Welcome to the July, 2024 Issue of Retirement Insight and Trends – 1 CFP and CRC CE Credit

Retirement InSight and Trends is the quarterly newsletter from the Retirement Resource Center that helps committed professionals with the practical application of new concepts in the field of retirement planning and income management.

The articles below comprise this retirement-specific newsletter. Click on the links below to read each article online separately, or **click here to view and print the issue in its entirety**.

1. *"Rollover and Transfer Rules for Beneficiaries of IRAs and Employer Plan Accounts"* by by Denise Appleby, MJ, CISP, CRC®, CRPS, CRSP, APA, Founder and Owner of Appleby Retirement Consulting, Inc. In this article, we will look at how to move assets from one inherited retirement account to another without making a mistake. Why is this so important? When an IRA owner makes a mistake moving their retirement account, there is usually a fix. But when it comes to the beneficiary, there is hardly ever a fix.
2. *"The New Retirement Reality"* by Michael Finke, PhD. I have written a lot about the new environment for financial assets and longevity, understanding some of the characteristics of the marketplace that tomorrow's retirees will have to face in the defined contribution era because, right now, individuals are responsible for making their own decisions about creating retirement income.
3. *"Adaptive-based Retirement Spending"* by Jamie Hopkins, Esq., LLM, CFP®, ChFC®, CLU®, RICP. The best thing we can do to improve our retirement income situation is to make a smart decision about when and how to retire. Most Americans think they will retire later than they actually do, as two-thirds retire earlier than planned.

This issue is worth one *free* CRC®, CFP®, CRPC®, ASPPA, and the American College's Professional Recertification Program (CLU®, ChFC®, CASL) CE credit upon reading all the articles and successfully completing the online quiz. An email will be sent to you and the Retirement Resource Center upon successful completion (score of 70% or more) of the CE exam.

Click here for the Continuing Education Exam that corresponds to this issue. Click here to see other free issues that you may read. Recent issues are eligible for CRC®, CFP®, CRPC®, ASPPA, the American College's Professional Recertification Program (CLU®, ChFC®, CASL) and other CE credit when you pass the online exam.

To report CE:

- Your score will automatically be sent to the Retirement Resource Center to report your CRC® credit to InFRE and/or CFP® credit to the CFP Board.
- You are responsible for reporting your CE hours for CRPC®, ASPPA recertification and the American College\'s Professional Recertification Program (CLU®, ChFC®, CASL).

Looking for additional CE opportunities? Visit the continuing education section of the Retirement Resource Center store to find hundreds of additional professional development and continuing education options by leading experts, the way you want to learn, at the level that's right for you.

Rollover and Transfer Rules for Beneficiaries of IRAs and Employer Plan Accounts

Denise Appleby, MJ, CISP, CRC®, CRPS, CRSP, APA, Founder and Owner of Appleby Retirement Consulting, Inc.

Editor's note: This article is an adaptation of the live webinar delivered by Denise Appleby in 2024. Her comments have been edited for clarity and length.
You can read the summary article here as part of the July 2024 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course Rollover and Transfer Rules for Beneficiaries of IRAs and Employer Plan Accounts for 1.0 hour continuing education (CE) credit.

By Denise Appleby, MJ, CISP, CRC®, CRPS, CRSP, APA, Founder and Owner of Appleby Retirement Consulting, Inc.

In this article, we will look at how to move assets from one inherited retirement account to another without making a mistake. Why is this so important? When an IRA owner makes a mistake moving their retirement account, there is usually a fix. But when it comes to the beneficiary, there is hardly ever a fix.

To that end, we will discuss what to do before the retirement account owner dies. How do you override distribution provisions, where you know under the tax code that a certain class of beneficiary can take distributions over their life expectancy, yet the plan document says, oh, no, you have ten years to do that? That needs to be corrected. You would agree with that.

So, we will look at rollover and transfer options based on the class of beneficiary and the type of account. Of course, we have to talk about spouse beneficiaries because we know they have certain options not available to other beneficiaries. How do we help them take advantage of those options?

To keep it simple, Traditional IRAs in this article mean traditional, SEP, and SIMPLE IRAs. When I say 401(k)s, I mean all employer plans, such as qualified, 403(b), and 457. Roth 401(k) means all designated Roth accounts: Roth 401(k)s, Roth 403(b)s, and governmental Roth 457(b) plans.

Who Owns Most of the Wealth Today?

Last year, *The New York Times* published an article saying that baby boomers own a significant portion of Americans' assets, with $16 trillion transferred within the next ten years. Now, when I hear ten years, my ears perk up. Why? Because we have a 10-year rule that applies to most beneficiaries who inherit retirement accounts. Baby boomers are aged 60 to 78, with an average life expectancy of 76.4 years.

What does that mean? If you work with clients who own retirement accounts, they will eventually be passed on to

their beneficiaries. And so, we have to be ready to have that conversation when your client comes to you and says, "Someone that I love died, and I inherited their account. What is my next move?"

We all know that most Americans need to save more for retirement. However, research shows that those with anything saved for retirement hold over 80% of their assets in tax-deferred retirement accounts.

As you meet with clients and discuss their financial planning goals and objectives, you must ask, "How much is in your IRA or other tax-deferred retirement accounts, and what are your plans for those who will inherit your retirement account?" We know most people will only spend it some, with over $38.4 trillion in tax-deferred retirement accounts right now and only $13.6 trillion in IRAs. Do you know what the research shows? The majority of assets that are held in employer plans will eventually be rolled over to IRAs.

Now, beneficiaries will do some of those rollovers, and the question becomes: can a beneficiary do a rollover? And if so, what are the rollover options? The answer depends on the class of beneficiary. What you do not want to have happen is for you to tell a beneficiary that you can do a rollover. They request the distribution, thinking it can be rolled over within 60 days. However, they can only do that if they are the spouse beneficiary. That is where I find a significant percentage of the mistakes made with rollovers: non-spouse beneficiaries think they can do a rollover.

Now, there is talk that this will be fixed, or some solution will be provided. In Secure Act 2.0, the IRS was instructed to implement a corrective procedure, but so far, nothing has been done, and until then, we have to be very careful.

SECURE Act 1.0: Key Changes for Beneficiaries

One of the things that came out of Secure Act 1.0 is the 10-year maximum period for beneficiaries. Now, you remember when Secure Act 1.0 was signed into law, the big thing was the "stretch is dead."

What does that mean really? Because we know under the old rules, if you inherited a retirement account and your life expectancy was 50 years, let us say you died ten years later: then, your successor beneficiary had 40 years to continue taking the distribution. However, they explained in Secure Act 1.0 that you are a beneficiary. This is not your retirement savings. Therefore, we will not allow you to stretch it over your life expectancy, and they provided certain exceptions for a class of beneficiary referred to as an eligible designated beneficiary.

Now, when you discuss rollovers, transfers, and distribution options, you have to know whether the beneficiary is a designated beneficiary, an eligible designated beneficiary, a non-designated beneficiary, or, here is the one that people miss: a successor beneficiary. Even IRA custodians who help their clients calculate RMDs get it wrong. I've looked at some of the largest custodians in the country and their process for calculating beneficiary RMDs, and they need to ask the right questions.

Who is Your Beneficiary?

One of those pertinent questions is: are you the primary beneficiary? Because the answer to that helps to drive the solution that the IRA custodian or professional provides to the IRA owner.

Let us discuss some things we must do before you meet with a client who has an IRA. Please ask your client, "Who is your beneficiary?" They will probably tell you, "Oh, my spouse," because most people think that. When they set up their 401(k), 403(b) account, or IRA, they think, "Oh, all the paperwork I have says that my spouse is a beneficiary."

We know that they must be named on the beneficiary form to be the beneficiary. If there is no named beneficiary form or the beneficiary does not survive the account owner, we look to the default provisions of the agreement. We should look for IRA agreements that are what I call estate-planning-friendly.

You may like Firm A because of their cheap trade fees and other benefits, but what about your beneficiaries? What happens if you die, and you do not have a surviving beneficiary? Are the assets going to go to your estate? Are they going to go to your spouse? Are they going to go to your children? The terms of the IRA agreement will determine that. That has to be part of the process of choosing which custodian is the best custodian for your

IRA.

Now, for a qualified plan, like a 401(k) plan and ERISA plans in general, the spouse is usually the default beneficiary unless the spouse properly consents to someone else being a co-primary beneficiary or the only beneficiary. Remind your clients to update their beneficiary designation forms after every life-affecting event. Was there a marriage, death, divorce, birth, or adoption? Review them at least once per year, even if they think that the designation and file are correct because sometimes, we just do not remember.

There is a real-life case where this woman started working at about age 20 and was unmarried; she named her mother, uncle, and sister as beneficiaries of her 403(b) account. She got married 20 years later. After being married, she dies. Now, you know her husband's thinking, "What is mine's hers, what is hers is mine." So, of course, that includes her 403(b) because if he had died, she would have gotten his 401(k)-retirement savings account. But the 403(b) is a non-ERISA account, and when she died, her sister, who was the only surviving of the three beneficiaries, went to the school, took the money, and ran, and she did not give the husband any. He sued the school board, and he lost because they said, "You are not the beneficiary on record at the time of death. So, therefore, it is not your money."

Almost a million dollars, and all because, all along, they thought they were each other's beneficiaries. It turned out not to be the case. Suppose someone says, "As per my will on the beneficiary form," that does not mean anything. The estate might inherit the account, or the IRA custodian might invalidate that beneficiary designation. It is determined according to the default provisions. Now, if your sister is a beneficiary under your will, then name your sister on the beneficiary form. Do not say, "As per my will," because that does not fly when it comes to an IRA.

Another action plan is to check default beneficiary provisions. Some default to the estate, some to a spouse, then children, some to a spouse, and some include varying provisions. I have seen those that even include parents and grandparents. So, you tell your client, "Even if you do not think you will need the default provisions, check it anyway. How does it fit into your plans?"

Check for Distribution Limitations

This is so important. I have worked with spouse beneficiaries on several cases. Now, we know that spouse beneficiaries have more options than those available to other beneficiaries. They can stretch it over your life expectancy; they can roll it over. But in this particular case, when the spouse beneficiary's attorney came to me, she had a check for over $5 million in her hand and a letter that said, "This is your RMD, and you cannot roll it over."

The attorney thought, "But that does not sound right." But when we checked the terms of the plan document, the husband had died before 2020. So, it is the old rules where a spouse beneficiary could say, "Oh, you have the five-year rule, or the life expectancy rule, if the participant died before their required beginning date, which was the case here." So, she followed up after five years when she got the check.

By that time, the entire $5 million was her RMD. She could not roll it over. She had to include $5 million in income in one year, which was no longer eligible for tax deferral. Not only that, but she also owed the IRS a 50% excise tax on that $5 million, right?

We got the excise tax away due to reasonable error, but come on. She is thinking $5 million; that is my retirement nest egg. I am going to wait until I am RMD age and take a little bit every year, and all of that was thwarted. Even though I felt sorry for her because she was dealing with a lot—her husband died—there has to be something in place where beneficiaries know what to do when the retirement account owner dies.

So when your client comes to you and says, "I inherited an employer plan," like a 401(k), tell them right away, "Go get a copy of the summary plan description agreement because we are going to use that to determine how soon we need to take action to protect your inherited benefits."

So, in this case, what could we have done? Check the terms of the plan document. They had given her five years, which would be ten years under the new Secure Act rules. In that case, we will say to the spouse beneficiary, "Do a direct rollover of those assets, either to your own IRA or a beneficiary IRA, and do that by December 31st of the year following the year of death, and you will have all the

options available to you as a spouse beneficiary." I will talk about that more later.

Check for stretch limitations. Successful beneficiaries are allowed to continue taking distributions after the primary beneficiary dies, but it is sometimes limited. With Secure Act 1.0, I use an example of a beneficiary who inherited an account, had a 50-year life expectancy, and died ten years later. Under the old rules, the successor beneficiary would have had 40 years, but under the new rules, if the beneficiary dies after 2019, they have only ten years.

But here is what I am finding. We worked with a custodian whose policy is that when the primary beneficiary dies and the successor beneficiary inherits the account, the successor beneficiary has to name their estate as the beneficiary. When that successor beneficiary dies, the estate has to take an immediate distribution.

So, you might think that you can tell your client, "Make sure the beneficiary names their successor beneficiary for their retirement account," and you would be right to tell them that because you are doing the right thing; but it does not work unless you check the terms of the IRA agreement to see if the IRA agreement includes a limitation that voids the plan that you are putting in place for your client with the inherited account.

Now, you will help your client put all those plans in place. Does it really mean anything if the successor beneficiary does not know? Well, it does because it affects your distribution options, but there is so much money that has been escheated to states. You know why? Nobody comes forward to claim those assets, and a lot of those are accounts where the account owner died, and the beneficiary does not know that they have inherited the account.

I know you are probably saying, "Well, I do not want anyone to be nice to me because they think they are going to inherit my retirement account. So, I do not want them to know that they are the beneficiary," which is fine. But if you name your two nieces as your beneficiary, tell someone if you do not want to tell them. Tell an attorney. Tell someone else that you trust. Please put it in writing; give them a letter and say, should you die, give this to my nieces, and that will tell the nieces that they inherited the account and tell them what to do.

I recommend including procedures in the letter. Do not take a distribution. Make sure you move the assets as a transfer. Things like that, which I am going to talk about later, help them protect the inherited assets from unintended distributions.

Operational Procedures

A common question is, how do you title an inherited IRA? The IRS says the title must include the decedent's and beneficiary's names. I hear talk that if that does not happen, it results in a distribution. I will tell you why that is not true. If you look at an inherited account and it includes only the beneficiary's name, find out if it is registered so that distributions are reported with a Code 4 in Box 7 of 1099-R.

That is what makes it an inherited account. Does the wrong title mean that it results in a distribution? No, you see Mitt here giving you the side eye saying, "Come on. You know that is not true," because a wrong title is an easy fix. All the customer has to do is go into their system, click, click, click, and fix the title. No harm, no foul. The titling is just for the IRS to know who the person who currently owns the account inherited it from, and that is an easy fix.

Now, when conversing with beneficiaries, you need to know the beneficiary class for distribution purposes. Distribution options are based on whether the beneficiary is a designated beneficiary, eligible designated beneficiary, non-designated beneficiary, or a successor beneficiary.

Now, when it comes to rollovers and transfers, what do you want to know? Are they the spouse, non-spouse, or a non-person? That drives the options that are available to them, particularly regarding rollovers and transfers.

How do you move an inherited account? Carefully! See this warning sign? It was added with a specific purpose because if you move the retirement account the wrong way, then, for example, here, a designated beneficiary who would have ten years, that could turn out into a one-year distribution period.

If someone is an eligible designated beneficiary and you tell them, "You can take the distribution over 30 years," but they take a distribution, thinking that they can roll it over, it turns out that the 30-year period was converted to a one-year period just because they chose the wrong method

when moving the retirement accounts.

The same is true for a beneficiary subject to the 10-year rule. So, there are some instances where non-spouse beneficiaries take distributions and roll them over because they think they can. The custodian sometimes accepts them, but that does not mean they are eligible to be rolled over.

What that means is they have an ineligible rollover that creates an excess contribution that will be subject to a six-percent excise tax for every year it remains in the account. I had a case where someone rolled over a distribution from an inherited account of about $400,000, six percent for every year it stayed in the account because they thought it was okay to do so.

Options for Non-person, Non-designated Beneficiaries

Non-person, non-designated beneficiaries cannot roll over a distribution that they take from an inherited account. We are talking about beneficiaries like an estate, a charity, or a non-qualified trust. They cannot do a 60-day rollover or a direct rollover.

So all this is important to know, depending on the type of account. Here is a question we are asking. Who is a beneficiary? A non-designated beneficiary, like an estate. What is the account? An inherited IRA. They can go from a traditional inherited IRA to a beneficiary traditional IRA, a Roth to beneficiary Roth. It has to be done as a transfer because it cannot be rolled over if they take a distribution. I hope I am breaking it down to where you can pull out this presentation and say, "Who? Non-designated beneficiary. What? An inherited IRA."

Now, for the non-designated beneficiary, what if it is an inherited 401(k)? The only option is for them to make a distribution to the beneficiary or annual distributions over the remaining life expectancy of the decedent if they died on or after the required beginning date or over the five-year period if they died before the required beginning date.

Same thing with an inherited Roth 401(k). No rollovers, no transfers.

Options for Non-spouse Beneficiaries

Non-spouse beneficiaries cannot do a 60-day rollover.

Here is a question. Who is the beneficiary? A non-spouse beneficiary. What is it? An inherited IRA. They can go from a traditional inherited IRA to a beneficiary traditional IRA or an inherited Roth IRA to a beneficiary Roth IRA only as a transfer. They cannot roll over a distribution.

Here is a real-life case where a beneficiary inherited a retirement. She inherited two IRAs. Her aunt left her two IRAs. She conversed with her husband, and they agreed, "We do not need the money. We are fine. So, we are going to stretch it over our life expectancy." They could stretch it then because it was pre-Secure Act. And then, even though they could not stretch it now unless they are eligible designated beneficiaries, the lesson is still the same.

She went to Bank 1, and she said, "My aunt left me this IRA. Here is the proof. I want to roll it over." The bank associate should have said, "Are you related to the account owner, or are you the spouse of the account owner?" And if she had said no, they should have said, "Well, you cannot roll it over."

Let us be honest because I have had that experience where I took my mom to one of those giant banks, and they were telling her, "You can put your CD on automatic rollover; every three months, it matures, so you roll it over," and I had to sit there and quietly explain that you can do a rollover only once during a 12-month period. They do not know. They want to help; they are usually very pleasant; but is that sufficient to help your client? No.

So, in this case, when she said, "I want to roll it over to my IRA," the bank associate handed her a distribution form and said, "Fill this out." Then, they gave her a check. She took the check and rolled it over to an IRA at Bank 2. Bank 2 does not ask her anything. They accept the check because their rollover contribution form says, "You confirm that you have had a conversation with your tax or legal advisor, and they have advised you that you can roll over these amounts."

Now, we know no one's consulting with a tax advisor. This protects the IRA custodian because when they sign, they

are attesting to the fact that they have sought tax or legal advice, which 90% of people do not do before they do an IRA transaction because they just want to get it done. She probably wanted to avoid paying a tax advisor or an attorney for fees to advise her about her options with the inherited account.

So, back to the story. This is an opportunity here for your client to learn from other people's mistakes, and this is one of them. Bank A gave her the check. She rolled it over. Guess what happened when she went to Bank No. 2? Same thing. It was like copy-paste.

When the IRS got the 1099-R, they saw a Code 4 in Box Seven. Remember we talked about Code 4? So, the IRS knew that she owed them income tax on that amount. She disagreed with the IRS. She took the IRS to court and explained it was a bank error.

The tax court said, "We are sorry for you, but that is no excuse. You have two ineligible rollovers. You have to include those distributions in your income, and you also owe a lot of money for failing to do that, not to mention the six-percent excise tax."

If it is an inherited 401(k), the spouse beneficiary can roll it over. Traditional 401(k) to a beneficiary, traditional IRA, traditional 401(k) to a beneficiary Roth IRA. This is the only opportunity for a non-spouse beneficiary to do a conversion with inherited accounts, rolling a traditional 401(k) to a Roth IRA.

A Roth 401(k) can be rolled over to a beneficiary Roth IRA. This has to be done as a direct rollover, where the beneficiary accounts are set up, and the plan administrator is instructed to make the assets payable directly to the IRA custodian for the benefit of the inherited retirement accounts.

Spouse Beneficiaries Have All the Options

They can do what other beneficiaries cannot. However, you have to be very careful, even more careful, when you are having conversations with beneficiaries.

A spouse beneficiary can treat a beneficiary IRA as their own, move it to a beneficiary IRA, or roll it over to their own employer plan account.

So, the question for you is, how do you advise your spouse beneficiary client? My advice is that when your client comes in to see you and tells you that they inherited a retirement account, you are going to ask them certain questions. I will tell you what those questions are later.

So, the IRA options are a beneficiary IRA, treat as own, or roll over to employer plan account. Suppose it is an employer plan like a 401(k). In that case, they can keep it in a beneficiary account and take distributions, roll it over to a beneficiary IRA as a direct rollover, roll it over to their own IRA, or roll it over to their employer-plan account.

What questions do you want to ask your spouse beneficiary client? "Are you under age 59½?" Why are you asking that? Distributions taken before the spouse beneficiary reaches age 59½ are subject to a 10% early distribution penalty unless made from a beneficiary account, or they qualify for some other exception.

So, you must find out from your spouse beneficiary client, do you plan to take distributions before you reach age 59½? If they do, you have to keep those assets in a beneficiary account so that they are reported with a Code 4 of Box 7 of 1099-R, which tells the IRS this amount is automatically exempt from the 10% penalty. If you are unsure what to do, have your spouse beneficiary client keep the assets in a beneficiary account because they can always move it to their account later. But if they move it to their account, they cannot go back.

This is another case that you can share with your client, where Ms. Sears inherited her husband's IRA and knew that beneficiary accounts were exempt from the 10% early distribution penalty. Now, his IRA was at Merrill Lynch, and she transferred it to her own IRA at her financial institution.

What is wrong with this picture? When she moved it to her own IRA, it was no longer a beneficiary IRA, and distributions from her IRA were no longer exempt from the 10% penalty due to the death exception. Still, when she filed her tax return, she did not pay the 10% penalty. How did the IRS know that she owed them? The 1099-R showed Code 1 in Box Seven. Code 1 is the custodian telling the IRS that Ms. Sears owes you 10%.

Ms. Sears took the IRS to court, and the tax court said, "Ms. Sears, you did qualify for the exception, but you messed it up when you moved it to your own account, and you cannot go back." So, she ended up having to pay over $6,000.

So, now the question is, who? Is it a spouse? What kind of account? Is it an inherited account? The spouse beneficiary can transfer a traditional beneficiary account to a beneficiary IRA. That must be a transfer. A traditional IRA to their own traditional IRA can be a transfer or a rollover. The rollover would be subject to the 60-day deadline and the one-per-year, IRA to IRA rollover rule. Roth IRA to a beneficiary Roth IRA must be a transfer. Roth IRA to own Roth IRA can be a transfer or a rollover.

When the spouse beneficiary chooses the rollover option, remind them they have 60 days to put it back. If it is an IRA, the IRA-to-IRA rollover limitation applies. You can do that only once every 12-month period, and only eligible amounts can be rolled over. So, for instance, if an RMD needs to be taken, they have to take that before they do the rollover.

Now, suppose the spouse beneficiary chooses a rollover option. In that case, it can only be made to their own IRA, not a beneficiary IRA, and here we have the issue of the 10% distribution penalty. So, if the spouse beneficiary wants to maintain it as a beneficiary account, they cannot use the rollover option.

Now, what if it is an inherited 401(k)? The traditional 401(k) can be rolled over to a beneficiary traditional IRA. The traditional 401(k) can be rolled over to a beneficiary Roth IRA. That would be a Roth conversion because we are going from traditional to Roth. The Roth 401(k) can be rolled over to a beneficiary Roth IRA. Direct rollover, only if they are rolling to beneficiary accounts, not 60-day rollover.

If it is a 401(k) and they want to roll it to their own IRA, they can do that with any of those accounts, just as they could with the inherited IRA. But in this case, if they roll it to their own IRA, they risk being subject to the 10% early distribution penalty.

So, if your client is under age 59½ and a spouse beneficiary, and they might be taking distributions from the inherited assets; they want to roll it to an IRA: encourage them to roll it to a beneficiary IRA, whether traditional or Roth, and that protects them from the 10% early distribution penalty, because as we talked about earlier, they can change their mind later on and move it to their own IRA, but keeping it in the beneficiary account protects them from the 10% early distribution penalty.

Inherited 401(k) and Roth 401(k) can roll a traditional 401(k) to their own traditional 401(k). Suppose the spouse beneficiary works for an employer with a 401(k), and the plan is designed to accept rollovers. In that case, they might want to consolidate and move it to their retirement account—some people like that: less paperwork, fewer statements, fewer things to keep track of. For a Roth 401(k), they can roll it to their own Roth 401(k); traditional 401(k) to own Roth 401(k). So, many options here are available for a spouse beneficiary.

Now, you have got to be careful because the Roth conversion option might seem great, but the question becomes, "Can the spouse beneficiary afford to pay the income tax that is due? Are they suitable for a Roth conversion?" Because unlike what some people are saying, not everybody is suitable for a Roth. We have to do a suitability assessment to make that determination.

Remind them that if they do the 60-day rollover, they have to complete it within 60 days. There are exceptions to that, but who wants to be bothered with that if you can avoid it? There is too much paperwork, too much work, and too much administrative red tape.

If the payer does an indirect rollover, they must withhold 20% from any taxable portion. Only eligible amounts may be rolled over, and indirect rollovers must be made to their accounts, not beneficiary accounts.

Practice Pointers

Some general practice pointers apply to both spouse and non-spouse beneficiaries.

If, for instance, the participant died and was supposed to take an RMD, or if the beneficiary is supposed to take an RMD for the year to roll over, that RMD must be taken before the rollover.

Why is that? An RMD is not eligible to be rolled over, and for any year that an RMD is due, the first distribution

for that year includes the RMD. So, you have got to check that box. If they do the rollover before taking the RMD, the RMD creates an excess contribution in the receiving account, and we do not want that.

Transfers and direct rollovers: Initiate these on the receiving end. Set up the accounts first. Some financial institutions want an acceptance letter from the receiving financial institution. Here is my recommendation: I see a lot of custodians stepping back from the responsibilities that they used to assume years ago.

Once upon a time, you could only do a direct rollover if the receiving custodian provided an acceptance letter. Now, some custodians are saying, "Oh, where do you want to send the money? Here is your check. Tell me who to pay it to," and then they wash their hands of it. Now, it is not that they are doing anything wrong; they are not doing things they used to do to protect the client. They do not care anymore.

So, the clients take these distributions to the receiving financial institutions, and sometimes, they are deposited into the wrong accounts. I recommend getting an acceptance letter anyway because the acceptance letter confirms the type of account established for receiving the funds. Is it a Roth? Is it traditional? If it says it is a Roth, they will know there is a disconnect if the client checks traditional on the box.

For spouse beneficiaries who want to maintain qualification for the 10% early distribution penalty exception, they must do direct rollovers to the receiving account. With the direct rollover, the assets are paid to the IRA custodian for the benefit of the IRA. So, say, for instance, it is an IRA FBO, Mary Jane, Beneficiary of John. The check would be made payable to IRA custodian ABC Company for the benefit exactly as the IRA is registered.

That protects your clients, too, because if the custodian mistakenly puts those amounts in the spouse beneficiary's own account, you can go to the custodian and say, "All the paperwork, all the instructions were clear as to what you were supposed to do; and so, the mistake is yours, and you are obligated to fix it."

Key Takeaways

Check beneficiary designations to ensure they are proper. In almost every client meeting I have participated in, the IRA owner pushes back when the advisor and I recommend bringing all your beneficiary forms.

One reason they do that is that some clients like to spread their money around. "I want to keep some at Firm A, I want to keep some at Firm B," and that is their right. What they usually do in that case is they do not want the advisor to know.

They want the advisor to think, "Oh, that account that I have with you is the only one I have, and I do not want you to ask me to bring other accounts to you, so I do not tell you about it." However, you must help your clients understand, "Listen, I am fine if you want to keep money elsewhere, but I am the only advisor who will go above and beyond to ensure you are protected and your beneficiaries are protected. One of the ways that I can do that is to review your beneficiary designation form to ensure that they follow your goals and objectives. Who do you want to be your beneficiary, and are they your beneficiary?" In the case I discussed earlier, where the woman was married for 20 years, and her husband did not get the assets, guess what? All the statements they sent her over the years said her husband was the beneficiary.

They had it somewhere on their system that the husband was a beneficiary, but it was not where it should be – on the beneficiary form. So, do not think that because you get your monthly account statement, and it identifies who you think the beneficiary is. Call and confirm that they have the proper beneficiary. If they made a change on the wrong system, but it shows up on the statement but is not reflected on the beneficiary form, then we have a problem.

Do not use the rollover method for IRA non-spouse beneficiaries. When a non-spouse beneficiary takes a distribution, that is it. Use only direct rollovers for non-spouse beneficiaries.

Look for opportunities for tax savings regarding spouse beneficiaries and ensure that the receiving account is eligible to receive the amount.

Rollover and Transfer Rules for Beneficiaries of IRAs and Employer Plan Accounts – Denise Appleby

About Denise Appleby, APA, CISP, CRPS, CRC®, CRSP, Founder and Owner of Appleby Retirement Consulting, Inc.

Denise has over 15 years of experience in the retirement plans field, and has co-authored several books and written over 400 articles on IRA rules and regulations.

Denise held several senior retirement plans related positions with Pershing LLC, which includes Vice President of Retirement Plans Products and Services, Retirement Plans Manager, Trainer, Training Manager, Compliance Consultant, Technical Help Desk Manager and Writer. Denise has extensive experience with training the staff and financial advisors of many broker-dealers on retirement plans related topics. Denise has also provided training to hundreds of financial advisors, as well as tax and legal professionals on the rules and regulations that govern IRAs, SEP IRAs, SIMPLE IRAs and qualified plans.

Denise's wealth of knowledge in retirement plans led to her making appearances on CNBC's Business News, Fox Business Network and numerous radio shows, as wells as being quoted in the Wall Street Journal, Investor's Business Daily, CBS Marketwatch's Retirement Weekly and other financial publications, where she gave insights on retirement planning. Her expertise and knack of explaining complex retirement plans rules and regulation, so that they are easily understood, created a demand for her to speak at various conferences and seminars around the country.

Retirement Speakers Bureau

Are you looking for a retirement speaker for your next conference, consumer event or internal professional development program? Visit the Retirement Speakers Bureau to find leading retirement industry speakers, authors, trainers and professional development experts who can address your audience's needs and budget.

©2024, Denise Appleby, APA, CISP, CRPS, CRC®, CRSP, Founder and Owner of Appleby Retirement Consulting, Inc. All rights reserved. Used with permission.

The New Retirement Reality

Michael Finke, PhD

Editor's note: This article is an adaptation of the live webinar delivered by Michael Finke in 2024. His comments have been edited for clarity and length.

You can read the summary article here as part of the July 2024 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course The New Retirement Reality for 1.0 hour continuing education (CE) credit.

By Michael Finke, PhD

I have written a lot about the new environment for financial assets and longevity, understanding some of the characteristics of the marketplace that tomorrow's retirees will have to face in the defined contribution era because, right now, individuals are responsible for making their own decisions about creating retirement income.

We need to take a more deliberate, step-by-step, goal-based approach to creating retirement income because we enable clients to live the lifestyle they want with the available resources.

This is important because it is the No. 1 service in the defined contribution era that would motivate consumers to seek a financial advisor to pay for professional financial advice to understand how much they can safely spend in retirement. Why is that the No. 1 reason why people would hire a financial advisor? We have a new generation of younger baby boomers. The baby boom peaked in 1958, so they are in their early 60s. They are the first generation to have to fund retirement from their savings. If you think about what we have done for people, 60% of employees are now investing in target-date funds, which, for many reasons, is not bad because if they had too much control over what they were investing in, they will probably underperform the market.

So, at least, we are giving the market returns through their target-date funds. But then, when they retire, they have yet to learn what they have been investing in. They have yet to learn how much income they can buy with the money they have saved. They fixate on the total dollar value and must instead consider how to translate that amount into a lifestyle. They want help trying to figure out whether they have enough and what sort of strategy they should use for investing that money to draw an income to fund the lifestyle that replaces their pre-retirement lifestyle.

But doing that is not easy. Many have no idea what percentage of their savings they invest in stocks or bonds. They have no idea what it costs to buy income. So, they need professional help, and this is the opportunity that advisors have to help a client use a straightforward process to develop a retirement income plan.

In the 60- to 69-year-old group, only 19% have any pension income. So, their primary income will be Social Security. A few had a public sector job with access to some form of pension. They have Social Security and retirement savings. This is different from even the older baby boomers because many older baby boomers if they worked for a big company, had access to at least a partial company pension. Today's workers do not have that. So, we are really among the first generation of retirees who do not

have any pension income.

When they retire, many people have a number they're shooting for; maybe it was half a million dollars, or a million dollars, or maybe $2 million. But they met that number. One of the reasons they met that number was because assets became so expensive. Stocks became expensive. Bonds became expensive. That means that their portfolio had tremendous value. They decided that they were going to retire. But then, to live the lifestyle that they want to be able to lead, in other words, to replace the lifestyle that they had before retirement, they are going to have to spend down that money. However, I consistently find that individuals have yet to realize that they will have to get comfortable with the idea of spending down their savings.

A few years ago, I interviewed retirees, asking them how they were spending money. Many of them were so proud of the fact that they were not spending down their savings. So, they would say things like, "We have more money today than we did ten years ago when we first retired," "We are doing a great job of going to the two-for-one dinners," and "We are living frugally." And they looked at me like I should pat them on the back because they had been so frugal in retirement. So, I would then ask them, "Well, you must really want to give that money to your kids."

Then, they would say, "Well, no, that is not why we are not spending the money. We helped them pay for college. They have got plenty of money. That is not our primary goal." But there are only two places that your money can go. It can either go towards funding your lifestyle, or it can go to others. So many retirees, especially mass-affluent, higher-wealth retirees, have yet to devise a plan. What will end up happening is that they will give what is known as an unintended bequest, which means that they die with a lot of money in the bank that they could have spent to provide joy. Instead, what they are doing is trying to preserve their assets.

We have got to move beyond this. In the defined contribution era, this is a psychological problem that we need to be able to help people solve by getting them to feel comfortable spending down their assets, including the home equity in their house. If they have home equity, that could be a source of satisfaction. That could be money that they spend to improve their lifestyle. If their goal is not necessarily to leave a significant bequest, if that is not their primary goal, they need to explore all options for taking the assets they have accumulated and turning that money into a lifestyle.

Step 1: Setting Lifestyle and Legacy Goals

Step 1 of using a goal-based retirement planning process is to have a conversation with a client where you talk about, "All right. How much of your nest egg do you want to leave to others? And how much of it do you want to actually spend?" because there are only two places that your money can go. It can either go towards fun stuff, or it can go towards passing it on to others. That may be fine. That may be what you want. But people should do this deliberately. They should have a conversation. If you are talking to a couple, they must agree about what they want to do with their money.

What I feel is that many couples have never had this conversation. Often, one of the most significant sources of value an advisor can provide is to get people to have this conversation for the first time. Very often, this couple has never even thought about, if it is a couple, that their money can only go to two places. So, what do you want to do with your money? Do you want to live better? Or do you want to pass it on to others? That may be what you want to do. But let us do it purposefully.

Now, I think that one of the reasons that people are not deliberate about spending their money in retirement is that we all feel that we will live forever. There is a piece of art created by Damien Hirst in 1991, and the title of the art is *"The Physical Impossibility of Death in the Mind of Someone Living*." I think it is such a great title because it is absolutely true. It is borne out by research that has been done on how we think about death. We cannot acknowledge the fact that we are not going to live forever. So, the artist wanted you to walk around this dead shark in formaldehyde and imagine that it was going to eat you so that you could come face-to-face with the reality that we are mortal.

How can an advisor help a client come face-to-face with this reality when it is something that we do not want to talk about? Whenever a financial professional talks with someone about any financial product that only has value if you are mortal, the tendency is simply to deflect, delay, or

deny. These are very consistent human responses to talking about your death. I have a financial advisor who is a friend of mine in Dallas, and one of the first things he talks about with clients is, "What do you want your money to do for you 50 years down the road? One hundred years in the future?" Let us talk about building a plan for what you want your money to accomplish, that percentage of your nest egg that you want to use and pass on to others to fund that legacy goal.

Then, you can have a conversation because now your money will allow you to live forever. This is what is known as symbolic immortality. Your legacy can help you live forever. But now, that creates the opportunity to discuss your income because you have already established immortality through your legacy. Let us discuss using the remainder of your assets to fund an income. It is an excellent way to enter into a discussion about income rather than using a technique that requires acknowledging your death. The worst thing that you can do is lead with your mortality. Please find a way to do it in a way that people can accept the fact that they are going to live forever. Then, let us plan on getting the most out of the portion of our assets that we will use to fund an income.

Step 2: What Should Income Look Like?

So, let us estimate the actual replacement rate from your pre-retirement lifestyle. For most higher-income workers, it is probably more like 60% of your gross salary that is what you want to be able to replace. So, if you are making $200,000, it will look more like $120,000, which you need to replace. Part of that will be replaced with Social Security. Part of that could be replaced with your investments. But what you will find is that many mass-affluent clients are going to need something extra.

They need more investments to fund the lifestyle gap. If you can estimate what that gap is, now you can begin to have a conversation about, "All right, of your investments, how much do you want to devote to plugging that hole in the gap between Social Security and the lifestyle that you want to be able to lead to replace the amount of money that you were spending before retirement? And what other assets can we tap to fund that lifestyle?"

So, let us say $200,000 is what you earn pre-retirement, gross. I am not saying you should cut down your spending after retirement. You should spend about the same amount of money after retirement as you did before you retired. That amount is about 55 to 60% of the amount of money that you were spending pre-retirement. Why? Well, because you were saving money for retirement. If you were taking advantage of catch-up savings, then that is a significant percentage of your overall gross salary that you are already just saving. That is not money that you are spending. You also had to pay payroll taxes during your working years that you do not have to pay after retirement. The amount you spent before you retired is $110,000 annually after tax.

This is precisely what I find when I look at retirees' spending data. We are creatures of habit. We live in the same house very often. We go to the same grocery stores. We drive the same car. We pay the same insurance. Our spending after retirement, on average, looks exactly like our spending before retirement, at the median. Now, some people spend more. Some people spend less. But, generally speaking, spending, on average, does not change.

One of the things I also want to mention is that I have researched life satisfaction, and what I find is that it is very often the kind of things that may seem frivolous, like going out to eat with friends or going out on vacations, these are the things that consistently predict life satisfaction. So, whatever plan you put together, you want to ensure that no matter what happens in the market or how long people live, they still feel comfortable spending money on frivolous things. So, you can ask people, "During the market crash in 2020, during the decline in 2022, did you cut back on going out to eat with friends? Did you take fewer vacations?"

If that is true, let us think about how to create a plan where you can feel comfortable spending money on those categories, no matter what happens in the market. I want to see the defined contribution retirees live as well as they did when they were working. If that means that your lifestyle is dependent on the ups and downs of the market, that means you are not living well. People tend to cut back on some of these categories when the market does not do well. Let us develop a plan to put a wall around that spending.

Criticisms of the Four Percent Rule

Let me take a minute to discuss the four percent rule and,

specifically, some of my criticisms of it. So, where was the four percent rule created? How did it come about? In 1994, a financial advisor named Bill Bengen wanted to make a critical point: even if your portfolio averages an eight percent return, that does not necessarily mean that you can safely withdraw eight percent from that portfolio every year.

So, what assumptions are involved in the four percent rule? Since we do not know what future asset returns will be, Bengen based his research on US historical averages before 1994. The available Ibbotson data provided stock and bond returns between 1926 and about 1990.

He also did not know, as none of us do, how long we would live, so he used a 30-year time horizon. He said, essentially, it is safe if the money lasts for 30 years. You do not know how much money you will spend, so he assumed constant inflation-adjusted spending. So, somebody who follows the four percent rule is basing the safety of the four percent rule on these assumptions.

So, a very simplified version of the assumptions of the four percent rule is that you start at 65. You withdraw four percent of your initial balance in real after-inflation terms. What does that mean? So, if you have a million dollars, you spend $40,000 the first year. If inflation is five percent, you spend $42,000 the following year. So, you will spend the same amount of money yearly in after-inflation terms. You are going to spend down your money. If you still have money in the bank at the age of 95, that is considered a successful retirement. If you ran out of money before the age of 95, that was considered to be a failure.

So, if you run a Monte Carlo scenario with a 10% chance of failure, that means that the money ran out 10% of the time before the age of 95. So, if you are a financial advisor who follows the four percent rule to the letter using these assumptions, then I think it is a good idea to set aside $10,000 and put it in an account that you can then use for your client to fund the purchase of a motorcycle at the age of 94. Then, encourage your client to ride it without a helmet because you have only estimated the safety of a withdrawal strategy up to the age of 95. What does that mean if you tell them they have a 90% chance of success?

That means they have a 90% chance of the money not running out before age 95. So, there is no assumption about anybody living beyond 95. According to the four percent rule, age ninety-five is the maximum age humans can live to. Is that realistic? Well, maybe in 1994, that was a relatively conservative assumption. But that is not really conservative now.

Today's Longevity Assumptions

So, how long are you going to live? Well, none of us know. But it is likely longer than you think. When you look at the longevity statistics, we are gaining about a year every decade in the United States. In the mad men era of the '60s, '70s, and '80s, there was a four-and-a-half-year difference between men and women. That has shrunk to about two and a half years. However, for clients of financial advisors who have enough money to worry about how long the money will last, the difference is less than a year between men and women. The big reason is that higher-income men have made considerable gains in longevity over a recent twenty-year period. Longevity after age 55 has grown by 5.9 years for men in the top tenth percentile of earnings, and it has gone up by 3.1 years for women in the top tenth percentile of earnings.

The increase in longevity for men is spectacular and has essentially occurred because men are smoking less than they used to. Men in the top tenth percentile of income smoke less than men in lower-income percentiles. So, men have done a great job of improving their longevity. Women who make more money also live longer for whatever reason. They are not smoking as much. They are exercising. They are eating better. That is great. But it means that that longevity is getting pushed out farther and farther.

The likelihood that one's spouse will still be alive at a given age is known as joint longevity, and joint longevity for a healthy 65-year-old couple has gone up to a 43% chance that one will still be alive beyond the age of 95. I talk to actuaries at insurance companies, and what they tell me is that for their healthiest customers, for people who are in the premier class of life insurance, there is actually a 57% chance that one spouse in a healthy couple is going to live beyond the age of 95. So, people who have enough money to worry about how long their money will last will live longer than the average American.

The big mistake I see many people making at retirement is they are assuming that if their dad died when they were 72,

they are going to say, “Well, I am not going to live much beyond 75 because it is just in my family.” Well, your dad lived differently. He lived in a different era, probably behaved differently, ate differently, maybe smoked, and exercised less often. Also, medical science has advanced significantly since even the early 1990s. Survival rates for many different types of cancers have gone up dramatically since the 1990s. So, the new reality is that people will live longer, especially higher-income people.

They need to think about possibly putting together a plan where the money will last into their 90s and beyond. Remember, the four percent rule assumes everybody is dying at 95. There is now a 43% chance in a couple that one will still be alive at 95.

Investment Risk is Lifestyle Risk

The new retirement reality is that people are living longer when it comes to longevity. Regarding investments, they generate less income to fund spending than they used to.

Now, we cannot base a retirement plan on this idea of harvesting income from an investment portfolio. First, there are more efficient ways to do it because it very often leads to putting too many of your stock investments in high-dividend stocks, which is not an efficient strategy, or taking too much risk with your bond investments to get a higher yield. Again, there are more efficient strategies. You should have a balanced portfolio. But you should also recognize that you will have to spend that money down if you want to maintain the lifestyle you had before you retired.

What does it mean to take investment risk? Imagine that you go to a bank. You are 55 years old. You put a thousand dollars into one of those vacuum tube thingamajigs and write a note to the teller saying, “Invest in stocks or bonds.”

You shoot it back up to the teller, who invests the money for the next 20 years. You come back 20 years later. Now, you are 75 years old. You need the money to fund spending that month. You ask for it back. You open up the vacuum tube, and the amount of money you have available is the amount you can spend that month. So, the growth in your bond or stock investments over those 20 years will determine how much cash you can spend that month. That is how I want to get people thinking about investing because investment risk is lifestyle risk.

When stocks do not perform as well as you had hoped, that means it will impact the amount of money you can spend that month. When you invest in safer investments, that means that, on average, you will have less income. But it also means there will be less variation in the amount of money you have available to spend. So, we can give too much credence to historical returns on stocks, which have been significantly higher than bonds or cash.

So, when we use the historical averages to project how much money a retiree will have 20 years down the road, we conclude that taking more investment risk is the only appropriate strategy for funding long-term spending goals. But if you actually put a dollar into a vacuum tube, shot it up for 20 years, and invested it in the S&P 500, bonds, or cash, this is the amount of money that you would have 20 years later.

Bill Bengen used data from the middle of the 20th century in the United States, years when stocks just trounced bonds. They were the obvious choice for any long-term investment. Also, the internet bubble between the late 1970s and the late 1990s was another period where stocks just thoroughly trounced bonds.

There have been several periods when stocks returned less than long-term bonds and even a couple of periods when they returned less than intermediate-term bonds. When we run a Monte Carlo simulation, we use these historical returns.

Well, if you think about between 1934 and 1953, a dollar never grew to an amount less than seven dollars over the next 20 years. Since the late 1980s, a dollar has never grown to seven over the next 20 years. So, in the current environment, you cannot expect stocks to do what they did for investors in historical periods. That means that if you run a Monte Carlo using these data, it can give you a false impression of the amount of income you can generate by taking greater investment risk. This is a big problem in retirement income planning and projections of safe spending amounts, and that is that you are using stock returns from this historical era that may not happen again in the future.

So, taking investment risk is not necessarily the solution

to all of life's problems. On average, it will allow you to spend more money and pass more money on to others. But it is not necessarily the foundation on which you can rest a safe retirement income strategy.

Step 3: Figure Out How Much the Client Needs to Spend

So, how should we think about taking investment risk? Imagine that someone puts 40 cards in front of you, and on the back of each one of those cards is written a return on your retirement portfolio. Most of the cards are between zero and 10%. One of them is positive 40%. Two are negative 20%. One is negative 30%. You spread all the cards out in front of you.

Then, you have to pick them up one at a time and live with the consequences of whatever you see on the back of that card. Now, most of the time, it is going to be between zero and 10%. But you could pick up the negative 20% card in the first year of retirement. You could pick up the negative 30% card in the first year of retirement. In 2022, many retirees picked up the negative 20% return card. Some retirees who put 10% of their portfolio in crypto and decided to put more of their bond portfolio in high-yield bonds may have picked up the negative 30% card in 2022.

What are the consequences of picking up the low-return card in the first year at the beginning of retirement? Well, let us say you were very conservative and followed the three percent rule, which I think is close to safer in today's environment. It gives you a 94% chance of success. But if you pick up the negative 20% return card, you go from a 94% chance of success down to a 69% chance of success. If you pick up the negative 30% card, you go from a 94% chance of success down to a 48% chance of success. So, what do you tell someone who goes from a 94% chance that they can take $30,000 out of a million-dollar portfolio to saying, "Now, it is less than 50/50."

Well, your only response is to ignore reality, which is not a very good response, especially if you started out thinking you had a 94% chance of success because you were so conservative. The only other response is that you will have to cut spending back. You could cut it back to $25,000. Maybe even less if you want to maintain the same 90% probability of success. But this shows you that you have to be willing to be flexible in the face of picking up a lousy card at the beginning of retirement. If you get unlucky, then there is always a possibility that you will have to cut back to avoid the possibility of running out of money too early.

This is one of the reasons why everybody should have a conversation with retirees or near-retirees about how much of their spending they are willing to cut back on if the markets do not do well. In my research, about 65% of spending in retirement is inflexible. So, you must be able to cover medical expenses, food, property taxes, and insurance. All of these things are essential expenses. No matter what happens to the market, you have to be able to cover them. Some expenses may seem flexible, but it should be up to the client to decide how flexible they are willing to be.

Are you willing to cut back on gym or country club membership if the market does not do well? If not, we must develop a strategy to lock in that part of your retirement budget. You may have some expenses that are more flexible. So, you may be willing to cut back on some of your entertainment, legacy goals, gifts, or things like that. That is fine. We will take greater investment risk when it comes to those spending goals. However, the client should always know that no matter what happens in the market, they will always be able to fund those basic expenses they want to put a wall around.

So, really, the conversation is about putting a wall around your basic expenses to make sure that no matter what happens in the market, you are always going to be able to cover those. One great question you can ask a client is, "How much do you need to live on?" Most people have never thought about that, but it initiates a conversation about their lifestyle, and it is a conversation that many people have never even thought about.

But it allows them to start getting into a mindset that opens them up to different types of possibilities, strategies, and financial products that can cover those inflexible expenses. You should never cover inflexible expenses using volatile assets because volatile assets require that you be flexible if the market does not do well. So, about 35% of a retiree's budget is flexible expenses, and for these categories, you can talk about how much you are willing to cut back. Do you want to put a wall around any of these expenses to insulate them from market risk? If you do, let us talk about some other solutions.

As part of the illustration of what is wrong with the four percent rule, imagine you have two retirees. They both are friends. They both have exactly a million dollars. One decides to retire on January 1, 2022. The advisor tells them they can pull out $40,000 plus inflation annually with a 90% probability of success. The other client waits a few months. They wait until May 20, 2022, to retire, and they now have $840,000 in their investment portfolio. They go to the advisor and say, “How much can we withdraw? We waited a few months,” the advisor tells them, “Well, according to the four percent rule, you can only spend $33,600.”

They say, “Well, that is not fair because we had the same amount of money as our friends. You told them they could spend $40,000, and we have more money in our investment portfolio now than our friends do. You are telling our friends they can spend $40,000 and telling me I can only spend $33,600.” The problem with a fixed spending rule is that it needs to acknowledge the new reality of where the market is and your new failure rate. To acknowledge that, we have to take new information into account, and when we take new information into account, we have to be willing to be flexible.

Step 4: Create a Plan for Funding Inflexible Spending

This is where I think it opens up a conversation to potential solutions. Those potential solutions can include Social Security, annuities, bonds, and money tapped from home equity. Home equity money could be a preferable solution or the only solution that some clients have to fund those inflexible spending goals.

What I find is that at the top percentiles, the people who get lucky and the market does really well at the beginning of retirement can actually spend more money. The ones who get unlucky have to continually adjust their spending downward, and what that means for some retirees is that they may have to cut back to the point where they are spending less than their inflexible spending goal.

For many retirees, this is what keeps them up at night. This is what they are worried about, and it is a possibility. When we run a Monte Carlo, we see that in some of the simulated retirements, people get unlucky, and they are going to have to cut back, and they may even have to cut back beyond that threshold where they do not have enough money that they need to be able to live on. So, part of the job of a financial advisor is to get the client to feel like they can continue to spend money no matter what happens in the market.

If you take an investment risk, there is an upside. But there is also a downside. The downside is that you might have to cut back if the market does not give you the returns you had hoped for. Can you create a lifestyle where you build a wall around the essential spending to satisfy the client and create a happy retirement? And if people have that income walled off, they will feel more comfortable spending money on frivolous things, like going out to eat with friends or going on vacations. If they do not have that spending walled off, they will not live as well as they could.

For many Americans, they may never get a chance to live the lifestyle that they want to lead in the defined contribution era. What does that lifestyle look like? What percentage of your expenses do you want to build a wall around? And then, what sort of solutions can I present to you to build that wall, to create a moat, so that no matter what happens in the market, you still feel comfortable spending the money you have saved?

In the defined contribution era, you need to have a plan for spending down your savings, and it isn't very easy. Especially when it comes to using riskier types of investments, there is always the possibility that you must be flexible. I like using a goal-based approach that distinguishes inflexible spending from flexible spending. Then, what you want to do is create a plan for funding both those flexible expenses and those inflexible expenses. Offer all the solutions to meet the inflexible spending goal.

About Michael Finke, PhD

Michael Finke, PhD, is Professor of Wealth Management and the Frank M. Engle Distinguished Chair in Economic Security at The American College of Financial Services. He joined The College in June 2016, having served since 2006 as a professor and PhD coordinator in the Department of Personal Financial Planning at Texas Tech University. From 1999 through 2006, he served as the director of graduate studies at the University of Missouri.

The New Retirement Reality – Michael Finke

Finke received a doctorate in consumer economics from The Ohio State University in 1998 and in finance from the University of Missouri in 2011, and his CFP® in 2006.

Finke is a nationally renowned researcher on the modern approach to retirement income planning and the science of creating a satisfying retirement. He was named to the 2012 Investment Advisor IA 25 list and the 2013 and 2014 Investment News Power 20. His research conducted with The American College professor, Wade Pfau, questioning the 4% rule was published in the Journal of Financial Planning and won the 2014 Montgomery-Warschauer award for the most influential article in the publication. He had previously won the award with Thomas Langdon in 2013. He was also selected to present his research on financial literacy and aging at the 2015 MIT Center for Finance and Policy Conference.

Retirement Speakers Bureau

Are you looking for a retirement speaker for your next conference, consumer event or internal professional development program? Visit the Retirement Speakers Bureau to find leading retirement industry speakers, authors, trainers and professional development experts who can address your audience's needs and budget.

©2024, Michael Finke, PhD. All rights reserved. Used with permission.

Adaptive-based Retirement Spending

Jamie Hopkins Esq., LLM, CFP®, ChFC®, CLU®, RICP®

Editor's note: This article is an adaptation of the live webinar delivered by Jamie Hopkins in 2024. His comments have been edited for clarity and length.

You can read the summary article here as part of the [July 2024 Retirement InSight and Trends Newsletter](), worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course [Adaptive-based Retirement Spending]() for 1.0 hour continuing education (CE) credit.

By Jamie Hopkins, Esq., LLM, CFP®, ChFC®, CLU®, RICP

The best thing we can do to improve our retirement income situation is to make a smart decision about when and how to retire.

Most Americans think they will retire later than they actually do, as two-thirds retire earlier than planned.

Pushing off retirement is very beneficial. We should plan for the uncertainty of retiring earlier than we project ourselves to retire. COVID is a recent example. In 2020/ 2021, many people were forced into retirement and didn't really want to retire yet. Now, they have to deal with that from a retirement income sustainability standpoint.

How We Make Decisions

Now, how do we make decisions? We make decisions based on our experiences and knowledge. We really can't make decisions about anything else. When it comes to retirement, what do we know? What have we experienced? When you think about retirement for most people, what do we learn throughout our lives regarding retirement planning? We learn about saving, not spending, and that we should save more than we spend. If you save more than you spend, you will grow your wealth. And if we keep doing this repeatedly from ages 20 to 65, we'll end up with enough money to retire. The retirement savings system's automatic behavior features and nudges that we have created as a society, as public policy, and as employers, revolve around this notion.

Most retirement decisions require more active decisions than we make regarding saving and investing. Even Social Security requires an active decision about how to spend and when to claim from ages 62 to 70.

But even at age 70, Social Security doesn't automatically turn on, which is very weird, as you don't get any benefit from deferring past age 70. Social Security, in fact, knows that there are people over 70 who have not claimed Social Security benefits.

We haven't learned about it, and we haven't experienced retirement, so we don't know a lot about it. Thus, Americans are not well-informed about retirement income planning.

The [American College recently released a new retirement income literacy survey](). It found that 81% of Americans

failed a retirement income literacy quiz, with an average score of 42%. Why? Because we learned about saving, not spending. We have yet to retire. We haven't lived through it. We need to gain experience with retirement income planning. Even though our family and friends can give us some insights into retirement, they are not the best resources for us regarding income, claiming decisions, and distributions.

Even if we look back at our grandparents or parents, they probably lived a very different retirement than we are going to live. This causes behavior bias against spending and retirement. We become fearful of it. We self-insure much risk. We don't spend what we could spend because we don't have the knowledge, comfort, or expertise to do that.

The 2023 American College Retirement Income Literacy Survey found a high correlation between increased knowledge about retirement income planning, retirement confidence, and access to a financial advisor. This is a correlation, not a causation-type finding.

What is Retirement Income Planning?

I describe retirement income planning as trying to hit a moving target in the wind. The targets are your and your client's individual financial goals. We can't create a great retirement income plan in silo, in a vacuum. We must know the goal: How much we want to travel, what we want to give back to our community and charity, our alma mater, and our grandkids. What's the legacy you want to leave behind?

Why is the goal moving? I don't know how long you're going to live or how long you'll be in retirement, whether one day or 40 years. The challenge of trying to create a fixed amount of income over an uncertain period of time is what makes the calculations and planning around retirement income so challenging.

There's wind because there will be things that push us off course: changes in public policy, tax law, inflation, and the market. Our own goals might change.

The Four Percent Rule estimates that you'll adjust your annual spending for inflation. We know that's not how spending works, and that's not how inflation works.

When inflation goes up, we prioritize spending, and eventually, spending and inflation come back down because we don't just keep spending on the same things. Inflation actually drives behavior to spend differently.

For someone with $1 million, it's the difference between $40,000 (4%) or $60,000 (6%) in income. When you have $1 million, you think, "I can't spend an extra $20,000." Suddenly, we can only spend 6 percent if it feels sustainable. Here's the thing. There are many ways to get there. Six percent is a sustainable withdrawal rate as long as we take a more adaptive approach.

From a retirement-income approach standpoint, if your income is between $150,000 and $250,000, 60% can be your target replacement ratio. If your income is between $20,000 and $100,000 a year, your target income replacement is close to 80%.

So, based on how much income you make during your working years when your income is higher, you typically need a lower replacement ratio in retirement. It's a very back-of-the-envelope view. It's not helpful when we get into an individual plan. The 4 percent strategy, again, one of the most useful, important findings we've had in retirement income planning, taught us much information about the sequence of returns risk and gave us a guideline for distributions. Still, it should be something other than what we rely on too much individually. Why? Because we don't live our lives like the 4 percent model suggests. It's not how we react. It's not based on reality. It is a simplistic model that used the technology at the time, but it is super important from a finding standpoint.

Another retirement income approach is what I call my grandparents' strategy, which is still alive and well today. You all know someone who wouldn't spend down their principal. What did they spend in retirement? They spent whatever their bonds, CDs, dividend stocks, Social Security, and maybe their pension paid out, and they didn't spend anything else.

In fact, many people use this approach today. JP Morgan Chase spending data shows that millions of Americans live like this, and they're very fearful of spending down principal. They self-insure. They're afraid of this risk. Why? Because they're afraid of failure. But retirement

isn't about success or failure.

In all these other scenarios, you could run out of money 20 years into retirement, fail retirement, or succeed in retirement. Retirement is not pass/fail. It's not success or failure. We don't want to use success or failure language anymore.

We Need Different Ways to Measure Retirement Success

Failure rates, in and of themselves, ignore the magnitude of failure. You live for 30 years in retirement, and you're one dollar short on the last day of your life. Many people would say that's a successful retirement. Still, with today's focus on success rates as an indication of retirement success, it's considered the same failure as someone who runs out of money in retirement on day two.

There are many ways to look at the average or magnitude of failure. Often, our past science relied on historical returns, which help predict future returns, but they need to guarantee that the way things mesh up together will be different in the future than we have seen. Last year's first quarter was a very good example of that. We had never experienced the bond and stock market react like that together ever. It was the worst first quarter we had ever seen. That doesn't mean that historical data isn't useful. Software firms such as MoneyGuidePro and eMoney allow you to enter your own market assumptions.

Where do we get happiness from spending? That's often also ignored in four percent distribution approaches. We assume a person should spend the same amount every year, and that's a good thing. But it probably doesn't align with happiness. Where do we get the most benefit for every dollar spent?

Retirement is not binary. It's not success or failure, and neither is life." And we don't typically, as Americans, fail in retirement. If you look at Americans, they are very resilient. They are very adaptive. It's not about IQ and a magic savings number. It's about AQ, adaptive ability quotient. And what we do in retirement, when we're running out of money or overspend in a year, we adapt. We cut back on spending. And we're able to then make assets sustainable. We might not have lived the life we wanted to because we didn't do the right amount of planning or planning ahead of time, but we adapt. And that's what life is about. It's about adapting.

Most retirement income plans that face a shortfall today can be sustained by making small adjustments to the plan. Sometimes, that means adjusting our spending, cutting back in certain areas, delaying Social Security, or working for six months longer. Very small, adaptable changes can make a huge difference. Pushing back retirement for two years would eliminate most of the retirement income shortfall projections in this country.

I'm not saying that this is doable for everybody, but we're talking about making minor adjustments and, moving away from this language of success or failure and moving to more of an adaptive-based approach. "What's the risk that we are going to have to change our spending over time?" is the conversation that I think we need to get to as an industry and a profession.

Retirement Income Approaches

You've probably all heard about safety-first, systematic withdrawal, and bucketing approaches to retirement income. They're all a little bit different. I think that we should learn the best things from all three approaches and combine them.

Systematic withdrawal approaches are helpful. They tell us what some sustainable approaches are. They tell us that the sequence of returns risk is really impactful to our plan, and it helps us manage around that. The safety-first approach tells us, "Look, there are expenses we need: healthcare, housing, food. I can't ignore these. So, I have to have some baseline of income out there." A bucketing approach says, "We should align our assets to their uses."

This all leans into the concept of mental accounting, where we treat assets differently based on their nature and origin. We do this with money all the time. In retirement, Americans do the same thing. Why? We were told that our savings should be put aside, that this is the most important thing we could ever do, and we don't like spending it down.

So, when we get to retirement, and we're told that we need a distribution strategy to spend down our income, we're being told to give up on this thing that we attached much meaning to. But if we can come up with that bucket

approach, it gives a story and a meaning around the assets that we have, such as our cash might be for Year One of retirement; our fixed income sources, such as annuities, fixed indexed linked annuities, TIPS, or bond ladders can be used to generate income in the midterm. Then, we can put our equity and growth assets in the bucket to obtain further income.

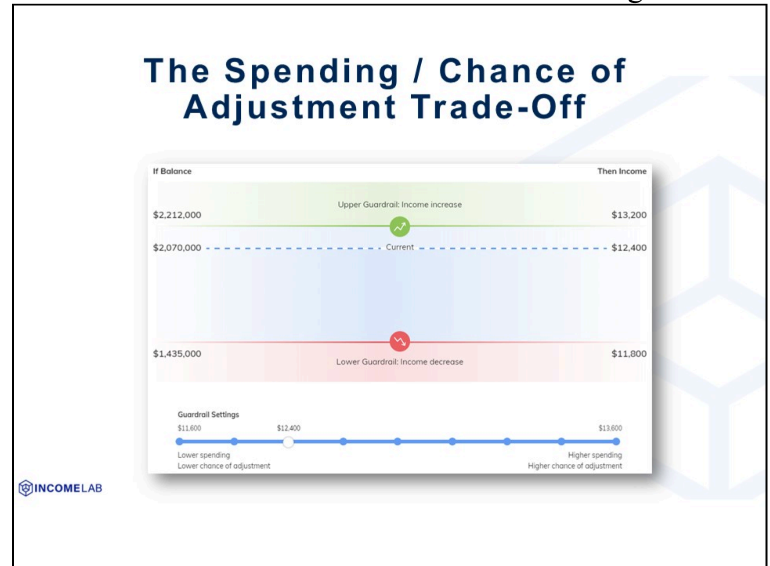
How we project retirement spending and how much we actually spend in retirement don't match up. They're very different. When we apply this type of testing to how people live their lives, it's almost 25% better than expected, which means sustainable withdrawal rates are probably a lot higher than we think they are. By just adapting to the way that people actually live and spend their money in retirement, we can go from a four percent to almost five percent withdrawal rate.

But are you willing to adjust to this? Can you adjust for year 30 by cutting back a little bit in year 13? All of a sudden, it starts changing the conversation. The conversation becomes not about the risk of failure but the likelihood that we will have to adapt to retirement and change our spending. Most people are willing to cut back, and they feel like they can. We should have the conversation about, "What can we cut back on, and can that help us make this more sustainable? What is the risk that we might have to cut back on our wants, needs, and some of our spending for a couple of years?" That's really the conversation.

Retirement Management means giving *Guidance* – Not *Scores.*

The way we have looked at retirement success and failure, static spending, and the four percent rule was based on the technology we had at the time. We were running these scenarios out of Excel sheets on desktops that had one percent of the processing power we have today. The reality is that technology has moved forward. We can run more complex scenarios, and over the next five years, we're going to have much better technology and solutions from a financial planning and income standpoint than we had even a decade ago.

Below is a screenshot from Income Lab, which can implement this adaptive-based spending approach and create guardrails. It's just one program out there that talks about guardrails.

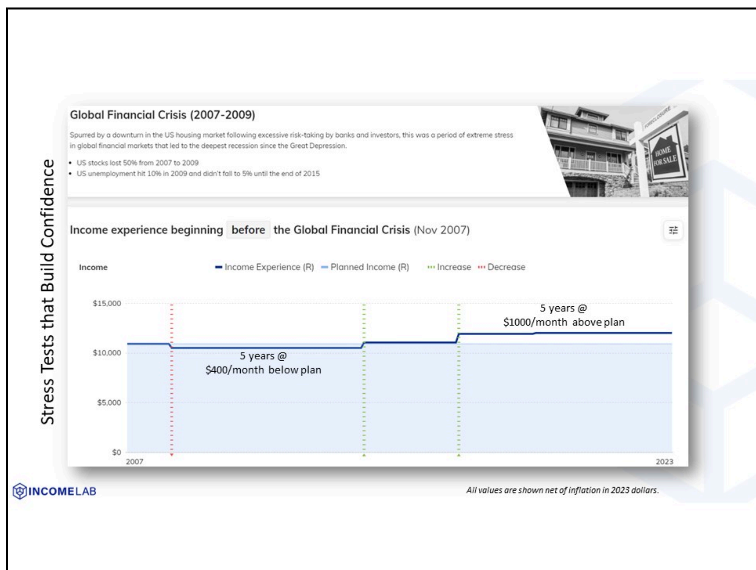


This idea of an upper and lower guardrail around your retirement income portfolio essentially says, "If our spending and assets stay within these two guardrails, we're okay."

That's a lot of what clients are looking for. Remember, we're trying to take their fear and uncertainty and give them hope and clarity back. While staying within this spending range, they know they're okay. But we can spend more money if our assets hit the upper guardrail value. Clients might choose to spend less money, but we will give them permission to spend more money and know that this is still on a sustainable path. Or, if we hit the downside guardrail of account balance, that means, "Look, our funded ratio is dropping too low. We need to adjust." And that means we need to cut back spending for some time.

And so, you can see current spending and current assets. If our assets hit the upper guardrail, we can increase spending. If our assets hit the lower guardrail, we decrease spending. So, as we're bouncing in between those ranges, all of a sudden, we know that everything is okay.

You can look at the global financial crisis and see how a portfolio might be impacted from a guardrail approach. But what you saw is that you wouldn't have to cut back for very long, and then you would actually have a situation where the income goes back up by more than that after cutting back for a bit.



You might have to cut back $400 a month for five years, below what you were hoping to spend for five years. And in that situation, everything recovered. We know the story. The market then went up, and we could actually increase spending. From 2012 to 2023, we could spend an additional $1,000 per month above plan.

So, total spending over this now almost twenty-year period increased despite retirement, basically, in the financial crisis, by taking an adaptive and guardrail approach to spending. And so, why am I bringing all of this up? Looking at success and failure is not how we live our lives.

Our goal is to build clients' confidence and tell them they are okay. Adaptive-based and a risk of changing your spending are much healthier ways in conversational pieces to approach this with clients, instilling more confidence in them than a success or failure metric, with fixed spending, with assumptions that don't align with reality. We will see more and more changes to this approach over time.

How Do We Put This into Practice?

We should treat retirement decisions and conversations with our clients like change management.

If you think about this, the decision to retire and move into retirement is a perfect change management situation. We are going from this pre-retirement stage, where we are saving and generating our income from work to this decision to retire and then to a retiring stage to figure out how to distribute the income. Some of it might be really abrupt, which is change management, too.

ADKAR is a popular change management approach that says, "What is the process of change management, that a client becomes aware that they have to go through the change? They have a desire to go through the change; they have knowledge about it, and they have the ability to do it." We reinforce this over and over because it's not just a linear path. It's going to adapt and change. We're going to have to reinforce this process as we move through it.

So, we can learn a lot from change management as financial service professionals, such as, "Are we helping our clients be aware of the issues? Are we helping them to have a desire to make the changes they're going to need to make that they know this will take?" They understand that small changes to their plan can make a 6 percent withdrawal rate more sustainable over time. Do they have the ability to put these things into place, which is often why they come to you to help with the ability to do this?

The last time NASA went to the moon, they were off track about 98% of the time. But they landed within seconds of when they projected to be there. Why? Because they planned to be off track. They planned to make constant adjustments. And so, when we look at retirement income planning, if we start the conversation with our ability to adjust, we'll make this more sustainable. All of a sudden, we're changing the conversation dynamic. That becomes part of the mindset and plan we set up early in the conversations.

It's not about failure. It's not the risk of adapting, a risk of cutting back in some areas, like your charitable contributions, eating out at restaurants, and shopping for new clothes. If the client is willing to adapt, we can make this plan sustainable and get to the moon on time. We can get to your retirement outcomes if you are willing to be flexible. It doesn't have to be tremendous, but can we work six months longer? That's equivalent to saving 1 percent more yearly for the previous 30 years. Can we work for a year longer? EBRI (Employee Benefit Research Institute) has shown that working a year longer is the equivalent of about 7.7 percent more inflation-adjusted income throughout the course of retirement

Those are small changes on the front end. Can we cut spending by five percent and suddenly make this sustainable? Not forever, but for three to five years in case

the market and funded ratio drop? Because of the change in technology, there can be a significant change in how we have these conversations, which can enhance our clients' confidence that they will be okay throughout retirement.

Adaptive-based Retirement Spending – Jamie Hopkins

About Jamie Hopkins, Esq., LLM, CFP®, ChFC®, CLU®, RICP

Jamie Hopkins has an extensive background in educational development, research, and writing. Jamie Hopkins is CEO of Bryn Mawr Capital Management, and SVP of Private Wealth Management at Bryn Mawr Trust. He is also the founder and President of FinServ Foundation, a 501(c)(3) dedicated to enhancing the financial services nextgen. Jamie is also a former Finance Professor of Practice at the Heider College of Business at Creighton University, and a former Professor of Taxation at The American College, where he helped co-create the Retirement Income Certified Professional® (RICP®) education program.

He has done consulting projects for a number of Fortune 500 companies. Jamie is also a highly sought after speaker, having done hundreds of webinars and speeches for the financial services industry.

Jamie is a regular contributor for Forbes and InvestmentNews on Retirement Income Planning. He is also a RetireMentor for MarketWatch and has been published in dozens of journals regarding tax law and retirement income planning.

In recognition of his impact on the financial services industry, he was selected by InvestmentNews as one of the top 40 financial service professionals under the age of 40. Additionally, he was selected by The American Bar Association as one of the top 40 young attorneys in the country. Professor Hopkins was also named as a Lawyer of Distinction in 2017 and was elected into the prestigious role as an American Bar Foundation Fellow. Jamie has won numerous awards for his articles and writing. He is an editor for the Midwest Law Journal and was listed as a "Mover & Shaker" in the reverse mortgage industry. Jamie has also been featured on WSJ podcasts, NPR radio, Fox radio, and on TV multiple times for NBC10 Philadelphia, PBS, and USAToday.

Retirement Speakers Bureau

Are you looking for a retirement speaker for your next conference, consumer event or internal professional development program? Visit the Retirement Speakers Bureau to find leading retirement industry speakers, authors, trainers and professional development experts who can address your audience's needs and budget.

©2024, Jamie Hopkins, Esq., LLM, CFP®, ChFC®, CLU®, RICP. All rights reserved. Used with permission.

Earn 1 free Continuing Education (CE) credit for the July, 2024 Issue of Retirement InSight and Trends

You can earn 1 CRC®, CFP®, CRPC®, ASPPA, and the American College's Professional Recertification Program (CLU®, ChFC®, CASL) CE credit for the January, 2024 issue of Retirement InSight and Trends.

Click here to access the quiz and earn 1 free CE credit upon successful completion of the quiz.

When you have completed the last question, click the "submit" button to submit your final answers. You may not return to review or change your answers after clicking submit or if you close the browser window. You may restart the quiz if needed.

You will only be allowed three attempts at passing the quiz so please make sure you have carefully read all the articles in this issue before starting the quiz. If you have trouble passing the first time, we recommend downloading the PDF version to consult while completing the quiz.

A score of 70% is required to pass the quiz and earn CE credit. An email will automatically be sent to you for your records as proof of successful completion.

Click here for additional CE opportunities through the Retirement Resource Center.