard the estate tax as morally unfair and an obstacle to family business continuity and growth. Critics call permanent repeal a boon to the mega-rich and fiscal suicide in a time of budget deficits, a Social Security and Medicare crisis, and war. The confusing reality is that there is statistical evidence both for and against the arguments presented by each side.

One thing is certain, however: Dealing with the uncertainties of the current state of the estate tax is a burden on Americans and their financial planning professionals who must re-evaluate estate planning options every year. For many on both sides of the issue, sensible reform is a preferable alternative to the success or failure of permanent repeal.

Outlook

In 2007, the Democrats regained power in Congress after 12 years of Republican control. The new Congress has been pursuing a fresh agenda, putting estate tax relief on the back burner. When the issue does resurface, it's likely that Congress will support reform over full and permanent repeal. Reforms such as lowering the estate tax rates to match capital gains tax rates and/or increasing the exemption amount have been proposed. Other options that have been discussed include doubling the exemption amount for married taxpayers, phasing out the tax over a five- or ten-year period, and replacing the estate tax with an inheritance tax (which would merely move the tax burden to the heirs). It remains to be seen what will be done, if anything.



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