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Have You Thought about Spending It?

> **"If money doesn't make you happy then you probably aren't spending it right"**
>
> **- Elizabeth Dunn**

Much of the information put forward by the financial media is about accumulation – making more money, building a bigger retirement account, acquiring more assets. But it is interesting to consider that **the value of having more only becomes real when we spend, consume, use up or give away our accumulated wealth.** So while you're diligently amassing your fortune, you might also want to think about spending it.

Elizabeth Dunn is a behavioral scientist whose work focuses on the relationship between money and happiness. Drawing from a wide range of studies, her conclusions affirm many conventional insights while also offering some surprising twists. It turns out having a lot of money isn't an essential component of personal happiness, but *how we spend our money* can enhance our enjoyment of things that matter most to us.

In her 2013 book, ***Happy Money: The Science of Happier Spending***, Dunn (with co-author Michael Norton), puts forth five principles for buying a greater degree of happiness:

1. Buy 'experiences' (instead of things). *Experiential purchases* are defined as purchases made with the primary intention of "acquiring a life experience: an event or series of events that one lives through." In contrast, m*aterial purchases* are those made principally to "acquire a material good: a tangible object that is kept in one's possession."

While new material purchases can momentarily increase satisfaction, their happiness value tends to fade over time, as we become used to them, and/or a "new edition" comes out. In contrast, experiences (such as vacations and special events) can be revisited in our memories, recreating happiness each time we recall them. And in some instances, the reliving of past experiences actually increases our enjoyment – we may remember them better than they were. Another factor: experiences tend to have a greater human component. "Research shows that experiences provide more happiness than material goods in part because experiences are more likely to make us feel connected to others."

2. Make it a treat. A little bit, often does go a long way. If we seek too much enjoyment (experiential or material) from spending, happiness diminishes. "Abundance, it turns out, is the enemy of appreciation." Yet extreme self-denial also tends to be self-defeating: "While there is no convincing evidence that reducing consumption provides a panacea for increasing happiness, a growing body of research suggests that *altering* consumption patterns can provide a route to getting more happiness for less money." In a simple illustration from the book, the enjoyment of a $5 specialty coffee tends to be greater if you have it once a week instead of every day.

3. Buy time. Time is money. Getting the best price is often a default driver in our financial decisions, but we should not neglect the happiness value of free time. Paying someone to clean your house or mow your lawn might seem like extravagances – "I can do it myself for a lot less" – but if paying someone else gives you time for things you really enjoy, it may be worth the additional expense. A key spending question: How will this purchase change the way I use my time?

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Five principles for more enjoyment from spending:

1. **Buy experiences (instead of things).**
2. **Make it a treat.**
3. **Buy time.**
4. **Pay now, consume later.**
5. **Invest in others.**

From *Happy Money: The Science of Happier Spending*, Elizabeth Dunn with co-author Michael Norton

4. Pay now, consume later. The proliferation of credit in developed economies encourages a "consume now and pay later" mindset. But immediate gratification is often a variation of the abundance paradox – the sooner we get it, the less enjoyment we derive from it. By paying up front and delaying consumption, "You can buy more happiness, even as you spend less money." Delaying consumption creates a period of positive anticipation ("I'm looking forward to our trip."), and avoids the downer of dealing with the bills after the fun is past.

5. Invest in others. One of Dunn's surveys asked respondents how much money they spent in a typical month on bills and expenses, and gifts for themselves ("personal spending"), compared to donations and gifts for others ("prosocial spending"). Across all income levels, people who devoted more money to prosocial spending reported themselves as happier. Sharing and generosity appears to deliver psychological benefits; we like ourselves better when we give. This explains why many wealthy individuals are great contributors to philanthropic causes.

There are nuances to these "happy spending" principles. A new car can be both a material and experiential purchase, especially if it's fun to drive. Any payment, for something now or later, usually involves some emotional pain, because spending money creates an opportunity cost, i.e., "What won't I be able to have because I'm buying this?" And prosocial spending should be voluntary; if you feel through peer pressure that you have to buy cookie dough from a co-worker's child for a Little League fund-raiser, you may not get much happiness from the purchase.

Something else: While there are legitimate and sometimes necessary reasons to borrow, debt is a major happiness blocker. Buying enjoyment today and paying for it later tends to diminish our immediate pleasure and produce lingering unhappiness. "Although the relationship between income and happiness is fairly weak among Americans, there is a much stronger relationship between individuals' happiness and whether they have difficulty paying their bills. In other words, what we owe is a bigger predictor of our happiness than what we make." Too much debt isn't good for the soul.

There is a lot of room for interpretation and personal application, but Dunn's spending principles articulate a useful framework for developing a general awareness of how to be happier spending our money.

Should you adjust your now-and-later financial perspectives?

There is a constant psychological tension between enjoying now and saving for later. A willingness to delay gratification is an essential component in accumulation success; we can't spend it all today and expect to have anything tomorrow. Yet the tug of the present can be overwhelming. In order to resist the urge to be a spendthrift, some of us may adopt an almost compulsive focus on retirement (because it is the ultimate delayed-gratification project of personal finance). But should all your financial "tomorrows" be exclusively connected to retirement?

A lot of the commentary in the mainstream financial media says "yes" – just note the volume of personal finance articles that repeatedly declare, "Your first accumulation priority is maximizing contributions to a qualified retirement plan." However, in light of Dunn's insights, it is possible that planning for intermediate, pre-retirement financial "experiences" or "treats" (a second home, a boat, a trip) might not only deliver great satisfaction prior to age 65, but also motivate us to better long-term financial achievement. For example, if your spending priorities are family experiences, you might find both financial and emotional satisfaction from an investment in a family vacation home compared to adding extra dollars to a 401(k) – and you won't have to wait until 65 to enjoy it.

And when you do contemplate a future retirement, your spending priorities might exert a strong influence on today's planning. If you want enough room for your kids and their families to visit often, it might help if you decide to pay off the mortgage. On the other hand, if the retirement priority is to see the world, maybe it's just easier to sell the house and buy an RV.

In many retirement planning scenarios, inheritance and estate planning can be after-thoughts ("Let's make sure you have enough to retire first."). But for someone who values leaving a legacy, this spending priority can prompt greater engagement in the planning process, and motivate them to consider creative ways to maximize their wealth.

Spending scenarios are critical considerations in financial management, because at some point most of us are going to begin drawing from our accumulated assets. But after a lifetime focused on accumulation, spending can be stressful (*"Can I afford to spend this today without bankrupting a tomorrow that I may not live to see?"*). This is where an immediate annuity, a one-time payment to an insurance company to guarantee a lifetime income, can be the epitome of a "happy" pay-now, consume-later transaction. Some "hindsight experts" might insist you can do better, or save money by managing these assets yourself. But time spent managing assets is time away from pleasurable activities; appointing trusted, competent financial professionals and using insurance products are ways to "buy time." After all, **is your primary goal to accumulate the biggest pile, or to maximize the enjoyment from your money?**

When it comes to money, the happiness factors are as essential as the mathematical projections in making decisions. And while any planning process usually entails some effort and serious contemplation, it might be a bit more enjoyable if spending received as much attention as accumulation. ❖

Do your financial plans include strategies for "happy spending"?

THE GREAT DELAY:

Opportunity Costs

Of College Debt

Opportunity costs are real, but calculating their financial impact is somewhat subjective. An arbitrary number is selected to represent an anticipated rate of return for an alternative we chose not to take. While the calculation that results is hypothetical, it still often provides interesting insights as to the real cost of our financial decisions.

Borrowing to pay for college is an interesting application of lost opportunity costs, because there are two costs to consider. The first is the opportunity cost of ***not*** going to college, and missing out on a higher lifetime income potential. The second is the opportunity cost of borrowing to acquire that higher income potential.

Since the middle of the last century, the dominant economic narrative regarding a college education is that a greater lifetime income potential is worth borrowing for. Today, at least half of that narrative remains valid: statistically, a college degree does correspond to higher lifetime earnings. But the costs of obtaining a degree, particularly if one has to borrow, are becoming steeper. And the long-term impact – the opportunity costs – are spilling over into the broader American economy.

It starts with a student loan…

A January 2014 report from the New York Federal Reserve found that 70% of recent college graduates had outstanding student loans, with an average balance of $29,000. (And it is not uncommon for graduate students to owe more than $100,000.)

For easy math, assume a student loan balance of $30,000 with an interest rate of 4.66%, the current rate for Direct Subsidized Student Loans. A monthly payment calculator from the Department of Education's Federal Student Aid website (studentloans.gov) shows a monthly payment of $314 for the next 10 years. And a summary lists the total loan cost as $37,658: $30,000 in principal, $7,658 in interest (see chart).

Student Loan Balance: $30,000
Interest rate for 10 Yrs: 4.66%

Monthly Payments:	Loan Cost Over 10 Yrs: Interest / Principal	Total
$314	$7,658 / $30,000	**$37,658**

But what if $314 were <u>saved</u> each month for 10 years?

If $314 were <u>saved</u> each month for 10 years….

Monthly Deposits:	**Accumulation Over 10 yrs at 3%**	**at 6%**
$314	**$43,988**	**$51,715**

Even at a rate of return lower than the interest charged, the projected opportunity cost is greater than loan costs shown on the Student Aid website. This is because opportunity cost calculates the compounded value of dollars allocated to a transaction, not just the numeric total. Thus, the "true" cost of paying $30,000 in college debt over 10 years is perhaps closer to $50,000. But this hypothetical calculation doesn't come close to quantifying the financial spill-over.

The 'real-world' ripple effect

"Every month that Gregory Zbylut pays $1,300 toward his law school loans is another month of not qualifying for a decent mortgage."

That's the lead sentence from a March 27, 2014, *Associated Press* article, "Student Loan Debt Widens US Wealth Gap." For Americans between ages 25-35, student loan debt marks a financial divide between those who are "making it," and those who may never realize the financial benefits from their educational investment. As David Dayen reported in a February 21, 2104, *New Republic* article:

> In 2012, 30-year-olds were more likely to have a mortgage if they had no student debt than if they did. The same trend held for vehicle purchases. In one way, this makes no sense—college graduates have much higher average wages than their counterparts, and should have a higher percentage of auto and home purchases. But student debt is holding them back.

Dayen calls this demographic divide the Great Delay. For those saddled with student loan debt, their financial progress is deferred, and they may never catch up to their debt-free peers.

In the current job market, where almost half of recent college graduates are either unemployed or underemployed (i.e., working in positions that don't require a college degree), student loan payments not only take a larger chunk of a smaller paycheck, but also keep them from buying homes and cars, starting families, or contributing to retirement accounts. These are huge opportunity costs. And the impact is felt by the broader economy, because a large segment of the population is on the economic sidelines; they can't buy, can't save, and can't borrow.

For motivated students, a college degree is still a good investment. But the opportunity costs of borrowing for it have perhaps never been higher – or wider. Today, graduating without debt provides distinct long-term financial advantages. ❖

If you have children that want a college education, do you have a plan to help them graduate debt-free?

IRA Rollovers:

A Loophole is Not a Loophole, even if the IRS Permits It

If you had a tax question regarding an IRA account, you might read an IRS publication online or consult with an attorney well-versed in tax law. If the attorney used written statements from the IRS to support his/her opinion, you might feel confident about the guidance you were given. Or maybe not. Because sometimes both the IRS and the experts get it wrong.

A recent tax court ruling on IRA rollovers may have minimal impact on most savers, but the case highlights the care individuals must take when making any changes to their qualified retirement plan accounts.

IRA Rollovers vs IRA Transfers

The IRA rollover provision allows an owner of the account to withdraw assets from a regular or Roth IRA without incurring income tax or early-withdrawal penalties – as long as the amount is re-deposited into a similarly titled account within 60 days. A primary reason for this provision is to allow IRA owners the ability to transfer funds to different financial institutions.

An IRA transfer is a similar transaction, except the owner of the account does not take physical receipt of the funds, but instead authorizes a direct transfer between two financial institutions. There currently is no limit on the number of direct transfers an account owner can execute in a single year, but rollovers are limited to one per IRA account every 12 months (as defined in the 2014 version of IRS Publication 590).

So What You're Saying Is…

A cursory examination of the rollover provision could prompt outside-the-box thinkers to use the 60-day rollover window for purposes other than re-allocating funds to a new investment option. An owner of a seasonal business could use a rollover to cover a shortfall at the end of a slow period, then replenish the IRA account when the busy season kicks in. Or a rollover could be used to temporarily purchase assets that normally cannot be part of an IRA (for example: A vintage auto could be purchased at auction for $25,000 and re-sold within 60 days, hopefully for a profit). Under very narrow circumstances, rollovers may be a tax-efficient way to cover emergencies or take advantage of short-term financial opportunities.

But this tax-free, penalty-free exclusion can be abused. Suppose an individual has six IRA accounts, each with a balance greater than $20,000. On January 1, the owner takes a $20,000 rollover withdrawal from IRA Account #1. On March 2, he repays IRA Account #1 by taking another rollover withdrawal from IRA Account #2. sixty days later, he repeats this process, repaying IRA #2 with $20,000 from IRA #3. Over the next 6 months, he replicates these transactions, using one IRA to repay the rollover from another. The end result: the owner of the IRA accounts has year-long access to $20,000 in funds that received a tax deduction for being set aside for retirement.

Actually…you can't do that

When a veteran tax lawyer and his wife botched three $65,000 sequential rollovers by missing a repayment deadline, the IRS dunned the couple for income taxes and early-withdrawal penalties. Subsequent discussions between the lawyer and the IRS resulted in a lower tax assessment, but the lawyer decided to contest the judgment in Tax Court, arguing his transactions had followed guidelines put forth specifically in Publication 590.

The court's decision surprised both the attorney and the IRS. After careful examination of the statute regarding rollovers, the tax court determined an individual is allowed only ***one*** rollover every 12 months, regardless of how many separate IRA accounts he/she might have. Consequently, the Court upheld the IRS's judgment, and imposed an additional fine of $10,260 because the lawyer asserted he was a tax specialist who "understood the letter of the law in the statute." Acknowledging the attorney may have based his actions on written IRS interpretations, the tax court judge added "taxpayers rely on IRS guidance at their own peril."

The court's decision also indicated the IRS's current interpretation of the rollover provision had been too generous, and that the agency's written guidance was incorrect. Several tax experts noted it is a rare instance where IRS enforcement is actually more lenient than the law requires, but the IRS stated the "correct" tax treatment of rollovers will become effective January 1, 2015. The agency will also rewrite Publication 590 in accordance with the Tax Court's new rollover regulations.

Since the window for executing a single rollover is 12 months, the "active life" of rollovers transacted today will not "expire" until after January 1. Thus, taxpayers are advised to consider the new interpretation as essentially effective immediately; the multiple-rollover loophole is considered closed.

As Dirty Harry once said: An IRA has to know its limitations

Qualified retirement plans are designed with incentives and penalties to encourage participants to leave the accounts untouched until retirement. While there are some hardship provisions that allow individuals early (i.e., pre-retirement age) access to funds, attempting to creatively circumvent these provisions to make tax-favored savings accessible today is contrary to the intent of the plans, and the IRS is likely to crack down on any transactions it deems abusive. As *Wall Street Journal* reporter Laura Sanders put it in a May 9, 2014, article about the recent rollover ruling: **"Don't appear to taunt the taxman."**

This case also illustrates the desirability of maintaining adequate liquid reserves. It seems unlikely the attorney would have executed three rollovers if he had $65,000 in the bank, or in life insurance cash values, or some other accumulation account that permitted low-cost liquidations. Those three IRAs held close

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to $200,000. It wasn't that the attorney and his wife didn't have the money. It was just in the wrong type of account.

Some people are so averse to the "carry costs" of liquid accounts (such as annual taxation, or buying a life insurance benefit) that they try to make qualified plans serve as emergency funds, home improvement capital, a source of college tuition, or a slush fund for financial opportunities. This all-in-one thinking may be particularly strong with individuals who have employer-sponsored retirement plans that allow loans. But these accounts are designed for retirement income. Attempting to re-position or liquidate these accounts prior to age 59½ puts the account owner at risk of violating IRS regulations.

The diversity of financial challenges one may encounter over a lifetime cannot be exclusively resolved with a qualified retirement plan. Better to establish a source of liquid cash reserves than try an outside-the-box transaction with a retirement plan. Because even if the IRS is wrong, it doesn't mean you'll be right. ❖

Investors Want to Buy…

Late in 2013, the Pasco County School District in Florida received a provocative offer from representatives of four wealthy New York families. As an investment group, the families proposed to buy life insurance policies on all 9,769 employees in the district, and over the next 55 years, to share a portion of the benefits with both the employees and the school district – at no cost to either group.

Presented as a "benefit stabilization funding" program for the school district, the proposal was, according to a May 6, 2014, *Wall Street Journal* article, "one of the largest efforts by investors to acquire life insurance on people in a single transaction."

For the investor group, the objective was to obtain, on a large scale, the investment returns and tax advantages associated with life insurance policies. The investors would pay all premiums, control cash values, and receive the largest percentage of the insurance benefit at the employee's passing (the estimated total insurance benefit per employee is between $200,000 and $350,000).

In exchange for insuring their lives, each employee in the plan receives a $50,000 death benefit. The benefit is permanent; even if the employee leaves the district or retires, it remains in force. The school district also receives a $50,000 payment at the employee's death, which is deposited to an account to fund employee benefits.

In documents presented to the school board, the investor group anticipated the plan would generate cash flow for the district for the next 55 years, in a bell-curved distribution, with smaller amounts at the beginning and end of the program. The investors estimated their outlay will be $400 million, a one-time transaction that would only cover current employees. Subsequent hires could be added at a later date, but they would be part of a different pool of policies.

Is this a legitimate proposal?

The advisers presenting the plan insisted the proposal was legally and actuarially sound, and based on similar plans that have been used by businesses and government entities. The district's teachers' union had tentatively endorsed the proposal, with a provision that allowed employees to opt out of the plan. But after seven months of evaluation, and a review by the by the Florida Office of Insurance Regulation, the school district decided that although the plan "offered meaningful long-term benefit," it would decline to participate. The plan may be legal, but its structure raised several ethical and financial questions.

Investors are buying the insurability of the district's employees in order to fund and control a pool of insurance policies. In exchange, the employees and district receive a fraction of the insurance benefit – at no additional cost. But employees are surrendering a significant portion of their insurability, which could limit the amount of additional life insurance they could personally secure for the benefit of their loved ones. If an employee has an insurable value of $1 million, does he/she want to forfeit 20-30 percent of it to strangers instead of providing for heirs?

A bedrock assumption in life insurance transactions is that all parties in the agreement have "insurable interests." This means the owners of a policy would suffer an emotional or financial loss if the insured were to die. In this transaction, one might argue that both the investors and the school district would benefit more from an employee's death than their continued good health. The Florida OIR stated the proposed arrangement "may violate Florida's insurable interest laws."

For the employees, the OIR also felt that the "free life insurance" benefits payable to their beneficiaries might not be tax-exempt, because the policy was initiated by a third party instead of the insured or a family member with an insurable interest.

The 55-year time frame presented another challenge. Although dividends[2] may generate positive returns over shorter periods, maximum profits were projected from investors receiving lump-sum death benefits on a periodic basis over five decades. From the beginning, the plan anticipated that every year would include some death-benefit cash infusions. (An April 4, 2014 *Tampa Tribune* article reported that 13 deaths were projected in the plan's first year, translating to a $650,000 boost for the employee benefit fund, and approximately $2.6 million returned to the investors.) With so many policies in place over such a long time period, there was concern that the numbers might not meet projections. The employees might exceed life

expectancy, deferring payments. Lower-than-anticipated investment returns could also decrease cash flow. Both conditions might challenge the resources of the investors, and make it difficult to continue paying premiums. If this should occur, it was uncertain if the school district would have legal recourse to compel the investors to keep the plan intact.

The value of keeping life insurance for your whole life

Joseph Belth, a renowned Indiana University professor emeritus of insurance, succinctly identified the critical issue in investor-owned life insurance plans: the belief that the investment group's financial strategies and policy management will out-perform the insurance company's overall experience. Can they do it? History says yes, no and maybe.

But setting aside the particulars of the Pasco County School District proposal, it is important to recognize a key financial concept motivating this investor group (and other financial institutions attempting similar purchases of stranger-owned life insurance): **they are focused on the value of holding life insurance until death**. All of the contracts in these plans were intended to remain in force for the insured's lifetime, no matter how long that might be. Cash values accumulated during the policy's existence may be used by the owners in a variety of ways, but the financial projections showing the greatest potential return are based on each contract ultimately delivering a guaranteed generally tax-free death benefit[3]. And the expectation of profit from this strategy is great enough that wealthy investors were willing to solicit the insurability of others with the promise of sharing a percentage of the profits.

For individual life insurance policyowners, this same metric applies. The rate of return from the death benefit in relation to premiums paid projects to be both guaranteed and profitable – especially if an insurance benefit left to beneficiaries is tax-exempt, and not diminished by payments to third parties. ❖

If, during your lifetime, you obtain life insurance, a prominent consideration should be:

Can this policy be kept in force the rest of my life?

[1]This article is not intended to promote or endorse the use of Stranger Owned Life Insurance.
[2] Dividends are not guaranteed. They are declared annually by the company's Board of Directors.
[3] All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

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