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Lighthouse Monthly

Generational Financial Acumen

Step Right Up!
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IRA Rollover Rules Amended
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Generational Financial Acumen

Andrew P. Wilson, CFP® - Founding Partner

Working in the financial services industry we see volumes of white papers, reports, and surveys that talk about retirement worries and concerns. The top of the list worries or concerns are typically the usual suspects of having enough money, healthcare, and Social Security solvency.

Recently, a new concern is appearing in retiree surveys. While it has been expressed in a number of ways, the subject is the same: generational financial acumen. In other words, an increasing number of retirees are concerned that younger generations lack sufficient financial knowledge and education.

Justified

Honestly, there are a number of reasons that it is not surprising to see such a concern surfacing. Here are a few that we note:

1. *Only a handful of states have a requirement for financial literacy prior to high school graduation.* Further, surveys conducted by the Department of Education, the US Treasury Department and JumpStart Coalition cements the fact that America's youth are sorely under educated and ill prepared to deal with personal finances. Consider that according to USA Today, in 1997, the average score on a 31-question financial literacy exam given to high school seniors was 57.3%. In 2008, the average score was at its lowest ever, 48.3%.

2. *People must take on more responsibility with their finances as pensions have become a thing of the past.* Self-directed retirement accounts such as 401ks are the norm. Therefore, saving for retirement and the management of such savings are the sole responsibility of a greater number of people. Accordingly, people must have a basic understanding of investing to achieve any level of success in accumulating a nest egg for retirement.

3. *The investing world is not as simple as it once was.* In the last 25 years we have seen the universe of pooled investment options explode from a relatively small number of mutual funds, to thousands of mutual funds and exchange-traded funds. At the same time, those choosing to investing using individual securities such as stocks and bonds will find that the financial statement of today's companies are complex.

4. *Knowledge transfer seems to be slowing.* The Baby Boomer generation, in a historical perspective, is the generation that has most utilized professional financial advisors » More

Therefore, as the financial world has grown in complexity, boomers have looked increasingly to advisors. As in any other service related industry (think car repair, plumbing, taxes), the need to understand or keep up diminishes as one relies further on professionals. To that end, a transfer of knowledge to younger generations starts to wane.

5. *Wall Street is giving pause to many in the younger generations.* The booms and busts of Wall Street and the scandals in the canyons of Wall Street has led many younger investors to sit on their hands. Additionally, real wages and real disposable incomes have been declining which means younger generations will have little interest in something that is not doable such as investing.

A few things

So, how do we help younger generations increase financial acumen? Below is a small list of things that one can do to help build foundation of financial knowledge.

- Ask questions. Money is one of those subjects that many find personal. Often times parents (or grandparents) don't like to meddle in such areas. But, the only way to gauge financial acumen is to ask questions. It may be best to start with non-threatening, general questions.
- Point them in the right direction. There are plenty of great books and websites that can help introduce topics.
- Have them meet your advisor. Logic would say that if you trust your advisor with your personal finances then you would likely trust that person to talk with your kids.

Lighthouse's approach

We are always happy to meet with client family members. Whether family members are clients or not, we are always happy to help where we can. Over the years many children of clients have become clients of ours themselves. We have also had many meetings with recent graduates to help go over new job benefits. Here at Lighthouse you have a team of professionals with a broad, deep understanding of personal finance. We encourage all clients to utilize our expertise to help you build financial acumen in your future generations.

We know that many of our clients have better things to do than keep up with tax codes, estate planning issues, or investing markets. To that end, that is why we were hired. So, if you need help pointing a child, grandchild or sibling in the right direction, feel free to call on us to help.

Coming soon

In early summer 2014 Lighthouse will be releasing an e-book that clients can download and share with younger generations titled *'A primer on money - your guide to personal finance.'* Be on the look out for a note about the e-book in the coming months.

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IRA Rollover Rules Amended

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IRS Changes Its Tune

Have you ever completed a task a certain way for as long as you can remember, say over 20 years, woke up one day and realized you were completing the task wrong the whole time? The IRS seems to have created this predicament for investors…sort of.

Court Decision Contradicts Guidance

For over 20 years Publication 590 has been the go-to piece of guidance given by the IRS surrounding IRA tax laws. Included in this guidance were detailed examples illustrating one taxpayer completing multiple rollovers with several IRAs over a 12-month period. In a recent tax court case, Bobrow v. Commissioner, the tax court unexpectedly reversed its previously accepted interpretation of the number of and the frequency at which IRA rollovers can be completed. Based on the IRS' Announcement 2014-15, "an individual is permitted to make only one rollover…in any 1-year period." This announcement clarifies that one rollover per year is strictly per taxpayer, not per IRA as previously understood.

What it means

First off, there are two types of IRA rollovers: direct and indirect.

1. A direct (aka trustee to trustee) rollover is when an investor never takes possession of the funds. EXAMPLE: Jane Smith has a $500,000 IRA at Fidelity but is switching advisors. Her new advisor uses Charles Schwab as custodian and she needs to rollover her $500,000 to her new IRA. To do a direct rollover, Jane requests that her account be liquidated and a check be made out to Charles Schwab, FBO (for the benefit of) Jane Smith. While Fidelity would be required to send the check to her home address, Jane then sends the check directly to Schwab. In no part of this transaction did Jane take cash and deposit it into her bank account.

2. An indirect rollover is when an investor takes possession of the funds. EXAMPLE: Jane Smith (from above) requested the $500,000 check from Fidelity to be made out to Jane Smith and she subsequently deposited the money into her bank account. She would have 60 days to send the $500,000 to Charles Schwab to be deposited into her new IRA in order to avoid a taxable event. If she does not do this within 60 days, the distribution would

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be subject to income tax and a possible 10% penalty if Jane is under age 59.5.

The recent change in tax interpretation only affects indirect rollovers. The greatest impact will be felt by investors who used the indirect rollovers as a bridge loan. A bridge loan is essentially a way to borrow money from yourself short term without having to pay income taxes or interest. You would not pay income taxes because as long as you rollover or refund the distribution within 60 days, it is not a taxable event. You would not pay interest because you would be borrowing the money from yourself instead of borrowing the money from a bank. If you have multiple IRAs it is easier to understand how the previous interpretation of the law allowed for investors to take advantage of the 60 day rule. If you had multiple IRAs, you were able to take one distribution from each and roll it over to another IRA within 60 days. This could create a bridge loan that lasted longer than 60 days, without disrupting the 60 day rule by dipping into separate IRAs every 60 days to replace or rollover the previous distribution.

For those savers, such as contract workers or consultants, that didn't take advantage of this opportunity and truly used an indirect IRA rollover as an emergency way to bridge income between projects, this is certainly a lost opportunity.

Does it affect you?

Probably not. This new interpretation of the tax law is more geared toward sophisticated investors or financial advisors that attempted difficult strategic rollovers. The majority of executed IRAs are direct which aren't affected. It also doesn't apply to employer plans rolled to an IRA, or Roth conversions. Additionally, nothing will take effect until January 1, 2015 and there is no retroactive reporting necessary. However, if you do more than one indirect rollover after January 1, 2015, you will have to include in your gross income the amount of the extra distribution. In addition, if you are under age 59.5, you could be assessed a 10% penalty. Let's say you did rollover the distribution but not within the 60 day limit, the amount rolled over could be counted as an excess contribution and you could then be taxed 6% per year for the excess contributions for as long as they stay in your IRA.

Remember that one time the tax laws changed and affected investors? Probably not because unfortunately the tax laws haven't changed just one time and probably won't change just one time more. Tax laws change regularly and it is important to be prepared with a flexible financial plan that can strategically respond to external and uncontrollable changes and challenges.

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Market Review

Step Right Up!

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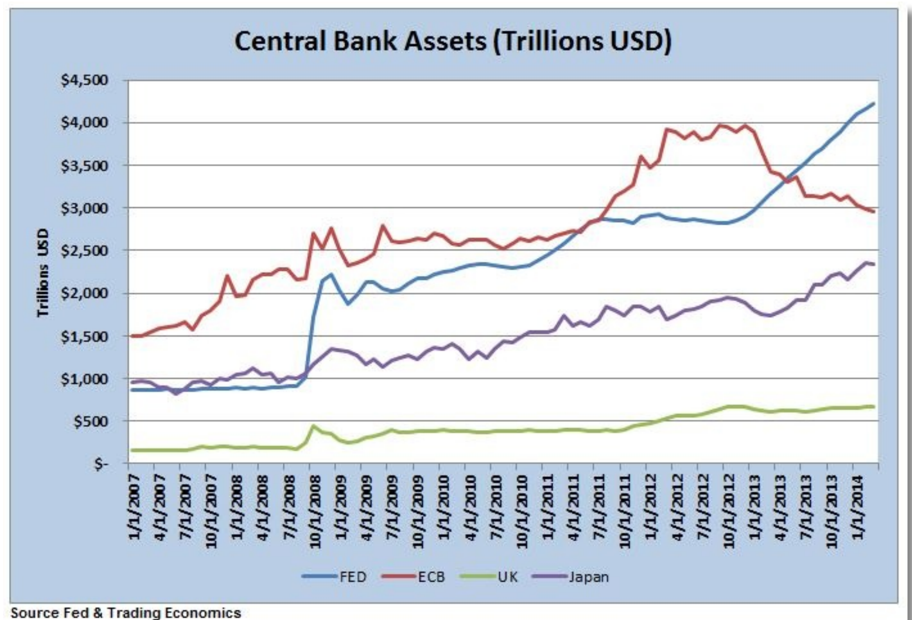
Most of you are familiar with the phrase in the title of this article. I am sure it congers up images of a carnival character with a megaphone trying to entice someone into trying something they might not usually try.

Here in the US, we have become dangerously comfortable with the reality that the US Federal Reserve (Fed) purchases US government and mortgage debt every month. Since the fall of 2008, the Fed has (almost non-stop) purchased trillions in bonds. In the chart at right, one can see the Fed balance sheet (blue line) has risen from a little over $800 billion dollars to approaching $4.5 trillion in just a few years. More troubling is that in a 2009 US House of Representative testimony then Fed Chairman Bernanke stated that the Fed would not 'monetize' the debts it was purchasing.



Source Fed & Trading Economics

The phrase 'monetizing debt', as it relates to Bernanke's comment, means printing money to ➳ **More**

purchase the debt without an offsetting reduction in the money supply. Since Bernanke's testimony in 2009, the Fed has monetized trillions of dollars of debts. For this article, I am going to table the debate of whether such extreme economic actions as monetizing debt and holding interest rates to the floor has helped or hurt the economy.

Since the onset of the financial crisis in 2008, the central banks of the United States, Japan and England have embarked on monetizing debts (see chart on the previous page). The outlier on the previous page's chart is the European Central Bank (ECB) (red line) who has seen its balance sheet shrinking.

Taking turns printing

In the chart on the previous page, it looks as though the Fed and the ECB are taking turns at balance sheet expansion. Although the Fed's balance sheet is still expanding, the rate of expansion is slowing since QE3 is now under a taper. Simultaneously, the Euro Area economy is struggling mightily. The shrinking ECB balance sheet and the struggling economy has led to calls for the ECB to start its own QE. Until now, the ECB has not printed money to buy bonds but is now strongly considering the idea.

With the Fed tapering its bond purchases, the Euro Area economy in a funk, and the ECB balance sheet shrinking, it looks like something will be done.

Who cares?

The reason all investors should take notice of the major global central bank's balance sheets is that the correlation with the global stock markets are extremely high. So, if the ECB continues to see its balance sheet shrink and the Fed soon stops its balance sheet expansion, recent history tells us that global stock indexes just may follow the balance sheets lower.

As the title of this article indicates, the ECB is feeling the pressure to step right up to the printing press. As I have indicated in other writings, it is not so easy for the ECB to just print like here in the US. The ECB charter prohibits the monetization of debts of sovereign nations. However, the calls from within Europe are growing louder for QE from the ECB.

Close eye

Just like at the carnivals of old, a close eye will need to be kept on the call for one to step right up. On the one hand, QE has certainly put a floor under the investing markets in the short-term. The medium and long-term outlook for QE is best explained by Mr. Bernanke in the very same testimony mentioned above regarding monetizing debt.

"At some point, you have to have a path of spending and taxes that will give you a stabilization of the debt-to-GDP ratio. If you don't, then fear that the debt will continue to rise will make it very difficult to finance it. And, at some point, you will hit a point where you will have to have both very Draconian cuts and very large tax increases, which is not something we want.

So, in order to avoid that outcome down the road, we need to begin now to plan how we are going to get the fiscal situation into a better balance in the medium term."

As of now the global central banks have their QE floor in place and this is keeping markets calm and in apparent order. But, it may be that the leader of the QE charge is changing hands as the ECB is called to step right up to test out their forbidden money printing machine.

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