

## NEW AUTOMATIC ROLLOVER RULES HELP OUT LAX RETIREMENT SAVERS

Younger workers who frequently change jobs often undermine their own efforts to build a solid retirement nest egg by cashing out their qualified retirement account every time they switch employers. New federal regulations may help them resist their own worst instincts.

Participants in defined-contribution retirement plans such as a 401(k) or 403(b) have several options when they leave their employer. They can instruct the employer to leave their funds in the plan if the plan allows that, roll the funds over into an individual retirement account or a new employer's plan, or ask for the funds in cash.

Some plans mandate that if the departing employee doesn't provide instructions, and the account is valued under \$5,000, the plan must cash out the account and send a check to the participant.

Studies show that workers with small accounts frequently take the cash and spend it on everything from vacations to pickups – but not for their retirement savings. A 2003 study by Hewitt Associates found that 80 percent of departing workers who had more than \$5,000 either left the money in their former employer's plan or rolled it into an IRA or a new employer's plan. But 87 percent of terminated workers with less than \$5,000 in their account cashed out their accounts. And small accounts are common with workers in low-paying jobs or who change jobs frequently.

Moreover, workers who cash in end up with significantly less than the distributed amount. The worker must pay ordinary federal and possibly state income taxes on the amount, and probably an additional 10 percent early withdrawal penalty if the worker is younger than 59 1/2. Someone in the 15 percent federal and 5 percent state tax bracket, subject to the 10 percent penalty, would end up with only \$3,500 on a \$5,000 cash-out.

In addition, the worker could lose thousands of dollars in future retirement funds because the money no longer grows tax deferred.

Under the new federal regulations, which go into effect March 28, 2005, employers whose retirement plan mandates cashing out small accounts when it doesn't receive instructions from the departing employee must automatically roll it directly into a default IRA on behalf of the employee if the account is worth \$1,000 to \$5,000. For accounts valued under \$1,000, the employer can still cash out the account.

As before, however, workers can instruct the plan to cash out the account, if they desire, or they can roll the money directly into their own rollover IRA or to a new employer's plan.

The regulations apply to nearly all tax-qualified defined-contribution plans, including government and church plans, and to all workers under age 62 or the normal retirement age under the plan, which is typically 65. The regulations don't apply to surviving spouses or to alternate payees named under what's known as a qualified domestic relations order used in divorce proceedings.

Employers can avoid the automatic rollover requirements by amending their retirement plan rules to eliminate mandatory distributions for small accounts, or to drop the mandatory distribution amount to below \$1,000. The money would then be left in the employer's plan until eventual instructions from the former employee. Some observers believe some plans will take this approach in order to avoid the cost of setting up default IRAs.

For workers tempted in the past to spend the mandatory distributions because it was money in hand, the new regulations may encourage them to keep the money growing tax deferred toward retirement. But workers still need to take some actions to help that money grow.

First, if the employer rolls the money into a default IRA, pay attention to how the money is invested. The employer is required to put the money into an investment that conserves principal, such as a low-earning money market that's not going to grow very fast over time. Consequently, the worker may want to move the money into investments within the IRA that will likely provide a better long-term return.

Second, if the employer's plan drops its mandatory distributions for small accounts and retains the money in the existing plan, the terminated worker may still want to move the money into an IRA or other employer plan. That way, workers won't lose track of small retirement accounts left with old employer plans, which is easy to do if they switch jobs often.

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## THE BENEFITS OF A COMPREHENSIVE LONG-TERM FINANCIAL PLANNING RELATIONSHIP

When should you hire a financial planner and for what purpose? Just for an hour or two every couple of years when a specific question or need arises? Or should you develop a long-term relationship with a planner that entails regular consultation and planning across the spectrum of your financial life?

The answer will depend in part on your financial circumstances and needs, but many financial planners believe that it's usually best if you can develop a regular, long-term relationship with a planner and take a comprehensive approach to your finances.

It's become popular these days for consumers to hire financial advisors on what is variously called "spot," "piecemeal," or "modular" financial planning. Typically, this involves occasionally hiring a financial planner for an hour or two on a per-hour fee basis, much as you would a lawyer. The planner might address such specific concerns as "What do I do with my aunt's inheritance?" "Should I roll my 401(k) plan into an IRA?" Or "Should I rent or buy a home?"

Proponents argue that spot planning is more affordable because consumers pay only for what they feel they need or want. Spot planning does provide a much-needed service for households that cannot afford the full-time services of a financial planner, or for those who feel competent enough to do their own financial planning with some occasional outside advice. But many households opt for piecemeal planning when comprehensive planning by a professional would serve them better.

To understand why, one first needs to understand what true financial planning involves. Financial planning provides a comprehensive, integrated approach to one's finances. It addresses the big financial picture by identifying short-term and long-term goals (nonfinancial as well as financial), analyzing current financial resources, and creating and implementing strategies and objectives for achieving those goals through the effective use and integration of your assets.

This is followed by regular monitoring and adjusting of one's financial plan and resources in response to changing personal circumstances and needs. Smart financial planning is not a one-time or occasional endeavor. That's why it's best if one can develop a comprehensive, long-term working relationship with a planner – whether you pay the planner on a hourly fee, percentage of invested assets, retainer, or commission basis.

The benefits of such a long-term planning engagement are many.

**Planning with context.** Piecemeal planning often means making decisions without taking into account the scope of one's overall financial picture. For example, how can an advisor recommend which mutual funds to buy inside your 401(k) if he or she doesn't know the rest of your investment picture or retirement assets?

Obtaining isolated advice on a particular concern – say a tax issue – can actually undermine another aspect of your financial life, such as a particular investment strategy.

**Avoiding a crisis before it happens.** Financial planners often see people come in their door for “panic planning.” Something's gone wrong and they need it fixed. Perhaps they're five years from retirement and they realize they don't have enough in their nest egg, or they over-invested in tech stocks in the bull market and their portfolio now lies decimated.

Sometimes it's too late for the planner to do much except help them pick up the pieces as best as they can. Working with a planner in a long-term relationship has a greater chance to avoid or minimize the impact of problems before they occur.

**Avoiding costly mistakes.** Limited piecemeal planning may save money up front, but could prove far more costly than comprehensive planning if key issues are overlooked. A financial planner working comprehensively and regularly with a client may recognize and recommend that it's time for a client to buy long-term care insurance. Consumers who visit a planner only every couple of years to address a specific issue – say rolling over a 401(k) plan – could miss out on this important piece of advice. Without adequate long-term care insurance, a stay in a nursing home or assisted living facility could drain everything you've saved.

**Getting things done.** It's easy in our busy lives to let important financial matters slide by – drafting a will, developing a budget, purchasing disability insurance. A financial planner with whom you meet regularly is in a better position to motivate you to implement critical financial strategies.

## SAVED BY THE BELL: CONSOLIDATING COLLEGE LOANS

The school-loan bell is about to ring and you don't want to be late.

Graduated or soon-to-graduate college students with sizable education loans may want to consider consolidating their loans by July 1, 2005. Historically low interest rates and the potential for dramatic changes in the federal government's student loan consolidation program may make this the last best time to grab a consolidation loan before the bell rings.

Here's how the federal consolidation loan program currently works. Students with multiple federally backed loans such as Perkins and Stafford loans can consolidate those loans into a single fixed-rate loan. (Private loans cannot be consolidated under this program, and loans already consolidated cannot be reconsolidated.) The rate is based on the weighted average of the consolidated loans, rounded up to the nearest one-eighth of a percent. Depending on the weighting, the consolidated rate may not necessarily be lower than the effective combined rate of the consolidated loans, but it probably will be.

Until July 1, 2005, consolidation rates go as low as 2.77 percent for students who consolidate their loans while they're still in school or within a six-month grace period immediately following graduation or leaving school. Students who don't consolidate until after the grace period pay a 0.6 percent higher interest rate – currently as low as 3.37 percent. In addition, some private lenders will reduce loan rates even further if you agree to automatic deductions from your checking account or you make on-time payments for a designated period.

Beyond potentially lowering the overall interest rate and saving hundreds or thousands of dollars in interest charges, borrowers benefit from consolidation in three other ways. First, they replace multiple payments, and paperwork, with a single monthly payment.

Second, and often the biggest benefit, is that consolidation allows borrowers to stretch out their loan payments for longer than the standard 10 years – as long as 30 years, depending on the size of the loan. This means smaller monthly payments, a big help for recent graduates working in relatively low-paying starter jobs.

Third, consolidation loans allow the flexibility of prepaying penalty free, which you might be able to afford once you move into a higher-paying job.

The incentive to consolidate by July 1 stems from several factors. First, consolidation rates are at record lows as the nation's overall interest rates have hit historical lows. But short-term interest rates have started to rise again, so consolidation rates are expected to

go up when new annual rates are announced July 1.

Another factor is the potential for the consolidation program itself to change. Private lenders who actually issue these loans have been lobbying to change the consolidation rates from fixed to variable – rates that could go as high as 8.25 percent. The Bush administration's proposed 2006 federal budget includes just such a recommendation. In a rising interest-rate environment, variable rates could add thousands of dollars in finance charges for some borrowers.

The Bush proposal would also add a 1 percent consolidation fee the borrower would have to pay and would double the fee the government charges lenders for originating the loans. Lenders would likely try to recoup those costs, possibly lowering or eliminating some of the loan-reduction incentives they currently give borrowers.

In light of the almost certain interest-rate hike, and the possible changes in the very heart of the program itself, consolidating education loans soon may be a smart move. But consolidating loans isn't for everyone.

Stretching out payments beyond ten years, for example, usually means borrowers pay more in total interest than if they pay the loan off in ten years. Lower consolidated payments may make you feel you can pile on new debt, compounding the problem.

Additionally, some student loans, such as Perkins, can be partially or completely forgiven for some graduates, such as teachers who work in low-income schools – but the loan cannot be forgiven if it is consolidated.

Moreover, if you've managed to pay your unconsolidated loans on time for close to 24 or 48 months, it might be wise to not consolidate. Why? Because some lenders will reduce interest rates for the remaining loan period by as much as two percent.

Whatever you do, don't miss the bus.