# Additional Praise for *Financial Independence*

"It is without reservation that I recommend John Vento's book *Financial Independence*. Not only does the book cover the myriad of information that one needs to know for financial health, but it is presented in a clear, concise and readable manner. Too often, the jargon thrown at a reader about financial affairs makes the average person feel ignorant and ready to give up all decisions to the 'professional' advisor. John makes it clear that the average person needs to be a participant in this process and provides the clear guidelines to make it possible."

—Lynn K. Robbins, PhD

"Drawing on 25 years of investment experience and a rich legacy of immigrant parents, John Vento defines the American Dream in realistic financial terms through his 10 Commandments of managing your finances and lifestyle. Step by step, he lays out in readable prose what he calls '10 Key Issues to Comprehensive Wealth Management,' the road to financial self-reliance, revealing the wisdom of that old tune so many of us failed to heed, 'Little Things Mean a Lot.'"

—Donald Martin Reynolds, PhD,
art historian and the author of numerous books,
articles, and reviews on American art and architecture

"I have known John Vento for more than 30 years. When it came time to decide who to entrust my private accounting practice clients, I did not have to think twice. John, to me, is a perfect example of success story. His professional and teaching experience enabled him to make complex issues understandable."

—Vladimir Slizinov, CPA, President, Savara Group

# Financial Independence (Getting to *Point X*)

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## AN ADVISOR'S GUIDE TO COMPREHENSIVE WEALTH MANAGEMENT

John J. Vento

WILEY

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*This book is dedicated to the memory of my parents, Rosario Vento and Concetta Giuffre Vento, for the sacrifices and commitments they made throughout their lives to provide their children with the opportunity to live the "TRUE" American Dream.*
*Momma and Poppa, I love you, miss you, and think about you every single day!*

"Financial Independence"

To achieve financial independence, one must know the difference between invested assets, personal use assets, and liabilities, as well as the difference between needs and wants. Wealthy people focus on accumulating investment assets, while the middle class and the poor focus on increasing their standard of living based on their cash inflow. The wealthy understand that the more investment assets may grow, the greater cash inflow from these investment assets may be. The greater cash inflow from these investment assets, the more investment assets may continue to grow. If you are able to accumulate sufficient investment assets to maintain your desired standard of living, your money will be working for you, instead of you working for your money.[1]

This is *point X*: financial independence.

[1]Investments are subject to market risks, including the potential loss of principal invested.

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# Preface

## Living the American Dream

My first clients were quintessential examples of successful American Dreamers. They came to the United States from Italy after World War II with nothing, and they created a wonderful life for themselves and their children by working hard, living modestly, and saving. I confess I learned more from their example than from any college course or studies to gain my licenses. As you might guess, these clients were my parents.

Rosario Vento, my father, was born in the small town of Messina, Sicily, in 1923, and my mother, Concetta Giuffre Vento, born in 1921, came from an even smaller village nearby called Sant'Agata. They lived through the Great Depression (which was as bad in Europe as it was in the United States), survived World War II by seeking shelter in the hills of Sicily, and were married shortly after the war's end. It was clear that opportunities in Sicily and throughout Italy were limited as a result of the devastation of war, so they made the difficult decision to place their hopes and dreams on a new life in America.

Because he could not afford to pay for two tickets, my dad initially came to America alone. After a year, he was able to afford to rent a small but comfortable apartment in Bensonhurst, Brooklyn, and had saved enough money to pay for a one-way ticket to the United States for my mother. She joined him and they began the great journey of their life together, eager to work hard and reap the rewards of living the American Dream.

Neither one had more than an eighth-grade education, nor did either one speak English very well. After arriving in the United States, my father worked as a barber, and my mother got a job as a seamstress in a sweatshop. They had three children in quick

succession, and then after a gap of eight years, one more (me). Together, they earned a modest income, but they always managed to live within their means and save what they could. They never owned a car; instead, they got around the city by walking or using public transportation. They rarely went out to dinner; instead, they always prepared fresh, homemade meals. Before they spent a dime, they always asked, "Is this necessary?" If the item was in fact a necessity, they would then ask: "Is there a less-expensive alternative?"

This was my parents' attitude toward money throughout their lifetime, in good times and bad. During the early years of their life in Brooklyn, they saved enough for a down payment for a house and obtained a mortgage, which they paid off over 30 years. They put all four of their children through college; one became a teacher, one a medical doctor, one a social worker, and one, a certified public accountant and a Certified Financial Planner (again, me).

After I graduated from college, I began helping my parents manage their finances, although as mentioned, they taught me much more about money than I was ever able to teach them. Each year, I prepared a Statement of Financial Position and a Statement of Cash Flow for them, an exercise that for me was not only a pleasure but a reconfirmation of the values they had taught me. They always lived well within their means, were careful savers, and were usually able to add funds to their investable assets. Over the years, I was able to assist them in developing a well-diversified investment portfolio.

Ultimately, the year my mother turned 75, they achieved a financial milestone that they had never thought possible. I was sitting at their kitchen table, sipping the espresso that my mother always prepared for me whenever I came to visit. On this particular day, I was there to talk to them about their finances. To my great joy, I was able to look my mother straight in the eyes, and say: "Congratulations, you and Papa are millionaires!" The combined value of their home, their invested assets, and their cash totaled just over a million dollars—and of course they had no debt.

Words cannot do justice to the expressions on their faces and the tears of joy in their eyes. At that moment, my parents knew they had accomplished one of their most cherished goals—financial independence. For them, the American Dream was not just a dream anymore; it was now their reality.

My mother passed away in 2006 and my father in 2011. They left this Earth knowing that they had lived comfortably and responsibly. They had been able to raise, care for, and educate their children, and they never became a burden to us. In fact, upon their passing, they were able to leave their children with a solid financial legacy that could be measured both in dollars and by example. This book is dedicated to them and to the hope that the guidance in these pages can help you achieve your financial dreams, too.

John J. Vento

# Acknowledgments

I want to thank everyone who helped make this book possible.

I want to first thank my three children, Christine, John, and Nicole, for working with me late at night and on the weekends in my office. Their assistance with typing, proofreading, and researching helped put all these words on paper. All of this "one on one" time brought us closer together, and their interest and willingness to help inspired me to get this done.

I'd like to thank my administrative assistant and good friend, Melanie Maguire, for keeping me and my office together no matter how demanding the workload. Your dependability, loyalty, and willingness to work hard to get the book completed are truly appreciated.

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Also, I want to thank Ruth Mills for helping me to rework my manuscript into a book and getting me through the finish line.

I'd like to give a huge thank you to everyone at John Wiley & Sons for giving me this opportunity to expand financial literacy throughout the country by sharing the knowledge necessary to achieve financial independence. Special thanks to Laura Walsh,

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Last but not least, to my wife Doreen, thank you for your patience and understanding for all the late nights and weekends I was away from home writing this book. I cannot possibly thank you enough for all the encouragement and enthusiasm you have shown me throughout our life together. Every time I am about to take on a challenging project you are always there to cheer me on and tell me, "just do it!"

J.V.

# Introduction

## Getting to *Point X*

Every kid over the age of five knows this expression. It can refer to many things, but the strongest image for most of us is an ancient, moldy pirate's map showing precisely where a long-lost treasure is buried. This book is about helping you discover your own "buried treasure." Of course, this is not a child's game. It is a guide to the necessary knowledge (with a special focus on tax facts and strategies) to help you accumulate the wealth you need to lead the life you desire.

I have been a certified public accountant (CPA) and a Certified Financial Planner™ (CFP®) for many years: I started my career working for KPMG (one of the Big Four accounting firms) and then established my own practice in 1987. I have worked one-on-one with literally thousands of individuals, assisting them in their pursuit of a secure financial future. I have helped these people pursue their financial goals, and this has given them and me tremendous pleasure. However, I have also seen people who, for many reasons, have been unable to achieve financial security. Needless to say, this is unfortunate.

With this book, my hope is to help everyone find financial security and financial independence: from the eager teenager who just received his first paycheck to the dual-income couple at mid-life who are paying their mortgage, putting their kids through college, and perhaps helping aging parents to the retired grandmother who wants to make sure her estate is in good order for the benefit of her loved ones. By combining financial planning with tax strategies, this book may help readers increase their personal wealth and pursue their financial independence, a position I refer to as *point X*.

## Financial Literacy and the New Norm

Before I explain in detail how to reach *point X*—financial independence—I want to talk a bit about how and why I came to write this book. The term *financial literacy* is not new, but it appears in our general lexicon more and more frequently these days, especially since the worldwide financial crisis of 2008, which continues to this day. Indeed, today's unsettled economy has been described by the *Wall Street Journal* and other sources as "the New Norm." Experts believe that the recent recession ushered in a "new norm" (or "new normal"), where the spendthrift ways indulged in by many before the 2008 crisis have been substituted with an increasing interest in saving, general frugality, and need to develop a stronger sense of financial literacy.

Basically, financial literacy means having a firm understanding of fundamental financial concepts and strategies, and the ability to manage money responsibly in order to ensure financial security. Financial literacy is essential to ensure the financial stability of individuals and families as well as the overall economic health of society as a whole.

As a result of the 2008 economic meltdown, it became stunningly obvious that many people have not managed their finances in such a way as to provide financial freedom for themselves and their families at any stage of their lives—much less after they retire. In fact, many financial organizations report that most (yes, most!) Americans currently reaching retirement age—the infamous Baby Boomers—have not planned or saved adequately for retirement.

Somehow over the last several decades—I believe since the end of World War II—many people in our society have come to believe many incorrect notions about money. These financial myths include such ideas as:

- "Owning your own home is everyone's right."
- "The real estate market will always rise."
- "You can live 'large' on credit and never pay any consequences."
- "If you need to work, you can always find a job."

These myths—a warped conception of the American Dream—exploded in a puff of smoke in 2008. (In fact, they were eroding for many years, but most people failed to heed the warnings.) As a result, many people have suffered financially, some tragically. Many

of us are disenchanted about this new norm in our society, as can be seen by the Occupy Wall Street movement and similar protests throughout the world. The lessons in frugality learned by earlier generations—people who lived through the Great Depression of the 1930s and World War II—had been lost, and many Americans were living way beyond their means, and they now had to pay up.

As a result of the 2008 Great Recession and its aftermath, we all must now relearn some essential financial truths, become financially responsible, and prepare for the financial realities of life. In other words, we must become *financially literate*. We must learn all we can about our money so that we can make the most informed financial decisions in all facets of our lives.

## *Point X*: Our Fundamental Financial Goal

*Point X* is literally and fundamentally the point at which we can stop working for our money and our money starts working for us. It is the spot at which our savings and investments alone generate enough income to support our chosen lifestyle, and allow us to continue to live that lifestyle without having to work for a paycheck. It is the place where we have achieved true financial independence.

For most of us, getting to *point X* is our most fundamental financial goal. It is the position we hope to achieve so that we can retire. Even if we do not wish to retire from productive and enjoyable work, we all still yearn to arrive at *point X*—often sooner rather than later—to feel financially secure and financially free.

What that number may be in terms of dollars is different for each of us. Some people can manage rich full lives on a modest income, and seem to be able to find their *point X* with ease and clarity. Others have multimillion-dollar annual incomes, yet still find themselves living way beyond their means and view getting to *point X* as an arduous and perhaps an impossible journey. How you determine your personal *point X* depends on several variables, including:

- Understanding your present standard of living.
- Projecting how you want to live after you retire (or after you stop receiving a paycheck).
- Figuring out how many years of saving it will take for you to reach *point X*.
- Figuring out how many years of financial independence you hope to enjoy after you reach *point X*.

Determining your personal *point X* also involves some mathematical calculations, including:

- The rate of return you hope to achieve on your investments.
- The effects of inflation and taxes on your investments before and after your retire.

Although this process of defining *point X* may look like grad-school calculus right now, I promise you it is really not all that difficult, and my purpose in writing this book is to explain this process in the simplest way possible.

## Ten Key Issues to Comprehensive Wealth Management

No matter how you define your particular *point X*, whether it is an annual income of $25,000 or an estate of $250 million, you need to not only understand but effectively deal with 10 fundamental wealth management issues. They are:

1. Committing to living within your means and conscientiously saving for the future.
2. Understanding taxes and how to effectively minimize your tax obligation.
3. Realistically defining your standard of living, including your net worth and your current cash flow.
4. Managing debt.
5. Insuring yourself and your family in case of extreme illness or death.
6. Protecting your property.
7. Planning for the education of yourself and your children.
8. Investing intelligently and productively.
9. Planning for retirement.
10. Preserving your estate.

Throughout our lives, we are in a perpetual state of change, financially and otherwise. Our needs and wants are constantly altering along with our income and our standard of living. What may seem like a financial priority at the age of 18 (buying a car; paying for college or graduate school) is probably quite different by the age of 30 (purchasing a first home or planning for the birth of a child). At 60, we may be considering retirement while simultaneously paying for a child's college education or an elderly parent's care—or all of the above. What makes these

financial issues even more challenging is that our economy is also in a constant state of change.

Throughout our lives, we will encounter many questions and problems relating to money, but every one of them will fall, in some way, under one or more of these 10 key wealth management issues. It is important that you understand them and work within them productively—that you become financially literate. Depending on how you prepare and handle each of these wealth management issues will determine how successful you will be on your path to financial independence, *point X*. Moreover, these issues are interrelated, and how you deal with one very often will have an effect on how you treat the others. For example, if you fail to manage debt properly, you will find it difficult to save for a home of your own, your child's education, or your retirement. Or, if you neglect to properly insure yourself against sickness or premature death, your spouse and family could be wiped out.

Woven into the issues of wealth management is a common variable. Throughout this book, I provide facts and strategies that will focus on minimizing this most significant expenditure, that is, *taxes*.

## Our Biggest Expense

Have you ever gotten to the end of the week, the month, or the year, and asked yourself *where did all my money go?* Many—maybe most—people are baffled by this question and do not understand how, even if they are earning a respectable salary, their entire salary could be used up, particularly when they were not especially extravagant. They find themselves with little or no savings, or even worse, in additional debt.

What do you consider to be your biggest expense? Most people think it is their mortgage or their rent. Others who have children in college feel sure that it is those endless educational expenses. Still others who may have serious health issues may believe it is their perpetual doctor, hospital, and prescription bills.

Well, I promise you, it is none of the above. It is taxes!

Yes, that is where most of your money has gone—and continues to go: Taxes, taxes, and even more taxes. For 2013, the maximum federal income tax rate is 39.6 percent. On top of that, the combined Social Security rate is 15.3 percent (half paid by the employer and half paid by the employee). Employers also have to pay additional payroll taxes under the Federal Unemployment Tax Act (FUTA) and State Unemployment Tax Act (SUTA). Depending on the state

and city you live in, you may also be paying well over 10 percent of your paycheck for these taxes; for example, New York City residents pay a combined state and city income tax, which is as high as 12.7 percent.

If payroll taxes were not enough, we also pay income and capital gains taxes on our other earnings, such as income from investments. We also pay sales tax on many items we purchase, and numerous excise taxes and other special taxes on many items we frequently do not even think about, such as alcohol, tobacco, and fuel. We pay for certain licensing fees, registration fees, parking meters, tolls, tickets, and summonses, all of which are forms of taxation. We also pay real estate taxes, school taxes, water and sewer taxes, mortgage recording taxes, and transfer taxes on property. If you choose to give large gifts to a friend or family member, you may be subject to a gift tax. Clearly the government will tax you to death; in fact, ironically it already taxes you for dying—a little something called estate tax.

If you take a close look at how much you pay for various taxes, chances are this number would be more than 50 percent of your overall expenditures. Keep in mind that some of these taxes are hidden but nevertheless included in your cost of living.

So, if you want to increase your savings, what would be the single most important expenditure for you to focus on in order to keep more of what you make and dramatically increase your savings? The answer, of course, is taxes—taxes, taxes, and more taxes.

But the fact is, most people completely overlook the importance of minimizing their taxes in order to help maximize their wealth accumulation.

Throughout this book, I provide hundreds of tax facts and strategies that will help you accelerate your wealth accumulation and dramatically increase your chances of reaching *point X*, financial independence.

## Take a Financial Planning Checkup

Before we begin to discuss hard figures, you should evaluate your financial situation by completing the Comprehensive Wealth Management Questionnaire. This questionnaire will help you start thinking about the financial issues you have under control and others that may need attention.

## COMPREHENSIVE WEALTH MANAGEMENT QUESTIONNAIRE

The following 20 questions will assist you with identifying your financial strengths and weaknesses and in setting your financial goals toward the pursuit of achieving financial independence, your very own *point X*.

1. Do you save 10 percent or more of your gross income (pay yourself first) before determining your standard of living? If you answered *no,* read Chapter 1, Committing to Living within Your Means.
2. Do you have easily accessible funds to cover at least three to six months of your living expenses in case of an emergency? If you answered *no,* read Chapter 1, Committing to Living within Your Means.
3. If you have a desire for a special purpose (i.e., a home, a special vacation, a wedding, or a business start-up), do you have plans for accumulating those funds? If you answered *no,* read Chapter 1, Committing to Living within Your Means.
4. Do you know if you are taking advantage of every tax deduction and tax credit available to you? If you answered *no,* read Chapter 2, Understanding Taxes, and pay particular attention to the tax facts and strategies at the end of each chapter.
5. Do you know the value of your financial net worth? If you answered *no,* read Chapter 3, Determining Your Financial Position.
6. Do you have a clear understanding of your *cash inflows* and *outflows*? If you answered *no,* read Chapter 3, Determining Your Financial Position.
7. Do you maintain a zero balance on your credit cards and maintain no other high-interest rate loans? If you answered *no,* read Chapter 4, Managing Debt.
8. Do you know whether you have the most favorable terms on your home or investment property mortgage(s)? If you answered *no,* read Chapter 4, Managing Debt.
9. Do you have medical insurance that covers basic medical expenses as well as catastrophic medical expenses? If you answered *no,* read Chapter 5, Insuring Your Health and Life.
10. Do you (or your parents) have a plan for paying for nursing home or long-term home health care costs? If you answered *no,* read Chapter 5, Insuring Your Health and Life.
11. Do you have long-term disability insurance to help pay your expenses if you (or your spouse) were unable to earn an income? If you answered *no,* read Chapter 5, Insuring Your Health and Life.
12. Will your family receive sufficient funds from your life insurance policies upon your death or the death of your spouse to ensure your family's

continued support and lifestyle? If you answered *no,* read Chapter 5, Insuring Your Health and Life.

13. Do you carry a minimum of $1,000,000 in personal liability insurance? If you answered *no,* read Chapter 6, Protecting Your Property with Insurance.
14. Do you have assets that you cannot afford to replace properly covered by insurance (e.g., car, home, fine jewelry, art)? If you answered *no,* read Chapter 6, Protecting Your Property with Insurance.
15. Do you have sufficient funds set aside to pay for your children (or grandchildren) to attend college? If you answered *no,* read Chapter 7, Paying for College.
16. Do you know if you will be financially ready to retire or become financially independent at your desired age? If you answered *no,* read Chapter 8, Planning for Retirement.
17. If you are changing jobs or retiring, are you confident that you understand your financial options and are making the right choices? If you answered *no,* read Chapter 8, Planning for Retirement.
18. Do you fully understand the different investment choices (stocks, bonds, mutual funds, etc.) available to you? If you answered *no,* read Chapter 9, Managing Your Investments.
19. Do you (and your spouse) have a will? Has it been reviewed by an attorney within the past five years and was it drafted in your current state of residence? If you answered *no,* read Chapter 10, Preserving Your Estate.
20. Do you (and your spouse) have a health care proxy and power of attorney? If you answered *no,* read Chapter 10, Preserving Your Estate.

#### *How to Use the Questionnaire*

To answer many of these questions, you will need to gather certain documents including copies of your will, health care proxy, insurance policies, and banking and brokerage statements. After you have answered these questions completely and honestly, you will quickly be able to identify the major wealth management issues you need to focus on.

Many of these issues should be addressed no matter what your age or situation. For example, even if you are single and still in your twenties, you should have sufficient health insurance, be saving for the proverbial rainy day, and be planning financially for retirement, if only by participating fully in your company's retirement plan. Also, you may need a will, a health care proxy, and a power of attorney. If you are married, have children, own a home

and other valuable property, additional issues will become increasingly important, like sufficient life insurance, health insurance, and property insurance. As you get into your fifties and beyond, you will be more and more concerned with paying for your children's education, possibly caring for aging parents, and (again) saving for retirement.

All of these subjects are addressed in detail in subsequent chapters of this book.

## The Power of This Book

Becoming financially independent is not something that happens by chance; it requires focus, discipline, determination, sacrifice, and a lot of hard work. If you are serious about achieving financial independence and are willing to make the commitment to do what it takes, then this book will provide you with the necessary tools to pursue your financial goals. In short, I will guide you toward reaching your own personal *point X*, financial independence.

Using financial planning strategies—the 10 key issues to comprehensive wealth management—and many real-life (though anonymous) client stories—I show how to navigate through the most critical factors that affect you and your family's financial life. Most important, I explain how to employ current tax facts and strategies in order to save hundreds—and perhaps thousands—of dollars every year. By doing so, you will not only minimize your biggest expense, you will maximize the money you can put into your pocket (or your investment portfolio), helping you reach financial independence.

Thus, this book is a complete resource for anyone concerned with building wealth and financial security in today's no-guarantee financial environment. Authoritative, comprehensive, and up to the minute, it is my hope that this book will become the essential financial guide for every individual and every family.

CHAPTER 1

# Committing to Living within Your Means

*Live within your means, never in debt, and by husbanding your money you can always lay it out well. But when you get in debt you become a slave. Therefore I say to you never involve yourself in debt. . .*

—Andrew Jackson,
seventh president of the United States

We all want to live the American Dream. Beginning with the earliest European settlers, Americans have sought the height of success and prosperity for themselves and their children, and we have believed firmly that we could achieve it, no matter our race, religion, nationality, or gender. All it took was hard work and discipline.

## The American Dream Becomes the American Nightmare

Our country was founded on the conviction that it was the land of opportunity and prosperity—that was the definition of the American Dream. In the early years of our country's existence, infinite real estate was available for the taking, a great boon for a basically agrarian society. If you wanted more land, all you had to do was pack up your wagon, travel farther west, and claim it. If you were willing to work hard, you could earn an honest living, rear and educate your children, and save for your family's future. These principles stood firm for almost two centuries.

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Nevertheless, perhaps because of the decades of affluence that followed World War II, this land of "equal opportunity" turned into the land of "expected entitlements." People came to believe that living beyond their means—usually on credit—was acceptable, and "living large" became the norm. Younger people no longer thought they needed to save for a down payment on a house, a new car, or a luxurious vacation. They could just put the costs on a credit card or take out a loan. Even professional financial institutions fed into this false sense of affluence, giving credit cards, large home mortgages, and home-equity loans to people they knew full well could never pay them off. This distorted definition of the American Dream significantly contributed to the financial crisis of 2008, which we are still experiencing today and may well continue to feel for decades. Our rich American Dream has become a nightmare.

Still, despite these gloomy facts, if my parents were able to come to a foreign land with only an eighth-grade education, barely able to speak the language, and end up as millionaires, certainly, anyone blessed with the education and opportunities available to most Americans today can become financially independent. Anyone can get to *point X*—the point at which you can support yourself and your family financially with your *investments*, not a salary. All it takes is knowledge of good financial practices and the discipline to carry them out.

## Living within Your Means: The Essential Step

The single most important step any individual must take to become financially independent is to commit to living within his or her means. This sounds obvious; this sounds easy. But believe me, it is not!

Amazingly, many people do not understand what "living within your means" actually implies! I believe that the definition of "living within your means" is living on *less than* your take-home salary and any other resources you receive, such as income from an annuity or a trust. Living within your means does *not* mean existing from paycheck to paycheck. Living within your means does *not* mean living on credit or on loans. Living within your means does *not* mean turning to parents or friends to pay the tab when you cannot quite meet the rent or need to buy a new computer. It means not only figuring out how to pay for your needs and wants, but budgeting your income so that you still have a little money left over.

### *Paying Yourself First*

In addition to living within your means, if you are ever going to get to *point X*, you must also *save* money. (You will ultimately need to invest this money productively, but I'll cover that in Chapter 9, Managing Your Investments.) I call this exercise *paying yourself first.* Therefore, "living within your means" includes not only such necessities as shelter, food, utilities, and clothing, but also payment into your personal savings. Ideally, that payment should be 10 percent or more of your gross pay. You may think that this is impossible, but once you get started, you will realize how easy it can be. And, of course, if you can afford more, by all means, put those funds in savings or invested assets.

The following is an example of how this could work and how this will help you achieve financial independence. If you are earning $52,000 a year, that is $1,000 a week gross income, and you are probably bringing home about $700 of that after taxes. If you *pay yourself first* by funding your 401(k) plan and save 10 percent of your gross income, that is $100 per week (or $5,200 a year), which may earn a rate of return with compounding over the time invested. If you start saving that at age 21 and retire at age 65, you will have saved $228,800 over those 44 years. Also, that $100 you save affects your take-home pay by only $70 (assuming a 30 percent tax rate), so you will be taxed on $900 instead of $1,000 per week, which means you will bring home $630 instead of $700 per week. Yes, that is $70 less money you have to spend on your needs and wants, but you get the full benefit of $100 saved. Assuming you can earn 7 percent per year on your 401(k) investments over the 44-year period,[1] you may be able to accumulate $1,383,829 by the age of 65. I believe this is a small price to pay for financial independence in the future. I do not know any easier way to achieve financial independence. By the way, this does not even factor in employer matching dollars, which can significantly increase your savings.

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[1]The rates of return shown above are purely hypothetical and do not represent the performance of any individual investment or portfolio of investments. They are for illustrative purposes only and should not be used to predict future product performance. Specific rates of return, especially for extended time periods, will vary over time. There is also a higher degree of risk associated with investments that offer the potential for higher rates of return. You should consult with your representative before making any investment decision.

"Paying yourself first" must be as much a necessity to you as the roof over your head, the food on your table, and the clothes on your back. It is not a luxury, not something you will start doing next week, or next month, or next year, but an essential expense that you must pay *now*.

### *Know the Difference between What You* Need *and What You* Want

If you asked most people to define the necessities (or essentials) of life, they would probably say: shelter, food, and clothing. I have just added another essential to that list, that is, saving money on a regular basis, or paying yourself first. However, defining what is essential (and not essential) in terms of shelter, food, clothing, and savings, requires some additional attention:

- Shelter should not be the biggest house in the best neighborhood decorated with the most expensive furniture (*not essential*); instead, shelter means a house or apartment that gives comfort and safety to your family, and which you can pay for and maintain with the money you have available (*essential*).
- Providing food for yourself and your family does not mean eating out every night at the fanciest restaurants or even ordering in from the local pizzeria or Chinese takeout (*not essential*); but preparing healthy meals from foods paid for within a food budget you have established (*essential*).
- Clothing does not mean buying the latest $200 jeans or other overpriced designer apparel (*not essential*), but planning for your family's clothing needs based on a well-thought-out budget (*essential*).
- In terms of saving money, you need not try to sock away 25 percent of your salary, especially if money is tight (*not essential*); you simply need to get in the habit of saving 10 percent or more of your gross pay (*essential*).

In other words, you need to begin to discriminate between the nonessentials and the essentials, your wants from your needs.

In working with thousands of people with regard to their finances over the past 25 years, I have noticed one common trait in every person who ultimately achieves financial independence: He experiences anxiety every time he is faced with the decision to make a purchase that is not essential. Whether it is an expensive

cup of coffee or an expensive car (or even a not-so-expensive car!), if he buys it, he experiences anxiety and guilt. In other words, for these people, the pain of purchasing a nonessential item exceeds the pleasure.

Usually, when faced with such a decision, instead of acting impulsively, they ask themselves if the purchase is necessary. *(Do I need a new suit for my first day at a new job?)* If the answer is *no*, they are comfortable with the decision. *(I can wear my old suit; I'll have it dry-cleaned and pressed, and no one will know that I've had it for three years.)* If the answer is *yes (My old suit is looking a little worn—and having a new suit will help me to feel confident on my first day on the job!),* they always look for a less-expensive alternative. *(Can I find an equally good suit at another store or on sale? Will a less-expensive suit look just as good—and make me feel just as self-confident?)*

The fact is, most Americans view this *essential* versus *nonessential* concept in completely the opposite way. Many people believe it is imperative to "keep up with the Joneses," to quote that old-fashioned expression, which implies a perceived necessity to appear as affluent as our friends, neighbors, and professional colleagues. Other expressions such as *shop till you drop* and *retail therapy* are now commonplace in our world, and are considered acceptable, amusing, and even cool! *Shopping till you drop* is thought by many people to be as beneficial to one's health as an afternoon of bicycling in a park; *retail therapy* is firmly believed to be a form of entertainment, and even an antidote to anxiety and stress.

We are supposed to feel good about racking up thousands of dollars on our credit cards—and many people actually do get immense pleasure from excessive shopping. (At least until the bills arrive.) And, as for putting money into the bank instead of splurging on a new big-screen TV—forget it. This behavior has nothing to do with providing the *essentials* of life, it has to do with satisfying our *wants*, not our *needs*. And, of course, more often than not, it has everything to do with whether or not we are living beyond our means.

Discerning the difference between *essentials* versus *nonessentials*, *wants* versus *needs*, is imperative if you are going to live within your means, save sufficient money, and ultimately get to *point X*. You may need to train yourself to associate anxiety and guilt instead of pleasure with making those exciting, but nonessential, purchases. You may need to frequently remind yourself and members of your family that short-term gratification from buying nonessentials is not

nearly as important or satisfying as achieving the long-term goal of financial security. When the pain you associate with sacrificing your financial future is greater than the immediate gratification of providing yourself and your family with nonessential items, you have mastered the skills necessary to becoming financially independent.

**DAILY FINANCIAL AFFIRMATION**

Securing my own and my family's financial future is my number one priority.
I live within my means.
I always pay myself first.
I say *no* to nonessential purchases.

**********

After you have written down this daily financial affirmation, say it out loud. Then post copies of it around your house in places where you (and other members of your family) will see it repeatedly throughout the day—in the center of your refrigerator door, on your bathroom mirror, and on your bedside table. Post another in your work place, such as next to your telephone or on your computer screen saver. Place a copy in your wallet or purse. Consciously read your Daily Financial Affirmation first thing in the morning and the last thing at night. During the day, if you experience a moment of weakness and are about to spend money on a nonessential expenditure, read your daily financial affirmation out loud once again.

## Simple Saving

A traditional savings account is the first place you should consider putting the money you are paying yourself. Having enough cash on hand to see you through an illness, injury, job loss, or other financial emergency can help you avoid taking on debt or tapping into your retirement assets. It is just a smart move.

How much you save will depend on your needs, responsibilities, and comfort level, but my rule of thumb suggests that you should have enough cash in savings to cover at least three months of expenses for couples (if both partners are earning an income), and enough cash in savings to cover six months' expenses, if you are single or for married couples with only one spouse earning an income. If you fear that your job is in jeopardy, or you think it will

take you longer than six months to get back on your feet financially should you lose your job, you should try to have even more in savings. Also, if you are saving for anything other than the proverbial rainy day, such as for a house, wedding, new car, or special trip, count these funds as extra. (It might even be helpful to open a separate savings account for these larger separate items you are saving for.)

Given the relatively low interest rates offered at this time on cash instruments (which include savings accounts, money market funds, and certificates of deposit, or CDs), and the fact that the current rate of inflation is higher than the interest rate, you may actually be losing money on the ultimate purchasing power of your savings. However, do not let this alarm you too much. Saving in this way is still an essential part of getting to *point X*. Also, these savings come with Federal Deposit Insurance Corporation (FDIC) insurance of up to $250,000 per depositor, so your money is safe.

#### *What Is the FDIC?*

It is important to understand the added safety and reduced risk of saving your money with the protection of the FDIC. For some people, having the peace of mind of knowing their money is guaranteed to be returned to them is priceless. Traditional types of bank accounts, such as checking accounts, savings accounts, and CDs, are insured by the FDIC. Banks also may offer what is called a *money market deposit account*, which earns interest at a rate set by the bank and usually limits the customer to a certain number of transactions within a stated period of time. All of these types of accounts generally are insured by the FDIC up to the legal limit of $250,000 per depositor, per institution, and sometimes even more for special kinds of accounts or ownership categories. For more information on deposit insurance, go to the FDIC website at www.fdic.gov.

Many banking and brokerage institutions also offer consumers a broad array of investment products such as mutual funds, annuities, life insurance policies, stocks, and bonds. Unlike traditional checking or savings accounts, however, these nondeposit investment products are *not* insured by the FDIC. Many people are under the false impression that if they purchase something through their bank that they will be protected by the FDIC. This clearly is not the case and you must always understand the risks associated with putting your money into non-FDIC-insured accounts.

### *Saving for Special Situations*

There's an old saying: "All work and no play makes Jack a dull boy." We could adjust that adage slightly and say, "All saving and no *splurging* makes Jack a dull boy." But perhaps it is the word *splurge* that needs the adjustment.

Getting to *point X* primarily refers to achieving ultimate financial independence, where you can stop working for your money and your money can start working for you. But for most of us throughout our lives, other expensive essentials (and nonessentials) will undoubtedly present themselves, and these will require special savings. These might include major purchases, such as buying a first home, paying for your own or a child's lavish wedding, celebrating a daughter's "sweet 16" birthday party or your parents' 50th wedding anniversary, or finally taking a lifelong dream vacation, such as going on a safari to Africa or a trip to the Far East.

When planning for these special events and purchases, you need to view them as requiring additional savings, beyond your cash security savings, and add them as line items to your budget. You might even consider opening separate savings accounts to help you budget for these special situations, and earmark these funds for that special purpose. Nevertheless, you should never sacrifice your primary long-term goal of achieving financial independence in order to meet these other shorter-term desires.

### *Easier Said Than Done*

Granted, a world of difference exists between knowing what to do and *actually* doing it. We know that in order to reach *point X* and become financially independent, we must spend less than we make and save more from our salaries, or *pay ourselves first.* But now comes the hard part: We must actually do it! And the prospect can be overwhelming, both emotionally and financially.

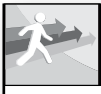
We live in a society of instant gratification; we want more and we want it now, whether it is a daily $5 cappuccino from the local coffee house, a $500 pair of shoes, a $50,000 car, or a $500,000 house. These examples may be exaggerations, but many of us feel bad about ourselves if we seem to be faring less well financially than our friends and colleagues. We feel a need to maintain a high standard of living, even if that standard of living is based on borrowed money and is measured in such superficialities as designer coffees and prestigious labels. Also, as discussed, many of us have learned to experience excessive spending as pleasurable, not painful. These

emotional factors attached to living within our means can be troublesome, powerful, and difficult to overcome. But, like dieting, it is essential to your health that you become aware of these feelings and correct them.

For many people, the reality is that they have already dug themselves into a huge financial pit, and getting out of it is going to be time consuming and painful. They may need to pay off thousands of dollars of credit-card debt (see Chapter 4, Managing Debt) or enormous school loans (see Chapter 7, Paying for College), before they feel that they can begin to seriously save. This is daunting, to be sure, but not hopeless.

### *Stop the Insanity*

Albert Einstein defined insanity as "doing the same thing over and over again and expecting a different result." If you have been living beyond your means and not saving—and wondering why you never have any money—now is the time to stop the insanity! Stop splurging on small nonessentials and start saving for the big essentials, the greatest being your own and your family's financial security. You must commit to living within your means, discriminate between nonessential wants and essential needs, and save for your future. It is your treasure, and ultimately, it is your *point X*.



## AN ACTION PLAN FOR COMMITTING TO LIVING WITHIN YOUR MEANS

- **Make the serious commitment to live within your means.** Discuss this commitment with your spouse and children, and urge them to commit as well.
- **Pay yourself first.** Include saving money in your budget, just as you do any other essential living expense.
- **Open a savings account**. **Save 10 percent or more of your gross pay.** Ask your bank to automatically move the designated amount from your checking account to your savings account.
- **Keep sufficient cash available** to cover three to six months of your basic living expenses, depending on your needs.
- **Place the "Financial Affirmation" in key places** around your house where you and members of your family will see it frequently.
- **If you are saving money for a special purpose, add that amount to your budget,** as an additional line item, and consider opening a separate account for that purpose.
- **Complete the Comprehensive Wealth Management Questionnaire (see the Introduction) to assist you in establishing your financial priorities and goals.**

CHAPTER 2

# Understanding Taxes

*The hardest thing in the world to understand is the income tax.*
—Albert Einstein,
father of modern physics

Taxes are the price we pay to live in our society. Our federal and state income taxes pay for everything from roads, public schools, public libraries, and hospitals to national parks, dams, the U.S. military services, and the salaries of all the people who work for the U.S. government, including the President of the United States. Our taxes also pay for Social Security, Medicare, and other social services. Although we want, need, and appreciate these services, many of us fear that a tremendous amount of money is wasted in the management of government—and we are paying for it.

The fact is, the average American family pays more than one-third of its income in federal, state, and local income taxes—and even more in property taxes, excise taxes, sales taxes, and other hidden taxes, such as taxes on cigarettes, liquor, and certain luxuries. In other words, for just about everyone, taxes are our biggest personal expense, by far.

In order to reach *point X,* it is imperative that you understand the basics of our tax system, and that you practice careful and creative tax preparation and planning so your personal tax burden does not deplete your income unnecessarily, and your wealth accumulates quickly and safely. Tax laws are incredibly complicated, and there

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

is no reason for you to read up on or understand the virtually infinite ins and outs of the often arcane U.S. Tax Code. Most people do need help from professional tax advisors to benefit from tax strategies; however, you should have enough basic knowledge about taxes and the tax system to ask the right questions and find the appropriate help to suit your own unique financial and tax needs. And that is what this chapter provides: an understanding of the basics you need to know to be financially literate.

## A Brief History of the U.S. Tax System

I begin this chapter with a very brief history of taxes in the United States, so you can be prepared for what is to come. I remember sitting in my first history class as a child and my teacher saying "The reason we study history is because our history tends to repeat itself."

The subject of taxes has been a significant part of American history since long before the American Colonies became the United States of America. Every school child remembers the Boston Tea Party of 1773, when the citizens of Boston dressed as Indians and dumped tea into Boston Harbor in protest to Britain's unfair taxation on tea throughout the Colonies. This rebellious act played a strong role in the start of America's Revolutionary War.

Actually, at the time of the Boston Tea Party, taxes had already been a part of the American Colonial government since almost the moment the first Colonists arrived. In addition to taxes imposed by Britain, each individual Colony imposed local taxes on themselves. The first property taxes were imposed on Colonists as early as 1634, less than 15 years after the Pilgrims landed at Plymouth Rock.

However, in the early years of the new nation, taxes were imposed by the individual states, not the federal government. Under Article VIII of the Articles of Confederation, formed in 1787, the United States federal government did not have the power to tax the citizens. Except for tariffs on imports and exports, virtually all power for taxation rested with state and local governments, and until the mid-nineteenth century, many of the states relied on property taxes as a major source of revenue.

### *Income Taxes and the Sixteenth Amendment of 1913*

After the American Revolution, tax on personal income was imposed by some state governments, but only in a small way. The first federal income tax was adopted as part of the Revenue Act of 1861,

to pay for the Civil War, but was allowed to lapse after the war was over. However, by the late nineteenth century, the increasing importance of intangible property, such as corporate stock, caused the states to shift to other forms of taxation. In 1913, the Sixteenth Amendment to the Constitution, which permitted the federal government to levy an income tax on individuals and corporations, was ratified.

The Sixteenth Amendment defined income as "all income from whatever source derived." In 1926, the law was organized as the U.S. Code, or the Internal Revenue Code, and included tax on income, estates, gifts, excise, and certain other things. Over the years, particularly in 1954 and 1986, the Code was revised and expanded, but essentially it has remained as it was devised almost 100 years ago.

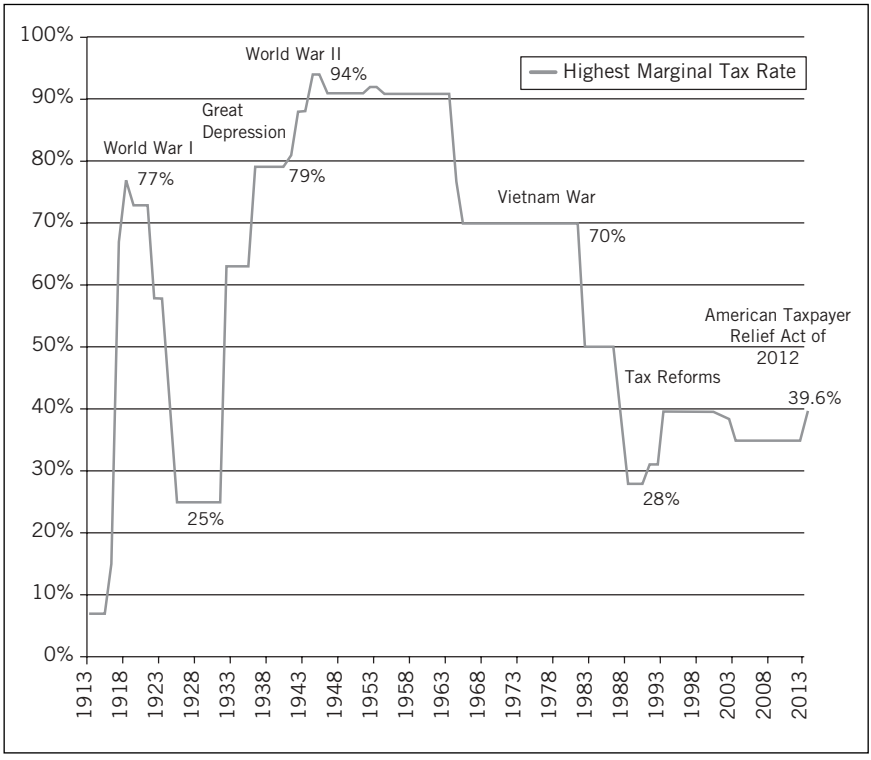
Federal income tax rates have fluctuated wildly since they were established in 1913. In 1913, the proponents of the federal tax assured citizens that the federal tax on income would be small. The opponents of the income tax urged that, at least, there should be a provision to the Sixteenth Amendment capping the tax rate at no more than 10 percent. However, in 1918 when the government wanted money to fight World War I, the federal income tax rate was increased to an astonishing 77 percent for those in the highest income bracket.

However, significant income tax cuts have been made over the years, usually based on the belief that tax cuts would spur economic growth. One such series of cuts was made during the 1920s; unfortunately, the last such cut in that series, made in 1928, was followed by the stock market crash in 1929 and the Great Depression. Taxes were raised again in the latter part of the Depression and reached new heights (94 percent!) during World War II, again in an effort to pay for a very popular war. Income tax rates were reduced significantly during the Johnson (1960s), Nixon (early 1970s), and Reagan (1980s) presidencies, and again between 2001 and 2008 during George W. Bush's presidency. Exhibit 2.1 illustrates the dramatic change in income tax rates since 1913.

#### *The Emergence of State and Local Income Taxes*

Although individual states have taxed individuals since even before the formation of the U.S. Constitution, most of these were taxes on property. Today, many states and some localities continue to

**Exhibit 2.1 Highest Marginal U.S. Income Tax Rate 1913 to 2013**




rely heavily on property taxes as well as on retail sales taxes. By the 1920s, many states had adopted taxes on income for both individuals and corporations, similar in definition and structure to the taxes imposed by the federal government. The states generally taxed residents on all of their income, including income earned in other states, as well as income earned by nonresidents in a particular state. (For example, many people who earn income in New York City live in the nearby states of New Jersey, Connecticut, and even Pennsylvania. As a result, they are taxed by New York State.)

### *Where Are We Now with Regard to Taxes?*

In recent years, we have experienced a very serious economic downturn, and the subject of raising tax rates, especially on the very rich (the so-called top 1 percent of the population), is a frequent topic of conversation among politicians and financial experts.

For the past several years, the federal income tax rates have hovered between 10 percent for those in the lower income bracket and 39.6 percent for those in the top income bracket. (Refer back to Exhibit 2.1, which shows income tax rates from 1913 through 2013.) Given our history, and the current state of our economy, not to mention the size of the national debt and the promises our government has made with entitlement programs, I think we all can predict where tax rates are headed. I believe it is not a matter of *if* taxes will increase, but *when*. And you need to be prepared. As I have said repeatedly, minimizing your largest expenditure (taxes) is critically important to your wealth accumulation plan and to your ability to reach *point X*. You should refer to appendix C, for some basic concepts and definitions of various types of taxes.

## Organizing and Retaining Your Records

Tax records should be carefully kept on a year-round basis—not thrown in a drawer or shoebox and then hastily assembled just for your annual tax appointment. Without tax records, you can lose valuable deductions by forgetting them on your tax return, or you may have unsubstantiated items disallowed, if you are audited.

Generally, returns can be audited for up to three years after filing; however, the IRS may audit for up to six years, if it discovers substantial unreported income. The three- and six-year limits start with the filing of a tax return; if no return is filed, the time limit never starts to run. In other words, if you have failed to file a return, you can be audited and taxed at any time.

### *Which Records Are Important?*

The following are some of the records that you will need to retain for tax purposes.

- Records of income received.
- Expense items, especially work-related expenses.
- Home improvements, sales, and refinances (for homes with profit potential of $250,000 or more).
- Investment purchases and sales information.
- The documents for inherited property.
- Medical expenses.
- Charitable contributions (records vary with value of gift).
- Interest and taxes paid.
- Records on nondeductible IRA contributions.

#### *How Long Should Records Be Kept?*

Just how long you should keep records is partly a matter of judgment and a combination of state and federal statutes of limitations. Federal tax returns can be audited for up to three years after filing (six years, if underreported income is involved). It is a good idea to keep most records for six years after the return filing date.

Some records are worth keeping permanently, partly because of long-term needs and partly because they take up very little room. Consider permanently retaining a copy of each year's tax return. Contracts, real estate buy and sell records, and records of property improvements should be retained for seven years after the property is sold.

If you are in business, your record requirements are more extensive.

## Tax-Preparation Services

If you have worked your way through this chapter, no doubt it is clear to you that calculating and paying your income taxes is not only a complicated process, but it is probably obvious to you that the laws and codes affecting taxes change annually making the job even more difficult. Bear in mind that you are legally responsible for your tax returns whether you prepare them yourself or hire someone else to prepare them for you. You have several choices.

#### *Internal Revenue Service*

One obvious resource for help with tax preparation is the IRS. Under certain circumstances, the IRS will prepare your federal income tax return if it is simple and you do not itemize your tax deductions. I would not recommend taking this approach, however, because it is not a function of the IRS to advise on strategies that can reduce your tax obligation; also, the IRS will not prepare any required state and local income tax returns.

Even if you would prefer to do your taxes yourself or hire a private professional preparer, the IRS also offers many publications to help with tax planning and preparation. Check out the IRS website (www.irs.gov) for further information.

### *Tax Planning and Preparation Software*

In general, two kinds of tax-related software are available: tax planning and tax preparation:

1. Planning programs help you to look into different strategies for managing taxes.
2. Preparation programs (such as Intuit's TurboTax or H&R Block At Home tax software packages) guide you through the preparation process.

If your taxes are relatively simple, these programs can save you time and money. However, if you have experienced major life changes (marriage, divorce, a significant inheritance), invest in the stock market, or are self-employed, you should probably secure the help of a tax professional.

### *Hiring a Tax Preparer*

Most taxpayers conclude that preparing their own taxes is simply too difficult and time-consuming, and turn to private professionals to help them with this process. For them, a professional tax preparer helps them prepare the most accurate tax return and protects them from liability. Also, a good tax preparer can provide advice on tax strategy and help manage more complex tax problems.

Tax advisors come in a number of guises with varying credentials and degrees of competence. The four most common are tax preparers (or nonlicensed services), enrolled agents (EAs), certified public accountants (CPAs), and tax attorneys, described in the following paragraphs; Appendix A offers an overview of various professionals who can help you with your wealth management goals.

**Nonlicensed National and Local Tax Services** These include such companies as H&R Block and other independent local firms. These preparers must now register with the IRS, and if they are not attorneys, certified public accountants, or enrolled agents (discussed in Appendix A), they must pass tests required by the IRS to prove they have the minimum acceptable competence to prepare tax returns.

These services are best for people with straightforward, simple returns.

**Enrolled Agents** EAs are required to pass an extensive examination on various topics of taxation and must also meet minimum continuing education requirements annually. They are also licensed and authorized to represent you before the IRS, should you be audited.

**Certified Public Accountants** CPAs are highly trained and have passed complex and extensive examinations in the areas of accounting, taxation, auditing, and business law in order to be licensed. They must obtain advanced degrees that include rigorous courses in both accounting and taxation. They must also meet a minimum work experience requirement before they can be granted a license. CPAs are required to meet minimum continuing education requirements on an annual basis and are authorized to represent you before the IRS, should the need arise. They also must adhere to a fiduciary standard to their clients.

**Tax Attorneys** These are lawyers who specialize in tax planning, and are most appropriate for those who have a complex tax situation that could result in legal problems, such as the sale of a business or a messy divorce.

Frankly, if you are committed to reaching *point X*, I strongly recommend that you secure the services of a professional tax advisor—one who is appropriate for your income and tax needs. In addition, you should schedule at least one additional meeting during the year, preferably before or after tax season, to discuss all of your tax planning and financial needs and goals.

## Accumulating Wealth through Tax Planning[1]

As mentioned, our single largest expenditure that we all have is our tax obligation. When you factor in federal, state, and local income taxes and then Social Security and Medicare taxes, at current tax rates, more than 35 percent of our paychecks go toward taxes. Then, when you consider sales tax, cigarette tax, fuel tax, excise tax, property tax, estate and gift tax, and other such taxes, this number can easily exceed 50 percent or more of your income.

[1]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

So, if our single largest expense is taxes, then it makes sense that tax planning can be the most significant step you can take toward saving money and accumulating greater wealth. The government requires you to pay no more than the amount of taxes you are legally obligated to pay, but, believe it or not, the majority of people pay much more simply because they do not spend the time to understand more about tax planning. You should consider the tax consequences when making any major financial decision, whether it is buying a house or taking out a loan for your child's college education.

#### *Tax* Avoidance *Is Not Tax Evasion!*

The term *tax evasion* has a scary connotation. Most of us know that tax evasion (not paying our taxes by illegal means, such as under-reporting income or overstating deductions) is illegal. People have been known to spend time in jail for tax evasion. Tax evasion is illegal, pure and simple.

Tax avoidance, however, is perfectly legal. Tax avoidance is the legal utilization of the tax code to one's own advantage; in other words, you can reduce the amount of tax you pay by means that are within the law.

#### *What Is Tax Planning?*

It could be said that *tax planning* is just another way of saying *tax avoidance*. It is a way of maximizing the amount of money you keep by minimizing the amount of taxes you pay. Tax planning means educating yourself about the many ways to avoid overpaying your taxes. By focusing on tax avoidance techniques, you will be able to minimize your taxes and maximize your wealth accumulation. More than any other method by far, this is the most efficient way to save money and accumulate wealth without dramatically altering your lifestyle.

Specifically, tax planning involves using every tax deduction, tax credit, and tax deferral method allowed in the tax code, and using it to your advantage. You must make tax planning part of your everyday life, and always ask yourself in every financial situation: *Is this the most tax effective way to handle this situation?*

#### *How Do I Learn about Tax Planning?*

I suspect that after reading the preceding paragraph, you may be feeling completely overwhelmed. What is more, you are probably ready to really chew me out. (Sure this guy knows about taxes—he is a CPA with an MBA in taxation.) And that is true. Tax deductions,

tax credits, and tax deferrals are second-nature to me: Studying these tax laws and strategies is what I do all day long. And, if you are like most people, your knowledge of taxes is probably limited. You bring your receipts to your tax accountant every year (if that), and hope for the best. Do not feel embarrassed—that is normal.

However, becoming educated about taxes is not really that difficult, and once you begin to see how much money you will save by taking advantage of various tax credits and other tax-related advantages, you will become very motivated. Actually, you have already taken the first step in your educational process by reading this chapter. Also, read other books, journals, and articles, particularly those that address your professional and personal concerns. I would also recommend visiting the following websites, which are packed with tax and financial planning strategies, such as CNN Money at http://money.cnn.com and Yahoo! Finance at http://finance.yahoo.com and then click on personal finance. Beyond that, speak to a financial advisor or your employer's human resources department about any and all employee tax-related benefits available to you, and make sure you act on them. Finally, communicate with your tax accountant and financial advisor. You need to do this more than once a year at tax time, when he or she is at their busiest. Instead, set up a meeting during the summer months, when most tax people are in a more leisurely period and can really focus on your needs and think creatively on your behalf.

In the meantime, I have provided, at the end of each chapter, my top "tax planning facts and strategies" as they relate to the key wealth management issue covered in each chapter. I believe that this section of each chapter will be the most valuable to you in your wealth-accumulation process. Read it carefully, and discuss it with your tax advisor to ensure that you are not paying a penny more in taxes than the law requires.

#### *Tax Benefits*

You can reduce the amount of tax you owe by participating in any number of tax benefits. You can reduce your total income (and therefore your progressive tax rate) if you contribute money to a retirement account, such as a 401(k) or IRA plan.

Tax benefits are how Congress rewards people for making certain types of financial decisions. The goal of tax planning is to choose when tax benefits make the most sense for you.

The income tax system is voluntary. People are free to arrange their financial affairs in such a way to take advantage of any tax

benefits. *Voluntary* does not mean that the tax laws do not apply; you must pay your taxes. However, *voluntary* does mean you can choose to pay less tax by managing your finances in a way to minimize your taxes.

Before you focus on your particular concerns, you need to get an accurate picture of your true net worth, figure out where your money is coming from (and going to) at this very moment, establish your financial goals, and begin to budget for the future. Chapter 3, Determining Your Financial Position, shows you how to do this. After all, you cannot get to point X if you do not know precisely where you are starting your financial journey.

#### *American Taxpayer Relief Act of 2012*

On January 2, 2013 President Barack Obama signed into law the American Taxpayer Relief Act of 2012. This law makes permanent or extends many of the so-called Bush-era tax deductions and credits that were set to expire in 2012 for most Americans under the 2010 Tax Relief Act. This book reflects the latest tax law changes from the American Taxpayer Relief Act of 2012 and I include many of the latest provisions in "Tax Facts and Strategies" at the end of each chapter.

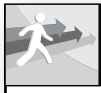
### TAX FACTS AND STRATEGIES[2] FOR WEALTH ACCUMULATION

- Maximize your tax deductions.
- Take full advantage of every tax credit.
- If possible, shift income and deductions to the tax year that will result in lower taxes.
- If possible, shift income among family members to take full advantage of lower tax brackets.
- Defer the payment of taxes to future years through the use of tax-deferred accounts.
- Maximize your tax-free sources of income.
- Meet with your employer's human resources department to ensure that you are taking advantage of all tax-free fringe benefits available to you.
- Communicate with your tax and financial advisor quarterly, not just at tax time.

(*Continued*)

[2]See footnote 1.

- Refer to this book, and other tax references, periodically to keep you on track with your finances, and to ensure you are using relevant and current tax facts and strategies.
- Make tax planning part of your life. Always ask yourself, "*Is this the most tax-effective way to handle this financial situation?*" By far, this is the most efficient way to save money and accumulate wealth, without dramatically altering your lifestyle.



## AN ACTION PLAN FOR UNDERSTANDING TAXES

1. **Carefully read through and study this chapter and appendix C.** By doing so, you will have begun to acquaint yourself with the basics of the U.S. tax system and the process of taxation. Remember: This is your biggest expense, and you need to become aware of ways to keep it in check, if not reduce it.
2. **Begin to take control of your own taxes.** Create a file or files and save appropriate paperwork in an organized and comprehensive way. Check and update these files monthly throughout the year, and then go through them again when you are preparing to file your taxes.
3. **If you prepare your tax returns yourself,** check with the IRS for the latest information on taxes, and use one of the formal tax preparation programs, such as Intuit's TurboTax or H&R Block At Home, to help guide you through the preparation process.
4. **If you decide to hire a professional tax preparer,** find a highly qualified tax advisor who best suits your needs and work with him. (Appendix A describes the differences between various professionals.)
5. **Consult with your tax advisor at least one other time during the year** to identify additional tax and financial saving strategies.
6. **Familiarize yourself with current tax facts and strategies** at the end of each chapter, discuss them with your tax advisor frequently throughout the year, and incorporate them into your financial life.
7. **Make conscientious tax planning a part of your life**. It is one of the best ways to amass wealth and reach *point X*.

CHAPTER 3

# Determining Your Financial Position

*Annual income twenty pounds, annual expenditure nineteen six, result happiness.*

*Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.*

—Charles Dickens,
English writer and social critic

Now that you have taken the extremely important step of committing to living within your means, and understand that taxes are a significant expenditure in your life, you need to determine what your financial situation currently looks like. This does not mean simply knowing your annual salary or identifying how much you take home in every paycheck—although that is definitely part of it. In order to live within your means, you must have a precise understanding of your financial assets, liabilities, and net worth, by preparing a *Statement of Financial Position*. You also need to know—and to track on a regular basis—where all your personal funds are coming from and going to: This is your *Statement of Cash Flow*. Finally, after taking a careful look at your current financial position, you must determine your financial goals, whether for 5 years, 10 years, or throughout your retirement years. Only then can you realistically budget for the future—and of course, reach *point X*.

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

## Figuring Your Financial Net Worth

You cannot get to *point X* unless you know your starting point, and to determine that, you need to figure out precisely just how much you are worth—financially, that is. Figuring your financial net worth involves preparing an essential document: a personal Statement of Financial Position.

To help guide you in its preparation, I have put together a sample Statement of Financial Position, shown in Exhibit 3.1, based on the financial lives of a hypothetical couple, James and Patricia Loomis: Much of the discussion in this chapter uses the information in Exhibit 3.1, so you can use it to follow along. (I have many clients who are similar to James and Patricia, but the Loomises are purely fictional.) In addition, to help you prepare your own personal Statement of Financial Position, I have provided a blank worksheet, shown in Exhibit 3.2.

## Case Study: How One Couple Learned They Were Spending More Than They Earned

James and Patricia Loomis are a successful—albeit fairly typical—American couple in their late thirties. They have been married for 12 years and have two children, a boy and a girl, ages 10 and 8. They live in an upscale suburb of Cleveland, Ohio. James is a lawyer who worked for seven years for a local Cleveland firm, but decided to go out on his own five years ago. He now has a successful practice, and he also owns the small office building that houses his practice. He purchased this building for $900,000 and still owes $740,000 on the mortgage. The current estimated fair market value is only $750,000 because real estate values have decreased over the past several years. At the time, purchasing the building seemed to be a better idea than paying rent to a landlord. His law practice is the tenant in the building and pays rent to James, who in turn uses this rent money to pay the building's mortgage.

Patricia has always managed to juggle caring for her family and working as a part-time writer since the birth of her children. Before having children, she worked as a journalist for several years at a newspaper in Cleveland. When she left the newspaper, she rolled over her 401(k) into an IRA. She is self-employed as a writer for a financial book author and gets paid $25,000 per year for providing this service. James and Patricia bought their house, a rather large

**Exhibit 3.1 James and Patricia Loomis, Statement of Financial Position**

James and Patricia Loomis

Statement of Financial Position as of December 31, 2012

| Assets | | Liabilities and Net Worth | |
|---|---|---|---|
| **Cash/Cash Equivalents** | | **Liabilities** | |
| Cash | $5,250 | | |
| Money Market | 10,600 | Current: | |
| Savings Account | – | Credit Card 1 - H {at 12%} | $6,000 |
| CDs | 10,000 | Credit Card 2 - W - {at 8%} | – |
| Total Cash/Cash Equivalents | $25,850 | Current Liabilities | $6,000 |
| **Invested Assets** at FMV | | Long-Term: | |
| Business Owned | $100,000 | Credit Card 1 - H {at 12%} | $28,000 |
| Office Building (paid $900,000) | $750,000 | Credit Card 2 - W - {at 8%} | 22,000 |
| Investment Portfolio {100% stocks} | 42,000 | Auto 1 note balance - H {at 10%} | 28,500 |
| Variable Annuity {100% stocks} | 25,000 | Auto 2 note balance - W {at -0-%} | 18,500 |
| IRA - H {100% stock} | 5,500 | | |
| IRA - W {100% money market} | 12,000 | Mortgage - Office Building - 30 Years at 9% fixed, 25 years remaining | $740,000 |
| SIMPLE PLAN-IRA - H {100% stock} | 13,000 | Mortgage - Primary residence - 30 Years at 6.5% fixed, 20 years remaining | $460,000 |
| 529 Education Savings Plan | 4,000 | | |

(*Continued*)

**Exhibit 3.1** (***Continued***)

James and Patricia Loomis

Statement of Financial Position As of December 31, 2012

| Assets | | Liabilities and Net Worth | |
|---|---|---|---|
| Life Insurance - H (cash surrender value) | 350 | Student loans 1 - H {at 3%} | 50,000 |
| {Face Value $300,000} | | Long Term Liabilities | $1,347,000 |
| Total Investments | $951,850 | | |
| **Personal Use Asset** at FMV | | | |
| Primary Residence (paid $600,000) | $700,000 | **Total Liabilities** | $1,353,000 |
| Personal Property and Furniture | 20,000 | | |
| Auto 1 | 28,000 | **Net Worth** | $392,700 |
| Auto 2 | 20,000 | | |
| Total Personal Use | $768,000 | | |
| **Total Assets** | $1,745,700 | **Total Liabilities and Net Worth** | $1,745,700 |

**Note to financial statements:**

H = Husband
W = Wife
FMV = Stated at the current fair market value

**Exhibit 3.2 Statement of Financial Position**

Statement of Financial Position As of December 31, 20 _ _

| Assets | | Liabilities and Net Worth | |
|---|---|---|---|
| **Cash/Cash Equivalents** | | **Liabilities** | |
| Cash | | | |
| Money Market | | Current: | |
| Savings Account | | Credit Card 1 - H {at %} | |
| CDs | _____ | Credit Card 2 - W - {at %} | _____ |
| Total Cash/Cash Equivalents | _____ | Current Liabilities | _____ |
| **Invested Assets** at FMV | | Long-Term: | |
| Business Owned | | Credit Card 1 - H {at %} | |
| Office Building | | Credit Card 2 - W - {at %} | |
| Investment Portfolio { } | | Auto 1 note balance - H {at %} | |
| Variable Annuity { } | | Auto 2 note balance - W {at %} | |
| IRA - H { } | | | |
| IRA - W { } | | Mortgage - Office Building - Years at % fixed, years remaining | |
| SIMPLE PLAN-IRA - H { } | | | |
| 529 Education Savings Plan | | Mortgage - Primary residence - Years at % fixed, years remaining | |

(*Continued*)

**Exhibit 3.2** (***Continued***)

| Statement of Financial Position As of December 31, 20 _ _ | | | |
|---|---|---|---|
| Assets | | Liabilities and Net Worth | |
| Life Insurance - H (cash surrender value) | | | |
| Face Value | _____ | | |
| Total Investments | _____ | Student loans 1 - H {at %} | _____ |
| | | Long Term Liabilities | _____ |
| **Personal Use Asset** at FMV | | | _____ |
| Primary Residence (paid $) | | **Total Liabilities** | _____ |
| Personal Property and Furniture | | | _____ |
| Auto 1 | | **Net Worth** | _____ |
| Auto 2 | _____ | | |
| Total Personal Use | _____ | | |
| | _____ | | _____ |
| **Total Assets** | _____ | **Total Liabilities and Net Worth** | _____ |

**Note to financial statements:**

H = Husband
W = Wife
FMV = Stated at the current fair market value

one, which was a stretch for them financially, about 10 years ago for $600,000. The house currently has a fair market value of $700,000, and the Loomises owe $460,000 on their mortgage.

In terms of other anticipated expenses, they know that they need to start saving for their children's education. The public schools in their town are excellent, so private school costs for elementary and high school for the Loomis kids are not an issue. However, James and Patricia know they will be sending their children to college within the next eight years, and they'll be paying college costs for at least six years, and for two children's education expenses for at least two of those years. It is also likely that their children, who are good students, will want and need graduate school as well, and will require financial help from James and Patricia.

James and Patricia do not foresee having to care for aging parents. Patricia's parents have both already died and James' parents are financially comfortable and have adequate long-term care insurance.

At this moment in their lives, James and Patricia are feeling financially sound. But is this accurate? A Statement of Financial Position will provide a clear picture of their true *financial net worth* and will begin to point out areas that may not feel problematic now but should be addressed before they become overwhelming in the future.

#### *Measuring Net Worth*

A personal Statement of Financial Position measures your financial net worth by assigning values to all of your financial assets and liabilities. Once you have identified the specific amounts of your assets and liabilities, you simply subtract the total of your liabilities from the total of your assets, and that amount is your financial net worth. This calculation represents one of the most basic accounting equations: (A − L = NW), or *assets* minus *liabilities* equal *net worth.* Let us walk through the process.

#### *Identifying Assets*

Your first step in this process is to identify every financial asset you have. An asset is simply anything you own that has a value, including cash, investments, your primary residence (if you own it) and any other real estate you own, your automobiles, retirement accounts,

furniture, and jewelry. Once you have identified all the assets you own, you should classify them in the following three categories: cash and cash equivalents, invested assets, and personal-use assets, described in the following paragraphs and referred to in the Statement of Financial Position shown in Exhibit 3.1.

1. ***Cash and cash equivalents*** include cash on-hand, bank accounts (savings and checking), money market accounts, and Treasury bills (T-bills). These accounts reflect what is called *liquid cash*, or money that is readily available for emergencies. James and Patricia have $25,850 in cash and cash equivalents, as can be seen on their Statement of Financial Position.
2. ***Invested assets*** are all assets that are reasonably expected to generate income. (These, of course, are the most important assets in achieving financial independence or getting to *point X*, since these are the assets that will be working to make money for you.) Examples of invested assets include a privately owned business, an investment portfolio, retirement accounts, and fixed and variable annuities. James and Patricia have $951,850 in invested assets, which are stated at current fair market value on their Statement of Financial Position.
3. ***Personal-use assets*** are the assets that, in effect, measure your standard of living. Personal-use assets typically do not generate income; instead, they require you to use additional resources to maintain or replace them. This would include a primary home, a vacation home, automobiles, furniture, jewelry, and artwork. James and Patricia have $768,000 in personal-use assets, which are stated at fair market value on their Statement of Financial Position.

It is worth noting that for the past several decades, until the economic crash of 2008, many people considered their homes to be an *invested asset,* not a *personal-use asset.* This was because during this period, real estate in the United States boomed, and many people made substantial financial killings by buying and selling houses; in other words, we experienced a real estate bubble. Sadly, that bubble has burst. The fact is, your home and vacation home should always be considered personal-use assets, not investment assets.

#### *Listing Liabilities*

Liabilities include any financial obligations you may have that require you to make payments, either currently or in the future. When you list your liabilities on your personal Statement of Financial Position, they fall into two categories:

1. *Current liabilities:* full payments for which are due within one year (i.e., short-term loans).
2. *Long-term liabilities:* payments that can be stretched out for one year or longer (such as student loans, business loans, mortgages, and home-equity loans).

When listing liabilities, be sure to include their terms as well as their current outstanding balance. Terms refer to the interest rates being paid, the numbers of payments to be made, and any prepayment penalties. (It will be essential to know and list these terms when evaluating your debt, which is discussed in detail in Chapter 4, Managing Debt.)

James and Patricia have current liabilities of $6,000 and long-term liabilities of $1,347,000. Therefore, their total liabilities are $1,353,000. (Technically, the current portion of their long-term liabilities, which are the payments that they are required to make over the next 12 months, should also be listed as current liabilities. However, for ease and clarity, I have not made this distinction, and I have included only $6,000 of their credit-card debt as current.)

#### *Calculating Your Financial Net Worth*

Now that you have listed all of your assets and liabilities, the moment of reckoning has come. When you subtract your total liabilities from your total assets, you will know your personal financial net worth.

The number that represents your financial net worth (and indeed, your entire personal Statement of Financial Position), may well be an eye-opener for you. It will reveal your financial strengths and weaknesses. For some people, this is a positive experience, making them feel financially secure and sound. However, for many people (maybe even the vast majority), these calculations often reveal areas that need improvement, and may even uncover serious financial problems. Nevertheless, identifying and facing financial realities serves as a starting point for putting your financial house in order.

### *Analyzing a Statement of Financial Position*

In James and Patricia's case, their financial net worth, as of December 31, 2012, is $392,700. At first glance, this appears quite positive for a couple who are not yet 40 years old. However, despite the fact that they have significant assets (a privately owned business, an office building, an expensive home), they have a false sense of financial security and are a long way from achieving *point X*.

To put it another way: If the Loomises liquidated all of their assets and paid off all of their liabilities, they would be left with $392,700 (cash) in their bank account. If they took this money and invested it prudently, they might be able to generate a 5 percent return on their investments.[1] This would provide them with an income of $19,635 per year before taxes. At this time, their annual income is $216,876, which allows them to maintain their current standard of living. Note that this number is *more than 10 times* what they can reasonably expect their current financial net worth to generate.

Clearly, they have not accumulated a sufficient amount of invested assets to allow them to be financially independent. (Chapter 8, Planning for Retirement, discusses in detail how the Loomises can close this gap so that they can achieve financial independence by the time that they are ready to retire.)

At the moment, they have a number of weaknesses in their Statement of Financial Position. First, as we have discussed, for a married couple in their late thirties, a financial net worth of $392,700 is not sufficient to meet their long-term financial needs. In addition, they have only $25,850 in cash or cash equivalents available in case of an emergency, which is also not sufficient. Their goal should be to have at least three months' income, which, in their case, would be approximately $54,000.

In addition, their invested assets are not as strong or positioned as well as they should be. Among their invested assets is James' office building, which (as mentioned) he purchased for $900,000 in 2006, but after the real estate crash of 2008, is now valued at only

[1]The rates of return shown above are purely hypothetical and do not represent the performance of any individual investment or portfolio of investments. They are for illustrative purposes only and should not be used to predict future product performance. Specific rates of return, especially for extended time periods, will vary over time. There is also a higher degree of risk associated with investments that offer the potential for higher rates of return. You should consult with your representative before making any investment decision.

$750,000. Furthermore, James' investment portfolio, variable annuity, and IRA accounts are 100 percent invested in stock. This is not a well-balanced portfolio, and he may be taking on too much risk. Conversely, Patricia has 100 percent of her IRA account in money market funds, which are currently paying 0 percent! It seems clear that they need professional guidance and management from a financial advisor to help them diversify their investments so that they can both minimize their risks and maximize their returns.[2]

With regard to their retirement accounts, they have a total of only $55,500, which includes a variable annuity and their IRA accounts. As a couple, they always had an excuse for not funding their retirement account and instead chose to buy an expensive home, go into private practice, and purchase an office building. These were the reasons they have underfunded their retirement accounts. Although their tax advisor encouraged them to do so each year, they chose to delay funding their retirement. This is not enough for a couple in their late thirties, and they will need to make significant contributions to their retirement accounts going forward to be able to retire comfortably in their late sixties. (Again, for more information, see Chapter 8, Planning for Retirement.)

They have set aside only $4,000 for their children's education, and their firstborn will be attending college within the next eight years. Given the current cost of a college education, they need to start fully funding their children's 529 plans and other educational saving plans. (For more information about preparing financially for their children's educational needs, see Chapter 7, Paying for College.)

Currently, James is covered for only $300,000 of permanent life insurance; Patricia is not covered at all. Given their family needs, they are significantly underinsured, and in the event of James' death, Patricia would not be able to maintain their current standard of living. They should increase the amount of life insurance coverage on both of their lives. (Life insurance options are explored in Chapter 5, Insuring Your Health and Life.)

With regard to liabilities, the Loomises also have some financial issues that must be addressed. Currently, they are carrying $34,000 in credit-card debt ($6,000 of which is included as a current liability) at the rate of 12 percent per year, and $22,000 at the rate of 8 percent per year. They also have a $28,500 car loan at 10

[2]Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

percent and an $18,500 car loan at 0 percent interest. James also has an outstanding student loan for $50,000 at 3 percent interest. They have clearly been living well beyond their means, and since their cash outflows consistently exceed their cash inflows, they have been forced to accumulate large amounts of credit-card debt. This unfortunately is very common for couples who are always trying to keep up with the Joneses. With regard to their high-interest debts, they need to consolidate their debt and lower their overall interest rates and monthly payments. (The one exception is the 0 percent car loan, which, based on the existing low interest rate, they should continue to make payments.)

James' office building has a mortgage of $740,000, which is almost equal to the building's current fair market value. Unfortunately, they will not be able to refinance this loan because of the extremely high debt-to-equity ratio (close to 100 percent). Nevertheless, they should make an attempt to secure a loan modification with their existing lender, but this may be difficult to accomplish given the current economy and the state of the building's reduced value.

Conversely, James and Patricia are in a perfect position to refinance the mortgage on their home and should be able to lower their rate from 6.5 percent to the current 30-year rate of 4.5 percent. In addition, they should take out an additional $100,000 from the equity in their home. This $100,000 should be used to wipe out all of their credit-card debt as well as James' $28,500 auto loan, which totals $84,500. Unfortunately, there is not sufficient equity in their home to cover his outstanding student loan, so they must continue to make payments on this low-interest rate personal loan. The balance of $15,500 (from the $100,000) should be added to their cash reserves.

The new mortgage at 4.5 percent interest, even with the additional $100,000, will cost them approximately $34,049 per year, compared to the $37,920 they are currently paying on their old home mortgage. This reduction ($3,871), together with reduction of the payments on their credit-card debt ($5,712) and James' auto loan ($7,656), improves their current cash flow by a total of $17,239 per year. Moreover, because the money they used to pay off their debts is now part of their refinanced mortgage, all of the interest payments may be tax deductible.

Some financial advisors believe that you should never pay off unsecured debt (such as credit-card debt) with secured debt (such as a home mortgage). However, I personally believe that under the right circumstances, this can be absolutely the right thing to do, as the example of the Loomises so strikingly shows.

### *An Important First Step*

Analyzing your Statement of Financial Position is one of the most important first steps for developing financial goals and implementing prudent financial strategies that will assist you in getting to *point X*. Moreover, the figure that represents your current financial net worth is perhaps the most significant number in your quest to get to *point X*, or financial independence. You need to calculate this number once a year in order to measure your success. Personally, I always analyze and update my Statement of Financial Position at the end of the year, to assist me in establishing my financial goals for the upcoming year, which are always a part of my New Year's resolutions. I strongly recommend that you do the same.

## Making Sense of Cash Flow

Building your personal financial net worth requires minimizing your liabilities and increasing your assets, particularly your invested assets. Therefore, in addition to calculating your net worth, you need to get a firm grip on where your money is coming from—and, perhaps even more important—where is it flowing to. In other words, you need to create a detailed personal Statement of Cash Flow.

Quite simply, a Statement of Cash Flow will show all of your *cash inflows* and all of your *cash outflows* (as we refer to them in the accounting profession) for a designated period of time, usually one year. As discussed in Chapter 1, the secret to achieving financial independence (or getting to *point X*) is to live within (and ideally below) your means, and to *pay yourself first* (i.e., save money). If your cash inflows exceed your cash outflows, then you will have discretionary income, which can (and should) be used to add to your savings, or your accumulated wealth.

However, if your cash outflows are greater than your cash inflows, then you are living beyond your means, are surely accumulating debt, and are severely limiting your chances of getting to *point X*. As with the Statement of Financial Position, I have created a sample Statement of Cash Flow (shown in Exhibit 3.3), representing the current financial life of James and Patricia Loomis, and will refer to it to help you identify relevant issues of your own. In addition, I have provided a blank Statement of Cash Flow worksheet for your personal use (shown in Exhibit 3.4). Before you can begin filling in your worksheet, you will need to gather copies of your pay stubs, most recent income tax return, and bank and credit-card statements for the preceding 12 months.

**Exhibit 3.3 James and Patricia Loomis, Statement of Cash Flow Before and After Recommendation**

| James and Patricia Loomis<br>Statement of Cash Flow (Before Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | | | James and Patricia Loomis<br>Statement of Cash Flow (After Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | | Net Cash Flow Increase |
|---|---|---|---|---|---|---|---|
| **Inflows** | | | | | | | |
| Self-employment income - H | – | | | – | | | |
| Wage income W2 - H | $190,000 | | | $190,000 | | | |
| Self employment income - W | 25,000 | | | 25,000 | | | |
| Wage income W2 - W | – | | | – | | | |
| | | $215,000 | | | $215,000 | | |
| Dividend income | | 840 | | | 840 | | |
| Interest income | | 280 | | | 280 | | |
| Net Rental Income ($78,000 Rental Income less mortgage on office building $77,244) | | 756 | | | 756 | | |
| **Total Inflows** | | | **$216,876** | | | **$216,876** | |
| **Outflows** | | | | | | | |
| **Invested Assets (pay yourself first)** | | | | | | | |
| Simple Plan Contributions - H | | $5,000 | | | $5,000 | | |
| IRA Contribution - W | | 1,500 | | | 1,500 | | |
| Dividend Reinvested | | 840 | | | 840 | | |
| Interest Reinvested | | 280 | | | 280 | | |
| **Total Outflows to Invested Assets** | | | $7,620 | | | $7,620 | |

| | | | | | |
|---|---|---|---|---|---|
| **Housing** | | | | | |
| Mortgage Home | $37,920 | | $34,049 | | |
| Rent | – | | – | | |
| Cable | 1,650 | | 1,320 | | |
| Cell Phone | 1,980 | | 1,584 | | |
| Cleaning | 4,800 | | 2,400 | | |
| Electricity | 1,950 | | 1,950 | | |
| Gardener/Snow Removal | 1,800 | | 1,800 | | |
| Insurance (home) | 2,350 | | 2,350 | | |
| Gas | 1,220 | | 1,220 | | |
| Internet | 540 | | 540 | | |
| Maintenance and Repairs | 1,200 | | 1,200 | | |
| Phone (land line) | 480 | | – | | |
| Supplies | 640 | | 640 | | |
| Property Tax (home) | 5,200 | | 5,200 | | |
| Water and Sewer | 1,250 | | 1,250 | | |
| **Total Outflows to Housing** | | $62,980 | | $55,503 | $7,477 |

(*Continued*)

**Exhibit 3.3** (*Continued*)

| James and Patricia Loomis<br>Statement of Cash Flow (Before Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | | James and Patricia Loomis<br>Statement of Cash Flow (After Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | Net<br>Cash Flow Increase |
|---|---|---|---|---|---|
| **Transportation** | | | | | |
| Bus/Taxi Fare | $840 | | $840 | | |
| Fuel | 6,230 | | 6,230 | | |
| Insurance | 2,800 | | 2,380 | | |
| Licensing | 90 | | 90 | | |
| Maintenance | 400 | | 400 | | |
| Tolls | 310 | | 310 | | |
| Other | 125 | | 125 | | |
| **Total Outflows to Transportation** | | $10,795 | | $10,375 | $420 |
| **Family Risk Management** | | | | | |
| Health | | | | | |
| Life | 1,400 | | 1,400 | | |
| Long-Term Disability | 1,200 | | 1,200 | | |
| Long-Term Care | – | | – | | |
| Other | – | | – | | |
| **Total Outflows to FRM** | | $2,600 | | $2,600 | |

| | | | | | |
|---|---|---|---|---|---|
| **Food** | | | | | |
| Groceries | $4,545 | | $4,545 | | |
| Dining Out | 10,400 | | 5,200 | | |
| Other | 600 | | 600 | | |
| **Total Outflows to Food** | | 15,545 | | 10,345 | $5,200 |
| | | | | | |
| **Personal Care** | | | | | |
| Clothing | $2,000 | | $2,000 | | |
| Dry Cleaning | 850 | | 850 | | |
| Hair/Nails | 680 | | 680 | | |
| Health Club | 1,200 | | 600 | | |
| Medical—Out of Pocket | 5,000 | | 3,000 | | |
| Organization Dues or Fees | 350 | | 350 | | |
| Other | – | | – | | |
| **Total Outflows to Personal Care** | | $10,080 | | $7,480 | $2,600 |
| | | | | | |
| **Entertainment** | | | | | |
| CDs | $520 | | $520 | | |
| Concerts | 1,200 | | 1,200 | | |
| Live Theater | 600 | | 600 | | |

(*Continued*)

**Exhibit 3.3** (***Continued***)

| James and Patricia Loomis<br>Statement of Cash Flow (Before Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | | James and Patricia Loomis<br>Statement of Cash Flow (After Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | Net<br>Cash Flow Increase |
|---|---|---|---|---|---|
| Movies | 380 | | 380 | | |
| Sporting Events | 500 | | 500 | | |
| Video/DVD | 350 | | 350 | | |
| Other | – | | – | | |
| **Total Outflows to Entertainment** | | $3,550 | | $3,550 | |
| | | | | | |
| **Loans Payments** | | | | | |
| Personal | | | | | |
| Student - 1 - H | 3,328 | | 3,328 | | |
| Student - 2 - W | – | | – | | |
| Credit Card 1 - H | 3,792 | | – | | |
| Credit Card 2 - W | 1,920 | | – | | |
| Auto Loan - 1 - H | 7,656 | | – | | |
| Auto Loan - 2 - W | 4,625 | | 4,625 | | |
| **Total Outflows to Loan Payments** | | $21,321 | | $7,953 | $13,368 |
| | | | | | |
| **Taxes** | | | | | |
| Federal Income Tax | $38,000 | | $38,000 | | |
| Self-Employment Tax - H&W | 19,125 | | 19,125 | | |

| | | | | |
|---|---|---|---|---|
| FICA/Medicare | – | | – | |
| State Income Tax | 9,400 | | 9,400 | |
| Other | 235 | | 235 | |
| **Total Outflows to Taxes** | | $66,760 | | $66,760 |
| | | | | |
| **Gifts and Donations** | | | | |
| Charity 1 | $2,400 | | $2,400 | |
| Charity 2 | 1,200 | | 1,200 | |
| Charity 3 | 500 | | 500 | |
| **Total Outflows to Gifts And Donations** | | $4,100 | | $4,100 |
| | | | | |
| **Professional Fees & Legal Obligations** | | | | |
| Accounting & Legal Fees | $600 | | $600 | |
| Alimony | – | | – | |
| Payments on Lien or Judgment | – | | – | |
| Other | – | | – | |
| **Total Outflows to Professional Fees & Legal Obligations** | | $600 | | $600 |

(*Continued*)

**Exhibit 3.3** (*Continued*)

| James and Patricia Loomis<br>Statement of Cash Flow (Before Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | | James and Patricia Loomis<br>Statement of Cash Flow (After Recommendations)<br>For the period January 1, 2012 to December 31, 2012 | | Net<br>Cash Flow Increase |
|---|---|---|---|---|---|
| **Child Care & Other Expenses** | | | | | |
| Child Care | $3,000 | | $2,400 | | |
| Clothing | 800 | | 800 | | |
| Domestic Help, Babysitting | 240 | | 240 | | |
| Lunch Money | 1,050 | | 1,050 | | |
| Medical | 250 | | 250 | | |
| Organization Dues or Fees | 300 | | 300 | | |
| School Supplies | 250 | | 250 | | |
| School Tuition | – | | – | | |
| Toys/Games | 600 | | 600 | | |
| Other | 200 | | 200 | | |
| **Total Outflows to Child Care & Other Expenses** | | $6,690 | | $6,090 | $600 |
| | | | | | |
| **Pet Care and Other Expenses** | | | | | |
| Food | | | | | |
| Grooming | – | | – | | |
| Medical | – | | – | | |

| | | | | | |
|---|---|---|---|---|---|
| Toys | – | | – | | |
| Other | – | | – | | |
| **Total Outflows to Pet Care and Other Expenses** | | | | | |
| **Personal Expenses** | | | | | |
| Cash Withdrawals | $1,200 | | $1,200 | | |
| Dues/Subscriptions | 600 | | 600 | | |
| Education | – | | – | | |
| Gifts (birthday, holiday, etc.) | 1,200 | | 1,200 | | |
| Vacation/Travel | 3,500 | | 3,500 | | |
| Other | 500 | | 500 | | |
| **Total Outflows to Personal Expenses** | | 7,000 | | 7,000 | |
| **Total Outflows** | | 219,641 | | 189,976 | $29,665 |
| **Discretionary Cash Flow*** | | **$(2,765)** | | **$26,900** | $29,665 |

*Cash inflows less cash outflows.

**Exhibit 3.4 Statement of Cash Flow**

| Statement of Cash Flow<br>For the period January 1, 20 _ _ to December 31, 20 _ _ | | | Statement of Cash Flow (After Recommendations)<br>For the period January 1, 20 _ _ to December 31, 20_ _ | | |
|---|---|---|---|---|---|
| **INFLOWS** | | | | | |
| Self-employment income - H | | | – | | |
| Wage income W2 - H | | | | | |
| Self employment income - W | | | | | |
| Wage income W2 - W | | | – | | |
| Dividend income | | | | | |
| Interest income | | | | | |
| Net rental income | | | | | |
| **Total Inflows** | | | | | |
| **OUTFLOWS** | | | | | |
| **Invested Assests (pay yourself first)** | | | | | |
| Simple Plan Contributions - H | | | | | |
| IRA Contribution - W | | | | | |
| Dividend Reinvested | | | | | |
| Interest Reinvested | | | | | |
| **Total Outflows to Invested Assets** | | | | | |

**Housing**

Mortgage Home

Rent –

Cable

Cell Phone

Cleaning

Electricity

Gardener/Snow Removal

Insurance (home)

Gas

Internet

Maintenance and Repairs

Phone (land line)

Supplies

Property Tax (home)

Water and Sewer

**Total Outflows to Housing**

(*Continued*)

**Exhibit 3.4 (*Continued*)**

| Statement of Cash Flow<br>For the period January 1, 20 _ _ to December 31, 20 _ _ | | | Statement of Cash Flow (After Recommendations)<br>For the period January 1, 20 _ _ to December 31, 20_ _ | |
|---|---|---|---|---|
| **Transportation** | | | | |
| Bus/Taxi Fare | | | | |
| Fuel | | | | |
| Insurance | | | | |
| Licensing | | | | |
| Maintenance | | | | |
| Tolls | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to Transportation** | | _____ | | _____ |
| | | | | |
| **Family Risk Management** | | | | |
| Health | | | | |
| Life | | | | |
| Long-Term Disability | | | | |
| Long-Term Care | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to FRM** | | _____ | | _____ |
| | | | | |
| **Food** | | | | |
| Groceries | | | | |
| Dining Out | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to Food** | | _____ | | _____ |

| | | | | |
|---|---|---|---|---|
| **Personal Care** | | _____ | | _____ |
| Clothing | | | | |
| Dry Cleaning | | | | |
| Hair/Nails | | | | |
| Health Club | | | | |
| Medical - Out of Pocket | | | | |
| Organization Dues or Fees | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to Personal Care** | | _____ | | _____ |
| | | | | |
| **Entertainment** | | | | |
| CDs | | | | |
| Concerts | | | | |
| Live Theater | | | | |
| Movies | | | | |
| Sporting Events | | | | |
| Video/DVD | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to Entertainment** | | _____ | | _____ |

(*Continued*)

**Exhibit 3.4** (*Continued*)

| Statement of Cash Flow<br>For the period January 1, 20 _ _ to December 31, 20 _ _ | | | Statement of Cash Flow (After Recommendations)<br>For the period January 1, 20 _ _ to December 31, 20_ _ | |
|---|---|---|---|---|
| **Loan Payments** | | | | |
| Personal | | | | |
| Student - 1 - H | | | | |
| Student - 2 - W | | | | |
| Credit Card 1 - H | | | | |
| Credit Card 2 - W | | | | |
| Auto Loan - 1 - H | | | | |
| Auto Loan - 2 - W | _____ | | _____ | |
| **Total Outflows to Loan Payments** | | _____ | | _____ |
| **Taxes** | | | | |
| Federal Income Tax | | | | |
| Self-Employment Tax - H&W | | | | |
| FICA/Medicare | | | | |
| State Income Tax | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to Taxes** | | _____ | | _____ |
| **Gifts and Donations** | | | | |
| Charity 1 | | | | |
| Charity 2 | | | | |
| Charity 3 | _____ | | _____ | |
| **Total Outflows to Gifts And Donations** | | _____ | | _____ |

| | | | | |
|---|---|---|---|---|
| **Professional Fees and Legal Obligations** | | | | |
| Accounting and Legal Fees | | | | |
| Alimony | | | | |
| Payments on Lien or Judgment | | | | |
| Other | _____ | | | |
| **Total Outflows to Professional Fees and Legal Obligations** | | _____ | | _____ |
| | | | | |
| **Child Care and Other Expenses** | | | | |
| Child Care | | | | |
| Clothing | | | | |
| Domestic Help, Babysitting | | | | |
| Lunch Money | | | | |
| Medical | | | | |
| Organization Dues or Fees | | | | |
| School Supplies | | | | |
| School Tuition | | | | |
| Toys/Games | | | | |
| Other | _____ | | _____ | |
| **Total Outflows to Child Care and Other Expenses** | | _____ | | _____ |

(*Continued*)

**Exhibit 3.4** (***Continued***)

| Statement of Cash Flow<br>For the period January 1, 20 _ _ to December 31, 20 _ _ | | | Statement of Cash Flow (After Recommendations)<br>For the period January 1, 20 _ _ to December 31, 20_ _ | | |
|---|---|---|---|---|---|
| **Pet Care and Other Expenses** | | | | | |
| Food | | | | | |
| Grooming | | | | | |
| Medical | | | | | |
| Toys | | | | | |
| Other | _____ | | _____ | | |
| **Total Outflows to Pet Care and Other Expenses** | | _____ | | | _____ |
| **Personal Expenses** | | | | | |
| Cash Withdrawals | | | | | |
| Dues/Subscriptions | | | | | |
| Education | | | | | |
| Gifts (birthday, holiday, etc.) | | | | | |
| Vacation/Travel | | | | | |
| Other | _____ | | _____ | | |
| **Total Outflows to Personal Expenses** | | _____ | | – | _____ |
| **Total Outflows** | _____ | | | – | _____ |
| **Discretionary Cash Flow*** | | _____ | | | _____ |

*Cash inflows less cash outflows.

#### *Identify Your Cash Inflows (Your Sources of Income)*

Begin your Statement of Cash Flow by summarizing all of your sources of income. This includes your annual salary (or salaries, if you have multiple incomes or if you are figuring cash flow for a couple, and both husband and wife work.) Include any freelance or self-employment income, interest and dividend income, as well as pension, Social Security income, and any and all other sources of income you may have. Do *not* include any earnings from tax-deferred accounts such as 401(k)s, IRAs, and annuities, because these are not available to pay for cash outflows. However, if you received *distributions* from these tax-deferred accounts, then you should include them as part of your cash inflows. Finally, these figures should reflect your gross pay, or before-tax income. Your taxes are most definitely listed under cash outflows.

James and Patricia Loomis's cash inflows include James' salary of $190,000 (which he budgeted for himself from his law practice), Patricia's part time self-employment income of $25,000, as well as dividend income of $840 from their investment portfolio and interest income of $280 on their money market accounts and CDs. Finally, they also have cash inflow from the office building, where James's law practice is the tenant; the rental income of $78,000 offsets the mortgage payment of $77,244 providing them with an additional $756 per year. As can be seen on the Statement of Cash Flow, their cash inflows total $216,876.

#### *Identify Your Cash Outflows (Your Expenses)*

Cash outflows include *essential* items (e.g., housing, food, clothing, and transportation) as well as *nonessential* items, or basically everything else you spend money on throughout the year. List each one of these basic items as a subheading (*Housing, Food, Personal Care, Entertainment,* etc.), then go through your checkbook and credit-card statements and summarize these payments in as much detail as possible. (Do not worry if you are not absolutely perfect; general trends will show up fairly quickly.) Some items will remain constant, such as your mortgage, your car loan payments, and your student loan payments. Others, however, may fluctuate, or jump out as excessive.

Your cash outflows should also include items that many of us do not commonly consider as part of our personal or family budget. For example, in the spirit of paying yourself first, the first line items

under the heading of *outflows* on your Statement of Cash Flow should be your invested assets, including savings, 401(k) contributions, and any reinvested dividends on investments. In other words, these funds should be considered an essential outflow of money, as important as your rent or mortgage, electricity bill, or grocery bill.

Also, all your tax payments (even those paid through your employer), should be highlighted and included as part of your cash outflows, including all tax payments from your income such as federal income tax, FICA and Medicare, and state and city income tax.

#### *Separating Essentials from Nonessentials*

Once you have listed your cash outflows in as much detail as possible, take some time to analyze your statement very closely. Begin to identify which items are *essential,* and which are *nonessential;* which ones are *needs*, and which are *wants.* If you are married, go through your statement with your spouse—and even show it to your older children, particularly teenagers who may be racking up big bills with an automobile, a cell phone, or other expenditures.

At first glance, certain items may appear to be necessities, such as shelter, food, clothing, and transportation. However, with a closer look, these apparent necessities can begin to look more like luxuries. For example, your house may be costing you more than you can really afford. You may have no trouble meeting the basic mortgage payment, but your electricity and gas bills, your lawn and garden maintenance, and your property taxes may be through the roof. A close analysis of your cash outflows might suggest that it could be worthwhile moving to a smaller house or a less expensive neighborhood.

Transportation costs—or more specifically, the cost of maintaining automobiles—are another area where the line between necessity and luxury can blur. Is owning a $50,000 car really that important? In a household with teenagers who drive, the need for two or even three cars may seem imperative, but are the costs becoming prohibitive? Like a house, the cost of a basic automobile may not be unaffordable, but the price of gasoline, insurance, and maintenance can put a big dent in a family budget.

With a close look at your Statement of Cash Flow, items that are completely nonessential are sure to jump out. Costs for such indulgences as manicures, theater tickets, or expensive birthday gifts may suddenly seem not only excessive, but frivolous. Also, small

cuts, when added together, can turn into big savings for you and your family.

Consider the following analysis of the Loomises' Statement of Cash Flow. It should inspire additional ideas for ways your family can cut costs.

#### *Analyzing a Statement of Cash Flow*

James and Patricia Loomis' cash outflows have been broken out in the following categories:

- Invested assets: $7,620
- Housing: $62,980
- Transportation: $10,795
- Family risk management and insurance: $2,600
- Food: $15,545
- Personal care: $10,080
- Entertainment: $3,550
- Loan payments: $21,321
- Taxes: $66,760
- Gifts and donations: $4,100
- Professional fees and legal obligations: $600
- Child care and other expenses: $6,690
- Other personal expenses: $7,000

In all, the Loomises' cash outflows total $219,641, leaving them with a discretionary cash flow of negative $2,765. (Cash inflows of $216,876 minus cash outflows of $219,641.)

In other words, James and Patricia are spending $2,765 more per year than they are bringing in. Also, like many people, they are subsidizing their overspending by increasing their credit-card debt. If they continue on this path, they may never achieve financial independence. They clearly need to make changes in their cash flow so that they can increase their invested assets (pay yourself first), turn their discretionary cash flow from negative to positive, and ultimately use the excess discretionary positive cash flow to pay down their debt.

As part of the analysis of their Statement of Financial Position, they (working closely with their Certified Financial Planner™) were able to uncover a strategy that consolidated most of their debt and reduced their cash outflow by $17,239. By closely

analyzing their Statement of Cash Flow, they were able to further improve their cash flow by eliminating some of the nonessential expenses. Finally, they (again, through working with their tax advisor, financial planner, and insurance agent) were able to find some additional creative ways to save on taxes and other important expenses.

#### *How One Family Cut Basic Costs*

After the Loomises held a family meeting (which included their two children, even though their kids are relatively young), they were able to begin to identify which of their basic expenses were absolutely essential and which were nonessential. With a little cooperation and compromise, they identified those expenses they could either minimize or eliminate. (As mentioned, these figures are listed in detail on James and Patricia Loomis' Statement of Cash Flow, shown in Exhibit 3.3. It will help if you refer to it throughout this discussion.)

They started with their housing expenses. In addition to reducing their mortgage payment, they were able to make some substantial cuts in their home maintenance costs. They eliminated two (of the five) television cable boxes they had in their home, reducing their cable cost by $330 per year. All family members agreed that they would not use their cell phones beyond the minutes allowed with their family plan, which saved them $396 per year. Because each family member had his or her own cell phone, they decided to eliminate the household landline, which saved them an additional $480 per year.

With regard to their house itself, James and Patricia discussed the possibility of moving to a smaller, less expensive home, acknowledging that they lived in one of the largest homes in their neighborhood, which was truly a nonessential expense. Even though they agreed that a home this size was not a necessity, they were not willing to downsize at this time. They were emotionally tied to the home, and they felt this was the best place to raise their children. They did make a commitment that once their children were away in college they would revisit this financial issue and make the decision of downsizing at that time. Still, with regard to the house, everyone agreed to keep their rooms clean and tidy so that their cleaning service could be cut from once a week to every other week for a savings of $2,400 per year. With these relatively small

sacrifices—all nonessentials—their total housing cash outflows were reduced by $7,477 per year.

After taking a close look at their transportation costs, the Loomises found that the only item they could reduce was their auto insurance. They contacted their insurance agent, who made them aware of a number of discounts they could be entitled to, such as increasing their deductible and taking a defensive driving course. By taking advantage of these offers, they were able to reduce their auto insurance by 15 percent, or $420 per year.

After closely examining their other insurance costs (listed under "family risk management" in Exhibit 3.3), they realized they were underinsured and therefore were not able to reduce their expenditures in this area; indeed, they need to increase them. James and Patricia made a commitment to meet with their life and disability insurance agent to discuss their insurance needs, and to make sure they had sufficient coverage.

Under the category of food, both James and Patricia were surprised that on average they were spending $200 per week dining out, which came to a whopping $10,400 per year. They agreed that they would reevaluate the type of restaurants they dined at, and would try to limit their dining out to no more than twice a month. This would reduce their dining out cost by $5,200 per year.

Under the personal care category, James agreed to eliminate his monthly fitness club membership since he had not been to the gym in over two years. Although Patricia kept her membership, they were able to save $600 per year.

With the help of their CPA, they were able to make a creative alteration to their out-of-pocket medical expenses. Because their health insurance plan is a high-deductible health plan (HDHP), they were able to set up a tax-deductible *health savings account* and contribute the $5,000 (for 2013 this could be as much as $6,450) that they typically paid for out-of-pocket medical expenses to the account. Because they are in a 40 percent marginal tax bracket, this saved them $2,000 per year in income taxes. As a result, they were able to reduce their out-of-pocket medical costs to $3,000 per year.

Regarding their entertainment expenses: concerts, theater, and sporting events are among the most important things the Loomises do as a couple and as a family, so their entertainment costs remained unchanged.

As a result of their loan consolidation, their loan payments (credit card and car loan) were reduced by $13,368 and their

mortgage payment by $3,871, which added $17,239 to their discretionary cash flow. (Refer back to Exhibit 3.3, the Loomises' Statement of Cash Flow.) After a brief conversation with their CPA, who reviewed their Statement of Cash Flow, they realized that they could take advantage of the child and dependent care credit on their tax return. Their accountant told them that based on their adjusted gross income, they were entitled to a tax credit of 20 percent (up to $3,000) of their child-care expenses for one dependent, and up to $6,000 of expenses for two or more dependents. Because their total child care cost was $3,000, they were entitled to a tax credit of 20 percent of this cost ($600). They were eligible for this credit because both of them work and need to pay for childcare for their children, both of whom are under the age of 13. In addition, because they had not taken this deduction before, their tax accountant was able to amend their tax returns for the past three years, and he secured a total return of $1,800. This deduction will continue to add $600 per year to their discretionary cash flow until their children reach age 13.

James and Patricia were amazed that they had gone from a negative cash flow of $2,765 to a positive cash flow of $26,900, and they were able to add $29,665 (about 15 percent of their annual income) to their discretionary cash flow. They decided they would use the extra money to fund James' SIMPLE (savings incentive match plan for employees) IRA (an additional $6,500) and Patricia's IRA account (an additional $3,500). By funding these accounts, they further reduced their tax liability by an additional $4,000 (40 percent of the $10,000 IRA deduction), giving them even more discretionary cash flow. They also made a commitment to establish a 529 plan for both their children's education and fund it with $10,000 per year.

They were also finally able to commit to purchasing the proper amount of life insurance (for both James and Patricia) and long-term disability coverage (for James), which came to $5,000.

After making all these essential financial commitments, they still had an additional $5,900 and decided they would use this money to pay down James' $50,000 student loan. They realized that if they were to make this additional payment annually, they might be able to eliminate this loan within five years.

Finally, the Loomises made a commitment to meet with their tax advisor at least once during the year (in addition to their annual tax visit) to discuss further tax-saving strategies. They believed that

in addition to the items they had already identified, they could reduce their taxes even further with proper tax planning. With all these cost-cutting efforts, the Loomis family has come a long way toward putting themselves on the right path to achieving financial independence, *point X.*

By asking yourself these sorts of detailed financial questions and answering them honestly, you may be able to cut your own monthly expenditures by at least 5 percent and maybe even as much as 15 percent, as the Loomises did—or perhaps even more.

#### *Little Things Mean a Lot*

If you and your family work closely to identify areas in your life where you could minimize expenses, you could easily save at least $10 or $20 or even $30 a day. Consider: By saving $20 per day, you would be saving $140 per week, about $608 per month, and $7,300 per year. If you are 30 years old, and if you invest that savings of $7,300 annually for 35 years (until you are 65 or about retirement age) at, an assumed, 8 percent rate of return, you will amass $1,257,914. To assist you in coming up with a number of easy ways to save money, see Appendix B, 101 Ways to Save $20 or More per Week.

## Establishing Your Financial Goals

By classifying your cash outflows as *essential* or *nonessential,* you begin to acknowledge and separate your *needs* from your *wants.* As a result, you start to determine your true standard of living (or lifestyle), the one you want to be living, the one you are actually living, and the one you need to be living if you want to get to *point X.*

#### *Defining Your Lifestyle—What Do You Consider "Wealth"?*

In our society, *wealth* is often defined as earning enormous paychecks; amassing huge investment portfolios; owning cavernous houses filled with expensive furniture and state-of-the-art electronics; driving multiple, high-end automobiles that cost in the six figures; enjoying luxurious vacations (including vacation homes) at ski resorts, Caribbean islands, and European capitals; having closets bursting with designer clothing (even for infants)—and the list goes on. Even so-called "middle-class" folks seem to want these things, perhaps on a slightly less-exalted scale, but the quest for material goods is the same.

Of course, none of these things are necessities, even for the truly wealthy; they are things we *desire*. But if we cannot afford them, some of us have been known to go into enormous debt to buy them, causing immense stress for ourselves and our families. This is a book about personal finance, so I am not going to discuss the social and emotional challenges often associated with great wealth—the workaholism, the strained marriages, the lack of time for children, the loss of friendships—even the diminishing of personal integrity and what we call *soul*. What my parents considered the "American Dream"—the freedom to work hard in order to have a secure and happy life for themselves and their children—has become warped.

The fact is, *wealth* need not mean aspiring to possess a breathtaking amount of money. For some people, wealth may mean living in a small house in a less affluent neighborhood so that they can afford to send their children to the best colleges. For others, wealth may mean giving up luxurious material goods in order to work in a less high-paying, but personally rewarding career, such as teaching, social work, or the arts.

It is imperative that you define what *wealth* means to you. In other words, you need to be clear about what standard of living (or lifestyle) you aspire to and how you propose to achieve it financially. And the curious fact is, no matter what you choose, you can still get to *point X*. As I have noted before, I have had clients who earn hundreds of thousands—even millions—of dollars annually, yet they struggle to pay their monthly bills; at the same time, I have had clients who live on modest wages, yet are well on their way to a secure retirement.

### *Getting to Point X—and the Places in Between*

Remember, this is a book about how to get to *point X*—the place where we can stop working for our money and our money starts working for us. For most people, *point X* means retirement, pure and simple. This is because it takes most middle-class people several decades to amass sufficient resources so that they no longer need to pull down a paycheck.

At the same time, for most people, a comfortable retirement is not their only financial goal—nor should it be. In addition to saving for retirement, most of us want to buy a house, educate our children, take a vacation every year, and give our families a few

special indulgences such as an expensive wedding. We may want to start a business or buy into a professional practice of some kind. What is more, some people have responsibilities that are sure to incur great expense, such as the need to support an aging parent or provide lifelong care for a disabled child.

Therefore, by definition, your financial goals include additional items beyond getting to *point X*—or saving for retirement. As with your overall lifestyle, only *you* can decide what those goals are.

#### *Your Financial Goals: What Is Most Important to You?*

Although I cannot tell you what is most important for you personally, as a Certified Financial Planner, I will express professional opinions about the value of certain financial decisions. By completing the Comprehensive Wealth Management Questionnaire in the introduction of this book, you will be able to identify your most significant financial goals and then be able to prioritize them in order of their importance to you. Here are my thoughts and recommendations:

- **Paying yourself first (saving).** As I have said repeatedly, unless you have an extraordinarily high-paying job, expect to receive a large inheritance, or know for certain that you will win the lottery, you must save your money and pay yourself first. You need to have cash in savings for that rainy day—in my opinion, enough cash to cover at least three-to-six-months' worth of living expenses. To reach your other financial goals, including *point X*, you need to pay yourself first.
- **Paying off your debts.** Today, many people are burdened with enormous debt. You should pay off all debt—especially high-interest credit-card debt—as quickly as possible, before you can begin to save seriously. If paying off your existing debt is one of your goals, turn to Chapter 4, Managing Debt.
- **Saving for retirement.** If you are in your twenties, the prospect of retirement probably seems incredibly remote, especially if you are planning a wedding, buying a house, or expecting a new baby. However, I cannot say it more strongly: If you want to get to *point X*, you need to begin planning for retirement and saving for it *now*. (I discuss this in detail in Chapter 8, Planning for Retirement.)

- **Buying a home.** Most people are eager to own their own home. Despite the problems regarding bad mortgage loans and the drop in real estate values in recent years, buying a house may still be a good financial decision, but, remember, you should consider your house as a *personal-use asset*, not as an investment asset. Aside from being certain that you can afford the mortgage and maintenance costs, you should plan to hold on to a property for at least a decade; the days of flipping houses for big financial gain are behind us. Today, owning real estate can be a good way to diversify your investment risk, and a well-chosen house or other property will most likely increase in value over a period of years, but bear in mind that it will take time.
- **Owning your own business.** Many people dream of owning their own business or buying into an existing practice, such as a medical, dental, or law practice. The financial ramifications of purchasing and managing a personal business are complicated. Still, owning your own business can be an excellent road to *point X*. Although the financial benefits of owning and operating your own business can be significant, so is the risk and time commitment required to achieve success. Before going into business for yourself, you must fully understand what you are getting yourself into.
- **Educating your children.** For me, educating my children is a top priority. I believe strongly that educating children is the best way to insure their financial future. These days, paying for college (and private elementary and high school, if that is your wish or need) is not only incredibly expensive, but is full of financial pitfalls. (See Chapter 7, Paying for College, for a full analysis of this issue.)
- **Funding unexpected situations.** Some people have unexpected or problematic situations in their life, such as the care of a disabled child or aging parent, which are among their most important financial priorities and require careful financial planning. There are a number of ways to arrange financially for these types of issues; for more information, see Chapter 5, Insuring Your Health and Life, and Chapter 10, Preserving Your Estate.
- **Funding special purchases.** We all have dreams—most of which usually cost money—whether it is a trip around the world, the ownership of a ski chalet in Utah, or a state-of-the-art gourmet

kitchen. Unfortunately, in recent decades, many of us have gotten into the habit of buying expensive items on credit. It used to be that if you wanted a new car, an expensive wedding, a trip to Paris, or a remodeled kitchen, you saved up for it. These days, people frequently put such purchases on credit cards or take out loans, creating big debts with high interest rates. Big mistake! You need to save.

## Finding Trusted Advisors

To effectively take care of all your financial needs, you will very likely need the help of several professionals, including a financial advisor, a tax advisor, a lawyer, and an insurance advisor. Please refer to Appendix A, Selecting a Trusted Advisor, to assist you in evaluating the qualifications and the type of advisor that would be most suited to assist you. Selecting a trusted advisor to guide you to financial independence is perhaps one of the most important decisions you will need to make on your journey to *point X*.

### TAX FACTS AND STRATEGIES[3] FOR DETERMINING YOUR FINANCIAL POSITION

When preparing your Statement of Financial Position and your Statement of Cash Flow and then considering your ongoing financial goals, it is imperative that you take your tax issues into account. Here are some tax-saving tips to consider when preparing your Statement of Financial Position and your Statement of Cash Flow.

- Do not use the government as your banker. When cash flow is tight, you may be tempted to pay your other bills before you pay any necessary taxes to the government, but *do not do it*. Government charges stiff penalties and interests and should always be the lender of last resort.

(*Continued*)

[3]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

- Remember that you may be able to deduct through 2013 state and local sales tax as an itemized deduction if it exceeds the state and local income taxes that would otherwise be deductible when you itemize.
- Increase your tax-free income by making sure your employer reimburses you for all business expenses you paid that are within the guidelines set by your employer and the IRS. For example, business travel, meals and entertainment, work car expenses, and continuing education. If you have job-related expenses that were not reimbursed by your employer, you may be able to take a deduction for the amount that exceeds 2 percent of your AGI, but getting reimbursed will always result in your paying less taxes.
- Income-tax-return preparation fees and fees for tax advice may be deductible but are subject to the 2 percent AGI floor. You can also deduct payment for fees for representation in a tax audit. Also, if you purchase books that provide tax and financial planning advice (including this one), they also fall in this category of tax-deductible expenses.
- If you are planning to make a large charitable contribution to a qualified charitable organization, you should consider making a gift of property such as stocks, bonds, mutual funds, or real estate that have increased in value instead of a cash donation. The full fair market value of the property is tax deductible as a charitable contribution if you held it for one year or more, and the gain is not subject to income tax. Therefore, you will not only increase your charitable contribution deduction, but you will also avoid paying the income tax on the gain.
- If you are not subject to AMT, you should consider accelerating your personal tax deductions by paying any state or city estimated income tax payments that are due in January before December 31. Making these payments a few weeks early to the state and city can reduce your federal income tax liability by as much as 39.6 percent of this early payment.
- If you will be itemizing your tax deductions and expect to be in a higher tax bracket this year than next, consider prepaying your January mortgage payment in December and also paying your first quarter real estate taxes before December 31. Not only will you get the tax break on this year's tax return, but the tax break will be higher if you expect to be in a lower tax bracket next year. This may be a wise strategy to implement in a year that you receive a large bonus, commission, or perhaps make a gain in a sale of property or other investments.
- Find a job for your dependent children to help fund some of their living expenses. Each child can earn up to $6,100 in 2013 without having to pay any federal income taxes.
- Make sure you choose the proper filing status when filing your income tax return, because this will determine the standard deduction you may claim as well as the tax rates that will apply to your level of taxable income. If you

qualify as *head of household*, be sure to take advantage of this filing status, because it can decrease the amount of taxes you will pay.

- If one or both of your parents qualifies as your dependent, you may claim *head of household* status even if they do not live in your home. To qualify, you must pay more than half of your parent's household expenses.
- If you are planning a wedding, you may want to consider postponing it until January to avoid the marriage penalty faced by many married couples. If both husband and wife are receiving a good income, their tax liability may be higher after they are married and are required to file jointly or married filing separately instead of filing as single.
- Let us say a lawyer and doctor intend to marry by December 31st of 2013. Each has $400,000 per year of taxable income after deductions.
  If they get married as planned on December 31, 2013 their tax liability will be $264,446 per the income tax rate schedules (Married Filing Jointly). If they wait one day to get married January 1, 2014, the 2013 tax table for singles would apply and each taxpayer would have a tax liability of $116,164 for a total of $232,328 for 2013. The savings of $32,118 could pay for a very nice honeymoon.
- You may be able to claim a child tax credit of $1,000 for each qualifying child who is younger than age 17 at the end of year. This credit is phased out for married couples filing jointly with an AGI starting at $110,000, $75,000 for single and head of household, and $55,000 for married filing separately.
- If you paid someone, such as a day care center, to care for your children or other dependents younger than age 13 so that you could work, you may qualify for the child and dependent care credit for these expenses. Depending on your AGI, the credit is 20 to 35 percent of up to $3,000 of the care expense for one dependent and up to $6,000 of expenses for two or more dependents; this credit can therefore be as high as $2,100, ($6,000 x 35 percent). If you are married, generally both spouses must work, unless one is incapable of self-care (disabled) or is a full-time student. Retroactively to tax years after 2011, the American Taxpayer Relief Act of 2012 ("ATRA2012") permanently allows taxpayers to offset their entire regular tax and AMT tax liabilities by the amount of most nonrefundable personal tax credits. This new law makes permanent the extension of the 35 percent dependent care credit and income phaseouts of this credit from $15,000 to $43,000 of adjusted gross income (above $43,000 adjusted gross income the credit is 20 percent of dependent care expenses).
- If you have a qualifying dependent of any age who is disabled, and lives with the taxpayer for more than half of the year you may still qualify for the dependent care credit described above.

(*Continued*)

- You may be able to qualify for the earned-income credit if you have qualifying children and meet certain requirements, and in limited cases, you may also qualify for this credit if you do not have children. For example, in 2013, the maximum earned-income credit with three or more qualifying children is $6,044 and $487 if you do not have qualifying children. The amount of this credit is based on your income level and whether you have no children or up to three children. If you consider yourself a low-income earner, this credit is most definitely worth looking at.
- If you finalize an adoption and pay qualified adoption expenses before the end of the year, you may qualify for the adoption credit. For example, the maximum adoption credit for 2013 is a nonrefundable credit $12,970 (this will be adjusted annually for inflation). For a "special needs adoption" this credit is $12,970 even if actual costs are less than this. For 2013, the amount of the credit phaseouts starting with adjusted gross income of $194,580 and is totally phased out at $234,580 (this will be adjusted annually for inflation).
- For 2013, if your company paid adoption expenses up to $12,970 you can exclude that from your income for tax purposes.
- Your employer provides you with a withholding certificate, Form W-4, where you indicate your filing status and allowances. This form is used to estimate what your tax liability may be by the end of the year. The more exemptions you claim, the less tax your employer withholds from your paycheck, but please keep in mind that this is just an *estimate* of tax to be paid: Your true tax is calculated when you file your actual income tax return. You should adjust your exemptions so that you are not overpaying or underpaying the taxes withheld from your paycheck. Although most people like a big tax refund at the end of the year, this simply means you are giving the government an interest-free loan. There is no easier way to improve your cash flow than by adjusting your exemptions so that you are not overpaying your tax with each paycheck.
- If you live and work in a foreign country and you meet the requirements of either the foreign bona fide residence test or the physical presence test, you may be able to exclude up to $97,600 of foreign earned income (employee or self-employed) in 2013. If you qualify for the foreign earned-income exclusion based on either of these tests, you may also be able to exclude up to an **additional** $92,784 in 2012 of actual housing expenses in excess of $15,216 from your federal taxable income depending on your qualifying foreign income and foreign location These income exclusions are adjusted annually for inflation. The 2013 housing exclusion amounts have not been officially announced when this book went to print.
- If you commute to your employment, your employer can provide you up to $240 per month mass transit or parking benefits for 2012 and $245 for 2013.

- If you discover that you have not taken advantage of any tax deductions or tax credits that you were entitled to, you can file an amended return to claim an additional refund. Generally, the statute of limitations is three years from the date you filed your tax return. Therefore, if you uncover a recurring error you can file a claim for refund for the last three years of tax returns. This is a great way to improve your cash flow, and it is another reason why you should meet with your tax advisor throughout the year.

## AN ACTION PLAN FOR DETERMINING YOUR FINANCIAL POSITION

You now understand the importance of preparing your Statement of Financial Position and calculating your true financial net worth and your current cash flow. You should also be getting a firmer grip on your personal financial goals and how to reach them—including, of course, getting to *point X*. Here is a quick action plan to both get you started and keep you going:

1. **Prepare your personal Statement of Financial Position.** In order to know your true financial net worth, you need to prepare this statement, and update it once a year. Use the worksheet shown in Exhibit 3.2 to assist you.
2. **Prepare your personal Statement of Cash Flow** in as much detail as possible. Working together with your spouse and children, identify and eliminate as many nonessential expenditures as possible. Use the worksheet shown in Exhibit 3.4 to assist you.
3. **Pay yourself first.** Use the money you save to decrease your debt and increase your invested assets.
4. **Define your lifestyle.** Carefully figure out what *wealth* means to you, and then figure out how you plan to financially achieve and support that lifestyle. Of course, discipline yourself and members of your family to live within your means, no matter what sort of lifestyle you choose.
5. **Find a highly qualified tax advisor** who best suits your needs and work with him or her closely throughout the year to identify additional tax- and money-saving strategies.
6. **Familiarize yourself with current tax strategies.** Discuss them with your tax advisor frequently throughout the year, and incorporate them into your financial life.
7. **Set long-term goals.** Annually, set goals for where you would like to be financially one year from now, five years from now, and in your retirement years. Revisit these goals throughout the year to make sure you are on track.

CHAPTER 4

# Managing Debt

*Be assured that it gives much more pain to the mind to be in debt, than to be without any article whatever which we may seem to want.*

—Thomas Jefferson, third president of the United States, from a letter to his daughter

## Case Study: How Two Doctors Went Bankrupt in Only a Few Years—What Not to Do

A few years ago, through one of my seminars, I met a young, recently married couple from Baltimore. Both Peter and Suzanne Ellis were physicians who had recently completed their residencies and were about to embark on their careers. Peter was an internist, and Suzanne was a gynecologist and pediatrician. At the time we met, both Peter and Suzanne had found positions in existing practices. Of course, they were no longer interns, but they were the low doctors on the totem pole in their respective practices, and, like most young professionals, had much to learn. Nevertheless, one of their dreams was to set up a full-service family practice where they would work together, and they wished to make that happen as soon as possible.

Peter and Suzanne were eager to talk to me because they had some fears about the fact that they were starting their professional and married lives with a combined debt caused by student loans of

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

more than $500,000. Yes, this is a lot of money, but frankly, I was not terribly concerned, because they were both only 30 years old, and I believed that their medical careers would provide them with the opportunities to make a well-above-average income for many years to come. However, I advised them to take their time, save up for larger purchases (such as launching their mutual practice or buying a house), and avoid credit card or other sorts of bad debt.

Despite my advice, they started off on the wrong foot. Wait—let me rephrase that: Peter and Suzanne made just about every financial mistake imaginable—and then some. In fairness to Peter and Suzanne, they were often led astray by bankers and mortgage lenders, who in my opinion, exercised behavior that bordered on the criminal.

Instead of deciding to work for four or five years with other doctors in established practices (and, therefore, learn the realities of the day-to-day life of a doctor and the business of running a medical practice)—and saving their money—they immediately borrowed more than $400,000 to establish a family practice of their own. The bank (which was a specialty cash-flow lender) was willing to provide the funds based on Peter and Suzanne's *potential* income (future cash flow), not their financial reality, which was, quite literally, no cash, no patients, absolutely no experience managing a medical practice, and a half-million-dollars'-worth of student loan debt. But Peter and Suzanne were feeling flush with their success (or the idea of it), and none of the advice provided by the so-called experts from their banks hinted that they might be living in a dream world—or more to the point, in a financial nightmare.

And things got worse. At the same time that they took out their business loan, they leased two cars, a Mercedes-Benz and a BMW, which they viewed as rewards for their hard work during medical school as well as symbols of their (potential) success. The monthly payments on the car leases seemed affordable, and, again, the financing company was more than willing to put up the money for the loans.

Peter and Suzanne found a location for their new practice, and they moved ahead with leasing the space, but it needed lots of renovation in order to become useable as a medical office. They thought the renovation would take three or four months, so they both kept their respective positions. Still, with both of them working full time and, at the same time, building out a medical office, they ran into several challenges. The construction ran into

additional delays and ultimately took 11 months to complete, not the 4 months they had originally planned, which, for one thing, adversely affected their business loan. Still, their bank said "no problem," and instead generously offered to defer the payment on their business loan. These deferred payments were simply added to the principal of their loan. Therefore, in addition to the $400,000 they borrowed to build out the office, they now owed an additional $40,000 in interest, which had accumulated over the additional 11 months.

During the months they were waiting for their office to be ready, they also decided to look for a house to buy in order to get out of the relatively small one-bedroom apartment they were renting in downtown Baltimore. They met with a realtor who, in turn, introduced them to a mortgage broker. They soon found their dream home (five bedrooms, five baths, a beautiful yard, an in-ground pool, etc.), which was selling for "only" $1,400,000. They still had no savings for a down payment or cash for the closing costs, and the earnings from their jobs just barely covered their monthly expenses. But, shockingly, the mortgage broker was able to work with a bank to provide them with some creative financing.

The bank was willing to give Peter and Suzanne 80 percent financing as long as the seller was willing to provide an inflated purchase price on their contract and then give back a seller concession for that amount. In essence, the seller agreed to artificially increase the contract price of the home so that Peter and Suzanne would qualify for a larger loan. (With this type of loan, at the closing, the seller agrees to lower the price, which ultimately allows the borrower to borrow more than 80 percent of the purchase price. This was a very common practice before the housing collapse of 2008. The banks, the lawyers, and the government regulators were fully aware of this practice and encouraged it to promote home ownership.) The bank was also "nice enough" to make it an *interest-only loan* with negative amortization. This meant that Peter and Suzanne were paying only part of the monthly interest on their mortgage loan; meanwhile, the principal balance increased every month, making the monthly payment more affordable in the short term. The mortgage broker also provided them with a *combo loan*, which allowed them to take on a home-equity loan for the remaining 20 percent of the purchase price.

Peter and Suzanne were overjoyed. Their particular American Dream (two successful doctors, practicing together in their own

office, and living in a beautiful home) seemed to be coming true very quickly, and they had not had to come up with a cent to pay for any of it. Or so it seemed, at least for a short period of time. They moved into their big new house and furnished it completely, putting most of their purchases on multiple credit cards, which banks and other financial institutions were only too eager to give them.

By the time the renovation of their office was finally done, they were already having a difficult time making their monthly payments for their home mortgage, car leases, credit cards—and of course all their business expenses. Also, at this time, Peter quit his salaried position to focus full-time on building up their new practice. Suzanne continued with her position because they felt it could be useful to have at least some guaranteed income coming in.

But life is full of surprises, and something unexpected happened: Not long after their office was finished and Peter began the practice, they learned they were going to have a baby. Although they were becoming more and more worried about their finances—and a child would certainly add to their financial burdens—they were thrilled. To complicate matters, six months into her pregnancy, Suzanne had to stop working for medical reasons and remain quiet at home. Then, after the birth of their beautiful and healthy baby boy, she insisted on staying home for an additional six months to care for their new son.

Throughout this time, Peter was not earning enough through his practice to be able to draw a salary; in fact he began tapping into his personal credit cards for an additional $150,000 cash just to keep the practice and his family afloat. Not only were Peter and Suzanne sinking under their financial obligations, in late 2008, soon after the birth of their son, the national (and international) economy spiraled into a severe recession.

People were not spending money unless it was absolutely necessary, making it very difficult for Peter to bring new patients into his practice. Banks were no longer making loans unless they knew for certain that the loans would be paid back. As a result, Peter and Suzanne couldn't borrow from Bank *A* to make their payments to Banks *B*, *C*, or *D* and so on, a practice they had become quite good at. The credit-card companies lowered their credit limits and started to demand repayment of loans that were greater than a certain limit. Real estate prices tumbled, and the house they had paid $1.4 million for only two years earlier was appraised

for only $800,000, making it impossible for them to sell the house without still owing a $600,000 debt, with no hope of ever being able to repay it.

Although Peter began to be able to draw a small salary from the practice and Suzanne went back to work full time at her original position, their liabilities exceeded their assets by more than $1.5 million, and their cash outflow far exceeded their cash inflow. They had no choice but to seek bankruptcy protection against their creditors.

Today, they are finally starting to see the light at the end of the tunnel. They were forced to sell their home in a short sale; they gave up their fancy cars; and they are now finally living within their means. The bankruptcy eliminated all of their credit-card debt, and they were able to renegotiate the terms of their business loans, which put them in a position that will allow them to pay their monthly obligations. The damage they did to their credit will take at least seven years to repair, and there is no telling how many years the stress has taken off their lives.

## Basic Principles for Managing Debt

Peter and Suzanne's story sounds incredible, but not only is it true, it is surprisingly similar to the financial life stories of thousands of Americans who are living far beyond their means. In recent years, many people have experienced severe financial difficulties because of the national and world economic crisis. Indeed, many people have lost their jobs and cannot find work, and as a result, have had to go into severe debt. However, for many others, their financial crises are the result of irresponsible behavior toward money, both on the parts of individuals as well as the financial institutions and our own government, who failed to regulate, and in fact encouraged, this type of behavior.

Peter and Suzanne's story could have had a much different ending if they had simply taken seriously my basic financial advice, described in the following sections.

### *Learn the Meaning of Financial Responsibility*

Being financially responsible implies learning the basics of personal financial literacy: figuring your net worth, figuring and carefully watching your cash flow, and learning about understanding the other financial tools required to make you secure. In Peter and

Suzanne's case, they were clueless about their personal financial situation while working toward opening a medical practice, which is a business proposition that requires a tremendous amount of financial savvy. They made no efforts to teach themselves about personal and business financial practices until it was too late.

#### *Live within Your Means and Always Pay Yourself First*

Peter and Suzanne started life at "less than zero" financially—by a huge amount; they had student loans of more than $500,000. Had they begun working in established practices, figured out how much they could earn as medical doctors, figured out their net worth, created a thoughtful and realistic cash flow, and, most of all begun saving, they could have moved toward the lifestyle that represented their American Dream on a much surer footing. And probably fairly quickly.

#### *Know (and Respect) the Difference Between* Wants *and* Needs

Peter and Suzanne *wanted* to share a successful medical practice, but they *needed* to learn more about the real life of a doctor and to begin saving for their goals. They *wanted* a lavish and beautiful home, but they *needed* a roof over their heads. They *wanted* to drive expensive automobiles and have all the other trappings that indicated success, but they *needed* a car (maybe two), some furniture, and some savings for unexpected surprises (like a baby). Even with their student loans, they could have bought a small house, decorated it modestly, and started saving for their joint family practice. They might even have bought a larger house where they could have both lived and worked. In any case, they did not need it all *now*.

#### *Learn to Say* No

And, of course, they should have been saying *no* to many things from the beginning. I am not saying they should have deprived themselves of every luxury, but they should have known that *if it looked too good to be true, it probably was*—to quote a useful cliché. (For example, the ease at which they were able to get both a large business loan and a home mortgage loan should have been red flags to them, especially because they originally felt uneasy about carrying their student loans.) They should have said *no* to starting their own medical practice before they were ready. They should

have said *no* to owning an enormous, expensive house when a modest one would have served them well for a few years. They should have said *no* to driving two expensive cars, when two more modest cars would have been sufficient. And they should have said *no* to buying all the items that resulted in their maxed out credit cards.

Although many of my clients have had difficulties with regard to debt, Peter and Suzanne's story is one of the most extreme tales of poor debt management I have ever witnessed. Managing debt is critical if you want to achieve *point X,* but as Peter and Suzanne's story illustrates, managing debt can be complicated and difficult, even for intelligent, well-meaning people, and it can get out of hand quickly and disastrously.

To achieve financial independence, you must first fully understand the concept of debt, and then you must make sure your own personal debt is under control.

## Good Debt versus Bad Debt

*Debt.* In a funny way, the word alone conjures up dank Dickensian prisons in the backstreets of London, with families chucked inside, starving, because they owe the local butcher, baker, and candlestick-maker. *Debtors' prisons*, as these sorts of places were known, imprisoned people (together with their families) who were unable to pay their bills. Although the act of being imprisoned for nonpayment of debt was outlawed in the late nineteenth century, in today's world of relatively trouble-free bankruptcy, some financial experts believe it might not be a bad idea to bring it back. I do not really agree; however, I sometimes believe it is far too easy for people to walk away almost scot-free from gross financial irresponsibility.

Conversely, for many people, debt is a scary concept, although it need not be. The fact is not all debt is *bad debt*; indeed some debt is not only good, it is essential for establishing good credit, and it can be an important factor in growing your wealth and helping you reach *point X.* In any case, understanding the difference between *bad debt* and *good debt* is imperative to becoming financially literate and financially independent.

Basically, *good debt* is money that people borrow for purchases and situations that, in the long term, will help them amass wealth and ultimately reach *point X.* Some examples of *good debt* include student loans, business loans, certain investment asset loans, and some personal-use asset loans (such as an affordable home mortgage).

In contrast, *bad debt* is money that people borrow (usually on a credit card) for the purchase of nonessential expenditures as well as many personal-use assets. (Recall from Chapter 3 that personal-use assets are assets that define your lifestyle, such as homes, automobiles, boats, jewelry, works of fine art, etc.) These items have value, but they require additional expense to maintain them, and, in some cases (such as with a car or boat), they depreciate in value over time. Thus, another way to define *bad debt* versus *good debt* is to consider whether the item is an *essential* or *nonessential* expense; is it a *need* or is it a *want*?

For example, if you wish to become a doctor, you may *need* to take out a student loan to pay for your education, putting you in substantial debt for many years. However, ultimately, you will be able to use your education to earn an above-average living. As a result, this is *good debt*. However, if after you have earned your degree, you may *want* to buy all the accoutrements that supposedly define success or an affluent lifestyle, like luxury cars and large houses, you can put yourself in serious financial straits, as Peter and Suzanne did. This, of course, is *bad debt*.

When you do not use debt properly, that can lead to significant financial hardship and can prevent you from ever becoming financially independent. However, when you use debt to leverage yourself in the pursuit of accumulating wealth, it can be a very powerful tool.

## Credit-Card Debt

The most common form of consumer debt is credit-card debt. In our world, we can use a credit card to charge everything from a tube of toothpaste to a three-week cruise in the Adriatic. However, if we do not pay off the credit-card charges when the bill arrives, the money used to buy the items purchased with the card become *debt*. And credit-card debt is like cancer: If you do not properly control it, it can kill you—financially, at least.

Ideally, you should use credit cards only as a convenient form of payment, which is often safer than using cash. Nevertheless, you should pay any credit-card charges at the end of each billing month. If you cannot afford to pay your complete credit-card balance at the end of each month, whether you have used it to buy a sweater or a sofa, you are *going into debt* in order to pay for the item or items you have purchased. Not only that, but you are going to

*pay interest* on those purchases—sometimes quite a large interest—so the item is costing you much more than you originally thought.

Basically, when you start using your credit card(s) without paying them off, you are subtly (or perhaps not so subtly) indicating that *you cannot really afford the purchases you have made.* To put it another way, these purchases are very likely *nonessential*; they are *wants* rather than *needs.* And when you begin charging true *essentials*—such as food, medications, or diapers—on your credit cards and are unable to pay for them when the bill comes due, you may well be on the brink of financial disaster.

#### *The Insatiable Credit Card*

Credit-card companies sometimes offer teaser rates of 0 percent so that you will use their credit card and maintain a running balance for a few months. Do not fall for this: It is a trap that lures you in until you have charged more than you can pay for, and then they sock you with a double-digit interest rate. Likewise, some retail stores offer 10 percent, 15 percent, and even 25 percent discounts on purchases, if you are willing to apply for an in-store credit card. Do not be lured in unless you can pay off the purchases when the bill shows up in your mailbox. Again, it is just a way to make you feel that you can afford a host of *nonessentials.* Credit cards can eat you alive.

To understand the voracious nature of credit cards and what it can mean to your financial future, consider this scenario: Your end-of-summer vacation week is coming up and you have no plans. You look in your newspaper's travel section or go online and find a great vacation package to Quebec for you and your spouse. This vacation will cost you $1,750—plus you have always wanted to go to Quebec. (Note the term *want.*) You book the trip, have a nice week away, and then with all of the incidentals and souvenirs included, you realize that your trip actually cost you closer to $2,500. At the end of the month, you have a few other unexpected bills, so you do not have the cash available to pay for the trip when the bill arrives, so you leave the charges on your card.

Over the next four months, several old friends come to visit from out of town, and you decide to entertain them at a few expensive restaurants and throw in a couple of Broadway shows and some sporting events; before you know it, you have added another $1,500 on your credit card.

Now winter is approaching and you *need* a new winter coat. While you are out shopping, you see a few great buys on sweaters, and simply cannot resist a pair of expensive boots. Suddenly, you have added another $1,500 to your credit card.

Now, it is a week before Christmas, and you realize that you have not purchased any gifts for your relatives and friends. You do not have a lot of extra cash, but, yes, you do have that credit card. There goes another $2,500.

Without really thinking about it, you have just spent $8,000 over just a few months for the purchases of any number of nonessential items—all *wants*, not *needs*. You even have justified this in your own mind, since your monthly minimum payment is only $150, an amount you can comfortably cover each month.

However, let us take a closer look at this scenario: You now have an $8,000 credit-card balance, and the interest rate on your card is 22 percent (not unusual), and the monthly payment is $150. The fact is, if you pay only the minimum each month, *it will take you almost 18 years to pay off this credit-card balance*; even worse, *you will end up paying $23,430 in interest*. In other words, over the 18-year period, *you would be paying a total of $31,430* for those nonessential items that you originally thought cost you $8,000, four times more than you expected. These purchases—and the undisciplined financial planning—have robbed you of the potential to save that $31,430 toward reaching your financial independence, or *point X*.

Every time you use a credit card to pay for a nonessential item that you cannot afford to pay for at the end of the month, you are severely jeopardizing your financial future. Money can compound quickly, or grow exponentially, almost magically, if it is saved. (For a detailed discussion of the power of compounding, see Chapter 11, The Time Value of Money.) However, this same powerful tool has the *opposite* effect if you borrow money, or go into debt, or maintain a large balance on your credit cards. Your debt can compound as quickly and magically as your savings. You cannot accumulate wealth if you are maintaining balances on your credit cards.

#### *Paying Down Credit-Card Debt*

When I evaluate a client's Statement of Financial Position, I very often discover that he or she is maintaining credit-card balances and paying double-digit interest rates (sometimes as high as 20 percent or more) on this debt. At the same time, the client has money

sitting in bank savings accounts or invested in other assets that are earning a lower rate of return than the interest the client is paying on his or her credit cards. In situations like these, it is sometimes wise to use the available cash to pay off the credit-card debt.

Let us assume you are paying your credit-card company 20 percent interest on a $5,000 credit-card balance, and, at the same time, you have $12,000 in a savings account earning 1 percent interest as well as $20,000 in an aggressive mutual fund account, where you hope to earn 9 percent per year over the long run while taking on a great degree of risk. If you had the following choices, which one would you choose?

1. Would you want to earn 1 percent on your money in your savings account (taxable as ordinary income) with FDIC insurance?
2. Or would you want to possibly earn 9 percent (while taking on a great deal of risk) through an aggressive mutual fund (possibly taxable at capital gain rates)?
3. Or would you want to save 20 percent interest on $5,000, guaranteed, by paying off your credit-card balance (tax free)?

The answer is obvious: You would pick option 3, which is 20 percent guaranteed tax-free savings. Therefore, if you have high credit-card balances, your best choice should be to *eliminate that debt.* (One caveat: If you use your savings or investments to pay off your credit-card debt, you must not turn around and run up more credit-card debt as soon as your cards are clear. Sooner or later, you will run out of money, and you will find yourself in even worse financial shape.)

#### *Other Surprising Resources for Reducing Debt*

If you do not want to raid your savings or money-market accounts, you can consider other potential resources for putting your out-of-control credit-card debt back in line. Here are a few suggestions.

**Take Out a Home-Equity Loan** If you own your own home and have sufficient equity, you might want to consider taking out a home-equity line of credit and using it to pay off your credit-card debt. A home-equity loan helps you in several ways. First, by using the loan to pay down the debt, you are trading 18 to 20 percent interest (on your

credit cards) for 5 to 6 percent interest (on the home-equity loan). If you itemize deductions on your income tax returns, the interest on a home-equity loan may also be tax deductible. (Again, beware: Do not pay off your credit cards with a loan and then run up the balance again. You will be even deeper in debt, and you will have to pay both the credit cards and the home-equity loan.)

**Borrow Against Your Life Insurance** If you have a whole-life insurance policy, you can borrow against it, and use the money to pay your debt. However, be sure to pay it back. If you die before the loan from the policy is paid off, the outstanding balance (plus interest) will be deducted from the value of the policy, and your beneficiaries may suffer.

**Borrow Against Your 401(k)** If you have a healthy 401(k) account, you may be able to borrow up to 50 percent of its value or $50,000, whichever is less. The interest is lower than credit cards, plus you are borrowing from yourself, not a bank or mortgage lender.

Bear in mind that borrowing from your 401(k) can have severe drawbacks, including these:

- You will be paying back the loan and its interest with after-tax dollars.
- You must repay the loan within five years.
- If you leave your job before you fully repay this loan, you will have to pay the balance of what you owe *immediately*. If you do not repay it, that amount will be treated as a distribution to you, and you will be taxed accordingly—with an additional 10 percent penalty to the IRS.

I am not a big fan of borrowing from your 401(k) plan, but I do believe it is better than using a credit card.

**Borrow from Family and Friends** If you find yourself deep in credit-card debt, consider borrowing from your mom, your sister, your rich maiden aunt, or your best friend in order to get rid of the money-sucking interest on a high credit-card balance. However, be sure to arrange to pay them back quickly—preferably with interest—to not only preserve good relationships, but to be sure that you treat this transaction as business (not a gift).

### *Reducing Credit-Card Debt the Old-Fashioned Way*

What if you do not have lots of extra cash in savings, a thriving 401(k) account, equity on real-estate or a life-insurance policy, or a rich aunt—and you have run up $10,000, $15,000, $20,000 or more in credit-card debt? You are probably anxious and frightened about this situation (and if you are not, you should be). But all is not lost; you can actually reduce your debt the old-fashioned way: Pay it back yourself. Here are some constructive actions you can take to get yourself back on track financially if faced with off-the-charts credit-card debt:

- **Stop using your credit cards.** While it is financially wise to have one or two (but not 10) active credit cards, stop using them until you pay them off. After you have paid them off, do not run up nonessential charges again. (Note: *Do not cancel* all of your credit cards. Canceling your cards can have a negative effect on your credit score. When deciding which credit card to keep, always keep the one that you have had the longest: This will help you maintain an overall higher credit score. More information about credit scores is provided at the end of this chapter.)
- **Consider using a prepaid credit card or a debit card.** Visa and MasterCard offer both types of cards. *Prepaid credit cards* are prefunded reloadable cards requiring payment in advance, after which you can use the card until the payment is depleted. You can use them anywhere you can use credit cards, as well as at ATMs. *Debit cards* provide electronic access to your bank accounts, and most relay a message to the bank to withdraw funds from a designated account. You can use debit cards as you would use cash or a check.
- **Know the enemy.** Paying off credit-card debt is war! You need to know yourself (and your apparent weakness for buying *nonessentials*)—and you need to know and understand the details of the credit cards you have been abusing. How many cards do you have? What is the sum total of all your credit-card debt? What interest rates are you being charged? How quickly can you pay this down?
- **Reduce your interest rates.** Many financial institutions will lower your interest rates if your credit is good—and sometimes even if it is not so good. Contact the institution and

plead your case. Or put higher-interest-rate balances on lower-interest-rate cards.

- **Set a due date to repay your debt.** As with any long-term project, it helps to have a firm goal in terms of time. Depending on how much debt you have, give yourself a date when you want to finish paying off your debt. Recheck your date each month, and make sure you are making significant progress.
- **Give yourself a break.** Paying off credit-card debt is admirable and rewarding, but it is like dieting—it takes strength and discipline, and you occasionally need to have a treat. This does not mean charge a trip to Paris on your newly cleared credit card—in fact, avoid anything having to do with credit cards. But perhaps, using cash, buy yourself a new outfit or go out for an evening at the theater. In other words, spend a little money—just do not put it on a credit card.

## Auto Loans

Buying a car is usually the first major purchase any of us ever make. However, unless you are a 17-year-old boy who has saved up his caddying tips to buy a third-hand jalopy—or unless you have significant disposable cash—you are most likely going to have to take out an auto loan in order to purchase a new car. Many people buy cars frequently (the average American buys a new car about once every four years), and many families have multiple cars, sometimes one for each member of the family. In this day of expensive cars, the purchase of an automobile is almost as complicated as the purchase of a house (and I am not even referring to buying luxury automobiles like a Lexus or a Mercedes-Benz). Moreover, buying a car is a very significant addition to your personal debt—and potentially a real roadblock to getting to *point X*.

Like any major purchase, you need to research the automobile market thoroughly before you buy and choose the car—and the financial requirements—that best suits your need. You must decide if you want to buy a used (or "pre-owned") car or a new car (which you will own when you pay off your loan), or if you want to lease a car (which you will return at the end of the lease's term, it would be like renting a house instead of buying it).

For many people, the price of a car they can afford really depends on the amount of a monthly payment they can add to their

budget. I have two helpful calculators that can help you determine how much of a car you can really afford: Go to the car loan calculator at http://money.msn.com, click on Personal Finance, click on saving & budgeting, scroll down to car buying tools, and click on the "How much car can I afford?" section. You can also go to http://finance.yahoo.com/calculator/index/, go to the Lifestyle section, and click on the "Should I lease or purchase an auto?" calculator. You may want to try various "what-if" scenarios with these payment calculators. This will give you some guidance on how much of a car you can actually afford to buy or lease.

Also, in addition to the auto loan or the cost of the lease, you need to consider the fact that you need to maintain your car, which can be expensive. Moreover, your car comes with a host of other necessary costs: insurance, annual license plates, and, of course, the ever-increasing cost of gasoline.

Given their high cost both to purchase and maintain, automobiles can be among the most treacherous purchases we make, not only financially but also psychologically. For many people, automobiles symbolize relative status. Are you a Mercedes-Benz or a Ford Taurus type? There is nothing wrong with wanting to own a Mercedes—unless you take out a loan for one when all you can really afford is the Taurus. Also, if, like Mitt Romney, you want your wife to have "a couple of Cadillacs," you had better be able to afford them, or you are going to be in financial trouble.

Most of us consider a car to be a necessity, an essential expense, a *need* rather than a *want*. However, among the many decisions involved in buying a car, some entail giving in to very expensive *wants* (a new Mercedes), rather than more economical *needs* (a used Ford). And you might even consider taking the bus.

## Student Loans

Whenever you make an investment in yourself and your future that promises to provide you with a better life and higher income, then the money you borrow to achieve that goal should be considered *good debt*. Therefore, if you need to take out a loan (or loans) to attend college or pursue an advanced degree or professional license, you should feel comfortable that you are incurring *good debt*. (Consult Chapter 7, which describes how to minimize this type of debt and still get the education you or members of your family need and deserve.)

If you qualify for low-interest-rate student loans, you need not be in any rush to pay them off. Nevertheless, make sure you make every payment on time, so that you can improve your credit score. (Again, more information on credit scores is provided at the end of this chapter.) Also, student loans may be a useful tax deduction. You may be able to deduct up to $2,500 of student loan interest from your taxable income, if you qualify under the income threshold. The maximum $2,500 of student loan interest may be deductible if the taxpayer's modified adjusted gross income is below $60,000 for single and head of household taxpayers and below $125,000 for married taxpayers filing jointly. The amount of the student loan interest that is deductible is phased out with higher modified adjusted gross income (MAGI) until there is no deduction for singles and heads of households with $75,000 MAGI and married filing jointly taxpayers with $155,000 MAGI. Although student-loan interest is considered consumer debt, if you use it wisely, your return on investment could far exceed your cost of interest. In other words, it is *good debt.*

## Home Mortgage Loans

On a national—and perhaps an international—level, we are in the process of digging ourselves out of one of the most serious financial debacles since the Great Depression of the 1930s. A large part of the problem had to do with a serious mishandling (in my mind, almost criminal) of home mortgage loans.

For several years leading up to the 2008 meltdown, banks were lending money for the purchase of a home sometimes without even verifying a person's income (with loans called *no-income-verification loans*) or their ability to repay the mortgage loan. If the bank determined that someone could not afford the mortgage payment, the bank would simply adjust the terms and provide an interest-only loan, an adjustable rate loan, a balloon payment loan, or some other form of creative financing so that you could purchase a little piece (and sometimes quite a large piece) of the American Dream.

At a certain point, some banks even allowed seller concessions, which simply were an inflated sales price so that one could buy a home and receive 100 percent financing. (How was this legal?) You did not even need to come up with closing costs because the banks worked those fees into the financing. In some situations, people were buying homes with no money down and walking away

with money at the closing. To make matters worse, the easy-credit policies during this period artificially increased the value of homes (demand for homes was greater than the supply) and provided consumers with an entitlement mentality that justified their unsustainable standard of living.

But, of course, as we know, it ultimately all came crashing down. It will now take us decades to correct this irresponsible behavior. Everyone was to blame, the federal government (regulators), the banks (lenders), and even the consumers (borrowers). We all should have known better.

#### *Owning a Home: Not Necessarily Good Debt*

The notion of owning a home has long been a significant facet of the American Dream. Since the economic boom years following World War II, Americans came to believe that possessing a home of their own was almost a right. They certainly thought owning a house made sound financial sense, mostly because for several decades, the value of a home escalated, sometimes very quickly.

No more; those days are gone. Today, following the Great Recession of 2008, the purchase of a home may be a good decision (and taking out a home mortgage can be considered *good debt*), but only if you can meet certain criteria.

Before you begin picking out your dream home in your favorite neighborhood, you need to figure precisely how much house you can actually afford. To help you with this choice financially, visit http://finance.yahoo.com/calculator/index/, go down to the Real Estate section, and click on "How much home can I afford?"

For example, if your current income is $80,000 from all sources, your monthly auto payment is $300, your minimum monthly credit card payment is $250, and your monthly student loan payment $300, how much of a home can you afford? Before we can answer this, we also have to make further assumptions that you will be taking a 30-year mortgage and can obtain a 4 percent interest rate and also have $70,000 available for a down payment. Based on these facts and the guidelines I have set for home affordability, you can afford to purchase a home with a $281,353 mortgage. Your monthly payment on this mortgage would be $1,343.

As a general rule, in my opinion, your total monthly debt payments (including car loans, credit card payments, student loan

payments, etc., as well as your home mortgage) should not exceed 33 percent of your gross monthly income. Moreover, before you can buy a house, you need to have saved 20 percent of the total cost of the home as the down payment, as well as all closing costs. Finally, before you buy, you should compare the costs of renting versus the costs of purchasing. If you cannot afford the monthly payments and costs of maintaining a home, you may need to rent rather than buy, or scale down your *wants*.

Also, given the high costs of acquiring (and ultimately selling) a house, you must be committed to living in this home for at least 10 years for it to begin to potentially increase in value. In addition, you should tally the everyday costs of home maintenance: property taxes, homeowner's insurance, heating, electricity, gas, and so forth. Finally, you also need to consider the cost of ongoing home maintenance: painting, major repairs, and so forth. And note: I have not mentioned those wonderful cosmetic accoutrements (also known as *nonessential wants*)—the new furniture, the beautiful decorations, the renovated family room in the basement, the gorgeous deck, and the in-ground pool.

A house should meet your basic living standards (*needs*), and should not be based on your ego (*wants*). Still, a house can increase in value if you hang on to it for many years and maintain it well. It can also help you financially in other ways.

### *Why a Mortgage Is Still* Good Debt

The reason a home mortgage is usually considered *good debt* is that from the moment you buy the house, it offers certain financial reliefs and leverage. For starters, your home mortgage interest may be tax deductible. (The federal government allows you to deduct mortgage interest expenses to the extent your mortgage does not exceed $1 million. Therefore, if you are in the 40 percent tax bracket and you are paying 6 percent interest on your mortgage, your after-tax cost for financing may actually be only 3.6 percent, which is 6 percent less the 40 percent tax savings). Real estate taxes are also tax deductible.

After you have been paying your mortgage for a few years and have built equity in your home, you can use the equity to leverage other purchases or financial needs.

When comparing the costs of owning a home versus renting, take the tax savings into consideration. If you pay rent, that

expense is not tax deductible and therefore does not provide the same advantages as paying a mortgage does. Also, in some situations, especially if you plan to live in your house for several years, the money you would be spending in rent could be building up as equity. This is when a mortgage becomes *good debt.*

#### *Refinancing a Home Mortgage*

During the past decade, a record number of Americans have refinanced their home mortgages as a result of historically low interest rates. The ultimate purpose of refinancing your home mortgage is to lower your costs of financing so that you free up more cash that can be used toward reaching financial independence, or *point X.*

To determine whether it makes sense to refinance your mortgage, you need to perform a breakeven analysis. Quite simply, you must determine the number of months it will take you to recover the costs of refinancing from the interest cost you will be saving.

Generally speaking, if you plan on living in your home past your breakeven period, then refinancing may be the right decision for you. The breakeven period is not determined by the cost of the new loan divided by the reduction in the monthly mortgage payments; although many bankers and mortgage brokers use this as a comparison point, it does not tell the whole story.

Mortgage refinancing is a complex and potentially expensive process in which you pay off one or more existing debts with a new home loan. Therefore, before you refinance, you need to know what your upfront closing costs will be, what your current and new interest rates will be, and a number of other details. Closing costs to refinance your mortgage can include loan origination fees, appraisal fees, attorney fees, mortgage recording tax, and so forth. In some cases, these costs could be as high as 2 percent of your loan amount.

However, if the figures work, every month after your breakeven point would result in a savings to you. In some cases, you may actually be able to reduce the number of years on your loan without increasing your monthly payment. There are numerous possibilities and what-if scenarios you need to consider when refinancing. Visit http://finance.yahoo.com/calculator/index/, go down to the Real Estate section, and click on "Should I refinance my home mortgage?" to determine your break-even point in months.

To clarify how to determine your true breakeven point, consider the following example. Let us assume that you owe $200,000 on

your current mortgage and you are paying 6 percent per year and have 20 years remaining on this loan. Let us also assume you can refinance this loan and obtain a new mortgage at 4 percent with the same 20-year term. If the bank and other fees associated with refinancing this loan come to $3,000, how many months will it take for you to recover your upfront closing costs and then ultimately have a true savings as a result of refinancing?

If you are able to reduce your interest rate from 6 percent to 4 percent, you will have a 2 percent savings on the $200,000 loan and will reduce your interest costs by approximately ($200,000 × 2 percent) $4,000 in the first year alone. Therefore, it will take you approximately nine months ($3,000 divided by $4,000 cost savings in the first year, or three quarters of a year) to recover your $3,000 out-of-pocket refinancing costs. Once you have recovered these costs, you will continue saving money at the rate of 2 percent of the outstanding balance for the duration of the loan. As long as you plan on owning the home and keeping the mortgage for more than nine months, refinancing your mortgage is the right choice. You should go through this example with your own set of facts to determine your own breakeven point in terms of months.

#### *Get Professional Advice*

For most people, buying a home is the single most significant purchase they will make throughout their lifetime. Do not rely on your gut instincts or your emotional *wants*. Do the hard research into the financial aspects of making this huge purchase.

Also, do not rely solely on the advice of your real estate broker or mortgage broker, because they may not always have your best interests in mind. Before making a final decision about the purchase of a house, consult with your tax and financial advisor.

### Business and Investment Loans

The best investment you can make is investing in yourself. For some people, this means furthering their education; for others, it means going into business for themselves; and for some, it may mean both. Going into business for yourself could be one of the most rewarding decisions you could make, but it could also be one of the most costly mistakes of your life. You should never jump into a business venture without first determining the likelihood of its success and your reasonably expected rate of return on your time and

investment. If you do not study this carefully and fully comprehend the risks, than this potential *good debt* could easily become a *bad debt.*

If you believe you have a great business plan that has a high probability of success and profit, that can reasonably be expected to exceed your cost of financing, and has an acceptable return on investment, then this may be considered *good debt.* Every time you evaluate a business opportunity or investment, you must do your best in determining not only your hard costs, but also your opportunity costs for entering into this business venture. *Opportunity costs* represent what you would have been able to earn with that money if you had invested it elsewhere.

Although the best investment you can make is an investment in yourself, do not take out any sort of business loan without researching it carefully. Consult with others who have gone into similar practices or businesses; study appropriate literature; and discuss the financial details with your tax and financial advisor. The same applies to investment loans.

## Understanding Credit

What is *credit*? Credit is the act of borrowing money with the agreement to pay it back at some future date. In fact, credit sounds suspiciously like *debt*; in other words, all the subjects we have just covered, including auto loans, student loans, home mortgages, business loans, and, curiously enough, *credit* cards. And indeed, the process of establishing good credit involves precisely these sorts of common loans.

As with debt, there is good credit and bad credit. If you have *good credit*, it means you pay what you owe on time; *bad credit* means you have a history of not paying your bills on time and letting debts (again, very often credit-card debt) build up, usually with high, speedily compounding interest rates. *Good credit* paves the way to getting to *point X*; *bad credit* is almost always a serious roadblock to reaching financial independence.

### *A Word about "No Credit"*

You may also have *no credit.* This means that you have never borrowed money from a commercial lender (such as taking out a credit card), and there is no record of your payment history. (Note: Many boarding school and college students, away from home for the first time, have no credit in their own names, but credit-card

companies and retail shops are quick to try to lure students into "establishing credit." This can be a good thing so long as the student pays his or her bills; however, it can be a tragic situation if the student takes out a host of credit cards, runs up huge balances, then either leaves his or her parents to pay them off, or is not responsible—before they even venture out into the work place—with huge debts and very likely a shaky credit history.)

Actually, some people prefer to maintain a no-credit history, or what is known as a *nontraditional credit history*. If this is your choice, be sure to pay your bills (rent, telephone, utilities, medical) in a timely way, and save all your receipts for up to three years. Then, if you want to apply for a loan of any kind (such as an auto loan or a home mortgage), you can use your receipts to prove your good credit.

#### *Establishing and Maintaining Good Credit*

The trick to establishing and maintaining good credit is pretty basic. At the most fundamental level, you need to:

- Open a checking account.
- Apply for a low-interest credit card.
- Keep your credit-card balance low—or, better yet, pay it off every month.
- Finally, pay all your bills on time, never missing a payment.

Beyond these fundamentals, you may also go after the bigger-ticket items like an auto loan or a home mortgage. How you handle these loans will affect your *good credit*—but conversely, the state of your credit will affect whether or not you will be permitted to take out these loans in the first place.

Establishing and maintaining good credit also involves living within your means financially and even paying yourself first. Toward that end, you need to establish a budget for all your expenses, and then, of course, stick to it. (If necessary, reread Chapters 1 and 3.)

Only when you understand your financial realities (and not your "dream lifestyle") can you create a budget that is appropriate for your financial situation and that you can maintain effectively. This involves being realistic about your spending habits, and knowing where you are spending most of your money. (Save your receipts, and study your bills each month.) It also means saving up for expensive items—new furniture, vacations, a down payment

on a house—and not putting these items on your credit card, unless, of course, you can pay them off at the end of the month. Staying on budget will assure not only that you will have *good credit*, it will help you on your road to *point X*.

## Your Credit Report and Your Credit Score

We have all seen those amusing ads on television, the ones with the cute jingles, often involving twentysomething young adults, who are now living in their parents' basement (because they cannot get a lease) or are charging 25 pizzas to feed their entire college dorm, only to have the "wolf" (read angry parents) show up at their door. But what exactly is a *credit report* or a *credit score*?

### *What Is a Credit Report?*

Anybody who has ever used a credit card or made a loan payment has a credit report: It is a formal statement (like a school report card) that sums up, among other things, all your "credit" behavior—such as timely payments, missed payments, the number of credit cards you have—surrounding all aspects of your credit. Your credit report determines whether or not you are in sound financial shape.

These reports are made to (and through) three major credit reporting agencies that maintain information on your credit history. These three agencies are:

1. Equifax Credit Information Services
   P.O. Box 740241
   Atlanta, GA 30374
   1-888-766-0008 or 1-800-525-6285
   www.equifax.com
2. Experian (formerly TRW)
   P.O. Box 2002
   Allen, TX 75013
   1-888-397-3742
   www.experian.com
3. TransUnion
   P.O. Box 1000
   Chester, PA 19022
   1-800-888-4213 (For ordering your credit report)
   1-800-680-7289 (For reporting fraud)
   www.transunion.com

Lenders, employers, landlords, and other service providers buy your credit information in the form of a credit report to help them decide whether to approve your application for a loan, credit card, job, housing, or to offer you a product or service at a particular rate.

#### *What Is Included in Credit Reports?*

Your credit reports from Equifax, Experian, and TransUnion include the following information:

- **Personal information.** Compiled from credit applications you have filled out in the past, this information normally includes your name, current and recent addresses, Social Security number, date of birth, and current and previous employers and your employment history.
- **Credit history.** The bulk of your credit report consists of details about credit accounts that were opened in your name or that list you as an authorized user (such as a spouse's credit card). Account details (which are supplied by creditors with which you have an account) include the date the account was opened, the credit limit or amount of the loan, the payment terms, the balance, and a history that shows whether or not you have paid the account on time. Closed or inactive accounts stay on your report for 7 to 11 years from the date of their last activity (depending on the manner in which you paid them).
- **Credit report inquiries.** Credit reporting agencies record an inquiry whenever your credit report is shown to another party, such as a lender, service provider, landlord, or insurer. Inquiries remain on your credit report for up to two years.
- **Public records.** Matters of public record obtained from government sources such as courts of law—including liens, bankruptcies, and overdue child support—may appear on your credit report. Most public record information stays on your credit report for years.

#### *What Is* Not *Included in Your Three Credit Reports?*

None of the credit reports from Equifax, Experian, and TransUnion include information about your checking or savings accounts, bankruptcies that are more than 10 years old, charged-off or debts placed for collection that are more than 7 years old, gender,

ethnicity, religion, political affiliation, medical history, or criminal records. Also, your credit score (discussed in the next section) is generated by information on your credit report, but it is not part of the report itself.

#### *Checking Your Credit Report*

You should check your credit report on a regular basis, at least once a year—and ideally two or three times a year, because the reports and your credit scores are constantly in flux. The three major credit reporting bureaus, Experian, TransUnion, and Equifax are required by law to give you a free copy of your credit report each year on request. Call 1-877-322-8228 or go to www.annualcreditreport.com to order your free credit reports.

You should take a close look at these reports to ensure that they are accurate and complete. If you identify errors or accounts that you do not recognize, you should report this to the credit bureaus immediately. These problems could jeopardize your credit score and may also be an alert to possible identity theft (discussed in the next section of this chapter).

#### *What Is a Credit Score?*

Your credit score, called a *FICO* score (named for the Fair Isaac Corporation), is a mathematical model designed to predict credit risk, based on data contained within your credit report; in effect, your credit score summarizes your credit information. Lenders typically review your credit report and credit score to determine whether to extend credit (i.e., whether to lend you money), and on what terms. A higher score usually means you pose a lower risk to the lender, who will, in turn, be more likely to offer you favorable interest rates.

Several factors can affect your credit score, including these:

- **The number of loans you are carrying.** These include a home mortgage, auto loans, student loans, retail store credit cards, and bank credit cards.
- **Types of credit used.** Creditors prefer a variety of loans—mortgages, auto loans, store credit, and so forth.
- **Payment history.** The credit score takes into account whether you have repaid your loans in a timely manner and consistently.

- **The length of your credit history.** The longer your credit history, the higher your score.
- **Public records.** Have you filed for bankruptcy? Have reports been made for lack of alimony payments or child-care payments? If so, these factors will affect your credit score adversely.
- **New accounts.** Have you added new accounts to your debt, and if so, how many? Try to maintain no more than three or four credit cards, because more than this can lower your FICO score, which would make you appear to be a higher credit risk to a lender.
- **Inquiries into your credit file.** Have lenders requested copies of your credit information? Fair Isaac's research shows that opening several credit accounts in a short period of time can be an indication of greater credit risk to the lender.

As the information contained in your credit report files change over time, so might any new scores based on your data. Your credit score from a month ago may have changed if there has been any recent activity on your credit file.

Your credit score is by far the most important factor that creditors look at to determine whether you are a good credit risk. Credit scores range from 280 to 850, with the higher value representing lower credit risk. (In other words, the higher your score, the easier it should be for you to obtain credit.) The median score ranges from 690 to 720. A poor credit score (below 600) can cost you the ability to access additional credit, insurance, utility services such as telephone and electricity, a rental unit, and even a job. Conversely, an excellent credit score (720 or above) will increase your chances of a loan approval as well as attractive interest rates and terms. This, of course, is the right direction to becoming financially independent.

#### *How to Improve Your Credit Score*

If you would like or need to improve your credit score, here are a few good suggestions:

- **Watch your percentage of debt.** Make sure your debt (including all bills and loans) remains under 36 percent of your gross annual income.
- **Use credit accounts regularly but conservatively.** Pay them off completely each month, as soon as the bill arrives.

- **Pay all of your bills on time.** The sooner the better.
- **Reduce the amount you owe.** Pay off your credit cards and other loans as quickly as possible. (See the section on paying down credit-card debt earlier in this chapter.)
- **Maintain credit cards that you have held for long periods of time.** If you have accounts at retail stores or credit cards that you have had for years, keep them open. Use them conservatively—and pay off balances at the end of each month. Creditors like to see that you have sustained long-term credit.
- **Get rid of your newest credit cards.** Cancel any cards you have applied for within the last six months, unless you have moved high-interest balances to cards with lower-interest balances. Do not apply for new credit cards until the balances on old cards are clear.
- **Avoid applying for new loans**. Creditors like to see that you can handle different types of loans, including auto loans, home mortgages, and student loans. However, do not take on more debt simply to improve your credit score. This is seen as a negative.
- **Check your credit reports regularly**. You are permitted one free credit report each year; however, ideally, it is better to check them more frequently.
- **Fix disputes quickly.** Do not let disputes go beyond 30 days or into collection.

## Preventing Identity Theft

So you followed all the rules, paid all your bills on time, and have maintained a terrific FICO score. Now you must also be prepared to take the necessary steps to protect it. Identity theft has become a widespread problem throughout the country. Identity theft occurs when someone steals your (financial) identity: In other words, they borrow money in your name, take out credit cards, open up bank accounts, file tax returns using your name, or simply sign your name to a letter.

For identity theft scam artists to steal your identity, they need only some of your personal information, like your name, current address, Social Security number, date of birth, and perhaps your mother's maiden name. If the scam artist gets his hands on your current credit card, driver's license, or birth certificate you will then become very easy prey. These criminals steal millions of identities each year by going through trash pails at people's

homes and workplaces. They will call or email you and represent themselves as government officials or financial institutions. They will fill out change of address forms on your behalf to get utility bill information. They will copy down your credit-card number and use it to make purchases. They will steal anything they can get their hands on to get your personal records.

Do not become a victim of identity theft and always be on the alert. Never provide anyone with your personal information unless you know who that person is. To protect yourself against identity theft, you must be proactive and always on the defensive. You should take the following steps immediately:

1. Check your credit report today and on an annual basis.
2. Buy a good shredder, and keep it handy so you can use it before discarding any sensitive personal documents.
3. File a police report if any of your personal financial information has been lost or stolen.
4. Immediately close any bank or brokerage accounts that have been accessed without your knowledge.
5. If you think you have been a victim of identity theft, put your credit report on fraud alert with all three credit bureaus.
6. Never print or write your telephone number, driver's license number, or Social Security number on your personal or business checks.
7. Do not sign the back of your credit card and definitely do not leave it blank. Instead write in "Photo ID Required."
8. Always keep your PINs and passwords in a safe and secure location.
9. Do not put your credit-card number or vendor account numbers on your checks when making payments.
10. Make a photocopy of everything in your wallet today and lock it up in a safe, or some other secure place. If your wallet is lost or stolen, you will have all of the relevant information such as account numbers and phone numbers to make the necessary calls to cancel them.

## Analyzing Your Debt

The essential starting point to debt management is analyzing your debt. To do this, take another look at your Statement of Financial Position (see Exhibit 3.2 in Chapter 3). Your personal Statement

of Financial Position is a snapshot of where you stand financially today; it is your starting point.

As discussed in Chapter 3, *debt* refers to all of your financial liabilities, or all the financial obligations you have to pay currently (within one year) and in the future (one year or longer). Gather together all the supporting documentation for your liabilities, and check the terms of these liabilities. (The terms include balances outstanding, monthly payments, interest rates, number of payments remaining, and any prepayment penalties.)

Identify the debt that you have incurred to finance your lifestyle, and focus on reducing and eliminating this type of debt going forward. If your consumer debt balances are high, you will need to implement a debt management program. A properly structured debt management program helps you identify which debt you need to eliminate first, along with the necessary steps you need to take to make your monthly payments easier to handle. Your number one priority should be to retire the debt with the highest interest rate while still making all of your required monthly payments. If there are less expensive alternatives, such as swapping high-interest credit cards for low-interest credit cards, you should take advantage of these lower rates. I have seen many cases where clients have shopped around for lower-rate credit cards and then used this as a means of negotiating with their current credit-card companies for a more attractive rate. Never assume that the interest rate you are paying is the lowest rate available to you. Negotiate, negotiate, and then negotiate. It will make a difference in the long run. You should also consider consolidating your consumer debt—as long as you can lower your overall interest rate.

As part of the debt analysis, you will also need to evaluate your existing mortgage and apply the principles discussed above under mortgage refinancing. If you go through the breakeven analysis and come up with a favorable breakeven point, take advantage of the lower rate. You should carefully consider the pros and cons of using your home as collateral to refinance and consolidate unsecured consumer debt such as credit cards and car loans.

If you have financial difficulties, your unsecured consumer creditors are very unlikely to take your property for nonpayment. Very often, you can renegotiate these loans and perhaps obtain forgiveness of debt. If you have a very weak balance sheet where your liabilities exceed your assets, then debt forgiveness may be an option before bankruptcy.

Conversely, if you have a very strong balance sheet and your assets significantly exceed your liabilities, you may want to consider consolidating your high-interest consumer debt into your mortgage refinancing. Not only will you be able to significantly lower your interest rate, but the interest you pay on this mortgage may also be tax deductible for you. I would only recommend this to individuals who have already accumulated a comfortable financial net worth and believe their probability of defaulting on their loans does not exist.

Once again, you cannot move forward effectively and efficiently on the road to financial independence until you clean up the liabilities section of your Statement of Financial position—in other words, your debts. Minimizing your liabilities and reducing your costs of financing will allow you to accumulate more invested assets much more rapidly.

### TAX FACTS AND STRATEGIES[1] FOR MANAGING DEBT

Here are several tax strategies to help you keep debt under control, but even more, to aid you in amassing more wealth on your path to financial independence or *point X.*

- **You may generally deduct qualifying mortgage interest** on up to two residences. To qualify, the loan must have been used to buy, build, or substantially improve your principal residence or second home, and it must be secured by this home. The interest paid on this loan is fully deductible to the extent the total debt does not exceed $1,000,000 (or $500,000 if you are married and filing your tax returns separately from your spouse).
- **Interest you pay on home-equity debt is deductible** on debt that is secured by your first or second home where the amount of debt does not exceed the lesser of $100,000 ($50,000 if you are married and filing your tax returns separately from your spouse) or the net equity in your home.

[1]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

- **If you refinance your home loan** and it is partly home-acquisition debt and partly home-equity debt, the overall limit is $1.1 million of this debt. Any interest paid on loans in excess of this debt ceiling is generally not tax deductible and treated as personal interest. If you can show that this excess was used as a business or investment loan, it may then be deductible under a separate set of rules.
- **If you pay points to a bank as prepaid interest, they are deductible over the term of the loan** unless they are paid on the purchase or improvement of your principal residence, and in this case, they would be deductible in the year you pay them. You are not allowed a current deduction for points already paid on a refinanced mortgage.
- Evaluate the makeup of your debt and convert nondeductible interest on personal loans (such as credit-card balances) into fully deductible interest by paying off these debts by **using a home-equity line of credit or through consolidating your loans as part of a home mortgage refinance.** Take advantage of the current 50-year low in home mortgage interest rates and convert high-rate nondeductible interests into low-rate deductible interests.
- **Investment interest paid to buy or carry investments is deductible** up to the amount of net investment income. If you do not have investment income, you may not deduct investment interest paid. The investment interest paid in excess of net investment income may be carried forward and deducted in future years when you have net investment income. You may not deduct interest paid on loans used to buy or carry tax-exempt securities.
- **If you incur a nonbusiness bad debt, you can deduct it as a short-term capital loss.** For example, if you make a personal loan to a family member or friend and you expect to get repaid and you are not normally in the business of making loans, you may be able to take this as a loss on your income tax return. You will have to prove that this was a bona fide loan, and it should be put in writing along with its terms.
- **Normally if a debt is cancelled or forgiven, it must be included in your gross income** for tax purposes. If, however, you were insolvent immediately before the cancellation or it occurred as part of a Title 11 bankruptcy case, it would generally not be taxable to you. For those who cannot repay their mortgages, including when the home values are less than the amount due on the mortgage ("upside down"), banks can cancel the indebtedness. The American Taxpayers Relief Act of 2012 **extends** for one more year through 2013 the cancellation of up to $2,000,000 ($1,000,000 if filing married separately) of "qualified acquistion indebtedness" on a principal residence. This means that up to $2,000,000 of forgiven or otherwise discharged indebtness is not subject to income tax.

## An Action Plan for Managing Debt

1. **Become crystal clear about the difference** between *bad debt* (very often high credit-card debt) and *good debt* (such as home mortgage loans, student loans, and business loans).
2. **If you have a large balance on your credit card(s),** make every effort to pay it off as quickly as possible and to maintain a zero balance on your cards.
3. **If you have significant high-interest credit-card debt,** consider using cash from savings or investments to pay off the balance. Or consider other ways to get rid of high-interest credit-card debt, such as taking out a home-equity line of credit (which may also allow you to deduct the mortgage interest on your tax return), or borrowing from your life insurance, or 401(k). It is important to get rid of the debt, but be very careful if you borrow from other sources.
4. After you have paid off your cards, **do NOT run up the balance on your card again!**
5. **If you have no credit-card debt, check your credit reports and your credit scores carefully.** You may need to actually use your credit cards a bit more frequently—yet prudently—to ensure that your credit score is healthy.
6. **If you have an outstanding auto loan or lease,** check it carefully. Are the fees and costs you are currently paying in line with your budget? Could you scale back on automobile costs? If you are paying on more than one automobile, could you eliminate one or more family cars?
7. **If you have a student loan**, make every payment on time to maintain good credit. Check to see if you qualify to deduct interest from the loan from your taxes. (See Chapter 7, Paying for College, for detailed information.)
8. **Avoid taking out a business loan for a fledgling business** until you have researched your business idea thoroughly. Discuss new business plans in detail with your tax advisor or a financial planner.
9. **If you are considering buying a home,** calculate carefully how much you can realistically afford to pay for a house. Do not forget that you will need to pay 20 percent of the price as a down payment (plus closing costs) in cash. Consult a financial expert to help you make this decision.
10. **Credit reports:** Request a copy of your credit report from each of the three credit-reporting agencies at least once a year. (By law, you are entitled to one free copy from each agency each year.) Better yet, pay the minimal fees to check these reports two or three times a year.
11. **Credit score:** If your credit score is under 720, take steps to raise it.
12. **Identity theft:** Take steps to avoid identity theft. If you fear you are the victim of identity theft, report it immediately to the three credit-reporting agencies and the Social Security Fraud Administration.

CHAPTER 5

# Insuring Your Health and Life

*There's a need for accepting responsibility . . . for a person's life and making choices that are not just ones for immediate short-term comfort. You need to make an investment, and the investment is in health and education.*

—Buzz Aldrin, astronaut

Even a sound, carefully planned investment strategy can fall apart if you have not prepared properly for unforeseen problems concerning health and life. If you or a member of your family is hit with a prolonged illness, a severe injury, a disability, or death (especially of the primary wage earner), the planning and investing you have so carefully developed can quickly disintegrate.

Health insurance and life insurance help protect you and your family from the unexpected. The premiums you pay will provide you with the peace of mind that comes with knowing that your assets and family will be protected, if and when the unexpected happens.

Having the right kind of health and life insurance at the appropriate stages of life is as important as the insurance itself. The type and extent of insurance you need as you age will change throughout your lifetime. The family health and life risk management issues that are important to a young couple are normally dramatically different than for an older couple in their retirement years. For example, a young couple may need health insurance to

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cover prenatal care or life insurance to replace the income lost if one of the spouses should die before the children are grown. In contrast, an older retired couple may have little need for life insurance but may want to protect themselves against the high cost of long-term care, and therefore need to consider investing in long-term care insurance.

The major health and life risk management issues are:

- Health (or medical) insurance
- Disability insurance
- Long-term care insurance
- Life insurance

Each of these issues is discussed in this chapter. Your particular situation will determine what type of insurance you need, what kind of policy or policies will work best for you, and the amount of coverage you should carry.

## Choosing a Health Insurance Plan

Health insurance is imperative, no matter what your circumstance—young or old, single or married, childless or raising a family. Without proper health insurance, a serious illness or accident experienced by you or any member of your family can bankrupt you and rob you of all your savings. And given the high cost of health care these days, it can happen very fast. *Nevertheless, today more than 50 million Americans are not covered by health insurance, and that includes more than 10 million children.* And the numbers are rising. This is an appalling and frightening statistic.

I often meet people who tell me they do not have health insurance coverage. Very often these are younger people who do not think they need coverage, individuals who have not been able to maintain a long-term job, and very often self-employed individuals who are struggling to pay their bills. Usually, their reason is that they simply cannot afford to pay the high premiums. My response to this way of thinking is you cannot afford to be *without* insurance coverage, it is a necessity. All it takes is one major illness or accident, and you can be completely wiped out financially. A prolonged visit to the hospital for a week or two could easily cost you several hundred thousand dollars. Adding this type of unexpected debt to your finances can hold you back and may even prevent you from ever

becoming financially independent. If you truly are not able to pay for health insurance premiums, you will want to find out if you are eligible for Medicaid or some other government-sponsored health insurance program. If you cannot be covered under Medicaid, then you have no choice but to purchase some other form of health insurance, even if the policy covers only catastrophic illness or accident. In my opinion, health insurance is not a choice; it is a necessity that you simply cannot do without. Life is about choices, so eliminate some of your wants and replace them with this vital need.

When making the decision of which type of insurance is appropriate for you, you will need to do a fair amount of research and some important thinking about your personal health and financial situation and needs.

First, you need to understand the various types of policies available to you. Consider the following questions:

- Are you covered through some sort of group plan through your job or union? Or must you buy your own insurance?
- If you are covered by a group plan, is it sufficient for your needs? Can you afford to pay the deductible and copayments, and is there a maximum limit on the coverage?
- Does it cover any specific situation or condition you or a member of your family may have? Verify that the policy does not exclude certain medical conditions or treatments, especially if you have a family history with these types of situations.
- Are the doctors you use and trust available under the plan? Or is the plan flexible, allowing you to use out-of-network caregivers?
- What sort of ongoing health care needs do you anticipate, such as a future pregnancy or care for a chronic health problem, such as asthma, diabetes, arthritis, or high blood pressure?
- How much can you afford to pay in premiums? You can determine this after analyzing your statement of cash flow and eliminating some of your unnecessary wants, and replacing it with this basic need.
- How high a deductible can you afford? The higher your deductible, the lower your premium will be, so in general, if you can self-insure yourself up to the amount of the deductible, then this would be a wise choice. This works best if you are in overall good health and are less likely to need the insurance unless a major medical situation occurs.

#### *Traditional Health Insurance Plans*

For decades, most Americans got their health insurance through their employers, and this is still the case. These insurers are usually private companies (Cigna, Aetna, and United Healthcare are a few well-known companies), and corporations, unions, or other organizations were able to negotiate good rates for their employees and members because the organizations were bringing so much business to the insurance company. Usually with these plans, the employer pays a portion of the cost of the plan and the employee pays a portion, often in pretax dollars.

#### *Indemnity Plans (Fee-for-Service)*

*Indemnity* plans or *fee-for-service* plans were long the traditional form of health insurance plan—and many companies still offer this type of plan to their employees. With a fee-for-service plan, the service provider (the doctor) is separate from the insurer (the insurance company). With fee-for-service plans, the insurer either pays the service provider (the doctor) or you (the patient), directly, usually after you have already covered the full cost of the service. Typically, indemnity plans cover 80 percent of the health service, and you pay 20 percent.

#### *Managed-Care Health Plans*

For the past 20 years or so, because of the high costs of both medical care and insurance, many companies have chosen to opt for *managed-care plans*. With this type of plan, the subscriber (or user) contracts with and makes monthly payments directly to the organization that provides the health-care service. (In some cases, an insurance company is not involved; however, most major health insurance companies offer both indemnity plans as well as managed-care plans.)

With a managed-care plan, the insured pays no deductibles and what used to be a small fee, which is now an ever-increasing fee or co-payment for office visits and medications, and most basic medical services and preventive care services are fully covered. To keep costs down, managed-care insurers control (i.e., *manage*) the costs of the medical care. For example, they may restrict access to a specific list of doctors; require patients to get a referral from a primary care physician in order to see a specialist (such as a heart surgeon

or a dermatologist); and require that the specialist also accept the insurance company's fee schedule.

The four principal types of managed-care plans are HMOs, PPOs, EPOs, and POSs, described in the following paragraphs.

**HMOs (Health Maintenance Organizations)** An HMO is a collection of hospitals, physicians, and other health-care providers who have joined to provide health-care services to its members. There are two types of HMOs:

1. ***Group HMOs***, which provide a group of doctors who provide healthcare in a central facility (usually a hospital).
2. ***Individual practice associations (IPAs),*** the more popular type, where doctors practice from their own offices as well as from community hospitals that are affiliated with the IPA.

Basic HMOs tend to be the least expensive form of health insurance. Copayments, when they are required at all, are usually small, and preventive care services are almost always completely covered. In exchange, patients must see only approved doctors and need to get permission from a primary care physician before seeing a specialist or getting any care outside the HMO. (IPAs can be a bit more flexible.)

**PPOs (Preferred Provider Organizations)** A PPO is a plan that shares characteristics of both an IPA and a traditional fee-for-service plan. The insurance company or provider group contracts with physicians and hospitals that agree to accept a negotiated fee for services provided for the insured. In addition (unlike a conventional HMO), a PPO also provides coverage for services not provided by the PPO network, so you can go to other doctors and hospitals at your own discretion, although you will be required to pay a higher fee. Also, PPOs allow you to see other doctors and specialists without prior approval.

**EPOs (Exclusive Provider Organizations)** Like an HMO, the insurance company contracts with various medical providers to offer services to members of the EPO at reduced costs, but it reimburses EPO members only when providers associated with the insurance company are used.

**POS (Point-of Service) Plans** This is another form of flexible HMO plan where you are encouraged to use network providers, but are allowed

to choose others outside of the plan, usually at a higher co-payment or deductible. This is called a point-of-service plan because you decide (at the point-of-service) whether to use it more like an HMO (within the HMO network) or PPO (outside the HMO network).

#### *Blue Cross/Blue Shield Plans*

If you are on a really tight budget, you might consider purchasing a Blue Cross/Blue Shield plan, which is a prepaid hospital and medical expense plan that covers you for major medical and hospital expenses if you become seriously ill or injured. Sometimes called *catastrophic health insurance*, with a Blue Cross plan, you are taking the chance that you will stay reasonably healthy and be able to pay for your basic preventive health services out of pocket. At the same time, however, you are protecting yourself from financial ruin if you should need substantial care or hospitalization. Premiums are lower on this type of coverage because you pay out-of-pocket for your common medical expenses, such as checkups and minor emergencies, and you will be charged a relatively high deductible, if you require hospitalization. Look for a policy that is guaranteed renewable, has a maximum lifetime benefit of at least $1 million, and covers at least 80 percent of your doctor and hospital bills after you meet the high deductible.

More than 35 independent Blue Cross/Blue Shield organizations are in operation around the United States, usually on a local or state level (such as Empire State Blue Cross). Although not technically insurance companies, they are for-profit corporations.

#### *Medicare*

Medicare (also sometimes called *Original Medicare*) is the United States government's health insurance program. Administered under the Social Security Administration, it is funded from Social Security taxes. It primarily provides medical insurance to citizens over age 65; it also covers Americans younger than age 65 who are collecting Social Security disability benefits and people of any age with end-stage renal disease (ESRD) or permanent kidney failure requiring dialysis or a kidney transplant.

You are automatically eligible for Medicare when you turn 65, although you must apply a month or two before your 65th birthday; if you apply later, your coverage can be delayed. If you have applied, coverage begins on the first day of the month in which

you turn 65. For more information, visit www.medicare.gov or call 1-800-MEDICARE (1800-633-4227).

Medicare covers three basic health care components: hospital insurance, supplementary medical care, and prescriptions, as well as an option plan run by private insurance companies. Medicare provides very limited coverage for only certain kinds of long-term care needs (discussed further in this chapter under the section on long-term care).

**Medicare Part A** This covers inpatient hospital services for up to 90 days. It also covers up to 100 days in post-hospital (rehab centers or nursing home) care in formal extended-care facilities. It is free to anyone who has paid Medicare taxes for more than a decade (or is married to someone who has).

**Medicare Part B** Medicare Part B (also known as SMI or supplementary medical insurance) covers doctors' services, outpatient care, laboratory tests, prosthetic devices, ambulance expenses, and other basic medical services—in other words, most things not covered under Medicare Part A (except prescription drugs). However, unlike Part A, which is free, Part B charges a monthly premium (which is deducted from your Social Security check) of slightly less than $100. There is also a small deductible along with a 20 percent co-pay on most services. This is why many people buy a Medicare supplemental insurance policy as well.

When you sign up for Medicare Part A, you will be asked if you want to be covered under Medicare Part B. You need not sign up for Part B if you are covered through insurance through your workplace or your spouse's current job; however, unless you or your spouse is actively employed and insured, you need Part B. If you fail to sign up right away (either when you turn 65, or when you stop working and are no longer covered by a private health insurance company) you will be charged a 10 percent premium for every year you could have signed up but did not.

**Medicare Part C** Medicare Part C (also known as *Medicare Advantage*) offers health plan options run by Medicare-approved private insurance companies, including HMOs and PPOs. These plans allow recipients to receive Medicare benefits and services covered under Part A and Part B, and most cover Part D (prescription drugs), and some even offer additional benefits, but for an additional cost.

**Medicare Part D** Medicare Part D (prescription drug coverage) covers the costs of both brand-name and generic prescription drugs at participating pharmacies. All Medicare recipients are eligible for this coverage; like Part B and C, it is a voluntary program; it also incurs a monthly fee and an annual deductible of about $300.

**Medigap** Medigap (also called *Medicare Supplement Insurance*) is a private health insurance policy designed to fill in the gaps that exist in fundamental Medicare coverage, including copayments, coinsurance, and deductibles. If you have Medicare as well as a Medigap policy, Medicare will pay its share of the Medicare-approved amounts, and then the Medigap policy pays its share. (A Medigap policy is different from a Medicare Advantage Plan because Advantage Plans are ways to get Medicare benefits, whereas a Medigap policy only supplements basic Medicare benefits. You cannot carry both a Medigap policy and a Medicare Advantage Plan.)

There are many different types of Medigap policies that are regulated under various federal and state laws, and vary in quality and cost. For additional information you should visit www.medicare.gov/medigap or call 1-800-Medicare (1-800-633-4227).

#### *Medicaid*

Medicaid is a combined federal and state program that helps with the medical costs of nearly sixty million Americans in qualified categories with limited income (generally between 100 and 133 percent of the federal poverty level with some states at higher levels depending on the eligible category). In 2012 for a family of four, the 100 percent federal poverty line was $23,050.) In more general terms, in order to be eligible for Medicaid, you must be financially needy, over age 65 or under age 21, blind, disabled, or receiving certain welfare benefits.

Starting in 2014, those eligible for medicaid coverage will include "all" those under 65 whose income is 133 percent or less than the federal poverty line. This will represent a significant increase to the number of people covered on Medicaid, which will put a tremendous strain on the system that is already on the brink of insolvency. Medicaid covers doctor visits, emergency care, hospital care, vaccinations, prescription drugs, vision, hearing, long-term care, and preventive care. Medicaid is administered on a state level; all states offer these services, and many states also provide additional services. For more information, visit www.healthcare.gov.

#### *Children's Health Insurance Program (CHIP)*

CHIP provides low-cost health insurance coverage for children (up to age 19) in families who earn too much to qualify for Medicaid, but can't afford private health insurance. Every state covers routine check-ups, immunizations, hospital care, dental care, and lab and x-ray services for children. Children receive free preventive care, but low fees may be required for certain services. Each state sets its own rules for CHIP; to find out more, visit www.medicaid.gov.

#### *COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985)*

COBRA requires employers with 20 or more employees to give you the opportunity to continue your health insurance under the company's insured group for up to 18 months, at your *own* expense. You are eligible for COBRA under any of the following scenarios:

- whether you leave your job voluntarily (or begin working part-time) or involuntarily.
- if your spouse, who was the primary insured member of your family, dies.
- if you are getting divorced from a spouse who is the primary insured member.

The employee retains all benefits (except for disability income coverage), and pays the employer premiums, up to 102 percent of the company's cost. COBRA coverage can be extended for up to 36 months under certain extenuating circumstances, such as the divorce or death of the employee. If you become eligible for Medicare, but your spouse isn't yet eligible for Medicare, your spouse can extend his or her COBRA coverage for up to 36 months or until he or she becomes eligible for Medicare—whichever comes first.

#### *Workers' Compensation Insurance*

Workers' compensation insurance is designed to compensate workers who are injured on the job or become ill through work-related causes and are therefore unable to draw a salary. Each state regulates its own workers' compensation insurance program, and details vary from state to state; however, normal benefits include medical and rehab expenses, disability income, and lump-sum payments for death and certain severe injuries.

### *The Patient Protection and Affordable Care Act*

On March 23, 2010, President Barack Obama signed the Patient Protection and Affordable Care Act of 2010, the central piece of legislation that overhauled the American healthcare system. A week later, on March 30, 2010, the President also signed the Healthcare and Education Reconciliation Act of 2010, a shorter piece of legislation that amended several provisions in the initial Patient Protection Act. Taken together, these two pieces of legislation provided for massive healthcare reform and include an estimated $437 billion in new taxes and fees. The expanded healthcare coverage provided by the legislation is expected to reduce the number of uninsured Americans from over 50.7 million to about 32 million. The legislation also included several extra pieces that are only imaginatively related to healthcare. In July 2012, the Supreme Court generally upheld the constitutionality of the controversial 2010 healthcare law.

Here are some of the provisions (which include a large number of non-health-related issues) in the health care reform laws that have already gone into effect:

- **Insurance for older children.** Children can remain on their parents' health insurance policies through age 26.
- **Insurance for pre-existing conditions.** Insurance companies cannot deny coverage to children with pre-existing conditions.
- **Adoption credits.** The credit for adoption expenses is increased to $12,970 for 2013 and is not refundable. This credit is adjusted annually for inflation and has been permanently extended.
- **Small business tax credits for providing healthcare.** Small businesses (as well as tax-exempt organizations) with up to 25 employees may qualify for a tax credit for the cost of purchasing health insurance for their employees. In general, eligibility for the credit is based partially on the number of full-time employees and on the average annual wages per employee. To qualify for the credit, the employer must pay at least 50 percent of the cost of health coverage at the single rate. For 2010 to 2013, the maximum credit was 35 percent of premiums paid by businesses and 25 percent of premiums paid by tax-exempt organizations. For 2014, the maximum credit

increases to 50 percent of premiums paid by businesses and 35 percent of premiums paid by tax-exempt organizations. The maximum credit goes to those employers who employ 10 or fewer employees and who pay annual average wages of no more than $25,000. The credit gradually phases out for firms with average wages between $25,000 and $50,000, and between 10 and 25 full-time equivalent workers. Because the calculation involves full-time or full-time equivalent employees, not the actual number of employees, an employer with more than 25 workers could qualify for the credit, if some or all of the workers are part-time.

- **Medicare drug coverage**. For those with Medicare drug coverage in the so-called donut hole, the law provides a 50 percent discount on brand-name drugs. Additional discounts are phased in over the coming years, and the donut hole will be eliminated by 2020.
- **Health insurance reporting requirement.** Starting in 2012, most employers must report the value of each employee's health insurance coverage on the employee's annual Form W-2.
- **Medical savings accounts.** Unless prescribed by a medical professional, over-the-counter medications can no longer be paid for with funds in a health savings account (HSA), flexible spending account (FSA), and health reimbursement account (HRA).
- The additional tax on nonqualified distributions from HSAs increases from 10 percent to 20 percent. For nonqualified distributions from an Archer medical savings account (MSA), the additional tax increases from 15 percent to 20 percent.
- **Drug industry fee.** An annual fee is assessed on drug manufacturers, starting at $2.5 billion in 2011 and increasing over the following years. Additional changes will go into effect over the next six years, including these:
  - **FSA limits.** In 2013, the amount that can be contributed to a Health Flexible Spending Account (FSA) will be limited to $2,500 per year, indexed annually for inflation starting in 2014. **Medical expense deduction.** In 2013, the 7.5 percent income threshold for deducting unreimbursed medical expenses will increase to 10 percent for those under **age 65. Those 65 and older** may continue to take an itemized deduction for medical expenses exceeding 7.5 percent of adjusted gross income through the year 2016.

- **Executive pay limit.** Starting in 2013, the compensation deduction for certain health insurance companies will be limited to $500,000 per year for high-level executives.
- **Medicare tax increases.** In 2013, the payroll Medicare tax will increase from 1.45 percent of wages to 2.35 percent on amounts above $250,000 earned by married couples filing joint returns, $125,000 for married taxpayers filing separately and $200,000 for other types of individual taxpayers. The income threshold levels will not be indexed for inflation. A 3.8 percent Medicare tax will be imposed on unearned income (interest, dividends, royalties, rental income, etc.) for single taxpayers with income over $200,000 and married couples with income of $250,000.
- **Medical device tax.** In 2013, a 2.3 percent excise tax will be imposed on the sale of certain medical devices.

#### *The Healthcare Mandate and Other Issues*

Starting in 2014, the so-called *mandate*—the heart of the healthcare act—will go into effect. This mandate requires that all Americans carry some form of healthcare insurance. Individuals who are not covered by Medicare, Medicaid, or other government health insurance will be required to maintain health insurance coverage or pay a penalty. Penalties will be calculated using a percentage of the taxpayer's income or a flat dollar amount. Subsidies and tax credits will be available to help lower income tax payer's pay for coverage. In addition, other factors will slowly go into effect, including these:

- **Health insurance exchanges.** Health insurance exchanges will be established by state to enable people to comparison shop for coverage.
- **Required coverage by large employers.** Large employers and big businesses (with more than 50 employees) must provide coverage for employees or face penalties.
- **Tax credits for small businesses.** Tax credits will increase from 35 percent to a maximum of 50 percent of premiums paid by qualifying small businesses that provide coverage for their workers. The credit available to nonprofit employees will increase from 25 percent to 35 percent.
- **Health industry fee.** An annual fee will be assessed on the health insurance industry, starting at $8 billion in 2014 and increasing over the following years.

- **Tax on "Cadillac plans."** In 2018, insurance companies will be assessed a 40 percent excise tax on health insurance plans with annual premiums exceeding $10,200 for individual coverage and $27,200 for family coverage. An increase in the threshold amount is allowed for retired persons who are age 55 or older (an additional $1,650 for single coverage and $3,450 for family coverage). These increased thresholds also apply for plans that cover those engaged in high-risk occupations.

#### *Health Savings Accounts*

Created in 2003, **Health Savings Accounts** (HSAs) are tax-free savings accounts—funded by employees, employers, or both—to spend on routine medical costs. Usually, HSAs are for individuals who are covered by high-deductible health plans but have no other health coverage.

A variation on an HSA is a Health Reimbursement Account (HRA), which is an account where the employer pays contributions to the tax-free accounts that employees can use to pay for medical expenses. Like the HSA, it is usually combined with a high-deductible health insurance policy. If your employer provides such a plan and you qualify, I would highly encourage you to take advantage of this pre-tax benefit that is being provided.

### Long-Term Care Insurance

If you or someone you are responsible for develops a prolonged physical illness, a disability, or a cognitive impairment, it's likely there will be a need for some form of long-term care. Many different care providers help people with chronic conditions overcome limitations that are keeping them from being independent. Long-term care is similar to traditional medical care, except that it relates to prolonged medical care treatment. Long-term care assists individuals by providing them with the best quality of life possible under the circumstances. It typically does not improve or correct medical conditions, but helps with the care. Long-term care services may include assistance with:

- Activities of daily living
- Home healthcare
- Respite care
- Hospice care

- Adult day care
- Care in a nursing home
- Care in an assisted-living facility

It is extremely important to note that these types of medical care are *not* covered under health insurance policies.

#### *Don't Be a Victim of Long-Term Care Costs*

Richard and Nicholas were two clients I had known for more than 20 years. They were twin brothers who lived next door to each other in a modest neighborhood in Brooklyn, New York. Although they were twins, their personalities were polar opposites. Richard was a hard-working, conservative guy who always *paid himself first*, paid his bills on time, and of course, had an excellent credit score. By the time he retired, he had managed to accumulate $1.5 million in investible assets and was able to retire at age 65 without changing the lifestyle he and his wife were accustomed to. They had two grown children, three grandchildren, and were settling in to a comfortable retirement life.

In contrast, Richard's twin brother Nicholas always had difficulty maintaining a job. He lived his life in the proverbial fast lane, regardless of the consequences. He never saved any money; worse, he continuously accumulated debt throughout his life. By the time he turned 65, he owed more in liabilities than he had in assets; in other words, he was broke. He had no choice but to continue working until his age and physical condition made it impossible.

Eventually, Nicholas was no longer able to care for himself; fortunately, Richard and his wife happily found him the care he needed in a nursing home on Staten Island. Because Nicholas was living off only a small Social Security retirement check, he was able to qualify for Medicaid. He received care in this nursing home, and it did not cost him or his family a dime. The nursing home took over Nicholas's monthly Social Security check, and Medicaid took care of the rest.

Six months after Nicholas entered the nursing home, Richard suffered a major stroke. Although he survived the initial stroke, he was unable to walk, feed himself, or dress himself without the help of his wife. His condition got worse, and it became impossible for his wife to continue caring for him on her own. As difficult as

the decision was, his wife and children decided that Richard would need the help only a nursing home could provide.

Richard's family was able to get him into the same excellent nursing home as his brother Nicholas; in fact, they became roommates, and in a funny twist of fate, ended up living out the rest of their lives together. However, their respective financial fates could not have been more different.

As mentioned, because Nicholas had no assets, Medicaid paid for his nursing home care. However, Richard, who had always lived responsibly and was able to accumulate assets to secure his family's future and peace of mind, was therefore ineligible for Medicaid. As a result, his family needed to pay for the nursing home costs out-of-pocket, and the bill came to more than $110,000 per year. They thought they had no choice but to pay because there was no other way to care for Richard. He lived for another 11 years, which almost completely wiped out the assets that he had worked so hard to accumulate.

Unfortunately, sometimes the Medicaid system rewards bad behavior and penalizes good behavior, and this is a classic example. Although Richard received the same care as his brother and lived in the nursing home for almost 12 years, this experience used up his entire life savings. His wife and children were denied the fruits of his labor and the benefits of the sacrifices he made for them throughout his life. Meanwhile Nicholas, who also lived at the same nursing home and received exactly the same care, did not have to pay a dime. This, in my opinion, is a very sad ending to what should have been a financial success story.

Perhaps one of the most important things to plan for once you become financially independent is how to protect the assets you have accumulated. Clearly, if you do not protect your financial independence once you have achieved it, it is almost as irresponsible as never taking the steps to achieve it in the first place. This is where meeting with a financial planner and elder care attorney is critical.

Richard could have taken the necessary steps early on to protect his family and the assets they were able to accumulate throughout their lifetime. This is one family health risk you cannot afford to take. *You must take preventive action to ensure that your life long hard work and assets are protected in case a catastrophic long-term illness occurs.* There are numerous strategies you can employ to protect your assets; however, *obtaining an adequate long-term care insurance policy* is probably the easiest way you can accomplish this.

There are numerous other planning options available that fall under the umbrella of Medicaid planning, which include Medicaid trusts, retaining a life estate, and outright property transfers. The rules and regulations in this area are quite complex and differ from state to state. This subject is beyond the scope of this book, but it does require serious attention. Therefore, my advice to every family is to seek out the proper help and guidance from a qualified Medicaid planning attorney. This planning must take place years in advance of developing the need for long-term care. If you or a family member require long-term care and have not already implemented a plan, you should immediately meet with a Medicaid planning attorney to minimize the loss of your hard-earned money.

#### *The Cost of Long-Term Care*

The cost of long-term care is extremely expensive. The cost depends on the amount and type of care that you will need and where and how you get it. For example, of the 50 states, New York State has one of the highest costs for obtaining care in a long-term care facility. According to a recent survey conducted in 2012 by Genworth Financial, the average cost of care for a private room in a New York nursing home is $123,005 per year, and the average cost to hire a home health aide is $50,336 per year. These costs not only vary state by state, but also county by county within each state. To find out the cost of the various options of long-term care treatments in your state, visit Genworth's website at www.genworth.com/content/home.html. Use this website to obtain a general guide of what your long-term care cost might be.

For most people, the cost of long-term care will wipe out their life savings within just a few short years. Being prepared for this type of family health management risk is critical to maintain your financial independence as well as that of your family's.

People pay for long-term care in a variety of ways. These include: using the personal resources of individuals or their families, obtaining long-term care insurance, and receiving some assistance from Medicaid for those who qualify.

As described earlier in this chapter, Medicaid is the government-funded program that pays nursing home care only for individuals who have low income and little or no assets. To get Medicaid help, you must meet federal and state guidelines for income and assets. Many people start paying for nursing home care out of

their own funds and "spend down" their assets until they are eligible for Medicaid. Medicaid may then pay part or all of their nursing home costs. You may have to use up most of your assets on your healthcare before Medicaid will help. Basically, you need to be broke, because this is a form of public assistance.

State laws differ about how much money and assets you can keep and be eligible for Medicaid. (Some assets, such as your home, may not count when deciding if you are eligible for Medicaid.) However, federal law requires your state to recover from your estate the cost of the Medicaid-paid benefits you receive. Contact your state Medicaid office or state department of social services to learn more about the rules in your state.

This is only the most general information. There are many other rules about what you can and cannot keep, but the bottom line is that if you are unmarried, you must give up almost everything you have worked so hard to accumulate in order to qualify for Medicaid coverage in a nursing home. Unmarried and married persons should get legal advice as to the available options regarding protecting your assets. This is a very hot topic, and the law is in a constant state of flux.

Rules for married people vary from state to state. For example, in community-property states, all of your income from any source (no matter which spouse the checks are made out to) is considered to be divided equally between both of you. In any other state, only checks that are made out to you count toward your Medicaid eligibility.

As is true for single people in most states, if the cost of a nursing home is higher than your income, you will qualify for the Medicaid nursing home funds. An elder-care attorney can help you figure this out. Your elder-care specialist can help you estimate the amount that your stay-at-home spouse would be able to keep—or even have the amount increased according to his or her needs—because it will be completely different in each state, as are the formulas that determine it.

After qualifying on the income test, you also need to pass an asset eligibility test. Your home, car, and personal property are generally protected for your healthy spouse. Married couples can also keep some money in investments or cash. You can obviously see that you will have to give up most of your assets to qualify. Studies of individuals entering nursing homes have documented that half of the people in the study on Medicaid were not poor

when they entered the facility. They had to "spend down" their assets until nothing was left before Medicaid took over.

While your spouse is living in the house, the state will not try to take it. Once your spouse dies, however, and the estate is left to your beneficiaries, the state could try to make a claim against the home by placing a Medicaid lien against it.

#### *Paying for Long-Term Care with Insurance*

Long-term care insurance is one other way you may pay for long-term care. This type of insurance will pay for some or all of your long-term care.

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) is a federal law that gives some federal income tax advantages to people who buy certain long-term care insurance policies. These policies are called *tax-qualified long-term care insurance contracts,* or simply *qualified contracts.* Numerous states also provide for special tax breaks for premiums paid for long-term care. These include tax deductions and tax credits which would help you pay part of the cost of your premiums. If you are paying premiums for long-term care insurance, be sure to let your tax preparer know, and ask your tax preparer to find out what special tax deduction or credits may be available in your state.

For 2013, qualified long term care insurance contract premiums can be deducted as medical expenses with limitations based on age (up to age 40 $360, 41 to 50 $680, 51 to 60 $1,360, 61 to 70 $3,640 and over 70 $4,550).

#### *Should You Buy Long-Term Care Insurance?*

Whether you should buy a long-term care insurance policy will depend on your age, health status, overall retirement goals, income, and assets. For example, if your only source of income is a Social Security benefit or Supplemental Security Income (SSI) and you have a minimal net worth, you probably should not buy long-term care insurance, because you may not be able to afford the premium and you may qualify for Medicaid.

Conversely, if you have a large amount of assets but do not want to use them to pay for long-term care, you may want to buy a long-term care insurance policy. Many people buy a policy because they want to stay independent of government aid or the help of family. They do not want to burden anyone with having to

care for them. However, you should not buy a policy if you cannot afford the premium or are not sure you can pay the premium for the rest of your life.

Consider buying long-term care insurance if:

- You have significant assets and income,
- You want to protect some of your assets and income,
- You can pay premiums, including possible premium increases, without financial difficulty,
- You want to stay independent of the support of others, and
- You want to have the flexibility of choosing care in the setting you prefer or one in which you will be most comfortable.

Private insurance companies sell long-term care insurance policies. You can buy an individual policy from an agent or through the mail. Or you can buy coverage under a group policy through an employer or through membership in an association. The federal government and several state governments offer long-term care insurance coverage to their employees, retirees, and their families. This program is voluntary, and premiums are paid by participants. You can also add a long-term care benefit rider through certain life insurance policies.

The following paragraphs describe some of the specific terms used in a long-term care policy that will determine your eligibility under the plan. When comparing policies, be sure to compare how each of the policies defines these terms.

**Activities of Daily Living** The inability to cope with activities of daily living (ADLs) is the most common way insurance companies decide that you are eligible for benefits. The ADLs most companies use are: *bathing, continence, dressing, eating, toileting, and transferring.* Typically, a policy pays benefits when you cannot do a certain number of the ADLs, such as two of the six or three of the six.

**Elimination Period** With many policies, your benefits will not start the first day you go to a nursing home or start using home care. Most policies have an *elimination period* (sometimes called a *deductible* or a *waiting period*). That means benefits can start 0, 20, 30, 60, 90, or 100 days after you start using long-term care or become disabled. How many days you have to wait for benefits to start will depend on the elimination period you pick when you buy your policy. You might be

able to choose a policy with a zero-day elimination period but expect it to cost significantly more.

**Inflation Protection** Protecting against inflation can be one of the most important additions you can make to a long-term care insurance policy, although it will increase the premium you pay. If your benefits do not increase over time, years from now, you may find that they have not kept up with the rising cost of long-term care. The younger you are when you buy a policy, the more important it is for you to think about adding inflation protection; otherwise, you will be only partially covered when the need arises.

**Underwriting** Companies that sell long-term care insurance medically *underwrite* their coverage. They look at your health and family history before they decide to issue a policy. You may be able to buy coverage through an employer or another type of group without any health underwriting or with more relaxed underwriting.

**Guaranteed Renewable Insurance** In most states, long-term care insurance policies sold today must be *guaranteed renewable*, which means that the insurance company guarantees you a chance to renew the policy. However, it does *not* mean that it guarantees you a chance to renew at the same premium; your premium may increase over time. You should consult with an insurance agent or broker who specializes in long-term care insurance and would be able to secure a policy that will meet your specific needs.

Do not let your long-term care needs wipe out your family's financial independence!

## Disability Insurance

If you became disabled and couldn't work, would you have enough savings to cover your living expenses until you were able to get back to work? For most people, the answer to this question is unfortunately no, which means that they would not be adequately prepared.

A *disability* is generally defined as a limitation of your physical or mental ability to work resulting from sickness or injury. It may be *partial*, in which case you are unable to perform certain job tasks and functions, or *total*, in which case you are unable to work at all.

According to the Council for Disability Awareness, 3 in 10 people entering the workforce today will become disabled before retiring, and 1 in 7 people can expect to be disabled for five years or more before retirement. These are startling statistics and make it very clear that short- and long-term disability is a necessity, especially if you are the primary wage earner in your family and your income is needed to cover your living expenses.

Most employers are required by law to provide some form of workers' compensation and short-term disability coverage for their employees. However, it is important to understand that very few employers provide *long-term* disability coverage, and this responsibility rests on your shoulders. The extent of coverage under these employer provided short-term disability plans are very limited and short in duration. Workers' compensation protects you if you are injured while performing your job at work. Short-term disability insurance replaces part of your income while you are injured or ill for any reason for a short period of time.

Depending on the state you live in and the policy that you are covered under through your employer, your benefits may be insufficient to allow you to continue meeting your basic living expenses. The requirements of an employer to provide short-term disability will vary based on your state of employment, because it is not required in all states.

New York State is one of the states that actually requires employers to carry short-term disability coverage for workers who are injured off the job or who suffer a serious illness. Using New York State as an example, the short-term disability benefits pay only $170 per week or up to 50 percent of the employee's salary, whichever amount is smaller. Payments will continue while you are disabled, but they end after 26 weeks. If you cannot afford to live on this amount per week for six months, then you need to be prepared.

#### *Social Security Disability Benefits*

The disability qualification under Social Security is different from the general definition, as well as how most insurance companies define it. Social Security pays only for *total disability*. No benefits are payable for partial disability or for short-term disability.

*Disability* under Social Security is based on your inability to work. They consider you disabled under Social Security rules only if:

- You cannot do work that you were able to do before;
- Social Security Administration decides that you cannot adjust to other types of work because of your medical condition; and
- Your disability has lasted or is expected to last for at least one year or to result in death.

SSA uses a much stricter definition in determining your eligibility for benefits. Under its program, the rules assume that working families have access to other resources to provide support during periods of short-term disabilities, including cash reserves from savings, workers' compensation, and short-term disability insurance.

To be eligible for Social Security disability benefits, you need to pass two tests. The first test is a "recent work" test based on the age when you become disabled. If you are under 24 at that time, you need to have worked 1.5 years out of the 3 years ending with the calendar quarter you are disabled. If you are over 30, you need to have worked at least five out of the 10 years ending with the quarter you are disabled. The second test is a "duration of work test" based on the age of becoming disabled. For example, if you became disabled before age 28, you must have worked at least 1.5 years (6 credits of employment), and if you were disabled at age 60, you need to have worked 9.5 years (38 credits for employment). For each year, four service credits can be earned from wages or self-employment. In 2013, you earn one credit for each $1,160 of wages or self-employment income. When you have earned $4,640, you have earned your four credits for the year.

It is entirely possible to be deemed disabled by a commercial insurance company and not by the Social Security Administration, because insurance companies set their own eligibility requirements. To receive benefits, the SSA requires that you be disabled from doing almost any sort of work, whereas commercial companies may require only that you be disabled from doing your own particular type of work or profession.

The Social Security Administration's benefits—for retirement, disability, survivors, or dependents—were initially intended to be a safety net that could be used to replace *some* of your lost income. You cannot rely on Social Security disability alone, and this is why it

is so important that you obtain a long-term disability policy through an insurance company.

#### *Long-Term Disability Insurance*

If you become seriously ill or injured, long-term disability insurance would substitute a portion of your salary after a certain period of time. Being able to replace the salary you were making before you became disabled and unable to work would be a necessity most people could not do without. If you don't have the proper insurance coverage, a long-term disability could potentially wipe you out financially and prevent you from ever becoming financially independent. You need to consider whether you and your family could survive comfortably without your salary. If the answer is no, then you must seek out the proper coverage immediately. This is one family health risk management issue you should not do without. This is clearly a need and not a want.

Ideally, you want to secure coverage that would pay you the typical maximum benefit of 66 percent of your income after an accident that leaves you unable to work at your current job. It should cover you in case of an illness or an accident.

You should have a policy that would cover you for what is known as *owner's occupation*, not *any occupation*. This is the option that clearly separates what is available on the market through insurance companies from what the Social Security Administration provides. If you become disabled and can no longer perform your current occupation, regardless of what other kinds of work you might be able to do, the insurance company will pay you this disability benefit. A policy that covers *any occupation* would pay you only if you could not perform any job at all.

Long-term disability insurance should be *guaranteed, non-cancelable,* and *renewable*. If it is not, your insurance company can cancel your policy. By including these options, the only reason your policy can be cancelled is if you stop paying your premiums. With these options, your insurance company cannot increase your premium or change any of your policy's provisions, even if there is a change in your health that may increase your probability of becoming disabled.

Your policy should have *residual benefits*, which means it will guarantee a certain percentage of your former job's income in comparison to your new job's income. It should also include Cost-of-living Adjustments (COLAs), via a rider that can be included

in your policy typically for an extra cost. This rider allows you to increase your coverage periodically so that you can factor in inflation to future benefits without having an additional physical.

The elimination period, which is the amount of time after your injury or the onset of your illness when you receive no benefits, varies from policy to policy. Ideally, a 60-day elimination period is preferable, but you can select a policy with a 90-day elimination period to reduce the cost of your premiums. I would recommend the 90-day period only if you can afford to live without a paycheck for 90 days. (This is also why I recommended in Chapter 1 that you have three to six months' worth of liquid cash available in case of an emergency. In essence, you are self-insuring against the possibility of a short-term disability by maintaining this cash reserve. If you do not have this emergency cash available, make sure you are working toward establishing an emergency fund for yourself and your family.)

## Life Insurance

Life insurance was originally designed to protect people while they were relatively young, in case the family wage earner died prematurely. Later on in life, once the children had grown and the couple's retirement nest egg had already been established, there was no longer a need for life insurance, and the policy would be cancelled. I believe that, for many people, this is actually the way their life insurance should be handled today. It is my opinion that most people should not be using life insurance as a savings strategy. If you're single and have no dependents, there is usually no need for you to have life insurance.

There are four basic questions to ask yourself when determining your life insurance needs:

1. Do I really need it?
2. What dollar amount do I need?
3. How many years will I need it?
4. What type of life insurance policy would best meet my needs?

Examine your statement of cash flow (described in Chapter 3). Now imagine what your family's statement of cash flow would look like, in the event that one or both wage earners were no longer alive and that income was no longer available. Could the remaining

family income cover the financial obligations and dreams you have set for the future, such as paying for your children's education? If your survivors would have enough money to maintain their standard of living, then you do not need life insurance. On the other hand, if there is a shortfall, you will need to make this up by securing the proper type and amount of life insurance.

Quite frankly, life insurance should really be called *income-replacement insurance.* After all, the policy cannot bring you back to life; it can only serve as a means to replace the income you would have earned if you had lived. As a general rule, many life insurance advisors recommend having at least 10 times your annual salary as a death benefit, to allow your family the ability to generate income with these funds that will partially replace the lost earnings when you are no longer around. How much life insurance you really need will depend on several factors, including these:

- What your current income is.
- What percentage of this income your family will need when you are gone.
- How many years your family will need this income to continue.
- What inflation rate you expect during this time period.
- What rate of return you expect your family will earn on the death benefit over this time period.
- What lump-sum payments your family will need to make when you die.

To help you determine what may be the right amount of life insurance for you and your family, consider the following example: Let us assume you currently earn $100,000 per year before taxes and that your family would need $75,000 per year to maintain their current standard of living after your death. Let us also assume that you would need this income stream for 15 years, because at that point, your home mortgage would be paid off and your children would be out of college and independent from your spouse. Let us also assume your family can expect to earn a 5 percent rate of return on this money. We will also assume you have sufficient assets set aside to cover your funeral costs, and to keep the example simple, we will not factor in any inflation. To factor in all of these other variables, I encourage you to use a financial calculator, such as the one I describe on the following page.

This hypothetical situation can be analyzed by also saying how much money you will need at a particular point of time in order to ensure a $75,000-per-year income stream over a 15-year period while these funds are earning a 5 percent rate of return. This is a present-value-annuity factor, and you can use Exhibit 11.5 in Chapter 11 to assist you with this calculation. By completing the worksheet on Exhibit 11.5, you will be provided the answer to this question.

In step 1, enter 5 percent and in step 2, enter 15 years. Then look up the proper present-value-annuity factor by looking at row 15 years and column 5 percent for a factor of 10.37966. In step 4 of this exhibit, insert $75,000 in annual cash receipts your family would need to receive. Then, multiply the $75,000 by the present-value-annuity factor of 10.37966.

Therefore, you would need approximately $778,475. I recommend rounding this off to $800,000, as this is really a rough estimate of your life insurance needs to replace the lost income from your unexpected death.

Please understand there are numerous ways to estimate the amount of life insurance your family would need and numerous other factors that may need to be taken into consideration. A financial calculator can assist you with this calculation because it can take numerous other factors into consideration. For example, you can use the financial calculator found at http://finance.yahoo.com/calculator/index/. Go to the Insurance section, and click on "How much life insurance do I need?" This online calculator will provide you with a reasonable estimate of the proper amount of life insurance to meet your needs. Securing the proper amount of life insurance will provide you and your family with a tremendous amount of security, and if you choose term insurance (described next), I think you will be surprised how affordable a large policy can be.

#### *Term Life Insurance*

*Term life insurance* is far less expensive than permanent life insurance. I strongly believe that term is the best type of life insurance for the vast majority of people, and it literally costs a fraction of the price when compared to permanent insurance. Term life insurance is an efficient way to protect your family, which will give you the highest coverage at the most affordable price.

One of your goals should be to make sure that by the time you are retired, you will have enough income from your retirement plans to support yourself—and your loved ones, after you are gone. Once you have enough to live on, there may be no need for life insurance. With that said, you should never cancel or attempt to change a policy without checking with your doctor and having a thorough physical, as you may want to keep insurance you otherwise would not have needed for medical reasons. By the time you are ready to retire and are financially independent, your need for life insurance and your need to pay the premiums may be gone.

Term life insurance protects you for a certain number of years (typically 1 to 20), and once the *term* of the policy is over, you can usually renew the policy and begin another term without providing evidence of your insurability, though often at a higher cost. If you die during the term of the policy, the insurance company pays out the death benefit to your beneficiaries. The older you get, the more expensive term insurance becomes, because it is more likely that the company will have to pay out the death benefit. By the time you are in your seventies, the premiums in term life insurance will be very high, but if you have planned properly, you should no longer need it. Depending on your particular situation and individual needs, you may want to select a level term policy, annual guaranteed-renewable term, decreasing term insurance, or increasing term life insurance.

With a *level term policy*, your premiums would stay the same for the term you have chosen, usually 5, 10, 15, or 20 years. You can also buy *annual guaranteed-renewable term insurance*, where, at the end of each year if you renew the policy, the premiums increase to reflect your new age. Another option is *decreasing term insurance*, which reduces the amount of your death benefit over time. This is typically used by people who want the peace of mind of knowing that in the event of the breadwinner's death, their mortgage can be paid off in full. (This is sometimes referred to as *mortgage insurance*, but is really a term life insurance policy.) This kind of policy starts with a specific death benefit that decreases each year until your policy expires, which typically goes hand in hand with the payoff of your mortgage.

There is also *increasing term life insurance*, which provides a death benefit that rises steadily as the term continues, which may be an option, if this meets your needs.

When selecting the number of years of coverage under your term policy, it must be long enough to protect your family so that

your family can be taken care of financially even after your death, and with the loss of your earned income.

#### *Permanent Life Insurance*

If you decide that you don't want term life insurance and that permanent life insurance will better meet your specific life insurance needs, there are three major types of permanent life insurance you can purchase: *whole life insurance, universal life insurance,* and *variable life insurance.* With whole life and universal life policies, the insurance company will invest your cash value and give you a declared interest rate. In contrast, variable life policies give you mutual-fund type investment options for your cash value, and you have numerous investment options to choose from.

One of the major advantages to these policies is that the money you invest in a cash-value life insurance policy will grow on a tax-deferred basis, similar to a fixed or variable annuity.

**Whole Life Insurance** A cash value policy, also known as a *whole life policy*, is a permanent policy in which you are guaranteed coverage for life. Your premiums are priced accordingly, because the insurance companies know that they will eventually have to pay out the death benefits (unless you let the policy lapse by not paying your premiums). These policies have a cash value, which means that the insurance company takes your annual premium, deducts some administrative fees and a profit margin plus the cost of death protection, and puts the rest into a savings account called your *cash value.* So you are actually buying term life insurance that will not expire, with a savings plan as an add-on. Whole life insurance is generally just a costly way to maintain a tax-deferred, and in some cases tax-free, savings account.

**Universal Life Insurance** This is a variation of whole life insurance, except that the return on the investment portion of your insurance premiums is not guaranteed and grows at a variable rate. As with whole life insurance, the insurance company makes many of the investment decisions.

Because whole life insurance policies and universal life insurance policies have cash values, if you decide not to keep your policy, or if you suddenly need money while you are alive, you can cash out. However, if your goal in buying life insurance is to put money aside, there are far better ways to save.

**Variable Life Insurance** In my opinion, there are far too many costs and risks associated with this type of life insurance; therefore, I will simply say avoid purchasing this type of life insurance since there are much better ways to accomplish your goals.[1]

**Comparing Term Life Insurance and Permanent Life Insurance** In most cases, purchasing a term life insurance policy that will cover you until you are financially prepared to retire is the most effective strategy. If you do not opt into a permanent policy (whether whole, universal, or variable life), you can use the money that it would have cost you toward accumulating wealth. If you also use this savings towards funding a qualified employer-provided retirement plan or an individual retirement account (IRA), you will be able to save in pretax dollars. This will make a significant difference in the time it takes for you to reach *point X*, financial independence. (I cover this in more detail in Chapter 8, Planning for Retirement.)

#### *A Second-to-Die Life Insurance Policy*

This type of policy is also referred to as a *survivorship life policy*: it insures two people (usually spouses), and it does not pay until both insured people have died. Such a policy is normally worth considering if you are going to leave a very large estate that will incur substantial estate taxes. The most common type of second-to-die policy is universal life, which is permanent insurance. You can also purchase 10-, 20-, or 30-year convertible second-to-die term life insurance, which is much more affordable. Keep in mind the primary purpose for this type of insurance is for estate planning; therefore, you do not want to outlive the term of your policy. Ultimately, a permanent second-to-die life insurance policy will be needed for this purpose.

Federal tax law allows you to leave an unlimited amount of money, tax-free, to your spouse. When your spouse dies, federal

[1]Before investing, you should consider the costs and fees associated with a variable life insurance policy. Plans are subject to enrollment, maintenance, administration/management fees, surrender charges, mortality and expense risk charges, and charges for any optional benefits. As with any investment, it's important to fully consider the plan's objectives, risks, charges, and expenses before investing.

taxes will be due on both your estates, and they usually must be paid within nine months of the death of the second spouse. A second-to-die life insurance policy could theoretically be used to cover the payment of these estate taxes.

If you have a substantial net worth and believe your estate will be subject to significant estate taxes, a permanent life insurance policy may then be the right choice for you. Although most people only need term insurance, high-net-worth individuals can take advantage of the significant tax savings a permanent insurance policy can offer. When combining a permanent life insurance policy with an irrevocable life insurance trust (ILIT), you can significantly preserve your family's financial legacy. (Estate planning with life insurance is covered in more detail in Chapter 10, Preserving your Estate.)

As you can see, having the right type of life insurance at different stages in your life is an essential part of any high-quality financial plan. Making the right choices will accelerate your progress to achieve financial independence. You must always remember to distinguish between what you *need* and what you *want*. Life insurance is perhaps the most unselfish *need* in your life, because you will not personally benefit from it; it is a need you fulfill for the benefit of your loved ones.

## Buying Insurance Policies

Before you purchase insurance, make sure you have done the proper research. Always shop around and compare policies to make sure you are getting what you really need at the best possible price available. When doing your comparison shopping, be certain you are comparing apples to apples (so to speak), because many policies have different options with many bells and whistles attached. You should not compare based on price alone, because the cheapest policy may not be the best policy to meet your needs. You must be sure to find out exactly what the policy will specifically cover and what is excluded from the coverage. Make sure you know specifically what is required for you to qualify for the benefits. Finally, you should reevaluate your needs each year and ensure that your policies are still meeting your requirements.

As a general rule, you always want to compare policies from two or more insurance companies. Many insurance companies offer

you a reduced premium if you are able and willing to pay on an annual basis instead of monthly or quarterly. Remember the simple rule that every time you purchase something, you must ask yourself is this something you *need* or something you *want*? And if it is a need, is there a less-expensive alternative? Following these simple rules will save you money and assist in your pursuit for financial independence.

When choosing an insurance company, make sure it is financially sound and will be around to pay your claim when the time comes. All insurance companies are not created equal, and very often, you may be quoted a lower price from a company that is not as financially sound as others you are comparing it to. The following are the four major rating services for insurance companies, which can assist you in determining their financial strength; check with these rating agencies before entering into an insurance contract:

- AM Best: www.ambest.com
- Moody's: www.moodys.com
- Standard & Poor's: www.standardandpoors.com
- Duff and Phelps: www.duffllc.com

Before you buy an insurance policy from any company, please be sure the company carries at least all of the following ratings:

- AM Best: A– or better
- Moody's: AA or better
- Standard & Poor's: AA or better
- Duff and Phelps; AA or better

Throughout your journey to financial independence, you never know what unexpected problems may happen. Being prepared for the unexpected is precisely what insuring your health and life is all about. There are major family risk management issues that we all need to be concerned about. Obtaining the proper health insurance, disability insurance, long-term care insurance, and life insurance can provide you with peace of mind. Being unprepared for the unexpected can rob you and your family of your pursuit to financial independence.

## TAX FACTS AND STRATEGIES[2] FOR INSURING YOUR HEALTH AND LIFE

- **Take full advantage of medical insurance premiums paid by your employer** on your behalf. This is considered a tax-free fringe benefit. These medical insurance premiums are 100 percent deductible by your employer and tax free to you. All payments made by the medical insurance company to cover your medical expenses are also tax-free payments made for your benefit.
- **Under the Affordable Care Act plan:** You have limited opportunities to deduct medical costs (including self-paid medical insurance premiums) for you and your family. Starting in 2013, your deduction may be limited to only the amount that exceeds 10 percent (7.5 percent for taxpayers over 65 through 2016) of your AGI. This is why having medical insurance through your employer and a Health Savings Account (HSA) is so important, because this allows you to pay for these costs in pretax dollars.
- **If your health insurance qualifies as a high-deductible plan,** you should establish an HSA, and fully fund tax-deductible contributions to cover future medical expenses. In 2013, individuals can contribute and deduct $3,250 for a single policy and $6,450 for a family. If you and your spouse are 55 or older, you can make an additional tax-deductible, catch-up contribution of $1,000 each.
- **Insurance premium costs for long-term care policies** may be partly or fully deductible, depending on your age, as well as the limitations on your AGI. (The limitations are similar to those for medical costs.) Benefits from a qualified long-term care insurance contract are generally not included as income and are tax free to the extent they are reimbursements of qualified expenses. For 2013, qualified long-term care insurance contract premiums can be deducted as medical expenses with limitations based on age (up to age 40 $360, 41 to 50 $680, 51 to 60 $1,360, 61 to 70 $3,640 and over 70 $4,550).
- During 2013, payments for personal injuries and sickness under a qualified long-term care insurance policy can be excluded up to $320 per diem.
- **Workers' compensation payments** for job-related injuries or illnesses are tax free.
- **Dividends on life insurance policies** are generally treated as a refund of your premiums and are not taxed until they exceed the total premiums paid.

[2]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

- **You can exchange certain insurance policies on a tax-free basis** if they meet certain requirements. Generally, you can exchange a life insurance policy for another life insurance policy, endowment policy, or an annuity contract. You can also exchange an endowment policy for another endowment policy or annuity contract, and annuity contracts for another annuity contract with identical annuitants. See your insurance advisor for more details.
- **Life insurance proceeds you receive upon the death of the insured are generally income-tax free** to the beneficiary. If not properly structured, however, the insurance proceeds may be subject to estate taxes (the 40 percent rate may apply) and the beneficiary may actually receive the reduced amount. This reduction may be eliminated by setting up an ILIT. (For more details, see Chapter 10, Preserving Your Estate.)
- **If you are terminally ill, you may be able to take a tax-free withdrawal from your life insurance policy** to pay medical bills and other living expenses. If your policy does not have an accelerated benefit clause, you may be able to sell your policy to a viatical settlement company without paying taxes. A viatical settlement allows you to sell your life insurance policy to a third party and collect a portion of the death benefits while you are still alive. Upon your death, your death benefits are paid to the buyer.

## AN ACTION PLAN FOR INSURING YOUR HEALTH AND LIFE

1. **If your employer offers health insurance, make sure you understand all facets of the plan.** If details of the plan are not crystal clear to you, make an appointment with your human resources representative and make sure it is explained to you.
2. **If your employer offers health insurance benefits, make sure your plan adequately covers your healthcare needs** (and your family's). If it does not, buy supplemental insurance or another policy altogether.
3. **Familiarize yourself with various types of health insurance plans:** Indemnity plans, managed-care plans, health discount plans, government plans, and so forth.
4. **If you are approaching age 65, become familiar with current Medicare laws.** Apply for Medicare at least one month before you turn 65, so you will be covered on the first day of the month of your birthday. Although you are automatically covered under Medicare Part A, clarify whether or not you want to be covered under Medicare Part B or Medicare Part D.
5. **Check to see if your employer offers disability insurance** as an employee benefit, because group rates are substantially lower than individual rates.

(*Continued*)

6. **If you must buy your own disability insurance** (which is usually expensive), consider buying a small policy now with a rider to add more later.
7. **When considering a disability insurance policy,** look for ways to cut down on the price of premiums, such as to age 65 (not lifetime), prepayment, or excluding chronic medical conditions that require treatment but will not cause permanent disability.
8. **Consider buying long-term care insurance,** especially if you are older than age 50 (or have parents who may require your help) or you have substantial assets to protect.
9. Carefully analyze your needs for buying life insurance.
10. **Understand the pros and cons of the basic types of life insurance** (permanent and cash value—also known as whole life—and term life insurance.)
11. If you feel unsure of your insurance choices and decisions, consider securing the help of an insurance broker or insurance advisor.
12. Always secure new insurance coverage before you drop an old policy. Never leave yourself without proper coverage.

CHAPTER 6

# Protecting Your Property with Insurance

*Property is the fruit of labor; property is desirable; it is a positive good in the world.*

—Abraham Lincoln,
16th president of the United States

Insuring your home, its contents, and your automobile are not only necessary, in some situations, they are required by law. This chapter shows you how to analyze your property insurance needs and make sure you are sufficiently covered. Protecting your property by implementing the proper risk management strategies is critical to achieving and maintaining your financial independence. The type and extent of insurance you need will change throughout your lifetime, as will the types of assets and the extent of wealth you have accumulated.

The three major personal property risk management issues include the following:

1. Homeowner's insurance
2. Automobile insurance
3. Umbrella liability insurance

Your particular situation will determine what type of insurance you need, what kind of policy will work best, and what amount of coverage you should have. You should consult with your property

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liability insurance agent or broker to fully evaluate your needs so that you can determine proper coverage to meet those needs. It is critically important to remember you should always secure your new insurance coverage before you drop your old policy. You never want to leave yourself unprotected without proper coverage in-between policies.

Insurance helps protect you and your family from the unexpected. The premiums you pay will provide you with the peace of mind that comes with knowing that your assets and family will be protected, when the unexpected happens.

I begin this chapter by sharing a client story that will underscore the importance of securing the necessary property and liability insurance. This is the most tragic story in the book, but I feel it is necessary to make you understand the importance of this topic.

## Case Study: How a Lack of Insurance Wiped Out One Woman's Life Savings

One of my clients is a medical doctor who devoted her entire life to helping children with cancer. She is one of the most caring and loving people I know. She became a doctor to care for and nurture children in need, which became her life's work. At the age of 50, she felt something was missing in her life. She had never been married and had no children of her own. She made the bold and courageous decision to adopt a child. I refer to her as Dr. Bigheart.

Dr. Bigheart started the long, emotional, and costly process of adopting a child. After several disappointments, she finally found a 3-year-old child named Tania, who was living in an orphanage in Russia. The child was a beautiful, blond-haired, blue-eyed little girl. She was very thin, wore old clothing, and was teary-eyed, but she still managed to smile when she first saw Dr. Bigheart, who also had tears of joy in her eyes, because she knew she had found her little girl.

She spoke with the social worker responsible for Tania, who told her about the process of adopting a child and learned it would be at least six months before this process would be completed and approved. The same day, she noticed that little Tania was very attached to a two-year-old boy named Joshua, and she found out this was Tania's brother. By the next day, Dr. Bigheart decided there was no way she could separate the siblings and leave Joshua behind. So she completed the paperwork to adopt both children at the same time.

As expected, the process took just over six months to complete, and she made six separate trips to Russia during this time, each time hoping to return with the children. Finally, that day came and she got on the plane from Moscow with both children in her arms. To this day, she describes this as the single most important day of her life.

She watched her children grow and went through the usual disappointments and joys of parenting. She finally felt that her life was complete. Through her work as a children's cancer doctor and her family life, she felt there was a true purpose and meaning to her life.

On Tania's 17th birthday, her mother surprised her with a brand-new car. Tania had gotten her driver's license and was a good driver. Six months later, Tania got into an argument with her boyfriend, and he broke up with her. She was very upset and drove off, speeding down the road in her car. She spun out of control and killed a man who was getting out of his car. Her car then crashed and rolled over, killing Tania instantly.

When Dr. Bigheart got the news of the accident, she rushed to the hospital. When the emergency room doctor told her that Tania did not survive, Dr. Bigheart collapsed and fell to the ground and could not stop crying. She was overcome with grief, could not catch her breath, and needed to be admitted into the hospital. She had just lived every parent's worst nightmare: the death of a child. The wake was heartbreaking; Joshua had lost his sister, and Dr. Bigheart had lost her daughter. The emotions she was feeling could not be described in words, but only through the expression in her face and eyes.

A month after her daughter's death, she was sued by the family of the innocent man who was struck and killed in the accident. The lawsuit was for wrongful death and the pain and suffering of his family, in the amount of $5 million. At this point, Dr. Bigheart came to me for advice, and I asked her to bring in her auto and other personal liability insurance policies. Just when it seemed like her life could not get worse, I had to tell her that she did not have enough coverage. She had only a basic auto liability policy, which provided only $300,000 in personal liability coverage. When I asked about her personal umbrella liability insurance, she said she never bothered to get that type of policy. She had never contacted her property and liability insurance agent about obtaining any additional coverage under a personal umbrella liability policy.

As I feared, after her auto insurance company reviewed the claim, it threw in the towel and said this claim was in excess of its policy limits. The insurance company informed Dr. Bigheart that it would pay the full $300,000 from the policy limits, but it refused to cover the legal defense costs. Dr. Bigheart was forced to retain a lawyer at her own expense to defend this case against her, seeking $5 million.

Along with the grief and depression that came with the loss of her daughter, she now had to deal with the fear that her life savings would be wiped out as a result of this lawsuit. The lawsuit dragged on for two years until it was eventually settled. She paid more than $80,000 in legal fees and made a final settlement to the victim's family of $800,000, of which the insurance company covered only $300,000. At the age of 67, she was forced to pay this $580,000 from her investment savings (and she said that was not even the most difficult part of the trial: having to relive what happened that day over and over was unbearable). Dr. Bigheart is now in her mid-70s and is still working part time. She was not able to fully retire because a big part of her retirement savings was wiped out.

*I cannot overemphasize the importance of having the appropriate property and liability coverage.* Speak to your property and liability agent or broker today. If you do not have the appropriate umbrella liability coverage, you must get it today. Property risk management is one of the keys to achieving and maintaining financial independence. The rest of this chapter describes what you need to know about the three major property risk management issues that are critical to getting to *point X*.

## Homeowner's Insurance

Homeowner's insurance needs to cover the cost of rebuilding or repairing your home in the event of damage from a fire, storm, burglary, or other type of catastrophe. Standard policies typically cover the house (the structure) and its contents (furniture, clothing, etc.), the latter usually for 50 to 70 percent of the amount for which you insured the structure of the house. Therefore, if you have $300,000 worth of insurance on the structure of your home, you would have between $150,000 and $210,000 worth of coverage for your personal belongings; this is above and beyond the $300,000 coverage for the structure.

Homeowner's policies also include liability coverage for damage or injury incurred inside or outside your house.

#### *Property Coverage*

An actual *cash-value policy* will compensate you for the cost of your belongings less their depreciation (used value), whereas a *replacement-cost policy* means that the insurance company must compensate you for the actual cost of replacing the lost or damaged items. For example, if you have a fire in one room of your house and all the furniture in that room is destroyed and you have a cash-value policy, your insurance company will ask you how much you spent for that furniture. If you spent $5,000 and you owned that furniture for 10 years, the insurance company may decide that its *current* value is only $2,000—because, after all, you used it for 10 years. And that is the amount the insurance company will pay you: $2,000.

In contrast, if you have a replacement-cost policy, the insurance company is likely to compensate you with at least $5,000 and probably even more, given that prices and inflation have increased and the cost of a new bedroom set may be more like $7,500 today. So which would you want to receive: $2,000 or $7,500?

Of course, you need to consider that the premiums on a replacement-cost policy will be more than for a cash-value policy, but the difference may be a small price to pay for the additional peace of mind you will have in knowing that you will be fully compensated should something catastrophic happen in your home.

In my opinion, you should always opt for a replacement-cost policy because it will provide you with a reimbursement sufficient to replace your loss.

#### *Liability Coverage*

Liability coverage is intended to protect your assets in the event that you are sued by someone who is hurt or whose property is damaged because of your negligence. For example, you may be a fanatic about keeping your house clean and safe at all times, and when it snows you are always the first one out the door with a snow shovel and rock salt to keep the sidewalk safe for others. But suppose an unexpected blizzard hits your hometown during Thanksgiving week, when you are visiting with your family out of town? While you are away, you obviously are not able to care for your property and ensure the safety of others by shoveling and properly cleaning the walkway. If an elderly woman trips and falls, breaking her leg and hip, that may require major surgery and hospitalization. Without the proper liability and insurance, you would be held

liable for her injuries, which could cost you hundreds of thousands of dollars.

Homeowner's insurance is for major disasters (as mentioned at the beginning of this section), not for filing small claims, such as a broken window from your neighbor's son playing hardball in his yard, so you can get back the money you contributed to premiums. In most cases, if you merely file one claim, that will not raise your rates or cancel your policy. But if you file multiple claims—in fact, as few as two, with certain policies—that may cause your insurance company to raise your premiums or even cancel your homeowner's insurance policy altogether. So it is best to get a policy with a high deductible, so that you have no reason to file lower-cost claims. The higher the deductible, the lower your premium; in essence, you are self-insuring for any damage up to the amount of the deductible. The standard flat dollar deductible is typically $1,000. I would recommend increasing this amount to $2,000, $5,000, or even more if you feel you can cover this cost on your own. Because you will not be filing small claims anyway, why not save the premium dollars, and you can use this savings to cover these deductibles in the event a situation occurs. Property insurance helps provide you with the peace of mind of knowing you will be made whole, when the unexpected happens to you and your property. Insurance provides you and your family with a safety net when unfortunate events occur such as fire, theft, burglary, and vandalism. If your home is damaged and uninhabitable, your insurer may also compensate you for the costs associated with maintaining a temporary residence (renting a hotel room or other home) elsewhere, while repairs are made on your home.

You must also have liability insurance as well as medical protection coverage for your visitors. Let us say your children decide to have a sleepover in your home with a few of their closest friends, and one of their friends falls and breaks his arm, you may need this coverage to help pay for the child's medical expenses.

As mentioned, homeowner's policies are designed to provide financial protection for you in the event of damage to your home, such as caused by a fire or water damage. These coverages are commonly a homeowner's major concern, but most policies often provide you with much more coverage. Your policy will also protect your personal property (e.g., furniture, appliances, and electronics) from damage as a result of fire or theft. Furthermore, the policy will protect you from liability that may arise from homeownership, such

as your child's friend's parents suing you from the sleepover. Please note, flood insurance typically requires a separate policy, because it is not covered through standard policies.

The majority of homeowner's policies are written under the HO-3 contract form. These form numbers are standardized throughout the insurance industry, so that if you purchase HO-3 insurance, you will be getting the identical coverage, regardless of your insurance provider. The HO-3 contract provides the following coverage:

- **Broad coverage for your dwelling.** Damage to your dwelling from most causes is covered unless it is specifically excluded.
- **Damage to your personal property for "named perils" only.** Your personal property is covered only against the perils specified in the contract. For example, if you do not live in an earthquake-prone area, but you are still concerned about fire, theft, flooding, and hail damage, you, as the homeowner, may elect to get a named perils policy and only declare coverage against fire, theft, flooding, and hail, while leaving the earthquake coverage off the policy.
- **Limited coverage for jewelry that is stolen.** Coverage is usually $500 to $2,000, depending on your resident state. The majority of policies do not cover jewelry that is lost.

**Endorsements Provide Additional Coverage** If you would like to increase the amount of your coverage for valuable items or want to protect yourself from identity theft, endorsements may provide the additional coverage you desire. You can increase your limits for items such as jewelry, furs, gold, silverware, or firearms.

**What Liability Insurance Covers and What It Doesn't Cover** Liability coverage is one of the most important parts of your homeowner's insurance policy in the event that an unfortunate accident or injury takes place on your property.

Most homeowner's insurance covers the following:

- Slips and falls. Accidental injuries that take place on your property can include many unexpected events including a slip or fall by a guest or visitor: If that person sues you, your insurance usually provides protection against judgments where you are found negligent and also offers medical payments to others who are hurt or injured on your property.

- Injuries to people who are hurt by you, by your household members, or by your pets, even when you are away from home.

On the other hand, your homeowner's insurance probably does *not* cover the following:

- Deliberate actions that result in a claim or loss are typically not covered by any insurance *policy*. For example, if one of your neighbors parks in your driveway and you want to teach him a lesson, so you hit him repeatedly with a baseball bat. Intentional acts of violence such as this would not be covered.
- Known hazards and risks. Failure to take reasonable precaution to repair, correct, or fix a situation that could result in injury or loss is typically not covered by insurance. Always keep your property in good condition and take care of potential hazards immediately. For example, if you have a defective sidewalk that is uneven and clearly a hazard, yet you simply choose to ignore it and it results in an injury to a third party, your insurance company may deny coverage.

For most people, their home is their castle and it also represents one of their most significant assets. Having the proper homeowners insurance is one of the important steps in keeping you on track to achieving financial independence. Without the proper insurance, one of your major assets can be lost and be impossible for you to replace. Furthermore, if you are sued for injuries sustained by others because of your negligence, you can also be wiped out financially.

## Automobile Insurance

Auto insurance is required by law, and the state you live in will dictate the extent and type of coverage required. An auto insurance policy is made up of seven different primary coverage types, each with its own premium: The cost for each of these protections will vary based on numerous factors such as where you live, the type of car you drive, your driving record, and even your credit history. The only way to find out what your cost of coverage will be is to ask for a personalized price quote. When pricing auto insurance, it always pays to shop around and you should always obtain a minimum of two price quotes from two separate insurance companies.

1. **Bodily injury liability** provides protection if you injure or kill someone while operating your car. It also provides for a legal defense if another party in the accident files a lawsuit against you. To protect your personal assets, you should have sufficient coverage against a judgment from a lawsuit as a result of a serious accident. Bodily injury liability covers injury to people, not the cost to repair or replace your vehicle. Generally, you would want the same amount of coverage for all of your cars.
2. **Medical payments, no-fault, or personal injury protection coverage** typically pays for the medical expenses of the injured driver and passengers in your car.
3. **Uninsured motorist coverage** pays for your injuries caused by an uninsured driver or, in some states, a hit-and-run driver, in a crash that is not your fault. Some states also offer uninsured motorist coverage for damage to your vehicle. Even if you live in a state with no-fault insurance, it is very important to have this coverage: you would be surprised by how many uninsured motorists are on the road. According to a recent report from the Insurance Research Council, about 13.8 percent of U.S. motorists (or one out of seven) are without insurance and operating their vehicles illegally.
4. **Comprehensive physical damage coverage** pays for losses resulting from damages to your car if it is stolen or damaged by flood, fire, or animals, but it does not cover collision. One strategy for keeping your insurance premium costs low is by selecting a high deductible. Self-insuring against these minor losses is wise as long as you have sufficient cash reserves to cover these costs when the need arises.
5. **Collision coverage** pays for damage to your car when your car hits, or is hit by, another vehicle or other objects. If you own an older car, you should consider dropping this coverage, because it is limited to the cash value of your car. Once again, self-insuring against certain losses can be wise as long as you have sufficient cash reserves to cover these costs when the need arises.
6. **Property damage liability** protects you in the event your car damages someone else's property. It also provides you with the legal defense coverage if a lawsuit is filed against you. For example, if you are backing out of your driveway and accidentally step on the accelerator instead of the brake

and crash into your neighbor's house and end up in their living room with your car, the property damage liability protection can come in handy.

7. **Rental reimbursement** coverage pays for the cost of a rental vehicle when the insured person's vehicle cannot be used because of losses covered under comprehensive or collision coverage.

The insurance industry uses shorthand to describe how much coverage each policy provides. For example, *30/50/20* means you have:

- $30,000 in bodily injury coverage per person,
- $50,000 in bodily injury coverage per accident, and
- $20,000 in coverage for property damage.

However, the standard minimum recommendation for homeowners auto liability coverage is at least *100/300/50:*

- $100,000 in bodily injury coverage per person,
- $300,000 in bodily injury coverage per accident, and
- $50,000 in property damage liability.

Most states use a no-fault auto insurance system; the other states use a third-party system to settle claims. To determine whether your state is a no-fault auto insurance state, contact your auto insurance carrier for this information or visit the insurance information institute website at www.iii.org. This website was established for improving public understanding of insurance, what it does, and how it works. No-fault states require drivers and their insurance companies to pay their own costs after a car accident, regardless of whether they were or were not responsible: this is why it is referred to as *no-fault.* Even with no-fault insurance, you may still need liability insurance, because if you cause an accident and the costs to the other injured people are above a certain amount, they can sue you to recover the difference. Without sufficient liability coverage, the shortfall would have to come out of your own pocket. In the case study discussed earlier in this chapter about Dr. Bigheart, this point of having sufficient liability coverage was underscored with her tragic real-life story.

If your child is going to drive, he or she has to have insurance. Insurance companies know that young drivers are risky drivers, so they will charge you high rates to protect this added risk. The only way to determine what the added cost of insurance will be once your young driver gets his or her license is to ask your insurance provider for a price quote. Knowing the answer to this before your child gets a license may encourage you to have your child wait until he or she is older.

If this does not go over well with your teenagers and you decide to have them apply for a driver's license, you can still save some money on your auto insurance by not purchasing another car. If you do purchase a car for your teenage driver, then you should also consider *not* buying your child a new car, because it is more sensible to have your child drive the oldest and least-expensive car you own: this helps keep your cost of insurance lower than it would be otherwise. Of course, if you have an older car, make sure it is still safe to drive: Your family's safety is always more important than saving some money.

An insurance company determines your premium based on certain statistics and facts about you and other drivers. These factors are based on your age, your gender, where you live, the type of car you drive, your driving record (i.e., whether or not you have been in accidents before or have been ticketed by the police), your credit score, and many other factors. Although some of these factors are out of our control, the ones that are not should be carefully analyzed before purchasing a car.

For example, the cost of insuring a red Corvette is much higher than insuring a white Dodge minivan. Selecting an eight-cylinder vehicle will generally cost you more than a six-cylinder vehicle because the number of cylinders limits the speed of the car. When analyzing which car to purchase for yourself and family members, be sure to ask your insurance company for a price quote on each separate vehicle. This may make your vehicle choice a wiser one and a less costly one.

The basic rule from Chapter 1, Committing to Living within Your Means, holds true with purchasing auto insurance as well as the automobile you are planning to buy. Always ask yourself, is the purchase of this vehicle a need or a want? If in fact it is a need, is there a less expensive alternative? And always remember, shop around and do comparisons to get the very best price possible.

## Umbrella Liability Insurance

Homeowner's, auto, and boat insurance policies do provide a limited amount of liability protection, but these policies may not provide you with enough coverage to protect your assets in the event of a major lawsuit. A major lawsuit can cost you significant dollars both in terms of legal defense costs and the ultimate settlement payments, beyond any amount you can reasonably expect to pay from your savings. Umbrella liability insurance policies provide you with a secondary layer of insurance protection that is over and above the normal coverage limits of your other policies; umbrella insurance protects you only after your homeowner's, auto, or boat insurance policy has paid or is expected to pay its maximum benefit.

For example, in the tragic story involving Dr. Bigheart, her insurance company raised the white flag and surrendered because the lawsuit that was brought by the family of the man killed by Dr. Bigheart's daughter was seeking $5 million, yet Dr. Bigheart's auto insurance policy limit for liability was only $300,000. And because Dr. Bigheart did not have an umbrella liability insurance policy, she had no other resources to turn to for help.

Umbrella liability insurance is like having a secondary parachute to protect you in case your first parachute fails or is insufficient to protect your assets. An umbrella policy can offer coverage above and beyond the liability protection of your standard policies, into the millions of dollars, in case you are sued under any of your other insurance policies as a result of an accident or injury, including those involving a natural disaster. The amount and type of coverage offered through an umbrella liability policy varies based on the policy and insurance provider. Be sure you know exactly what the policy you purchase covers and does not cover.

Your total combined insurance policies for homeowner's, auto, boat, and umbrella must cover at least an amount equal to or greater than your personal net worth. This is why, in my opinion, a personal liability umbrella policy is something that no one who owns a car and a home should do without, and I recommend buying a policy that will fully protect you. Personal liability umbrella coverage typically ranges from $1 million to $5 million, and in some cases, you can obtain even more. Moreover, the cost of that insurance is very low: you can expect to pay only $250 to $350 per year for $1 million in coverage; each additional million dollars' worth of coverage typically costs only $175 per year.

Most insurance companies will require you to have a certain level of coverage (as described below) under your regular insurance before you can purchase an umbrella policy. Therefore, very often you will need to upgrade the coverage under your home, car, and boat insurance policy. Most personal umbrella policies will require you to maintain at least the following amount of coverage under your other policies in order to be eligible for this additional coverage.

- **Auto Insurance Policy:** $300,000 person and $300,000 occurrence (for bodily injury) and $100,000 (for property damage).
- **Homeowner's Insurance Policy:** $300,000 liability.
- **Boat insurance Policy (if applicable):**
  - $100,000 liability for boats under 26 feet long and under 50 horsepower.
  - $300,000 liability for boats 26 feet and longer, or 50 horsepower and up.

The following paragraphs describe some of the coverage you can typically find under a personal umbrella insurance policy. It is important to review and compare these policies carefully so you can determine exactly what you are and are not covered for.

**Bodily Injury Liability** This covers the cost of damages to another person's body—for example, the cost of medical bills as well as liability claims resulting from:

- Injuries to other parties due to a severe auto accident where you were at fault.
- Injuries sustained by a guest in your home.
- Injuries sustained by your child's friend who falls and breaks a leg while playing in your yard.
- Injuries caused to others by your dog.

**Property Damage Liability** This covers the cost of damage or loss to another person's physical property—for example, the cost associated with claims resulting from:

- Damage to someone's vehicle as a result of an auto accident where you were at fault.

- Damages to public or private property accidentally caused by your family members.
- Damages incurred when your dog destroys a neighbor's couch with its paws.

**Rental Property Insurance** If you own rental property, you can protect yourself against liability that you, as the landlord, may be subject to—for example, the cost of liability claims from:

- Someone who slips on ice in front of your rental property, or
- Someone who has been bitten by your tenant's dog.

**Umbrella extended coverage** may also be provided in the event you are sued for:

- Slander, which is injurious spoken statements.
- Libel, which is injurious written statements.
- Malicious prosecution.
- False arrest or imprisonment.
- Various other personal liability situations.

One of the most frequently overlooked reasons to purchase umbrella insurance is because you have children. Just think back to the tragic story I shared with you about Dr. Bigheart and her daughter. As your child's parent, you are responsible for your child's actions, which could result in financial hardships if a serious accident, injury, or even death occurs because of your minor child's actions. The age of majority is the age at which a minor becomes an adult, in the eyes of the law of your resident state. This age is 18 in most states, but a few states extend the age of majority to 19 or 21.

Millions of Americans are nearing retirement age: on average, more than 7,000 are turning age 65 every day. Some of them have lived their lives based on the principles in this book and are now financially independent. Yet, as we saw with Dr. Bigheart, the cost of a major lawsuit could easily wipe out their entire life savings.

As mentioned, the premiums for an umbrella insurance policy typically range from only between $250 and $350 a year for $1 million in coverage, and about $175 or more a year for every additional million dollars in coverage thereafter. In my opinion, that is a very small price to pay for the added peace of mind that comes from the protection provided through these policies.

## Buying Insurance Policies

Before you purchase insurance, make sure you have done the proper research. Always shop around and compare policies to make sure you are getting what you really need at the best possible price available. When doing your comparison shopping, be certain you are comparing the detailed coverage and limitations that may apply. Are these policies providing the same level of coverage? Are the deductibles the same for each policy? And does one policy exclude certain items and the other one include them? It is easy to obtain a less expensive policy by purchasing one that provides you with more limited coverage. Also, do not compare based on price alone, because the cheapest policy may not be the best policy to meet your needs. You must be sure to find out exactly what the policy will specifically cover and what is excluded from the coverage. Make sure you know specifically what is required for you to qualify for the benefits. Finally, reevaluate your needs each year and ensure that your policies are still meeting your requirements.

As a general rule, you always want to compare policies from two or more insurance companies. You may also want to consider increasing your deductible, which will generally lower your premiums. Also, many insurance companies offer you a reduced premium if you are able and willing to pay on an annual basis instead of monthly or quarterly. You should find out about multiple policy discounts if you are purchasing a number of policies through the same insurance company (for example, your auto, home, and umbrella policy).

When choosing an insurance company, you want to make sure it is financially sound and will be around to pay your claim when the time comes. All insurance companies are not created equal, and very often, you may be quoted a lower price from a company that is not as financially sound as the others you are comparing it to. There are four major rating services for insurance companies that can assist you in determining their financial strength; check with these rating agencies before entering into an insurance contract:

- AM Best (www.ambest.com)
- Moody's (www.moodys.com)
- Standard & Poor's (www.standardandpoors.com)
- Duff and Phelps (www.duffllc.com)

Before you buy an insurance policy from any company, please be sure the company carries at least a rating of "AA" or better from Moody's, Standard & Poor's, or Duff and Phelps; if you are evaluating an insurance company through AM Best, look for a rating of "A–" or better.

Throughout your journey to financial independence, you never know what unexpected property risk issues may arise. Being prepared for the unexpected is precisely what insuring and protecting your property is all about. There are major family risk management issues that we all need to be concerned about. Obtaining the proper homeowner's, auto, boat, and personal umbrella liability coverage can provide you with the peace of mind of knowing you and your property will be protected. Being unprepared for the unexpected can rob you and your family of your pursuit to financial independence.

### TAXFACTS AND STRATEGIES[1] FOR PROTECTING YOUR PROPERTY

- Generally, the cost of personal homeowner's, automobile, boat, and umbrella liability insurance are not tax-deductible. Insurance reimbursements to the extent of your loss are generally not taxable. If you receive an insurance reimbursement in excess of your adjusted basis (i.e., what you paid for it), this will result in a gain you must report as income unless you acquire replacement property and elect to defer the gain.
- If you own a rental property, you can generally deduct most of the expenses associated with maintaining and managing the property as well as the cost of property insurance, which includes premiums for fire and liability.
- Casualty and theft losses attributable to personal use property may be partly tax deductible. For example, if a major hurricane damaged your home, causing extensive damage to the structure of your home as well as your personal contents, you can take a tax deduction, but only after applying the limitations

[1]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

set by the Internal Revenue Code. After the casualty or theft loss amount is determined (less insurance reimbursement) a dollar floor reduces the deductible loss. The dollar floor is $100 for each separate loss, then the personal casualty and theft losses for the year are further reduced by 10 percent of your adjusted gross income.

- Having the proper insurance coverage on your property will provide you with a tax-free reimbursement of your loss.
- Casualty losses resulting from federally declared disasters, such as Hurricane Sandy that hit the east coast in October 2012, may be deducted in the prior tax year by filing an amended return. This is done to expedite funds into the hands of disaster victims. For Hurricane Sandy, the effect of deducting the casualty loss for 2011 on an amended return should be compared to the results of deducting the loss on your 2012 return so that the largest tax benefit can be chosen. The goal is a simple one: take the loss in the year that provides you with the most tax benefit.
- Insurance reimbursements for the cost of added living expenses attributable to damage to your home do not reduce a casualty loss. The payments from the insurance company for these excess living costs are generally not taxable and are treated separately from the payments for property damage.
- As a matter of law, compensatory damage for physical injury or sickness is treated as tax free. For example, if you are injured in a car accident and you sue the driver and are awarded $100,000 because of your back pain, you do not have to pay taxes on this settlement payment. In contrast, however, damages for nonphysical personal injuries are taxable, such as from discrimination, back pay, wrongful termination, or injury to your reputation. So if you sue a former employer for wrongful termination not because you were not performing your job responsibilities well but because your boss fired all the women in your department and promoted all the men, and if the court rules that you were indeed wrongfully terminated and awards you $1,000,000, you will have to pay taxes on that $1,000,000.
- You may be able to avoid the tax on gain from the sale of your principal residence if you owned and used the home for at least two years during the five-year period ending with the date of the sale. For a single individual, you may be able to exclude $250,000 of the gain. For a married couple filing jointly, you may be able to exclude up to $500,000 of the gain. This tax-free income is by far one of the most favorable reasons for home ownership: it does not get better than this.
- You will be able to take a depreciation deduction if you own property used in your business or other income-producing activities, such as rental real estate. If you purchased rental real estate, you may be permitted to take a deduction every year, for 27½ years, for residential real estate property. Even if your property is increasing in value each year, the government allows you to

(*Continued*)

take a write off for depreciation, which is actually a phantom deduction. You may be able to generate a positive cash flow and actually pay no income tax on this income after deducting this depreciation expense.

- If you purchased and installed qualified residential alternative energy equipment, such as solar hot water heaters, solar electricity equipment and wind turbines for your home through December 31, 2016 you may be able to take a credit of 30 percent of the cost without dollar limit.
- If you made home energy efficiency improvements to your home you may be entitled to a residential energy credit. The credit is 10 percent of the cost of qualified improvements with an overall lifetime limit of $500 through December 31, 2013.
- If you constructed a new home (including using third-party contractors) before 2014 that meets certified energy efficiency qualifications you may be entitled to either a $1,000 or $2,000 new home energy efficiency credit.
- If you purchase a qualified plug-in electric vehicle by December 31, 2013 you may be entitled to a credit equal to 10 percent of the cost of the vehicle up to $2,500.

## AN ACTION PLAN FOR PROTECTING YOUR PROPERTY

1. Consult with your property liability insurance agent or broker to fully evaluate your homeowner's insurance needs so that you can determine proper coverage to meet those needs.
2. Always secure your new insurance coverage before you drop your old policy. You never want to leave yourself unprotected without proper coverage in-between policies.
3. When buying homeowner's insurance, choose a replacement-cost policy (rather than the cash-value policy) because it will provide you with a reimbursement sufficient to replace your loss (in the event of fire or other damage specified in your policy).
4. Make sure your homeowner's insurance includes both liability insurance and medical protection coverage for your visitors, to protect you in case someone is injured on your property and brings a lawsuit against you.
5. Remember that auto liability coverage is required in all states, and anyone who owns a home and has significant assets should strongly consider buying a minimum of 100,000/300,000/50,000 in coverage: $100,000 for bodily injury coverage per person, $300,000 for bodily injury coverage per accident, and $50,000 for property damage liability. Collision and comprehensive damage are both optional types of auto liability insurance coverage.

6. Make sure your children and other members of your household are insured under your auto insurance policy. (Check with your auto insurance company since these rules vary by state). Also, keep in mind that you can probably lower your insurance premiums if your children drive an older car, rather than a brand-new, expensive model.
7. Consider buying an umbrella liability insurance policy, which provides a secondary layer of insurance protection that is over and above the normal coverage limits of your other insurance policies: This can cost only $250 per year but can protect you up to $1 million if you are sued.
8. When choosing an insurance company, check with the major insurance ratings services to determine the quality of the company: You want to be sure that your insurer will be in business and financially sound, if something happens and you need the protection offered by that company.

CHAPTER 7

# Paying for College

*An investment in knowledge always pays the best interest.*
—Benjamin Franklin, founding father of the United States

Most parents struggle with the difficult decisions they need to make when it comes to juggling all of their competing financial needs. Throughout this book, I discuss many financial goals that we typically have throughout our lifetime. These include building a cash reserve, minimizing debt, paying for health and life insurance, protecting your property, and saving for retirement. Each time we focus on one of our goals, our limited resources require us to make sacrifices with the other goals. Therefore, parents need to make very important decisions when it comes to how to pay for education. The information I provide in this chapter will help you make an informed decision and prepare you to meet this challenge.

In fact, one of the most satisfying aspects of my work as a Certified Financial Planner™ is that I have the opportunity to meet with some amazing people and become an integral part of their lives. There is no more satisfying feeling than helping clients and their children achieve their financial goals and live out their dreams.

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

If you are like most parents, one of your biggest concerns is, *how am I going to pay for my children's education when the time comes to send them off to college?* Some parents hope their children will receive academic or athletic scholarships or grants. But for most parents, the reality is they will have to pay the majority of the cost of college from their savings—or even worse, they may have to go into debt.

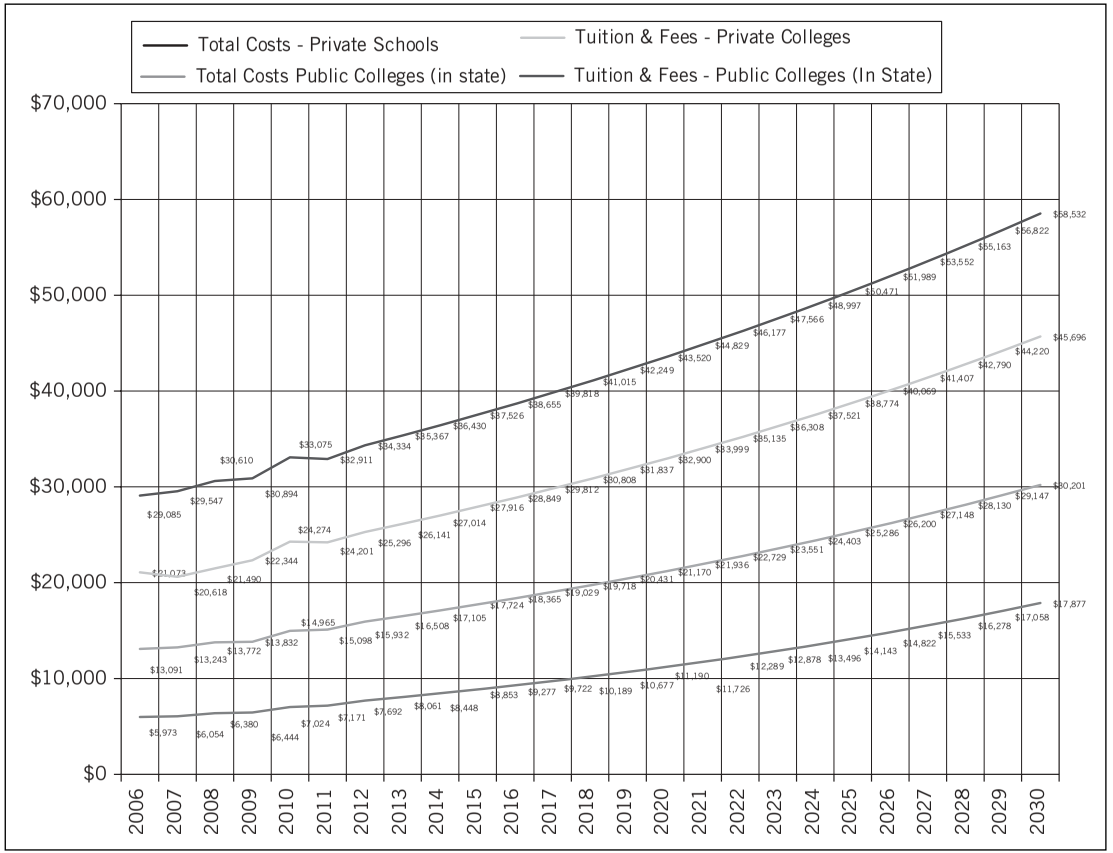
Moreover, the cost of college is skyrocketing. According to the College Board, from 2001 to 2011, published tuition and fees at public four-year colleges and universities increased at an average rate of 5.6 percent per year *beyond* the rate of general inflation. The College Board also cited the tuition and fees at a private four-year college and university (for the 2010–2011 school year) as an average $28,500—which is a whopping $114,000 for four years! When you include room and board, that is $38,589 per year—or $154,356 for four years. (For more information about the cost of college, I encourage you to visit their website at www.collegeboard.org.)

Exhibit 7.1 shows how four-year college costs are projected to increase, from 2006 to 2030—which is when parents of babies born in 2012 will be sending those kids to college. As you can see, college costs are projected to rise at an alarming rate that far exceeds the rate of inflation, so if you are a parent, you need to find ways to save for your child's education that will have a reasonable chance of keeping pace with these increasing costs.

To have a fighting chance to succeed with this financial goal, you need to avoid the financial mistakes that are made by many parents. The key to accomplishing this is having a good understanding of the key components of paying for a college education. These components usually include some combination of personal savings, Section 529 plans,[1] Coverdell education plans, savings bonds, financial aid (such as federal grants, loans, and scholarships) as well as education

[1]529 Plans are subject to certain restrictions. By investing in a plan outside your state residence, you may lose available state tax benefits. 529 plans are subject to enrollment, maintenance, administration/management fees, and expenses. If you make a withdrawal for any other reason, the earnings portion of the withdrawal will be subject to both state and federal income tax and a 10 percent federal tax penalty. As with any investment, it's important to fully consider the plan's objectives, risks, charges, and expenses before investing. Units of the 529 plan investment options are municipal securities and may be subject to market value fluctuation. Before investing in a state-specific 529 plan, you should compare your own state's qualified tuition program and any state tax or other advantages it may provide.

**Exhibit 7.1 Projected Annual Four-Year College Costs 2006–2030 (in 2011 constant dollars)**



tax deductions and credits. I will cover each of these in this chapter after sharing the following client story with you.

### Case Study: How *Not* Saving for Your Child's Education Can Ruin Your Finances—and Your Child's

About 23 years ago, a young couple named Kathy and Bill came to my office to have their income tax return prepared. During the interview, I asked whether they had any dependents that we could claim on their tax return. They both looked at each other and smiled and then turned to me at the same time and said "we have a dependent on the way." Kathy was four months pregnant. Of course, I immediately congratulated them, and then I told them they needed to start saving now for their child's college education. They both laughed at my suggestion: they thought I was joking. I replied that it is never too early to start saving for a child's education, and I recommended that they establish a Section 529 Plan before the end of the year.

They both lived and worked in New York City and qualified to contribute $5,000 each to New York's 529 College Savings Program. This would have given them the added advantage of a $10,000 New York State tax deduction. This would translate into a $1,200 state and city income tax savings (based on 12 percent tax rate); therefore they could have set aside $10,000 for their child's education, which would have only cost them $8,800 after the tax savings. I further explained to them that any gain they make from this 529 Plan over the next 18 years would be distributed *tax free* if they used it to pay for qualified higher education expenses. That is right: there is both a tax break for putting money into the plan up front *and* tax-free income when you take it out to pay for college. However, although they appreciated my advice, they felt it was too early to start saving: they said they needed the money to pay for their child's new bedroom set, clothing, and other items. In sum, they said they could not afford to do it this year, but they would start next year.

Kathy was a school teacher and earned a modest salary, but she had great benefits, not to mention a lot of vacation time. Bill was an electronics salesman and his salary was based mostly on commissions from his sales. His income varied widely from year to year and he did not have much in terms of employee benefits from this job.

Every year during tax season, I met with them and again reminded them of the advantages of planning and preparing for their child's college education costs. But every year, they always had

an excuse for why they were not able to set the money aside, even though they were losing out on the many tax benefits available. They had to set their priorities based on what was most important to them at that time. They always chose to satisfy their *immediate wants* and not set aside money for their *future needs.* Every year that Bill earned a nice bonus, this money went for things like vacations, new cars, furniture, remodeling of their home, and a new built-in pool in the backyard. They always justified their spending with the pleasure of immediate gratification they experienced.

The days, the months, and the years went by, and then it was time for their son Billy to start looking at colleges. Billy had just turned 16, started studying for his SAT exam, and was very excited about starting his junior year of high school. Billy was interested in medicine and told his parents he wanted to become a doctor. Kathy and Bill were very excited and had never seen their son more motivated and eager about school. The three of them spent the afternoon doing Google searches about what colleges would be best to attend to prepare him for becoming a doctor. When they saw what the average cost was they were in shock: $32,000 to $52,000 per year seemed to be the price range for a private college, and $15,000 to $25,000 a year for a public in-state college. Although this troubled Kathy and Bill, they did not want to let Billy know they were concerned.

The next two years Billy hit the books and brought his grade point average from 82 to 87. He studied long and hard for the SAT exam and was able to score a 1900 on the three parts. He applied to a dozen schools that he believed he had a reasonable chance of being accepted to. Some were private and some were public. Also, he was committed to going away to school and did not want to apply to any local colleges. From November through May 1, Billy rushed to the mailbox after school each day to see if he had received any college acceptance letters.

Of the schools he applied to, he was rejected from six of his choices, accepted to four, and wait-listed at two. Of all the schools he visited, he fell in love with Quinnipiac University in Connecticut, but this was one of the two schools at which he was wait-listed. He and his parents visited the schools and did further research on the remaining six college choices. Two of the schools were public, one was in New Jersey, and the tuition with room and board would have been about $25,000; the other was a New York state school (SUNY) that would have cost about $7,000 per year.

Although both these schools would have provided Billy with a top-rate education, he and his parents were not completely satisfied. They felt more comfortable with a private education, with small class sizes, a beautiful campus, and comfortable dorms. The other two private schools he was accepted to would have cost $40,000, and he had been awarded a $15,000 merit scholarship; still, this would have cost approximately $25,000 per year.

It was April 28 and there were only two days left before the big decision needed to be made. It was on this date that the letter came from Quinnipiac that notified Billy he had moved from the wait list to the acceptance list. Billy was extremely excited, and he could not wait to tell his parents the great news. The only problem was this school cost more than $50,000 per year, and there was no mention of a scholarship in the letter.

His parents were overjoyed when they saw how excited and thrilled their son was. When Billy said "I am going to Quinnipiac: this was always my first choice," his parents showed their excitement as well as acceptance, but inside their heads they were thinking, *How in the world are we going to pay for this?*

Later that evening, Kathy and Bill were lying in bed, discussing their concern about how they were going to pay for this education. Bill realized they would never qualify for financial aid because their combined income was just over $100,000. Kathy looked at their savings and realized they did not even have enough money available to cover the first semester. They both agreed that they should have listened to my advice 18 years ago, before Billy was even born. But now it was too late, and they had to make a difficult choice: *Do we take away our son's first-choice college and send him to a public college, which will cost a fraction of the price?* Of course, they made the decision to give Billy what he wanted and not what they could afford.

Kathy said she would be able to get a $50,000 loan from her 401(k) plan at work. Bill agreed that would get them through the first year; then they would figure out a plan for the second year later.

By the time the second year came, they had to max out their credit cards to get the money needed to pay that year's tuition. They were having a very difficult time paying their bills and making the minimum payments on their credit cards as well as the 401(k) loan. They did not want Billy to take out any student loans of his own, and they did not apply for any government-based student loan programs. They were confused about how these loans worked, so they simply chose to ignore any of the options available.

When they looked over their finances, they realized that their main asset was their home and that they had more than $250,000 in equity just sitting there, which they could access. They immediately applied for a home-equity loan and were approved for a $150,000 loan. They used these funds to get through the next two years of college and to catch up with some other bills they had fallen behind on. Unfortunately, during Billy's fourth year of college, Kathy had a nervous breakdown and made the decision she could not go back to her full-time job.

Kathy was notified by her personnel department that she was required to pay back the $50,000 401(k) loan within 30 days of her last day of employment or it would be deemed an early distribution. They simply had no funds available and nowhere else they could borrow from. When tax time came, they owed $20,000 in taxes plus a $5,000 early withdrawal penalty to the IRS. What made matters worse was that this happened in 2009, when the real estate market crashed.

Billy graduated college, but he was not able to go to medical school because his grades were not high enough for him to even consider applying. After six months of interviewing, he was able to get an entry-level job working in the administrative department of a local hospital.

In the meantime, the recession continued to cause financial strain to the family because Bill did not get his usual bonus for two years because of low sales volume. Bill and Kathy were in a financial mess, and they knew they needed to do something drastic to straighten out their finances and minimize the stress in their lives. So they made the difficult but necessary decision to sell their house. Even with the drop in real estate values, they were able to sell their home, eliminate all of their debt, and still have about $20,000 in cash left over.

They moved into a small rental apartment and were able to significantly minimize their monthly expenses. They were able to live off Bill's salary and Kathy's new part-time job.

This story could have had a much happier ending if they had simply started a college savings plan early on. They made almost every financial mistake possible throughout Billy's first 22 years of life. To be financially responsible and achieve and maintain financial independence, you need to *forego your short-term wants*, and then *plan and prepare for your family's long-term needs.*

Do not make the same mistakes these parents made. Start planning for your child's education as soon as possible. Be open to your

children about financial decisions and what consequences these decisions will have on the family's future. Your family's financial situation is not a topic that needs to be kept private; instead, it should be shared and understood by all of your family members. Understanding the difference between your family's needs and your family's wants involves the participation of you, your spouse, and your children. Making the right choices and fully understanding the consequence of these actions is a must. Taking advantage of college savings programs will help you get there more easily. Understanding how scholarships, government grants, and student loans can help is essential. Taking advantage of all the special tax deductions and credits that may help subsidize the cost of college is a must. This chapter will provide you with what it takes to get not only your children, but you and your spouse through the burden and stress of paying for a college education.

## Conducting a "Needs Analysis" for Your Children's College Educations

The starting point for planning to pay for education is performing an education "needs analysis." Before creating an educational funding plan, you must first determine your estimated needs. For each of your children that you expect will be attending college, you will need to estimate his or her total cost for higher education. This estimate should include their tuition, fees, books, supplies, equipment, tutoring, transportation, and possible extracurricular activities. If you believe your child will be going away to school, you will also need to estimate the added room and board, meal plans, as well as travel costs. Once you have estimated what this cost may be per year in today's dollars, you will need to adjust this for the expected education inflation rate and determine this for each year they will be attending college.

If you are like most parents, saving for your child's education is a major financial concern. Given the fact that the current cost of a four-year college education could be well into the six figures for certain colleges and universities, this will most likely cost you a lot more than you have anticipated. I would recommend utilizing the various college funding calculators provided at Yahoo! Finance or savingforcollege.com. To calculate how much money you will need, answer the following questions:

- How many years until your child enters college?
- How many years do you expect your child will be attending college?

- What is the total current cost for attending the college of your child's (and your) choice?
- What is the expected rate of inflation (assume 5 percent or more) for college costs?
- How much money do you currently have saved and earmarked for this purpose?
- What is your expected after-tax return on your investments during this time frame?

After inputting the above information into the college funding calculator, you will be able to determine how much money you will need to save each year (or the lump sum you need now) to cover the total cost of your child's future college education needs.

Let us walk through an example, answering each of the questions above as follows:

- If your child is five years old now, you have about 12 years until your child attends college,
- If you expect your child to obtain a bachelor's degree, you will need to cover four years of college expenses,
- If the annual cost of tuition and all fees at today's prices is $17,000,
- If you allow for a five percent inflation rate,
- If you have $10,000 set aside already for your child's college education,
- And if you expect to earn an eight percent return on your investments,[2]
- Then *you will need to save $131,586 by the time your child goes to college.* To meet that goal, you will need to either invest a lump sum now of $52,255 or you will need to save and invest $5,607 each year, for the next 12 years.

And that is only for *one* child.

Fortunately, the sooner you start to save, the more manageable this financial goal becomes. For most people, this calculation

[2]The rates of return shown above are purely hypothetical and do not represent the performance of any individual investment or portfolio of investments. They are for illustrative purposes only and should not be used to predict future product performance. Specific rates of return, especially for extended time periods, will vary over time. There is also a higher degree of risk associated with investments that offer the potential for higher rates of return. You should consult with your representative before making any investment decision.

becomes a reality check and a rude awakening. Unfortunately, most parents are not prepared when this day comes, and they put their children and themselves into debt (as Kathy and Bill did, in the case study at the beginning of this chapter). This does not have to be the case for you and your family. By taking full advantage of the powerful education planning management strategies discussed in this chapter, you can and will be prepared.

By taking full advantage of the tax savings offered through Section 529 "qualified tuition plans," Coverdell Education Savings Accounts, and savings bonds, you can accumulate the money you will need much more rapidly and possibly on a tax-free basis. By understanding all the government grants and loans available and how to qualify, this may go a long way in reducing your costs. By encouraging your children to do well in high school, they may qualify for merit scholarships and other awards. Lastly, if you qualify, you may be eligible for special tax deductions and credits in the years that your children attend college and that you pay for their college costs.

Therefore, there are numerous strategies you can use to make this process much more affordable. Lastly, you should seriously consider state and city colleges and universities that provide a top-rated education at much more affordable prices. A college education is extremely valuable, but you must fully weigh out the benefits and compare them to the cost. As I have said throughout this book, you must always be able to distinguish between your *needs* and your *wants*. Since a college education is clearly a *need* in today's society, you then must ask yourself if there is a less-costly college-selection alternative. Planning and paying for your child's education is one of the keys to achieving and maintaining financial independence.

## Strategies for Saving Money for College Education

Here are four of the most commonly used strategies for saving money for a college education:

1. Section 529 college savings programs.
2. Uniform Gifts/Transfers to Minors Act (UGMA/UTMA) account.
3. Coverdell Education Savings Accounts.
4. U.S. savings bonds.

Each has distinct advantages as well as some drawbacks. Understanding how each of these education savings techniques work will go a long way to helping you decide which approach (or combination of approaches) would work best for your individual circumstances. Exhibit 7.2 provides a detailed comparison of these four options, based on 2013 tax rules, followed by a detailed discussion of each of these four strategies, plus a few more you might consider.

#### *Section 529 Plans "Qualified Tuition Plans"*

IRS Code Section 529 was created in 1996 with the passage of the Small Business Job Protection Act. This was the birth of *qualified tuition plans,* commonly referred to as *529 plans,* which were specifically designed to help people save and ultimately pay for college education on a federal tax-free basis. Investment assets held within a 529 plan account accumulate on a tax-deferred basis. Withdrawals of accumulated earnings as well as principal are federal income tax-free, if you use them for qualified higher education expenses at any eligible postsecondary educational or vocational institution in the United States. Some states also allow you a tax-deductible contribution for state income tax purposes, if you establish your 529 plan in that state's sponsored program.

Qualified expenses generally include:

- Tuition
- Room and board
- Books and supplies
- Special needs services in connection with enrollment at a qualified institution

You can open a 529 Qualified Tuition Plan account for your children, your grandchildren, or anyone who is a U.S. citizen or legal U.S. resident. There are no age or family relationship limitations on 529 plan beneficiaries. In fact, you can even open an account naming yourself as the beneficiary to help with your own higher education expenses.

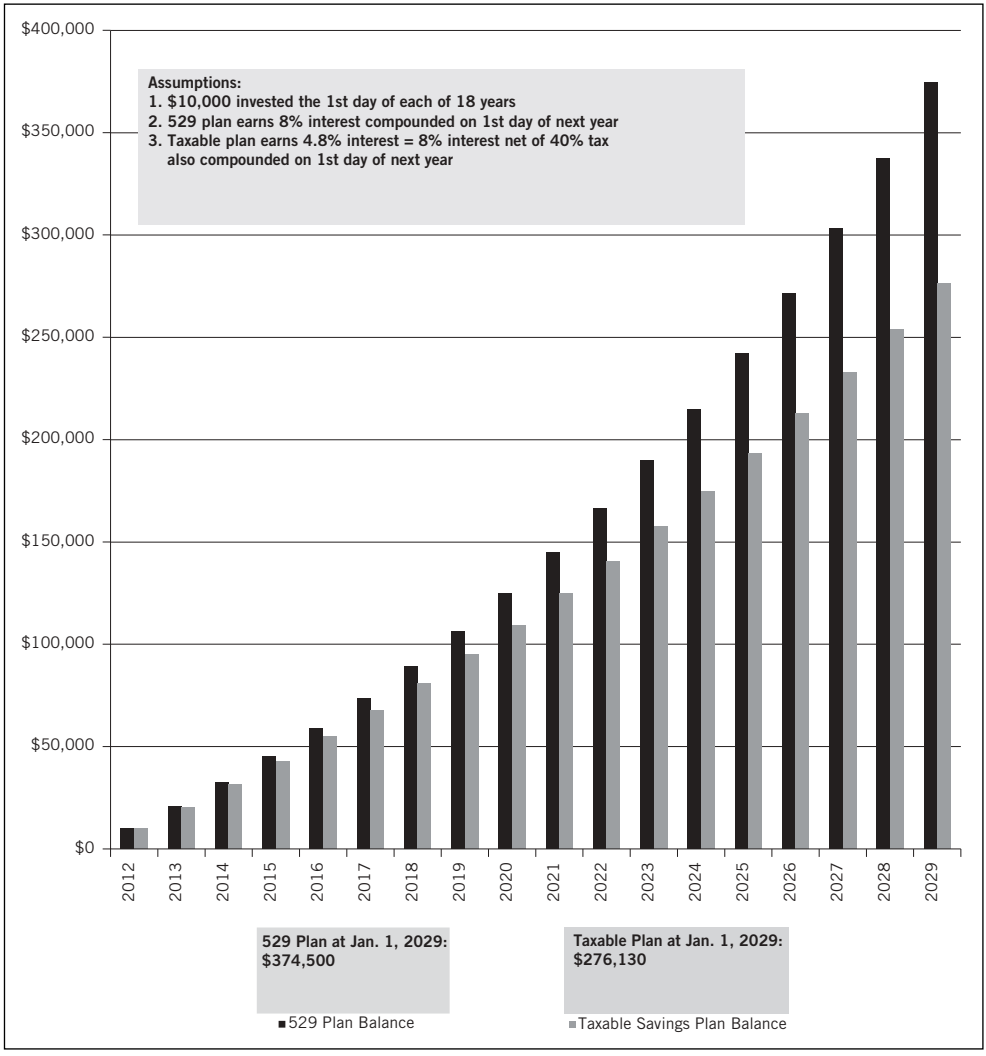
Section 529 plan earnings can be tax free, if you use them to pay for qualified higher education costs. Exhibit 7.3 shows how your earnings can grow on a tax-free basis. First, Exhibit 7.3 shows the difference between investing $10,000 in a taxable account and a

**Exhibit 7.2 Comparison of Higher Education Savings: Tax-Deferred, Tax-Exempt, and Taxable Plans**

| Attribute | Section 529 Plan[3] | UGMA/UTMA | Coverdell Education Savings Account | U.S. Savings Bonds |
|---|---|---|---|---|
| Federal taxation of account earnings | Tax-deferred and then tax-exempt when used for qualified higher education expenses | Taxable each year | Tax-deferred and then tax-exempt when used for qualified education expenses (including elementary or secondary education) | Tax-exempt when used for qualified higher education expenses |
| Income limits | None | None | Phases out at from $95,000 to $110,000 for single filers, head of households, and married filing separately, and $190,000 to $220,000 for married filing jointly filers | Inflation adjusted income limits apply. Phases out at $74,700 to $89,700 for single and head of household filers and $112,050 to $142,050 for married filing jointly filers |
| Control of assets | The account owner retains control of assets and can choose to change the beneficiary or revoke the account through a nonqualified withdrawal | Custodian controls the assets until the beneficiary reaches the age of majority | The responsible individual named on the account controls assets, which must be used for the benefit of the named minor. Assets will be transferred to the beneficiary at age 30 | The account owner retains control of assets and can choose to change the beneficiary or redeem the bond |
| Ability to change beneficiary | Can be changed to a qualified family member of the current beneficiary without adverse federal tax consequences | No | Can be changed to a member of the family of the current beneficiary if the right to do so is established when the account is opened | Can be changed to a qualified family member of the current beneficiary without adverse federal tax consequences |
| Penalty for nonqualified withdrawals | Subject to federal and possibly state income tax and a 10 percent penalty on earnings | Subject to federal income tax each year, no penalty applies | Subject to federal and possibly state income tax and a 10 percent penalty on earnings | Subject to federal income tax on earnings, no penalty applies |
| Gift tax treatment (2013 amounts) | Gifts of up to $70,000 ($140,000 for married couple) qualify for federal gift tax exclusion, provided no other gifts are given to the beneficiary over the following five years | Qualified for the annual $14,000 gift tax exclusion | Qualified for the annual $14,000 gift tax exclusion | Qualified for the annual $14,000 gift tax exclusion |

[3]See footnote 1.

**Exhibit 7.3 Growth of Savings Invested in a Tax-Free 529 Plan versus a Taxable Savings Account**




tax-exempt account, with subsequent investments of $10,000 at the beginning of each year for 18 years. This example also assumes an eight percent annual rate of return with a 40 percent marginal tax rate.[4] This illustration demonstrates the possible value of tax-exempt earnings over time through a 529 education savings plan.

[4]See footnote 2.

As you can see, if you invest the same amount of money in both plans, *you could earn almost $100,000 more* over 18 years when you invest in the tax-free 529 plan.

As you evaluate various college savings options, you should consider both the tax advantages and control you have with each type of plan; for example:

- **Control**—With a section 529 plan, you are able to exercise control over who the ultimate beneficiary of these funds will be, and can even terminate the account if you wish. Therefore, if your firstborn decides not to go to college, and you have invested in a 529 plan in his name, you can transfer the funds to your second child, or you can simply terminate the plan. If you do not want your beneficiary to have the ultimate control of these funds, then a 529 plan may be the right choice for you, as it clearly gives you flexibility.
- **Tax advantages**—A 529 plan offers a variety of noteworthy tax advantages, such as high account limits, tax-free withdrawals, and accelerated federal gifting and estate tax benefits—and, in some cases, state tax deductions. This is perhaps one of the most tax-effective strategies for saving and paying for higher education. There are no income limitations as to who can establish an account. High-income earners can take full advantage of these tax benefits. *This is my number one recommended strategy for an education savings plan.*[5]

#### *Uniform Gifts to Minors Act and Uniform Transfers to Minors Act*[6] *(UGMA/UTMA)*

The Uniform Gifts to Minors Act (UGMA) and Uniform Transfers to Minors Act (UTMA) accounts allow your children to invest for their college education by holding the funds in their own accounts. Any income generated from this account will be taxed each year directly to the child, which may allow a portion of the income to be taxed at a lower rate.

These accounts provide you with a method to transfer assets out of your name and into that of a minor, without having to establish a trust (which can be expensive). Please note that these transfers are

[5]See footnote 1.
[6]See footnote 1.

considered completed gifts and may require the donor (the person that gave the gift) to file a gift tax return.

UGMA and UTMA accounts were not created specifically as savings vehicles for college, but many parents use them for this purpose because these assets typically become available to the minor when they are in the early years of college.

The accounts are managed by a custodian—usually a parent, grandparent, relative, or friend. Individuals can make an irrevocable transfer for any amount to these accounts as a gift to the minor. In the event that the custodian passes away before the child reaches majority (i.e., is considered an adult by state law, which varies from state to state between ages 18 and 21), the account may then be includable in the taxable estate of the donor (i.e., the custodian).

The key difference between UGMA and UTMA accounts is that UTMA law allows more flexibility with the type of investments that can be included in the account. The UGMA law limits the type of investments that can be held in these accounts to bank deposits, securities (stocks, bonds, mutual funds), and insurance policies.

The main income-tax advantage to transferring these assets to a child used to be that all the income earned on these investments would be subject to tax at the child's significantly lower marginal tax rate. However, the IRS created a "kiddie tax" that has significantly reduced the tax advantage of establishing these accounts and was specifically created to close this tax loophole and to discourage this type of tax-saving strategy. This tax may apply to your child if he or she has investment income (such as interest, dividends, and capital gains). For 2013, the kiddie tax on unearned income from investments will apply when this income exceeds $2,000. The first $1,000 is not taxed because of the standard deduction and the second $1,000 is taxed at the child's tax rate. The excess income over $2,000 is then taxed at the parents' higher tax rate. The kiddie tax applies not only to children younger than age 19, but also to children who are full-time students ages 19 to 23 and do not have earned income exceeding half of their own support. The kiddie tax only applies to the child's investment income over $2,000; it does not apply to earned income from wages or self-employment.

Another major disadvantage to these types of accounts is that all assets transferred under UGMA and UTMA laws represent an irrevocable gift (transfer). Upon reaching the age of majority under the state UGMA/UTMA laws, the child gains control of the assets and may use them any way he or she wants to. For example,

if little Suzie decides to jump on the back of her boyfriend's motorcycle on her eighteenth birthday and head to California to start a new life, she can take the money with her, because she is no longer considered a minor.

Yet another major potential disadvantage of UGMA or UTMA accounts is that they may affect the amount of financial aid your child receives. This is discussed further in the government grants and loans section of this chapter.

This is one of the major reasons why parents may want to invest in their own name instead of the child's because when it comes to qualifying for financial aid, parental assets and income are less of a factor than the child's. If your child is approaching his or her college years, the custodian is permitted to spend down the account for the benefit of the child prior to completing the financial aid forms.

As a general rule, I discourage people from using UGMA or UTMA accounts as a method of saving for a child's education. The minimal tax savings you may achieve is usually not worth the potential pitfalls. If you want to retain control of the assets, take advantage of tax- deferred savings and qualified tax-free withdrawals, and not jeopardize any potential financial aid, you should avoid these types of accounts. Instead, use one or more of the other education saving vehicles covered in this chapter.

If you do use either a UGMA or UTMA account, you should seriously consider spending down the account (instead of using your own money) for the benefit of your children for such expenses as their high school tuition, computers, and whatever else they may ask for. You will then have extra funds of your own available to fund a Section 529 plan.

#### *Coverdell Education Savings Accounts*

A Coverdell Education Savings Account (ESA) was formerly known as an Education Individual Retirement Account. A Coverdell ESA is a tax-advantaged educational savings account designed specifically to encourage savings to cover future education costs. These accounts can be used to pay for elementary education, secondary education, and college costs, such as tuition, books, uniforms, and other education-related expenses.

The tax treatment of a Coverdell ESA is similar to the Section 529 Plan with some significant differences. Similar to a 529 Plan,

Coverdell ESAs allow your investments to grow tax deferred, and the distributions can be tax free for qualified education expenses at a qualified institution.

The major and most significant difference in these plans, however, is how *qualified expenses* are defined. Qualified expenses under a Coverdell ESA account include private primary and secondary school, and not just college and university as is the case with Section 529 plans. This could make a Coverdell ESA account your best choice when saving for a private elementary or high school education. If not used for this purpose, you can, of course, use the account for higher education expenses.

The key features of a Coverdell Education Savings Account include the following:

- There are income limitations for the donor, which may affect the ability to make contributions into a Coverdell ESA. For tax year 2013 if you were a single individual, head of household, or a married taxpayer filing separately, you can make the full contribution if your income was below $95,000, and then it is phased out through $110,000. A married couple filing jointly can make a full contribution if their income level was below $190,000 and then it is phased out through $220,000. The money held in a Coverdell ESA account is not considered part of your child's assets when applying for federal financial aid, as long as your child is listed as the *beneficiary* and not as the *account owner.*
- The custodian of a Coverdell ESA account (i.e., you, the parent) can change *the named beneficiary without incurring taxes or penalties,* as long as the new beneficiary is an eligible family member of the previous beneficiary.
- Coverdell ESAs have an annual contribution limit of $2,000 per child; therefore, the use of a Coverdell is limited. This $2,000 annual contribution limit has been extended permanently under the American Taxpayer Relief Act of 2012.
- Coverdell ESAs allow almost any type of investment to be held, including stocks, bonds, and mutual funds.
- The funds in a Coverdell ESA must be used for qualified education expenses by the time the designated beneficiary is 30 years old. Alternatively, you can change beneficiaries to another family member younger than the age of 30 in order to avoid taxes and penalties before that time comes.

- Coverdell ESAs allow distributions on a tax-free basis for qualified elementary and secondary school expenses and not only for college and universities.

Try to fit a Coverdell ESA into your overall education savings strategy. If you do not qualify to contribute to an ESA account because of the income limits, encourage other family members to do so, assuming they qualify. For example, if your child gets a summer job, you can invest the extra cash he or she earns into an ESA account (based on your child's income level). Although this education tax saving break is limited, everything you do in the aggregate will make a difference in the long run.

#### *Savings Bonds*

U.S. savings bonds are yet another popular way of saving for college. They offer a low rate of return on your investment, but they are also low risk. For example, if you purchased $1,000 in series EE bonds or series I bonds between May 1 and October 31, 2012, the rate would have been 0.60 percent or 2.20 percent respectively. The series EE bonds would have earned only $6 and the series I bonds would have earned only $22 over a one-year period, which is not an attractive rate of return, especially when you consider the loss of purchasing power due to inflation.

However, savings bonds are considered a very safe investment, because they are backed by the full faith and credit of the U.S. government. Both the principal and earned interest is safe, which means you cannot *lose* money due to market changes, because U.S. savings bonds are not considered marketable securities. U.S. savings bonds are registered with the U.S. Treasury Department; therefore, you can easily replace them if you lose them or they are stolen or destroyed. This is in contrast to bearer bonds, which are almost equivalent to having cash. Anyone who presents the bonds to a bank, even if they have been stolen from you, can convert them to cash at any time. You would then be out of luck because bearer bonds are not registered to the owner and are treated the same as lost cash.

Through a special Education Savings Bond Program, interest on certain savings bonds is tax free when you use them to pay for qualified higher education expenses. The U.S. savings bonds that qualify for this tax-free treatment include series EE bonds issued after December 31, 1989, and all series I bonds.

You must also be very careful and make sure you meet the following requirements for this tax-free treatment.

- The bond owner (you) must be at least 24 years old on the bond issue date (the first day of the month in which the bonds were purchased).
- Parents can purchase bonds for their children, but the bonds must be registered in the parents' name.
- The child cannot be listed as a co-owner, but the child can be listed as a beneficiary.
- You can also purchase bonds for your own education, in which case the bonds must be registered in your own name.

Currently, there is an annual purchase limit of $30,000 per owner for Series EE Bonds and $30,000 for Series I Bonds. A husband and wife purchasing bonds as co-owners would be able to purchase up to $60,000 in a single year. The purchase limit for Series I Bonds is not affected by purchases of series EE Bonds; these purchase limits are independent of one another.

There are, of course, some major advantages and disadvantages to purchasing qualified Series EE and I U.S. Savings Bonds. First, let us look at the advantages:

- You don't need to open an account with a financial institution, because U.S. savings bonds are registered and issued by the U.S. Treasury Department. You can walk into almost any bank, credit union, or savings and loan to buy U.S. savings bonds. However, you can now also get savings bonds online, directly from the U.S. Treasury, at treasurydirect.gov.
- You can buy savings bonds for as little as $25, which makes them easily affordable for most people.
- The interest on these bonds is always exempt from state and local income tax and may be fully exempt from federal income taxes when the bonds are used for qualified college expenses.

Now for the disadvantages:

- You are locking yourself into a very low rate of return, which most likely will not keep pace with inflation. With interest rates at historical lows, the rate of return currently offered by these bonds does not make them an attractive choice. This is

the biggest disadvantage; therefore, you need to weigh this low return against the safety and security of knowing they are government-guaranteed obligations.

- The exemption from paying federal income taxes when you use savings bonds to pay for college expenses is more restricted than some of the other alternatives: Series EE and I Bonds are only exempt from taxation when they are used for tuition, not room, board, or books.
- For 2013, if you (as the taxpayer holding the bonds) file your taxes as single or head of household, there is an income phase out for adjusted gross income between $74,700 and $89,700; if you are married and filing jointly, the phase out is $112,050 through $142,050. This may completely eliminate the tax advantage of using U.S. savings bonds as a vehicle for saving for college, if your income reaches these levels in the year you need the funds.

For all the above reasons, although savings bonds are a popular way of saving for college, it is not one of my favorites, especially for potentially high-income earners.

#### *Roth Individual Retirement Accounts*

I know what you are thinking: why are Roth IRAs included in this chapter as a strategy for saving money to pay for college? The simple answer to this question is that although a Roth IRA was not established as an education savings vehicle, it can serve that purpose if you use it in the right way.

Let us assume your son or daughter has been working at a part-time job and has earned $7,500 or more over the year. What would be the best use for this money? I am sure your child is thinking video games or designer jeans, but that is not the correct answer, of course.

The best use for this money is to fund a Roth IRA for $5,500 and a Coverdell Education Savings Account for $2,000. The argument for doing this is even stronger if your income level does not allow *you* to contribute to these accounts on your own, but your child would qualify based on his or her level of income. I have already covered the many benefits of establishing a Coverdell Education Savings Account, so now I am going to focus on the Roth IRA.

Let us also assume your child managed to save $5,500 per year for five years in a Roth IRA and now is in his third or fourth year of

college. Let us also assume that this $27,500 is now worth $45,000 because of some good investment choices.[7] Your child would be able to take a distribution from this account to cover the cost of undergraduate or graduate school. Assuming he took the full $45,000 out in one year, only $17,500 ($45,000 less $27,500) of this amount would be subject to tax. Moreover, this income is subject to tax *at your child's low tax rate*, which could be as low as 0 percent, if it is structured properly.

Furthermore, although the IRS levies a 10 percent penalty if you withdraw money from a retirement account before you are 59½ years old, there is an exception to this penalty if you use that distribution to pay for qualified higher education costs. Therefore, this amount would not be subject to this penalty. Once again, Roth accounts were not designed to cover higher education expenses, but you can clearly use them as an additional strategy for saving for college.

Furthermore, if your child does not need the funds to cover higher education expenses, it is still a benefit for your child to have this money invested in a tax-free retirement account before he even graduates from college. This would give your child an amazing start and advantage to achieving and reaching his or her own financial independence. I always encourage children and their parents to start saving for retirement as soon as possible.

#### *Government Grants and Loans*

When you consider the multitude of options and opportunities available for saving and paying for college education, the subject of government grants and loans probably has the most ambiguity associated with it. In 2007 through 2008, the U.S. Department of Education's National Center for Education Statistics conducted a study that revealed the following selected findings regarding student financial aid:

- Types of financial aid received by undergraduates in 2007–2008:
  - Sixty-six percent of all undergraduates received some type of financial aid. For those who received any aid, the total average amount received was $9,100.
  - Fifty-two percent received grants averaging $4,900.

[7]See footnote 2.

  - Thirty-eight percent took out an average of $7,100 in student loans.
  - Seven percent received aid through work-study jobs, averaging $2,400 in wages.
  - Two percent received an average of $5,400 in veterans' benefits.
  - Four percent of students had parents who took out an average of $10,800 in Parent Federal PLUS (Parent Loan for Undergraduate Students) loans, which are included in total aid but are not included in student loans because they are loans for parents of dependent students.
- Sources of aid received by undergraduates in 2007–2008:
  - Forty-seven percent of all undergraduates received federal student aid, the average amount of which was $6,600.
  - Sixteen percent received an average of $2,500 in state-funded grants.
  - Twenty percent received an average of $5,000 in grants funded by the postsecondary institution they attended.
- Federal Title IV of the Higher Education Act, federal aid for undergraduates in 2007–2008:
  - Twenty-seven percent of all undergraduates were awarded federal Pell grants, at an average of $2,600. A Federal Pell grant is financial assistance, awarded by the federal government to undergraduate students on the basis of need. The grant may be used toward tuition, room and board, books, or other educational costs. This money does not have to be repaid.
  - Thirty-four percent of all undergraduates took out federal Stafford loans, averaging a total of $5,000. A Stafford loan is a student loan offered to eligible students who are enrolled in accredited American institutions of higher education to help finance their education. They are made available to students through the William D. Ford Direct Loan Program and the Federal Family Education Loan (FFEL) program.
  - Thirty percent of undergraduates received subsidized Stafford loans, at an average of $3,400. Stafford loans are federal loans that come in two forms, subsidized and unsubsidized. Subsidized loans are based on need; unsubsidized loans are not. The interest on the subsidized Stafford loan is paid by the federal government while the student is in school and during the six-month grace period.

    - Twenty-two percent of undergraduates received an average of $3,200 in unsubsidized Stafford loans.
- Income distribution of undergraduates:
    - Among all dependent undergraduates, 28 percent came from families with incomes under $40,000, and another 28 percent had family incomes of $100,000 or more.
    - Among all independent undergraduates, 40 percent had incomes under $20,000.
- Aid received by graduate students in 2007–2008:
    - Seventy-four percent of graduate students received some type of financial aid.
    - The average amount of total aid received was $17,600.
    - Fifteen percent received an average of $12,100 in assistantships.
    - Forty-three percent took out an average of $18,500 in total student loans. This included 39 percent with an average of $15,600 in Stafford loans and 5 percent with an average of $15,500 in Graduate PLUS loans.

These selected findings from the most recent U.S. Department of Education study should give you some idea of the type and sources of financial aid that may be available.

It is also very important to understand how the federal government and institutions calculate how much aid they provide students, whether in the form of grants, federal loans, or work study. For the most part, the formula to determine the amount of need for financial aid will factor in your family's ability to pay over time. This is expressed as an *expected family contribution*. If there is a gap between the cost of attendance at a school and the expected family contribution, a financial aid offer may be made. According to the U.S. Department of Education's *Federal Student Aid Expected Family Contribution Formula Guide*, here are the essential factors in the expected family contribution calculation:

- What you, as the parents, currently earn
- What your child (the student) currently earns
- What the parent owns
- What the student owns directly

The most heavily weighed factors in evaluating eligibility for financial aid is current income received by the parent or child and

then whether the parent or the child has control over financial assets. It is vital to understand the significance and importance that these key factors play in determining financial aid. You should consider these factors when you are selecting the college savings vehicles you plan to use as well as how you plan to hold ownership to these assets.

Understanding what effect your overall savings will have on your chances of receiving financial aid is critical to assessing your additional needs. There are several types of financial aid including, federal, state, and institutional. Federal aid is the most widely used form of assistance available to college students. To be considered for federal aid, a student must complete the financial aid Free Application for Federal Student Aid (FAFSA) forms.

Exhibit 7.4 provides the ranges of parental and student income and assets that are used to calculate the annual expected family contribution for any given student. Once the expected family contribution has been determined, a college's or university's financial aid officer subtracts it from that institution's cost for attending their college or university, in order to determine the annual financial need. Exhibit 7.4 reveals that *income* is more heavily factored in the calculation than *assets,* and that *student* income and assets are factored in more heavily than his or her parents' income and assets. Exhibit 7.4 also highlights the impact that some of the most common college saving vehicles will have on your child's ability to qualify for financial aid.

**Exhibit 7.4 Factors Used in Calculating the Annual Expected Family Contribution for Financial Aid Purposes**

| | Parents | Students |
|---|---|---|
| Income | 22% to 47% of available income | 50% of available income over $6,000 |
| Assets | 0% to 5.64% of assets, including:<br>• Mutual funds<br>• Securities<br>• Bank accounts, CDs<br>• 529 savings plans where the account owner is the parent(s) | 20% of assets held in student's name, including:<br>• UGMA/UTMA accounts not held in a 529 Plan<br>• Minor trusts not held in a 529 Plan<br>• Savings bonds (in student's name) |
| | Qualified retirement plans are not considered | Qualified retirement plans (including Roth IRAs) are not considered |

*Source:* This information is based on the U.S. Department of Education's Federal Student Aid Expected Family Contribution Formula Guide, 2012–2013.

However, Exhibit 7.4 does not take into consideration withdrawals from a 529 plan, which can have a direct effect on a student's financial profile for the purpose of determining expected family contribution and therefore can affect the extent of that student's financial aid package. The significant differences in determining the effect of a 529 plan withdrawal is whether the 529 plan is a *prepaid tuition plan* or a *college savings plan.*

*Prepaid 529 tuition plans* commonly allow you to purchase units or credits at a participating college or university, which can then be applied toward future tuition payments. In some situations, they can be used to cover the cost of room and board. The majority of these plans sponsored by the state have residency requirements. Investments in prepaid tuition plans are also sometimes guaranteed by the sponsoring state government.

*Savings 529 tuition plans* generally allow you to establish an account for a beneficiary for the purpose of paying the beneficiary's qualified educational costs. As the account holder, you typically have several investment choices for your contributions in the 529 savings plan, which typically include stock and bond mutual funds as well as money market funds. Some also offer age-based portfolios. You can usually use the distributions from 529 savings plans at any U.S. college or university. Your beneficiary has the flexibility of choosing any college or university he or she gets accepted to, in any state. It is important to note that the investments in these 529 savings plans are not guaranteed by state governments.

Prepaid 529 plans are treated differently than 529 savings plans because they are considered *resources* rather than *assets.* This distinction is significant and extremely important to understand. Although assets held in prepaid 529 plans are not considered in the federal student financial aid calculation, the *withdrawals* from these plans will reduce your financial aid eligibility dollar-for-dollar. This means that withdrawals are direct reductions in the amount of financial aid that would have otherwise been available. This is an important distinction and why you should avoid 529 prepaid plans at all costs, if you believe there is a possibility that your child may qualify for financial aid. In this situation, the 529 savings plan would be a much better alternative.

With a 529 savings plan, the portion of the withdrawal that represents a return of your principal contribution is not included as income and therefore would not have a negative effect on eligibility for federal financial aid. Furthermore, the portion of the

withdrawal that represents earnings is not included as income to the beneficiary (i.e., your child) or the college saver (i.e., you) as long as you use it to pay for qualified higher education expenses. The key issue to remember is that these withdrawals will not result in a dollar-for-dollar reduction in the amount of financial aid that your child would have otherwise received.

The information in this section provides a basic understanding of the calculations used in determining eligibility for federal student financial aid. For more detailed information regarding the financial aid process, the many different types of financial aid available, and how your particular facts and circumstances may affect the chances of qualifying, visit the following websites:

- www.finaid.org: one of the most comprehensive sources of information about student financial aid,
- www.ed.gov: the website for the U.S. Department of Education,
- www.fafsa.ed.gov: the Department of Education's website for the FAFSA, which provides comprehensive information on federal student aid and allows users to apply online for such aid,
- www.studentaid.ed.gov: the website for the Department of Education's Federal Student Aid (FSA) programs, and
- www.collegeboard.com: the website for The College Board, a national nonprofit membership association composed of more than 5,200 schools, colleges, universities, and other educational organizations.

There are numerous government grant and loan programs. It is important for you to do your research and become thoroughly familiar with these options early on when planning for your college funding needs. If you believe you will qualify for some of these programs, you can factor these funds into your college-funding plan. On the other hand, if you believe you will not be entitled to any of these programs, because of your income and assets, you will clearly need to focus more on the other college savings programs described in this chapter.

#### *Athletic Scholarships*

For those proud parents who may be counting on little Johnny's football skill or Christine's gymnastic abilities to pay their way through

college, take a hard look at what your actual chances are of receiving athletic scholarships:

> According to the most recent U.S. Department of Education study, "approximately 1 percent to 2 percent of undergraduate students in bachelor's degree programs receive athletic scholarships, equaling a total of about $1 billion a year. While that monetary amount is growing at a rate of 4.5 percent year over year, the percentage of those that actually receive athletic scholarships has not risen higher than 1.8 percent since 1995–1996."
>
> —Mark Kantrowitz, publisher of FinAid.org

## Education Tax Deductions and Credits

During the years your child is attending college, you may qualify for significant tax savings through education tax deductions and credits. Because tax credits can be a dollar-for-dollar reduction in your taxes, I cover this in great detail. The two major education tax credits for higher education are The American Opportunity Tax Credit and The Lifetime Learning Credit.

### *American Opportunity Tax Credit*

To qualify for the American Opportunity Tax Credit in 2013, your family member (student) must be taking at least one-half of the normal course load of a full-time student for the first four years of post-secondary education. This is available under the following circumstances:

- You can qualify for full credit if your tax filing status is married filing jointly with an adjusted gross income under $160,000.
- You can qualify for partial credit if your tax filing status is married filing jointly with an adjusted gross income up to $180,000.
- If you are married as of the last day of the year, you must file jointly to claim this credit; married persons filing separately are not eligible.
- All other filing statuses can qualify for full credit if your adjusted gross income is under $80,000.

- All other filing statuses can qualify for *partial credit* for adjusted gross income up to $90,000.
- This tax credit is available for qualified tuition and related fees incurred and paid in the first four years of post-secondary education for the taxpayer, spouse, and/or dependents.

The American Opportunity Tax Credit is equal to 100 percent of the first $2,000 of qualified expenses paid in the tax year, plus 25 percent of the next $2,000. Therefore, the maximum tax credit allowed in any given year is $2,500 per student, if there is at least $4,000 in qualifying expenses. It is important to note that this $2,500 credit is available for each eligible student in your household. In other words, if you qualify for this tax credit, it would be the same as receiving a $2,500 tax-free scholarship for each of your children who qualifies. In essence, the federal government is subsidizing the cost of sending your child (or other family member) to college. Up to 40 percent of this tax credit can be refundable, even if it exceeds your tax liability for the year.

The American Taxpayer Relief Act of 2012 extended the American Opportunity Credit through 2017.

#### *Lifetime Learning Credit*

The Lifetime Learning Credit does not call for your child (or any other family member) to have a certain degree or workload requirement. This credit may be claimed for one or more courses at an eligible education institution that is either part of a post-secondary degree program or part of a non-degree program taken to acquire or improve job skills. The Lifetime Learning Credit can be claimed for an unlimited number of years. For 2013, here are the requirements:

- You can qualify for full credit if your tax filing status is married filing jointly with an adjusted gross income under $107,000.
- You can qualify for partial credit if your tax-filing status is married filing jointly with an adjusted gross income up to $127,000.
- If you are married as of the last day of the year, you must file jointly to claim this credit; married persons filing separately are not eligible.

- All other filing statuses can qualify for full credit if your adjusted gross income is under $53,000.
- All other filing statuses can qualify for partial credit if your adjusted gross income is up to $63,000.
- This tax credit is available for tuition and enrollment fees for undergraduate, graduate, or professional degree programs for you, your spouse, or your dependents.

The Lifetime Learning Credit provides an annual per taxpayer reimbursement for qualified tuition and related expenses per family in the amount of $2,000 per year. This means if you pay qualifying expenses for more than one eligible student, the overall credit you may claim remains $2,000, regardless of the number of children who are students in your household. This credit is based on a 20 percent factor of qualified expenses. Therefore, to obtain the full $2,000 credit, you must have at least $10,000 of qualified education expenses for all eligible children who are students in your family. This tax credit is nonrefundable; therefore, you will not be entitled to receive it if it exceeds your regular tax plus Alternative Minimum Tax (AMT) liability.

If you have more than one qualifying child in college during the same year, you may have the option of using both the American Opportunity Tax Credit and the Lifetime Learning Credit in the same year; however, you cannot claim both in the same year for the same person in college.

#### *Employee Educational Assistance Programs*

Under the Employee Educational Assistance Program, an employer can reimburse an employee's tuition, enrollment fees, books, supplies, and equipment for undergraduate and graduate studies. This tax-free treatment applies, provided that the courses do not satisfy the employer's minimum education standards and do not qualify you for a new profession. Both undergraduate and graduate courses qualify for this exclusion.

These working-condition fringe benefits can be excluded from the employee's income, up to $5,250 per year. This is a tax-free benefit to the employee (i.e., you or your spouse); at the same time, your employer receives a full business tax deduction.

It is important to note that neither the employer nor the employee can claim an education tax credit for the same expense.

If the employee has expenses that exceed the $5,250 employer reimbursement, the employee will be permitted to claim the American Opportunity Tax Credit or the Lifetime Learning Credit for those expenses paid over this amount. Of course, the employee needs to meet the qualifications for these credits. Under the American Taxpayer Relief Act of 2012 the employer-provided education assistance has been made permanent.

### TAX FACTS AND STRATEGIES[8] FOR PAYING FOR EDUCATION

- Establish and fund the maximum annual contribution of $2,000 per year to a Coverdell Savings Account for each of your children under the age of 18, if you or your child qualifies. Although there is no upfront tax deduction, all future earnings and principal will be paid out tax free if you use it to cover private school costs, from kindergarten through graduate school.
- Consider transferring appreciated property (such as stocks, bonds, and mutual funds) that you plan to sell (to cover education costs), to your children age 19 and older or children who are full-time students ages 19 to 23, if their earned income is more than half of the amount of their support. They can then sell this appreciated property and have the capital gain taxed at a rate as low as 0 percent, as long as their overall income is still at or below the 15 percent tax bracket. They can then use this money to pay for their education, and you can avoid paying tax on any gain.
- Keep in mind that if you buy U.S. EE Savings Bonds or I Bonds to pay for educational expenses and you defer reporting the interest, you may be eligible to exclude the accumulated interests from income when you redeem the bonds.
- Also keep in mind that if you receive a scholarship and fellowship as a degree candidate, these payments are tax free to the extent that they pay for tuition, cost-related fees, books, supplies, and equipment that are required for your courses. Any amounts paid for room and board as well as other incidentals are taxable.

[8]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

- Consider establishing a Code Section 529 plan, which allows you to prepay your designated beneficiaries' qualified higher education expenses or establish a savings plan from which such expenses can be paid. Although you do not receive any federal tax deduction for the contributions you make to these plans, the distributions are generally tax free to the extent that you use them to pay for qualified higher education expenses. If your state has its own sponsored savings plan, you may get the added benefit of a state tax deduction for any contributions you make before the end of the year. Each state has different rules, however, so be sure to check with your tax advisor.
- If you paid qualified tuition and fees for an eligible student in the first four years of college or post-secondary institution, you may qualify for the American Opportunity Tax Credit of up to $2,500 for each eligible student through 2017. Special rules apply, and this credit starts to phase out for married couples filing jointly with incomes over $160,000 and $80,000 for people filing as single, head of household, or qualifying widows and widowers.
- If you paid qualified expenses for yourself, your spouse, or your dependents who are enrolled in eligible educational institutions during the year, you may be able to claim the Lifetime Learning Credit of up to $2,000. This credit does not have a degree or workload requirement. The credit may be claimed for one or more courses that are either part of a post-secondary degree program or a part of a non-degree program to acquire or improve job skills. This credit is not limited to the first four years of post-secondary education, and there is no limit on the number of years it can be claimed. The credit is 20 percent of the first $10,000 paid in 2013, and the maximum credit per family is $2,000 per year. Special rules apply, and for 2013 this credit starts to phase out for married couples filing jointly with incomes over $107,000 and at $53,000 for people filing as single or head of household.
- If you are not getting the benefit of this educational tax credit because of your high income level on your tax return and your child has his or her own tax liability against which the credit may be claimed, you can forego claiming your child as a dependent exemption on your tax return. This allows the education tax credit to be claimed on your child's tax return. Calculate your tax bill as well as your children's and take advantage of the method that provides your family with the greatest tax savings.
- For tax year 2013, you may be able to deduct up to $4,000 of qualifying higher education tuition and fees paid, depending on your income and filing status. This deduction is not available to those married filing jointly taxpayers with incomes $160,000 or more or other taxpayers with incomes of $80,000 or more. You cannot claim the deduction for expenses of a dependent if you have taken the American Opportunity Tax Credit or the Lifetime Learning

(*Continued*)

Credit in the same year. If you qualify for both the education expense deduction as well as the education tax credits, you must choose to take advantage of one. You should calculate your tax both ways, and then claim the one that provides you with the highest tax savings. Typically, the credit will provide the highest tax savings because it is a dollar-for-dollar reduction of your tax liability.

- If you paid interest on a qualified student loan, you may be able to claim an above-the-line deduction of up to $2,500 on your 2013 tax return. This amount is phased out in 2013 for married couples filing jointly starting at $125,000, and $60,000 for individuals filing as single or head of household. If you are married and filing separately, however, you may not claim this deduction, no matter what your income level.
- The American Taxpayer Relief Act of 2012 now expands the tax deductibility of student loan interest by not limiting it to the first 60 months of payments. If you take continuing education or refresher courses including advanced academic courses or vocational training, you may be able to treat these expenses as a work or business expense deduction if they are taken to improve your job- or professional-related skills. These expenses are generally itemized deductions and are limited or completely eliminated by the 2 percent of AGI (adjusted gross income) limitation. You should determine if these costs qualify for the Lifetime Learning Credit or the above-the-line deduction for tuition and fees. You should always take the deduction that will result in the greatest tax savings to you. You may also be able to deduct the cost of obtaining a Master in Business Administration (MBA) degree if the courses enhance the skills required in your current position, are not considered a minimum job requirement, and do not qualify you for a new job.

## AN ACTION PLAN FOR PAYING FOR EDUCATION

1. **Find out—today—what your child's college expenses might be,** even if college is still 18 years away. Do not wait until your child is in high school, because by then, it will be too late for you to save anything to help your child, and you will regret not having started planning sooner. For example, in 2012, the average cost of a four-year college's tuition plus room and board amounted to about $150,000 for all four years. That is a lot of money to come up with when your child is a junior in high school, but believe it or not, if you start saving when your child is very young, you can reach that goal.
2. **Do not spend money on what you want to buy now**—your *immediate wants*—without first setting aside money for your *future needs*. No matter what it is you think you "need" now—furniture for your child's nursery, tennis or piano lessons for your budding prodigy, or a bigger home so your kids can each have their own room—none of that is really as important as saving for your child's education. Do not make the same mistake so many parents make by not starting to save now.
3. **Determine your family's "needs analysis"** by using the college cost calculator at http://finance.yahoo.com/calculator/index/; scroll all the way down to the Career and Education section, then click on "When should I begin saving for my child's college?" This helps you calculate *your* specific needs by plugging in your child's age, how much you have saved already, and other factors.
4. **Understand the differences among the four most commonly used approaches to saving for college:** the Section 529 college savings programs; UGMA/UTMA accounts; the Coverdell Education Savings Accounts; and U.S. savings bonds. Each has different tax implications, income restrictions, and factors affecting who controls the money in the account, as well as other differences, so discuss them with your tax advisor to determine which of these is best for your family's needs.
5. **Keep in mind that you have the most control and the greatest tax benefits if you save money via a 529 plan:** The example in this chapter showed a difference of almost $100,000 more if you save via a tax-exempt 529 than if you save via a taxable account. Find out how much more *you* could earn by doing a similar comparison using your specific savings plan.
6. **Understand that if you use a** Uniform Gift/Transfer to Minor Act to transfer assets to your child for him or her to use for college, your child will have total control over that money—and may decide not to use it for college after all. Look for other ways to help your child save for college.

(*Continued*)

7. **Consider saving via a Coverdell Education Savings Account** for your child's primary or secondary education expenses, in addition to college, if you plan to send your child or children to private schools.
8. **Recognize that although investing in U.S. savings bonds is safe**, they also offer only a very low return, which may make it very difficult for you to reach your child's financial needs for college expenses.
9. **If your child has a part-time paying job, consider establishing a Roth IRA in your child's name.** Although this is a retirement account, your child can withdraw money from it to pay for college, and that withdrawal will be taxed at your child's tax rate, which could be as low as 0 percent, if structured properly. And if your child decides not to go to college, he or she will have already begun saving for retirement!
10. **Learn as much as you can about what financial aid your child might qualify for,** based on your (and your spouse's) income and assets as well as that of your child. See Exhibit 7.4 for 2012–2013 guidelines.
11. **Find out if you qualify for either of the two major education tax credits**—the American Opportunity Tax Credit and the Lifetime Learning Credit: These depend on the amount of courses your child is taking in college, your (and your spouse's) income, and your tax filing status. If you are unsure whether you qualify, talk to your tax advisor or financial advisor.

CHAPTER 8

# Planning for Retirement

*If you don't want to work, you have to work to earn enough money so that you won't have to work.*

—Ogden Nash, American poet

Everyone should be planning financially for retirement, regardless of how old or young you are. Many employers no longer guarantee employee pensions, so your financial needs during your retirement may rest completely on your shoulders. People coming to retirement are facing concerns that retirees did not face 20 or 30 years ago, including living longer and supporting themselves throughout turbulent financial times.

This chapter helps you determine your financial needs for retirement, and then how to properly fund them. I show you how to determine your own individual *point X*, financial independence. I also describe tax implications and other risks that might jeopardize your retirement plans, and what steps you need to take to secure the peace of mind that comes from a financially secure retirement.

## Case Study: Saving versus Not Saving for Retirement: The $1.7 Million Difference

When it comes to being prepared for retirement, I believe there are two client profiles that most people tend to follow. One is not having any plan at all, and the other is having a well-thought-out

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

retirement planning strategy. Unfortunately, most people do not have a real plan to achieve their retirement goal of becoming financially independent. After reading through this chapter, ask yourself whether or not you will follow the example set by my clients Mr. and Mrs. Poorman or Mr. and Mrs. Richman.

Before telling you their specific stories, I would like to highlight four critical issues that will control and significantly affect your success or failure in reaching your retirement goals:

1. How much of your income will you save and invest each year?
2. How many years will you be setting aside money for your retirement?
3. What type of investments will you use to meet your goals?
4. Will you be disciplined and stay on track?

Let us start by considering the story of two clients of mine, who I will call Mr. and Mrs. Poorman. About 25 years ago, the Poormans came into my office for the first time to have their income tax return prepared. They were recently married and had started their first jobs out of college about four years earlier. When I prepared their income tax return, I noticed they had not participated in their company's 401(k) plans and had not taken any steps in saving for retirement. I discussed the advantages of starting to save at an early age and also went through a tax calculation with them that showed them they would save 35 percent of the amount they could contribute to an IRA. They were quite impressed with the tax savings available by setting money aside for their retirement.

Although they agreed that funding a retirement plan was the smart thing to do, they said they had no money available to do so. They had just finished paying for their wedding and honeymoon, and they had no money left for savings. Although they were concerned about the future, they said they would definitely do this next year when they had some extra cash. Over the next three years, they set money aside for a down payment for their home and were not able to fund their retirement. Over the next two years, once again, they said they were unable to fund their retirement because they needed to furnish their new home. This story continued throughout their lives, with the birth of their first and then second child. Before they knew it, it was time for their two sons to go to college, and they were still not able to set money aside for their retirement.

Throughout their lives, they always had what appeared to be valid excuses for not saving for their future. They failed to understand that they must first set money aside each year and *then* determine their standard of living based on what was left over. Each year, they came in to see me and talked about all the new events and projects that were going on in their lives, and each year, they swore as soon as they were done, they would start putting money away for retirement. Although they seemed to understand the importance of saving for the future, their attitude was always *we will start next year, after all, it is no big deal if we wait another year.*

Moreover, in the years that they did manage to set aside some money, they turned a deaf ear to my suggestions of investing in a well-diversified stock and bond mutual fund portfolio. Instead, they decided to keep their savings in a non-retirement account, which earned little or no interest from their savings and money market funds. Because *they* did not understand the stock and bond market, they felt it would be best for them not to get involved. They were fearful of the stock market, because their parents had lost quite a bit of money in the crash of 1987. Also, even though they did not understand the basics of investing, they were not willing to work with an advisor to guide them through this process. The Poormans did not have a disciplined approach to saving for retirement and acted like they had no choice other than ignoring and avoiding the decisions that needed to be made to ensure their financial future. In fact, the Poormans had no plan to reach their own financial independence—their own *point X*—at any point in their lives.

Twenty-five years later, they are in their early 50s and still living paycheck to paycheck to maintain their current standard of living. In fact, they recently borrowed all of the equity in their home to pay for their two sons' first two years of college at private universities.

Are you living your life in a manner similar to the Poormans? If so, you can and must change the pattern of this vicious cycle immediately. This is a matter of financial life and death, with no way to get around it unless you are willing to make the necessary changes.

The same year I met the Poormans, I also met the Richmans. Their story was amazingly similar to the Poormans, but with significantly different results based on the decisions the Richmans made. The Richmans were also recently married when I met them, but they decided early on to be conservative with their spending, and they understood the importance of saving for

tomorrow. They had a modest wedding and only invited their closest friends and family members. They had a weeklong honeymoon and were able to get a great deal on an all-inclusive trip to the Bahamas. When they first met with me, they not only had no debt, they had a combined savings of more than $18,000! As I prepared their tax return, I noticed they had started funding their retirement accounts during their first full year of employment after college.

Even though they did not qualify for an IRA tax-deductible contribution, they both agreed that they would make an annual nondeductible IRA contribution. The Richmans clearly had a vision of what was truly important to them. When they found out the following year that they had twins on the way, they became even more disciplined and focused about their finances. Financial security for their family was now their number one priority and not the materialistic goods and services that measure a person's standard of living throughout their lifetime. They always came in and joked about the fact that they will "pay themselves first," and then determine what they can afford after they set aside their savings. They knew that what they saved and set aside was not meant to be spent on nonessential items.

They also realized the value of the tax savings the government offered them through fully funding their retirement accounts. They were able to save significantly more money because they were doing it with pretax dollars. This 35 percent tax savings (from their 401(k) contributions) meant they would have 35 percent more set aside each year.

The Richmans understood the power of the time value of money. They started saving from their very first paycheck and understood early on that their young age was one of their most valuable investment assets. They knew that the longer they saved, the greater their chance of achieving financial independence. They appreciated the fact that the amount of time they had to save and invest was more important than a strategy of trying to time the entry point to investing in the market. They took a dollar-cost-averaging approach to saving and investing for their future, by having a payroll deduction from their retirement account come out of each and every one of their paychecks.

Although the Richmans were not in the financial service industry and did not fully understand investing, they did seek out my advice. They kept a large portion of their money invested in stock

and bond mutual funds; they were not overly concerned about the ups and downs of the market because they saw themselves as long-term investors. Their investment approach was simple: they were well diversified in a balanced portfolio and viewed themselves as owners of many quality businesses as both shareholders and bond holders. Each year when I spoke to them and prepared their tax return, we also took a look at their asset allocation and made the appropriate changes to rebalance their portfolio. They stayed very disciplined throughout the past 25 years and focused on buying quality investments, were properly diversified, patiently held on to their investments even during down markets, and rebalanced their portfolio annually.[1]

Today, the Richmans have more than $1.7 million in retirement savings, have paid off their home mortgage five years early after taking advantage of falling interest rates, and have also set aside sufficient funds to get their son and daughter through four years of state college.

From early on in their relationship, even before they were married, they had a clear plan for a comfortable retirement and a strategy for achieving financial independence. Everyone has the ability to achieve financial independence. If you are an able-bodied individual with a job, you can also achieve financial independence, by simply paying yourself first, and then living within the budget of whatever is left over. It really is that simple. If my parents were able to do it as Italian immigrants working for modest wages, so can you!

So, would you consider yourself like Mr. and Mrs. Poorman or Mr. and Mrs. Richman? Are you willing to do what it takes to live your life like the Richmans? If so, congratulations! You have just made your commitment to planning for a comfortable retirement and for achieving financial independence for you and your family.

## Retirement Equation: Calculating Your Personal *Point X*

Most people have the desire and dream of becoming financially independent. Wanting to achieve this goal requires planning; you cannot leave this to chance. I define financial independence as the point where your money can start working for you instead of you

[1]Asset allocation does not assure or guarantee better performance and cannot eliminate the risk of investment losses. Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

working for your money, and at the same time you are able to maintain your desired standard of living.

This number is different for everyone because there are so many variables that need to be taken into consideration. The starting point is estimating how much income you will need in retirement and then determining whether your current savings and investment plan will be able to provide you with sufficient income. This is the centerpiece of planning for retirement and being able to go through these calculations will guide you to what it will take to get there.

The 10 key questions in determining your own *point X* are shown in Exhibit 8.1. Although there are many other variables you need to consider, these are the questions you need to analyze and answer when trying to determine your retirement planning strategy.

The answers to these questions will enable you to calculate how much money you will need when you retire. The math used in this calculation is quite complicated because there are so many variables (including present value and future value calculations). Therefore, it is best to use an online retirement planning calculator. Simply go to http://finance.yahoo.com/calculator. Scroll down to the Retirement topic and click on "How much will I need to save for retirement?" You will be able to run through an unlimited number of "what if?" scenarios.

**Exhibit 8.1 Ten Questions to Determine Your *point X* for Financial Independence**

1. What is your current age?
2. What is your combined (current) family annual income?
3. As of today, how much do you have in retirement savings (investable assets)?
4. What inflation rate do you expect before and during retirement?
5. What age do you reasonably expect to retire?
6. How many years do you estimate you will live in retirement?
7. What percentage of your current income do you need in retirement?
8. What is your projected retirement income from defined benefit plans and Social Security benefits?
9. What after-tax rate of return do you expect on your investments before retirement?
10. What after-tax rate of return do you expect during retirement?

This exercise will give you a reality check, and you may need to alter some of your assumptions. But remember, it is best to be conservative and realistic. If the amount you will need to save does not appear achievable, you will need to go back and make some adjustments in your standard of living not only now but in retirement. Never forget the lesson of Chapter 1: *Live within your means.*

## The High Cost of Waiting to Save for Retirement

Should I start saving now or later? That is the question. The answer quite simply is ***now***!

Almost everyone has the desire to save for retirement. But all too many people delay this process, believing that next year it will be easier. As shown in the story about the Poormans, there will always be an excuse not to save this year. Falling into this trap can have financially devastating consequences to your financial security. Most people do not know when they should start and how much they should save each year. Quite simply, you need to start immediately, and my general rule of thumb is putting away 10 percent or more of your gross income each year.

The easy way out of making the right decision is to justify it by saying you will wait until your income level increases. Unfortunately, with every salary increase most people simply increase their standard of living and not their retirement savings. The longer you wait, the harder it will be to accumulate the amount you need to be financially independent. Remember one of the most valuable investment assets you have is time: the more years you save the greater your chance of financial success.

The financial rewards of starting to save at an early age for retirement far outweigh the costly mistake of waiting and spending your money on your wants. By starting with even small amounts each month, you may be able to accumulate a great deal of retirement savings over time. By far the easiest way to do this is by contributing to your employer's retirement plan or if that is not available, to an individual retirement account (IRA). Implement a retirement saving strategy that allocates a specific dollar amount or percentage (I recommend at least 10 percent) of your salary every pay period. Therefore, you are paying yourself first, as though saving for retirement is your number one required expense. In fact, saving for retirement is not an expense because it adds to your investable assets, but treating it as such is of utmost importance to your success.

If you are not convinced of the old saying *time is money*, I want you to spend some time thinking about the following example, which compares two individuals with different views on the value of time as it relates to saving.

Melanie started saving at the age of 25, setting aside $2,000 per year for 10 years, which then continued to grow for an additional 30 years. Over the 40-year period, her tax-deferred account grew at a rate of 8 percent per year, bringing the value of her account to ***$291,565***.[2]

Brian delayed saving for retirement until the age of 35, when he also began to save $2,000 per year for 10 years, which then continued to grow for an additional 20 years. Over the 30-year period, his tax-deferred account grew at a rate of 8 percent per year,[3] bringing the value of his account to ***$135,042***.

Exhibit 8.2 shows the difference in how their savings grew.

Both Melanie and Brian set aside $2,000 per year over a 10-year savings time span. They both managed to save $20,000, but they ended up with significantly different results when they reached the age of 65: Because Brian started 10 years later than Melanie, his savings were $100,000 less than Melanie's! This example verifies that time is money and that one of your most valuable financial assets is time. By getting off to an early start with your retirement savings program, you can take advantage of the power of compounding.

Your annual savings have the potential of earning a rate of return, and so does your reinvested earnings. Look at the Rule of 72 in Exhibit 11.1 to see just how powerful compounding can be. This is the secret to financial independence: by letting your money work for you, eventually, you will no longer have to work to maintain your desired standard of living.

If you have been finding it difficult to save money on a regular basis, implement the following savings strategies that will take money directly from your paycheck on a pre-tax basis. By utilizing

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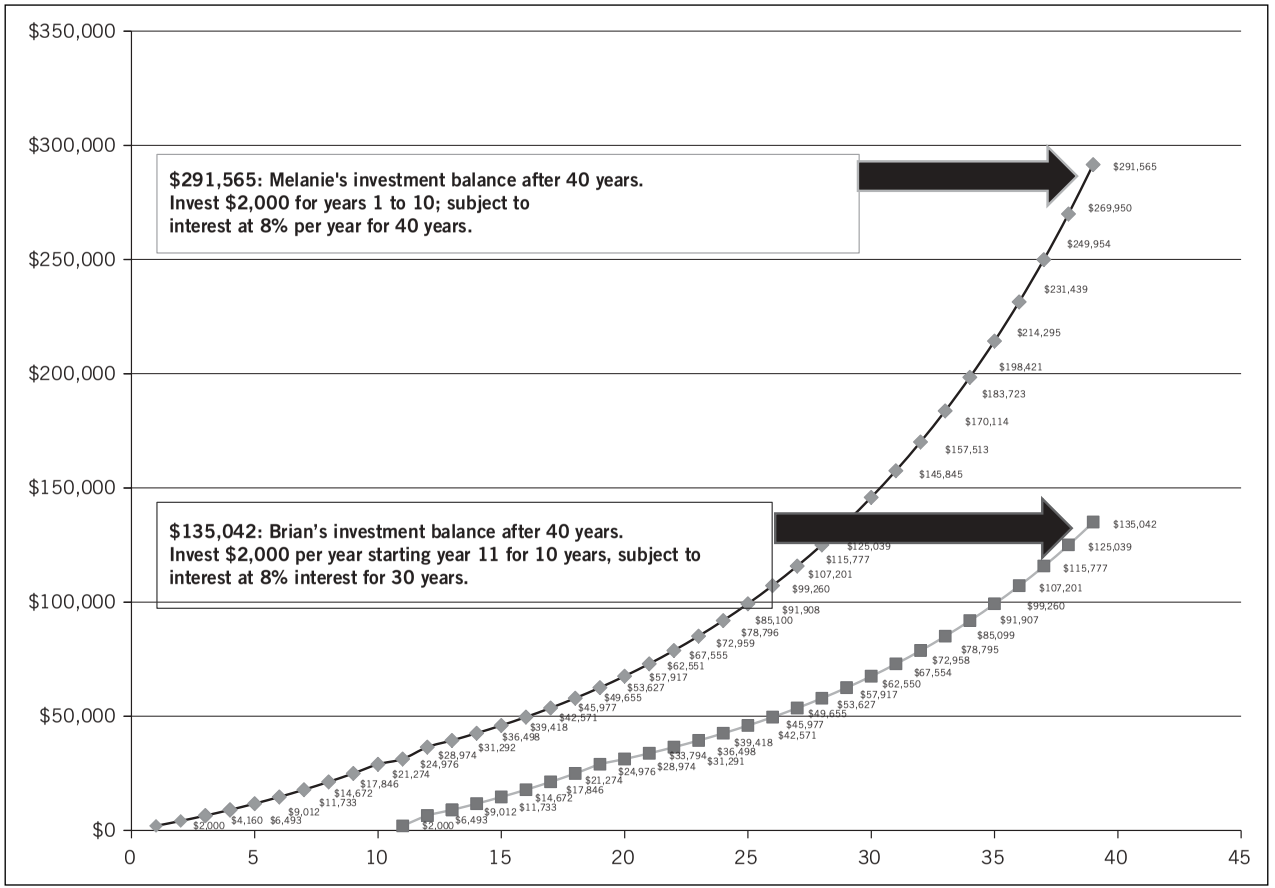
[2]The rates of return shown above are purely hypothetical and do not represent the performance of any individual investment or portfolio of investments. They are for illustrative purposes only and should not be used to predict future product performance. Specific rates of return, especially for extended time periods, will vary over time. There is also a higher degree of risk associated with investments that offer the potential for higher rates of return. You should consult with your representative before making any investment decision.

[3]See footnote 2.

**Exhibit 8.2 Benefits of Saving Earlier**



employer-sponsored retirement plans, you will establish a systematic strategy that will force you to pay yourself first and at the same time you will do this in a tax-efficient manner and implement a dollar-cost-averaging investment plan.

*No matter what method you use, it is extremely important that you start saving now!*

## What You Can Expect to Receive from Social Security

Social Security benefits are viewed by many of us as the building blocks of our retirement planning strategy. The current Social Security system is under a great deal of stress, and many people fear that it will no longer be around when they are ready to retire. Advances in medicine have increased life expectancies beyond any actuarial assumptions used when the program was originally established. These longer life spans have dramatically increased the number of people collecting Social Security benefits.

On January 1, 2011, the very first Baby Boomers—people born between 1946 and 1964—turned 65. Millions of them are rushing toward retirement age, and they have been promised by our government that they will be taken care of. During 2011 alone, an average of more than 7,000 people turned 65 every single day, and this number is expected to rise in the years to come. This has caused and will continue to cause a strain on the Social Security system. This all comes at a really bad time for the federal government, which is already flat broke, and for a national economy that is already on the brink of financial disaster.

A 2011 report from the Social Security Administration released the following startling facts:

- In 1945, there were 41.9 active workers to support each person receiving Social Security benefits.
- In 2010, there were only 2.9 workers supporting each Social Security pensioner.
- It is projected that by 2040, there will be only 2.1 active workers to support each Social Security pensioner.

For higher-income earners, Social Security replaces a proportionally smaller percentage of retirement benefits. Before 2003, you could receive full Social Security retirement benefits on reaching age 65. The age to qualify for full retirement benefits began to

increase on a graduated scale. By 2027, the age to qualify for full Social Security retirement benefits will have increased to age 67, where it is scheduled to remain. It is my belief that this retirement age for full benefits will continue to increase in order to avoid the insolvency of the Social Security system.

In a 2011 Social Security Trustees Report, a warning was issued about the serious problems facing Social Security in the future. The trustees indicated that program costs (benefits paid) were more than noninterest income (Social Security payroll taxes) for the first time in 2010, and they expect this situation to continue. Without changes, the Social Security Trust Fund will be exhausted by 2036, and there will only be enough money to pay about 77 cents for each dollar of scheduled benefits.

Chances are that most people will probably have to wait longer to qualify for full Social Security benefits and these benefits will be replacing a *smaller* percentage of their preretirement income. Therefore, it is critically important to understand that your long-term retirement planning strategy should factor in a more limited role for your Social Security benefits when calculating required income in retirement.

Many people fear that Social Security benefits may no longer be there at all when they are ready to retire. I believe that future benefits will be reduced by further extending the age to qualify for retirement, eliminating and reducing cost-of-living increases, and by decreasing the payment requirements for new retirees. On top of this, the Social Security tax rate will be increased and the dollar limit on which the tax is imposed will be increased. The combination of these factors will be the only way to ensure the continued sustainability of the system and the continued payment of these benefits.

One of the first steps in developing a retirement planning strategy is estimating your Social Security benefits in retirement. The Social Security Administration (SSA) no longer mails the annual estimated benefit statements. Instead, to obtain this information, you must go online to www.ssa.gov/estimator. This retirement calculator will give you an estimate based on your actual Social Security earnings record. This SSA website and calculator will ask you for the following information:

- Your name.
- Social Security number.
- Date and place of birth.

- Your mother's maiden name.
- Additional information you provide about future earnings.
- Age at which you expect to stop working.

Based on this information and your actual earnings history as maintained by the SSA, the retirement calculator generates an estimate of the amount you would receive under three scenarios:

1. If you retire at age 62 (the earliest date you can receive benefits).
2. If you wait until full retirement age (which currently ranges from 65 to 67, based on year of birth).
3. If you continue working until age 70 before claiming retirement benefits.

You cannot use the retirement estimator if you have blocked access to your personal information; in that case, you need to request that a statement be mailed to you. In the meantime, if you want a rough benefit estimate, you can use the "quick calculator" at www.socialsecurity.gov/OACT/quickcalc/index.html. Most likely, however, *this rough estimate will not match the information provided by your Social Security statement.* Therefore, I recommend using the SSA's quick calculator only to get a rough estimate of your Social Security benefits, both in today's dollars as well as inflation adjusted future dollars.

The quick calculator asks you three simple questions that helps calculate your Social Security benefits. Be sure to do this in both current and future dollars, because you will need this information later when calculating the retirement equation to your personal *point X.* Please note that these benefit estimates depend on your date of birth and on your *estimated* earnings history. For security, the quick calculator cannot access your earnings record (i.e., the information that you have provided to the U.S. government every year that you file a tax return). Instead, it estimates your earnings based on the information you provide.

## Qualified Retirement Plans

If the government had a program that would provide you with an interest-free loan so that you could take this money and invest it for the long term to secure your retirement, would you take advantage

of such an offer? What if this program also included a provision that if you lost some of this money through your investments, you would not have to pay back that portion of the loan to the government? What if this program also allowed you to start paying back the loan gradually (also interest free) over your life expectancy, starting at the age of 70½?

Although this program sounds too good to be true, it is, in fact, available to every working individual in the United States, and far too few are taking advantage of it. Quite simply, this is precisely what happens when you contribute money to a retirement account and take advantage of the tax-deferral option.

*Tax deferral* is a method of postponing the payment of income tax on income earned in the current year until you withdraw the funds from the tax-deferred account. The government uses the Internal Revenue code to influence taxpayers' behavior. The government wants individuals to save money for the long term and specifically to allow them a secure, comfortable, and sustainable retirement. With that said, the Internal Revenue code allows individuals to take advantage of tax deferral in many different ways to help encourage and accelerate an individual's retirement savings. There is no single better strategy for achieving financial independence than by doing it in a tax-advantaged way.

For example, Individual Retirement Accounts and 401(k)s allow taxes to be deferred. Also, various insurance products, such as fixed and variable annuities as well as certain life insurance contracts, also allow taxes to be deferred.

There is a significant benefit to deferring taxes as long as possible, because it allows the entire principal and earnings to compound on a tax-deferred basis, which can have a dramatic effect on your retirement savings over an extended period of time. The benefit of this tax-deferred compounding was highlighted in the section on "The High Cost of Waiting" (Exhibit 8.2), where Melanie accumulated $156,523 more than Brian simply by starting 10 years earlier (even though the total amount each of them set aside was the same $20,000). Clearly the combined effects of tax deferral with compounding are significant over long periods of time.

For many people, the initial tax-deferral period is during their higher-income earning years when their tax bracket is much higher. The added benefit to this is that you are deferring income out of years that would require you to pay a higher tax rate and possibly picking up this income in years where you will be subject to a lower

tax rate. Although there is no guarantee that you will be in a lower tax bracket in retirement (especially since I believe it is inevitable that tax rates will increase in the future), tax deferral is still one of the most powerful tools available in retirement planning.

Now that you are convinced that tax-deferred compounding is the most effective way to achieve financial independence, let us look at a summary of some of the most popular plans available. There are numerous options available for funding your retirement on a tax-deferred basis, depending on your particular facts and circumstances. Of course, these options are also limited to what may be available through your employer: some plans are fully funded by your employer, some are partially funded by you, and some are fully funded by you.

A *qualified retirement plan* is a plan that meets requirements of the Internal Revenue Code and as a result, is eligible to receive certain tax benefits, primarily a tax deduction to your employer and tax deferral to you. These plans must be for the exclusive benefit of employees or their beneficiaries. There are two kinds of qualified plans: defined-benefit plans and defined-contribution plans. Keep in mind that, in most cases, withdrawals made before age 59½ are subject to a 10 percent penalty, unless you qualify for one of the exceptions. Withdrawals must begin no later than April 1 of the year after you turn age 70½ and are subject to income taxes in most cases.

The following sections describe various types of qualified retirement plans. Once you have a good understanding of the various qualified retirement plan options available, you will be in a much better position to achieve financial independence. These retirement plans are by far the most tax-efficient weapons available to you in your pursuit to accumulating wealth. The fact that the government gives you this ability to defer the payment of significant tax dollars amounts to an interest-free loan from the government. Think about this for a minute. You have the ability to obtain an interest-free loan, and at the same time the potential of earning a rate of return with these funds. You cannot afford *not* to take advantage of this.

#### *Defined-Benefit Pension Plans*

With this type of plan, an employer commits to paying you (the employee) a specific benefit for life, beginning when you retire. The amount of the benefit is known in advance and is usually based on factors such as your age, your earnings, and your years of service. Defined-benefit plans do not have contribution limits, because

they are based on a specific benefit to be paid in retirement. Today, very few private employers provide defined-benefit plans because they have turned out to be very costly, given the low rates of return from the equity markets in recent years and the longevity that employees are experiencing in their retirement years. These plans are primarily offered through government jobs. I believe the traditional defined benefit pension plan will become a thing of the past.

#### *Defined-Contribution Plans*

In contrast to a defined-benefit plan, a defined-contribution plan does not promise to pay you a specific amount when you retire. Instead, your employer generally allocates contributions to your account, many times in the form of matching contributions. As an employee, you may be able to make contributions to your account within the plan. Therefore, the retirement benefit you receive from a defined-contribution plan depends solely on the value of your account balance when you retire.

#### *Money Purchase Pension Plans*

This type of plan provides you with either a lump-sum payment or a series of monthly payments. The size of this benefit depends on the size of the contributions to the plan. Your employer usually funds money purchase pension plans, although some will allow employee contributions.

#### *Profit-Sharing Plans*

These plans are funded by your employer and employee contributions are usually optional. When you retire, you will usually receive your benefit as a lump sum. The company's contributions and your retirement benefit may depend on the company's profits. A profit-sharing plan can also be set up as part of a 401(k) plan, and employee contributions may also be available.

#### *Savings Plan*

This type of plan provides a lump-sum payment on your retirement. You, as an employee, fund a savings plan, although your employer may also contribute. You may be permitted to borrow a part of your vested benefits. A savings plan can also be set up as part of a 401(k) plan.

#### *Employee Stock Ownership Plan (ESOP)*

With this type of plan, your employer periodically contributes company stock toward an employee's retirement plan. When you retire, the ESOP may provide a single payment of stock shares. At age 55, with 10 or more years of plan participation, you must be given the option by your employer to diversify your ESOP account, up to 25 percent of its value. This diversification enables you to invest in other stocks, bonds, etc., so that you are not solely invested in the success of your company. This diversification option continues up to age 60, at which time you have a one-time opportunity to diversify up to 50 percent of your account.

#### *401(k) Plan*

This is a qualified plan established by employers to which eligible employees may make contributions (in the form of deductions from your salary) on a post-tax or pretax basis. Employers offering a 401(k) plan may make matching or nonelective contributions to the plan on behalf of eligible employees. Some plans allow you to contribute money on an after-tax basis; these plans are known as Roth 401(k) plans.

#### *403 (b) Plan*

These plans are offered by tax-exempt and educational organizations for the benefit of their employees. At retirement, employees have a choice of a lump sum or a series of monthly payments. These plans are funded by employee contributions.

#### *Self-Employed Plan*

These plans were specifically intended for self-employed people. They are funded completely by wage-earner contributions and provide either a lump-sum payment or periodic withdrawals when you retire. Self-employed plans have the same investment options as IRAs. Contributions to self-employed plans are tax deductible within certain generous limitations.

#### *Simplified Employee Pension (SEP)*

These plans were designed for small businesses. Like IRAs, they can provide either a lump-sum payment or periodic withdrawals when you

retire. They are principally funded by the employer, although some SEPs do allow employee contributions. SEPs are usually held in the same types of accounts that hold IRAs. Employee contributions in those SEPs that allow them may be tax-deductible to the employee.

#### *Savings Incentive Match Plans for Employees (SIMPLE)*

These plans were also designed for small businesses. They can be set up either as IRAs or as 401(k)s. The employee funds them on a pre-tax basis, and employers are required to make matching contributions.

### The Difference between Traditional IRAs and Roth IRAs

Individual Retirement Accounts (IRAs) are available to all wage earners at any salary level, as well as to nonworking spouses. You and your spouse cannot contribute more than your combined earned income to an IRA. IRAs are funded completely by the individual's contributions and not by an employer. This is why they are referred to as "individual" retirement accounts. These specially designated retirement accounts are typically held with a bank, brokerage firm, mutual fund company, insurance company, or other financial institutions. Once you set up an IRA, you have several investing options. You can choose to invest in stocks, bonds, mutual funds, exchange-traded funds (ETFs), cash equivalents, real estate, and other investments. You have total control over these accounts, and you can elect a lump-sum payment or periodic withdrawals when you retire.

You can choose from two different types of IRAs, either a traditional or a Roth. Please keep in mind that these are simply the titles on the account and do not represent an investment. The decision on whether to open an IRA and which type is completely independent of how the funds will be invested once the account is established.

Contributions to traditional IRAs may be tax deductible if you meet the requirements; your withdrawals will be taxable in the year that you make those withdrawals. Therefore, a traditional IRA gives you a tax deduction in the current year and a tax deferral for any earnings, but ultimately you will pay tax when you withdraw from your account. In contrast, contributions to a Roth IRA are *not* tax deductible, but qualified withdrawals are tax-free. Therefore, Roth IRAs do not give you a tax deduction in the current year, but ultimately your qualified withdrawals including earnings will be paid out to you tax-free.

So the real question to ask yourself when deciding between a traditional and a Roth IRA is whether you prefer getting the tax benefit in the current year or tax-free income in retirement?

Both a traditional IRA and Roth IRA are subject to the same contribution limits, which are $5,500 in 2013. The maximum *total* annual contribution an individual can make to a traditional and Roth IRA at the same time is $5,500 (as of 2013). There is a special "catch-up" provision that allows individuals age 50 and older to save even more by allowing them to contribute an additional $1,000, for a total limit of $6,500 per year. See Exhibit 8.3 for details.

**Exhibit 8.3 Table 1: 2013 Effect of Modified AGI on Traditional IRA Contribution If You Are Covered by a Retirement Plan at Work**

| Filing Status | **Married Filing Jointly or Qualifying Widow(er)** | **Married Filing Separately** if you lived with your spouse at any time during the year | **Single or Head of Household or Married Filing Separately** and did not live with spouse any time during the year |
|---|---|---|---|
| MAXIMUM TRADITIONAL IRA **contribution** is the lesser of actual taxable compensation or the amount below: | | | |
| Under Age 50 | $5,500 | $5,500 | $5,500 |
| Over Age 49 | $6,500 | $6,500 | $6,500 |
| Maximum Modified Adjusted Gross Income for above Full TRADITIONAL IRA **deductions**: | | | |
| | $95,000 | $ZERO | $59,000 |
| The TRADITIONAL IRA contribution is phased out for higher incomes and reduced to $ZERO at the following Modified Adjusted Gross Income level of: | | | |
| | $115,000 | $10,000 | $69,000 |

**Exhibit 8.3 Table 2: 2013 Effect of Modified AGI on Traditional IRA Contribution If You Are Not Covered by a Retirement Plan at Work**

| Filing Status | **Single, Head of Household or Qualifying Widow(er)** | **Married Filing Jointly or Separately** with a spouse who **is not** covered by a plan at work | | **Married Filing Jointly** with a spouse who **is** covered by a plan at work |
|---|---|---|---|---|
| MAXIMUM TRADITIONAL IRA **contribution** is the lesser of actual taxable compensation or the amount below: | | | | |
| Under Age 50 | $5,500 | $5,500 | $5,500 | $5,500 |
| Over Age 49 | $6,500 | $6,500 | $6,500 | $6,500 |
| Maximum Modified Adjusted Gross Income for above TRADITIONAL IRA **deductions**: | | | | |
| | No Modified AGI Limit for Full Deduction | No Modified AGI Limit for Full Deduction | $178,000 | $ZERO |
| The Maximum TRADITIONAL IRA contribution is phased out for higher incomes and reduced to $ZERO at the following Modified Adjusted Gross Income level of: | | | | |
| | | | $188,000 | $10,000 |

**Exhibit 8.3 Table 3: 2013 Effect of Modified AGI on Roth IRA Contributions**

| Filing Status | **Married Filing Jointly** and **Qualifying Widow** | **Married Filing Separately** if you lived with your spouse at any time during the year | **Single, Head of Household, or Married Filing Separately** and did not live with spouse any time during the year |
|---|---|---|---|
| MAXIMUM ROTH IRA **contribution** is the lesser of actual taxable compensation or the amount below: | | | |
| Under Age 50 | $5,500 | $5,500 | $5,500 |
| Over Age 49 | $6,500 | $6,500 | $6,500 |
| Maximum Modified Adjusted Gross Income for above ROTH IRA contributions: | | | |
| | $178,000 | $ZERO | $112,000 |
| The Maximum ROTH IRA contribution is phased out for higher incomes and reduced to $ZERO at the following Modified Adjusted Gross Income level of: | | | |
| | $188,000 | $10,000 | $127,000 |

***Traditional Individual Retirement Accounts (IRAs)***

Traditional IRAs can be an excellent way to save for retirement. If you do not participate in an employer-sponsored retirement plan, or if you would like to save more money than that plan allows, then a traditional IRA could be a great choice for you. A traditional IRA is simply a tax-deferred savings account that you can establish through a financial institution.

One of the greatest advantages of a traditional IRA is the potential for tax-deductible contributions. For example, if your marginal income tax rate is 40 percent, then a $5,500 tax-deductible traditional IRA contribution could save you $2,200 in income tax. Would you not rather put that $2,200 aside for your own retirement than pay it in taxes to Uncle Sam?

Your contributions to a traditional IRA must come from a nonretirement account in order for it to be treated as a current-year contribution. You may also transfer assets directly from another qualified plan, such as a SEP or a SIMPLE IRA. You can also roll over money from a qualified employer-sponsored plan, such as a 401(k) or 403(b), after you change jobs or retire. It is important to note these rollovers are not considered current-year contributions but are simply transfers from prior-year contributions.

Not every person contributing to a traditional IRA is entitled to a tax deduction. If you are an active participant in a qualified retirement plan through your employer (such as a 401(k) plan), your IRA deduction may be reduced or eliminated, based on your

modified adjusted gross income. For example, here are the restrictions for 2013:

- If you file your tax return as a single person and your AGI is $59,000 or less, you can receive the full tax deduction.
- If you are married and file your tax return jointly and your combined AGI is $95,000 or less, you can receive the full tax deduction.
- If you file your tax return as a single person and your AGI is more than $69,000, you are not eligible for a tax deduction at all.
- If you are married and file your tax return jointly and your combined AGI is more than $115,000, you are not eligible for a tax deduction at all.
- If you file your tax return as a single person and your AGI is between $59,000 and $69,000, you can receive a partial deduction.
- If you are married and file your tax return jointly and your combined AGI is between $95,000 and $115,000, you can also receive a partial deduction.
- Finally, if you (and your spouse, if you are married), are not an active participant in an employer-sponsored retirement plan, you are eligible for a full tax deduction, regardless of your AGI.

If you do not qualify for a tax-deductible contribution, you can always make a full *nondeductible* contribution. This will require you to keep track of your basis in the IRA with the IRS, so that once you start making distributions you will not be taxed on the portion of the distribution that is considered a return of your basis (nondeductible contribution). I would only recommend making nondeductible contributions if you do not qualify for a Roth IRA contribution.

The money in a traditional IRA grows and compounds on a tax-deferred basis—which means you will not pay taxes until you start receiving distributions after you retire. Many retirees are in a lower tax bracket during this stage of their lives. Therefore, your tax rate and the overall amount of taxes you save when making these contributions may be much greater than the amount of taxes you will pay on the distributions in retirement. Although withdrawals are taxed as ordinary income, many states have special

exclusions which may result in little or no tax paid at the state level on these distributions.

The IRS gives you all of these significant tax-advantaged savings in order to encourage you to be responsible and save for your retirement. However, the IRS will also penalize you if you take distributions from your retirement account before you reach age 59½—once again to encourage responsible savings for retirement (because obviously, if you are withdrawing from your retirement account before you are retired, that will deplete the money that is supposed to be there for you when you retire!). In addition to paying income tax on these withdrawals, you may also be subject to a 10 percent federal income tax penalty.

There are some exceptions to the early withdrawal penalty, for example:

- If you withdraw money as a result of a disability,
- If you use that money to pay for medical insurance while you are unemployed, or
- If you use that money to pay for higher-education expenses.

Once you reach age 70½, you must begin taking annual required minimum distributions (RMDs) from a traditional IRA, starting no later than April 1 of the year after the year you reach age 70½. If you do not take your RMD, you will be subject to a 50 percent income tax penalty on the amount that you should have withdrawn.

#### *Roth IRAs*

Roth IRAs are another type of specially designated account that allows individuals to save money for retirement in a tax-efficient manner. You cannot deduct the contributions you make to a Roth IRA. However, qualified Roth IRA distributions are free of federal income tax and are not included as part of your AGI once you retire. If you expect to be in a higher tax bracket in retirement, a Roth IRA could be a great choice.

An added benefit even to individuals who expect to be in a lower tax bracket is that unlike traditional IRA distributions, Roth IRA distributions are not added to your AGI. When your AGI reaches a certain level, up to 85 percent of your Social Security benefits can also become taxable. Many retirees who are

required to take their required minimum distribution (RMD) from their traditional IRAs are forced to pay taxes on their Social Security income; a Roth IRA could possibly avoid this additional tax.

Roth IRAs can be valuable in that individuals can contribute to a Roth after age 70½, provided they are still working and have earned income. There is no RMD requirement with Roth IRAs and therefore no mandatory distributions due to your age, although beneficiaries of Roth IRAs must take mandatory distributions.

Also, you can withdraw contributions—but not the earnings on those contributions—from your Roth IRA, at any time and for any reason, without paying tax, and those withdrawals are not subject to the 10 percent federal income tax penalty. The tax and penalty apply only to the earnings—which is the amount received above your contribution. However, the earnings *are* subject to income tax and the IRS 10 percent penalty if you withdraw them before you retire. In order to make a qualified tax-free and penalty-free distribution of earnings, your account must meet the five-year holding requirement and you must be age 59½ or older. If not, these earnings withdrawals are subject to the 10 percent federal income tax penalty. The exceptions to this penalty are the same as under the traditional IRA.

The eligibility to contribute to a Roth IRA phases out for taxpayers with higher incomes. The rules regarding eligibility for traditional and Roth IRAs are confusing (to say the least). Therefore, I encourage you to visit http://finance.yahoo.com/calculator/index, then scroll down to Retirement and click on "How much can I contribute to an IRA?" This calculator will assist you in determining your eligibility for either IRA.

I believe every individual should take full advantage of the tax benefits that are available through employer-sponsored retirement plans and should fully fund their IRA accounts each year based on eligibility. There is no more efficient way to save for your retirement than to do it through a tax-advantaged account. The government is giving you a gift that will allow you to accelerate your savings over time.

Because of the strict annual contribution limits, many higher-income individuals may not be able to save sufficient funds for retirement through conventional retirement accounts. Moreover, many individuals have delayed the process of saving for retirement and will not have sufficient funds set aside when the time comes.

Establishing an annuity may very well be the solution to addressing this problem.

## Fixed and Variable Annuities

By far annuities, in particular variable annuities, are one of the most controversial financial planning strategies in planning for retirement. Many financial advisors are dead set against annuities and do not believe they are appropriate for their clients. Others are strong advocates for annuities and believe they should be part of an individual's overall retirement strategy. I believe that both sides of this argument have some merit, but the true answer lies with the needs of the individual. In my opinion, annuities are not right for everyone, but depending on your specific circumstances, they may be exactly what you need. Before you consider when annuities are appropriate and when they are not, however, you need an overview of what annuities are all about.

An annuity is an investment product created by a life insurance company that promises to provide a series of payments over time. An *annuity contract* is not a qualified retirement plan. However, it does provide tax-deferred growth like a qualified retirement plan. One of the biggest advantages to establishing an annuity is that there are no contribution limits, which gives you the opportunity to save substantially more for retirement. After fully funding your employer-provided retirement plans and your IRA accounts, you can use an annuity to complement your overall retirement savings strategy.

One of the biggest arguments against annuities is that they typically have contract limitations, fees, and charges, which can include mortality and expense charges, account fees, underlying investment management fees, administrative fees, and charges for various other optional benefits. The majority of annuities have backloads (surrender charges) that are assessed if you (as the contract owner) surrender the contract before a certain period of time. All withdrawals of earnings are taxed as ordinary income, and the tax advantage of long-term capital gain and qualified dividends does not apply to earnings from annuities. Withdrawals of the income portion of the annuity prior to age 59½ may also be subject to a 10 percent federal income tax penalty.

All guarantees are made by the insurance company issuing the contract and are based on their claims-paying ability. Furthermore, annuities are not guaranteed by the FDIC or any other government agency.

It is possible with some annuity contracts to purchase an insurance option that could pay an income for a specified period of time, including your lifetime or the lifetimes of you and your spouse. The guaranteed retirement income or income for life option may just give you the peace of mind you need, if you fear outliving your money.

With both a fixed or variable annuity, you have the option of either an immediate or deferred annuity. Deciding on which is the most appropriate for you is a function of when you anticipate starting the distribution process:

- With an *immediate annuity,* you typically fund it with a lump-sum premium up front. Payments usually start immediately after the contract is funded and continue for the life of the contract. This type of annuity is often purchased at the beginning of retirement and is usually more suitable for someone nearing or already in retirement.
- A *deferred annuity* can be funded with either a lump-sum or a series of contributions over time during the accumulation period. The accumulation period is the time during which premiums are paid for a purchase of an annuity. The payments are typically deferred for a certain number of years and are based on the account value after the accumulation period. The income payment amount will depend on several factors, such as the initial investment amount, the contract's actual rate of return, the contract holder's age, and the number of years payments will be received.

#### *Fixed Annuities*

A fixed annuity is a contract with an insurance company that guarantees a fixed and guaranteed rate of interest on your money during the life of the contract. In essence, you give your money to an insurance company, and it promises to pay you back with a predetermined rate of interest. Fixed annuities are typically viewed as conservative investments; the biggest risk associated with them is the claims-paying ability of the insurance company making the guarantee.

In the current low-interest-rate environment, most fixed annuities do not offer an attractive rate of return. Therefore, if you are seeking

growth and the potential of your investment returns beating inflation, then a fixed annuity may not be appropriate for you.

#### *Variable Annuities*

A variable annuity is a long-term investment vehicle designed specifically for retirement. It is a contract, where you (as the contract holder) agree to make a single payment or a series of payments to an insurance company in exchange for a future income. These income payments to you from the insurance company, which are typically made in retirement, can be planned to last for the lifetime of a contract holder (individual or joint), such as a husband and wife.

Throughout the accumulation period, you invest in an assortment of investment subaccounts based on your risk tolerance, time horizons, and long-term goals. If you have purchased an annuity with income-for-life guarantees or with a guaranteed death benefit, you may be willing to take on some additional risk, because of the downside protection. You can take part in the growth potential of the stock market or other investment choices. The future value of the annuity and the amount of income available in retirement depend on the performance of these investments. This may provide you the opportunity for greater growth and increase your chances of outpacing inflation.

The actual account value of a variable annuity (which includes the investment principal and income) is not guaranteed. However, the value of your account will depend on the performance of your investment choices within the subaccounts of the variable annuity. Therefore, the account value may be worth more or less than your original purchase if you ultimately choose to surrender it. The additional guarantees you may be able to purchase typically do not guarantee the actual account value, but they may guarantee an income stream for life or a death benefit.

A variable annuity may also offer you the option to purchase guarantees for an additional cost. These guarantees can help protect against the downside risks of investing in the stock market, through guaranteed lifetime payout options. Some contracts provide guaranteed death benefits, regardless of the actual account value. In my opinion, some of these guarantees are exactly what makes variable annuities so valuable to many individuals.

Some financial analysts believe that retirees may get more financial security by combining insurance products and mutual funds.[4] Most people would agree that insuring ourselves against the risk of the unknown is the prudent thing to do. Risk management is an everyday part of our lives. We have health insurance, life insurance, long-term disability insurance, long-term care insurance, auto insurance, homeowner's insurance, and so on to protect many aspects of our life and the security of our family. Therefore, it is only natural that we take steps to guarantee the long-term security of our retirement. With the proper riders, the variable annuity contract with an insurance company can provide us with this added peace of mind. This form of insurance may not be necessary or appropriate for everyone. But in many cases, I believe it should be one of the tools used as part of your overall retirement planning strategy.

## Retirement Funding: "Needs Analysis"

The starting point for planning for retirement is performing a "needs analysis." In other words, you must first estimate how much money you will need after you retire, for *the rest of your life*. You will also need to estimate the benefits you will receive from your defined-benefit retirement plan and Social Security. Then, you need to determine what investment assets you currently have that you can use during your retirement. Finally, you identify the amount of retirement investment assets you will need to generate sufficient income to support your anticipated cost of living in retirement.

To do this, let us revisit Chapter 3 and analyze James and Patricia Loomis' retirement planning needs, as an example. We have already worked through the most difficult part of this retirement planning needs analysis because we already have the Loomis' statement of financial position (shown in Exhibit 3.1), and their statement of cash flow (shown in Exhibit 3.3).

We start by analyzing their statement of financial position and specifically by focusing on their investment assets, because these are the assets that will help generate the necessary income when they retire. The total value of their investment assets as of December 31, 2012, was $951,850. Then we will look at their statement of cash flow (after recommendations) to determine their total cash

[4]Based on an article from the *Wall Street Journal* dated March 8, 2011, "Making the Case to Buy an Annuity."

outflow to sustain their current standard of living. The Loomis' total cash outflow was $189,976.

To complete this analysis, we need the answers to the 10 key questions and assumptions from Exhibit 8.1, shown here in Exhibit 8.4.

James is currently 37 years old and his wife Patricia is 36. Their combined family income is $216,876, as outlined on their statement of cash flow as of December 31, 2012 (see Exhibit 3.3). Based on their statement of financial position (shown in Exhibit 3.1), their total investment assets are $951,850. However, from this amount, we will exclude the $4,000 currently in the educational savings plan, because this will not be available during their retirement. We will also subtract the $740,000 mortgage on the office building. That leaves them with a net of $207,850 in investable retirement savings assets ($951,850 less $4,000, less $740,000).

Although it is impossible for anyone to accurately predict the actual rate of inflation before and during their retirement, the Loomises have decided to estimate a 3 percent inflation rate, which is above the historical average. James will reach his full Social Security retirement age at 67 and will also be entitled to Medicare at the age of 65. Therefore, the Loomises are using this age as their realistic retirement age.

**Exhibit 8.4 Sample Answers to Determine *Point X* for Financial Independence**

1. What is your current age? James is 37 years old and Patricia is 36 years old.
2. What is your combined (current) family annual income? $216,876.
3. As of today, how much do you have in retirement savings (investable assets)? $207,850.
4. What inflation rate do you expect before and during retirement? 3 percent.
5. What age do you reasonably expect to retire? James at 67 and Patricia at 66.
6. How many years do you estimate you will live in retirement? 29 (with Patricia living to age 95).
7. What percentage of your current income do you need in retirement? 42 percent based on cash flow needs analysis, less estimated Social Security benefits.
8. What is your projected retirement income from defined benefit plans and Social Security benefits? James expects $31,212, and Patricia $15,606, from Social Security, based on today's dollars.
9. What after-tax rate of return do you expect on your investments before retirement? 7 percent.
10. What after-tax rate of return do you expect during retirement? 5 percent.

Based on James' family history, he does not believe he will live past age 90; based on Patricia's family history, she expects to live until age 95. Because they are both in relatively good health, they would like to use age 95 for Patricia and therefore expect to live 29 years in retirement.

James went to the Social Security website and used the retirement estimator calculator: He expects to receive $31,212 per year in Social Security benefits; his wife expects to collect $15,606 per year, for a total of $46,818. This represents about 21 percent of their current annual income. Because Social Security benefits are adjusted to future benefit dollars, they feel comfortable assuming that their Social Security benefits will cover only 20 percent of their retirement income needs.

Based on the detailed needs analysis of their cash flow statement, they believe they will need 42 percent of the current year's income to maintain their standard of living in retirement. Here's how they calculated this:

- They took their total cash outflow for the 12 months ending December 31, 2012, which was $189,976, and they subtracted the $7,620 of outflows being added to their investment assets.
- They also subtracted the $34,049 per year from their annual home mortgage payment, because this mortgage would be paid off a few months before James turns 67.
- They further analyzed their cash flow statement and realized they would no longer need to make the $1,400 per year for term life insurance or the $1,200 per year payment for James' long-term disability.
- They also subtracted the $3,328 in student loan payments currently being paid, because they anticipate this loan will be paid off in the next five years.
- They also subtracted the $19,125 in Social Security tax, because this will no longer be applicable in their retirement years.
- We also prepared a tax projection based on their expected retirement income and determined that their overall federal and state income tax would be reduced from the current $47,400 to $40,400, which reduced their cash outflows by $7,000.
- They also would have been able to eliminate their entire child-care-related expenses of $6,090, but they chose not to do so, because they factored in helping their future grandchildren.

Based on these calculations, they realized they will need $116,254 ($189,976 less $7,620, less $34,049, less $1,400, less $1,200, less $3,328, less $19,125, less $7,000). In addition, the Loomises plan on being very active and fully enjoying their retirement; therefore, they wanted to budget an additional $18,000 per year for travel and entertainment.

This brings their total cash flow needs in today's dollars at $134,254, which represents about 62 percent of their current cash inflows. As mentioned, they estimated that Social Security will cover about 20 percent of their retirement needs, leaving them with a 42 percent shortfall. Therefore, they will have to have sufficient investable retirement assets by the time James reaches his expected retirement age of 67.

Based on the answers to the above questions along with the assumptions made, we are ready to determine James and Patricia Loomis' *point X*—the amount of investable assets they will need in order to secure a comfortable retirement and maintain their current standard of living. We utilized a "cost of retirement" calculator and input all the above facts and assumptions, and we determined the following:

- The annual income that the Loomises will need in the first year of retirement above and beyond Social Security will be $221,094, which represents their cash flow needs adjusted at a 3 percent rate of inflation.
- They will need to have $4,867,452 in investable assets saved by the time they are ready for retirement.
- Their current investable assets are expected to grow to $1,582,207 based on their expected rate of return over the next 30 years.
- This means they will have a shortfall of $3,285,245 ($4,867,452 less $1,582,207).
- To meet this savings shortfall, they will need to save 10.92 percent of their current cash inflow each year.
- They will need to save $23,686 (10.92 percent of their current income) in their first year, and this amount needs to increase every year to keep pace with inflation.

You can conduct a similar analysis of your own financial situation by going to http://finance.yahoo.com/calculator under the Retirement section, and click on "How much will I need to save

for retirement?" This will give you an opportunity to do numerous what-if scenarios utilizing your particular facts and circumstances.

Based on the analysis we conducted for the Loomises in Chapter 3, they are on a clear path to achieving financial independence. They were saving $7,620 per year before implementing the cash flow recommendations we made. They were also able to free up an additional $26,900 after implementing the cash flow savings strategies outlined in Chapter 3. They had already committed to funding James's SIMPLE plan with an additional $6,500 and Patricia's SEP IRA with an additional $3,500 for the year. After their retirement needs analysis, they have further agreed to fund a $5,000 nondeductible IRA for the year for James since he had already made the maximum contribution for 2012 and they committed to adding at least $2,380 per year to their variable annuity. This will bring their total savings to $25,000 starting this year, which is more than they need to achieve financial independence in retirement.[5]

### TAX FACTS AND STRATEGIES[6] FOR PLANNING FOR RETIREMENT

Here are several tax strategies that will help you reach your retirement planning goals at an accelerated rate, which will put you on the path for financial independence, *point X*.

- Compare the benefits of a traditional IRA to a Roth IRA and choose the one that is best for your particular situation. With a traditional IRA, you get a current year tax deduction for your contribution and tax-deferred growth. With the Roth IRA contribution, you do not receive any upfront tax deduction, but your qualified withdrawals are completely tax free.

[5]For more information on the costs/fees and risks associated with investments, see Chapter 9.

[6]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

- With a Roth IRA, you do not have to take a required minimum distribution (RMD) at age 70½. This may have the added benefit of keeping your AGI low enough to also avoid paying taxes on your Social Security benefits during your retirement years.
- The deadline for making a traditional or Roth IRA contribution is April 15, the regular due date for filing your income tax return, even if you are filing an extension.
- Fully fund your employer-provided retirement plan before the end of the year: the deferral limit for a 401(k) is $17,500 for 2013; the deferral limit for a SIMPLE plan is $12,000 for 2013.
- Take advantage of the additional deferral limit "catch-up" contribution to a 401(k) of $5,500 and to a SIMPLE plan of $2,500 for each participant age 50 or older.
- Establish a Roth IRA, $5,500 for 2013 per spouse ($6,500 if age 50 or older) if you qualify (AGI under $178,000 if married). If your income exceeds this level, establish these as traditional non-deductible IRA contributions. Under the new law, you can then convert these to a Roth IRA, regardless of your income level.
- There is no income limitation for converting a traditional IRA to a Roth IRA. Consider converting part or all of your traditional IRAs into a Roth IRA so that all your future earnings can grow tax-free. This can be very beneficial, especially in years where you are in very low tax brackets and in years where your IRA accounts have decreased in value. Keep in mind, however, that a conversion is a taxable transfer, and you must report it on your tax return for the year of the conversion.
- If you made a contribution to a retirement plan (including an IRA or Roth IRA), you may be eligible for a nonrefundable saver's credit. This credit can be as much as 50 percent of the first $2,000 of eligible retirement contributions made in 2013. This means you could receive a saver's credit of $1,000 by simply making a $2,000 retirement plan contribution. Talk about great incentives to save for your retirement!
- If you are separated from your employment for any reason, such as getting laid off, quitting, or retiring, you may be entitled to a distribution from a qualified employer retirement plan, which would be fully taxable if not properly handled. You must set this up as a tax-free rollover, which allows you to make a tax-free transfer of a distribution from one qualified employer retirement plan to another qualified plan or to a traditional IRA. You should instruct your employer to directly rollover the funds either to a traditional IRA you designate or to the plan of your new employer. If you elect the distribution to be paid directly to you, you still have 60 days to make a tax-free rollover yourself. If you do not meet these requirements, the full amount may be subject to tax and an additional 10 percent penalty.

(*Continued*)

- Generally, there is a 10 percent penalty that applies to taxable distributions made to you before age 59½ from qualified plans. You may avoid the 10 percent penalty if you meet one of the following exceptions: rollover; disability; separation from service if age 55 or older; medical costs; substantially equal payments for at least five years, as beneficiary of a deceased plan participant, IRS levy, or if part of a qualified domestic relations court order. For more details on the exceptions to the early withdrawal penalty, see IRS Form 5329 and instructions.
- In addition to the above penalty exceptions, with a traditional IRA, you may avoid the 10 percent penalty if you use the distribution to pay for qualified higher education expenses or if the distribution is used for qualified first-time homebuyer expenses of up to $10,000.
- You should avoid borrowing money against your retirement plan because that can have dire consequences. For example, if you leave your employer before you pay off the loan, your employer will reduce your vested account balance by the amount of the outstanding loan and will report this loan amount as a taxable distribution in the year you separated from service. This amount may be subject to tax and the 10 percent penalty.
- Making elective salary deferrals to your company's retirement plan allows you to defer tax on your salary and get a tax-free buildup of earnings within your plan until you start making withdrawals when you retire. You must take full advantage of these plans by taking the maximum deferral allowed by your employer's plan. If you cannot manage to do the maximum, then you must at least contribute the minimum that will maximize your employer's match.
- Many employer-sponsored 401(k) plans now allow employees to contribute as after-tax Roth contributions. If you take advantage of a Roth 401(k), you can make significantly higher contributions than what would be available in a Roth IRA. Keep in mind Roth contributions are made in after-tax dollars, so you will not receive any upfront tax savings.
- Where employer plans include a qualified Roth contribution program conversions can also be made from a pre-tax contribution 401(k) account to the Roth 401(k) account. Keep in mind however, that a conversion is a taxable transfer and you must report it on your tax return for the year of the conversion.
- When rolling over retirement plan distributions, your employer must withhold 20 percent if the check is first paid to you. To avoid the 20 percent withholding, you should have your employer make a direct rollover to your new employer's qualified plan or an individual IRA. Doing a direct rollover will avoid the problems associated with this 20 percent withholding.
- If you are collecting Social Security benefits, up to 85 percent of these benefits could be subject to federal income tax. You can avoid paying income tax on your Social Security benefits if your provisional income is $25,000 or less

if you are single, or $32,000 or less if you are married and filing jointly. Planning your retirement income to include tax-free withdrawals such as from a Roth IRA account may allow you to keep your income under these thresholds and ultimately avoid paying tax on your Social Security benefits.

- If you are 65 years of age or older before January 2nd of the following tax year or blind, you can benefit from a higher filing threshold and a higher standard deduction. This additional standard deduction is $1,200 per spouse if married and $1,500 if filing as a single taxpayer.
- For 2012 and 2013 the American Taxpayer Relief Act of 2012 allows taxpayers 70 $^1/_2$ or older to take up to a $100,000 tax-free distribution to the charity(ies) of his or her choice from an individual retirement account. This will allow a taxpayer to meet their RMD (required minimum distribution) without increasing their adjusted gross income. This can be used as a strategy to avoid paying taxes on social security benefits for lower income taxpayers, and can avoid the 3.8 percent Medicare tax on net investment income for higher income taxpayers.
- For 2013, the maximum annual benefit that can be funded by a defined benefit plan is $205,000. These contributions are deductible to the business entity and never subject to Social Security and Medicare taxes when contributed on behalf of an employee. Earnings on investments and subsequent withdrawals are also not subject to Social Security and Medicare taxes. Starting in 2013, this becomes even more important since the 0.9 percent increase in Medicare tax for high income salaries and self-employed earnings may apply, as well as the additional 3.8 percent Medicare surtax on net investment income.
- For 2013, an employee may make up to a $17,500 salary deferral (withholding) contribution from pre-tax dollars to a defined contribution plan such as a 401(k), 403(b) and profit-sharing plan. An additional $5,500 contribution can be made if the taxpayer is 50 years old or older. The maximum employer and employee contribution for 2013 is $51,000. The maximum contribution is based on $255,000 in wages (lower limits apply for key employees and highly compensated employees [HCE]). It should be noted that the employer portion of contributions is not subject to Social Security or Medicare taxes.
- For 2013, the maximum compensation to be considered for a SEP contribution is $255,000, which allows for a $51,000 tax deductible contribution.
- For 2013, an employee may make a pre-tax salary deferral up to $12,000 to their SIMPLE (Savings Incentive Match Plans for employees) retirement plan. If 50 or older, the employee can make an additional $2,500 catch-up salary deferral. In a matching SIMPLE plan the employer's contribution is the lesser of 3 percent of the employees taxable compensation or actual salary deferral (there are some exceptions to this rule).

## AN ACTION PLAN FOR PLANNING FOR RETIREMENT

1. **Calculate how much money you will need when you retire**. There are many retirement calculators available online, including one at http://finance.yahoo.com/calculator. Scroll down to the Retirement topic and click on "How much will I need to save for retirement?" You will be able to run through an unlimited number of "what if?" scenarios.
   Once you know how much you will need, you can start planning to reach that goal—your personal *point X.*
2. **Start saving and investing for your retirement as soon as you finish school and start working.** You may not believe it, but you *can* live on 90 percent of what you earn, no matter how little you think that is. So set aside at least 10 percent of your earnings, because the earlier you start, the better off you will be: You have the benefit of time on your side, to help that money grow. Do not keep putting off saving for your retirement until "later," whether that is next year, or when you get a raise, or a promotion, or a new job—start saving *now.*
3. **Learn the difference between various types of retirement plans**. Then find out what the maximum is that you can contribute to the plans that apply to you. If you are not sure about this, meet with a financial advisor who can review your specific financial situation and help you plan better for your future.
4. **Invest as much as your company will allow you to contribute into your employer's 401(k) plan**. You do not have to pay income taxes on that money now, because you are not receiving it currently as income. Plus, most employers still match at least some percentage of what you contribute. Getting a 3 percent employer match is like getting a 3 percent raise. If not contributing makes you ineligible for the match, that would be like turning down a raise your employer is willing to give you.
5. **Do not worry about the day-to-day ups and downs of the stock market: keep in mind that you are saving for *the long haul***—for your retirement. So if you are in your twenties, that is at least 40 years away. But even if you are in your fifties and hope to retire at 65 but accept that you may be working until you are 70, you still have at least 10 years before retirement. So what happened to the stock market today is not important to the money you will need and hopefully have when you retire. Just keep saving, and keep investing, with your long-term goal in mind.

CHAPTER 9

# Managing Your Investments

*In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.*

—Warren Buffett, most successful investor of the twentieth century

This chapter provides information and guidance for dealing with investment, beginning with basic definitions of various investment vehicles: stocks, bonds, mutual funds, and exchange-traded funds (ETFs). I then give general information on the process of creating an investment portfolio that considers your financial goals, comfort levels, expectations, and the effects of inflation and taxes on these investments. I will also discuss how to adjust a portfolio as your financial goals change.

The purpose of this chapter is to provide you with an understanding of investing, which normally takes people many years to learn on their own. Unfortunately, many investors learn this lesson the hard way and never recover from their financial losses. It is important that we learn from our past and do our best to not repeat the mistakes history has taught us. The rewards from proper investing have been very generous when investors have adopted an

*Financial Independence (Getting to Point X): An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

investment discipline that allows them to purchase quality investments and then allow those investments to take their course. This may have been best said by Warren Buffett, the primary shareholder, chairman, and CEO of Berkshire Hathaway, who is also considered by many to be the most successful investor of the twentieth century:

> Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

The information and guidance on investments that I provide in this chapter is designed to help you stay the course toward financial independence and your *point X*.

## Analyzing Your Risk Tolerance

Every investor has his own unique view on risk and can only tolerate a certain amount of losses before he or she becomes emotional. This ultimately leads to bad investment decisions. Of course, a higher level of risk corresponds to the potential for a higher rate of return on your investments. If your investing risk tolerance were as simple as stating you want the highest rate of return in the long run, then you would simply invest in the most speculative types of investments. But it is not that simple; instead, you need to examine your own personal tolerance to risk so that the ultimate investment portfolio you choose will have staying power in both good and bad times. It is important to remember that it is you, the individual investor, who must have the staying power.

Common sense tells us that we should buy investments when they are low and try to sell them when they are high. This obviously results in gains as long as you, the investor, have staying power. Unfortunately, we human beings bring our emotions into the investment decision-making process and quite frankly, emotions cost money. When the economy is booming and the stock market reaches new highs, people are more likely to invest their money because of all the positive news and emotions surrounding the market. Naturally, the opposite is true when the economy is doing poorly and the world is filled with negative news. Most investors are not willing to invest then; in fact, many sell their investments at lower prices at this time. If Macy's department store ran a 50 percent off sale

on every item in the store, most people would rush to Macy's and buy everything they could. On the other hand, if Macy's increased its prices by 50 percent from the original price, very few people would shop in their store. However, when it comes to investing, human nature makes us react very differently than this, and many people tend to buy high and sell low.

Therefore, it is critically important that you select an investment model that you are willing to stay with, even in the worst of markets. The appropriate investment plan for you should be the one that provides you with the highest potential rate of return in the long run that is within your risk tolerance.

Part of determining your risk tolerance goes back to analyzing your personal behavior and how you deal with your other life issues. For example, if you typically are a nervous individual and tend to go down the straight-and-narrow path in life, then you most likely will choose a more conservative investment risk model. On the other hand, if you are fearless and like to live life in the fast lane, then you would most likely choose a more aggressive investment risk model.

In evaluating your risk tolerance, you must also take into consideration what your ultimate financial goals will be. This will help you determine your time horizon. Generally, the shorter your time horizon, the less risk you should be willing to take on. For example, an 18-year-old investor who has 49 years ahead of her before retirement can generally tolerate a much greater level of risk than a 60-year-old who is only 7 years away from retirement.

Because the question of your own personal risk tolerance revolves around human behavior and emotions, it is important to understand your own investment psychology. I consider this the investor's psychological evaluation of his or her risk tolerance. There are many ways to measure your risk tolerance and numerous questionnaires are provided at many investment websites. You can also find one at http://finance.yahoo.com/calculator; scroll down to "Career & Education" and click on "What is my risk tolerance?" You will find 10 risk tolerance questions to help identify your comfort level with investment risk. Exhibit 9.1 provides a simplified version of a risk investment, risk profile questionnaire. Please take a few moments to answer these questions to determine your own investor risk tolerance profile and score.

**Exhibit 9.1 Six Questions to Assess Your Investor Risk Tolerance Profile and Score**

1. How many years will you stay invested for?
   1. ___ 5 years or less
   2. ___ 5–10 years
   3. ___ 10 years or more
2. What would you typically consider most important when investing?
   1. ___ Preserving your capital
   2. ___ Conservative growth with income
   3. ___ Maximum growth
3. A year after making a $50,000 investment, your account value drops to $40,000 and the Dow Jones Industrial Average is also down by 20 percent. How would this make you feel and what would you do about it?
   1. ___ Extremely uncomfortable: I would sell my investments immediately.
   2. ___ Uncomfortable, but I would be willing to listen to my financial advisor's recommendation.
   3. ___ I would view this as a buying opportunity and would be willing to invest more money at these lower prices.
4. Which of the following phrases matches your view of taking on risk with your investments?
   1. ___ Not willing to take on risk
   2. ___ Willing to take a limited amount of risk
   3. ___ Willing to take a high level of risk
5. If you invested $50,000, which range of possible outcomes would you be most comfortable with within a year?
   1. ___ Value fluctuating from $48,500 and $51,500 (3% increase or decrease)
   2. ___ Value fluctuating from $46,500 and $53,500 (7% increase or decrease)
   3. ___ Value fluctuating from $45,000 and $55,000 (10% increase or decrease)
6. Which of the following statements best describes your attitude toward life?
   1. ___ Slow and steady wins the race.
   2. ___ Live a balanced life, everything in moderation.
   3. ___ The greater the risk, the greater the reward.

Now that you have answered these six questions, you are ready to determine your risk profile score. Simply add up the numbers next to each question you check off in the questionnaire. For example, if you checked off item number 2 for each question, your risk profile score would be a 12. This would place you in the conservative growth investor profile as outlined below.

| Investor Risk Tolerance "Profile" | "Score" |
|---|---|
| ___ Conservative Income | 6–7 |
| ___ Income | 8–10 |
| ___ Conservative Growth | 11–13 |
| ___ Growth | 14–16 |
| ___ Maximum Growth | 17–18 |

The answers to the questions in Exhibit 9.1 provide you with a numerical score that measures your tolerance to investment risk. The higher your score, the more risk you would be able to tolerate. Understanding your risk tolerance is one of the most fundamental first steps you must take before implementing any investment strategy.

#### *Understanding Investment Risk*

Now that you have evaluated your own risk tolerance, it is important to understand exactly what the investment risks are. Once you understand what the different investment risks are, you will be better prepared to make more informed investing decisions, put together an investment portfolio that includes various asset classes, and manage your investments. There are numerous types of investment risks; the most common include inflation risk, interest rate risk, market risk, economic risk, and company- or industry-specific risk.

***Inflation risk*** is the threat that your investment returns will not keep pace with the rate of inflation. For example, if inflation increases each year by 3 percent, but your investments are only growing by 1 percent, you are losing money. This will reduce your purchasing power and effectively reduce your real rate of return on your investments, net of inflation. In order for your portfolio to have a reasonable chance of beating inflation, it should include growth-oriented stocks, growth and income stock mutual funds, and other growth-related investment vehicles. These types of investments have historically outpaced the rate of inflation over the long term, although there is no guarantee that they will do so in the future.

***Interest rate risk*** is typically associated with bonds and other fixed-income investment vehicles, which tend to be sensitive to changes in interest rates. When interest rates rise, the value of these investments falls. Of course, the opposite is true as well: As interest rates drop in our economy, the value of these investments increase. One way to protect against interest rate risk when you believe interest rates will be rising is to shorten the duration of your bond holdings (closer maturity dates).

***Market rate risk*** is the risk of when the overall market experiences a decline. It typically drags down the value of all securities at the same time. Market rate risk is a result of the aggregate movement in the market and may not relate

specifically to your investments. Market risk can affect almost any type of investments; including stocks, bonds, commodities, real estate, and many others.

***Economic risk*** occurs when the overall economy experiences a downturn, such as when a recession occurs. These economic downturns can result in a decrease in earnings and profits from the underlying companies you may be invested in. This can diminish a company's ability to pay a dividend or even the interest on its bonds. It is important to note that certain companies and industries may be more sensitive to economic changes than others. For example, companies that produce luxury items will be much more sensitive to economic downturns than companies that produce necessities.

***Company- or industry-specific risk*** occurs when an event affects only a specific company or industry—for example, if accounting irregularities are discovered during a particular company's financial statement audit, the value of investment in that company is likely to decrease. These types of events can have a significant effect on a company's value as well as the confidence investors can place with its management. By far, this is the strongest reason for a well-diversified portfolio and why you should never keep all your eggs in one basket.

## Stocks, Bonds, Mutual Funds, and Exchange-Traded Funds

The most efficient and popular way to invest is by purchasing individual stocks, bonds, mutual funds, and exchange-traded funds (ETFs). Therefore, I believe that it is essential that I provide you with a description of each of these investment vehicles.

### *Stocks*[1]

A stock represents a fractional ownership interest in a corporation. When you invest in a corporation, you become a partial owner in the company's business and can participate in the company's profits or losses. As a shareholder in a corporation, you

[1]As with other investments, there are generally fees and expenses associated with buying and selling securities. Fees may include taxes, commission costs, markup, account transfer and maintenance fees, and custody fees.

have the benefit of limited liability protection: This protection minimizes your downside to no more than your investment in the company.

When the corporation makes a profit, you may be rewarded with a dividend. Furthermore, if the corporation continues to grow its revenues and profits, so will the value of the stock you own. You can also realize these gains in the stock's value by selling your shares of a company.

If the company does not do well, you may never see the payment of a dividend, and in fact, the value of your stock could decline. The risk and potential reward associated with investing in stocks are generally much higher than with the other investment vehicles. Therefore, you should be prepared to experience high volatility when investing in stocks.

#### *Bonds*[2]

A bond represents a loan that you make to a corporation or government entity, which then in return promises to pay you back with interest over time. In essence, you act as the banker (lender), and the bond issuer is the borrower. This indebtedness to you is documented through a bond certificate, which is issued to you by the entity.

The bond issuer typically needs to raise money to meet other obligations or to facilitate certain projects. If you decide to invest in that issuer's bond, you are willing to lend your money in exchange for the promise to be paid back with a specific rate of interest. The bond investor usually will receive regular interest payments every six months. The interest payments on a bond is usually fixed and stated as a percentage of its "face" value.

It is important to understand that bonds come with interest-rate risk (described previously): As noted, the values of bonds have an inverse relationship with the direction of interest rates in our economy. The longer the time frame to maturity, the more sensitive the fluctuation in market price will be.

When you own individual bonds purchased at face value and hold them to maturity, you will receive the interest payments plus your original principal. Of course, this assumes that the bond issuer does not default on its promise and ultimately pays you back.

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[2]See footnote 1.

Not all bond issuers are created equal. The stronger their balance sheet and the higher their credit rating, the lower the risk involved. The opposite is also true. Therefore, it is logical that the higher the risk associated with purchasing the bond, the higher the rate of return that will be offered by the bond issuer. Bonds are typically considered safe investments, but keep in mind the higher the rate of return being offered is typically associated with a higher potential for default risk.

Bonds can be divided into three major categories: U.S. Treasury bonds, municipal bonds, and corporate bonds. Each category has its own unique features, which you should take into consideration when selecting and evaluating the components of your bond holdings.

**U.S. Treasury Securities** Bonds, bills, and notes issued by the U.S. government are also known as *Treasuries* and typically represent the highest-quality bonds available to investors. However, in August 2011, credit-rating agency Standard and Poor's (S&P) announced that it had downgraded the U.S. credit rating for the first time in history. This sent shock waves throughout the credit markets. S&P said, "Political brinksmanship in the debate over the debt had made the U.S. government's ability to manage its finances less stable, less effective, and less predictable." In spite of this, many people continue to invest in U.S. Treasury securities, clearly for their known safety and peace of mind. I would be very cautious here because U.S. Treasury yields are currently at historical lows and below the expected inflation rate. What may seem like a very safe and conservative investment could still result in losses.

U.S. government bonds are issued by the U.S. Department of the Treasury. They are extremely liquid and traded on the secondary market. Treasury securities are backed by the full faith and credit of the U.S. government. They are considered to have less risk than other bonds, and are considered a safe haven especially during turbulent economic times. The interest earned on treasury bonds is exempt from state and local taxes. There are four major categories of U.S. Treasury securities:

1. ***Treasury bills*** (T-bills) are short-term bonds that mature in less than one year. They are sold at a discount from their face value and do not pay interest until their maturity.

2. ***Treasury notes*** (T-notes) earn a fixed rate of interest every six months and have maturities ranging anywhere from 1 year to 10 years.
3. ***Treasury bonds*** (T-bonds) have maturities ranging from 10 to 30 years. Similar to treasury notes, T-bonds also have a coupon payment every six months.
4. ***Treasury Inflation-Protected Securities*** (TIPS) are inflation-indexed bonds. The principal of TIPS is adjusted by changes in the Consumer Price Index. They are typically offered in maturities ranging from 5 to 20 years.

**Municipal Bonds** Municipal bonds are issued by state and local governments. The money raised by the issuance of these bonds is typically used to pay for public service projects, such as the construction of public schools, highways, low-income housing, sewer systems, and other municipality projects. Municipal bonds are exempt from federal, state, and local income taxes for investors who live in the jurisdiction where the bond is issued: This "triple tax-free" treatment can make them very attractive investments to high-income taxpayers. Exhibit 9.2 shows the equivalent corporate bond rates of return to municipal bonds: For example, if you have a marginal tax rate of 40 percent, you would have to earn 10 percent on a corporate bond to equal a 6 percent rate of return on a municipal bond.

There are two major categories of municipal bonds issued by state and local government:

1. *General obligation bonds* are secured by the full faith and credit of the issuer and are supported by the issuer's taxing authority.
2. *Revenue bonds,* unlike general obligation bonds, are secured by the revenues specified in the legal contract between the bond holder and bond issuer. They are required to use these revenues for repayment of the principal and interest on the bonds. They are not backed by the full faith and credit or taxing authority of the municipality; instead, they are backed solely by the revenue-generating ability of the municipal project, such as a bridge toll and other user fees. Under certain circumstances revenue bonds can be subject to federal, state, or local alternative minimum tax.

**Exhibit 9.2 Municipal versus Corporate Bonds**

| In State Municipal Bonds Rate | Corporate Bond Equivalent Rate at Marginal Federal, Local Tax Rate of: | | | |
|---|---|---|---|---|
| | 10% | 20% | 30% | 40% |
| 1.00% | 1.11% | 1.25% | 1.43% | 1.67% |
| 2.00% | 2.22% | 2.50% | 2.86% | 3.33% |
| 3.00% | 3.33% | 3.75% | 4.29% | 5.00% |
| 4.00% | 4.44% | 5.00% | 5.71% | 6.67% |
| 5.00% | 5.56% | 6.25% | 7.14% | 8.33% |
| 6.00% | 6.67% | 7.50% | 8.57% | 10.00% |
| 7.00% | 7.78% | 8.75% | 10.00% | 11.67% |
| 8.00% | 8.89% | 10.00% | 11.43% | 13.33% |
| 9.00% | 10.00% | 11.25% | 12.86% | 15.00% |
| 10.00% | 11.11% | 12.50% | 14.29% | 16.67% |
| **If $10,000 investment—the annual amount of return based on the above table** | | | | |
| $100 | $111 | $125 | $143 | $167 |
| $200 | $222 | $250 | $286 | $333 |
| $300 | $333 | $375 | $429 | $500 |
| $400 | $444 | $500 | $571 | $667 |
| $500 | $556 | $625 | $714 | $833 |
| $600 | $667 | $750 | $857 | $1,000 |
| $700 | $778 | $875 | $1,000 | $1,167 |
| $800 | $889 | $1,000 | $1,143 | $1,333 |
| $900 | $1,000 | $1,125 | $1,286 | $1,500 |
| $1,000 | $1,111 | $1,250 | $1,429 | $1,667 |

This exhibit shows the equivalent full taxable interest rate at different marginal tax rates to result in the same after tax rate for in-state municipal bonds.

**Corporate Bonds** These bonds are issued by corporations and other for-profit business entities, which issue bonds in an effort to raise capital for their expansion and other operating needs. Corporate bonds generally pay a higher level of interest than government bonds, because they are not backed by the government. A business that has a strong balance sheet, strong earnings, and an excellent credit rating will pay a much lower rate of interest than a business that is not as financially stable. It is important to understand that when a corporation

provides a higher interest rate on their bonds, these bonds come with greater risk. Lastly, it is essential to note that interest earned on corporate bonds is subject to ordinary income tax rates.

### *Mutual Funds*[3]

Mutual funds have become one of the most popular ways to invest because of their many benefits, which include access to professional money managers, diversification, multiple asset classes, convenience, and liquidity, and many other benefits. Mutual funds also offer investors easy access to investing your money (at all levels—that is, regardless of how much or how little money you invest).

When you invest in a mutual fund, you become a shareholder of that mutual fund. As a shareholder, you will participate in the profits and losses of the mutual fund. Keep in mind that investing in mutual funds is similar to investing directly with an individual corporation, in that your liability is limited to the amount you invested.

The management team of a mutual fund typically includes one or more investment managers, who are assisted by a team of investment analysts in deciding what and when to buy particular investments within the framework defined in the mutual fund's prospectus. These investment decisions involve trading securities, recognizing capital gains and losses, and generating interest and dividends, all on behalf of the mutual fund and its investors. As one of the mutual fund's investors, you participate in these results in proportion to your holdings.

Some of these earnings are paid out to shareholders on a quarterly basis in the form of a dividend and/or capital gain distribution. You have yet another way to participate in the success or failure of your mutual fund investment by selling the shares you own. If you sell your mutual fund shares at a price higher than you originally paid, you may realize capital gains and conversely, if you sell them for less, you may realize capital losses. As a result, mutual funds provide you with three opportunities for growth of your investments, through dividends, capital gains distributions, and possibly capital gains on the sale of your investment.

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[3]As with other investments, there are generally fees and expenses associated with buying mutual funds. Some of these fees may include shareholder transaction costs, investment advisory fees, and marketing and distribution expenses.

When you invest in a mutual fund, you are pooling your money together with many other investors under the common control and management of an investment company. A mutual fund company is an investment company that professionally manages your investment portfolio. Every mutual fund company has a list of various mutual fund's investment options with varying objectives as stated in their prospectus. You can pick and choose the mutual fund type that is best aligned with your own long-term objectives.

These mutual fund objectives typically include broad categories, such as:

- ***Growth funds,*** which invest primarily in securities that are expected to increase in capital value, rather than yielding income from dividends and interest.
- ***Growth and income funds,*** which have a dual strategy of increasing in capital value and providing current income generation by paying dividends and interest.
- ***Equity income funds,*** which invest in a variety of different income investments, but generally invest in securities from established, credit-worthy companies that consistently pay dividends.
- ***Balanced funds,*** which include both stocks and bonds in a single portfolio that attempts to have a diversified asset allocation.
- ***Bond funds,*** which invest primarily in bonds and other debt instruments.
- ***Tax-exempt bond funds,*** which invest in municipal bonds (which are debt securities issued by a state, municipality, county, or special-purpose district).
- ***Money market funds,*** which earn interest while maintaining a net asset value of one dollar per share, typically invested in short-term securities representing high-quality, liquid debt and monetary instruments.

Within each of these broad categories, there are other many subcategories, for example:

- ***Domestic funds,*** which invest only in securities from within the investor's country of residence (such as the United States).
- ***International funds,*** which invest in securities located anywhere outside of the investor country of residence.

- ***Global funds,*** which can invest in securities located anywhere in the world, including the investor's country of residence.
- ***Emerging markets funds,*** which invest in securities in a single developing country or a group of countries: Typically, they include countries in Eastern Europe, Africa, the Middle East, Latin America, the Far East, and Asia.
- ***Small-cap funds, or small-market capitalization funds,*** which generally invest in securities with a market capitalization between $300 million and $2 billion.
- ***Mid-cap funds, or middle-market capitalization funds,*** which generally invest in securities of companies with a market capitalization that ranges from $2 billion to $10 billion.
- ***Large-cap funds, or large-market capitalization funds,*** which generally invest in securities of companies with a market capitalization of $10 billion or more.
- ***High-income funds,*** whose objective is to pay a high income to shareholders. To accomplish this, they typically invest in high-risk financial instruments.

There are many other subcategories, with new ones being created every year; therefore, you should always consult with your investment advisor and read the prospectuses before investing in any fund. One of the drawbacks to mutual funds is that they cannot be traded throughout the day, and their purchase and sale price is determined at the close of the day.

Which mutual fund is right for you depends on your particular facts and circumstances, including your risk tolerance and ultimate investment objectives. I believe that mutual fund investing can be the most convenient and efficient way for an individual investor to meet their investing objectives. They offer you, the average investor, direct access to professional money managers, which would otherwise be available only to large institutions. They allow you to increase your level of diversification beyond what you could do on your own. They also expand the asset classes and choices that would normally be available to you. Finally, they are a convenient way to invest that also provides liquidity and ease of access to your funds.

#### *Exchange-Traded Funds (EFTs)*

An ETF is an investment vehicle that trades just like a stock on the stock exchange. An ETF holds assets such as stocks, bonds, or

commodities, similar to what is done through a mutual fund. However, unlike a mutual fund, but similar to a stock, an ETF's value fluctuates throughout the day. Many ETFs are based on a particular index, such as the S&P 500, the Dow Jones Industrial Average, gold index, corporate bond index, health care index, and many others. ETFs are not actively managed; instead, they simply hold investments that represent a particular index. This makes ETFs more attractive to certain investors because they have lower costs, and most mutual fund managers cannot consistently outperform the indexes.

If you prefer investing in asset classes and do not put much weight on the value of active investment management, then ETFs may be better suited for you than investing in mutual funds. Conversely, if you do value the decision-making abilities of professional investment managers, then mutual funds may be the better choice for you.

As with any decision in life, you must weigh the advantages and disadvantages of investing in individual stocks and bonds, mutual funds, or ETFs. For many people, the right choice may be a combination of all of the above.

## Diversification and Modern Portfolio Theory

It is every investor's ultimate goal to achieve the highest possible rate of return without taking on any unnecessary risks. The question is, *is it possible to increase my rate of return without taking on more risk?* If so, it should be every investor's objective to do so.

Modern portfolio theory has shown us that this is an achievable goal. Many large institutional investors use modern portfolio theory in managing their portfolio, and this is an investment strategy that you should be aware of and should employ. Modern portfolio theory attempts to maximize an investment portfolio's expected return within a given risk profile. It attempts to minimize risk for a given level of expected return, by cautiously choosing the size of various asset classes within a portfolio.

This theory discovered that if you spread your investment dollars among several different asset classes, you may be able to lower your volatility on your overall investment portfolio without sacrificing your return on investment. This is possible because different types of assets often change in value in opposite ways because they are negatively correlated. For example, generally, when we see the

value of stocks increase, the value of bonds tends to decrease. This is an example of negatively correlated asset classes. The theory also showed that diversification can also lower risk even if assets' returns are not negatively correlated. One of the underlying presumptions of this theory is that investors are rational and that markets are efficient.

When we analyze the risk versus return of cash, bonds, stocks, and alternatives, it has been shown that a properly diversified portfolio that includes these asset classes can minimize risk without sacrificing return. For example, in Exhibit 9.3, Investment Growth Based on Rates of Return 1980 to 2011, you can clearly see that if you invest 20 percent of your portfolio in stocks and 80 percent in bonds (rather than 100 percent in bonds), that can result in less risk with a higher return. The general rule of investing states the higher the risk, the higher the potential rate of return. This Nobel-prize-winning discovery by Harry Markowitz was able to show that with a properly diversified portfolio that included both stocks and bonds, it was actually possible to increase your rate of return and, at the same time, lower the risk of the overall portfolio. This is an amazing discovery which goes against the basic premise "the higher the risk, the higher the return."

The beauty of diversification is that when you have a group of asset classes, some of which are negatively correlated, you can reduce the volatility (i.e., risk) of your portfolio and at the same time possibly increase your rate of return.

Many financial scholars have come to realize that all investment classes fluctuate in value, but that different asset classes fluctuate differently under different sets of circumstances. It has also been found that many asset classes are not positively correlated and in fact in some cases are inversely correlated.

Distributing your investment risk among different asset classes can help to smooth out your investment return. Diversification is an investment strategy that every investor should use. Diversification is also one of the main reasons I am a big advocate of mutual funds and exchange-traded funds (ETFs) for both novice and experienced investors. Whether you have $1,000 or $10 million to invest, these investment vehicles can provide you with the level of diversification that is essential to maximizing your risk and reward equation.[4]

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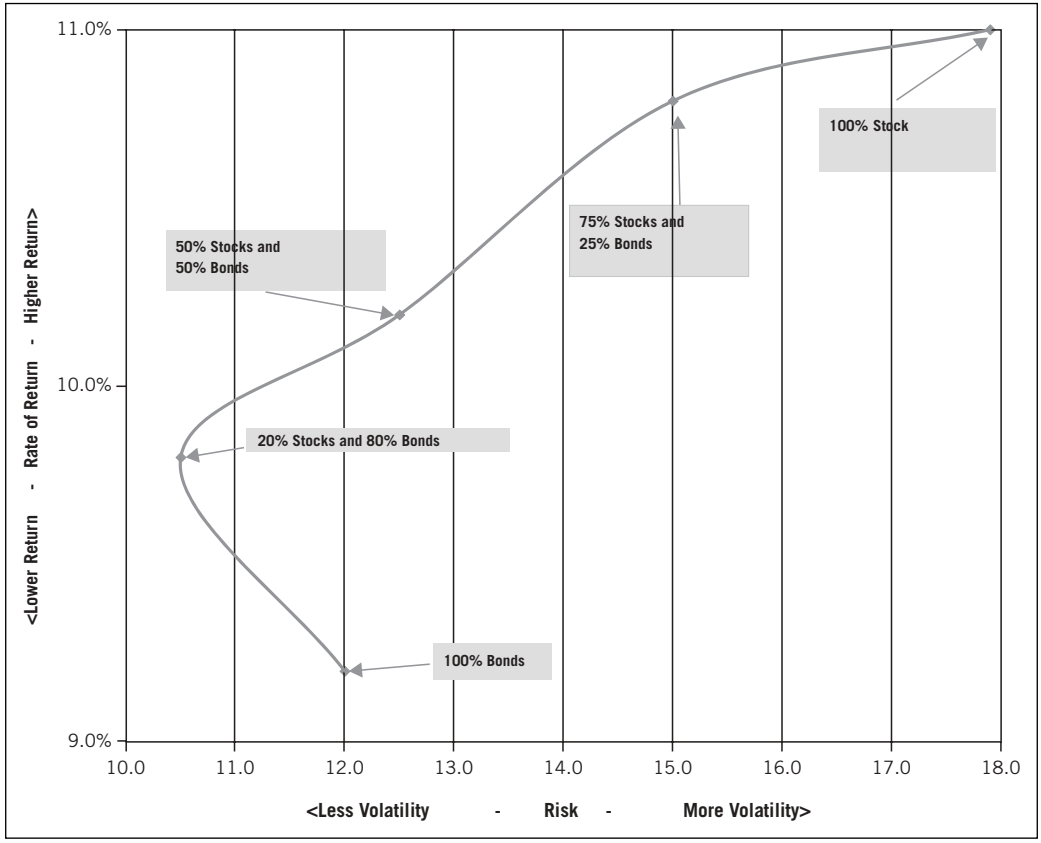
[4]Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

**Exhibit 9.3 Investment Growth Based on Rates of Return 1980 to 2012**



## Asset Allocation and Rebalancing[5]

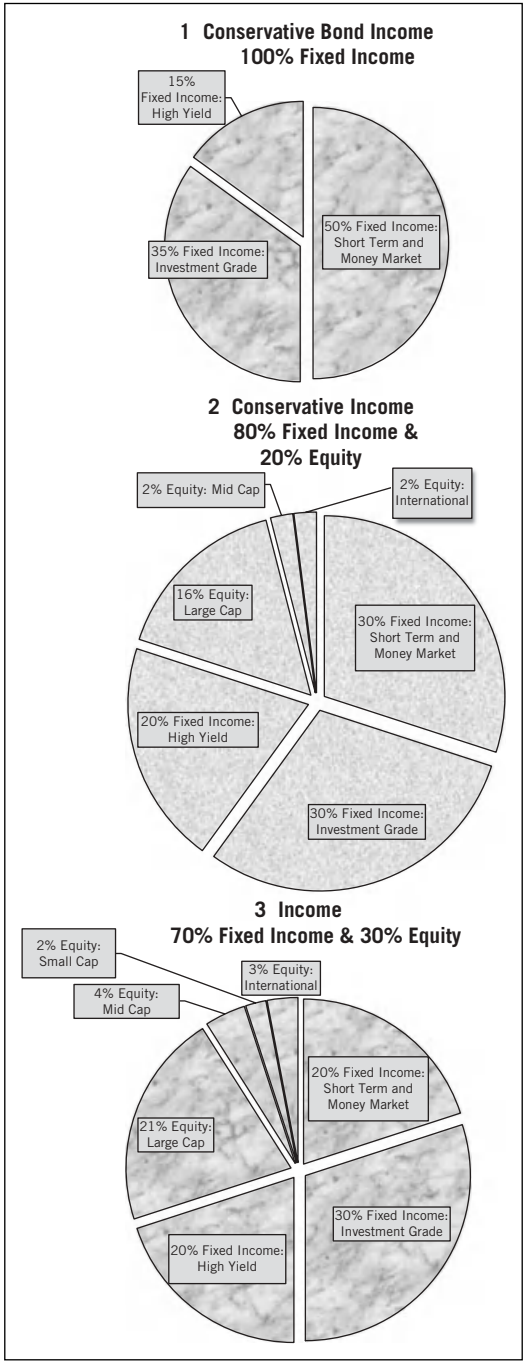
Asset allocation is an investment strategy that provides a systematic approach to diversification that may help you establish the most efficient blend of assets based on your particular risk tolerance level and investing time horizon. Studies have shown that asset allocation is more important than all other factors in managing your investments. Although it is helpful to work with a professional money manager who has a proven successful track record, selecting the right balance of asset classes is more important. Asset allocation seeks to control investment risk by diversifying a portfolio among the four major asset classes:

1. *Cash* includes currency, coins, checking accounts, savings accounts, money market accounts, and certificates of deposit.
2. *Bonds* include government, municipal, and corporate bonds.
3. *Equity* represents an ownership interest in a business entity by investing in a company's stock.
4. *Alternatives* include investments in tangibles, such as real estate, art, precious metals and stones, as well as collectibles.

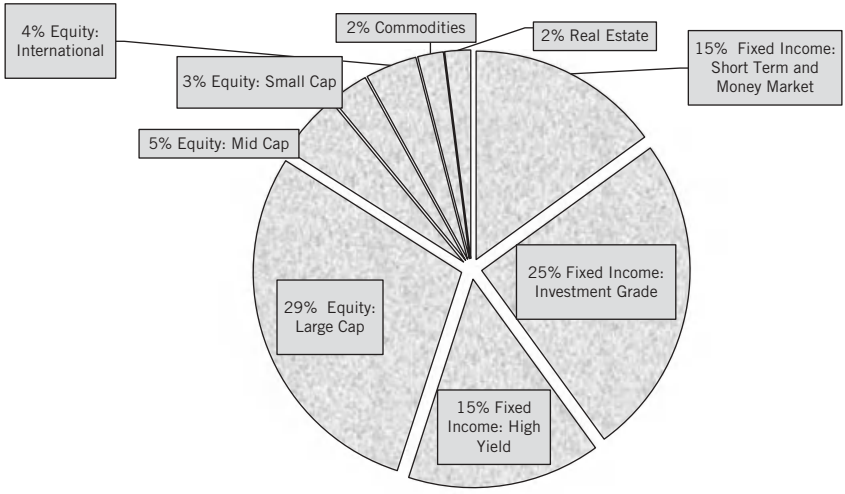
Each asset class has a different level of risk as well as potential rate of return. The basic idea is that while one asset class may be increasing in value one or more of the others may be decreasing. Therefore, asset allocation and diversification may help you ride out market fluctuations and protect your portfolio from a major loss in any one asset class. They may also provide you with the staying power and control over your emotions even after a big downturn in the market. However, it is important to understand that asset allocation and diversification do not guarantee against loss. They are simply strategies that may help smooth the ride to your financial independence, *point X*. It is fundamental to find a mixture of asset classes with the highest potential return within your risk profile. Exhibit 9.4 shows seven sample asset allocation models that can be used as a guide to fit into your own risk tolerance level. There are, of course, an unlimited number of variations to these sample models.

[5]Before you rebalance your portfolio, you should consider whether the method of rebalancing you decide to use will trigger transaction fees or tax consequences. Your financial professional or tax adviser can help you identify ways that you can minimize these potential costs.

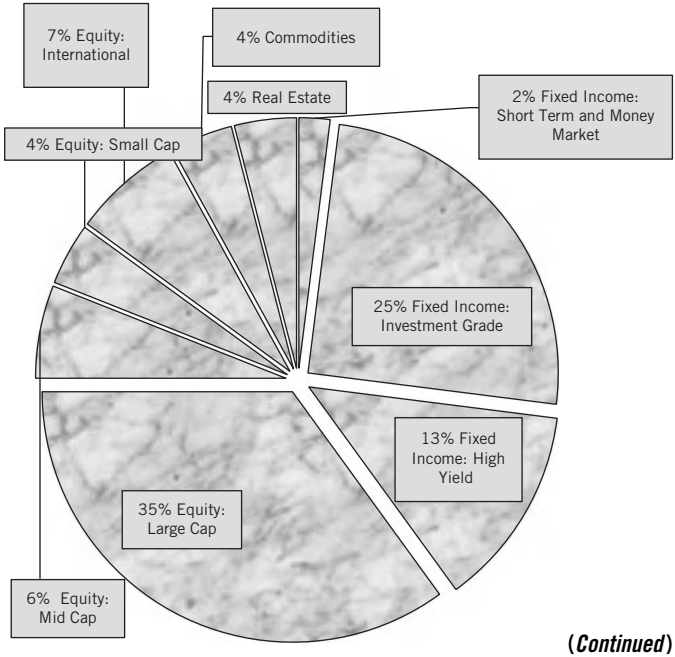
**Exhibit 9.4 Seven Sample Asset Allocation Models (1 = Most risk-adverse investor; 7 = Most aggressive investor)**



**4 Conservative Growth**
**55% Fixed Income + 43% Equity + 2% Commodities + 2% Real Estate**

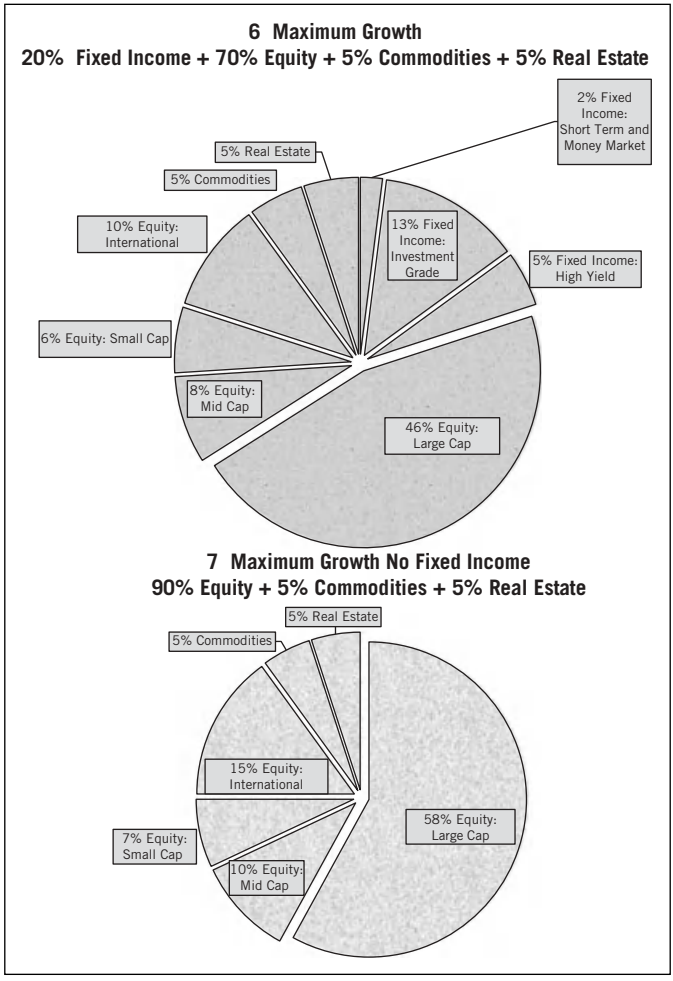



**5 Growth**
**40% Fixed Income + 52% Equity + 4% Commodities + 4% Real Estate**




(*Continued*)

**Exhibit 9.4** (*Continued*)




Depending on your risk tolerance and time horizon, you can select anywhere from model 1 to model 7; for example:

- If you will need money in the near future, you should consider a model that involves less risk, such as model 1, 2, or 3.
- If you are saving for retirement and have 10 or more years until you will need access to these funds, you may be able to take on more risk and would like to increase your potential for growth. In this case, model 4, 5, 6, or 7 may be more suitable.
- If your time horizon is less than a few years, you should probably not be investing at all; instead, you should keep your

cash in a savings account for easy access. Investing should always be viewed as a long-term commitment.

It is very important to keep in mind that there is no one approach that will fit every individual investor.

Now that you have selected your ideal asset allocation model based on your acceptable risk tolerance, it is important to monitor and maintain this allocation. Rebalancing your portfolio is one of the essential aspects of maintaining a successful investment strategy over time. Rebalancing requires you to analyze the changes in your asset allocation model periodically and make changes in an attempt to bring you back to your original allocation. You do this by selling and buying various investments within each of the asset classes, to maintain your established asset allocation.

Suppose the original asset allocation model you established included 1 percent cash, 28 percent stock, and 71 percent bonds. During a period of falling interest rates, your bond values increased to represent 76 percent of your portfolio and your stock values now only represent 23 percent of your overall portfolio. Rebalancing will require you to sell off part of your bond portfolio and to purchase additional stock holdings to bring you back to your original model. This also forces you to sell some of your bond holdings that have done well at a higher price and allows you to purchase stocks that have not done well at a lower price. This is a systematic approach to buying low and selling high for at least some portion of your overall investment holdings. It is also important to note that by maintaining your asset allocation, you will keep your risk tolerance level within your comfort zone.

To further highlight how the rebalancing would work, refer to Exhibit 9.5, Investment Rebalancing. Here, we start with the sample investment model 1, conservative bond income, with 15 percent allocated to fixed high-yield bonds, 35 percent allocated to fixed-income investment-grade bonds, and 50 percent to fixed-income short-term and money-market. After year 1, the initial asset allocation percentages have changed because of the performance of each asset class. In order to rebalance and put your model back to its original allocation, you would be required to purchase $1,875 of fixed-income short-term bond mutual funds and money-market and you would have to sell $788 of fixed-income investment-grade bond mutual funds and $1,088 of fixed-income high-yield bond mutual funds. This would take you back to your original percentage allocation.

**Exhibit 9.5 Investment Rebalancing**

**Sample Investment Model 1 — Conservative Bond Income**

| | Market Value of Portfolio | | | | % of Portfolio | | | |
|---|---|---|---|---|---|---|---|---|
| | Total | Fixed Income High Yield | Fixed Income Investment Grade | Fixed Income Short Term and Money Market | Total | Fixed Income High Yield | Fixed Income Investment Grade | Fixed Income Short Term and Money Market |
| Initial Investment | $100,000 | $15,000 | $35,000 | $50,000 | 100.00% | 15.00% | 35.00% | 50.00% |
| % Change Year 1 | | 10% | 5% | –1% | | | | |
| Change During Year 1 | $2,750 | $1,500 | $1,750 | $(500) | | | | |
| Year-1 Before Rebalance | $102,750 | $16,500 | $36,750 | $49,500 | 100.00% | 16.06% | 35.77% | 48.18% |
| REBALANCE - Year 1 | $– | $(1,088) | $(788) | $1,875 | | | | |
| Year-1 After Rebalance | $102,750 | $15,413 | $35,963 | $51,375 | 100.00% | 15.00% | 35.00% | 50.00% |
| % Change Year 2 | | 4% | 6% | 0% | | | | |
| Change During Year 2 | $2,774 | $617 | $2,158 | $– | | | | |
| Year-2 Before Rebalance | $105,524 | $16,029 | $38,120 | $51,375 | 100.00% | 15.19% | 36.12% | 48.69% |
| REBALANCE - Year 2 | $– | $(200) | $(1,187) | $1,387 | | | | |
| Year-2 After Rebalance | $105,524 | $15,829 | $36,933 | $52,762 | 100.00% | 15.00% | 35.00% | 50.00% |
| % Change Year 3 | | 2% | 3% | 5% | | | | |
| Change During Year 3 | $4,063 | $317 | $1,108 | $2,638 | | | | |
| Year-3 Before Rebalance | $109,587 | $16,145 | $38,041 | $55,400 | 100.00% | 14.73% | 34.71% | 50.55% |
| REBALANCE - Year 3 | $– | $293 | $314 | $(607) | | | | |
| Year-3 After Rebalance | $109,587 | $16,438 | $38,355 | $54,793 | 100.00% | 15.00% | 35.00% | 50.00% |

In the example provided, rebalancing is being done once a year, always taking you back to your original asset-allocation model investment percentages. Once again, this is a systematic approach that allows you to not only stay within your risk tolerance profile but also allows you to sell a portion of your holdings after they have increased in value and to purchase a portion of your holdings that have decreased in value. The added benefit to this is that you are using a disciplined approach to buying low and selling high for at least a portion of your portfolio.

For many investors, rebalancing once a year is usually sufficient. However, in recent years, because of the high volatility in the markets, rebalancing more frequently has become more appropriate. Rather than using a specific date or time frame, I think it is best to use a percentage change in your allocation as the trigger point for rebalancing. For example, if any one asset class percentage within your model changes by more than 5 percent of its original value, that would be a trigger point for rebalancing.

One of the major advantages of using rebalancing as one of your investment strategies is that it provides you with a disciplined approach to taking profits from some of your winners, allowing you to cash in on these gains. Another advantage to rebalancing is that it allows you to pay close attention to your portfolio, because you are examining the changes in your investment allocation, which will also allow you to reevaluate your individual investment choices within each asset class. Finally, rebalancing may smoothen out your overall investment rate of return.

## Dollar-Cost Averaging

The simple fact of investing is that if you could always buy at market lows and always sell at market highs, then you would guarantee yourself a profit and never have a financial worry. Unfortunately, after 25 years of working with thousands of individuals, I have yet to meet any investor or financial advisor who has figured out a system to accomplish this. One simple philosophy to investing is that you must be realistic as to what is possible and what is not.

Far too many investors try to predict the market along with their entry and exit points. This strategy typically results in a disappointing overall rate of return. To participate in market gains you need to be invested in the market during its profitable days. Trying to time the market is a very risky game. Instead, focus on the

amount of time you will be invested in the market and not on the timing of your individual investments. An investment strategy that may help you find the way around these investing pitfalls is *dollar-cost averaging*.

With a dollar-cost averaging investing strategy, you put a certain amount of money into your investment portfolio every month over an extended period of time. Regardless of market conditions and the ups and downs in the value of your particular investments, you will be committed to purchasing a certain dollar amount each month. When the individual share price of your investment increases, you buy fewer shares, and when the individual share price of your investment decreases, you will buy more shares with the same monetary investment. Therefore, your average cost per share will reflect both the low prices and high prices you paid. This system averages out the overall price per share you ultimately will pay.

One of the main advantages of dollar-cost averaging is that you are *not* trying to predict the entry or exit point of your investments. This approach simply puts you into a routine of investing on a regular basis, regardless of market conditions. This investment strategy may also reduce your risk of investing a large sum of money in one investment when the share price may be overvalued.

Another big advantage to utilizing a dollar-cost averaging investment strategy along with a rebalancing strategy is that it may help smooth your investment ride, especially during volatile markets. You will not experience the largest possible gains during a bull market, but you may minimize your losses during a bear market. The simple idea is the more you do to take the emotions out of investing, the more likely you are to stick to your investment strategy. The ultimate goal, of course, is to come back to your original asset allocation model, periodically rebalancing and consistently adding funds to your investment portfolio on a regular basis so that you can pursue your targeted rate of return on your investments over time.

Most people do not realize that when they are contributing to their 401(k) plan at work through each paycheck, they are actually implementing the dollar-cost averaging investment strategy. As I have mentioned repeatedly throughout this book, there is no better way to achieving financial independence than by doing it in a tax-efficient manner. Combining these investment strategies with a systematic savings plan that includes paying yourself first is the best way I know of becoming financially independent.

## Inflation and Taxes: The Biggest Drains on Investment Return

Inflation and taxes are perhaps the two biggest drains on your investment returns. Taking these factors into consideration is very important in your journey to achieving financial independence.

The technical definition of inflation is the rise in consumer prices over time. It is vital to your savings that your investment returns keep pace with the rate of inflation in order to avoid a true loss of purchasing power. If the average inflation rate has been 3 percent and your after-tax adjusted rate of return on your investments is below 3 percent, you are in fact losing purchasing power and diminishing your wealth.

In order to accumulate wealth, your investment objective should be to earn a rate of return after taxes that will exceed the prevailing inflation rate. Looking back to the history of the investment markets, the one way to beat inflation is by having some of your money invested in growth-oriented investments. This includes growth stocks, growth mutual funds, growth ETFs, and growth alternative investments. These investment vehicles may provide the potential for returns that could exceed inflation over the long term. Of course, these growth-oriented investment vehicles also come with a greater risk than other types of investments.

As you select your asset allocation model based on your risk tolerance level, never forget that smart investors always focus on a well-diversified portfolio. Taking on too much risk or taking on too little risk can both be equally damaging to your financial success. You must find your own perfect balance in determining your own risk-reward ratio.

When investing, you must always consider the tax consequences of your investment when determining your true rate of return. Here are just a few examples of how taxes affect investments:

- If you hold an investment for more than a year, you will have the added advantage of long-term capital gains treatment. Net short-term capital gains are taxed as ordinary income, which means they can be taxed at a federal rate as high as 39.6 percent (based on 2013 tax rates). In contrast, net long-term capital gains are taxed at a preferential federal rate that does not exceed 20 percent (based on 2013 tax rates).

- Starting January 1, 2013, there are three possible income tax rates on long-term capital gains (investments held for more than one year): 0, 15, and 20 percent.
- If you are in the 15 percent income tax bracket or lower, your gain may be free of federal income tax.
- If you are above the 15 percent income tax bracket but below the 39.6 percent income tax bracket, your long-term capital gain rate will be capped to no more than 15 percent for federal income tax purposes.
- For those subject to the 39.6 percent taxable income bracket, the long-term capital gain rate will be capped at 20 percent for income tax purposes.

### Medicare Surtax on Net Investment Income

- Starting in 2013, a new 3.8 percent Medicare tax is imposed on net investment income for single or head of household taxpayers with income over $200,000, married couples filing jointly or a qualifying widow(er) with income over $250,000, and married taxpayers filing separately with income over $125,000.
- The combined maximum income tax rate and Medicare tax rate on short-term capital gains could be as high as 43.4 percent (39.6 percent + 3.8 percent).
- The combined tax rate for long-term capital gains for those in the 39.6 percent income tax bracket could be as high as 23.8 percent (20 percent + 3.8 percent).
- For those taxpayers subject to the 3.8 percent medicare tax that are below the 39.6 percent income tax bracket, the combined maximum long-term capital gains tax rate could be as high as 18.8 percent (15 percent + 3.8 percent).

If you do not pay attention to the tax consequences of your investments, you may be paying significantly more in taxes than the law requires.

The following tax facts and strategies are an extremely important part of your overall investment strategy. To maximize your true rate of return after taxes, you must be aware and take advantage of each of these tax facts and strategies.

## TAX FACTS AND STRATEGIES[6] FOR MANAGING YOUR INVESTMENTS

- If your investments incurred foreign taxes, you can claim those foreign taxes as a tax credit or as an itemized deduction.
- If you are planning to sell a piece of business or investment property and plan on replacing it with other business or investment property, take advantage of Internal Revenue Code Section 1031 Exchange Rules. With a qualified exchange, you can postpone the current tax liability until you dispose of the new property.
- If you are starting a business as a corporation, take advantage of Internal Revenue Code Section 1244 Stock. Under these rules, if your business fails, you can deduct up to $50,000 of the loss against ordinary income if you file your taxes as single, and up to $100,000 if you are married and file your taxes jointly. Otherwise, the loss would be subject to the capital loss limitation rules, which state that you can take capital losses only to the extent of capital gains plus $3,000 in any given year; the balance of the losses can be carried to future years.
- Consider selling some of your investments in stocks, bonds, or mutual funds that have declined in value from when you originally purchased them. To realize these capital losses, you must complete the transaction before December 31. Capital losses can offset capital gains for the current year, plus an additional $3,000 in capital losses can be used to offset your ordinary income. Any excess loss above this amount can be carried forward to future years.
- You can then buy back these investments after 30 days to avoid the wash sale rules, which would otherwise disallow these losses. The *wash sale rules* prevents you from claiming a loss on a sale of stock if you buy replacement stock within 30 days before or after the sale.
- Stock dividends and stock splits on common stock are usually not taxable, but dividends paid out of current or accumulated earnings of a corporation are, in fact, taxable. Be sure to include only *taxable* dividends on your income tax return.
- Dividends from most domestic corporations and many foreign corporations are usually treated as qualified dividends. For 2013, qualified dividends receive favorable tax-rate treatment and are taxed at a rate of 20, 15, or 0 percent. Taxpayers who are in the overall tax rate bracket of 15 percent or less will pay 0 percent on their qualified dividend income; most others will

(*Continued*)

[6]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

pay the 15 percent rate except those with higher incomes subject to the new 39.6% income tax bracket, who will pay 20 percent.

- Under The Patient Protection and Affordable Care Act, starting in 2013 there is a 3.8 percent Medicare tax on net investment income if your modified adjusted gross income is above $250,000 for married filing jointly and qualifying widow(er), above $125,000 for married filing separately, and $200,000 for single and head of household.
- When evaluating different investment choices, you must consider the overall rate of return after taxes, which may make a tax favored type of investment more attractive.
- Interest from municipal bonds and municipal bond funds are generally not subject to regular income tax, if the underlying bonds are from the same state or local government you reside in. If the municipal bonds are not from the state you reside in, they will be free of federal tax and may be subject to your state and local tax. If part of your investment objective is to generate tax-free income, you should consider buying municipal bonds. But to receive this triple-tax-free advantage, make sure they are from the state or local government in which you reside. Starting in 2013, with the medicare surtax on 3.8 percent on net investment income, municipal bonds can be more attractive since they are also exempt from this new tax.
- If you take an early withdrawal from a certificate of deposit, you may be able to deduct the full amount of the early withdrawal penalty from your income tax return.
- Interest on securities issued by the federal government (such as Treasury bonds, notes, and bills) is fully taxable at the federal level, but it is not subject to state or local income tax.
- Capital losses on the sale of property held for personal use such as your home are not tax deductible.
- When evaluating investment and financial decisions, you should consider the after-tax effects of a transaction so that you truly understand your real rate of return when compared to other investment choices.
- If you hold a capital asset for more than a year, you will receive long-term capital gains treatment and the preferential tax rate of 20 percent or 15 percent or 0 percent. If you hold a capital asset for a period of one year or less, it is taxed as ordinary income and can be taxed at a rate as high as 39.6 percent. Holding capital assets over a year can make a significant difference in the amount of tax you pay. This is yet another reason why you should treat investing as a long-term endeavor and avoid impulsive short-term trading.
- Keep an accurate record of all stock transactions, along with when you bought it, especially if you purchased stock from the same company at different times. By using specific identification, you may be able to control the amount of gain or loss on the sale or part of your investment holdings. You are required to make adequate identification, typically by giving your broker specific instructions of which shares are to be sold. This must be communicated to you in writing through the brokerage firm.

## ACTION PLAN FOR MANAGING YOUR INVESTMENTS

1. **Know how tolerant of risk you are, before you invest in anything.** If you know you are the type of person who prefers to "play it safe," then you should invest accordingly; conversely, if you are more of a risk taker, that will determine your approach to investing as well.
2. **Understand the different types of risk that can affect your investments.** Learn as much as you can about inflation risk, interest rate risk, market-rate risk, economic risk, and company-specific or industry-specific risk—all of which may influence how well or how poorly your investments perform.
3. **Diversify your investments so that you do not have "all your eggs in one basket."** If you spread your investment dollars among several different asset classes, you may be able to lower your volatility on your overall investment portfolio without sacrificing your return on investment. For example, you might invest some of your money in specific company stocks, some in bonds, and some in mutual funds or exchange-traded funds (ETFs).
4. **Do not try to predict when it is best to invest; instead, invest regularly with the same amount of money,** whether the market you are investing in is up or down. This is called *dollar-cost averaging*, and this approach helps you develop a routine or habit of investing. It also helps you not get emotional about your investing.
5. **Know the tax implications of your investments.** There are differences that can affect the value and after tax performance of your investment portfolio. Consider hiring a financial planner to help you get the most from your investments.

CHAPTER 10

# Preserving Your Estate

*In this world nothing can be said to be certain, except death and taxes.*
—Benjamin Franklin, Founding Father of the United States

So you have worked hard, lived within your means, followed the guidance provided in this book, and reached your very own *point X*, financial independence. Congratulations!

Your whole life, you dreamed of becoming financially independent for the benefit of yourself and your family; now it is time to turn your attention to preserving your estate so that your loved ones can benefit from your life's hard work and sacrifices. If you do not take the necessary steps to preserve your estate, unintended beneficiaries may take a significant amount of your estate instead. These unintended beneficiaries include the federal and state governments, the state administrator, attorneys, and perhaps even relatives you have not spoken to in decades. The money you may spend today on a qualified estate attorney may save your estate significant dollars in both estate taxes and administrative costs down the road.

Estate planning can give you peace of mind by assuring your family's financial security will continue even after your death. It can significantly reduce estate taxes, administrative costs, and assure that your loved ones will be taken care of. It allows you to dispose of your assets as you see fit, with consideration given to your heirs'

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

individual needs. It is important to understand that estate planning is not just for the wealthy.

## The Federal Gift and Estate Tax System

The federal gift and estate tax system is a unified system that works hand-in-hand with virtually the same rules and tax rates that are applicable. The main difference between the two is that the gift tax is imposed on the donor for gifts made throughout his or her lifetime, whereas the estate tax is imposed on the donor based on the value of his or her net estate on death.

The American Taxpayer Relief Act of 2012 permanently extends the estate, gift, and generation skipping tax exemptions based on the 2011 amount of $5,000,000, increased each year subject to inflation adjustments, resulting in $5,120,000 exemption in 2012 and $5,250,000 for 2013. The tax rate increases from 35 percent to 40 percent starting January 1, 2013.

In order to ensure that you preserve your estate for your intended beneficiaries, it is important to stay on top of the ever-changing rules of the game. Working closely with a trusted tax advisor is perhaps one of the best ways to ensure that you can take advantage of these tax law changes when they arise.

## Legal Documents to Consider for Estate Planning

Regardless of the size of your estate, you should consider addressing your own individual planning issues, in order to preserve your estate and make your wishes known, preferably in writing. I recommend meeting with a qualified estate planning attorney to determine if you need a will prepared, based on your particular facts and circumstances. If you have no minor children, or if all of your assets are held jointly with your spouse, or if you have no assets to speak of, then your estate may not need to go through probate. If so, you may not need a will. Or, if you are willing to have your assets administered and distributed according to the rules of your particular state, you may also not need a will.

If you need a will, it must be prepared in accordance with the laws in your resident state. Although your will may still be valid after you move to a new state, certain parts of it may become invalid or may require changes due to the unique laws of your new state of residence. If the laws of your new state are different, this could invalidate your will or certain parts of it. It is always best to update it

and to use an attorney who is familiar with the laws of your current state of residence.

In my opinion, everyone should consider their own particular needs; then you should determine what legal documents are most appropriate for you, whether it is a will, a trust, a health care proxy, a living will, or durable power of attorney (or some combination thereof)—all of which I will explain in this chapter. Please note that the names of some of these documents vary from state to state.

Before I discuss the details of estate planning techniques, it is important to understand some of the key legal documents that may be needed in this planning process. An effective estate plan may need to include one or more of these documents that may cover all three phases of your life. Phase I is while you are alive and well, Phase II is in the event that you become disabled, and Phase III is after your death.

To preserve your estate and allow your loved ones to share in your success of reaching *point X*, you will need to address numerous legal forms so that your legacy can be transferred with ease. All of the legal forms described in the next sections must be appropriate to your particular state of residence and must be the "statutory" forms. These forms, usually drafted by the state legislature, cannot be refused within that particular state if they are prepared and executed correctly. Utilizing the statutory forms will minimize the likelihood of these documents being questioned for content.

If you already have an estate plan that includes some of these documents, pull them out and review them. You will be surprised how quickly they can become out of date with changes that take place throughout your life, such as marriage, the birth of a child, or the death of a loved one. You (and your spouse, if you are married) should have your will reviewed at least once every five years by an attorney to ensure that it is up to date with both your wishes and the laws that apply in your current state of residence. You should review and update these documents more frequently in the event of legislation changes. Your financial advisor or estate attorney should bring any legislative changes to your attention so that you can take the necessary steps to ensure your will is still fulfilling your wishes and minimizing your estate-tax exposure.

Also, I cannot overemphasize the importance of working with a qualified estate attorney who is thoroughly familiar with the laws

in your state of residence. All of the following documents should be drafted by and executed in front of an attorney. If your financial and family situation is very simple, you may want to consider using an online legal service such as LegalZoom or Nolo. Although these online legal services can save you some money up front, I still believe that in most cases, the legal advice and associated cost of working directly with an attorney should more than pay for itself in the long run.

#### *Preparing Your Will to Distribute Your Assets after Your Death*

A will, also called a *last will and testament,* is a written document that provides instructions on how you would like to distribute your assets after death. It is the most popular and basic estate planning document, and also addresses many of your wishes and desires after death. (Here again, the term *property* does not apply only to real estate but to all personal property you own, including investments, etc.)

It is extremely important to understand that a will only covers assets held soley in your name. Assets that already have named beneficiaries, jointly held property with rights of survivorship, and transfer-on-death accounts (TDAs) are examples that pass automatically upon your death as a matter of law. These different types of ownership are discussed later in this chapter. Also, you should be aware that a will becomes effective only upon your death and after it is probated; therefore, you can change your will at any time prior to your death, assuming that you still possess the legal capacity to execute the document.

#### *Creating a Trust for a Specific Beneficiary(ies)*

A trust is a legal document that creates an arrangement where one person (named the *trustee*) manages property given by another person (named the *trustor*) for the benefit of a third person, (named the *beneficiary*). If used properly, a trust can be a very effective estate planning tool that also allows you to avoid postmortem (i.e., after-death) legal fees.

Trusts differ from wills: they are separate legal entities. Like a will, trusts spell out how you want your property distributed. Trusts let you customize the distribution of your estate with the added advantages of property management. Trusts are covered in more detail later in this chapter.

#### *Designating a Health Care Proxy*

A *health care proxy* is a document where you designate an individual to make decisions regarding your health care treatment in the event you are unable to provide informed consent because you have become incapacitated. This is also known as a *durable power of attorney for health care.* The person you designate can generally make decisions regarding medical facilities, medical treatments, surgery, and a variety of other health care issues. Much like a durable power of attorney, the health care proxy involves important decisions; therefore, you should take extreme care when choosing who will make them on your behalf. This is solely used for health care decisions and should not be confused with a general power of attorney.

A health care proxy provides an individual with strong beliefs about the type and level of health care the individual will receive, even after he or she is not capable of making the decision personally because of his or her mental and/or physical state. This proxy provides the most flexibility for a health care agent to make decisions, based on the day-to-day conditions of a patient.

The cost of medical treatment is significant, especially when there are prolonged serious medical conditions involved. Making your wishes clear through a health care proxy can save your estate significant dollars on unwanted medical treatments.

#### *Establishing a Living Will*

A *living will,* which is also known as a *directive to physicians* or a *health care directive,* spells out the kinds of life-sustaining treatment you will permit in the event of your incapacity. It gives doctors and hospitals your instructions regarding the nature and extent of the care you want should you suffer permanent incapacity, such as an irreversible coma. This concerns life support services of various kinds, from respiratory assistance to feeding tubes.

Unlike with a health care proxy, a living will does not appoint an individual to make decisions for you and does not require actions on anyone's part. Instead, the directive provides written instructions from you for the attending physician. The decision for or against life support is one that only you should make. That makes the living will a valuable estate planning document. When I have this difficult but necessary discussion with clients, they almost always tell me they would choose to not prolong their lives if they are suffering from a terminal and painful illness. This is especially

true if prolonging their lives will wipe them out financially instead of being able to provide for their loved ones. This is a difficult and sensitive topic, and I believe that every individual should have the right to make his or her choices known through a living will. A living will may be used in conjunction with a durable health care power of attorney. Bear in mind that laws governing the recognition and treatment of living wills may vary from state to state. It is important that you make your wishes known in writing, and not leave these decisions to your loved ones.

#### *Designating Durable Power of Attorney*

*Durable power of attorney* is a legal agreement that enables you to designate who will make your legal and financial decisions. This document may be necessary in order to avoid the need for a guardianship or conservatorship; unlike the standard power of attorney, durable powers remain valid even after you become incapacitated. Obviously, in order for this power to be valid, you need to have capacity when you execute this document (as with the execution of all documents).

A durable power of attorney appoints a person you designate to act for you and handle financial matters should you be unable or perhaps unavailable to do so. This power of attorney may include delegating control over all of your assets and belongings, including real estate, bank accounts, brokerage accounts, and so on. It can be valid either when you execute it or it can become valid at a specific time or event, such as if you become incapacitated.

A power of attorney that is not valid on its execution is called a *springing power of attorney* because the powers spring out at some time in the future. Usually, this is prepared for an individual who does not trust giving someone full power of attorney at the time of its execution. The problem with a springing power of attorney is that in the event that you want the powers to start upon your incapacity, no one will accept the power of attorney until you secure a court order to certify that you are incapacitated. This is a very long and costly process and the power of attorney may not be legally valid at the time you need to use it.

A general (i.e., nonspringing) power of attorney should be used only if you absolutely trust the person you are granting the powers to, because if your power of attorney conveys that right

to that person on execution, that individual has the ability to misappropriate your assets at any time without your knowledge. Therefore, your decision on which type of power of attorney to execute requires very careful consideration. You should exercise extreme caution when providing someone with this level of control.

## The Probate and Administration Process and Why You May Want to Avoid It

Surrogate courts or probate courts are special courts of law that have specific jurisdiction over proceedings incident to the settlement of a decedent's estate. If you die and have a will, your will must be probated in order to have it legally recognized. The legal definition of *probate* is "the act of proving that an instrument purporting to be a last will and testament was executed in accordance with legal requirements and of determining its validity thereby." If you die without a valid will, your estate will go through the *administration process*. In this instance, when you die without a valid will, you are considered to have died *intestate*, and the intestacy laws of your state of residence will determine who will receive your assets.

The major problems associated with both probate and administration include high administrative costs, lengthy delays, open public record of the estate, retention of assets and court involvement and supervision, not to mention all the added legal and accounting fees. The probate and administrative fees can consume between 6 percent and 10 percent of your gross estate, according to the American Bar Association. In my opinion, these are the major reasons you would want to avoid going through probate or administration, and applying some of the strategies outlined in this chapter can accomplish this. Spending a few thousand dollars on estate planning while you are alive can ultimately save your beneficiaries a significant amount of money, headaches and delays.

If you are a private person and do not look favorably on disclosing your personal finances to others, you should be aware that the proceedings of the probate courts are a matter of public record open to anyone interested in knowing your personal financial affairs.

Properly titling your property, naming beneficiaries, and establishing trusts may facilitate your estate to pass to your heirs without having to go through the probate or administrative processes. If you

do the proper estate planning while you are alive and well, you can pass your estate to your loved ones privately, without unnecessary delays and expenses; also, this process may allow you to control your estate after death.

#### *Estate Planning Strategies That Keep You in Control after Death*

If you would like to have continued control of your estate after your death, there are several planning strategies you may want to implement while you are alive. Each of these provides a different degree of control over distribution, and each has different pros and cons. Essentially, you need to understand how your property will be distributed when you die with or without a will, with or without some form of joint ownership, with or without beneficiary-designated contractual agreements, and with or without a trust.

Understanding how each of these estate planning strategies works and interacts with one another is essential to properly controlling your estate after death. If you do not take all of these facts into consideration during the estate planning process, the results could be dramatically different than what you had intended.

#### *What Happens to Your Estate When You Have a Will—and When You Do Not*

As mentioned, when someone dies without a will, that is called dying *intestate*. When that happens, the laws of your state will determine who your assets are distributed to. These laws are always based on your family tree. When a blood relative cannot be located, the state may then be entitled to take over ownership of all of your estate: This is the common law doctrine known as *escheat*. If you have not implemented any estate tax planning strategies and you do not have a will, you are going to have the least control over the distribution of your assets and the fulfillment of your last wishes.

I encourage almost everyone to have a will as the most basic estate planning strategy, especially if you are not willing to implement some of the other estate planning strategies. Another essential reason to have a will is if you have minor children. If both you and your spouse die at the same time (for example, in a car accident or plane crash), it is best if you have already determined in advance who will care for your children. You would not want any of your family members fighting over legal custody of your children. Avoiding potential family conflicts over child custody will not

only avoid the expensive legal process but make it more likely that family members will work in harmony in looking out for your children's best interest.

With the exception of individuals with minor children, the following may represent situations where a will may not be necessary:

- If you have no assets in your individual name (for example, if all your assets are either jointly held or are in the name of a trust for others) or if all the assets in your name have designated beneficiaries other than your estate (for example, if you have a named beneficiary for your life insurance or IRA account), then a will is not necessary because all of your assets will be transferred by operation of law. Therefore, you do not need a will to designate anything to anyone. I realize that even the poorest of people have some assets such as clothing, furniture, and other personal belongings, but this level of assets does not justify going through the costly probate process. Therefore, even if a will exists in these cases, it would still not be financially justified to go through this process.
- If you want to leave your assets to your beneficiaries in the same proportion as predetermined by your state's laws, you do not need a will to accomplish this. In this case, if you die with or without a will, your individual beneficiaries will receive the same inheritance. Therefore, a will is necessary when your wishes are different from your state's predetermined (default) allocations.

By having a properly drafted will, you can decide who will ultimately inherit your assets. Also, you can choose your executor as well as set up any trusts that you may want after death. The *executor* is someone you appoint (in your will) to carry out your last wishes, as outlined in your testament.

The only people who can contest a will are people who would be entitled to receive a certain percentage of your estate if you die without a will. For example, if you are a widow or widower and you have three living children and no deceased children, your three children would equally receive your estate, under all state intestacy laws (provided you do not have a trust naming someone else to receive some or all of your assets). However, suppose you execute a will and decide to exclude one of your children. When you pass away and the

will is offered for probate, the excluded child has standing to contest the will because he will be receiving less than he would have received under the intestacy laws (namely one-third of the estate).

However, it is important to remember that someone who has standing to contest a will cannot contest the will on the grounds that he or she does not like its terms; instead, that person must allege and prove in court that the will was not properly executed, or that the person (e.g., you) did not have the requisite capacity to make the will at the time of its execution or the will was not properly executed in accordance with the formal requirements of the state. If someone contests the will and is successful, then the will is declared void and the estate will be distributed in accordance with the state intestacy laws.

#### *What Happens to Your Estate When You Have Beneficiary-Designated Contractual Agreements*

Yet another estate planning strategy to control your estate after death is through a *contractual agreement by beneficiary designation.* For example, if you have a retirement plan through your employer, an IRA, life insurance, or an annuity contract, you can and should designate a beneficiary. The rights to the proceeds from these contracts will automatically pass to the individual(s) you designate as your beneficiary. Using a designated beneficiary on these contracts typically has the added benefit of avoiding probate.

Alternatively, you can also designate your estate as the beneficiary, if you want the asset to be transferred in accordance with your will. Unfortunately, this makes these assets subject to probate; therefore, I recommend avoiding this choice, if possible. It is extremely important to review these contracts to make sure your beneficiary designations reflect your current wishes, because these contractual agreements supersede the intentions you state in your will.

#### *What Happens to Your Estate When You Have a Trust*

Perhaps the most flexible estate planning strategy that allows you to control your estate before and after your death is by creating a trust. A trust can be created while you are alive (called an *inter vivos trust)* or after your death through your will (called *a testamentary trust*). A trust can give you the maximum control over the distribution of your estate after your death because the terms of a trust provides the trustee with your specific instructions.

A trust can have the added advantage of using the services of professional asset managers, who can protect your assets in the event of your incapacity. When a trust is set up properly, you can use it as a mechanism to significantly reduce your gift and estate tax liabilities. Later in this chapter, we will cover in great detail the many estate planning strategies that can be implemented with a trust. When evaluating whether a trust strategy is appropriate for you, you need to consider the upfront costs and ongoing administrative and professional fees to maintain it.

## Using a Planned Gifting Strategy

For 2013, the gift tax exclusion is $14,000 per year. What this means is that you can make a gift in this amount to anyone—and to as many people as you like—every calendar year, and that money will not be subject to gift tax or included in your taxable estate. Furthermore, it will not be added back to your lifetime exemption of $5.25 million for 2013. This amount can be increased to $28,000 per year if a non-donor spouse agrees to split the gift. This can be a great way to transfer assets to children, grandchildren, and other intended heirs while you are still alive. Ultimately, this will reduce the taxable value of your estate and, at the same time, your ultimate estate tax liability.

In theory, if you and your spouse want to gift $28,000 to 10 people this year, you could reduce your estate by $280,000. Based on the 2013 federal estate flat tax rate of 40 percent, you would save your estate $112,000, assuming you would have a taxable estate upon death. With a properly structured lifetime gifting program, you could significantly reduce and in some cases completely eliminate any potential estate tax liability.

Two of the most overlooked exceptions to the gift tax exclusion limitation have to do with tuition and medical payments—specifically:

1. Any qualified tuition payments made on behalf of a donee beneficiary (for example, your child or grandchild) are not considered a gift if you make the payment directly to the educational institution.
2. Any medical payments made on behalf of a donee beneficiary are also not considered a gift if you make the payment directly to the medical provider.

Therefore, you can pay an unlimited amount of someone's college tuition directly to the school and still be permitted to give an additional $14,000 directly to the donee beneficiary without affecting your lifetime exemption. Therefore, you may want to consider paying your children's and grandchildren's tuition directly to the institution and use this as one of your valuable estate planning tools.

## Ownership of Property and How It Is Transferred

A critical part of the estate planning process revolves around how the ownership of property (this includes real estate and any other assets you hold title to) is treated and ultimately how it is transferred to your beneficiaries. In fact, the manner in which you hold title to your property will supersede provisions contained in other documents, such as your will. Many times people may execute a will with the intention of leaving some of their property to particular individuals, yet those individuals do not receive what was intended by the decedent because all their property was jointly held with other individuals.

For example, here is a very common scenario where a decedent's wishes may be denied because of operation of law. A parent (typically a widow or widower) may have joint bank accounts with only one of his or her children, for convenience purposes only. This is usually done with a child who is the primary caregiver for that parent or who simply does the parent's banking. The parent makes a will leaving all of his or her assets equally to his or her children. When the parent passes away, those bank accounts become the legal property of the child that had joint ownership over the bank accounts. Therefore, the legal title of the account passes by operation of law and supersedes the intention of the parent as stated in the will.

For this reason, it is extremely important for you to verify the ownership of property and how it is held. You can either gain or lose significant tax benefits, depending on how you structure the ownership of your property. The following are the four basic forms of legal ownership to property. Understanding the differences between each can have a considerable impact on how your estate assets are eventually transferred.

### *Individual Ownership*

*Individual ownership* occurs when one person owns a 100 percent interest in a property. For example, if you own a piece of real estate, a bank account, or a brokerage account and your name is

designated as the only owner, this would be considered individual ownership. Through an estate, ownership is passed in accordance with a will or by the laws of intestacy. The complete value is included in the gross taxable estate of the decedent.

When two or more persons own property, it is said to be held *concurrently*. There are several types of concurrent ownership, including *tenancy in common, joint tenancy*, and *tenancy by the entirety*.

#### *Tenancy in Common*

*Tenancy in common* is the most common type of concurrent ownership in property. In this context, *tenant* means *owner* (not *renter*, as it does in everyday language). Each tenant (*owner*) has the right to convey his or her interest in the property. When one of the tenants (*co-owners*) dies, that tenant's interest passes to his or her heirs or by will to someone else. With this type of property ownership, each owner has an undivided fractional share of the property.

In other words, suppose you own a house with your husband, and the deed to your house is held by *tenancy in common*. What that means is if your husband dies, his ownership of the house passes to his heirs, that is, not to you, even though you "co-own" the property. For that to happen, you would have to own the property as "joint tenants," described in the next section.

#### *Joint Tenancy*

*Joint tenancy* exists when two or more persons share equal, undivided whole interests in the property. The key feature of joint tenancy is the right of survivorship, whereby, upon the death of one of the joint tenants, his interest is automatically passed to the others by operation of law and cannot be transferred in accordance with a will or trust document.

An added benefit of joint tenancy is that it avoids probate with respect to this asset. Anyone can share joint interests, but there are additional tax benefits when this arrangement is shared between a husband and wife, which is known as a *qualified joint tenancy*. Under qualified joint tenancy, half of the property is included in the first decedent's estate. Because of this, the surviving spouse obtains a stepped-up basis on the first decedent's half of the property. A *stepped-up basis* allows the beneficiary to value the property at the decedent's date of death for tax purposes, and this value is used to determine gain or loss upon the eventual sale of the asset. Quite

simply, the cost for determining gain or loss is based on the property's value after death, rather than on what the decedent actually paid for it. If any non-spouses participate in joint ownership, the entire value of the property is includable in the decedent's estate, reduced only to the extent that the estate can prove that the surviving tenant contributed to the cost of the property in proportion to his share.

#### *Tenancy by the Entirety*

*Tenancy by the entirety* is another form of concurrent ownership, similar to joint tenancy, but it can only be created between a husband and wife. Tenancy by the entirety differs from joint tenancy and tenancy in common in that neither spouse can convey his or her interest without the express consent of the other; therefore, one of the main advantages to this type of joint ownership is that it offers protection from creditors. Under common law, husband and wife are viewed as one person. Neither party can alienate or encumber the property, so that upon the death of one, it is inherited by the survivor (in the event of a divorce, it becomes a tenancy in common). However, tenancy by the entirety is recognized only in certain states. Check with your attorney to see if your state allows this form of joint ownership: it may be vital to maintaining your financial independence in the event creditors try to put a claim against your property.

Through community property statutes, all property earned or acquired by either spouse is owned in equal shares by each spouse. The essential principle of community property is that the earnings of either husband or wife and the revenue from their property belong to the "community" of their marriage. There are no restrictions on how each spouse can give away his or her half of the community property for estate purposes. There is no law requiring one person to leave his or her half to the surviving spouse.

There are nine states that currently have community property laws: Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, and Wisconsin.

#### *Amount Includable in the Estate and the Stepped-Up Basis*

The amount includable in the estate of a decedent is based on his or her percentage of ownership. It is important to remember that the beneficiary can be chosen by the decedent, except in the case of joint tenancy, under which the surviving joint tenant(s) automatically inherit(s) the interest of the decedent.

There are major tax benefits to the beneficiary of property from an estate. The beneficiary of the property interest receives a stepped-up basis, as of the date-of-death value or the alternative valuation date (six months later). The beneficiary may be able to avoid or minimize capital gains tax on the sale of this asset, because their cost basis is increased to this estate valuation. Here is a common scenario of the benefit from this stepped-up basis:

A widow or widower passes away while owning real property. The children inherit the property either through a will or through administration (if there is no will, as described at the beginning of this chapter). The house is valued at $750,000, and the children sell it within a year for $750,000, with closing fees of $30,000. In this example, the children will collectively realize a $30,000 loss on their personal tax returns. If this asset is the only asset in the estate, it will not be subject to estate taxes, and the beneficiaries still receive the stepped-up basis. They not only receive the property free of estate tax, but may also be able to get an income tax deduction from the costs of selling the property.

## Reasons for Creating a Trust

As mentioned earlier, perhaps the most flexible estate planning strategy that allows you to control your estate before and after death is by creating a trust. A trust can be created while you are alive (an *inter-vivo* trust) or after death through your will (a *testamentary* trust). A trust can give you the maximum control over the distribution of your estate after death because the terms of a trust will provide the trustee with your specific instructions.

A trust is a device of protection and control of someone's assets and is also used to protect current and future beneficiaries. When a trust is created, there are three key parties involved with its creation.

- The first party is the *trustor,* sometimes called the *settler or grantor of the trust*, and is the individual who establishes and funds the trust.
- The second party is the *trustee,* who can be a person or an institution. The trustee is entrusted to hold legal title to property in order to administer it for the benefit of the beneficiary in accordance with the trust document.
- The third party is the *beneficiary* (or beneficiaries), who must eventually receive 100 percent distribution of the trust

corpus (which refers to all property transferred to a trust. For example, if a trust is funded with $100,000 in cash, that money is considered the trust corpus).

There are four key questions you must answer in order to know the type of trust you may need to establish. All trusts can be specifically defined and classified after asking these questions.

1. Was the trust created during an individual's lifetime or upon his death?
   - If the trust was created during an individual's lifetime through a separate legal document (a trust document), this is considered an inter-vivo trust.
   - If the trust was created after death within a last will and testament, it is considered a testamentary trust.
2. Do you want the ability for the trust to be changed, altered, amended, or revoked by the trustor?
   - If the answer to this question is yes, then this is considered a revocable trust.
   - If the answer to this question is no, then this is considered an irrevocable trust.
3. For federal income tax purposes, how is the trust classified and taxed?
   - Grantor trust
   - Simple trust
   - Complex trust
4. How does the trust define income?
   - It is important to note that a trust document's definition of income is considered its accounting income and this can be different than the tax law definition of income. These definitions can have a significant impact on distributions and taxation to both the trust and the beneficiaries.

*A living trust (inter-vivo)* is a trust that is set up during your lifetime and takes effect when you transfer assets into the trust. A living trust can be used to transfer legal titles to property, including cash, stocks, real estate, etc., and can provide a means to manage these assets during your lifetime. Although these asset transfers change the legal title, you (as the creator or grantor) can retain income from the assets throughout your lifetime. Therefore, you

maintain control and the decision-making authority over the assets. These types of trusts are frequently used as a substitute for a will, because the trust usually terminates upon the death of the grantor and the trust documents dictate who the beneficiaries of the assets will be. You can also select the person you want as the trustee, which could include yourself, to carry out the instructions set out in the trust document. You can name successor trustees to take over if and when you can no longer act as the trustee. Last but not least, a living trust also helps you avoid and minimize the administrative expenses, delays, and publicity involved with probate, because these trust assets transfer by operation of law.

In contrast, a *testamentary trust* is a trust created through a will and only takes effect when you die. With these trusts, legal title to the assets does not transfer until your death. There is no separate legal trust document; it is created by a clause in your will. One of the pitfalls of a testamentary trust is that it will *not* avoid probate because the trust can be created only through the probate of a will.

#### *Revocable and Irrevocable Trusts*

Most trusts are revocable (in other words, you retain full control)—if you create a revocable trust, you can make future changes and even terminate the trust. On the other hand, if the trust is irrevocable, you give up control; therefore, changes and termination are very difficult and sometimes impossible to make.

When you transfer assets into a revocable trust, they are not considered a completed gift; therefore, you do not have to file a gift tax return, which is required when a gift exceeds $14,000 in any given year. However, upon the death of the trustor (i.e., you, as the creator of the trust), the assets of a revocable trust are included in your taxable estate. These assets are considered to be part of your estate because you retained beneficial ownership and control of those assets. Therefore, revocable trusts are not useful in minimizing estate taxes, but they do serve the purpose of avoiding probate or administration because the trust assets pass to your beneficiaries, in accordance with the trust document you created.

Living trusts allow you to control the distribution of your estate, and certain trusts may enable you to reduce or avoid some of the taxes and fees that will be imposed on your estate after death. When you establish a revocable living trust, you are permitted to be the trustor, the trustee, and the beneficiary of that trust. By setting up a

living trust, you transfer ownership of certain assets you would like to place in the trust from yourself to the trust. You are no longer the legal owner of the assets you placed in your trust. Your trust is now the legal owner, even though as the trustee, you maintain complete control of these assets.

#### *A-B Trusts*

One of the most popular living trusts is an A-B trust, which is also known as a *bypass trust* or a *credit shelter trust.* This also allows the surviving spouse to possibly double the amount of his or her estate-tax exemption when the surviving spouse dies. When you use an A-B trust, two trusts are created upon the death of the first spouse. The decedent's assets will be separated between the survivor's trust, ("A" trust), and the decedent's trust, ("B" trust). This will create two separate legal entities, both of which are permitted to use the full amount of the federal and state estate tax exemption.

The surviving spouse still maintains full control of her own trust ("A" trust). She can also receive income from the deceased spouse's trust ("B" trust) and can even make withdrawals of principal for health, support, or maintenance when needed. Upon the death of the second spouse, the assets of both trusts pass directly to the heirs, and will avoid probate.

With the enactment of the 2010 Tax Relief Act, some couples may no longer need an A-B trust to maximize the federal estate tax exemption, because of the new portability rules. With the passage of the American Taxpayer Relief Act of 2012, the spousal portability has been permanently extended, with annual inflation adjustments to the exemption from estate and gift taxes with a tax rate of 40 percent in excess of the limit starting in 2013. Form 706, the estate tax return, must be filed to establish that amount of portability of the spouse's exemption. This new higher threshold has eliminated many people from being subject to the federal estate tax altogether. With the introduction of this new provision called *portability,* A-B trusts may not be as beneficial as they were in the past, but they should still be fully used by married couples. Portability of the exemption to the surviving spouse is now made available through an election on the estate tax return Form 706. This allows the surviving spouse to use their spouses' unused exemption plus their own, allowing a married couple to exempt up to an expected $10.5

million starting in 2013 from federal estate taxes. Before you make this rushed decision about not using an A-B trust, there are several issues you must consider.

It is critically important to note that many states have their own estate or inheritance tax laws you will need to consider. Currently, none of the states has adopted the federal concept of portability. Therefore, if you are married and leave all your assets to your surviving spouse, he or she will only be able to use his or her own state exemption, and your exemption will forever be lost. Furthermore, a trust provides you with the ability to shelter the appreciation of assets placed in the trust. It may also protect these assets from creditors and allow you to preserve the state estate tax exemptions for both you and your spouse.

#### *How a Trust Is Taxed*

How a trust is classified and taxed for federal income tax purposes depends on the type of trust involved. When determining which type of trust would be most suitable to meet your financial objectives, it is important to understand how different trusts are taxed.

There are three types:

1. With a *grantor trust*, for income tax purposes, the trust is treated as if it does not exist. All income in a grantor trust is reported on the trustor's personal income tax return, as if the trust was never created. All revocable trusts are considered grantor trusts and are taxed in this manner. Some irrevocable trusts are treated as grantor trusts when the terms of the irrevocable trust creates a grantor trust for income-tax purposes. If a trust is not considered a grantor trust, it is taxed in a manner similar to personal individual income taxation except the tax rates are compressed and the trust is subject to the maximum tax rate at a much lower threshold. Income earned by a trust will either be taxed at the trust level or at the income beneficiary level. A trust is permitted to take an income distribution deduction against the trust income for all income that is properly distributed from the trust. Under the American Taxpayer Relief Act of 2012 the following will be the tax brackets on income taxable to the trust and estates in 2013:

- 15 percent on taxable income up to $2,450
- 25 percent on taxable income over $2,450 but not over $5,700
- 28 percent on taxable income over $5,700 but not over $8,750
- 33 percent on taxable income over $8,750 but not over $11,950
- 39.6 percent on taxable income over $11,950

In addition to the above income tax, a trust or estate will have to pay a 3.8 percent Medicare tax on net investment income starting in 2013 under the Patient Protection and Affordable Care Act. The tax is imposed on the lesser of "undistributed net investment income" or excess of adjusted gross income over the dollar amount at which the highest tax bracket begins, which would be the excess of $11,950 for 2013.

2. With a *simple trust,* all income must be distributed and is taxed at the income beneficiary level. If the income is not properly distributed, it can be deemed distributed even if it was not.
3. With a *complex trust,* the trustee has certain discretion and can either distribute or not distribute the income to the beneficiaries. Any income not distributed to the beneficiaries is taxed at the trust level and at the trust's tax rate. The trustee has up to 65 days after the close of the trust year to make a distribution, which would be considered made during the previous tax year.

#### *Transfers with Retained Life Interests*

When assets are transferred and the transferor retains the use and enjoyment of the transferred asset for the remainder of his or her life, the rules of Internal Revenue Code Section 2036 apply. This is most common when individuals transfer real property to their children and retain a "life estate" interest in the property for themselves. This simple transfer is fairly common as it accomplishes the following benefits to estate planning:

- It avoids probate or administration of your will when you die, with respect to this asset, as the property is already in your children's name.
- By retaining the "life estate," the IRS still considers the assets owned by you, and your children are therefore entitled to a

stepped-up basis. Without the "life estate," in the case of an outright gift, your children will not be entitled to a stepped-up basis.
- The life estate also protects you in case of a dispute between you and your children, because with the life estate, you cannot be disturbed or evicted from the property. Even in the best families, children get divorced; some predecease their parents, and some may have family arguments that may impact the children's decision to try to remove you from your house.

#### *Split-Interest Trusts*

Certain trusts are established through the transfer of assets into the trust with the stipulation that there will be an *income beneficiary* as well as a *remainder beneficiary*. A remainder beneficiary of a trust is entitled to the principal of the trust outright after the interest of the prior beneficiary has been terminated. These types of trusts are referred to as *split-interest trusts* and include the following:

- Grantor-retained income trust (GRIT)
- Grantor-retained annuity trust (GRAT)
- Grantor-retained unitrust (GRUT)
- Qualified personal residence trust (QPRT)

The major advantage of establishing these split-interest trusts include the following:

- You (as the trustor) continue to control the income for a set period of time.
- There is an objective discount in the value of the gifted asset, at the time the gift is made.
- All future growth of the asset remains outside of the living estate of the trustor (transferor).

These three points are critical components of several sophisticated estate planning techniques. The value of the gift can be significantly reduced based on the value of the retained interest by the transferor. Because the value of the gift is significantly reduced by implementing this strategy, you can minimize and in certain cases eliminate the gift tax consequence of the transfer. If someone

makes a gift of a future interest in a property and retains the right to use that property during a period of time, they are deemed to have given only a partial interest.

For example, let us assume you gave a gift of stock with a current fair market value of $500,000 to a trust, but you retained the right to all income generated by this gift for a set time period of 20 years. You will need to determine the present value of this future gift to be completed 20 years from now. The IRS allows you to use the present value of this future gift of $500,000, 20 years from now, which is discounted based on the applicable IRS long-term interest rate. For the purpose of our example, we will assume that the IRS long-term interest rate has been set at 5 percent at the time of the gift.

Therefore, the future value (FV) of the gift is set at $500,000, the applicable long-term interest rate ($i$) is equal to 5 percent, and the number of periods ($n$) is equal to 20. At this point, you would turn to Exhibit 11.4 "Present Value Factors" (in Chapter 11) and go to the column with 5 percent and then go down the row for 20 years to find the factor of 0.37689. In other words, based on the present-value factor table, the IRS will allow you to objectively discount the value of this gift from $500,000 to $188,445 ($500,000 × 0.37689). This technique will allow you to transfer $500,000 to the trust for the benefit of your beneficiaries and will only use up $188,445 of your lifetime exclusion. Therefore, if you ultimately have a taxable estate upon death, you have reduced your taxable estate by $311,555 ($500,000 − $188,445). Assuming the estate tax rate upon your death is 40 percent, this will result in a reduction of your estate tax liability by $124,622 ($311,555 x 40%). In addition, any future appreciation in the value of this $500,000 stock will not be included in your estate. The only catch is that you (i.e., the transferor) must live beyond the 20-year period established by this trust. If you die before the completion of this gift (which, in this example, is 20 years) the full value of the stock as of your date of death will be included in your estate. That defeats the whole purpose of establishing the split-interest trust. Therefore, the biggest pitfall in using this technique is that the trust must terminate before you die. If it does not, the trust assets are valued as a part of your estate, and these assets will be included as of the date of death value.

To highlight the significance of this estate planning technique, let us assume that the $500,000 is worth $2 million on your date of

death, which is 21 years after the stock was transferred into the trust. One of the major advantages of transferring property out of your estate while you are alive is that all future capital appreciation will avoid being included in your estate valuation upon your death. Once again, this is a powerful technique for minimizing your estate tax liability and maximizing the amount that gets passed on to your heirs. Let us also assume that your estate would have been subject to the estate tax rate of 40 percent; this technique would have reduced the ultimate federal estate tax liability by $724,622($2 million less $188,445= $1,811,555 × 40%). This is a somewhat complex estate tax planning technique, but a very effective one for preserving your estate and ultimately maximizing the amount you pass on to your loved ones.

This tax planning technique has been significantly limited by the creation of Internal Revenue Code Section 2702, which in essence, eliminates the use of GRITs with four major exceptions:

1. If the GRIT was established before September 20, 1999.
2. If the beneficiary of the GRIT is not related to you.
3. If the asset in the GRIT is your (the trustor's) primary home or vacation home, held in a qualified personal residence trust (QPRT).
4. If the trust is a GRAT or a GRUT.

You should consult with an experienced estate tax attorney and financial planner to determine whether using a split-interest trust would be beneficial to you. These are clearly advanced estate tax planning techniques and can only be properly used with the guidance of an estate tax attorney that specializes in these matters.

#### *The "Charitable" Trust*

Charitable trusts are created when you have a charitable intent and would also like to accomplish the following:

- Have continued control of income.
- Potentially get an immediate charitable deduction while you are alive.
- Potentially eliminate capital gains tax.
- Potentially eliminate or reduce estate taxes.

These types of trust include the following:

- Charitable lead annuity trust (CLAT).
- Charitable lead unitrust (CLUT).
- Charitable remainder unitrust (CRUT).
- Charitable remainder annuity trust (CRAT).

In theory, these charitable remainder trusts work the same as the split-interest trusts discussed above, except that the remainder beneficiary is a qualified charitable organization under 501(c)(3) of the Internal Revenue Code. The present-value calculations and the benefit of removing assets from your estate would be the same, with the added benefits of getting a charitable deduction. A charitable remainder trust allows your spouse or children to access the earnings from assets in the trust for a time, with the asset eventually going to charity.

The vast majority of people simply give donations to charity by cash or issuing a check. Such donations typically entitle you to take a tax deduction in the year of your contribution, but you must be prepared to prove it with a receipt from the charity.

There are several more sophisticated gifting techniques you can use that will not only benefit your charity but, if structured properly, can significantly lower your income and estate taxes. Both you and the charity can significantly increase the benefit from your charitable gift if it is made from highly appreciated property of almost any kind. When you own property that has increased in value and at the same time you have a charitable intent, you can get the best of both worlds. By gifting the property to the charity, you may be entitled to an income tax deduction for the fair market value of the gift; the charity could then sell the appreciated property, if it chooses to do so, and the charity will not be subject to capital gains tax. Therefore, you not only lower your taxable income by avoiding the capital gains tax but you also benefit from a higher charitable deduction since the gift is being made in pretax dollars.

To obtain the tax advantages associated with charitable giving, the gift must be made to a qualified charitable organization, which means the charitable organization must:

- Have been organized in the United States.
- Be operated on a nonprofit basis.
- Not be involved with political activities.

**Exhibit 10.1 The Pros and Cons of Various Gifting Strategies**

| Gifting Strategy | Pros | Cons |
|---|---|---|
| Outright Gift | Income tax deductible in year of gift | No retained interest, or control after gifted |
| Charitable Lead Trust | A current gift to charity<br>Current income tax deduction<br>Transfers assets to heirs at a future discounted value | Charitable gift is irrevocable<br>With current income tax deduction, future income is taxable to the donor<br>Donor gives up the use of income generated throughout the life of the trust |
| Charitable Remainder Unitrust | Current income tax deduction<br>Bypass capital gains tax on appreciated property will reduce estate taxes | Charitable gift is irrevocable<br>Qualified appraisal commonly required<br>Complex administration and setup |
| Charitable Remainder Annuity Trust | Current income tax deduction<br>Bypass capital gains tax on appreciated property<br>Fixed income stream | Fixed payment is not limited to the net amount of trust income<br>Qualified appraisal commonly required<br>Complex administration and setup |

- Must be a qualified charitable organization recognized by the IRS as a 501(c)(3).

In addition to these qualified charitable organizations, you may give to veterans' posts, certain fraternal orders, volunteer fire departments, and civil defense organizations.

#### *Using a Trust to Further Increase the Benefits of Charitable Gifting*

There are several different gifting strategies available for planned giving, which include giving an outright gift to charity or setting up a charitable trust. Each has its own pros and cons, summarized in Exhibit 10.1.

**Charitable lead trusts** are designed for individuals who would like to see their charity benefit immediately from their gift. With a charitable lead trust, your gift can have an immediate benefit to your charity, and at the same time it may entitle you to benefit as well. If you usually make outright contributions to your charity, and generally sell an appreciated investment and give all or some of the money to charity, you may be a perfect candidate to take advantage of the benefits offered by using a charitable trust.

With a charitable lead trust, you are actually gifting the income to the charity from the asset and not the actual asset. Your deduction will be based on the rate of return the charity can reasonably expect to receive, the duration of the trust, and the IRS valuation tables used in calculating the value of the gift. With a charitable lead trust, the income from the gifted assets will go to the charity; the charity will then continue to receive distributions throughout the life of the trust. You can establish the life of the trust for a set number of years or an individual's lifetime including your own. Once this time period has expired, the trust will terminate and the remaining assets will be paid to you or your beneficiaries. If during your lifetime, you are interested in increasing your gifts to charity as well as your tax benefits, a charitable lead trust may enable you to accomplish your goals. With a charitable lead trust, you can also pass an appreciated asset on to your heirs with little or no estate taxes.

**Charitable remainder trusts** allow you, or your beneficiaries, to receive payment of a specified amount annually, and at the end of the trust period, the designated charity receives the remainder assets. You can receive either a percentage (Charitable Remainder Unitrust) of the value of the trust or a fixed amount (Charitable Remainder Annuity Trust). The trustee can sell off the highly appreciated assets gifted to the trust and then reinvest the proceeds to generate income, and avoid capital gains tax. This strategy may allow you to rebalance your investment portfolio without the typical tax consequences and at the same time you can shift your investments to high income-generating assets, which will improve your cash flow. Furthermore, you may also be eligible for a current year income tax deduction on the calculated present value of the remainder interest that will ultimately go to the charity at a future date. Although the gift to the trust is irrevocable, you do have control over which charity will eventually receive this gift.

#### *Summing Up What You Need to Know about Trusts*

You must choose a trustee wisely and clearly state your intentions in the trust document. Even when the beneficiary does not receive any benefit for decades, the beneficiary will ultimately assume ownership of the trust assets. During the period in between the trustee is in charge of controlling the assets in the trust, and complying with the instructions in the trust document. Choosing someone

who knows how to handle financial matters and who will carry out your intentions is critically important to the successful utilization of these trust strategies. Trusts are highly complicated instruments that must strictly conform to tax rules and regulations; you must consult with an experienced estate tax attorney and a financial planner before implementing these strategies.

## Benefit from a Family Limited Partnership

If you own a family business, rental properties, or a farm, you may have some additional estate planning hurdles to deal with down the road. If you are "hard-asset rich" but cash poor, your family may be faced with liquidity problems upon your death, when it comes time to paying the estate taxes. The federal government requires your executor or administrator to pay your estate tax liability within nine months of your date of death. Your family members may have no intention to sell any of the property you left behind for them, but they may be forced to do so to pay the estate taxes. The key goal of any estate planning strategy is to minimize estate taxes and to also provide the necessary liquidity when the time comes. The main objective is to preserve the estate and to allow your family to continue to own and operate the family business, rental properties, or farm.

Therefore, the formation of a family limited partnership is another estate planning strategy that you can use in these situations. A family limited partnership is typically established as a separate legal entity to hold and manage a family business or investment property; it may also open up the opportunity to various other estate and income tax planning strategies.

The family limited partnership agreement provides control to the parent and divides the right to the income, including future appreciation in value among family members, in an attempt to provide financial and tax benefits to the overall family. These family partnerships typically commence by creating a general limited partnership, followed with the assets being transferred into partnership. As the parent, you can then start the process of gifting limited partnership interests (non-controlling interests) to your children. You would continue to hold the general partnership interest (controlling interest), and this would make the parent the partner with full control. The children would have no control as limited partners. The parent would continue to maintain and exercise complete

control even after your children become majority partners, as long as they are the only limited partners. As limited partners, your children would share in the income of the family limited partnership in proportion to their ownership interests, which have been established through your gifts.

This estate tax planning strategy allows you to provide your children with an ownership interest while you are alive, and at the same time, it allows you to reduce your future estate tax liability with the added benefit of a succession plan for your family-owned business, property, or farm. You will be able to gift limited partnership interests to your children over time, which will allow you to take full advantage of the $14,000 (possibly $28,000 if you are married) annual gift tax exclusion without giving them control of the money or property. If that was not reason enough, you may also benefit by having their share of the income from this family limited partnership taxed at their lower income tax rate that may apply.

The full value of the partnership interests transferred to your children while you are alive will escape inclusion in your taxable estate, including any appreciation in value after the date of transfer. This is a very powerful estate planning strategy if you are able to take advantage of it.

## Estate Tax Planning and Life Insurance

An Irrevocable Life Insurance Trust (ILIT) is another estate planning strategy that includes using a trust that can be set up to hold life insurance policies, preventing the proceeds from being included in your taxable estate.

One of the key features of an ILIT is that it allows you to keep the death benefit out of your estate. You (as the trustor) can make annual gifts to the trust in order for the trustee to pay for the life insurance premiums each year. These gifts are made annually, up to $14,000 per beneficiary, which will also serve the purpose of further lowering the estate value and estate tax liability. Therefore, not only does the value of the estate get reduced by the gifts you make each year, but ultimately the entire death benefit will escape estate taxes on your death.

It is very important to note that you never want to own life insurance in your own name if the possibility exists that your estate may be subject to estate taxes. The death benefit from life insurance held in your name will be included in your taxable estate.

Based on the current estate tax rate, the federal government may be entitled to 40 percent of your death benefit. Although life insurances proceeds are generally not subject to income tax, they can and will be subject to estate taxes if owned by you and you have a taxable estate. The transfer of ownership of a life insurance policy from an individual who dies within three years of the transfer to anyone else, including a trust where the insured is the transferring individual will cause the death benefit of the policy to be included in the taxable estate. Starting in 2013, the federal estate tax rate of 40% has been made permanent with an inflation adjusted exemption of $5.25 million.

A second-to-die insurance policy insures two people and pays a benefit after the death of the second person. (See Chapter 5, Insuring Your Health and Life, for more details.) The premiums are typically much less expensive than premiums for a single life insurance policy, because they are based on the life expectancies of the two insured individuals, the husband and wife. Because the unlimited marital deduction allows assets to pass to the surviving spouse without federal estate taxes, the estate taxes in general do not become an issue until the death of the second spouse. When the estate assets pass out of the marriage to the heirs, this is when you normally incur the estate tax liability. Thus, a second-to-die survivorship life insurance policy could pay a benefit at the time when your family really needs it, to pay estate taxes.

Once again, you must seek out a qualified estate attorney and financial advisor to not only set this up properly, but also to administer the trust because there are strict guidelines that must be followed each year. The cost and availability of life insurance depends on a number of factors such as your age, health, and the type and amount of insurance coverage you want to purchase. Before implementing a planning strategy involving life insurance, it would be sensible to make sure that you are insurable.

#### *Spousal "Portability" of the Exclusion*

The 2010 Tax Relief Act revived the estate tax after it was eliminated in 2010. Perhaps one of the most significant changes created by this act is spousal "portability" of the exclusion, which has been made permanent with the American Taxpayer Relief Act of 2012. If the first spouse to die does not fully use his or her exclusion, then the surviving spouse may inherit the decedent spouse's unused

exclusion and may therefore be entitled up to an inflation adjusted $10.5 million exclusion upon his or her death.

The spousal "portability" is only available if an election is made by the executor or administrator on a timely filed IRS Form 706, for the first spouse to die. If this form is not filed and the election is not made, the surviving spouse will be limited to only her $5.25 million exclusion. Therefore, even if an estate tax return is not required to be filed upon the death of the first spouse, the surviving spouse and the executor should consider filing and making this election to preserve the full amount of the exclusion that was made available under spousal "portability" rules. If the surviving spouse remarries, she can only take advantage of portability rules once. This rule prevents an estate from taking advantage of the spousal portability exclusion more than once because of multiple marriages.

Estate taxes are an important concern in distributing your estate because the money your estate pays in taxes will not be available to your heirs. Each estate is allowed a federal estate tax exemption and a certain amount that can pass tax free, either through lifetime gifts or after death. By implementing some of the strategies covered in this chapter, you should be able to preserve more of your estate for the benefit of your loved ones. If upon your death, the total value of your estate is less than the applicable exemption amount at the time of your death, no federal estate taxes will be due. Always remember to check the rules for your state of residence, because the exclusion can be much lower at the state level. I would recommend going to your resident's state department of taxation and checking out what the exclusion would be at the state level for you. You can, of course, also ask your attorney and financial planner to provide you with further guidance with the state estate tax rules, since they do vary by state.

I would encourage you to go to www.smartmoney.com/calculator, scroll to "Taxes," and then click on "Estate." Then click on "Estate Taxes" under "Estate Planning" to calculate the amount of estate taxes you may owe based on today's estate tax exemption and rates. Be sure to use your statement of financial position (as discussed in Chapter 3), and do not forget to add the death benefit of any life insurance held in your name when determining your net worth for this calculation. You should use this calculator to estimate the approximate amount of federal estate taxes that would be required to be paid based on the current tax laws.

An important part of estate planning not only includes knowing the strategies to minimize taxes but also to plan on how you and your family will pay them when the time comes. As mentioned, estate taxes are generally due nine months after the date of death, and are to be paid with cash. There are basically just a few options when it comes to how your executor will pay the estate taxes upon your death, including:

- Using your current savings and liquid investments.
- Borrowing the money.
- Liquidating hard assets, such as selling real estate.
- Using life insurance proceeds.

If the first three options are not appealing or practical, then you should consider life insurance, and consider implementing the strategies I discussed earlier in this chapter, in the section on "Estate Tax Planning and Life Insurance." Paying the estate taxes when the time comes could present a challenge to the executor and your survivors. This is why it is essential to put a plan in place that will include how the ultimate estate taxes will be paid. You must put a plan of action in place while you are still alive; otherwise, your executor and survivors may be forced to liquidate your assets at bargain prices in order to meet this time-sensitive estate tax obligation.

### Tax Facts and Strategies[1] for Preserving Your Estate

- If you give your child or any other individual an interest-free or below-market interest loan, you can limit or even completely avoid imputed interest by the IRS, as long as the total outstanding loan balance owed to you by this individual does not exceed $100,000 and tax avoidance is not the principal purpose of this loan.

(*Continued*)

[1]IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that this book (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. (iii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

- When you sell property that you inherited, you are automatically given a holding period of more than one year (long term capital gain treatment). Generally, you will also receive a step-up in basis to the fair market value of the property as of the date of death. In many cases, this step-up in basis completely eliminates the income tax on the sale of most inherited properties. With a step-up in basis, the cost for determining gain or loss is based on the property's value at death and not based on what the decedent actually paid for it.
- When determining the gain or loss from the sale of property that was gifted to you, your cost basis is generally determined by the donor's cost basis, plus all or part of any gift tax paid. If you sell the gifted property for less than the donor's cost basis, you cannot report a loss. Making gifts of appreciated property to a family member who is in a lower tax bracket before an anticipated sale can reduce the overall income tax to be paid by the family as a whole.
- You can give gifts throughout your lifetime and receive an exemption for the first $5,250,000 of taxable gifts starting in 2013; this is in addition to the $14,000 annual gift to any number of persons per year. These gifts will not be subject to gift tax to you and can be received on a tax-free basis by the recipient.
- You can make annual gifts of $14,000 to any number of persons, typically children or grandchildren, without incurring a gift tax. If a husband and wife both engage in gifting, they can jointly give away $28,000 per year per recipient without incurring a gift tax. Over several years, the amount of money that can be transferred to beneficiaries can be substantial, thereby reducing the size of the taxable estate and the ultimate estate tax liability.
- You can pay an unlimited amount of someone's college tuition directly to the school and still be permitted to give an additional $14,000 directly to the donee beneficiary without affecting your lifetime exemption. Therefore, you may want to consider paying your children's and grandchildren's tuition directly to the institution and use this as one of your valuable estate planning tools.
- You can pay an unlimited amount of someone's medical expenses directly to the hospital and still be permitted to give an additional $14,000 directly to the donee beneficiary without affecting your lifetime exemption.
- Gifts and inheritances you receive are not taxable, but distributions taken from an inherited IRA or qualified plan are taxable.

- A gift or inheritance will be taxable if in fact it is a payment for services rendered.
- By establishing an Irrevocable Life Insurance trust (ILIT), you can reduce the size of your taxable estate each year while providing your beneficiaries with a larger inheritance. Each year, you make a gift to the ILIT, which lowers your taxable estate. The trust then buys life insurance for the benefit of your beneficiaries. When you die, the life insurance proceeds are kept outside of the estate (ownership by the trust). Then, these proceeds are not subject to estate tax and are also income-tax free to your beneficiaries. This is a must-do for large estates that will be subject to estate taxes.
- A beneficiary can claim an itemized deduction for the amount of federal estate taxes paid on income in respect of a decedent (IRD). Be sure to ask the executor of the estate for the amount of federal estate taxes paid on the IRD. Your share may be used as a miscellaneous deduction not subject to the 2 percent AGI floor.
- As a married person, you may be able to reduce or eliminate estate taxes by using the marital deduction that allows the passing spouse to transfer an unlimited amount of assets to the surviving spouse free from estate and gift tax.
- Prior to January 1, 2010, the estate tax exemption was subject to the "use it or lose it" rules for each spouse. Therefore, if a spouse died without sufficient assets to use up his or her full estate tax exemption, the unused amount was lost forever. Under the American Taxpayer Relief Act of 2012, the portability (originally established in 2010) between spouses of the lifetime estate tax exemption has been made permanent and for 2013 the inflation adjusted amount is $5,250,000. Any unused portion of the deceased spouse's exemption is available and added to the estate tax exemption of the second spouse. This will preserve the full $10,500,000 estate tax exemption for the married couple. The spousal "portability" is only available if an election is made by the executor or administrator on a timely filed IRS Form 706, for the first spouse to die. If this form is not filed and the election is not made, the surviving spouse will be limited to only her $5.25 million exclusion. Therefore, even if an estate tax return is not required to be filed upon the death of the first spouse, the surviving spouse and the executor should consider filing and making this election to preserve the full amount of the exclusion that was made available under spousal "portability" rules.

## An Action Plan for Preserving Your Estate

1. **Decide which legal documents you need, to ensure that you and your estate are taken care of properly.** Most people should have a will. You may also want to have a living will, a health care proxy, and a durable power of attorney, and you may want to set up one or more trusts, in addition to your will. These documents ensure that your wishes are followed, should you become incapacitated and not able to make decisions for yourself. Your will ensures that the assets you have accumulated during your lifetime will be distributed the way you want them to be, to whomever you choose, on your death.
2. **Keep in mind that if you die without a will, your estate will be distributed according to the relevant laws in the state where you lived.** Generally, these laws follow your family tree, but distributions may be made in a proportion that is not what you would have wanted. Keep in mind these distribution rules vary state by state.
3. **Take advantage of gifting strategies that can help you prevent losing some of the value of your estate to taxes.** For example, at present, you can gift up to $14,000 (to as many people as you want) each year, which achieves two benefits. First, you can give money directly to your family, friends, or philanthropies while you are alive; second, by lowering the value of your estate, your estate taxes will be lower.
4. **Make sure you understand the difference between various types of property ownership:** individual ownership, joint tenancy, and tenancy by the entirety, as each has a different effect on what happens to that property upon your death.
5. **If you have a significant estate you must meet with an experienced estate attorney and implement some of the advanced tax planning techniques mentioned in this chapter.**

CHAPTER 11

# The Time Value of Money

One of the most important concepts to accumulating wealth and becoming financially independent is understanding the *time value of money*. By far, the most valuable asset we have is time, but unfortunately it is usually something we take for granted and then do not fully appreciate until later in life.

The time value of money formulas are highly complex mathematical equations, beyond the scope of this book; however, I recommend you purchase a financial calculator, which can perform these calculations for you. In fact, if you are in the business world, owning a financial calculator is a necessary tool in order for you to succeed. Rather than making this a complicated chapter that sounds like calculus, I am going to give you some very simple examples and financial tables that will make this an easy concept to understand.

Before we get started, I would like to define the most basic interest formula:

$$I = P \times R \times T$$

$I$ = Interest calculated

$P$ = Principal

$R$ = Annual interest rate

$T$ = Time period covered in the interest calculation (number of months out of 12)

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

For example, if you have $100,000 and are earning 5 percent interest over one year, the components of the formula would be $P$ = $100,000, $R$ = 5%, and $T$ = one year. Therefore, $100,000 × 5% × (12/12) one year = $5,000. This represents the most basic interest formula.

After one year, your principal would now be worth $105,000, which would be the original $100,000 plus $5,000 in interest.

In year two, you would have $P$ = $105,000, $R$ = 5% and $T$ = one year. Therefore, $105,000 × 5% × (12/12) one year = $5,250. As a result, in year two, your original $100,000 increased its earning power by $250 with all other factors remaining the same.

With each year that passes, the earning power increases: This is referred to as the *power of compounding*. You can truly appreciate this over time, because the outcome can be astonishing.

## The Rule of 72

Before I describe how to use the financial tables provided in the following pages, I would like to explain the *Rule of 72*, which unlocks the answer to how long it will take you to double your money. Of course, the answer to this depends on your interest rate (rate of return). Simply divide the assumed rate of return into 72. For example:

- If your assumed rate of return is 10 percent, divide 10 into 72, which equals 7.2 years.
- If your assumed rate of return is 5 percent, divide 5 into 72, which equals 14.4 years.

So, for the purpose of this example, let us assume a rate of return of 10 percent per year and a starting point of $25,000. Based on the Rule of 72 (see Exhibit 11.1), here's how that amount will increase:

- In 7.2 years, that $25,000 will double to $50,000.
- In 14.4 years, it will double once again to $100,000.
- In 21.6 years, it will double once again to $200,000.
- In 28.8 years, it will double once again to $400,000.
- In 36 years, it will double once again to $800,000.
- In 43.2 years, it will double once again to $1.6 million.

**Exhibit 11.1 Rule of 72**

| Annual Rate of Return | Years to Increase Your Investment | | | | | |
|---|---|---|---|---|---|---|
| | 2 times | 4 times | 8 times | 16 times | 32 times | 64 times |
| 1% | 72.00 | 144.00 | 216.00 | 288.00 | 360.00 | 432.00 |
| 2% | 36.00 | 72.00 | 108.00 | 144.00 | 180.00 | 216.00 |
| 3% | 24.00 | 48.00 | 72.00 | 96.00 | 120.00 | 144.00 |
| 4% | 18.00 | 36.00 | 54.00 | 72.00 | 90.00 | 108.00 |
| 5% | 14.40 | 28.80 | 43.20 | 57.60 | 72.00 | 86.40 |
| 6% | 12.00 | 24.00 | 36.00 | 48.00 | 60.00 | 72.00 |
| 7% | 10.29 | 20.57 | 30.86 | 41.14 | 51.43 | 61.71 |
| 8% | 9.00 | 18.00 | 27.00 | 36.00 | 45.00 | 54.00 |
| 9% | 8.00 | 16.00 | 24.00 | 32.00 | 40.00 | 48.00 |
| **10%** | **7.20** | **14.40** | **21.60** | **28.80** | **36.00** | **43.20** |
| 11% | 6.55 | 13.09 | 19.64 | 26.18 | 32.73 | 39.27 |
| 12% | 6.00 | 12.00 | 18.00 | 24.00 | 30.00 | 36.00 |
| 13% | 5.54 | 11.08 | 16.62 | 22.15 | 27.69 | 33.23 |
| 14% | 5.14 | 10.29 | 15.43 | 20.57 | 25.71 | 30.86 |
| 15% | 4.80 | 9.60 | 14.40 | 19.20 | 24.00 | 28.80 |
| 16% | 4.50 | 9.00 | 13.50 | 18.00 | 22.50 | 27.00 |
| 17% | 4.24 | 8.47 | 12.71 | 16.94 | 21.18 | 25.41 |
| 18% | 4.00 | 8.00 | 12.00 | 16.00 | 20.00 | 24.00 |
| 19% | 3.79 | 7.58 | 11.37 | 15.16 | 18.95 | 22.74 |
| 20% | 3.60 | 7.20 | 10.80 | 14.40 | 18.00 | 21.60 |

**If Initial Investment Was $25,000 on January 1, 2013**

**At the below interest rates, by what month will the investment reach the future amount?**

| | Annual Interest Rate | | | | | |
|---|---|---|---|---|---|---|
| Future Amount > | $50,000 | $100,000 | $200,000 | $400,000 | $800,000 | $1,600,000 |
| 1% | 2084-Dec | 2156-Nov | 2228-Nov | 2300-Oct | 2372-Oct | 2444-Sep |
| 2% | 2048-Dec | 2084-Dec | 2120-Dec | 2156-Nov | 2192-Nov | 2228-Nov |
| 3% | 2036-Dec | 2060-Dec | 2084-Dec | 2108-Dec | 2132-Dec | 2156-Nov |
| 4% | 2030-Dec | 2048-Dec | 2066-Dec | 2084-Dec | 2102-Dec | 2120-Dec |
| 5% | 2027-May | 2041-Oct | 2056-Mar | 2070-Jul | 2084-Dec | 2099-May |

(*Continued*)

**Exhibit 11.1 (*Continued*)**

| | Annual Interest Rate | | | | | |
|---|---|---|---|---|---|---|
| Future Amount > | $50,000 | $100,000 | $200,000 | $400,000 | $800,000 | $1,600,000 |
| 6% | 2024-Dec | 2036-Dec | 2048-Dec | 2060-Dec | 2072-Dec | 2084-Dec |
| 7% | 2023-Apr | 2033-Jul | 2043-Nov | 2054-Feb | 2064-May | 2074-Sep |
| 8% | 2021-Dec | 2030-Dec | 2039-Dec | 2048-Dec | 2057-Dec | 2066-Dec |
| 9% | 2020-Dec | 2028-Dec | 2036-Dec | 2044-Dec | 2052-Dec | 2060-Dec |
| **10%** | **2020-Mar** | **2027-May** | **2034-Aug** | **2041-Oct** | **2048-Dec** | **2056-Mar** |
| 11% | 2019-Jul | 2026-Jan | 2032-Aug | 2039-Mar | 2045-Sep | 2052-Mar |
| 12% | 2018-Dec | 2024-Dec | 2030-Dec | 2036-Dec | 2042-Dec | 2048-Dec |
| 13% | 2018-Jul | 2024-Jan | 2029-Aug | 2035-Feb | 2040-Sep | 2046-Mar |
| 14% | 2018-Feb | 2023-Apr | 2028-Jun | 2033-Jul | 2038-Sep | 2043-Nov |
| 15% | 2017-Oct | 2022-Aug | 2027-May | 2032-Mar | 2036-Dec | 2041-Oct |
| 16% | 2017-Jul | 2021-Dec | 2026-Jun | 2030-Dec | 2035-Jun | 2039-Dec |
| 17% | 2017-Mar | 2021-Jun | 2025-Sep | 2029-Dec | 2034-Mar | 2038-May |
| 18% | 2016-Dec | 2020-Dec | 2024-Dec | 2028-Dec | 2032-Dec | 2036-Dec |
| 19% | 2016-Oct | 2020-Jul | 2024-May | 2028-Feb | 2031-Dec | 2035-Sep |
| 20% | 2016-Aug | 2020-Mar | 2023-Oct | 2027-May | 2030-Dec | 2034-Aug |

These mathematical facts are accurate and verifiable, yet most people are astonished when they truly understand the power of compounding and how powerful the time value of money can be.

In Chapter 8, Planning for Retirement, we discussed the retirement equation of how to achieve financial independence and reach *point X*. After having a better appreciation for the time value of money, you can now understand why it is so critical to pay close attention to these key factors. Achieving the highest rate of return within your risk tolerance (Chapter 9, Managing Your Investments) is a critical component to this equation. Starting early and having a better appreciation of your most valuable asset—time—will give you a tremendous advantage to achieving your financial goals.

To do your own financial calculations to determine what it will take to achieve your own financial independence—*point X*—you need to understand how the following four financial tables work.

#### *Future Value (FV) Factor of a Sum Certain*

The Future Value (FV) factor of a sum certain will determine how large a single sum will become at the end of a specified period of time if the amount invested earns a specified interest rate (rate of return) with compounding each period. Please refer to Exhibit 11.2, "Future Value Factors of a Sum Certain," as I take you through this example. The purpose of Exhibit 11.2 is to determine the future dollars you will have based on your *investment today* over a period of time at an assumed interest rate (rate of return).

For example, if you invested $10,000 today at 7 percent return per year, after 20 years, you would have $38,700. The way you would determine this is by looking at Exhibit 11.2, going down the year column to 20 years, and then going across to the 7 percent column per year to obtain the factor of 3.870. You then take the current single sum of $10,000 and you multiply it by the future value factor of 3.870 percent ($10,000 × 3.870) = $38,700.

For comparison purposes, if you take all of the same assumptions but are fortunate enough to generate a 10 percent return on your money, you would end up with $67,270 after the same 20-year period. If you look at Exhibit 11.2, the cross section of 20 years at 10 percent gives you a FV factor of 6.727 percent. This additional 3 percent return on your money over a 20-year period with compounding would result in an additional $28,570 of earnings. This example highlights the importance of trying to generate the highest possible rate of return within your risk tolerance over the long run.

#### *Future Value (FV) of an Annuity Factor*

The Future Value (FV) of an annuity factor will determine the future value of a stream of equal payments made at regular intervals over a specified period of time if the amount invested earns a specified interest rate (rate of return) with compounding each period. Please refer to Exhibit 11.3, "Future Value of an Annuity Factor," as I take you through this example. The purpose of Exhibit 11.3 is to determine the future dollars you will have based on your *annual investment* over a period of time at an assumed interest rate (rate of return).

For example, if you invested $5,000 annually at 5 percent return per year, after 25 years, you would have $238,635. The way you would determine this is by looking at Exhibit 11.3, going down

## Exhibit 11.2 Future Value (FV) Factors of a Sum Certain

**The purpose of this table is to determine the future dollars you will have based on your investment today over a period of time at an assumed interest rate (rate of return).**

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your investment amount today. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. This is your future dollars. |

| Year | 1% | 2% | 3% | 4% | 5% | 6% | 7% |
|---|---|---|---|---|---|---|---|
| 1 | 1.010 | 1.020 | 1.030 | 1.040 | 1.050 | 1.060 | 1.070 |
| 2 | 1.020 | 1.040 | 1.061 | 1.082 | 1.103 | 1.124 | 1.145 |
| 3 | 1.030 | 1.061 | 1.093 | 1.125 | 1.158 | 1.191 | 1.225 |
| 4 | 1.041 | 1.082 | 1.126 | 1.170 | 1.216 | 1.262 | 1.311 |
| 5 | 1.051 | 1.104 | 1.159 | 1.217 | 1.276 | 1.338 | 1.403 |
| 6 | 1.062 | 1.126 | 1.194 | 1.265 | 1.340 | 1.419 | 1.501 |
| 7 | 1.072 | 1.149 | 1.230 | 1.316 | 1.407 | 1.504 | 1.606 |
| 8 | 1.083 | 1.172 | 1.267 | 1.369 | 1.477 | 1.594 | 1.718 |
| 9 | 1.094 | 1.195 | 1.305 | 1.423 | 1.551 | 1.689 | 1.838 |
| 10 | 1.105 | 1.219 | 1.344 | 1.480 | 1.629 | 1.791 | 1.967 |
| 11 | 1.116 | 1.243 | 1.384 | 1.539 | 1.710 | 1.898 | 2.105 |
| 12 | 1.127 | 1.268 | 1.426 | 1.601 | 1.796 | 2.012 | 2.252 |
| 13 | 1.138 | 1.294 | 1.469 | 1.665 | 1.886 | 2.133 | 2.410 |
| 14 | 1.149 | 1.319 | 1.513 | 1.732 | 1.980 | 2.261 | 2.579 |
| 15 | 1.161 | 1.346 | 1.558 | 1.801 | 2.079 | 2.397 | 2.759 |
| 16 | 1.173 | 1.373 | 1.605 | 1.873 | 2.183 | 2.540 | 2.952 |
| 17 | 1.184 | 1.400 | 1.653 | 1.948 | 2.292 | 2.693 | 3.159 |
| 18 | 1.196 | 1.428 | 1.702 | 2.026 | 2.407 | 2.854 | 3.380 |
| 19 | 1.208 | 1.457 | 1.754 | 2.107 | 2.527 | 3.026 | 3.617 |
| 20 | 1.220 | 1.486 | 1.806 | 2.191 | 2.653 | 3.207 | **3.870** |
| 21 | 1.232 | 1.516 | 1.860 | 2.279 | 2.786 | 3.400 | 4.141 |
| 22 | 1.245 | 1.546 | 1.916 | 2.370 | 2.925 | 3.604 | 4.430 |
| 23 | 1.257 | 1.577 | 1.974 | 2.465 | 3.072 | 3.820 | 4.741 |
| 24 | 1.270 | 1.608 | 2.033 | 2.563 | 3.225 | 4.049 | 5.072 |
| 25 | 1.282 | 1.641 | 2.094 | 2.666 | 3.386 | 4.292 | 5.427 |
| 26 | 1.295 | 1.673 | 2.157 | 2.772 | 3.556 | 4.549 | 5.807 |
| 27 | 1.308 | 1.707 | 2.221 | 2.883 | 3.733 | 4.822 | 6.214 |
| 28 | 1.321 | 1.741 | 2.288 | 2.999 | 3.920 | 5.112 | 6.649 |
| 29 | 1.335 | 1.776 | 2.357 | 3.119 | 4.116 | 5.418 | 7.114 |
| 30 | 1.348 | 1.811 | 2.427 | 3.243 | 4.322 | 5.743 | 7.612 |
| 31 | 1.361 | 1.848 | 2.500 | 3.373 | 4.538 | 6.088 | 8.145 |
| 32 | 1.375 | 1.885 | 2.575 | 3.508 | 4.765 | 6.453 | 8.715 |
| 33 | 1.389 | 1.922 | 2.652 | 3.648 | 5.003 | 6.841 | 9.325 |
| 34 | 1.403 | 1.961 | 2.732 | 3.794 | 5.253 | 7.251 | 9.978 |
| 35 | 1.417 | 2.000 | 2.814 | 3.946 | 5.516 | 7.686 | 10.677 |
| 36 | 1.431 | 2.040 | 2.898 | 4.104 | 5.792 | 8.147 | 11.424 |
| 37 | 1.445 | 2.081 | 2.985 | 4.268 | 6.081 | 8.636 | 12.224 |
| 38 | 1.460 | 2.122 | 3.075 | 4.439 | 6.385 | 9.154 | 13.079 |
| 39 | 1.474 | 2.165 | 3.167 | 4.616 | 6.705 | 9.704 | 13.995 |
| 40 | 1.489 | 2.208 | 3.262 | 4.801 | 7.040 | 10.286 | 14.974 |
| 41 | 1.504 | 2.252 | 3.360 | 4.993 | 7.392 | 10.903 | 16.023 |
| 42 | 1.519 | 2.297 | 3.461 | 5.193 | 7.762 | 11.557 | 17.144 |
| 43 | 1.534 | 2.343 | 3.565 | 5.400 | 8.150 | 12.250 | 18.344 |
| 44 | 1.549 | 2.390 | 3.671 | 5.617 | 8.557 | 12.985 | 19.628 |
| 45 | 1.565 | 2.438 | 3.782 | 5.841 | 8.985 | 13.765 | 21.002 |

## Exhibit 11.2 Future Value (FV) Factors of a Sum Certain

**The purpose of this table is to determine the future dollars you will have based on your investment today over a period of time at an assumed interest rate (rate of return).**

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your investment amount today. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. This is your future dollars. |

| Year | 8% | 9% | 10% | 12% | 15% | 20% | 25% |
|---|---|---|---|---|---|---|---|
| 1 | 1.080 | 1.090 | 1.100 | 1.120 | 1.150 | 1.200 | 1.250 |
| 2 | 1.166 | 1.188 | 1.210 | 1.254 | 1.323 | 1.440 | 1.563 |
| 3 | 1.260 | 1.295 | 1.331 | 1.405 | 1.521 | 1.728 | 1.953 |
| 4 | 1.360 | 1.412 | 1.464 | 1.574 | 1.749 | 2.074 | 2.441 |
| 5 | 1.469 | 1.539 | 1.611 | 1.762 | 2.011 | 2.488 | 3.052 |
| 6 | 1.587 | 1.677 | 1.772 | 1.974 | 2.313 | 2.986 | 3.815 |
| 7 | 1.714 | 1.828 | 1.949 | 2.211 | 2.660 | 3.583 | 4.768 |
| 8 | 1.851 | 1.993 | 2.144 | 2.476 | 3.059 | 4.300 | 5.960 |
| 9 | 1.999 | 2.172 | 2.358 | 2.773 | 3.518 | 5.160 | 7.451 |
| 10 | 2.159 | 2.367 | 2.594 | 3.106 | 4.046 | 6.192 | 9.313 |
| 11 | 2.332 | 2.580 | 2.853 | 3.479 | 4.652 | 7.430 | 11.642 |
| 12 | 2.518 | 2.813 | 3.138 | 3.896 | 5.350 | 8.916 | 14.552 |
| 13 | 2.720 | 3.066 | 3.452 | 4.363 | 6.153 | 10.699 | 18.190 |
| 14 | 2.937 | 3.342 | 3.797 | 4.887 | 7.076 | 12.839 | 22.737 |
| 15 | 3.172 | 3.642 | 4.177 | 5.474 | 8.137 | 15.407 | 28.422 |
| 16 | 3.426 | 3.970 | 4.595 | 6.130 | 9.358 | 18.488 | 35.527 |
| 17 | 3.700 | 4.328 | 5.054 | 6.866 | 10.761 | 22.186 | 44.409 |
| 18 | 3.996 | 4.717 | 5.560 | 7.690 | 12.375 | 26.623 | 55.511 |
| 19 | 4.316 | 5.142 | 6.116 | 8.613 | 14.232 | 31.948 | 69.389 |
| 20 | 4.661 | 5.604 | **6.727** | 9.646 | 16.367 | 38.338 | 86.736 |
| 21 | 5.034 | 6.109 | 7.400 | 10.804 | 18.822 | 46.005 | 108.420 |
| 22 | 5.437 | 6.659 | 8.140 | 12.100 | 21.645 | 55.206 | 135.525 |
| 23 | 5.871 | 7.258 | 8.954 | 13.552 | 24.891 | 66.247 | 169.407 |
| 24 | 6.341 | 7.911 | 9.850 | 15.179 | 28.625 | 79.497 | 211.758 |
| 25 | 6.848 | 8.623 | 10.835 | 17.000 | 32.919 | 95.396 | 264.698 |
| 26 | 7.396 | 9.399 | 11.918 | 19.040 | 37.857 | 114.475 | 330.872 |
| 27 | 7.988 | 10.245 | 13.110 | 21.325 | 43.535 | 137.371 | 413.590 |
| 28 | 8.627 | 11.167 | 14.421 | 23.884 | 50.066 | 164.845 | 516.988 |
| 29 | 9.317 | 12.172 | 15.863 | 26.750 | 57.575 | 197.814 | 646.235 |
| 30 | 10.063 | 13.268 | 17.449 | 29.960 | 66.212 | 237.376 | 807.794 |
| 31 | 10.868 | 14.462 | 19.194 | 33.555 | 76.144 | 284.852 | 1,009.742 |
| 32 | 11.737 | 15.763 | 21.114 | 37.582 | 87.565 | 341.822 | 1,262.177 |
| 33 | 12.676 | 17.182 | 23.225 | 42.092 | 100.700 | 410.186 | 1,577.722 |
| 34 | 13.690 | 18.728 | 25.548 | 47.143 | 115.805 | 492.224 | 1,972.152 |
| 35 | 14.785 | 20.414 | 28.102 | 52.800 | 133.176 | 590.668 | 2,465.190 |
| 36 | 15.968 | 22.251 | 30.913 | 59.136 | 153.152 | 708.802 | 3,081.488 |
| 37 | 17.246 | 24.254 | 34.004 | 66.232 | 176.125 | 850.562 | 3,851.860 |
| 38 | 18.625 | 26.437 | 37.404 | 74.180 | 202.543 | 1,020.675 | 4,814.825 |
| 39 | 20.115 | 28.816 | 41.145 | 83.081 | 232.925 | 1,224.810 | 6,018.531 |
| 40 | 21.725 | 31.409 | 45.259 | 93.051 | 267.864 | 1,469.772 | 7,523.164 |
| 41 | 23.462 | 34.236 | 49.785 | 104.217 | 308.043 | 1,763.726 | 9,403.955 |
| 42 | 25.339 | 37.318 | 54.764 | 116.723 | 354.250 | 2,116.471 | 11,754.944 |
| 43 | 27.367 | 40.676 | 60.240 | 130.730 | 407.387 | 2,539.765 | 14,693.679 |
| 44 | 29.556 | 44.337 | 66.264 | 146.418 | 468.495 | 3,047.718 | 18,367.099 |
| 45 | 31.920 | 48.327 | 72.890 | 163.988 | 538.769 | 3,657.262 | 22,958.874 |

## Exhibit 11.3 Future Value (FV) of an Annuity Factor

**The purpose of this table is to determine the future dollars you will have based on your annual investment over a period of time at an assumed interest rate (rate of return).**

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| Years | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your annual investment amount. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. This is your future dollars. |

| Year | 1% | 2% | 3% | 4% | 5% | 6% | 7% |
|---|---|---|---|---|---|---|---|
| 1 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 |
| 2 | 2.010 | 2.020 | 2.030 | 2.040 | 2.050 | 2.060 | 2.070 |
| 3 | 3.030 | 3.060 | 3.091 | 3.122 | 3.153 | 3.184 | 3.215 |
| 4 | 4.060 | 4.122 | 4.184 | 4.246 | 4.310 | 4.375 | 4.440 |
| 5 | 5.101 | 5.204 | 5.309 | 5.416 | 5.526 | 5.637 | 5.751 |
| 6 | 6.152 | 6.308 | 6.468 | 6.633 | 6.802 | 6.975 | 7.153 |
| 7 | 7.214 | 7.434 | 7.662 | 7.898 | 8.142 | 8.394 | 8.654 |
| 8 | 8.286 | 8.583 | 8.892 | 9.214 | 9.549 | 9.897 | 10.260 |
| 9 | 9.369 | 9.755 | 10.159 | 10.583 | 11.027 | 11.491 | 11.978 |
| 10 | 10.462 | 10.950 | 11.464 | 12.006 | 12.578 | 13.181 | 13.816 |
| 11 | 11.567 | 12.169 | 12.808 | 13.486 | 14.207 | 14.972 | 15.784 |
| 12 | 12.683 | 13.412 | 14.192 | 15.026 | 15.917 | 16.870 | 17.888 |
| 13 | 13.809 | 14.680 | 15.618 | 16.627 | 17.713 | 18.882 | 20.141 |
| 14 | 14.947 | 15.974 | 17.086 | 18.292 | 19.599 | 21.015 | 22.550 |
| 15 | 16.097 | 17.293 | 18.599 | 20.024 | 21.579 | 23.276 | 25.129 |
| 16 | 17.258 | 18.639 | 20.157 | 21.825 | 23.657 | 25.673 | 27.888 |
| 17 | 18.430 | 20.012 | 21.762 | 23.698 | 25.840 | 28.213 | 30.840 |
| 18 | 19.615 | 21.412 | 23.414 | 25.645 | 28.132 | 30.906 | 33.999 |
| 19 | 20.811 | 22.841 | 25.117 | 27.671 | 30.539 | 33.760 | 37.379 |
| 20 | 22.019 | 24.297 | 26.870 | 29.778 | 33.066 | 36.786 | 40.995 |
| 21 | 23.239 | 25.783 | 28.676 | 31.969 | 35.719 | 39.993 | 44.865 |
| 22 | 24.472 | 27.299 | 30.537 | 34.248 | 38.505 | 43.392 | 49.006 |
| 23 | 25.716 | 28.845 | 32.453 | 36.618 | 41.430 | 46.996 | 53.436 |
| 24 | 26.973 | 30.422 | 34.426 | 39.083 | 44.502 | 50.816 | 58.177 |
| 25 | 28.243 | 32.030 | 36.459 | 41.646 | **47.727** | 54.865 | 63.249 |
| 26 | 29.526 | 33.671 | 38.553 | 44.312 | 51.113 | 59.156 | 68.676 |
| 27 | 30.821 | 35.344 | 40.710 | 47.084 | 54.669 | 63.706 | 74.484 |
| 28 | 32.129 | 37.051 | 42.931 | 49.968 | 58.403 | 68.528 | 80.698 |
| 29 | 33.450 | 38.792 | 45.219 | 52.966 | 62.323 | 73.640 | 87.347 |
| 30 | 34.785 | 40.568 | 47.575 | 56.085 | 66.439 | 79.058 | 94.461 |
| 31 | 36.133 | 42.379 | 50.003 | 59.328 | 70.761 | 84.802 | 102.073 |
| 32 | 37.494 | 44.227 | 52.503 | 62.701 | 75.299 | 90.890 | 110.218 |
| 33 | 38.869 | 46.112 | 55.078 | 66.210 | 80.064 | 97.343 | 118.933 |
| 34 | 40.258 | 48.034 | 57.730 | 69.858 | 85.067 | 104.184 | 128.259 |
| 35 | 41.660 | 49.994 | 60.462 | 73.652 | 90.320 | 111.435 | 138.237 |
| 36 | 43.077 | 51.994 | 63.276 | 77.598 | 95.836 | 119.121 | 148.913 |
| 37 | 44.508 | 54.034 | 66.174 | 81.702 | 101.628 | 127.268 | 160.337 |
| 38 | 45.953 | 56.115 | 69.159 | 85.970 | 107.710 | 135.904 | 172.561 |
| 39 | 47.412 | 58.237 | 72.234 | 90.409 | 114.095 | 145.058 | 185.640 |
| 40 | 48.886 | 60.402 | 75.401 | 95.026 | 120.800 | 154.762 | 199.635 |
| 41 | 50.375 | 62.610 | 78.663 | 99.827 | 127.840 | 165.048 | 214.610 |
| 42 | 51.879 | 64.862 | 82.023 | 104.820 | 135.232 | 175.951 | 230.632 |
| 43 | 53.398 | 67.159 | 85.484 | 110.012 | 142.993 | 187.508 | 247.776 |
| 44 | 54.932 | 69.503 | 89.048 | 115.413 | 151.143 | 199.758 | 266.121 |
| 45 | 56.481 | 71.893 | 92.720 | 121.029 | 159.700 | 212.744 | 285.749 |

## Exhibit 11.3 Future Value (FV) of an Annuity Factor

**The purpose of this table is to determine the future dollars you will have based on your annual investment over a period of time at an assumed interest rate (rate of return).**

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| Years | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your annual investment amount. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. This is your future dollars. |

| Year | 8% | 9% | 10% | 12% | 15% | 20% | 25% |
|---|---|---|---|---|---|---|---|
| 1 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 |
| 2 | 2.080 | 2.090 | 2.100 | 2.120 | 2.150 | 2.200 | 2.250 |
| 3 | 3.246 | 3.278 | 3.310 | 3.374 | 3.473 | 3.640 | 3.813 |
| 4 | 4.506 | 4.573 | 4.641 | 4.779 | 4.993 | 5.368 | 5.766 |
| 5 | 5.867 | 5.985 | 6.105 | 6.353 | 6.742 | 7.442 | 8.207 |
| 6 | 7.336 | 7.523 | 7.716 | 8.115 | 8.754 | 9.930 | 11.259 |
| 7 | 8.923 | 9.200 | 9.487 | 10.089 | 11.067 | 12.916 | 15.073 |
| 8 | 10.637 | 11.028 | 11.436 | 12.300 | 13.727 | 16.499 | 19.842 |
| 9 | 12.488 | 13.021 | 13.579 | 14.776 | 16.786 | 20.799 | 25.802 |
| 10 | 14.487 | 15.193 | 15.937 | 17.549 | 20.304 | 25.959 | 33.253 |
| 11 | 16.645 | 17.560 | 18.531 | 20.655 | 24.349 | 32.150 | 42.566 |
| 12 | 18.977 | 20.141 | 21.384 | 24.133 | 29.002 | 39.581 | 54.208 |
| 13 | 21.495 | 22.953 | 24.523 | 28.029 | 34.352 | 48.497 | 68.760 |
| 14 | 24.215 | 26.019 | 27.975 | 32.393 | 40.505 | 59.196 | 86.949 |
| 15 | 27.152 | 29.361 | 31.772 | 37.280 | 47.580 | 72.035 | 109.687 |
| 16 | 30.324 | 33.003 | 35.950 | 42.753 | 55.717 | 87.442 | 138.109 |
| 17 | 33.750 | 36.974 | 40.545 | 48.884 | 65.075 | 105.931 | 173.636 |
| 18 | 37.450 | 41.301 | 45.599 | 55.750 | 75.836 | 128.117 | 218.045 |
| 19 | 41.446 | 46.018 | 51.159 | 63.440 | 88.212 | 154.740 | 273.556 |
| 20 | 45.762 | 51.160 | 57.275 | 72.052 | 102.444 | 186.688 | 342.945 |
| 21 | 50.423 | 56.765 | 64.002 | 81.699 | 118.810 | 225.026 | 429.681 |
| 22 | 55.457 | 62.873 | 71.403 | 92.503 | 137.632 | 271.031 | 538.101 |
| 23 | 60.893 | 69.532 | 79.543 | 104.603 | 159.276 | 326.237 | 673.626 |
| 24 | 66.765 | 76.790 | 88.497 | 118.155 | 184.168 | 392.484 | 843.033 |
| 25 | 73.106 | 84.701 | **98.347** | 133.334 | 212.793 | 471.981 | 1,054.791 |
| 26 | 79.954 | 93.324 | 109.182 | 150.334 | 245.712 | 567.377 | 1,319.489 |
| 27 | 87.351 | 102.723 | 121.100 | 169.374 | 283.569 | 681.853 | 1,650.361 |
| 28 | 95.339 | 112.968 | 134.210 | 190.699 | 327.104 | 819.223 | 2,063.952 |
| 29 | 103.966 | 124.135 | 148.631 | 214.583 | 377.170 | 984.068 | 2,580.939 |
| 30 | 113.283 | 136.308 | 164.494 | 241.333 | 434.745 | 1,181.882 | 3,227.174 |
| 31 | 123.346 | 149.575 | 181.943 | 271.293 | 500.957 | 1,419.258 | 4,034.968 |
| 32 | 134.214 | 164.037 | 201.138 | 304.848 | 577.100 | 1,704.109 | 5,044.710 |
| 33 | 145.951 | 179.800 | 222.252 | 342.429 | 664.666 | 2,045.931 | 6,306.887 |
| 34 | 158.627 | 196.982 | 245.477 | 384.521 | 765.365 | 2,456.118 | 7,884.609 |
| 35 | 172.317 | 215.711 | 271.024 | 431.663 | 881.170 | 2,948.341 | 9,856.761 |
| 36 | 187.102 | 236.125 | 299.127 | 484.463 | 1,014.346 | 3,539.009 | 12,321.952 |
| 37 | 203.070 | 258.376 | 330.039 | 543.599 | 1,167.498 | 4,247.811 | 15,403.440 |
| 38 | 220.316 | 282.630 | 364.043 | 609.831 | 1,343.622 | 5,098.373 | 19,255.299 |
| 39 | 238.941 | 309.066 | 401.448 | 684.010 | 1,546.165 | 6,119.048 | 24,070.124 |
| 40 | 259.057 | 337.882 | 442.593 | 767.091 | 1,779.090 | 7,343.858 | 30,088.655 |
| 41 | 280.781 | 369.292 | 487.852 | 860.142 | 2,046.954 | 8,813.629 | 37,611.819 |
| 42 | 304.244 | 403.528 | 537.637 | 964.359 | 2,354.997 | 10,577.355 | 47,015.774 |
| 43 | 329.583 | 440.846 | 592.401 | 1,081.083 | 2,709.246 | 12,693.826 | 58,770.718 |
| 44 | 356.950 | 481.522 | 652.641 | 1,211.813 | 3,116.633 | 15,233.592 | 73,464.397 |
| 45 | 386.506 | 525.859 | 718.905 | 1,358.230 | 3,585.128 | 18,281.310 | 91,831.496 |

the year column to 25 years, and then going across to the 5 percent column per year to obtain the factor of 47.727. You then take the annual investment of $5,000 and you multiply it by the FV annuity factor of 47.727 percent ($5,000 × 47.727) = $238,635.

For comparison purposes, if you take all of the same assumptions but are fortunate enough to generate a 10 percent return on your money, you would end up with $491,735 after the same 25-year period. Look at page 2 of Exhibit 11.3; the cross section of 25 years at 10 percent gives you a FV annuity factor of 98.347 percent. This additional 5 percent return on your money over a 25-year period with compounding would result in an additional $253,100 of earnings. This example highlights the importance of trying to generate the highest possible rate of return within your risk tolerance over the long run.

#### *Present Value (PV) Factor of a Sum Certain*

The Present Value (PV) factor of a Sum Certain will determine the current value of a single sum to be paid at a specified date in the future if the amount invested earns a specified interest rate (rate of return) with compounding each period. Please refer to Exhibit 11.4, Present Value Factors of a Sum Certain, as I take you through this example. The purpose of this table is to determine the *present investment* needed for a future amount of dollars over a period of time at an assumed interest rate (rate of return).

For example, if you wanted $100,000 in 20 years, how much would you need to invest today at a 5 percent interest rate (rate of return) per year? The way you would determine this is by looking at Exhibit 11.4, going down the year column to 20 years, and then going across to the 5 percent column per year to obtain the factor of 0.37689. You then take the future amount of dollars needed of $100,000 and you multiply it by the PV factor of 0.37689 percent ($100,000 × 0.37689) = $37,689. Therefore, if you would like to have $100,000 in 20 years and expect to earn a 5 percent return on your money, you would need to invest $37,689 today.

We can verify and cross-check this calculation by using the FV factors from Exhibit 11.2. If you now look back to Exhibit 11.2, year 20, rate of return 5 percent, you will come up with a FV factor of 2.653 percent. If you take the $37,689 and multiply this FV factor of 2.653, you come up with the same $100,000 with a small rounding difference. This not only verifies and confirms these

calculations, but also proves that the PV and FV factors have an inverse relationship to one another.

It is important to note that the PV factor is used to find the PV of a future payment, by discounting them at some specific rate and this factor is always less than one. In contrast to the FV factor, which is used to find the FV of a present amount, it is always greater than one

#### *Present Value (PV) of an Annuity Factor*

The Present Value (PV) of an annuity factor will determine the current value of a stream of equal payments made at regular intervals over a specified period of time if the amount invested earns a specified interest rate (rate of return) with compounding each period. Please refer to Exhibit 11.5, Present Value on an Annuity Factor, as I take you through this example. The purpose of this table is to determine the present investment needed to have *equal future annual cash receipts* over a period of time at an assumed interest rate (rate of return).

For example, if you wanted to receive $25,000 annually for 25 years, how much would you need to invest today with a 4 percent interest rate (rate of return)? The way you would determine this is by looking at Exhibit 11.5, going down the year column to 25 years, and then going across to the 4 percent column per year to obtain the factor of 15.62208. You then take the amount you want to receive annually $25,000 and you multiply it by the PV annuity factor of 15.62208 percent ($25,000 × 15.62208) = $390,552. Therefore, if you would like to receive $25,000 per year over the next 25 years and expect to earn a 4 percent return on your money, you would need to have $390,552 today.

For comparison purposes, if you take all of the same assumptions but are fortunate enough to generate a 10 percent return on your money, you would only need $226,926. Look at page 2 of Exhibit 11.5, the cross section of 25 years at 10 percent gives you a PV annuity factor of 9.07704 percent. This additional 6 percent return on your money over a 25-year period with compounding would allow you to receive the same $25,000 annual annuity payment, with an investment of $226,926. This means you would be able to invest $163,626 ($390,552 less $226,926) less today and still manage to generate the same annual annuity payment. This example highlights the importance of trying to generate the highest possible rate of return within your risk tolerance over the long run.

## Exhibit 11.4 Present Value (PV) Factor of a Sum Certain

**The purpose of this table is to determine the present investment needed for a future amount of dollars over a period of time at an assumed interest rate (rate of return).**

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| Years | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your future investment amount. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. This is your present value. |

| Year | 1% | 2% | 3% | 4% | 5% | 6% | 7% |
|---|---|---|---|---|---|---|---|
| 1 | 0.99010 | 0.98039 | 0.97087 | 0.96154 | 0.95238 | 0.94340 | 0.93458 |
| 2 | 0.98030 | 0.96117 | 0.94260 | 0.92456 | 0.90703 | 0.89000 | 0.87344 |
| 3 | 0.97059 | 0.94232 | 0.91514 | 0.88900 | 0.86384 | 0.83962 | 0.81630 |
| 4 | 0.96098 | 0.92385 | 0.88849 | 0.85480 | 0.82270 | 0.79209 | 0.76290 |
| 5 | 0.95147 | 0.90573 | 0.86261 | 0.82193 | 0.78353 | 0.74726 | 0.71299 |
| 6 | 0.94205 | 0.88797 | 0.83748 | 0.79031 | 0.74622 | 0.70496 | 0.66634 |
| 7 | 0.93272 | 0.87056 | 0.81309 | 0.75992 | 0.71068 | 0.66506 | 0.62275 |
| 8 | 0.92348 | 0.85349 | 0.78941 | 0.73069 | 0.67684 | 0.62741 | 0.58201 |
| 9 | 0.91434 | 0.83676 | 0.76642 | 0.70259 | 0.64461 | 0.59190 | 0.54393 |
| 10 | 0.90529 | 0.82035 | 0.74409 | 0.67556 | 0.61391 | 0.55839 | 0.50835 |
| 11 | 0.89632 | 0.80426 | 0.72242 | 0.64958 | 0.58468 | 0.52679 | 0.47509 |
| 12 | 0.88745 | 0.78849 | 0.70138 | 0.62460 | 0.55684 | 0.49697 | 0.44401 |
| 13 | 0.87866 | 0.77303 | 0.68095 | 0.60057 | 0.53032 | 0.46884 | 0.41496 |
| 14 | 0.86996 | 0.75788 | 0.66112 | 0.57748 | 0.50507 | 0.44230 | 0.38782 |
| 15 | 0.86135 | 0.74301 | 0.64186 | 0.55526 | 0.48102 | 0.41727 | 0.36245 |
| 16 | 0.85282 | 0.72845 | 0.62317 | 0.53391 | 0.45811 | 0.39365 | 0.33873 |
| 17 | 0.84438 | 0.71416 | 0.60502 | 0.51337 | 0.43630 | 0.37136 | 0.31657 |
| 18 | 0.83602 | 0.70016 | 0.58739 | 0.49363 | 0.41552 | 0.35034 | 0.29586 |
| 19 | 0.82774 | 0.68643 | 0.57029 | 0.47464 | 0.39573 | 0.33051 | 0.27651 |
| 20 | 0.81954 | 0.67297 | 0.55368 | 0.45639 | **0.37689** | 0.31180 | 0.25842 |
| 21 | 0.81143 | 0.65978 | 0.53755 | 0.43883 | 0.35894 | 0.29416 | 0.24151 |
| 22 | 0.80340 | 0.64684 | 0.52189 | 0.42196 | 0.34185 | 0.27751 | 0.22571 |
| 23 | 0.79544 | 0.63416 | 0.50669 | 0.40573 | 0.32557 | 0.26180 | 0.21095 |
| 24 | 0.78757 | 0.62172 | 0.49193 | 0.39012 | 0.31007 | 0.24698 | 0.19715 |
| 25 | 0.77977 | 0.60953 | 0.47761 | 0.37512 | 0.29530 | 0.23300 | 0.18425 |
| 26 | 0.77205 | 0.59758 | 0.46369 | 0.36069 | 0.28124 | 0.21981 | 0.17220 |
| 27 | 0.76440 | 0.58586 | 0.45019 | 0.34682 | 0.26785 | 0.20737 | 0.16093 |
| 28 | 0.75684 | 0.57437 | 0.43708 | 0.33348 | 0.25509 | 0.19563 | 0.15040 |
| 29 | 0.74934 | 0.56311 | 0.42435 | 0.32065 | 0.24295 | 0.18456 | 0.14056 |
| 30 | 0.74192 | 0.55207 | 0.41199 | 0.30832 | 0.23138 | 0.17411 | 0.13137 |
| 31 | 0.73458 | 0.54125 | 0.39999 | 0.29646 | 0.22036 | 0.16425 | 0.12277 |
| 32 | 0.72730 | 0.53063 | 0.38834 | 0.28506 | 0.20987 | 0.15496 | 0.11474 |
| 33 | 0.72010 | 0.52023 | 0.37703 | 0.27409 | 0.19987 | 0.14619 | 0.10723 |
| 34 | 0.71297 | 0.51003 | 0.36604 | 0.26355 | 0.19035 | 0.13791 | 0.10022 |
| 35 | 0.70591 | 0.50003 | 0.35538 | 0.25342 | 0.18129 | 0.13011 | 0.09366 |
| 36 | 0.69892 | 0.49022 | 0.34503 | 0.24367 | 0.17266 | 0.12274 | 0.08754 |
| 37 | 0.69200 | 0.48061 | 0.33498 | 0.23430 | 0.16444 | 0.11579 | 0.08181 |
| 38 | 0.68515 | 0.47119 | 0.32523 | 0.22529 | 0.15661 | 0.10924 | 0.07646 |
| 39 | 0.67837 | 0.46195 | 0.31575 | 0.21662 | 0.14915 | 0.10306 | 0.07146 |
| 40 | 0.67165 | 0.45289 | 0.30656 | 0.20829 | 0.14205 | 0.09722 | 0.06678 |
| 41 | 0.66500 | 0.44401 | 0.29763 | 0.20028 | 0.13528 | 0.09172 | 0.06241 |
| 42 | 0.65842 | 0.43530 | 0.28896 | 0.19257 | 0.12884 | 0.08653 | 0.05833 |
| 43 | 0.65190 | 0.42677 | 0.28054 | 0.18517 | 0.12270 | 0.08163 | 0.05451 |
| 44 | 0.64545 | 0.41840 | 0.27237 | 0.17805 | 0.11686 | 0.07701 | 0.05095 |
| 45 | 0.63905 | 0.41020 | 0.26444 | 0.17120 | 0.11130 | 0.07265 | 0.04761 |

## Exhibit 11.4 Present Value (PV) Factor of a Sum Certain

**The purpose of this table is to determine the present investment needed for a future amount of dollars over a period of time at an assumed interest rate (rate of return).**

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| Years | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your future investment amount. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. This is your present value. |

| Year | 8% | 9% | 10% | 12% | 15% | 20% | 25% |
|---|---|---|---|---|---|---|---|
| 1 | 0.92593 | 0.91743 | 0.90909 | 0.89286 | 0.86957 | 0.83333 | 0.80000 |
| 2 | 0.85734 | 0.84168 | 0.82645 | 0.79719 | 0.75614 | 0.69444 | 0.64000 |
| 3 | 0.79383 | 0.77218 | 0.75131 | 0.71178 | 0.65752 | 0.57870 | 0.51200 |
| 4 | 0.73503 | 0.70843 | 0.68301 | 0.63552 | 0.57175 | 0.48225 | 0.40960 |
| 5 | 0.68058 | 0.64993 | 0.62092 | 0.56743 | 0.49718 | 0.40188 | 0.32768 |
| 6 | 0.63017 | 0.59627 | 0.56447 | 0.50663 | 0.43233 | 0.33490 | 0.26214 |
| 7 | 0.58349 | 0.54703 | 0.51316 | 0.45235 | 0.37594 | 0.27908 | 0.20972 |
| 8 | 0.54027 | 0.50187 | 0.46651 | 0.40388 | 0.32690 | 0.23257 | 0.16777 |
| 9 | 0.50025 | 0.46043 | 0.42410 | 0.36061 | 0.28426 | 0.19381 | 0.13422 |
| 10 | 0.46319 | 0.42241 | 0.38554 | 0.32197 | 0.24718 | 0.16151 | 0.10737 |
| 11 | 0.42888 | 0.38753 | 0.35049 | 0.28748 | 0.21494 | 0.13459 | 0.08590 |
| 12 | 0.39711 | 0.35553 | 0.31863 | 0.25668 | 0.18691 | 0.11216 | 0.06872 |
| 13 | 0.36770 | 0.32618 | 0.28966 | 0.22917 | 0.16253 | 0.09346 | 0.05498 |
| 14 | 0.34046 | 0.29925 | 0.26333 | 0.20462 | 0.14133 | 0.07789 | 0.04398 |
| 15 | 0.31524 | 0.27454 | 0.23939 | 0.18270 | 0.12289 | 0.06491 | 0.03518 |
| 16 | 0.29189 | 0.25187 | 0.21763 | 0.16312 | 0.10686 | 0.05409 | 0.02815 |
| 17 | 0.27027 | 0.23107 | 0.19784 | 0.14564 | 0.09293 | 0.04507 | 0.02252 |
| 18 | 0.25025 | 0.21199 | 0.17986 | 0.13004 | 0.08081 | 0.03756 | 0.01801 |
| 19 | 0.23171 | 0.19449 | 0.16351 | 0.11611 | 0.07027 | 0.03130 | 0.01441 |
| 20 | 0.21455 | 0.17843 | 0.14864 | 0.10367 | 0.06110 | 0.02608 | 0.01153 |
| 21 | 0.19866 | 0.16370 | 0.13513 | 0.09256 | 0.05313 | 0.02174 | 0.00922 |
| 22 | 0.18394 | 0.15018 | 0.12285 | 0.08264 | 0.04620 | 0.01811 | 0.00738 |
| 23 | 0.17032 | 0.13778 | 0.11168 | 0.07379 | 0.04017 | 0.01509 | 0.00590 |
| 24 | 0.15770 | 0.12640 | 0.10153 | 0.06588 | 0.03493 | 0.01258 | 0.00472 |
| 25 | 0.14602 | 0.11597 | 0.09230 | 0.05882 | 0.03038 | 0.01048 | 0.00378 |
| 26 | 0.13520 | 0.10639 | 0.08391 | 0.05252 | 0.02642 | 0.00874 | 0.00302 |
| 27 | 0.12519 | 0.09761 | 0.07628 | 0.04689 | 0.02297 | 0.00728 | 0.00242 |
| 28 | 0.11591 | 0.08955 | 0.06934 | 0.04187 | 0.01997 | 0.00607 | 0.00193 |
| 29 | 0.10733 | 0.08215 | 0.06304 | 0.03738 | 0.01737 | 0.00506 | 0.00155 |
| 30 | 0.09938 | 0.07537 | 0.05731 | 0.03338 | 0.01510 | 0.00421 | 0.00124 |
| 31 | 0.09202 | 0.06915 | 0.05210 | 0.02980 | 0.01313 | 0.00351 | 0.00099 |
| 32 | 0.08520 | 0.06344 | 0.04736 | 0.02661 | 0.01142 | 0.00293 | 0.00079 |
| 33 | 0.07889 | 0.05820 | 0.04306 | 0.02376 | 0.00993 | 0.00244 | 0.00063 |
| 34 | 0.07305 | 0.05339 | 0.03914 | 0.02121 | 0.00864 | 0.00203 | 0.00051 |
| 35 | 0.06763 | 0.04899 | 0.03558 | 0.01894 | 0.00751 | 0.00169 | 0.00041 |
| 36 | 0.06262 | 0.04494 | 0.03235 | 0.01691 | 0.00653 | 0.00141 | 0.00032 |
| 37 | 0.05799 | 0.04123 | 0.02941 | 0.01510 | 0.00568 | 0.00118 | 0.00026 |
| 38 | 0.05369 | 0.03783 | 0.02673 | 0.01348 | 0.00494 | 0.00098 | 0.00021 |
| 39 | 0.04971 | 0.03470 | 0.02430 | 0.01204 | 0.00429 | 0.00082 | 0.00017 |
| 40 | 0.04603 | 0.03184 | 0.02209 | 0.01075 | 0.00373 | 0.00068 | 0.00013 |
| 41 | 0.04262 | 0.02921 | 0.02009 | 0.00960 | 0.00325 | 0.00057 | 0.00011 |
| 42 | 0.03946 | 0.02680 | 0.01826 | 0.00857 | 0.00282 | 0.00047 | 0.00009 |
| 43 | 0.03654 | 0.02458 | 0.01660 | 0.00765 | 0.00245 | 0.00039 | 0.00007 |
| 44 | 0.03383 | 0.02255 | 0.01509 | 0.00683 | 0.00213 | 0.00033 | 0.00005 |
| 45 | 0.03133 | 0.02069 | 0.01372 | 0.00610 | 0.00186 | 0.00027 | 0.00004 |

## Exhibit 11.5 Present Value (PV) of an Annuity Factor

The purpose of this table is to determine the present investment needed to have equal future annual cash receipts over a period of time at an assumed interest rate (rate of return).

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| Years | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your annual cash receipts you want to receive. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. You need to invest this amount. |

| Year | 1% | 2% | 3% | 4% | 5% | 6% | 7% |
|---|---|---|---|---|---|---|---|
| 1 | 0.99010 | 0.98039 | 0.97087 | 0.96154 | 0.95238 | 0.94340 | 0.93458 |
| 2 | 1.97040 | 1.94156 | 1.91347 | 1.88609 | 1.85941 | 1.83339 | 1.80802 |
| 3 | 2.94099 | 2.88388 | 2.82861 | 2.77509 | 2.72325 | 2.67301 | 2.62432 |
| 4 | 3.90197 | 3.80773 | 3.71710 | 3.62990 | 3.54595 | 3.46511 | 3.38721 |
| 5 | 4.85343 | 4.71346 | 4.57971 | 4.45182 | 4.32948 | 4.21236 | 4.10020 |
| 6 | 5.79548 | 5.60143 | 5.41719 | 5.24214 | 5.07569 | 4.91732 | 4.76654 |
| 7 | 6.72819 | 6.47199 | 6.23028 | 6.00205 | 5.78637 | 5.58238 | 5.38929 |
| 8 | 7.65168 | 7.32548 | 7.01969 | 6.73274 | 6.46321 | 6.20979 | 5.97130 |
| 9 | 8.56602 | 8.16224 | 7.78611 | 7.43533 | 7.10782 | 6.80169 | 6.51523 |
| 10 | 9.47130 | 8.98259 | 8.53020 | 8.11090 | 7.72173 | 7.36009 | 7.02358 |
| 11 | 10.36763 | 9.78685 | 9.25262 | 8.76048 | 8.30641 | 7.88687 | 7.49867 |
| 12 | 11.25508 | 10.57534 | 9.95400 | 9.38507 | 8.86325 | 8.38384 | 7.94269 |
| 13 | 12.13374 | 11.34837 | 10.63496 | 9.98565 | 9.39357 | 8.85268 | 8.35765 |
| 14 | 13.00370 | 12.10625 | 11.29607 | 10.56312 | 9.89864 | 9.29498 | 8.74547 |
| 15 | 13.86505 | 12.84926 | 11.93794 | 11.11839 | 10.37966 | 9.71225 | 9.10791 |
| 16 | 14.71787 | 13.57771 | 12.56110 | 11.65230 | 10.83777 | 10.10590 | 9.44665 |
| 17 | 15.56225 | 14.29187 | 13.16612 | 12.16567 | 11.27407 | 10.47726 | 9.76322 |
| 18 | 16.39827 | 14.99203 | 13.75351 | 12.65930 | 11.68959 | 10.82760 | 10.05909 |
| 19 | 17.22601 | 15.67846 | 14.32380 | 13.13394 | 12.08532 | 11.15812 | 10.33560 |
| 20 | 18.04555 | 16.35143 | 14.87747 | 13.59033 | 12.46221 | 11.46992 | 10.59401 |
| 21 | 18.85698 | 17.01121 | 15.41502 | 14.02916 | 12.82115 | 11.76408 | 10.83553 |
| 22 | 19.66038 | 17.65805 | 15.93692 | 14.45112 | 13.16300 | 12.04158 | 11.06124 |
| 23 | 20.45582 | 18.29220 | 16.44361 | 14.85684 | 13.48857 | 12.30338 | 11.27219 |
| 24 | 21.24339 | 18.91393 | 16.93554 | 15.24696 | 13.79864 | 12.55036 | 11.46933 |
| 25 | 22.02316 | 19.52346 | 17.41315 | **15.62208** | 14.09394 | 12.78336 | 11.65358 |
| 26 | 22.79520 | 20.12104 | 17.87684 | 15.98277 | 14.37519 | 13.00317 | 11.82578 |
| 27 | 23.55961 | 20.70690 | 18.32703 | 16.32959 | 14.64303 | 13.21053 | 11.98671 |
| 28 | 24.31644 | 21.28127 | 18.76411 | 16.66306 | 14.89813 | 13.40616 | 12.13711 |
| 29 | 25.06579 | 21.84438 | 19.18845 | 16.98371 | 15.14107 | 13.59072 | 12.27767 |
| 30 | 25.80771 | 22.39646 | 19.60044 | 17.29203 | 15.37245 | 13.76483 | 12.40904 |
| 31 | 26.54229 | 22.93770 | 20.00043 | 17.58849 | 15.59281 | 13.92909 | 12.53181 |
| 32 | 27.26959 | 23.46833 | 20.38877 | 17.87355 | 15.80268 | 14.08404 | 12.64656 |
| 33 | 27.98969 | 23.98856 | 20.76579 | 18.14765 | 16.00255 | 14.23023 | 12.75379 |
| 34 | 28.70267 | 24.49859 | 21.13184 | 18.41120 | 16.19290 | 14.36814 | 12.85401 |
| 35 | 29.40858 | 24.99862 | 21.48722 | 18.66461 | 16.37419 | 14.49825 | 12.94767 |
| 36 | 30.10751 | 25.48884 | 21.83225 | 18.90828 | 16.54685 | 14.62099 | 13.03521 |
| 37 | 30.79951 | 25.96945 | 22.16724 | 19.14258 | 16.71129 | 14.73678 | 13.11702 |
| 38 | 31.48466 | 26.44064 | 22.49246 | 19.36786 | 16.86789 | 14.84602 | 13.19347 |
| 39 | 32.16303 | 26.90259 | 22.80822 | 19.58448 | 17.01704 | 14.94907 | 13.26493 |
| 40 | 32.83469 | 27.35548 | 23.11477 | 19.79277 | 17.15909 | 15.04630 | 13.33171 |
| 41 | 33.49969 | 27.79949 | 23.41240 | 19.99305 | 17.29437 | 15.13802 | 13.39412 |
| 42 | 34.15811 | 28.23479 | 23.70136 | 20.18563 | 17.42321 | 15.22454 | 13.45245 |
| 43 | 34.81001 | 28.66156 | 23.98190 | 20.37079 | 17.54591 | 15.30617 | 13.50696 |
| 44 | 35.45545 | 29.07996 | 24.25427 | 20.54884 | 17.66277 | 15.38318 | 13.55791 |
| 45 | 36.09451 | 29.49016 | 24.51871 | 20.72004 | 17.77407 | 15.45583 | 13.60552 |

## Exhibit 11.5 Present Value (PV) of an Annuity Factor

The purpose of this table is to determine the present investment needed to have equal future annual cash receipts over a period of time at an assumed interest rate (rate of return).

| Insert | | Your Calculation |
|---|---|---|
| % | Step 1 | Insert your expected annual return on your investment. |
| Years | Step 2 | Insert the amount of years of your investment. |
| | Step 3 | From the table identify correct interest column and insert result for row that has correct number of years and insert the factor at left. |
| $ | Step 4 | Insert your annual cash receipts you want to receive. |
| $ | Step 5 | Multiply factor in step 3 times step 4 amount. You need to invest this amount. |

| Year | 8% | 9% | 10% | 12% | 15% | 20% | 25% |
|---|---|---|---|---|---|---|---|
| 1 | 0.92593 | 0.91743 | 0.90909 | 0.89286 | 0.86957 | 0.83333 | 0.80000 |
| 2 | 1.78326 | 1.75911 | 1.73554 | 1.69005 | 1.62571 | 1.52778 | 1.44000 |
| 3 | 2.57710 | 2.53129 | 2.48685 | 2.40183 | 2.28323 | 2.10648 | 1.95200 |
| 4 | 3.31213 | 3.23972 | 3.16987 | 3.03735 | 2.85498 | 2.58873 | 2.36160 |
| 5 | 3.99271 | 3.88965 | 3.79079 | 3.60478 | 3.35216 | 2.99061 | 2.68928 |
| 6 | 4.62288 | 4.48592 | 4.35526 | 4.11141 | 3.78448 | 3.32551 | 2.95142 |
| 7 | 5.20637 | 5.03295 | 4.86842 | 4.56376 | 4.16042 | 3.60459 | 3.16114 |
| 8 | 5.74664 | 5.53482 | 5.33493 | 4.96764 | 4.48732 | 3.83716 | 3.32891 |
| 9 | 6.24689 | 5.99525 | 5.75902 | 5.32825 | 4.77158 | 4.03097 | 3.46313 |
| 10 | 6.71008 | 6.41766 | 6.14457 | 5.65022 | 5.01877 | 4.19247 | 3.57050 |
| 11 | 7.13896 | 6.80519 | 6.49506 | 5.93770 | 5.23371 | 4.32706 | 3.65640 |
| 12 | 7.53608 | 7.16073 | 6.81369 | 6.19437 | 5.42062 | 4.43922 | 3.72512 |
| 13 | 7.90378 | 7.48690 | 7.10336 | 6.42355 | 5.58315 | 4.53268 | 3.78010 |
| 14 | 8.24424 | 7.78615 | 7.36669 | 6.62817 | 5.72448 | 4.61057 | 3.82408 |
| 15 | 8.55948 | 8.06069 | 7.60608 | 6.81086 | 5.84737 | 4.67547 | 3.85926 |
| 16 | 8.85137 | 8.31256 | 7.82371 | 6.97399 | 5.95423 | 4.72956 | 3.88741 |
| 17 | 9.12164 | 8.54363 | 8.02155 | 7.11963 | 6.04716 | 4.77463 | 3.90993 |
| 18 | 9.37189 | 8.75563 | 8.20141 | 7.24967 | 6.12797 | 4.81219 | 3.92794 |
| 19 | 9.60360 | 8.95011 | 8.36492 | 7.36578 | 6.19823 | 4.84350 | 3.94235 |
| 20 | 9.81815 | 9.12855 | 8.51356 | 7.46944 | 6.25933 | 4.86958 | 3.95388 |
| 21 | 10.01680 | 9.29224 | 8.64869 | 7.56200 | 6.31246 | 4.89132 | 3.96311 |
| 22 | 10.20074 | 9.44243 | 8.77154 | 7.64465 | 6.35866 | 4.90943 | 3.97049 |
| 23 | 10.37106 | 9.58021 | 8.88322 | 7.71843 | 6.39884 | 4.92453 | 3.97639 |
| 24 | 10.52876 | 9.70661 | 8.98474 | 7.78432 | 6.43377 | 4.93710 | 3.98111 |
| 25 | 10.67478 | 9.82258 | **9.07704** | 7.84314 | 6.46415 | 4.94759 | 3.98489 |
| 26 | 10.80998 | 9.92897 | 9.16095 | 7.89566 | 6.49056 | 4.95632 | 3.98791 |
| 27 | 10.93516 | 10.02658 | 9.23722 | 7.94255 | 6.51353 | 4.96360 | 3.99033 |
| 28 | 11.05108 | 10.11613 | 9.30657 | 7.98442 | 6.53351 | 4.96967 | 3.99226 |
| 29 | 11.15841 | 10.19828 | 9.36961 | 8.02181 | 6.55088 | 4.97472 | 3.99381 |
| 30 | 11.25778 | 10.27365 | 9.42691 | 8.05518 | 6.56598 | 4.97894 | 3.99505 |
| 31 | 11.34980 | 10.34280 | 9.47901 | 8.08499 | 6.57911 | 4.98245 | 3.99604 |
| 32 | 11.43500 | 10.40624 | 9.52638 | 8.11159 | 6.59053 | 4.98537 | 3.99683 |
| 33 | 11.51389 | 10.46444 | 9.56943 | 8.13535 | 6.60046 | 4.98781 | 3.99746 |
| 34 | 11.58693 | 10.51784 | 9.60857 | 8.15656 | 6.60910 | 4.98984 | 3.99797 |
| 35 | 11.65457 | 10.56682 | 9.64416 | 8.17550 | 6.61661 | 4.99154 | 3.99838 |
| 36 | 11.71719 | 10.61176 | 9.67651 | 8.19241 | 6.62314 | 4.99295 | 3.99870 |
| 37 | 11.77518 | 10.65299 | 9.70592 | 8.20751 | 6.62881 | 4.99412 | 3.99896 |
| 38 | 11.82887 | 10.69082 | 9.73265 | 8.22099 | 6.63375 | 4.99510 | 3.99917 |
| 39 | 11.87858 | 10.72552 | 9.75696 | 8.23303 | 6.63805 | 4.99592 | 3.99934 |
| 40 | 11.92461 | 10.75736 | 9.77905 | 8.24378 | 6.64178 | 4.99660 | 3.99947 |
| 41 | 11.96723 | 10.78657 | 9.79914 | 8.25337 | 6.64502 | 4.99717 | 3.99957 |
| 42 | 12.00670 | 10.81337 | 9.81740 | 8.26194 | 6.64785 | 4.99764 | 3.99966 |
| 43 | 12.04324 | 10.83795 | 9.83400 | 8.26959 | 6.65030 | 4.99803 | 3.99973 |
| 44 | 12.07707 | 10.86051 | 9.84909 | 8.27642 | 6.65244 | 4.99836 | 3.99978 |
| 45 | 12.10840 | 10.88120 | 9.86281 | 8.28252 | 6.65429 | 4.99863 | 3.99983 |

### *Summing Up*

Having a solid understanding of the tables in this chapter is essential to calculating and budgeting your way to financial independence. With the time value of money and the power of compounding, you can map out your own formula to financial success. These tables will provide you with the answers to the following essential questions:

1. How much will my current investment account be worth (see Exhibit 11.2) based on an assumed rate of return at a particular point in time (your *point X*)?
2. If I invest a fixed amount annually, how much will it be worth (see Exhibit 11.3) based on assumed rate of return at a particular point in time (your *point X*)?
3. How much will I need to invest today (see Exhibit 11.4) based on an assumed rate of return so that I can have a certain amount of dollars at a future date (your *point X*)?
4. How much will I need to accumulate (see Exhibit 11.5) in my investment account based on an assumed rate of return so that I can receive an annual annuity payment starting at a particular point in time (*point X*) for a fixed number of years?

The answers to these four essential questions are found in Exhibits 11.2 through 11.5. I recommend you reread this section until you have a full understanding of how these numbers work. Also use a number of "what-if" scenarios and test these tables to answer these questions for your particular facts and circumstances. These tables and calculations are an essential tool in Chapter 8, Planning for Retirement, and, of course, in planning and determining your very own financial independence—*point X*.

# Appendix A

## Selecting a Trusted Advisor

Perhaps one of the most important decisions you will need to make in your pursuit to financial independence is the selection of a trusted advisor. This trusted advisor will be your life coach, who will be there for you during good times and bad times and whose primary goal will be to help you achieve your long-term financial objectives. This trusted advisor should be a financial planner who can analyze your financial status and assist you in setting up and implementing a financial program to achieve your ultimate goal of financial independence. Developing a close relationship is critical to your overall success because your advisor should understand you and have a clear picture of your financial goals and dreams. This trusted advisor and his or her team must be able to provide you with comprehensive wealth management services that include financial planning, tax preparation and planning, investment advising, risk management, education planning, retirement planning, and estate planning services.

The best place to start is by asking your friends and family if they can recommend a trusted advisor with whom they have worked well. Before meeting with financial planners, you should do some research about their backgrounds, including their education and other relevant credentials. A good place to start would be visiting their websites, and then the licensing board website for whatever credentials they hold.

*Financial Independence (Getting to Point X) : An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

You should meet and interview a few financial planners who can meet your needs. When meeting with them, consider the following 10 questions:

1. Do you have confidence in the person who referred you to this advisor?
2. What education and credentials does this advisor hold to make him or her qualified to advise you? (Read through the qualifications of trusted advisors listed below and decide what is most important to you.)
3. What is the compensation model for the advice and service: fee-based, hourly, or commission? (Fee-based is a percentage of your money under management; hourly is based on time charges; and commission is transaction based.)
4. What are the financial advisor's areas of expertise and does this line up well with your needs? (Wealth management issues go hand in hand with the areas of expertise.)
5. What standard of care will this advisor be held to, fiduciary or a suitability standard? (These terms are described in the next section.)
6. What is the extent of services that will be provided: is it transactional or is it truly a trusted advisor relationship? (*Transactional* means compensation is based on commissions.)
7. Is the financial decision-making customized to you or does the advisor take a one-size-fits-all approach? One-size-fits-all is not appropriate. An 18-year-old person's goals and risk tolerance are much different from an 80-year-old retiree's.
8. Does the financial advisor provide tax advisory services such as tax planning and preparation that are integrated into your overall financial planning?
9. What is the organizational structure of the advisor's firm: will you be dealing directly with the same advisor or a junior member of the team?
10. What is the financial advisor's philosophy and approach to handling risk: Does this advisor make you comfortable?

There are more than 100 designations, or credentials, in the financial service industry, with many more being created each year. It is very important to understand the difference between these designations so that you can narrow down your search to those who are the most qualified and suitable to meet your needs. In this

appendix, I provide you with a description of the designations that in my opinion are most respected and recognized in the financial industry. I have subdivided these into the following categories: financial planners, tax advisors, investment advisors, insurance advisors, and attorneys.

## The Difference between Suitability and Fiduciary Standards

The *suitability standard* requires a client to receive recommendations that are suitable, or appropriate, to the individual's particular circumstances. Under the suitability standard, financial professionals are not required to put the client's best interests first. Financial professionals are also not obligated to disclose conflicts of interest. This standard is less rigorous than the *fiduciary standard*, which requires financial professionals to act in the best interests of their clients. They are required to disclose conflicts of interest. The fiduciary standard also requires that financial professionals do not maximize their own compensation ahead of their clients' best interests.

The fiduciary standard only applies to certain financial professionals and industries. There is a big movement for securities sales people (such as financial advisors and insurance agents) to be required to be subject to this higher standard. When evaluating who you should rely on to guide you through your life journey of financial independence, selecting the proper trusted advisor is critically important. When evaluating your choices of advisors, you should ask to what standard they are being held.

## Financial Planners

The title *financial planner* frequently refers to a financial advisor who develops and implements a comprehensive wealth-management plan based on your needs analysis, which includes your long-term financial goals, together with issues pertaining to investments, estate planning, tax planning, risk management, education planning, and debt management. Many financial service providers refer to themselves as *financial planners,* but quite often, they do not consider a client's overall financial situation. A true financial planner should address all of these issues because they are interrelated, and quite often, how you deal with one will have a direct effect on the others. When choosing a financial planner, make sure you are receiving comprehensive service and not simply being sold on one particular product or service.

#### *Certified Financial Planner™ (CFP®)*

Certified Financial Planner™ (CFP®) is perhaps the most widely recognized credential in the financial planning industry. These advisors must pass a comprehensive financial planning exam and the rigorous certification requirements that are administered by the CFP board. Upon passing this painstaking two-day exam, prospective CFP® candidates must also complete at least three years of professional experience and earn a bachelor's degree in order to obtain the CFP® designation. The academic requirements for certification include courses covering insurance, estate, retirement, education, tax, and investment planning, as well as ethics and the financial planning process. CFPs must abide by a code of ethics that includes adhering to a fiduciary standard as well as complying with specific practice principles. Most Certified Financial Planners™ are also investment advisors, but not all investment advisors are Certified Financial Planners™. Financial planners may be fee-only or fee-based.

#### *Chartered Financial Consultant® (ChFC®)*

The Chartered Financial Consultant® (ChFC®) designation was originally created by the **life insurance** industry. The ChFC® designation requires the same core courses as the CFP® designation, plus two additional elective courses that tend to focus on general **financial planning** issues. There is no comprehensive board exam required for this credential. The ChFC® designations are granted by The American College. Those who earn this designation are considered knowledgeable in financial planning matters and are considered to have the ability to provide appropriate financial advice.

To be eligible for this designation, the applicant must already have a minimum of three years of relevant work experience in the financial service industry. It is also highly recommended that applicants have a degree connected to finance or business before applying, because that will make the course of study easier to master.

### Tax Advisors

Tax advisors include professionals licensed or authorized by their state and/or the Internal Revenue Service, who have advanced training and are knowledgeable as to the tax law. They are retained in order to legally minimize the client's tax burden and assist them in being compliant with the law.

### *Certified Public Accountant (CPA)*

The Certified Public Accountant (CPA) designation is the oldest and most respected financial credential in the United States. This designation has long been widely recognized by the public as the definitive credential of tax expertise. CPA requirements vary by state, but generally a CPA needs 150 semester hours of undergraduate level courses that cover accounting, auditing, and business law, plus a bachelor's degree or higher in order to sit for the 14-hour, two-day exam. This comprehensive exam covers accounting, auditing, bookkeeping, taxes, business law, ethics, and more.

A CPA is always an accountant, but not all accountants are CPAs. CPAs handle a variety of jobs and tasks. They offer income tax preparation and advice for a range of clients including individuals, small businesses, and corporations. To maintain their license, every three years CPAs must take 120 hours of continuing education courses in order to stay abreast of changes in their profession.

Many states have a second tier of accountant qualification, usually entitled Public Accountant (PA) or Licensed Public Accountant (LPA). However the majority of states have closed the designation of PA to new entrants, with only about 10 states continuing to offer this designation.

Certain CPAs who are interested in specializing in financial planning can also obtain a Personal Financial Specialist (PFS) designation, which is offered by The American Institute of Certified Public Accountants (AICPA). To qualify, CPAs must be members in good standing and complete the additional educational and testing requirements.

### *Enrolled Agent (EA)*

EAs provide a very important service to the general public. An EA is an individual designation provided by the IRS. It is one of the few designations that signifies a concentration of proficiency in the field of taxation. Unlike CPAs, who may or may not provide tax services, all EAs specialize in taxation.

The specialized EA exam administered by the IRS is broken down into four parts of three hours each over a two-day testing period. This exam covers personal, estate, and corporate taxes, as well as ethics and IRS regulations, but does not include accounting, auditing, bookkeeping, or business law.

EA status is awarded by the IRS to individuals who meet its requirements. Individuals who earn this designation must adhere to ethical standards and are required to complete 72 hours of continuing education credits every three years to maintain this status.

EAs are granted the same privilege as attorneys and CPAs, who have the authority to represent clients before the IRS, with a properly executed IRS Form 2848 Power of Attorney and Declaration of Representative.

## Investment Advisors

An investment advisor is defined by the Investment Advisers Act of 1940 as a "person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications."

In 2010, the Dodd-Frank Act amended certain provisions of the Investment Advisory Act of 1940 by delegating to the states responsibility over certain investment advisors who have under $100 million of assets under management. This amendment to the Act increased the threshold above which all investment advisors must be registered with the Securities and Exchange Commission (SEC) from $30 million to $100 million under management. This means that state securities regulators now have the primary authority over a substantial number of investment advisors who were previously subject to primary regulation by the SEC.

### *Registered Investment Advisor (RIA)*

Registered Investment Advisors (RIAs) are either registered with the SEC or the state securities agency in the state where they have their principal place of business. Investment advisors are prohibited from providing advice known to be deceitful or fraudulent. They are also prohibited from acting as a principal on their own accounts by buying and selling securities between themselves and their clients. Investment advisors have a fiduciary duty to their clients, which holds them to a much higher standard. This means they have a fundamental obligation to provide not only suitable investment advice but they are always obligated to act in the client's best interests and not their own.

Most investment advisors charge either a flat fee for their services or a percentage of the assets under management. On average, fee-based advisers charge between 1 and 1.5 percent of the assets

under management per year for providing ongoing investment advisory services, and they do not charge commissions. This typically will limit potential conflicts of interest between the investment advisors and their clients. The advisor will generally get paid more as the client's asset base grows from the advisor's recommendations, because the advisor's fees are based on assets under management. This is a significant difference when compared to transactional compensation (commissions) as is usually the case with a stock broker.

RIAs are normally established by individuals or small investment firms that are independent of the larger financial services firms. They are also commonly known as financial advisors, asset managers, money managers, portfolio managers, investment counsellors, or investment managers.

The SEC and State Security Regulators do not make any recommendation or endorsement of any investment advisor; in fact, if one is registered, it simply means that the investment advisor has fulfilled all of the necessary requirements for registration.

#### *Chartered Financial Analyst® (CFA®)*

The chartered financial analyst® (CFA®) designation is considered to be one of the most elite and difficult credentials to obtain in the investment management industry, which focuses on financial analyses. The academic requirements and standards for this designation are second only to that of a CPA. This designation requires three years of coursework that covers a range of topics and disciplines such as technical and fundamental analysis, financial accounting, and portfolio theory and analysis. Those who earn this designation frequently become portfolio managers or analysts for a variety of financial institutions.

#### *Investment Advisory Representative (IAR)*

Individuals who work for investment advisory companies and whose main responsibility is to provide investment related advice are referred to as investment advisory representatives (IARs). IARs are only permitted to provide advice on topics on which they have successfully passed the appropriate examinations and are properly licensed.

An IAR is also required to be registered with the appropriate state authorities. Many IARs hold either the CFP® or ChFC® designations, to increase their credibility and financial knowledge.

#### *Stockbroker*

A stockbroker is a legal term that refers to an investment professional who buys and sells securities on behalf of clients. Stockbrokers are regulated by state securities commissioners and by the SEC. They are also subject to oversight by the Financial Industry Regulatory Authority (FINRA), which is an industry self-regulatory body. Stockbrokers must recommend "suitable" investments, but they are generally not required to have a fiduciary duty to their clients. Stockbrokers are also legally referred to as *registered representatives*. They may also call themselves *financial advisors, financial consultants,* or *investment consultants.*

### Insurance Advisors

Before we get into the specialized designations for insurance advisors, it is important to understand the difference between an insurance agent and an insurance broker.

#### *Insurance Agents*

Insurance agents are insurance professionals who serve as a liaison between an insurance company and the insured. Insurance agents have an administrative responsibility, which relates to the timely and accurate processing of forms, premium payments, and the related paperwork. An agent does not have a duty or responsibility to conduct a thorough examination of your finances or to make certain that you have been provided proper coverage. As the insured person, it is *your* responsibility to make sure you have purchased the necessary coverage.

Insurance agents can be captive or independent. A captive agent is an agent who works for only one company and, therefore, sells policies provided by only one insurance company. In contrast, an independent agent is one who works for many insurance providers and can provide a comparison of different insurance policies and providers.

#### *Insurance Brokers*

An insurance broker is required to have a broker's license, which normally means the broker will have additional educational qualifications and broader experience than an insurance agent. Brokers typically provide a variety of different insurance products to meet

your needs. Most states require insurance brokers to have a higher duty of responsibility to their clients than an agent. Brokers have the duty to analyze your particular situation and secure the proper and adequate coverage that you may require. Typically, brokers will charge an administrative fee or the premium payments may be higher to reflect this higher level of service.

#### *Chartered Life Underwriter® (CLU®)*

The Chartered Life Underwriter® (CLU®) designation was originally created by the life insurance industry. This is a professional designation for individuals who wish to specialize in life insurance and estate planning. Individuals must complete five core courses and three elective courses, and successfully pass all eight two-hour, 100-question examinations to receive the designation. The courses required to earn this professional designation are offered through The American College. There is no comprehensive board exam required for this credential.

#### *Chartered Property Casualty Underwriter® (CPCU®)*

The Chartered Property Casualty Underwriter® (CPCU®) is respected as the premier designation in property-casualty insurance. This designation is offered by the Insurance Institute of America. This program provides a broad understanding of the property-casualty insurance industry and focuses on the legal, financial, and operational aspect of risk management and insurance. This designation requires the completion of eight courses of intensive academic study, but as with the CLU and the ChFC, there is no comprehensive board examination required.

### Attorneys

To become a lawyer, you must have an undergraduate degree and then successfully complete three years of law school to earn a law degree. After law school, generally you must pass a bar examination in the state where you will be practicing law.

#### *Tax Attorney*

Tax attorneys are lawyers who have additional advanced education and training in tax law. Tax attorneys typically get involved with high-level tax matters, which may require a legal opinion or legal

representation with the IRS or tax courts. Tax attorneys can negotiate settlements on your behalf and are trained to analyze complicated tax matters and can formulate a plan for resolving your problem and settling your case. Tax attorneys are most qualified to:

- Represent someone in lawsuits with the IRS.
- Represent someone in criminal IRS investigations.
- Represent someone accused of tax fraud against a taxpayer.
- Represent someone in income tax audits and appeals before the IRS.
- File estate-related tax returns and representation in estate tax audits.
- Assist with business start-ups, mergers, and acquisitions that involve complex structures.
- Handle employee payroll tax issues and disputes.
- Advise on international business transactions and related tax treaties.

#### *Estate and Elder Law Attorneys*

An attorney who specializes in estate and elder law typically has an expertise in trust, estate, and/or Medicaid planning. These attorneys will work very closely with financial planners and will draft and execute the legal documents required as part of the overall financial planning process. These attorneys are experts in drafting wills, health care proxies, power of attorneys, and trust documents. Many of these attorneys also handle transactions that involve a family business and real estate.

Some of these attorneys refer to themselves as *Elder Law Attorneys* and will have an added level of expertise in Medicaid planning for assisted-living or nursing-home care. They can provide an asset protection plan for clients who may need long-term care. They may also represent individuals in both contested and uncontested guardianship actions.

# Appendix B

## 101 Ways to Save $20 or More per Week

Here is a list of 101 ways you could save $20 or more. That may not sound like a lot of money to you, but watch how that $20 can grow:

- If you tuck away that extra $20 into a savings account every week, at the end of the year, *you will have $1,040.*
- If you are 30 years old and invest that additional $1,040 for 35 years (until you are 65) at 8 percent rate of return, *you will have $179,209.*
- If you are able to save $20 or more per day ($7,280 per year) for 35 years at an 8 percent rate of return, *you will have $1,254,466.*[1]

That is pretty astonishing; that as little as $20 per day has the potential of accumulating to more than $1 million over 35 years. With that said, becoming a millionaire is within almost any hard-working American's reach. All you need is the desire, willingness, discipline, and information provided throughout this book to help get you there.

Working together with your entire family, you could easily adopt several of these savings strategies, allowing you to set aside

[1]The rates of return shown above are purely hypothetical and do not represent the performance of any individual investment or portfolio of investments. They are for illustrative purposes only and should not be used to predict future product performance. Specific rates of return, especially for extended time periods, will vary over time. There is also a higher degree of risk associated with investments that offer the potential for higher rates of return. You should consult with your representative before making any investment decision.

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as much as $20 or more *per day*. Your family finances should be discussed and shared with your entire family so that a cooperative commitment to financial responsibility and ultimately financial independence can be achieved.

Go to www.finance.yahoo.com/calculator, scroll down to "Saving & Spending," and click on "How much should I save to reach my goal?" to determine just how quickly and easily you can accumulate a million dollars or more based on an assumed number of years, rate of return, and dollar amount to be set aside each year. You could also use Exhibit 11.3, "Future Value (FV) on an Annuity Factor," to calculate this amount.

In Chapter 3, I showed you how to prepare your own Statement of Cash Flow and then to analyze this statement with your family to improve and increase your discretionary cash flow. The additional cash flow provided through these cost-saving strategies should be added to your investment assets, which will lead you to financial independence.

The following is a list of 101 basic money-saving tips that will help you find the extra money needed to start a serious savings plan. These recommendations have been listed in the same order as your Statement of Cash Flow, shown as Exhibit 3.4 in Chapter 3.

**Housing**

1. Cut your cable TV costs. Drop premium TV channels. Switch to basic cable, join Netflix and Hulu.
2. Package your telephone bill with your cell phone, Internet, and your cable TV.
3. If you have a cell phone and rarely use your landline, consider getting rid of the landline.
4. If you rely on your landline at home or at work and use your cell phone rarely, check out pay-per-use cell phones.
5. Make sure you are getting the best package deal from your telephone provider. Contact your provider and discuss the most economical telephone plan for you and your family.
6. Refill your cleaning product spray bottles with a less expensive refill, instead of buying another more expensive spray bottle.
7. Buy generic or store-brand products.
8. Clean your house yourself. If you must have a cleaning person, consider cutting it down to every other week or once a month.

9. Learn to do simple home repairs yourself such as shampooing rugs, declogging a sink, and mowing your lawn. Try to avoid calling expensive plumbers, gardeners, and handymen, if possible.
10. Reduce your heat and air-conditioning costs by using a programmable thermostat to minimize your utility use and cost.
11. Replace incandescent light bulbs with compact fluorescent bulbs (CPLs). These use more than 70 percent less energy and last much longer, which will save you money on the cost of light bulbs and on your electricity bill.
12. Never let the hot water run in the sink or shower unless you are actually using it, and try to cut your time in the shower by half to significantly reduce your hot water use and cost.
13. Ensure that your home—especially your attic—is sufficiently insulated. If the insulation in your attic is less than 6 inches thick, you are under insulated. Insulation of 12 inches thick can lower your heating and cooling costs by 25 percent in a year.
14. Compare the many different home insurance policies and find the one that is right for you. Some websites, such as www.RateSupermarket.ca, will make it easier for you to choose the insurance company that best fits your needs.
15. Install an alarm system in your home: With monthly monitoring, this will save you more on your home insurance premiums.
16. Taking out higher deductibles on your insurance policies will decrease your insurance premiums.
17. Ask your insurance agent for money-saving tips on your premiums.
18. Smoking can increase your home insurance premium because of the increased risk of house fires caused by careless smoking. This is another great reason to quit smoking.
19. When you leave a room in your house, turn off the light.
20. Installing ceiling fans can also help save money by using less air conditioning.
21. Clean out the coils in your refrigerator every six months to keep it running efficiently. Having only one refrigerator in your home will cut energy costs as well.
22. You can save up to 14 percent or more on your energy bill by upgrading to a tankless or solar water heater.
23. Buy a home that is affordable to prevent going into debt.

24. If you refinance your home mortgage, you may be able to reduce your interest cost as well as the term of the loan.
25. Reduce your loan-to-value (LTV) ratio by paying down your principal, which may eliminate the need for private mortgage insurance (PMI); at the same time, you may qualify for a lower rate on your home mortgage.

**Transportation**

26. If you drive to work, take public transportation or car pool.
27. Also inquire about car pools to school and extracurricular activities for your children.
28. Find the least expensive gas stations in your neighborhood, and get into the habit of gassing up there.
29. Read your automobile owner's manual. If your car can run on regular unleaded gas, then stop paying high prices for premium gas.
30. Avoid driving over 55 miles per hour to save gas.
31. Having a good driving record can help save you money on insurance premiums. Always be alert whenever you are driving and be sure to never drink and drive.
32. You can also save money on your auto premium by qualifying for antitheft, multicar, good student, and low mileage discounts, to name a few.
33. Wash your own car. You can save anywhere from $5 to $30 on an expensive car wash and you can usually do it just as well, if not better, on your own.
34. Buying a used car can be much less expensive than a car that is brand new. The idea of buying used items also apply to many other areas as well.
35. Cleaning your car's air filter when you change the oil can save you money by improving your gas mileage.
36. Ensure you have the right amount of air pressure in your tires to improve gas mileage.

**Family Risk Management**

37. Buy term life insurance when you are young. It is better to get as much protection as you can at a younger age when you are still healthy and the price will be locked in at a lower rate.
38. Ensure that you choose the proper length of term life insurance coverage that best suits your needs.

39. Before getting a life insurance policy, check with your employer's human resources department to find out if your company offers this coverage to employees. Companies typically get these policies at a much cheaper rate than an individual can.
40. Unfortunately, insurance companies take into account your physical health. Therefore, people who smoke, have high cholesterol levels, have high blood pressure, are overweight, and have other problems (including depression) will usually have higher insurance premiums than a person who is in good physical shape and health. Improve you health to lower your premium costs.
41. Sit down with your family and plan your goals. Save money by planning which expenses are necessary and unnecessary. (Needs vs. wants.)

**Food**

42. Give up the expensive $4.00 designer coffee you buy every morning on your way to work. Instead, pick up coffee at a less expensive coffee shop for $1.25—or better yet, bring a thermos of coffee from home.
43. Brown-bag your lunch—and your kids' lunches, too.
44. When possible, buy meat, vegetables, pasta, and other ingredients in bulk, make casseroles and stews, and then freeze unused portions.
45. Use leftovers for tomorrow's lunch or reheat for the next day's dinner.
46. Buy groceries and other household items in bulk from stores such as Sam's Club and Costco.
47. Cut up your vegetables yourself instead of buying them precut.
48. Most major grocery stores and drugstores offer rewards cards that make you eligible for their sales, special discounts, and rewards. Take advantage of these offers.
49. Some stores even allow you to earn points with every purchase you make. Once a month or so, you will be able to cash in the points for gift certificates at the store.
50. Find dual-purpose rewards cards. Many grocery stores (such as Winn-Dixie, Tom Thumb, and Stop & Shop) also give you gas discounts as well as grocery discounts.
51. Plan your weekly shopping using supermarket circulars to buy groceries that are on sale.

52. Learn how to "extreme coupon." Using coupons with store sales and promotions will save you extra money. Online coupon codes are another source of savings for many people; before you make any online purchases, do a quick search to see if the retailer has any available coupons. Many websites collect a database on all the coupons available online such as RetailMeNot.com.
53. Eat one vegetarian meal per week. It is not only healthier, it is cheaper.
54. If you and your family eat out more than once a week including ordering food in, commit to only a once-a-week "splurge" at a restaurant. Better yet, make that once a month!
55. When eating out with your spouse or a friend, share a meal. Portions are usually much more than you should be eating anyway so you will eat less and save money.
56. Take advantage of restaurant coupons and early bird specials.
57. Learn to cook your favorite restaurant recipes at home for a fraction of the price!
58. Give up junk foods completely: Not only are they expensive, they are unhealthy.
59. Make your own baby food with fresh fruits and vegetables.
60. Make your own flavored water by squeezing fresh fruit into the water.
61. Stock up on your favorite wine or other beverages when they are on sale.
62. Buy your favorite type of wine from a less expensive winery. For example, purchasing a California wine may be less expensive than a French wine, but just as tasty.
63. Buy the cheaper brands of liquor, Scotch, gin, vodka, and so forth, especially if you use a mixer.
64. Planning your meals can save you money and time. When grocery shopping, you will know exactly what you need to buy so there is no excess food thrown out at the end of the week.
65. Eating a healthy breakfast will help you save money by cutting down on larger meals later in the day.

**Personal Care**

66. Do not throw out torn clothing or broken items; instead, mend or repair.

67. When possible, wear clothing more than once between washes and dry cleaning. Your clothes will not only last longer but you will cut down on cleaning costs.
68. Buy clothing that can be hand or machine washed to avoid dry cleaning costs.
69. Hang your clothes to dry instead of drying them in the dryer. This saves money on your utility bills as well as wear and tear on your clothing.
70. Buy clothes at discounted brand name stores, such as Marshalls, T.J. Maxx, and so forth. You can also check out resale or vintage stores.
71. Try coloring your hair at home with over-the-counter hair dyes instead of professionally or if you want to have your hair colored professionally, extend the time between colorings with over-the-counter touch-ups.
72. Learn how to trim your own hair, especially bangs.
73. Do your own manicures and pedicures.
74. Give up smoking, not only for health reasons but to save money. Use the savings accumulation calculator to determine how much this is actually costing you over time.
75. Ask your doctor to prescribe generic medications, and use generic over-the-counter products.
76. Instead of paying monthly gym fees, take up walking, running, biking, or using workout videos.
77. When cleaning out your closet, sell your clothing or donate it to receive a tax deduction.
78. Usually when signing up for a service, you can have fees waived just by asking if they will cut out all the excess fees such as sign-up or maintenance fees.

**Entertainment**

79. Avoid ordering pay-per-view events on a regular basis; cut down to once a month.
80. Wait for movies to come out on DVD or use programs like Netflix instead of the high price of going to a movie theater.
81. When you do go to the movies, bring snacks from home instead of paying for overpriced snacks at the theater.
82. Check out free events offered in your neighborhood. Many towns offer free concerts and movies in the park or at the beach during the summer.

83. If you buy a lot of books, magazines, or movies, buy these items online, used, or rent them from your public library.

**Loan Payments**

84. Negotiate a lower credit card rate. Several credit card companies will reward good credit with a lower rate.
85. If you are not paying off your credit cards each month, stop using them. Destroy them or store them in a safe place to eliminate temptation.
86. Clear your credit card debt. The first step in becoming financially independent is through clearing all of your debts that you have first. Even if you have a minimal 1 percent per month (12 percent per year) interest on an $8,000 balance, this will cost you more than $20 a week.
87. Do not pay unnecessary maintenance fees on your bank accounts. Switch banks or get the fees removed.

**Taxes**

88. Use the tax facts and strategies provided at the end of each chapter in this book to minimize your biggest expenditure, which is taxes.

**Gifts and Donations**

89. Do not donate money when you cannot afford it. Instead of donating money, donate your time or other items that you no longer need.
90. There is no need to buy expensive gifts for birthdays or holidays. Remember, it is not the cost of the gift that matters, it is the thoughtfulness, so save money by buying something less expensive that the person you are giving the gift to will still enjoy.

**Professional Fees and Legal Obligations**

91. Do not view accounting and legal fees as an expense. If the professional services provided are not saving you many times the cost of the fee, then it is time to look for a new advisor.
92. Make sure you are securing your professional services from a trusted advisor who can meet your professional needs (see Appendix A).

**Child Care and Other Expenses**

93. Save on children's toys: Buy them when they are on clearance, after the holidays. Put them away to give to your child at a later date or when your child is invited to a party, and have your child choose one of these gifts to give to his or her friend.
94. Save on children's clothes: Ask family and friends for hand-me-down clothes that their children have outgrown.
95. Save on children's furniture: Avoid spending money on children's furniture. Instead, check out thrift shops and antique stores for dressers, chests, armoires, and other such items: With a fresh coat of paint and new hardware, these are perfect for a child's room.

**Pet Care and Other Expenses**

96. Shop at pet specialty stores such as Petco, which usually offer pet food, even name-brand varieties as well as other pet supplies, at much lower prices than grocery stores.
97. Cats and dogs need teeth cleanings. Instead of buying expensive pet tooth care, wash their teeth with a paste made of baking soda and water, using a soft cloth.
98. Avoid buying expensive bedding or toys for pets. Use old blankets for bedding; make play toys out of old clothes. (Stuff catnip toys with bulk catnip.) The animals will not know the difference.
99. For annual pet vaccinations, check with your local animal shelter to see if they are providing these services for free or for a minimal fee.
100. If you or your child is yearning for a pet, choose a dog or cat from an animal shelter. It is not necessary to spend thousands on a special breed.

**Personal Expenses**

101. Do not spend as much on vacations. Instead of going on expensive vacations, traveling first class, eating at the most expensive restaurants, going on all the most expensive tours, and going to overpriced five-star hotels, fly coach, cook in the hotel if possible, and go to a safe, fun, cheaper hotel.

# Appendix C

## Basic Concepts and Definitions of Various Types of Taxes

In the United States, taxes are imposed on individuals and corporations by the federal government, most state governments, and some local (or city) governments. These include taxes on income, property, sales, imports, payroll, estates, and gifts, as well as various license fees.

### *Federal Income Taxes*

At the federal level, the Internal Revenue Service (IRS) imposes income tax based on individuals, corporations, estates, and trusts. Income subject to tax includes almost all income from whatever source; with regard to income earned outside the United States, residents are taxed on worldwide income, but may be allowed a foreign tax credit if foreign taxes were paid on the same income. The tax is based on taxable income (as defined) times various tax rates at different levels of income. You, as an individual, are permitted to reduce your taxable income by taking personal allowances and certain tax-deductible expenses—such as home mortgage interest, state and local taxes, charitable contributions, medical, and certain work- and investment-related expenses. You can also reduce your taxes through tax credits, some of which may be refunded if they exceed the tax calculated.

In 2013, the current federal tax rates on income vary from 10 to 39.6 percent of taxable income.

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### *State Income Taxes*

In the United States, 43 states and many localities impose an income tax on individuals; 47 states and many localities impose a tax on the income of corporations. Tax rates vary by state and locality, and they may be fixed or graduated. State and local income taxes are imposed in addition to federal income tax, and are determined under state law. Most states conform to many federal concepts and definitions, including defining income and business deductions. Some states have alternative measures of taxable income, or alternative taxes, especially for corporations.

States imposing an income tax generally tax all income of corporations organized in the state and individuals residing in the state. Taxpayers from another state are subject to tax only on income earned in the state or apportioned to the state. Businesses are subject to income tax in a state only if they have sufficient connection to the state.

### *Estate and Gift Taxes*

Estate and gift taxes in the United States are imposed by the federal and most state governments. An *estate tax* is an excise tax levied on the right to pass property at death. (Here, "property" does not mean real estate only; instead, it means any and all personal property, which includes real estate as well as all other assets and belongings: cars, jewelry, furniture and furnishings, investments, etc.) The estate tax is imposed on the estate, not the beneficiary. Some states impose an *inheritance tax* on recipients of bequests. *Gift taxes* are levied on the giver (i.e., donor) of property where the property is transferred for less than it is actually worth. An additional *generation-skipping transfer (GST) tax* is imposed by the federal and some state governments on transfers to grandchildren (or their descendants).

Taxable gifts are gifts made in excess of an annual exclusion ($14,000 for gifts made in 2013) per donor per donee. The taxable amount of an estate is the gross fair market value of all rights considered property at the date of death (called the *gross estate*), less liabilities of the descendant, costs of administration (including funeral expenses), and certain other deductions. State estate taxes are deductible, with limitations, in computing the federal taxable estate. Bequests to charities reduce the taxable estate.

Estate tax applies to all property owned in whole or in part by a citizen or resident at the time of his or her death, to the extent of

the interest in the property. Generally, all types of property are subject to estate tax. Whether a descendant has sufficient interest in property for the property to be subject to gift or estate tax is determined under applicable state property laws.

Taxable values of estates and gifts are the fair market value. For some assets, such as widely traded stocks and bonds, the value may be determined by market listings. The value of other property may be determined by appraisals, which are subject to potential contest by the taxing authority. Monetary assets, such as cash, mortgages, and notes, are valued at the face amount, unless another value is clearly established. Life insurance proceeds are included in the gross estate, when owned by the descendant.

#### *Payroll Taxes*

*Payroll taxes* are the taxes an employer withholds and pays on behalf of his employees and are based on the wages or salary of the employee. Payroll taxes are imposed by the Federal and most state governments. Revenues from these taxes are used to fund such programs as Social Security, Medicare, unemployment compensation, workers' compensation, and health care.

In the United States, payroll taxes are assessed by the Federal government, all 50 states, the District of Columbia, and numerous cities. These taxes are imposed on employers and employees and on various compensation bases. They are collected and paid to the taxing jurisdiction by the employers. Most jurisdictions imposing payroll taxes require reporting quarterly and annually.

**Income Tax Withholding** Federal, state, and local withholding taxes are required in those jurisdictions imposing an income tax. Employers must withhold the tax from wages paid to their employees in those jurisdictions. Computation of the amount of tax to withhold is performed by the employer, based on representations by the employee regarding his or her tax status on IRS Form W-4. Amounts of income tax withheld must be paid to the taxing jurisdiction, and they are available as refundable tax credits to employees. Income taxes withheld from payroll are not final taxes, merely estimated prepayments. Employees must still file income tax returns and self-assess tax, claiming amounts withheld as payments. Based on the American Taxpayer Relief Act of 2012, the Internal Revenue Service has prepared the following income tax withholding tables based

on annual income as follows (Table 7, Annual Payroll Period [IRS Notice 1036], Released 1/4/13):

| | Single or Head of Household Filers | | Married Filing Jointly Filers | |
|---|---|---|---|---|
| Tax Rate | Income Above | Income Up to | Income Above | Income Up to |
| 0% | $ 0 | $ 2,200 | $ 0 | $ 8,300 |
| 10% | $ 2,200 | $ 11,125 | $ 8,300 | $ 26,150 |
| 15% | $ 11,125 | $ 38,450 | $ 26,150 | $ 80,800 |
| 25% | $ 38,450 | $ 90,050 | $ 80,800 | $154,700 |
| 28% | $ 90,050 | $185,450 | $154,700 | $231,350 |
| 33% | $185,450 | $400,550 | $231,350 | $406,650 |
| 35% | $400,550 | $ 402,200 | $406,650 | $458,300 |
| 39.6% | $ 402,000 | No Limit | $ 458,300 | No Limit |

**Social Security and Medicare Taxes** Federal social insurance taxes are imposed equally on employers and employees consisting of a tax of 6.2 percent of wages up to an annual wage maximum ($113,700 in 2013) for Social Security plus a tax of 1.45 percent of total wages for Medicare. For 2011 and 2012, the employee's contribution was reduced to 4.2 percent, while the employer's portion remained at 6.2 percent. To the extent an employee's portion of the 6.2 percent tax exceeds the maximum by reason of multiple employers, the employee is entitled to a refundable tax credit on filing an income tax return for the year.

Starting in 2013, employees and the self-employed will also be required to pay 0.9 percent additional Medicare tax on their earned wages and self-employed income in excess of limits based on their income tax return filing status ($250,000 for married filing jointly, $200,000 for single, head of household, or qualifying widow(er), or $125,000 for married filing separately).

**Unemployment Taxes** Employers are subject to unemployment taxes by the Federal and all state governments. The tax is a percentage of taxable wages with a cap, which varies by jurisdiction and by employer's industry and experience rating. Some states also impose unemployment, disability insurance, or similar taxes on employees.

**Reporting and Payment** Employers must report payroll taxes to the appropriate taxing jurisdiction in the manner each jurisdiction

requires. Quarterly reporting of income tax withholding and Social Security taxes is required in most jurisdictions. Employers must also file reports of unemployment tax quarterly and annually with each applicable state, and annually at the Federal level.

Each employer is required to provide each employee an annual report on IRS Form W-2 of wages paid and Federal, state, and local taxes withheld, with a copy going to the IRS and many states. These are due by January 31 and February 28 (or March 31, if filed electronically), respectively, following the calendar year in which wages are paid. The Form W-2 constitutes proof of payment of tax for the employee.

Severe penalties apply where Federal income tax withholding and Social Security taxes are not paid to the IRS, and administered properly.

#### *Medicare Surtax on Net Investment Income*

Starting in 2013, The Patient Protection and Affordable Care Act (2010) provides a new 3.8 percent tax on net investment income (including interest, dividends, capital gains, rental and royalty income, and passive business income).

This new Medicare tax may be imposed on the net investment income for single and head of household taxpayers with income over $200,000, married couples and qualifying widow(er) with income over $250,000, and married filing separately with income over $125,000.

For individuals this tax applies to the **lesser** of: (1) an individual's "net investment income" for the tax year, **or** (2) any excess of "modified adjusted gross income" (MAGI) for the tax year over the applicable threshold amount.

For example, if a single taxpayer has $180,000 of wages and also received $30,000 in net investment income, their modified adjusted gross income would be $210,000 or $10,000 above the threshold amount. The 3.8 percent Medicare surtax would apply to the lower of net investment income ($30,000) or the excess of modified adjusted gross income over the threshold amount ($10,000). Therefore, only the $10,000 will be subject to this 3.8 percent Medicare surcharge for a total of $380.

#### *Property Taxes*

Property taxes are most commonly applied to real estate and business property, including interest in land, buildings, and improvements.

Ownership interests include ownership of title as well as certain other rights to property. Automobile and boat registration fees are a subset of this tax.

Property taxes are imposed on owners of property by most local governments and many special-purpose authorities, and these taxes are usually based on the fair market value of the property. Property tax rules and rates vary widely. Taxes on property are typically imposed only at the local level, although there may be multiple local jurisdictions that tax the same property.

Property tax is based on the fair market value of the property being taxed. The amount of tax is determined annually based on the market value of each property on a particular date.

The assessment process for property taxes varies by state, and sometimes within a state. Each taxing jurisdiction determines values of property within the jurisdiction and then determines the amount of tax to assess based on the value of the property. Payment times and terms vary widely. If a property owner fails to pay the tax, the taxing jurisdiction has various remedies for collection, including seizure and sale of the property.

#### *Sales Taxes*

Sales taxes are imposed on the price at retail sale of many goods and some services by most states and some localities. Sales tax rates vary widely among jurisdictions, from 0 percent to 10 percent, and may vary within a jurisdiction based on the particular goods or services taxed. Most jurisdictions exempt food sold in grocery stores, prescription medications, and many agricultural supplies. Generally, cash discounts, including coupons, are not included in the price used in computing tax.

Sales tax is collected by the seller at the time of sale, or remitted as use tax by buyers of taxable items who did not pay sales tax. Sales taxes, including those imposed by local governments, are generally administered at the state level. States imposing sales tax require retail sellers to register with the state, collect tax from customers, file returns, and remit the tax to the state.

There are no federal sales taxes in the United States.

#### *Excise Taxes*

Excise taxes are imposed at the federal and state levels on the manufacture, sale, and/or consumption of a wide variety of goods,

including alcohol, tobacco, tires, gasoline, diesel fuel, coal, firearms, telephone service, air transportation, unregistered bonds, and many other commodities and services. Some jurisdictions require that tax stamps be affixed to goods to demonstrate payment of the tax.

#### *Tariffs, Customs, and Duties*

The United States imposes tariffs or customs duties on the import of many types of goods from many jurisdictions. The duty is levied at the time of import and is paid by the importer of record. This tax must be paid before the goods can be legally imported. Rates of duty vary from 0 percent to more than 20 percent, based on the particular goods and country of origin. Customs duties or tariffs are only imposed by the federal government.

A wide variety of other taxes, some called *user* or *license fees,* are imposed. Failure to properly comply with customs rules can result in seizure of goods and criminal penalties against involved parties. The U.S. Customs and Border Protection (CBP) enforces customs rules.

#### *Licenses and Occupational Taxes*

Many jurisdictions within the United States impose taxes or fees on the privilege of carrying on a particular business or maintaining a particular professional certification. Common examples include accountants, attorneys, stockbrokers, barbers, casinos, dentists, doctors, auto mechanics, and plumbers. *Licensing* or *occupational taxes* may be a fixed-dollar amount per year for the licensee, an amount based on the number of practitioners in the firm, a percentage of revenue, or any of several other bases. Persons providing professional or personal services are often subject to such fees. In addition to the tax, other requirements may be imposed for licensure.

All 50 states impose *vehicular license fees.* Generally, the fees are based on type and size of vehicle and are imposed annually or biannually. All states and the District of Columbia also impose a fee for a driver's license, which generally must be renewed with payment of fee every few years.

#### *User Fees*

Fees are often imposed by the Federal or state governments for use of certain facilities or services. For example, fees are often imposed

for use of national or state parks, use of certain highways (called *tolls* on toll roads), parking on public streets, and use of public transportation. Such fees are usually imposed at the time of use.

#### *Administrating Taxes: Collecting and Distributing*

Three different entities handle different aspects of taxes:

1. Congress and the President of the United States write and approve the tax laws.
2. The IRS is responsible for enforcing the laws, for collecting taxes, for processing tax returns, for issuing tax refunds, and for turning over the money collected to the U.S. Treasury.
3. The U.S. Treasury is responsible for paying various government expenses.

Taxes in the United States are administered by literally hundreds of tax authorities. At the federal level, there are three tax administrations:

1. The Alcohol and Tobacco Tax and Trade Bureau (TTB) administers taxes on alcohol, tobacco, and firearms. TTB is part of the U.S. Department of Justice.
2. The IRS administers all other taxes on domestic activities. The IRS is a division of the U.S. Department of Treasury.
3. The CBP administers taxes on imports (as mentioned, as part of customs duties). The CBP belongs to the U.S. Department of Homeland Security.

Organization of state and local tax administrations varies widely. Every state maintains a tax administration. A few states administer some local taxes in whole or in part. Most localities also maintain a tax administration or share one with neighboring localities.

### Income Taxes: Concepts You Should Know

Under the U.S. tax system, everyone is taxed, in some way or another. This includes every person, company, corporation, or nonprofit organization. (Partnerships are not taxed; rather, their partners are subject to income tax on their shares of income and deductions, and they take their shares of credits.)

In plain terms: *You are taxed based on your income.* Income is any money you have earned because you have worked for it or invested for it. Income includes wages, interest, dividends, profits on investments, and pensions; however, it does not include gifts such as inheritances or scholarships. People and organizations are responsible for reporting their income and calculating their tax. Some organizations are exempt from tax, but they still are legally required to file a tax return.

The amount of taxes you owe is based on your income. People who earn more income pay higher taxes than those who earn less; this means that tax rates get progressively higher the more you earn. Conversely, you can reduce your taxes by taking advantage of various tax benefits—or, to put it another way, through intelligent tax planning. But it is up to you to take control of your tax situation.

The Federal income tax is usually the largest tax you will have to pay every year. As mentioned, most American families pay about a third of their gross income in taxes, including Federal, state, and possibly local taxes, Social Security taxes, and property taxes.

#### *General Payment or Withholding of Income Taxes*

The U.S. Federal and state income tax systems are self-assessing systems. In other words, taxpayers must declare and pay tax, but they are not assessed by the taxing authority. Employers must withhold income tax, as well as Social Security and Medicare taxes from wages. Quarterly payments of estimated taxes are required if taxes are not paid through withholding. Married taxpayers who both work must consider if they need to raise their withholding because of the graduated tax rates. The tax withholding tables that your employer uses does not factor in the possibility that the overall family income can be in the higher tax bracket because of multiple jobs or the fact that your spouse also works.

#### *Progressive Tax Rates*

Personal income taxes are figured on a progressive rate: the larger the amount of the taxable income, the higher the rate at which it is taxed. Also, income is taxed in *brackets.* In other words, as income moves from a lower range to a higher range (or bracket), the percentage of tax goes up. The higher rate applies only to the income in that particular bracket, not the entire taxable income. The tax

rate for each rate—whether it is 10 percent, 25 percent, or more—is called the *marginal tax rate*. The *total tax liability*, which is calculated by dividing the tax liability by the taxable income, is called the *average tax rate*, and is usually much less.

#### *Filing Status*

Taxes depend in part on filing status, which is based on your marital and family status as of the last day of the tax year (which is December 31). Filing status affects whether you are required to file an income tax return, the amount of your standard deduction, and your tax rate. If you have a choice (such as married, filing jointly; or married, filing separately), you should calculate your taxes both ways, and obviously choose the status that results in the lower rate.

The five filing statuses are:

1. ***Single taxpayers:*** Unmarried or legally separated from their spouses.
2. ***Married, filing jointly:*** Married couples who combine their income and allowable deductions can file one tax return.
3. ***Married, filing separately:*** Each spouse files his or her own return, reporting only his or her income, deductions, and so forth.
4. ***Head of household:*** A taxpayer who is unmarried or considered unmarried and pays more than half the cost of keeping up a home for himself or herself and a dependent child or relative.
5. ***Qualifying widow or widower*** with a dependent child.

#### *Pay-As-You-Go Process*

As anyone who has ever received a paycheck knows, our active wages are not the amount we actually receive; instead, our *take-home* pay is comprised of our gross wages minus our taxes. By law, you must pay your taxes throughout the year. This is called *pay as you go*. For most people, this means your income taxes are taken out of your paycheck and sent directly to the Federal Government. At the end of the year, you have paid in a certain amount of money in taxes.

Self-employed persons also prepay their taxes by forwarding part of their income to the IRS, four times a year on specified dates. These are called *quarterly estimated tax payments*.

If you paid in more than you owe, the government refunds the amount in excess of what you owed. This is called a *tax refund.* If you have not paid enough to cover what you owe, then you have a balance due. And you must pay this amount due by April 15 of the following year, or the government will charge you interest and penalties on the amount you have not paid.

**Federal Withholding Tax Allowances** These taxes depend on the level of your earnings and the number of allowances you claim. (These allowances are requested on a form called a W-4, which you fill out at the behest of your employer). A taxpayer is allowed one for him- or herself, and one for each dependent, including spouse, children, or parents if they are being supported by the taxpayer. Certain other special or additional allowances are permitted or claimed based on a variety of things, such as marital status (married, single, separated, divorced); amount of time worked during the year, and so forth.

**Federal Insurance Contributions Act** All employed workers (except certain employees of the Federal Government) must pay taxes under the Federal Insurance Contributions Act (FICA), for old-age benefits, survivors' benefits, disability benefits, and hospital insurance benefits. This tax is commonly known as Social Security (and includes Medicare), and various percentages are allotted to both, depending on current law. The employer pays 50 percent, and the employee pays 50 percent. Self-employed people must pay the whole tax, but they can deduct 50 percent on their tax returns.

**Other Withholding Taxes** Most states also require income taxes, and the rates differ from state to state. Some cities also impose income taxes.

## Calculating Your Taxable Income and Liability

Calculating and paying income taxes is an incredibly complex process. It can be a tricky process just to define such concepts as *gross income* as well as the *true income subject to tax* (which is calculated by subtracting adjustments, deductions, and exemptions from gross income). Beyond that, the Internal Revenue Code places all sorts of conditions and exceptions on how the idea of *income* can be defined and treated. Nevertheless, it is important that you comprehend the basic definitions of the most important terms as well as the fundamentals of this process.

### *Gross Income*

Gross income is all the income you receive during the year from whatever source. Personal gross income falls into three general categories:

1. ***Active income:*** Wages, salaries, bonuses, tips, commissions, as well as certain other forms of income including pension income and alimony.
2. ***Portfolio income:*** Interest, dividends and profits generated from most types of investment holdings, including savings accounts, stocks, bonds, mutual funds, options, and futures.
3. ***Passive income:*** Income derived from real estate, limited partnerships, and other tax shelters.

Certain income may be *tax exempt*, including:

- Child-support payments
- Compensations from accident, health, and life insurance
- Gifts and inheritances
- Municipal bond interest
- Scholarships and fellowships
- Veterans benefits

In addition, the amount of deductions and write-offs that taxpayers can take in certain categories are subject to a number of rules, regulations, and limitations.

*Capital gains* is the gross income received when an individual sells an asset (such as a stock, bond, or real estate) for more than its original cost. Capital gains are taxed at different rates, depending on the holding period of the asset. Also, restrictions are imposed on the capital losses a taxpayer can take in any given year.

### *Adjusted Gross Income*

A number of adjustments against your basic gross income are permitted, before you reach a number that represents your adjusted gross income. These elements include (with possible limitations):

- Tuition costs for higher education (through 2013).
- IRA deductible contributions.

- Self-employed health insurance.
- Penalty on early withdrawal of savings.
- Alimony paid.
- Moving expenses.
- Deductible contributions to a Health Savings Account (HSA) and Archer Medical Savings Account (MSA) that you or your spouse made.

The ultimate number reached is termed your *adjusted gross income (AGI).*

#### *Deductions: Standard and Itemized*

After you have calculated your AGI, you can consider other deductions. You can take the *standard deduction,* which is a fixed amount that depends on your filing status (for 2013 the standard deduction for most taxpayers is: $6,100 single, $12,200 married filing jointly and surving spouse, $6,100 married filing separately and $8,950 head of household). Or, you can list *itemized deductions,* which allow taxpayers to reduce their taxable income by listing certain personal expenditures, including:

- Medical expenses (in excess of 10 percent of AGI or 7.5 percent if 65 or older).
- State and local income tax (or sales tax through 2013).
- Real property taxes.
- Residential mortgage interest.
- Private mortgage insurance premiums treated as qualified mortgage interest through 2013.
- Charitable contributions.
- Job and other expenses (in excess of 2 percent of AGI).

These deductions are usually subject to various restrictions and limitations. The decision to take a standard or itemized deduction may change from year to year, depending on your needs. Starting in 2013, the American Taxpayer Relief Act of 2012 reinstates the phaseout of itemized deductions for high income taxpayers. The phaseout is 3 percent for the amount of itemized deductions in excess of the following threshold adjusted gross income amounts, not to exceed 80 percent of itemized deductions allowable before this limitation:

- $250,000 adjusted gross income for single filers.
- $300,000 adjusted gross income for married filing jointly and surving spouse filers (one-half of these amounts for married filing separately filers.
- $275,000 adjusted gross income for head of household filers.

In 2013, standard deductions for those who are dependents of another is the greater of $1,000 or $350 plus the taxpayer's earned income.

#### *Exemptions*

Exemptions allow you a deduction from your AGI based on the number of dependents an individual has: For 2013, each exemption allows the taxpayer a $3,900 deduction. A taxpayer can claim an exemption for him- or herself, his or her spouse, and any dependents, which can include children or other relatives earning less than a certain income. Furthermore, an exemption can only be claimed by one taxpayer in any given tax year. Starting in 2013, the American Taxpayer Relief Act of 2012 reinstates the phaseout of personal exemptions for high income taxpayers The phaseout amounts begin at the following levels of adjusted gross income of:

- $300,000 married filing jointly and surviving spouse filers until $422,500 above which there is no exemption (one-half of these amounts for married filing separately filers.
- $250,000 single filers until $372,500, above which there is no exemption.
- $275,000 head of household filers until $397,500, above which this is no exemption.

### Calculating and Filing Your Taxes

To estimate the amount of tax you must pay, you now need to address a number of issues:

- The tax rate applicable to your personal income
- Tax credits
- Tax forms and schedules
- Procedures for tax liability

### *Tax Rates*

To find the amount of your taxable income, you subtract deductions (standard or itemized) and personal exemptions from your AGI. Once you know the amount of your taxable income, you must refer to tax rate tables to find the amount of taxes you owe. Exhibit C.1 shows how you can calculate what your tax rate is at various income levels, whether you are single, married and filing jointly, married and filing separately, a head of household, or a qualifying widow or widower. The American Taxpayer Relief Act of 2012 has permanently extended the tax brackets of most Americans that were set to expire in 2012. These brackets are 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. For some high income taxpayers the highest bracket is now 39.6 percent, which applies to any taxable income for 2013 (adjusted for inflation in subsequent years) **above** the following amounts:

- $400,000 for single filers.
- $450,000 for married filing jointly and surviving spouse filers.
- $225,000 for married filing separately filers.
- $425,000 for head of household filers.

**Exhibit C.1 Table 1 2013 U.S. Tax Rate Schedule for Individual: Filing Status Is Single**

Example: IF you are SINGLE and your taxable income is $92,000 for 2013 your U.S. income tax is $19,053

| Taxable Income | | | The Tax Is | |
|---|---|---|---|---|
| $87,850 | | | $17,891 | |
| $4,150 | Multiply by | 28% | $1,162 | |
| $92,000 | Total Taxable Income | | $19,053 | Total Tax |

2013 Schedule X: Use if your 2013 filing status is SINGLE

| **If Taxable Income Is** Over | But Not Over | Then the Tax Would Be | | | | Taxable Income of the Amount Over |
|---|---|---|---|---|---|---|
| $- | $8,925 | | | 10% | MULTIPLIED by | $- |
| $8,925 | $36,250 | $893 | PLUS | 15% | MULTIPLIED by | $8,925 |
| $36,250 | $87,850 | $4,991 | PLUS | 25% | MULTIPLIED by | $36,250 |
| **$87,850** | **$183,250** | $17,891 | **PLUS** | **28%** | **MULTIPLIED by** | **$87,850** |
| $183,250 | $398,350 | $44,603 | PLUS | 33% | MULTIPLIED by | $183,250 |
| $398,350 | $400,000 | $115,586 | PLUS | 35% | MULTIPLIED by | $398,350 |
| $400,000 | --------- | $116,164 | PLUS | 39.6% | MULTIPLIED by | $400,000 |

**Exhibit C.1 Table 2 2013 U.S. Tax Rate Schedule for Individual: Filing Status Is Married Filing Jointly or Qualifying Widow(er)**

Example: IF you are MARRIED FILING JOINTLY and your combined taxable income is $220,000 for 2013 your U.S. income tax is $49,066

| Taxable Income | | | The Tax Is | |
|---|---|---|---|---|
| $146,400 | | | $28,458 | |
| $73,600 | Multiply by | 28.0% | $20,608 | |
| $220,000 | Total Taxable Income | | $49,066 | Total Tax |

2013 Schedule Y-1: Use if your 2013 filing status is MARRIED FILING JOINTLY or QUALIFYING WIDOW(ER)

| **If Taxable Income Is** Over | But Not Over | Then the Tax Would Be | | | | Taxable Income of the Amount Over |
|---|---|---|---|---|---|---|
| $- | $17,850 | | | 10% | MULTIPLIED by | $48,600 |
| $17,850 | $72,500 | $1,785 | PLUS | 15% | MULTIPLIED by | $17,850 |
| $72,500 | $146,400 | $9,983 | PLUS | 25% | MULTIPLIED by | $72,500 |
| **$146,400** | $223,050 | $28,458 | **PLUS** | **28%** | **MULTIPLIED by** | $146,400 |
| $223,050 | $398,350 | $49,920 | PLUS | 33% | MULTIPLIED by | $223,050 |
| $398,350 | $450,000 | $107,769 | PLUS | 35% | MULTIPLIED by | $398,350 |
| $450,000 | --------- | $125,846 | PLUS | 39.6% | MULTIPLIED by | $450,000 |

**Exhibit C.1 Table 3 2013 U.S. Tax Rate Schedule for Individual: Filing Status Is Married Filing Separately**

Example: IF you are MARRIED FILING SEPARATELY and your taxable income is $80,000 for 2013 your U.S. income tax is $16,133

| Taxable Income | | | The Tax Is | |
|---|---|---|---|---|
| $73,200 | | | $14,229 | |
| $6,800 | Multiply by | 28% | $1,904 | |
| $80,000 | Total Taxable Income | | $16,133 | Total Tax |

2013 Schedule Y-2: Use if your 2013 filing status is MARRIED FILING SEPARATELY

| **If Taxable Income Is** Over | But Not Over | Then the Tax Would Be | | | | Taxable Income of the Amount Over |
|---|---|---|---|---|---|---|
| $- | $8,925 | | | 10% | MULTIPLIED by | $- |
| $8,925 | $36,250 | $893 | PLUS | 15% | MULTIPLIED by | $8,925 |
| $36,250 | $73,200 | $4,991 | PLUS | 25% | MULTIPLIED by | $36,250 |
| **$73,200** | $111,525 | $14,229 | **PLUS** | **28%** | **MULTIPLIED by** | **$73,200** |
| $111,525 | $199,175 | $24,960 | PLUS | 33% | MULTIPLIED by | $111,525 |
| $199,175 | $225,000 | $53,884 | PLUS | 35% | MULTIPLIED by | $199,175 |
| $225,000 | --------- | $62,923 | PLUS | 39.6% | MULTIPLIED by | $225,000 |

**Exhibit C.1 Table 4 2013 U.S. Tax Rate Schedule for Individual: Filing Status Is Head of Household**

Example: IF you are HEAD OF HOUSEHOLD and your taxable income is $60,000 for 2013 your U.S. income tax is $9,503

| Taxable Income | | | The Tax Is | |
|---|---|---|---|---|
| $48,600 | | | $6,653 | |
| $11,400 | Multiply by | 25% | $2,850 | |
| $60,000 | Total Taxable Income | | $9,503 | Total Tax |

2013 Schedule Z: Use if your 2013 filing status is HEAD OF HOUSEHOLD

| **If Taxable Income Is** Over | But Not Over | Then the Tax Would Be | | | | Taxable Income of the Amount Over |
|---|---|---|---|---|---|---|
| $- | $12,750 | | | 10% | MULTIPLIED by | $- |
| $12,750 | $48,600 | $1,275 | PLUS | 15% | MULTIPLIED by | $12,750 |
| **$48,600** | $125,450 | $6,653 | **PLUS** | **25%** | **MULTIPLIED by** | **$48,600** |
| $125,450 | $203,150 | $25,865 | PLUS | 28% | MULTIPLIED by | $125,450 |
| $203,150 | $398,350 | $47,621 | PLUS | 33% | MULTIPLIED by | $203,150 |
| $398,350 | $425,000 | $112,037 | PLUS | 35% | MULTIPLIED by | $398,350 |
| $425,000 | --------- | $125,365 | PLUS | 39.6% | MULTIPLIED by | $425,000 |

#### *Alternative Minimum Tax*

Some taxpayers (those in higher tax brackets) are subject to *alternative minimum tax (AMT)*. AMT is designed to ensure that high-income taxpayers with many deductions and tax-shelter investments are paying their fair share of taxes.

Retroactive to years starting after 2011, the American Taxpayer Relief Act of 2012 **permanently** increases the exemption from this tax (with annual inflation adjustments starting in 2013). For 2013 the exemptions are as follows:

- $51,900 for unmarried taxpayers.
- $80,800 for married joint or surviving spouse tax return filers.
- $40,400 for married filing separately filers.

#### *"Kiddie" Tax*

A dependent child's unearned income (interest, dividends, capital gains) if below age 18, or 18 to 23 if a full time student, may be taxed at the parent's usually higher income tax rates. For 2013, the first

$2,000 of the child's unearned income generally would not be taxed at the parents' rate.

#### *Tax Credits*

After determining taxable income and calculating tax liability (i.e., the amount you owe), you may be allowed to take certain *tax credits.* A wide variety of tax credits may reduce income tax at the federal and state levels. Some credits are available only to individuals, such as the child tax credit of $1,000 for each dependent child or the earned income tax credit for low-income wage earners. A few credits, such as the foreign tax credit, are available to all types of taxpayers.

**Difference between a Tax Deduction and a Tax Credit** It is important to understand the difference between a tax deduction and a tax credit. A *tax deduction* reduces the amount of income you pay taxes on; a *tax credit* reduces dollar-for-dollar the amount of taxes you pay.

For example, if you have a $1,000 tax deduction from your income, and you are in the 35 percent tax bracket, you will save $350 ($1,000 × 35 percent) in taxes. Conversely, if you have a $1,000 tax credit, this amount is deducted, dollar-for-dollar, from your tax liability, and you will save $1,000. Some of these tax credits can only be used to reduce your tax liabilities. Others can be refundable after your tax liability has been reduced to zero.

#### *Tax Forms and Schedules*

The IRS requires taxpayers to file their returns using specific tax forms, usually a 1040 form or some variation. The government no longer automatically mails these tax forms to taxpayers. Individuals should go online to www.irs.org to download the necessary forms or publications they need to prepare their tax returns. The vast majority of tax payers use a paid preparer or an online tax program to file their tax returns.

## Other Tax Considerations

As complicated as this process already is, certain other variables may need to be taken into account with regard to personal taxes.

#### *Estimated Taxes*

For most people, taxes are taken out of their paychecks by their employers. However, if you work for yourself or otherwise receive income that is not subject to withholding (investments, consulting

fees, freelance jobs, etc.), you are required to pay estimated taxes to comply with the *pay as you go* ruling. Estimated taxes must be paid in four installments throughout the year—on April 15, June 15, September 15, and January 15 (of the next tax year.) Failure to estimate and pay these taxes is subject to a penalty.

#### *April 15*

The tax year corresponds to the normal calendar year: January 1 through December 31. Taxpayers must file their returns no later than April 15 of the year immediately following the tax year. (This can be done electronically.) If the taxpayer has withheld more than his liability, he will receive a refund; if he has underpaid his tax liability, he must pay the difference.

#### *Extensions*

If needed, you can apply for a filing extension, with a due date of October 15. Nevertheless, you, the taxpayer, must estimate the taxes due and remit any estimated taxes due with the application for the extension. (In other words, a tax extension does not give a taxpayer more time to pay his taxes.)

#### *Amended Returns*

If you discover you have overlooked certain taxable income or a potential deduction(s) or credits, you can file an amended return up to three years from the date you filed your original return or two years from the time you paid the taxes, whichever is later.

#### *Audited Returns*

Although the chances of being audited are low, the IRS does review some returns to make sure the returns have been correctly calculated: this review is called an *audit.* The IRS conducts a few random checks; it also targets high-income earners. In addition, certain items can trigger an audit: a sudden increase in income; returns missing a signature; itemized deductions that are exceedingly high or higher than previous years or the average of others in the same tax bracket.

The IRS can take three years from the date of filing to audit your return. If it does audit your taxes, the IRS will be looking to see that all income received was properly reported and that any and all deductions were legitimate. As a result, it is imperative that you keep complete and accurate records, and store them for at least three years, or to be on the safe side, for six years.

# About the Author

John J. Vento[1] is the president of a New York City-based certified public accounting firm as well as the Certified Financial Planning® firm of Comprehensive Wealth Management Ltd., since 1987. His firm works with clients throughout the country and is focused on professional practices, high-net-worth individuals, and those committed to becoming financially independent. He has been the keynote speaker at various seminars and conferences throughout the United States, which focus on tax and financial strategies that create wealth. John has been ranked among the most successful advisors of a nationwide investment service firm and has held this distinction since 2008.

John graduated from Pace University with a bachelor's degree in business administration in public accounting, and continued on to earn an MBA in taxation from St. John's University. He is a certified public accountant (CPA) and a member of the American Institute of Certified Public Accountants and the New York State Society

[1]John J. Vento is an advisor with H.D. Vest. The views and opinions presented in this book are those of John J. Vento and not of H.D. Vest Financial Services® or its subsidiaries. All investment-related information in this book is for informational purposes only and does not constitute a solicitation or offer to sell securities or insurance services. Securities offered through H.D. Vest Investment Services SM, Member: SIPC, Advisory Services offered through H.D. Vest Advisory Services SM, 6333 North State Highway 161, Fourth Floor, Irving, TX 75038, 972-870-6000.

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*Financial Independence (Getting to Point X): An Advisor's Guide to Comprehensive Wealth Management* John J. Vento

of Certified Public Accountants. John is also a Certified Financial Planner™ (CFP®). He holds a Series 7 stock broker license and a Series 24 security principal license. He has been a registered representative and advisor representative with H.D. Vest Investment Services and H.D. Vest Advisory Services since 2001.

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